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FREE TRADE AREA IN SOUTHEAST EUROPE: GROWTH POTENTIALS AND IMPLICATIONS FOR CROATIA[2]

ABSTRACT

Paper focuses on preconditions, actual trade flows and growth potentials of the Free Trade Zone in Southeast Europe. Further trade liberalisation and implementation of all 21 bilateral trade agreements would be important incentive for intra-regional trade, especially within SEE-5, where, according to gravity model results, there exist situations of "under-trade". Bilateral trade between Croatia and S&MN represents such "under-trade" situation that gives large space for Croatian export growth to this market. On the other hand, trade with B&H is already above the predicted level and it could even fall in the future because great part of B&H imports was triggered by Western assistance. According to the analysis, the establishment of the Free Trade Area in SEE gives potentials for an increase in intra-regional trade (especially SEE-5), but these benefits could be fully reached only by pursuing parallel trade integration towards the EU in order to avoid trade diversion effect.

Key words: *Southeast Europe, Croatia, European Union, intra-regional trade, regional cooperation*

1. Introduction

The paper analyses the group of Southeast European countries in a wider sense, which comprises Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Macedonia, Romania and Serbia and Montenegro (known as SEE-7). Sometimes this group of countries focuses only five economies (SEE-5, excluding Bulgaria and Romania) due to different bilateral trade and overall political arrangements with the European Union.

These seven SEE countries signed in June 2001 a Memorandum of Understanding on the establishment of a Free Trade Zone in the region by the end of 2002 based on a network of bilateral trade agreements. Although the end of 2002 marked as a target for signing all 21 regional trade agreements was missed, but now all agreements are signed and either ratified

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or in the process of ratification. According to theoretical as well as empirical studies, the static effect seen as trade creation could be positive and it is realistic to expect the increase in intra-regional trade in general. The reduction of customs and other trade barriers would reduce the trade costs that would benefit trade within the region.

Today the level of intra-regional trade is still relatively low, but with high growth rates and considerable scope for expanding. Since the increased trade is considered to be the important engine of growth, the aim of the paper is to analyse growth potentials and trade possibilities of Free Trade Area in SEE, with special reference to Croatia.

Paper aims to test the hypothesis that the establishment of Free Trade Area in SEE could result in higher rates of intra-regional trade, especially for Croatia as the most developed country in the region, but this process would be beneficial for all SEE countries only if it is pursued together with parallel integration process towards the EU.

Paper is divided in four sections. After the introduction, second section analyses necessary preconditions for successful trade integration of Southeast Europe, actual intra-regional trade flows and SEEC's trade relations with the EU. Third section throw some light on Croatian trade patterns, generally and particularly with other SEECs. Last section gives concluding remarks.

2. Preconditions for trade integration of Southeast European countries

There are some important basic preconditions and factors for successful implementation of trade integration within the region, especially in the case of regional trade agreement (RTA) among developing countries. These preconditions are economic and non-economic, mostly political ones.

2.1. Regional cooperation

The most important political preconditions are peace, political stability, respect for human rights and prevalence of the rule of law. Although peace is a precondition for successful integration, the successful integration at the same time contributes to consolidation of peace. There are many examples of regional arrangements between developing countries that include one or more members that have recently been or still are confronted by serious conflicts or civil strife (ECOWAS, COMESA and SADC in Africa, CACM and the Andean Community in Latin America) (Kennes, 2000, p. 53) However, by focusing energies on trade and investment as opposed to border tensions and disputes, welfare enhancing growth opportunities can be significantly increased.

Political preconditions are embodied in the Stability Pact that is launched in June 1999 on the EU's initiative. The Stability Pact (SP) is a primarily political initiative to assist seven Southeast European countries on their way to political, economic and security integration and cooperation among themselves. It represents a political declaration of commitment and a framework agreement on international cooperation to develop a long-term strategy for stability and growth in SEE.

Another process initiated by the EU – Stabilisation and Association Process (SAP) – is mainly focused on supporting the five SEECs (or Western Balkan countries) to meet

the EU membership criteria. These two processes are in general complementary because they have the same goal and it is the support for SEECs on their way towards European institutions and integration. In fact, the EU approach is based on the belief that SEE countries wishing to build links with the EU must first prove their readiness to cooperate with their neighbours. Both the SP and SAP encourage regional cooperation, but their measures are different. Since SP is a political instrument and has a broader thematic scope, it supports regional cooperation in several areas:

– trade and investment,
– local democracy and cross-border cooperation,
– media,
– infrastructure and energy,
– organised crime and
– managing and stabilising population movements.

Progress in regional cooperation is evident, especially in the field of trade liberalisation within the region that would further facilitate trade and attract foreign direct investments, in the field of infrastructure and energy.

The regional cooperation gives the effect of exploiting scale economies, which is very important for the more efficient provision of public goods within the region, such are transport and communication infrastructure, hydroelectric and other sources of energy, the environment, water basins etc. If countries deal with regional public goods individually, without internalizing the effect on other countries in the region, it may result in what has been called "the tragedy of the commons" or "prisoner's dilemma". (Schiff, 2002, p. 11) It means that everyone loses due to a lack of cooperation because costs of providing public goods individually can be large. They can be substantially decreased if resources are pooled through regional agreements or at least regional cooperation.

These effects are recognised as a core objective within the Stability Pact, particularly in the sector of infrastructure and energy. The Infrastructure Steering Group (ISG) that has been established under the auspices of the SP, aims to develop regional strategies for the development of different infrastructure sectors in Southeast Europe. The SP's role in the ISG is to foster improved information flows between the countries of the region and it seeks to develop political consensus among the countries on the adoption of regional rather than national strategies. (SCP, 2003, p. 5) There have been developed the regional infrastructure strategies under the supervision of the Infrastructure Steering group for SEE which include 53 projects totalling 4 billion Euros, of which 3 were completed and 40 started at the end of 2003. (Commission of the European Communities, 2004, p. 22)

Particularly important is the regional transport strategy that is consistent with the Trans-European Networks and the Pan-European Corridors, in order to improve intra-regional trade and overall economic development. In spring 2004 these five SEE countries should sign a Memorandum of Understanding on the development of the South East Europe Core Regional Transport Network.

Within the infrastructure, energy is a crucial area because sufficient and efficient provision of energy is very important element of economic and social development, and still is a big problem in some parts of the SEE region. In November 2002 there was initiated the Regional Energy Market and these countries signed the Memorandum of Understanding on the Regional Electricity Market in Southeast Europe. It defines the rules and objectives for the establishment of an integrated regional energy market in SEE by 2005, which will be eventually integrated in the European Community's Internal Energy Market.

The SP will have a similar role in forthcoming regional gas initiative in order to achieve optimisation and economies of scale at the regional level. It is a way of a more efficient provision of important public goods such is infrastructure and energy within the region. Due to the cooperation, every country gains with the lower costs of providing public goods on the regional level.

2.2. Macroeconomic environment and level of development

Besides political, there are very important economic preconditions for successful trade integration in order to improve convergence within the region. They are mostly related to sound macroeconomic environment since these SEE countries have faced similar macroeconomic disequilibria during the 90s. They have experienced the lack of GDP growth, decrease in industrial production, large trade and current account deficits as well as high unemployment rates.

All countries have made some progress and economic situation in last several years have been more favourable. (Table 1)

Table 1

Macroeconomic indicators for SEECs in 2000 and 2002

- in percent (%)

Country	Real GDP growth		Consumer prices		Unemployment rate (end of period)		Current account (% of GDP)	
	2000	2002	2000	2002	2000	2002	2000	2002
Albania	7.8	6.0	0.0	5.3	16.8	14.0	-7.2	-8.1
B&H	4.5	2.3	5.1	1.0	38.7*	40.0*	-20.8	-22.0
Bulgaria	5.4	4.3	10.3	5.8	16.9	18.1	-5.6	-4.1
Croatia	2.9	4.5	6.2	2.2	16.1	15.2	-2.3	-5.0
Macedonia	4.5	0.0	10.6	1.5	32.2	30.0	-3.0	-6.9
Romania	1.8	4.5	45.7	22.5	7.1	9.0	-3.7	-4.0
Serbia and Montenegro	6.4	3.0	85.6	19.3	12.6	13.0	-4.2	-15.5
SEEC-7	3.7	4.1	23.4	8.2	12.2**	13.6**	-4.7	-6.6

* Unemployment rate only for the Federation of B&H
** Estimate of the average weighted unemployment rate according to the Labour Force Concept
Source: WIIW, 2003

For the first time in the past 10 years in 2000 GDP growth is recorded in all SEE countries. Still, most of the countries show lower growth rates in 2002 compared to 2000, although the SEE region as a whole grew at a higher rate. At the same time, in the period after 2000 the inflation in SEECs steadily declined and all countries except Serbia and Montenegro and Romania have maintained one-digit inflation rates over the past two years. Inflation has been brought down to a regional average of 8.2% mainly due to policies based on external anchors and prudent macroeconomic frameworks. Recorded unemployment rate is high in all countries, except Romania, and is particularly high in Bosnia and Herzegovina and Macedonia. Current account deficit for the region and for most of the countries has been increased, reaching 6.6% of GDP in 2002. This high deficit is a result of a large trade deficit in all countries. International trade for the region as a whole recorded positive growth in nominal terms, although import growth was higher than export growth. High trade deficits reflect the low export growth due to the low competitiveness of goods and services produced in SEECs. On the other hand, high import growth results from the high import dependence and process of restructuring. The result was high trade deficits in all countries, but significant private remittances, positive balances of services and official transfers contributed to relatively limited current account deficits.

Although SEE countries have faces similar macroeconomic problems, their level of development is quite divergent. (Table 2)

Table 2

The level of development and structure of GDP in 2001

- USD

Country	GNI p/c	PPP GNI p/c	GDP (millions)	Years with negative growth (1989-2001)	Structure of GDP (in %)		
					Agri-culture	Industry	Services
Albania	1,340	3,810	4,114	4	50	23	26
B&H	1,240	6,250	4,769	-	15	31	55
Bulgaria	1,650	6,740	13,553	6	14	29	57
Croatia	4,550	8,930	20,260	5	9	33	58
FRYM	1,690	6,040	3,426	7	11	31	58
Romania	1,720	5,780	38,718	6	15	35	50
S&MN	930	..	10,861	5	15	32	53

Source: World Bank, 2003

Economic convergence is most often summarized by GNI per capita and regarding to this criteria, the Southeast Europe is a developing, though very heterogeneous region. Croatia is the most developed SEE country with 4,550 $ GNI p/c, almost three times higher than the GNI p/c of the second most developed economy of Romania. The

difference between GNI p/c of Croatia and Serbia and Montenegro is 4.9 times. The real convergence could be also analysed by GNI p/c using purchasing power parity rates. According to these data, divergence among SEE countries is less pronounced and difference between less developed and highest developed country is only 2.3 times.

GDP of two most developed countries (Croatia and Romania) accounts for over 60 per cent of the total GDP of the region.

The differences in the structure of the SEECs' GDP are also pronounced and show a great heterogeneity and divergence in economic development.

Although the process of trade integration in Southeast Europe formally does not require economic policy measures besides trade liberalization, membership in WTO and IMF in fact implies some degree of convergence of economic policies in these countries. Therefore the membership in these organizations2[3] could be seen as a step towards the minimum of macroeconomic preconditions.

2.3. Intra-regional trade in Southeast Europe

After the decade 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. (Table 3 and table 4)

Table 3

Southeast European trade: Intra-regional exports in 2001

- in percent (%)

of: to:	ALB	B&H	BLG	CRO	MAC	ROM	S&MN
ALB	-	0.0	0.5	0.3	1.1	0.1	0.0
B&H	0.0	-	0.2	12.4	2.0	0.1	13.1
BLG	0.0	0.0	-	0.2	1.4	1.3	0.9
CRO	0.3	10.3	0.1	-	4.6	0.2	2.1
MAC	1.0	0.5	2.2	1.2	-	0.1	9.3
ROM	0.0	1.1	2.6	0.1	0.1	-	3.4
S&MN	1.4	19.3	4.2	3.3	29.0	1.3	-
SEE – total	2.8	31.2	9.8	17.4	38.3	3.1	28.7
EU	91.8	46.3	55.2	55.0	41.4	65.1	47.0

Source: WIIW, 2003

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[3] All SEE countries are members of IMF, while BiH and Serbia and Montenegro have still not become members of WTO.

Table 4

Southeast European trade: Intra-regional imports in 2001

- in percent (%)

of: to:	ALB	B&H	BLG	CRO	MAC	ROM	S&MN
ALB	-	0.0	0.0	0.0	0.2	0.0	0.1
B&H	0.0	-	0.0	1.4	0.3	0.1	2.8
BLG	2.4	0.3	-	0.1	5.4	0.9	4.8
CRO	1.0	18.8	0.0	-	2.5	0.0	3.0
MAC	1.2	0.9	0.3	0.7	-	0.0	7.6
ROM	1.0	0.5	2.4	0.2	0.7	-	3.5
S&MN	0.1	7.4	0.3	0.4	9.1	0.4	-
SEE – total	5.7	27.9	3.0	2.9	18.1	1.4	21.8
EU	77.4	37.2	49.8	55.9	46.1	63.0	49.1

Source: WIIW, 2003

It should be pointed out that available trade data are underestimated because of the still relatively high proportion of unreported trade (not just smuggling) due to the absence of border points (e.g. between Kosovo and Serbia until 2001) and trade through "no man's land" (e.g. Brčko area). Anyhow, the presented data show that there are in fact two different sub-groups of SEECs regarding intra-regional trade orientation. One group consists of countries from ex Yugoslavia and they are relatively significantly trade oriented among them, especially B&H, Macedonia, Serbia and Montenegro, while Croatia's export orientation is much higher than import orientation. More or less, situation today is very much similar to that prior to 1989 when there existed little trade among SEE countries except for economic links within ex Yugoslavia. Today the intra-regional trade is still mostly ex Yugoslav trade. Still, actual geographic patterns also reflect the legacy of war in Croatia and B&H that still shape trade flows, especially between Croatia and Serbia and Montenegro. These two countries traded extensively before 1991, but their trade links have never been restored.

On the other hand, Albania, Romania and Bulgaria belong to the second group that has low trade shares of intra-regional trade. Some of these countries do not maintain any trade relations with other countries in the region for various reasons.

In some cases reasons are related to still existing trade barriers, mostly non-tariff ones. According to Tschäni and Wiedmer (Tschäni and Wiedmer, 2001, p. 8-9), there are some measures, which are not in the best interest of regional cooperation, especially in countries that restrict cross-border trade and are not in the line with international rules and practices. Difficulties at border crossings can be mentioned as an example, which are exacerbated if they are prevalent on both sides. Seen in this light, problems due to customs valuation and functioning of customs have a particularly strong regional component.

Although some non-tariff trade barriers still exist, the trade liberalisation during last several years was quite significant. It seems that actual effects on intra-regional trade flows by now have not been considerable because firms lack the capacity to respond to a more beneficial trade regime. (Anastasakis, Bojičić-Dželilović, 2002, p. 8)

We should stress that the major reason of relatively low actual and potential intra-regional trade is related to the similar trade structure and lack of complementarity. SEE economies have relatively similar factor endowments and, thus, similar comparative advantages. There is no wide base for strong expansion in inter-industry trade, although inter-industry trade dominates. On the other hand, the strong growth of intra-industry trade is unlikely to happen because it is characteristic for developed countries with diversified economic and trade structure.

Having in mind the fact that four SEECs had already formed common market and that many trademarks are already known from the past, we can assume that entry costs would be relatively lower than for other markets. Lower entry barriers would again be significant advantage from the point of view of the more developed country in the region.

Another static effect that is opposite to trade creation – trade diversion, is likely to occur, especially in the case of RTA where the structures of the economies and trade are similar. The similar structure of SEECs indicates that trade diversion would happen and it would be again to the benefit of the country having more locational advantages.

According to these conclusions, one could conclude that there is a reasonable doubt that the establishment of the Free Trade Zone in Southeast Europe without parallel integration processes toward the EU, could result in higher growth rates and catching-up the European economies. The intra-regional trade liberalization and liberalization in trade with the EU are two dimensions of integration process that are inseparable and should be pursued together, but having in mind that multilateral liberalization is also needed to avoid trade diversion and welfare loss.

2.4. SEEC's trade relations with the European Union

The EU policy towards Southeast Europe is based on two policy strategies: accession to the EU which involves Bulgaria and Romania, and the Stabilisation and Association Process for Albania, Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia and Serbia and Montenegro to prepare for future membership in the EU. Bulgaria and Romania are two SEE countries that have quite different position comparing to other SEE countries because they are part of the current phase of EU enlargement. They have signed Accession Partnerships with the EU and would join the EU in January 2007.

On the other hand, EU policy framework for relations with Albania, B&H, Croatia, Macedonia and Serbia and Montenegro is Stabilization and Association Process (SAP). It supports the countries' development and their prospects for becoming EU members in the future by implementing three main instruments: Stabilisation and

Association Agreements (SAAs) with individual countries, financial assistance and autonomous trade measures.

Regarding SAAs, two countries of the region have already signed these Agreements: Macedonia in April 2001 and Croatia in October 2001. Albania has conducted nine rounds of negotiations on concluding a SAA with the EU since January 2003, while B&H still has not began the negotiations, although a Feasibility Study on opening SAA negotiations was adopted by the Commission in November 2003. The Commission started work on a Feasibility Study on opening negotiations with S&MN since autumn 2003, while Kosovo also benefits from all the elements of the SA process, with the only exception of the possibility of contractual relations with the EU.

Second instrument of the SA process represent the EU financial assistance provided mainly through the CARDS programme, for which the EU has allocated around 5 billion Euros. This financial assistance has been gradually redirected from infrastructure reconstruction and democratic stabilisation to institution building and justice, which are crucial for increasing countries' capacity to implement reforms.

Third important instrument of SA process that has helped all countries of the region to considerably increase their export orientation towards the EU concerns the EU's trade measures. Namely, the EU has introduced special trade measures for these five SEE countries in September 2000, that have provided the wide-ranging free access to the EU market for almost all goods. It seems that Albania and S&MN have benefited the most from these measures, which brought lower tariffs for about half of their exports to the EU, while the other half already benefiting from duty-free access to the EU market. (Table 5)

Table 5

   Number of exported products and applying tariffs in the SA countries'
   export to the EU in 1999 and 2002

Country	No. of products exported		No. of products (% of exports) for which 2002 tariff is:		
	1999	2002	Zero MFN	Same as in 1999	Lower than in 1999
Albania	34	23	7 (8%)	2 (6%)	14 (54%)
B&H	44	40	12 (18%)	26 (48%)	1 (1%)
Croatia	128	126	32 (22%)	83 (37%)	3 (2%)
Macedonia	42	37	5 (10%)	27 (48%)	2 (4%)
S&MN	80	70	15 (11%)	0	45 (48%)
Total SEE-5	n.a.	n.a.	(16.6%)	(28.3%)	(16.9%)

Source: Commission of the EC, 2004

The presented data show a narrow export base for all countries (the only exception is Croatia with 126 exported products in 2002) with negative dynamics: all countries have further reduced the number of products exported to the EU between 1999 and

2002. It seems that these countries have not fully exploited the tariff reduction that has been offered by the EU. The tariff reduction has been significant especially for Albania and Serbia and Montenegro because a high proportion of their exports to the EU in 2002 (54% and 48%) have been subject to the tariffs that are lower than three years ago. Croatia has much more diversified export structure, but for only 3 products the tariff rate in 2002 is lower than in 1999.

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 SEEC-5 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.

3. Effects for Croatia

3.1. Characteristics of Croatian Foreign Trade

Although Croatia is the biggest SEE exporter to the EU, it has been faced with similar problems as other countries of the region: traditional export structure and lack of structural reforms. (Table 6)

Table 6
Croatia's export structure in 1992, 1997 and 2002

- in percent (%)

Product group	Export share		
	1992	1997	2002
0 Food and live animals	9.97	9.22	8.1
1 Beverages and tobacco	2.43	2.91	2.73
2 Raw materials, excluding fuels	6.23	6.25	5.58
3 Mineral fuels and lubricants	8.63	10.23	9.35
4 Animal and vegetable oils and fats	0.14	0.33	0.25
5 Chemical products	12.98	13.68	10.31
6 Products classified according toconstituent material	17.85	14.13	14.72
7 Machines and transport equipment	18.48	18.04	28.45
8 Miscellaneous ready-made products	22.70	25.15	20.58
9 Miscellaneous transactions and unmentioned goods	0.60	0.06	0.02
Total	4,597.492	4,170.699	4,903.6

Source: Statistical Yearbook of Croatia, 1993, 1999 and 2003

The data show that the export structure has not changed much throughout 90s and that the major changes have been an increase in export share of mineral fuels and lubricants, as well as decrease in miscellaneous manufactures. Traditional industries have still remained or have become the main exporters.

A more detailed analysis on 2-digit level shows similar trends. Table 7 presents the export shares of ten most important export products, based on combined tariff nomenclature.

Table 7

Export shares of ten most important export products

- in percent (%)

Product	1992	1997	2002
89	9.62	3.90	12.32
27	8.71	10.28	9.34
85	5.20	8.31	9.12
62	9.83	9.46	5.52
84	2.81	4.19	5.43
61	2.08	3.43	4.55
44	4.64	5.41	4.52
39	5.13	5.86	3.68
94	2.76	3.17	3.14
64	4.05	5.42	3.02

89 - ships and vessels; 27 - mineral fuels and mineral oils; 85 - electrical machinery and equipment and parts thereof; 62 - articles of apparel and clothing accessories, not knitted or crocheted; 84 - nuclear reactors, boilers, machinery and mechanical appliances, parts thereof; 61 – articles of apparel and clothing accessories, knitted or crocheted; 44 - wood and articles of wood; wood charcoal; 39 - plastics and plastic products; 94 - different products; 64 – footwear and parts of such articles

Source: Croatian Information Documentation Referral Agency

The most important export products that have made about 30% of total Croatian export are ships, vessels, mineral fuels and oils, electric machinery and equipment, while ten products account for over 60% of total export. These data indicate relatively high export concentration, from 21,11% in the beginning of the period, 21,57% in 1997 and 22,53% in 2002. (Škuflić, Vlahinić-Dizdarević, 2004) It seems that the structure has not been changed significantly since the most of these products have remained more or less the same share in export. Only group 84, 85 and 61 have succeeded to increase their export shares. Shipbuilding has been the biggest exporter, but it should be pointed out that this industry has a very high import component (up to 80 percent), which means that net exports are much lower than their gross value. Some labour-intensive industries like textile industry; footwear and wood processing still have high shares in total Croatian exports, competing mostly on low prices.

It seems that Croatian economy did not succeed to restructure its industry towards high value-added, as well as knowledge- and technology-intensive export sectors. The competitive position of exports can hardly be improved in next years because the main problem is not a loss of price (cost) competitiveness, but rather the lack of structural reforms, weaknesses in trade-related institutional capacity, insufficient restructuring of domestic industry and diversifying export products.

Having in mind this fact of lack of diversification and technological upgrading of Croatian export, it could be expected that Croatian exporters would faced important problems and growing competition in EU, but also in SEE markets. Although Croatia had been significantly trade oriented towards the EU still in 80s, other Central and East European countries (CEECs) that have entered EU in 2004 have experienced higher growth rates of exports during the 90s and succeeded to increase the share of exports to the EU much more than Croatia.

Table 8

Croatian merchandise export towards the main markets,
1992, 1997 and 2002

- in millions of USD
- in percent (%)

Country	1992	1997	2002
TOTAL	4,427	3,981	4,899
EU	53.98	50.21	52.68
- Italy	20.53	19.77	22.70
- Germany	17.46	18.74	12.47
EFTA	1.38	1.23	0.78
CEFTA	25.71	16.53	12.35
- Slovenia	23.27	11.93	8.72
- Hungary	0.93	1.18	1.69
- Bulgaria	0.05	0.23	0.24
- Romania	0.05	0.38	0.16
OTHER COUNTRIES			
- B&H	4.40	15.70	14.37
- S&MN	0.45	0.18	3.51
- Macedonia	1.97	1.88	1.20

Source: Central Bureau of Statistics of Republic of Croatia

During the last 10 years Croatian export to EU has been stagnated in absolute and relative terms, with the same export share of about 50%. Such disappointing results have been the result of above mentioned undiversified and unsophisticated export structure, but they are also related to the international position of Croatia that has not been favourable. Croatia has been the country left outside the European regional integration processes till 2002, although process of liberalization of Croatian economy

formally started in the early 90s. The trade system was unilaterally liberalized, since Croatia had been signed only two free trade agreements (with Macedonia and Slovenia) till January 2000, and with two more countries (Bosnia and Herzegovina and Hungary) till April 2001. The process of accessing WTO has also lasted for a very long time and Croatia has become a member of the WTO in November 2000. This delay caused significant disadvantage for Croatia because trade liberalization and transitional adjustment have been postponed for several, very important years. The most of CEECs signed their free trade agreements with each other and with the EU in the mid of 90s, which put Croatian exporters in unfavourable position. The vast of CEECs' products have been subject to lower EU tariffs in comparison with Croatian exports and these costs have raised the price of Croatian goods relative to ones from other CEECs.

3.2. Croatian trade with Southeast European countries

It is natural for neighbours to trade for a number of reasons. The transportation costs are low, language similarities lower communication barriers and reduce transaction costs, cultural affinity among neighbours influences tastes and it causes profitable complementarities to emerge. Generally, the intra-regional mobility of production factors is also higher than inter-regional. (Sabolović, 1994, p. 92.) Yet, the four ex Yugoslav republics have been faced with some special regional circumstances due to the war and dissolution of the former Social Federal Republic of Yugoslavia. Their trade implications are related to the high costs on importers and exporters due to the slower and more costly movement of goods through newly established borders.

As we have seen in the section 2.3. trading among ex Yugoslav republics is becoming more important in recent years with high growth rates. According to the theoretic assumption that is based on South-South model of regional trade integration, benefits of the increased trade go to the more advanced country whose comparative advantages are similar to the world average. In the case of Southeast Europe, Croatia would benefit the most because its export structure is more diversified and more similar to the world average and Croatia's intra-regional export is significantly higher than import from most of the SEECs. At the same time, many Croatian trade marks are already known from the past in the ex Yugoslav markets, that is and could be even more important competitive advantage for Croatian exporters.

Kaminski and Rocha (Kaminski, Rocha, 2003) used gravity model based on the 2000 data, in order to predict potential trade flows within the SEE region. Then they compared the predicted trade with actual trade between these countries, which indicate "realization ratios". Their results are shown in Table 9.

Table 9

Realization Ratios in Geographic Patterns of Trade

- in percent (%)

	Albania	B&H	Croatia	Macedonia	S&MN	Total with SEE-5
Albania	-					4
B&H	0	-				102
Croatia	4	156	-			53
Macedonia	11	15	39	-		58
S&MN	1	129	18	142	-	65
Total SEE-5	4	102	53	58	65	57
Bulgaria	12	5	3	41	84	34
Romania	4	14	4	6	32	13

Source: Kaminski and Rocha, 2003

According to the presented data, there is an evident "under-trade" between Croatia and most of the SEE-5; trade with Albania was 96% below the predicted level in 2000, trade with S&MN 82% below and with Macedonia 61% below the predicted level. On the other hand, Croatian trade with B&H could be characterised as "over-trade" because it was 56% above predicted level. The realisation ratios between Croatia and other two SEE countries (Bulgaria and Romania) are extremely low, but it is hard to expect more important growth of their bilateral trade.

So, the results of the gravity model they have used suggest potentials for an increase in total SEE-5 intra-regional trade, except for the B&H that already has intra-regional trade above the predicted level. It means that trade between B&H and other two countries (Croatia and S&MN) could even fall in the future. It should be said that some of these trade flows were triggered by the Western assistance that financed the most of the B&H imports, so it could be expected that Croatian exporters would face additional problems in B&H market.

The above-mentioned World Bank study also calculated the Grubbel-Lloyd indexes of intra-regional trade in SEE that indicate the level of intra-industry trade. It should be pointed out that their results are limited because the disaggregated intra-regional trade data are not available for all countries and are of low quality. Anyhow, as it could be expected, the values of GL index for intra-SEE-5 (ex Yugoslav republics) are extremely low, which suggest two important implications.

First, the low level of intra-industry trade implies limited potentials for growth, at least in the short time, i.e. until new industrial capacities are built. It also means that there are week interactions among firms operating in the same production networks. (Kaminski, Rocha, 2003, p. 29) Second, the low level of intra-industry trade, or with other words –

high level of inter-industry trade, could also suggest a high potential for protectionism and further regional inequalities.

Another study (Škuflić, Vlahinić-Dizdarević, 2004) has calculated Grubbel-Lloyd indexes in the bilateral trade between Croatia and B&H that is now its second most important export market. According to their results, Croatian trade with B&H has been mostly inter-industry (GL index 38,2), while intra-industry trade is characteristic for apparel and clothing, ships and vessels. It is important to notice that it is mostly vertical intra-industry trade, which means differentiation by different quality, and Croatian relative unit value per export is growing, that could imply better competitive position of Croatian exporters on B&H market.

To conclude, there are important potentials for Croatia to increase its exports to some countries of the region, especially to Serbia and Montenegro. Geographic proximity, the size of the economies, common past and removal of trade barriers are important factors that could boost the future trade flows. On the other hand, potentials for future export growth to B&H are relatively limited and they have mostly reached the upper limits. Further export growth could be realised only with more technology-upgrading and restructuring exports towards high value-added products.

4. Concluding remarks

There are several important preconditions for successful trade integration of Southeast Europe. After a decade of political and economic instability and negative GDP growth, all countries of the region have recorded positive GDP growth in past several years, relatively sound macroeconomic environment with mostly one-digit inflation rates, large trade and current account deficits and high unemployment rates. Progress has been also made in the field of improved regional cooperation, especially trade liberalisation, infrastructure and energy. Signing and ratifying all 21 bilateral trade agreements among SEECs that gives the space for further liberalisation of trade and other flows within the region have fulfilled formal preconditions.

As a consequence of economic and political normalization in the region, intra-regional trade have been rising after 2000, reshaping trade patterns mostly as ex Yugoslav trade. More or less, situation today is very much similar to that prior to 1989 when there existed little trade among SEECs, except economic links within ex Yugoslavia. Further reduction of customs and non-tariff barriers could boost trade in the short time, but the main reason of relatively low potentials for trade growth is related to their similar trade structures, lack of complementarities and domination of inter-industry trade. Extremely low level of intra-industry trade among SEECs indicates low growth potentials and high pressure for protectionism. In order to avoid trade diversion effect that could lower welfare effect and increase inequalities within SEECs, it is very important to pursue parallel integration process towards the EU, which is already their most important trading and overall economic partner. The EU has introduced special trade measures for SEE-5 within SAP in September 2000, that have provided the

wide-ranging free access to the EU market for almost all products. It seems that Albania and S&MN benefited the most from these measures.

Croatia is the most developed country in the region with the most diversified export structure, comparing with other SEEC, although most traditional industries have still remained the biggest exporters. Having in mind this fact of lack of technological upgrading, it could be expected that Croatian exporters would face growing competition in the EU market, but also in SEE markets. Therefore the important Croatian advantage could be common past in ex Yugoslavia and the fact that many trade marks are already well-known in ex Yugoslav republics, that could lower entry costs. For Croatia, there are considerable potentials for increasing exports to S&MN, while export growth to B&H has mostly reached its limits. Further export growth could be realised only with more technology-intensive and restructured exports towards high value-added products.

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ZONA SLOBODNE TRGOVINE NA JUGOISTOKU EUROPE: RAZVOJNI POTENCIJALI I IMPLIKACIJE ZA HRVATSKU

SAŽETAK

Rad istražuje preduvjete za trgovinsko povezivanje zemalja Jugoistočne Europe, aktualne trgovinske tijekove te razvojne potencijale zone slobodne trgovine u ovoj regiji. Daljnja liberalizacija trgovine te implementacija svih 21 bilateralnih trgovinskih sporazuma bit će važan poticaj intra-regionalnoj trgovini, posebice između 5 zemalja Jugoistočne Europe, gdje, sudeći prema rezultatima gravity modela, postoji situacija "pod-trgovine". Bilateralna trgovina između Hrvatske te Srbije i Crne gore predstavlja takvu situaciju "pod-trgovine", što upućuje na značajnu mogućnost porasta hrvatskog izvoza na ovo tržište. S druge strane, trgovina s Bosnom i Hercegovinom premašila je gravity modelom predviđenu razinu te se čak može očekivati i njen pad jer je BiH uvoz velikim dijelom bio financiran sredstvima pomoći Zapadnih zemalja. U radu se zaključuje da bi uspostavljanje zone slobodne trgovine na Jugoistoku Europe moglo potaknuti intra-regionalnu trgovinu, a posebice onu koja se odnosi na međusobnu trgovinu pet zemalja regije (SEE-5), no potpune koristi ove bi zemlje mogle ostvariti samo kroz paralelnu trgovinsku integraciju s Europskom unijom te tako izbjeći negativne posljedice efekta skretanja trgovine.

Ključne riječi: *Jugoistočna Europa, Hrvatska, Europska unija, intra-regionalna trgovina, regionalna suradnja*

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