

TRADE LIBERALISATION IN SOUTHEAST EUROPE - RECENT TRENDS AND SOME POLICY IMPLICATIONS¹

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Abstract

Trade liberalisation in Southeast Europe (SEE) has been strongly promoted by the European Union (EU) in recent years, as part of its initiatives aimed at stimulating regional cooperation among the SEE countries. The Stabilisation and Association Process launched in 1999 for the five countries of the so-called western Balkans - Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and Serbia and Montenegro (formerly FR Yugoslavia), or the SEE-5 - explicitly requires the implementation of regional cooperation, as a condition for speeding up the process of EU integration. In the area of economic cooperation, trade liberalisation has become one of the principal instrument for promoting these objectives. A Memorandum of Understanding on Trade Liberalisation and Facilitation was signed on 27 June 2001 in Brussels by the Foreign Trade Ministers of SEE countries, which envisaged the conclusion of bilateral free trade agreements. Given the importance of these initiatives on trade liberalisation, the paper analyses recent trends in trade of the SEE countries. In order to introduce the argument, some general features regarding the degree of integration of SEE countries in 1989 are first presented (section 2). The impact of the political and economic events of the 1990s on trade relations among the SEE countries is then considered (section 3). On the basis of more recent foreign trade statistics, trade patterns of the SEE countries over the last five years are analysed in some detail (section 4). Some controversial issues raised in recent debates on trade liberalisation in SEE are also discussed, explaining why interpretations sometimes differ (section 5). The main conclusions and some policy implications are given at the end (section 6).

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1. Background

Trade liberalisation in Southeast Europe (SEE) has been strongly promoted by the European Union (EU) 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 Stabilisation and Association Process (SAP) launched in mid-1999 for the five countries of the so-called western Balkans - Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia and Serbia and Montenegro (formerly FR Yugoslavia), or the SEE-5 – explicitly requires the implementation of regional cooperation by SEE countries in various areas.

In the economics field, trade liberalisation has become one of the principal instruments for promoting regional cooperation in SEE. The trade liberalisation initiative has been carried forward within the activities of the Stability Pact for SEE adopted in mid-1999 to help reconstruction efforts of the SEE countries affected by the 1999 conflict - in addition to the SEE-5, also Bulgaria and Romania (or the SEE-7). A Memorandum of Understanding on Trade Liberalisation and Facilitation (MoU) was signed on 27 June 2001 in Brussels by the Foreign Trade Ministers of the seven SEE countries, while Moldova has also joined in the meantime.² The MoU envisaged the conclusion of bilateral free trade agreements (FTA) among the seven (today eight) SEE countries, providing for a substantial reduction or elimination of tariff barriers. After some initial delays, the process has by now been completed (except for UNMIK/Kosovo, where first steps were taken only recently to include it in the initiative). Whereas at the end of 2003, some 23 (out of a total of 28) of these free trade agreements had been signed, of which a number of them were also waiting to be ratified, by 1 December 2004, practically all the agreements had been signed, ratified, and are today being applied. The only exception was the Agreement between Serbia-Montenegro and FYR Macedonia which, though applied since October 1996, yet needs some revisions.

Trade liberalisation 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, 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 liberalisation in SEE could have a positive impact on both economic recovery and political stability. Trade

²Therefore today the process includes eight countries; whenever possible, Moldova will also be included in the analysis.

liberalisation 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 liberalisation 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 bigger 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. As stressed in a recent EU Commission Report (2003), when fully implemented, free trade agreements among SEE countries are expected to boost intra-regional trade, to enhance efficiency, increase competition and enable economies of scale (Commission, 2003, p. 11).

Given that the ongoing process of trade liberalisation in SEE will probably have important longer term implications, these issues merit more analytical work than has been undertaken to date. The paper focuses on trade in SEE, as the principle form of economic integration today among the SEE countries. In analysing trade patterns in SEE, the paper will consider, whenever possible, the SEE-8, namely the eight countries signatories of the Stability Pact MoU. When discussing issues related to the EU Stabilisation and Association Process, however, the narrower group of five countries (the western Balkans) will only be taken into account (the SEE-5).³

In order to introduce the argument, we will first consider the general features and degree of integration of SEE countries on the eve of the transition in 1989 (section 2). We will then look at the most important political and economic events which have taken place in this region in the 1990s, and the way they have affected trade relations among the SEE countries (section 3). The post-2000 phase, following the launch of the trade liberalisation initiative, is discussed in some detail, focusing on the main features of trade patterns of individual SEE countries over the last five years (section 4). Some controversial issues raised in recent debates on trade liberalisation in SEE are also discussed, explaining why interpretations sometimes differ (section 5). The main conclusions and some policy implications, also regarding current EU policies in the SEE region, are given at the end (section 6).

³ In both cases, Kosovo will not be considered. Although Kosovo, according to UN Security Council Resolution 1244, is still officially part of Serbia and Montenegro, until very recently it has not participated in the trade liberalisation process. Up to now, Kosovo has concluded a free trade agreement with Albania (applied since Oct. 1, 2003) and negotiations with FYR Macedonia were to be launched by the end of 2004. Foreign trade statistics of Kosovo are not readily available, so all data for Serbia and Montenegro (formerly FR Yugoslavia) exclude Kosovo.

2. Pre-1989 trade patterns in SEE

Which factors determine trade flows and the level of economic integration among the SEE countries today? This question cannot be properly addressed without taking into account the political and historical context, namely (1) the level of economic integration in SEE in 1989 on the eve of transition; and (2) the multiple impact of the political events of the 1990s on international, political and economic relations among the SEE countries during the past fifteen years.

When the transition to a market economy started in 1989, the general situation in SEE was very different than it is today (see Table 1). At that time, five countries in the SEE region were in a political and economic union within SFR Yugoslavia (Bosnia and Herzegovina, Croatia, Macedonia, Slovenia, and FR Yugoslavia, then represented by the two republics - Serbia with its two autonomous provinces, Kosovo and Voivodina, and Montenegro) and as such had substantial trade and other economic links. SFR Yugoslavia was the most developed and the largest country in SEE, both in terms of territory and population, and because of its specific position in international economic relations, it was much less dependent on trade with the other socialist countries than its SEE neighbours (see Uvalic, 1992).

Table 1. Some indicators on SEE countries in 1989

	Area (in 000 square km)	Population (mln 1990)	GDP/cap (1989 US\$)	Exports to CMEA (%)	Imports from CMEA (%)	Exports to SEE (%)	Imports from SEE (%)
Albania	28.7	3.2	723	46.3	44.8	n.a.	n.a.
Bulgaria	110.9	8.9	2,320	83.0	71.5	13.4	6.5
Romania	237.5	23.2	1,730	40.5	38.5	3.2	4.4
SFRY	255.8	23.8	2,490	29.9	26.3	2.1	2.2

Source: Uvalic (1997b) based on various sources (World Bank, OECD, UNECE, IMF, EIU).⁴

Bulgaria and Romania had for several decades been members of the CMEA, which naturally determined their main trade orientation in line with the ‘socialist division of labour’; consequently, they had a higher proportion of their foreign trade with the other socialist countries. This was particularly true for Bulgaria, which was the country most dependent on intra-CMEA trade. As to Albania, it was the most closed economy in Europe. After having abandoned the CMEA in the early 1960s, it had for many years followed its own autarkic development strategy and had limited economic links with the rest of the world, including its closest neighbours. The last of the SEE-8 countries, Moldova, in 1989 was still part of the USSR, so it is to be expected that the largest part of its trade was with

⁴ In reporting trade shares with the CMEA countries, it should be noted that problems of pricing of intra-CMEA trade, which essentially makes it non-comparable with non-CMEA totals, render estimation of these trade shares very hazardous.

the other Soviet republics. Similarly to the case of SFR Yugoslavia, Moldova's dependence on intra-regional trade was the direct consequence of it being part of a political and economic union.

Regarding more specifically trade links in the SEE region, there was relatively little trade in 1989 among the then four SEE countries (see Table 1).⁵ In the case of Bulgaria, 13.4% of its exports went to, and 6.5% of its imports came from, the other two major SEE countries, Romania and FR Yugoslavia.⁶ For the other SEE countries, regional trade at that time was even less important. The share of the three SEE countries in Romania's exports and imports in 1989 amounted to only 3.2% and 4.4% respectively, and in FR Yugoslavia's even less - 2.1% of exports and 2.2% of imports. These very low shares of mutual trade among the SEE countries clearly show that the SEE region in 1989 was not at all economically integrated – if we exclude links *within* countries.

In 1989, the most integrated part of the SEE region was SFR Yugoslavia – paradoxically, since many political and economic problems had for years pushed in the opposite direction. Since the mid-1970s, there was rising regional autarky and fragmentation of the Yugoslav market, as evidenced by increasing sales on the local markets, the duplication of industrial plants in many sectors, impediments to the mobility of capital and labour across republican borders, and weak inter-republican integration of enterprises (see Uvalic, 1993).

Nevertheless, inter-republican trade in former Yugoslavia has always represented an important part of overall trade for all its republics. Throughout most of the 1970-89 period, for all Yugoslav republics “exports” to the other republics within the country were more important than exports abroad, clearly suggesting that Yugoslav republics were more integrated among themselves than with the outside world (Uvalic, 1993).⁷ As shown by Udovicki (1996), market forces had strongly resisted the political segmentation of SFR Yugoslavia: the level of integration among its regions was found to be similar to that of countries inside a common market (e.g. the EU), while the estimations permitted the author to refute the hypothesis on increasing autarky of the Yugoslav republics. As remarked by the author, “Yugoslav regions exhibited an unfortunate level of economic interdependence - high enough to make a trade war extremely costly, but not high

⁵ Moldova is not considered here, since at that time it was still part of the USSR, which clearly could not be considered the SEE region.

⁶ Bulgarian foreign trade with Albania in 1989 is not considered, as data are not reported in IMF statistics; it is very likely that the amounts were negligible.

⁷ The only exception was 1983, when the relative share of exports for all Yugoslav republics was higher than inter-republican trade, but this was due to particular circumstances. The widening trade deficit and enormous foreign debt had constrained Yugoslav authorities to implement an austerity package in the early 1980s, which had provoked a serious economic crisis and had forced all republics to try and increase exports to foreign markets as much as possible (Uvalic, 1992, pp. 10-16; see also Hinic, 1994, p. 93).

enough to make it impossible” (Udovicki, 1996, p. 455). Other studies have also suggested that the level of economic interdependence among the Yugoslav republics was greater than usually sustained on the basis of purely political arguments (Hinic, 1994).

In 1987, the last year for which data on inter-republican trade is available, “exports” to the other republics represented 13-29% of Gross Material Product (GMP)⁸ of the individual Yugoslav republics, and as such were more important than foreign trade for all republics, except for Serbia and Slovenia, as the most export-oriented republics (see Table 2). It should also be noted that the oscillations observed in local, inter-republican and foreign trade were closely related to export performance on world markets. In times of deteriorating external conditions, the existence of alternative markets within the country, in the other republics, was an important factor compensating for the temporary loss of foreign markets (Uvalic 1993).

Table 2. Trade by destination of Yugoslav republics in 1987 (in % of GMP)

Republics of SFR Yugoslavia	Deliveries to the local market	Deliveries to markets of other republics	Deliveries abroad (Exports)
Bosnia & Herzegovina	56.1	24.2	19.8
Croatia	67.0	18.7	14.3
Macedonia	60.8	21.4	17.8
Montenegro	57.5	25.0	17.5
Serbia (with K & V)	69.0	13.4	17.6
Serbia proper	62.3	17.4	20.3
Kosovo	64.6	24.0	11.4
Voivodina	58.1	28.8	13.1
Slovenia	57.5	20.3	22.2

Source: Uvalic (1993), based on data of the Serbian Institute of Statistics.

In the late 1980s therefore, despite geographical proximity, there was very little trade among the four SEE countries (Albania, Bulgaria, Romania and SFR Yugoslavia), though there was also substantial trade *within* SFR Yugoslavia. The SEE region actually consisted of two subregions: the first, economically relatively integrated, encompassing the six republics of former Yugoslavia; and the second, characterised by very weak mutual trade links, consisting of the other three SEE countries. Trade flows between the two SEE subregions were negligible (Uvalic, 2001).

⁸ GMP, or Social Product in Yugoslav terminology, is the value added of ‘productive’ sectors of the economy, thus excluding ‘non-productive’ sectors such as education, health, defence, banking, other services.

The fact that the SEE was not very integrated in 1989 – except for the area of former Yugoslavia - had been determined to a large extent by non-economic factors – historical, political, geo-strategic, ideological - including the existence of the CMEA which had direct implications for trade patterns of its members; the specific international position of SFR Yugoslavia as a non-aligned country, increasingly orienting its trade towards western partners; or deliberate autarkic policies of Albania sustained by the idealisation of self-sufficiency, which isolated it for many years from the rest of the world. These historical and political factors were undoubtedly more important in determining economic relations and trade patterns of SEE countries during many years of socialism, than any purely economic interests or considerations. This conclusion may be valid still today.

3.The 1990s: the impact of transition and disintegration

Since 1989, a number of important political and economic events have fundamentally changed the overall situation in SEE. During the first decade of transition to market economy and multiparty democracy, important systemic changes have been implemented in all former socialist countries in SEE, though at variable speed. Initial market-oriented reforms also included radical changes of the foreign trade system and substantial trade liberalisation. During the 1990s, the volumes of trade of SEE countries have fallen sharply - including trade with other SEE countries - under the impact of the very deep recession of the early 1990s, the break up of the Yugoslav monetary and economic union, and the imposition of trade and other barriers by the newly created states.

Other important events have accompanied the transition, directly affecting trade patterns of SEE countries. The G24 group of countries - the EU in particular – in 1989 decided to actively support the transition in former socialist countries with a series of measures, including major trade liberalisation and various forms of financial assistance offered through the PHARE programme – though during the first half of the 1990s, only Albania, Bulgaria and Romania (of the SEE countries) were able to benefit from these EU measures (see Uvalic, 1997a). Bulgaria and Romania signed Association Agreements with the EU in 1993, which facilitated access of their products to EU markets. The dissolution of the CMEA in 1991 also directly affected Bulgaria and Romania, fundamentally changing their trade orientation away from traditional partners towards the EU. Similar changes took place in Albania following EU policies of trade liberalisation and opening up, facilitated by Albania's signing of a Trade and Economic Cooperation Agreement with the EU in 1992.

In addition, the political disintegration of SFR Yugoslavia in mid-1991 has also led to fundamental changes in SEE. The break-up of the country resulted in the almost doubling of the number of states in the SEE region, which thereafter no longer consisted of four, but of seven transition countries. The split also

substantially slowed down the process of integration of its successor states with the rest of Europe (except for Slovenia).⁹ Five military conflicts, policies of ethnic cleansing, inward-oriented nationalistic policies which gave priority to political over economic aims, delays in carrying forward the transition to multiparty democracy and market economy, poor and deteriorating economic performance, international sanctions against FR Yugoslavia, its decade-long isolation and NATO bombardments in spring 1999, are among the principal reasons of the delayed process of EU integration. These are also the main reasons for the exclusion, or late inclusion (after 1996), of countries of former Yugoslavia into EU programmes sustaining the transition.

Parallel with the slowdown in establishing relations with the EU, the political disintegration of former Yugoslavia has also substantially decreased the level of economic integration among the countries within SEE. The creation of independent states and the process of state-building led to the introduction of trade and other barriers to the free movement of goods, services, labour and capital, also as a means of raising budget revenues and protecting the newly created national economies. The suspension of trade links in 1991-92 was one of the main reasons for the very sharp fall in output in all successor states of Yugoslavia, much more pronounced than in many other transition economies.¹⁰ In addition, we must consider the military conflicts, embargoes, and politically-motivated trade wars, which have normally had a direct impact on trade flows among SEE countries, contributing to a much lower level of trade than otherwise could have been the case.

All these events have contributed to important changes in regional economic groupings, the position of individual SEE countries, and their trade patterns. During the 1990s, the EU has emerged as the most important trading partner for the large majority – though not always all - SEE countries (see Table 3 below). Albania, Bulgaria and Romania have very quickly reoriented their trade from traditional partners towards primarily the EU. SFR Yugoslavia, thanks to preferential access to European Community (EC) markets since the early 1970s and long-established economic links with western countries, in 1989 already mostly traded with the EC countries. After the difficult years of extreme political instability in the early 1990s, most of its successor states have also succeeded in making the EU their most important trading partner.

In addition to this general orientation towards the EU, during the 1990s trade between the two SEE sub-regions has not been subject to major changes. Most SEE countries have substituted traditional trading partners almost exclusively

⁹ For some of the factors that led to the break-up of SFR Yugoslavia, see Uvalic (1992) and (1993).

¹⁰ A detailed analysis of recent economic performance and current problems of the SEE countries is found in Uvalic (2003c).

with non-SEE countries (primarily the EU). During the 1990s, the already marginal economic links between the SEE sub-region comprising the successor states of former Yugoslavia, and the one comprising the other three SEE countries, have in no way been strengthened, while the trade links between Albania, Bulgaria, and Romania seem to have become even weaker.

In order to illustrate these trends in trade of SEE countries in the second half of the 1990s, we have considered the SEE as one regional trading partner, and have compared its relative importance for the SEE countries with that of the EU in 1998 (see Table 3).¹¹ Slovenia has also been included in the analysis, due to past trade links with the other countries in the region within the former common state. These calculations may not be fully accurate - especially in those years, the foreign trade statistics of some SEE countries were rather incomplete (see notes regarding sources below); still, they can suggest certain key features in trade patterns of SEE countries that existed at that time.

Table 3. EU and SEE shares in total trade of SEE countries (in %) - 1998

Country (and sources)	EU share in Exports	EU share in Imports	SEE share in Exports	SEE share in Imports
Albania (IMF; BH excluded)	88.8	77.9	3.0	7.2
Bosnia&Herzegovina (BH Central Bank & IMF)	21.9	29.5	66.6	52.8
Bulgaria (IMF)	51.7	46.5	7.7	3.4
Croatia (IMF; Albania and FRY excluded)	48.7	62.6	25.2	12.2
FYR Macedonia (IMF)	50.3	46.4	23.4	32.8
Romania (IMF; FRY excluded)	64.6	57.9	1.9	1.0
Slovenia (IMF; FRY and Croatia excluded)	65.5	69.5	15.1	1.9
FR Yugoslavia (Yugoslav statistics & IMF)	32.9	38.7	35.1	16.3

Source: Uvalic (2001). Whenever available, data of the IMF have been used (*IMF Direction of Trade Statistics Quarterly*, September 1999). Given that for Bosnia and Herzegovina and FR Yugoslavia IMF statistics were rather incomplete, they have been integrated with national sources: for Bosnia, unpublished data on foreign trade of both entities obtained directly from the Central Bank of Bosnia and Herzegovina in mid-January 2000; and for FR Yugoslavia, *Index* no. 1, 1999, Federal Statistical Office.

The data presented reveal that for Albania, Bulgaria and Romania, trade with the other SEE countries in 1998 was of marginal importance. For most countries of former Yugoslavia, on the contrary, trade with the other SEE countries still

¹¹ If the EU, represented by 15 countries, is considered as one trading partner, it seems appropriate to consider all the SEE countries as one regional trading partner as well.

represented a rather significant portion of overall trade. The disintegration of SFR Yugoslavia in 1991-92 has led to the breaking up of many traditional trade links, to the introduction of trade and other barriers, to several military conflicts, embargoes and the imposition of restrictions of various other kinds, all of which have naturally contributed to a drastic reduction in the *overall level* of trade, including trade with the newly created neighbouring states. Yet despite of reductions in absolute trade levels, most successor states of former Yugoslavia have maintained some trade with their former trading partners, in a few cases - Bosnia and Herzegovina and FR Yugoslavia – even rather significant.

Thus we see that in 1998, Bosnia and Herzegovina actually traded much more with the other SEE countries than with the EU, both in terms of exports (67%) and imports (53%); even higher shares had been registered in 1997 (see Gligorov, 1998). FR Yugoslavia in 1998 also exported more to the other SEE countries (35%) than to the EU (33%), though its imports from the EU (39%) were more than double the share of imports from SEE (16%), confirming its enormous import dependence on the EU (a feature typical of other SEE countries as well).

There were no other cases where the SEE share of trade exceeded the EU share in 1998, though in a few countries it was still rather significant. For FYR Macedonia, we find that 24% of its exports and 33% of its imports in 1998 were from other SEE countries. Croatia in 1998 exported even more to the other SEE countries (25% of total) than FYR Macedonia, although it imported much less (only 12% of total). By that time, Slovenian trade with the other SEE countries was much less important, yet its exports to the SEE region also occasionally increased (as e.g. during 1995-97, from 14.9% to 17.1%).

In the second half of the 1990s, trade in the SEE region was frequently shaped along ethnic lines, being very intensive especially between Croatia and Herzegovina (part of the Bosnian Federation), FR Yugoslavia and the Republika Srpska (the Serb part of Bosnia and Herzegovina), and Kosovo and Albania. Due to the recent wars and various trade embargoes imposed in the SEE region, there has also been a substantial amount of smuggling (see Muço and Frasher, 2003), especially across some of the ‘soft’ borders mentioned above (i.e. Serbia and Republika Srpska, Albania and Kosovo, Croatia and Herzegovina). Consequently, a substantial part of trade among some of the SEE countries has been illegal trade, sometimes taking place in barter form, which has not been registered in any way. The reported official statistics therefore undoubtedly underestimate the actual amount of regional trade in SEE during the 1990s. It should also be stressed that during the years of international sanctions and the trade embargo, a large part of FR Yugoslavia’s trade took place through neighbouring countries (Bulgaria, Macedonia, Republika Srpska), which determined a higher share in its regional trade than otherwise would have been the case, were it able to trade directly with the EU countries.

Major disruptions in trade of all SEE countries have taken place in 1999 as a consequence of the war in FR Yugoslavia. The NATO bombardments have further divided the SEE region, through the destruction of infrastructure, transport and communication lines, new ecological barriers, although precisely because of these region-wide consequences of the 1999 conflict, there is major interdependence among the SEE countries today. At the same time, further disintegration of the SEE region should also not be excluded.¹²

4. Recent trends in SEE trade: Effects of trade liberalisation

After a decade of marked political instability, since late 2000 we have been assisting the renewal or fresh establishment of political, economic, and other links of the five SEE countries (western Balkans) in both directions: with the EU, and with the other countries in the SEE region. This process of reintegration of the SEE-5 is being accompanied by comprehensive trade liberalisation, which concerns both regional trade within SEE, and the SEE countries' trade with the EU. In mid-1999, the EU launched its Stabilisation and Association Process (SAP) which offered the SEE-5 generous trade preferences, contractual relations through the signing of Stabilisation and Association Agreements, a new programme of financial assistance (CARDS), and for the first time since the beginning of the transition, prospects of future EU membership.

As part of the process of SEE-EU trade liberalisation, tariff barriers have been removed or lowered in trade between the SEE-5 and the EU, on both sides. On the one hand, within economic reforms required by the transition to a market economy, all SEE countries have by now applied radical reforms of their foreign trade regimes, including substantial trade liberalisation. On the other hand, the EU has sustained the transition in SEE by granting duty-free access to its markets, though at different times and under different arrangements for the single SEE countries. Since autumn 2000, the EU autonomous trade measures have established a uniform system of trade preferences for the western Balkans, that enable duty-free access to EU markets for practically all goods, including agricultural products (with only a few exceptions), thus covering more than 95% of SEE products. These free trade provisions have been incorporated into the Stabilisation and Association Agreements, so far concluded with Macedonia (April 2001) and Croatia (October 2001). The SEE-EU trade liberalisation process is being implemented on an asymmetric basis, envisaging initially a

¹² After the end of the 1999 military conflict, FR Yugoslavia has practically lost all control over Kosovo, whereas the future of the state union of Serbia and Montenegro is also uncertain. FR Yugoslavia has been transformed into a weak state union in March 2002 and officially changed its name into Serbia and Montenegro in February 2003. After a period of three years, therefore in 2006, the two republics ought to re-examine the issue of a common state; referendums will most probably be organised inviting citizens to express their preferences.

greater opening of EU markets, than those of the SEE countries. As noted earlier, Bulgaria and Romania have been offered measures of trade liberalisation by the EU much earlier, within Association Agreements concluded in 1993. Moldova is a case apart, as it is covered by the Stability Pact's MoU on Trade Liberalisation and Facilitation, but not the EU's SAP. For the moment, Moldova is covered by the EU wider Europe initiative, and as other CIS countries it has concluded a Partnership and Cooperation Agreement, which offers less substantial trade preferences than the other types of agreements.

In the meantime, a more favourable climate has also been created for developing regional linkages within SEE. Although the objective of regional co-operation has been pursued by the EU since 1996 through the Regional Approach, until recently not much has been achieved in terms of concrete results. Thanks to the radical change in the political regimes in Croatia (in January 2000, after President Tudjman's death) and in Serbia (in October 2000, after the end of the Milosevic regime), the situation has improved in the meantime and a number of initiatives have been undertaken to enhance regional cooperation. Today, regional co-operation has become one of the main pillars of both the SAP and the Stability Pact for SEE, as both initiatives emphasise the importance of regional co-operation for achieving more permanent peace, stability and development in SEE.

Within current initiatives of regional cooperation, one of the main forms of economic cooperation concerns the process of trade liberalisation in SEE, which is being carried forward within the Second Working Table for Economic Reconstruction and Development of the Stability Pact for SEE.¹³ The process of trade liberalisation, as envisaged by the Memorandum of Understanding (MoU) on Trade Liberalisation and Facilitation, has by now practically led to the creation of a free trade area in the SEE region.¹⁴ By now, almost all of the envisaged 28 free trade agreements have been signed, ratified and are being applied, by the eight participants in the initiative; the only exception is the Agreement between Serbia-Montenegro and FYR Macedonia which, though applied since October 1996, needs to be reviewed.¹⁵ In the case of the three countries members of CEFTA - Bulgaria, Romania, and Croatia (as of March 1, 2003) - it is the CEFTA provisions that regulate free trade among them.

What have been the effects of these two parallel processes of trade liberalisation - in EU-SEE trade, and in trade among countries of the SEE region? How has trade liberalisation affected trade patterns of individual SEE countries over the past

¹³ The World Bank has a related programme on Trade and Transport Facilitation in SEE (TTFSE), which also covers the SEE-7.

¹⁴ This applies primarily to trade in industrial products, as some restrictions have remained in trade of agricultural products.

¹⁵ Details can be found in the most recent available Matrix of FTAs in SEE provided on the web page of the Stability Pact (see www.stabilitypact.org).

years? It ought to be stressed that although trade liberalisation in EU-SEE trade has been implemented to a variable extent, and at different times, for the individual SEE countries (depending essentially on the status of a country's relations with the EU), it is still a process that has been in course for a longer period than the process of trade liberalisation within the SEE region.

Regional trade liberalisation started in mid-2001 when the MoU on trade liberalisation was signed by the seven SEE countries, and the large majority of bilateral free trade agreements have been signed several years ago. However, because of the process of ratification, it is only since 2004 that about two thirds of these FTAs have effectively been applied. Still, the other agreements have application dates which go back to 2001-3 or even earlier, as they refer to provisions adopted within CEFTA or within bilateral free trade agreements, such as those signed between FYR Macedonia and FR Yugoslavia in 1996, or Croatia and FYR Macedonia in 1997. Moreover, if we exclude Moldova, a marginal trading partner for the other SEE countries (see below) and a country that has joined the initiative only later, the total number of FTAs comes down from 28 to 21. Among these 21 agreements, more than half – 12 FTAs - have been applied *before* 2004. So although it may be too early to evaluate the full impact of trade liberalisation on SEE countries' regional trade, the analysis of trade flows in recent years may still prove useful for drawing some preliminary conclusions.

The most recent available trade statistics of the SEE countries over the past five years (1999 - 2003) have been used to calculate the relative shares of the two main groups of trading partners - the EU and the SEE - in total trade (see Tables 4 and 5 below). SEE countries' trading partners have again been divided into three main groups: the EU-15, the SEE-8 (the eight countries signatories of the MoU on trade liberalisation), and "other countries". IMF statistics have been used whenever they were available, but in cases of missing values they were supplemented with national statistics.¹⁶ In order to check for the accuracy of these calculations, the respective EU and SEE shares have also been compared with WIIW data on SEE trade.¹⁷ The analysis enables us to draw some conclusions regarding recent trends in trade of the SEE countries with the EU and with the

¹⁶ Most data used to calculate the shares are from the IMF (2004), *Direction of Trade Statistics - Yearbook 2004*, with a few exceptions. In the case of FR Yugoslavia, only national statistics have been used, given that IMF statistics still do not include three of its main trading partners (Bosnia and Herzegovina, Croatia and FYR Macedonia). In a few other cases, missing values in IMF statistics have been supplemented with national statistics (e.g. trade between Bosnia and Herzegovina and Serbia and Montenegro, or Croatia's trade with Serbia and Montenegro and Moldova). All data for Serbia and Montenegro do not include Kosovo.

¹⁷ The WIIW trade matrix, available for the 2000-3 period on the web of the WIIW Institute, includes SEE trade shares (exports and imports, as % of total) and the value (in US\$) of total trade of the individual SEE countries (though not the values of SEE countries trade by partner country).

SEE group over the 1999-2003 period. These conclusions are also presented synthetically in Graphs 1, 2, and 3 (Appendix).

4.1. SEE – EU trade

During the last five years, 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 - in 2003, 23% of its exports and 28% of its imports were to/from the EU. Albania, Bulgaria and Romania have much higher relative shares, especially of exports going to the EU (as high as 90% in the case of Albania), while the shares of imports from the EU are generally lower. These shares of trade with the EU have also been relatively stable over the past five years, the only exception being Albania - the share of its imports from the EU having fallen from over 80% in 1999 to 68% in 2003 (see Table 4).

Table 4. EU shares in total trade of the SEE-8 (in %), 1999-2003

EU shares in Exports						EU shares in Imports					
	1999	2000	2001	2002	2003		1999	2000	2001	2002	2003
Albania	93,64	93,34	90,96	92,14	93,35	Albania	80,18	74,81	74,70	70,72	68,22
B&H	46,70	53,06	56,82	51,42	57,17	B&H	38,62	39,99	39,00	37,75	36,42
Bulgaria	54,20	51,74	55,19	56,13	57,09	Bulgaria	50,01	44,93	49,77	50,53	49,82
Croatia	49,09	53,43	52,55	50,52	52,92	Croatia	56,49	55,76	55,47	55,54	56,00
Macedonia	44,72	42,58	48,75	42,99	48,93	Macedonia	40,14	38,13	42,74	54,76	51,60
Moldova	20,56	21,66	21,29	22,36	23,36	Moldova	26,65	29,10	27,42	26,41	28,38
Romania	65,48	63,95	67,95	67,29	67,90	Romania	60,49	56,68	57,42	58,65	57,86
S&M	36,40	36,80	41,46	39,12	41,28	S&M	41,50	36,89	36,88	37,26	40,62

Sources: Calculated on the basis of data of the IMF (2004), *Direction of Trade Statistics - Yearbook 2004*, supplemented in a few cases by national statistics of FR Yugoslavia, Croatia, and Bosnia and Herzegovina (see note 16). Data for Serbia and Montenegro do not include Kosovo.

For the remaining four 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. In several cases, these EU shares have remained well below 50% (e.g. in the case of Macedonian or Serbian-Montenegrin exports, or Bosnian and Serbian-Montenegrin imports). Moreover, as stressed earlier, as late as 1998 Bosnia and Herzegovina and FR Yugoslavia still had a relatively larger share of exports directed towards the SEE, than towards the EU.¹⁸

¹⁸ The trade shares for Bosnia and Herzegovina in recent years represent the major divergence with respect to previous calculations (see Uvalic, 2003a and 2003b), which suggested that Bosnia and Herzegovina traded less with the EU. The divergence arises primarily from different sources used, leaving the question of reliability of foreign trade statistics for Bosnia and Herzegovina open. Whereas in the previous papers, national statistics of Bosnia and Herzegovina were used (as IMF statistics were still very incomplete), in the present paper we have relied almost exclusively on IMF statistics. Bosnian foreign trade statistics still today

Trends in exports to the EU: Over the past five years, 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, Moldova and Romania have been subject to minor oscillations than those of Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia-Montenegro (the SEE-4), where much higher volatility has been present. Thus whereas in 2002, a drop in the share of exports directed to the EU has been registered by all four countries, in 2003 these EU shares again increased, in a few cases quite substantially (e.g. in the case of FYR Macedonia or of Bosnia and Herzegovina).

Trends in imports from EU: Most SEE countries shares of imports from the EU have been relatively stable over the past five years, 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 80% in 1999 to 68% in 2003; and FYR Macedonia which has, on the contrary, increased its share from 40% in 1999 to 52% in 2003. In 2003, three SEE countries had a EU share of imports lower than 50% (Bosnia and Herzegovina, Moldova, and Serbia and Montenegro).

4.2. Intra-SEE trade

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 (the SEE-4), than for the other four countries (see Table 5). 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), while Bulgaria and Moldova have been registering somewhat higher shares which have also been more variable (oscillating between 7% and 12%). As to the SEE-4, their reliance on intra-SEE trade applies primarily to exports. In 2003, the SEE share of exports was over 35% for Macedonia, almost 30% for Bosnia and Herzegovina, 31% for Serbia and Montenegro and almost 20% for Croatia, though subject to substantial variations in recent years. Whereas in 2001-2, the SEE share in total exports of

report only trade with the major trading partners (and not all countries), so IMF statistics do seem to be more complete. The only country missing in Bosnia's trade in IMF statistics was Serbia and Montenegro, so the value was taken from national statistics of Serbia-Montenegro.

individual countries had increased in all four countries, in 2003 the upward trend has continued in only three of them, the exception being Bosnia and Herzegovina.

Table 5. SEE countries shares of intra-regional trade (in % of total)

SEE shares in Exports					SEE shares in Imports						
	1999	2000	2001	2002	2003		1999	2000	2001	2002	2003
Albania	2,91	4,24	5,30	3,88	3,16	Albania	6,68	7,15	5,86	7,18	6,10
B&H	38,94	30,76	29,77	36,39	29,56	B&H	32,11	28,36	29,18	31,02	32,58
Bulgaria	10,42	13,09	10,19	9,58	9,90	Bulgaria	2,23	4,48	3,03	2,85	3,33
Croatia	15,15	15,64	16,67	19,32	19,52	Croatia	2,73	2,44	2,90	3,25	3,94
Macedonia	30,70	33,74	32,38	35,85	35,36	Macedonia	19,85	17,60	19,43	20,35	21,31
Moldova	10,17	8,84	7,48	9,53	12,40	Moldova	15,83	17,55	13,18	11,10	9,52
Romania	4,28	6,04	4,59	3,55	4,25	Romania	1,58	1,62	1,53	1,29	1,53
S&M	34,36	30,71	27,40	29,70	31,46	S&M	24,15	22,03	14,93	12,24	9,01

Sources: Same as for Table 4.

Trends in intra-SEE imports: On the import side, the SEE countries shares of regional trade in 2003 were much lower: 33% for Bosnia and Herzegovina, 21% for Macedonia, 9% for Serbia and Montenegro and less than 4% for Croatia. The trends have also been much less variable across countries, as in almost all cases the SEE shares in overall imports have been stagnating over the past five years. The only real exception is FR Yugoslavia, where the share has drastically fallen - from 24% of total imports in 1999, to 9% in 2003. 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. As noted earlier, before the political normalisation of 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 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.

4.3. SEE trade balances

Trade balances of SEE countries with each of the three sub-groups of trading partners show some further interesting features (see Graph 3, Appendix). Some SEE countries today have much more balanced trade in general than the others, having less pronounced trade deficits and a much higher coverage of imports by exports. In 2003, three countries – Albania, Bosnia and Herzegovina, and Moldova - had a trade deficit with all three groups of countries (the SEE-8, the EU-15, and the “other countries”), while the others - Bulgaria, Croatia, FYR Macedonia, Romania, and Serbia and Montenegro – have also registered a deficit

in trade with the EU, as well as with the “other countries”, but a surplus in their regional intra-SEE trade. 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 two groups of trading partners. Although for SEE countries the regional markets, as an alternative to EU or other developed countries markets, represent only the “second best” solution, they contribute to achieving a more balanced overall trade balance.

5. 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.

5.1. How important is regional trade in SEE?

The analysis of recent trends in trade of the SEE countries has led to the conclusion that 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. These conclusions run counter to frequent statements in various policy papers on SEE, which have sustained that intra-SEE trade is a very low portion of their overall trade, that the SEE region is not integrated economically, and that there are no valid economic reasons to promote regional integration. Sometimes these statements are also documented by what seem to be inaccurate statistics about the SEE countries recent trade patterns.

One of the most striking examples are the conclusions on SEE regional trade of several EU Commission's documents. 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 BiH, representing some 20% of its total” (Commission, 2003, p. 11). The EBRD (2003) also reports rather low regional trade figures for several SEE countries in 2002, particularly for FYR Macedonia and Serbia and Montenegro: the share of exports to other countries of the SEE sub-region for FYR Macedonia is reported to be 10%, while for Serbia and Montenegro only 4.2% (EBRD, 2003, p. 86).

The above figures on intra-SEE trade are therefore much lower than the data presented in Table 5. How can these differences be explained? We will try and give the most important reasons which lie behind these different interpretations.

(1)*Averages hide substantial differences in regional trade:* The conclusions of the EU Commission Reports are clearly based on average figures on intra-SEE trade. However, we have seen that the role of intra-SEE trade is extremely variable across countries, being much more important for the four countries that originated from SFR Yugoslavia than for the other countries. In addition, dependence of the SEE-4 on intra-regional trade is present primarily regarding their exports, and much less regarding imports. Therefore, the use of *average trade figures* can be highly misleading, since averages among all the SEE countries, or between exports and imports, hide substantial variations among both the trade patterns of individual SEE countries, and the different relative weight of exports/imports in overall SEE trade.

(2)*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 most recent IMF yearbook (IMF, 2004), values are missing for some of the main trading partners of several SEE countries.¹⁹ 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. Our own calculations in the present paper are an attempt to present a more accurate analysis of the SEE countries trade patterns in recent years, based on a combination of international and national sources, though some problems with foreign trade statistics of the SEE countries still remain.²⁰

¹⁹ In the IMF *Direction of Trade Statistics Yearbook 2004*, 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.

²⁰ The omissions in internationally available statistics are only the by-product of problems with national foreign trade statistics. There are reasons to believe that regional trade in SEE is still today underestimated, since official statistics of several SEE countries underreport existing trade flows. For Bosnia and Herzegovina, until very recently, foreign trade statistics were not available for the whole country, but separately for its two entities (the Bosnian Federation and the Republika Srpska), while the Bosnian district of Brcko was not covered by either of the two. Since foreign trade statistics of the Bosnian Federation were for many years more readily available, in publications of some international organisations only the Federation's trade was taken into account, leading to serious underestimations of the country's foreign trade. Similarly for Serbia and Montenegro, Kosovo's trade is not included in its foreign trade statistics, while it is also questionable how accurate are the statistics on foreign trade of Montenegro.

(3)*Conclusions depend on the definition of the SEE:* Whether intra-regional trade is "low" or "high" also crucially depends on the definition of SEE. For example, Gligorov's definition of the region in his various papers on trade in the Balkans (see Gligorov 1997, 1998, 1999) includes ten, sometimes even eleven countries - in addition to the SEE-7, also Greece, Hungary, Slovenia and Turkey, for which regional trade is not very important, and his conclusions have also frequently been based on this broader definition of the region. If we restrict the analysis to the western Balkans (the SEE-5), the conclusions are somewhat different: it is precisely for most countries within the narrower group of SEE-5 - practically all countries except Albania - that regional trade still plays an important role.

(4)*Which threshold?* The conclusions on the importance of regional trade also depend on the threshold we apply for distinguishing between "low" and "high" levels of trade. This is clearly a matter of definition, but it would seem reasonable to consider that a double-digit figure - anything above 10% of overall trade - cannot be discharged as negligible.

To what extent average trade figures for the whole SEE region can be misleading, or how the conclusions depend essentially on the definition of the SEE region, can be illustrated by a further example. In Table 6, we have reported the values of total trade of the SEE-5 and of the SEE-7 in 2000 (the year referred to in the EU Commission's Report), and the respective average shares for the two groups of SEE countries.

Table 6. SEE countries regional trade, as % of total trade, 2000

Country group	Exports	Imports	Exports + Imports
SEE-5			
Trade with other countries in the SEE-5 group (mln. \$)	1671.2	1823.2	3494.4
SEE-5 total world trade (mln. \$)	6885.5	14652.6	21538.1
Share of SEE-5 trade in total trade (in %)	24.3	12.4	16.2
SEE-7			
Trade with other countries in the SEE-7 group (mln. \$)	2762.2	2260.2	5022.4
SEE-7 total world trade (mln. \$)	22012.5	32882.6	54895.1
Share of SEE-7 trade in total trade (in %)	12.5	6.9	9.2

Source: Calculated on the basis of data provided in the *IMF Direction of Trade Statistics Yearbook 2001*, except for Bosnia and Herzegovina and FR Yugoslavia, for which national statistics have been used.

Regional exports of the SEE-5 in 2000 represented 24.3%, while regional imports 12.4%, of their total exports/imports respectively. If we now consider total trade (the sum of exports and imports) for the same SEE-5 group, we see that the

average share of regional trade was 16.2% of their overall world trade. These shares are therefore clearly much higher than the 6-7% figure cited by the EU Commission in its two Reports on SAP. The most plausible explanation is that a part of foreign trade data for some SEE countries was omitted in EUROSTAT statistics (which were probably used in these calculations), automatically introducing errors in the total trade figures of the individual SEE countries and in the respective shares of the SEE subgroups. Another possible explanation for the difference may be that "regional trade" in the EU documents is based on the wider definition of the SEE region, namely the SEE-7 – though in a document evaluating the SAP, it is the narrower definition of the SEE region, comprising only the five SAP countries, that ought to be used (and the average figure of 9% in Table 6 is still higher than the figure reported by the Commission).

The figures reported in Table 6 also clearly show how the respective trade shares of different partners crucially depend on the definition of the SEE region. If we consider the SEE-5 only, the shares of their exports, imports, or the sum of the two going to the other countries in the SEE-5 group, are much higher than if we consider the SEE-7. Precisely because Bulgaria and Romania trade *very little* with the other SEE countries, whereas they account for a much higher relative portion of overall SEE-7 trade (both regarding exports and imports), including them in the SEE group decreases significantly the importance of intra-SEE trade.

5.2. Is there potential for increasing regional trade in SEE?

In order to have the dynamic growth effects from trade liberalisation, the key issue is whether the potential for expanding trade among SEE countries really exists. 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-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 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 former Yugoslav SEE countries, so here the potential for expansion of trade is much larger (Kaminski and de la Rocha, 2002, p. 52).

More sophisticated gravity model estimates have recently 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 (as we have seen previously, from statistics presented in Table 5). 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.

Returning to the question posed at the very beginning of the paper (see section 2) - which factors determine trade flows among the SEE countries – three groups of considerations seem important.

(1)*Path dependencies*: Geography and the level of economic development matter, but even more important for the SEE countries seem to be the historical linkages, inherited trade patterns and path dependencies. Economic considerations are perhaps not the most important, or not even the most relevant, for actual trade flows of the SEE countries. As in the past, both before 1989 and throughout the 1990s, trade patterns in the SEE region have been heavily influenced by non-economic - essentially political - factors, it is very likely that this will remain so also in the future. Many concrete examples from the recent history of the SEE countries can be given to confirm this statement, on the fundamental importance of political and historical determinants of trade patterns in the SEE region (and probably in other regions as well).²¹ Whether there is a potential for increasing regional trade in SEE, therefore, does not seem the most relevant question, since these non-economic factors seem to have played a much more important role.

(2)*Timing of policy-induced measures*: Another factor which has fundamentally influenced SEE countries trade patterns in recent years is the very different timing of various policy-induced measures of trade liberalisation. The main conclusion that can be drawn is that uncoordinated action in this area is likely to give unsatisfactory results, at least in the short run. The trade orientation of those SEE countries for which regional trade has remained very low - Albania, Bulgaria, Romania - has been determined much more by earlier EU measures of trade liberalisation which have enabled a shift in the destination of their trade towards primarily the EU during the 1990s, than by the MoU on trade liberalisation in SEE launched only in 2001.²² This conclusion is strengthened further if we consider that once they enter the EU in 2007, Bulgaria and Romania will have to abandon the FTAs concluded with the other SEE countries (as Slovenia had to, prior to its joining the EU in May 2004). Albania has also had access to EU markets for a longer time than the other SEE countries, since it has

²¹ In recent years, there has been a lot of "ethnic" trading between Croatia and the Bosnian Federation on the one hand, and between the Republika Srpska and FR Yugoslavia on the other, on purely political grounds. The international sanctions against FR Yugoslavia and the NATO bombardments, which are purely political instruments of pressure, have forced FR Yugoslavia into above potential trade with some of its neighbours (Republika Srpska, Macedonia, Bulgaria), while the military conflict with Croatia has determined rather low trade levels throughout the 1990s. The drop in Serbia and Montenegro's imports from other SEE countries after 2000 has been determined by the fundamentally changed political circumstances, which have allowed direct imports from the EU, instead of via neighbouring countries as during the 1990s.

²² The Association Agreements that Bulgaria and Romania have concluded with the EU in 1993 have clearly greatly facilitated their trade reorientation towards primarily EU markets.

concluded a Trade and Economic Cooperation Agreement with the EU already in 1992. The other four SEE countries of former Yugoslavia were granted EU trade preferences much later (some in 1996-7, while others as Serbia and Montenegro, only in November 2000). Not surprisingly, Moldova is the SEE country that trades least with the EU: in addition to greater distance and traditional integration with the USSR economy, the Partnership and Cooperation Agreement concluded with the EU provides more limited trade preferences than those granted to the acceding or the SAP countries.

(3)*Other autonomous factors:* We should also consider what Damjan and Masten (2002) have referred to as “autonomous factors” which determine trade flows after the introduction of trade liberalisation. As shown by these authors on the example of Slovenia, trade liberalisation may take time to have effect, and free trade agreements can thus be “time-dependent”. Immediately after the enforcement of a FTA, autonomous factors - such as domestic demand patterns - may be of greater importance, since they may or may not stimulate expansion of bilateral trade flows. In other words, the tariff reduction – trade expansion mechanism does not always take place immediately, but could be substantially delayed. As seen from the example of the SEE region, trade liberalisation may not even lead to trade expansion, as clearly emerges from our analysis of trade flows among some of the SEE countries in recent years. Whereas some of the specific factors which have crucially influenced such trends in the SEE region have already been mentioned, other autonomous factors would also need to be investigated, as they could prove to be rather important in determining trade flows of the SEE countries.

6. Conclusions and policy implications

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

Importance of regional trade: Although the SEE region is today even less integrated than it was in 1991, some economic links inherited from the past - namely from former Yugoslavia - have been maintained. This suggests the general importance of path-dependent, historically inherited trade patterns, as they seem to survive even under exceptionally unfavourable conditions as were those in the Balkans in the 1990s. For one group of SEE countries - primarily Bosnia and Herzegovina, FYR Macedonia, and 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, as was the case also in 1989.

Impact of the MoU trade liberalisation initiative? 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 liberalisation 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, the MoU trade liberalisation 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 liberalisation with the EU have already enabled a major re-orientation of the SEE countries' trade primarily towards the EU. Uncoordinated policy initiatives in the area of trade liberalisation therefore cannot give the expected results, at least not in the short run.²³

Towards a customs union? Presently, trade liberalisation is based on bilateral free trade agreements among the SEE countries. As an alternative, a more synchronised, multilateral free trade arrangement in SEE would have been a better option, or 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 2000 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 co-operation 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 harmonising 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 liberalisation undertaken so far greater.

²³ It could be argued that if the scope for increased trade is there, the path dependency issue could be only temporary.

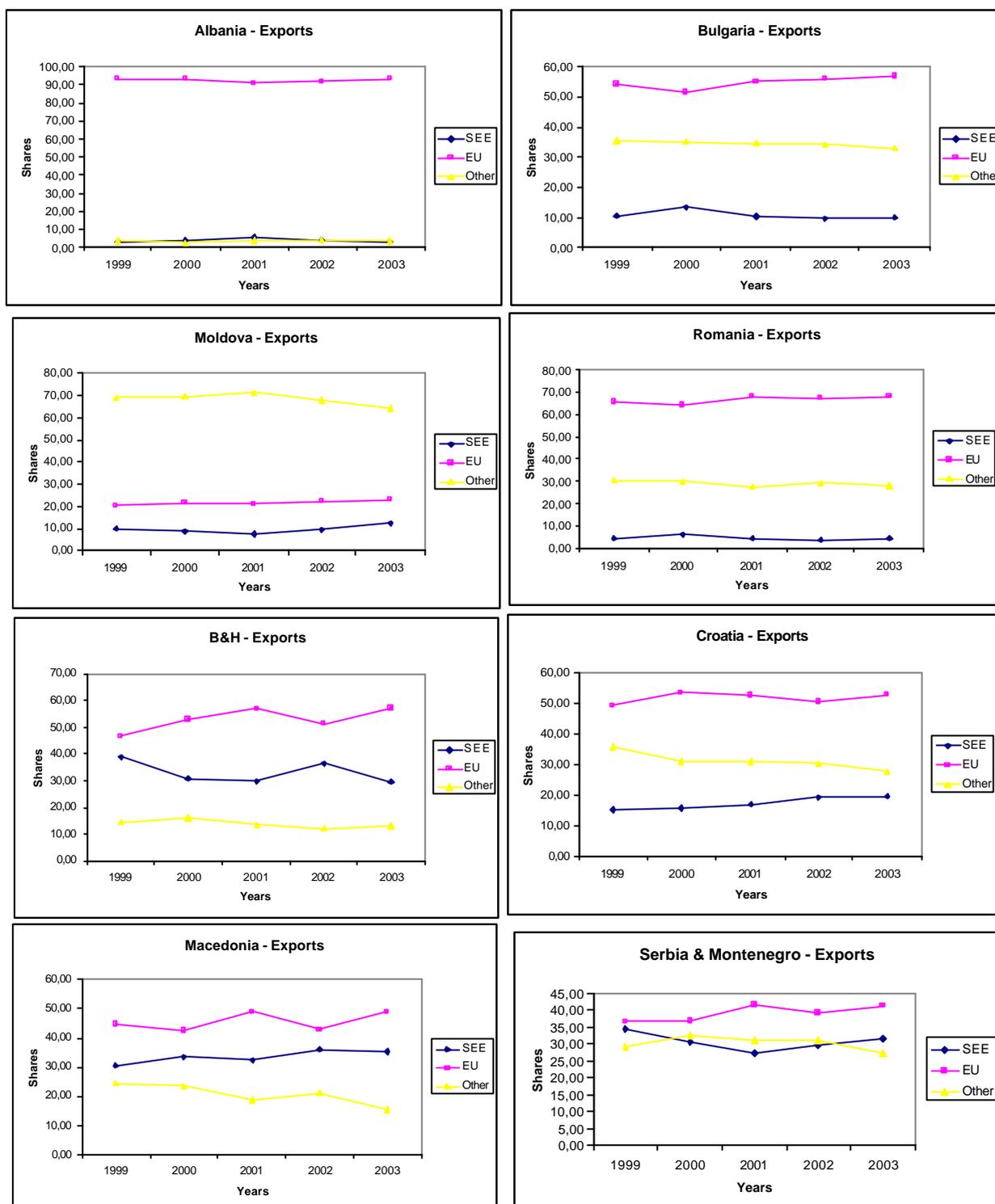
Compensating uneven effects of trade liberalisation: The eventual negative effects of trade liberalisation for some SEE countries, suggested in a recent World Bank study (Kaminski and de la Rocha, 2002), need to be seriously considered within the overall EU measures for this region. If the less developed countries are likely to lose more from trade liberalisation because of the negative distributional effects or the loss of customs revenues, they ought to be compensated more, through official assistance programmes, than the developed SEE countries. Current EU measures on trade liberalisation ought to be closely combined with measures supporting economic development of the SEE countries.

Beneficial overall effects of trade liberalisation: Even if the SEE region, however we define it, today does not qualify as an economically integrated region, this does not mean that trade liberalisation 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 liberalisation can have a number of positive effects, both political and economic. The political argument for promoting trade liberalisation 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.²⁴ Trade liberalisation 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 liberalised markets in the SEE region has been an important factor enabling better overall export performance than otherwise would have been the case.

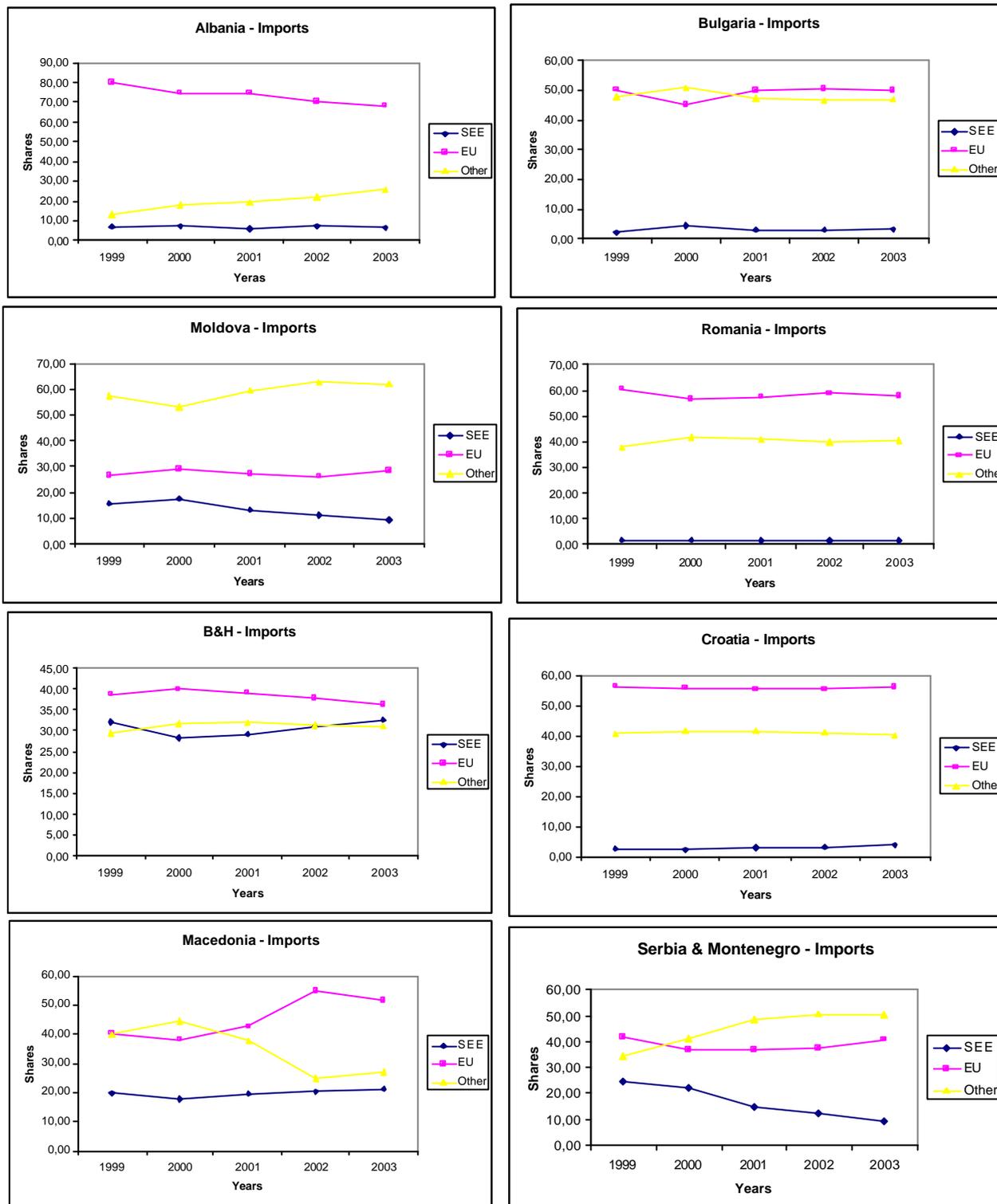
²⁴ It is not a coincidence that the EU Commission has introduced a new term for its contractual relations with the SEE-5 - the Stabilisation and Association process, the new element being precisely the word "stabilisation". On the experience of regional cooperation in other European regions, see Uvalic (2002b).

APPENDIX – Graphs

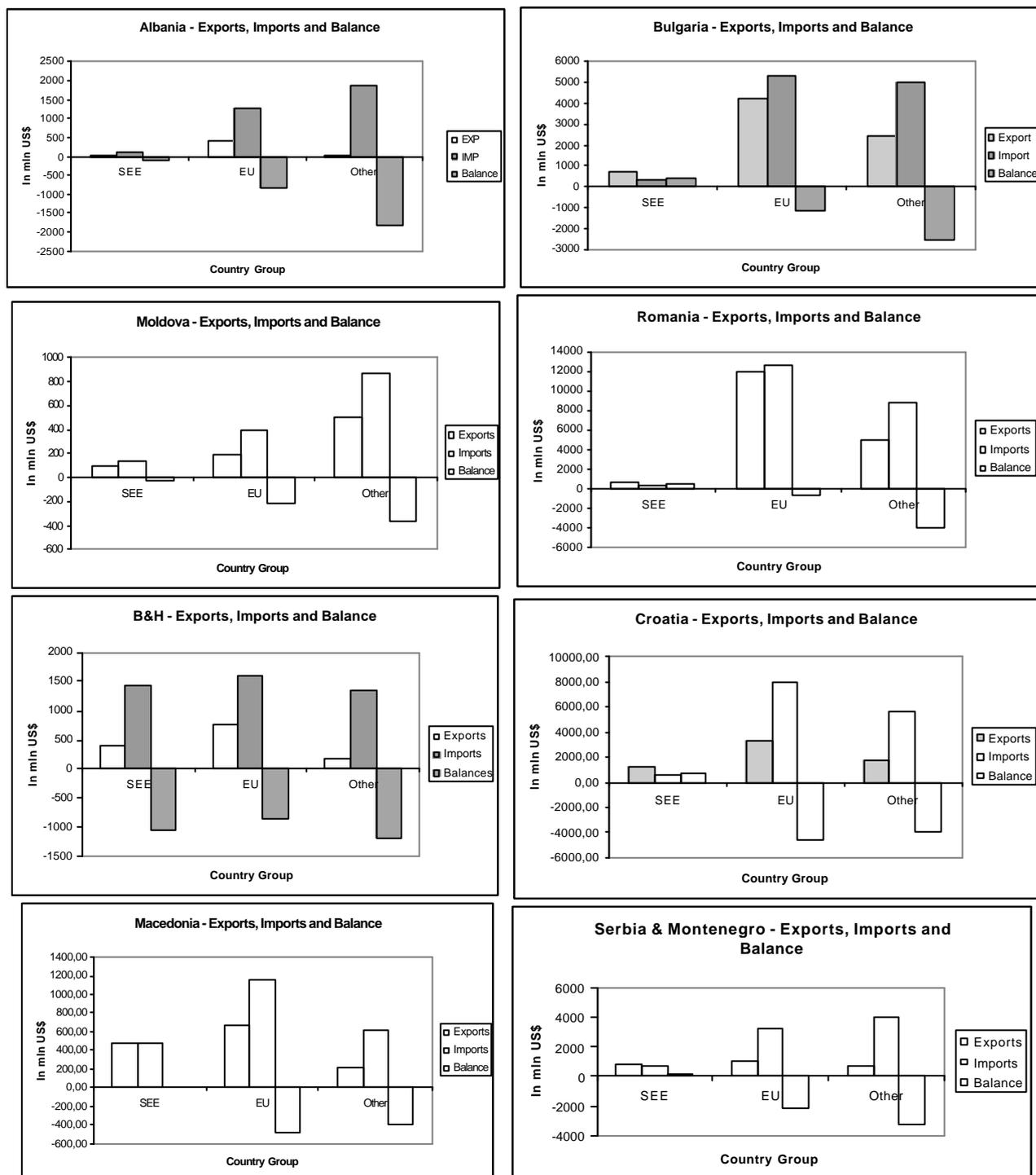
Graph 1. Exports of SEE countries by country groups



Graph 2. Imports of SEE countries by country groups



Graph 3. Exports, Imports and Trade Balances of SEE countries by country groups, 2003



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