

Proceedings from the Third International Conference

REGIONAL COOPERATION AND ECONOMIC INTEGRATION

Challenges and Opportunities

*October 15th - 17th 2009,
Skopje, Republic of Macedonia*

in organization of
Ss. Cyril and Methodius University, Faculty of Economics -Skopje
and the Customs Administration of the Republic of Macedonia



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Skopje, 15.10.2009

Dear Colleagues,

The Faculty of Economics, Ss. Cyril and Methodius University from Skopje and the Customs Service of the Republic of Macedonia started cooperation with the World Customs Organization in Brussels. The Faculty of Economics from Skopje became a member of the International Customs University Network (INCUN) of the WCO and accepted to help the process of developing university programs that would incorporate the professional standards of the WCO. Thus, university programs in the field of economics and business should be upgraded in order to provide contemporary standardized programs of higher education for the customs officers that would result in creation of a highly professionalized human capital for the needs of the Customs Administration.

On the 5th of October, 2007 in Brussels, the former General Secretary of the WCO, Mr. Michael Dannet and the former Dean of the Faculty of Economics from Skopje, Prof. Bobek Suklev, Ph.D. signed a Memorandum of Understanding in order to confirm their mutual will to cooperate and make efforts for the establishment of a Training Centre for the whole CEFTA-2006 in the Republic of Macedonia. Two months later, on the 14th of December 2007, the Macedonian Government gave its official consent to this idea.

Finally, on the 25th of June, 2009 the establishment of the Regional Training Centre – World Customs Organization as a unit of the Faculty of Economics, Ss. Cyril and Methodius University from Skopje in cooperation with the Customs Service of the Republic of Macedonia was approved by the Council of the WCO in Brussels.

The actual General Secretary of the WCO, Mr. Kunio Mikuriya, the Director of the Customs Service of the Republic of Macedonia, Mr. Vanco Kargov, and the actual Dean of the Faculty of Economics, Prof. Ljubomir Kekenovski, Ph.D. exchanged official documents on the opening of the Regional Training Centre – World Customs Organization on the 28th of October, 2009 in Skopje.

In order to promote the newly established training centre in the Republic of Macedonia we organized the International Conference on: Regional Cooperation and Economic Integration – Challenges and Opportunities which took place at the Faculty of Economics, Ss. Cyril and Methodius on the 15th-16th October 2009, in Skopje.

With respect,

*Ljubomir Kekenovski, Ph.D.
Dean of the Faculty of Economics,
Ss. Cyril and Methodius University
Skopje, Republic of Macedonia*

*Vancho Kargov
Director of
the Customs Administration of
the Republic of Macedonia*



WORLD CUSTOMS ORGANIZATION OPENED REGIONAL TRAINING CENTER IN THE REPUBLIC OF MACEDONIA

Capacity building is the basic task of all administrations. But, we believe that building of these capacities is best done on a regional level. Customs Administrations of one region have similar challenges and very similar procedures, so why not having a common training centre through which they can try and overcome the common issues. The solution lies in the human resources. Through this training centre, the customs administrations of the region can improve their activities and operations. In the Republic of Macedonia, the Customs Administration is devoted to enhancement and improvement of these capacities. The Faculty of Economics at University of Ss. Cyril and Methodius in Skopje has a long history, expertise and excellent infrastructure for it, while the Government gives its support to this Project. Although it is a decision of the World Customs Organisation, the decision for opening of this Regional Training Centre was passed upon the initiative of this Region. The training will not be focused solely to the Macedonian customs officers, but to all customs officers of the region. Through exchange of best practices and training, the Customs Administrations create a network and develop further cooperation. That is why every Customs Administration from the region will promote and support modernization. Through this centre, the university professors and staff will be able to transfer their knowledge to the people they train. WCO has developed a partnership program called PICARD and for the last two years, the Faculty of Economics cooperates with us through this programme.

*Kunio Mikuriya
Secretary General
World Customs Organization*

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Part I

REGIONAL TRADE AGREEMENTS AND REGIONAL COOPERATION

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THEORETICAL BACKGROUND AND SOME PRACTICAL EVIDENCES ON RTAS AND TRADE OPENNESS

Abstract:

International trade and integration theory to some extent over simplifies the expected positive results of the trade liberalization. In the theory is not enough to observe that actual value of benefits measured by GDP or GNI increases are at large different among the states included into the trade liberalization. Differences are to be observed to get multilateral and regional trade liberalization efforts successful.

Based on regional integration theory and general trade theory advocating maximizing of benefits in totally open economies we assessed, based on different researches and texts, that countries in region with similar production structure and similar level of GDP have potentially better chances to create larger benefits out of regional trade liberalization.

Based on theory and evidences accelerated trade increase in WBCs region is highly needed due to low levels of present GDPs and on the other side by request of the EU to fulfill the criteria of effective and functional market economy. Formal introduction of diagonal cumulation of rules of origin by EU Commission in 2009 will help to boost the regional trade increase.

Key words: *International trade theory, trade liberalization effects, regional economic integration, rules of origin.*

INTRODUCTION

Opening of economies is, along with the improvement of human capital, the key driver of economic national growth. Countries succeeding in increasing trade and attracting FDIs grow faster than countries that fail to become sufficiently open to the global economy.

Greater openness means fiercer competition on the domestic markets. This obliges politicians to improve institutional framework and prompts companies to continually optimize their production processes and develop new products. Results are seen in liberalizing efforts attached to multilateral WTO negotiation process. Beside that trade liberalization interests and achievements are presented by growing interest to agree on constructing different forms of so called Regional Trade Agreements (RTAs). RTAs, or as we can call them today Economic Integration Agreements (EIA) among states, were growing in their number and complexity as in the past. They developed and implemented different levels and forms of trade liberalization among the partner countries. We would like to understand the theoretical reasoning to explain fast growth in the number and form of RTAs in the past approximately 20 years. Beside that it is important to see whether multilateral trade liberalization is really an option which already hit its limits. Additionally may be interesting to understand whether present global economic crises adds some difficulties to the process of multilateral trade liberalization efforts including the future stability and number growth of different EIAs.

1. Multilateral and regional trade liberalization in the time perspective

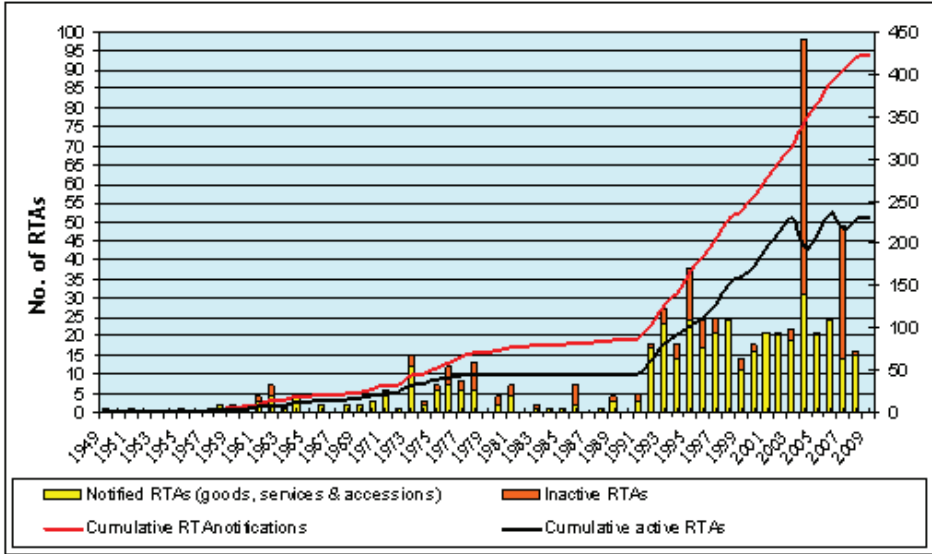
After Treaty of Rome (1957) establishing European Economic Community (EEC), the opening process of individual national economies started to be two lain process in fact. First trade liberalization was related to contractual parties of GATT, later transferred into WTO (1995) members. WTO members negotiate multilateral trade liberalization whit relative good success for trade in goods. There were some exceptions not included in the tirade liberalization schemes like for textile and agricultural products. Second trade liberalization track were negotiations among countries establishing Regional Trade Agreements (RTAs) where one of the most development successful experiences was related to EEC. RTAs in general were giving member states chances to get (more) open access for their goods and later services to the partner countries' markets faster in comparison to multilateral process. WTO multilateral negotiations proved to be successful mostly during Uruguay round (The Uruguay...) – before WTO establishing. After establishment of the WTO multilateral trade liberalization process got slower (as already had had sometimes in the GATT's past). The reasons for last years slowing down of global multilateral trade liberalization process are at least twofold.

The number of members in the WTO is increasing. The most important was accession of China at the end of 2001. After 1995 total of 24 new members entered WTO. It represents around 17% of present (19.6.2009) total membership (WTO member...). Additionally in the WTO process of multilateral negotiations we can find additional 33 countries which are included in the process as WTO observers. Among them most important is probably Russian Federation. Beside the growing number of the WTO membership the increasing complexity of the issues negotiated makes the multilateral trade negotiations slow and difficult to achieve generally accepted results. Problems with how to master major differences among members to further liberalization are present symmetrically in less and in more developed group of countries. Developed members like members of EU have problem to accept liberalization proposal in the area of their Agriculture policy. On the other side less developed members have some general reservations too, like their reservation to further service trade liberalization. Today such developments show rather

stagnant situation in the multilateral trade liberalization process. Stagnation is protruded from 2001 due to stand still situation regarding the process of agreement based on Doha Development Agenda (Doha...).

Development of a number of new RTAs or broader of EIAs in past decade or so could be partially at least contributed to the stagnation in the process of multilateral trade negotiations.

Chart 1: Explosion of the RTAs number after 1990s (1948- 2008)*



* Chart 1 shows all RTAs notified to the GATT/WTO (1948-2008), including inactive RTAs, by year of entry into force

Source: WTO Secretariat

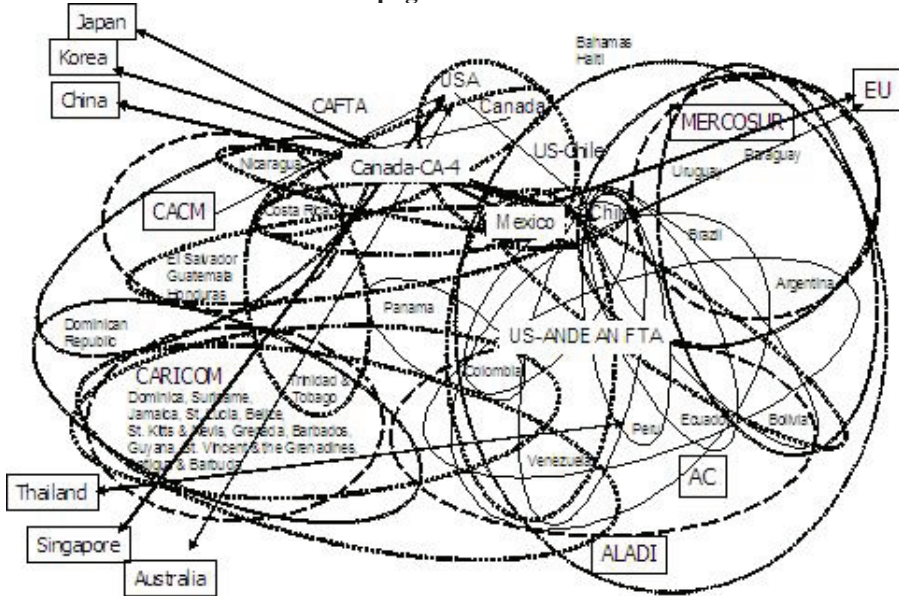
Other reason stimulating RTAs number growth, especial the reasons for their number explosion after 1994 are result of new global economic and technological changes and developments. Befor explaining such reasons let us observe that process of RTAs number growth and concept of multilateral trade liberalization are closely interlinked. The evidence of their interdependence is seen from formal obligation that all WTO members have. They have to report RTAs establishment to WTO. In the period 1948-1994, the GATT received 124 notifications of RTAs (relating to trade in goods), and since the creation of the WTO in 1995, almost 300 additional arrangements covering trade in goods or services have been notified. WTO members (as, previously, GATT contracting parties) are bound to notify the regional trade agreements (RTAs) in which they participate. Nearly all of the WTO’s Members have notified participation in one or more RTAs (some Members are party to twenty or more). Notifications may also refer to the accession of new parties to an agreement that already exists, e.g. the notification of the accession of Bulgaria and Romania to the European Union Customs Union.

Reasons for RTAs accelerated number growth after 1994 is partially based on fast and in

the past never experienced large increase technological achievements. This achievements are characterizes by two specifics. The number of new technical solutions important for standard and new production or to other business activities is growing fast in last decades; inventions in telephony, electronic, informatics and elsewhere else in economy based on interactions of inventions mentioned already. The second in past economic history newer experienced fact about technological solutions in last decades is that new inventions have relative short live in economic terms because new inventions make them obsolete or change the specifics an abilities related to older inventions. A good example is fast aging in reducing use of telefax machines. Nowadays only around 20 years after their first commercial introduction, fax machines are mostly replaced by multiple functional scanning and printing devices which are supported directly by computers. Technological progress offers new challenges and opportunities to business. Due to its relative faster change and introduction of more able new technological it pushes businesses into stronger competition by cutting production and other costs and increasing quality and multi functionality of products. Businesses can be fast in introducing and replacing new technologies if they can earn much and fast on their implementation. Product based on use of new technology need larger free accessible markets. Concept of large free market open markets, exceeding even the market potential of the largest world economies, are demanded by all industries and businesses (MNCs) involved in producing and trading standard or easy to imitate products often called commoditized products (Peng, 2009, p.91). Competitive elements important to succeed on the market with such types of products are mostly reduced only to level of price competition. Easy and secure investments (FDIs) and easy access to the large market to utilize the economics of scale effects are (or have been) the must important bases for business success of companies dealing in commoditized productions. On the other side those product are becoming increasingly important in GDP formation of many emerging market countries, who partially from that reason too often involve themselves into overlapping integration (RTAs) schemes (see chart 2).

In many cases sectors of so called commoditized production are still important for GDP formation in developed countries too. Among such important industries in developed nations whether due to the their part in GDP formation or due to high share of employed workers, most important are: car production, textile and closing production and trading, pharmaceutical products in the generic segment, products for sport and entertainment (bicycles, gym and fitness equipment,..), home appliances and many other industries and products.

Chart 2: Overlapping RTAs structure in the Western Hemisphere – “Spaghetti bowl effects”



Source: Richard Baldwin, “Multilateralising regionalism: The WTO’s next challenge,” *VoxEU*, February 29, 2008.

Creation of market niches and efforts to size the market with the uniqueness of trade marks in such segments of productions and trade are not really securing longer term market success which should provide needed coverage of the associated costs.

With the second effect (need for large markets) which supports creating a number of new RTAs we have to be observable in the present situation of global financial and economic recession environment. It could be that era of enthusiastic RTAs creation is approaching to its end following the present global financial and economic crises impacts. Negative national economic effects which at list short term accompany creation of a new FTA potentially threaten present and future process of multilateral and regional (FTA’s) trade opening. Such sentiments, decisions and potential future developments are evidenced even in today’s EU practices. As The wall Street Journal reported in March (Forelle, 2009) that older EU members led by German Chancellor rejected plead of a number of new Eastern Europe EU member countries led by Hungary, for a bailout package of up to 190 billion €. Eastern EU members face decrease in their sails to “old Europe”, and are troubled by external over indebtedness. They suggest that within EU already some protectionist developments could be sensed. Old EU members as GB, France or Germany have little desire to persuade their populations to add East European problems to their own. Signs of taking care only of own problems, creating threats of evoking protectionism, are increasing around the glob. If in close future there will be no coordinated political global scale activity leading to agreements similar to those reached in Bretton Woods in 1944, the world might easily repeat the behaviour of the years between the two World Wars.

PART I:

Nowadays such actions will create similar negative economic effects for all countries as were created during the Great Depression years. If we could expect such developments than for foreseeable future the interest for different formations of RTAs will no doubt be substantially decreased and forgotten. But let us try to be optimistic and explain why even today openness created within the RTAs framework or by multilateral trade negotiations could be beneficial for the partners included.

Up to recently beside expansion of regional trade liberalization connected to creation of growing number of RTAs the world had experienced rather successful general trade liberalization too.

Table 1: History of World Multilateral Trade Liberalization

GATT and WTO trade rounds					
Name	Start	Duration	Countries	Subjects covered	Achievements
Geneva	April 1947	7 months	23	Tariffs	Signing of GATT, 45,000 tariff concessions affecting \$10 billion of trade
Annecy	April 1949	5 months	13	Tariffs	Countries exchanged some 5,000 tariff concessions
Torquay	September 1950	8 months	38	Tariffs	Countries exchanged some 8,700 tariff concessions, cutting the 1948 tariff levels by 25%
Geneva II	January 1956	5 months	26	Tariffs, admission of Japan	\$2.5 billion in tariff reductions
Dillon	September 1960	11 months	26	Tariffs	Tariff concessions worth \$4.9 billion of world trade
Kennedy	May 1964	37 months	62	Tariffs, Antidumping	Tariff concessions worth \$40 billion of world trade
Tokyo	September 1973	74 months	102	Tariffs, non-tariff measures, “framework” agreements	Tariff reductions worth more than \$300 billion dollars achieved
Uruguay	September 1986	87 months	123	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc	The round led to the creation of WTO, and extended the range of trade negotiations, leading to major reductions in tariffs (about 40%) and agricultural subsidies, an agreement to allow full access for textiles and clothing from developing countries, and an extension of intellectual property rights.
Doha	November 2001	?	141	Tariffs, non-tariff measures, agriculture, labor standards, environment, competition, investment, transparency, patents etc	The round is not yet concluded.

Source: WTO – adjusted

A new data set on openness indicators and trade liberalization dates allows the 1995 Sachs and Warner study on the relationship between trade openness and economic growth to be

extended to the 1990s. New evidence on the time paths of economic growth, physical capital investment, and openness around episodes of trade policy liberalization is also presented. Analysis based on the new data set suggests that over the 1950–98 period, countries that liberalized their trade regimes experienced average annual growth rates that were about 1.5 percentage points higher than before liberalization. Post liberalization investment rates rose 1.5–2.0 percentage points, confirming past findings that liberalization foster growth in part through its effect on physical capital accumulation. Liberalization raised the average trade to GDP ratio by roughly 5 percentage points, suggesting that trade policy liberalization did indeed raise the actual level of openness of liberalizers. However, these average effects mask large differences across countries (Wacziarg, Welch, 2008).

2. Empirical and theoretical evidences on positive effects of trade openness

The World Bank has argued that the round of trade talks launched in November 2001 in Doha, Qatar, marked the first time that developing country interests were placed at the center of a multi-lateral round of trade negotiations. The Bank favors lifting the protectionist measures that have locked low-income countries out of rich-country export markets. A Bank report *Global Economic Prospects 2004: Realizing the Development Promise of the Doha Agenda*, outlined the benefits that would flow to developing countries and the world's poor from a liberalization of international trade. It estimated that a Doha agreement that substantially lowered agricultural and manufacturing tariffs and ended agricultural subsidies could cut the number of people living in poverty by eight percent by 2015.

There is a growing consensus in empirical studies that greater openness to international trade has a positive effect on country per-capita income. A study by Frankel and Romer (1999) estimates that increasing the ratio of trade to GDP by one percentage point raises per-capita income by between one-half and two percent. Numbers of other studies reach similar conclusions, though the estimated size and statistical significance of the effects vary. (Edwards (1998) or, for a more skeptical view, Rodrik (1999).)

The proposition that greater openness to international trade has a positive effect on country per-capita income is consistent with economic theories going back at least 200 years. The oldest and most widely agreed is that trade lets an economy make better use of its resources, by allowing imports of goods and services at a lower cost than they could be produced at home. In particular trade enables developing countries to import capital equipment and intermediate inputs that are critical to long run growth, but which would be expensive or impossible to produce domestically. From this perspective exports are the price the economy pays to get access to these valuable imports. Other possible benefits include more intense competition, which obliges local firms to operate more efficiently than under protection, and greater awareness of new foreign ideas and technologies.

What of the impact of freer trade on the incomes of the different society segments? As noted above, theoretical works suggests that higher average incomes in a country are generally associated one-for-one with higher incomes of the people in the society. The same work finds that this link applies to income increases caused by more trade: in other words, the impact of trade on the income of the different segments of the society is generally the same as that on per-capita incomes. Thus, for example, a 10 percent increase in the trade to GDP

ratio could ultimately raise per-capita income by five percent (cautiously taking the lower bound of the estimates by Frankel and Romer), and one would in general also expect a five percent rise in the income of the different society segments; owners of labourer and owners of capital for instance. .

But it is important to underline that there is nothing guaranteed about this outcome in relation to the open trade benefits among the people in the nation. Many factors can influence both growth and distribution of open trade effects. Further, the success of a trade opening is itself often affected by the macroeconomic climate, the quality of institutions and other factors.

One part of neoclassical trade theory gives some evidence on the potential problem of non equal distribution of the open trade environment benefits among the society groups or segments. The distribution of gains in case of fully employed and open economy following neoclassical approach developed by Heckscher -Ohlin and specified by Stolper-Samuelson theorem shows uneven distribution of the open trade benefits among social population groups. The theorem is one of basic concepts in the theory of trade, describing relation between the relative prices of goods' output, in the situation of with open trade, and relative factor rewards, specifically, real wages real and real returns to capital. More abundant and more intensively used production factor creates exports. The owners of such production factor experience relative increase of their incomes in relation to the owners of the other production factor. Free and open trade inside the society according to the theorem distributes benefits of open trade unevenly among domestic society groups. In spite of restrictive assumptions; like total trade openness, full employment of factors in the economy and perfect factor mobility within the nation and none towards other countries, still the theorem delivers an important message for real trade environment today. It shows that expected general benefits of trade opening might not been evenly distributed among the groups in the society. Such fact suggests that discussion on further trade opening whether on multilateral or regional – FTAs- bases might not be evenly acceptable and supported by all society groups. Uneven distribution of trade benefits might lead to the use of economic policies and measures which could try to “correct” the “unacceptable” distribution of the free trade benefits inside the society. Further more the interest to intervene by economic policy measures could be further stimulated and increased by the next theoretically known inequality created by free trade in distribution of the benefits.

Classical and neoclassical trade theory show (under usual assumptions) that expected trade benefits when trade is free or liberalized will create as analyses show an increase in GDP growth. Even in the most theoretical case when as a result of trade liberalization all countries will experience 1,5% point higher GDP growth, actual benefits measured by the size of GDP increase will substantially differ among the countries. Explanation of that fact is obvious. But the message is that because of the similar liberalization efforts actual GDP increases are strongly different than interest for trade liberalization among countries might be strongly different. Obviously nations with higher GDP levels could expect larger increase in the absolute value of GDP as poorer or less developed countries.

If we connect such potential reservation to the trade liberalization process among differently developed countries (developed and less developed) with the actual differences in the society

distribution of the achieved liberalized trade benefits then it might be understandable the following facts.

1. The reasons for slow progress in Doha agenda implementation – the problem is in different size of expected benefits for more and less developed nations, based on differences of GDP levels and productions structure causing internal distribution of trade benefits.
2. Interest for trade liberalization expectedly could be stronger in nations where majority of population might expect free trade benefits – normally that would be expected to be countries with relative abundant labour force.
3. In case of countries with similar levels of GDP free trade positive effect are not so much uneven, causing that interest to liberalize trade is generally supported. Especial in the case of similar production structure presuming similarities in abundance of production factors.

The reasoning in the point 1 seems well supported by arguments and problems accompanying efforts to finalize the Doha agenda liberalization program (Doha...). Conclusions suggested in point 2 are a bit confusing. In fact the most populated nation's which no doubt have relative abundance of labour are not front runners in the efforts for multilateral trade liberalization. Why so might have a few different explanations. One is that real impact of labour masses in labour reach countries (BRIC for instance) on political agendas of the governments is not really strong due to political tradition - specific and new democratic structures in such societies. Countries with relative abundance of capital in opposite are not showing strong labour/workers opposition to trade liberalization. In present crises we see same reservation as explained above when national government are not willing to help transitional countries although they are part of EU. In many cases in more developed nation labour force is not openly against trade liberalization although it threatens their relative incomes and in longer run as well their employment. Incomes are already proportionately high and will be with more trade additionally increased although less than incomes of the owners of the capital. In longer run they will have to seek new employment due to economy restructuring. In many countries – especially EU social support programs offer help during employment restructuring. Till recently in developed economies the labour force has not seen effects of trade opening as substantial problem and danger to their incomes and employment.

Conclusions suggested in point 3 above are consistent with the findings of different analyses searching for the answers when or at what conditions regional trade cooperation – concluding of EIAs – might be more beneficial in increasing GDP (El-Agraa, 2004). More developed countries – countries with higher GDP – and well developed production structure are potentially partner who can benefit more in case of EIAs introduction. EU in practice intends to implement such theoretical concept. The Copenhagen European Council of 21 and 22 June 1993 defines the economic and political conditions for accession to the European Union. Within the Copenhagen enlargement criteria one is related to specific market development level of candidate countries. It demands functional market economy, which among other requires certain level of economic development. Often this criterion within last enlargements was not really applied in practice. If this criteria in the future will play its role than for candidate and accessing countries to the EU the success in developing their economies and markets as the bases for EU joining is extremely important.

3. CEFTA regional cooperation and potential to increase trade openness

Based on above theoretical overview opening of trade among similar partners is easier and potential more equally beneficial to all countries participating. In case of Western Balkan Countries (WBCs) who are CEFTA members we could expect that more liberal trade could be beatifically to all. First question obviously goes to the fact that CEFTA on bilateral bases opens (in general) trade in the region. With such general status as always could be found some application problems. Let us mention some of them.

Table 2: Intra regional export and import relative to total export and import of the region (% , 2005)

Import	Alb.	B&H	Cro.	FRYMac.	Mont Neg.	Serbia	Total intra.r.export/ total export
Export							
Alb.	- (-)	0,0 (0,0)	0,0 (0,0)	0,0 (0,0)	0,9 (0,5)	0,4 (0,0)	1,7
B&H	0,2 (0,2)	- (-)	20,5 (2,6)	0,9 (0,7)	1,9 (3,9)	14,6 (3,4)	38,2
Cro.	0,2 (0,8)	13,0 (17,9)	- (-)	0,8 (2,5)	0,8 (7,0)	3,2 (3,0)	18,1
FRYMac.	1,3 (1,0)	2,5 (0,7)	4,0 (0,4)	- (-)	0,7 (1,2)	21,8 (4,3)	30,3
Mont.Neg.	1,1 (0,2)	5,3 (0,4)	1,4 (0,0)	0,5 (0,0)	- (-)	36,8 (1,9)	45,1
Serbia	0,1 (0,1)	18,5 (11,8)	3,6 (0,9)	5,8 (8,1)	9,0 (34,8)	- (-)	36,9
Total intra regional import/t.import	(2,4)	(30,8)	(4,0)	(11,4)	(47,4)	(12,7)	

Calculated from table: Trade among countries in the region, with EU and World in 2005, see A. Kumar, CEP Istanbul Documents, December 2008.

In the CETA one of the EU candidate countries is not included - that is Turkey. For WBC region their partnership in RTA with Turkey could be potentially beneficial. In CEFTA is Moldova whose status towards the EU accession process is totally undefined. Till recently (Commission, 2009) among members of CEFTA the diagonal accumulation of product origin was not possible.

Why this recent, at first glance just technical change is really important for future faster growth in CEFTA and Turkey region based on easier – more liberalized - trade? To answer the question two clarifications beside above theoretical framework are necessary:

- a) Is present regional trade of CEFTA and Turkey developed enough to hope that trade liberalized on the bases of FTAs agreements could develop positive effects on economic growth of members? At that stage we would leave aside effects of internal society distribution of such potential benefits.
- b) What is diagonal cumulation of product origin and how can it help to additional increase in regional GDPs growth?

Speaking about trade in the region based on the data from previous years we see, that regional trade – trade among partners in CEFTA - is relative small (Table 2).

Table 3: GDP in 2006 relative to GDP of 1989 (% – 1989=100%)

	GDP index
Albania	144
Croatia	105
B&H	75
FRY Macedonia	91
Montenegro	73
Serbia	64

Source: Transition report update 2007, EBRD, p. 64

Major trade flows for all CEFTA members and for Turkey are focused on EU. Regional integration has limited starting trade bases for enhancing open trade benefits. Trade effects are larger with the level of GDP. Unfortunately many of WBCs have their GDPs on low levels often even below levels from the period of ex SFRY (Table 3). WBCs have signed a new Central European Free Trade Agreement (CEFTA) on December 19, 2006 in Bucharest. Data for last years regional trade developments are difficult to collect. But partial data available show that CEFTA have yet not contributed a lot to increases of regional trade. We may conclude that up to 2009 CEFTA was not really enhancing the level of regional trade. The reasons among other elements are connected to the issue of rules of origin in the region and towards the EU in the past.

All economic integrations provide free access to partner markets only for products which actually originate from partner's country. Origin is the "economic" nationality of goods in international trade. There are two kinds of products in relation to their origin; non-preferential and preferential products.

Non-preferential origin of a product confers to the origin of products subject to all kinds of trade (border) policy measures (such as anti-dumping measures, technical barriers, permissions, certificate requirements, VERs, ...) or tariffs and quotas. The concept of the rule of origin is also used for statistical purposes, for example to correctly collect data for export and import or for balance of payments. Preferential or non-preferential provisions in relation to rule of origin is used as well in cases of public tenders or origin marking. The use of origin concept is one of "building blocks" to implement in practice the provisions of any type of the economic integration among states. Preferential rule of origin confers certain benefits on goods traded between particular countries – often among countries joined in the economic integration. Entry of goods which are declared preferential origin into the EU is possible at a reduced or zero rate of duty and eventually free of other entry barriers too. In either case, an important element in determining the origin of goods and their preferential or non preferential status is their proper tariff classification. In the EU case traded goods are identified by a code number from the Combined Nomenclature (CN). Before trying to determine their origin and specific origin status it is essential that their CN code has been properly identified. Movement of goods within Customs unions, in fact EU is even higher form of economic integration – it is internal market integration type – or within

any other type of economic integration, is not based on their origin status but on the fact that they have to comply with provisions for their free circulation within the integration. Products in trade with the countries outside economic integration (third countries) not fall within the scope of the customs union free movement but remain subject to a preferential or non preferential treatment based on origin and declaration of the importing countries members of the economic integration.

Non-preferential rules are applied together with all kinds of trade policy measures like, for instance, in cases of using anti-dumping duties and countervailing duties, trade embargoes, safeguard, retaliation measures and quantitative restrictions. The non-preferential status of goods is additionally often used in cases of tariff quotas, for trade statistics purposes, for public tenders, for origin marking, and similar. In addition, the EU's export refunds in the framework of the Common Agricultural Policy are often based on non-preferential origin.

There are two basic concepts to determine the origin of goods namely 'wholly obtained' products and products having undergone a "last substantial transformation". On bases of these two concepts the origin of product (economic nationality of product) defines whether according to tariff schedule of a country or of economic integration is going to have preferential or non-preferential treatment when crossing the border of a state or of economic integration. The last case refers to situation where countries implemented customs union or higher level of economic integration among them.

If only one country is involved the "wholly obtained" concept will be applied. In practice this will be restricted to mostly products obtained in their natural state and products derived from wholly obtained products. If two or more countries are involved in the production of goods, the concept of "last, substantial transformation" determines the origin of the goods. In general the criterion of last substantial transformation is expressed in three ways:

- by a rule requiring a change of tariff (sub) heading in the tariff schedule nomenclature (according to WTO this is Harmonized nomenclature system- HS or in the case of EU it is Combined Nomenclature system – CN);
- by a list of manufacturing or processing operations that do or do not confer on the goods the origin of the country in which these operations were carried out;
- by a value added rule, where the increase of value due to assembly operations and incorporation of originating materials represents a specified level of the ex-works price of the product.

When two or more countries are involved in the production of a good – that was wished to be part of CEFTA integration environment till 2009 - , the origin of the good must be determined (case of the EU) in accordance with Article 24 of Council Regulation No 2013/92 (CC). Articles 24 CC states: "Goods whose production involved more than one country shall be deemed to originate in the country where they underwent their last, substantial, economically justified processing or working in an undertaking equipped for that purpose and resulting in the manufacture of a new product or representing an important stage of manufacture". This provision might cause a problem with free access to the EU market. Goods coming from the country with which EU wants to establish specific (free) trade relations could be denied preferential origin and free entry on EU market when they are result of different transformation stages in other countries before their final exporter to the EU. If rules of origin are not properly adjusted than the above EU rule could restrict trade with CEFTA countries. When products were subsequently transformed in a number of countries in the region and not substantially enough in the last one – in country exporting

to the EU than they'll be denied the preferentially entry. This will happen although EU offers individually each CEFTA country preferential access to its market. Preferential origin is in general conferred on goods from particular countries¹, for instance CEFTA members, which have fulfilled certain criteria (generally signing the SAA with the EU) allowing preferential rates of duty to be claimed. While the provisions of the individual arrangements may vary in certain details, most preferential origin arrangements have a number of common provisions. Each individual arrangement has its own legal base. In the past EU has introduced a number of different arrangements with regard to applying preferential rules of origin with its different partners in Mediterranean area in WBCs area towards ACP countries and other partner countries.

Table 4: List of EU rules of origin by country groups

EU Preferential Arrangements
EFTA countries
Central and Eastern European Countries Central
Western Balkan countries (Croatia and Macedonia only)
Mediterranean Countries
Other countries and territories
EU Autonomous preferential arrangements
Overseas Countries and Territories
Generalized System of Preferences
Western Balkan countries (WBCs – rest of the countries)
Ceuta and Melilla

Source: http://ec.europa.eu/taxation_customs/customs/customs_duties/rules_origin/preferential/article_779_en.htm

In the case of the WBCs who are integrated within CEFTA agreements EU applies two different approaches. WBCs in the group of Preferential Arrangements are only two states from the region: Macedonia and Croatia, both on the bases of active Stabilization and Association Agreements (SAA - OJL 84,20/3/2004, p.13 and OJL 26, 28/1/2005, p.3). Both have on the bases of SAA in the Protocol No. 4 given the right to bilateral cumulation of rules of origin only. In relation to the logic of ex SFRY production and intra-trade relations this probably is not the best solution to utilize the preferential trade relations with the EU defined in the SAA and in the specific Accession Protocols (OJL 388, 29/12/2004, p.3 and OJ L 26, 28/1/2005, p. 222). Such bilateral cumulation solution is not really supportive to mutual trade development in the scope of CEFTA. The situation is more complicated due to the fact that other WBCs are in another group of the EU rules of origin - autonomous preferential measures (Table 6.). In this group are: Albania, B&H, Serbia and Montenegro

¹ Rules proving the origin of a product from a particular country in Europe fall into three main categories:

Percentage rules: A product is considered originating if the cost of materials and components imported from outside a free-trade area does not exceed a specified percentage of its ex-works price. In EU case often 40%.

Sufficient transformation: A product is considered to be “sufficiently transformed”, and therefore originating, if its tariff heading (a four digit code) under the Harmonized System of the World Customs Organization is different from those of its imported contents.

Processing requirements: A product is considered originating if specified minimum processing operations have been carried out within the exporting country.

To claim the relevant preferential treatment based on the product origin the most commonly used is a EUR 1 Certificate (ATR Certificate for goods exported to Turkey under the EC's Customs Union arrangements with that country). The EUR.1 is recognized as a certificate of origin in the external trade in legal sense. It is issued by relevant (agreed) institution/authority of the exporting state.

including Kosovo, who is declared in 2008 an independent state. Council Regulation (EC) No 2007/2000 of 18 September 2000 (OJL 240, 23/09/2000, p.1) introduced exceptional trade measures for countries and territories participating in or linked to the European Union's Stabilization and Association process (SAAP). Countries included are listed above. Regulation (EC) No 2007/2000 provides for unlimited duty-free access to the Community market for nearly all products originating in the countries and territories benefiting from the Stabilization and Association process. Last change of the Council Regulation was on May 11, 2005. Beside some changes in quantities of products which can be exported to EU from Croatia, Macedonia, B&H, Serbia and Montenegro the major change is relating to Montenegro who signed the SAA with the EU on October 15, 2007. The amended Council regulation so anticipates implementation of SAA provisions after ratification of all EU members by stating: "Montenegro will remain beneficiary of Regulation (EC) No 2007/2000 insofar as that Regulation provides for concessions which are more favourable than the concessions existing under the contractual regime" (Eur-lex, May 2008). The same amended Council regulation mentions as well Kosovo in a exclusively formal point 5, stating that "by Commission Regulation (EC) No 1398/2007 [3], Montenegro and Kosovo [4] have been removed from the scope of application of the Council Regulation (EC) No 517/94 of 7 March 1994 on common rules for imports of textile products..... On such bases article 3 of Regulation (EC) No 2007/2000 has therefore become obsolete and should be deleted" (Eur-lex, May 2008). That Kosovo is going to be a separate custom territory from EU regulation point is seen from the same Council regulation where in Article 1 is stated "... the customs territories of Serbia or Kosovo...".

Obviously enough EU had problems with defining the implementation of preferential rules of origin for different WBCs in the same manner. The problems were result of different level of contractual relations between the EU and countries in the region. Additionally the region is in the sense of defined "state custom territory" rather unstable due to the recent formation of new states in the region. However the different treatment of the countries in the region is not the major obstacle to faster trade increase within CEFTA or between CEFTA members and the EU. The basic problem was that EU in relation to WBCs applied only the so called bilateral definition of rules of origin when giving preferential status to regional exports based on SAA or on application of autonomous measures. As mentioned above in March 2009 EU commission introduced the role of diagonal accumulation in the region. These will probably help to increase regional trade provided:

- that businesses from the region will see advantages in increased regional production and trade cooperation,
- that customs procedures will be properly developed and implemented, including controls and issuing the origin certificates.

Because WBCs are integrated in the new CEFTA so called diagonal cumulative rules of origin for the integrated partners could really bring them substantially better economic and welfare results in the future. The historic reasons (part of WBCs had been in one state) and production structure reasons (supporting and interdependent past structures of production) make diagonal cumulative regional rules of origin a substantial stimuli to faster increase of trade among majority of CEFTA members.

CONCLUSIONS

International trade and integration theory to some extend over simplifies the expected positive results of the trade liberalization. In the theory is not enough just to observed that

actual value of benefits measured by GDP or GNI increases are at large different among the states included into the trade liberalization. Not on such bases but still different effects of trade liberalization were respected during GATT rounds giving different periods and levels of liberalization to contracting parties based on their development levels. Even more the theory and practice often does not consider internal distribution of trade liberalization benefits among different social/economic groups. It is true that suggestions given by theory (Stolper/Samuelson Theorem) depend on (too) many assumptions to be evidently connected to practical aspect of trade liberalization. These to aspects partially explain problems with multilateral trade liberalization efforts especially after acceptance of Doha Agenda.

Based on regional integration theory and general trade theory advocating maximizing of benefits in totally open economies we assessed, based on different researches and texts, that countries in region with similar production structure and similar level of GDP have potentially better chances to create larger benefits out of regional trade liberalization. Following that logic we looked to trade cooperation of the WBCs who are CEFTA members. Past regional trade is limited and on partial data we stated that after 2006 – CEFTA establishment – was not substantially increased. Among other potential reasons for such unfavorable development we focused on rules of origin in the region providing potential production cooperation in the region with still free access to EU (major partner) market. Some technical explanations of the logic and practicalities of the rules of origin in the Eu practice helped us to develop some optimism for future faster regional trade development. The optimism was based on decision of the Eu Commission from March 2009 introducing the right to diagonal accumulation of origin in CEFTA region.

Based on theory and evidences accelerated trade increase in WBCs region is highly needed due to low levels of present GDPs and on the other side by request of the EU to fulfill the criteria of effective and functional market economy. Just formal introduction of diagonal cumulation of rules of origin will not be enough to boost the regional trade. Proper and focused utilization of the new opportunities should be connected to practical business decisions and development plans. It should be simultaneously supported by transparent and adequate administrative activities on the borders of all participating counties.

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THE IMPACT OF WORLD ECONOMIC CRISIS ON THE SUSTAINABLE GROWTH OF THE SOUTH-EASTERN EUROPEAN COUNTRIES: DOES REGIONAL COOPERATION MATTER?

Abstract

The analysis is focused on the sustainable economic growth of South-Eastern European countries (SEE) in the conditions of global economic crisis. Statistical data indicate that those countries experienced slow growth of GDP during the first transition period of 1989 - 1998. During the second 1999 – 2007 period, GDP growth was faster due to higher growth of export, domestic demand and inflows of foreign direct investments (FDI). In 2008, the global financial crisis had an impact on the decreasing growth rate of exports as well as on lower inflows of FDI with the worsening of economic performances and rising unemployment. Since the SEE countries are faced with the rising protectionism at the global and EU markets, the author suggests straightening regional and economic integration by trade facilitation and enhancing inflows of FDI between countries in the region. However, intensive competition, financial crisis and complex adjustment process of the candidates' countries on the way to the accession to the EU market makes the future growth more difficult.

Key words: *global crisis, foreign direct investment, regional cooperation*

INTRODUCTION

The aim of this paper is to analyse the macroeconomic tendencies in the past twenty years (1989- 2008) in the countries of South Eastern Europe. The coverage includes all countries in the region and for the purpose of analysis they are divided into Western Balkan countries and the countries of transition which are already members of the European Union. The region's countries have embarked on a steady course towards full EU integration since all of them, (except Serbia and Kosovo) have signed pre-accession agreements (Stabilization and Association Agreements – SAAs). However, the lack of progress regarding the EU candidacy in Serbia, Macedonia, and Bosnia and Herzegovina is evident, while Croatia, as a candidate country, has had problems with finalising its negotiations by the end of 2009 because of the bilateral disagreement with Slovenia. Having in mind this adjustment process period towards the EU memberships and at the same time the impact of the global financial crisis on the region's economy, it is evident that promoting regional cooperation is an economic and trade priority and that tighter relations between the neighbouring countries will be a prerequisite.

The paper examines how Western Balkan countries may achieve a sustainable rate of economic growth comparing them with New EU members from the region (Bulgaria, Hungary, Romania and Slovenia). We shall analyse first the macroeconomic indicators during the transition to market economy and then search why sustainable high economic growth has not resulted in a higher employment in the Western Balkan. Finally, we are going to analyze briefly the economic impact of World economic crisis on this region.

1. Macroeconomic performance of South Eastern European countries (SEEs) during the past 20 years

The territory of South-Eastern Europe is 859,000 km², or 14.5 per cent of Europe (without Russia). On this territory lived 77.9 millions of inhabitants (in 1989), or 13.4 per cent of the European population (without Russia). At the beginning of 2007 the EU-27 recorded a population of more than 495 million persons. The South Eastern Europe had almost 76 million inhabitants in 2007 (see table 1).

Western Balkan countries (WBCs) had together a population representing nearly 5 per cent of the total EU-27 population. During the last twenty years, the population in this region has shrunk by 2,8 per cent. The declining tendencies are much more pronounced in the countries which are already in the EU (-3, 1%) than in Western Balkan (-1, 8%). In the fast growing world population it is unusual that a region has a declining population. It is evident that the region's participation in the world population decreased from 1,51% in 1989 to only 1,16% in 2007. This fall in the population of the region differs from the past performances in population's growth in the region and could be explained only by larger emigration and war operations in Western Balkan countries. Since the majority of émigrés were younger, it is quite likely that this tendency of negative rate of population growth will persist.

Table 1: Population in South Eastern Europe (in thousands), 1989, 1998, 2007

Region/ Country	Population (in 000)			Percentage of world Population		Rate of growth
	1989	1998	2007	1989	2007	1989-2007
A. Western Balkan	23732	23952	23294	0.48	0.36	-0.11
Albania	3196	3367	3153	0.06	0.05	0.53
Bosnia and Herzegovina	4398	3502	3508	0.09	0.05	-1.25
Croatia	4501	4265	4441	0.09	0.07	-0.08
FYR Macedonia	1891	2015	2042	0.04	0.03	0.43
Montenegro	638	630	625	0.01	0.01	-0.11
Serbia	9108	7583	9525	0.18	0.15	0.23
Kosovo	..	2590	2143	..	..	..
B. EU members	54188	53205	52492	1.03	0.80	-0.17
Bulgaria	8990	7985	7679	0.17	0.12	-0.85
Greece	10056	10579	11172	0.19	0.17	0.58
Hungary	10398	10211	10006	0.20	0.15	-0.23
Romania	22852	22509	21565	0.44	0.33	-0.32
Slovenia	1892	1921	2010	0.04	0.03	0.33
TOTAL	77920	77157	75786	1.51	1.16	-0.18

Source: DZS, Statistical Yearbook of Croatia; Eurostat, Yearbook, various issues

On the other hand the EU is facing the challenge of needing a more dynamic immigration policy to overcome labour shortage in the foreseeable future. In the coming decades the high number of ageing baby boomers will increase the number of elderly. In the EU-27 there are four persons of working age (15-64 years old) for every person aged 65 years or over, in 2060 the ratio is expected to be two to one (Eurostat, 2008). According to the Eurostat projection for the period 2008-2060, the annual number of births is projected to decrease while the annual number of deaths is projected to continue rising. It seems that positive net migration will be the only population growth factor. However, this poses the question of the ability to counterbalance the negative natural change in SEEs in the long run, since one eighth of the total population of this region emigrated. Western Balkans is the main European emigrating territory: almost a quarter (22.6 per cent) of the entire population emigrated during the past 25 years (see table 2).

The populations of the countries of South-East Europe, which have already joined EU, were far less inclined to emigrate (7.6 per cent). Bulgarians are most frequent emigrants among those countries with 12.6 per cent of emigrants. The dissolution of Yugoslavia, with the civil war and its consequences, coupled with difficulties in transition policies, are the main reason for huge exodus of population in a number of countries in the Western Balkans. Migrants tend to leave countries where economic conditions are relatively poor (low GDP per capita or high unemployment) and move to countries where conditions are better.

Table 2: Migratory movements in South-Eastern Europe, 2005 (in thousands)

Region/Country	Population (1)	Emigration (2)	Immigration (3)	Balance (2-3)	% of emigrated (2:1)
<i>South-Eastern Europe</i>	77,775	9,731	2,512	7219	12.5
<i>A) WBCs</i>	25,309	5,727	818	4,909	22.6
Albania	3,563	860	83	777	24.1
BiH	4,430	1,472	41	1,431	33.2
Croatia	4,442	726	661	65	16.3
FYR Macedonia	2,045	371	121	250	18.1
Serbia and Montenegro *	10,829	2,298	512	1,786	21.2
<i>B) EU members</i>	52,466	4,004	1,694	2,310	7.6
Bulgaria	7,450	937	104	833	12.6
Greece	10,668	1,218	97	244	11.4
Hungary	10,007	471	316	155	4.7
Romania	22,330	1,244	133	1,111	5.6
Slovenia	2,011	134	167	-33	6.7

Source: United Nations Population Division (UNDP); *- Montenegro declared independence from Serbia and Montenegro on June 3, 2006.

The tendencies in gross domestic product (GDP) in SEE region show two distinct features (table 3). GDP has decreased in WB countries: in the year 2007 it reached only 79 per cent of the volume obtained in the year 1989. In comparison with new member countries of the EU, there used to be an increase in GDP of 33% during the period 1989 to 2007. However, since the world achieved an unusually high rate of growth during these 18 years, the role of SEE in creation of world GDP has shrunk from 1,76 per cent in 1989 to 1,17 per cent in 2007 (table 3).

What are the main reasons for such poor performance of economic growth of this region? The analysis shows that almost all transition countries, during the first nine years of restoration of capitalism and development of market economy, have a decrease in GDP: in Bosnia and Herzegovina, Montenegro and Serbia the volume of GDP almost halved, it was lowered for 30 per cent in Bulgaria, by quarter in Romania, by 19 per cent in Croatia and by 8 per cent in Hungary. In the same period, insignificant growth has been obtained in Albania and Slovenia, which could be explained by the specific type of privatisation in these countries. The main reasons for this contraction could be found in the former nature of industries created in former socialist countries (autarchy, manufacturing with low level of technology etc.), lack of entrepreneurship and forms of privatisation of industries.

The opposite situations developed in the region after 1998. All countries experienced a yearly growth of almost 4 per cent. However, this growth was faster in NMS of the EU (4, 3 per cent yearly) than in Western Balkan countries (where the average growth was only 2, 16 per cent yearly). The lowest growth rate has been obtained in Macedonia, Montenegro and Serbia while the fastest was in Albania, Bosnia and Herzegovina, Bulgaria and Romania.

Table 3: Gross Domestic Products (GDP) of South Eastern Europe

Region/ Countries	GDP (in million US \$, PPP of 1990)			Percentage of world GDP		GDP growth rate (%)	
	1989	1998	2007	1989	2007	1989-2007	1998-2007
A. Western Balkan	124548	81293	98506	0.47	0.21	-1.30	2.16
Albania	7917	8001	13570	0.03	0.03	3.00	6.05
Bosnia & Herzegovina	17810	9261	14500	0.07	0.03	-1.12	5.11
Croatia	35860	29189	39030	0.13	0.08	0.47	3.29
Macedonia	7956	6175	7150	0.03	0.01	-0.68	1.62
Montenegro	2835	1485	1756	0.01	0	-2.68	1.88
Serbia	52430	27182	34500	0.20	0.07	-2.30	2.69
B. Members of EU(2007)	342489	319652	462410	1.29	0.97	1.68	4.19
Bulgaria	55883	38793	60010	0.21	0.13	0.39	4.95
Greece	101425	118351	171400	0.38	0.36	2.96	4.19
Hungary	71776	66039	96400	0.27	0.20	1.65	4.29
Romania	90051	66895	100700	0.34	0.21	0.62	4.63
Slovenia	23354	23574	33900	0.09	0.07	2.10	4.10
TOTAL	467037	394945	560916	1.76	1.17	1.03	3.97

Sources: For the year 2007: Authors calculations based on IMF World Economic Survey, 2008

Rather low GDP growth rates in SEE countries compared with the world and dynamic economies should be explained (see table 4). Without any doubt, the decline of GDP in Western Balkan Countries (WBCs) for the whole 18 years period might be explained primarily by the war which took place in Croatia, Bosnia and Herzegovina and Serbia in the nineties. In the countries which are already in the EU, low rate of growth is primarily due to the costs of transition process. Privatisation, coupled with the creation of an open economy and enhanced liberalization process has caused lower growth rates in those countries! If we compare those countries growth rates with the Greece rate of growth, the cost of transition process becomes evident.

Table 4: Annual rates of growth of GDP per capita for the period 1989-2007

Region	Population	GDP	GDP per capita
World	1.32	3.33	1.99
EU-15 *	0.43	1.86	1.38
USA	1.18	2.75	1.55
China	0.97	8.68	6.91
India	1.83	6.27	4.37
SEE	-0.14	1.03	1.18

Source: A. Maddison: *Contours the World Economy*, Oxford University Press, 2007;

*with Norway and Switzerland

In the 1998-2007 periods there was a reversal of the rates of growth in Western Balkan countries. They became positive, although some countries were lagging behind (Macedonia and Montenegro). The analysis of the whole period between 1989 and 2007 shows that the fastest growth was obtained in Albania (71%) and in Greece (69%), while Serbia, Montenegro, Bosnia and Herzegovina experienced in 2007 the level of GDP which was still below the level obtained in the year 1989. The divergences in performances are huge and they have considerably influenced the emigration rate: the lower the rate of growth, the higher the emigration (see table 5).

Table 5: The level of GDP per capita and annual rate of growth in SEEs

Region/ Country	GDP per capita in \$ (PPP, 1990)			Index 1989=100		Annual Rate of growth (%)		
	1989	1998	2007	2007	1998	1989/ 1998	1998/ 2007	1989/ 2007
A. Western Balkan	5248	3394	4229	80,6	64,6	-4.72	2.47	-1.18
Albania	2477	2807	4305	174	113,3	1.39	4.87	3.10
Bosnia &Herzegovina	4050	2645	4133	102	65,3	-4.63	5.08	0.11
Croatia	8001	6530	8789	109,8	81,6	-2.23	3.36	0.53
Macedonia	4202	3065	3502	83,2	72,9	-3.45	1.50	-1.01
Montenegro	4443	2357	2860	63,2	53	-6.80	1.97	-2.50
Serbia	5756	2672	3622	62,9	46,4	-8.10	3.43	-2.54
Members of EU(2007)	6320	6008	8809	139,4	95,1	-0.55	4.31	1.87
Bulgaria	6216	5644	7815	125,7	90,8	-1.07	3.69	1.27
Greece	10086	12511	15342	152,1	124	2.42	2.29	2.35
Hungary	6903	7434	9577	138,7	107,6	0.82	2.85	1.83
Romania	3941	3168	4670	118,5	80,4	-2.39	4.40	0.94
Slovenia	12340	12272	16866	136,6	99,4	-0.07	3.59	1.74
SEE	5994	5119	7401	123,5	85,4	-1.71	4.19	1.18
World	5140	5720	7311	142,2	111,3	..	..	..

Source: A. Maddison: *Contours the World Economy*, Oxford University Press, 2007.

In EU member countries the rate of growth in the analysed period used to be 4.2 percent yearly, which is the sign of return to the previous level of growth. Those rates are above the

EU growth rates and a sign that those countries are catching up with the rest of the EU. Table 5 shows that the GDP per capita in the region raised during the period of 18 years for 23, 5 per cent but this are the result of uneven growth of two regions. Countries, which are already in the EU have obtained the increase in GDP per capita of 39,4 per cent while Western Balkan countries suffered an decrease of GDP per capita for one fifth (index 80,6 per cent for the whole period). A poor performance of the whole region has been opposite with the world tendency of GDP per capita, which grew faster than in the region. In the year 1989 South Eastern Europe has got GDP higher than used to be in the world as a whole (for 16,6 per cent). In the year 2007 the region used to be only 1, 2 per cent above the world level of GDP per capita.

What countries contributed to such poor results of SEE Europe? The annual growth rate of GDP per capita shows that in the first period of transition (1989-1998) the negative growth rate of GDP per capita occurred. Few exceptions should be noted: Greece remained on the upward route, followed by Albania and Hungary. All other countries have got negative rate of growth: the largest being on the territories which experienced the economic consequences of the war.

In the second period of transition (1998- 2007) the situation has changed: all countries have obtained a sizeable increase in the GDP per capita. However, larger growth rates were in the countries which are already members of the EU than in WBCs which are on the way to be accepted in EU. Taking the whole 18 - year's period in analysis, Western Balkan countries have obtained a negative rate of growth of GDP per capita (regardless that there used to be an increase of GDP per capita in Albania, Croatia and Bosnia and Herzegovina). On the other side the new member states of the EU are witnessing rather modest increase in GDP per capita (1, 2 per cent yearly).

2. Comparative analysis of the performance of South Eastern Europe in the period 1989-2007

The world is witnessing unprecedented rates of growth in the second half of the 20th century (Madisson, 2007). In spite of the fast population growth in the period 1950-1973, the growth rate of GDP per capita is much higher in the period 1950-1973 (2,91%) than in the period 1913-1950 (1,82%). The same applies to the growth in the period 1989-2007 for which we have presented the figures for SEE in this paper. It is evident from the figures that the declining tendencies in the SEE population don't correspond to the world tendencies (see table 4). The increase of GDP is less than a third of the rate obtained in the world as a whole. Finally, GDP per capita has been growing in SEE countries in this period by a rate of growth which was 40% lower than in the world. The conclusion is clear: South Eastern Europe is lagging not only behind the world, but also the Western Europe and the USA. If we compare the figures of SEE with those of China and India as transition countries, the picture is rather depressing.

When comparing the performances of SEE countries in the analysed period we have observed huge differences in the rates of growth which could be only partly explained by

the war conditions in WBC. In order to find a proper answer for those differences we have tried to correlate the pace of privatisation with the rates of growth. Namely, some countries followed the principle of “big bang” approach in privatising the economy in short period of time, while the others were more caution. For example, in the year 2002 in Hungary about 80% of GDP was produced by private sector, compared with 65% in Slovenia, 45% in Bosnia and Herzegovina and only 40% in Serbia. In 2007, Slovenia and Croatia reached the level of 70%, Serbia 55%, Bosnia 60% and Macedonia 65% (EBRD, Report 2008). The speed of privatization was not correlated with the rate of growth and quality of privatisation was responsible for differences. This is, however difficult to measure.

Rising demand has contributed to a fast increase in trade deficit: it is reported in SEE’s every year. The FYR of Macedonia, Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo were particularly dependent on imports (Table 6).

Table 6: Trade balance of South Eastern European countries

	Exports (mil US \$)		Export	Trade Balance	
	2004	2007	per capita (US \$)	(million of US \$)	
			2007	2004	2007
A. Western Balkan	17.221	45591	1959	-22.625	-33.830
Albania	601	1.079	342	-1.583	-2.899
Bosnia & Herzegovina	2.087	9947	2834	-4.570	-5.704
Croatia	8.215	12623	2842	-518	-1.836
Macedonia	1.675	3350	1658	-8.346	-12.933
Serbia	4.082	17689	1857	-1.139	-1.627
Montenegro	561	903	1445	-6.469	-8.831
B. Members of EU	234227	179.227	4460	-15.113	-36.174
Bulgaria	18524	18.524	1913	-3.688	-10.141
Hungary	93434	93.434	9282	-3.555	435
Romania	40176	40.176	1863	-6.612	-24.138
Slovenia	27093	27.093	13479	-1.258	-2.330
TOTAL	279818	208.283	3693	-37.738	-70.004

Source: Eurostat, 2009

In 2007, the average of imports and exports relative to GDP registered a value of 40% for the EU-27. According to the available Eurostat data, lower levels were reported in Albania (35 % in 2005) and Kosovo (27% in 2006). On the other hand, significantly higher values were recorded in 2006 for the FYR of Macedonia (57%) and Montenegro (64%) while Croatia and Bosnia and Herzegovina also showed values above the average 50 per cent (Eurostat, 2009). Membership of Western Balkan states in the Central European Free Trade Agreement (CEFTA) and the associated bilateral free trade agreements used to be a sign of liberalizing trade relations that resulted in increased trade and investment linkages among the region’s economies. However, national statistics of those countries shows that

only a limited portion of total import comes from Western Balkan countries (in FYR of Macedonia 11, 7 per cent, in Croatia 5 per cent and Bosnia and Herzegovina 23 per cent). It is visible that the effect of CEFTA agreement in changing existing structure so far has been negligible.

Significant and rising imbalances in the trade and current accounts and a rising external debt constitute potential risks to macroeconomic stability. In SEE current account deficits continued to widen. Countries which experienced the largest deficit (Montenegro, Bulgaria, Romania and Bosnia) are not the countries with the fastest growth (see table 7).

Table 7: Current account deficit of South Eastern European countries

Region/Country	Current Account (mil US \$) deficit			Current account as percentage of GDP		
	2003	2005	2007	2003	2005	2007
Country						
A. WBCs	6022	7743	14190	-	-	-
Albania	399	726	1151	-6.7	-3.9	-3.6
Bosnia and Herzegovina	1629	1913	1939	-19.5	-17.5	-12.8
Croatia	2162	2555	4437	-7.2	-6.3	-8.6
FYR Macedonia	184	158	248	-4.0	-2.7	-3.2
Serbia	1532	2194	5285	-6.8	-8.6	-32.5
Montenegro	116	197	1130	-7.5	-8.4	-12.9
B. Members of EU	11390	22497	43312	-	-	-
Bulgaria	1022	3405	8592	-5.1	-12.5	-21.7
Hungary	6698	8418	8895	-7.9	-7.6	-6.4
Romania	3455	10054	23843	-5.8	-10.2	-14.4
Slovenia	215	620	1982	-0.8	-1.7	-4.2
TOTAL	17412	30240	57502	-	-	-

Source: EBRD, 2008

The current account deficit shows that all analysed countries were living above their capacity of economy and possibilities and the majority of them show the rising level of this deficit. This conclusion surfaced when we were presenting the total amount of deficit (expressed in US \$) for WBC and for SEE countries which had already joined the EU: they were doubling its current account deficit every two years. Current account deficits as a percentage of GDP in WBCs in 2007 ranged from 3, 6% in Albania to 32,5% in Montenegro, with Bosnia and Herzegovina and Kosovo recording values over 12%. In most countries, this percentage has increased since 2003, but reductions were seen in Albania (almost 3 percentage points) and Bosnia and Herzegovina. This deficit is financed by increasing net capital inflows. The SEE region as a whole has obtained a sizable amount of foreign credits and FDI (table 8).

Relatively large flows of FDI entered into SEE countries, however on very uneven level. Even though FDI flows did not contribute largely to growth of SEE economies at the beginning of 1990s. Privatization FDI did not show any signs of contribution to the GDP growth; however, more benefit is expected with the end of privatization through Greenfield investment with direct and immediate effects on employment and output growth (Jovančević, R. and Šimurina, J. 2008).

At the global level, FDI inflows reached an estimated \$1.8 trillion in 2007, surpassing the previous record level of 2000 (WIR, 2008) with a rise in flows to South-East Europe. The financial and credit crisis that started in the latter half of 2007 has not substantially affected FDI inflows to the region thus far. In fact, between 2004 and 2007, total FDI net to transition economies nearly doubled, from \$15, 7 billion to a \$30, 4 billion.

Table 8: Foreign direct investments in South Eastern Europe (SEE)

Country/Region	FDI net (in millions of US \$)		Cumulative inflows (millions of US \$)	Per capita inflows (US \$)
	2004	2007	1989-2007	1989-2007
WBCs	2791	10541	42509	1790
Albania	324	641	2655	830
Bosnia & Herzegovina	708	2023	5124	1464
Montenegro	63	717	1986	3150
Croatia	732	4644	18515	4208
FYR Macedonia	322	321	2234	1106
Serbia	966	2195	11995	1225
Members of EU	12933	19816	125377	2375
Bulgaria	2879	8154	29444	3770
Hungary	3405	2197	48557	4810
Romania	6368	9818	44894	2060
Slovenia	281	-353	2482	1240
Total SEE	15724	30357	167886	2205

Source: EBRD, 2008

Cumulative inflows of FDI for the period 1989-2007 in SEE reached almost 170 billion US \$, but was unevenly distributed by the countries. Calculation on per capita basis shows that the SEE countries, members of the EU, were able to attract 33 per cent more FDI per capita than countries in WB. As far as countries concerned, the largest inflow per capita in this period was in Hungary (4810 \$) followed by Croatia (4208) and Bulgaria (3770\$). The smallest inflow of the FDI per capita was in Albania (only 830 \$), Macedonia (1106) and Serbia (1225). Slovenia, as the most developed country of the region attracted only 1240 \$ per inhabitant. However, the correlation of FDI per capita with the growth rate of economies exists, dependent on the time- lags between the entrance of FDI and increase of GDP, although not a high one.

The analysis of the structure of FDI projects in SEE showed that manufacturing is the main investment activity. However, the leading investment sectors in SEE have been food, business-to-business services, non-metallic mineral products, automotive components, electronics, plastics and chemicals. The top four fastest growing sectors in both SEE and the Western Balkans are: business services, plastics and rubber, transport services, and machinery and equipment (World Bank, 2007).

2.1. Impact of remittances on South-Eastern European Economies

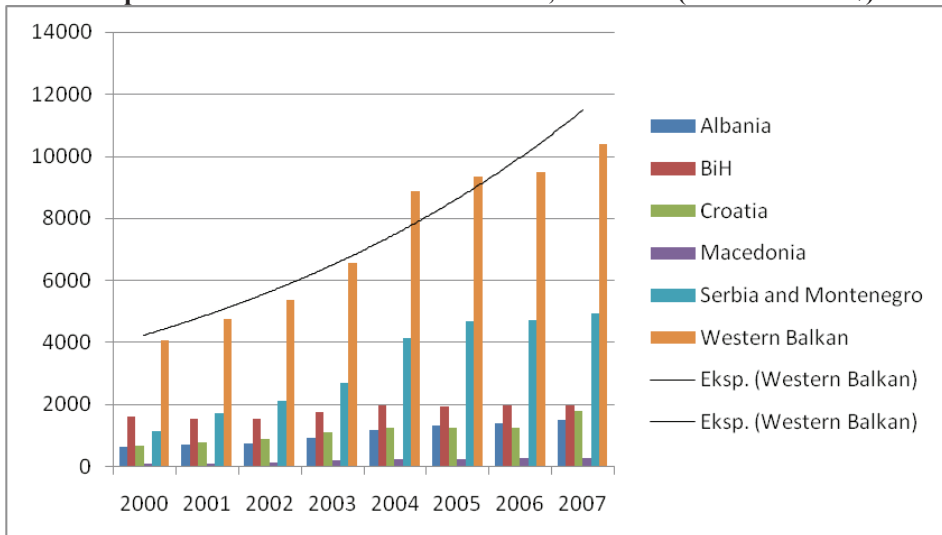
There is also a link between remittances and trade deficit. The remittances have impact

on a larger trade deficit; mainly financing private consumption of imports. For most SEE countries remittances are, after the foreign direct investment, the most important source of external finance. Compared with the GDP of countries of South-Eastern Europe, remittances add approximately 7 per cent to the recorded GDP (World Bank, 2008). The remittances are the most important source of consumption in Bosnia and Herzegovina (17.2 per cent of GDP); very close to this high percentage are Albania (14.9 per cent of its GDP) and Serbia and Montenegro (13.8 per cent). Those percentages are placing these countries among the top remittance-receiving countries in the World. The developed countries in this region rely considerably less on remittances as a source of domestic consumption (Hungary 0.3 per cent, Greece 0.6 per cent, and Slovenia 0.9 per cent).

The data of the World Bank shows that during the analyzed period of eight years in South-Eastern Europe, the inward remittances have increased three fold, from USD 6.9 billion to USD 21.2 billion. The remittances to the Western Balkan have more than doubled in the period from 2000 to 2007 (from USD 4.1 billion to USD 10.4 billion).

Graph 2 shows remittances by countries in the Western Balkan region. In Serbia with Montenegro, the remittances more than quadrupled in the period analysed (from USD 1.1 billion to USD 4.9 billion), while Bosnia kept the same level from 2004 to 2007 (USD 1.9 billion). In Croatia, remittances more than tripled (from USD 0.6 billion to USD 1.8 billion) and Albania received USD 1.5 billion from remittances in 2007 alone. However, remittances could not be a substitute for a sound economic and social development policy.

Graph 2: Remittances in Western Balkan, 2000-2007(millions of US \$)



Source: The World Bank, Migration and Remittances, Fact Book 2008.

Note: Migrant’s remittances are defined, by official international methodology, as the sum of workers’ remittances compensation of employees and migrants transfers.

South-East European countries are opening themselves to the free movement of goods and services, but have also a freer entrance of foreigners and professional workers. In the 21st century, according to the data available, increasing number of foreigners will be working in this region and accordingly, more and more outward remittances are registered

in their balance of payments. Between the year 2000 and 2006 the total amount of outward remittances increased from USD 755 million to USD 1,779 million, what means increase of 2.4 times (without Serbia and Montenegro). It is quite likely that inflow of foreign capital will further increase the size of outward remittances.

3. What might be the impact of world economic crisis to the SEE countries?

Prevailing labour market conditions have led to rising unit labour costs and a demand for greater labour market mobility and increased labour force participation. The survey of the Gallup running out in 2008 shows that approximately 20% of the respondents from the West Balkan countries would like to move to another country with the exception of Croatia, where only 7% would like to move temporarily or permanently abroad. The extremely incentive to mobility is evident in Kosovo, where three-quarters of interviewees thought there were better opportunities abroad (Balkan Monitor, 2008).

Looking at the evolution of wages in the period from 1998 to 2006, nominal wages and salaries increased in all countries: they have increased by a third in Serbia (from 169.7 to 233.3 EUR) and almost 60 % in Croatia (from 578.6 to 905.7 EUR), 80% in Bosnia and Herzegovina (from 150.3 to 275.1 EUR) and by 40 % in Montenegro (from 173.9 to 246 EUR) – Eurostat, 2009. However, in the conditions of global crisis it would be impossible for wages to continue growing. On the other hand, the unemployment rate has risen in 2009, as a consequence of the economic crisis. In all SEE countries, unemployment rates were higher in 2007 than the EU-27 average, with the highest values of almost 44% in Kosovo, 35% in the FYR of Macedonia and 29% in Bosnia and Herzegovina followed by Montenegro with a 19.3 % rate and Serbia with an 18.3 %. The lowest values were recorded in Croatia with an unemployment rate of 9, 6% (Eurostat 2009). The Western Balkans’ countries have not succeeded in combating unemployment, because of the economic crisis and the lack of possibilities for development. The consequences of unemployment are: the emigration of intellectuals (brain drain), more illegal work, higher levels of violence and drug trafficking, and generally, increased criminality.

Table 12: Unemployment rate ¹ in EU and Western Balkan states

	1999	2000	2001	2002	2003	2004	2005	2006	2007
EU-27	..	8.7	8.5	8.9	9.0	9.0	8.9	8.2	7.1
Albania ²	18.4	16.8	16.4	15.8	15.0	14.4	14.1	13.8	..
Bosnia-Herzegovina	..	39.7	40.0	41.1	41.6	41.8	43.9	31.1	29.0
Croatia	14.5	17.0	16.3	14.7	14.1	13.6	12.6	11.1	9.6
FYR Macedonia	32.4	32.2	30.5	31.9	36.7	37.2	37.3	36.0	35.0
Serbia	14.5	13.3	13.3	14.5	16.0	18.7	21.1	21.1	18.3
Montenegro	19.3	19.3	21.2	20.7	22.7	27.7	30.3	29.6	19.3
Kosovo	..	..	57.1	55.0	49.7	39.7	41.4	44.9	43.6

Source: Eurostat, 2009; (1) proportion of the labour force aged 15-64 in unemployment (%); (2) data refers to registered unemployment

The present recession is spreading pervasive effects throughout the global economy that go well beyond substantial declines in GDP (expected contraction by 1.7 per cent in 2009),

and world trade in goods and services is expected to drop 6.1 percent in 2009, with sharper contraction in trade volumes of manufactured products (World Bank, 2009). Commodity prices have halved, generating sizable shifts in terms of trade and current account positions, while rapidly lowering domestic inflation across the world. Large financing gaps on balance of payments are emerging in number of countries, which are increasingly likely to require large-scale support from official sources. The crisis is already taking its toll:

a) The rates of growth are becoming negative. The growing integration of the SEE into the global economy, in spite of the benefits, has also increased the global exposure to world recession. Europe has been most negatively affected by recent developments, with an expected 2 percent contraction of GDP in 2009, compared to 4.2 percent growth in 2008 (World Bank, 2009). Slower growth in response to falling demand from the developed countries in the 2008 and 2009 will effect growth in the SEE. In the foreseeable future SEE countries will be facing a difficult tasks of having to obtain the same growth rate with smaller foreign credit infusion, while being based mainly on the domestic resources. That implies a considerable change in the economic policy.

b) The exports are falling. The structure of exports in the transition region is dominated by a lower value –added goods and commodities, which may be less sensitive in the conditions of global slowdown. The adjustment process in the SEE countries will be especially difficult, because the exports to the EU area are declining, and remittances from the European Union are falling. Some countries of the region will continue to run excessive current account deficits combined with higher proportion of domestic debt in foreign currencies. The balance of payment deficit in some countries of the region demonstrates their weakness by tighter external financing, lower consumer confidence and declining asset prices. It may be supportive that in the global crisis SEE will have access to EU pre-accession and structural funds in the context of adjustment process of EU candidate countries.

c) The levels of FDI in the world are considerably lower. The financial stress should be the highest among those countries which have been drawing foreign capital for a long time, in order to provide growth and domestic lending. Some countries which have entered the global financial crisis with current account deficits in excess of 8 percent of GDP would be especially vulnerable to a reversal of capital flows.

d) Credits are scarce and the costs of borrowing are and will be much higher.

CONCLUSION

The world economic crisis poses new challenges to the economic policies of South Eastern Europe. Stronger mutual ties of SEE countries might alleviate some troubles lying ahead caused by rising protectionism in the developed countries. Government countries of the region should create a new economic viable policy to respond to the new global circumstances.

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REGIONAL INTEGRATION OF UKRAINE IN THE CONDITIONS OF GLOBAL ECONOMIC CRISIS

Abstract

Problems of Ukraine's regional integration in the current financial crisis conditions are under review. Characteristics are given to the impact the world financial crisis has on development of Ukraine's economy. Distinguished are the peculiarities of the state's European integration processes, including the perspective creation of a free trade zone with the EU.

Key words: *world financial crisis; regional integration; Ukraine; European integration; economic growth; gross domestic product.*

INTRODUCTION

Problems of regional integration are extremely important for the nowadays development of the Ukraine's country and determination of its place in the world. The world financial crisis is a real explosion for both the developed countries and the economies in transition. National economic and political disturbances taking place in Ukraine make the situation in the country anything but simple. Ukraine is not only geographically a European country. There is no need to prove its European identity from the historical, economic and political perspective. Unfortunately, at this point there is still no clear signal from the EU as for the perspective of Ukraine's membership, including terms and conditions of such membership.

1. World financial crisis and developments in Ukraine

Evolution of the world financial crisis 2008-2009 cannot but engage Ukraine. The point is also that as well as during the world financial crisis 1997-1998 Ukraine has a lot of its own aggravators in the form of the internal economic and political crises.

When estimating the current world financial crisis one can already make a conclusion that it makes the most serious and large-scale breakdown since studies of crises by the international economic science began. Traditionally, economic theory tracks the beginning of economic crises to 1825. But even the so called Great Depression 1929-1933, by both its intensity and consequences, now lags behind the crisis set to break out in 2008. As long as the Great Depression was characterized by an unprecedented fall in industrial production

(46%) and duration (37 months), it did not embrace the monetary sphere to such extent – from an exchange rate formation to a collapse of financial and banking institutions. The modern world economy is a more complex formation as compared to that existing in the times of the Great Depression. And currently the magnitude of a fall or a rise of industrial production is not the main indicator of the crisis' destructiveness.

Based upon the theory of a cyclic development, the world financial crisis 2008 is essentially in conformity with the ideas of economic cycle and its stages. The regular world economy develops in this very way – cyclically. Therefore, however cynically it may sound, crises are an absolutely natural state of the international economic development.

By some evidence, the first signs of the impending crisis began to show up as yearly as in 2002-2003. Already in early 2005 and up to 2007, that is over a period of 2-3 years, an absolutely unpredictable situation in the financial field could be observed (first of all the euro-dollar ratio, whereby the exchange rate of the euro rose significantly). This is the first reason. The second one is the considerable appreciation of real estate in the world, mortgage crisis in the US and so on. The third reason is the food cost: food supplies went down and it started going up in price.

Those three factors – dollar-euro, real estate costs and the food crisis –were the reason why the world shook with fever. Here one should add the so called derivatives which are more virtual than real money.

As for Ukraine, here we can see a situation which cannot be expressly estimated. Firstly, in the course of all years of its independence exactly in 2008 does Ukraine possess a market economy with the most highly advanced attributes and a corresponding degree of integration into the world economy. Secondly, the domestic economic and political crises started well before the most prominent showings of the world financial crisis, including its direct impact on Ukraine. Thirdly, the de facto repudiation by the political and economic authorities of the impact the world financial crisis has had on Ukraine proved to be one of the obstacles to a prompt formulation of an AP to mitigate such an impact.

The very development of the internal crisis in Ukraine has somewhat wimped the world crisis. And besides all other things, Ukraine faced the autumn 2008 completely unprepared to the severe impact of the external disturbances.

The first serious impacts of the world financial crisis came up to Ukraine as far back as in late summer. Here the case in point is the export businesses – metallurgy, chemical industry and so on. In addition, as for Europe Ukraine's exports is somewhat specific. When giving a correct estimate of what constitutes a Ukrainian export – 50% of the exports throughout the years of independence – one should say that it is crude products. Whereas in developed countries 80% of exports is made of manufactures. In fact the structure of Ukrainian exports is typical for the African states, but not for a country that is geographically situated in Europe and strives to become a member of the EU.

As for the correlation (balance) between the major world currencies, a few observations can be made. First, dynamics of euro-dollar is changing sure enough and nobody,

including experts from the FRS and the ECB, makes an attempt to predict it for this or that direction.

Second, from the point of customary Ukrainian depositors (who are not professional players on the exchange market) attempts to transfer hryvnya assets into dollars, dollars into euros and so on are more likely to work harm than benefit. Third, when looking at the interest rates one can make a conclusion that even with the inflation taken into account, interest payments on hryvnya deposits are still higher than those on the foreign exchange currency.

Apart from the above examined single issues connected with the Ukrainian crisis and the impact of the world financial breakdown on Ukraine, there exists a nation-wide level on which developments can be affected.

The country must understand that not only domestic economic and political problems but also the external disturbances are of a destructive nature.

1. On the political and social levels one should honestly tell the people of Ukraine that the situation is not just difficult, but also such that will probably be aggravating. As judged by the dynamics of the internal and external processes, Ukraine has not yet reached the lowest point of the crisis (the so called “bottom”). At the same time it is still difficult to predict for how long the country will be in the state of depression and when the recovery and expansion will start.

2. One must do their utmost to mitigate social consequences of the crisis for the poorest. A panic on the cash foreign exchange market is not only economically ungrounded but also artificially maintained. Both problems with a number of commercial banks and general restrictions on withdrawal of deposits equally undermine confidence in the country’s political and economic management.

3. Apart from the lack of a general strategy of overcoming the current crisis, Ukraine has no estimates as for a possible increase in the unemployment rate and the amount of funds necessary for making redundancy payments, as well as the sources of such funds. Analysis of a decrease in public financing of social and cultural sphere should also be made.

4. The state must realize once and for all that the harmed export-oriented industries contribute over 47% to the GDP of the country. And backing-up those industries has to become a priority that overcomes any political likes and dislikes of the government.

5. On the nation-wide level questions of economic security must be solved. The first in the rank here are external issues – from energy prices to the banking system protection (with the foreign share in this system taken into account).

6. At last, actions aimed at minimizing consequences of the world financial and internal crises should be viewed from the point of a possibility of their practical implementation. At the same time such actions should not be presented as a political (successful or not, but still political) project.

The world will certainly overcome the global financial crisis 2008. As due to any other

crisis, changes in the balance of power will take place. Taking into account everything that is now going on in the world, taking into account all the depth of the economic and political disturbances, difficulties arise when trying to predict a new alignment of forces. And for Ukraine it is important not only to minimize the impacts of the world financial crisis, but also to make an attempt and find its appropriate place in the new, post-crisis alignment of forces.

2. Ways of Ukraine's European integration under current conditions

Ukraine is not only geographically a European country. There is no need to prove its European identity from the historical, economic and political perspective. Unfortunately, at this point there is still no clear signal from the EU as for Ukraine's membership perspective, including terms and conditions of such membership.

At the same Ukraine shouldn't get caught in an endless loop waiting for membership in the EU. There are examples of successful countries (those very Switzerland or Norway) which are not members of the EU, but nobody tries to dispute their European identity. This very example does not exclude a Ukraine's way of raising the maturity of its economic and political systems, achieving by it the level of the European countries, notwithstanding whether Ukraine is officially a member of the EU or not.

The legal basis of Ukraine-EU relationship is Partnership and Cooperation Agreement (PCA) signed for the term of 10 years. On March 5, 2007 Ukraine and the EU started negotiating a new framework agreement with an interim working title "new enhanced agreement" (NEA) between the EU and Ukraine. Until PCA is signed, NEA is extended by stipulation on a yearly basis.

Currently the following institutes of cooperation are in operation:

1. Summit EU-Ukraine (with the participation of the President of Ukraine and the EU Trio composed of: a prime-minister or a head of the EU presiding state, the President of the European Commission (EC) and the High Representative of the EU on the common external and defense policy);
2. Cooperation Council (with the participation of the Prime-minister of Ukraine and the EU Trio composed of: a minister for foreign affairs of the EU presiding state, the President of the EC and the High Representative of the EU on the common external and defense policy);
3. Committees and sector sub-committees on cooperation;
4. Committee on parliamentary cooperation.

Besides, regular Ukraine-EU Trio and expert consultations are carried out. In aggregate, over 80 official meetings and consultations on the highest and expert levels between Ukraine and the EU annually take place.

At the same time the EU avoids answering questions as for Ukraine's membership perspective. In its documents Brussels only "recognizes European aspirations of Ukraine and welcomes its European choice". The EC mandate letter for negotiations with Ukraine on Association Agreement between the EU and Ukraine states that its execution "shall not

determine in advance the future development of relations between the EU and Ukraine”. In fact the EU will try to institutionalize the NEA as an alternative to the EU expansion having secured Ukraine’s part as one of the states leaders in implementation of the ENP.

With that, understanding of the inadequateness of the ENP and a tough stance of Ukraine led to a start, inside the EU, of a search for Ukraine’s new status in its relationship with the Union. The evidence thereon is Ukraine’s “association partnership” with the EU proposed by France.

The question of outlining the membership perspective has not only an important political or geostrategic meaning, but also opens a range of extremely important economic, legal and other aspects which has direct influence on both the nature of the bilateral relations and the solution of a series of practical issues. The point at issue is in particular the prospect of abolishing visa requirements, granting pre-accession assistance, “screening” of laws, asymmetric opening of markets, access to the internal procedures of the decision making, etc.

That is why the question concerned remains important for Ukraine in its dialogue with the EU. Keeping it on the agenda makes the Union look for additional tools to secure constructiveness and appropriateness of its position.

On 21 February 2005 during the session of the Council on cooperation Ukraine and the EU signed a three-year AP (AP) – a bilateral political document containing measures on extension of political cooperation and enhancing of economic integration of Ukraine and the EU. At the same time one should note the significant imbalance of the parties’ actions and liabilities within the AP, according to which Ukraine takes an overwhelming majority of liabilities in the field of internal democratic changes, economic reforms and adjustment of national legislature to the norms and standards of the EU in a serious of economic sectors. The EU’s contribution to implementation of the AP is the following:

- technical and financial assistance within the new assistance mechanism “European Neighborhood and Partnership Instrument”,
- proclaiming Ukraine a market economy in the context of antidumping probes (February 2005),
- delivery of an agreement on a simplified issuance of visas (June 2007, implemented on 1 January 2008),
- enhanced cooperation in the sphere of regional security (the mechanism of joining the EU statements on international issues, founded in 2005),
- enhanced cooperation in Transnistria solution,
- European Investment Bank’s financing programmes extended to Ukraine,
- Enhancement of sector cooperation (energy, transport, science and technology), Ukraine’s participation in topical programmes and agencies of the EU.

The major contribution of the EU to the AP is the proclamation of the perspective of enhanced economic integration of Ukraine (access to the internal market of the EU) after a due implementation of domestic economic and political reforms. One should note the vital difference between the views of Ukraine and those of the EU on the ultimate goal of their cooperation within the AP: if the EU considers it an instrument of Ukraine’s involvement

into the ENP, Ukraine in its turn considers the Plan as a preparatory stage of bringing its bilateral relations with the EU on a brand new level, transition from the principles of cooperation and partnership within the PCA to principles of a political association and economic integration within the NEA. Execution of this agreement on the basis of those principles should create the prerequisites for a preparation of Ukraine's membership in the EU. Expiration of the EU-Ukraine AP raised the question of its future. Europeans voted for its unconditioned extension. Such a stance could be explained by the EU's fears that the cancellation of the AP with Ukraine would be considered evidence of a "collapse" of the ENP and will have the same consequences for the APs with other EU neighbor countries. Ukraine in its turn voted for making a common appraisal of the AP in accordance with its principle of common property and responsibility. After long negotiations this proposal was accepted by the EU.

In the field of a regulatory cooperation arrangements on the Ukraine's joining Agreement on Conformity Assessment and Acceptance of Industrial Products (ACAA), preparation for the launch of an industrial dialogue to stimulate small and medium enterprises, cooperation in agricultural production, sanitary and phytosanitary. The questions of appropriate preparation of Ukraine's industry to operation under the new EU legislation on registration, evaluation, authorization and restriction of chemical substances (REACH), starting a separate dialogue on utilization of geographic marks, benefiting from the EC expert assistance in the elaboration of Ukraine's tax code become increasingly urgent.

The political declaration to the aforementioned Agreement provides for an execution of bilateral treaties between Ukraine and Poland, Hungary, Slovak Republic and Romania on the rules of the local near-border movement for the residents of the border areas. An important achievement of the Ministry for foreign affairs in the first half of 2008 was the successful implementation of the Treaty on the light near-border movement with Hungary, signing of an analogous treaty with the Slovak Republic and the launch of negotiations on the same issue with Romania.

The treaty on readmission between Ukraine and the EU regulates procedures connected with identification and return of the citizens of Ukraine and the third countries, stateless persons who entered or stay on the territory of the EU illegally. The matter of principle in the agreement is reaching a compromise by the parties as for setting up a two year transition period concerning return of the migrants from the third countries back to Ukraine, which will give time for creation of the relevant institutional capacities in the sphere of migration management and strengthening of the border control.

In the course of a session of the ministers of justice and internal affairs of Ukraine and the EU Trio (Luxemburg, 11.06.2007) Working agreements on establishment of operational cooperation between State border service of Ukraine and the European Agency on management of operational cooperation on the external borders of the EU (FRONTEX) members were concluded. The priority directions of their implementation were specified. One of the most acute issues in this sphere remains the resumption of a joint border and customs control on the territory of both Ukraine and the EU states due to the accession of new nine EU members to the Schengen zone. In the course of the 10th session of the

Committee on cooperation between Ukraine and the EU (November 2007, Brussels) a proposal as to establishment of expert consultations with a view to achieving the relevant agreement between the EU and Ukraine was made.

The strategy on cooperation between the EU and Ukraine in the sphere of energy is set forth in the provisions of Memorandum on mutual understanding as to cooperation in energetic signed December 1, 2005. The memorandum embraces the following spheres of extended bilateral cooperation:

1. Nuclear safety.
2. Integration of the electric energy and gas markets.
3. Enhancement of security of energy supply and transit of carbon dioxides.
4. Structural reform, rise of standards of occupational safety and protection of environment in the coal mining industry.
5. Energy efficiency.

Significance of the Memorandum is in the common tasks of the EU and Ukraine energy policy which are directed on the implementation of strategic interests in the sphere of diversification and safe supply of energy resources as well as electric energy. The Memorandum also declares Ukraine's membership in the Treaty on energy cooperation (TEC) which came into force on 1 July 2006. In July 2008 the EC won a mandate to set up negotiations in the framework of Ukraine's preparation for its accession to the TEC. First consultations on Ukraine's accession to the Energy community took place on 16-18 September 2008.

The most urgent question of Ukraine-EU cooperation today is holding negotiations on Agreement on Ukraine's associate membership instead of the Partnership and cooperation agreement which shall include a clear prospect of a free trade zone creation between Ukraine and the EU.

In comparison with the present PCA the Agreement on the association with the EU is a completely new, enhanced pattern of relations between Ukraine and the EU. The basis of political association is the convergence of Ukrainian and the EU positions on all questions on international peace and security, provision of Ukraine's direct participation in the EU policies, agencies and programs, joint efforts as for insurance of Ukraine's national security. The basis of economic integration is the creation of an enhanced and comprehensive Free trade zone EU-Ukraine on the grounds of the four freedoms which will lead to a stage by stage integration of Ukraine into the EU internal market.

In the course of the summit agreements on the addition of provisions putting in a practical mechanism of provision by the parties of the principles of independence, territorial integrity and inviolability of borders, as well as the obligations as to adherence of these principles for third parties, to the Agreement were achieved. Therefore the Agreement on association sets up a legal basis for a transformation of the EU into a guarantor of Ukraine's national security, which is extremely important today in the region. Besides, this sets up the prerequisites for bringing Ukraine-EU relationship to a level of the allied practical partnership in the sphere of security.

3. Creation of a free trade zone with the EU

Year by year trade turnover between the EU and Ukraine and a flow of foreign direct investments from the EU to Ukraine keep rising. Since April 2007 active measures have been taken as for creation of a legal basis for Ukraine-EU enhanced cooperation. Significant progress in negotiations on the economic and sector parts of the Agreement on association have been reached. Inter alia, a project of a set of provisions on several sector questions has been worked out.

After solution of the issue of export tariffs with the EU (16 January 2008) the Protocol on Ukraine's accession to the WTO was signed. In these circumstances official negotiations on the creation of an enhanced and comprehensive EU-Ukraine free trade zone was officially set up on 18 February 2008 pending the visit of the member of the EC on trade P. Mendelson to Ukraine. Provision on the FTZ shall specify the legal basis for a free movement of goods, services, capital and partially labor force between Ukraine and the EU as well as regulatory adjustment aimed at stage by stage integration of Ukraine's economy into the EU common market. The first round of negotiations on creation of the FTZ took place on 23-25 April 2008 in Brussels.

Setting up of a dialogue on foreign trade statistics, clarification and cancellation of reasons for discrepancies in statistical data remains an up-to-date issue. Building-up a negative trade balance of Ukraine with the EU has also stressed the importance of settlement of a complex of questions concerning access of Ukrainian goods to the EU market.

From the point of the geo-economic development of Ukraine the problem of the FTZ with the EU is of great importance. The key element of the enhanced agreement should become the chapter on the FTZ. Discussions on creation of the FTZ have been held since 1999 when the research made by the EC found it unpractical due to the low economic development of Ukraine.

Given first of all the political interests, the EU is not ready to offer Ukraine a prospect of membership. There are no real signals as for that when Ukraine will obtain a prospect of membership. However, the EU cannot leave it out of its integration processes. A FTZ is a standard instrument of cooperation with the third countries.

Negotiations on abolishing customs tariffs between Ukraine and the EU shall be based on the agreements within the WTO. And after admission of Ukraine to the WTO one can talk about implementation of the FTZ.

Adjustment to the EU standards and norms will make it possible to cancel the barriers in the short-run perspective and to increase access to the markets of the EU in a middle term. But in this case a classic FTZ shall make a limited positive impact on Ukraine's economy.

In 2004 a group of independent experts worked out a new form of economic and trade cooperation between Ukraine and the EU through "enhanced free trade" (or free trade zone +). As opposed to the classical free trade zone, the one with "+" means not only the abolishment of customs duties, but also liberalization of trade in services and adjustment

of Ukraine's regulatory environment to that existing in the EU. This formula will bring the bilateral relations beyond the existing agreements between the EU and other countries that do not lay claims to membership (for instance, Chili or the Mediterranean countries).

Negotiations on creation of the free trade zone between Ukraine and the EU officially started on 18 February 2008. Provisions on the FTZ will become a part of a new enhanced agreement between Ukraine and the EU. They will specify the legal basis for a free movement of goods, services, partly work force between Ukraine and the EU, as well as for a regulatory adjustment aimed at a stage-by-stage integration of Ukraine's economy into the EU Common Market.

The second round of negotiations on creation of the EU-Ukraine free trade zone took place on 23-25 April 2008 in Brussels. In its course the parties agreed a set of areas in which the first projects of articles be drafted as well as outlined the framework vision of the depth of the mutual agreements. Agreements shall include definite provisions on creation of a free trade zone. The stress was made on adaptation and adjustment of Ukrainian legislation to the *acquis communautaire* (EU legislation) in the corresponding spheres.

The third round of talks on creation of free trade zone between Ukraine and the EU took place in Kiev on 7-11 July 2008. The negotiation was a stage-by-stage discussion of the following issues:

- Trade of goods (instruments of trade protection, tariffs, technical barriers in trade, customs issues and facilitation of trade);
- Sustainable development and trade;
- Intellectual property rights (including geographical names);
- Trade in services;
- Government purchases;
- Competition (state assistance, antitrust legislation).

Further to the third round agreements were reached that the EU will consider providing Ukraine with financial assistance to promote reforms connected with implementation of the provisions on the FTZ. Besides, the EU informed Ukraine on the work of the EC on drafting the approaches as to the implementation of norms of regulatory adjustment considering necessary changes on the institutional and/or on legislative level.

By offering free trade the EU so allows Ukraine to get access to its markets of goods, services and capital and to get a prospect of economic integration. At the same time one should not forget about economic interests which the EU will protect while holding negotiations on the FTZ.

Large producers of agricultural products in France, Spain and Italy are worried about increased competition with Ukrainian goods; therefore they might demand an exclusion of agricultural products from the FTZ. Similar concerns are expressed by producers of non-ferrous metals and chemicals in Germany and France.

In this context one should remember about possible consequences of Ukraine-EU FTZ for

relations with Russia. The advocates of integration of the countries of the former USSR consider that the enhanced trade and economic cooperation with the EU will prejudice relations with Russia. Nevertheless Russia itself is interested in creation of an FTZ with the EU within the framework of one of the four common “road-maps of cooperation” with the EU.

Therefore the issue of impeding creation of an FTZ between Ukraine and the EU should be transferred from the political to economic area. This will be an ordinary competition between the two countries for the EU market with its 450 mln of consumers. Besides, for Russia an FTZ with the EU is a primary instrument of expansion of exports, while Ukraine considers it to be an instrument of domestic reforms.

Hence, for Ukraine creation of the FTZ is on the current stage the most optimal way of integration into the European community, which will facilitate the maturity of the national economy up to the standards of the EU. Meanwhile the decision on the comprehensive accession of Ukraine to the EU remains in a purely political sphere and should not prejudice the development of the FTZ.

The status of a transit country in terms of the energy products flowing from Russia to Europe and the allknown events of January 2009 also underline the economic component of the relations between Ukraine and the European countries. There is a number of other extremely important directions of further development of the economic component in the relationship between Ukraine and the countries of Europe.

CONCLUSION

Already now we can say, from the point of the economic theory and practice, that the current crisis has practically an unprecedented character. And now it is quite difficult to predict its scales, term and dynamics. Given such an uncertainty one can expect volatile movements of the commodity prices, foreign exchange rates, etc. All this contributes to a destabilization of economic situation and aggravation of a state of uncertainty.

Analysis of the first year of the world financial crisis shows that the letter goes on under conditions of extremely high interdependence of national economies. And this means that the crisis spreads quickly in the international economy, involving practically all countries. Therefore the crisis gets a universal character with all relevant consequences.

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ANALYSIS OF THE MACROECONOMIC EFFECTS OF THE EUROPEAN INTEGRATION AND THE EU-TRANSFERS

Abstract

A macroeconomic model suitable for both mid- and long-term forecasts and scenario analysis, can be a useful decision making tool for the economic policy. Several modelling methods and other techniques were published which can be useful to estimate the impact of the integration and the EU transfers. The HERMIN model family was developed especially for the new members of the EU and the candidate countries. These models focus on the macroeconomic effects of the accession and the financial support received from Brussels. We have developed in our institute (ECOSTAT) the so-called ECO-TREND calibrated model for analyzing the Hungarian economy using the modelling experiences of the HERMIN models. The assessment of the model parameters has been either based on standard statistical methods, or on experts' estimations. Our modelling experiences could be useful for the countries of the Balkan region in order to create their own HERMIN type models. In the last section of the paper forecasts are presented until 2020 completed by the analysis of three different macroeconomic scenarios based on different drawing rate and structure of expenses of EU transfers, which play a significant role in the long-term convergence of Hungarian economy. The paper presents several channels through the transfers can be effective.

Key words: *European integration, EU transfers, macroeconomic modelling, HERMIN models, scenario analysis, long-term model*

INTRODUCTION

It is important to take in consideration what role the European integration and the EU-transfers in the convergence process play in the new EU member states and the Balkan countries. Several modelling methods and other techniques were published which can be useful to estimate the impact of these two mentioned factors. The HERMIN model family

was developed especially for the new members of the EU and the candidate countries. These models focus on the macroeconomic effects of the accession and the financial support received from Brussels. We have developed in the Department for Economic Modelling of the ECOSTAT Institute the calibrated model ECO-TREND for analyzing the Hungarian economy using the modelling experiences of the HERMIN models. Our modelling experiences could be useful for the countries of the Balkan region in order to create their own HERMIN type models, especially because these countries are receiving a large amount of supports during the next years, and this may raise the growth rate and further the convergence in case of an appropriate use of the transfers. Therefore, the present paper focuses on the effects of EU transfers on the catch-up process, after a short overview of evaluation techniques known from the literature.

Paper is organised as follows. Firstly, an overview on the system of EU-supports is given focusing on the structure and targets of the Structural and Cohesion Funds with special emphasis on Hungarian aspects by presenting the targets and measures of the actual programming period. Secondly, the evaluation methods known from the special literature will be discussed. Then, the main causal relations built in the model 'ECO-TREND' will be presented focusing on the effects of the EU-transfers. Finally, the effects of the EU-transfers on the catch-up process of the Hungarian economy will be analysed, where both the baseline and alternative scenarios will be presented.

1. The effects of the EU-transfers on the long-term growth

The endogenous theories of growth occurred in the 80s. They criticised the basic assumption of Solow's model stating that the technical development is an exogenous condition for the national economy. Romer (1986) observed that the economic development is a function of the fixed capital with increasing and not with decreasing return. This recognition catalysed the emergence of endogenous growth theories.

The endogenous growth models focus on technical development in the long-term growth, i.e. the R&D activities and the development of the infrastructure are considered as the basis of the long term catch-up process. Since the EU-transfers are concentrated basically to these areas, they relevantly contribute to the economic growth and speed up the catch-up process. In order to examine this, we survey below the structure of use and the main targets of the EU-transfers.

One of the main purposes of the EU is to promote the economic development of the member states and to support the catch up of the less developed regions and member states, to eliminate the different development levels, to strengthen thus the economic and social cohesion. The financial means available for cohesion policy since 2007 are structural funds (namely the European Regional Development Fund and the European Social Fund) and the Cohesion Fund serving to achieve the above purposes by means of granting capital transfers. The principle of additionality is an important point of view, stating the minimum level of state development investments the given member state has to realize out of own resources in order to prevent union resources from ousting other state investments of the

given state. The handling of this issue has been tightened up strictly since 2007, namely, the receiving country which cannot fulfil the additional expenditure purposes has to pay back the received EU subsidies.

The establishment of the Cohesion Fund was ordered by the Maastricht Treaty. It supports the catching up of the most underdeveloped member states of the Union in the period of the preparation for the monetary union. The main purpose is to strengthen the economic and social cohesion and to decrease the difference among the development levels of the different regions. The resources of the cohesion funds are available for those EU member states where the GNP per capita calculated at purchasing power parity does not reach 90 percent of the EU average.

Regarding the programming period of 2007-2013, Hungary is entitled to EU resources in the value of 25.3 billion euros whereas the contribution of the country amounts to 4.4 billion euros in the frame of cohesion policy. This amount can be spent according to the National Strategic Reference Frame having been ratified by the European Commission. The aim of the national strategic reference frames is to connect the general national programmes including the economy modernization measurements of the member states to the Lisbon strategy serving economic growth and job creation. The second aim of this strategy is to solve the problem of regional differences in Hungary.

Besides the aims of the EU transfers it is important to mention the structure of the use of subsidies. Studies on this object (eg. Bradley-Morgenroth [2004]) rank the incoming transfers to three main groups: infrastructural investments, development of human capital and subsidies to production. Regarding the distribution of transfers in Hungary in the period of 2004-2006, 63 percent of the funds were spent for infrastructural investments, 17 percent for human capital investments and 20 percent for production subsidies.

The structure of subsidies shifted to infrastructure by 2000-2006, whereas the ratio of subsidies to human capital decreased. The reason for this is that the importance of telecommunication and information technology development and environment protection is increasing continuously, and the use of Structural Funds is more effective in the case of greater projects such as infrastructural investments than that of smaller and more complicated projects like human capital investments [European Commission, 2004].

Referring to the period after 2013, conceptions connected to EU financial funds did not take shape yet. Deriving from this, neither the size nor the structure of the subsidy frame expected for the second half of the next decade is known yet. However, there are certain processes considered to be possible. We formed our expectations and the system of external conditions used for our impact studies according to them. Namely, we expect subsidies even for the period of 2014-2020, Hungary is thought to be the net beneficiary of the common European budget. The value of the transfers is expected to decrease of course, as Hungary catches up to the development level of the European Union. On the other hand, recent structural changes are expected to proceed, the ratio of amounts spent on agricultural subvention are very likely to decrease further, whereas the ratio of infrastructural subsidies increases, within which environment protection and information technology are expected to be the most preferred areas.

2. Theoretical background, international experiences on modelling EU transfers

2.1. The HERMIN model

The model HERMIN was established in the European Union, because it was necessary to set up a model that is suitable to analyse the development of the peripheral countries. The model can handle the supply-side effects of the structural funds to the economy. The model deals with the foreign relations, especially the income-flows. Its aim is the economic modelling of the countries which joined later the Union before and after the accession (Bradley et al. 1995, 2003, 2005).

The HERMIN macro-sectoral modelling framework has been widely applied to structural fund analysis at the national level and macro-regional level. The model is strongly growth-orientated, its target is the analysis of the long-term supply-side shocks (structural reforms, the development of the infrastructure, etc.) The model is composed of four sectors: the manufacturing, the market services, the agriculture and the government services at least. This level of disaggregation is necessary to identify the key sectoral shifts in a developing (regional) economy over the years of the Structural Fund program. The model is made up of three main blocks: a supply side, an absorption side and an income distribution side.

HERMIN is basically a neo-Keynesian model with some neo-classical features in the supply-side. Two sectors are modelled: a manufacturing and a market services sector. Output of the manufacturing sector is driven by world demand and cost and price competitiveness, while the output of the market services sector is determined by the final demand. Wages are determined in the manufacturing sector in a bargaining model and are sensitive to the tax wedge, unemployment and productivity. The model attempts to capture the external effects of public investments to the accumulation of physical and human infrastructural capital. Interest and exchange rates are exogenous to the model, and expectations are adaptive.

Based on the ex-post simulations of the model, the potential effects of the realised programs can be quantified. For example, in the case of Spain, Greece and Ireland, the effects of the structural funds during the 1994-1999 financial planning period are positive, though they increased the GDP level by a modest 1-1.5 percent, and by 0.5-1 percent in the long run, i.e. this increase in the growth will be sustained. However, in Portugal, these effects are much stronger, around 3-3.5 percent and 2 percent in the long run (ESRI 2002).

2.2. The QUEST model

The model QUEST is a global macroeconomic model with strong micro-foundation which contains a well specified supply side allowing for the modelling of the productive impact of investment in infrastructure and human capital. Behavioural equations of the households and firms are derived from the intertemporal optimisation problem for utility and profits (Roeger 1996; Roeger – in't Veld 1997).

The model captures the response of private sector agents to the fiscal injection and allows for the possibility that public spending crowds out private investments and leads to lower

total investment spending due to consumption smoothing. On the basis of assumptions on the productive impact of the additional spending, the model provides an estimate of the potential benefits of the Cohesion Policy programmes. The model can be described as a New Keynesian-Neoclassical Synthesis-based DSGE (dynamic stochastic general equilibrium) model, which combines the rigours of dynamic general equilibrium models with features of Keynesian style rigidities.

The QUEST is partly estimated, but for those equations that could not directly be estimated, estimates available in the empirical literature are used. The initial positive effects of the cohesion policy can be decreased through the increase in the capital accumulated because of the effect that this capital can crowd out private investments. In the long run, the increase in the GDP level is higher than the short term increase triggered by the positive supply side effect, which continues after the supported period as well. Fiscal transfers attached to the cohesion policy programs appear in the model as intergovernmental fix transfers. It is an assumption in the model that these transfers put a burden on the EU15 countries in the portion of their GDP, and the regions lagging behind receive more financial support than what they pay. In the case of the cohesion policy, the rules of additionality and co-financing have to be fulfilled. Additionality requires that Structural Funds are additional to domestically-financed expenditure and are not used to substitute for it. The co-financing principle means the EU provides only matching funds to individual projects that are part of the operational programmes and that the EU funds are matched to a certain extent by domestic expenditure.

Ex-ante simulation has been done for the 2000-2006 financial planning period with the QUEST in the case of the four cohesion countries. The results were published in the second report of the European Commission, which is about the economic and social cohesion. Based on the results, transfers will have more moderate effect than that predicted by other models, which can be explained by inclusion of the agents' expectations and their anticipatory behaviour, the long-term real appreciation and the crowding-out effect of the supports for private investments.

2.3. Case studies

There are mainly three types of evaluation methods for assessing the effectiveness of the cohesion policy of the European Union: case studies, econometric estimations and model simulations [Ederveen et al. 2003].

The different studies do not give a unified picture about the effect of capital transfers by the EU on the convergence. The picture which can be drawn is ambiguous, because the methods used for evaluation have different advantages and disadvantages, so that the questions to be answered by them are not the same. Case studies for example generally give an exact picture about the properties of a given project, or about the way of realisation, but are less practical for quantifying the effects of the funds, or for drawing conclusions on aggregated, regional and country level.

There are a wide variety of case studies in which single projects are evaluated. Some

focus on the way in which the funds are actually spent, others emphasise the impact of the funds on local authority practices. A study titled *Funds and Games* by Ederveen [2003] gives a good outline about case studies and in the followings some elements of it are to be reviewed. Lolos (1998) evaluates the success of macroeconomic and structural policies in Greece and Portugal over the 1980s and 1990s and concludes that the cohesion support in Portugal has been more successful than in Greece. The European Commission [1999] tends to be positive in their paper about the impact of cohesion policy. Its verdict is that programs of Cohesion Fund that have been evaluated contributed significantly to productivity growth and employment. Bachtler and Taylor made a research based on evaluation of projects and surveys of EU officials for the period 1994-99. They did not arrive at a quantitative impact, but they had some critical observations: projects often lack a clear rationale, it is difficult to establish coherence of EU-funded strategies with the broader policy context and the allocation procedure is over-elaborated or bureaucratic, which raises questions about procedural efficiency.

2.4. Econometric studies

Econometric studies consist of two categories: those looking for indirect evidence regarding the impact of cohesion support on convergence and those that directly measure the extent to which regional growth is determined by the cohesion support. The ex-post econometric analyses thus complement the model simulations that are based on ex-ante evaluations. It can be said about the majority of the studies, that they estimate generally one regression equation, in which EU transfers are represented among the explanatory variables.

A number of econometric studies directly measure the impact of cohesion policy on economic growth. Some of these studies find support for the convergence hypothesis. Fayolle and Lecuyer (2000) measured the economic growth of European regions over the period of 1986-96. They find that growth is enhanced by cohesion support, although its impact is strongly conditioned by the national membership. Based on the study of Ederveen et al. [2003], Structural Funds have a conditional effect, because they only facilitate convergence in countries with high export and import ratio per GDP, low corruption index and better quality institutions. Fuente [2002] examined the effects of cohesion supports on the convergence and on the rate of employment in Spanish regions, which belonged to the first objectives of EU supports. According to their results, EU transfers had significant effects in Spain, they increased the growth rate of the output by 1 percentage point and they increased the employment rate annually by 0.4 percentage point during the examined period.

Econometric studies give more pessimistic results in general about the effects of the funds than most of the model simulations. Econometric models try to estimate the real effects of the supports in contrast with the potential quantifications of the model simulations. Moreover, they do not assume the productivity of investments, the absence of the crowding-out effect and the accomplishment of additionality. The weakness of econometric research is the scarcity and bad quality of data. In several cases, there is no detailed and/or regional level database at the researchers' disposal, which would be necessary. Available data do not

contain in every case the necessary length time series, thus making harder the quantification of the long term effects of Structural Funds.

3. The structure of the model ECO-TREND

The ECO-TREND is a yearly macroeconomic simulation model, frequently used for forecasting and for policy simulation at the ECOSTAT Institute. We also develop complex macroeconomic scenarios regularly with the help of this model. ECO-TREND can be used for analyzing the macroeconomic effects of the EU transfers. First we will show the main characteristics of the ECO-TREND model, then we will focus on the transmission mechanism of the EU transfers (Cserhádi et al. 2004, Keresztély 2004).

ECO-TREND is a yearly calibrated model, which means that the parameters of the model are determined by a very complex method using stochastic estimation results, experts' informations and expectations for the future behaviour of the specific equation together. The main exogenous determinants of the model are the items affecting foreign trade turnover (world market prices, the boom of external markets, devaluation) and lending interests in real terms affecting venture investments directly and taxation items (personal income taxes, corporate taxes, taxes related to customs and imports, VAT-rate, etc.). The information system of the model follows the national accounts categories of the ESA95 European Union Statistical standards.

ECO-TREND consists of four main blocks such as the demand and supply blocks determining real categories and employment, the block of prices and money and the block of income distribution. The stochastic equations lie in the centre of the model complemented with identities. Additional to employment and wage determination, the supply block provides the potential, theoretical supply by means of a production function. GDP is determined from the supply side, but the final demand components (private and public consumption, investments, exports) are determined by stochastic equations, as well, while imports are calculated as a balancing item of the demand and supply blocks. Real and nominal categories are related by prices determined by stochastic equations. Labor demand is formulated as a function of the capacity utilization rate and real wages whereas labor supply is dominantly determined by demographic factors. Actual values of labor demand and labor supply imply the corresponding rate of unemployment. Domestic prices are represented by the consumer price index (CPI) and the producer price index (PPI) while the effect of world markets are transmitted via export and import prices. CPI strongly follows PPI whereas PPI is dominantly affected by import prices.

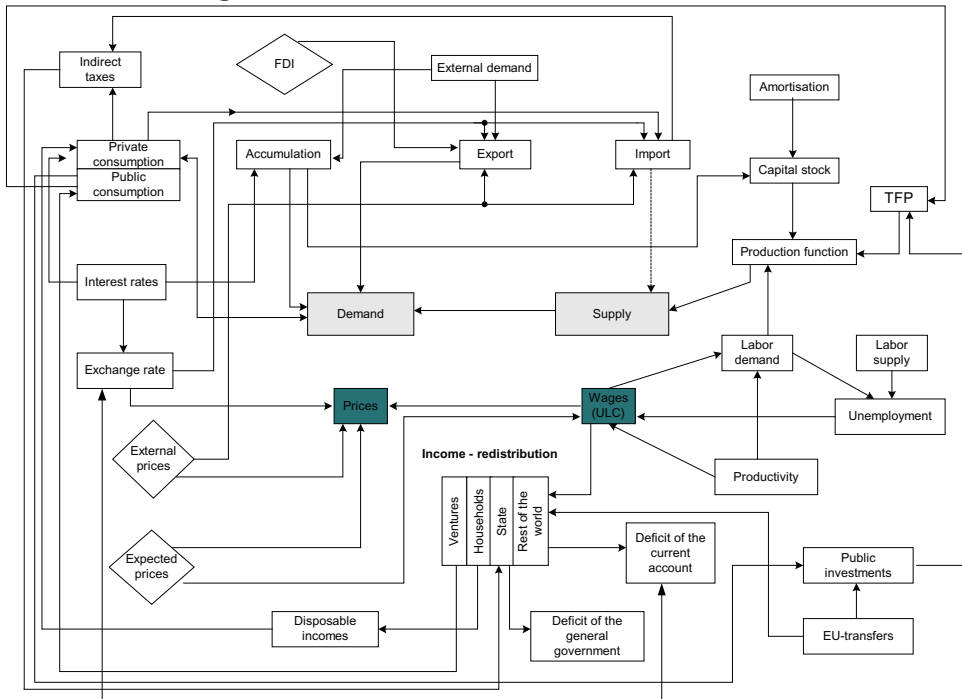
With respect to the income block, disposable incomes of the corporate sector and households, the general government budget, foreign disposable income and the balance of payments are all determined by means of their income balances and the balance of payments. There are three income balances in the model such as the income balances of the corporate sector, private households and the general government. Profits and savings of the corporate sector are calculated by subtracting wages and taxes from the net GDP. This balance includes both the amounts of wages as input figures to the balance of private incomes and the taxation items of the state budget balance. Disposable income is determined in the balance

of private incomes by adding mixed, proprietor and transfer incomes to the wages paid in the corporate sector and subtracting taxation items. Savings are derived as the difference of disposable income figure and consumption.

The balance of the general government is made up of three parts as follows: the central budget and the two social security funds. The revenue side of all sub-balances includes taxes, contributions paid by the corporate sector and households whereas on the expenditure side there are certain benefits and transfer income payments. Aggregation of the balances of the three income proprietors complemented by the balance of payments provides the income distribution matrix of the national economy and the net lending/borrowing positions of the different sectors.

The basic structure of the ECO-TREND model can be seen in Figure 1.

Figure 1: The structure of the ECO-TREND model



Source: ECOSTAT

3.1. Transmission mechanism of the EU transfers in ECO-TREND

Transfers from the Cohesion and Structural Funds of the European Union are getting more and more important growth factor in Hungary. The total factor productivity is endogenous in ECO-TREND, so we can analyse the spill-over effects of the EU transfers to the productivity and the long term growth (Cserhádi et al. 2007). The functional structure of the EU transfers is the following: infrastructure, human capital and production subsidies.

The TFP is determined by these factors as explanatory variables in the model. The public investments are influenced by the amount of the EU transfers, as well. The model also calculates the co-financing requirements. The sum and the functional structure of the EU transfers affect the general structure of the government expenditures which has a further effect on the TFP and the long-term growth performance. Regarding the growth effects, the additionality assumption was accepted. The model also calculates the values of the national accounts categories by a transition matrix.

4. The impact analysis of the functional structure of EU transfers

The exogenous assumptions of the baseline scenario are as follows.

- The external demand is expected to increase annually by 2-2.5 percent.
- The expected inflation rate declines gradually to 3 percent by 2011. The reason for this is that we assume rational expectations in the model, namely, economic participants expect consumer price indices corresponding to price stability on the long term (cca. 3 percent)
- Deposit and lending interest rates converge to the actual euro interest rates by 2012.
- Foreign direct investments are expected at about 3-4 billion euros per year.
- The amount of the used EU transfers reaches 2-3 percent of the GDP from 2009.
- The interest rates of the long term government bonds converge to the eurozone level.

Assumptions connected to EU transfers are as follows.

- 80 % of the available 25.3 billion euros will be properly used for the period 2007-2013. In the next period there is a gradual decline in the volume of the transfers.
- The assumed functional structure of the EU transfers is the following: 63 percent for infrastructural investments, 17 percent for human capital investments and 20 percent for production subsidies.¹
- The structure of the government expenditures is unchanged for the whole forecasting period.

We have examined how we can catch-up to the average level of the EU25 in terms of GDP per capita (measured at purchasing power parity) until 2020. The results show that the domestic level is 62.1% of the average level of EU25, and it gradually goes up to 76.7% by the end of the examined period.

The GDP per capita is only one of the indicators of the catch-up process, although it is a very important index. It is not less important that also the income level of the household sector should approach to the average level of the developed countries. We have examined the development of the disposable income of households (QDI). Results show that the convergence of this indicator measured at purchasing power parity is slower than that of

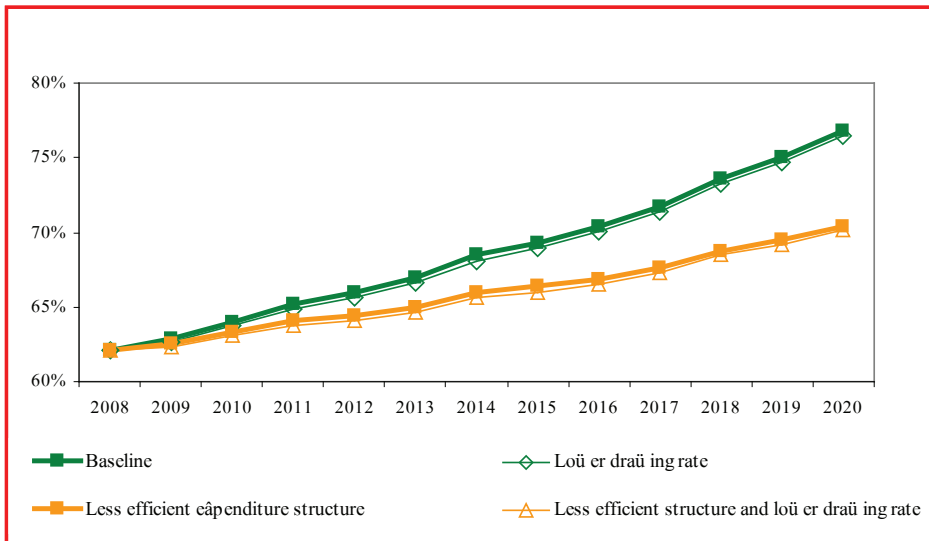
¹ The functional structure of the transfers was taken from Bradley – Morgenroth [2004].

the GDP per capita: the 53.1% of 2008 will grow only up to 66.6% by 2020. This means that the average annual increase of the disposable income will be only 3.3%. This relevant difference can be explained by two factors. On the one hand, the gross national income (GNI) grows slower than the GDP (its average growth rate is 3.5%), since the stock of foreign capital in Hungary is far higher than the stock of the Hungarian capital abroad. This means that the income of the foreign investors in Hungary is far higher than the income received by the Hungarian investors from abroad. On the other hand, the distribution of incomes continually changing at the expense of the households; this phenomenon can be observed also in the developed countries.

In the sequel, three scenarios will be presented, in which certain conditions are changed compared to the baseline. It is assumed in the first case that we will not be able to draw 80% of the EU-sources; instead, the rate of use will be only 60%. The second scenario considers the 80% rate of use, but it is assumed that the structure of the use is less favourable compared to the baseline scenario. This latter means that fewer sources will be devoted to growth supporting projects, like R&D, infrastructure or human capital. This was assumed not only for the EU-sources, but for the whole expenditure of the general government as well. The third scenario is the combination of the previous two ones, i.e. the rate of use and the structure are less favourable than in the baseline.

We underline the development of two indicators when comparing the scenarios.

Figure 2: The gross domestic product
(at purchasing power parity, in the percentage of EU25)

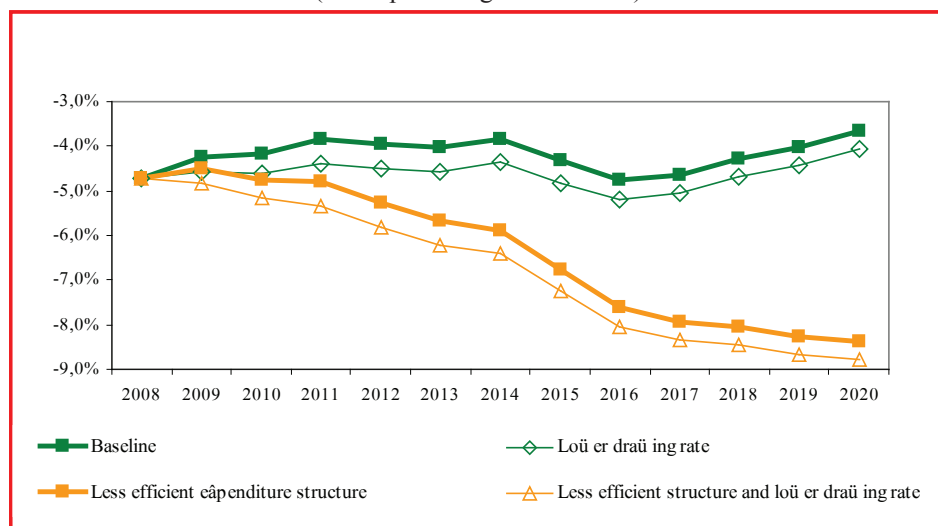


Source: ECO-TREND model, ECOSTAT

The GDP per capita measured at purchasing power parity shows an interesting evolution in the examined scenarios. A relevant deviation can be observed only when the structure of use becomes inefficient, and there is less difference, when only the use of rate decreases.

This means that, although the amount of use of EU-sources is an important factor, it is even more important that it should be attached with an efficient structure of use.

Figure 3: The current account balance
(in the percentage of the GDP)



Source: ECO-TREND model, ECOSTAT

If one examines the balance of current payments, it turns out that the income receivers compensate the effect of changes in income by taking credits from abroad. This means that there are only small differences in the evolution of the indicators of the real sphere at the expense of a higher deficit of the current payments.

Table 1: The long term performance of the different scenarios in 2020

	2020			
	Baseline	Loü er draü ing rate	Less efficient cãpenditure structure	Inefficient structure and loü er draü ing rate
GDP (at ppp, EU25=100)	76.7	76.4	70.4	70.1
Disposable income of the households (at ppp, EU25=100)	66.6	66.5	66.3	66.2
Balance of the general government (in the percentage of the GDP)	-1.4	-1.5	-1.5	-1.6
Current account balance (in the percentage of the GDP)	-3.7	-4.0	-8.4	-8.8

Source: ECO-TREND model, ECOSTAT

The amount of EU-transfers influences the potential growth, therefore also the speed of catching-up and also the indicators of equilibrium. The effect of the structure of use is even stronger, therefore we conclude that Hungary has not only to increase the amount of

received EU-transfers, but the country has to endeavour to use them in an effective way, as well.

CONCLUSION

The estimation and the scenario analysis obtained by using our HERMIN type macromodel has made obvious that the amount of the EU transfers and especially the structure of the expenditure play an important role in the long-term convergence process. In the baseline scenario we reach 77 percent of the GDP of EU25 until 2020, but if we suppose lower drawing rate and less efficient structure of the EU transfers, the catch-up process is significantly slower. So it would be very useful for the countries of the Balkan region to develop their own national HERMIN model, so they could quantify the effect of the integration and EU supports, and they could use these results in the economic decision-making.

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PERFORMANCE AND ENLARGEMENT IN POST-LISBON STRATEGY (A NEW APPROACH)

Abstract

*The Lisbon Strategy is facing fundamental challenges in the coming years. On the one hand it has to find the way how to develop a knowledge based economy of high competitiveness on the wide interpretation of sustainability. On the other hand the Lisbon process should count with the further enlargement of the integration. The sustainability and enlargement processes **demand new approach** in quantification of the performance of the member states as well as that of the candidate countries. Our suggestion is the development of **an indicator from international rankings (Relative Total Performance)** that both expresses the different interpretations of sustainability with much background information as well as gives an opportunity for a comprehensive comparison of different countries.*

Key words: *Lisbon Strategy, enlargement, sustainable development, international rankings*

INTRODUCTION

Two important processes mark the following period of the European Union. The **Lisbon Strategy** has changed a lot during its nine years but remained the fundamental reform programme of the Union. Now it is facing its next stage from 2010 and it is searching the main pillars and priorities of a strategy that enables the European integration to face the 21st century. One core element of the renewal is the challenge to synthesise growth and employment with **sustainable development**.

On the other hand the Union continues the **enlargement strategy**. On the 5 November 2008 the European Commission has divulged the Enlargement Package 2008 including the current extension strategy on the one hand and the annual reports on the candidate and potential candidate countries. On the whole the documents try for highlighting the possibilities, advantages and the stabilisation power which opened up by the enlargement. Moreover they point out the necessary steps to proceed forward. In his report Olli Rehn, Enlargement Commissioner reckoned that important steps can be taken in 2009, primarily in the case of Western Balkans as far as enlargement is concerned.

As a communication from the Commission the document entitled ‘Enlargement Strategy and Main Challenges 2008-2009’ contains the present challenges in terms of enlargement on the one hand and some fundamental elements of the enlargement strategy on the other hand. Moreover it summarises consequences by the events of the recent period as well

as composed suggestions for the next steps of enlargement. The Strategy also highlights that enlargement is one of the most effective means of the European Union, which helps extending its activities in terms of peace, security, freedom, democracy and preventing conflicts. It is stressed that the attractive power of the EU in the candidate and potential candidate countries is her contribution to stability as well as stimulation to reforms. It is of vital importance that the accession perspectives should be visible and reliable and member countries should support enlargement.

However, in terms of sustainable development the relations between the Lisbon Strategy reform, the monitoring system of social-economic development and the enlargement raise some important **questions**.

1. In case Western Europe's falling behind does not decrease Are the objectives of the Lisbon Strategy based on sufficiently up-to-date premises? The question comes up: is it the execution of the strategy, the fragmentation of the internal markets, the underlying principles or the basic approach that lies behind the problem?
2. Should the opportunities to utilise Europe's outstanding competitive advantages in certain areas and its international position be given up due to the grave impact of the current crisis on Europe? Is it necessary and possible to elaborate a new strategy based on a new approach?
3. Are the set of indicators of the Lisbon Strategy or the most complex database of the European Committee and Eurostat (SDI – Sustainable Development Indicators) or the annually updated OECD Factbook (Economic, Environmental and Social Statistics) sufficient to evaluate the candidate countries?

Our **responses**, discussed in detail below are as follows.

1. There is an unequivocal step backwards in the area of strategic thinking and the focus is on economic crisis management and stability.
2. Europe has different social models but all are linked to the common history of the continent. This inheritance should be maintained in terms of sustainability and hence Europe has a major role in the reshaping of the global system. The Post-Lisbon Strategy should be based on a wide interpretation of sustainability including economic, social and environmental criteria.
3. In order to carry out our analysis it is not sufficient to only use the OECD and EU comparisons. Thus we are selecting the comparative database from the sets of indicators of some 150 international country rankings.

1. The fall of strategic thinking

The announcement of the Lisbon Strategy and its priorities reflected the international and European euphoria of the year 2000. Nevertheless, it was a breakthrough in terms of **handling together the activities related to the economic, social, technological and legal harmonisation**, instead of each area being treated separately as it had been before. **This remained the basis of the renewed strategies too** (Zádor, 2005, 2005a). The boom at the beginning of the year and the favourable state of European macro economics raised

hopes of building a knowledge based society, a fast execution of structural reforms and in general strengthening the role of the business sector. High-tech start-up companies were expected to develop fast, the integration of the innovation sector was expected to make fast progress and in general the EU was expected to catch up fast. This is where it was first stated that the basis of all this and the driving force of the future in general must be the area of Information Technology (Zádor, 2004, 2004a).

The **2006, 2007 and 2008 Spring European Council** identified **four priority areas (R&D and innovation, business environment, employment opportunities and an integrated energy/infrastructure policy)** which are the pillars of the renewed Lisbon Strategy (Zádor, 2006, European Commission, 2007). Within these areas the European Council agreed a limited number of specific actions which it urged Member States to complete by set deadlines. The 2008 Spring European Council launched the second cycle of the renewed Lisbon Strategy, which will be completed in 2010. The Council adopted in May 2008 a recommendation on the broad economic policy guidelines for the Member States and the Community (2008 to 2010) and in July 2008 a decision on guidelines for the employment policies of the Member States, which together form the “Integrated guidelines for growth and jobs”.

In the context of the current economic downturn, the Commission has proposed a **European Economy Recovery Plan** (hereafter ‘the Recovery Plan’⁶), which the European Council in **December 2008** agreed. This plan provides for a **co-ordinated budgetary stimulus, within the Stability and Growth Pact**, to boost demand and restore confidence, taking account of Member States starting positions and efforts already undertaken in response to the economic problems.

The Recovery Plan agreed by the European Council called on Member States to submit updated stability or convergence programmes, which the Commission has assessed, taking due account of the **need to ensure the reversibility of the fiscal deterioration, improving budgetary policy-making, and ensuring long-term sustainability of public finances.**

To fully implement the Lisbon strategy for growth and jobs, this recommendation should also contain specific recommendations to the Member States belonging to the euro area. (12) The European Parliament has adopted a resolution regarding this Recommendation, 4 OJ L 137, 27.5.2008, p. 13. 5 OJ L 198, 26.7.2008, p. 47. 6 COM(2008) 800.

2. The Budapest Concept: the sustainable Post-Lisbon strategy – a Renewal

The **strategic task of the EU** today is the elaboration of a set of tasks to ensure a **new type of catching up in a qualitative way**. The renewal of strategic thinking is a leading notion of today (Gáspár, 2008), mostly with the new emerging trends of the global world. The content thereof can only be determined in the context of fitting into the entirety of **sustainable development**. Equally, **competitiveness** can only be realistically increased to the extent of sustainability. The actual content of sustainable development must be determined keeping in mind the importance of **social and environmental issues** and the resolutions thereof, as well as taking into consideration the diverse correlation between

these problems and **economic** development (Szabó, 2007). **The international position** of the Balkan and East Central European countries can only be evaluated by way of **analysing these three areas separately as well as by examining their interactions** and the tasks emerging as a result of this evaluation must also be approached in the same way.

In order to examine the individual factors we have established a thesis for each of them as follows here:

Thesis No. 1.: the development and growth of the economy can only be sustained, i.e. balanced if the stability of the economy is ensured in a socially sustainable way and in no way is it ecologically harmful long term. In other words:

- a) Economic growth is not accompanied by the breaking up of the internal and external balances, when the involvement of external resources mainly finances an already imbalanced situation,
- b) The external and internal financing of growth is secured by the integration of the human resources of the national economy on the basis of a modernising economic structure resulting from the induction and absorption of technical development,
- c) The extensive factors of economic growth do not expand at the expense of the environment; whereas the intensive factors prefer an environmentally conscious way of technological development.

Thesis No. 2.: by social sustainability we mean a parallel progression of economic growth and social cohesion. I.e. there is a social and political consensus to do away with reproductive social falling behind. To be able to achieve this, the systems of social distribution are operated and the international resources available are used in a way that solidarity, fairness and social incentivisation can all equally prevail. I.e. the redistribution of centralised revenues contributes to the creation of opportunities via the education policy and the efficient operation of the health care system. Within the scope of social sustainability there is an endeavour to have a social dialogue which enhances knowledge and innovative commitment as well. Besides the economic aspect of financiability, the interaction between social sustainability and a sustainable society refers to the environmental sustainability of the quality of life. I.e. it presupposes a type of development where work and life conditions are shaped in an environmentally conscious way.

Thesis No. 3.: one of the most relevant conditions of sustainable development is a global approach: where both planning and control take into consideration the interrelations of society, economy and environment in a balanced way. From an environmental aspect this can be achieved in the event that a) the economic and social players have an inherent interest in using inputs for reproduction which do not represent any harm to the immediate environmental factors, b) urbanisation is carried out and the transport systems are built such that the quality of life of the members of society is of the utmost priority, c) if the energy supplies are available for development, the enhancement of the efficiency thereof is accepted by all players of the economy.

3. Monitoring and evaluation – an alternative method

3.1. International rankings and the Relative Total Performance

There are several experiments to use composite indices for measuring development (Bandura, 2005). We have tried to make a selection from the worldwide available and most widely used various rankings so that we are able to cover as many aspects of social-economic and environmental development as possible. We believe that the global picture drawn by the results of the individual rankings is suitable to assess and compare the development level of the Balkan and East Central European region respectively, while offering an exciting opportunity to compare the results of different types of development analysis (Adamecz et al, 2008). On the one hand it allows the drawing of conclusions about the relative situation about the country by way of a **simultaneous examination of several aspects**; on the other hand the **particular indicators** arising from the statistical and questionnaire based surveys used for the individual rankings provide a detailed image of the social and economic situation and allows deeper comparisons. In our presentation we will endeavour to cover both areas (Gáspár, 2008a).

However, in order to handle the findings in a uniform way and to describe the overall situation we will take into consideration that the rankings first of all reflect the **Euro-Atlantic perspective** and judgement **but they allow a wider scope of evaluation** of the state of development of some Balkan and East Central European countries together with their **respective post-Lisbon Strategy development opportunities** than the **Lisbon indicators or Eurostat's index system of sustainable development**.

One of the main difficulties of drawing the global image stems from the fact that the international rankings have been created for a highly varying number of countries and even the set of countries chosen for the individual rankings were of a highly diverse nature. The social and economic image resulting from the particular indicators is not confused by that, however, the overview, which takes into consideration several aspects simultaneously, the group of countries involved in the examination had to be standardised. A too narrow group of countries (e.g. regional or sub-regional groups such as the Visegrád countries) would have excluded worldwide comparisons and the exploration of the central/peripheral situations. At the same time we did not want to expand the group to include the greatest number of countries present in all rankings because it would have distorted the picture since the individual aspects of development do not change in a linear fashion from country to country but there is a greater density thereof in the first third of the ranking lists. As a consequence the wide spectrum would have obliterated the qualitative differences between the developed and the quasi developed countries.

Therefore in the first instance we included 30 countries of **OECD** in our research, to which we added **5 countries invited to be a full member** of the organisation - Chile, Estonia, Israel, Russia and Slovenia - as well as **5 potential members** that OECD pay a special attention to, namely Brazil, China, India, Indonesia and South Africa. We have also included in the circle those **EU countries which are not OECD members** as well as **the neighbouring and the South-Eastern European countries** for a regional comparability. From the latter we have excluded Albania and Moldova due to the great extent to which

their state of development is different from the group of countries examined. Furthermore, Serbia-Montenegro had to be excluded because of missing data in some areas. Thus the circle of countries was extended by 10 more to include **50 countries in total**: Malta, Cyprus, Bulgaria, Rumania, Latvia, Lithuania, Croatia, the Ukraine, Bosnia & Herzegovina and Macedonia.

The international rankings containing several aspects offer two types of situation analysis: one **based on the place in the ranking** and another **based on the sets of values** that create the ranking itself. If one wants to draw conclusions via the ranking position, one must face a series of issues in addition to the fact that the rankings are not cumulative nor can they be directly compared. On the one hand, because the countries are ranked on the basis of their respective values of competitiveness, or, to be more precise, to the assumption that a better position reflects a better state of welfare and that it implies better future shaping conditions and a better position for development. On the other hand, the ranking position of individual countries does not reflect the difference between the quality level of their respective performances and the non-even changes or leaps thereof.

In view of the above the **sets of values themselves are more representative**. Obviously, due to their nature they are not cumulative either. It can also be an issue that the value data of some index does not reflect the general standard of performance of the examined countries. I.e. it cannot be judged how much a good performance as per a given aspect (e.g. the level of freedom of economic activities) is actually worth on an international scale, and how much it contributes to the development possibilities between the other countries.

Therefore we need the data of the ranking positions, which express the hierarchic structure of world economics and the **future development possibilities resulting from the different potentials for development**. Also, the data are not concentrated around one value, they are widespread enough to describe realistic potentials and conditions. Finally, the unwritten laws of today's world economics are determined by the Euro-Atlantic perspective and competitiveness, which Hungary and Spain must also be subject to.

To be able to compare the aspects of rankings both the values and the positions must be considered in a complex way. Each must express the **relative performance of the given country compared to the leading ones**. The point of reference is not a special reference value – which is not even available most of the time, although there are indices made up this way – but the best performing country taking into consideration the weakest performance of the selected group of countries. This way the actual scope of values will be examined, since the bottom limit value is not zero. Although this approach does not allow to go beyond the scope of competitiveness, within this scope it does ensure a good evaluation.

The totalled impact of the relative results of the positioning and the value data has been considered according to their respective geometric average as follows here (Gáspár. 2008a):

$$\text{Relative Total Performance} = \sqrt{\left(1 - \frac{R_H}{R_{\min}}\right) \left(\frac{V_H - V_{\min}}{V_{\max} - V_{\min}}\right)}$$

where R stands for Ranking, V the index value underlying the position, H and S stand for Hungarian and Spanish position or value respectively. The minimum position is $R_{\min}=50$, with one exception: in the case of the ESI index Malta, Cyprus and Luxemburg are not listed in the ranking because of their small size.

We have selected for international indicators to compare and link the rankings **numerically**. These are the following: **Global Competitiveness Index (GCI)** prepared by **World Economic Forum**, the **Index of Economic Freedom (IEF)** published by the **Heritage Foundation**, this latter has administrative and social aspects too, as well as the **Environmental Sustainability Index (ESI)** calculated by the **Universities of Yale and Columbia** and the **Human Development Index (HDI) of UNDP**. These indicators, when used jointly, take into consideration the economic, social and environmental aspects of competitiveness and sustainability. In addition, instead of one index they provide a more detailed image in some aggregate particular indices (World Economic Forum, 2008, The Heritage Foundation, 2008, Environmental Sustainability Index, 2008, UNDP, 2008).

The values and the results of the individual indices covering the chosen countries are as follows: reviewing the examined group of countries it appeared realistic and reasonable to separate the scale of performance into 3 major scales – **leading, middle range, catching up** - with 2 minor steps (**bottom and top**) within each of the 3 major ones, i.e. altogether 6 scales. It also has to be considered, naturally, that the names of these categories refer to the chosen group of developed and medium developed countries:

82,5-100%	Absolute leaders
66-82,5%	Second line of leaders
50-66%	Top middle range
33-50%	Bottom middle range
16,5-33%	Catching up
0-16,5%	Falling behind

3.2 The Relative Total Performance of some Balkan and East Central European countries

On the OECD basis the relative total performance of ten Balkan and East Central European countries we calculated. These are (in alphabetical order) Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Hungary, Macedonia, Poland, Romania, Slovak Republic and Slovenia. Owing to missing data in many cases Serbia and Montenegro could not be participated in the research. This is a great loss; however, on the basis of a comprehensive comparison of 50 countries **it is possible to have an alternative view on the development** of many of our region's countries. The table of the calculated numbers can be found in the Appendix (Table 1).

As far as the **global competitiveness** is concerned (Graph 1 – see Appendix) most countries of the region belong to the **catching up or falling behind category**, except for Slovenia and Czech Republic, which reach the (lower) middle layer of the relative total performance. Among the Balkan countries of the survey Croatia shows a better overall performance ahead of Romania, Bulgaria and Macedonia, while Bosnia and Herzegovina has the lowest relative result on an OECD basis. The Balkan countries mostly meet the

basic requirements of competitiveness at a higher relative level, among them Bulgaria has the most even performance in terms of the different factors of competitiveness. Romania is relatively better in efficiency factors, while Croatia does so in terms of innovation. The drawing factor of East Central European countries competitiveness is rather efficiency than the basic factors, only the Czech Republic and Slovenia shows a relative innovation advantage.

In terms of **economic freedom** (Graph 2) the countries of the research on average show a **better relative performance** than in competitiveness, even if most belong to the catching up or falling behind category on OECD basis. The East Central European countries are at the entrance of the higher middle layer, but what is worth noting that Bulgaria reaches the middle layer, Romania and Macedonia are very close to it and Croatia shows a relatively low performance. It is also remarkable that the **overall freedom performances are the results of very heterogeneous characteristics** of different types of freedom. One of the leading features of transition seems to be the relatively high reduction in the size of the state sector, mostly in Romania, Macedonia, Bulgaria and Bosnia-Herzegovina. In the case of Hungary, Croatia and Slovenia the overextension of the government size must be one of the main withdrawing factors. Another characteristic of the general picture is that while the reduction of the state sector as well as liberalisation of labour market are relatively far ahead in the Balkan countries, the freedom from corruption is still a serious task to tackle, as well as liberalisation does not go along with a low level of administrative and financial bottlenecks when starting a business.

Environmental issues (Graph 3) show a quite different picture. Croatia, Slovakia and Romania reach the higher middle layer; Bosnia-Herzegovina, Hungary and Poland perform at the lower level of the middle part, while, mostly relative to the overall state of development, Bulgaria and Macedonia show a much better environmental performance than Slovenia and the Czech Republic. Among the countries in the research either the reduction of **environmental stresses or the human factor or both play the leading role**. According to the international surveys and comparisons it is Poland, Croatia and Slovakia that take mostly into account the global aspects in terms of environment.

The **human factor** (Graph 4) of sustainability is measured by the Human Development Index, which in all cases perform in the lower or higher middle categories or very close to them. The differences among the countries are also smaller than in the case of competitiveness or economic freedom. **The structure of the human factor is quite a divergent picture**, however. Life expectancy indexes are the most even as expected. In terms of education the differences are much higher; however, the GDP performance polarises the countries most. It seems that the Balkan and East Central European countries are better developed in terms of human factors than economically-technically, which offers a better chance to catch up. In the case of Slovakia, Czech Republic and partly Croatia the three factors of human development are quite even, while Slovenia, Poland, Hungary, Romania and Bulgaria take an education drawn path.

It is also worth analysing the relative total performances of different fields from a country's point of view. There is no place here to give an overview of all countries analysed but there are two of the Balkan examples, which look as follows.

Macedonia

Macedonia (Graph 5) shows different levels of relative total performance from the falling behind to the second line of developed category. Most cases – 9 indexes from 19 – are the catching up layer, which is the 16,5-33% of the best performances on OECD basis. The best relative performance the country expresses in economic freedom and human development; however the global competitiveness results are much more under the performance of other countries both in terms of the whole range in the research as well as of the selected ten countries. The relative material underdevelopment can also be seen in the GDP index of the Human Development Index. In case one links it to the sub-indexes of the GCI, it turns out that it is not the level of production which appears as bottleneck but rather the efficiency of production as well as its innovative potential.

A high level relative performance appears in reducing the government size and environment stresses. Shrinking the role of state in the economy as well as liberalisation are important factors of transition; however these elements are quite far a distance from competitiveness, though the relatively better performance in human factors (education) and in the possibility to launch business are promising and may help increasing the performance of many fields that used to be produced by the state. The international rankings also reflect Macedonia in the contradiction of opening markets and enterprises poisoned with a relatively high level of corruption.

The environmental factor improves the overall performance of the country; however it is worth noting that even if the natural and mental aspects of the environment are relatively well off, the social and institutional capacity of Macedonia to make use of the environmental advantages is quite low.

Bulgaria

Overall, Bulgaria (Graph 6) shows a performance one category higher than Macedonia: low middle layer. 4 indexes are in the high middle part or above, 5 low middle cases, 5 belong to the catching up category and in 4 cases the country is falling behind. These latter are all indexes of the global competitiveness. In the case of Bulgaria not only the efficiency and innovation factors are weak – which is a general feature of the region – but also the basic requirements. Romania is another example of relatively low basic competitiveness but in her case the innovation and efficiency factors contribute more to global competitiveness.

Like in the case of Macedonia the environmental and economic freedom issues enhance the relative performance of Bulgaria on OECD basis. Bulgaria however shows better results in freedom to launch business, which is linked to a higher level of freedom from corruption.

In terms of the environmental sustainability the natural reservation is either not supported too much with social and institutional capacities, though at a higher rate than in Macedonia. This better performance, however, goes together with a much lower level of global stewardship. In this respect the highest contradiction appears again in the case of Romania where a leading performance of environmental systems (81,4) and reducing environmental stresses (90,6) are blocked by the relatively lowest level of global stewardship and second lowest in social and institutional capacity.

The human factor shows a quite interesting picture. Bulgaria has the highest score in the

Educational index of the Balkan countries (excluded Slovenia, which belongs to the leading team at OECD level too in terms of education). What is more interesting and promising that this human factor is linked to a relatively better GDP index, the highest again among Balkan countries (excluded Slovenia again, which is regularly debated as a Balkan country at the same time). The bottleneck of a human development lead model in Bulgaria can be the very low level of life expectancy, the lowest of all countries in the survey.

CONCLUSIONS

1. The Lisbon Strategy is facing fundamental challenges in the coming years. On the one hand it has to find the way how to develop a knowledge based economy of high competitiveness on the wide interpretation of sustainability. On the other hand the Lisbon process should count with the further enlargement of the integration. The sustainability and enlargement processes **demand new approach** in quantification of the performance of the member states as well as that of the candidate countries. Our suggestion is the development of **an indicator from international rankings (Relative Total Performance)** that both expresses the different interpretations of sustainability with much background information as well as gives an opportunity for a comprehensive comparison of different countries.
2. The various international rankings reflect the values of the **Euro-Atlantic world**: their concept of modernisation as it had shaped during the past centuries together with the more up-to-date concept of sustainable development. Thus our respective statements and conclusions regarding the sustainability and catching up of the Balkan and East Central European economies and societies are only valid if interpreted within this set of values. The rankings themselves provide a certain picture, but their **palette-type examination** enables the indices of various aspects, based on relative performances, to provide a more uniform image; and the several hundreds of indicators behind the indices allow us to have a more detailed overview of the domestic processes as well as the international perception thereof.
3. By the Relative Total Performance of most of the indicators the discussed region belongs to the **catching up and low middle range category** on an OECD basis. However, it is important to stress that catching up does not mean an absolute level of economic output but a relative performance in terms of a wide range of indicators and hence catching up refers to structural features and efforts. As a general feature the survey shows that the Balkan region, even if on a solid level relative to OECD, has a **stronger potential in the human and environmental factors than in the economic-technical environment**. The differences in these factors are much smaller too among the countries of the research, though each reflects a unique structure and development model.
4. The above contradictions are further burdened by the fact that they **do not appear in an improving international position**. A significant part of the catching up energies of the countries invested into maintaining the competitiveness level: a typical feature of the catching up and middle range is the constant fight to get

to the top of the middle range, otherwise there is a grave danger that the lower relative performance that can be achieved by a lower position in the hierarchy rates the country lower and lower. The main risk of this is not a lower position but the narrowing of future perspectives. The situation drawn by the survey about the countries shows a basic similarity to the world wide position which is called **latent state of development** by literature (Kozma, 2004): **ready to catch up, rich and efficient human assets, which operate with a limited performance under relatively weaker financial and technical conditions but have future potential**. The current situation can be described with the specialist terminology of “**underperforming latent development**”.

5. It is valid for all countries that the Post-Lisbon Strategy can only offer a balanced development in a complex approach to sustainability, by way of **strengthening the elements of social and environmental sustainability**, thus increasing the utilisation of human assets, thus creating the foundations of an innovative and better performing economic development.

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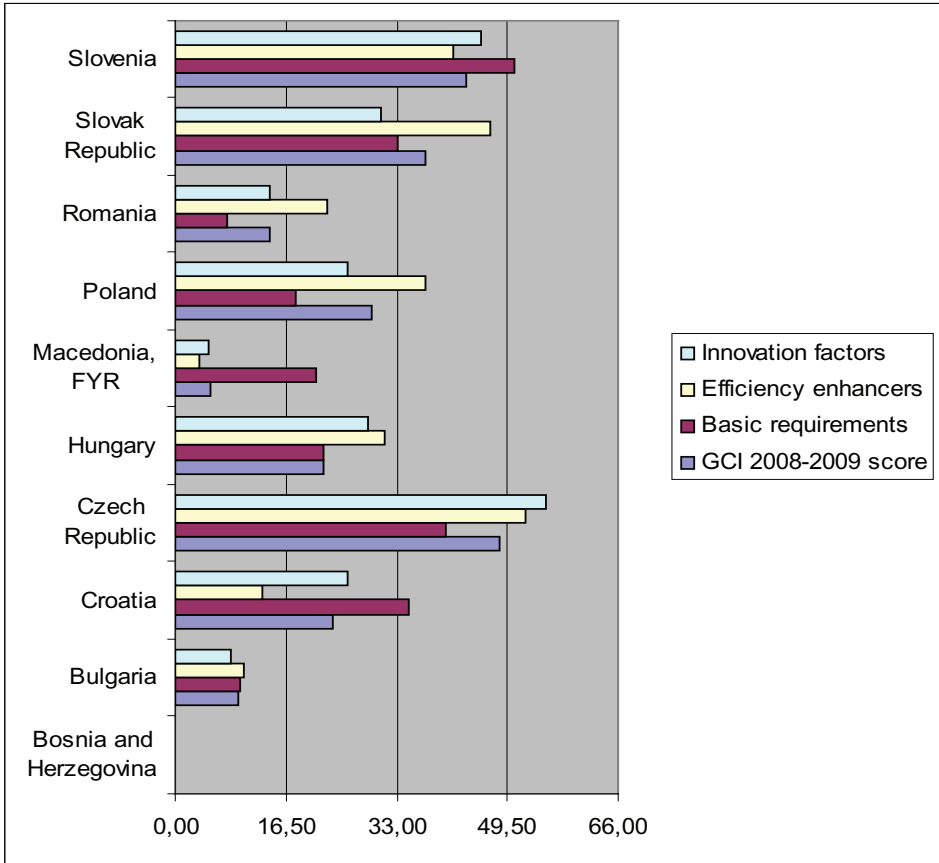
Appendices

Table 1: Relative Total Performance of selected countries in four indexes and their sub-indexes

Relative Total Performance of some countries	GCI 2008-2009 score	Basic requirements	Efficiency enhancers	Innovation factors	Heritage Foundation Index of Economic Freedom	Business Freedom	Gov't Size	Freedom from Corruption	Labor Freedom	Environmental Sustainability Index	Environmental Systems	Reducing Environmental Stresses	Reducing Human Vulnerability	Social and Institutional Capacity	Global Stewardship	Human Development Index	Life Expectancy Index	Educational Index	GDP Index
Bosnia and Herzegovina	0,00	0,00	0,00	0,00	8,37	17,20	48,80	7,45	15,16	37,06	53,33	85,66	53,28	4,56	19,59	30,81	49,11	30,88	15,26
Bulgaria	9,33	9,80	10,27	8,16	34,66	31,65	58,30	24,04	60,12	30,50	42,96	79,31	48,42	17,91	17,67	35,95	40,89	51,24	26,62
Croatia	23,35	34,87	12,87	25,69	13,11	19,90	18,35	16,67	8,02	65,30	57,40	96,19	74,58	35,07	43,39	41,48	53,01	38,68	38,98
Czech Republic	48,22	40,44	52,15	55,09	53,55	25,15	44,06	35,59	55,71	21,59	18,76	18,11	92,93	51,85	22,20	58,56	56,56	53,67	57,89
Hungary	22,00	22,11	31,12	28,69	48,48	47,30	16,23	41,37	48,39	39,53	27,35	65,90	90,04	54,40	25,52	54,06	42,79	69,95	51,86
Macedonia, FYR	5,34	20,87	3,66	4,90	28,80	27,33	68,57	4,08	33,10	23,48	44,12	64,62	34,65	12,07	31,68	27,02	45,30	33,07	17,34
Poland	29,36	18,09	37,15	25,69	21,72	14,48	40,75	19,93	14,14	47,68	37,82	44,93	55,12	53,14	64,77	52,28	51,33	63,89	42,60
Romania	14,12	7,66	22,56	13,95	30,50	48,52	80,91	9,86	20,19	52,48	81,40	90,60	45,97	7,47	13,90	33,34	32,78	42,82	25,10
Slovak Republic	37,22	33,21	47,00	30,55	54,93	36,71	53,97	32,96	45,20	57,49	68,24	30,51	97,03	65,27	44,62	48,76	47,31	47,53	48,67
Slovenia	43,44	50,60	41,52	45,50	25,63	45,45	27,39	53,75	0,00	18,83	39,53	48,26	7,19	30,29	37,85	65,34	59,66	81,51	61,66

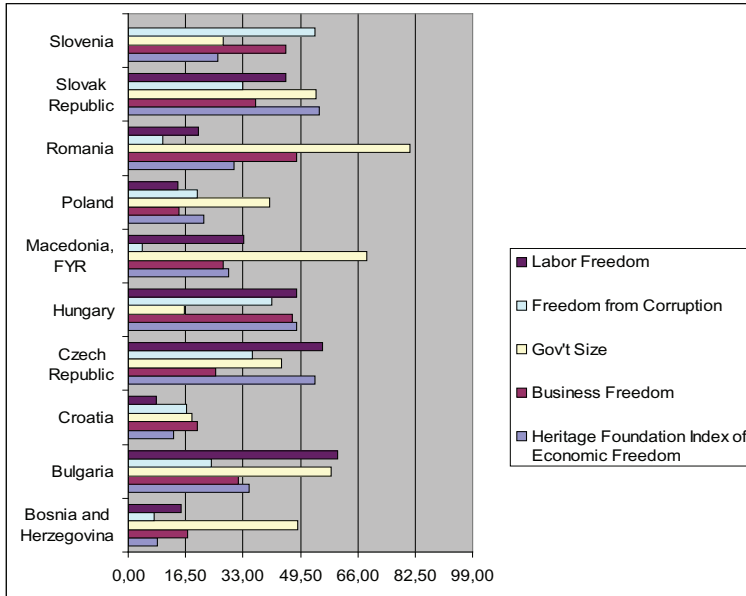
Source: own calculation by GCI, HFI, ESI and HDI

Graph 1: The Global Competitiveness Index – Relative Total Performance



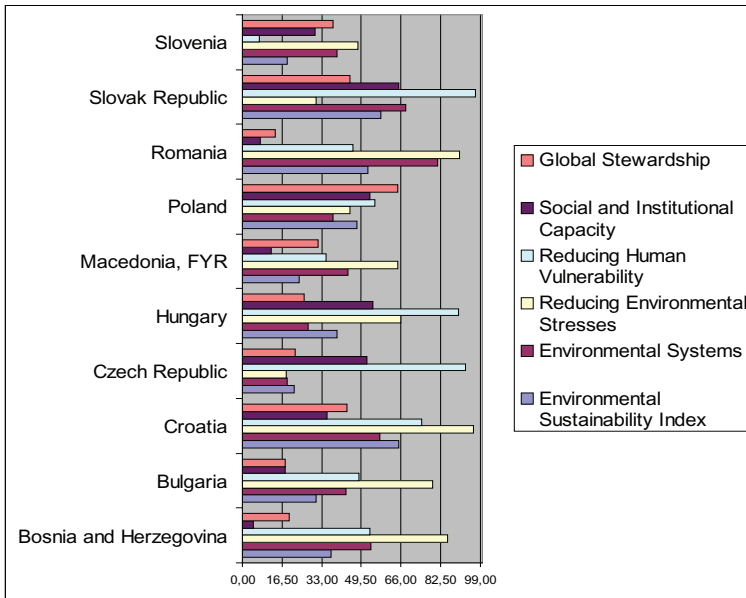
Source: Own calculation by GCI, HFI, ESI and HDI

Graph 2: Index of Economic Freedom – Relative Total Performance



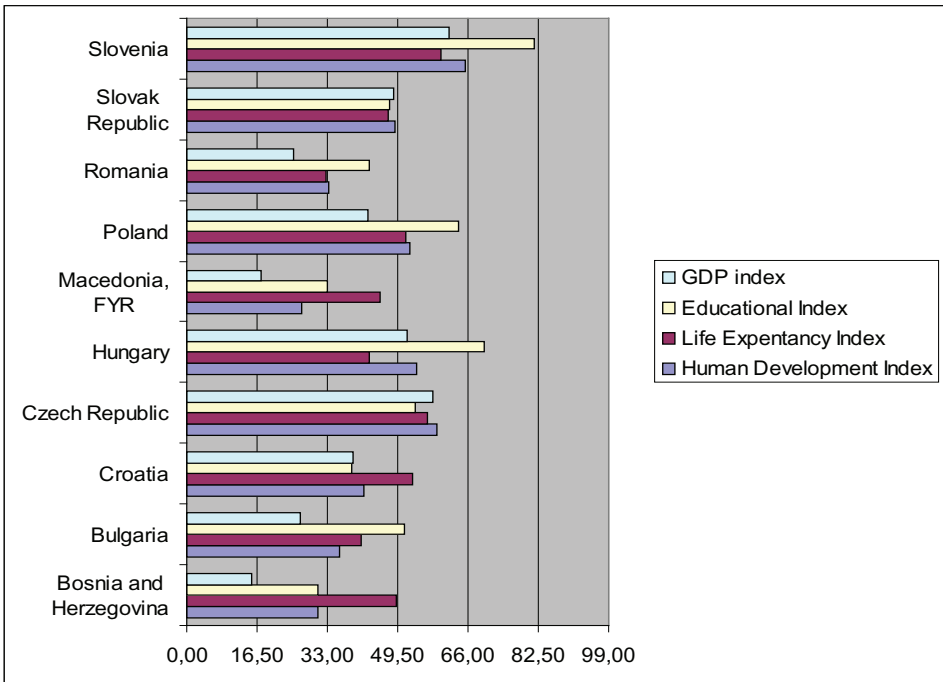
Source: Own calculation by GCI, HFI, ESI and HDI

Graph 3: Environmental Sustainability Index – Relative Total Performances



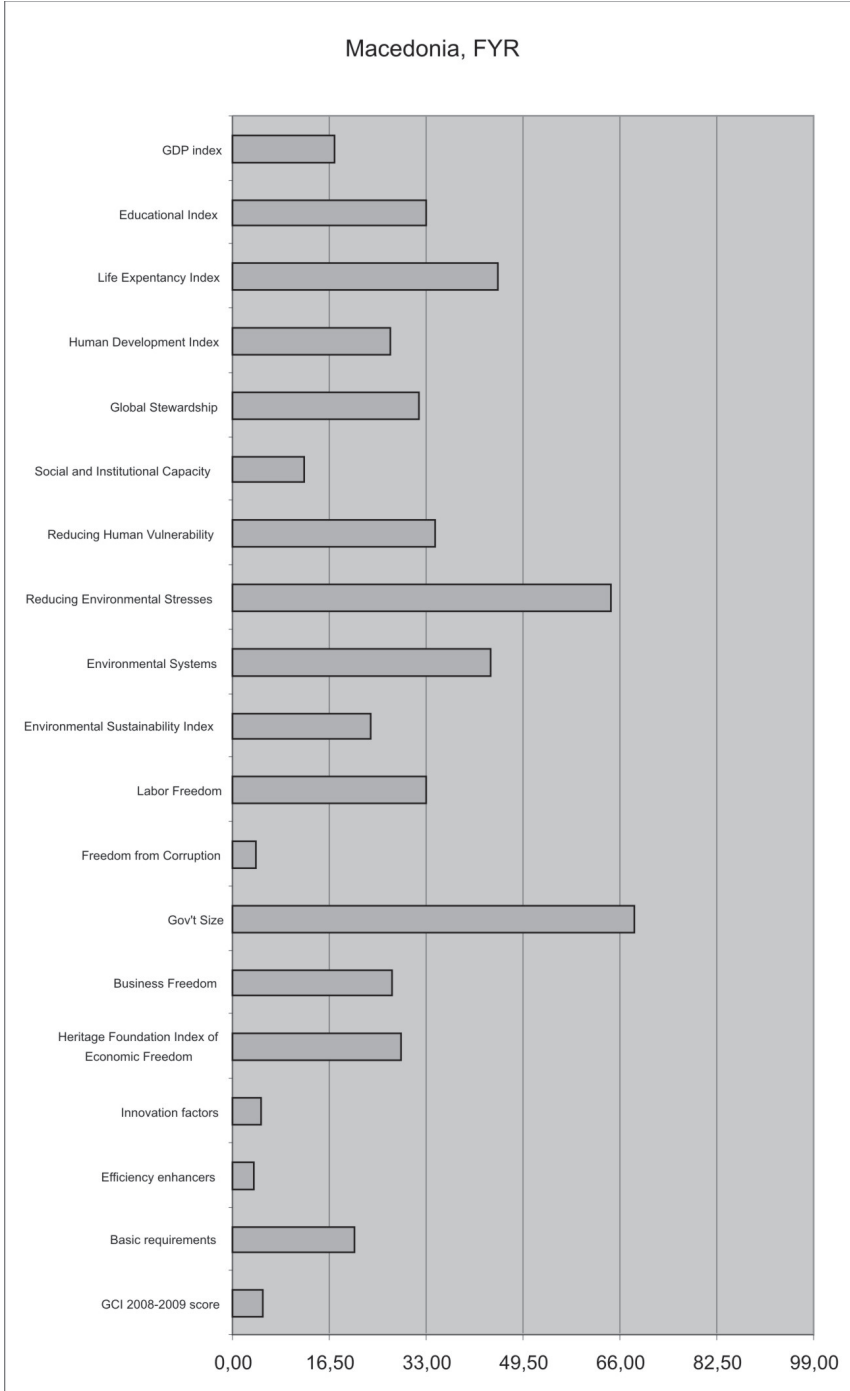
Source: Own calculation by GCI, HFI, ESI and HDI

Graph 4: Human Development Index – Relative Total Performance



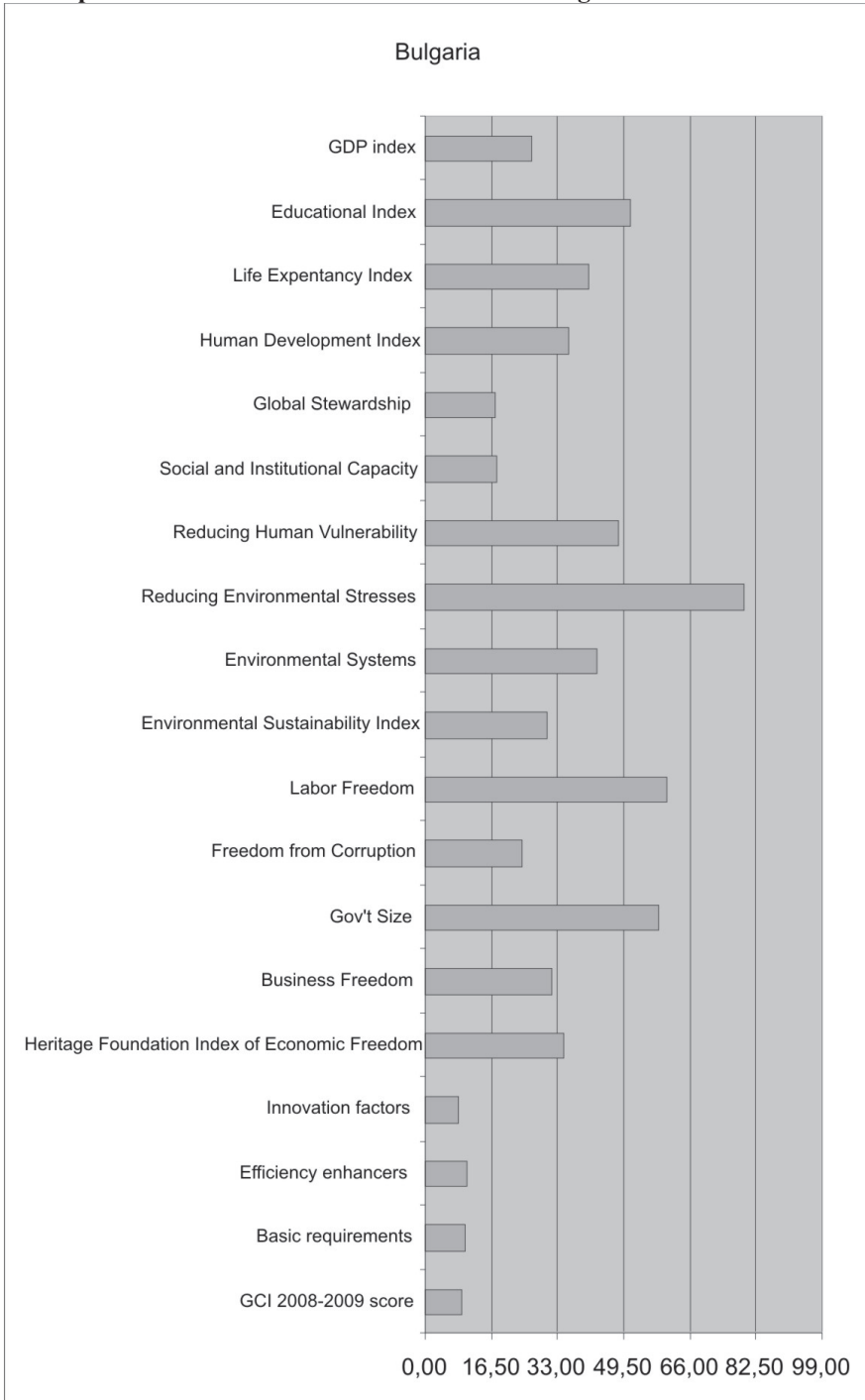
Source: Own calculation by GCI, HFI, ESI and HDI

Graph 5: The Relative Total Performance of Macedonia in different fields



Source: Own calculation by GCI, HFI, ESI and HDI

Graph 5: The Relative Total Performance of Bulgaria in different fields



Source: Own calculation by GCI, HFI, ESI and HDI

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COMPARISON OF TRADE PATTERNS OF SELECTED SOUTH-EASTERN EUROPEAN COUNTRIES

Abstract

This paper examines the trade patterns of selected south-eastern European countries. The empirical research comprises the analyses of: dispersion and concentration, comparative advantages, intra-industry trade, trade specialization, export competitiveness and export similarities. The methodology of the paper is based on applying the following indicators of international trade: TEI (Trade Entropy Index), RCA (Revealed Comparative Advantages), Grubel-Loyd Index (GL), RUV (Relative Unit Value), Index of Export Competitiveness and Index of Export Similarities (ES). The empirical results for the observed countries reveal the conclusion about existing comparative advantages in raw materials and labor intensive sectors (base metal, textiles, footwear, wood). Those products with a higher level of comparative advantage do not have a higher ratio between the unit value of exports and imports which points to unfavourable trade patterns. All the observed countries show the most favorable position on the EU 25 markets in agricultural and textile sectors. Analyzed countries do not have competitive export structures but complementary.

Key words: *trade patterns, comparative advantages, trade specialization, export competitiveness, south-eastern European countries*

INTRODUCTION

The purpose of this paper is to analyze changes in the trade patterns of selected south-eastern European countries, as well as to explain the noted similarities and differences in the dynamics and direction of movements in comparative advantages and in trade specialization. The analysis comprises the following countries: Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia. During the last 15 years of transition these countries have witnessed an abundance of very interesting and significant economic events. Croatia and Macedonia are candidate countries for joining the EU while Bosnia and Herzegovina, Serbia and Montenegro are prospective candidate countries.

All these countries face the challenge of more active inclusion in the European integration process, and one of the key factors in this path is the improvement in trade patterns and export competitiveness. The changes of export structure towards higher value added products are a precondition of growth in export competitiveness. The latest trends on the international markets are characterized by a significant fall in demand and a strengthening of competitive pressure. In this context the ability of the adjustment to new market circumstances is especially important for the achievement of continual growth

in production and in exports. Present theoretical knowledge supports open policies of international trade. The liberalization and openness of the markets and global reduction of demand create new challenges for strengthening export competitiveness (Buturac and Grzinic, 2009). This paper is focused on the analysis of: dispersion and concentration, comparative advantages, trade specialization, intra-industry trade, export competitiveness and export similarities. The methodology of the research is based on applying the following indicators of international trade: TEI (Trade Entropy Index), RCA (Revealed Comparative Advantages), RUV (Relative Unit Value), Index of Export Competitiveness and Index of Export Similarities (ES).

The paper is divided into three parts. After the introduction, the second part is related to a brief review of methodology. The results of empirical research of the openness, dispersion and concentration, comparative advantages, export competitiveness and export similarities are shown in the third part. Brief conclusions are then drawn.

1. Methodology

The empirical analysis of changes in the trade patterns of selected south-eastern European countries was calculated using the following indicators:

- trade entropy index (TEI) for the analysis of the dispersion and concentration;
- revealed comparative advantages (RCA) for the analysis of comparative advantages;
- Grubel-Loyd Index (GL) for the analysis of intra-industry trade;
- relative unit value indicator (RUV) for the analysis of horizontal and vertical specialization;
- the indicator of export competitiveness;
- the indicator of export similarities (ES).

The dispersion and concentration of export and import structure are analyzed applying empirical calculations TEI indicator („Trade Entropy Index“) which is calculated according to the following expression:

$$I_{xi} = \sum_j b_{ij} \ln \left(\frac{1}{b_{ij}} \right) ; \quad 0 < b_{ij} < 1; \quad \sum_j b_{ij} = 1$$

where b_j is the share of the export of individual product i in total export of manufacturing j . The same is valid for imports. The higher value of the indicator reveals a higher level of export dispersion, i.e. a lower level of export concentration. Conversely, the lower value of entropy index means lower dispersion, i.e. higher concentration. A high concentration or low dispersion implies a high share of product or several products in total export structure. Otherwise, low concentration or high dispersion reveals the fact that none of the products has significantly higher share in export structure relative to other products.

The RCA indicator is used for the analyses of comparative advantages. The methodology

for calculating the RCA indicator was originally developed by Bela Balassa (1965). Later, numerous derivations originated from this indicator. The RCA indicator is useful for the purpose of comparing comparative advantages for individual product groups¹. The RCA indicator is calculated by the formula:

$$RCA = \ln \left[\frac{X_i}{M_i} \right] \times \left(\frac{\sum_{i=1}^n X_i}{\sum_{i=1}^n M_i} \right) \times 100$$

X is defined as the value of exports, while M is the value of imports. Index i is the product group classified according to SITC. A positive value indicates that the country has comparative advantages in the corresponding product group. Conversely, a negative sign for the RCA indicator implies that there are no comparative advantages. An alternative for RCA indicators is the Lafay's RCA index. Compared to Balassa's RCA indicator, Lafay's index takes in regard the flows of trade inside each sector of the economy, GDP as well as exports and imports for each group of products.²

The GL index shows the level of intra-industry trade specialization. The methodologies and calculations of the GL index were developed and applied by Grubel and Lloyd (1975).³ For individual product groups the GL index is calculated using the formula:

$$GL_i = \frac{\sum_{i=1}^n (X_i + M_i) - \sum_{i=1}^n |X_i - M_i|}{\sum_{i=1}^n (X_i + M_i)} * 100$$

GL_i is the value of the Grubel-Lloyd index for product group i . X is defined as the value of exports, and M is the value of imports. The coefficient can vary from 0 to 1. The closer it is to 1, the higher the degree of specialization in intra-industry trade. A lower value of the coefficient shows that the country has a higher level of specialization in inter-industry trade.

The RUV indicator was originally developed by Abd-el-Rahman (1991). Later, numerous derivations originated from this indicator (Greenaway, Hine and Milner 1994). The RUV indicator is useful for the purpose of analyses of horizontal and vertical intra-industry trade. The indicator is based on the unit value of exports and imports. The unit value of exports is calculated as the value of exports divided by the quantity and the unit value of imports as the value of imports divided by the import quantity:

¹ See more details about the use of RCA indicator in Balassa (1965), Lafay (1992), and for transition economies Kaminski and Ng (2001), Yilmaz (2005), Buturac (2005).

² See more details about the use of Lafay's index in Lafay (1992).

³ See more details about the use of index of intra-industry trade specialization in transition economies in Kaminski and Ng (2001).

$$1 - \alpha \leq \frac{UVX_i}{UVM_i} \leq 1 + \alpha$$

UVX_i refers to the unit value of exports of product groups i , and UVM_i refers to the unit value of imports. Parameter α is a dispersion factor. The value of the parameter can be arbitrarily fixed. In most studies the parameter is assumed to be equal to 0.15 (Algieri 2004; Reganati and Pittiglio 2005). If the exports and imports unit value differ by less than 15%, then intra-industry trade is horizontal, and if the difference is higher, intra-industry trade is vertical. If the RUV is within the interval (0.85; 1.15) intra-industry trade is horizontal; conversely if it is outside of this interval it is vertical. If the RUV is greater than 1.15, the country is “exporting quality” while if it is smaller than 0.85 the country is “importing quality”. Vertical intra-industry trade is assumed to have two components, high quality (HQVIIT) and low quality (LQVIIT). A high share of LQVIIT means that a country is specializing in relatively low-priced export goods in the vertically differentiated sectors. A high share of HQVIIT implies that VIIT takes the form of high-valued exports. Therefore if the relative unit value of a good is below the limit of 0.85, it is considered to be a low quality export. Conversely, if the RUV indicator is over the limit 1.15, it is considered a high quality export. In summary, intra-industry trade (IIT) contains the following components:

$$IIT = HIIT + LQVIIT + HQVIIT$$

Export competitiveness is analyzed applying the indicator of competitiveness⁴. It is the ratio between exports of the product, i , to observed market c and total imports of this product from the market c :

$$Ic_i(a, c) = \frac{EX_i(a, c)}{\sum_{i=1}^n IM_i(c)} \times 100$$

$EX_i(a, c)$ is the export of the product, i , of country, a , to the market c . The total import

product, i , from market, c , is $\sum_{i=1}^n IM_i(c)$

Export Similarities - ES indicator shows the level of similarities in the structure of exports between two countries. It is calculated using the following formula:

$$ES(ab, c) = \sqrt{\sum_i \left[EX_i(ac) - \frac{EX_i(ac) + EX_i(bc)}{2} \right]^2}$$

ES indicator is used for measuring the different structures of exports of county a and of country b in country c . $EX_i(ac)$ describes a part of export products i of country a in country

⁴ See more details about indicators of competitiveness in Yilmaz (2005).

c in total exports of country a in country c . In this way the indicator is calculated assuming values in the interval from 0 to 1. The closer the ES indicator is to 1 the more similar the structure of exports between two countries is.⁵

2. Empirical analysis

2.1. Analysis of export and import trends

The periods of transition were characterized by a process of accelerated opening and integration of south-eastern European countries into the international market. Therefore, in this introductory part of the empirical analysis basic indicators and trends in international trade and rising trade openness are presented. The growth of openness and liberalization of domestic markets had strong impacts on import growth. In all countries export growth was recorded, but it was less than import growth (apart from Serbia and Montenegro). Average annual export and import growth rates from 1996 to 2006 were the highest in Bosnia and Herzegovina, and the lowest in Macedonia (table 1).

Table 1: The basic indicators of exports and imports

	Average annual growth rate (%)		Relative deficit ⁶ (%)		$\frac{Export + Import}{GDR}$ (%)	
	Export	Import	1996	2006	1996	2006
Bosnia and Herzegovina	25.68	15.78	-64.39	-37.60	44.83	89.50
Croatia	7.87	9.67	-26.64	-34.90	61.89	65.01
Macedonia	6.94	7.92	-17.28	-22.10	62.74	96.61
Serbia and Montenegro	12.80	12.10	-38.03	-35.05	41.12	66.06

Source: COMEXT, own calculations.

It is clear that the movements in exports and imports of goods determined corresponding movements in the balance of trade. All economies face a trade deficit. It is interesting that the relative deficits of Bosnia and Herzegovina, Croatia and Serbia and Montenegro were in 2006 at approximately the same level. At the same time, Macedonia recorded the lowest relative deficit. During the observed period relative trade deficit reduced in Bosnia and Herzegovina and in Serbia and Montenegro. On the other hand, relative deficits increased in Croatia and in Macedonia. It is noted that Bosnia and Herzegovina had extremely significant fall in relative deficit from 1996 to 2006.

⁵ For details about the concept of the ES indicator see in Finger and Kreinen (1979).

⁶ Relative deficit is defined as $\frac{x - m}{x + m}$, where x is the value of merchandize export, and m the value of merchandize import.

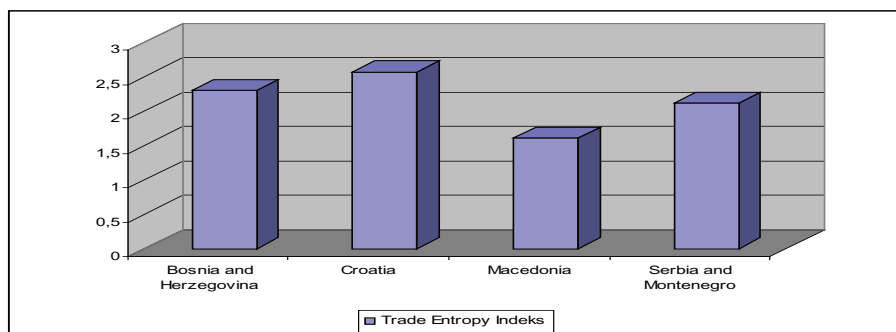
In all analyzed countries, trade rose rapidly relative to the rate of growth in GDP, which has resulted in a considerable growth in the share of trade in GDP. The most intensive growth in the share of exports and imports in GDP occurred in Bosnia and Herzegovina: it rose by 44.7% from 1996 to 2006. Out of the analysed transition countries the country with the lowest share of exports and imports in GDP in 2006 was Croatia (65.0%), practically stagnating in the share of exports in GDP.

2.2. Dispersion and concentration of export structures

In turn, the dispersion and concentration of export structures are analyzed. Trends of the dispersion and concentration of merchandize export in south-eastern European countries were determined by process of transition, existing trade relationships, and the closeness of a strong economic structure – the EU. However, dynamics in the change of economic structure, the level of integration and trade specialization can have significant influence on the higher or lower level of export concentration. The level of concentration and dispersion was analyzed by applying the “Trade Entropy Index”.

Croatia has the highest level of export dispersion, and Macedonia the lowest (figure 1).

Figure 1: Trade Entropy Index in 2006



Source: COMEXT, own calculations.

Compared to other analyzed countries, the Croatian export structure is specific in terms of a high share of the shipbuilding industry in total exports.⁶ The greatest part of the exports of Serbia and Montenegro (40.0%) is related to base metal and articles of base metal. Strong concentration of Macedonian exports is determined by the domination of base metals and articles of base metal, as well as products of textile industry. These two sectors have a share in total Macedonian exports above 75.0%. Similarly, base metals and articles of the base metal are the most significant sectors in the export structure of Bosnia and Herzegovina.

⁷ The main change in the composition of Croatian export in the transition period is the recovery of shipbuilding industry exports from 1998 onwards which increased the share of machinery and transport equipment in total exports.

2.3. Comparative advantages

The results from the previous parts of the paper show that the period of transition was characterized by a significant increase in the openness and the volume of international trade. The key question in this part of the paper is: does an increase in openness in international trade correspond to positive changes in trade structure? A positive change in the trade structure implies a change of comparative advantages towards higher value added sectors and products as well as a higher level of trade specialization. In this part, comparative advantages are analyzed while trade specialization is analyzed in the following part of the paper.

The comparison of comparative advantages for selected south-eastern European countries is analysed by the RCA indicator. The empirical results are displayed in table 2.

Table 2: The RCA indicator in 2006

Sectors	Bosnia and Herzegovina	Croatia	Macedonia	Serbia and Montenegro
Machinery	-0.36	-0.42	-1.50	-0.99
Base metal	0.36	-0.36	0.84	0.40
Textiles	-0.23	-0.17	0.17	-0.20
Foodstuffs	-1.45	-0.17	0.05	-0.14
Wood	0.82	0.18	-0.93	-0.27
Mineral	-0.40	-0.38	-0.69	-0.94
Miscellaneous manufactured articles	0.62	-0.21	-0.95	-0.43
Vehicles	-1.39	-0.78	-2.03	-1.26
Plastics	-1.07	-0.42	-2.83	-0.23
Chemical	-0.87	-0.70	-2.34	-0.90
Footwear	0.43	-0.01	0.36	0.15
Skins, leather	-0.12	0.01	-0.76	-0.87
Pulp of wood, paper	-0.95	-0.50	-2.85	-1.00
Stone, plaster, cement	-1.74	-0.42	-1.05	-1.08
Animal products	-2.06	-0.61	-0.67	-0.88
Precision instruments	-1.17	-1.44	-2.40	-1.37
Vegetable products	-1.13	-0.57	-0.11	0.70
Natural or cultured pearls	0.51	-0.64	-	0.40
Animal or vegetable fats and oils	-0.90	-0.53	-	-0.46
Arms and ammunition	1.22	-	-	0.20

Source: COMEXT, own calculations.

All observed countries, except Croatia, have comparative advantages in base metal and articles of base metal, footwear, natural or cultured pearls, arms and ammunition. Bosnia and Herzegovina is the only one that has comparative advantages in miscellaneous manufactured articles. Unlike Macedonia and Serbia and Montenegro, Bosnia and Herzegovina and Croatia have comparative advantages in trade with wood. Conversely, Macedonia and Serbia and Montenegro have comparative advantages in trade with vegetable

products while Bosnia and Herzegovina and Croatia do not. A common characteristic for all countries is the presence of comparative advantages in low value added sectors.

2.4. Intra-industry trade and trade specialization

After comparative advantages were analyzed, the trade patterns concerning the realized economic benefits from international trade are explored. For this purpose horizontal and vertical specialization are analyzed. Horizontal intra-industry trade occurs when similar products are simultaneously exported and imported, mainly due to product differentiation. Vertical intra-industry trade represents the simultaneous export and import of goods within one industry but where the products belong to different stages of production. Empirical research of intra-industry trade began in the mid-1960s. The first results were exposed by Balassa (1965). The most well known work on intra-industry trade was made by Grubel and Lloyd (1975). This research was then followed by what we know today as the theory of intra-industry trade (Dixit and Stiglitz 1977; Krugman 1980, 1981; Lancaster 1980; Helpman 1981). The role and significance of intra-industry trade in the process of globalization and integration of transition economies on international markets is becoming more important than previously. Research in the field of international trade shows that intra-industry trade is the fastest growing segment in the international trade of transition economies (Aturupane, Djankov and Hoekman 1997; Kaminski and Ng, 2001). The key question is what happens with the comparative advantages and utility in international trade. Namely, we can ask does an increase in the integration with international markets and growth in intra-industry trade specialization correspond to changes in comparative advantages towards higher value added sectors?

The most commonly used indicator for the measuring of the level of specialisation in intra-industry trade is the Grubel-Lloyd index. Empirical results of the calculation of the Grubel-Lloyd index for selected transition south-eastern European countries are shown in table 3.

Table 3: The GL index in 2006

Sectors	Bosnia and Herzegovina	Croatia	Macedonia	Serbia and Montenegro
Machinery	0.72	0.51	0.24	0.24
Base metal	0.72	0.58	0.50	0.62
Textiles	0.82	0.79	0.89	0.81
Foodstuffs	0.18	0.79	0.97	0.86
Wood	0.42	0.77	0.45	0.74
Mineral	0.69	0.55	0.58	0.26
Miscellaneous manufactured articles	0.54	0.74	0.44	0.59
Vehicles	0.19	0.24	0.13	0.15
Plastics	0.31	0.52	0.05	0.78
Chemical	0.40	0.29	0.09	0.28
Footwear	0.67	0.99	0.77	0.85
Skins, leather	0.90	1.00	0.54	0.29
Pulp of wood, paper	0.36	0.44	0.05	0.23
Stone, plaster, cement	0.12	0.52	0.40	0.21
Animal products	0.07	0.35	0.58	0.29
Precision instruments	0.27	0.05	0.08	0.12
Vegetable products	0.28	0.38	0.93	0.39
Natural or cultured pearls	0.62	0.33	-	0.62
Animal or vegetable fats and oils	0.38	0.41	-	0.57
Arms and ammunition	0.25	-	-	0.80

Source: COMEXT, own calculations.

As seen from the table, all countries have a higher level of intra-industry trade specialization in labour-intensive sectors: textiles, base metal, wood, footwear, skins and leather. At the same time, inter-industry trade prevails for capital intensive sectors and high technology sectors: vehicles, chemical, precision instruments.

Intra-industry trade can be separated into horizontal and vertical types based on the unit value of exports and imports (Algieri 2004; Reganati and Pittiglio 2005). The unit value of exports is calculated as the value of exports divided by the quantity and the unit value of imports as the value of imports divided by the import quantity. If RUV is within the interval 0.85- 1.15, intra-industry trade is horizontal; conversely if it is outside of this interval it is vertical. In table 4 the first three products at the three digit level of SITC⁷ concerning the calculated RUV values are shown. At the same time, for every product its related export share is noted.

⁸ SITC is the shortcut for Standard international trade classification

Table 4: The indicator of the ratio between unit value of exports and imports (RUV) in 2005

SITC	PRODUCTS	RUV	RCA	% EXPORTS
Bosnia and Herzegovina				
048	Cereal	1.40	-0.49	0.59870
285	Aluminum	1.36	0.13	4.83567
713	Piston engines and parts	1.30	0.11	7.82918
Croatia				
272	Fertilizers	16.39	-3.99	0.00005
613	Fur	9.27	0.02	0.03013
515	Organic compounds	7.48	-0.58	0.12720
Macedonia				
012	Meat	4.28	-0.62	0.71033
048	Cereal	2.19	-0.34	0.69073
676	Iron and steel	1.46	-0.85	0.71033
Serbia and Montenegro				
248	Wood	1.74	-0.03	1.48370
061	Sugars, molasses and honey	1.65	0.59	4.22487

Source: COMEXT, own calculations.

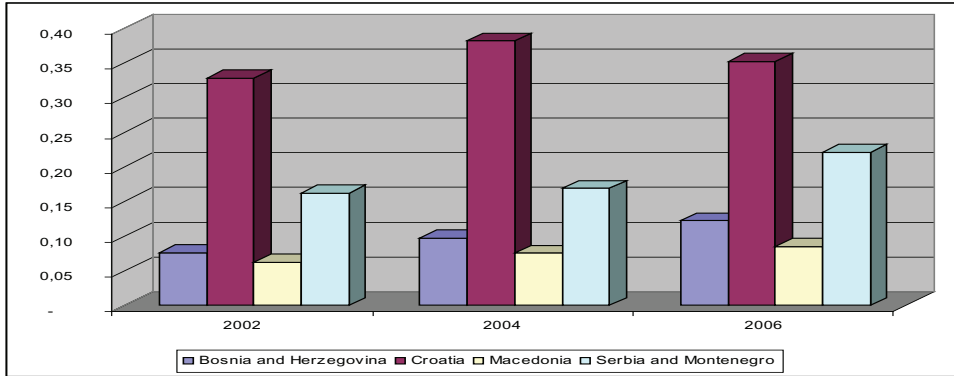
The analysis of the results leads to the conclusion that the great majority of products in which the observed countries realize the highest values of the RUV indicator belong to the sphere of raw materials or labour-intensive products. Compared to other analyzed countries, Croatia has the largest number of the products at the three digit level of SITC which have the values of the RUV indicators above 1.15 (vertical specialization with high value added products). At the same time common characteristics for all countries are a domination of horizontal specialization and vertical specialization with low value added products in the trade structures. Also, it is noted that for Croatia and Macedonia none of the first three products have an export share higher than 1.0%. On the other hand, the first three products according to the RUV indicator for Bosnia and Herzegovina and Serbia and Montenegro have a significant role in their exports structures. However, the values of the RUV indicator in these countries are pretty low.

The analysis of comparative advantages, intra-industry trade and trade specialization does not reveal an unambiguous conclusion for overall trade patterns. On the one hand, there are sectors with comparative advantage, while on the other hand there are sectors which do not have comparative advantage. At first sight the unfavourable ratio on behalf of the sectors without comparative advantage does not have to necessary lead to a conclusion about unfavourable trade structures. The reason is a characteristic of small countries where it is expected that comparative advantages and trade specialization will be found in a smaller number of sectors and products. However, the results of the correlation analysis for all products at the three digit level of SITC show that products with a higher level of comparative advantage do not have a higher ratio between the unit value of exports and imports. This points to unfavourable trade patterns.

2.5. Export competitiveness to EU markets

The European Union is the most important export destination for all observed countries. That is why in this part of the paper the emphasis is on the analysis of export competitiveness to EU markets. As an indicator of export competitiveness we use the ratio between the export share of individual product i to observed markets and total import of that product from observed market. The comparison of the export competitiveness between domestic production activities is shown in figure 2.

Figure 2: The indicator of total export competitiveness to EU 25 markets



Source: COMEXT, own calculations.

According to the total indicator of competitiveness Croatia has the best position to the EU 25 markets relative to the other observed countries. Macedonia has the lowest value of the indicator. Although Bosnia and Herzegovina, Macedonia and Serbia and Montenegro have significantly lower levels of total competitiveness to the EU 25 than Croatia, there are positive trends in the growth of competitiveness. More detailed view about competitiveness is shown in table 5 where the competitiveness of individual economic sectors is shown.

The obtained results lead to the conclusion that Croatia has a significantly better position in terms of EU-25 markets compared to other countries. All countries improved their position to EU markets from 2002 to 2006 in agricultural products. While Croatia faced deteriorating the export competitiveness in textiles and clothing, Macedonia and Serbia and Montenegro improved competitiveness in these sectors. The characteristic of Bosnia and Herzegovina is a significant improvement of export competitiveness in transport equipment.

Table 5: The indicator of export competitiveness to EU 25 markets by sectors

<i>Bosnia and Herzegovina</i>			
	<i>2002</i>	<i>2004</i>	<i>2006</i>
I. PRIMARY PRODUCTS	0.11	0.12	0.10
Agricultural products	0.15	0.18	0.18
Energy	0.02	0.00	0.01
II. MANUFACTURED PRODUCTS	0.07	0.10	0.14
Machinery	0.01	0.02	0.05
Transport equipment	0.02	0.12	0.18
Chemicals	0.01	0.01	0.04
Textiles and clothing	0.19	0.18	0.16
<i>Croatia</i>			
	<i>2002</i>	<i>2004</i>	<i>2006</i>
I. PRIMARY PRODUCTS	0.27	0.26	0.24
Agricultural products	0.53	0.50	0.76
Energy	0.09	0.09	0.05
II. MANUFACTURED PRODUCTS	0.35	0.45	0.39
Machinery	0.20	0.29	0.29
Transport equipment	0.12	0.50	0.28
Chemicals	0.37	0.42	0.36
Textiles and clothing	0.86	0.77	0.56
<i>Macedonia</i>			
	<i>2002</i>	<i>2004</i>	<i>2006</i>
I. PRIMARY PRODUCTS	0.05	0.05	0.05
Agricultural products	0.11	0.12	0.17
Energy	-	0.01	0.00
II. MANUFACTURED PRODUCTS	0.07	0.09	0.11
Machinery	0.01	0.01	0.01
Transport equipment	0.01	0.01	0.01
Chemicals	0.01	0.01	0.01
Textiles and clothing	0.36	0.40	0.45
<i>Serbia And Montenegro</i>			
	<i>2002</i>	<i>2004</i>	<i>2006</i>
I. PRIMARY PRODUCTS	0.27	0.24	0.24
Agricultural products	0.55	0.49	0.61
Energy	0.02	0.01	0.01
II. MANUFACTURED PRODUCTS	0.12	0.14	0.21
Machinery	0.04	0.04	0.06
Transport equipment	0.11	0.05	0.07
Chemicals	0.09	0.17	0.19
Textiles and clothing	0.24	0.23	0.30

Source: COMEXT, own calculations.

2.6. Export similarities

The paper so far has analysed changes of comparative advantages, trade specialization and export competitiveness. However, now, we discuss the question of export similarities, analysing whether observed countries have complementary or competitive export structures.

Table 6: Matrix of the ES indicator in 2006

	Bosnia and Herzegovina	Croatia	Macedonia	Serbia
Bosnia and Herzegovina	-	0.10	0.27	0.12
Croatia	0.10	-	0.22	0.17
Macedonia	0.27	0.22	-	0.14
Serbia and Montenegro	0.12	0.17	0.14	-

Source: COMEXT, own calculations.

The empirical results, displayed in table 1, show that the most similar export structures are found in Bosnia and Herzegovina and Macedonia. On the other hand, the highest difference is between Bosnia and Herzegovina and Croatia.

The values of the ES indicator are much closer to 1 than 0, which reveals a conclusion that the observed countries have complementary export structures.

CONCLUSION

The period of transition in south-eastern European countries was marked by significant growth in trade volume and openness of domestic markets. The growth of the openness and liberalization of markets have favored the dynamic growth of imports in all observed countries. Apart from Serbia and Montenegro, export growth was somewhat lower than import growth. All countries face a high level of relative trade deficit. Common characteristic for all analyzed countries is the existence of comparative advantages in low value added sectors: base metal, wood, textiles, footwear. A similar situation is found in terms of competitiveness. In all observed countries agricultural and textile sectors showed the most favorable position to the EU markets. In the group of observed countries Croatia has the highest level of competitiveness to EU 25 markets in each economic sector. Croatia is specific for its relatively good position in competitiveness of transport equipment. This could be explained by the significant value in the export of the shipbuilding industry. The analysis of trade specialization leads to the conclusion that the great majority of products in which the observed countries realize the highest values of the RUV indicator are related to raw materials or labour-intensive products. At the same time, a common characteristic for all countries is the domination of horizontal specialization and vertical specialization with low value added products in trade structures. Intra-industry trade prevails in low value added sectors (base metal, textiles, footwear, skins and leather) and inter-industry trade

in high technology sectors (precision instruments, chemical, vehicles). The analysis of comparative advantages, intra-industry trade and trade specialization show a small number of sectors with comparative advantages, as well as vertical specialization with high value added exports. At first sight the unfavourable ratio on behalf of those sectors without comparative advantage does not have to necessary lead to a conclusion about unfavourable trade structures. It is to be expected for small countries that comparative advantages and trade specialization will be found in a smaller number of sectors and products. However, correlation analysis shows that products with a higher level of comparative advantage do not have a higher ratio between the unit value of exports and imports (RUV). It points to unfavourable trade patterns. Finally, the analysis of export similarities reveals the conclusion that selected south-eastern European countries have complementary export structures.

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Part II

CEFTA-2006 TRADE COOPERATION

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CEFTA-2006 PROGRESS AND WORLD ECONOMIC CRISIS

Abstract

The signing of the updated CEFTA was supposed to be an historic event in South East Europe. The remaining countries that are still waiting on EU membership should operate in a free-trade zone, economies should finally have the opportunity to grow above politics and companies looking for growth could expand to neighboring markets. Has the reality met these high expectations? Has CEFTA really changed the playing field?

As the „old” CEFTA countries experienced substantial trade increases among each other, implementing the agreement, one could expect the same for SEE. The enlarged CEFTA should help move SEE nearer to the creation of a single market, but CEFTA expansion would not in itself liberalize trade in goods beyond the tariff reductions envisaged in the bilateral FTAs (these are annexed to the new CEFTA agreement). While the business communities are expecting an increase in investment, (because a single market plays a key role in attracting investment), trade and investment would continue to be held back by shortcomings in these countries’ business environment, especially licensing procedures, deficient infrastructure and differing product standards.

CEFTA expansion would also not ease the worries of South-East European countries about the likely slowdown in EU enlargement, and may even intensify these concerns. The credibility of the accession process has been gravely weakened by increasing “enlargement fatigue “ within the EU and a string of negative messages over the past year to the Western Balkan aspirants about when, and even if , they might expect to become members. May there be concerns within South-East Europe that the EU sees CEFTA as a substitute for, rather than a facilitation of, EU integration? What is a future of CEFTA as a multilateral agreement for regional co-operation, especially under aggravating circumstances of world economic crisis?

These are the issues we would try to analyze in this paper, using statistical data basis and comparing trade flows between the CEFTA-6 countries, within and outward region.

Key words: *CEFTA updated, trade region, trade cooperation, integration, economic crisis.*

INTRODUCTION

CEFTA-2006 is one of the greatest achievements of the regional co-operation in SEE promoted by the Stability Pact and a long process took place before its actual coming into force. Trade experts working under the Stability Pact had suggested that the SEE countries adopt a single regional trade agreement back in 2001 but this was not politically feasible at the time. Hence the decision to go for a network of bilateral free trade agreements (FTAs). Since 2001 the countries of the region negotiated and ratified a network of 32 bilateral FTAs, under the guidance of the Stability Pact. These FTAs already helped improve the political and economic relations between the countries and it led many to conclude that a single agreement would yield even more benefits. Therefore the SP's Trade Working Group Recommended in 2005 that it explore the feasibility of developing a single agreement, possible based on the Central Europe Free Trade Agreement- CEFTA. The original CEFTA required that members must have a contractual relationship with the EU and be WTO members- and this was not case for SEE countries at the time. The countries could be eligible for new CEFTA if they agreed to apply WTO rules and procedures in advance of membership and if they were in advanced stages of negotiations with the EU and the WTO.

The significance of "old" CEFTA, which has been successful in its aim of restoring trade links severed in the early 1990s and promoting European integration, declined after May 2004, when five of its members- Hungary, Poland, the Czech Republic, Slovakia and Slovenia – joined to EU. However, the looming expansion of CEFTA into South- eastern Europe has breathed new life into the agreement.. Five Sought-east European countries – Bosnia and Herzegovina, Albania, Serbia, Montenegro and Moldova from former Soviet Union, plus Kosovo, agreed to join an expanded CEFTA on December 19th 2006. They formed an eight –member regional trading bloc alongside CEFTA's existing members, Croatia and Macedonia, (Bulgaria and Romania also signed the agreement in Bucharest, but left CEFTA almost immediately when they joined the EU on January 1st 2007).

The CEFTA 2006 includes issues such as trade in services, government procurement, state aid and intellectual property rights. The "old" CEFTA countries experienced substantial increases in trade with each other on implementation of the agreement and one could expect the same for SEE as well as an increase in investment, because a single market plays a key role in attracting investment, thereby promoting economic growth, job creation and in reducing unemployment. There will also be a unified system for resolving trade disputes.

The enlarged CEFTA should help move south- eastern Europe nearer to the creation of single market, but CEFTA expansion will not in itself liberalize goods trade beyond the tariff reductions in the bilateral FTAs (these are annexed to the new CEFTA agreement). The new CEFTA had been intended to come into force on May 1st 2007, but delays in the ratification process mean that this target was missed. By the end of t May, six of the eight parties had ratified CEFTA and since November 22ed 2007 trade relationships between SEE countries are regulated by CEFTA -2006 Agreement.

1. Significance and contribution of CEFTA-2006

CEFTA is a multilateral agreement of the Western Balkan Countries and Moldova, with the primary aim to provide liberalization of the foreign trade regime within the region, by consolidation of all former bilateral agreements signed among them. Complete introduction of a zone of free trade, according to CEFTA 2006 should be realized until 31.12.2010.

Apart of the primary goal, the intention of CEFTA 2006 agreement was to encourage regional integration and cooperation among countries of South Eastern Europe during process of development and fulfillment of political, security and legal criteria for their forthcoming integration into the European Union. CEFTA 2006 is more comprehensive than the original CEFTA and the rest of the bilateral FTAs, covering bigger number of areas, that till CEFTA 2006 was not subject of negotiations.

Namely, beside trade of goods liberalization, for the first time this agreement anticipates the possibility of liberalization of trade in services, public purchases, investment and intellectual property rights protection. Extended areas of cooperation should create sound fundamentals for increasing of opportunities for economic cooperation among countries in the region, as well as fostering of the harmonization processes of their measures and the international standards. New CEFTA agreement foresees that member states should recognize the WTO agreement concerning the technical barriers to trade, undertaking the obligations to harmonize the national technical standards with the WTO regulations and those of EU, latest till 31.12.2010. (Draft of the Agreement on Modification of and Accession to the Central European Free Trade Area Agreement, Bucharest, 6th of April 2006, p.10)

Member states are obliged to facilitate the tariff procedures and formalities and to provide fast flow of goods, whereas important role goes on the reform of rules for origin of goods. (Draft of the Agreement on Modification of and Accession to the Central European Free Trade Area Agreement, Bucharest, 6th of April 2006, p.11)

As said above, establishment of functional free trade area is a priority goal of CEFTA 2006. The liberalization process started in May 2007 has different intensity for both groups of products: industrial and agricultural. Concerning industrial goods' exchange, dismantling of tariff expenditures and their equivalent measures were realized for bigger number industrial goods right after agreement entered in force. For a small number of goods listed in Annex 2 of the Agreement, in the bilateral trade between some members, tariffs continued to be applied with the noted decrease, according to defined time schedule. (Annex 2 of the Agreement for Modification and Accession to CEFTA, Article 8, Official Journal of the Republic of Macedonia, No. 59/06)

Including 31.12.2008, tariffs were totally annulated for all industrial goods traded among member states of CEFTA 2006.

Regarding the trade in agricultural goods, the Agreement foresees step by step tariff decrease till their entire annulations, having on mind that all countries negotiate among them on bilateral regime for import and export of agricultural goods. (Annex 3 of the

Agreement for Modification and Accession to CEFTA, Article 10, Official Journal of the Republic of Macedonia, No. 59/06)

If tariffs for protection of agricultural goods imposed by some member countries and according to the regime of the most favorite nation are lower than preferential tariffs, than countries in their mutual exchange should use lower tariffs (MFN).

The Agreement was extended with time deadline till 1st May, 2009, period until the member states can agree additional concessions in the mutual trade in agricultural goods. It has to be stressed that the Agreement of CEFTA 2006, strictly forbids use of export subsidies for agricultural products in exchange among countries, alongside faster creation of free trade zone.

Concerning the Republic of Macedonia, trade in agricultural goods is almost fully liberalized with all member states of CEFTA. For a very small number of sensitive agro-alimentary goods between R. Macedonia on one hand and on the other Albania, Croatia and Moldova, trade in mentioned goods is performed in the framework of non tariff quotas, while for quantities above quotas, during export or import, MFN tariff is charged or certain percent of basic tariff.

For Macedonian exporters, application of multilateral agreement regulations means not only liberalization of foreign trade regime, but also facilitation and unification of customs procedures, transit rules and simplification of rules for origin of goods. In this regard CEFTA 2006 provides the following opportunities: multi – CEFTA cumulation, extended cumulation (use of raw-materials with EU, EFTA and Turkey origin) and SAP cumulation of origin (use of raw – materials from EU or member states of CEFTA 2006 participating in the process of stabilization and association).

Apart of trade liberalization, CEFTA 2006 is a framework for development and extension of cooperation among member countries in the area of trade in services, investments, public purchases and intellectual property protection.

Member countries of CEFTA 2006 are obliged with agreement on progressive liberalization of trade in services and mutual opening of their markets of services according to the regulations of the General Agreement of Trade in Services of WTO (GATS). Member countries' obligation is to provide fair and equal treatment and full protection of investment coming from other countries, or investment of other member states to be treated as domestic as and not less favorable than investment from third countries. All above relates and to the public purchases originating from other member states.

Regarding public purchases, countries are obliged till 1st May 2010 at the latest, to enable step by step opening of their national markets for public purchases and treatment of foreign suppliers, goods and services equally as domestic. (Public purchases, Article 35, CEFTA Agreement, Official Journal of the Republic of Macedonia, No. 59/06)

Intellectual property protection, in terms of fast penetration of technical progress and unstoppable globalization processes are main preconditions for attraction of credible

investors. This is a particularly sensitive issue regarding conditions in the Western Balkan countries and Moldova, where efficient application of legislation lags behind, as well as sound mechanisms for intellectual property protection. Thus, CEFTA 2006 Agreement obliges member states to develop and implement appropriate efficient mechanisms for protection and guarantee the intellectual property rights. In this regard countries are obliged to respect the Agreement for Trade –related aspects of intellectual property rights (TRIPS)

Conclusion of CEFTA 2006, and particularly its successful implementation, that is still on test, is considered as extraordinary important process in this part of Europe.

Mentioned countries have clearly demonstrated and expressed will for realization of CEFTA goals, but also they will have to prove their readiness to overcome their mutual turbulent past and to leave it to historians, and to take the future of their people and the entire region into their hands and hard-headed and reasonably to build it on sound fundamentals, today and now.

This agreement means start of an era of real integration, or in other words readiness to work and live according to certain rules and standards, that is a kind of test for the entire region, as well as a test for readiness and maturity to integrate into more advanced, high developed integration – EU. This needs a lot of will, work, knowledge, patience and above all persistence to follow the underlined direction and goal.

2. From CEFTA agreement to single market

The next few years will be crucial in the updated free trade agreement, as countries will prove that they can work together to bring about economic reform and progress. It is expected that such effects will take time, no free-trade- agreement is a magic pill to the region, nor will Albanian goods spontaneously become Croatian staples. CEFTA has been put in place, and it is now up to businesses to forge ahead and created networks of cross-border trade. However, though the business community stands behind the agreement and sees its possibilities, it is still frustrated by some remaining, and some new, barriers to trade.

Since the end the Kosovo conflict in 1999, the growing political stability, trade policy liberalization (with FTAs and CEFTA 2006), as well as the prospects of accession to the European Union for some countries in the sub-region, have created more favorable circumstances for foreign trade and foreign direct investment. Nevertheless, the trade balance, especially for goods, remains strongly negative in most countries. Remittances may make up for part of the difference but at the same time they reinforce the weak level of international competitiveness of many local enterprises. Foreign direct investment remains modest in all Balkan region.

Low wages have until now allowed some industries, using cheap labor as a means for attracting foreign investment and maintaining price competitiveness. However, this may

only provide temporary reprieve shortages of skilled staff (at the same time as general education levels are going up) and rising expectations are driving up labor costs. Other conditions also have to improve in order to make business profitable and attractive.

Despite the achievements to date, the SEE countries face major challenges in maintaining stability and achieving stronger links with EU. Although the countries share many historical, cultural and geographic commonalities, their record in development is not uniform. Romania's and Bulgaria's accession in January 2007, EU's decision to open accession negotiations with Turkey, Croatia and Macedonia but not (yet) with the other countries, and the uncertain future status of Kosovo, are testing for regional cooperation. However, with its ratification by Serbia, CEFTA 2006 were coming into force and could prove to be an effective vehicle for intraregional cooperation.

While trade with the EU is important for all SEE countries,(export and import with EU amounts 84 percent from all Balkan countries' foreign trade (Kikerkova, 2007, p.267) trade between neighboring countries in the sub-region has ample room for development. Cooperation within the sub-region is also essential for fostering economic growth in individual countries. It is true that regional trade liberalization is progressing under CEFTA, but countries must nevertheless take steps to ensure that they obtain optimum benefits from membership in the free trade agreement. Despite recent efforts by the authorities, the private sector sees further need to improve harmonization of and consistency in, trade policies and strategies, both within countries and between countries.

The preparation and dissemination of trade information, and its use both for strategy making and for business operations, are areas in which most countries can do better. Business conditions for enterprises vary enormously, with some countries scoring low on some criteria and high on others. Greater coherence in these conditions and an emphasis on strengthening points that are currently weak would help enterprises to gain international competitiveness both for exporting and for attracting foreign investment.

However, for only two years of the functioning of CEFTA 2006,the trade exchange with region recorded significant increase. SEE countries show very high interdependence of export of agricultural goods, and a significant interdependence of export of non-agricultural goods. But this is not exactly fact for exchange of goods on the import side. The most of the countries of SEE record less than 10% of their total import for non-agricultural goods from CEFTA 2006 countries. (The Mission of the Republic of Macedonia in Brussels, March 2009) One of the important causes for import's low level especially of industrial goods from CEFTA member states, is very low capacity in industrial production of each of the economies as well as inefficiency and low level of productivity.

Despite the achievements to date, the results from liberalized trade by CEFTA-2006 agreement are very different between countries –members. For example, Serbia produced a surplus of EUR 370,9 million in trade with CEFTA countries in the first mounts of 2009 (www.intracen.org). The surplus was made owing to export of agricultural products, especially wheat, and beverages. The country has a large trade volume in the CEFTA region accounting for nearly 20 percent of all exports under CEFTA and in those countries is 90

percent of its own trade surplus (www.b92.net/eng/). Considering that Croatia waits for its acceptance in the EU (projected at either 2011 or 2012) shortly after the agreement takes full effect in 2010, accusation that CEFTA is merely a “waiting-room” document without the teeth of an actual, working free trade agreement might bare weight.

Nevertheless some countries did not experience the positive effects on the trade exchanges as a result of the CEFTA membership. This is the case of the Bosnian economy ,despite its high level of dependence on trade both of agricultural as well as of non-agricultural goods from CEFTA 2006 countries. In the first six mounts of 2008 the Bosnian economy did not experience positive effects of the trade exchange. CEFTA also failed in meeting expectations in the areas of investment, the general standard of living, employment etc. After six mounts of usage of the agreement, Bosnia’s trade deficit has exceeded EUR 110,0 million (www.b92.net/eng/insight/opinions). Bosnia has the most liberal trade policy in the South Eastern Europe, and more than 30 percent of trade exchange is done with the region (www.intracen.org).

Macedonia is very important player in trade region both as importer and exporter. On the import side predominant products are non-agricultural goods which came from Serbia and Croatia; on the export side the agricultural products consist Macedonian exports which go to Serbia, Croatia, Bosnia and Herzegovina and Kosovo.

Regardless of what is and what isn’t working under CEFTA, price variations between countries can range between 20 and 50 percent, thus implying that cross-border trade will eventually force the issue and consumers will benefit. Companies with regional focus and capabilities will naturally seek out grater sales outlets to boost sales.

The deficiencies in CEFTA exist more in the application than in the agreement itself. The fact is that some countries still find ways to, outside of the spirit of the agreement, continue to protect the domestic market through various measures besides customs. But, that is not solution of problems which come from world economic turmoil. Although the region has not potential to be the motor of economic development for its member states, the SEE countries should try to use the given opportunity trough CEFTA 2006 in order to fulfill their goals towards EU integration and achieve comprehensive development for their people.

3. The impact of economic crisis to CEFTA agreement

The economic downturn whose impact can not fully be realized or appraised at the moment is one of the most serious challenges the region is facing. At the same time, fighting recession is largely occupying the EU member states and risks diverting their attention away from South East Europe.

Apart from the pledges bring at the last Leaders of the Group of Twenty’s Summit which imply that only open world economy based on market principles, effective regulation and strong global institutions are sure foundation for sustainable development and rising prosperity for all of us, means that protectionism and closed economy are anachronism. From the other hand, it is obviously that some countries under aggravate circumstances because of economic and financial crisis, could protect the domestic market.

The Leaders of the Group of Twenty (meet in London on 2 April 2009) have pledged to do whatever is necessary to:

- restore confidence, growth and jobs;
- repair the financial system to restore lending;
- strengthen financial regulation to rebuild trust;
- fund and reform the international financial institutions to overcome this crisis and prevent future ones;
- promote global trade and investment and reject protectionism, to underpin prosperity; and
- build an inclusive, green, and sustainable recovery.

They start from the belief that prosperity is indivisible; that growth, to be sustained, has to be shared; and that the global plan for recovery must have at its heart the needs and jobs of hard – working families, not just in developed countries but in emerging markets and the poorest countries of the world too; and must reflect the interests, not just of today’s population, but of future generations too.

The current crisis is the outcome of multiple failures, above all, that of the international monetary system. The neo-liberal ideology that has promoted widespread deregulation in banking and finance has created a system plagued with endogenous instability, a result forecasted by numerous economic theorists.

The financial crisis will affect the real economy through a number of channels. In many countries asset prices have fallen significantly. This will have an important impact due to the wealth effect. The sharp fall in home prices in US erased this source of consumption and the stock market crash has created a huge problem for retirement pension funds, which must be redressed by increasing the shockingly low household savings rate.

The Euro-zone too is now entering recession. GDP will fall by at least -1.5 percent until summer 2009 at best, with some countries looking particularly vulnerable (Spain and Italy). Even the German neo-mercantilist model is facing major challenge. In the rest of the EU, the UK will experience a shock very similar to the one in the US and the “new entrants” will fall into deep recession.

The serious contraction of consumer demand, already obvious on the car market and in house building, has increased the number of enterprise bankruptcies. Unemployment, which has already increased, will soar across the board, increasing household insolvency when and where unemployment benefits are too low or too restricted in scope.

Governments will be compelled to increase the scope of the financial relief programs adopted in the fall of 2008. In the face of increasing economic hardship governments will respond by increasing budget deficits. Budget deficits will not be confined to 2009, however. As the credit expansion mechanism looks disabled for the foreseeable future and economic activity will remain depressed for a significant period, public spending will be the only way of avoiding the current recession developing into a full-fledged depression.

The direct and indirect consequences of the crisis will be of such magnitude that significant changes are inevitable in economic policies and institutions.

Current economic crisis has brought in potentially adverse effects on further, political and social stabilization in the Western Balkans, whilst economic slowdown may additionally influence the developments agendas in the region, as well as, raises a question of CEFTA agreement's full implementation. In addition, the Bosnian Parliament has adopted a law envisaging better protection of local farmers against imported goods from neighboring countries (Croatia, Serbia and Montenegro). For the first few years, BIH has officially had preferential treatment in trade relations with neighboring countries. Yet, it failed to capitalize on that, as Serbia and Croatia, as well as some of other countries, managed to limit Bosnian import through other measures. The situation is even worse now than when Bosnia has equal status with all other countries, and is being overwhelmed with imported goods from Serbia and Croatia.

A worsening economic and social situation in the country, suffering from the growing effects of the global economic downturn, has renewed requests from local farmers and producers for better government protection. Some Bosnia's officials defended this position by citing CEFTA regulations which, according to them, allow unilateral measures such as this in a case of larger trade imbalances. "Bosnia and Herzegovina is a member of CEFTA and cannot behave like this", said Doris Pack, member of European Parliament.

The global economic turmoil is, perhaps, one of reasons for countries' selfish behavior, but could not be resolution of the problems, especially if the country is a member of some regional integration, such as CEFTA. In such circumstances, the Regional Cooperation Council as a successor of the Stability Pact, carried out its substantial activities with a view to creating an atmosphere for the region to double its efforts to keep the European partners, international organizations and financial institutions (IFTs) as well as other partners engaged, by enhancing regional cooperation, applying the necessary EU accession reforms, and taking a pragmatic and flexible stance towards open bilateral issues in the spirit of cooperation, understanding and good neighborly relations.

CONCLUSION

CEFTA 2006 is achievement of the regional co-operation in SEE countries promoted by the Stability Pact. CEFTA is all about business making the rules and regulations governing trade in the region simpler and increasingly harmonized with those of the EU and the WTO.

The expansion of CEFTA will probably lead to a modest increase in intra-regional trade flows. However, given the dominant role of trade with the EU for most countries in the region, and infrastructural and other impediments to regional trade in the total trade of the CEFTA -8 is unlikely to increase substantially. CEFTA expansion will also not ease the worries of south-east European countries about the likely slowdown in EU enlargement, and may even intensify these concerns. The credibility of the accession process has been gravely weakened by increasing "enlargement fatigue" within EU and a string of negative

messages over the past year to the Western Balkan aspirants about when, and even if, they might expect to become members. The current economic and financial crisis even more contribute to instability and aggravate the relationships between the countries. In order to overcome the challenges of the economic recession and with outstanding bilateral issues affecting regional cooperation, it is in the best interest of South-East Europe not to decrease its commitment to regional cooperation or stay away from pre-accession reforms.

The presence and efforts of the EU are also essential for keeping stability at its doorstep and assuring that the region does not regress. Most importantly, the region must assume and deepen its share of responsibility. The governments of SEE should employ joint and concerted efforts in facing future challenges, speed up reforms in order to progress on the EU integration, cooperate on finding solutions to bilateral problems, and engage jointly in large-scale development projects assisted by IFIs that would remedy consequences of the economic crisis and give additional incentives to continued reforms.

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The mission of the Republic of Macedonia in Brussels, March 2009.

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DYNAMICS AND COMPOSITION OF TRADE RELATIONS BETWEEN CROATIA AND CEFTA 2006 COUNTRIES

Abstract

Structural and dynamical aspects of foreign trade and capital flows between international markets, Croatia and the CEFTA 2006 region have profound macroeconomic impact in actual global economic scene. Thus comparative merchandise trade analysis between Croatia and countries in the region and their competitiveness on international financial market has been required. Therefore, the first part of the paper deals with trends analysis of foreign trade flows between Croatia and its neighbors. The accentuation has been laid upon merchandise trade composition and direction analysis with CEFTA 2006 countries, and especially upon structural shifts in foreign trade balance at bilateral and multilateral levels. The impact of dynamic merchandise trade growth between Croatia and CEFTA 2006 on increasing imbalance with bilateral partners, as possible hindrance to further trade growth within the region has been investigated. The paper analytically evaluates possible impact of trade and financial flows growth among CEFTA 2006 member states on balancing their current account usually suffering from serious overall deficit. The second part focuses on Croatia and CEFTA 2006 countries efficiency in approaching international financial markets. Emphasis is put on capital account composition shifts, especially FDI flows. FDI concentration index has been employed as a measure of FDI attraction efficacy, and as competitiveness indicator of Croatia and CEFTA 2006 countries on international markets. Accentuation has been put on long term trends and efficacy of each country's FDI attraction. Degree of adaptability on actual fluctuation in global financial markets has been examined. Special part of analysis includes international FDI flows within CEFTA 2006 with special reference to Croatian FDI flows to the region.

Key words: Croatia, CEFTA 2006, FDI, Foreign trade, South East Europe, Western Balkans.

INTRODUCTION

Central European Free Trade Agreement was originally signed by Poland, Hungary, Czech and Slovak Republic in 1992. The objectives of that Agreement were: a) to promote, through the expansion of trade, the harmonious development of the economic relations between the CEFTA members and thus to foster in the members the advance of economic activity, the improvement of living and employment conditions, and increased productivity and financial stability; b) to provide fair conditions of competition for trade between the member countries; c) to contribute in this way, by the removal of barriers to trade, the harmonious development and expansion of world trade (Central European Free Trade Agreement, 1992, pp.2). CEFTA 2006 Agreement has expanded the list of objectives. The most important include: improvement of conditions for further promotion of investment, including foreign direct investment; expand trade in goods and services; provide appropriate protection of intellectual property rights in accordance with international standards; and to provide effective procedures for the implementation and application of this Agreement (Annex 1 CEFTA 2006, 2006, pp.3). The Agreement entered into force on 26 July 2007 for five Parties - Albania, Macedonia, Moldova, Montenegro and UNMIK/Kosovo, while for Croatia it entered into force on 22 August, for Serbia on 24 October and for Bosnia and Herzegovina on 22 November 2007. Full implementation of CEFTA 2006 started at the end of 2007 (CEFTA 2006, 2009). Consequently, a long term analysis of the impact of the CEFTA 2006 Agreement on foreign direct investment and foreign trade among member countries is limited. The strengthening of economic ties in the region is of a great importance since the main goal of this integration is the preparation of business sectors for the competition in the EU. Products of CEFTA 2006 countries can withstand competition in the market of the region itself, but need additional adjustment to meet strict EU standards to compete alongside the products from the EU. Therefore, the cooperation for consolidation of competitiveness for their products in the joined EU market is necessary.

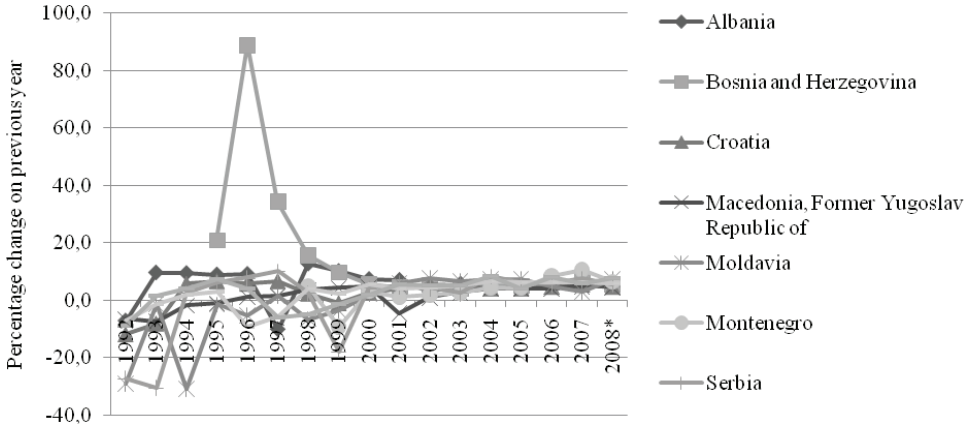
Concerning investment, the principal competitive advantages lie in the low labor costs, flexible labor policy and increased future productivity potential. The region is especially appealing for its low labor costs. The SEE region trails behind other European countries in the quality of infrastructure, research and development (R&D) and governance. Even so, it is the continent's most attractive region for establishing factories and other production units (FIAS, The Multi-donor Investment Climate Advisory Service of the World Bank Group, 2007, pp. 2).

1. Basic macroeconomic indicators of CEFTA 2006 countries

As already mentioned above, full implementation of the CEFTA 2006 Agreement started at the end of 2007. Member countries of this Agreement are: Albania, Bosnia & Herzegovina, Croatia, Macedonia, Moldova, Montenegro and Serbia. When comparing some of their basic macroeconomic indicators it is evident that the indicators show different degree of coherence over the years and among countries. Indicators like inflation, current account balance, export (as the percentage of GDP) and FDI inflows show large oscillation over the past ten years, and they also differ from country to country in the region. One of the indicators that had shown great oscillations in the early nineties for all countries is the GDP growth rate. The annual GDP growth rate displayed great variation in that period and even after 2002. Figure 1 and Figure 2 show the GDP growth rates in the period 1992-2008

and after 2002, respectively. The estimates for 2008 show that the highest GDP growth is expected to be for Moldova (7.3 percent) and the lowest for Croatia (4.6 percent).

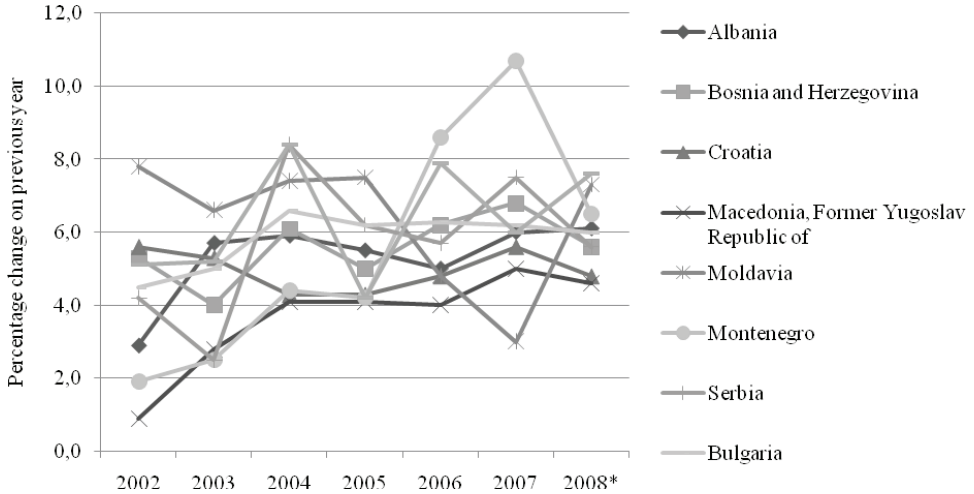
Figure 1: Real GDP growth rate (Growth rate of GDP volume), 1992-2008



Source: The World Bank; CIA, the World Factbook

Note: *GDP-real growth rate (estimation)

Figure 2: Real GDP growth rate (Growth rate of GDP volume), 2002-2008



Source: The World Bank; CIA, the World Factbook

Note: *GDP-real growth rate (estimation)

Another comparison shows that Croatia has by far the highest GDP p.c. in the region. In 2009 estimated average value of the GDP (PPP) p.c. for the region is 9,444 units of current international dollars, while the Croatian GDP p.c. is 18,057. It exceeds even the GDP p.c. of Bulgaria and Romania which are the former CEFTA and present EU members. The lowest GDP p.c. has Moldova. It amounted to 3,094 dollars which is 32.76 percent of averaged CEFTA 2006 GDP p.c. or 17.14 percent of Croatian GDP p.c. (Table 1).

Table 1: Gross domestic product based on purchasing-power-parity (PPP) per capita GDP (units of current international dollars)

Country	2009 (estimation)
Albania	6,916
Bosnia and Herzegovina	7,434
Croatia	18,057
Macedonia, Former Yugoslav Republic of	9,031
Moldavia	3,094
Montenegro	10,898
Serbia	10,679
CEFTA 2006	9,444
Bulgaria	12,296
Romania	12,214

Source: International Monetary Fund, World Economic Outlook Database, April 2009

All countries have faced current account deficit since 2000 (Table 2). Estimates predict that the increasing deficit will decline in 2009 for all CEFTA 2006 countries.

Table 2: Current account balance (billion of U.S. dollars)

Country	2006	2007	2008*	2009*
Albania	-0.508	-0.994	-1.752	-1.244
Bosnia and Herzegovina	-1.025	-1.92	-2.766	-1.525
Croatia	-3.287	-4.443	-6.519	-3.811
Macedonia, Former Yugoslav Republic of	-0.056	-0.569	-1.253	-1.201
Moldavia	-0.404	-0.747	-1.186	-0.99
Montenegro	-0.65	-1.128	-1.512	-0.989
Serbia	-2.986	-6.199	-8.648	-4.915

Source: International Monetary Fund, World Economic Outlook Database, April 2009

Note: *Estimation

The highest current account deficit as percentage share of GDP in 2008 has Montenegro, and the lowest Croatia (Table 3).

Table 3: Current account balance (as percent of each country's GDP)

Country	2006	2007	2008*	2009*
Albania	-5.6	-9.1	-13.5	-11.3
Bosnia and Herzegovina	-8.4	-12.7	-15.0	-9.3
Croatia	-6.7	-7.6	-9.4	-6.5
Macedonia, Former Yugoslav Republic of	-0.9	-7.2	-13.1	-14.1
Moldavia	-11.8	-17.0	-19.4	-19.4
Montenegro	-24.1	-29.3	-31.3	-23.2
Serbia	-10.1	-15.3	-17.3	-12.2

Source: International Monetary Fund, World Economic Outlook Database, April 2009

Note: *Estimation

2. FDI inflows to CEFTA 2006 countries

The analysis of FDI inflows and outflows in CEFTA 2006 countries includes data before the ratification of CEFTA 2006 Agreement in parliaments and full implementation at the end of 2007. Total amount of FDI in the region has increased in the last ten years approximately 8.7 times. In 2007 it amounted to 12.3 billion of current US dollars (Table 4).

Table 4: Foreign direct investment, net inflows (billion of current U.S. dollars)

Country	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Albania	0.05	0.05	0.04	0.14	0.21	0.14	0.18	0.34	0.26	0.33	0.48
Bosnia and Herzegovina	0.00	0.07	0.18	0.15	0.12	0.27	0.38	0.71	0.61	0.72	2.11
Croatia	0.53	0.93	1.46	1.08	1.34	1.13	2.05	1.08	1.79	3.43	4.92
Macedonia, FYR	0.02	0.13	0.03	0.17	0.44	0.08	0.10	0.16	0.10	0.35	0.32
Moldova	0.08	0.08	0.04	0.13	0.05	0.08	0.07	0.09	0.19	0.25	0.49
Montenegro										0.62	0.88
Serbia	0.74	0.11	0.11	0.03	0.17	0.14	1.36	0.97	1.61	4.50	3.11
CEFTA 2006	1.42	1.36	1.86	1.70	2.33	1.83	4.14	3.34	4.56	10.20	12.30
Bulgaria	0.50	0.54	0.82	1.00	0.81	0.90	2.10	2.66	4.31	7.51	8.97
Romania	1.22	2.03	1.04	1.04	1.16	1.14	1.84	6.52	6.48	11.39	9.49

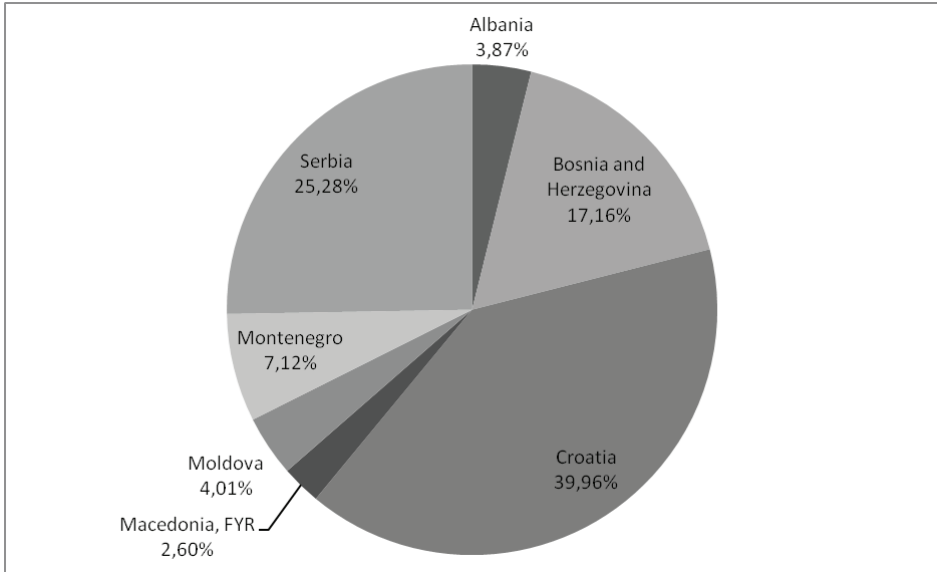
Source: *The World Bank*

If the GDPs of CEFTA 2006 countries were added up together, the CEFTA 2006 GDP would amount to around 234.5 billion of current international dollars (2007). This means that the average FDI share in the total CEFTA 2006 GDP is 5.25 percent, while the value of FDI in each country ranges from 1.82 in Macedonia (the lowest) to 13.85 percent in Montenegro (the highest). For comparison, the total EU-27 GDP based on purchasing power parity (PPP) for 2007 amounted to 14762.11 billion of current international dollars, whereas the total FDI (net inflows) in 2007 amounted to 1095.77 billion of current US dollars. Thus, the share of FDI in the total EU GDP is 7.42 percent. If we extract twelve newcomers¹ to the EU as the unique group, we will get the GDP of approximately 1719.6 billion of current US dollars. In the same year, the FDI inflows to 12 new EU countries were around 102.91 billion of dollars or 5.98 percent of the GDP. That matches up the share of CEFTA 2006 FDI inflows in its GDP.

As already mentioned before, total FDI inflow into the CEFTA 2006 countries in 2007 was 12.3 billion of current US dollars. Croatia had the largest share of total FDI inflow (39.96 percent or 4.92 billion of current US dollars), while Macedonia had the smallest share (2.6 percent or 0.32 billion) (Figure 3).

¹ In 2004 ten countries entered EU: Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Malta and Cyprus, whereas additional two countries became EU members in 2007: Bulgaria and Romania.

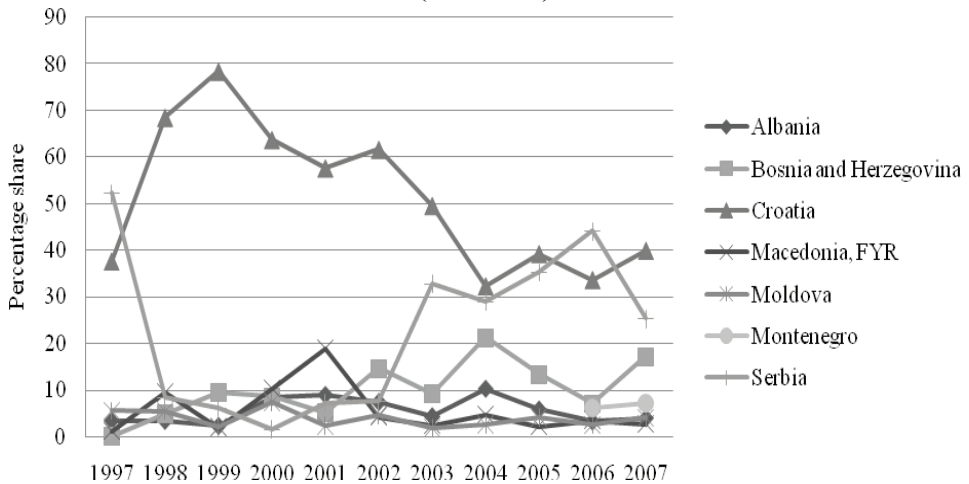
Figure 3: Distribution of total FDI inflow into the region in 2007



Source: The World Bank

If the analysis is expanded to the 1997-2007 period, it is evident that Croatia has had the largest share throughout the whole period, except in 2006. The largest share was in 1999, when 78.45 percent of all FDI inflows to the region were invested to Croatia (Figure 4)

Figure 4: Percentage share of each country's FDI in total FDI inflows into the region (1997-2007)



Source: The World Bank

The regional FDI p.c. data, between 1997 and 2007, confirm it has grown 8.81 times (from 55.84 current US dollars p.c. in 1997 to 492.08 in 2007). In 2007, Montenegro had the highest FDI p.c (1,461.94 USD) and Albania had the lowest (150.57 USD) (Table 5).

Table 5: FDI p.c. (current US dollars)

Country	1997	2007
Albania	15.38	150.57
Bosnia and Herzegovina	0.27	530.19
Croatia	116.54	1,108.16
Macedonia, FYR	7.92	156.03
Moldova	21.54	145.72
Montenegro	-	1,461.94
Serbia	96.73	421.23
CEFTA 2006	55.84	492.08
Bulgaria	61.85	1,175.09
Romania	54.16	440.18

Source: The World Bank, International Monetary Fund, World Economic Outlook Database, April 2009

Further analysis provides a brief recapitulation of FDI inflows to the Western Balkans by the country of FDI origin and by activity that was most attractive for foreign investors. First thing that can be noticed is that Austria is the major investor in the region. Its share in each country's total FDI inflows ranges from 7.1% for Montenegro to 32.9% for Bosnia and Herzegovina. The second country that has a large share in Western Balkans' FDI inflows (although not in Croatia) is Greece, with the share in total FDI stock (2004-2007) of 54.2% for Albania, 13.7% for Serbia (FDI inflows 2000-2008), and 9.9% for Macedonia (FDI inflows 2003-2008). Germany, Slovenia and Italy also play a significant investment role for countries of Western Balkans. Regarding activities and sectors, financial intermediation is the most interesting sector for foreign investors. For Croatia, 41.7% or 7,212.1 mil EUR are invested in financial intermediation (except insurance and pension funds) in the 2000-2008 period; for Serbia, financial intermediation has a share of 30.8% in total FDI inflows 2004-2008, that is 4,620.3 mil USD; in Bosnia and Herzegovina total investment in financial intermediation for the 2004-2008 period amounts to 2,627.0 mil KM or 38.1%; investment in banks and companies is the main target for foreign investors in Montenegro with 1,339.1 mil EUR or 46.3% of total 2001-2008 gross FDI inflows; investment in the financial intermediation accounts 395.0 mil EUR or 23.8% of Macedonian total FDI inflows 2003-2008; and finally, the share of monetary and financial intermediation in total FDI stock between 2004 and 2007 amounts 29.7%. Other sectors that attract the most FDI inflows to each Western Balkans country are: real estate activities, wholesale trade, commission trade and retail trade, post and telecommunications and production of food and beverages (Table 6).

Table 6: Countries of Western Balkans and major countries by FDI origin and most attractive activities for investment

FDI destination country	Top 3 countries by FDI origin	Top 3 activity
Croatia ¹	Austria (29.8%)	Financial intermediation, except insurance and pension funds (41.7%)
	Netherlands (17.7%)	Manufacture of coke, refined petroleum products (8.1%)
	Hungary (12.1%)	Real estate activities (7.4%)
Serbia ²	Austria (21.4%)	Financial intermediation, except insurance and pension funding (30.8%) ³
	Greece (13.7%)	Postal service activities and telecommunications (15.8%) ³
	Norway (12.6%)	Wholesale trade and mediation (9.2%) ³
Bosnia and Herzegovina ⁴	Austria (32.9%)	Financial intermediation, except insurance and pension funding (38.1%)
	Serbia (and Montenegro) (21.7%)	Post and telecommunications (19.9%)
	Slovenia (9.9%)	Manufacture of basic metals (5.8%)
Montenegro ⁵	Russia (13.4%)	Banks and companies (46.3%)
	Hungary (11.2%)	Real estate (41.7%)
	Great Britain (9.3%)	Intercompany debt (11.5%)
Macedonia, FYR ⁶	Austria (16.1%)	Total services (55.4%)
	Greece (9.9%)	Manufacturing (27.4%)
	Slovenia (8.8%)	Financial intermediation (23.8%)
Albania ⁷	Greece (54.2%)	Transportation, storage and communication (36.8%)
	Italy (11.7%)	Monetary and financial intermediation (29.7%)
	Austria (7.7%)	Manufacturing industry (15.9%)

Source: Croatian National Bank, National Bank of Serbia, Central Bank of Bosnia and Herzegovina, National Bank of the Republic of Macedonia, Central Bank of Montenegro, Bank of Albania.

Note: ¹2000-2008, million EUR;

²2000-2008, million USD; Classification by country of payment and not country of investment;

³2004-2008;

⁴2004-2008 (I-IIIQ), million KM;

⁵2001-2008 (I-IX), million EUR;

⁶2003-2008, million EUR;

⁷2004-2007, FDI stock by country of origin and by sector (as a share of total FDI stock)

The main message to potential investors is that SEE's² improved competitiveness within key target sectors, including automotive, agribusiness, business support services and ICT, coincides with the acute pressures on labor availability within the leading recipients of FDI in Central Europe. This convergence enhances the prospects for SEE to increase its share of European FDI (FIAS, The Multi-donor Investment Climate Advisory Service of the World Bank Group, 2007, pp. 4).

² South East Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Moldova, Montenegro, Romania and Serbia.

2.1. Croatian FDI outflows to the Western Balkans region

Total Croatian FDI outflows to the region were 828.6 million EUR (2000-2008), which is approximately 43.4% of total Croatian FDI outflows. Of that amount, 57.5% of investment has gone to Serbia (476.5 million EUR). On the other hand, total FDI outflows from Serbia to Croatia, from 1993 to 2008 (IIQ), amounted to -6.95 million EUR. However, the intensive investment between these two countries has begun in 2003 (HGK, 2009). Croatian investors have primarily invested in food industry, building material industry and retail. It is about the sectors that mainly have good market conjuncture, so it can be stated that the Croatian investors have done a good job in evaluating Serbian market. The largest business dealings have been done by one of the leading Croatian concern – Agrokor. This company has gained good positions in frozen food industry, food oil industry, bakery industry and retail. The first step for Agrokor was the acquisition of leading Serbian frozen food brand – Frikom. Agrokor has stabilized, technologically modernized the company and expanded the market assortment offering new products like frozen fish and seafood. The net income of Frikom in 2007 was nine times bigger than it was in 2006. The second large acquisition was takeover of food oil and margarine factory Dijamant in Zrenjanin. In the capital structure, Agrokor takes fourth position with the share of 12.82%. The second successful investor in Serbian economy is Nexe group from Našice. This company has integrated in its system three carefully selected companies. The largest among them is Building Ceramic industry Polet. The second acquisitioned firm is Jelen Do, the largest quarry on the Balkans. The smallest member of Nexe group is brick factory Stražilovo in Srijemski Karlovci. All three companies have increased their net income and production, and acquired significant market share in branches, respectively (Harak, 2008).

Another country that has received a large amount of FDI from Croatia is Bosnia and Herzegovina. Croatian companies have invested around 287.2 million EUR from 2000 to 2008. That makes 34.7% of Croatian FDI outflows to the region or 15.0% of total Croatian FDI outflows in the same observed period, while investors from Bosnia and Herzegovina have invested 61.7 million EUR which is 0.4% of total FDI inflow to Croatia. Croatian investors have mainly invested in post and telecommunications, food and beverages industry and financial intermediation and retirement insurance, whereas investors from Bosnia and Herzegovina have mainly invested in retail, manufacture of food products and beverages and manufacture of chemicals (HGK, 2009). The most significant investors from Croatia are; T-HT and Croatian Post Zagreb which are part-owners of Croatian Telecommunications Mostar and Croatian Post Mostar (investment worth 136.4 million KM, 2007 – that is the 8th largest investment to Bosnia and Herzegovina from 1994 to 2007); Croatian oil company INA which has, together with Hungarian MOL, recapitalized Energopetrol from Sarajevo (46.0 million KM, 2007 – 18th); Zagrebačka banka which is, as the daughter firm of Italian UniCredit Group, the owner of UniCredit Bank from Mostar (82.2 million KM, 2004 – 11th); Fininvest from Čabar which is the owner of similar factory for wood processing in Drvar (43.3 million KM – 20th); and Agrokor's companies Ledo which owns ice-cream factory in Čitluk (21.7 million KM) and Konzum with the chain store across Bosnia and Herzegovina (Šutalo, 2008). A possible cooperation between Croatia and Bosnia and Herzegovina could be expected in the field of energetic. The latter is a signatory of the Declaration on the Ionian-Adriatic gas pipeline project. The Ionian-

Adriatic gas pipeline is conceived as the project that should connect and facilitate the gasification for all countries in the region (HGK, 2009).

According to Croatian National Bank data, Croatia has from 2000 to 2008 invested 50.5 million EUR in Macedonia. That is just about 6.1% of Croatian FDI outflows to the region or 2.6% of total Croatian FDI outflows. From 1993 to 2005 Macedonian firms have invested 0.71 million EUR in Croatian economy. About 40 Croatian companies operated in Macedonia in 2008 – half the number than in Kosovo. Lately, interest of Croatian investors has increased. Firstly, the company INGRA (for construction of investment facilities, import, export and representation) has paid for Macedonian construction company Mavrovo 7.0 million EUR in 2008, what is equal to the Croatian FDI outflows to Macedonia from 1993 to 2005. Furthermore, in the same year INGRA has purchased Mavrovo Engineering, the company that is not proprietary associated to construction company Mavrovo. Macedonian farmers expect a lot from Croatian tourism as a chance for the placement of their agricultural products. Macedonian agricultural products are of good quality and relatively cheap, plus they meet European eco standards. Another possible Croatian interest is the placement of Macedonian wines, which are sold as Macedonian products, or as the brand of a Croatian distributor. The overall investment 40 million EUR worth is planned to increase production of vegetables in greenhouses. Besides the interest for the network of redemption centers for vegetables and fruits, Agrokor is interested in opening even 25 supermarkets (Mlakar and Ranogajec, 2008). The newest investment in Macedonia is in the field of insurance. In June 2009, Croatia's largest insurer Croatia Osiguranje has opened 3.25 million EUR worth society of non-life insurance.

Albania has so far attracted 8.6 million EUR (2001-2008) which is 1% of total Croatian FDI outflows to the region in the same period. According to Croatian Chamber of Economy there has not been any registered Albanian investment to Croatian economy. Nevertheless, possible areas of cooperation can be identified. They include energetics (electro energetics and petroleum and gas exploration); machinery, electro industry and electronics; pharmaceutical industry; construction and investment works (infrastructure, hydro energetic objects) (HGK, 2009).

Croatian FDI outflow 2000-2008 to Montenegro was 5.8 million EUR which is 0.3% of total Croatian FDI outflow in the same observed period. Potential branches for investment into Montenegro are tourism, electric power industry, banks and companies and real estate.

3. Croatian merchandise trade with CEFTA 2006 countries

Table 7 and table 8 show Croatian volumes of export and import with CEFTA members, respectively, while table 9 shows balance of trade of already mentioned sides.

Table 7: Croatian export by country of destination (million USD)

Country	2002	2003	2004	2005	2006	2007	2008	Total
Bosnia and Herzegovina	704.40	892.40	1,153.80	1,256.10	1,310.50	1,782.50	2,178.00	9,277.70
Macedonia	59.08	70.46	74.01	81.45	83.26	116.90	143.11	628.27
Montenegro	-	-	-	-	6.41	154.64	186.64	347.69
Serbia (and Montenegro)*	172.40	190.77	294.04	393.37	516.72	664.90	778.40	3,010.60
Albania	17.47	27.54	27.32	21.22	30.90	35.33	44.38	204.16
Moldova	1.81	3.49	8.06	2.51	2.00	3.43	2.03	23.32
Total CEFTA 2006	955.16	1,184.66	1,557.23	1,754.65	1,949.78	2,757.69	3,332.56	13,491.73
Share of total exports (%)	19.48	19.15	19.41	20.00	18.79	22.30	23.62	20.84

Source: Republic of Croatia-Central Bureau of Statistics

Note: *From 2006 just Serbia

Table 8: Croatian import by country of origin (million USD)

Country	2002	2003	2004	2005	2006	2007	2008	Total
Bosnia and Herzegovina	166.40	231.20	348.60	453.20	600.40	733.90	819.00	3,352.70
Macedonia	66.95	74.48	116.57	144.63	179.99	221.90	278.81	1,083.33
Montenegro	-	-	-	-	0.32	6.70	7.07	14.08
Serbia (and Montenegro)*	53.24	76.73	140.92	169.04	227.39	329.50	428.10	1,424.91
Albania	0.27	0.67	0.73	1.40	2.70	3.03	4.78	13.56
Moldova	1.31	3.59	4.49	5.78	7.80	6.61	8.74	38.32
Total CEFTA 2006	288.16	386.67	611.30	774.05	1,018.60	1,301.64	1,546.50	5,926.91
Share of total imports (%)	2.69	2.72	3.68	4.17	4.74	5.04	5.03	4.29

Source: Republic of Croatia-Central Bureau of Statistics

Note: *From 2006 just Serbia

Table 9: Current account balance of Croatia with CEFTA 2006 countries (million USD)

Country	2002	2003	2004	2005	2006	2007	2008	Total
Bosnia and Herzegovina	538.00	661.20	805.20	802.90	710.10	1,048.60	1,359.00	5,925.00
Macedonia	-7.87	-4.02	-42.56	-63.18	-96.74	-105.00	-135.70	-455.06
Montenegro	-	-	-	-	6.09	147.95	179.57	333.60
Serbia (and Montenegro)*	119.17	114.04	153.12	224.33	289.33	335.40	350.30	1,585.69
Albania	17.21	26.87	26.60	19.82	28.20	32.29	39.60	190.59
Moldova	0.50	-0.10	3.57	-3.27	-5.80	-3.19	-6.71	-15.00
Total CEFTA 2006	667.00	798.00	945.93	980.60	931.19	1,456.05	1,786.06	7,564.83
Total current account balance	-5,818.40	-8,022.40	-8,565.00	-9,787.80	-11,125.50	-13,474.90	-16,616.78	-73,410.78

Source: Republic of Croatia-Central Bureau of Statistics

Note: *From 2006 just Serbia

Total Croatian export to the CEFTA members reached 3.3 billion USD in 2008. In comparison with 2007, when total export to CEFTA was around 2.8 billion USD, this is an increase of about 20.8 percent. On the other hand, total Croatian import from the CEFTA members in 2008 was around 1.5 billion USD. The import rose 18.8 percent in comparison with 2007, when it amounted to 1.3 billion USD. Croatia has the largest surplus in merchandise trade with Bosnia and Herzegovina. In 2008 it amounted to 1.4 billion USD. From 2002 to 2008, total surplus was 5.9 billion USD. Bosnia and Herzegovina is for Croatia the second most important merchandise export destination, first being Italy -from 2001 to 2008 total export to Italy amounted to 15 billion USD, whereas total export to Bosnia and Herzegovina was around 9.8 billion USD. Croatia ranks as first among trade partners concerning both exports and imports from and to Bosnia and Herzegovina (in period 2001-2008, Croatian shares in Bosnia and Herzegovina's exports and imports were 17.9 and 17 percent, respectively). According to Croatian Chamber of Economy data, the most important Croatian export product to Bosnia and Herzegovina in 2008 is crude oil and oils derived from bitumen minerals (30 percent of export) and the most important Bosnian and Herzegovinian exports are crude aluminum (18.5 percent of exports to Croatia) and electric energy (7.3 percent). Another significant surplus in merchandise trade is realized in trade with Serbia. In 2008 it amounted to 350 million USD. Crude oil and oils derived from bitumen minerals and polymers ethylene in primary forms are major Croatian export products to Serbia in 2008, whereas flat-rolled iron products or non-alloy steel and electric power are the most frequent commodity imported from Serbia. The surplus in merchandise trade is also realized in trade with Montenegro and Albania. In 2008, Croatian export to Montenegro (187 million USD) was 26.4 times higher than Montenegrin export to Croatia (7 million USD). Among CEFTA members, the smallest import to Croatia was from Albania. In 2008 it amounted to 4.8 million USD and Croatian export was around 44.8 million USD, thus making a surplus in merchandise trade with Albania of 39.6 million USD. The major Croatian export products to Albania in 2008 are articles of iron and steel (excluding prefabricated articles) and stranded wire, cables, plaited bands and the like, while major Albanian exports to Croatia are footwear with outer soles of rubber and plastics, corn and plants and parts of plants (including seeds and fruits). The only two counties that record surplus in merchandise trade with Croatia in 2008 are Macedonia and Moldova. The deficit with Macedonia was 135 million USD, while the deficit with Moldova was significantly smaller and it amounted to 6.7 million USD. In 2008 a half of Macedonian exports to Croatia were iron or steel flat-rolled products. On the other hand, major export products from Croatia to Macedonia include electrical machinery, equipment and parts thereof (7.8%), edible products (6.2%) and soaps and cleaning preparations (6.2%). Unlike the "old" CEFTA, which was composed of developed transition countries, now members of the EU, the "new" CEFTA gathers countries of Western Balkans plus Moldova. "New" CEFTA has proved to be a successful experiment for Croatian companies, since it has opened a market with around 28 million potential consumers to them. Statistics show a steady growth of foreign trade with CEFTA member states. As already mentioned above, the most significant merchandise trade of Croatia is realized with Serbia and Bosnia and Herzegovina. Trade with other members of CEFTA is still relatively small. Apart from the regime of free trade, one of the possible explanations for such good results in merchandise trade with "new" CEFTA is a much smaller competition on the markets of this integration, compared to the markets of Western Europe. Nevertheless, experts point out that all this

cannot be a reason to relax, given that the other members of CEFTA are also approaching the EU and that brings further openness of their markets to stronger competition from the Western Europe (Milovan, 2008).

CONCLUSION

Expanding CEFTA was a proposal floated by Croatia as an alternative to the EU's original idea of creating a so-called "Balkan Free Trade Zone". Brussels' plan came under fierce criticism in Croatia, with many complaining that it would slow Croatia's road to EU accession by lumping it together with other states that are not as far along in the process (Cuk, 2006). But even at the end of 2007, after the new CEFTA 2006 Agreement has entered into force and included new members of South East Europe, plus Moldova, the topics associated with CEFTA had mostly political connotation in Croatia. In the meantime, the integration stopped being taboo and its existence is noticeable not only in the statistical evidence on foreign trade. This is mostly associated with the fact that the CEFTA fulfilled expected goal and increased the volume of trade which was stimulated by the regime of free trade (Brnić, 2008). According to Dr. Erhard Busek, Special Coordinator of the Stability Pact for South East Europe, CEFTA 2006 was one of the greatest achievements of the regional co-operation in SEE promoted by Stability Pact and a long process took place before its actual coming into force. Another challenge was to ensure that CEFTA 2006 would be a modern agreement – one that would be able to adapt to the dynamic environment in SEE. Lot of efforts were put in the adaption of the old CEFTA treaty to include issues such as trade in services, government procurement, state aid and intellectual property rights. It is believed that such a modern agreement would be an excellent tool in preparation for EU membership. An increase in investment can also be expected, because a single market plays a key role in attracting investment, thereby promoting economic growth, job creation and in reducing unemployment. The expansion of CEFTA 2006 to include a range of newer trade policy areas should add to the impact of the trade liberalization in goods and services (Busek, 2008).

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CEFTA 2006 AND ECONOMIC CRISES – CASE OF SERBIA^{1*}

Abstract

According to the recommendations of the European Union, countries seeking membership in the Union are encouraged to create free trade zones on their territories. CEFTA-2006 actually has the role of preparing countries for full-fledged membership in the Union. During the past decade, a long period of instability, international isolation, and economic turmoil adversely affected living standards of the vast majority of the population of the region, so Serbia readily waited the signing of this free trade agreement. CEFTA-2006 has its shortcomings but also has its advantages and we will try, in this article, to specify some of them.

As a result of the country's growing integration with regional and world markets, Serbia has started to feel the effects of the current global economic crisis. The authors analyses the development of CEFTA-2006 in the new international surroundings and also exploring the development of cooperation in the SEE region and the future of CEFTA agreement. Live economic cooperation with their neighbors should bring Serbia and others countries in the region possibilities to overcome all the obstacles in the coming months.

Key words: *CEFTA 2006, Serbia, economic crisis, free trade.*

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INTRODUCTION

CEFTA is an agreement that presently defines a unified free trade zone in Southeastern Europe. As its very name says, the Agreement was initially formed between Central European states, i.e. the countries of the so-called Visegrad Group: Poland, Hungary, and Czechoslovakia (later the Czech Republic and Slovakia). It was signed on December 21, 1992 in Kraków, Poland, and went into effect in July 1994.²

The member countries hoped that CEFTA would facilitate their more rapid preparation for and integration into the institutions of Western Europe and their accession to the political, economic, security and legal system of the EU (*acquis communautaire*). In the second round, the Agreement was joined by Slovenia in 1996, Romania in 1997, Bulgaria in 1998, Croatia in 2003, and Macedonia in 2006.³

All the state-signatories of the original Agreement, except for Croatia and Macedonia, have since joined the European Union and, thereby, left CEFTA. Under the patronage of the Stability Pact for Southeastern Europe, in the context of the Stabilization and Association Process, it was decided that the existing CEFTA was to be expanded with countries from Southeastern Europe. There was also talk of including Ukraine.⁴ In the Balkan region, a model of bilateral free trade agreements already existed within the framework of the Stability Pact for Southeastern Europe (Jelisavac and Zirojević, 2008, pp. 101).

The new agreement, called CEFTA 2006, was initiated on November 9, 2006, in Brussels and signed on December 19, 2006, at the Southeast European prime ministers' meeting in Bucharest. The agreement was ratified on March 31, 2007, and went into force on July 26, 2007.

1. Advantages of CEFTA 2006

The CEFTA 2006 agreement is the result of years of pressure on the part of the European Union and represents a harmonization of previously signed bilateral agreements on free trade between the countries of the region. The good results, in terms of lowered tariffs and trade growth, which came out of the bilateral agreements, were a step forward; however, this was mostly a result of the fact that the comparison base was extremely low. In addition, the agreements differed among themselves, making for a complicated network of mutual trade ties. Also, a further handicap was the lack of harmonization of rules on product origin, which prevented investors from treating the region as one whole. CEFTA 2006 is a step further and represents a modernization of trade rules in the region (the inclusion of provisions on trade in services, public procurements and intellectual property protection), as well as their unification.

CEFTA 2006 brings to its member countries the stimulation of the strengthening of economic cooperation and facilitation of easier cross-border joint production, thanks to

² For further information, see: CEFTA Agreement: <http://www.worldtradelaw.net/fta/agreements/cefta.pdf>, 22/11/2007.

³ For further information, see internet page: <http://www.ukom.gov.si/cefta2003/eng/cefta/>, 22/11/2007.

⁴ For further information, see internet page: <http://www.unian.net/eng/news/news-160543.html>, 22/11/2007.

the implementation of the protocol on the cumulation of product origin in the region. This Agreement also brings a much clearer definition of trade rules than was the case with the previous 32 bilateral free trade agreements. Also CEFTA 2006 brings a new, more efficient dispute-resolution mechanism (consultations, recommendations of the Joint Committee, mediation, arbitration, the WTO mechanism) protects against arbitrary measures, which increases legal security in mutual trade.

One of the more important issues is the so-called diagonal cumulation of origin. In practice, this originally meant that all CEFTA countries could export their products to the EU market duty-free. However, under “own products” were classified only products in which the share of domestic added value was more than 50%. Thus, a product that had 40% Chinese, 45% Serbian, and 15% Macedonian added value was an essential expatriate, i.e. without a defined origin, which means that it did not have preferential treatment *vis-à-vis* the EU. From now on, however, with the advent of the CEFTA agreement, the cumulation of Serbian and Macedonian added value would be allowed. This is very important, especially for textile manufacturers, where, for example, the cotton is imported from Egypt, the fabric produced in Serbia, and the shirt sewn in Bosnia.

Facilitates the introduction of modern and stable conditions for the regulation of trade in the region, including new areas; demands strict respect of WTO rules, and provides WTO accession support for the countries that are not yet members (Republic of Serbia and Bosnia and Hercegovina). This practically implies that even before WTO membership, the systemic setting of the economy should be adjusted to WTO rules, representing a strong factor of predictability and transparency for foreign partners, foreign investors and entrepreneurs themselves.

CEFTA 2006 facilitates the process of integration into the EU through harmonization with the legal structures and standards of the EU. The Union supported and emphasized the signing of CEFTA 2006 as one of the priorities of its regional policy *vis-à-vis* the Western Balkans; free trade in the region, by way of a single agreement, is mentioned as one of the conditions in the draft Stabilization and Association Agreement between Serbia and the EU. As additional confirmation that CEFTA is good preparation for accession to the EU stands the fact that Slovenia, Poland, the Czech Republic, Slovakia, Hungary, Bulgaria and Romania, as CEFTA members, became full-fledged members of the EU; of course, this was neither the only nor the most important prerequisite.

Prior to CEFTA 2006, relations between countries in the region were partial, i.e. not all the countries had active political and economic relations. This agreement can be an instrument of economic and, subsequently, political stabilization. As a whole CEFTA 2006 agreement sends a positive signal that the region is constructing an attractive and stable environment for business.

2. Shortcomings of CEFTA 2006

As one of the blocs with the smallest territorial scope, CEFTA has a relatively high gross domestic product (GDP) and could, in that sense, represent a relatively important bloc. Still, since this alliance is only a transitional step toward the EU, its short-term character limits it in the political sense.

As with every other agreement that “strips” the state of some prerogatives of sovereignty, this agreement also has negative consequences for internal economic development. Paradoxically, both CEFTA and other accession processes of Southeastern Europe into the European Union erect short-term trade barriers, despite the fact that, in the long term, they are opening the way to a unitary market.

Joining a regional integration can lead to a sudden growth of imports, which affects uncompetitive products and leads to further consequences for a country’s trade balance of payments. Also, as a rule, such agreements bring reductions in customs revenues. And, finally, due to increased imports and reductions in product costs in the amount of customs duties, certain sectors will experience increased competition.

In order to avoid the said negative effects, countries most often resort to measures of protecting the domestic economy. Domestic protection measures are carried out in accordance with WTO measures and laws on foreign trade in cases of:

- Dumping and subsidized products whose imports bring serious damage to domestic production;
- Exaggerated growth of imports, threatening production, employment and domestic sales;
- Exceptional situations and growth in agricultural imports, if these cause serious disruptions on the market.

Another possible obstacle to the implementation of CEFTA 2006 is non-tariff barriers. Fortunately, the Agreement provides for organized activity toward the elimination of non-tariff barriers, through the work of three subcommittees: Subcommittee for non-tariff and technical barriers, Subcommittee for the cooperation of customs organs, including rules of origin, and Subcommittee for agriculture, including sanitary and phytosanitary measures.

3. The economic crisis, Serbia and CEFTA 2006

The newest global financial crisis began in July 2007 when a loss of confidence by investors in the value of securitized mortgages in the United States resulted in a liquidity crisis that prompted a substantial injection of capital into financial markets by the United States Federal Reserve, Bank of England and the European Central Bank. In September 2008, the crisis deepened, stock markets worldwide crashed and entered a period of high volatility, and a considerable number of banks, mortgage lenders and insurance companies failed.

Although America’s housing collapse is often cited as having caused the crisis, the financial system was vulnerable because of intricate and highly-leveraged financial contracts and operations, a U.S. monetary policy making the cost of credit negligible therefore encouraging such high levels of leverage, and generally a “hypertrophy of the financial sector” (financialization). Beginning with failures caused by misapplication of risk controls for bad debts, collateralization of debt insurance and fraud, large financial institutions in the United States and Europe faced a credit crisis and a slowdown in economic activity. The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions

in the market value of equities and commodities. Moreover, the de-leveraging of financial institutions further accelerated the liquidity crisis and caused a decrease in international trade. World political leaders, national ministers of finance and central bank directors coordinated their efforts to reduce fears, but the crisis continued.

For Republic of Serbia, CEFTA 2006 Agreement entered into force on 24. October 2007. The Agreement stipulates that no import customs shall be increased nor the new ones will be imposed other than those prescribed by the existing bilateral free trade agreements between parties. Also, the Agreement stipulates accumulation of products origin, meaning that products exported from Serbia are considered of Serbian origin if integrated materials are originating from any other CEFTA country, European Community, Iceland, Norway, Switzerland (including Liechtenstein) or Turkey, provided that such products have undergone sufficient processing (where the value added there is greater than the value of the materials used) in Serbia (SIEPA).

In order to better explain what CEFTA 2006 has brought, it is necessary to recall the characteristics of mutual trade between the agreement's signatory countries. Intra-regional trade as a share of total trade with the world differed from country to country – from 0.2% (Moldavia) to 35% (Bosnia and Hercegovina). Also, there was a high convergence in the export supply (labor and resource-intensive goods, low added values, low growth rates of demand on the international market). Each individual CEFTA country already had a high share of trade with the countries of the European Union, 50-80%, in which Italy and Germany were dominant.

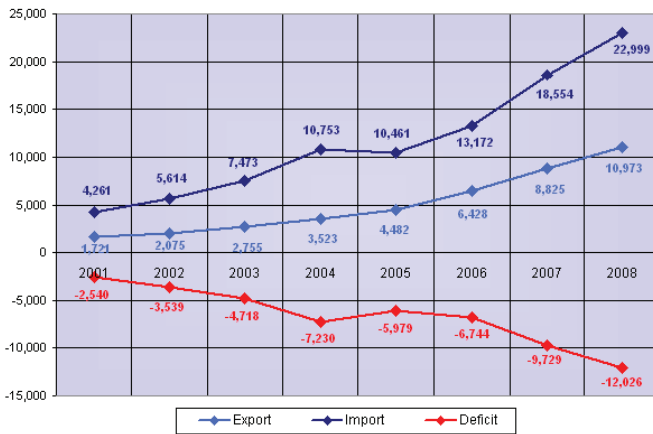
With the intention of introducing rules of behavior in trade relations, CEFTA 2006 was supplemented by separate amendments that regulated certain areas and specific procedures, all toward the goal of its simplest possible implementation.⁵ The free trade regime encompassed all industrial products and 90% of agricultural products, while for the remaining 10% the member countries could retain certain protection measures until 2010, in accordance with the rules of the World Trade Organization (WTO). The free trade zone was to be formed by December 31, 2010.⁶ Certain areas were more precisely regulated and deadlines for harmonization were defined.

The overall foreign trade in the Republic of Serbia, for the period of January - December 2008 amounted to USD 33,972 million, which was a 24.1% increase, compared to the same period in 2007. The value of export amounted to USD 10,973 million, which was a 24.3% increase when compared to the same period in 2007, while the value of imports amounted to USD 22,999 million, which was a 23.9% increase relative to the same period in 2007. The deficit amounted to USD 12,026 million, which was an increase of 23.6% in relation to the same period in 2007. The export - import ratio equaled 47.7% and was lower if compared to the same period in 2007 when it was 47.6% (see chart 1).

⁵ For further information, see internet page: Agreement on the Amendment of and Accession to the Central European Free Trade Agreement: <http://www.stabilitypact.org/trade/Cefta%20Agreement%20Amendment%20of%20and%20Accession%20to%20the%20Central%20European%20Free%20Trade%20Agreement%20-%20Preamble.pdf>, 22/11/2007.

⁶ For further information, see internet page: CEFTA 2006: <http://www.stabilitypact.org/trade/documents/trade-FINAL-joint%20declaration.pdf>, 22/11/2007.

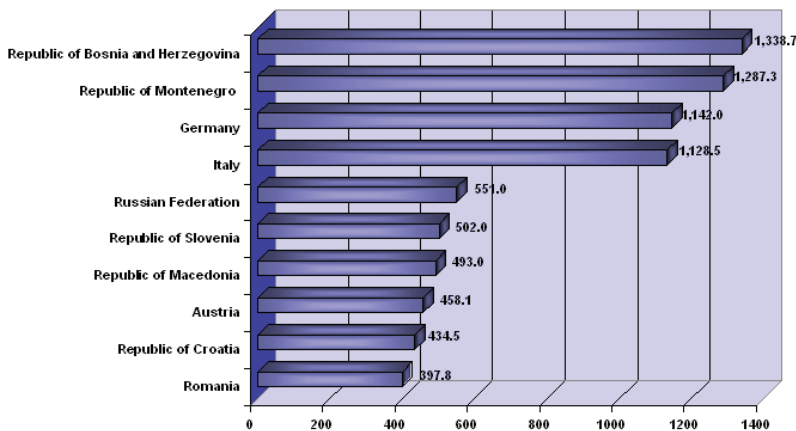
Figure 1: Foreign trade in period 2001 - 2008 (in USD mill.)



Source: SIEPA, Internet, http://www.siepa.sr.gov.yu/site/en/home/1/importing_from_serbia/foreign_trade_data/

The major foreign trade partners in export in the reference period were: Republic of Bosnia and Herzegovina (USD 1,338.7 million, 12.2% of total export), Republic of Montenegro (USD 1,287.3 million, 11.7% of total export), Germany (USD 1,142.0 million, 10.4% of total export), Italy (USD 1,128.5 million, 10.3% of total export), Russian Federation (USD 551.0 million, 5.0% of total export), Republic of Slovenia (USD 502.0 million, 4.6% of total export), Republic of Macedonia (USD 493.0 million, 4.5% of total export), Austria (USD 458.1 million, 4.2% of total export), Republic of Croatia (USD 434.5 million, 4.0% of total export) and Romania (USD 397.8 million, 3.6% of total export) (see chart 2).

Figure 2: Major export countries in 2008 (in USD mill.)



Source: SIEPA, Internet, http://www.siepa.sr.gov.yu/site/en/home/1/importing_from_serbia/foreign_trade_data/foreign_trade_by_countries/

The major foreign trade partners in import in the reference period were: Russian Federation (USD 3,492.6 million, 15.2% of total import), Germany (USD 2,704.4 million, 11.8% of total import), Italy (USD 2,184.4 million, 9.5% of total import), China (USD 1,829.2 million, 8.0% of total import), Hungary (USD 815.3 million, 3.5% of total import), France (USD 747.4 million, 3.2% of total import), Bulgaria (USD 746.6 million, 3.2% of total import), Ukraine (USD 661.0 million, 2.9% of total import), Republic of Bosnia and Herzegovina (USD 644.5 million, 2.8% of total import) and Romania (USD 631.3 million, 2.7% of total import).

The value of export in the Republic of Serbia, for the period of January - April 2009 amounted to USD 2,274 million, which was a 34.6% decrease when compared to the same period in 2008, while the value of imports amounted to USD 4,759 million, which was a 37.0% decrease relative to the same period in 2008. The deficit amounted to USD 2,485 million, which was a decrease of 39.0% in relation to the same period in 2008. The export - import ratio equaled 47.8% and was higher if compared to the same period in 2008 when it was 46.0% (see chart).

For the period of January - April 2009, the tendency of export and import fall continued from the end of 2008. As a main factor we emphasize global economic crisis which brought to the fall of economic activity in the world and in the Serbia. The decline of Serbian export is also consequence of declining in the prices of primary products on the world market as they form a large part in Serbian export. The main reason for decline in import is fall of industrial production in Serbia.⁷

Regarding the structure of export, and according to the products by economic destination (based on the principle of prevalence), the most notable, in the period of January - April 2009, were: reproduction products 60.0% (USD 1,365.6 million), then consumer goods 30.5% (USD 693 million) and equipment 9.5% (USD 215.6 million).

Foreign trade by products was the largest with members of the European union (more than half of total exchange). Surplus in trade is made with Republic of Bosnia and Herzegovina, Republic of Montenegro and Republic of Macedonia. The largest deficit is with Russian Federation mainly because import of energy, oil and gas. After the EU, second largest trade partner of Serbia are countries of CEFTA 2006. With CEFTA 2006 Serbia has surplus in trade of USD 370.9 million, which is mainly the result of export agriculture products (grain, beverage, etc.). The greatest import share are iron and steel, electrical energy, products of non metal minerals and other energents. For mentioned period the value of export amounted to USD 705.4 million, while the value of imports amounted to USD 334.5 million. The export - import ratio equaled 210.9%.

We can conclude that CEFTA 2006 is very important region for Serbia. Its importance is mainly for Serbian export, because Serbia has a surplus with CEFTA 2006. After the European Union countries members of CEFTA 2006 are second foreign trade partner of Serbia.

CONCLUSION

Agreement that presently defines a single free trade zone in Southeastern Europe, CEFTA agreement, provides harmonization of tariff and other administrative regulations with the

⁷ For further information, see internet page: Republika Srbija - Spoljnotrgovinska robna razmena, april 2009. <http://www.agropress.org.rs/tekstovi/11182.html>, 29.05.2009

standards of the World Trade Organization, removal of trade barriers in the region, and introduces arbitration for dispute resolution and the rule of diagonal cumulation. As any other agreement, it is the result of compromise, which means that it has both advantages and drawbacks. Nevertheless, it is expected that it will strongly influence the mutual trade of the countries of Southeastern Europe and promote their process of integration into the European Union.

CEFTA 2006 envisages an improved mechanism for settlement of disputes that might occur during the agreement implementation, which represents a new quality and a factor of higher security of liberalisation in the region. Besides the abovementioned, new areas have been opened for development of mutual relations as regards liberalisation of services, investment issues, public procurements, intellectual property, and possibility for CEFTA cumulation of origin among the Parties.

In summary, CEFTA 2006 provides: full conformity with WTO, free trade up-front in all industrial products and many agricultural products (>90%), modern provisions on trade-related issues, evolutionary clauses on new trade issues, mechanisms for implementation and dispute settlement, harmonization on EU-acquis and a pre-accession track.

A necessary condition for the success of CEFTA 2006 is that all the countries that have accepted the Agreement should have the same obligations and fulfill all the accepted provisions. It is not enough to accept provisions only on paper, for the sake of satisfying the international community: it is necessary to genuinely carry out the principles of free trade, in order to secure the region's more rapid economic development and its convergence with the European Union. We believe that all the countries are aware of the fact that the road to the EU market, WTO membership, the size of foreign investments, etc. greatly depend on the individual implementations of CEFTA 2006.

SEE countries are heading for EU membership at different pace. However, there is the only one "European road" to take them to this end. The creation of a single regional market (CEFTA 2006) is constructive step to reinforce European perspective for all SEE countries. As far as Serbia is concerned, accompanied with necessary investments in infrastructure, will the country move closer to the EU. CEFTA 2006 is an important economic means to a major political end.

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FOREIGN TRADE, LIBERALIZATION AND COMPETITIVENESS OF THE MACEDONIAN ECONOMY

INTRODUCTION

Trade liberalization, severe competition, as well as the intensive technological changes has increased the policy debates on possibility to improve the international competitiveness of sectors, industries and national economy as a whole. Special emphasis should thus be placed on the concept pointing at reduced effectiveness for the policies once oriented towards local industrial and economic advantage (UNCTAD 1999). Countries are therefore compelled to adopt such economic and trade policies that directly affect the ability of firms and industries to slot in and capture as much as possible of potential gains in growing trade and investment. Noteworthy is here to mention that losses are inevitable at same time, taking into consideration the pressure of competitive environment. Analyzing the issue of competitiveness one may certainly go into the proper combination of comparative and industry-specific advantages so as to contribute to increase the competitive advantage.

The concept of competitiveness, however, is one of the most elusive and misapprehend as given various interpretations. Comparative advantage though stringently described within the Ricardian model has been also unlikely inferred and measured when extended beyond the classical trade theory (Dornbusch et al., 1977). Worth mentioning here is the use of equilibrium prices once costs are being assessed. Insofar as markets are not in equilibrium wage or currency adjustments may possibly reduce the ability to export. That is to say, costs weigh against the market prices are to be the basis of competitive but not comparative advantage. It is the most common in empirical trade literature to use Balassa (1965) index of 'revealed comparative advantage' (RCA) so as to measure the particular advantage, although the better indicator for such assessments is Domestic resource cost criterion, proposed by Bruno (1965) and argued onwards by Balassa and Schydrowsky (1968), Bruno (1972), Krueger (1972), Srinivasan and Bhagwati (1978). Even though very simplified, the principle of comparative advantage is not to be applied in explaining the intra-industry trade that clarifies economies of scale, monopolistic competition and product differentiation (Krugman and Obstfeld, 2000). Many scholars argue that international competitiveness arises from the theory of comparative advantage using the term alike, while the others observe the concept within the economy – wide characteristics. The most

divisive, as well as mainly popular is the macroeconomic concept of competitiveness despite the microeconomic that is less controversial even with the variety of indicators in the group. Economic literature comprises different indices measuring the competitiveness considered as the widespread version of the macro concept. The best known among the others is the World competitiveness index that stands for the composite of various elements compacted into a single index (WEF/IMD, annual since 1995). The second approach to measure the macro competitiveness is to be an aggregate of microeconomic concept underlying the terms of labor and total factor productivity (Dollar and Wolff, 1993). Applied economists have been too much aware about the importance of competitiveness as determinant of macroeconomic performances as specially focus on real exchange rate and the real effective exchange rate (Lipschitz, McDonald, 1991; Marsh, Tokarick, 1994). This indicator is to be considered as clearly macroeconomic taking into consideration that measures the level of currency misalignment based upon the purchasing power parity assumption. Nevertheless, one may possibly use it as a micro-level concept if applies the price index of particular industry rather than the economy-wide price indices (Helleiner, 1991). Despite various measures of microeconomic competitiveness¹, by far the most popular are cost competitiveness (Turner, Gollup, 1997; Siggel, Cockburn, 1995), as well as the price ratios (Durand, Giorno, 1987).

As shown above, the concept of competitiveness comprises loads of dimensions which may well explain the complexity of the particular issue. Special emphasis should thus be placed on balance of trade, living standard or real income as the two-dimensional case in point (Hatsopoulos at al., 1990). The authors assert that countries can attain the export improvements at the cost of reduced real income that is not to be considered as increased competitiveness. Put differently, the country is said to be competitive if only ménage to achieve the central economic policy goals, especially growth in income and employment, without running into balance of payments difficulties (Fagerberg, 1988, p. 355). On the other side, the real effective exchange rate is supposed to be uni-dimensional indicator since it measures the level of currency misalignment that may improve or reduce the international competitiveness. Although the most invasive and by far the most influential, price competitiveness indicators are usually believed to be one-dimensional concept since those are mainly focused on unit labor cost criterion. This measure is to be very important for policy making as certain monetary aggregates in the small open economies. It is argued that the unit labor cost increase may lessen the market share, hinder the economic growth and add to unemployment. There is widespread evidence, however, that some of the most growing economies in terms of GDP and exports have also experienced a faster growth in relative unit labor cost (Fagerberg, 1988).²

Several concepts suggested in the theory are deterministic since they observe and measure actual performances (cost, prices, market share etc). The minority of them accentuate the potential performances that are not promptly observable. They depend upon the variables which determine the competitiveness in accord with the models of stochastic

¹ Studies behind microeconomic competitiveness have better theoretical base since they focus on producers and their ability to compete for market share, profits or the possibility to export.

² The particular phenomenon is sometimes known as “Kaldor paradox” pointing at the best simplification when unit labor cost is put forward to determine the concept of international competitiveness.

nature (Fagerberg, 1988).³ Among the micro-economic models of competitiveness the most stochastic is the one that compares the expected price of products, based upon quality characteristics with the actual price, at which expected price is regressed on the measured quality elements (Swann and Taghavi, 1992).

Taking into consideration the importance of competitiveness within the context of increased trade liberalization, as well as different approaches to explain the elusive but crucial concept this paper intends to broadly analyze the international competitiveness of the Macedonian economy as a case in point. Thus, the first part will examine the current account developments and external vulnerability. The second part of the study points to the structure and dynamics of foreign trade. The last part of the paper refers to econometric analysis of the set of variables which represent the fundamental elements of price and cost competitiveness.

1. Current account developments and external stability assessment

Nearly two decades Macedonia has faced an irregular transition after the independence in 1991. The UN sanctions against the northern neighbor, one of the Macedonia's major markets, the two economic embargoes by the southern neighbor (1992 and 1994) and the lack of an appropriate infrastructure have damaged the economic growth until 1996.

Table 1: Selected economic indicators

average	1998-2002	2003-2008
Inflation (average)	2,44	2,5
Unemployment (%)	32,3	35,98

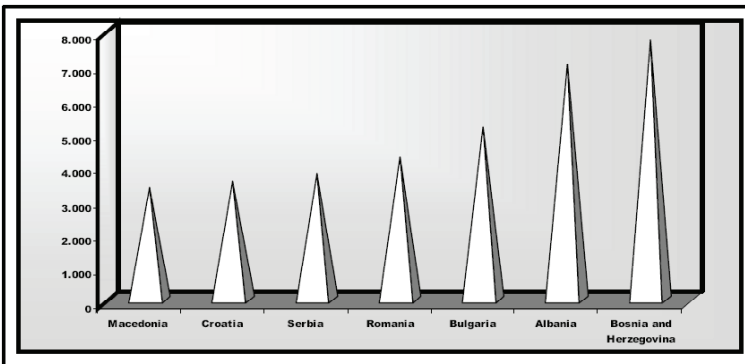
Source: NBRM

Even though the economy was exposed to GDP subsequent rise up to the year 2000, the commitments to free trade, economic reforms and regional integration were undermined by the Albanian uprising in 2001. GDP growth managed to retrieve in 2003 notwithstanding, it was much less prominent to the one of Central and Eastern Europe transition economies (Figure 1). Macedonian economy held on to restored dynamic in 2006 even with the considerable collapse in manufacturing and construction. Economic situation remained optimistic in 2007 amid the stronger domestic demand set off by improved terms of trade and remittances, as well as the rising investment that increased the GDP growth to 5 %. Although these positive episodes have been once reversed, the real growth has reached 6 % in the first half of 2008 driven particularly by construction, transport and retail sector. Strong investment, the industrial production growth, but also the high unemployment rate put forward few capacity restraints and possibility to persevere with this favorable supply response. The unemployment has been actually a problem for Macedonia for a long period

³ This author develops an example of macroeconomic stochastic indicator of competitiveness in order to explain the market share of a country by three variables: technical competitiveness reflected in R&D expenditures, price competitiveness determined by terms of trade and unit labor cost, as well as the output capacity.

of time. During the transition process the unemployment rate has fluctuated at around 35% as it was considered the highest one within the region. Macedonia's consumer price levels stay ahead relatively low, although sometimes followed with periods of deflation. The inflation, however, accelerated to 3,2% and 10% in 2006 and early 2008, respectively even with the exchange rate anchor. The situation behind emerged from the principal increase in excise taxes for alcohol and tobacco, as well as the higher energy and oil prices (Table 1).

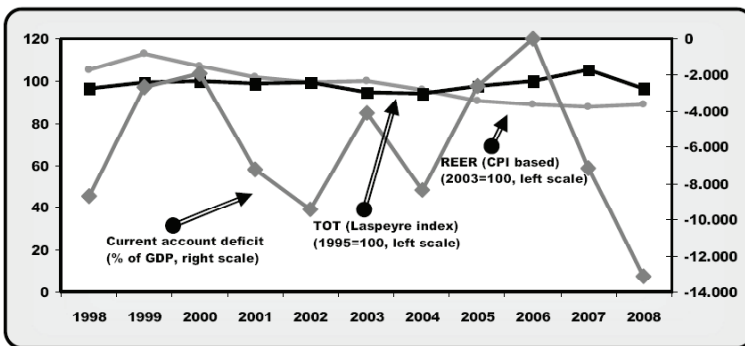
Figure 1: Real GDP growth (average 1998-2008)



Source: WEO and own estimates

Within the past years, Macedonia is one of few transition economies which productivity levels have turned down weigh against the country's mayor trading partners.

Figure 2: Current account deficit, TOT and REER

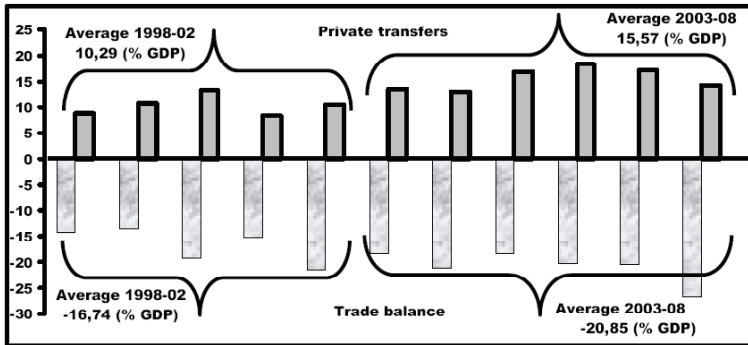


Source: WEO, IFS, NBRM and own estimates

The low investment levels have not been compensated with proper allocation of the resource to growth-oriented sectors of the economy. As the productivity and exports fell down, the current account deficit continued to grow deeper undermining the growth and macroeconomic stability of the country. Specifically, the current account deficit averaged to 6,51% of GDP for the period of 1998-2008 and was strongly accompanied by the negative trade balance accounted for 18,98% within the same period. In the first half of the particular period the average trade deficit was estimated to 16,74%. The increase in oil price, revitalization of some industrial capacities, trade liberalization process and thereby

the tariff decrease have fueled imports within the second half, thus imposed worsening of the trade balance to 20,85% of GDP. The lowest current account deficit was recorded in 2006, determined principally by the large increase of private transfers (Figure 2).⁴

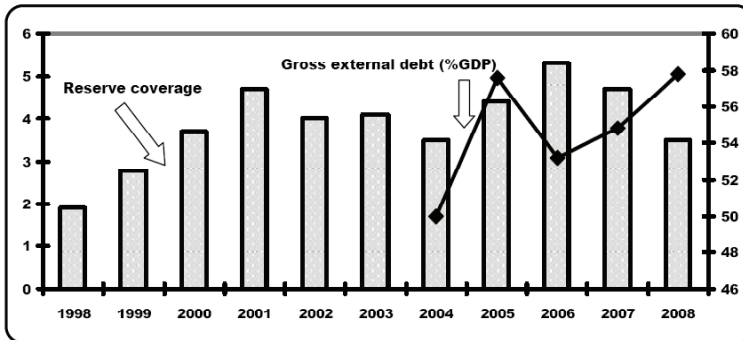
Figure 3: Trade balance and private transfers



Source: NBRM and own estimates

As of 2007, the situation started to considerably change, at which the highest current account and trade deficit was accounted in 2008 setting up the questions about competitiveness, real exchange rate and external vulnerability. The main reasons behind are to be found in rising imports of investment, intermediate goods and energy, strong decline in terms of trade, drop down of private transfers due to the events in Kosovo and domestic elections, as well as the sharp fall in exports owing to the slower global growth (Figure 3).

Figure 4: Reserve coverage and external debt



Source: NBRM and own estimates

The large current account deficit imposed an external vulnerability increase, although the external debt remains manageable (IMF Country report, 09/61). The rise of external debt especially pointed in some period is to be a reflection of large current account deficit and the necessity to increase the reserve coverage (Figure 4). While the capital inflows have

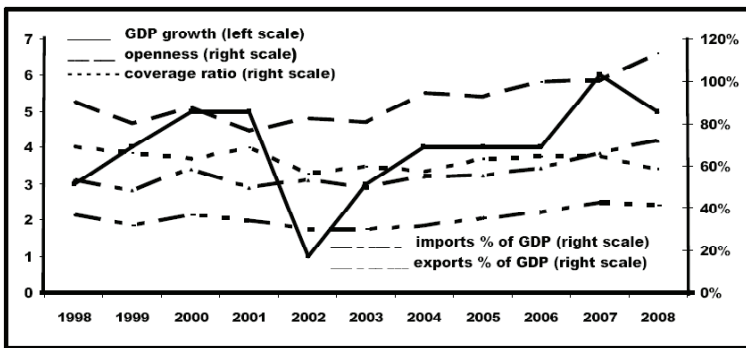
⁴ One of the negative effect of remittances on the current account is the “boomerang effect” that occurs when remittances induce an increase of imports and trade balance deficit in the remittance-receiving country.

been recovered from 2004 onward, the decline in reserve coverage was reversed once within the same period, as well as in 2008. However, noteworthy is to mention that any decrease in foreign reserve ratio does not necessarily boost the external vulnerability if the foreign reserves save for an adequate level. That is to say, the estimated coverage ratio of 3,5 months for the imports projected in 2009 is to be considered an adequate level taking into account the size and exposure of the country onto the international capital markets (NBRM Annual Report, 2009).

2. Dynamics and structure of foreign trade

Within the recent years Macedonia continued with the high levels of foreign trade liberalization. Thus, the country became a WTO member state, but also managed to sign a number of free trade agreements amid the one for enlarging CEFTA to a new framework. Consequently, the levels of openness to trade are to be very high amounting for 87,62% in 2000 to 100% in 2007. Nevertheless, majority external and internal shocks the country has undergone through the transition imposed a permanent setback and low participation of exports to GDP (31,7% to 41,57% in 1999 and 2008, respectively), unlike the imports that have raised dramatically within the same period (48, 06% to 71,60% of GDP).

Figure 5: GDP growth, openness, coverage ratio, imports and exports (% of GDP)



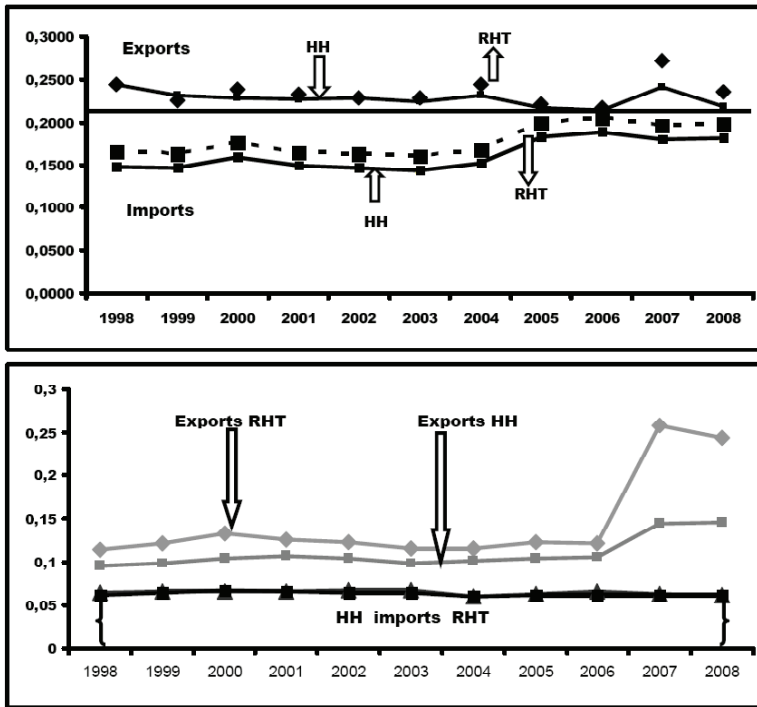
Source: WEO, NBRM and Ministry of Finance

The export performances went downhill especially in 2001 owing to the political crisis which set off a severe contraction in output the same as exports. The situation started to recover mere in 2004, at which the export share of GDP managed to return on its pre-crisis level in 2005. The foreign trade started to aggravate over again in 2008, principally due to vast changes in the global economy along with the increase of domestic demand for imported goods (NBRM, Annual report, 2008). The terms of trade deterioration, intensive private consumption and investment, as well the escalation of the world financial crisis are to be found behind the foreign trade increase in 2008, upon which the imports have been added to a great extent unlike the exports (22,4% and 9,9, respectively). All through the particular period imports have outpaced exports as they have risen by an annual average growth rate of 12% and 14%, respectively. Consequently, the coverage ratio has permanently deteriorated from one year to another (Figure 5).

Patterns of Macedonian foreign trade exhibit high concentration level of the exports, unlike the imports within the period 1998-2008. The particular findings stand for the most

widely treated summary measures of concentration, such as Herfindahl – Hirschman (HH) index, as well as the one developed by Hall and Tideman (1967) and Rosenbluth (Niehans, 1961).⁵

Figure 6: Indices of exports and imports concentration



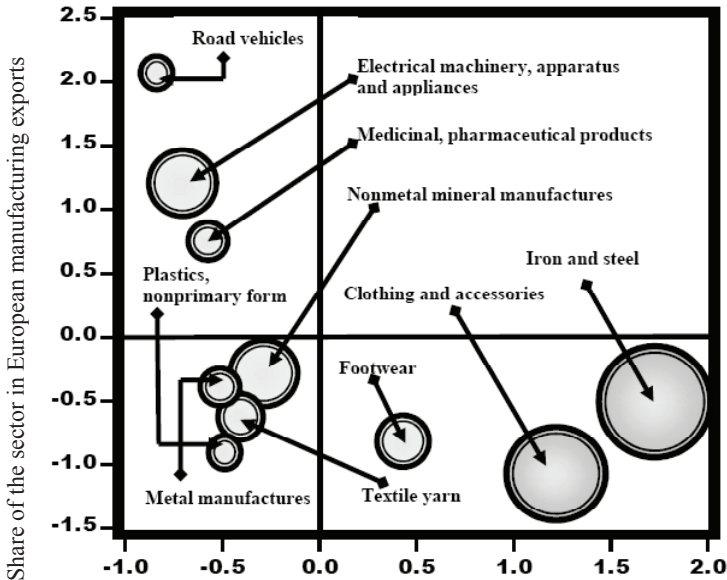
Source: NBRM and own estimates

The both indices suggest that country is heavily dependant on a limited number of sectors the same as trading partners that implies exports instability and vulnerability to business fluctuations and the terms of trade swing. What is more of a concern is the upward tendency after 2004, with some deviations within the last year. Thus, the main drivers of Macedonian export performances are principally the primary products (beverages and tobacco, iron and steel, petroleum products and clothing) which account for around 70% of the total exports. These sectors in aggregate level create surplus in the foreign trade, which means that coverage ratio is to be above the average. Some important sectors, however, record deterioration in the value of particular indicator in 2008 if compared with 1998 (textile fibers, metalliferous ore, scarp and non-ferrous metal). The recovery of iron and still and certain refined oil products are to be found in the renewal of the large steel factory in 2004, as well as the removal of Serbian protectionist barrier to imports. Yet, exports of petroleum products have decreased for the first time in 2007 owing to the prohibition imposed by UNMIC (USAID, Report on foreign trade, 2008). In 2008, a certain decrease have been noticed in exports of iron and steel down to the reduction of global consumption, as well as the negative shifts in metal price. Quite the reverse, imports by sectors have rather than

⁵ The Rosenbluth index and Gini coefficient are related due to the similarity of Lorenz curve and the concentration curve.

diversified structure as considered to be fairly understandable if taken into account the size of the country and trade liberalization process (Figure 6). Special emphasis here should be placed on the import structure consisted of high value added manufactures (equipment), as well as the oil products and energy which price is quite changeable on the world markets.

Figure 7: Share of manufacturing exports (average 2000-2008)



Macedonia's market share in manufacturing products

Source: UN Comtrade and own estimates

As regards the export markets, noteworthy is to mention that few trading partners (mostly EU and western Balkan counties) receive almost 95% of the total exports, unlike the imports that exhibit no structural change within the period into consideration. Further analysis made about the Macedonian manufacturing exports suggest that the loss of competitiveness and the market share is to be a reflection of the strong export concentration and the patterns of specialization. We have therefore examined the development of market share of the ten two-digit sectors accounting for 90% of total Macedonian manufacturing exports (Figure 7). Subsequently, we have made a comparison with the share of the particular sectors into the European manufacturing exports as the largest trading partner. The evidence obtained suggests that Macedonian exports have increased in most of the sectors the country is being specialized and export concentrated. These sectors, notwithstanding, are those with decreasing share into the European manufacturing exports. The analysis, principally, points toward the weaker near – term export growth prospects, although the latest FDI was supposed to diversify exports.

3. Modeling the determinants of exports and imports so as to better assess the competitive performances of the Macedonian economy

Trade equations are usually interpreted as for the time series behavior of the appropriate exports and imports quantities and prices. There is no single answer among the

scholars on the possibilities these equations to be specified since those depend on number of factors, such as: type of the commodity to be traded, the final use, institutional framework, purpose of modeling, as well as the data availability. Generally the theory suggests two principle models: model of imperfect and the one of perfect substitutes (Goldstein and Khan, 1985, p. 1044).

Within this part of the study a selected set of macroeconomic variables is going to be applied so as to examine their influence on exports and imports. The analysis is to be completed for the period 1998Q1 to 2008Q3 proceeded by intensive trade and price liberalization. In addition, the selected timeframe was limited to availability of some variables before the year 1998, as well as the possible abstraction from the break imposed by 1997 devaluation. However, the total number of 43 observations allows the specific econometric approach to be applied without reflecting more significantly on reduction of the degrees of freedom. The assessment of trade equations is to be made by employing the maximum likelihood estimator of Johansen so as to estimate a long-run (cointegration) relationship between exports or imports and the appropriate macroeconomic fundamentals. This method in particular is suitable for multivariate analysis (can detect more than one cointegrating vector) and might also account for autocorrelation of the endogenous variables. One of the most important advantages over the single-equation (Engle – Granger) is the possibility to include both jointly dependant I(1) and I(0) variables (Harris and Sollis, 2003). The Johansen method goes through several steps, beginning with the Vector Auto Regression (VAR) model that is to be transformed into Vector error correction model (VECM). Thus, the lag length specification of the underlying VAR model has to be made at first. Furthermore, one should make an appropriate selection of the deterministic components intended for the long- and short-run relation among the variables. The estimation proceeds by jointly testing for cointegration and deterministic components. Finally, the restrictions have to be imposed on the cointegrating vector (s) obtained.

$$\Delta y_t = \Pi y_{t-1} + \sum_{i=1}^{p-1} \Gamma_i \Delta y_{t-i} + Bx_t + \varepsilon_t$$

where

$$\Pi = \sum_{i=1}^p A_i - I, \Gamma_i = - \sum_{j=i+1}^p A_j$$

Within the above equation, y_t stands for the k -vector of non-stationary I(1) variables (exports or imports and the respective macroeconomic determinates), x_t indicates

the d -vector of deterministic variables and ε_t is a vector of innovations. Granger's representation theorem states that if the coefficient matrix Π has reduced rank $r < k$, one

should consider $k \times r$ matrices α and β each with rank r such that $\Pi = \alpha\beta'$ and $\beta' y_t$ is I(0). Additionally, r corresponds to the number of cointegrating relations (the cointegrating rank) whereupon each β column is to be considered a cointegrating vector. Special emphasis should be here placed on the elements of α known as adjustment parameters in the VEC model. In principal, Johansen's method is to estimate the Π matrix as of the unrestricted

VAR and to test if one may reject the restrictions implied by the reduced rank of Π .

3.1. The analysis of exports

The econometric analysis of exports is based upon the variables which represent the basic elements of price and cost competitiveness (Jefferson Institute, 2006). Accordingly, the neo-classical economic theory special attention pays to the real exchange rate (RER) and real effective exchange rate (REER) as a measure of price competitiveness (Edwards, 1989 and Lipschitz, 1979). In addition, the appreciation/depreciation of the real exchange rate of the particular country exhibits loss/gain in the levels of competitiveness (Edwards, 1989). The equilibrium real exchange rate is to be implemented as a reference to determine the currency misalignment (RER appreciation or depreciation). Principally, there are few problems related to RER as a measure of competitiveness (Minale, 2002). At first, measuring the competitiveness as a relative price may certainly narrow the definition of competitiveness. Moreover, competitiveness of the economy is not to be just a function of wages and prices (relative to other countries) but it is also greatly influenced by the non-price factors. Secondly, the intuition behind RER as a measure of competitiveness is hardly applied to developing countries which have the advanced ones as their trading partners (Minale 2002). Implicitly, the RER definition is based upon the assumption of the tradable homogeneity, as well as availability of technology to all the countries without cost. Productivity measures are also very important to study the export competitiveness. However, competitiveness is not to be determined merely by productivity, but also cost of inputs in the production. Indeed, a well-known measure of international competitiveness combines labor cost and productivity into a single measure of labor cost per unit output. Unit labor cost (ULC) are broadly used for international comparisons of cost competitiveness but also have been compared in terms of ULC trends or the real effective exchange rate. The meaning of the ULC concept might be even better understood when expressed in terms of the ratio of labor compensation per unit of labor (wage or the total labor cost per employed person or per hour worked) and the productivity of labor (measured as output per employed person or per hour). The country may therefore improve its competitiveness either by decreasing its labor cost per person employed or raising the productivity performance. Unit labor costs are most easily measured and best understood for tradable sectors of the economy but it is also useful for analysis at the level of the aggregate economy. Noteworthy is here to mention that a change in unit labor cost in the non-tradable sector also impacts the tradable sector, in particular when non-tradable products or services are used as an input by the tradable sector. Moreover, many service industries are becoming more tradable themselves, which is an indication that the distinction between tradable and non-tradable sectors of the economy is becoming increasingly anachronistic. An exclusive focus on unit labor cost in the manufacturing industry may therefore be a too restrictive approach to study competitiveness (van Ark et al, 2005). Even for tradable, the ULC index may not to be considered as comprehensive measure of competitiveness for several reasons. Firstly, ULC measures deal exclusively with the labor cost. Although they account for the major share of inputs, the cost of capital and intermediate inputs are to be also the crucial factors for comparisons of cost competitiveness between countries. Secondly, the measure reveals only the cost competitiveness as some durable consumer and investment goods competitiveness is also determined by other factors than costs, such as technological and social capabilities and demand factors. Thus, in the literature of competitiveness attention is given not only to the factor input, but also the innovation and production capacity (Porter, 1990, Fagerberg et al, 2005). The importance of export supply function is specially emphasized in the literature (Stern, Francis and Schumacher, 1976) since most of the

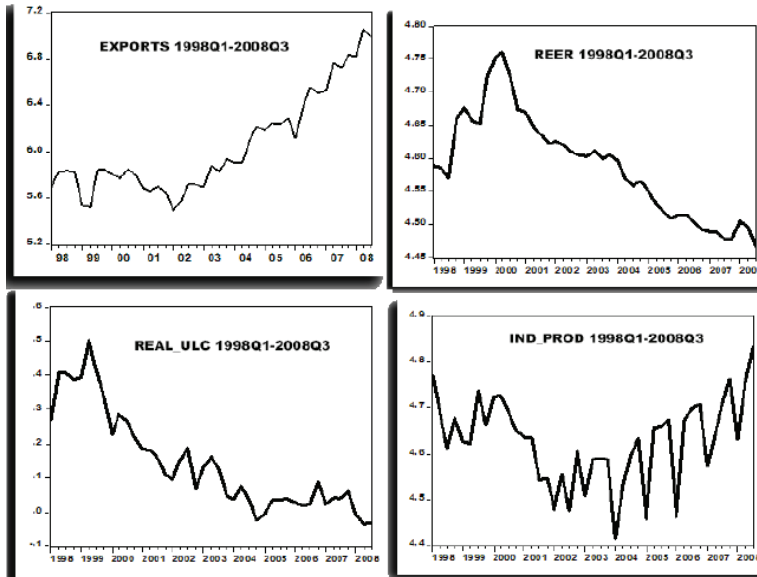
empirical studies have not put this variable in the models handled by the assumption of infinite price elasticity. This is to be probably justified in the case of import supply as for the small open economy it is quite hard to believe that infinite price elasticity of export supply holds. Principally, if the world demand for goods coming from a certain small open economy increases, the country will be most probably unable to meet the demand without the change in export price (Goldstein and Khan, 1978). Taking into consideration the above theoretical notations the model herewith exhibits exports as a function of the real effective exchange rate (CPI based), real unit labor cost⁶ at the level of the aggregate economy, as well as the index of industrial production to capture the production capacity (Figure 8).⁷

$$EXPORTS = f(reer, real_ULC, ind_prod)$$

Following the proposed model of Jefferson institute the initial set of variables included the one as a proxy for the fiscal burden of the economy. In addition, different VECM specifications were estimated. However, the fiscal burden was not a significant determinant of exports and therefore was excluded so as to avoid losing degrees of freedom. All the data are expressed in logarithmic values thus stand for the variable elasticity.

Furthermore, the data for exports (nominal, dollars) are obtained by the Macedonian state statistical office. Unit labor cost and industrial production are expressed in index number and have been attained by the National Bank of Macedonia. The real effective exchange rate is obtained by the International Financial Statistics, whereupon the increase stands for the real appreciation i.e. reduction in the price competitiveness or vice versa.

Figure 8: Exports and the long – run determinants



Source: NBRM, State statistical office, IFS and own estimates

Prior the cointegration analysis one should apply unit root test for each series in the

⁶ Real unit labor cost is obtained as the unit labor cost has been deflated by the producer price index.

⁷ The seasonal factor from the variables was removed by using three quarterly seasonal dummy variables.

VAR since the test for cointegration is only valid when working with series known to be nonstationary. Thus the applied Augmented Dickey-Fuller and Phillips-Perron tests failed to reject the hypothesis of unit root at 1%, 5% and 10% level, although without intercept and trend in the case of industrial production. Furthermore, the lag order selection of the test VAR was obtained by two criteria: the residual tests, as well as the information criteria. In addition, the three seasonal dummy variables are included in the VAR model as the exogenous ones. The residual tests suggest that the most appropriate model is VAR (1), while the information criteria as expected propose different lag order (Schwarz and Hannan-Quinn information criteria indicate one lag, while Akaike information criterion suggests 4 lags).

Taking into consideration the small sample, as well as the importance of residual tests the further analysis of the export regression is going to proceed with one lag included. The Johansen maximum likelihood method is applied on the set of endogenous variables, thus the next step refers to testing the number of cointegrating relations. Moreover, the procedure may be implemented by two test statistics, such as: maximum eigenvalue of the stochastic matrix and the trace of the stochastic matrix. The both statistics suggest one cointegrating vector (Table 3). Yet, the vector individual assessment does not give proper information on the economic relations, thus some restrictions have to be imposed in accordance with economic theory (Harris and Sollis, 2003). Within the case in point the vector coefficients are normalized on the coefficient of the export variable i.e. this variable is considered to be an endogenous.

Table 3: Unrestricted cointegration rank test (exports)

Hypothesized		Trace	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.677007	74.73144	47.85613	0.0000
At most 1	0.336675	27.26615	29.79707	0.0953
At most 2	0.210618	10.02558	15.49471	0.2788
At most 3	0.002197	0.092360	3.841466	0.7612

Hypothesized		Max-Eigen	0.05	
No. of CE(s)	Eigenvalue	Statistic	Critical Value	Prob.**
None *	0.677007	47.46530	27.58434	0.0000
At most 1	0.336675	17.24057	21.13162	0.1609
At most 2	0.210618	9.933220	14.26460	0.2164
At most 3	0.002197	0.092360	3.841466	0.7612

Note: Max-eigenvalue test indicates 1 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

** MacKinnon-Haug-Michelis (1999) p-values

In line with economic theory the very high positive coefficient on industrial production implies no infinite price elasticity for a small open economy such Macedonia is. In other

words, the exports are also led by the suppliers i.e. 1% increase of output implies an exports rise for about 3,49%. The reason behind is to be found in the revitalization of the metal manufacturing industry in 2004, the start over process of the mining factory and enhanced vine production in 2005, as well as the increased FDI inflows within the manufacturing industry (iron, steel and ferrous-nickel). The positive signals of export supply in 2008 were imposed by the higher metal price. The analysis also points towards the exports high price elasticity (REER depreciation of 1% leads to an exports increase of 2,9%). The coefficient seems to be reasonable taking into consideration the low value added products of Macedonian exports (45% of total exports). In principal, the quantitative effects dominate the price effects on long run, so the expected influence of REER depreciation on trade balance is to be observed eventually (Kipici, Kesriyeli, 1997).

Table 4: Vector error correction estimates (exports)

<i>Cointegrating Eq:</i>	<i>lexports (-1)</i>	<i>lind_prod (-1)</i>	<i>lreer (-1)</i>	<i>lreal_ulc (-1)</i>	<i>c</i>
<i>CointEq1</i>	1.000000	-3.485789 (0.30737) [-11.3408]	2.926085 (0.43874) [6.66924]	1.137636 (0.24574) [462940]	-3.508535
<i>Error Correction:</i>	<i>D(lexports)</i>	<i>D(lind_prod)</i>	<i>D(lreer)</i>	<i>D(lreal_ulc)</i>	
<i>CointEq1</i>	-0.018210 (0.07667) [-0.23749]	0.250995 (0.03869) [6.48726]	-0.003662 (0.01687) [-0.21712]	-0.115618 (0.02880) [-4.01471]	
<i>c</i>	0.021011 (0.03307) [0.63541]	0.021515 (0.01669) [1.28944]	0.008236 (0.00727) [1.13228]	-0.037953 (0.01242) [-3.05593]	
<i>@seas (1)</i>	0.105369 (0.04703) [-2.24267]	-0.102215 (0.02373) [-4.30751]	-0.004020 (0.01034) [-0.38863]	0.008848 (0.01766) [0.50096]	
<i>@seas (2)</i>	0.083403 (0.04637) [1.79863]	0.025131 (0.02340) [1.07403]	-0.015574 (0.01020) [-1.52687]	0.090071 (0.01742) [5.17165]	
<i>@seas (3)</i>	0.049327 (0.04570) [1.07940]	-0.008977 (0.02306) [-0.38930]	-0.023161 (0.01005) [-2.30401]	0.019285 (0.01716) [1.12357]	

Standard errors in () and t-statistics in [].

Note: If the variable *lexports* is interpreted as a LHS one in a causal model, then the coefficient of the "RHS" variables must be multiplied by -1.

Namely, after the devaluation of around 16% in 1997 the real exchange rate has appreciated mostly owing to the NEER appreciation (Serbian dinar depreciation). However, the sustained appreciation has not been materialized due to the Balassa – Samuelson effect, thus REER started to decline again caused by the depreciation of the relative price of domestic to foreign tradable goods mostly with transition economies. One possible explanation of this depreciating REER-tradable trend is increasing differentiation of tradable output. Low profitability, low investment, and lack of technological enhancements have prevented Macedonian firms from producing high-value-added and high-quality goods, which also explain Macedonia's inability to improve export performance and access new markets (Loko and Tuladhar, 2005, p.3). Finally, the exports exhibit an expected (in terms of the

coefficient sign) but moderate elasticity to the real unit labor cost. The reason behind is to be found in the upward productivity movements caused by the GDP growth with simultaneous decline of the persons employed. Additionally, the higher productivity levels have been noted principally within the non-tradable sector that is to be not unusual considering the FDI inflows within the service sector. The higher productivity levels have been discreetly recorded within the tradable sector, however, pointing towards finalization of the reforms. Nevertheless, the productivity gains have improved the unit labor costs, thus outpaced the gross wage increases considered higher compared to the other countries in the region. The adjustment coefficient is very low heading for inertia in the movements. In other word exports should fall sufficiently to bring about 1,8% of the total adjustment needed per quarter until equilibrium is restored (Table 4). In order to examine the importance of each variable explaining the total variability of the initial VAR the variance decomposition has been made by applying the Choleky procedure.

Table 5: Variance decomposition of the exports prognosis error

Estimating the random shocks in the variable of the initial VAR	The first sequence in the variables (%)	The second sequence in the variables (%)
<i>exports</i>	62,79	62,79
<i>reer</i>	6,70	12,19
<i>real ulc</i>	28,51	23,42
<i>ind prod</i>	2,00	1,60
Total	100	100

Note: The variance of the prognosis error was decomposed after the period of 8 quarters. The unrestricted VAR of first order in levels was estimated.

As the relative contribution of the variables to the total variability depends upon the sequence of their setting into the procedure the two sequences have been established: 1) *reer* → *real_ulc* → *ind_prod* → *exports* and 2) *real_ulc* → *ind_prod* → *reer* → *exports*. According to the results obtained one may notice a significant inertia in the export movements, which is partially confirmed by the adjustment coefficient. Hereunder in the first sequence, the real unit labor cost explain 28,51% of total variability. The change of sequence, however, imposed an increased influence of *reer*, while unit labor cost has smaller share in explaining the total variability (23,42%). The change of the sequence does not significantly alter the role of industrial production, which means that it has a very stable influence in explaining the fluctuations of exports (Table 5).

3.2. The analysis of imports

As for the analysis of exports the model developed by Jefferson institute has been followed to analyze Macedonian imports. Thus, the econometric analysis performed within their study was commenced by including a set of variables presenting the import demand function. Principally, the import demand makes imports to be a function of domestic income (activity) and domestic price relative to the price of import substitutes. Thus, import demand function if assumed constant price and income elasticity may be written as follows:

$$IMPORTS = \left[\frac{P_d E}{P_f} \right]^\lambda Y^\Omega$$

whereupon, Y stands for the domestic income (activity), P_d is domestic price, P_f is foreign price, E corresponds to nominal effective exchange rate, while λ and Ω indicate the price and income elasticity of import demand, respectively. Thus, the income is expected to have positive sign, as well as the relative domestic to foreign price approximated by REER (an increase indicate REER appreciation that positively corresponds to import demand). Taking logs of the previous equation and differentiating with respect to time the imports growth might be expressed as:

$$imports = \lambda(p_d + e - p_f) + \Omega(y)$$

The partial adjustment of import demand in which import growth is assumed to adjust partially to difference between equilibrium imports growth in period t and the actual import growth in the previous period can be written as follows:

$$m_{t-1}\beta_0 + \beta_1 pm + \beta_2 y + \beta_3 m_{t-1} + \mu_t$$

where, β_1 is λ , β_2 corresponds to Ω (short run price and income elasticity), pm is the growth of domestic relative to foreign prices and μ_t is the error term.

So far, the analysis of import income and price elasticity i.e the import demand function either in developed or developing countries has been widely observed among the scholars (Khan, 1974, Goldstein and Khan, 1985, Warner and Kreinin, 1983, Haynes and Stone, 1976, Marquez, 1990). The general conclusion of the studies is that income and price elasticity are considered to be significant determinants of imports, although the price elasticity is likely to be below the income elasticity (in most studies below unit, unlike the income elasticity that has a propensity to be above unit). However, a small number of studies analyzed the impact of trade liberalization on imports behavior (Bertola and Faini (1991). One of the earliest studies of the trade liberalization impact on import demand was obtained by Faini et al (1992). The authors assumed two types of imports, such as: those subject to quantitative restrictions and imports that might freely enter the economy. They suggest that the estimated income elasticity is generally higher than unity, and the relative prices (approximated by REER) are significant with elasticity less than unity. The authors have also found that the real effects of income and price changes on import behavior are more evident when the analysis also includes the impact of import controls and/or liberalization policies. Thus, import demand studies, which do not evaluate the effect of import policy changes, should be interpreted with caution, as far as the estimates of the income and price elasticity are concerned.

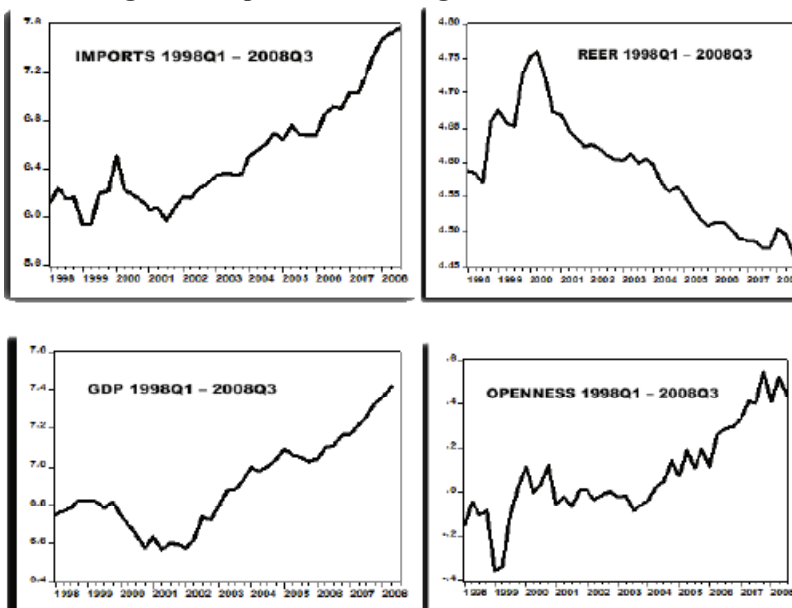
Taking into account the above theoretical considerations the analysis within this paper is going to be performed as imports is considered to be a function of domestic income (economic activity), relative prices (approximated by REER) and openness, as a variable employed as a proxy for import tariffs.

$$IMPORTS = f(reer, GDP, openness)$$

Additionally, all the data are expressed in logarithmic values thus stand for the variable

elasticity. The seasonal factor from the variables GDP and imports were removed by the conventional methods for seasonal adjustment (Census X12, multiplicative). Furthermore, the data for imports (nominal, dollars) are obtained by the Macedonian state statistical office. The degree of openness is a variable computed as a ratio of foreign trade and GDP. Moreover GDP is considered as a variable representing the domestic income (economic activity). The data on GDP (in millions of national currency, 1997=100) has been obtained by the Macedonian state statistical office. Yet, for the purpose of this analysis it has been converted to dollars using the average exchange rate on monthly base for the particular period obtained by the National bank of Macedonia. The real effective exchange rate is obtained by the International Financial Statistics, whereupon the increase stands for the real appreciation i.e. rise in imports (Figure 9).

Figure 8: Imports and the long – run determinants



Source: NBRM, IFS, State statistical office and own estimates

As in exports the unit root test for each series in the VAR has preceded the cointegration analysis. Thus the applied Augmented Dickey-Fuller and Phillips-Perron tests failed to reject the hypothesis of unit root at 1%, 5% and 10% level. Furthermore, the lag specification of the test VAR was also obtained by two criteria: the residual tests, as well as the information criteria. The residual tests suggest that the most appropriate model is VAR (1), while the information criteria as expected suggest different lag order (Schwarz information criterion indicate one lag, Hannan-Quinn proposes 2 lags, while Akaike information criterion suggests 4 lags). Taking into consideration the small sample, as well as the residual tests suitability for VAR (1) the further analysis is going to proceed with one lag included. As the Johansen maximum likelihood method is applied on the set of endogenous variables, the number of cointegrating relations has to be estimated. Subsequently, the two test statistics recommend one cointegrating vector (Table 6). Finally, vector coefficients within the

import equation are normalized on the coefficient of the import variable i.e. this variable is considered to be as endogenous.

Table 6: Unrestricted cointegration rank test (imports)

Hypothesized No. of CE(s)	Eigenvalue	Trace Statistic	0.05 Critical Value	Prob.**
None *	0.590963	61.73256	47.85613	0.0015
At most 1	0.337112	25.08061	29.79707	0.1586
At most 2	0.175400	8.223513	15.49471	0.4418
At most 3	0.007687	0.316366	3.841466	0.5738

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 Critical Value	Prob.**
None *	0.590963	36.65195	27.58434	0.0026
At most 1	0.337112	16.85710	21.13162	0.1788
At most 2	0.175400	7.907147	14.26460	0.3882
At most 3	0.007687	0.316366	3.841466	0.5738

Note: Max-eigenvalue test indicates 1 cointegrating eqn(s) at the 0.05 level

* denotes rejection of the hypothesis at the 0.05 level

** MacKinnon-Haug-Michelis (1999) p-values

As expected in economic theory explained above, Macedonian imports exhibit positive income elasticity above unit i.e. 1% GDP increase imposes 1,12% rise in imports. In principal, the economic activity in the Republic of Macedonia has undergone two external shocks (1999 and 2001). The both of them have determined a certain decrease in the economic activity, especially within the production to be exported, as well as the gross capital formation. The increased economic activity has been recorded in the year 2000 owing to the reforms performed within the fiscal policy. The value added tax implementation had a positive impact on net exports, but also accelerated the private consumption and investment. One of the highest rates of economic activity was noticed in 2005 (4% GDP increase) principally due to the increased domestic demand and exports. At the same time a certain rise has been noticed in the gross fixed capital formation (capital goods), as well as the private consumption owing to the increased wages, credits and retail. The particular tendency continued in 2007 when the improved terms of trade and remittances boosted incomes and domestic demand. The favorable chocks, however, have been reversed by the end of 2008. The Republic of Macedonia is overall a small country highly dependent upon different kind of goods to be imported (on average 65% production materials, 12% capital goods and 23% consumption goods). The particular situation, as well as the high levels of trade liberalization imposed by the reduction of many trade barriers due to the WTO accession and free trade agreements stipulate very high openness to trade. That is to be confirmed by the positive coefficient that indicate 1,11% rise in imports for a unit increase in openness. The situation is quite expected taking into consideration the ratio “import/

GDP” that has been running from 53% in 1998 to 72% in 2008. On the other hand, imports impose low levels of price elasticity (0,7% increase in imports at REER appreciation of 1%). Taking into consideration that Macedonia is a small open economy highly dependent upon imports on intermediary and investment goods (in average 77% of total imports) coefficient is considered to be quite reasonable. That is to say, Macedonia has increased the imports for energy and oil in 2007 and 2008 although their price on world markets has recorded a certain increase (Table 7).

Table 7: Vector error correction estimates (imports)

<i>Cointegrating Eq:</i>	<i>limports (-1)</i>	<i>IGDP (-1)</i>	<i>lopenness(-1)</i>	<i>lreer (-1)</i>	<i>c</i>
<i>CointEq1</i>	1.000000	-1.121499 (0.07456) [-15.0419]	-1.109049 (0.06968) [-15.9158]	-0.698609 (0.19931) [-3.50521]	4.547053
<i>Error Correction:</i>	<i>D(limports)</i>	<i>D(IGDP)</i>	<i>D(lopenness)</i>	<i>D(lreer)</i>	
<i>CointEq1</i>	-0.289170 (0.25893) [-1.11681]	0.332638 (0.09155) [3.63337]	0.247394 (0.22201) [1.11436]	-0.025159 (0.05671) [-0.44363]	
<i>c</i>	0.034142 (0.01709) [1.99834]	0.016145 (0.00604) [2.67263]	0.016334 (0.01465) [1.11499]	-0.002228 (0.00374) [-0.59550]	

Standard errors in () and *t*-statistics in [].

Note: If the variable *limports* is interpreted as a LHS one in a causal model, then the coefficient of the “RHS” variables must be multiplied by -1.

The adjustment coefficient is moderately high i.e. imports should fall sufficiently to bring about 29% of total adjustment needed per quarter until equilibrium is restored (90% of total adjustment might be achieved within one year and half).

Table 8: Variance decomposition of the imports prognosis error

Estimating the random shocks in the variable of the initial VAR	The first sequence in the variables (%)	The second sequence in the variables (%)
<i>imports</i>	18,38	18,38
<i>reer</i>	39,72	31,95
<i>openness</i>	38,35	38,35
<i>GDP</i>	3,56	11,32
<i>Total</i>	100	100

Note: The variance of the prognosis error was decomposed after the period of 8 quarters. The unrestricted VAR of first order in levels was estimated.

Since it is very difficult to interpret the estimations of VAR parameters the method of variance decomposition has been also applied in order to examine each variable contribution to total variability of imports. Thus, two sequences have been used for the decomposition procedure of the estimated prognosis after the period of two years: 1) *GDP* → *reer* → *openness* → *imports* and 2) *reer* → *GDP* → *openness* → *imports* (Table 8). According

to results obtained it may be noticed a certain change in explanation of total variability in different sequences only in the case of GDP and REER, while imports and openness are to be quite stable while explaining the fluctuations. Thus, the import fluctuation after the two year period are explained 18,38% by its own variance and 38,35% by the variance of the openness indicator .

CONCLUSIONS

Within the past decade Macedonian total exports have fallen as a percentage of world totals, while increase has been noticed in most of the sectors the country is being export concentrated. These sectors in particular are those with decreasing share into European manufacturing exports, as one of the main trading partners. As exports and productivity fall the current account deficit exposed vulnerabilities in coverage ratio and external debt. Exports are also dependent upon the REER movements, unlike imports which are responsive to the certain shifts of openness indicator. Exports explicitly show a high inertia in their movement. Put differently, exports should fall sufficiently to bring about 1,8% of the total adjustment needed per quarter until equilibrium is restored. In principal, the both sequences used to examine the influence of random shocks within the variables after the period of two years indicate higher levels of REER and real unit labor cost in explaining the total variability unlike the industrial production that remains quite stable. On the other hand, imports prove faster adjustment to the equilibrium level. Additionally, GDP and REER exhibit some changes in explanation of total variability after 8 quarters, while openness indicator is quite stabile at explaining the certain imports fluctuations.

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REGIONAL COOPERATION – IS IT A FORM OR A REALITY? THE CASE OF THE REPUBLIC OF MACEDONIA

*Nobody can predict how big can be
 the gap between the idea and its realization.*

KANT

Abstract

Following the positive effects from CEFTA in the process of integration of the countries form Central and Eastern Europe within the European Union, the EU decided to offer the similar arrangements to the countries form the Western Balkan. The main goal of these arrangements was to increase the economic integration and cooperation among the countries from the region in order to speed up the process of fulfilling the defined criteria for their accession to the EU.

In December 2006 the multilateral free trade agreement for the Western Balkan countries “CEFTA-2006” was created. The purpose of CEFTA-2006 was to establish a free trade area for goods and services among Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Montenegro, Moldova, and Serbia. This agreement replaced the 32 bilateral free trade agreements that were used to regulate the trade exchange of goods within the Western Balkan zone. Except for goods and services, the agreement should provide full protection of intellectual property rights, harmonization of their national technical standards with those of the WTO TBT Agreement, achievement of fair - competition practices and gradual liberalization of public procurement of the member-states. Up to 2010 the full establishment of free trade zone should be achieved.

Liberalization of trade should increase the competitiveness of the region, increase the foreign investments and this will positively stimulate the economic growth of the Western Balkan countries.

This paper analyzes the trade exchange of the Republic of Macedonia with the countries from the region, and tries to answer weather the CEFTA-2006 has the power to induce the qualitative changes in the international trade of Macedonian economy.

Key words: *trade exchange, CEFTA-2006, Western Balkan countries, regional cooperation, Republic of Macedonia*

INTRODUCTION

Almost two decades, Macedonia has been in the process of transition. This is a long enough period for summarizing the results of the transition, which, for the sake of the truth, are not

pleasant. The expectations that transition would improve the economic performances and bring the Republic of Macedonia closer to the “European family” have not come true. On the contrary, the Republic of Macedonia is now facing worse conditions than at the outset of the transition. It is in a deep economic and social crisis, and moreover, it has been listed in the group of the least successful transitional economies under the common name of “Western Balkans.”

Up to 2006, Macedonia together with Croatia and Albania managed to sign the Stabilization and Association Agreement with the EU. Furthermore, the Republic of Macedonia was the first among the countries from South Eastern Europe that had met the request to sign bilateral agreements on free trade with all the countries in the region by the year 2002 and as a result it has completed the process of liberalization of regional trade as it was suggested by the European Union and the larger international community. For instance, in the period from 1996 until 2006 Macedonia signed 11 bilateral free trade agreements with the countries from the closer and the broader region. Signing the multilateral free trade agreement CEFTA -2006, all these 11 bilateral free trade agreements were replaced.

However, the anticipated results are missing and the advantages of a larger market are not there yet. In general, in the period 1996-2008 the Macedonian exports to the countries with free trade regimes is increasing with lower rate compared to the growth rate of the imports from the same countries. Consequently, the trade deficit from the exchange increases during the whole period. This is shown in Table 1.

The Macedonian exporters have difficulties in retrieving the lost markets in the region and they poorly use the signed agreements on free trade. Also the exporters are facing problems with the severe competition at the regional markets which are distinctly opening towards an increasing number of the importers from the other countries.

Table 1: Trade exchange of the Republic of Macedonia in the period 1996-2008 under the free trade agreements

	Export		Import		Export/Import	Trade deficit/BDP
	(million USA \$)	growth** rate of export	(million USA \$)	growth** rate of import		(from the total trade exchange)
1996	327,96		289,88		113,14%	14,14%
1997	332,48	1,38	343,58	18,52	96,77%	15,67%
1998	335,36	0,87	458,81	33,54	73,09%	16,89%
1999	337,47	0,63	402,77	-12,21	83,79%	15,68%
2000	446,46	32,30	542,46	34,68	82,30%	19,78%
2001	375,87	-15,81	473,27	-12,75	79,00%	14,30%
2002	1.017,31	170,65	1.830,96	286,87	55,56%	22,62%
2003	1.259,44	23,80	2.059,40	12,48	61,16%	20,60%
2004	1.557,25	23,65	2.324,07	12,85	67,01%	25,40%
2005	1.838,61	18,07	2.389,00	2,79	76,96%	21,75%
2006	2.324,61	26,43	2.683,77	12,34	86,62%	21,94%
2007*	3.242,21	39,47	3.617,39	34,79	89,63%	24,34%
2008*	3.832,79	18,22	4.770,45	31,88	80,34%	n.a

Source: Reports on foreign trade of Macedonia 2007 and 2008

Notice: * regional trade exchange under CEFTA – 2006; ** authors' calculations

In the following sections will be presented the some of the characteristics of Macedonian foreign trade before and after the creation of CEFTA -2006.

1. Regional cooperation before CEFTA-2006

The creation of “the Western Balkans” (Macedonia, Bosnia, Croatia, Serbia, Montenegro and Albania) was intended for initiating a better regional cooperation, signing bilateral agreements on a free trade, forming a free-trade zone, which would bring them closer to the EU. In the period from 1996 until 2006, Macedonia signed 11 bilateral free trade agreements with the countries from the closer and the broader region (Bulgaria, Turkey, Bosnia and Herzegovina, Albania, Serbia, Croatia, Ukraine, Romania, Hungary and Moldova and the EFTA countries).

Table 2: Regional trade exchange of the Republic of Macedonia, by selected countries, in the period 1996-2006

	Serbia		Croatia		Bulgaria		Roamnia	
	Participation of trade in the total trade under the free trade agreement	Net export or (net import) (million USA \$)	Participation of trade in the total trade under the free trade agreeme.	Net export or (net import) (million USA \$)	Participation of trade in the total trade under the free trade agreement	Net export or (net import) (million USA \$)	Participation of trade in the total trade under the free trade agreeme.	Net export or (net import) (million USA \$)
1996	51,89%	80						
1997	66,67%	68						
1998	51,89%	(6)	16,25%	(11)				
1999	59,19%	70	15,00%	(14)				
2000	53,14%	145	10,72%	(10)	12,65%	(71)		
2001	50,05%	109	12,25%	12	14,60%	(82)		
2002	15,13%	61	4,00%	4	5,30%	(106)		
2003	12,44%	135	3,92%	2	5,27%	(123)		
2004	15,31%	102	3,74%	15	6,72%	(156)	2,94%	(113)
2005	17,12%	196	3,69%	6	7,33%	(158)	1,63%	(61)
2006	16,79%	275	4,05%	45	7,59%	(120)	2,09%	(79)

Source: Reports on foreign trade of Macedonia 2007 and 2008

Table 3: Regional trade exchange of the Republic of Macedonia, by selected countries, in the period 1996-2006

	Bosnian and Herzegovina		Moldova		Albaina	
	Participation of trade in the total trade under the free trade agreement	Net export or (net import) (million USA \$)	Participation of trade in the total trade under the free trade agreement	Net export or (net import) (million USA \$)	Participation of trade in the total trade under the free trade agreement	Net export or (net import) (million USA \$)
2002	1,12%	4			0,53%	13
2003	1,08%	12			0,63%	13
2004	1,15%	21			0,72%	20
2005	1,75%	26	0,01%	(0,21)	0,88%	19
2006	1,84%	38	0,01%	0,04	1,06%	29

Source: Reports on foreign trade of Macedonia 2007 and 2008

Notice: The free trade agreement with Bosnia and Herzegovina and Albania were signed in 2002 and with Moldova in 2005.

The results of the analysis of the regional trade exchange between Macedonia and countries from the closer and the broader region, during the period 1996-2006, are ambiguous regarding the realization of the expected effects from the bilateral free trade agreements. Despite all signed bilateral agreements, the scope of regional trade exchange in the period 1996-2001 was low and its average participation in the total foreign trade was 26 %. One of the reasons for relatively small scope of trade exchange was the low level of the used preferential agreements. The low level of used preferential quotas associated with the delay in their granting to the firms due to the institutional lack of capacity to manage these activities. (Temenukova, 2003).

The Macedonian exporters have difficulties in retrieving the lost markets in the region, they poorly used the signed agreements on free trade, and they were facing problems with the severe competition of the regional markets that were visibly opening towards an increasing number of other countries. The results of the regional cooperation can be summarized as follows. The first part consists of countries with which the Republic of Macedonia has registered a surplus and a solid level of covering the import with the export on the one side, but a low average level of employed quotas in conformity with the signed agreements in the export, as well as in the import, on the other. The second part consists of countries with which the exchange of the Republic of Macedonia registers deficit and a significantly low level of covering the import with the export, as well as a higher level of employed quotas in conformity with the agreement, particularly as regards the import.

For instance, until 2001, Serbia was the biggest Macedonian trading partner in the region, and Macedonia marked positive results in the trade balance from the exchange. Also the exchanges of goods with Albania and Bosnia and Herzegovina resulted with surplus from the trade. On the other side is trade exchange with Bulgaria, Romania and Moldova, where the results of the goods exchange were not pleasant. For instance, the import of goods from Bulgaria, during the whole period was exceeding the export of Macedonian goods at the Bulgarian market.

The structure of the Macedonian export sector, where the producers of raw materials and of goods with low level of industrial finalization dominates, is inherited situation from the previous economic system, where the process of creating the production structure of the Macedonian economy was determined from the needs of the Yugoslav economy. The more developed republics in the Yugoslav federation (Slovenia, Croatia, and Serbia) forced their economic interests and had created production structures where producers of goods with high level of industrial finalization were dominating. The rest of the republics were inputs and raw materials suppliers of their production. After the brake down of the Yugoslav federation, and building a new market oriented economies in the region, the situation from the aspect of the production structure was not changed. The regional cooperation among the countries from the region is not enough strong impulse for changing the structures of countries' export sectors. During the whole period, 70 % of Macedonian export consists of goods with low level of industrial finalization (food, steel, iron, products from steel and iron, chemicals, and textile).

After 2001, the trade exchange of Macedonian economy shifted from regional markets to the larger European markets. The signing the SAA with the European Union was the reason for this change, whereby all administrative barriers in the trade exchange were removed. The participation of trade exchange with the European companies in the total trade exchange within the trade under the free trade agreements is significantly high (more than 60%). As an exporter of row materials and intermediary goods and an importer of goods with high level of industrial finalization, the week Macedonian production is not in a position to reach a better market access at the Union market. In the period 2002-2006 the import of goods is almost double from the export of goods in the European market. As a result, the trade deficit in the trade exchange with the Union has an increasing tendency.

Table 4: Trade exchange of the Republic of Macedonia with the EU in the period 2002-2006

	EU		
	Amounts of trade exchange within trade under the free trade agreement (million USA \$)	Participation of trade in the total exchange within trade under the free trade agreement	Net export or (net import) (million USA \$)
2002	1.754	61,58%	-554
2003	2.061	62,11%	-507
2004	2.417	62,28%	-503
2005	2.551	60,33%	-383
2006	2.976	59,41%	-324

Source: Reports on foreign trade of Macedonia 2007 and 2008

2. Trade exchange within CEFTA – 2006: the case of Macedonian economy

Expectations for the positive effects on the trade exchange among the countries from the Western Balkans from the number of bilateral free trade agreements were not realized. Furthermore, the positive impact on economic growth of these economies was absent too. The gap between the region and the EU increases. Political instability in the region has a supportive role for the disintegration of the region.

In order to bring to an end of this process of disintegration of the Western Balkan region, and to create a cooperative environment, and having in mind the positive effects from the integration process of Central European countries, the Union offered to the countries of the region a new arrangement, so called, CEFTA-2006. The main goal of the new agreement was to reintegrate these countries, speed up the process of their international liberalization, enhancing the economic performances of these economies through intensifying the economic cooperation within the region. The creation of CEFTA-2006 was considered as a key device for speeding up the process of successful fulfillment of the benchmarks for obtaining a full membership into the EU.

This agreement replaced the 32 bilateral free trade agreements that were used to regulate the trade exchange of goods within the Western Balkan zone (Kikerkova, 2007). Except for goods and services, the agreement should provide full protection of intellectual property rights, harmonization of their national technical standards with those of the WTO TBT Agreement, achievement of fair - competition practices and gradual liberalization of public procurement of the member-states. Up to 2010 the full establishment of free trade zone should be achieved.

The implementation of the multilateral agreement during the past two years increased the trade exchange of goods with the countries from the region. Reducing the quantitative and qualitative barriers in the regional economic cooperation stimulates the Macedonian foreign trade. In 2007 the exchange of goods was increased for 35%, and in 2008 for 80% compared with the scope of exchange in 2006. The export of goods exceeds the import of goods and has positive effects on Macedonian trade balance. After the trends of reducing the scope of trade before 2006, signing the multilateral agreement CEFTA -2006 induce countries to augment their mutual cooperation. Beside the increase the scope of exchange within the CEFTA-2006, still the exchange of goods with EU dominates in the total foreign trade. The more important is the fact the unfavorable structure of goods exchange, i.e. the raw materials and intermediary goods are dominant in the Macedonian exports, opposite to the structure of Macedonian imports which is dominated by the goods with high industrial finalization. Therefore, one of the main sources of permanent increasing of the trade deficit is the permanent increasing of the scope of exchange with the European companies. (This is shown in Table 5).

Table 5: Participation of trade exchange within the CEFTA – 2006 in the total trade exchange

	Amount of total trade exchange (million USA \$) (1)	Amount of trade exchange within the CEFTA- 2006 (2)	(2/1)%	Net export or (net import) (million USA \$)
2006*	6.164	1.188	19,27	388
2007	8.584	1.606	18,71	378
2008	10.754	2.172	20,20	656

Source: Reports on foreign trade of Macedonia 2007 and 2008 and authors' calculations
Notice: Data for 2006 is for the comparison.

Table 6: Participation of trade exchange within the CEFTA – 2006 in the total trade exchange

	(million USA \$)	2006	2007	2008
Serbia	trade within the CEFTA-2006	841	987	1.465
	Net export or (net import)	275	191	405
Croatia	trade within the CEFTA-2006	203	274	136
	Net export or (net import)	45	54	93
Bosnia and Herzegovina	trade within the CEFTA-2006	92	123	158
	Net export or (net import)	38	53	52
Albania	trade within the CEFTA-2006	53	93	143
	Net export or (net import)	29	53	71
Moldova	trade within the CEFTA-2006	0.30	0.45	3
	Net export or (net import)	0.04	0.09	(3)
EU*	trade within the SAA	2.976	4.770	5.617
	Net export or (net import)	(324)	(405)	(853)

Source: Reports on foreign trade of Macedonia 2007 and 2008

Notice: Data for 2006 and EU is for the comparison.

The data for trade exchange among countries in the region unambiguously leads to the conclusion that there is a positive quantitative change in the scope of exchange, but there is still missing the qualitative changes in the structure of the exchange. During the period 2006-2008, the intermediary goods, food and raw materials keep their level of participation in the structure of exports. Unfortunately, if this situation persists, then on the long run Macedonian economy couldn't expect positive effects on the economic growth from its trade openness.

CONCLUSION

The participation of the total trade in the BDP increases continuously. Started from 76% in 1994 it has increased up to 109% in 2007¹. Beside the raised trade liberalization, the positive effect on the economic growth of the country is missing. All signed agreements

¹ Report on foreign trade of Macedonia 2008

stimulated the growth rate of the Macedonian imports of 4.42% and the growth rate of Macedonian exports of only 2.18% per year (Kikerkova, 2007:268).

Before signing the multilateral free trade agreement CEFTA-2006, the trade cooperation with countries from the region was a form than a reality. The other countries in the region of Western Balkans cannot boast with a better fate than the one of the Republic of Macedonia. Pushed in the same “mold” of the export-de-stimulating, that is to say the import-stimulating transition model (Croatia and Albania), totally dependent on the foreign aid (Bosnia and Herzegovina), beginners in the process of reformation (Serbia and Montenegro), they, alike the Republic of Macedonia, go “backwards” on the path of the economic and political changes, lagging in every sense not only behind the developed countries, but also behind the other transition economies. This is why the mutual economic contacts of the Western Balkan countries are more of a formal character than of a real regional cooperation.

Signing the multilateral free trade agreement CEFTA-2006, the situation in the regional foreign trade started to alter quantitatively. The scope of exchange goods with all countries increases, and Macedonian exports exceeds the Macedonian imports. But the structure of exchanged goods remained the same. The inference is that without changes in the structure of export sector of the economy we can not expect a vivid economic growth and development, and the trade deficit will persist as one of the major macroeconomic problem.

The reasons for the bad economic situation in Macedonia, and its economic trade cooperation should be looked for in the inadequate transitional model, the too technical approach towards reforms, the strong insisting on stabilization instead on development components, the emphasis on speed instead on efficiency, the “imported” economic policy, the external shocks... All of them together resulted into negative economic performances.

We also disagree with comments saying that a part of the blame for the negative situation in the domain of regional cooperation is to be searched in the incapability of the managerial structure in the Macedonian industry, which is allegedly “not restructured and market oriented.” We deeply believe that the management is not just the reason, but more the consequence of the development and the surroundings in which it is located. So, assuming again, if the managers are irreproachably doing their job, the regional trends of cooperation will not experience a positive turning point without institutional changes. On the other hand, the Republic of Macedonia does not have a proper export strategy, and therefore it does not have an elaborated export politics that could stimulate the exports production at least within the limits of the rules of the EU and the WTO. “The export is no longer a question of choice; it is the only option offering healthy perspectives on the long run” (Temenugova, 2003). While claiming this, we take into consideration the undisputable fact that the Republic of Macedonia actually does not have an export offer due to a very simple fact – it has no adequate production (the Macedonian GDP has not yet reached the level it used to have in 1989). The amortized equipment (80%), the low usage of the capacities (20-30%), the high unemployment rate (34%), the lack of investments (domestic and foreign), the raw material-base production structure, the high (internal and external)

debts present the factors that will not make the “production wheel” stir in the near future. As long as there is no adequate production, there can be no successful export offer.

The process of European integration is a complex mission for the countries from the Western Balkan. Therefore they should use the given opportunities within the CEFTA-2006 in order to facilitate their economic cooperation and integration, and consequently to this to improve their economic performances and speed up their economic growth. This is the only way how the countries of the region can achieve their utmost goal to become a full member into the EU.

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Report on foreign trade of Macedonia 2007

Report on foreign trade of Macedonia 2008

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CEFTA-2006 AS BASIS FOR ECONOMIC REINTEGRATION OF WESTERN BALKAN COUNTRIES

Abstract

Trade theory's arguments of high direct interdependence between economic growth and trade liberalization have been confirmed by numerous practical evidence and confirmations. Practical experience also confirms that a country, situated in a prosperous and well trade connected region, gains positive external influences and benefits in its total economic growth and prosperity, and vice versa.

Striving to get better market access and different trade preferences with the EU, Balkan countries demonstrated a complete lack of capacity to face the issue of trade and economic reintegration of the Balkan region. Historical evidence clearly points out that the region suffers from a process of disintegration within the last one hundred years. The dissolution of the region has been especially severe during the last two decades. This could be considered as one of the most important causes for the lagging behind of each of its independent economies. Most of the Balkan countries implemented significant reforms and paid special attention to the macroeconomic stability. Yet, their economies happen to be very vulnerable and exposed even to slightest external shocks and do not record significant economic growth over the last two decades. The situation is even worse for the Western Balkan countries from which only Croatia managed to slightly surpass the development level reached in 1989.

This article would try to explain weather the multilateral free trade agreement – CEFTA-2006 has the capacity necessary to help reintegration and economic and trade growth of the Western Balkans economies.

Key words: *CEFTA-2006, trade liberalization, Western Balkan countries, economic reintegration, trade exchange of goods*

INTRODUCTION

For over a decade the international community launched several initiatives on the establishment of at least a free trade area that would facilitate trade exchange and would help the reestablishment of economic ties and partnerships among the Western Balkan countries. The outcome of the many initiatives was the signing up of several regional cooperation agreements such as: BSEC, SECI, SEECP etc. (Kikerkova, 2008:353-354). All of these agreements resulted with slight and insignificant improvement of the trade cooperation within the region. Finding a lack of capacity and insufficient political will of

the governments of Western Balkan countries to enhance their mutual economic and trade cooperation, the EU took a further step by offering these countries the Stabilization and Association Agreement as a special regional free trade agreement. Offering the opportunity for gaining a candidate status until full membership in the EU, the SAA stresses the priority of a creation of a free trade area among countries that signed this agreement with the EU. The creation of a free trade area of the Western Balkan countries with a signed SAA is considered to be one of the milestones in the measuring of the successfulness of the fulfillment of the necessary criteria for obtaining a full membership into the EU. However, in the period from 2001 until 2006 only three countries in the region (Macedonia, Croatia and Albania) managed to sign a SAA with the EU. Also, they never tried to create a free trade area among themselves. At the end of 2007 Bosnia and Herzegovina also signed a SAA, though it is not in function, yet (Kikerkova, 2008:354).

After the fall of the socialist system, Western Balkan countries regulated their trade exchange of goods by bilateral free trade agreements. One of the initiators and the leader in the process of signing bilateral free trade agreements within the region was the Republic of Macedonia. It had 11 from a total of 32 signed bilateral free trade agreements in the region. Despite all of the signed free trade agreements, trade-partners' Customs Offices were not prevented to apply different administrative and red tape procedures on exports from the Balkans and transit of goods. These practices especially affected exports of agricultural unprocessed products which spoiled easily and which were deliberately kept on border lines until they would become useless. The physical design of the border passes of all the Balkan countries looked as it was created not to allow, but to prevent the flow of people and goods, which is completely opposite of the modern western business practices. The political instability of the region additionally complicated the whole picture. Because all of the mentioned obstacles, the efforts for trade liberalization did not result with a significant economic growth of the country, as all of the signed agreements provided growth of total Macedonian exports of only 2.18% and growth of total Macedonian imports of 4.42% per year (Kikerkova, 2006:114).

The given preferential treatment of goods within the Stabilization and Association Agreement and the huge capacity of the EU market created additional problems for the trade exchange of goods within the Western Balkan. Countries that signed the SAA started to divert their trade towards their EU partners, which created additional neglect of the trade partners from the nearest neighborhood. This was also the case with Macedonia. Before the signification of the SAA with the EU, the trade with Western Balkan countries created 23% of the total Macedonian trade exchange, while in 2006 it amounted for only 8% of its total trade exchange.

The creation of the multilateral free trade agreement for the Western Balkans named CEFTA-2006 finally put an end to this negative trend.

1. Main provisions of trade liberalization under CEFTA-2006

CEFTA-2006 is a multilateral free trade agreement which replaced the 32 bilateral free trade agreements that were used as basis for the regulation of the trade exchange of goods

within the Western Balkans. It is supposed to help the establishment of a free trade area for agricultural and non-agricultural goods among Albania, Bosnia and Herzegovina, Macedonia, Moldova, Serbia, Kosovo, Croatia and Monte Negro. The free trade area for non-agricultural goods started to function at the end of 2008, while the free trade area for agricultural goods was supposed to become in full function in May 2009. The establishment of the full free trade area is supposed to be realized at the end of 2010. Except for goods, the agreement should provide trade liberalization also of services, full protection of intellectual property rights and achievement of fair-competition practices and gradual liberalization of public procurement of the member-states.

Liberalization of trade exchange of non-agricultural goods under the Agreement considers elimination of all import tariffs which not comply with Article VIII of GATT from 1994, complete elimination of export tariffs and measures with equivalent effects and elimination of all quantitative instruments and measures with equivalent effect (*Draft of the Agreement on Amendment of and Accession to the Central European Free Trade Agreement, 2006:4-6*). Trade liberalization for non-agricultural goods under CEFTA-2006 started at the beginning of 2007 and was fully implemented by the end of 2008.

Full liberalization of agricultural goods trade under CEFTA-2006 was effectuated at the beginning of May this year. The new regime completely eliminates tariffs and quotas, as well as export subsidies. If a member-state continues to persist on the use of a certain export subsidy, the rest of the members may use compensatory duties for protection and implementation of fair-competition rules on their markets. They are also obliged to apply WTO rules on sanitary and phytosanitary measures (*Draft of the Agreement on Amendment of and Accession to the Central European Free Trade Agreement, 2006:7-9*).

CEFTA-2006 also complies with the WTO TBT Agreement and obliges its member-states to harmonize their national technical standards with those of the WTO and the EU by the 31st of December 2010 (*Draft of the Agreement on Amendment of and Accession to the Central European Free Trade Agreement, 2006:10*).

Even more important is the fact that member-countries have to facilitate and unify customs and transit procedures and formalities and to provide easy exchange of goods through their border lines. Trade facilitation under CEFTA-2006 also means simplification of the rules of origin of goods. Regarding the rules of origin the multilateral agreement provides the opportunity for intra-CEFTA cumulation of origin. This means providing proof of origin of a good if it consists of raw-materials and components imported from one or more of the CEFTA-2006 member-states (Tosheva and Efremov, 2007:16).

Articles XXII, XXIII and XXIV of the Agreement allow the implementation of safeguard and antidumping measures and regulate their application (*Draft of the Agreement on Amendment of and Accession to the Central European Free Trade Agreement, 2006:17-20*). Safeguard and antidumping measures should be introduced on bilateral basis in the damaged economy of the importer and they are relevant only for the exporting country that caused the damage. The damage is defined as a serious injury of the competitive advantages of domestic producers of the importing country or serious damage of any sector of the

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economy that could cause serious damage upon allocation of resources in the importing country. The introduced safeguard measures should comprise clear elements of gradual reduction until complete elimination within a period of one year. The introduced measure could be reused in two mandates, after which it could not be implemented in a two-year period of time. Safeguard measures could also be introduced in the case of a serious misbalance in the balance of payments of a member-state and should be implemented until it is rebalanced again (Art. XXV, 2006:20).

CEFTA-2006 is managed by a Committee of member-states representatives, which is managed by a Secretariat situated in Brussels. Eventual trade disputes among member states should be resolved through an international arbitration, as all member-states have not become members of the WTO, yet.

2. CEFTA-2006 effects upon the trade exchange of goods among Western Balkan countries

The creation of the CEFTA-2006 had a positive effect upon the total trade exchange of goods of the Western Balkan countries. For only two years of the functioning of this multilateral free trade agreement the trade exchange within the region recorded a significant increment.

**Table 1.: Trade exchange of goods within CEFTA-2006
for the period 2007 and 2008* (in Euro)**

Country	2007		2007		2008*		2008*	
	export	%	import	%	export	%	import	%
Albania	43389586	0,70	194950972	3,42	42854255	1,05	1160043198	2,71
Bosna and Herzegovina	1086905061	17,59	2066295209	36,25	625147881	15,32	2253810899	52,63
Croatia	2004754382	32,44	949019634	16,65	1644464755	40,29	504079000	11,78
Macedonia	725147449	11,74	448737377	7,87	4673100143	11,45	256093839	5,98
Moldavia	6422056	0,10	5012522	0,09	6300404	0,15	3920032	0,09
Monte Negro	182935515	2,96	910917243	15,98	87806254	2,15	540538182	12,62
Serbia**	2080746592	33,68	1107250310	19,42	1207500771	29,59	607855818	14,19
Kosovo	489969489	0,79	18235770	0,32	-	-	-	-
Total:	6179270129	100	5700419037	100	4081384463	100	4282340958	100

Source: *The Mission of the Republic of Macedonia in Brussels, March 2009*

*Note: Data for 2008 are accounted only for the first six months of the year

**Note: Data for Serbia include data for Monte Negro

Comparing the realized total trade exchange with the world, data for CEFTA-2006 trade exchange of goods show the following:

Table 2: Data on exports of agricultural and non-agricultural goods among CEFTA-2006 members and their total world trade**

	Albania		B&H		Croatia		Macedonia		Moldavia		M. Negro	
	2007	2008*	2007	2008*	2007	2008*	2007	2008*	2007	2008*	2007	2008*
Total exp. of AG products CEFTA-2006	17.54 %	6.65%	70.52%	75.60%	43.92%	46.84%	48.23%	54.72%	1.29%	3.13%	89.64%	94.30%
Total exp. of AG products of the world (in mill. EUR)	57.23	38.00	166.10	86.24	953.57	411.50	468.71	265.28	371.22	156.01	53.17	24.93
Total exp. of NON-AG products CEFTA-2006	4.58%	6.06%	33.80%	34.43%	19.58%	20.93%	26.52%	31.54%	0.27%	0.43%	23.41%	27.64%
Total exports of NON-AG products of the world (in mill. EUR)	727.46	665.62	2869.2	1626.3	8097.9	4191.5	2887.5	1804.7	609.89	326.90	577.86	232.58
Total exp. from CEFTA-2006	14.79%	6.09%	35.81%	36.50%	22.27%	24.23%	29.55%	34.51%	0.65%	1.30%	28.99%	34.10%
Total exports from the world (100%)	784.09	703.62	3035.3	1712.6	9001.6	4603.0	3356.2	2070.0	981.12	482.92	631.03	257.51

Source: Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009

*Note: Data for 2008 are accounted only for the first six months of the year

** Note: Due to methodological problems of incomparability, data on Serbian trade exchange within the region are not included in the table.

Table No. 2 clearly points out the heavy dependence of CEFTA-2006 member state on exports of agricultural goods. But there is also a significant interdependence of exports of non-agricultural goods. Data published by the Economic Chamber of Serbia in July, 2008, also confirm the above mentioned conclusion. However this is not the case with the two smallest members – Albania and Moldavia. The tendency of increasing interdependence on all kinds of exports kept going on in the first six months of 2008, and there is no doubt that this tendency was maintained until the end of the year. Following the time-schedule for complete liberalization of agricultural goods and for creation of a free trade area for agricultural goods until May, 2009, a further increment of the interdependence of trade exchange of agricultural goods might be expected, especially the unprocessed ones .

However, the following Table No.3, does not confirm the same interdependence of CEFTA-2006 member-states on their trade exchange of goods on the import side. This is especially true for the import of non-agricultural goods, where the most of the countries record less than 10% of their total import for this kind of products from CEFTA-2006 countries. This is though not the case with Bosnia and Herzegovina and Monte Negro. They depend on more than a half of their total trade exchange of non-agricultural goods and on more than 2/3 of their total trade exchange of agricultural goods on their CEFTA-2006 trade partners.

Table 3: Data on imports of agricultural and non-agricultural goods among CEFTA-2006 members and their total world trade**

	Albania		B&H		Croatia		Macedonia		Moldavia		M. Negro	
	2007	2008*	2007	2008*	2007	2008*	2007	2008*	2007	2008*	2007	2008*
Total imp. of AG products CEFTA-2006	6.42%	5.67%	50.76%	86.83%	8.18%	7.18%	33.78%	30.15%	0.25%	0.17%	73.44%	78.84%
Total imp. of AG products of the world (100%) in mill. EUR	506.94	295.48	1144.7	635.79	1564.4	853.28	622.95	387.57	340.68	209.15	262.92	145.37
Total imports of NON-AG products CEFTA-2006	6.39%	7.32%	24.91%	49.42%	4.76%	4.59%	8.76%	8.77%	0.18%	0.27%	41.7%	52.67%
Total imports of NON-AG products of the world (100%) in mill. EUR	2541.7	1356.9	5961.3	3443.2	17262.1	9650.3	4604.6	3132.0	2357.3	1317.4	1720.9	808.58
Total imports from CEFTA-2006	6.39%	7.02%	29.08%	55.25%	5.04%	4.80%	11.74%	11.12%	0.19%	0.26%	45.92%	56.66%
Total imports from the world (100%) in mill EUR	3048.74	1652.4	7106.0	4079.0	18826.5	10503.6	5227.5	3519.6	2698.0	1526.6	1983.8	953.96

Source: Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009

*Note: Data for 2008 are accounted only for the first six months of the year

** Note: Due to methodological problems of incomparability, data on Serbian trade exchange within the region are not included in the table.

Both the total export and the total import of goods of CEFTA-2006 member-states record increment for the first six months of 2008 in comparison with 2007. Still, this evidence is not enough to confirm the possibility for economic reintegration of the region. In order to obtain more relevant information on this matter we have to look for more detailed data on the economic structure of the foreign trade exchange in the region.

3. Analysis of the structure of the trade exchange of goods within CEFTA-2006

The CEFTA-2006 trade exchange of goods is accurately statistically evidenced under the Standard International Trade Classification of Goods (SITC), both on the import and on the export side for each member-state.

3.1. Trade exchange of Albania

Recorded statistical data point out that Albania and Moldova have the weakest capacity within the region. Albania especially has a weak export capacity for agricultural products. Total exports of agricultural products for 2007 amounted a bit more than 10 million Euro, while for the first six months of 2008 it was only about 2 million Euro. Most of the agricultural imports were fruits, oil seeds and plants, vegetables and beverages and spirits. Almost half of these exports were determined for Kosovo, while other important partners were Serbia, Macedonia and Croatia.

About 41.2% of the total non-agricultural exports from Albania to CEFTA-2006 trade partners consist of iron and steel, 18.47% of mineral fuels and 13.6% of plaster and cement. Other items are present only in small portions. Here also half of this export was determined to Kosovo and about ¼ to Macedonia.

On the import side of agricultural products in Albania are present: animal and vegetable fats and oils with 21.7%; products of the milling industry with 14.97%, beverages and spirits with 10.47%; followed by imports of vegetables (8.35%) and miscellaneous edible preparations (7.49%). Almost 2/3 of these imports come from Macedonia, Serbia and Kosovo.

Half of the Albanian total CEFTA non-agricultural imports consist of mineral fuels, while the rest of the imports are rather fragmented on different items, among which 18.52% consist of iron and steel. The major part of these imports - 2/3 - derives from Serbia, Macedonia and Croatia (Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009).

3.2. Trade exchange of Bosnia and Herzegovina

Bosnia and Herzegovina is quite an opposite case in comparison with Albania. It is heavily dependent on trade both of agricultural, as well as of non-agricultural goods from CEFTA-2006 countries. The export of agricultural products consists of dairy products (17.58%), animal and vegetable fats and oils (11.71%) and preparations of cereals and flour (11.40%). Half of the agricultural export goes to Croatia, 1/3 to Serbia, and there is a significant participation of Monte Negro.

Among the non-agricultural export items the most important are: mineral fuels (18.53%), iron and steel (15.30%), aluminum and aluminum products (12.87%), products of iron and steel (11.34%) and wood and products thereof (10.09%). The most important trading partners that import about 90% of its total CEFTA-2006 export are Croatia and Serbia.

The import structure of agricultural products is rather fragmented. The most important import items here are: beverages and spirits (20.20%), tobacco and cigarettes (9.23%), preparations of cereals and flour (8.31%), products of the milling industry (8.30%) and dairy products (7.09%). Almost all of the imports of these products originate from Croatia and Serbia, and a small portion from Macedonia.

On the import side of non-agricultural products the most important items are: mineral fuels (31.61%), iron and steel (9.36%), products of iron and steel (7.71%), electrical machines and equipment (5.9%), plastic and products thereof (4.70%) and pharmaceuticals (3.07%). About 60% of this kind of import comes from Croatia and another 1/3 of the total CEFTA-2006 trade comes from Serbia. Macedonia also participates with a small amount (Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009).

3.3. Trade exchange of Croatia

Croatia is the member state of this multilateral free trade agreement with largest economic and trading potential. It exports to the other member-states: beverages and spirits (14.93%), tobacco and cigarettes (14.76%), miscellaneous edible preparations (12.05%), dairy products (10.16%) and meat and food preparations (7.08%). Two thirds of its total agricultural export within CEFTA-2006 goes to Bosnia and Herzegovina, 15.4% goes to Serbia, and Macedonia and Monte Negro import 3 % of its total export each.

On the export side of non-agricultural products the most important item are mineral fuels that create 32.57% of the total Croatian non-agricultural export to CEFTA-2006 members. Electrical machines and equipment create 8.86%, machinery and mechanical appliances 8.52%, and other items such as: plastics and iron and steel are rather fragmented and create about 5% of the total export each. About 63% of these exports go to Bosnia and Herzegovina and more than 29% to Serbia.

Bosnia and Herzegovina and Serbia are also major Croatian CEFTA-2006 trade partners on the import side. Croatia imports from the region: beverages and spirits (14.75%), dairy products (13.43%), preparations from cereals and flour (7.71%), preparations from vegetables and fruits (6.75%) and vegetables (6.36%). Bosnia exports more than 45% of the agricultural products, Serbia 24.33% and Macedonia 21.52%.

Iron and steel is the most important import item from CEFTA-2006 to Croatia and it creates 23.18% of the total CEFTA import in this country. Aluminum and aluminum products create 15.24%, iron and steel products 12.28%, mineral fuels 6.50% and furniture 5.21%. The regional structure is almost the same as that of the agricultural import from CEFTA -2006. Bosnia creates 54.3% of Croatia's total imports from the region, Serbia 27.82% and Macedonia 16.31% (Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009).

3.4. Trade exchange of Macedonia

Looking at the Macedonian export structure within the region, on the side of the agricultural products we find out that 24.82% of Macedonian exports consist of fresh vegetables, 22.75% of beverages and spirits, 9.34% of cereals and flour, 5.15% of miscellaneous edible preparations and also 5.15% of preparations from vegetables. About 63.6% of the agricultural export from this country goes to Serbia, 14.33% to Croatia, and 11.23% to Bosnia.

Macedonian export of non-agricultural products within CEFTA-2006 consists of: mineral fuels (27.89%); iron and steel (26.79%), iron and steel products (12.62%) pharmaceuticals (5.05%), electrical machinery and equipment (4.44%). Almost 2/3 of this export is determined for Serbia, 16.29% for Croatia and 6.4% to Bosnia.

Macedonia is also an importer from the region. The most important agricultural import items from the region for this country are: preparations from the milling industry (17.82%), animal and vegetable fats and oils (11.79%), miscellaneous edible preparations (9.65%), preparations of cereals and flour (9.47%) and dairy products (7.29%). Major exporters of these products from the region are Serbia with 77.20% and Croatia with 17.82% of the total Macedonian import of agricultural products from CEFTA-2006.

Serbia and Croatia are major exporters of non-agricultural products in Macedonia as well. They create 68.51% and 18.22% respectively of the total Macedonian imports of these products from the region. Dominant import items from this group are: steel and iron (17.34%), mineral fuels (16.14%), electrical machines and equipment (8.28%), plastics (5.84%), paper and paper board (5.11%) (Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009).

3.5. Trade exchange of Moldavia

Looking back in history, Moldavia has never been a traditional partner to the Western Balkan countries. The multilateral free trade agreement affected positively Moldavian trade with the region, however total Moldavian trade exchange with CEFTA-2006 is rather insignificant. This is not only a result of the lack of trading ties and partnerships, but also on the low capacity of the Moldavian economy.

Total Moldavian export of agricultural products in CEFTA-2006 countries in the first half of 2008 reached 3.31% of its total agricultural export at that period of time and was almost doubled comparing to the total realized export in the region the year before. Almost 2/3 of Moldavian agricultural export in CEFTA-2006 consists of residues and waste from the food industries and prepared animal fodder. Another 15.84% consist of animal and vegetable fats and oils and 6.46% of dairy products. Almost 90.5% of this kind of export is done with Serbia and 6.5% with Albania.

The export of non-agricultural products consists basically of iron and steel (73.94%). About 60% of it goes to Serbia and a bit less than 30% to Croatia.

Looking at the import side, about half of its total agricultural import from the region consists of oil seeds and plants and about 18% of food preparations. Almost 90% of the total agricultural CEFTA-2006 import in Moldavia is realized by only one partner – Serbia.

The import of non-agricultural products consists of pharmaceuticals (21.85%), chemical products (18.73%), paper and paper board (15.37%), active organic substances (10.49%), boilers and machines (9.78%), glass and glass ware (8.73%). For non-agricultural imports from the region Moldavia has three major partners: Serbia that creates almost 60% of total

regional imports to Moldavia, Croatia with 25% and Albania with almost 15% (Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009).

3.6. Trade exchange of Monte Negro

Despite Moldavia, Monte Negro, also a small economy, is highly dependent on intra CEFTA-2006 trade. As exporter of agricultural products Monte Negro appears with export of beverages and spirits with 44.01%, fruits and nuts with 22.55%, preparations from cereals and flour with 6.98% and meat and edible residuals of meat with 5.66% preparations from cereals and flour. Almost half of the export of agricultural products is determined to Serbia, 22.76% to Bosnia, 21.90% to Kosovo and 5.53% to Albania.

Half of the export of non-agricultural products is effectuated in iron and steel, 7.42% in wood and products from wood, 5.63% in pharmaceuticals, 5.59% in boilers and machines and 3.59% in mineral fuels. Almost 2/3 of this export is realized with Serbia, 12.52% with Kosovo, 9.52% with Croatia and 5.30% with Albania.

Monte Negro's imports from CEFTA_2006 members consist of preparations of food (15.21%), dairy products (12.06%), products of the milling industry (9.7%), meet and fish preparations (7.69%), vegetable and fruit preparations (7.10%) and preparations of cereals and flour (6.59%). More than 90% of the import of agricultural products derives from Serbia. The rest comes from Croatia and Bosnia.

Import of non-agricultural products in this country consists of: boilers and machinery (10.15%), iron and steel (9.45%), electrical machinery and equipment (9.11%), vehicles and equipment, other than rail and tramway (7.36%), iron and steel (7.62%) and furniture (5.48%). Over 63% of this import is done with Serbia, Croatia and Bosnia participate with more than 15% each, while Macedonia and Albania create additional 2.5% each (Calculated on basis of data from the Mission of the Republic of Macedonia in Brussels, March 2009).

3.7. Trade exchange of Serbia

Finally, Serbia is a member state with a significant trade surplus within the region. The analysis of the trade exchange of this country is not an easy task, as data available from the source used in this article are incomplete and incomparable, which is a result of statistical and methodological omission in their processing. The Serbian side does not divide separately from its total trade data the trade realized on the side of Kosovo. Also, not all of the data are presented by clear distinction of the Serbian and the Monte Negro's trade. Therefore, we had to use data processed and published by the Economic Chamber of Serbia. This data are given in American dollars and they show that the creation of CEFTA-2006 created a 38.4% increment of the realized Serbian trade within the region in 2007 in comparison with the trade realized a year before. Serbia's major CEFTA-2006 trade partners are Croatia, Bosnia, Macedonia and Albania. The total amount of the effectuated export from Serbia into CEFTA-2006 for 2007 reached 3.4 billion American dollars, which

is 37.1% of the total Serbian trade with the world at that time. Total import from CEFTA-2006 in 2007 amounted 2.5 billion dollars, which is 14% of Serbia's total import from the world. It is obvious that Serbia registers trade surplus in the regional trade. Data for 2008 show further increment both of exports and imports from the region.

Serbian economy has a substantial potential for export of agricultural products and realizes a surplus in the trade of this kind of products in CEFTA-2006. The most important exporting agricultural products are: processed meat, animal and vegetable fat and oil, live animals, beverages and spirits, dairy products and preparations from cereals and flour.

The import of agricultural products from the region consists mostly of fruit and vegetables, fruit and vegetable preserves, tobacco and cigarettes, processed meat and fish.

The export of non-agricultural products is effectuated in iron and steel, products of iron and steel, products of copper, mineral fuels, plastics and products thereof and electrical machines and vehicles.

The import of non-agricultural products from the region consists of: mineral fuels, iron and steel, products of iron and steel, electrical machines and furniture (Economic Chamber of Serbia, 2008: 4-9).

CONCLUSION

The analysis in this article confirms the following conclusions:

1. The multilateral trade agreement CEFTA-2006 replaced 32 bilateral free trade agreements in the region of Western Balkans. It perceives the establishment of a full free trade area among its member states until the end of 2010. This multilateral agreement should facilitate not only the trade exchange of goods, but also the trade of services and intellectual property. It should also help the harmonization of sanitary and phytosanitary measures according to the WTO standards, provide implementation of the TBT agreement and simplify the rules of origin.
2. The implementation of the multilateral agreement during the past two years increased the trade exchange of goods among all of its member states. Major traders in the region are Croatia and Serbia, followed by Bosnia and Herzegovina, Macedonia and Monte Negro. Albania, Kosovo and Moldova record an increment of trade exchange within the region, however their total capacity is much lower compared to the rest of the members.
3. All of the ex-Yugoslav states find the region as a very important market for export of their agricultural output. Monte Negro, Bosnia and Herzegovina and Kosovo import most the needed agricultural products from the region. Also Macedonia shows a significant dependence on this kind of import from CEFTA-2006 partners.
4. The region shows however much lower interdependence on the trade exchange of non-agricultural goods. The interdependence is even lower on the import side. Greater import of non agricultural goods (about 30% in average from the

total import of these products from the world) record Bosnia and Herzegovina, Macedonia and Monte Negro. The dependence from this kind of import is even higher for Kosovo.

5. The exchange of non-agricultural goods consist mostly of iron and steel, iron and steel products, mineral fuels, plastics and similar goods that have low level of industrial finalization. Croatia and Serbia figure as exporters of some electrical equipment and machinery, which also implies for Bosnia to a certain extent. However both the export and the import of industrial goods from all member states are rather fragmented and extensive, which confirms the very low capacity in industrial production of each of the economies and their inefficiency and low level of productivity. The inability to provide more sophisticated processed goods on their domestic and regional market orients these countries to depend significantly on imports of such products from Western European economies.
6. Data on trade exchange undoubtedly confirm that by increasing their mutual trade within the CEFTA-2006 almost all of the countries registered a slight decrement in the trade with other countries, especially with the EU. This is a confirmation more for the weakness and low capacity of their economies.
7. Also, each of the member states depends on trade exchange of goods only on one or two major trading partners from the region, while the cooperation with the rest of the member states is insignificant.
8. All these conclusions point out that the region has not the potential to be the motor of a significant economic development for its member states at present. The region is heavily dependent on several developed Western European states, mostly members of the European Union. It seems that real economic development of each member state and the whole Western Balkan region could be achieved through its real economic integration in the EU.
9. The process of European integration is not an easy task for the Western Balkan countries. Therefore, they should try to use the given opportunity through CEFTA-2006 to its utmost as they could ease the EU integration process and enjoy its benefits. Therefore, even under the conditions of the latest economic recession in the world they should proceed with the trade liberalization and facilitation, foster their mutual cooperation, respect and fully implement a good neighborhood policy and should try to improve the transport and customs infrastructure on multilateral basis.

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TRADE LINKS BETWEEN THE COUNTRIES IN THE REGION OF SOUTHEAST EUROPE: ARE THE NEIGHBORS OF THE REPUBLIC OF MACEDONIA BACK?

Abstract:

The year 2009 marks a historic double anniversary in the European continent. Twenty years ago, the Iron Curtain crumbled, and peaceful democratic change transformed Central and Eastern Europe. In May this year, EU celebrated the 5th anniversary of the latest enlargement that brought altogether 12 new Member States. The latest enlargement is a win-win situation. Trade between the old and new member states grew almost threefold in less than 10 years. An even more illustrative is the fivefold growth of trade among new member states. But, what is the situation like in the “rest” of Europe – in the Region of Southeast Europe (SEE) and precisely in the Republic of Macedonia? What is the trade structure like and is the level and development of regional trade integration such (especially after the lastly signed CEFTA 2006 agreement), so it can promote regional cooperation between neighbours? These are the main questions and concerns that this paper tries to answer, providing detailed statistical analysis of the level of trade and the level of participation of each country in the Region in international trade relationships, the level of regional integration, as well as the concentration of imports and exports of the Republic of Macedonia in the period 2000-2008.

Key words: *trade flows, geographical concentration of imports and exports, regional cooperation, CEFTA 2006, Southeast Europe, Republic of Macedonia*

INTRODUCTION

The region of SEE encompasses the “Eastern Balkans” (Bulgaria and Romania) and the “Western Balkans” (including all successor states of the former SFR Yugoslavia minus Slovenia, plus Albania). Since Romania and Bulgaria are already members of the EU, they are not taken as members of “our SEE group”. So, in this article we are practically dealing with the countries which formed the so called SEE-5 group (which incorporates Bosnia and Herzegovina, Croatia, Montenegro, the Republic of Macedonia and Serbia, plus Albania), making the difference between the concept of “Western Balkans” and the SEE-5 group of countries inexistent. (European Commission, 2006, p. 41).

As a direct product of the Stability Pact of 1999, the European Commission recommended a new strategy with reference to the countries from the “region” of Southeast Europe - the Stabilization and Association Process (SAP), with their basic legal instruments - the Stabilization and Association Agreements (SAA). Those agreements which contain a substantial trade liberalization component, are already signed between EU and all

countries in the Region, apart from Kosovo¹, pointing out that among other things, “the speed of accession will depend upon the progress that each country will make in regional cooperation”.

A new path to intensify economic activity and liberalization of the intra-regional trade in SEE is provided by the Agreement on the Amendment of and Accession to the Central European Free Trade Agreement – CEFTA, signed on 19.12.2006 in Bucharest. The new CEFTA 2006, which should help the establishment of a free trade area among member countries², entered into force on 21.11.2007³ and along with the SAA process provides a spur to further reduction of national obstacles to trade and investment and opening up of markets to competition and growth. It also implies greater responsibility of countries in the region for fostering trade and implementation of relevant economic policies (Qerimi, Qerim and Sergi, Bruno, S., 2007, p.65).

The CEFTA Joint Committee on 08.10.2008 in Chisinau under the Moldovan chair-in-office endorsed measures which contributed to the efforts of abolition of all import duties on agricultural products, including tariff quotas, except for a list of very sensitive agricultural products. Further it called for elimination of non-trade barriers and updating quarterly the matrix on specific activities/measures affecting trade; facilitation in the application of the diagonal cumulation of origin; promotion of cooperation among customs administrations, and taking further actions on the possible conclusions of multilateral and bilateral agreements on harmonization of technical regulations and standards and mutual recognition of conformity assessment procedures. (Commission of the European Communities 2009, p.31),

The CEFTA agreement was implemented smoothly in 2008 and trade volumes exchanged between the neighbors appear to be increasing. However, problems relating to the status of Kosovo have arisen recently, in particular concerning acceptance of products originating from the customs territory of Kosovo. But, what do real data actually show and has the situation in trade relations between the countries in Southeast Europe⁴ really improved after signing the CEFTA 2006 agreement? In order to try to find answers to these questions, as well as develop an understanding of the latest level of openness of each of the economies in question, in the next section we present country-by country analysis of the level of

¹ The first was signed between the Republic of Macedonia and the European Union (09.04.2001), the second between the Croatia and EU (29.10.2001), the third between EU and Albania (12.06.2006), the fourth between EU and Montenegro (15.10.2007), the fifth with Serbia (29.04.2008) and the last with Bosnia and Herzegovina (16.06.2008). For Kosovo, a partially recognized breakaway province of Serbia, negotiations on a Stabilisation Tracking Mechanism began in 2003 and are still ongoing. The EU is still divided on how exactly to continue the SAP with Kosovo, as some of its members remain opposed to Kosovo’s independence.

² The member countries are: Albania, Bosnia and Herzegovina, Croatia, Moldova, Montenegro, Republic of Macedonia, Serbia and UNMIK/Kosovo. Among the signatory states were Romania and Bulgaria too, but since Romania and Bulgaria entered the EU in 2007, they are no more members of CEFTA, thus they are not taken as members of SEE-8 “group” either.

³ The Agreement entered into force on 26.07.2007 for Albania, Moldova, Montenegro, Republic of Macedonia and UNMIK/Kosovo, for Serbia on 24.10.2007 and for Bosnia and Herzegovina on 22.11.2007.

⁴ We are actually concentrating on the group SEE-8, but omitting Romania, Bulgaria and Moldova since at present, Romania and Bulgaria are already members of EU and Moldova’s participation in regional trade relationships is negligible. So, the member countries of SEE in this analysis are: Albania, Bosnia and Herzegovina, Croatia, Montenegro, Republic of Macedonia, Serbia and UNMIK/Kosovo (whenever data is available).

trade and the level of participation of each country in the Region in international trade relationships. Then, we conduct comparative statistical analysis of trade flows between the “neighbors”, for the years 2007 or 2006, depending on the availability of data. Before presenting a few conclusions concerning the potential for cooperation in the region of Southeast Europe, we finally concentrate on the geographical concentration of imports and exports, especially in the Republic of Macedonia, in the time period 2000-2008.

1. Country-by-country analysis: level of trade

A SEE country by country international trade analysis is conducted from two separate angles. Firstly, each country’s imports and exports are compared to its GDP, which means that imports, exports and trade are analyzed as percentage of GDP for each country in the region, in order to check whether or not a country is globalizing. Secondly, in order to compare the openness to the world, the imports and exports of each country in SEE are compared to world imports and exports.

Data for imports, exports and GDP (all in current US dollars), as well for imports, exports and trade as percentages of GDP in 2006, are obtained from the World Bank’s *World Development Indicators* (2008). The major problem with this data is the “lack of intra-regional network”. One explanation for this could be that some of the countries have only been independent for couple of years and until recently failed to provide trade statistics according to the Harmonized System or Combined Nomenclature (Atanassova 2006, p. 174). For instance, since Montenegro formally declared its independence from Serbia and Montenegro on 3 June 2006, the data was not incorporated in the official source so it was not possible to conduct the analysis separately for Montenegro.

Table 1: GDP, Trade, Exports and Imports of good and services in 2006 in the region of SEE

Countries	GDP (mill. of \$)	Exports		Imports		Exports (% of GDP)	Imports (% of GDP)	Trade (% of GDP)
		(mill. of \$)	%	(mill. of \$)	%			
Albania	9098	2297	0.02	4500	0.03	25	49	42.3
Bosnia & Herzegovina	12255	4496	0.03	8187	0.06	25	47	86.6
Croatia	42925	21454	0.15	24678	0.17	48	57	74.2
Macedonia	6217	2998	0.02	4258	0.03	50	68	99.1
Montenegro	-	-	-	-	-	-	-	-
Serbia ¹⁾	31989	-	-	-	-	27	47	61.3
WORLD	48461854	14635235	100.0	14403234	100.0	30	29.7	49.9

Source: The World Bank (2008). *World Development Indicators*, Tables: 4.2; 4.8; 4.14; 6.1.

Note: 1) Data for Kosovo is incorporated

The conclusions deriving from the analysis of data given in Table 1 are as follow:

1) Imports may be considered a function of nation’s productivity, measured by its GDP, since imports exceed exports in case of all SEE countries (in case of Albania it exceeds 1.96 times; in case of Bosnia and Herzegovina 1.82 times; for Croatia 1.15 times and for Macedonia 1.42 times). According to the explanation provided by Naghshopour, this excess of imports over exports is a “wealth effect”, which might occur whenever “a nation

becoming wealthier consumes more of its goods and services rather than exporting them and also consumes more foreign products” (Naghshopour 2008, p. 202).

2) When exports and imports as percentage of GDP are analyzed, we notice, again, that the percentage is bigger for imports than for exports, which might not always be a healthy sign of openness. This ratio is highest in case of Albania (imports exceed exports by 1.96 times) and lowest in case of Croatia (1.19 times). For Bosnia and Herzegovina, Macedonia and Serbia the shares are 1.88; 1.36 and 1.74 respectively. The same conclusion stands when analyzing the data for percentages of trade (the last column in Table 1). The presence of mild openness is noticed probably only in the case of Macedonia (the percentage almost exceeds 100% of GDP) and in no other country where the percentages are below 100% (42.3 for Albania; 86.6 for Bosnia and Herzegovina; 74.2 for Croatia and 61.3 for Serbia). So, in order to be truly globalizing nations, in the long run, SEE countries need to increase substantially their exports.

3) As the openness of SEE countries compared to the world are concerned, the shares of imports and exports for all SEE countries are very low and in the range 0.02-0.06 (except for Croatia where the shares were between 0.15 and 0.17) but still, shares of imports were greater than export shares. In any case, no matter our crude measure of openness, the data does not provide any evidence of globalization.

2. Trade within the region of SEE

The geographical profile of the trade structure between the countries of SEE that we are concentrating on is rather puzzled issue. No matter the geographical factors (the closeness between the countries in the Region) it is a fact that due to various historical and political reasons, the Region has never been politically integrated, so “trade flows are still below their potential, suggesting that there is scope for direct action to promote trade even further” (Falcetti et.al 2005, p.58). So, we witness the efforts for help of international organizations to participate, or create institutions to foster trust. One among these initiatives is the formation of CEFTA-2006 which finally leads to expectation that geographical proximity would lead to trade creation in the Region.

Table 2: Trade within the region of SEE, 2006 or 2007 (per cent of total)

	Albania ¹⁾		Bosnia & Herzegovina ²⁾		Croatia ²⁾		Macedonia ²⁾		Montenegro ¹⁾		Serbia ¹⁾		Serbia & Montenegro		Kosovo ²⁾	
	Ex.	Im.	Ex.	Im.	Ex.	Im.	Ex.	Im.	Ex.	Im.	Ex.	Im.	Ex.	Im.	Ex.	Im.
Albania ¹⁾			-	-	0.3	1	1.6	1.6					5	0.9		
Bosnia & Herzegovina ²⁾	0.32	0.054			20.86	18.50	0.1	0.97	2.75	0.124	9.93	4.27			0.93	0.53
Croatia ²⁾	0.28	0.01	14.4	2.85			0.95	0.86	1.25	0.03	5.36	1.27				
Macedonia ²⁾	2.17	0.37	2.62	0.66	4.88	2.1			0.82	0.03	19.05	8.58				
Montenegro ¹⁾	1.63	0.23	4.55	2.76	1.4	4.07	0.32	1.05			27.41 ³⁾	27.12 ³⁾				
Kosovo ²⁾	12.6	2.2	3.2	1.9	1.1	2.5	10.5	15.1	1.8	1.0	11.7	14.1				
Serbia ¹⁾	0.97	0.006	12.2	2.8	4.0	2.87	4.5	1.67	11.7	0.72						

Source: Calculations are made according to original data obtained from INSTAT (Albania Institute of Statistics); Bosnia and Herzegovina Statistical Office; Central Bureau of Statistics, Croatia; State Statistical Office of the Republic of Macedonia; The Statistical Office of the Republic of Montenegro; The Statistical Office of Kosovo; Statistical Office of the Republic of Serbia.

Note: 1) Data is for 2006; 2) Data is for 2007; 3) It includes Kosovo as well

In order to check such a hypothesis, we look closer into the SEE trade data for the years 2007 or 2006 (results are shown in Table 2) and compare them with the results for the year 1996 when it was shown that history induced trade diversion to the Region (Sekulovska-Gaber 2003, p.300). But, before proceeding further with the analysis we need to clarify certain things. Firstly, since Romania and Bulgaria entered the EU in 2007 and are no more members of CEFTA, they are not included in the analysis. The second thing is the participation of three independent entities (Serbia, Montenegro and Kosovo) in the “place” of Yugoslavia, with the explanation that, if not taken into consideration the declaration of independence of Montenegro, according to the data of some sources, Serbia and Montenegro were taken together.

While in 1996, for many SEE countries other countries “in the group” were not important trading partner (a lot of zeros, with an exception perhaps for Republic of Macedonia), mostly because of the inherited divisions, general underdevelopment and overall security problems, figures in Table 2 show that the low levels of trade between SEE countries were overtaken and the “neighbours are back” for most of the countries in the Region (for Albania it is Serbia and Montenegro; for Bosnia and Herzegovina it is Croatia, and vice

versa for Croatia; for Macedonia it is Serbia, as well as for Montenegro; for Kosovo these are Macedonia and Serbia, and finally for Serbia it is Bosnia and Herzegovina). So, the creation and implementation of CEFTA-2006 acts as an incentive for closer integration in the Region, and as Jentisch-Muller pointed out: "...the quickest way to achieve the "Four freedoms" for the movements of goods, services, capital and people is not through a wholesale adaptation of the acquis but rather targeted removal of barriers that currently obstruct these freedoms" (Jentisch-Muller, 2007, p.7).

3. Geographical concentration of imports and exports of the Republic of Macedonia

Macedonia's recent history, like that of most other Balkan countries, begins in the 1990s. No matter the fact that Macedonia peacefully achieved its independence in 1991, it hasn't had less of a decline in GDP or trade. It took Macedonia until 2003 to return to the 1991 level of GDP (Naghshopour 2008, p. 211). According to the report given by the World bank (WB, February 2008:7), growth was sluggish, but toward the end of the period, Macedonia has experienced considerable growth rates. GDP grew on average 3% annually in real terms and per capita GDP in EUR showed a jump of 26% between 2000 and 2006 (See Table 3).

Table 3: Aggregate economic growth indicators of the Republic of Macedonia, 2001-2006

	2000	2001	2002	2003	2004	2005	2006
GDP/capita (EUR at exch. rate)	1921	1887	1981	2025	2128	2279	2432
GDP real growth	4.5	-4.5	0.9	2.8	4.1	3.8	3.5

Source: "Labor Costs and Labor Taxes in the Western Balkans", WB, February 2008

Both imports and exports in the Republic of Macedonia had overall positive trends, and in fact, they grew by more than 2.5 times (See Tables 4 and 5). The main nagging problem in this area was that total imports exceed total exports and Macedonian imports from all SEE countries grew faster than exports (from 1.89 times for imports from Croatia; 2.35 times for Serbia and Montenegro; 6.3 times for Albania and 6.47 times for Bosnia and Herzegovina, to 1.91 times increase of exports in Serbia; 3.43 times in Croatia; 3.79 times in Bosnia and Herzegovina and 5.68 times in Albania).

The same can not be said for the geographical concentration of Macedonian imports and exports in the Region of SEE, since almost in the whole period, exports exceeded imports in all SEE countries (apart for Croatia in 2000 and for Serbia and Montenegro in 2004, when imports exceeded exports). Looking into the structure of import-export data, it is clear that in the whole period, the most important trading partner of Macedonia was Serbia⁵ (always more than 70% in the import, as well as in the export side), while Croatia was on the second place, creating almost ¼ of imports and between 11% and 17% of exports.

⁵ Before the independence of Montenegro in 2006, data is given for Serbia and Montenegro.

Table 4: Imports of the Republic of Macedonia from the countries in the region of SEE (thousands of US\$)

Countries	2000	2001	2002	2003	2004	2005	2006	2007 ¹⁾
Albania	3093 (1.2%)	1306 (0.62%)	1127 (0.44%)	3963 (1.36%)	6346 (1.16%)	9077 (2.44%)	11722 (2.92%)	19522 (3.18%)
Bosnia & Herzegovina	5337 (2.08%)	4150 (1.98%)	14299 (5.59%)	11753 (4.02%)	16306 (2.97%)	23582 (6.34%)	26515 (6.62%)	34518 (5.63%)
Croatia	57858 (22.54%)	46391 (22.10%)	55229 (21.59%)	63550 (21.76%)	65782 (12%)	75253 (20.22%)	79030 (19.72%)	109737 (17.89%)
Montenegro ²⁾	-	-	-	-	-	-	-	1339 (0.22%)
Kosovo ³⁾	-	-	-	-	-	-	-	-
Serbia ²⁾	-	-	-	-	-	-	-	448404 (73.08%)
Serbia and Montenegro ²⁾	-	158020 (75.30%)	185191 (72.38%)	212799 (72.86%)	459544 (83.86%)	264215 (71%)	283412 (70.73%)	-
S.R. Yugoslavia ²⁾	190362 (74.17%)	-	-	-	-	-	-	-
Total CEFTA	256650 (100%)	209867 (100%)	255846 (100%)	292065 (100%)	547978 (100%)	372127 (100%)	400679 (100%)	613520 (100%)
Total imports	2093872	1693601	1995156	2306353	2934626	3232837	3752256	5227576
Concentration of Imports ⁴⁾	12.25%	12.40%	12.83%	12.66%	18.67%	11.51%	10.68%	11.74%

Source: Computations are according to the data obtained from the State Statistical Office of the Republic of Macedonia, for selected years.

Note: 1) Preliminary data; 2) Naming is according to the official name of a country

3) No data is available since only countries with significant participation in Macedonian imports are shown

4) Computation is according to Michaely's formula $C_r = 100 \sqrt{\frac{\sum (X_i / X)^2}{n}}$ where X_i national imports in certain country in certain period;
 X total national imports in certain period

In order to show the difference between the geographical concentration of Macedonian imports and exports, we compute Michaely's coefficient of concentration C_r . The results of the computed coefficients of concentration (given in the last row of Tables 4 and 5) show greater concentration on the export than on the import side, which is in accordance with economic theory (Sekulovska-Gaber 2004, p.361). Since lower coefficients are signs of higher diversification (exports or imports are not highly concentrated), the obtained results for the geographical concentration of imports and exports show more than clear that, due to signed CEFTA-2006 agreement, coefficients are lower in the years 2006 and 2007 (compared with the previous years), which is a sign for a more balanced trade exchange of the Republic of Macedonia within the Region of SEE, after 2006. In other words, the "neighbors" of the Republic of Macedonia, after signing the CEFTA-2600 agreement, started to come back!

Table 5: Exports of the Republic of Macedonia in the countries of the region of SEE (thousands of US\$)

Countries	2000	2001	2002	2003	2004	2005	2006	2007 ¹⁾
Albania	12834 (3.06%)	10019 (2.85%)	13871 (4.11%)	17419 (4.55%)	23689 (4.89%)	27522 (4.45%)	40708 (5.15%)	72894 (7.54%)
Bosnia & Herzegovina	23197 (5.54%)	16283 (4.63%)	18310 (5.42%)	23793 (6.22%)	33226 (6.85%)	50457 (8.15%)	65793 (8.32%)	88021 (9.1%)
Croatia	47689 (11.39%)	58488 (16.62%)	59078 (17.5%)	66174 (17.31%)	80158 (16.54%)	81075 (13.1%)	124707 (15.77%)	163869 (16.95%)
Montenegro ²⁾	-	-	-	-	-	-	-	2768 (0.29%)
Kosovo ³⁾	-	-	-	-	-	-	-	-
Serbia ²⁾	-	-	-	-	-	-	-	639415 (86.13%)
Serbia and Montenegro ²⁾	-	267013 (76%)	246384 (72.97%)	274994 (71.92%)	347602 (71.72%)	459661 (74.29%)	559609 (70.76%)	-
S.R. Yugoslavia ²⁾	335103 (80%)							
Total CEFTA	418823 (100%)	351803 (100%)	337643 (100%)	382380 (100%)	484675 (100%)	618715 (100%)	790817 (100%)	966967 (100%)
Total exports	1322617	1157507	1115527	1366989	1675877	2415161	3356248	3356248
Concentration of Exports ⁴⁾	31.67%	30.40%	30.27%	27.97%	28.91%	27.33%	23.56%	28.80%

Source: Computations are according to the data obtained from the State Statistical Office of the Republic of Macedonia, for selected years.

Note: 1) Preliminary data; 2) Naming is according to the official name of a country

3) No data is available since only countries with significant participation in Macedonian exports are shown

4) Computation is according to Michaley's formula $C_r = 100 \sqrt{\frac{\sum (X_i / X)^2}{n}}$ where X_i national exports in certain country in certain period;
 X total national exports in certain period

CONCLUSIONS

After the disintegration of the Soviet Union and dissolution of the Warsaw pact, the four and a half decade dichotomy of the world ("East" and "West") came to an end. The process of fragmentation, besides the Soviet Union, was likewise inevitable for other multinational countries, such as Yugoslavia. Thus, on the territory of Yugoslavia seven independent entities came into existence, Republic of Macedonia, being among them as well.

No matter the fact that apart from the sub-regions of former Yugoslavia, Albania joined the group of SEE countries, in economic terms, the "remaining" of the region of SEE (so called "Western Balkans") is relatively small, especially because the two largest economies, Bulgaria and Romania left the "region" and joined the EU. With the disintegration of Yugoslavia, traditional links were interrupted, contrary the 1980s, when the "home market" played an important role and exports between the various republics of the SFRY ranged

between 13-29% of the Gross Material Product (European Commission, 2006, p.39). It was shown that in the 1990s history induced trade diversion to the Region and for many SEE countries other country “in the group” was not important trading partner (Sekulovska-Gaber 2003, p.300).

Attempts to revive economic integration in the region only gained momentum after the end of the Kosovo War with the creation of the Stability Pact for SEE in 1999. Hence, the recent adoption of the more acceptable term of “South East Europe”, to replace the charged term “Balkans”, guided by the EU, managed to come up with a more consistent regional policy, based on the SAP, financial assistance and a reassured political presence in the region. In accordance with the Stability Pact’s “Memorandum of Understanding on Trade Facilitation and Liberalization”, as the most prominent regional initiative involving SEE, a free trade area in the Region of SEE through the CEFTA agreement was established.

The analysis showed that this free trade agreement which started operating in January 2007 already shows positive results, since trade volumes exchanged between the neighbours appear to be increasing. So, the lastly signed CEFTA-2006 agreement finally started promoting regional cooperation between the neighbours. The same conclusion could be drawn when the geographical concentration of imports and exports of the Republic of Macedonia are computed. In other words, since those coefficients diminished in 2006 and 2007 in comparison with the period 2000-2004, it might be concluded that the neighbours of the Republic of Macedonia, after signing the CEFTA-2006 agreement, started to come back.

On the other hand, the results from the analysis of the latest level of openness of each of the economies in question showed mild openness, present only in the case of Macedonia, which means that the actual exploitation of the opportunities given by the agreement is far below the real potential of the Region. Thus, in the long run, in order to be truly globalizing nations, SEE countries need to increase their exports substantially.

And finally, concerning the potential for cooperation in the region of Southeast Europe, no matter the limits, it is expected that the mentioned measures will be important, not only for development of joint trade relations, attracting foreign direct investment and fostering intra-regional trade, but especially for further integrating the region into the global trading environment. Since the gradual implementation of a free trade area and the harmonization of national legislation with EU standards are part of the already signed SAAs, regional cooperation could also help facilitation and acceleration of the process of integrating the Region with the EU countries. Furthermore, this can be a clear signal of the commitment of the SEE countries towards their EU membership.

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Part III

SOME ASPECTS OF TRADE STATISTICS AND REPORTING

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NEW CONCEPT OF INTERNATIONAL TRADE STATISTICS

Abstract

Our world has become increasingly dynamic and multidimensional mainly due to ever faster globalisation. Economic actors now behave as if the world consists of a single market for goods and services, capital and labor. Globalisation and its key drivers – transnational companies have significant effects on economies that become more interlinked and interdependent, on investment, production, trade and diffusion of technology etc. Measurable facts about globalisation are only partly available. Official statistics, as a tool for policy making and for monitoring the effects of policies, should measure the reality of our social, economic, cultural, political and institutional world. In the increasingly globalized world traditional methods of measuring the national economy are not suitable. Activities of transnational enterprises caused that traditional foreign trade statistics are not usable as a tool for facilitating strategic governmental policy decisions on the economic and non-economic aspects of globalized world economy and world trade.

In the paper we will discuss the main distortions in the gathering of statistical data on international trade transactions caused by the activities of transnational companies. The main tool is the new concept of the international trade statistics which is known as Foreign Affiliate Trade Statistics (FATS). The key to a better, comprehensive picture of the world economy and world trade is to capture the flows between parent companies and foreign affiliates. This will help explain the relationships of companies across national boundaries, the way the world trade flows occurring, better understanding the features of the contemporary world economy and world trade and policy decisions making.

Serbia, Macedonia and many other countries, is facing a rapid globalisation process of its economy. Having the huge impact of globalisation on economic and social spheres and the need for relevant statistical information in this field, it is important that national statistical authorities take a necessary steps in: first, understanding the current changes in international trade statistics, second, implementing them in their own national statistical systems and third, constantly adapting their statistical methods and infrastructure to an evolving international framework.

Key Words: *FATS, globalisation, transnational companies, foreign affiliates, foreign direct investment.*

1. Contemporary concept of international trade and foreign trade statistics

Classical concept of international trade uses the modern definition of this activity as an exchange of goods and services across national borders. This definition was adequate in the past when it included most of the trade flows between nations. Nowadays international trade flows become so diverse and complex that made simply defining international trade impossible.

International Trade has become most important economic activity in the world economy. During the second half of 20th century international trade have grown faster than the world production. Since world production is the source of products that are traded in international trade we can conclude that trade is continuously augmenting its share in total global activity. In table 1 we can observe this dynamical growth of international trade activity in past few years. But international movement of private capital in the form of foreign direct investments (FDIs) is also very significant in the second half of 20th century and specifically in years presented in table 1.

Table 1: World production and exports 2005-2008, billions USD

	2005	2006	2007		2008
			Actual	Projection	Projection
World Production	44,745	48,245	52,850	53,352	57,323
World Production PPP	61,259	66,229	65,752	70,807	75,632
World Exports	12,822	14,697	14,240	16,786	18,334
Trade in Goods	10,296	11,893	10,950	13,581	14,854
Trade in Services	2,526	2,804	3,290	3,205	3,480
Foreign Direct Investments	945	1,305	1,833	...	...

Note: Data for 2007 and 2008 are IMF projections.

Source: International Monetary Fund "World Economic Outlook" Washington, 2007, UNCTAD, FDI Database, Internet, www.unctad.org [Accessed 21/03/2008], World Bank "World Development Indicators" 2009, WTO "International Trade Statistics" 2008 and UNCTAD "World Investment Report" 2008.

Regarding international trade, foreign direct investments, represent the specific form of export and import of goods and services (Stojadinović Jovanović, 2008a). The act of foreign direct investing and selling production of local affiliate in host country or in other countries represent the new form and surrogate for traditional importing and exporting.

This we will elaborate in the next part of our paper.

But due to global financial crisis world export as well as world production have declined significantly and were below the IMF projections for 2007. The most prominent is the decline in international trade in goods while international trade in services show more resilience to effects of the global economic crises. The flows of foreign direct investment show also the resilience to the first effects of the global economic crises. The FDI in 2007 were 1 833 billion USD which was a rise of 40% in FDI flows comparing to the previous year. But if we analyse the situation of specific economies with a large inflow of foreign capital in the form of FDI we can observe that most of transnational companies in the period of global crises were trying to salvage its parent companies, mainly located in developed countries mostly affected by crisis, redrawing the capital from even successful and profitable not affected by crisis.

Foreign trade statistics that is in use in almost all countries in the world today records all sales of goods made abroad as exports and all purchases of goods made abroad as imports. The most important thing is that customs authorities record the movement of goods across national boundaries as official trade flows. Goods have a physical substance so they are visible when they cross borders and easily recordable. Goods are still the dominant objects that are exchanged internationally and they account for about 75% of total world exports according to 2006 IMF data (Bjelić, 2008a). Customs authorities record trade flows using so called Harmonized System classification of goods in international trade. This data afterwards need to be recalculated according to Standard International Trade Classification of goods (SITC rev. 3) that is in use internationally for statistical purposes.

But services are not as visible as goods and their trade is usually referred as invisible trade. Trade in services statistics is value according to payments that are connected to execution of services abroad. This payment is recorded in Balance of payments of each country in the world. Many services that are executed abroad are not entered into official statistics because their related payments are in many cases unrecorded. Foreign direct investments are also recorded in Balance of payment as financial flows but from this data we can not determine their connection with classical trade flows. We can only distinguish inflows from outflows of foreign direct investments.

When official statistics records export or imports it records sales and purchases of all Serbian companies abroad. These Serbian companies can be under control of nationals of our country or they can be controlled by foreign companies so they are affiliated of a parent company incorporated abroad. Under Serbian law, and law of many other countries, all this companies are Serbian companies, registered in Serbia and required to operate under Serbian law.

This classical concept of foreign trade statistics is correct since it observes customs territory of a country as a central point and records all trade activities with other territories in the world, using the concept of transnationality of goods movement and not the transnationality of business activity. But increasingly more flows of goods and services in international trade are either replaced or complemented with investment flows within TNCs. The activities

of TNCs have changed the structure and the way of performing of international trade. Because of that fact, known as transnationalisation of international trade, our analysis and understanding of trade flows must include also new forms of selling goods and services on international market – forms of selling through foreign affiliates.

This is the main reason why we need to define and adopt new framework of foreign trade statistics which will enable us to analyse international trade flows from a different angle keeping in mind that transnational companies and investment flows are the backbone of globalisation of international economy. The importance of transnational companies in contemporary international trade we will present in the next part of our paper.

2. Transnationalisation of international trade

The main feature of contemporary international trade is its transnationalisation – the growing role and impact of transnational companies and their affiliates. The second half of the 20th century is characterized by the increasing number and impact of TNCs. TNCs are the key drivers of foreign direct investments in the world economy and by increasing undertaking of FDI's they expanded their activities all around the globe.

Global foreign direct investment (FDI) flows had upward trend during 1990s and reached the peak in 2000 (with inflows of 1 411 billion USD). After the sharp decreases until 2003, global foreign direct investment flows continued to grow for four consecutive years and reached in 2007 the highest level ever recorded (with inflows of 1 833 billion USD, which surpassed the previous record set in 2000 by 422 billion USD). Together with the continued growth of FDI in all the three major groups of economies - developed countries, developing countries and the transition economies of Central and Easter Europe, TNCs expanded their activities and affiliates all over the world. The number and activities of TNCs and their affiliates rose exponentially. Nowadays there are 78 817 TNCs (parent companies) with 794 894 foreign affiliates around the world (UNCTAD, 2008).

Undertaking direct investment abroad, TNCs establish affiliates abroad and conduct production in them (international production) with aim of selling on local market and other markets. Indicators of international production, such as sales, value added, assets, employment and exports of foreign affiliates light up the importance of foreign affiliates in the world economy. Their international production continues to grow. The estimated sales, gross product and exports of foreign affiliates increased in 2007 by 20,7%, 19,4% and 15,4% respectively (Table 2). The value added (gross product) of foreign affiliates worldwide accounted for 11% of world GDP in 2007 (compared to 10% in 2006 and to 9% in 2005), sales amounted to 31 trillion USD, export exceeded 5 billion USD, and the number of employees reached almost 82 million.

Table 2: Selected indicators of global transnationalisation

Item	Value at current prices (billions of dollars)				Annual growth rate (%)
	1982	1990	2006	2007	2007
FDI inflows	58	207	1 411	1 833	29,9
Inward FDI stock	789	1 941	12 470	15 211	22,0
Sales of foreign affiliates	2 741	6 126	25 844	31 197	20,7
Gross product of foreign affiliates	676	1 501	5 049	6 029	19,4
Exports of foreign affiliates	688	1 523	4 950	5 714	15,4
Employment of foreign affiliates	21 524	25 103	70 003	81 615	16,6
GDP (in current prices)	12 083	22 163	48 925	54 568	11,5
Exports of goods and services	2 395	4 417	14 848	17 138	15,4

Source: UNCTAD (2008), *World Investment Report 2008*, UN, New York and Geneva, p. 10, Table I.4.

The sustained growth of foreign direct investments, foreign affiliates and related indicators reflect the importance of foreign direct investments and transnational companies in the world trade and world economy. For our research the most important variables are flows and stock of foreign direct investments of parent companies, sales of foreign affiliates and export of foreign affiliates (Table 2). Flows of foreign direct investments have risen dramatically since 1990. Consequently, average annual growth in the stock of global FDI (at 12,8%) has outpaced that for world nominal gross domestic product (4,8%) and that for world merchandise trade (8,1%) over the past two decades. These large increases in global FDI and activities of TNCs were underpinned by a number of factors, including: the liberalization of trade, investment and capital markets, the deregulation and privatization of service industries and increased competitive pressures stemming from globalisation and technological change. Another important development underlying global direct investment has also been the break-up of eastern block of former socialist countries when TNCs could for the first time to expand their activities all around the world. In recent years, there were also emergence of companies based in developing economies and economies in transition as active outward investors.

Data shows (Table 2) that in 1982 FDI flows were less than 60 billion USD, while the total world exports (2,4 trillion USD) were almost equal to sales of foreign affiliates (2,7 trillion USD). In 1990 FDI flows were above 200 billion USD, while sales of foreign affiliates were 6,1 trillion USD and significantly above the total world exports of 4,4 trillion USD. In 2007, when FDI flows exceeded 1,8 trillion USD, the sales of foreign affiliates dramatically increased on 31,2 trillion USD while total world exports were 17,1 trillion USD and were only 55% of these sales. It can be observed that the sales of foreign affiliates of transnational companies (international production) increased world-wide from 2,7 trillion USD in 1982 to 6,1 trillion USD in 1990 to 25,8 trillion in 2006 and to 31,2 trillion USD in 2007, and that these sales are nowadays nearly twice as high as world exports, what means that firms sell more through foreign affiliates than through traditional export. The analysis shows that after 1990 firms export more through FDI than through traditional, cross-border exportation. Thus, outward direct investment and international production are now more important than exporting (Bjelić, 2008a), in terms of the delivery of goods and services to foreign markets.

3. Foundations of the new concept of international trade

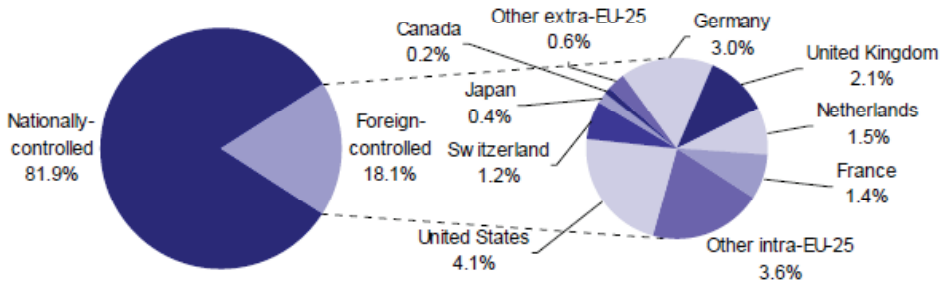
When a large transnational company places an investment in a company abroad taking control over this foreign company business policy we know that this is a flow of private capital in a form of foreign direct investment. But this investment can have an huge impact on the international trade if this affiliates have been involved in international trading. Usually parent company replaces its direct export to a country by investing in a company operating in that country. In this way parent company do not export more to that country rather it supplies the country by producing goods locally in its affiliate and selling those goods on a host country market. This mode of operation in international trade is referred to as international production looking from a standpoint of a parent enterprise. So the conclusion will be that foreign direct investment have a substitutive effect on trade flows since FDI has replaced direct export.

But this is not completely accurate. Let suppose that this foreign affiliate is a greenfield investment with a installed capacity several times over the local demand of host country. Usually parent companies set up a foreign affiliate in order to supply goods in several neighboring countries especially if these countries are all members of a same trade block. New plant needs new machines so greenfield FDI usually creates new import flows for a host country of a foreign affiliate. If we suppose that machines are imported from a country where parent company is located this investment creates export flows for a home country also.

But due to a large production capacity of a new plant and a strategy of parent enterprise of serving a regional market from one centre, products from a new affiliates are exported from host country all over its regional neighbors. In this way greenfield FDI also creates export flows for a host country.

The above is all hypothetical but highly likely in practice of international trade. Some would argue that FDI flows and involvement of TNC in production activities is not so important but next figure show that in European Union foreign-controlled companies i.e. foreign affiliated accounted for 18% of value added generated in 2005. Most important parent companies came from outside of the EU – from USA.

Figure 1: Share in total value added generated by nationally controlled and foreign-controlled enterprises in 2005 (breakdown by country of origin, average for all reporting countries), percentage



Source: Eurostat "Foreign-controlled enterprises in the EU" Eurostat Statistics in Focus, 30/2008, Office for Official Publication of the European Communities, 13.02.2008, p. 5, Figure 8.

The discussion elaborated above will mean that in classical concept of foreign trade statistics most of the mentioned activities will be recorded in foreign trade statistics of a host country of a foreign affiliate. But new approach in gathering statistics on international trade will record all the mentioned activities to a foreign trade statistics of a home country of a parent company which is in this example ultimate controlling authority. New concept of international trade defines export of a country not only as its direct export but it also includes the foreign sales of the affiliates of parent companies of that country in the host country and all other countries. But this export, under new concept, does not include export that foreign affiliates of outside parent companies have made from the observed country.

Due to this unprecedented role of transnational companies in international trade we can conclude that traditional official foreign trade statistics can not provide us with a needed data for a quality analysis of international trade flows. That is why new statistical framework is being set up having in focus the activities of foreign affiliates in international trade.

4. Foreign affiliates trade statistics (FATS)

Some new approaches try to minimize the effects of distortions in gathering of statistical data on international trade transactions caused by TNCs. The main tool is the new concept of the international trade statistics which is known as *Foreign Affiliate Trade Statistics* (FATS). The key to a better, comprehensive picture of the world economy and world trade is to capture the flows between parent companies and foreign affiliates. This can only be achieved through an expanded collection of data of foreign direct investments and associated financing arrangements, that is activities of transnational companies and their foreign affiliates.

Interest in FATS has arisen from two primary reasons: GATS and globalization. Entering into force on January 1, 1995, the WTO General Agreement on Trade in Services (GATS) is the first set of multilaterally negotiated and legally enforceable rules covering international trade in commercial services (excluding government services). According to GATS, international trade in services can take place through four modes of supply:

- mode 1 – cross-border supply, in which only the service crosses the border,
- mode 2 – consumption abroad, occurs when consumers consume services while outside their country,
- mode 3 – commercial presence, in which the service supplier establishes its commercial presence in another country,
- mode 4 – presence of natural persons, when an individual has moved temporarily into the territory of the consumer to provide a service.

For FATS the most important flow of international trade in services is mode 3 – commercial presence. The important step in building more comprehensive statistics has been the publishing of *Manual on Statistics of International Trade in Services* (MSITS), which has been a joint product of the United Nations, European Commission, IMF, OECD, UNCTAD and WTO. According to MSITS, by applying a simplified approach to the statistical treatment of GATS modes of supply in order to facilitate the compilation of statistics by

modes of supply, FATS correspondents to mode 3 and partially mode 4 (Table 3). Partial, supplementary information on presence of natural persons (mode 4) may also be available from FATS, if employment by foreign affiliates is among the variables collected and if their foreign employees, who have moved temporarily to the country of location of the foreign affiliates, can be separately identified. However, accordingly MSITS, FATS is primarily related to mode 3 (commercial presence). The international delivery of a great number of services requires close contact between producers and consumers, which can be achieved often only through affiliates established abroad (GATS mode 3, commercial presence) and FATS should enable the measurement of this particularly important channel of delivery.

Table 3: Correspondence between modes of supply and statistical coverage

Mode	Statistical coverage
Mode 1 Cross-border supply	BPM5: part of commercial services (excluding travel and construction services)
Mode 2 Consumption abroad	BPM5: travel
Mode 3 Commercial presence	FATS: FATS statistics BPM5: part of construction services
Mode 4 Presence of natural persons	BPM5: part of commercial services (excluding travel, including construction services) FATS (supplementary information): foreign employment in foreign affiliates BPM5 (supplementary information): labour-related flows

Source: United Nations, European Commission, IMF, OECD, UNCTAD and WTO (2002), *Manual on Statistics of International Trade in Services*, Geneva, Luxembourg, New York, Paris, Washington, D.C., p. 24, Table 1.

Besides Manual (Chapter IV, *Foreign Affiliates Trade in Services Statistics*), detailed discussion and recommendations for FATS and for statistics on AMNE (*activities of multinational enterprises* – AMNE) have been given in the *OECD Handbook on Economic Globalisation Indicators* (Chapter 3, *The Economic Activity of Multinational Enterprises*) and in the fourth edition of the *OECD Benchmark Definition of Foreign Direct Investment* (Chapter 8, *FDI and Globalization*).

In this context, we have to make a difference between *Foreign Affiliates Trade in Services Statistics* (FATS Statistics), *Foreign Affiliate Trade Statistics* (FATS) and *Foreign AffiliaTes Statistics* (FATS), because they are all known as FATS. The point is that it was first developed FATS Statistics (*Foreign Affiliates Trade in Services Statistics*), i.e. FATS for services. In the development of FATS, this was the first purpose of FATS contained in MSITS. Currently it is in faze of expanding it above the services in FATS (*Foreign Affiliate Trade Statistics* or only *Foreign AffiliaTes Statistics*), including both services and goods.

MSITS (2002) focuses on foreign affiliates producing services (*foreign affiliates trade in services statistics* - FATS statistics), but notes that most of its recommendations for compiling these statistics are equally applicable to goods and services. *OECD Handbook on*

Economic Globalisation Indicators (2005) notes that FATS variables should be compiled for all foreign affiliates, not only those affiliates in services. Although guidance in this Handbook on collection of AMNE data extends to businesses outside the service sector, it is fully consistent with the guidance in MSITS. *OECD Benchmark Definition of Foreign Direct Investment, 4th edition* (2008) draws from these existing guidelines in suggesting basic data and methodology that may be used.

According to recommendations and guidelines in existing international publications, in the following text it will be given the basics of FATS methodology. FATS may be developed for both:

- affiliates of foreign firms in national economy, i.e. foreign-owned affiliates in the compiling economy (inward FATS) and
- affiliates of national firms located abroad, i.e. foreign affiliates of the compiling economy (outward FATS).

Principles for recording FATS build on existing international statistical standards, in particular the fifth edition of the International Monetary Fund's *Balance of Payments Manual* (BPM5) and the *System of National Accounts 1993* (1993 SNA). FATS should cover those affiliates in which the single direct investor (or an associated group of investors acting in concert) has a majority ownership (more than 50%) of the ordinary shares or voting power. Thus, the statistical population of FATS is a subset of the FDI universe (which includes ownership criteria of 10% or more) and comprises subsidiaries (majority-owned corporations) and branches (wholly or jointly owned unincorporated enterprises) but excludes associates (corporations owned at 10-50%). However, countries are encouraged to provide supplemental statistics in cases where there is majority ownership by multiple foreign direct investors, ownership of exactly 50% by a foreign direct investor and in cases in which a qualitative assessment has been made that effective control has been achieved through a minority stake in an enterprise. FATS should cover all foreign affiliates, not only producers in services but also producers in goods. However, the activity classification to be used for reporting to international organizations provides more detail for services than for goods.

FATS variables may be attributed or classified in two main ways: geographical (by country) and by primary industrial activity of the producer. In addition, some variables may be classified by product. The geographical breakdown indicates in which country the production took place and where the owner of the producing affiliate is located. Attributing variables by country differs between inward FATS and outward FATS.

For inward FATS, the question is whether to attribute FATS variables to the country of the immediate investor (first foreign parent) or to that of the ultimate investor (ultimate beneficial owner – UBO (term used in MSITS and closer to the concept of ownership than to that of control) or unit of ultimate control (term used in OECD Handbook and closer to the concept of control)). It is recommended that the primary principle be the country of ultimate investor of the affiliate because that is the country that ultimately owns or controls, and therefore derives the benefits from owning or controlling the direct investment

enterprise (affiliate). Ultimate investor is the first person (company or individual) at the head of a chain of companies that directly or indirectly controls all the enterprises in the chain without itself being controlled by any other company or individual. We have given the two examples in Figure 1, where the chain of ownership runs from top to bottom. In our first case company G is the foreign parent (direct investor) of company H, while company F is its ultimate investor (company F’s indirectly held ownership in company H is 42%). In our second case, company J is both, the foreign parent and the ultimate investor of company K. Company I is not the ultimate investor because it is not the majority owner of company J.

Figure 2: Ultimate investors

I	II
Company F	Company I
70%	30%
Company G	Company J
60%	80%
Company H	Company K

However, considering that information on immediate investors may be available from linkages to FDI data (FDI flows, in BPM5 and BD3 framework, are compiled only in respect of the immediate investing country) and to facilitate comparisons with these data, countries are encouraged to compile data in which variables are attributed according to the country of the immediate investors.

For outward FATS, two options are possible. The variables may be attributed to the country of location of the affiliate (immediate host country) or, if the ownership is through a directly held affiliate located in another country – to the country of that affiliate (ultimate host country). It is recommended attributing them to the country of the affiliate whose operations are described by the variables, for that is the country in which the foreign direct investor’s commercial presence exists. For example, if a British company owned an affiliate in the United States through a holding company located in Bermuda, then in British outward FATS the affiliate should be classified in the United States rather than in Bermuda.

According to primary industrial activity of the producer that indicates which sector of activity is concerned, it is recommended that FATS variables be classified by activity according to *ISIC, Rev.3*, and grouped according to the *ISIC Categories for Foreign Affiliates (ICFA)* which have been derived from ISIC. ICFA is given in MSITS. These categories cover all activities, but with more detail provided for services than for goods.

Some variables may be classified by product, according to the types of goods or services produced. As a longer term goal, countries are encouraged to work toward disaggregating by product some variables such as sales, output, exports and imports (other variables, such as value added and employment, can not be classified by product). This breakdown should

be on a basis compatible with EBOPS for services and according to the Harmonized System for trade in goods, to facilitate comparisons with resident/non-resident trade classified on this basis.

In *developing FATS*, there are two basic approaches. The first is to conduct surveys that directly request information on the operations of resident affiliates of foreign firms and foreign affiliates of domestic firms. The second, which can be used only for inward FATS, is to identify the subset of existing data on resident enterprises that is accounted for by foreign-owned firms. Links to existing domestic statistics should also be used as a source of information on FATS.

Foreign Affiliates Trade Statistics are in the early stage of development. However, their collection and dissemination are taking an increasing importance at Eurostat, the OECD and the UNCTAD. An initial step towards international harmonization of basic concepts and definitions was taken via MSITS. This and other mentioned concepts have been accepted internationally, but they need to be supplemented and extended. A major difficulty involves data comparability, where numerous problems consist. There are many factors which most frequently affect the international comparability of data and also comparability between data from different national sources. The latest important step is the adoption of *EU Regulation No 716/2007 on Community statistics on the structure and activity of foreign affiliates* (European Communities, 2007) that is the legal framework according to which member states are required to provide inward and outward FATS to Eurostat starting from 2008 onwards, which was until then carried out on voluntary basis.

CONCLUSIONS

Contemporary concept of foreign trade statistics observe only the flow of goods and services across national borders. The activities of transnational companies are largely statistically unobserved except in the mode 3 of international trade of services. The second half of the 20th century, especially the period after 1990, is characterized by the rising role of transnational companies and their affiliates in international trade. The analysis in the paper shows that nowadays firms deliver goods and services to foreign markets more through their foreign direct investment operations (international production in foreign affiliates) than through traditional forms of international cross-border trade – export and import. The activities of TNCs have changed the structure and the way of performing of international trade. Traditional foreign trade statistics are not adequate any more as a tool for facilitating trade policy decision making.

New concept of analysis of international trade, and the new statistical framework for foreign trade derived from it, define export of countries more broadly so it does not include only direct export but also includes the foreign sales of the affiliates of parent companies of that country in the host country and all other countries. But this export, under new concept, does not include export that foreign controlled affiliates made from the observed country. In the paper we proposed approaches and guidance on how to minimize the effects of distortions in the compiling of statistical data on international trade transactions caused by the activities of transnational companies. The main tool is the new concept of the international trade statistics known as Foreign Affiliate Trade Statistics (FATS). FATS is in the early stage but its adoption and implementation in national foreign trade statistics and its international harmonization will lead to a more comprehensive picture of the world economy and world trade which captures the flows between parent companies and their affiliates.

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HARMONIZATION OF FINANCIAL REPORTING IN THE REPUBLIC OF MACEDONIA AND EUROPEAN UNION IN FUNCTION OF REGIONAL COLLABORATION AND ECONOMIC INTEGRATION

Abstract

Besides other factors important for economic development of one country, very important pre-condition is the existence of efficient capital market. Companies, especially companies from emerging countries, in order to draw attention to foreign investors must have standardized financial statements. In this paper we are focused on Macedonia and we will put accent on unification of financial reporting in Macedonia with financial reporting and regulation in European Union. Multinational corporations in Macedonia are enforced to comply with IAS/IFRS from January 1, 2005 but still they are not fully harmonized and have some problems with the implementation of international standards and fully compliance with them.

Important contribution to financial reporting in European Union has the acceptance of the European Directives (4, 7 and 8) related with accounting, with final aim: harmonization of financial reporting in all countries members of European Union. Directives regulate the form and content of financial statements, preparing consolidated financial statements, auditing of financial statements as well as harmonization of accounting education. In accounting regulation of European Union special contribution has Decree of Council of Europe from 2002 related to preparing of consolidated financial statements for the companies listed on European Stock Exchanges. Also EFRAG in 2002 recommends EC endorsement of all existing International Accounting Standards. EFRAG has reviewed all 41 standards and concluded that there are “no actual inconsistencies between IAS 1 to 41 and the last versions of the 4th and 7th Directives”.

In this paper we are going to analyze issues that companies in European Union have in implementation of IAS/IFRS and to fix the level of implementation of these standards in European Union countries. Also we are going to present the current situation in Macedonian companies about implementation of IAS/IFRS, four years after their translation and the

requirement for compulsory implementation in the companies listed on Macedonian Stock Exchange. At the end, our aim is to give recommendation for Macedonian companies and regulatory bodies how to achieve full compliance with European Union accounting regulation that will contribute to easier and faster economical collaboration and integration with the European Union. This is also in accordance with the strategy of the Government of Republic of Macedonia in the Country Action Plan for development of accounting profession in Macedonia.

Key words: *financial reporting, harmonization, European Union Directives, regional collaboration, economic integration, International Financial Reporting Standards*

INTRODUCTION

Fast technological changes in all industries, especially in manufacturing industries and information technology are result of the international trade growth and worldwide expansion. This, have implication on the capital market expansion which influences the growth of the international companies. Mentioned growth is accompanied with increased movement of capital, labor force and market of products and services. According to this, highlight is placed on the importance of the accounting and international financial reporting harmonization. Accounting and financial reporting system have different development in each country. Because of that, efforts are made for financial reporting harmonization on local, regional and world level.

In this paper we will try to present basic efforts of the Republic of Macedonia for adjusting its financial reporting with the financial reporting in the European Union. This is in line with the country's strivings to become European Union member.

1. The process of regional cooperation and economic integration

On 26 of May, 1999, European Commission suggested new form – Process of Stabilization and Association for Bosnia and Herzegovina, Croatia, Serbia, Montenegro, Macedonia and Albania, as a way of strengthening the existing regional approach of Western Balkan toward European Union. One step in this process is signing of the Agreement for Stabilization and Association.

The process of stabilization and association is special type of regional approach of the Western Balkan countries in the European Union. This countries gained possibility for the first time, on the basis of their own adjusted approaches, to become members of the Union. This process of stabilization contains stimulations as different programs, but also imposes certain political and economic conditions to be fulfilled. Requests which were imposed to countries from Central and Eastern Europe are also imposed to countries from the Western Balkan. According to the criteria which were defined by the European Council on the summit in Copenhagen (1993), countries from the Western Balkan are obliged to direct their political, economic and institutional development towards values and models on which EU is founded: democracy, human rights respect and market economy. These requirements were also imposed on Macedonia and, in general, we succeed to fulfill them.

Regional approach understands defining and realizing of the European Union policy towards certain neighbour regions. EU has special goals and interests towards certain

regions, including western Balkan. Regarding to the specifics of the separate areas, goals of the regional approach are usually reflected in strengthening of the peace and stability, democracy development and ownership rights, respecting human and minorities' rights, regional cooperation etc.

In spite of the regional cooperation, EU also implies economic integration, which is realized in the area including many different countries in order to remove any barriers in movement of goods, services and production factors and people.¹

Regional integration is political objective with special meaning for the European Union. It is a factor that influences realization of the other key political objectives as integrated market, monetary union, expansion and competition ability of the European economy, etc. This procedure is relatively slow, but, „information for the value of the regional integration show that it is high according to the average labor productivity in the European countries“². Consequences of this is high amount of income per capita, „agglomerations effects, from researching shows 64% of variances in productivity among European regains.“³ Corrado and others point out the importance of regional connections, vis-a-vi connections between countries, pointing out the regional similarities and differences.⁴

2. International differences in accounting and financial reporting

Fast changes in manufacturing and information technologies as well as expansion of international trade and capital markets, have resulted in growth of the multinational corporations which are forced to deal with intensified movement of capital, labor force and markets. These changes are accompanied by fluctuating price factors, fluctuating interest rates and exchange rates as well as domestic and international taxes and regulatory changes. Besides that, basic inflation and changes of specific industrial goals have increased prices of many assets and have increased operations' and investments' risk.

This situation in which companies operate requires larger scope of capital. That capital is always provided by the companies for higher prices. Due to changes in prices and cash flows there is also increased risk of keeping liquid assets. All of these factors have influenced companies to require new ways of credit finance and ways of controlling risks trough derivative transactions and hedging.

In the European Union about 7000 European listed companies were report their 2005 consolidated figures under IFRS for the first time. The adoption of IFRS in Europe is considered as the most revolutionary financial reporting development since Pacioli's double-entry bookkeeping, even more revolutionary than the adoption of the Fourth and Seventh EU Directive. ⁵ For now on, companies in Europe and worldwide will speak one accounting language.

¹ Kigan i Grin: Global Marketing, Prentice Hall, 2000

² De Benedictis и др. (2005), III. 13.

³ Ciccone (2002), III. 220

⁴ Corrado и др. (2005), III. 156

⁵ Hoogendorn (2006), pp. 23

Companies prepare and present financial statements in order to publish the effects of the transactions and events inside and outside of them, and which are connected with their financial positions and results. Whether transactions influence financial statements and on which way, depends on the accounting policy chosen by the company's management. For each type of transaction, management has to decide how to reflect them in the financial reports. Relating to this, certain frames, containing standards in different countries or international accounting standards, promote methods of recognition and measurement, consolidation and presentation. Some standards allow many options referring to above topics. Others are very strict and allow only one specific method for measurement.

Companies located in countries where accounting regulation and standards (national or international) allow various choices regarding to above mention topic have more flexibility in accounting, referring to presentation and measurement of the ownership, results and financial position. As a result of this, users of the financial reports from the companies in countries with flexible accounting are going to face more problems comparing the operations of the different companies in comparison with the users of the annual accounts from companies located in countries with low flexibility of accounting. These differences in the accounting system are obstacle for comparison of the financial results from companies that use different accounting standards. Companies which operate in different countries insist on harmonization of the accounting standards. Harmonization is going to make financial information comparable and will improve transparency for the users of the financial reports. This will reduce and information asymmetry between shareholders and management of the companies. At the end, this will reduce the cost of the companies' capital.

It is well known that shareholders use information from financial statements during their decision making. Considering wide variety of projects or activities, usage of this information is very similar, but method of calculation and cost and revenue formulas may defer depending on the companies' location, type of accounting standards used, or other factors (for example, legal system, development of the capital market, culture, etc). All this information gained from annual accounts is useful only if they can be matched against certain benchmark. Matching will be difficult if level of accounting flexibility significantly varies among companies. Accounting flexibility means that existing free choice, the same type of transactions and events can reflect on different way in different companies. This accounting flexibility is not an only problem connected with the comparability in those countries where accounting standards allow freedom for decision making. The necessity of foreign and domestic shareholders to compare financial statements of the companies located worldwide was big problem in the past and in the present. Company's profit or loss can be taken as a measure for further assessment and consideration as a benchmark only if matching is not impossible because of accounting flexibility, or other factors. Matching of two financial statements based on different accounting policies, cannot be realized on simple way. But in the comparison of the financial statements representing transactions and events in accordance with certain accounting policy is very important the accounting policies to do not be too much different, to level to which comparison will be meaningless. Accounting policies and decisions of certain company are, and will be in the future, under great influence of the rational environment and rational accounting standards and practice. In the time when standardization and international harmonization are, at the first glance, well accepted and developed, national differences still exists. Evidences from practice

witness that even behavior of multinational companies on several international stock exchanges is under great influence of national accounting characteristics.

3. Harmonization of the financial reporting in Republic of Macedonia with the European Union

In recent terms of working influenced by globalization, technological development and integration processes, accounting and financial reporting have a special role and importance not only within the national economy, but also at the regional and world level. Today, accounting is facing fast changes and adequate adjustments to the new conditions due to the globalization. Related with this is the request for recognition of the international accounting qualifications which was stimulated by successfully completed Uruguayan Round of trade negotiations and the General Agreement on Trade in Services-GATS.⁶ GATS relates to general obstacles which arise during the regulation of the international trade and foreign investments, including also international practice of accounting and other professions.

Republic of Macedonia is transferred to market economy and follows the orientation for cooperation on international level, first of all with European Union. In this application period for membership in EU, our country undertakes activities and achieves required standards which are precondition for entering the Union. In that direction Republic of Macedonia undertakes adequate steps for reforms in accounting system reforms introducing International Accounting Standards, International Financial Reporting Standards and International Standards on Auditing and also makes efforts for harmonization of the financial reporting with fourth and seventh Directive of the accountants' commission of EU. This is separately underlined in the national plan for development of accounting profession in Macedonia. Directions lead to adjusting with other Directives too, with intention to achieve unified financial data from financial reports. In this direction, especially shall be specified the Decree of the European Council from 2002 which refers to completion of consolidated financial reports of the companies quoted on stock exchanges in accordance with International Accounting Standards/International Financial Reporting Standards. Also, shall be mentioned the efforts from European Union towards overview and passing on the accounting standards for small and medium enterprises.

After becoming independent Republic of Macedonia become member of the United Nations. Also its membership in other international financial organizations, economic associations and similar, imposes efforts to be made for harmonization of the financial reporting with that of the European Union. This is obligatory because Macedonia is potential member of the European Union. Under influence of economic crisis, requirements are imposed referring to passing new laws and institutional building which are essential for successful reforms and getting closer to European Union.

Process of financial reporting harmonization is very important for Republic of Macedonia as prospective EU member. Macedonia is obliged to adjust its laws and regulation with EU that means obligation to provide adjustments in the field of financial reporting. First,

⁶ IFAC Handbook, Technical Pronouncements, 1998, стр. 14 ас њелл ас Minovski Zoran: Government Accounting and Accounting for Nonprofit Organizations, Faculty of Economics, Skopje, 2004, str.38

it refers to adjusting of accounting principles and rules in accordance with Fourth and Seventh Directive of EU as well as implementation of IAS and IFRS. Due to the previously mentioned, IAS and IFRS are accepted and implemented in the big companies as well as companies who are listed on the Macedonian Stock Exchange. Also, International Standards on Auditing and Code of Ethic issued by International Federation of Accountants (IFAC) are accepted and implemented. The IAS/IFRS implementation must be result of cost-benefit analysis, and in Macedonia although implementation of IAS/IFRS imposed immense costs for companies (to engage consultants for IAS implementation and to invest in young and well educated employees, or even to change accounting software), the benefit of IAS/IFRS implementation is great and important for overall Macedonian economy: attracting foreign capital. Now in the Macedonia are in progress activities related with translation of the last versions of IAS, IFRS and ISA as well as Code of Ethics of IFAC and is expected that these pronouncements in Macedonian language will be issued at the beginning of 2010 in the Official Gazette. Until now in Macedonia are in force IAS, version from 1995, translated in Macedonian language and published at the end of 2004. This last version of IAS significantly varies with the latest version of Standards and, consequently, companies are faced with the issue which standards are valid for them: the latest one issued in Macedonian language, or the one that is latest published by the Standard Committee. Also, Macedonian regulatory bodies have planned translation of International Accounting Standards for Small and Medium Size Companies.

A step further in the process of harmonization of accounting profession is in the field of accounting education. Part of this harmonization of the accounting education is The Faculty of Economics – Skopje and its Department for accounting and audit. The Department has changed its syllabus and adjusts it in accordance with IAS, IFRS and ISA as well as rules and codes of ethics of international accounting bodies (IFAC, ACCA, and CIMA). Many students after their graduation at the Faculty are enrolling ACCA studies, international certification of accountants. Students from this Department are exempt of the first five exams, out of 14. Even more, the Institute for Certified Auditors of Macedonia this year starts the activities of certification auditors with the program in accordance with the one of ACCA. This internationally recognized certification allows mobility of accountants and auditors and their ability to do accounting in accordance with international standards. Such internationally certified accountants will be able to prepare comparable financial statements in accordance with international standards and EU regulation as well as auditors will be able to perform audit in different countries as employees of any big four' auditing firms.

Big companies listed on Macedonian Stock Exchange are obliged to use IAS and IFRS in order to protect interests of the financial statements' users and to attract potential investors, as well as it is a valuable source for the decision makers in the same companies. On that way straightforward and clear information are provided for the users of financial information with acceptable costs for their preparation. It is also an objective which is desired during the process of defining appropriate system of accounting and financial reporting. But, there are intensive activities for solving accounting problems referring to harmonization and increasingly important requirements for equal systems for financial reporting on international level. In spite of the individual characteristics of developed countries, there is a need to be considered specific characteristics for their operations in transition countries such as Republic of Macedonia.

Although Macedonian accounting regulation has accepted International Accounting Standards and International Financial Reporting Standards as well as Code of Ethics of IFAC, and they are obligatory for the companies listed on Macedonian Stock Exchange, there are still some differences and items that cannot be reconciled with IAS/IFRS. Here we are going to mention some of them. Firstly, financial statements schedules prescribed from Public Revenue Office are not in compliance with those in European Union. Second, Macedonian regulation prescribed depreciation rates that is not in accordance with IAS 16. In accordance with this standard the company is allowed to adopt depreciation rate in its convenience, but in Macedonian case, in order to prepare financial statements for tax purposes, the companies must to use depreciation rates prescribed in depreciation rate schedule issued by Ministry of Finance. Third, the new Tax law from January 1, 2009 is not in accordance with IAS 12 Differed tax. With our new law there is no anymore need for differed tax because tax rate is calculated only on distributed income. Forth, before acceptance of IAS and IFRS, in accordance with Macedonian national standards, there was revalorization rate for fixed assets for tax purposes in order to have more realistic base in recognizing costs and calculating tax. When companies started to use IAS/IFRS they were obliged to remove these revalorization rates and to make evidence of fixed assets in financial statements at historic costs. Now companies are faced with issue to have two bases of fixed assets: one for tax purposes with previously used revalorization rate and one in accordance with IAS/IFRS. The companies cannot report their fixed assets in accordance with IAS/IFRS because in the software system in our Public Revenue Office they have greater base for calculation costs and therefore, income taxes. Fifth, in accordance with Macedonian regulation and financial statements scheme there is no item for evidence of short term provisions, although it exists in IAS 36. Furthermore, all differences in accounting regulation and partially implementation of IAS/IFRS will lead to not comparable GDP. Data for GDP calculation are draw from financial statements of the companies, so more harmonized accounting profession means bigger comparability of GDP across countries. Besides all these issues in accounting harmonization that are going to be solved and achieved fully harmonization with European Union regulation in near future, there might be other not so important differences. In general Macedonian accounting regulation is almost fully harmonized with European Union accounting regulation.

Therefore, results of the researches are expected in defining steps that have to be undertaken in accounting profession in order to allow reducing of the harmonization pressure with respecting of particular environment specifics. Every country has its role in the growth and development of the companies. Their operations have to be reported by accounting in order final financial information to be useful for the users of the financial information. This will lead business transactions and results to be achieved on sound information basis. Along with the benefits in the country, harmonization of standards will contribute for better inclusion of the country in the process of integration and globalization in EU.

CONCLUSION

Financial reporting, in general, is considered as a part of communication process. Because of the different characteristics of individual national environments, standards' and accounting bodies' creators have imposed different alternatives for recognition, measurement and

presentation of assets, liabilities, equity, income and expenses. They choose the most appropriate measures in their national environments for policy of recognition, measurement, consolidation and presentation of financial statements. In every country annual financial report provides information for financial position and financial results. Differences in financial reporting between countries derive from different environmental, culture and other influences. Reasons for differences were examined and harmonization of accounting is started as a result of the business globalization worldwide.

The process of financial reporting harmonization in accordance with the European Union regulation is especially important for Republic of Macedonia as a candidate member. Therefore, Republic of Macedonia has responsibility to adjust its laws with the European Union laws, understanding adjustment in the field of accounting and financial reporting. It contains adjustment of accounting principles and rules in accordance with Fourth and Seventh Directive of EU as well as implementation of IAS and IFRS. Most of these requirements are fulfilled in Macedonia and we can confidently say that Macedonia is not at the end on the list of European countries referring to accounting harmonization. There are countries member of European Union with investments in Macedonia that have bigger gap between their national accounting and accounting in accordance with 4th and 7th European Union Directives and International Accounting Standards and International Financial Reporting Standards. Even Fourth and Seventh European Union Directives are not fully complied with IFRS. Because the Fourth and Seventh EU Directives were rather broad and permissive, significant differences in accounting policies and practices in the 25 European countries exist.

In the Republic of Macedonia, efforts are made for unification of financial reporting with the EU, having in mind processes of globalization and regional integration which is in line with activities of the WTO and other international and regional organizations for enhancing movement of goods, services, capital, capital market, rational management of the companies which act in international level, etc. This is in accordance with the strategy of the RM Government stated in the national action plan for development of accounting profession. But, at the end we cannot expect full or near-full comparability. We should take a step back and suggest IFRS to become more principle-based and less complex. With this we are going to avoid a situation in which CFOs do not understand their own financial statement.

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THE GRAVITY MODEL AS WORKHORSE: WHAT CAN WE LEARN ALMOST FIFTY YEARS LATER?

Abstract

This paper tests the gravity model, where the logarithm of the stock (or flow) of the immigrants from origin to destination country is a positive function of wage differentials, size differentials, income inequality differentials and a negative function of distance as proxy variable for migration costs. The results of the estimation confirm that GDP per capita of the destination countries as a proxy variable for wage differentials, and population of the destination countries as a proxy variable for size differentials are important determinants which significantly influence migration flows between 72 countries of origin and fifteen European Union destination states.

Key words: *Central and Eastern European countries, European Union, gravity models, fixed effects model, migration, and panel data.*

INTRODUCTION

Tinbergen (1962), Pöyhönen (1963) and Linnenmann (1966) first used the gravity model to explain bilateral trade flows of some observed countries. Since then this instrument has been widely used in the applied literature to evaluate the impact of regional agreements,² the impact of monetary union, and the impact of foreign direct investments on trade flows, and to simulate trade potential.³

The gravity equation has been successfully applied instead of trade flows to a whole range of international flows, such as for instance immigration into European Union (EU) member states (Marques, 2005, Svaton and Warin, 2007), and foreign direct investments, immigration and EU enlargement (Breitenfellner et al., 2008). Thus the central aim of this paper is to confirm the assertion that the gravity model, almost fifty years after its first introduction, is still a useful workhorse for researchers. At a time when the issue of labour mobility has never been more topical in the territory of Europe (Zimmerman, 2009), this paper uses the gravity equation as a workhorse to analyse immigration into fifteen EU member states.⁴

For this purpose two different datasets on migration stocks and flows for fifteen EU member states and 72 countries of origin were newly formed for each year over the period 1996 to 2006 using the OECD database. Thus one of the contributions of this paper is that it compiles new datasets on migrant stocks and flows, which allow us to control a relatively large set of fixed effects by using panel techniques suggested by Cheng and Wall (2005).

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² For instance Caetano and Galego (2005), Bussierre et al (2005), Rault et al (2007)

³ See Egger (1999), Fuchs and Wohlrabe (2005).

⁴ The countries selected for analysis are: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.

Consequently, the model is firstly estimated using the entire sample of 87 countries and then estimated on sub-samples, based on country of origin.⁵

Another contribution of this paper is that it introduces a model which is reminiscent of the generalized gravity equation. This model is grounded on the theoretical suppositions of the Ortega and Peri (2009, 9-13) migration model, allowing for unobserved individual heterogeneity between migrants and non-migrants. Namely, migrants systematically differ from non-migrants along important dimensions that are hard to measure, such as for instance ability, risk aversion, or the psychological costs of living away from home.

In accordance with the suppositions of the migration model, the main testable hypothesis supposes that the stock (or inflows) of the migrant population in the destination country is determined by the wage differentials between origin and destination country, where GDP per capita of the destination countries is introduced as a proxy variable for labour income differentials between origin and destination countries. The second testable hypothesis supposes that the bilateral migration flows between the origin and sending country are determined by size differentials, where the population of the destination country is used as a proxy variable for size differentials. The third hypothesis supposes that bilateral migration flows are related to income inequalities between the origin and sending countries, where the Gini coefficient of the destination country is used as a proxy variable for income inequality differentials.

An important contribution of this paper is the inclusion of alternative proxy variables in the gravity model, which are introduced in order to confirm the robustness of the analysis and to reinforce the generalized version of the gravity model. Thus the Gini coefficient of the sending country is introduced as a proxy variable for income inequality differentials, the population of the sending country is introduced as a proxy variable for size differentials, and GDP per capita of the sending country is introduced as a proxy variable for wage differentials between the two countries, with a negative sign on these variables expected.

The paper is structured as follows. Section Two presents the gravity model in its basic form, reviews the theoretical literature, presents the Ortega and Peri (2009) migration model and presents the empirical model used to analyse determinants of bilateral migration flows. Section Three describes and presents the datasets, especially those on stocks and flows of the migrant population in the destination countries and estimates the effects of wage differentials, size differentials and income inequality differentials between the sending and receiving countries by using a fixed effects estimator. Section Four provides some concluding remarks.

1. Gravity model

1.1. The gravity approach

The gravity model is a mathematical device used for the analysis of bilateral trade flows between different countries or geographical entities in empirical research. The gravity approach says that attractiveness between two entities is proportional to the product of

⁵ These samples are: EU-15 member states, Central and Eastern European countries and the developing world.

their mass and inversely proportional to the distance which separates them. In its basic form, the gravity model states that foreign trade between two countries is a positive function of their GDP as a proxy variable for their respective supply (conditions in the source country) and demand (conditions in the host country), and a negative function of the distance between two countries as a proxy variable for transportation costs. Thus the basic model has following form:

$$(1) \quad \ln trade_{ijt} = \alpha_0 + \alpha_1 \ln GDP_{it} + \alpha_2 GDP_{jt} + \alpha_3 \ln Dist_{it} + \epsilon_{ijt}$$

If the basic explanatory variables of the gravity equation are distance and economic size, then theory allows the inclusion of many variables that may explain trade flows between two observed countries, such as GDP per capita, foreign direct investment, exchange rate volatility as well as dummies for similar languages, common border and free trade agreements. The gravity model has gained theoretical foundations due to the development of new theories of international trade, which assume imperfect competition. Helpman and Krugman (1985) propose a formalization of the gravity equation in which intra and inter-industry trade approaches are reconsidered. The Bergstrand (1989) model represents an extension of the Helpman and Krugman model, taking into account the supply and demand functions of trade flows.

1.2. Literature overview

Empirical studies consistently identify GDP per capita differences and size differences between sending and receiving countries as key drivers of migration between nations, and indicate that economic theory does not provide a fully satisfactory model for analysing the causes and effects of migration. This discrepancy between empirical studies and theory has led to the coexistence of several interdisciplinary approaches which are presented in more detail in Hatton and Williamson's (2005) work. For instance the so-called macroeconomic theories in the neo-classical tradition explain migration by looking at skill differences in the labour supply and demand between two observed countries as well as the differences in their wages, while microeconomic theories try to explain the migration incentives of the individuals involved through cost-benefit deliberations based on lifecycle income and taking into account investment in human capital.⁶

The so-called world dual labour theory explains international migration by means of push and pull factors, where the pull factors represent the following four characteristics of modern industrial society: structural wage inflation, lack of motivation for low-status jobs, economic dualism between a human capital-intensive core workforce and a peripheral workforce, and demographic trends in labour supply. Similarly, other new theories assume that the decision to migrate is taken on the family level rather than by individuals. The objective of migration is the collective maximization of the income in absolute and relative terms in comparison with reference families or neighbours as well as risk minimization under conditions of undeveloped insurance markets.

Thus Hatton and Williamson's book presents a synthesis of the theoretical models, and at the same time shows the non-linearity of the relationships between the stage of development

⁶ See for instance Andersen (2005)

and migration flows between two countries. If the level of development of the sending and host countries is measured by GDP per capita, then the relationship between GDP per capita differentials and the share of migration is not collinear. Accordingly, when a given level of development of the sending country is achieved, the migration flows into the host country are reduced. Similarly, re-migration back to the sending country begins when income differentials between the sending and the host countries reach a maximum.

The present analysis is based on the migration theory presented by Ortega and Peri (2009), which is fully consistent with the generalized gravity model. In this model the log of bilateral migrations (either stocks or flows) is a function of sending and receiving country effects, that is, expected income differentials and migration costs. Ortega and Peri tested the prediction of the model with aggregate panel data on stock and flows of migrants. It is important to note that their empirical specification allowed focusing on the factors that determine immigration into the destination countries. They also showed that mis-measurement can be a problem due to classification. Namely, some countries define immigrants on the basis of place of birth, while others define an immigrant population on the basis of nationality. In this way they suggested the measure of so-called net instead of gross immigration for each of the destination countries.

The basic empirical specification estimated by Ortega and Peri is as follows:

$$(2) \quad \ln(\text{Migration})_{odt} = D_{ot} + D_d + \phi_w \ln(\bar{W}_{dt-1}) + \phi_1 \ln(Y_{dt-1}) + \phi_2 \ln(\beta X_{od}) + \varepsilon_{odt}$$

where *Migration* represents either inflows or stock of the immigrants in the host country, the term D_{ot} is the set of country-of-origin by time dummies, D_d are destination country dummies, \bar{W}_{dt-1} is the difference in GDP per capita between sending and destination countries, Y_{odt-1} are time-varying variables for the destination country (such as population, Gini coefficient, share of young workers), X_{od} are time invariant proxy variables (as for instance distance, common language, contiguity), and ε_{odt} is the zero-mean measurement error.

1.3. The model and methodology

While Cheng and Wall (2005) showed that the country pair fixed effects model is preferred to all other specifications that estimate the gravity model, this paper tested a similar specification of the gravity model as presented in equation (2) by using a fixed effects estimator. We also weight the stock of immigrants as a dependent variable by the population of the destination country to correct for heteroskedasticity of measurement errors. Since the decision to migrate is probably based on historical experience, we lag the explanatory variables for one period, allowing them to affect the stock of immigrants in the following year. When immigrants are coming from countries characterized by very different levels of socio-economic development, the model is firstly estimated using the entire sample of countries and then estimated on sub-samples based on country of origin.

In this way we analyse the stock of immigrants originating in the EU-15 countries, Central and Eastern European countries and the developing world. Following Ortega and

Peri specifications in log-log space and the Cheng and Wall approach:

$$(3) \quad \ln STOCK_{ij,t} = \alpha_{ij} + \beta_1 \ln GDPpc_{jt-1} + \beta_2 \ln GDPpc_{it-1} + \beta_3 \ln POP_{jt-1} + \beta_4 \ln POP_{it-1} + \beta_5 \ln GINI_{jt-1} + \beta_6 \ln GINI_{it-1} + \beta_7 \ln DIST_{ij} + \beta_8 CONTIG_{ij} + \beta_9 COMLANG_{ij} + \lambda_t + \varepsilon_{ij,t}$$

Equation (3) specifies the gravity model where $STOCK_{ij,t}$ is the stock of the origin country population in each of the destination countries expressed as a percentage of the total population in the host country, $GDPpc_{jt-1}$ is the GDP per capita of the sending (or origin) country, $GDPpc_{it-1}$ is the GDP per capita of the destination (or host) country, POP_{jt-1} is the population of the country of origin, POP_{it-1} is the population of the host country, $GINI_{jt-1}$ denotes the Gini coefficient of the country of origin, $GINI_{it-1}$ is the Gini coefficient of the host country, $DIST_{ij,t}$ is a proxy variable for distance between country of origin and the host country, $CONTIG_{ij,t}$ and $COMLANG_{ij,t}$ are the dummy variables taking the value of 1 if the sending country and destination country are contingent and have the same language. Finally, the terms α_{ij} are the country-pair individual effects covering all unobservable factors related to the country-pair migrations costs, λ_t are time specific effects and $\varepsilon_{ij,t}$ is the error term.

The main hypothesis of this paper is that the stock of the migrant population in the destination country is determined by the income per person differentials between the sending and host countries. Thus the stock of migration should decrease with the origin country GDP per capita ($\beta_1 < 0$) and increase with the host country's GDP per capita ($\beta_2 > 0$). According to the Ortega and Peri (2009) specifications, the GDP per capita of the destination country, which is measured as PPP gross domestic product per person, explicitly captures the effect of the difference in incomes between the destination and origin countries. In particular, the assumption is that average expected labour income in the host country \bar{W}_d is adequately measured by GDP per capita of the destination country.

If we suppose that costs of migrants increase with distance, a negative sign for β_7 is expected. Distance fundamentally determines migration. For instance, Central and Eastern European countries, which are geographically closer to the observed EU-15 member states, may have a distance advantage in comparison with the developing North African countries. Migration is also higher between a pair of countries sharing a border and a common language. For this reason a positive sign is expected for the term β_8 and β_9 . As the gravity model in its basic form assumes that the stock of the migrant populations will increase with the size differentials,⁷ a positive sign is expected for this variable as a measure of size differentials between the sending and receiving countries in the present analysis.

The supposition is that a country with an increasing population may find it easier to absorb new immigrants with little consequence for its own population. According to this supposition

⁷ Linnemann (1996) included population as an additional measure of country size, where a positive sign is to be expected.

a positive sign can be expected for the variable POP_{it-1} ($\beta_2 > 0$), and a negative one for POP_{jt-1} ($\beta_1 < 0$), as a proxy variable for size differentials. As mentioned above, Ortega and Peri also introduced the Gini coefficient as a measure of income distribution, where the Gini coefficient of the destination country ($GINI_{it-1}$) is a proxy variable for income inequality. It is supposed that in the periods when the income distribution is more equal, the opposition to immigration in the host country may be milder. Thus a positive sign is to be expected for $GINI_{it-1}$ ($\beta_6 > 0$), and by contrast a negative sign for $GINI_{it-1}$ ($\beta_5 < 0$), as proxy variables for income inequality. The next section will present the data sources and the regression results.

2. Empirical analysis

2.1. Data

We introduce a generalized gravity equation as a basic empirical specification that is estimated using the fixed effects method. We initially tested the gravity model on migration inflows data and migration stock data. The data on yearly flows into 15 European Union member states are provided from OECD migration statistics. The EU member observed states are: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. Most of the data provided from the OECD database are taken from the individual contributors of national correspondents appointed by the OECD Secretariat with the approval of the authorities of the member countries. Consequently, these data have not necessarily been harmonized at the international level. Thus the series presented in relatively standard format does not imply that the data have been fully standardized and are comparable at the international level. Since the database provides annual series for the ten most recent years, we used migration inflow and stock data from 1996 to 2006.

This bilateral database, which has more than fourteen thousand items, is carefully examined and organized separately for two datasets on migration flows and stocks. While all country-pairs which show only zero items in the observed period are omitted, the final dataset of approximately six thousand items is formed on migration stocks and approximately five thousand cross-section items on migration flows. More precisely, the 5874 items that represent the stock of the immigrant population by nationality and 5247 items that represent inflow of immigrant population by nationality are extracted from the larger migration database of 14,204 items. Preliminary tests⁸ show that the first extracted dataset of the 5874 items, which represent the stock of foreign-born population in fifteen EU member states from 1996 to 2006, is more reliable in comparison with the mentioned second extracted dataset. This reliability of the first dataset is somehow linked with the zero value items.

While the first dataset has less than 9 per cent 0 values, the second dataset has more than 17 per cent zero values. Finally, we add one to each observation relative to stock and flow of immigrants so that when taking logs we do not discard the 0 observations. The testing repeatedly shows that the second dataset, which represent inflows of foreign-

⁸ Redundant (Likelihood Ratio) fixed effects test.

born population, is less reliable and consequently excluded from further research. It is worth noting that we use data provided from OECD migration statistics as given. Thus we introduce gross values of either stock or inflow of immigrant's population in EU-15 member states, while Ortega and Peri introduced gross or net values of immigration.

Data for population (given in thousands) and gross domestic product on purchasing power-parity (PPP) per capita was taken from the web version of the IMF's International Financial Statistics (www.imf.org), extracted April 2009). Gini coefficients for EU-15 member states as destination countries and all other countries of origin were taken from UNU-WIDER Database (WIID, World Income Inequality Database V2.0c May 2008). Data for distances, contiguity and common language were taken from the CEPII website (www.cepii.fr). Distance data is measured in km between the partner countries' capital cities. Countries are considered to share a common border when they share a land border. The list of the countries of origin of the migrants for the bilateral migration data is in Appendix 1.

2.2. Results of the analysis

The results of the estimation using the fixed effects (FE) model are robust to various model specifications and regressions methods. We alternatively introduce either GDP or population as a measure of the country size differences as predicted by a basic version of the gravity model presented in equation (1). Marques (2005) points out that GDP as a proxy variable shows a negative effect on either stock or inflows of immigrants, especially when GDP per capita is introduced in the model. When the population is alternatively introduced in the same model, this variable shows a positive expected sign. Our testing of the regression model (3) completely confirmed these findings of the cited analysis.

It is also characteristic that the introduced proxy variable for wage differentials between origin and destination country ($GDPpc_{i,t,l}$) shows highly significant values of the coefficients and sign as expected. When we estimated the model firstly in the entire sample of countries and then on three different sub-samples of countries, the results of the estimation by using the fixed effect estimator repeatedly confirmed these finding. We also introduced Pooled Least Squares with cross section weights (EGLS) as an alternative estimation method. Remember that results of the fixed effects estimator are more reliable in comparison with the pooled EGLS method.

The proxy variable $POP_{i,t,l}$, which by supposition shows population differentials between the sending and destination countries, reveals a positive expected sign with the significant values of the coefficients by using the fixed effects estimator, and the proxy variable $GINI_{i,t,l}$, shows relatively low values of coefficients and at the same time either a negative or positive sign in each of the columns. As Svaton and Warin (2007) argue, the negative statistically significant coefficients for this variable means that immigrants dislike more unequal societies and allocate themselves to countries with a more even distribution of income.

But Svaton and Warin, who used a similar source of data for fourteen European member states from 1994 to 2004 (namely, OECD Migration Outlook, 2006), show a positive sign for the Gini coefficient as the proxy variable for income inequality. How to explain these

differences? It is worth noting that the Svaton and Warin analysis did not include GDP per capita as a proxy variable for the wage differentials. More precisely, when GDP per capita is excluded from equation (3), the $GINI_{it-1}$ coefficient as a proxy variable for income inequality switches the expected sign. In this way it is possible the form the supposition that the Gini coefficient as a proxy variable sometimes changes the expected sign, especially when it is simultaneously included with GDP per capita in the model. But further analysis will show that this switching of the expected signs can also be attributed to something quite different.

It is worth noting that the fixed effects estimator does not allow estimation for time-invariant variables (as for instance distance, border and common language). But Cheng and Wall (2005) suggested a methodology which also enables estimations of the coefficient for the time-invariant variables. In terms of econometric terminology, we first estimate the regressions using the standard fixed effects estimator. As the time-invariant variables are collinear with the country-pair individual effect, which precludes the estimation of coefficients for distance, border and common language as time-invariant variables, we estimate additional regression of the estimated country-pair effects on time-invariant variables in order to filter out the importance of these variables in the fixed effects using this equation

$$\alpha_{ij} = \beta_0 + \beta_1 DIST_{ij} + \beta_2 CONTIG_{ij} + \beta_3 COMLANG_{ij} + \mu_{ij}$$

The results of the estimation using additional regression for the entire sample of countries are robust. Cheng and Wall also argue that the standard fixed effects estimator for estimating gravity models may suffer from estimation bias due to omitted or mis-specified variables. They show that the introduction of period dummies and country-pair dummies largely eliminates this problem. The two-way fixed effects estimator by prediction captures those factors such as physical distance, the length of the border or contiguity, history, culture, and language that are constant over the span of the data. We repeat a complete estimation by introducing the so-called two-way fixed effects model, which additionally involved the country-pair and time dummies in the regression model.

The estimated coefficients on the GDP per capita for the destination ($GDPpc_{it-1}$) country remain always highly significant at 1 per cent confidence and positive for both the entire sample of these countries or sub-samples of Developing, CEEC and EU-15 member states. A somewhat surprising result is that the introduced methodology simultaneously changes the expected signs on GDP per capita of the sending countries ($GDPpc_{jt-1}$) as proxy variables for wage differentials between two countries.

It is interesting that the destination country population as proxy variable for the size differentials between the sending and destination countries (POP_{it-1}) repeatedly shows a positive expected sign with highly significant values of the coefficients for either the sample of all countries or each individual sub-sample of the countries and that the Gini coefficient of the destination country ($GINI_{it-1}$) as a proxy for income inequality also shows a negative expected sign for all the observed samples of countries in the present analysis with mainly insignificant values of coefficients.

CONCLUSION

The central aim of this analysis was to confirm the assertion that the gravity model, almost fifty years after its first introduction, is still a useful workhorse for researchers. To confirm this affirmation, the analysis formed two different datasets on migration stocks and flows for the fifteen European Union member states as the destination countries and 73 other states that represent sending countries. At the same time this paper introduced an equation that is reminiscent of the generalized gravity equation. Testing showed that the gravity model is, almost fifty years after the first successful implementation, still a useful instrument.

The results of the estimation by using the fixed effects estimator for either the entire sample of data or for sub-samples of developing countries, Central and Eastern European countries and EU-15 states clearly showed that GDP per capita of the destination country is a significant proxy variable for wage differentials between two countries and that the population of the destination country is also characteristic as a proxy variable for population differentials between the sending and receiving country.

But the results of the estimation less characteristically rejected the supposition that the Gini coefficient of the destination country is a significant proxy variable for income inequality between the sending and destination country. While our dataset (on stocks) covered different strata of the immigrant population, which involved either highly educated individuals or unskilled immigrant individuals from the sending countries, the introduced proxy variable for income inequality showed either a positive or negative expected sign with mainly insignificant values of the coefficients.

We supposed that the Gini coefficient is sensitive measure for income inequality. Nevertheless, the further research, which data will enable differentiation of immigrant's population by the level of education or by occupation, will either confirm or reject given hypothesis.

Appendix 1: List of the countries of origin of migrants for the bilateral migration data

EU: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Netherlands, Portugal, Spain, Sweden, United Kingdom,

CEE: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania Poland, Romania, Slovenia, Slovakia,

Developing world: Afghanistan, Albania, Algeria, Argentina, Armenia, Azerbaijan, Bangladesh, Byelorussia, Bosnia and Herzegovina, Brazil, Cameroon, Cape Verde, China, Colombia, Congo Republic, Congo the Democratic Republic, Croatia, Cuba, Cyprus, Ecuador, Egypt, Ethiopia, Georgia, Ghana, India, Indonesia, Iran, Iraq, Kenya, Korea Republic, Kyrgyzstan, Lebanon, Libya, Macedonia, Malta, Malaysia, Mexico, Moldova, Morocco, Nigeria, Pakistan, Philippines, Russian Federation, Saudi Arabia, Serbia and Montenegro, South Africa, Sri Lanka, Sudan, Syria, Thailand, Tanzania, Tunisia, Turkey, Ukraine, Uzbekistan, Vietnam,

Other countries: Australia, Canada, Japan, Norway, Switzerland, United States

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Part IV

CEFTA-2006 AND ENHANCING COMPETITIVENESS OF THE REGION - SOME SECTORAL ASPECTS

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SOURCES OF COMPETITIVE ADVANTAGE IN THE CROATIAN MANUFACTURING INDUSTRY

Abstract

The purpose of this paper was to examine the relationships between firms' characteristics, strategic behavior of manufacturing firms and firms' performance (measured as value added per employee). The research questions were tested with data collected from company survey carried out during the period of October-December 2007 in Croatia. The data was analyzed using chi-square test and one-way analysis of variance (ANOVA). The results indicate that company size, technological intensity and firms' experience do affect the performance differences among companies. Higher percentage of small companies appeared to have higher productivity as compared to medium-sized and large companies. Younger firms outperformed older firms, while companies with higher level of technological intensity had higher productivity than those with lower technological level. Furthermore, the paper identifies several strategic behavior variables that affect firms' performance. High performing companies had higher volume of sales per employee and higher levels of profit per employee. Finally, the paper discusses implications of findings for policy makers and managers.

Key words: manufacturing industry, performance, sources of competitive advantage, strategy, Croatia

INTRODUCTION

The manufacturing industry is still one of the largest sectors in national economies as measured by value added and employment. Under the growing pressure of the intensified global competition it faces a number of challenges. Manufacturing industry in Croatia is critical to the country's overall economic development at present and may affect the whole economy in the coming years. The Croatian manufacturing industry faces a number of threats and opportunities, which require the understanding of factors and strategies that drive performance of the companies.

Researchers express a growing interest in the examination of the competitiveness of the manufacturing industry as a whole and its individual sectors. Past research has identified various sources of competitive advantage in several industries, but those requirements seem to differ across different countries and industries. Far less attention has been given to the process of building competitive advantage in the Croatian manufacturing industry as a whole, although there are some studies related to the specific sectors in the manufacturing industry in Croatia (Anic, Rajh and Teodorovic, 2008a; 2008b; Anic et al, 2008a; 2008b).

This paper examines sources of competitive advantage in the Croatian manufacturing industry. Specifically, the analysis identifies and measures differences in performance among manufacturing firms, and focuses on the following research questions: RQ1: What is the relationship between firms' characteristics and their performance? RQ2: How is the strategic behavior of manufacturing firms related to firms' performance? Performance is defined as productivity measured as value added per employee. Comparison was made between high and low performing companies regarding firms' characteristics and their strategic behavior. In this study we focus on meso level determinants, including average company size, company experience, technological intensity, expenses per employee, average monthly wages, capital intensity, marketing intensity, new product development efforts, export intensity, average training expenses.

The data for this study was obtained from the company survey carried out during the period of October 2007 to December 2007 in Croatia. Data was analyzed using cross tabulation analysis (chi-square test) and one-way analysis of variance (ANOVA).

This study builds on previous work involving competitiveness, manufacturing strategy, industrial restructuring and performance in the manufacturing industry. It provides valuable insights into the factors associated with success in the manufacturing industry and the activities to be undertaken in order to improve the performance of the manufacturing firms. This study's findings provide to policy makers and executives guidelines and benchmarks for developing successful policy measures and business strategies. Managers may understand what affect their corporate success, while policy makers may receive valuable input in how they might effectively provide support for underperforming industry in order to secure jobs and value creation in the long run.

The paper's structure is as follows. After this introduction, section two briefly gives an overview of the Croatian manufacturing industry. Section three presents some selected previous works on analyzed topic. The methodology used in this research is presented

in section four, which is followed by research results in section five. Section six includes conclusions with theoretical and managerial implications, limitations of research, and future research directions.

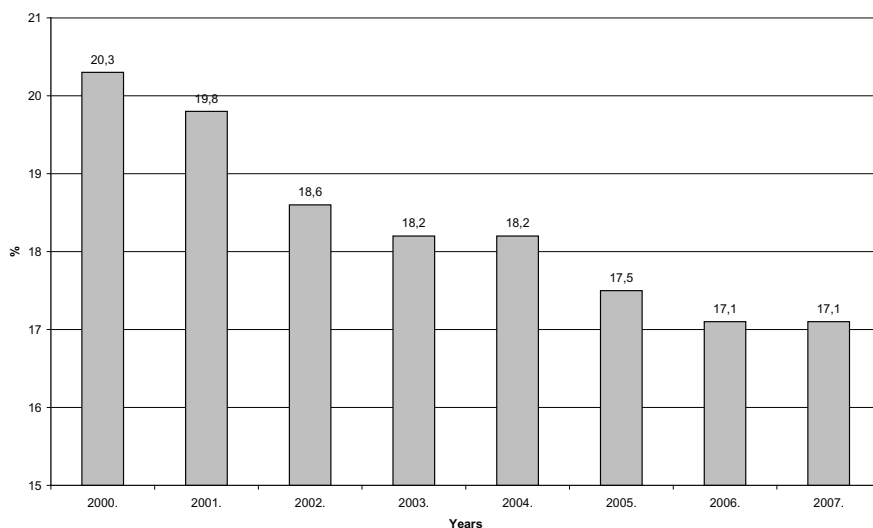
1. Overview of the croatian manufacturing industry

The manufacturing industry is an important economic sector in Croatia. It generates 17% of total gross value added (GVA) and participates with 20% in the total employment. The share of manufacturing in GVA has been declining since 2000. It decreased from 20.3% in 2000 to 17.1% in 2007 (Figure 1). At the same time the service industries increased their share in GVA. This trend has already been seen in other transition and post-transition countries in Europe (Veselica and Vojnic, 2007). The decline of manufacturing industry raises two big issues. The first one is related to the process of deindustrialization, while the second issue is the weakening of the competitiveness of the manufacturing industry that adds to it.

Since 2000 the Croatian manufacturing industry has undergone major changes. As shown in Figure 2, between 2000 and 2007 GDP and industrial volume increased. As compared to 2000 in 2007 GDP grew by 43.7% and industrial volume by 48.4%. There is a positive correlation between GDP and industrial output ($r=0.52$).

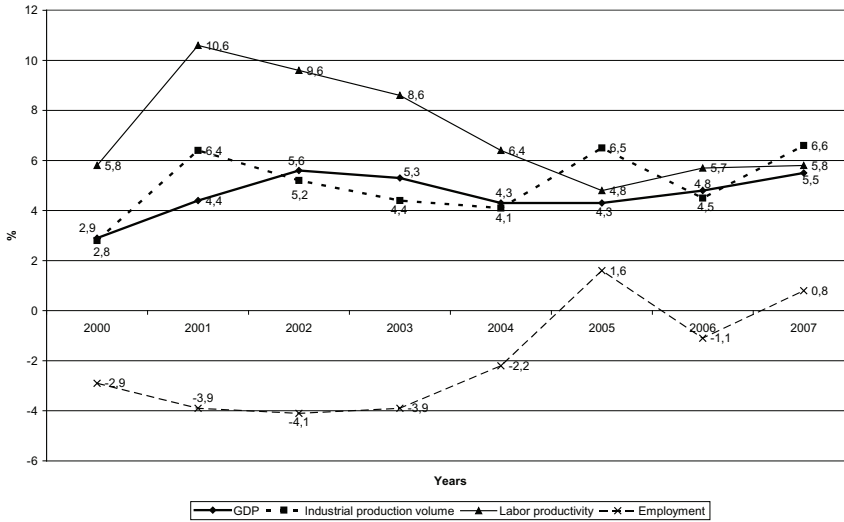
Labor productivity as one of the indicators of competitiveness is relevant for the analysis of the competitiveness of Croatian manufacturing industry. Correlation analysis indicates that there was a negative correlation between employment and productivity ($r=-0.81$). This indicates that manufacturing firms were restructuring passively in pursuit of short-term survival. Enterprises tried to reduce employment, while industrial output increased. On average, employment in manufacturing industry has been declining since 2000.

Figure 1: Share of gross value added of manufacturing industry in economy (in %)



Source: DZS RH.

Figure 2: Main development trends in the Croatian manufacturing industry, 2000-2007, chain indices, %



Source: DZS RH.

2. Theoretical background

Past research proposed various definitions and models of competitiveness at the national, sector-based and company level. Competitiveness is a comparative concept of the ability and performance of a firm, sub-sector or country to sell and supply goods and/or services in a given market. The “official” definition of OECD of a nation’s competitiveness is “the degree to which a country can, under free and fair market conditions, produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real incomes of its people over the long term” (Garelli, 2002).

When describing competitiveness it is important to distinguish between indicators which describe the economic results or outcomes and its determinants which include inputs necessary to achieve the result. When measuring outcomes past research takes into account productivity, profitability and growth indicators. Several studies indicate that productivity is a major performance indicator in various manufacturing industries, and that thus managers should consider all factors that could enhance productivity (Fischer and Schornberg, 2007).

The ability to compete depends on a number of factors. As for the analysis of sector competitiveness with “The Competitive Advantage of Nations” Michael Porter (1990) recognizes four pillars of competitiveness: factor conditions, demand conditions, related and supporting industries, firm structure, strategy and rivalry. The Irish National Competitiveness Council uses a Competitiveness Pyramid structure to examine the factors that affect national competitiveness. It distinguishes in particular between policy inputs

in relation to the business environment, the physical infrastructure and the knowledge infrastructure and the essential conditions of competitiveness that good policy inputs create, including business performance metrics, productivity, labor supply and prices/costs for business.

There is quite a large body of literature that examines the sources of competitive advantage at the firm level. There are several approaches to competitiveness at the firm level. One approach deals with resource-based view which examines internal resources and competencies of the firm (Barney, 1991). Another approach explores the competitive advantage as a positional advantage, which describes a firm's low-cost or differentiation strategy (Porter, 1985).

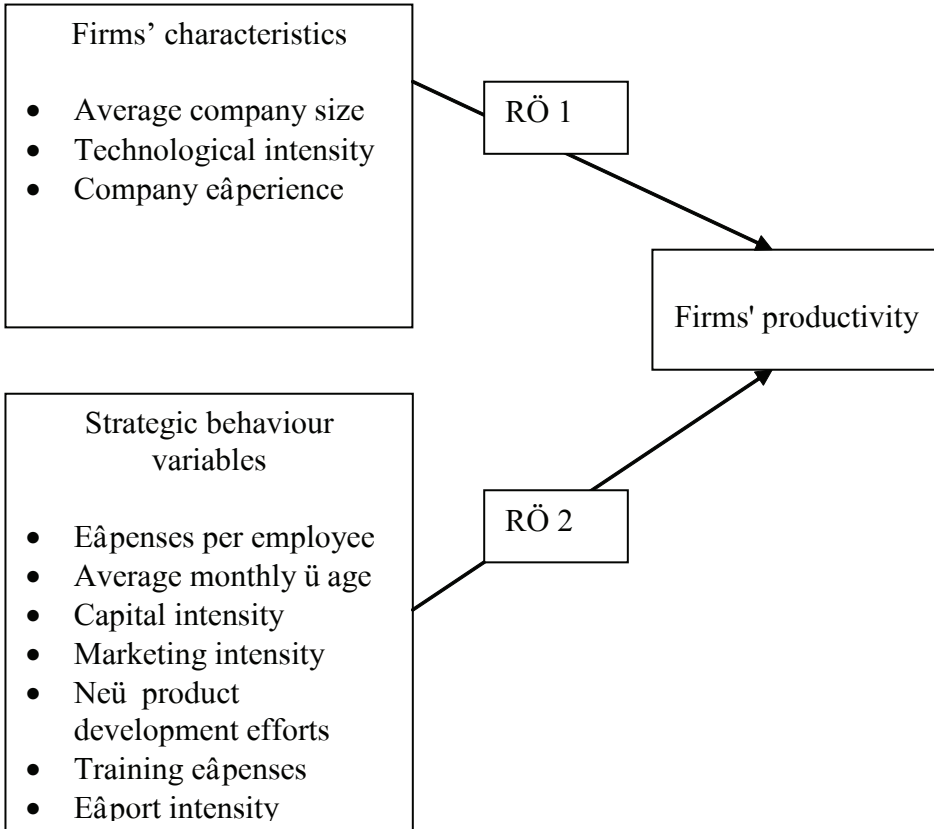
Firm performance is directly affected by competitive strategy (cost leadership and differentiation) and manufacturing strategy (Amoako-Gyampah and Acquah, 2008). Theory suggests that successful companies can follow either or both a low cost or differentiation strategy (Hall, 1980; Porter, 1980; Karnani, 1984). Both the competitive position and resource-based approaches have been integrated into a theory of competitive advantage that links sources of competitive advantage with positional advantage and performance in a single model (Wensley and Day, 1988). The model posits that superior skills and resources lead to positional advantage or competitive strategy which, in turn, leads to superior performance in the marketplace, and the results of superior performance.

Key issues in the concept of competitive advantage deal with the questions of which skills and resources are most effective, how they can be transformed into competitive positional advantage, and which combination of differentiation and low-cost strategies will product the best performance. Numerous previous studies have analyzed the causal links between growth and profitability, exports and productivity, market share and profitability, R&D and profitability, investments and growth, firms' size and productivity and the like (Goddard et al. 2005; Czarnitzki and Kraft, 2004; McKinsey, 2002; Koerner and Weiss, 2001; Bernard and Jensen, 1999).

This paper focuses on one particular economic sector - manufacturing industry in Croatia, which relies on the adapted competitiveness framework. This approach examines the relationships between the firms' characteristics, firms' strategic behavior and their performance. The conceptual framework used in this study is presented in figure 3.

This paper links three firms' characteristics variables and nine strategic behavior variables to value added per employee performance variable. A number of empirical studies have focused on productivity as a surrogate measure due to the limited access to other performance measures (Smith and Reece, 1999). Value added-based labor productivity is shown to be the single most frequently used performance measure (Fischer and Schornberg, 2007).

Figure 3: Conceptual model



3. Methodology

3.1. Survey and sample profile

The data for this study was obtained from the company survey carried out during the period of October-December 2007 in Croatia. The questionnaire was sent by mail to 644 leading manufacturers in the manufacturing industry - sector D following the NACE classification (NKD, 2002). The manufacturing firms were identified using the database of the Croatian Chamber of Economy. A total of 210 completed questionnaires were obtained, producing a response rate of 33%. The questionnaire included basic information about the companies, firms' financials taken from balance sheet and income statements, information on technologies, R&D, innovation activities, business organization and market-related data as well. Summary statistics on sampled manufacturing firms is presented in table 1 and table 2.

Table 1: Main business activity, n = 210

Main manufacturing industries	n	%
Manufacture of food products and beverages	17	8.1
Manufacture of tobacco products	3	1.4
Manufacture of textiles	16	7.6
Manufacture of wearing apparel, dressing and dyeing of fur	15	7.1
Tanning and dressing of leather, manufacture of luggage, handbags, saddlery harness and footwear	18	8.6
Manufacture of wood and of products of wood and cork, except furniture, manufacture of articles of straw and plaiting materials	17	8.1
Manufacture of pulp, paper and paper products	10	4.8
Publishing, printing and reproduction of recorded media	7	3.3
Manufacture of coke, refined petroleum products and nuclear fuel	4	1.9
Manufacture of chemicals and chemical products	15	7.1
Manufacture of rubber and plastic products	13	6.2
Manufacture of other non-metallic mineral products	8	3.8
Manufacture of basic metals	11	5.2
Manufacture of fabricated metal products, except machinery and equipment	11	5.2
Manufacture of machinery and equipment	6	2.9
Manufacture of electrical machinery and apparatus	10	4.8
Manufacture of radio, television and communication equipment and apparatus	1	0.5
Manufacture of medical, precision and optical instruments, watches and clocks	5	2.4
Manufacture of motor vehicles, trailers and semi-trailers	3	1.4
Manufacture of other transport equipment	9	4.3
Manufacture of furniture	10	4.8
Recycling	1	0.5
Total manufacturing industry	210	100.0

Table 2: Sample characteristics, n = 210

Company profile	
1. Company size (% of manufacturing firms)	
1.1. Small companies (less than 50 employees)	11.9
1.2. Medium-sized companies (from 50 do 250 employees)	43.3
1.3. Large companies (more than 250 employees)	44.8
2. Average revenues per company in 2006 (HRK)	341,261,461
3. Average export revenues per company in 2006 (HRK)	131,652,196
4. Average capital intensity in 2006 (HRK)	297,500
5. Average value added per employee in 2006 (HRK)	129,563
6. Sample share in total manufacturing revenues (%)	43.0
7. Sample share in total manufacturing employment (%)	34.5
8. Sample share in total manufacturing fixed assets (%)	38.7

According to the share in the Croatian manufacturing, the sample of manufacturing firms might be regarded as the representative one.

3.2. Measurement and data analysis

A review of relevant literature was used to develop measures for variables applied in this study, which was then adapted to the study context.

Table 3: Variable definitions and measurements

Variable name	Variable description
Firms' characteristics	<ul style="list-style-type: none"> • Average company size category includes (1) small companies (with less than 50 employees), (2) medium-sized companies (from 50 to 250 employees) and (3) large companies (with more than 250 employees). • In determining technological intensity manufacturing industries were classified according to their global technological intensity in the following four groups: (1) low technology, (2) medium-low-technology, (3) medium-high-technology, (4) high-technology (OECD, 2007). • Company experience variable includes (1) companies established before 1990, (2) companies established during the period of 1990-1999, and (3) companies established after 1999.
Strategic behavior variables	<ul style="list-style-type: none"> • Expenses per employee were measured in HRK. • Average monthly wage was expressed as the ratio of net month wages per employee in HRK. • Capital intensity was measured as the amount of fixed assets in relation to number of employees in HRK. • Marketing intensity was measured as the ratio of marketing expenses to total sales in %. • New product development efforts are expressed as the ratio of the expenses related to new product development to total sales in HRK. • Training expenses include all expenses that the firm is paying for education and training of their employees. They are expressed as the ratio of expenses for training to sales in %. • Export intensity was measured as the ratio of exports to total sales in %. • Sales volume and profit before taxes were expressed in HRK per employee.
Performance/Productivity	<ul style="list-style-type: none"> • Performance was measured in HRK using value added per employee. Value added was calculated by summing up wages, depreciation and profits before taxes.

Data was analyzed using one-way analysis of variance (ANOVA) and cross tabulation analysis (chi-square test).

4. Results

This paper linked firms’ characteristics, firms’ strategic behavior to firms’ performance (employee productivity). The RQ1 deals with the relationships between firms’ characteristics and their performance. Chi-square test results are presented in table 4. Chi-square test results show that significant differences ($p < 0.05$) existed in all observed firms’ characteristics variables between low and high performing companies. Accordingly, there are significant differences between high and low performing companies in company size, technological intensity and company experience.

Table 4: Chi-square test results: The relationships between firms’ characteristics and their productivity

Firms’ characteristics	Productivity level		p-value
	Low	High	
1. Company size (% of manufacturers)			
1.1. Small companies (less than 50 employees)	46.2	53.8	0.02
1.2. Medium-sized companies (from 50 do 250 employees)	68.5	31.8	
1.3. Large companies (more than 250 employees)	71.2	28.8	
2. Technological intensity			
2.1. Low	75.5	24.5	0.01
2.2. Medium-low	48.8	51.2	
2.3. Medium-high	55.2	44.8	
2.4. High	57.1	42.9	
3. Company experience			
3.1. Established before 1990	75.9	24.1	0.04
3.2. Established during the period of 1990 – 1999	56.7	43.3	
3.3. Established after 1999	60.0	40.0	

In the sample of manufacturing firms there were more small companies that exhibited higher productivity levels than medium-sized and large companies, while there were more medium-sized companies and large companies than small companies that exhibited lower productivity levels. These findings might be explained by the fact that small manufacturing firms use their resources more productively and have a lower share of administrative personnel, i.e. overhead expenses.

With respect to technological intensity, the highest proportion of low performing companies was in the group of the low technological intensity companies. The major causes are lower levels of value added and relatively higher levels of labor intensity.

In the group of companies with medium-low technological intensity was the highest proportion of high performing companies, which followed the process of restructuring more efficiently and thus decreased the number of employees. At the same time, there were more low performing companies than high performing companies in the group of medium-

high and high technological intensity companies, due to the higher depreciation of fixed assets and the presence of obsolete technologies.

The findings indicate that in the sample there were a higher percentage of younger companies that had higher productivity than older companies. Low performing companies were mostly companies with longer tradition, while younger companies belonged mostly to the group of the high performing companies. Younger manufacturing firms employ up-to-date equipment, have higher level of capital intensity and organize their business processes more efficiently.

The RQ2 deals with the relationships between firms' strategic behavior and their performance. As the findings of one-way ANOVA presented in table 5 suggest that significant differences existed between low and high performers in all observed variables ($p < 0.05$), except for new product development expenses ($p = 0.95$) and training expenses ($p = 0.15$).

Table 5: ANOVA results: The relationship between firms' strategic behavior and their productivity

Firms' strategic behavior	Productivity level		p-value
	Low	High	
1. Total expenses per employee (HRK)	309,906	870,787	0.00
2. Average monthly wage (HRK)	3,343	5,190	0.00
3. Capital intensity (HRK)	199,419	491,011	0.00
4. Marketing intensity (%)	1.1	3.3	0.04
5. New product development expenses (%)	1.3	1.3	0.95
6. Training expenses (%)	0.2	0.4	0.15
7. Export intensity (%)	45.4	32.6	0.01
8. Volume of sales per employee (HRK)	312,400	926,532	0.00
9. Profit per employee (HRK)	5,095	97,231	0.00

High performing companies had higher expenses per employee, paid out higher monthly wages and had higher marketing intensity. At the same time, high performing companies had higher sales per employee and generated higher profitability, as compared to low performing companies. High performing companies in the Croatian manufacturing have higher costs and invest more in marketing and thus follow differentiation strategy. As the theory suggests (Hall, 1980, Porter, 1980, Karnani, 1984), a successful differentiation strategy increases the firm's costs, but provides attractive high-quality products and services that produce superior sales, market share and profitability.

As expected, high performing companies had higher capital intensity. The use of capital equipment makes labor more productive. Increased capital intensity raises the productivity of labor. Higher labor productivity enables companies to pay out higher wages. At the same time, higher productivity contributes to higher profitability. Past research indicates that productivity is higher in more capital-intensive sectors. Those sectors tend to be highly profitable (Ahrend, 2006; Ghosal and Nair-Reichert, 2009).

The findings of ANOVA show that significant differences existed in export intensity across high and low performing companies ($p < 0.05$). Surprisingly, low performing companies

had higher export intensity than high performing companies. As the theory suggests, the relationship between export intensity and productivity depends on the structure and value of exports and the level of income of importing country (Crinò and Epifani, 2008).

The findings of one-way ANOVA show that no significant differences existed among the two firm types in new product development expenses ($p=0.95$) and training expenses ($p=0.15$). Low levels of investments in new product development and training activities in the Croatian manufacturing industry may explain these findings.

CONCLUSION

This paper explored the relationships between firms' characteristics, firm's strategic behavior and their performance in the Croatian manufacturing industry. Performance was measured as productivity (measured as value added per employee). Our first contribution is the identification of the impacts of firms' characteristics on productivity. The results indicate that company size, technological intensity and firms' experience do affect the performance differences. Accordingly, more small companies were found to have high productivity than medium-sized and large companies. High performing companies had higher levels of technological intensity. A higher percentage of younger companies appeared to have higher productivity than older companies. On the other hand, low performing companies were mostly medium-sized companies and large companies, had lower levels of technological intensity and were older companies according to their age of operation.

Our second contribution is the identification of the relationship between firms' strategic behavior and their productivity. Several factors were identified to contribute to productivity. As compared to low performing companies, high performing companies are companies that reported higher expenses per employee, higher monthly wages and higher marketing intensity. They exhibited higher capital intensity. High performing companies had higher volume of sales per employee and higher levels of profit per employee. Interestingly enough, high performing companies were found to have lower export intensity, while differences in new product development expenses and training expenses were not found to be statistically significant.

The findings of this paper have implications for the design of the Croatian development strategy of the manufacturing industry and the formulation of the policy measures targeted towards enhancing the competitiveness of the manufacturing industry. The strategy should take into consideration the repositioning of the manufacturing industry according to changing market environments and the EU strategic documents. Policy measures should among others focus on creating more favorable investment and business environments in which manufacturing firms would invest more in technology, marketing and human resources, and seek to increase the levels of capital intensity. Those factors have been identified as being important for achieving higher levels of productivity. Since investments in R&D and new product development are overall considerably low as compared to international benchmarks, the policy measures should additionally put more efforts on those issues. According to the EU standards and guidelines, those identified measures might be realized by using horizontal and regional state aids.

Furthermore, several managerial implications might be derived from the findings of this

study. Firstly, companies should seek to enhance the productivity level. If the productivity increases, sales and profits will increase too. In order to increase productivity (i.e. value added per employee) a higher investment level is necessary, mostly in new technology, know-how and marketing. Since past research suggests that new product development is a crucial element of business strategy, it is advisable for managers to focus on this aspect and to design new approaches for market repositioning of their companies. Managers should be aware to greater extent to allocate more resources for human capital development and enhancing labor skills and competencies in their companies. In order to have skilled labor and sustain the best workers, it is necessary for companies to increase the level of productivity, which would help them pay out higher wages.

Although this study produced some interesting and meaningful findings, there are some limitations as well. First, although the data employed in this research were better than previously available ones, more abundant and richer data would have enlarged the scope of analysis. Like most survey studies, this study took a “snapshot” of a sample of the industry at a single point in time. Several years of data would have provided further information as to how strategic behavior changes. Despite these limitations, the results of this study offer useful insights into the productivity and sources of competitive advantage in the Croatian manufacturing firms.

There are several areas in need for further research. In order to understand the sources of firm’s competitive advantage, scholars should carry out longitudinal studies to capture how sources of competitive advantage and firms’ behavior evolve over time. More accurate measures of performance and firm’s strategic behavior should be conceived and tested.

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THE INVESTMENT IN HUMAN CAPITAL – THE RIGHT WAY TO ENHANCE COMPETITIVENESS IN BALKAN TRANSITION ECONOMIES

Abstract

The aim of this paper is to discuss and to point out the need of the investment in human capital, in order to increase competitiveness of Balkan transition economies. At the very beginning of this paper it is presented the role of human capital in a knowledge-based economy. Intention is to show that high competent employees positively influence companies' performance and competitiveness, which would, in turn, contribute to the competitive economy. Further, it is considered what Balkan transition economies should do, in order to improve their human capital. The main accent is placed on need of establishing a better quality of higher education system and more investments in a science and technology development. After that, in this paper, there are analyzed the reforms of higher education systems in Balkan transition economies. Research findings provide an insight into the improvements in higher education systems that have been already done in Balkan transition economies, problems that have to be solved, and the effect of higher education on human resources development. The implications of these findings, both theoretical and practical, are discussed.

Key words: *human resources development, higher education system*

INTRODUCTION

At the beginning of the 21st century all the economies in the world have been faced with a lot of challenges: fast and radical changes in the environment, increasing global competition, global financial crisis, increasing importance of new information technologies, and domination of knowledge as a key factor that influences competitive advantages. Traditional sources of competitive advantage, such as production capacities, access to financial resources, distribution channels or economies of scale, are necessary but not sufficient for success in today's business world. In such circumstances it is crucial for every country's economy, no matter is it developed, developing or transition, to have well educated, skilled and competent people. Lifelong learning, education and training are prerequisites for adaptation to international and local environment and they are the main factors that influence the overall socio-economic development of any country. Human resources development improve the quality of human capital, increasing the level of employment, the level of income and social integration, which in turn lead to the increase in living standards. In fact, human resource development is an investment in human capital, which is actually the investment in people. European standards encourage the development of human resources through investment in education and training, employment, small and

medium-sized enterprises, and regional development. Balkan transition economies in their efforts to adopt the European standards, enhance competitiveness, and become more attractive for foreign direct investments have encountered a lot of problems and challenges. Human resource development represents one of the most important one.

1. The role of human capital in a knowledge-based economy

In a knowledge society, competitiveness is to have the knowledge advantage. If a company wants to grow and develop, it has to answer on the challenges of the global market, faster and better comparing to its competitors. One of the key conditions for achievement of this goal is the existence of high competent employees. Human capital is actually one of the most important source of companies' competitiveness and it also influences economic development of a country and facilitate FDI.

Here, it will be shortly discussed a few theories which are focused on the importance of human capital in facilitating FDI, explaining country's development and international competitiveness. They are: Monopolistic advantage theory, Internalization theory, International technology gap theory and Porter's competitive diamond. Proponents of Monopolistic advantage theory argued that investor firms typically possess monopolistic advantages that enable them to succeed over indigenous firms in their operations abroad. These monopolistic advantages stem from superior knowledge and/or oligopoly. Superior knowledge pertains to the investor company's intangible assets, such as 'technology, management and organization skills, marketing skills, and the like (Root, 2001, pp. 376). These intangible assets reside within the human talent in the firm. Thus, in order to gain a competitive advantage firms seek to acquire and retain such human talent. Internalization theory, also known as transaction-cost theory, asserts that firms seek to lower transaction costs by replacing external markets with internal flows (Casson, 1987; Root, 2001). In the context of new knowledge generation, 'the most direct way to prevent disclosure and thereby earn monopoly rent is for the firm to internalize its knowledge. Instead of selling its knowledge to outsiders, the firm applies that knowledge only to production under its control (Root, 2001, pp. 378). The creation and transfer of new knowledge are made possible by and through human talent in the organization. Thus, in order to attain and maintain a firm's competitive advantage and excel abroad, it is imperative that the company succeeds in attracting and retaining human talent. Internalization theory is also known as the product life-cycle theory of international trade (IPLC) (Vernon, 1966). It explains how imitator countries close the technology gap by acquiring and learning the technology of the innovator country, so much so that over time, the innovator country becomes the net importer of the product that they developed. In order to close the technological gap, the imitator country has to possess the human power that can acquire and absorb the advanced technology. Porter's competitive diamond seeks to account for a country's international competitiveness through an analysis of its factor conditions; demand conditions; related and supporting industries; firm strategy, structure and rivalry; government; and chance (Porter, 1990). The "factor conditions" refer to a country's factors of production, labour (or more specifically, human capital) being one of them. By analyzing these four theories we can realize that all of them point to the pivotal role that highly trained and developed human resources – human capital or talent can play in affecting a country's ability to expand abroad through FDI and/or gain international competitiveness.

One of the most important studies in the field of human capital in the European Union is the study which was conducted by the Lisbon Council from the Brussels and Accenture

Consulting. The study highlights that the transition to the economy based on knowledge, requires combination of skills (such as technological, information, problem solving skills, adaptability and team work) and specific knowledge (such as engineering, mathematics, languages and economics). The study “skills for the future,” emphasizes that while individuals should take responsibility for the development of their own skills, business sector (employers) should have a significant role in determining which skills are needed by individuals. Educational institutions must be developed having in mind that education should be continuous developmental process that lasts the entire life. Also, policy and decision makers must play a key role in supporting and boosting these actions. (Huskić, 2007-2008, pp.5)

All countries in the European Union pay great attention on investment in human resources development. But, one of the best examples of positive effects of investment in human resource development is Ireland. Three decade before, Ireland depended on help of rich countries. Today, its GDP per capita is the second highest in the EU. In front of them is the only Luxembourg. The key to their success is a planned development, implementation and management of investment in human capital. In the National Development Plan, Ireland highlights the crucial role of development human capital for the economic growth and development. Investment under the Human Capital Priority of NDP 2007-2013 is indicatively estimated at €25.8 billion. The investment and funding source by Programme is set out below.

Table 1: Human capital priority

Programme	All figures in €million current prices					Total
	Exchequer	PPP	Local Auth.	State Bodies	NTF (National Training Fund)	
Training & Skills Development	4,785	0	0	104	2,829	7,718
Schools Modernisation & Development	4,521	540	0	0	0	5,061
Higher Education	12,422	595	0	0	0	13,017
Human Capital Total	21,727	1,135	0	104	2,829	25,796

Source: Ireland’s National Development Plan, 2007-2013, Chapter 9: Human Capital Priority http://www.ndp.ie/documents/NDP2007-2013/NDP_Main_Ch09.pdf

Investment in education, training and upskilling, broadly termed as investment in human capital, has played a very important role in Ireland’s successful economic performance. The biggest amount of many, as it is presented at the table above, has planed for higher education. It has provided a well skilled and flexible labour force and thereby helped make Ireland a major attraction for domestic and foreign enterprises. Ireland was particularly successful in harnessing European Social Fund (ESF) receipts to very good effect. Human Capital funding in the Plan 2007-2013 will be domestically generated but the objective will still be to ensure access to a very good standard of education and training for all and, in particular, to provide the labour force with the skills and adaptability to meet the challenges of the future. (Ireland’s National Development Plan, 2007-2013, pp.190) Similar to Ireland, the other European countries too, have come to the conclusion that investment in human resource development is vital to their economic development and international competitiveness.

Balkan transition economies should take an example from the European countries and pay more attention on investments in human resources. There are open opportunities for transition economies to develop human resource, by using the new EU program of help. Candidates and potential candidate countries for the accession to the EU can receive help in transition and institution building and in improving regional and transborder cooperation. Beside that, countries candidates can receive help in regional development, human resources development and rural development. (Huskić, 2007-2008, pp.4) It's up to transition countries whether they would be capable to use that chance in the best possible way, or wouldn't.

2. Higher education as an investment in human capital that pays individual and social dividends

As it is presented in the Ireland's example investment in the higher education is actually investment in human capital. As well as, many surveys show that education is an investment in human capital that pays individual and social dividends. Data from the U.S. Bureau of Labour Statistics show that earnings rise and unemployment declines for each higher level of education. (Schiller, 2008, pp. 17) According to the data from the Brazilian Statistical Bureau, in 1998, the difference between a monthly wage of a university graduate and a worker with no degree was 814% (Blom, 2001, pp.185). This undoubtedly indicates that education is a key determinant of wages in Brazil. But relation between level of education and wages wasn't examined only in the developed and developing countries, no it was a subject of a great interest in transition economies, as well. Valuation of human capital and the role of education have attracted a great deal of attention in the studies on the pro-market reforms in post-socialist economies. A large body of literature has documented substantial rise in private returns to education during early transition from central planning to market economy: (Krueger and Pischke, 1995) for East Germany, (Rutkowski, 1996) for Poland, (Chase, 1998) for Czech and Slovak republics, (Kertesi and Kollo, 2002) for Hungary, (Lubyova and Sabirianova, 2001) for Russia and Slovakia. In 2004 year, research was conducted in Bulgaria, Romania and Serbia and the results provide estimates of returns to education. The results indicate that there are significant differences in the "marketability" of different types of education. Tertiary education is highly and increasingly rewarded in all three countries for both sexes. Despite the largest relative supply of higher educated in the labour force in Bulgaria, they receive much higher wage premium than their counterparts in Serbia and Romania. It is also interesting to point out that labour markets in Serbia and Romania provide higher rewards to education for men than for women. In both countries for men, each succeeding educational level brings wage premium but for women only the higher education brings a significant wage premium. Further explanation of the differences in valuating human capital between men and women in Romania and Serbia may be found in the different employment compositions and chances of salaried employment across gender. The analysis also reveals significant positive contribution of the individual post-graduate training to the wage determination. This finding hints at the existence of some imperfections in the formal educational systems and their incapability to respond fully to the current labour market demands. (Arandarenko et al, 2006, pp. 15)

In Serbia the difference between average salary of highly educated employees and unqualified workers, in 2008 year, is very significant. The detail data are presented in the table 2.

Table 2: Employees, according to education level and average salary in September 2008

Values in dinars

	Republic of Serbia							
	Total		Central Serbia				Vojvodina	
			The rest		Belgrade			
	Number of employees	Average salaries and wages	Number of employees	Average salaries and wages	Number of employees	Average salaries and wages	Number of employees	Average salaries and wages
Total	1100875	45406	812040	45777	332322	56250	288835	44364
VIII (The highest level of education)	215933	75370	162698	75716	80171	87573	53235	74312
VII	89055	51094	66373	50910	26771	59851	22682	51632
VI	348396	41219	253389	41635	112978	48444	95007	40109
V	50369	27024	34815	27536	13150	34108	1554	25880
IV	57780	47613	47201	47702	23587	55419	10579	47213
III	194596	35024	144924	34790	47396	42366	49672	35706
II	60673	28984	46857	28288	14954	30651	13816	31344
I	84073	25153	55783	24151	13315	28155	28290	27129

Source: Statistical Office of the Republic of Serbia, *Communications-Employment and Earnings*, no. 357. LVIII, 29.12.2008., pp. 6.

As it can be seen from the table, the data from the Statistical Office of the Republic of Serbia show that the difference between salaries of the highest level of educated employees and unqualified workers in September, 2008 was 256,83%. For the same period, the structure of the unemployed, according to their qualifications is presented in table 3.

Table 3: The structure of the unemployed, according to their qualifications

Level of education	Number of unemployed people	Percentage of unemployment
VIII (The highest level of education)	33persons	-
VII	30.546	4,2%
VI	29.696	4,1%
V	8.973	1,2%
IV	196.188	27,0%
III	192.833	26,5%
II	39.273	5,4%
I	228.923	31,51%

Source: Republic of Serbia National Employment Service, *Monthly Statistics Bulletin Unemployment and Employment in the Republic of Serbia*, No. 73, September, 2008, pp. 15.

The data given show that with increase in education level wages rise, whereas unemployment rate falls. Thus, it is perfectly understandable that more and more people see education as an investment that would provide them with a job, higher earnings and better life quality. Not only that education has positive implications for individuals, but there is compelling

evidence that human capital and education are potentially important driving forces in the determination of long-run growth; see e.g. Lucas (1988), Barro (1991), Stern (1991) Mankiw et al. (1992), Benhabib and Spiegel (1994), Rehme (2007), etc.

All in all, having in mind that higher education has a significant role in the development of an individual as well as economy, higher education institutions are in front of a great challenge of how they can respond appropriately to the needs of the society and the global market.

3. The process of higher education reform in the Balkan transition economies - case study of Serbia

Increasing internationalization reaches also the worlds of teaching, learning and research. Universities cannot escape the consequences of globalization and the heightened atmosphere of competition this creates in a situation in which financial resources are harder to obtain. The new trends can be seen in terms of universities as knowledge brokers, global markets for students, international student and faculty mobility, international diploma recognition, availability of programmes through Internet, and the development of strategic alliances between institutions as providers on a global basis. Rapid advances in communication technologies in recent years have made collaboration and co-operation between institutions of higher education increasingly possible and desirable both within and among countries. At the same time, reduced funding for research programmes make inter-institutional collaboration increasingly necessary. Not all the internationally-gearred changes are positive, though, and higher education institutions in weaker countries risk losing further relevance unless adequate strategies of twinning and co-operation are set in place. At the same time, higher education institutions have a key contribution to make to realizing both sub-regional imperatives and at the regional levels within distinct national contexts where the role of higher education institutions as actors of regional economic development/agents of urban development is growing rapidly.

Confronted with those challenges, Balkan transition economies had to keep pace with the trend of reforms in the process of obtaining higher education qualifications in Europe, defined by the Bologna process and EHEA (European Higher Education Area). The intention is to make it possible for students to compare their qualifications with the qualifications acquired by students at other European higher education institutions, as well as the possibility of improvement of student exchange programmes or continuation of studies at a related institution in Europe, which is a prerequisite for future integration processes and free exchange of intellectual resources in Europe.

All Balkan transition economies made a series of measures in order to implement Bologna declaration, but here it will be presented the measures that Serbia made. Namely, the Republic of Serbia adopted the Law on Higher Education in 2005, which implements completely the Bologna Declaration, signed by Serbia in September 2003. With that act Serbia bound itself to coordinate higher education policy with a group of European countries, the aim of it being to form European zone of higher education by 2010 and, at the same time, to preserve cultural, linguistic and national specificities, which is one of the basic postulates of Bologna Declaration. According to Article II of the Law on Higher

Education (hereinafter: the Law) the field of higher education is of special importance for the Republic of Serbia as it is a part of international, and especially European educational and scientific field. Three subjects are responsible for the Law's implementation: the National Council for Higher Education, the Commission for Accreditation and Quality Assurance and the Ministry.

Immediately after it was set up, the National Council for Higher Education and the Commission for Accreditation and Quality Assurance started making norms and standards, so that the accreditation of higher education institutions and study programmes in compliance with Bologna Declaration could start as soon as possible. The European Qualifications Framework was taken as a point of departure, as well as the experience of majority European countries signatories of Bologna Declaration, with the aim to adjust it and implement as much as possible in the system of higher education in Serbia. The National Council approved the following acts on October 20, 2006: Standards for Accreditation of Higher Education Institutions and Study Programmes, Standards for Self-certification and Assessment of Quality of Higher Education Institutions, and the Standards and Procedures for External Quality Assurance of Higher Education Institutions. On December 11, 2006, the Commission for Accreditation and Quality Assurance became a full member of INQAAHE (International Network for Quality Assurance Agencies in Higher Education). (Grupa autora, 2007, pp.3).

The novelties in the Law are a consequence of the legislator's intention for the system of higher education in Serbia to become a part of international, especially European educational area, as well as to enable Serbia's institutions to enter the process of acknowledgement of higher education qualifications in Europe. They are mostly reflected in types and levels of studies, introducing the European credit transfer system (ECTS – a system of unique point scoring for students' study obligations), creating study programmes that are compatible and comparable to study programmes organized/carried out at higher education institutions in other European countries, and providing quality of higher education. The innovations mentioned are indispensable assumptions for synchronization with European system of higher education and improvement of academic mobility of professors and students, which were postulated in the Law, article IV, as one of the principles of higher education.

When it comes to types and levels of studies, the Law makes difference between three levels of studies. First level studies are basic academic studies and basic professional studies. Second level studies are graduate academic studies – master, specialist professional studies and specialist academic studies, whereas doctoral academic studies represent third level studies. The previous law did not offer professional studies, master studies, nor doctoral studies, but only basic academic studies, postgraduate studies and doctoral dissertation. Basic academic studies may last three or four years, whereas master studies last a year or two, depending on the duration of basic studies. More precisely, the volume of studies is expressed with the sum of ECTS credits, which is yet another novelty in the Law. Namely, a certain number of ECTS credits are assigned to every course within a study programme, whereas the volume of the studies is indicated with the sum of ECTS credits.

Legal solutions that are given, seen in providing high quality, transparency, measurability of study work-load and introduction of European credit transfer system, are all in the function

of involving Serbia in a unique European high education area, which creates conditions for higher mobility of students.

As it is already mentioned, in Serbia standards for accreditation are adopted, too, in order to improve quality of higher education institutions and programmes. Standards for accreditation of higher education institutions comprise 13 standards. They are as follows: basic tasks and aims of a higher education institution, planning and monitoring, organization and management, studies, educational-scientific and artistic work, academic staff, non-academic staff, students, facilities and equipment, library, course books and information technology, financial resources, inner mechanisms for quality assurance, public character of their work. Twelve accreditation standards of the study programmes are: the structure, purpose and objectives of the curricula; competences of the graduates; curriculum; quality and international compliance of study program; enrolment of students, their grading and promotion; the faculty staff; material resources; quality control; and distance learning.

Obviously, the purpose of Standards for accreditation of higher education institutions is assuring the quality of their work by making it better. Namely, higher education institutions are required to define clearly and in detail strategy of ensuring the quality of teaching process, management of higher education institution, extracurricular activities, as well as conditions of work and study. Higher education institutions are especially urged to monitor the quality of teaching, conducting the exams, students' efficacy during the course of their studies in the whole as well as in specific subjects, the quality of the course books, and taking actions for removing perceived faults. It is important to emphasize the active role that students have in adopting and implementing the strategy of quality assurance. The assessment of teaching process quality, established through a poll given to students, is especially important.

The purpose of Standards for accreditation of study programmes is improving their quality, which is a prerequisite in students' obtaining competence and, consequently, creating high-quality and competent human resources. Study programme quality control implies constant and systematic monitoring of its realization and taking actions for the improvement of the quality regarding curriculum, teaching, professors, assessment of students' course books and required literature. These measures aim to ensure obtaining competence and academic skills which are socially justified and useful. Attempts are made to achieve both development of creative skills and acquiring specific practical skills needed for practicing a profession. Specifically, the main aim of the Standards for accreditation of study programmes is encouraging development of competences, namely general competences or transferable competences and course-specific competences which serve the function of realizing professional and scientific occupation at a high level of quality. Focus on the results of study programmes expressed in competences is rather evident. Hence, competences, by which we imply synthesis of theoretical and practical professional knowledge and skills, are a global aim of education. (Devjak, 2008, pp. 2).

Implementation of quality of standards, established in the Law on Higher Education and Bylaws on standards is of essential importance for the improvement of the quality of higher education system and involvement of the Republic of Serbia in the unique European area of higher education.

However, the reform of higher education is a great challenge for all Balkan transition economies, as well as for the Republic of Serbia. On their way, the institutions are confronted with various problems, like: insufficient financial resources for quality improvement, deficit in competent professors in some field of science, inadequate management in higher education institutions, outdated equipment and etc. So, they made a first step in their improvement, but they must to do much more.

CONCLUSION

In this paper it have been confirmed a correlation between human capital, economic development and facilitating FDI. It has been presented an example of an Ireland who had a great successful investment in human capital which had in turn contributed to its economic development. It has also been point out that the most percentage of investment in human capital was in the improvement of quality of higher education. Having, in mind those facts, it can be conclude that it is crucial for every Balkan transition economy to invest more in improvement of a higher education system. High quality higher education will provide competent experts capable of using their knowledge to contribute to economic growth and development of the country. Beside that, people are becoming more aware of the fact that by investing in their own education they get the chance to find a better job and improve their life circumstances. Thus, it can be stated that in the 21st century the institutions of higher education are becoming more important, not only to a country but also to an individual. As well as, higher education institutions must promote processes aimed at regional integration. Cultural and educational integration should be the bases for political and economic integration. In a global environment, higher education institutions must approach their studies on regional integration in the light of the specific economic, social, cultural, ecological and political aspects involved. Greater emphasis should be given to the regionalization of specific disciplines, through programmes which target specific needs that will generate employment.

At the very end of this paper it should be said that Balkan transition economies advanced their higher education system to a great extent by implementing Bologna Declaration. However, what is still left to be done is: to define a clear education policy, to invest more intensely into the development of science and education, to adopt the National Strategy of the higher education system reformation, as well as to follow the process of implementation of the international standards and to constantly pass and adopt National Reports on Bologna Process Implementation. All the regulations mentioned, with appreciating the experiences of other countries in the region, would be used to make hypotheses for even more successful reformation of the higher education system. When the institutions of higher education are concerned, they have faced reality that the world is changing and they need to follow it. If Balkan transition economies want to have high quality higher education institutions which would be able to compete with the other higher education institutions in the world, they need to invest much more money in education and science research. It is the only way to develop their human resources and achieve international competitiveness.

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COMPARISON OF MARKETING ACTIVITIES BETWEEN MNCs AND DOMESTIC COMPANIES IN SERBIA

Abstract

The aim of this study was to examine differences in marketing orientation and marketing activities between MNCs' subsidiaries and local companies in the Serbian market. In order to investigate it, research addressed three issues: a) whether companies find marketing orientation as an important part of their business strategy; b) what kind of marketing activities they perform; and c) how many employees work in marketing department. Previous studies undertaken on this matter, primarily focused on marketing activities in transnational companies, therefore there is very scarce number of studies that investigated this topic in developing countries. It could be noticed that the implications of this study are numerous, referring to exchange of marketing capabilities between MNCs' affiliates and local companies. Research evidence suggest that transnationals have larger marketing units and conduct larger variety of marketing activities than domestic companies. Furthermore, MNCs are more aware of the importance of incorporation of marketing orientation in the total business system, while local firms tend to underestimate strategic role of marketing – planning and control are highly disregarded in Serbian firms.

Key words: *marketing activities, MNCs' subsidiaries, Serbian companies, organization of marketing unit*

INTRODUCTION

The process of transition, which took place in 1990s in Eastern Europe (and in Serbia is still actual), primarily meant the change from centrally oriented economies to market oriented ones (Enew, Wright and Kirnag, 1996). The main difference has occurred in the approach to customers – marketing gained on importance. Marketing is not only much broader than selling, it is not specialized activity at all. It encompasses the entire business. It is the whole business seen from the point of view of the final result, that is, from the customer's point of view (Drucker, 1993). Keeping in mind such complexity of marketing, it is very difficult to establish valid parameters: a) to determine whether organization has adopted marketing concept and b) to review all marketing activities in some company.

1. Literature review

However, some generalizations can be made. Literature review indicates that there are three streams of studies conducted on this matter. First, the structural role of marketing has

been investigated thoroughly in transnational corporations, and show that there are great differences in the location of the marketing function among companies (Workman et al, 1998; Achrol, 1997). Second, studies reveal that marketing has power, while it depends on environmental conditions (Homburg et al, 1999). Finally, research into the organization of marketing activities finds that wide variations exist (Tull et al, 1991) and it should be investigated in more detail in the future. A major drawback lays in fact that all previous studies focused large, multinational companies, while marketing strategy and activities in small, domestic companies are currently understudied.

It should be noted also that there is not any significant differences between service and manufacturing firms in their approach to goals, policies and overall plans for their offerings (George and Barksdale, 1974). More precisely, industry sector and societal context, firm size (Hise, 1965) and global orientation explain a significant proportion of the influence of the marketing function on strategic decision making (Homburg et al, 1999). Since MNCs are always larger, more territory spread and more globally oriented than domestic companies, local firms need to overcome some obstacles in order to achieve level of marketing activities of MNCs.

There are numerous problems that should be bypassed by local firms. Several studies have discussed the technology and productivity gaps between MNC affiliates and local firms, and highlighted the importance of absorptive capacity: local firms need to have sufficient innovative capabilities to adopt technologies introduced by MNC (Girma, 2003; Kinoshita 2001). In the European transition economies, where “soft” technology – marketing and management are weak, it can be argued that outward-oriented MNCs might provide some of the skills that are in shortest supply (Kokko and Kravtsova, 2006).

Furthermore, it could be stated that labour mobility is limited in developing countries, due to high wage gap that exists between MNCs’ subsidiaries and domestic firms. Actually, employees prefer to work for foreign companies regarding the fact that they can earn higher salaries and their jobs are more secure (Wang and Blomstrom 1992; Sjöholm, 1999). Therefore, marketers are more attracted to look for a job in multinationals.

It is usually supposed that MNCs’ subsidiaries have adopted and apply marketing orientation completely. However, that is not always a case. Subsidiaries could just sell the parent’s products in the host country and do not engage in local production or in marketing activities at all. In that situation, they have small sales department in host countries, which also deal with marketing activities (Kokko and Kravtsova, 2006). Moreover, parent company can opt to centralised organisational structure and impose certain limitations on activities to protect the brand name, as it was recognized that the individualism of branches could dilute the overall brand (Lloyd and Ogbonna, 2003).

Previous studies (Javorcik, 2004; Yudaeva et al, 2004) imply that higher educational level, better infrastructure, stronger financial sector, better protection of intellectual rights and other indicators of relatively high development of domestic country lead to larger and more diversified marketing departments of MNCs’ affiliates. With regard to that, some specifics of Eastern Europe and Serbia must be taken into consideration.

Despite the fact that many studies have stressed that the contribution of marketing to the

process of transition is significant (Thomas, 1991) there are still many limitations that diminish its total effects (Hooley, 1993). Although marketing helps the processes are done more efficiently than before, some structural problems that the companies have to overcome are quite challengeable.

There are several constraints that firms have to take into consideration when adopting and practicing marketing orientation in transitional countries. Namely, those are the general infrastructure problems (Thomas, 1991), the lack of managerial expertise, weakness of supporting industries (Buntzman et al, 1993), perception barriers (McDonalcd, 1993; Shipley and Fonfara, 1993), etc. Naturally, if monopoly prevails in the market, then marketing just adds to the costs, without increasing revenues.

Some factors driven by demand should be noted also. Excess demand, characteristic for many segments of Eastern Europe lessens the importance of marketing. Moreover, limited competition implies that consumers do not have valid choice, and therefore, many buyers lack reference points when new brands enter a market (Becker and Baker, 1995). On the other hand, in some markets, excess supply is present, however, low purchase power for these consumers restrains the marketing development.

In order to accelerate overcoming of listed problems most Governments in transitional countries are offering some incentives to foreign companies in order to bring them to the domestic market and achieve certain benefits of foreign direct investments (FDI). The most common advantages of FDIs are productivity and technology spillovers, while managerial and marketing effects are not as much obvious. Setting up of foreign MNCs' subsidiaries usually is accompanied with bringing of some company-specific intangible assets that enables them to be competitive in domestic market. Some of these intangible assets, marketing among other knowledge, can be expected to spill over to local firms over time as a result of employee turnover, linkages, or simple demonstration effects (Kokko and Kravtsova, 2006). At the same time, learning from the experiences of MNCs and bridging their mistakes, business in the developing countries may much better address marketing issues and benefit from that.

As mentioned before, literature review reveals strong gap in this field of study. With just a few studies referring to the examination of how marketing strategies differ between local firms and MNCs' affiliates in developed countries almost nothing is known about it in a country in transition such as Serbia. Therefore, the purpose of this paper is to examine whether there is the difference in adoption of marketing strategy and executing of marketing activities between Serbian companies and MNCs' subsidiaries, which are doing their business on the territory of Serbia.

2. Research design and methodology

In order to address possible variations in marketing approach in MNCs and domestic companies, we investigated the differences in marketing practices between Serbian companies and MNCs operating in Serbia. We are starting from premise that foreign companies operating in Serbia conduct unified marketing practices which reflects their

global orientation.(Homburg et al, 1999) We focused our investigation on the following research questions:

- Do local and foreign companies comprise the same set of marketing activities?
- Up to what extent they find the marketing is significant for their business success?
- How many employees are involved in conducting marketing activities?

If Serbian companies in large extent perform the same activities as MNCs and consider marketing orientation as very important, then it is reasonable to conclude that approach to marketing of both local and multinational firms is quite similar. Furthermore, one of the expected results is the larger staff employed in marketing department in foreign companies as far as the total number of their employees is much greater than the number of employees in domestic companies. If, on the other hand, prevail that Serbian companies apply their own, particular marketing practices, different to those applied in foreign companies operating in Serbia, this would imply that there are not much spillovers of marketing capabilities from multinationals to local firms.

In order to answer the research questions, we used a survey in total of twenty two companies operating in Serbia, divided into two independent samples: Sample 1 (Serbian companies) and Sample 2 (MNCs' subsidiaries in Serbia). None of the domestic companies has experienced significant changes in marketing, ownership status or management in its recent past.

The research took place during 2008 and adopted questionnaire that was handed to specialists working within marketing department. Therefore, access to companies was an important criterion that led us in this research (convenient sampling). Questions included following areas: the organisational position of marketing department in the company (6 questions), the process of planning of marketing activities (5 questions) and structure of promotional costs (6 questions). We also collected some general data about selected organisations such as size, history, industry sector.

To see whether same marketing activities are applied in two independent samples (H_0 : Two independent samples are from the same population; H_1 : Two independent samples are from different populations), we performed nonparametric statistics, since assumptions required by parametric statistics were not fulfilled (such as sufficient size of samples to provide for normal distribution, both samples having the same variance, as well as the requirement of the variables being compared to be measured on an equal interval level) (Reaves, 1992). To analyze collected data we performed the Mann-Whitney U test for testing the null hypothesis that two independent samples are coming from the same population, at the significance level $p \leq 0.05$. Obtained results are presented in the following section.

3. Research findings and discussion

Section I of the Questionnaire, which regards the organisational position and structure of marketing activities, has been transformed into 12 different variables. The results of

the Mann-Whitney U test indicate that H_0 (Two independent samples are from the same population) can be rejected and H_1 accepted at the significance level of $p \leq 0.05$ for 3 variables: VAR6, VAR7 and VAR9 (see Table 1).

Table 1: Selected results of Mann-Whitney U statistics for 3 variables from section I

	VAR00006	VAR00007	VAR00009
Mann-Whitney U	33,000	30,000	33,000
Wilcoxon W	111,000	85,000	88,000
Z	-2,062	-2,562	-2,062
Asymp. Sig. (2-tailed)	,039	,010	,039
Exact Sig. [2*(1-tailed Sig.)]	,080(a)	,050(a)	,080(a)

Distribution of frequencies for the 3 variables in two independent samples reveals the following differences in some characteristics of the role of marketing function between Serbian companies and MNCs subsidiaries operating in Serbia:

1. The marketing department counts less than 10 employees in 75% of Serbian companies, while that is the case in 40% of sampled subsidiaries.
2. 50% local companies conduct market research among other marketing activities, while that is the usual activity within marketing department for all MNCs subsidiaries.
3. 70% of foreign companies deal with customers' complaints, whereas only 25% of Serbian companies perform the same

Research evidence suggests that marketing department has not been yet fully developed in Serbian companies. Larger marketing department implies that functions within it could be more diversified and each individual could be more specialised for performing his tasks, and therefore the whole department is more effective and productive. Consequently, the lack of personnel who deal with customers' complaints or conduct market researches in Serbian companies is not surprising, regarding the fact that marketing departments are smaller than those in MNCs subsidiaries.

It should be noted that traditionally marketing activities, such are sales and promotion are equally present in both groups of companies. One interesting result from this part of the analysis is that there is no statistically significant difference between Serbian and foreign companies regarding other activities that are considered to be a part of marketing functions (Jobber and Fahy, 1996). Actually, quality management, prices policy and distribution management are disregarded in 70% of MNCs subsidiaries and 75% of domestic companies. However, Public Relations (PR) are considered to be an integral part of a marketing department in 90% of foreign and 67% of domestic companies.

Sections II and III, which examined the process of planning of marketing activities and the structure of marketing costs, has been transformed into 17 different variables. The results

of the Mann-Whitney U test indicate that H_0 (Two independent samples are from the same population) can be rejected and H_1 accepted at the significance level of $p \leq 0.05$ for 4 variables: VAR16, VAR19, VAR20 and VAR29 (see Table 2).

Table 2: Selected results of Mann-Whitney statistics for 4 variables for sections II and III

	VAR00016	VAR00019	VAR00020	VAR00029
Mann-Whitney U	25,000	24,000	29,500	26,000
Wilcoxon W	80,000	79,000	84,500	81,000
Z	-2,815	-2,609	-2,226	-2,630
Asymp. Sig. (2-tailed)	,005	,009	,026	,009
Exact Sig. [2*(1-tailed Sig.)]	,021(a)	,017(a)	,043(a)	,025(a)

Distribution of frequencies for 4 variables in two independent samples reveals the following differences in strategic approach to marketing between Serbian and foreign companies operating in Serbia:

1. All MNCs in Serbian market plan marketing activities continuously, while only 41.7% Serbian companies has adopted the same practice. 58.3% local companies are planning their activities from time to time, not on constant basis.
2. Some companies do not perceive the importance of planning. Although all MNCs subsidiaries operating in Serbia think that planning of marketing activities is either very important (80%) or just important (20%), it is not the case with Serbian ones (25% consider it highly important, 25% as important, 17% are neutral regarding this question and 33% consider planning of marketing activities as unimportant operation)
3. Very similar findings occurred in the field of the measurement of effectiveness of promotional efforts. All but one foreign company measure how effective their promotional activities were, whereas only 33.3% domestic companies include the same operation in their list of activities.
4. Frequency of advertising also differed from one sample to another at statistically significant level. MNCs advertise more often (continuously: 80%; often: 10%; when need arises: 10%) than Serbian companies (continuously: 33.3%; often: 16.7%; when need arises: 41.7%; and rarely: 8.3%).

It could be stated that strategic role of marketing has not been yet perceived at full extent in Serbian companies. Therefore, all efforts are more focused to operational and organizational activities, while planning and control are neglected. Moreover, heavier advertising by MNCs could be explained by higher budget that they usually have than domestic companies, and consequently, they are more interested in and familiar with cost-benefit analysis for advertising.

Structure of advertising costs in different media is almost the same for MNCs and Serbian companies. Expenditures for television are the highest, followed by newspapers and magazines, then for billboards and finally for the radio. Data clearly shows that small and medium companies do not use television to advertise due to small advertising budget that they have. However, they try to avoid radio due to its local reach.

The structure of sales promotion costs is very much similar between samples. Almost all companies are taking part in some fairs, and that causes the highest expenditures in this group of costs. Then, it is followed by merchandising and representation costs. At the last place of this structure stand prize games that most of the companies in both samples do not organize at all. This could be explained by the shortage of finances for smaller ones or by the type of industrial sector for larger companies in which the return on investments in prize games would not be satisfying.

CONCLUSION AND IMPLICATIONS FOR MANAGEMENT

Overall results from the study suggest that there are no many differences in marketing activities between Serbian and MNCs operating in Serbia. Statistically significant differences in marketing practices between two samples are found for 7 out of total of 30 variables. This leads us to the conclusion that marketing activities performed in Serbian companies are rather similar to the marketing practices executed in MNCs subsidiaries.

Certain differences can be observed also. The process of economic reform in Eastern Europe has been accompanied by a growing interest in the role and applicability of Western-style marketing. Although a number of studies have highlighted the potential benefits of marketing to the process of transition, the extent to which marketing has developed is still limited and there are a variety of constraints which inhibit the positive contribution that may be made by marketing (Enew, Wright and Kirnag, 1996). Marketing had no prominent role in the socialist past of the transition economies, and the availability of relevant skills is still limited. Foreign MNCs, by contrast, typically operate in industries where product differentiation and marketing are important. It is conceivable that MNCs are prepared to transfer these skills to their wholly or majority-owned affiliates.

As our research also showed, import of marketing capabilities from foreign MNCs to Serbian companies should be done predominantly at strategic level. Serbian companies should diversify marketing activities that they perform, employ more staff and put more focus on preparing and closing activities, beside organisational ones. The role of continuous planning and tracking results of marketing efforts have to be recognized in order to achieve the level of marketing efficiency of foreign companies.

There are several limitations to this study that should be recognized. Firstly, the narrowness of our approach in focusing only on surveying randomly selected 12 Serbian and 10 MNCs operating in Serbia prevented us from broader and stronger generalisation of our results. Secondly, we assumed that foreign companies undertake codified marketing practices (e.g. market research everywhere comprises same set of activities) which does not have to be the case. Finally, we did not take into account the feedback correlation that exists between Serbian and foreign companies. Actually, we did not examine how Serbian marketing practice affects marketing practice of MNCs subsidiaries, which could be relevant.

However, this paper only represents a small step to understand main similarities and differences between Serbian and MNCs and what kind of spillovers could be expected in transitional economies concerning “soft” elements. Future research should expand on the present investigation through increasing the number of Serbian companies and MNCs and through medium term studies of marketing department developments.

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PUBLIC SERVICE OBLIGATION MODEL ON EUROPEAN SOUTHEAST AIR TRANSPORT MARKET

Abstract

Air traffic market of the Southeast Europe has the above average dynamics of growth, conditioned however by the undeveloped market and insufficient traffic connection. Paper will consider the different levels of achievements in traffic results of air carriers and airports of the Southeast Europe including macroeconomic analyses of 11 countries belonging to this the region. following by analysis and categorization of the airports according to European Union documents and directives. The future development under the new economic circumstances means adjustments of business models that have been implemented. Connections with main European destinations are dominant and all leading European air carriers are already present in the region. Low Cost Carriers (LCC) are more and more coming - forming bases with two or three aircraft, but with dominant connections to the most developed European markets. In the expansion financing of LCC carriers in Europe some airports have taken part with various concessions, regions with direct or indirect "subventions" and other subjects obtaining through the so increased transport effects level some positive economic and social benefit. Due to demand level, connection within the region is possible with regional aircraft (approx. 50-100 seats), with indispensable relationship of national air carriers, as a first step to provide and realize privatization process for some of the most successful air carriers. The undeveloped network within the region is real fact. The best air connections within the region are via Vienna. The paper will also consider the air traffic forecasts of the Southeast Europe region, which will follow expected implementation of improved model and benefits for the population and economy of eleven countries. It also means necessity to cooperate and find out efficient mode of integration which will follow air traffic and legal framework of the European Union. Positive example can be implementation of PSO (Public Service Obligation) for air carriers of the Southeast Europe network. Implementation of PSO within the region would increase economic activities level among the regional countries, economic development and progress, political stability and continuation of the European integrations.

Keywords: *Air Transport Market of Southeast Europe, Cooperation, Competition, PSO (Public Service Obligation), Traffic Forecast, Economic Development*

INTRODUCTION

Air transport plays a vital role in the **European economy** and for international trade. This industry generates €120 billion in annual revenues, employs 3 million people and accounts for more than 30% of worldwide air transport. Including indirect and induced impacts the air transport industry generates about 4.2 million jobs in Europe and contributes more than USD 331 billion to European GDP. If catalytic impacts are included, the number of jobs increases to 7.6 million and GDP to over USD 1,226 billion, representing 24% of the total jobs and 34% of the GDP worldwide. (www.eu.int).

It is an opportunity for industry and consumers, especially because tourism is a major growth area in the coastal regions. Forecasts for aircraft movements and passenger traffic (Southeast Europe) are above the average growth rates for rest of the Europe and worldwide. There are potentially 414 European airports at which different air carriers can operate; therefore, there is an opportunity for further growth. Consequently, the affordable air travel will be increasingly available to a greater number of people.

Creating a single European market more than 58 million people and 30 airports of the Southeast Europe region would be fully integrated consisting thus market for 500 million people in total.

Air traffic market of the Southeast Europe has the above average dynamics of growth, conditioned however by the undeveloped market and insufficient traffic connection. This specially refers to the city pairs within eleven countries belonging to this market.

Herein below there are fundamental economic indicators for countries of the Southeast Europe region and appertaining indicators of air traffic and infrastructure development degree in air transport. This paper initiates the need and justification for introduction and application of “Public Service Obligation” (PSO) model that would considerably improve traffic connection. In such a case the invested funds into application of the inter-regional air traffic are several times more economical and lower when compared with high investments in railway and road infrastructures. New air routes within the region would considerably improve and increase economic integrations and cooperation, being of special interest having in mind the undeveloped degree of the region as a whole.

1. Macroeconomic analysis of the region

Countries in the region over the last twenty years have passed violently through a period marked by war events, and transition processes. Relative political stability has created the conditions of faster economic growth within the region in the last five years. Slovenia, Bulgaria and Romania entered the European Union, and all the other countries are moving in the direction of the euro integration processes.

Table 1: General macroeconomic data for the region countries (2008)

Country	Population, 1000 persons	GDP, EUR mill	GDP per capita, EUR at PPP	Annual inflation, %	Unemployment rate, reg., %	Current account, % GDP
Albania	3170	8632	6400	3.4	12.6	-12.7
Bosnia & Herzegovina	3843	12476	6800	7.5	23.4	-12.8
Bulgaria	7602	34118	10100	12.0	5.6	-25.3
Croatia	4435	41416	13600	6.1	9.0	-10.9
Kosovo	1805	2378	2300	5.3	40.0	-
FYROM	2048	6695	8700	8.3	33.8	-12.7
Moldova	3790	4400	2930	11.5	2.1	-19.9
Montenegro	628	3340	11400	7.4	17.2	-29.2
Romania	21513	137035	11200	7.9	6.0	-12.3
Slovenia	2040	37126	23300	5.5	4.4	-5.9
Serbia	7350	33708	9300	11.7	14.0	-17.6

Source: The Vienna Institute for International Economic Studies (www.wiiv.ac.at). For Moldova and Kosovo IMF, World Bank and various international sources;

From the above data it can be concluded that five biggest economies (Romania, Croatia, Slovenia, Bulgaria and Serbia) have the share of 88% in total GDP of the region.

Table 2: GDP growth rates 2006 - 2013

Country	2006	2007	2008	2009	2010	2014
Albania	5.5%	6.3%	6.8%	0.4%	2.0%	6.0%
Bosnia & Herzegovina	6.9%	6.8%	5.5%	-3.0%	0.5%	4.5%
Bulgaria	6.3%	6.2%	6.0%	-2.0%	-1.0%	5.0%
Croatia	4.7%	5.5%	2.4%	-3.5%	0.3%	4.0%
FYR Macedonia	4.0%	5.9%	5.0%	-2.0%	1.0%	2.0%
Montenegro	8.6%	10.7%	7.5%	-2.7%	-2.0%	4.0%
Moldova	4.8%	4.0%	7.2%	-3.4%	0.0%	5.0%
Romania	7.9%	6.2%	7.1%	-4.1%	0.0%	4.1%
Serbia	5.2%	6.9%	5.4%	-2.0%	0.0%	5.5%
Slovenia	5.9%	6.8%	3.5%	-2.7%	1.4%	3.5%

Source: IMF World Economic Outlook, April, 2009

Due the recession trends macroeconomic forecasts are changing very often in the direction of reducing average annual growing rates.

2. Air transport market

General indicators of air traffic development in 2008 are shown below. The number of passengers and cargo carried at airports, the number of airports and air carriers in each country, and finally the synthetic indicator number of passenger carried per capita, which indicates the degree of development and mobility of the population. Southeast Europe region is a modest, undeveloped region, which represents only 1.3% passenger transportation in the world scheduled traffic and 1% of the number of international airports in the world.

Table 3: General air transport indicators of the Southeast Europe region

Country	Passengers (000)			Cargo 000 t	Airpo- rts	Airli- nes	Passen. per Capita
	International	Domestic	Total				
Albania	1,267	0	1,267	3.5	1	4	0.40
Bosnia& Herzegovina	550	0	550	1.5	3	1	0.15
Croatia	4,610	554	5,164	13.9	8	4	1.15
FYROM	697	0	697	2.8	2	1	0.34
Montenegro	1,109	0	1,109	0.8(p)	2	1	1.85
Serbia	2,680	0	2,680	7.2	2	2	0.36
Kosovo	1,131	0	1,131	1 (p)	1		0.60
Romania	8,250	500	8,750	24 (p)	11	8	0.41
Bulgaria	6,200	290	6,490	18 (p)	4	8	0.85
Moldova	848	0	848	0.8	1	5	0.22
Slovenia	1,705	0	1,705	12.0	2	1	0.85
Total/Average	29,047	1,344	30,391	84.0	37	35	0.52

Source: According to different sources, prepared by authors

Tabular display clearly indicates passenger transportation in the region on level of 30 million, and the poor mobility of the population (only 0.5 trips per capita). Furthermore, it is obvious that the leaders of the region are (except for residents of Montenegro, which “traditionally” often use the services of air transportation), Croatia, Slovenia and Bulgaria. It is important to emphasize that the domestic scheduled air transport exist only in three region states (Croatia, Romania and Bulgaria). Leading representatives in air cargo transport are EU members (Romania, Bulgaria and Slovenia) followed by Croatia. A more detailed analysis of air carriers of the Southeast Europe region, as well as indicators of airport infrastructure are shown below.

Table 4: List of dominant airlines in Southeast Europe region

Airline	N° a/c	Aircraft Types	Routes	Passengers	Index 08/07	PLF (%)	Employees	Productivity
Albanian Airlines	4	3 Bae 146; 1 MD 82 w1	4	220	110	51	165	1,333
BH Airlines	2	2 ATR 72	6	73	107	66	90	811
Croatia Airlines	10	4 A320, 4 A319, 2 Q400	43	1,869	109	65	1,114	1,678
Macedon. Airlines	2	2 B737,	7	215	96	71	159	1,352
Monteneg. Airlines	6	5 FOKKER 100; 1 EMB 195	11	498	107	64	409	1,218
JAT	15	10 B737, 5 ATR72	37	1,330	103	62	1,697	784
Kosova Airlines				-	-	-	-	-
Tarom	24	2 A310, 4 A318, 11 B737, 7 ATR42	47	1,900	105	62	2,482	766
Bulgaria Air Group*	20	8 B737, 6 Bae 146, 2 A319, 3 A320, 1 ATR42	34	1,500	110	65	1,600	938
Air Moldova	4	3 A320, 1 EMB 120	15	402	131	61	658	611
Adria Airways	14	2 A320, 7 CRJ 100/200, 4 CRJ900, 1 B735	26	1,302	115	63	719	1,811
TOTAL	101		230	9,309	108	65	9,093	1,024

Source: According to various sources, prepared by authors

The highest passenger traffic volume is performed by Croatia Airlines and Tarom. Adria Airways and Croatia Airlines are the leaders in productivity metrics measured by passenger carried per employee. At the same time Tarom and Bulgaria Air Group operate with the biggest number of aircraft in structure of the fleet. The majority of routes are served by Tarom, Croatia Airlines, JAT, Bulgaria Air Group and Adria Airways.

In the region of Southeast Europe with more or less success, on the market were present also other aviation companies in the period 2006 to 2008.

- Albania: Ada Air, Albatros Airways, Belle Air;
- Bulgaria: Air Sofia, Air Via, Aviostart Airlines, BH (Balkan Holiday)Air, Bright Aviation Service, Heli Air, Vega Airlines;
- Croatia: Air Adriatic, Laus Air, Dubrovnik Airline, Trade Air;
- Moldova: Aeriantur-M, Air Moldova Intl., Moldavian Airlines, Renan Airlines;
- Romania: Carpatair, Romavia, Blue Air, Acvila Air, Tiriak Air, Chris Air, JetTranAir;
- Serbia: Avio Genex

They are dominantly oriented on charter passenger and cargo transport, and structure of the fleet is very diverse. Above mentioned 26 air carriers generate relatively modest results, a part of them has been bankrupt or reduce the scope of operation and gradually abandon the old, depreciated and inefficient fleet of Russian aircraft Yak, Antonov and Tupolev. Only in Romania last four to five years stoped the operations: Jaro Intl, Angel Airlines, Dac Air, LAR.

Finally, it is necessary to observe number and categories of airports in SE Europe region. Traffic, economic and political criteria for categorization of the airports is starting from the capitals and main cities of the region, together with minimum traffic volume of at least 500,000 passengers a year. Above mentioned criteria give the following view of the size and number of primary airports in the region.

Table 5: Primary airports in the region Southeast Europe

AIRPORT		PASSENGERS			Index 08/06	Runway Length (m)
		2008	2007	2006		
1	Bucharest OTP	5,064,230	4,978,587	3,513,576	144	3,500
2	Sofia	3,230,696	2,746,178	2,209,348	146	3,600
3	Belgrade	2,650,048	2,512,890	2,222,445	119	3,400
4	Zagreb	2,192,453	1,992,445	1,728,413	127	3,252
5	Burgas	1,936,853	1,949,198	1,702,000	114	3,200
6	BucharestBBU	1,768,000	982,220	700,000	253	3,200
7	Ljubljana	1,673,079	1,524,028	1,334,355	125	3,300
8	Varna	1,450,192	1,493,267	1,400,000	104	2,500
9	Tirana	1,267,041	1,107,325	906,103	140	2,750
10	Split	1,203,778	1,190,551	1,095,852	110	2,550
11	Dubrovnik	1,191,474	1,143,168	1,120,453	106	3,300
12	Prishtina	1,130,640	990,259	882,731	128	2,500
13	Timisoara	957,000	836,518	753,934	127	3,500
14	Chisinau	847,900	688,800	548,300	155	3,590
15	Cluj	753,000	390,521	244,366	308	2,100
16	Skopje	652,339	626,644	542,319	120	2,450
17	Tivat	568,083	574,011	451,289	126	2,500
18	Sarajevo	506,398	505,269	466,186	109	2,600
19	Podgorica	541,030	460,020	381,847	142	2,500
TOTAL		29,584,234	26,691,899	22,203,517	133	

Source: According to various sources, prepared by authors

Bucharest (OTP) with over 5 million passengers is the biggest airport in the sample of 19 primary airport. At the same time the fastest growth rate was recorded on the airports Cluj, Bucharest (BBU), Chisinau, Sofia, and Bucharest (OTP). Absolute growth in the term of the passenger number in the period 2006 - 2008 is recorded in Bucharest (OTP) +1.5 million passengers and Sofia +1 million passengers. Especially interesting is an exceptionally high increase in the number of passenger at the airport Bucharest (BBU) due to low cost "invasion." Blue Air, Sky Europe, Wizz Air, Germanwings, Easyjet, Nouvelair have started new routes from Bucharest BBU to popular European destinations.

Besides the list of primary airports in the region there is also a few secondary and tertiary international airports. Using the criteria of passengers carried from 100,000 – 500,000 the **secondary** international airports (Pula, Sibiu, Plovdiv, Zadar, Iasi, Arad, Bacau and Rijeka) generate 1.4 million passengers in the year 2008.

Tertiary international airports in SE Europe region with annual passenger traffic of less than 100,000 (Constana, Targu Mures, Ohrid, Maribor, Nis, Baia Mare, Banja Luka, Mostar, Bol – Brac and Osijek) generate 317 thousands passengers in the year 2008.

The analysis did not take into account the domestic airports and smaller airfields for general aviation.

It is interesting to note that the listed categorization of the airports belonging region Southeast Europe by European Commission Regulation looks significantly different, as shown below:

Figure 1: European statistical categorization of the airports in region:

Category 0 (0 - 15,000)	Category 1 (15,000 - 150,000)		Category 2 (150,000 - 1,500,000)		Category 3 (over 1,500,000)
Osijek Mostar Brac Banja Luka	Baia Mare Nis Maribor Ohrid Targu Mures	Constana Rijeka Bacau Arad Iasi	Zadar Plovdiv Sibiu Pula Podgorica Sarajevo Tivat Skopje	Cluj Chisinau Timisoara Prishtina Dubrovnik Split Tirana Varna	Ljubljana Bucharest OTP Burgas Zagreb Belgrade Sofia Bucharest BBU
TOTAL					
4	10		16		7

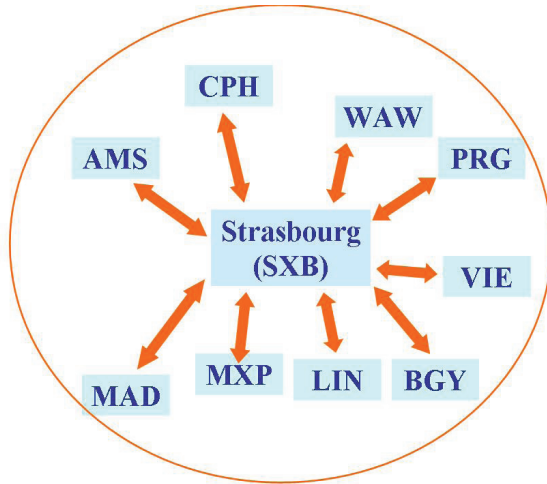
Source: European Commission Regulation (EC) No 1358/2003 (in term of passenger carried)

Comparing the current situation on the airports of the former Yugoslavia to the record achievements in business 1987 year average annual growth rate of passengers carried for the period 1987 – 2007 is only 0.43%. But, there is a significant difference in level of passenger air traffic growth in the newly born countries. The most dynamic growth has been recorded in Kosovo (Index = 3667), Montenegro (+87%), Slovenia (+64%), Bosnia and Herzegovina (+46%), and Macedonia (+39%), while the bigger loser is Serbia (-26%), followed by Croatia (-9%).

3. PSO European practice

Obligation of public service implementation is possible in conditions when air transport is of vital importance for development of particular region. In such a case the state/ government can determine the service quality level for all the carriers operating on certain route and if necessary, the state could pay certain subvention if none of carriers would fly without subvention.

Similarly, the PSO can be established by member state for region cooperation within this country with a region in another country. For example the French Strasbourg, being connected with several capitals with nine PSO routes.

Figure 2: PSO routes connecting Strasbourg:

Source: Misetic et al. 2008: 364

Ten EU country members (Finland, France, Greece, Ireland, Italy, Germany, Portugal, Spain, Sweden and the United Kingdom) impose traffic on 226 PSO routes. Norway and Island, not being EU members, as EEA¹ members apply identical principles when it comes to PSO routes. Norway has PSO routes from 29 airports. The highest number of PSO routes in the European Union is in France (78), then Italy (31), Portugal (27), United Kingdom (26), Greece (25) and Spain (16) routes. In Portugal even 73.5 % of all flights in domestic air traffic are under PSO model, in Ireland 34.3 % of flights, then in Greece 19 %, France 17.1 %, Spain 16.7 % and Italy 14.9 %. (Misetic et al. 2008: 365)

The PSO routes status can be defined:

- **with limited access** (if none of air carriers is interested to perform transport under the previously set conditions on specific PSO route, the authorities can appoint one carrier to be granted with respective financial subvention for accepting the obligation to perform this transport);
- **with open access** (that can attract several air carriers ready to accept these conditions).

The biggest number of PSO routes with limited access is in France, Greece and the United Kingdom. Tenders are mostly awarded to the domestic carriers. Only 5 % of PSO routes with limited access in the European Union countries are performed by foreign carriers. On the other hand, out of 139 routes with limited access, 27 European air carriers are engaged on about 5 routes. Olympic Airlines is on the top of the list of carriers with the highest number of routes (22), i.e. all routes in Greece are under the PSO status. (Misetic et al 2008: 365). Tenders as basis for air carriers bidding for PSO routes transport are foreseen for the period of 3 years. The proposal for this term extension to four or five years is under course. According to practice and previous experience in biddings, the prevailing number

¹ European Economic Area

of PSO routes remain under competence of the most competent and interested carriers. The same implementation model is proposed for the region of Southeast Europe, applying strictly terms and conditions of the EU.

4. Air traffic forecast

Herein below there are the IATA forecast of passenger traffic volume for the period 2008-2012, referring only to the international scheduled traffic. Respective data for the new born state of Kosovo are included into the traffic forecast data of Serbia.

Table 6: IATA Passenger Forecast 2008 – 2012

Base location	No.of Cnty Pair	Passenger Vol 2007 (000)	Forecast annual percent changes %					AAGR'08-'12
			2008	2009	2010	2011	2012	
Albania	9	1,070	6.4%	6.5%	6.4%	6.2%	6.1%	6.3%
Bosnia-Herzegovina	9	530	8.7%	8.4%	7.8%	7.6%	7.5%	8.0%
Bulgaria	29	4,540	7.4%	7.8%	7.4%	7.2%	7.1%	7.4%
Croatia	25	3,226	6.5%	6.6%	6.5%	6.4%	6.4%	6.5%
Macedonia	11	610	7.0%	6.7%	6.4%	6.3%	6.3%	6.5%
Moldova	14	685	9.6%	9.5%	9.3%	9.0%	8.9%	9.3%
Montenegro	7	648	8.9%	8.0%	7.6%	7.1%	6.8%	7.7%
Romania	29	5,949	8.4%	7.8%	7.1%	6.7%	6.6%	7.3%
Serbia	30	2,851	8.8%	8.2%	7.3%	6.9%	6.6%	7.6%
Slovenia	26	1,323	8.3%	5.9%	5.8%	5.3%	5.2%	6.1%
Total	189	21,433	7.9%	7.6%	7.1%	6.8%	6.7%	7.2%

Source: IATA Passenger Forecast 2008 – 2012 (2008), Montreal – Geneva

According to the IATA forecast, the average annual growth rate in international scheduled passenger traffic in the region for the period 2008–2012 amounts to 7.2%. The highest average rate of growth is in Moldova (9.3%), and Bosnia and Herzegovina (8%). The lowest rate of growth is forecast for Slovenia (6.1%), and Albania (6.3%). Consequently, the volume of passenger transportation shall be increased within the period of 2008–2012 by eight million passengers. All leading carriers of the region (Croatia Airlines, Tarom, Bulgaria Air-Hemus, Adria Airway, JAT ...) must recognize here their opportunity for future air transport development within the region.

Regarding the IATA cargo forecast for the region the average annual rate of growth for the period 2008 – 2012 would be 4.6%. The highest average rate of growth is Slovenia (5.6%), while the lowest average rate of growth is forecast for Bulgaria (3.7%).

IATA Forecast are published in the October 2008, but in the meantime forecasts for global air transport volumes were significantly revised due to global economic crisis and recession affecting whole Europe and the region.

Substantial downward revision of passenger traffic forecast (December 2008) air travel post-financial sector crisis is 12% lower compared to pre-crisis industry forecast (2009-

2012), and 9% lower in the year 2016. Air freight volumes are also expected to shrink in both 2008 and 2009. However, a more rapid recovery in line with world trade is anticipated with a return to 6%+ growth by 2010. (www.iata.org/economics).

Financially, the world's airlines saw a huge recession over 2008, based on substantial growth in fuel prices (+36%) which turned the net profit for the year 2007 (12.9 billion USD) in 8.5 billion USD of loss with real option to reach 16-17 billion USD for the year 2008. (Pearce 2009: 2,4).

In different scenarios for airline alliancing and mergers most likely scenario emphasizes elements of slowly lessening regulation, more joint venture and niche carriers, steady growth of demand, national identity guarded and gradually less government interference. (Kleymann, B. and Seristö, H. 2004:195). Consequently, it can be concluded that the Southeast European countries have real necessity and opportunity of positioning for the PSO implementation, although the strategy of expansion towards this region in air transportation is already evident in presence of solid air carriers of Central Europe, like Austria Airlines, Malev, CSA, Allitalia.

5. PSO model in the region

European Union Council of Ministers in 2004 authorized the European Commission to start negotiations with eight southeast European partners (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the former Yugoslav Republic of Macedonia, Romania, Serbia and Montenegro and the U.N. Mission in Kosovo) on a European ECAA² agreement. The objective was to integrate the EU's neighbors in the Southeast Europe into the EU's internal aviation market, with open market access and full application of the EC³ aviation law. The negotiations opened in March 2005 with a multilateral high-level meeting, at which all negotiating parties expressed support for reaching an ECAA agreement as quickly as possible. In order to give the ECAA partners time to prepare for the full application of EC aviation law, the EU developed a country-specific gradual approach: Once ECAA partners have fully implemented EC aviation law the ECAA airlines will have open access to the EU market. The transitional arrangements were negotiated in October and November 2005 with each ECAA partner individually. After only nine months of negotiations, the text of the ECAA agreement was agreed upon by all parties in December 2005.

The outcome of these negotiations constitutes significant and valuable progress. The level of regulatory convergence is unprecedented, as all partners have agreed to align their national aviation legislation to the complete aviation acquis of the community. Harmonized rules in Europe will create a common, free and safe air transport market, which can be a driving force for other sectors and contribute to the development of the whole region, benefiting consumers and industry alike. This is major step forward where air transport will play a key role in creating impetus for the political and economic integration of Europe.

² Common Aviation Area

³ European Commission

At the moment the level of air transport connections within the region is shown bellow.

Table 7: Destinations and frequencies within region - 2008

Airline	No. of routes	SEE routes	Destinations / Weekly frequency	SEE freq.
Adria Airways	27	6	Ljubljana - SJJ 7x; TGD 3x; TIA 7x; SKP 11x; OTP 4x; PRN 14x	46
Croatia Airlines	36	4	Zagreb - SJJ 14x; SKP 7x; TDG 3x; PRN 4x	28
Bulgaria Air - Hemus	34	3	Sofia - TIA 2x; SKP 2x; OTP 5x	9
Air Moldova	16	1	Chisinau - OTP 5x	5
Albanian Airlines	4	1	Tirana - SKP 3x	3
Belle Air	19	1	Tirana - PRN 12x	12
BH Airlines	6	1	Sarajevo - SKP 3x	3
Macedonian Airlines	6	0	-	0
Tarom	38	2	Bucharest - SOF 11x; KIV 4x	15
Carpatair	34	1	Timisoara - KIV 6x;	
Montenegro Airlines	14	3	Podgorica - BEG 21x; LJU 2x; Tivat - BEG 14x	37
JAT	33	4	Belgrade - SKP 18x; LJU 7x; TGD 33x; TIV 31x	89
Total	267	27		247

Source: According to various sources, prepared by authors

According to the above data only 10.1% of existing routes are oriented to the area of Southeast Europe (primary airports connections only). Mainly existing routes connect the above mentioned area with the central, western and northern Europe. Average weekly frequency on half of the Southeast Europe routes (13/27) is less than one daily flight.

Taking into account the **long term schedule planning**⁴ (fleet diversity, man power planning, protecting hubs, adding or changing hubs and adequate facilities at airports) and **market evaluations**⁵ (frequency and time of service, adding new and dropping existing markets, pricing policy, competitor behavior, code sharing agreements and alliances) (Bazargan, M. 2004:32) there is necessity for creating a new network model to increase air connectivity within the region.

List of existing routes indicates the possibility to **establish new routes** on the following city pairs which would be conducted in phases:

- a) First phase (by the end of year 2010) - priority
 - o Evaluation of existing routes and city pairs;

⁴ +60 months

⁵ 12-36 months

b) Second phase from 2011 to 2012

- Bucharest ↔ Belgrade, Zagreb, Sarajevo;
- Belgrade ↔ Bucharest, Sofia, Zagreb;
- Ljubljana ↔ Sofia;
- Sofia ↔ Belgrade, Ljubljana, Zagreb, Podgorica;
- Zagreb ↔ Sofia, Bucharest, Belgrade, Tirana.

c) Third phase after the year 2012

- Bucharest ↔ Tirana, Podgorica, Prishtina;
- Belgrade ↔ Tirana, Chisinau;
- Ljubljana ↔ Chisinau;
- Sofia ↔ Sarajevo, Tirana, Chisinau;
- Zagreb ↔ Chisinau...

Traffic on the specified new city pairs would be served by the formula 3+3 equally by two airlines on the route. (For example Croatia Airlines on route ZAG↔OTP in days 1.3 and 5 and Tarom on the same route in the days 2, 4 and 7.) Of course there are other possible combinations: 2+4, 4+3 etc. The specified list of routes can be amended with other combinations which include other primary airports in the region: Burgas, Varna, Split, Dubrovnik, Timisoara, Cluj and Tivat.

The implementation of the proposed project with introduction of PSO for the region should take into account the cultural and ethnic differences, particularly cultural fit factors: work style, management style, attitude towards the customer, team spirit, performance focus, attitude towards learning, risk taking etc. . . (Iatrou, K. and Oretti, M. 2007: 178) Application of the PSO model must take into account the low living standard, price elasticity of demand and the appropriate amount of the ticket price. (Vasigh, B., et al. 2008: 65.75)

Creating a single European market more than 58 million people and 30 airports of the Southeast Europe region would be fully integrated consisting thus market for 500 million people in total. In order to be successful in this process the airlines of Southeast Europe should segment their market properly, avoiding the mistakes of both over and under-segmentation, and build a sound understanding of the needs of their customers in each of the market segments. (Shaw 2007:48)

At the same time standard of living in the region points to the need of avoiding influence of exogenous factors (cyclicality, ease of access to capital, cost of aircraft, competition, consolidation...) and endogenous factors (labour, management, pricing...) to generate losses in aviation sector. (Pilarski, 2007: 85-176)

Such a project requires an economic evaluation to a deeper look at all the possible economic and social effects within the region, all in the context of further European integration processes. One of the key factors is a partnership interested subjects within the region to achieve the high level of synergy necessary for implementing the project.

CONCLUSIONS_

Committing to continue harmonizing legislation with EU laws, removing the remaining market access restrictions on flights between the EU and the region, removing existing

blockages in air traffic management system, committing the region to work together and to improve inter-regional relationships, creating investment opportunities and enabling capital flow to support implementation of PSO model in the region, the air traffic market analysis can offer the following conclusions:

- Connections with main European destinations are dominant and all leading European air carriers are already present in the region;
- LCC are more and more coming - forming bases with two or three aircraft (WizzAir in Bulgaria and Romania), but also with dominant connection to the most developed European markets. In the expansion financing of LCC carriers in Europe some airports have taken part (various concessions), regions (direct or indirect “subventions”) and other subjects obtaining through the so increased transport effects level some positive economic and social benefits;
- The undeveloped network within the region is real fact - **10.1% of existing routes** (The best air connections within the region are via Vienna!)
- Due to demand level, connection within the region is possible with regional aircraft (approx. 50-100 seats), with indispensable relationship of national air carriers, as a first step to provide and realize privatization process for some of the most successful air carriers;
- Implementation of PSO within the region would increase economic activities level among the regional countries, economic development and progress, political stability, continuation of the European integrations ...;
- Project could be partly financed in interaction of the interested parties: countries within the region, air carriers – partners within the region, EU through institutions of the European funds

The project should be thoroughly analyzed in order to be offered to the interested entities for final evaluation and implementation.

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THE RULE OF LAW AND INDEPENDENT JUDICIARY – PREREQUISITES FOR REGIONAL COOPERATION AND INTEGRATION WITH THE EU (CASE STUDY OF SERBIA)

Abstract:

The author discusses the significant theoretical and constitutional issue of governmental organization based on the principle of the rule of law, separation of powers and the corresponding question of the independent judiciary. The aim is to stress the significance of achieving the separation of powers and independent judiciary system as necessary presuppositions of democratic political environment, institutional and procedural guarantees of the rule of law, legal state, basic human rights and civil liberties. It is emphasized that the separation of powers and independent judiciary represent civilisational inheritance and social values. The paper shows that the rule of law and independent judiciary represent significant prerequisites for the integration of Serbia into the EU. Independent judiciary and the rule of law assume the central position in the intensified process of regional cooperation and the economic integrations. The paper emphasizes that the need to establish the independent judiciary in the Republic of Serbia is prioritized in the process of reform by the European Commission and the Council of Europe, and therefore must be completed. The author demonstrates that the rule of law and independent judiciary ensure legal security necessary for economic integrations. Without legal security and legal certainty, which result from the rule of law, economic integrations would not be feasible either. The paper concludes that foreign investments and economic integrations require legal certainty and security which are the consequence of the fully and truly implemented rule of law.

Key words: *rule of law, independent judiciary, economic integrations, regional cooperation, European integrations, legal security*

INTRODUCTION

The rule of law is an ancient ideal and form of governmental organization according to which decisions should be made by applying known principles or laws, without the intervention of discretion in their application. This form of governmental organization is intended to be a safeguard against arbitrary governance. In Anglo-American tradition, the most influential version of the rule of law is the one popularized by British jurist A.V. Dicey in 1885 (Dicey, 1959). Dicey's doctrine on the rule of law is a threefold one: the absolute supremacy or predominance of regular law as opposed to the influence of arbitrary power and the absence of discretionary authority on the part of the government; equality before the law; the constitution in the result of the ordinary law of the land developed by the judges on a case by case basis. The rule of law involves: the rights of individuals are

determined by legal rules and not the arbitrary behaviour of authorities; there can be no punishment unless a court decides there has been a breach of law; everyone, regardless of their position in society, is subject to the law.

The rule of law does not have a precise definition, and its meaning can vary between different nations and legal traditions. Although no precise definition, the purpose of the rule of law is the protection individual rights and freedoms of abuse freedom of state power. It can be understood as a legal-political regime under which the law restrains the government by promoting certain liberties and creating order and predictability regarding how a country functions. In the most basic sense, the rule of law is a system that attempts to protect the rights of citizens from arbitrary and abusive use of government power.

Since it protects individual rights, the rule of law requires an independent judiciary. For the rule of law is not only sufficient technical division of powers between the legislature, executive and judiciary, as it exists in almost all modern states. What characterized the rule of law in the organization of government is an independent judiciary. As a significant institutional bond rule of law, independence of the judiciary provide effective judicial and administrative protection and realization of freedom and rights of citizens, because “there is no liberty if the judicial power is not separate from the legislative and executive authorities” (Monteskje, 1989, pp. 176).

Important characteristic of the rule of law is the legitimacy of the creation of law and legitimacy in the implementation of law which is primarily reflected in the impartial judiciary. Judges, the voice of the law, should be categorical about the realization of basic human rights and freedoms. “No judges, no rights, no rights, life has no value. Judge is the living law. The law in his personality and life gets” (Marković, 1977, pp. 19).

Therefore, the main elements of the rule of law are: the separation of powers, independent judiciary, protection of individual freedoms and rights and limit state power.

1. The modern concept of the rule of law

Different people have different interpretations of the meaning of ‘the rule of law’. Among modern legal theorists, three major views are known as the formal approach, the substantive approach, and the functional approach. The formal interpretation holds that the law must be prospective, well-known, and have characteristics of generality, equality, and certainty. Other than that, the formal view contains no requirements as to the content of the law. This formal approach allows laws that protect democracy and individual rights, but recognizes the existence of rule of law in countries that do not necessarily have such laws protecting democracy or individual rights. The substantive interpretation holds that the rule of law intrinsically protects some or all individual rights. In addition to the formal and substantive interpretations of the term rule of law, another leading interpretation is the functional definition which is consistent with the traditional English meaning that contrasts the “rule of law” with the “rule of man.” According to the functional view, a society in which government officials have a great deal of discretion has a low degree of “rule of law”, whereas a society in which government officers have little discretion has a high degree of “rule of law”. The rule of law is thus somewhat at odds with flexibility,

even when flexibility may be preferable. There are other views as well. They include the minority view that the rule of law guarantees democracy.

In 1959, an international gathering of over 185 judges, lawyers, and law professors from 53 countries, meeting in New Delhi and speaking as the International Commission of Jurists, made a declaration as to the fundamental principle of the rule of law. This was the Declaration of Delhi. They declared that the rule of law implies certain rights and freedoms, that it implies an independent judiciary, and that it implies social, economic and cultural conditions conducive to human dignity. The Delhi Congress gave rise to three important elements in the concept of the Rule of Law. First, that the individual is possessed of certain rights and freedoms and that he/she is entitled to protection of these rights and freedoms by the State. Second, that there is an absolute need for an independent judiciary and bar as well as for effective system for the protection of fundamental rights and freedoms and third, that the establishment of social, economic and cultural conditions would permit men to live in dignity and to fulfill their legitimate aspirations. The Declaration of Delhi reaffirms the principles expressed in the Act of Athens adopted by the International Congress of Jurists in 1955, particularly the one that independent judiciary and legal profession are essential to the maintenance of the Rule of Law and to the proper administration of justice. It recognizes that the Rule of Law is a dynamic concept for the expansion and fulfillment of which jurists are primarily responsible and which should be employed not only to safeguard and advance the civil and political rights of the individual in a free society, but also to establish social, economic, educational and cultural conditions under which his legitimate aspirations and dignity may be realized.

In the twenty-first century, the rule of law has been considered as one of the key dimensions that determines the quality and good governance of a country.

2. The independent judiciary

An important bond of political freedoms of citizens, legal state and rule of law is the separation and independence of the judiciary from the legislative and executive. For the rule of law and legal state technical division of powers between the legislature, executive and judiciary is not sufficient as it exists in almost all modern states. What characterizes the organization of the legal state and the rule of law is an independent judiciary. As a significant institutional and procedural bond, the rule of law and the legal state, the independence of the judiciary provides effective judicial and administrative protection and realization of freedom and rights of citizens, because “there is no liberty if the judicial power is not separate from the legislative and executive authorities” (Monteskje, 1989, pp. 176).

Independence of the judiciary is a necessary prerequisite of a democratic political environment. It is the institutional bond and the rule of law and fundamental human rights and civil liberties. Because of its importance, the independence of the judiciary has reached the level of achievements of civilization and social values. It contributes to protecting and ensuring legal security and legal equality as important legal values. All these are reasons why the European Union affirms the independence of the judiciary and the realization sets in Serbia as an important condition for joining the European Union.

The United Nations has endorsed the essential importance of an independent judiciary by its adoption of the *Basic Principles on the Independence of the Judiciary* at its Seventh

Congress in 1985. As a consequence of the adoption of the *Basic Principles* by the UN General Assembly, each member state is expected to guarantee the independence of its judiciary in its constitution or the laws of the country.

Independence of the judiciary is the value that is affirmed by both United Nations and the European Union. Namely, it is the subject of the European Convention for the Protection of Human Rights and Fundamental Freedoms, as well as specific recommendations on the independence, efficiency and role of judges made by the Committee of Ministers of the Council of Europe (R-94/12).

Independent judiciary and the separation of powers assume the central position in the intensified process of regional cooperation and the integration of Serbia in the EU. Establishment of an independent judiciary in the Republic of Serbia is set as a priority in the reform process by the European Commission and the Council of Europe. Since the reform of the judiciary system is a priority in the process of Serbian attempts to join the EU, it is necessary to establish independent, competent and efficient judiciary capable of enforcing laws by European standards. For that reason, the Ministry of Justice has proposed the *National Judiciary Reform Strategy*, which was adopted by the National Assembly on May 25th of 2006. Its basic objective is to restore public trust in the judicial system of the Republic of Serbia by establishing the rule of law and legal certainty.

The judicial independence becomes one of the necessary conditions for the improvement of regional cooperation and inclusion of Serbia into European integrations. It is a priority of the reform financed by the EU through European Agency for Reconstruction, and is undertaken by the Council of Europe Parliamentary Assembly.

When discussing the Republic of Serbia, we should not forget that in the last half century, the judiciary in Serbia was in the unity government. It is then the separate state functions, not a separate government, which is independent of the legislative and executive authorities. The principle of separation of powers is a prerequisite for the independence of the judiciary. However, he only proclaimed the Constitution of Serbia in 1990, and the Constitution of Yugoslavia in 1992. After half a century long experience of the unity government, the independence of the judiciary remained only at the level of constitutional proclamation.

Therefore, it is necessary for a comprehensive reform of the judiciary with the goal of establishing high-quality, independent and effective judiciary that will guarantee the rule of law.

3. Reform of the judiciary - a necessary condition for the inclusion of Serbia into the European Integration

Reform of the judiciary in Serbia is the central point in the process of joining the European Union. The reason for this is an imperative to ensure that laws governing the area of the judiciary are compliant with standards and practices the Council of Europe.

Since the reform of the Serbian judiciary a priority in the process of Serbia joining the

European Union, because it is necessary to provide guarantees for independent, professional and efficient judiciary able to apply European standards, the Ministry of Justice has proposed the *National Judiciary Reform Strategy*, which was adopted by the National Assembly on May 25th of 2006.

The main goal of the *National Judiciary Reform Strategy* is independent and efficient judiciary able to implement European standards which would restore the citizens' confidence in the judicial system of the Republic of Serbia by establishing the rule of law and legal certainty.

The aim of the reform is to establish high-quality, independent and effective judiciary. Effective judiciary is based on the fundamental principles that provide a framework for the establishment, development and organization of judicial institutions. Four basic principles are: independence, transparency, accountability and efficiency. An independent, transparent, accountable and efficient judiciary is capable of implementing European standards, the protection of human rights and civil liberties and establishing the rule of law and legal security.

National Judiciary Reform Strategy has determined the period of six years (2006-2012) for the implementation of reform objectives and the establishment of the judicial system that will answer the needs of new social values and restore the confidence of citizens. The reform of the judiciary of the Republic of Serbia includes twelve fundamental goals of the reform. Each of these four basic principles (independence, transparency, accountability and efficiency) contains three targets.

The first goal of judicial reform is the creation of an independent judicial system. It includes three targets: independent administrative management, independent budget authority, independent establishment of general framework and internal structure and work of the courts. Another objective of the Strategy is the creation of transparent judicial system. Conditions for its implementation are: open appointment process and the improvement of judges and open disciplinary proceedings, appropriate access to information from court records and procedures, and improved public relations and greater participation of the public. The third goal of judicial reform is a responsible judicial system. For its realization it is necessary to fulfill the following conditions: the existence of clear standards for performance of judicial duties and their practical application, effective judicial administration and court management, and effective use of court and prosecutorial resources. Fourth goal of the reform is efficient judicial system. Its implementation is necessary for the following: better access to justice, a standardized system of training and professional training of employees, a modern network of courts and modern equipment for the judicial and penal system.

Due to the great importance of the Strategy to establish standards for independent and effective judiciary is the realization of one of the emergency conditions of regional cooperation and association of Serbia to the European Union, the implementation of the project financed by the European Union through the European Agency for Reconstruction and implemented by the Parliamentary Assembly of the Council of Europe.

4. The rule of law and independent judiciary (the quality of legal institutions) - prerequisites for economic development, regional cooperation and economic integrations

The rule of law is usually thought of as a political or legal matter. But in the past ten years the rule of law has become important in economics, too. Indeed, it has become the motherhood and apple pie of development economics. The rule of law is held to be not only good in itself because it embodies and encourages a just society, but also a cause of other good things, notably growth.

Until recently, the rule of law was regarded as a matter of political and moral philosophy while neoclassical economists paid little or no attention to the rule of law in the course of economic analysis. Thanks to the contributors of Austrian school of economic thought and institutional economists, the rule of law was shown as an influential motherhood in economic development. Douglass C. North, a distinguished recipient of the Nobel prize in economics back in 1993, demonstrated the significance of the rule of law in his book “Institutions, Institutional Change and Economic Performance” where he wrote that the inability of societies to develop low-cost effective institutions capable of reducing transaction costs is the very reason of economic stagnation in both historical and current perspective. The rule of law and the ability of institutional flexibility were recognized as a driving vehicle in the process of economic growth and development.

In economics, the idea of the rule of law was initiated by two distinguished economists. In his book, *The Constitution of Liberty*, Friedrich August von Hayek wrote that the aim of the rule of law is to set a basic framework of general rules perceived without coercive action (Hayek, 1998). Simply, the more specific the law becomes, the higher the magnitude of coercion. In 1690, enlightenment philosopher John Locke captured the essence of the rule in a brilliant sentence: “Wherever law ends, tyranny begins” (Lok, 2002, pp. 339).

Current economic issues confirm that Hayek and Locke were right. When Asian crisis (1997-1998) deflated the expectations of the right policies, the essence of the rule of law became obvious. Without a low-cost institutional setting of policymaking based on the rules rather than discretionary action, no macroeconomic reasoning may give desirable results.

The rule of law is a goal of development policy. There is no economic development and growth without economic freedoms, which guarantee the rule of law. Therefore, the rule of law is a condition for economic growth and development. Economic growth, political modernization, the protection of human rights, and other worthy objectives are all believed to hinge, at least in part, on the rule of law. Policymakers in developing and transition nations are thus seeking ways to establish or strengthen the rule of law in their countries. Investment rating services, non-governmental organizations, and other students of development are producing indices that try to measure the degree to which a nation enjoys the rule of law.

It is widely believed that well-functioning law and legal institutions and a government bound by the rule of law are important to economic, political and social development. As a

result, practitioners in the development field have focused their attention more and more to reforms intended to improve law and legal institutions. Multilateral institutions such as the World Bank and many policymakers throughout the world believe the rule of law promotes economic development.

Law is important to the market economy because it is the common basis on which parties can make agreements; it provides parties with confidence that disputes can be resolved efficiently and fairly. For this reason, the predictability and order that the rule of law promotes in substantive laws is viewed as the stabilizing force behind much economic development. The rule of law helps set the “rules of the game” in critical areas such as investments, property, and contracts.

The rule of law also serves as an important assurance of social rights and government accountability. Governmental restraint is especially critical for many transition economies where a previously planned economy is to be transformed into one that is market-based. When the government is no longer the sole owner of land, capital, and labor, the rule of law guarantees that the crucial elements of the economy will be free from arbitrary governmental actions. The rule of law thus assures market participants that the government will adopt a hands-off approach to investments and production, allowing those participants to fully exercise their rights in relation to land, labor and capital.

The efficiency of the courts is an important component in rule of law reforms as the existence of a judiciary is a fundamental aspect of the rule of law. At the most basic level, this simply meant that courts needed to be available to adjudicate disputes and enforce resolutions. For countries that are further along in the reform process, more complex structural reforms that strengthen court capacity, independence, and transparency are needed.

To increase accountability and transparency, information technology systems may be installed to provide greater public access. To increase independence of the courts, the government can provide them with funding that will allow them to make their own financial and administrative decisions. Furthermore, for countries that have already established these structural reforms, to encourage the adoption of the rule of law, court performance should be evaluated on a periodic basis. Independence, accountability, efficiency, access, affordability, alternative dispute resolution mechanisms, and the quality of professionals are some of the characteristics that may provide an accurate measurement of the system’s success.

Another important rule of law reform goal is to build the legal rules. As Fuller stated, “laws must exist” (Fuler, 1999, pp. 49). Economic reforms have generated a large number of new economic laws in developing countries. Between 1990 and 1995, 45 developing and former socialist countries enacted new investment laws or codes covering a wide range of areas. Many of these investment laws were passed to liberalize the existing investment regime in the developing country by offering clear and broad legal protection for all types of investments.

To encourage additional country-specific development, in the early 1990s the World Bank and the International Monetary Fund (IMF) began conditioning financial assistance on the implementation of the rule of law in recipient countries. These organizations provided aid to support initiatives in legislative drafting, legal information, public and legal education, and judicial reforms, including alternative dispute resolution. By conditioning funds on

the establishment of the rule of law, the World Bank and the IMF also hope to reduce corruption, which undermines economic development by scaring away investors and preventing the free flow of goods and capital.

Currently, in its Millennium Development Goals (MDG), the United Nations (UN) also champions the rule of law as a vehicle to bring about more sustainable environmental practices. The MDGs are eight goals that the UN hopes to achieve by 2015 in an effort to respond to the world's greatest development challenges. The MDGs call on nations to make laws in areas such as international environmental and energy law, and also call on nations to encourage their citizenry to abide by those rules through changes in custom. The UN explicitly acknowledges that achievement of the MDGs rests heavily on the development of the rule of law, among other factors.

One reason the development community is fostering legal and judicial reform is the belief that, beyond their intrinsic worth, such reforms will help improve economic performance. This belief in the power of legal and judicial reform to spur economic development is supported by a growing body of research showing that economic development is strongly affected by the quality of institutions – including the quality of a nation's legal institutions.

The structure and quality of political institutions can affect whether the government facilitates or inhibits economic development. Stated most simply, the incentives institutions create for government decision-makers will determine whether the government uses its power to create a framework for productive economic activity or to redistribute wealth to itself or its supporters.

These arguments establish a strong basis for the claim that a successful economy requires appropriate legal and political institutions. Despite the difficulty inherent in measuring the quality of institutions, progress is being made in investigating the link between institutional quality and economic development. Despite all the problems with measuring the quality of institutions, almost all empirical work on the subject has concluded that institutional quality – in one form or another – correlates strongly with economic development.

The rule of law and the quality of legal institutions exert certain influence on the economic and social development. Also, the rule of law, independent judiciary and the quality of legal institutions provide legal security and legal certainty that are necessary for regional cooperation, foreign investments and economic integrations.

CONCLUSION

The rule of law and judicial independence are institutionalized guarantees of the legal state, as well as basic human rights and civil liberties. This very essence is what assigns them the status of civilizational inheritance and social values. The judicial independence is the ability of a judge to decide a matter free from pressures or inducements. Additionally, the institution of the judiciary as a whole must also be independent by being separate from government and other concentrations of power. The principal role of an independent judiciary is to uphold the rule of law and to ensure the supremacy of the law. If the judiciary is to exercise a truly impartial and independent adjudicative function, it must have special powers to allow it to “keep its distance” from other governmental institutions, political

organisations, and other non-governmental influences, and to be free of repercussions from such outside influences.

The rule of law and judicial independence contribute to protection and validation of the legal security and legal equality. Hence the EU insists on consistent separation of powers and judicial independence and their establishment in Serbia is seen as a reform priority and a significant condition for joining the EU.

However, past experience shows that the realization of the true separation of powers and independence of the judiciary in the Republic of Serbia faced with numerous problems. This situation is a consequence of half a century long experience of the unity government. Namely, a necessary condition for the rule of law and independence of the judiciary is the principle of separation of powers, which should allow the independence and autonomy of all three forms of state power. Separation of powers is a constitutional proclamation in Serbia until 1990 and in Yugoslavia in 1992. A special problem is that today the independence of the judiciary is at the level of the constitutional proclamation, while in reality the situation is still problematic, since the judiciary is often reduced to the offices of the political power. Also, position of the Ministry of Justice clearly shows the influence of executive authorities of the judicial power. This is a consequence of the fact that the executive power in Serbia traditionally tend to be interfere with the exercise of judicial power. It violates separation of powers, the rule of law and independence of the judiciary.

Due to the above situation it is necessary to implement complete and comprehensive reforms that aim at the establishment of modern independent and just judiciary and the rule of law. Only the real implementation of it could be say about a democratic political system and Serbia as a legal state.

The National Assembly of the Republic of Serbia adopted the *National Judiciary Reform Strategy* which is the basic task of creating an independent and effective judiciary capable of implementation of European standards. The period of six years (2006-2012) is allocated for the implementation of the National Strategy provides. As a result, it is perhaps too early to evaluate the reform process, the success of the implementation of reform objectives and the establishment of an independent judicial system and the rule of law. However, we can say that so far none of the three conditions referred to the independence of the judiciary is realized.

The rule of law and independent judiciary ensure legal security necessary for economic integrations. Without legal security and legal certainty, which result from the rule of law, regional cooperation and economic integrations would not be feasible. Foreign investments and economic integrations require legal certainty and security which are the consequence of the fully and truly implemented the rule of law.

It is depressing that in tree years, which is one half of the period anticipated for the implementation of the reform of the judiciary, not one goal set by National Judiciary Reform Strategy has been fully achieved. It remains to be seen whether and to what extent, the reform objectives identified in the National Strategy whose implementation and fulfillment is one of the conditions for regional cooperation and the integration of Serbian in the European Union will be achieved in the upcoming period.

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Part V

FDI FLOWS IN SOUTH EASTERN EUROPE

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KEY DETERMINANTS OF FOREIGN DIRECT INVESTMENTS: EMPIRICAL EVIDENCE FROM THE EU CANDIDATE COUNTRIES

INTRODUCTION

Foreign direct investment (FDI) has been a centrepiece of economic literature and empirical studies over the past two decades as a result of its rapid growth, on one hand and its multi-fold contribution to economy of a host country, on the other hand.

The importance of FDI for the growth and economic development of the South-Eastern European countries to which the present European Union (EU) candidate countries (Croatia, Macedonia and Turkey) belong has been highlighted in numerous papers.

First of all, FDI provides capital for closing the gap between the low domestic savings in these countries and the huge need for investment. So, FDI inflows are of vital importance for improving and accelerating the long-term economic growth and development of EU candidate countries.

FDI does not only provide the recipient country with fresh capital, but also with transfer of technology and managerial and other skills (Estrin et.al, 1997 and Lankes and Venables, 1996. This in turn increases the international competitiveness of its goods and services, leading to higher volumes of sales and profits of it companies.

FDI can contribute to job creation on a long run. However, effects of FDI on job creation in the EU candidate countries are not straightforward due to the fact that the majority of FDI in those countries represent acquisitions of existing companies, rather than green-field investment.

Another potential benefit of FDI is speeding up the EU accession process. Those countries that experienced higher FDI inflows in the early years of transition have been more advanced in fulfilling two economic criteria for joining the EU and have started

the association process earlier (Zakharov, V. and Kusic, S., 2003, pp.8). That explains the role of FDI in the acceleration of the EU integration process.

Taking into account the importance of FDI for the economy, governments of the EU candidate countries, are faced with the challenge how to attract more foreign direct investment. To answer the question, this paper uses data on EU FDI outward stocks per capita in the EU candidate countries in the period between 1999 and 2007 to investigate the determinants of foreign direct investments and to provide econometric estimation of these determinants. It is a first attempt of that kind since the previous empirical research on the determinants of FDI to EU accession countries focused on the world FDI to those countries and not specifically on the part of FDI coming from the EU member countries to EU candidate countries. This is of crucial importance for establishing a relationship, if any, between the EU economic integration and foreign direct investment.

Before we proceed with econometric estimation of the determinants of FDI, in Section 2 we undertake a comparison of the world FDI patterns and FDI patterns of the EU candidate countries. In Section 3 we investigate a number of determinants that could influence the level of EU FDI outward stock in the EU candidate countries. In Section 4 we describe the econometric methodology for identifying the key determinants of FDI and discuss the obtained estimation results. The last section concludes the paper and recognizes some of the policy implications of the econometric results presented in this paper.

1. Global FDI trends and FDI trends in the EU candidate countries

World FDI have increased considerably over the past two decades, reaching a record level of \$1.8 trillion in 2007, well above the previous all-time high set in 2000.

According to the World investment report 2008, the region of South-Eastern Europe, to which the EU candidate countries (Croatia, Macedonia and Turkey) belong, has also seen seven years of uninterrupted growth. FDI flows to these countries in 2007 increased by 50%, setting a new record of \$86 billion.

As for the world FDI inflows to the EU candidate countries (Croatia, Macedonia and Turkey), they are relatively small, but highly focused to Croatia. Macedonia has received a negligible share of FDI among the EU candidate countries (See Table 1).

**Table 1: Distribution of world FDI flows among the EU -
- candidate countries by range, 2007**

Range	FDI Inflows	FDI Outflows
Over \$5.0 bn	Turkey	
\$1.0 bn to \$4.9 bn	Croatia	Turkey
\$0.1 bn to \$0.9 bn	Macedonia	Croatia
Less than \$0.1 bn		Macedonia

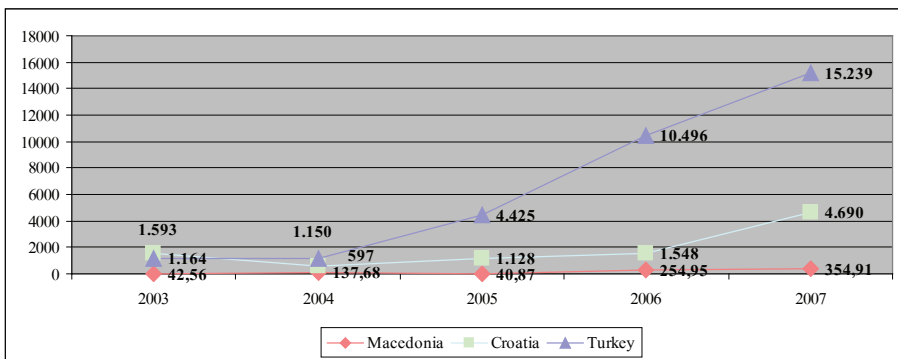
Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics) and annex table B.1. in World Investment Report 2008

FDI became an important part of the domestic economies of the EU accession countries. In 2000, the FDI stock averaged just 12,43% of GDP, ranging from 7,2% in Turkey to 15% in Macedonia and 15,1% in Croatia. By 2007, the FDI stock averaged 50,1 percent of GDP, ranging from a minimum of about 22,2 percent in Turkey to 41,1 percent in Macedonia and a maximum of 87 percent in Croatia.

European Union (EU) member countries traditionally have been the largest sources of FDI in EU candidate countries. In 2007, EU-27 accounted for about 99% of total FDI inflows to Croatia, 75% of total FDI inflows to Macedonia and two thirds of total FDI inflows to Turkey (See http://ec.europa.eu/enlargement/candidate-countries/index_en.htm)

In 2007 EU-27 FDI outward flows to the EU candidate countries (Croatia, Macedonia and Turkey) recorded their fifth consecutive year of growth reaching a record level of EUR 20 billion compared to only EUR 2 billion in 1999, which represents a nine-fold increase. The EU FDI outward flows to Croatia, Macedonia and Turkey grew particularly strongly between 2006 and 2007 (302,97%,145,19% and 139,21%, respectively).

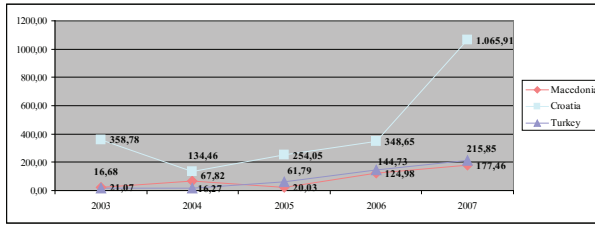
Figure 2: EU FDI outward flows to EU - candidate countries for 2003-2007 (in millions EUR)



Source: Eurostat , *Pocketbook on candidate and potential candidate countries 2009 edition*, p. 6-7 and web site of the National Bank of the Republic of Macedonia (www.nbrm.gov.mk)

Regarding the FDI inflows per capita, a big difference can be observed among the EU candidate countries. In the period 2003-2007 Croatia has by far been the major recipient of FDI inflows per capita among the three EU candidate countries with EUR 358,78 in 2003 and EUR 1065,91 in 2007 (five to six times higher than in Turkey and Macedonia, respectively). In the same period the FDI inflows per capita in Turkey varied between EUR 16,68 in 2003 to EUR 215,85 in 2007 in Macedonia. The smallest FDI inflows per capita in the above mentioned period were recorded in Macedonia-EUR 21,07 in 2003 and EUR 177,46 in 2007.

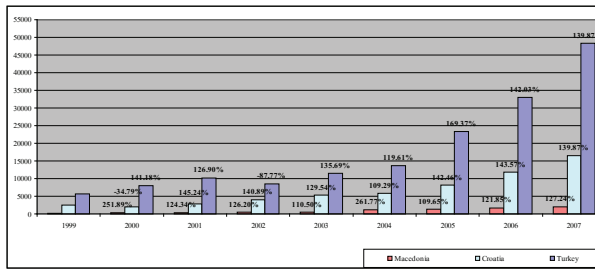
Figure 3: EU FDI outward flows to EU - candidate countries per capita for 2003-2007 (in EUR)



Source: Eurostat, *Pocketbook on candidate and potential candidate countries 2009 edition*, p. 6-7 and NBRM

Concerning the EU FDI stocks in the three EU candidate countries, EU FDI outward stocks in those three countries, although low in absolute values, have shown steady growth during the period 2000 to 2007 (see Figure 4).

Figure 4: EU FDI outward stocks in the EU - candidate countries and their annual growth rate, 1999-2007 (in million EUR)



Source: Eurostat, *Statistics in focus 68/2008* and NBRM and author's own calculations

EU FDI outward stocks held in Macedonia increased nineteen times during the period 1999 to 2007, from 106 million EUR in 1999 to reaching 2,06 billion EUR in 2007.

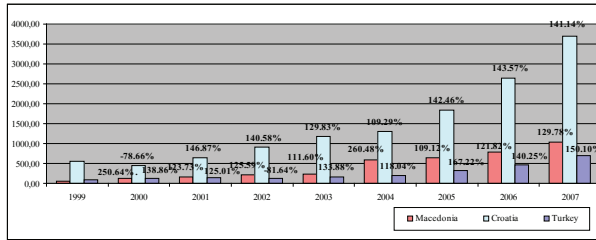
In the same period EU FDI outward stocks in Croatia expanded from 2,8 billion EUR in 2001 to 16,4 billion EUR in 2007. The period 2005-2007 saw the biggest growth since Croatia started negotiations with the EU (i.e. 201% from 2005 to 2007).

Turkey recorded also a substantial increase in the level of EU FDI outward stocks from 1999 to 2007. In the period 1999-2001, EU-15 FDI outward stocks in Turkey almost doubled. In 2001, direct investors from the EU-25 held EUR 10.2 bn worth of FDI outward stocks in Turkey. After falling by 17% in 2002, EU-27 FDI stocks to Turkey increased considerably (by four times) over the period 2003-2007, peaking at EUR 48 bn in 2007.

Concerning the EU FDI outward stocks per capita, a big difference can be observed among the EU candidate countries. In the period 1999-2007 Croatia has by far been the major recipient of FDI outward stocks per capita among the three EU candidate countries with EUR 562.03 in 1999 and EUR 3739.32 in 2007 (three to more than five times higher than in Macedonia and Turkey, respectively). In the same period the EU FDI stocks per capita held in Macedonia varied between EUR 52.74 in 1999 to EUR 1030.00 in 2007. The smallest FDI

stocks per capita held by EU member countries in the above mentioned period was recorded in Turkey with only EUR 86.73 in 1999 and EUR 683.81 in 2007.

Figure 5: EU FDI outward stocks in the EU - candidate countries per capita and their annual growth rate, 1999-2007 (in EUR)



Source: Eurostat, *Statistics in focus* 68/2008 and NBRM and author's own calculations

The increase of EU outward flows to the EU candidate countries in the last five-six years raises the issue of the sustainability of these inflows and to what extent, they are a result of the improved macroeconomic conditions, on one hand and the progress that EU candidate countries achieved in the EU enlargement process, on the other hand.

2. Determinants of foreign direct investments from the EU member states to the EU candidate countries

A number of economic theories and perspectives have been developed to explain the determinants of FDI since the late 1950s, when the topic started to receive scholarly attention. The main FDI theories range from the mainstream economic theories, internalization models to Dunning's eclectic paradigm.

With reference to the empirical studies, they have investigated the impact of location-specific determinants of FDI on the FDI location decision into and within the United States, the EU or, more recently, China. Rather less attention has been devoted to the South-Eastern European countries, with several authors (Lankes, H.P. and Venables, A., 1996 and Meyer, K.E. 1998) simply reporting aggregate data or using case study and survey methods, and relatively few econometric studies. (Lansbury et al., 1996, Holland, D. and Pain, N., 1998, Resmini, L., 2000, Campos, N. and Y. Kinoshita, 2003, Bevan, A.A. and Estrin S., 2004, Botric, V. and Skuflic, L., 2005, and Grosse, R. and Trevino, L.J., 2005).

The purpose of this paper is to enrich the econometric research of the FDI determinants by empirical estimation of the most significant factors that have determined past decisions of the EU investors and those that will influence their future decisions to invest in the EU candidate countries.

In order to investigate the determinants of foreign direct investments to EU candidate countries, we use annual data on EU FDI outward stocks per capita in EU candidate countries in the period between 1999 and 2007. The selection of variables is based on the economic literature as well as previous empirical research of the determinants of FDI in South-eastern European countries. The econometric models will be estimated using the ordinary least square (OLS) method.

The paper explores the impact of the classical independent variables (market size, labour costs, quality of labour force, infrastructure and transportation costs), policy variables

(macroeconomic stability and openness of the economy), non-economic factors, such as governance, agglomeration effect and the effect of EU accession on EU FDI outward stock per capita in the EU candidate countries.

GDP per capita serves as a measure of market size. The size of the market is an important factor for attracting FDI flows. However, Botric and Skuffic (2005) have found out that the size of the market does not have a significant impact on the FDI flows to the South-Eastern European countries.

Labour costs are another important FDI determinant. Cheap labour is of particular interest for the EU-27 countries which wage levels are high and which companies look for reduction of costs by relocating production to countries where resources are available at a lower cost. Therefore, there could be also a positive correlation between FDI and labour costs.

Foreign investors should be concerned not only with the labour costs, but also with the quality of labour, since high skill workers can learn and implement new technology and the training costs would be in that case considerably lower

Availability of good infrastructure is a necessary condition for any type of FDI. Among the several candidates for the infrastructure variable we have chosen the number of mobile cellular subscriptions per 100 people.

According to the gravity model, proximity to the home country is an important factor for explaining the trade volumes between countries. Since FDI flows are closely related to trade flows we can apply the analogous argument for the FDI. Further geographical distance between the home and host country markets implies higher transportation costs.

We expect that the more FDI from EU will be directed to the EU candidate countries with larger market size, lower labour cost, higher educated labour force, better infrastructure and closer to EU.

However, investment decisions are also influenced by economic and political stability. For the macroeconomic stability, we add the policy variable consumer price index as a measure of inflation. A track of low inflation is a clear signal to foreign investors how successful the host country is and thus the prospect of further growth. On the other hand, higher return on investment boosts FDI and as a result of that the increase of prices of products in which the foreign investor invested, should be positively correlated to the FDI. Therefore we can not predetermine the expected sign of inflation rate.

Another important determinant of FDI that can be assessed within the overall economic policies is the external liberalization. For this, we use the variable trade openness measured as a ratio of export and import to GDP. According to Basar and Tosunoglu (2005) a country can attract more FDI if the ratio between the foreign trade (import and export) and GDP is higher. Other authors, Caves (1996) and Singh and Jun (1996) doubt in the existence of relation between the FDI and the openness of the economy. For our group of the three EU candidate countries, we expect the openness of the economy to have positive impact on FDI flows to the EU candidate countries.

Non-economic factors, such as governance, also influence the decisions of foreign investors. To assess the governance, we use the variable Euromoney country risk ranking. The better country ranking implies that the country is more attractive for FDI. Deichman (2001) and Bevan and Estrin (2000) found a significant positive relationship between the country risk and FDI.

Along with the variables described above, we include the agglomeration effect. Various empirical studies present evidence on the presence and importance of the self-reinforcing effect of foreign investment. Agglomeration economies emerge when there are some positive externalities by collocating near other economic units due to the presence of knowledge spillovers, specialized labour markets and supplier network. Once agglomeration economies set in, there will be a snow balling effect of FDI inflows in successful countries (Kinoshita, Y. and Campos, N.F., 2002)

The experiences of the earlier EU enlargements demonstrate that economic integration can contribute significantly to an increase of FDI inflows (Zakharov, V. and Kusic, S. 2003). In our model we add a dummy variable-EU accession negotiations which serves as a proxy for the EU accession effect on FDI. We hypothesize that the EU candidate countries with started formal EU accession negotiations will attract more FDI than those countries that have only candidate status.

3. Econometric models and results

The objective of this section is to specify an econometric model for estimating the impact of investment climate and the EU accession on the growth of FDI in the EU candidate countries.

One possible approach is to estimate a gravity model. This model has proved very successful in estimating trade flows and has been used by some authors for estimation of the effect of EU integration on FDI flows (Brenton et.al, 1999 and Egger, P. and Pfaffermayr, M., 2004).

To test the impact of the EU accession on FDI stock per capita in the EU candidate countries, it is important that we control for the other determinants of FDI. Based on a sample of 27 observations (9 years x 3 countries), we employ the following five model specifications, where model (1) is our benchmark model:

$$\ln FDIPC_t = \beta_0 + \beta_1 \ln GDPPC + \beta_2 WAGEDIF + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + u \tag{1}$$

$$\ln FDIPC_t = \beta_0 + \beta_1 \ln GDPPC + \beta_2 WAGEDIF + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + \beta_6 CPI + \beta_7 \ln TROPEN + u \tag{2}$$

$$\ln FDIPC_t = \beta_0 + \beta_1 \ln GDPPC + \beta_2 WAGEDIF + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + \beta_6 CPI + \beta_7 \ln TROPEN + \beta_8 RANKING + u \tag{3}$$

$$\ln FDIPC_t = \beta_0 + \beta_1 \ln GDPPC + \beta_2 WAGEDIF + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + \beta_6 CPI + \beta_7 \ln TROPEN + \beta_8 RANKING + \beta_9 \ln FDIPC_{t-1} + u \tag{4}$$

$$\ln FDIPC_t = \beta_0 + \beta_1 \ln GDPPC + \beta_2 WAGEDIF + \beta_3 SECONDARY + \beta_4 \ln MOBILE + \beta_5 \ln DIST + \beta_6 CPI + \beta_7 \ln TROPEN + \beta_8 RANKING + \beta_9 \ln FDIPC_{t-1} + \beta_{10} NEG + u \tag{5}$$

whereas:

t - a particular year (*t*=1,2,...9) in the period 1999-2007;

FDIPC- logarithm value of the EU-27 FDI outward stocks held in the EU candidate countries measured in million Euros per capita. Data on this variable in Euros were collected from Eurostat (for Croatia and Turkey) and from the National Bank of the Republic of Macedonia (for Macedonia);

lnGDPPC - logarithm value of the gross domestic product of the EU candidate countries per capita measured in million Euros. Data on GDP per capita in Euros were collected from Eurostat;

WAGEDIF- absolute value of the difference between the average gross monthly wage in Belgium and the average gross monthly wages in the EU candidate countries expressed in US dollars. We have used the difference between the wages in order to produce a bigger contrast between the labour costs of EU (Belgium) and the labour costs of the host countries (EU accession countries). Data on average gross monthly wages in US Dollars were taken from the statistical division of the United Nations Economic Commission for Europe;

SECONDARY- total gross secondary school enrolment rate. It is the number of pupils enrolled in secondary, regardless of age, expressed as a percentage of the total population in the theoretical age group for secondary education. Data for this variable were obtained from UNESCO Institute for Statistics;

MOBILE- number of mobile cellular subscriptions per 100 people in the EU candidate countries. Data for mobile subscriptions were obtained from the World Development Indicators Database 2008 of the World Bank;

DIST- airline distance in kilometers between Brussels and the capital cities of Macedonia, Croatia and Turkey (Skopje, Zagreb and Ankara). Data for the distance between the capital cities was obtained from www.indo.com/distance;

CPI-consumer price index where base year is 2005. Data are obtained from the Statistical Division of the United Nations Economic Commission for Europe;

lnTROPEN- logarithm value of openness of the economy defined as a share of trade (import and export) in GDP. Data for calculation of this variable were obtained from UNCTAD Handbook of Statistics;

RANKING- this variable denotes the ranking of the country according to the Euromoney country risk ranking. Data were obtained from the September issues of Euromoney magazine for the period 1999-2007;

lnFDIPC_{t-1} - logarithm value of the EU-27 FDI outward stocks held in EU candidate countries measured in million Euros per capita in the previous year.

NEG - denotes the dummy variable EU formal negotiations. It takes value 1 for the period from the formal beginning of the accession negotiations onwards and value 0 otherwise. Data for this variable were obtained from the web site of European Commission Enlargement (http://ec.europa.eu/enlargement/candidate-countries/index_en.htm).

It is worth mentioning that the dataset represents a huge progress over the datasets used in the earlier econometric studies on this topic. The data is balanced i.e. there are no missing observations.

On the basis of the data for the above mentioned variables for the period 1999-2007 and by applying the econometric software package EViews 6, we have obtained the following results:

Table 2: Determinants of FDI: Dependent variable= FDI stock per capita in year t

<i>variable</i>	Model 1	Model 2	Model 3	Model 4	Model 5
<i>LOG(GDPPC)</i>	0.544284 (0.158372) ***	0.534746 0.164444***	-0.005045 0.304262	0.152342 0.295630	-0.162915 0.322514
<i>WAGEDIF</i>	0.000577 (0.000141) ***	0.000569 0.000188***	0.000567 0.000174***	0.000222 0.000322 *	0.000211 0.000298
<i>LOG(DIST)</i>	-1.784674 (0.314970) ***	-1.217531 0.783777	-0.790082 0.754567	0.601180 0.934152	0.128269 0.900880
<i>LOG(MOBILE)</i>	0.406643 (0.096818)***	0.380709 0.106024***	0.245301 0.118284*	0.258726 0.295341	0.303610 0.274075
<i>SECONDARY</i>	0.007332 (0.024770)	0.002866 0.027337	0.010321 0.025552	0.004429 0.022699	0.004923 0.020983
<i>CPI</i>		-0.001726 0.004300	0.002953 0.004587	-0.000567 0.004731	-0.001824 0.004426
<i>LOG(TROPEN)</i>		0.723016 0.905690	0.007846 0.019725	1.792446 0.998653*	1.421671 0.944801
<i>RANKING</i>			0.042107 0.020554*	0.003639 0.023487	0.012692 0.022260
<i>LOG(FDIPC(-1))</i>				0.382394 0.193472*	0.322671 0.181750*
<i>NEG</i>					0.327494 0.177960*
<i>Adjusted R²</i>	0.940018	0.935857	0.945095	0.952488	0.959408

Standard errors are presented in brackets below coefficients. ***, **, *, indicate statistical significance at level of 1%, 5% and 10% respectively.

How are the above obtained econometric results interpreted?

The model (1) in the second column of Table 2e explains the variations of FDI stock per capita as a result of the classical FDI determinants. This model shows that market size expressed as GDP per capita, labour costs, transportation costs and infrastructure play important role in attracting FDI from EU to the EU candidate countries. When it comes to labour costs, a negative correlation is found between wage difference as a proxy for labour costs and FDI in our model which is consistent with the theoretical expectations that FDI is driven by lower labour costs. This is in case when vertical FDI is dominant. The coefficient of the variable secondary school enrolment rate is not statistically significant, so that we can conclude that FDI in these countries are not looking for skilled workers, but are mainly driven by cheap labour force. The distance (DIST) confirms the former expectations i.e. it affects inversely the level of FDI. In the estimated model, the coefficient of the variable

DIST shows that if the distance between Brussels and one of the capital cities of the EU candidate countries increases for one kilometre, that will lead to decrease of the FDI inflow to EU candidate countries for 0.0009 million Euros.

In model (2) which is presented in the third column of Table 2, we add two policy variables: openness of economy, as a proxy for external liberalization and consumer price index, as a proxy for macroeconomic stability. The econometric results suggest that neither of these variables are determinants that significantly influence the investments decision of EU investors to invest in the EU candidate countries. The positive, although not significant impact of TROPEN on FDI indicates that the EU candidate countries which are more open to international trade are valued more by EU investors. Consumer price index as a proxy for inflation is negatively related to FDI stocks, but not statistically significant. This finding suggests that macroeconomic stability, seems to be of a secondary concern to EU investors investing in the EU candidate countries. However, the obtained econometric results should not undermine the importance of macroeconomic stability for attracting FDI on a long run.

In model (3) we add the variable Euromoney country ranking (*RANKING*) as a proxy for governance. This variable is statistically significant and shows that if the country ranking improves for one place, that will contribute to increase of the FDI inflows to the EU candidate countries for 0,04 million Euros. The results in this model differ from those previous obtained in sense that GDPPC now turns out to have negative coefficient, opposite to models (1) and (2). This happens again in model (5) and the fact that it is not statistically significant (from model (3) to model (5)) indicates that FDI in these countries are not market-seeking, but export oriented.

The models (1)-(3) (without the agglomeration effect) show that the FDI in candidate countries are mostly driven by cheap labour force, access to local market (infrastructure) and non-economic factors, such as governance. This conclusion is more valid for the earlier investors when there is no prior experience. Once we introduce the agglomeration effect in model (4), proxied by the stock of FDI with a 1-year lag, the R square increases. The coefficient of this variable implies that once the FDI stock in the EU candidate countries reaches a critical mass, it is an indicator of favourable investment climate and attracts more FDI flows to those countries.

After including the EU accession effect in the last model, the econometric results have been partly changed. Namely, in the model (5) only the variable FDI per capita from the previous period ($FDIPC_{t-1}$) and the dummy variable negotiations (*NEG*) turned out to be statistically significant. The positive and significant regression coefficient of the dummy variable *NEG* suggests that progresses achieved in the EU integration process plays a crucial role for the EU candidate countries in attracting more FDI. The EU candidate countries that have already started with the formal EU association negotiations are more preferred by EU investors than those countries that have only a candidate status.

CONCLUSION

In this paper we have analyzed the determinants of EU FDI outward stocks per capita in the

EU candidate countries (Croatia, Macedonia and Turkey) in the period 1999-2007 using a gravity model. We have tested the significance of a number of determinants of FDI to the EU candidate countries: classical determinants (market size, labour costs, quality of labour force, infrastructure and transaction costs), policy variables (macroeconomic stability and external liberalization), non-economic factors (governance), agglomeration effect and the EU accession effect. We have found out that agglomeration economies and the achieved progress in the EU accession process are the key determinants of foreign direct investment from the EU member states to the EU candidate countries. Also important is the governance, proxied by the Euromoney country ranking.

Our findings suggest a need for concentrated policy efforts between the EU and the EU candidate countries furthest behind in the EU accession process (Macedonia) to speed-up the start of the formal EU negotiations. In this regard, Macedonia's government should accelerate the harmonization of its laws with the EU laws as a basis for formal start of negotiations and should further improve the general investment environment. The other party in the negotiations, the EU can also encourage more FDI flows to Macedonia by more rigorous analysis and objective assessment of the progress achieved, allowing greater flexibility in sequencing of reforms and accession tasks and extending additional financial aid and political support to Macedonia (Bevan et.al., 2001). Failure to do that, could deteriorate further Macedonia's position in the EU integration process and may cause a vicious circle where the stagnation in the EU enlargement process decreases FDI inflows to Macedonia and slows down economic reforms and as a consequence negatively influences future progress of the country on the way to EU integration.

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DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN SOUTHEAST EUROPEAN COUNTRIES

Abstract

The ability to attract international capital can offer large potential benefits for developing countries. The objective of this paper is to reveal the main determinants of foreign direct investments in southeast European countries (SEEC). We perform an econometric model based on a panel data analysis for 8 countries with similar economic, political and cultural surroundings: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia. The observation period is 1995 – 2008. Unit root tests have been applied for all 32 variables included in the model. Some of the variables have been differenced in order to become stationary, which improves the econometric model. Empirical results indicate that business freedom, fiscal freedom, GDP growth rate, population, exchange rate, current account as a percentage of GDP and property rights are factors on which Southeastern European countries' policy makers should focus when seeking to attract foreign direct investment.

Keywords: *foreign direct investments, panel regression with fixed effects, unit root test, southeast European countries.*

INTRODUCTION

The ability to attract international capital offers various benefits to the host country. Foreign capital can flow to a country in the form of direct investment or portfolio investment. This paper focuses on foreign direct investment - FDI.¹ As a source of extra capital, it supplements or adds to domestic savings, thus enabling the country to increase the capital accumulation. This improves the long term growth prospects and increases the wealth of the population. This type of financing helps finance increased need for resources, which was especially important for former centrally-planned economies at the beginning of the transition process. FDI contributes positively to the recipient's balance of payments, through the initial transaction and by adding to export growth. Since FDI flows are non-debt-creating, they are a preferred method of financing external current account deficits, especially in

¹ According to the definition of the EU: *Foreign direct investment is the category of international investment in which an enterprise resident in one country (the direct investor) acquires an interest of at least 10 % in an enterprise resident in another country (the direct investment enterprise). Subsequent transactions between affiliated enterprises are also direct investment transactions.*

developing countries, where these deficits can be large and sustained (Demekas et al., 2005). The acquisition of intangible assets is also very important for the host country. There is a common perception of FDI as an important factor in the transition process contributing to the restructuring of enterprises and the transfer of know-how. FDI facilitate the transfer of technology and foster the exchange of managerial expertise, marketing know-how that cannot easily be obtained by companies in the host country. When foreign firms employ domestic labor, employees attain various forms of formal and informal training that is generally unavailable in local firms. All of this contributes to a higher productivity. FDI also allow local entrepreneurs to learn about export markets and stimulate competition with local firms. These various favorable indirect effects in an economy, arising from FDI, are referred to as “spillover effects”.

Since the beginning of the transition process, former centrally-planned economies have opened their borders to foreign partners, seeking markets for their products, as well as foreign products and capital for their economy. Economic integration into the world economy is an extremely important aspect of economic transformation. FDI, as pointed out in this paper, are important for the integration and development of the economies of these countries. They play a key role in the globalisation process as an important element of initiation and development of international relations. Therefore, governments tend to take different measures in order to attract more foreign capital.

This paper focuses on a part of the transition countries, specifically the Southeast European countries. While the benefits for the host country are straightforward, one must ask himself what are the motives for foreign investors to place their capital in another country, what drives the capital from one country to another? The key question for the countries in South-Eastern Europe, countries seeking foreign capital, is how to attract foreign investors, what to do to stimulate capital owners to come to their country? In what aspects they could improve their competitiveness in attracting FDI? In this paper, we are trying to find answers to these questions, and reveal the main determinants that have influenced the FDI inflow to the SEE countries.

The paper is structured as follows. In the first section, the trends and distribution of FDI on global and regional level are explained. Further, there is a brief description of the main determinants of foreign direct investment which are most commonly recognized as relevant factors in the economic literature. In the third section, used data and statistical methodology are elaborated. Following, the empirical results are presented and final comments are given.

1. Trends and distribution of FDI

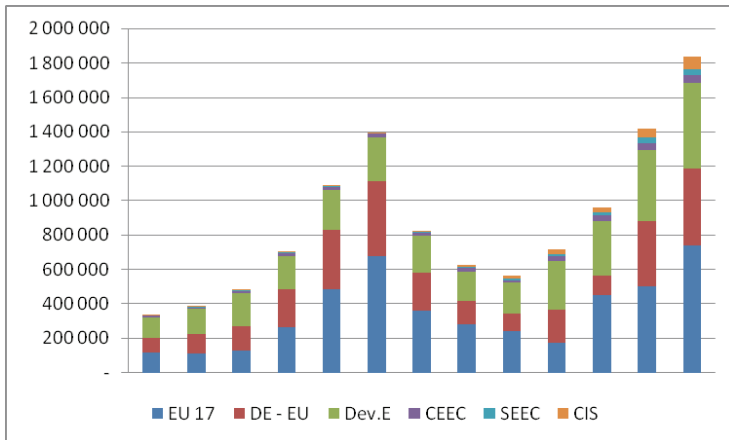
Global FDI flows have increased significantly during the last few decades and have become an important aspect of the ongoing global economic integration. The world FDI flow has raised from 13,346 billion dollars in 1970 to 54,077 billion in 1980, kept the upward trend during the 1990s and reached its peak in 2000, at 1.398,183 billion dollars. After that they started dropping until 2003, just to rise again and reach a record peak at 1.833,324 billion dollars in 2007.² In the last few years total FDI flow increased with an average annual growth rate of 34,6%. FDI inflow in 2007 is 141 times higher than

² To some extent, the record FDI levels in dollar terms also reflected the significant depreciation of the dollar against other major currencies. However, even measured in local currencies, the average growth rate of global FDI flows was still 23% in 2007. (World Investment Report, 2008)

the one recorded in 1970. FDI inflows are viewed as a measure of the extent to which a country or a region is integrated into the world economy. Therefore, policies to attract FDI are included in the governmental agenda of many countries. Despite these policies, FDI growth is unevenly distributed among the economic regions of the world. Developed countries have traditionally been both the largest home and host countries of FDI. It is important to note that FDI in developed countries are usually in high-technology sectors, while FDI in developing countries are in low-cost and labour-intensive sectors. Developed economies are usually recipients of horizontal FDI, while less developed economies are hosts of vertical investments.³

Since the beginning of the 1990's, the importance of developing and transition economies as recipients of FDI has increased. Although not as large recipient of total inward FDI as Latin America and East and South Asia, the transition economies have become an increasingly important destination for global FDI. They still attract a small share of the world's FDI, a share that is moreover unevenly distributed in the region. Central Europe and the Baltic States have received more FDI per capita than South-Eastern Europe and the Commonwealth of Independent States, which is understandable, given the differences in starting points and in political and economic developments, and also the geographical advantages of CEEC being closer to their partners from EU. Figure 1 shows the inward FDI flows in the period 1995-2007, divided by group of countries, while Figure 2 presents the distribution of FDI inflow by group of countries in 2007. It can be noticed that EU17 receives the largest amount of FDI, followed by other developed economies, which confirms the claim that most FDI flow between developed countries. On the other side, transition countries receive a small, even a negligible amount at the beginning of the analyzed period. However, their importance as host countries increases since 2000. In 1995 transition economies received 5 percent of the world flows, in 2000 2%, while in 2007 they received 8% of the FDI inflows.

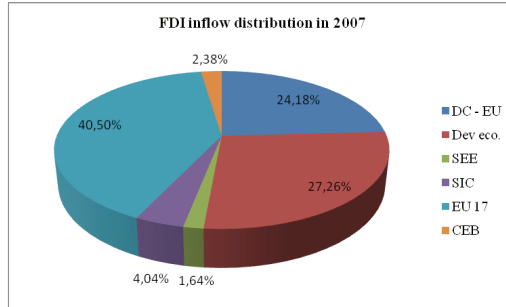
Figure 1: FDI inflow in the period 1995-2007



Source: UNCTAD, WIR database⁴ (www.unctad.org)

³ In developed economies, investors duplicate the entire production process and usually intend to penetrate new markets (market-seeking investment), while in developing economies only a part of the production process is placed and FDI are undertaken with the aim to take advantage of lower factor costs or natural resources.

⁴ Note: EU 17 (Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxem-

Figure 2: FDI inflow distribution in 2007

Source: WIR database, UNCTAD (www.unctad.org)

Figure 2 shows that SEEC lag behind CEES in FDI inflows. Only 1,64% of the world FDI inflow in 2007 has been toward SEE countries. Since the beginning of the transition process until 2008, they have received cumulative FDI inflow of 150.356 million dollars. They are mainly a result of the privatization processes and less greenfield investments, which have a stronger influence on the host economy, especially the labour market. Greenfield investments presume opening new companies and employing new people, while privatized firms usually rely on the already employed staff, and undergo large restructuring, most often resulting in massive lay-offs

If we analyze the distribution of FDI inflow in the former centrally-planned economies, we can conclude that at the beginning of the transition process the CEEC attracted more foreign capital than the SEEC. However, that gap is now smaller, as in the last few years FDI inflow in SEEC grow with a higher average rate relative to CEEC. This is mostly due to the attractiveness of Croatia, Bulgaria and Romania. The latter two are members of EU since 2007. Lately, also Montenegro proves to become an interesting destination for FDI. In 2008 it received the highest amount of FDI per capita and FDI as a percent of GDP (18,2%), followed by Bulgaria, while Romania is almost at the bottom of the table in this aspect. Macedonia has never been a very attractive destination for FDI. Compared to other countries of the region, only Albania has received less FDI inflow per capita in 2008. During the transition period, Romania was the largest recipient of FDI in the region, with cumulative FDI inflow during 1989-2008 of 55.894 million dollars, followed by Bulgaria. On the other hand, Macedonia is among the countries with low FDI inflow, with a cumulative amount of 3.226 million dollars, leaving only Montenegro behind (see figure 3). If we analyze the cumulative FDI inflow per capita, we can conclude that the leaders in the region are Romania, Bulgaria and Montenegro. (see Table 1)

bourg, Malta, Netherlands, Portugal, Spain, Sweden, United Kingdom); DE – EU (Gibraltar, Iceland, Norway, Switzerland, Canada, USA, Australia, Bermuda, Israel, Japan, New Zealand); Developing economies (Africa, Latin America and the Caribbean, Asia and Oceania); CEEC (Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia); SEEC (*Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania, Serbia*); CIS (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russian Federation, Tajikistan, Turkmenistan, Ukraine, Uzbekistan)

Table 1: FDI inflows in SEE countries

Country	FDI inflows 2008	Cumulative FDI inflows 1989-2008 (mil. US\$)	Cumulative FDI inflows per capita 1989-2008 (US\$)	FDI inflows per capita 2008 (US\$)	FDI inflows 2008 (% of GDP)
Albania	880	3.601	1.125	275	6,8
BIH	1.200	6.323	1.664	316	6,5
Bulgaria	8.472	41.448	5.454	1.115	17,0
Macedonia	612	3.226	1.613	306	6,4
Montenegro	783	2.769	4.195	1.186	18,2
Romania	11.000	55.894	2.576	507	5,5
Serbia	2.487	14.482	1.931	332	4,9
Croatia	4.098	22.613	5.091	923	5,9

Source: Economic statistics and forecasts of EBRD (www.ebrd.com)

2. Determinants of FDI

The importance of FDI for the development and integration of transition countries intrigued a large number of researchers to study the factors that determine FDI inflows towards these countries. The is most widely used framework in empirical studies of the determinants of FDI is Dunning's eclectic paradigm (OLI framework). According to this theory, three groups of factors determine the choice of investment in a foreign country: *ownership specific advantages* (all tangible and intangible assets that give the firms cost advantages over its local competitors and market power sufficient to cover the costs of producing abroad), *location advantages* (characteristics of the host country which make it profitable to produce abroad and allows the firm to minimise production costs, take advantage of large demand or knowledge spillovers) and *internalisation advantages* (gives the firm an opportunity to avoid pure market transactions and implies that the firm's most efficient alternative of utilising an ownership and location advantages is to exploit them through FDI).

FDI are usually directed toward countries where it is possible to combine the ownership and location advantages through internalisation advantages of FDI. Ownership and internalization advantages are firm-specific characteristics, while location advantages are external to firms and affect the magnitude of FDI flows.⁵ In the rest of the paper we focus on location specific advantages, since they are the only ones that governments can control and influence in order to attract more foreign capital, and they gain increasingly in importance since the global era.

⁵ The factors important for an investment decision depend also on the investment strategy. The market-seeking FDI are usually connected with the following determinants: market size, per capita income, market growth, consumer preferences. The resource-asset seeking FDI are drawn by lower labour costs, physical infrastructure, price of raw materials. The efficiency-seeking FDI is motivated by creating new sources of competitiveness for the firms and is directed where the cost of production is lower, also considered are price of factors of production, membership in regional integration processes.

The economic literature usually numbers the following standard determinants of FDI: country size (measured by nominal GDP), economic prospects of the country (measured by the GDP growth rate), level of income (GDP per capita), trade openness, import tariffs, business climate (tax rate on companies), infrastructure, factor costs, factor endowment, education (Botric and Skuffic 2005; Resmini, 2007)

One of the traditional determinants found in almost all FDI studies is the *openness* of the economy, usually measured as the trade (import plus export) share of GDP. It is expected that the greater the openness of the country, the greater the economic integration of the local economy into the regional and global economic flows. This should have a positive influence on the FDI. The *market size*, proxied by real GDP or GDP per capita, proves to be significant for the level of FDI. A higher GDP is related to a higher level of investment, for market seeking FDI while for resource and efficiency seeking FDI it is the opposite case. Beside GDP, the population can also be used as a measure of the size of the country. The economic literature also numbers the *labour costs* as a determinant influencing FDI. For countries like SEEC, where there is a higher unemployment rate and lower wages, it can be expected this to be a relevant motive for foreign investors.

Besides the traditional determinants, for our sample of countries, many studies include specific transition-related determinants, such as large scale privatization, small scale privatization, private sector share, restructuring and efficiency of the institutions (easiness to open a company, lack of corruption, transparency, contract law, security of property rights). These variables capture the effect of the transitional changes and transformations of the economy. Some studies lead to a conclusion that both economic transformation and political instability reduced FDI inflows into transition economies of Central Europe and the Balkans (Brada et al. 2004). SEEC have undertaken various reforms in order to improve the public efficiency and become more attractive to foreign investors. Nevertheless, in the Stability Pact for South-Eastern Europe, the Investment Compact is a very interesting initiative. The SEECs have adopted a joined procedure to encourage FDI.⁶ The literature also suggests that improvement of the investment climate, by undertaken economic reforms, more open trade policies, privatizations tailored to foreign investors, the integration process with the EU, plays an important role in boosting FDI inflows into the European transition economies (Resmini, 2007). For European transition countries, policy variables have been more important and have a clearer impact on FDI than economic variables.

The European integration process also plays an important role in determining the course of FDI in Europe. CEEC are a proof of this statement. According to Liebscher, they have experienced trade intensification and a wave of FDI inflows, not just since they became members of EU, but even in the years prior 2004 (Liebscher, 2007). He was right to expect the same for Bulgaria and Romania.

⁶ This initiative tends to permit a quasi-uniform procedure to host FDI and to improve transparency. With the Investment Compact, the SEECs work together for unifying FDI registration and approval procedures with those for domestic firms, allowing acquisition of real estate by foreign investors for FDI purposes, minimizing FDI-related requirements on statistical reporting, work and residence permits, eliminating discrimination in access to government procurement contracts and removing obstacles to FDI in financial and professional services. (OECD, 2005).

3. Data and methodology

Panel data set is used for the assessment of the determinants of foreign direct investments (FDI). This data set includes data for eight Southeastern European countries, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia. Since the observed period is from 1995 – 2008, the data is consisted of total 112 observations (8 countries*14 years). The main data source was the official statistical data published by EBRD. The index of economic freedom and its components was taken from the official data of Heritage foundation.

Originally, the research includes 32 variables: foreign direct investments as dependent variable and exports of goods and services, imports of goods and services, merchandise exports, consumer prize index, current account as percentage from GDP, employment, currency exchange rate, fixed-line penetration rate, GDP, GDP per capita, general government balance, general government debt, general government expenditure, industrial gross output, internet users, labour force, population, unemployment, general index of economic freedom⁷, business freedom index, trade freedom index, fiscal freedom index, government size index, monetary freedom index, investment freedom index, financial freedom index, property rights, freedom from corruption, external debt as percentage of GDP, gross average monthly earning in economy, large scale liberalization and index and overall infrastructure reform index as independent variables.

Augmented Dickey-Fuller unit root test was performed on all variables, after which, some of the variables were transformed in order to become stationary. Variable transformation is presented in Appendix A. Appendix B contains the coefficients of the unit root test.

To determine the effect of these variables on foreign direct investment, panel data regression model is used. Panel data regression model takes time series for observed period of 14 years for 8 countries. One way to take into account the “individuality” of each country or each cross-sectional unit is to let the intercept vary for each country but still assume the slope coefficients are constant across time. In literature, this model is known as fixed effects (regression model). The term “fixed effects” is due to the fact that, although the intercept may differ across individuals (here the 8 countries), each individual’s intercept does not vary over time, it is time invariant (Gujarati, 2003, pp.642).

By performing series of regressions with different variables included and excluded from the model, we have reached the best regression equation. This conclusion was made according to the statistical significance of the regression coefficients and coefficient of determination.

⁷ Index of economic freedom is calculated by the Heritage foundation and Wall Street Journal. Economic freedom is the fundamental right of every human to control his or her own labor and property. In an economically free society, individuals are free to work, produce, consume, and invest in any way they please, with that freedom both protected by the state and unconstrained by the state. In economically free societies, governments allow labor, capital and goods to move freely, and refrain from coercion or constraint of liberty beyond the extent necessary to protect and maintain liberty itself. Ten components of economic freedom are used to calculate this index, assigning a grade in each using a scale from 0 to 100, where 100 represent the maximum freedom. The ten component scores are then averaged to give an overall economic freedom score for each country. The ten components of economic freedom are: business freedom, trade freedom, fiscal freedom, government size, monetary freedom, investment freedom, financial freedom, property rights, freedom from corruption and labor freedom.

The regression equation, with 12 independent variables, follows:

$$\begin{aligned} \Delta FDI_{i,t} = & \beta_0 + \beta_1 \Delta BF_{i,t} + \beta_2 \Delta CA / GDP_{i,t} + \beta_3 \Delta FC_{i,t-1} + \beta_4 \Delta PR_{i,t-2} + \beta_5 \Delta TEL_{i,t} + \\ & + \beta_6 \Delta UNE_{i,t-1} + \beta_7 EMP_{i,t-2} + \beta_8 EXR_{i,t-4} + \beta_9 \Delta FF_{i,t} + \beta_{10} GDP_{i,t} + \beta_{11} GE_{i,t} + \beta_{12} \Delta POP_{i,t-2} \\ & i = 1, 2, 3, \dots, 8 \\ & t = 1, 2, 3, \dots, 14 \end{aligned}$$

where i stands for the i th cross sectional unit, or number of countries in our example, and t denotes the t th time period.

$\Delta FDI_{i,t}$ stands for the dependent variable, foreign direct investments, transformed by first difference, in order to reach stationarity. β_0 represents the regression constant. β_1 , β_2 , β_5 , and β_9 represent regression coefficients of the independent variables: business freedom index, current account/GDP, fixed-line (mobile) penetration rate and fiscal freedom index. All variables have been differenced once for stationarity. Coefficients β_3 , β_4 , β_6 and β_{12} are coefficients for the independent variables freedom from corruption, property rights, unemployment and population. Besides their first difference transformation, these time series are included in the regression model with time lags. The number of lags is specified in index t . Certain variables with time lags seem to depict a better regression model. Coefficients β_7 , β_8 , β_{10} are β_{11} coefficients of the independent variables employment, currency exchange rate, gross domestic product and general government expenditure. These time series are stationary and they don't need to be transformed by differencing. All of these variables, except gross domestic product, are included in the regression model with time lags.

3.1. Empirical results

This section explains the results of the panel regression model presented in the previous section. Total number of observations was 112 (8 countries*14 years). Due to the missing data (two countries, Serbia and Montenegro, were excluded), differencing and time lags (5 periods were excluded), number of observations has decreased down to 44, which is sufficient to produce robust estimates. The estimated results are summarized in Table 2.

From 12 included independent variables, 8 are statistically significant at 95%.

Business freedom index is positively and significantly associated with the FDI inflows, suggesting that investors are more likely to invest in the countries that have higher value of this index. The panel regression model indicates that if the business freedom index increases for one point on the scale for 1 – 100, the FDI inflow will increase by 51,873 million dollars. Business freedom is a quantitative measure of the ability to start, operate, and close a business that represents the overall burden of regulation, as well as the efficiency

of government in the regulatory process. The business freedom score⁸ for each country is a number between 0 and 100, with 100 equaling the freest business environment.

Current account as percentage of gross domestic product has negative and statistically significant effect on the foreign direct investment. Current account represents the balance of trade as difference between exports and imports of one country. Observations from all countries have negative sign for this variable, which means that they have trade deficit. Regression model shows that the increase of negative percentage of current account/GDP means increase of trade deficit, which has negative impact on foreign direct investment.

*Freedom from corruption*⁹ is a variable that contributes to the model, has positive effect on FDI, even though its coefficient is not statistically significant. One possible explanation is that corruption is not a major determinant within Southeastern European countries. Corruption erodes economic freedom by introducing insecurity and uncertainty into economic relationships.

Property rights index has negative and statistically significant effect on foreign direct investments. Since this variable includes time lag 2, it means that amount of FDI for current period (year) will be influenced by the value of the index two periods ago. This is understandable since the investors first analyze the situation with available empirical data for past periods that will influence the FDI inflow in some future period.

The property rights component is an assessment of the ability of individuals to accumulate private property, secured by clear laws that are fully enforced by the state. It measures the degree to which a country's laws protect private property rights and the degree to which its government enforces those laws. The more certain the legal protection of property, the higher a country's score. The greater the chances of government expropriation of property, the lower a country's score.

Fixed line penetration rate is a determinant that is statistically significant and determines the FDI inflows in Southeastern European countries. The question here is why this effect is negative? If we closely examine the time series for different countries, we can see that for the last couple of years, the fixed line penetration rate marks stagnation, or even decrease. This is normal since the usage of mobile telephony has significantly increased. On the other side, for the same period FDI have increased, what brings us to have negative correlation between these two variables. Differencing twice the variable fixed line penetration rate and differencing once the variable FDI, also contributes to this effect.

⁸ The business freedom score is based on 10 factors, all weighted equally, using data from the World Bank's Doing Business study: starting a business—procedures (number), starting a business—time (days), starting a business—cost (% of income per capita), starting a business—minimum capital (% of income per capita), obtaining a license—procedures (number), obtaining a license—time (days), obtaining a license—cost (% of income per capita), closing a business—time (years), closing a business—cost (% of estate) and closing a business—recovery rate (cents on the dollar).

⁹ The freedom from corruption score component is derived primarily from Transparency International's Corruption Perceptions Index (CPI) for 2007, which measures the level of corruption in 179 countries. The CPI is based on a 10-point scale in which a score of 10 indicates very little corruption and a score of 0 indicates a very corrupt government. In scoring freedom from corruption, the authors convert the raw CPI data to a scale of 0 to 100 by multiplying the CPI score by 10. The higher the level of corruption, the lower the level of overall economic freedom.

Table 1. Determinants of FDI – panel regression

Variable		Coefficient	Std. error	t-stat.	p-value
	Constant	457,605	1747,270	0,262	0,796
BF	Business freedom index	51,873	21,659	2,395	0,024*
CA/GDP	Current account/GDP	-122,375	34,981	-3,498	0,002*
FC	Freedom from corruption	3,187	18,006	0,177	0,861
PR	Property rights	-88,352	20,840	-4,240	0,000*
TEL	Fixed-line penetration rate	-166,389	60,858	-2,734	0,011*
UNE	Unemployment	4,649	76,707	0,061	0,952
EMP	Employment	-13,477	28,346	-0,475	0,638
EXR	Currency exchange rate	37,408	12,898	2,900	0,008*
FF	Fiscal freedom index	69,386	17,087	4,061	0,000*
GDP	Gross domestic product	208,364	54,550	3,820	0,001*
GE	General gov. cons.	-67,291	41,812	-1,609	0,120
POP	Population	-4448,839	1190,190	-3,738	0,001*
R-squared		0,859	Mean dependent variable		507,447
Adjusted R-squared		0,766	S.D. dependent variable		1139,785
S.E. of regression		550,804	Akaike info criterion		15,753
Sum squared residuals		7888023	Schwarz criterion		16,483
Log likelihood		-328,560	Hannan-Quinn criterion		16,023
F-statistic		9,302	Durbin-Watson stat		2,753
Probability (F-statistic)		0,000			

*Statistical significance at 95%

Unemployment rate as percentage of labour force is a variable that contributes to the model, but its effect is not statistically significant. The same conclusion is for variable *Employment*. This indicates that employment is not a major determinant of FDI. One possible reason may be that the officially announced data may not always depict the real unemployment situation in the country.

Exchange rate has a statistically significant and positive impact on FDI. Exchange rate means value of national currency that is exchanged for 1 US\$. If this rate increases, it means devaluation of the national currency. Since most of the FDI inflows are in Euros or Dollars, according to the model, it seems that investors prefer to invest when the value of their money increases. Exchange rate is variable which is included in the model with 4 time lags. This means that before making an investment decision, the investors analyze the exchange rate for the past 4 years. This makes the investment cheaper.

*Fiscal freedom index*¹⁰ has strong statistically significant and positive impact on the FDI. A closer analysis of these two variables shows that fiscal freedom index has increased during the observed period, and it becomes stagnant for the last four to five years. This is not a negative trend, since this index has reached value greater than 70 (on a scale 1 – 100) which

¹⁰ Fiscal freedom is a measure of the burden of government from the revenue side. It includes both the tax burden in terms of the top tax rate on incomes (individual and corporate separately) and the overall amount of tax revenue as a percentage of GDP. Thus, the fiscal freedom component is composed of three quantitative factors: the top tax rate on individual income, the top tax rate on corporate income and total tax revenue as a percentage of GDP.

shows fiscal improvement in observed countries. This makes fiscal freedom an important determinant of FDI.

Gross domestic product (GDP) presented in the analysis as annual percentage change, shows positive and significant effect on the FDI. Since the variable GDP is included in the analysis as percentage change, positive percentage change or increase in GDP should increase the FDI inflows. Foreign investors will invest in a country where the perceived profitability of their projects is secured and the signals transmitted by the GDP are good indicators for doing so.

General government consumption as percentage of GDP does not have a statistically significant impact on the FDI. The relationship with the independent variable is negative, yet since it is not significant it does not require further explanation. The observed countries still have to attain a certain level of development so that the share of governmental expenditures will not fluctuate significantly.

Population is the last variable in the observed panel regression and it shows negative and highly significant relationship with the FDI inflows. The question here stands for the negative sign on this statistically significant coefficient. With further observation of the time series, we noticed that the annual data for population (given as millions of inhabitants) sometimes does not change for several years. This is understandable since the population is not very dynamic and does not have significant changes for a short time period. Also, countries like Bulgaria, Croatia, Romania and Serbia have shown decrease in population. On the other hand, the FDI inflows kept on increasing, which explains the negative correlation between these two variables. The conclusion is that the population is important determinant of FDI. The decrease of population in some countries due to migration in EU countries after receiving EU membership (Bulgaria, Romania) and migration in other countries due to war (Croatia, Serbia) does not influence the FDI inflows, since these markets still have a great potential.

The determination coefficient R^2 , or goodness of fit of the fitted regression is 84,9%. This means that the sample regression line fits the data very well. It also means that the 84,8% of the total variation in the dependent variable is explained by the regression model.

Regarding the assumptions of the regression, the Durbin-Watson statistics is 2,753 which suggest that there is no autocorrelation in the data. The Jarque-Bera test of normality has coefficient 0,008 and p-value of 0,996 which indicates that we can accept the normality assumption. The conclusion is that the overall panel data regression model with fixed effects is good.

CONCLUSION

SEEC historically have not been a very attractive destination for FDI. Their importance as a host country increases in recent years, although it still remains on a lower level than other European countries. Membership in EU proves to be crucial for high FDI inflow, since Romania and Bulgaria are countries with the highest inflow of foreign capital in South-Eastern Europe.

To determine the effect of different variables on foreign direct investment, panel data regression model was used. The analysis includes observations from eight Southeastern European countries, Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia, for the period 1995-2008.

The key determinants that were found significant by the performed analysis are: *business freedom index, current account as percentage of gross domestic product, property rights index, fixed line penetration rate, exchange rate, fiscal freedom index, gross domestic product (GDP) and population*. Therefore, while developing policies for attracting foreign direct investments, countries from South-Eastern Europe should take into account the above mentioned factors. A special attention should be paid to the determinants that can be influenced by the government, such as business freedom, fiscal incentives, efficient protection of property rights.

Appendix A: Data source and stationarity transformation

Independent variables	Measure	Source	Unit root	Transformation
Exports of goods/serv.	Percentage change	EBRD	I(0)	(X ₁)
Imports of goods/serv.	Percentage change	EBRD	I(0)	(X ₂)
Merchandise exports	Millions US \$	EBRD	I(2)	Δ^2 (X ₃)
Cons. prices (end-year)	Percentage change	EBRD	I(1)	Δ (X ₄)
Current account/GDP	Percentage	EBRD	I(1)	Δ (X ₅)
Employment	Percentage change	EBRD	I(0)	(X ₆)
Exchange rate	Nat. currency per US \$	EBRD	I(0)	(X ₇)
Fixed-line penetration	Rate (per 100 inhabitants)	EBRD	I(2)	Δ^2 (X ₈)
GDP	Percentage change	EBRD	I(0)	(X ₉)
GDP per capita	US \$	EBRD	I(2)	Δ^2 (X ₁₀)
General gov. bal.	% of GDP	EBRD	I(1)	Δ (X ₁₁)
General gov. debt	% of GDP	EBRD	I(1)	Δ (X ₁₂)
General gov. exp.	% of GDP	EBRD	I(0)	(X ₁₃)
Industrial gross output	Percentage change	EBRD	I(0)	(X ₁₄)
Internet users	Rate (per 100 inhabitants)	EBRD	I(2)	Δ^2 (X ₁₅)
Labour force	Percentage change	EBRD	I(0)	(X ₁₆)
Population	Millions inhabitants	EBRD	I(1)	Δ (X ₁₇)
Unemployment	% of labour force	EBRD	I(1)	Δ (X ₁₈)
Index of econ. freed.	Scale 1-100	HF*	I(1)	Δ (X ₁₉)
Business freedom index	Scale 1-100	HF*	I(1)	Δ (X ₂₀)
Trade freedom index	Scale 1-100	HF*	I(1)	Δ (X ₂₁)
Fiscal freedom index	Scale 1-100	HF*	I(1)	Δ (X ₂₂)
Government size index	Scale 1-100	HF*	I(0)	(X ₂₃)
Mon. freedom index	Scale 1-100	HF*	I(1)	Δ (X ₂₄)
Invest. freedom index	Scale 1-100	HF*	I(2)	Δ^2 (X ₂₅)
Finan. freedom index	Scale 1-100	HF*	I(1)	Δ (X ₂₆)
Property rights	Scale 1-100	HF*	I(1)	Δ (X ₂₇)
Freedom from corr.	Scale 1-100	HF*	I(1)	Δ (X ₂₈)
External dept/GDP	% of GDP	EBRD	I(1)	Δ (X ₂₉)
Monthly earnings	Percentage change	EBRD	I(0)	(X ₃₀)
Large scale privat.	Scale 1-4	EBRD	I(0)	(X ₃₁)
Overall infr. reform	Scale 1-4	EBRD	I(1)	Δ (X ₃₂)
Dependent variable				
Foreign direct invest.	Millions US \$	EBRD	I(1)	Δ (Y ₁)

*HF – Heritage foundation

Appendix B: Non-stationarity analysis – ADF (Augmented Dickey Fuller test)

Variable	No transf.		First difference		Second difference	
	χ^2 stat.	P-value	χ^2 stat.	P-value	χ^2 stat.	P-value
Independent variable						
Exports of goods/serv.	31,298	0,000				
Imports of goods/serv.	31,359	0,000				
Merchandise exports	0,080	1,000	13,683	0,622	60,215	0,000
Cons. prices (end-year)	71,623	0,000				
Current account/GDP	24,244	0,084	61,089	0,000		
Employment	38,434	0,001	31,298	0,000		
Exchange rate	14,929	0,245	20,464	0,059	61,299	0,000
Fixed-line penetration	36,584	0,002	24,795	0,037	50,939	0,000
GDP	72,641	0,000				
GDP per capita	0,016	1,000	11,312	0,789	58,562	0,000
General gov. bal.	25,094	0,068	55,804	0,000		
General gov. debt	12,283	0,267	47,482	0,000		
General gov. exp.	33,224	0,007				
Industrial gross output	45,565	0,000				
Internet users	0,628	1,000	15,521	0,214	24,234	0,019
Labour force	53,996	0,000				
Population	16,558	0,167	51,476	0,000		
Unemployment	18,341	0,304	46,303	0,000		
Index of econ. freed.	6,449	0,892	38,078	0,000		
Business freedom index	21,497	0,002	33,234	0,000		
Trade freedom index	5,897	0,921	40,232	0,000		
Fiscal freedom index	14,322	0,281	39,908	0,000		
Government size index	48,204	0,000				
Mon. freedom index	14,114	0,294	58,581	0,000		
Invest. freedom index	6,094	0,413	18,350	0,005		
Finan. freedom index	6,854	0,739	31,186	0,002		
Property rights	3,059	0,548	14,076	0,007		
Freedom from corr.	12,921	0,375	39,740	0,000		
External dept/GDP	20,717	0,189	51,510	0,000		
Monthly earnings	62,356	0,000				
Large scale privat.	39,449	0,003				
Overall infr. reform	31,550	0,011				
Dependent variable						
Foreign direct invest.	5,088	0,995	44,904	0,000		

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FOREIGN DIRECT INVESTMENTS AND COMPETITIVENESS ENHANCEMENT OF WEST BALKAN COUNTRIES

Abstract

Undoubtedly, the forthcoming period is certainly bringing about drastic changes in world economy, thus this will surely exert influence on general economic situation in European countries. The Western Balkan, this "rich" and yet "poor" territory, with the turbulent past, controversial events and unstable situation is becoming an inexhaustible field of always current and interesting themes for both writing and discussing. Independently deserved or even partly forced unenviable situation in Serbia as well as in the neighbouring countries in the region is causing the need for consideration of the possibilities to improve current position and achieve defined goals. Before we start to analyze this theme, we must ask ourselves if it is justified to talk about financial sources and modes in the period of upcoming world crisis and uncertain economic trends?! Is the crisis an ideal excuse for the rich to become richer and an unfortunate set of circumstances for the poor to become poorer?! Viewpoints on such serious matters are different and contradictions are certainly huge, but the fact is that the transitional countries must gradually adapt to the forthcoming situation as well, and to continue to follow the way in the direction from the transformation of centrally-planned economies to the market oriented ones. In the aforementioned circumstances, a considerable and reliable financial support is necessary. Such support must initially be manifested through the foreign direct investments. The purpose of this paper is to prove that the inflow of the fresh capital, which is already insufficient and missing component in the economies of the aforementioned countries, is an initial factor of economic development and the major condition for economic recovery. The foreign capital undoubtedly provides very important benefits to host countries and it results in achieving political and economic stability, strengthens the legal and institutional framework, introduces new technological knowledge, improves business environment, as well as advances the managerial and organizational labor competences. However, this paper will emphasize all negative characteristics of foreign direct investments, as well as confirm the existing circumstances, which will eventually lead us to the conclusion that certain consequences always accompany every transitional process. The purpose of this paper, in addition to analyzing current situation and possible development potentials, is to point to the importance of creating an attractive investment environment in the Western Balkan countries. It is also important to emphasize that a key role in attracting the foreign capital, is most certainly held by privatization, liberalization and process of establishing macroeconomic stability. In the following text, we will discuss the relevant standards of competitiveness in the aforementioned countries, as well as their current values and possibilities of future progress. To summarize, we will provide an overview of the basic FDI forms and motives that are behind the actions of foreign investors, where we will particularly emphasize quantitative indicators of FDI flow in Western Balkan countries in the previous period.

Key words: *foreign direct investments – FDI, transition, investment environment, competitiveness, developing countries*

INTRODUCTION

In the conditions of the current economic and financial crisis that is becoming stronger with time and gradually enters our region, perhaps from one point of view, it might be ungrateful to speak about investing the foreign capital due to the existence of great instabilities and risks. However, on the other hand, the inflow of the fresh capital is always welcomed, since it brings about numerous benefits for the domestic economy and boosts the growth and development of one transitional country. If there are conditions for foreign direct investment inflow in one country they would enable the rapid recovery of the country's economy, easier overcoming of the forthcoming potential crisis and the successive and steady development which would in turn result in the continuous constant growth with time. Foreign capital undoubtedly gives considerable benefits to the developing countries because it influences the establishing of political and economic stability, strengthens both legal and institutional framework, introduces new technological knowledge and achievements, exerts a positive effect on business environment and improves managerial and organizational skills of the employees. The role of the foreign private capital in transitional countries increases proportionally with the speed with which they achieve the transformation and the reform that lead them towards the market economy. Thus, they reach certain degree of economic stabilization and economic growth. (Vidas-Bujanja, 2008) The positive aspect of the foreign direct investments is the subject of numerous scientific researches, and the authors of the expert literature frequently exploit this topic. Moreover, it was proved in numerous real life situations. When we discuss the inflow of the foreign capital into a transitional country, we cannot overlook numerous negative elements particularly in terms of the host country's point of view. The growth of competition, collapse of domestic entrepreneurs, illegal privatizations, union strikes, accumulation of huge profits from the irregular dealings and the crime growth are only some of the numerous negative effects that accompany the aforementioned process. Unfortunately, we are witnessing these negative happenings in the West Balkan Countries. However, these circumstances are convenient for the investments and entrance of the large transnational companies which might be said to have somehow irresponsibly and naively approached the realization of the aforementioned processes. Transition has started some time ago and some of its effects can already be seen, but numerous changes will be introduced in the forthcoming period and it is difficult to forecast their influence on the national economies. We can only hope that the governments of the countries in question will make more concrete steps towards solving the current problems, support the inflow of the foreign capital and enable regular and unrestrained realization of investment projects. Of course, we must not ignore the fact that the transitional process is always more or less painful and it always leaves behind certain consequences.

In terms of the current situation in Serbia and other West Balkan countries, as well as the need of these countries for the fresh capital, this paper will emphasize the key features, positive and negative sides of foreign direct investments and the most common motives of the foreign investors. The special care will be given to the analysis of the incoming flows of foreign direct investments and their significance for the mentioned countries. By applying specific comparative analysis of the basic pillars of competition and the analysis of the global competitiveness index and subindex, we would point to the current circumstances and possibilities for future improvements in West Balkan countries that are constantly striving towards achieving some level of the status that the developed countries have.

1. On foreign direct investments

The experiences of the large number of the transitional countries showed that FDI represent more favorable form of the necessary accumulation inflow compared to the classical loan arrangements that could be obtained from the international financial institutions. FDI also contributes to the improvement of economic situation, development of economic activities, growth of employment and productivity, growth of export and establishment of economic prosperity in developing countries. Former socialistic, nowadays transitional economies have undergone various phases regarding their attitude towards the role of FDI within the framework of the transformational processes of their economies. These processes usually start from the phase of doubt, then go through euphoric phase and again return to the phase of doubt regarding the role and importance of the FDI in the development of the national economy. (Vidas-Bubanja, 2008)

Foreign direct investments can appear in several different forms depending on the investors' goals and the nature of his business activity, as well as the current situation in the country where he wants to invest. The country's competitive ability and attractiveness are also important. Some of the previous and the future forms of foreign capital investments in West Balkan countries are Greenfield and Brownfield investments, Mergers and Acquisitions.

Foreign direct investments favorably influence the general environment by creating necessary preconditions for sustainable long-term economic development of some country. (Savić, 2007) However, sometimes the situation might not be so ideal. We are familiar with numerous unpleasant experiences of certain transitional countries. Foreign direct investments often condition the uncontrolled exploitation of the natural resources, especially those that are non-renewable, they influence the growth of unemployment rate and create technological dependence on foreign companies, they form consumption pattern that is often inadequate considering the level of the host country development and can sometimes seriously endanger its national sovereignty.

We can certainly say that the basic model of the international company that invests its funds into some transitional country is the company that aims at achieving higher profits and strengthening its power. In compliance with the aforementioned facts and depending on the motive of the investor, i.e. strategic investment goal, foreign direct investments can be divided into four groups: market, productive, resource and strategic. (Reiljan, Reiljan, Anderson, 2001). Besides obtaining satisfactory profits, expanding their business activities and conquering new markets, the investors most frequently want to exploit the existing rare resources, to use favorable legislative regulatives of the country they are investing in, hire cheap but skilled labor force and in this way reduce the costs of their operations and achieve desirable profits. It is interesting to mention the category of the strategic investments the purpose of which is to obtain the resources, the means and capabilities which the company believes will improve or support its core competence and core advantages in the regional and world market. (Dunning, 1994)

2. Foreign direct investments in West Balkan countries

West Balkan countries underwent number of changes in recent years regarding transformation of centrally - planned to market economy. Until recently, huge interventions

from government regarding all spheres of economic life of one country were such that the private ownership and free economic flows were impossible to achieve. As the contrast to the mentioned system, the market economy, which implies absolute freedom of the movement of capital, emerges. Market economy also implies privatization of state owned companies, fair competition and formation of market prices only based on freely established relation between the demand and supply. West Balkan countries are making exceptional efforts in order to transform their economic systems and improve their competitive position primarily by establishing liberal laws on foreign direct investments, reducing the corporate profit tax as well as the removing of trading barriers and investment prohibitions.

Depending on the current economic situation present in some country, as well as its competitive position, the foreign investor will apply the most adequate form of capital investment. It is important to stress that the West Balkan countries have moderate capital accumulation. These countries were recently faced with wars and devastation and are constantly faced with political feuds and instability, as well as the high inflation rate, exceptionally slow economic growth and development, etc. If we consider the overall situation, it is quite clear why these countries are at the lower level of economic development compared to their neighbors and why they need larger inflow of the foreign capital. The inflow of foreign direct investments in the region of Central and Eastern Europe has been insignificant up to 1990. The value of the overall inflow was approximately \$500 million that was mostly invested in Hungary. (Claessens S., Oks D., Polastri R., 1998, str. 7). More intense investments in West Balkan countries started from 2000, thus the inflow of foreign direct investments in recent years shows the constant growth, which is unfortunately slowed down because of the world economic crisis.

Table 1: FDI inflows by West Balkan countries, 2005-2007 (millions of dollars)

Country	FDI inflows (millions of dollars)		
	2005.	2006.	2007.
Albania	262	325	656
Bosnia and Herzegovina	595	708	2022
Croatia	1788	3423	4925
Macedonia	97	424	320
Montenegro	478	618	876
Serbia	1609	4499	3110

Source: *World Investment Report 2008*.

In the aforementioned period, Croatia achieved constant and increasing inflows of the foreign direct investments, while other countries showed various oscillations. The presented data show that Macedonia had the smallest inflow in 2005 only \$ 97 million while the leading position was again held by Croatia which had \$1788 million. However, Serbia had slightly smaller inflow of \$ 1609 million FDI. Other countries- Albania, Bosnia and Herzegovina and Montenegro had more modest but steady inflow of the foreign capital. In 2006, Albania attracted the smallest number of investors and achieved very low inflow of only \$ 325 million FDI, while Serbia achieved the record inflow of \$ 4499 million. Also in 2006, thanks to the selling of the following companies: Mobtel, Hemofarm, Vojodanska banka and Panonska banka, as well as selling the license to the third mobile telephone operator, the record inflow of foreign direct investments of almost \$ 4.3 billion was achieved. Although

such results seem encouraging, they do not give the real picture, because the inflow of investments in the following year (2007) was halved. (Savić Lj., 2008).

Countries strive towards attracting larger amounts of foreign direct investments and obtaining the larger inflow of foreign capital. Thus, in the following section of this paper we will discuss the current competitive advantages of the West Balkan Countries by analyzing 12 pillars of competitiveness that are further divided into three groups: basic requirements, efficiency enhancers and innovation and sophistication factors, as well as the analysis of the global index and particular sub indices of competitiveness.

3. Competitiveness of the West Balkan countries

Countries strive towards attracting larger amounts of foreign direct investments and obtaining the larger inflow of foreign capital. Thus, in the following section of this paper we will discuss the current competitive advantages of the West Balkan Countries by analyzing 12 pillars of competitiveness that are further divided into three groups: basic requirements, efficiency enhancers and innovation and sophistication factors, as well as the analysis of the global index and particular/individual sub indices of competitiveness.

Table 2: The 12 pillars of competitiveness

BASIC REQUIREMENTS	
1. Institutions	KEY FOR FACTOR-DRIVEN ECONOMIES
2. Infrastructure	
3. Macroeconomic stability	
4. Health and primary education	
EFFICIENCY ENHANCERS	
5. Higher education and training	KEY FOR EFFICIENCY- DRIVEN ECONOMIES
6. Goods market efficiency	
7. Labor market efficiency	
8. Financial market sophistication	
9. Technological readiness	
10. Market size	
INNOVATION AND SOPHISTICATION FACTORS	
11. Business sophistication	KEY FOR I N N O V A T I O N - DREIVEN ECONOMIES
12. Innovation	

Source: *The Global Competitiveness Report 2008.-2009.*

The above given Table 2 shows the basic pillars of competitiveness that play the key role in foreign investor’s decision making on investing in some country. If a certain country strives to attract foreign capital to stimulate its economic growth, equal attention must be given to the each of the mentioned pillars. Unity of production capacities, efficiency and innovation represent competitive basis of every country. Therefore, it is necessary to put huge efforts into creation and continuous development of these pillars.

3.1. Comparative analysis of the global overall index and subindex of competitiveness in the West Balkan countries in the period from 2008 to 2009

Table 3: Global Competitiveness Overall Index 2008-2009

Country	Overall Index	
	Rank	Score
United States	1	5,74
Slovenia	42	4,50
Croatia	61	4,22
Montenegro	65	4,11
Serbia	85	3,90
Macedonia	89	3,87
Bosnia and Herzegovina	107	3,56
Albania	108	3,55
Chad	134	2,85

Source: *The Global Competitiveness Report 2008-2009*.

After taking into consideration all 12 indices of competitiveness, we can move to interrelated comparison of West European countries in terms of the position they have in the list of 134 world countries. In Table 3, in addition to mentioned countries, the United States and Chad are also included for the purpose of the clearer overview of the best and the worst level of the global competitiveness index in the period from 2008 to 2009. The case of our neighboring country Slovenia is the most interesting one. Slovenia is an ex SFRJ country which holds the 42th place on the list and has significantly better competitive position than Serbia or Macedonia. Croatia lags behind Slovenia slightly, while Bosnia and Herzegovina and Albania considerably lag behind Slovenia. The fact that Montenegro has the 65th place, close to Croatia, cannot be taken as the completely valid, because the mentioned country has only recently achieved its independence and therefore the real picture on its competitiveness cannot be given.

It is interesting to review the ranking of the West Balkan countries when we break down the mentioned global competitiveness index into subindices related to basic requirements, efficiency enhances and innovation factors.

Table 4: Global Competitiveness Subindex 2008-2009

Country	Basic requirements	
	Rank	Score
Finland	1	6,18
United States	22	5,50
Slovenia	38	5,13
Croatia	49	4,69
Montenegro	59	4,52
Macedonia	68	4,42
Serbia	88	4,15
Bosnia and Herzegovina	98	3,93
Albania	100	3,89
Zimbabwe	134	2,88

Source: *The Global Competitiveness Report 2008-2009*.

In the case shown in the Table 4, when we concentrate on the particular index regarding the fulfilment of the basic requirements for achieving the competitiveness of a certain country, we notice that the United States are not in the first place but Finland. This data is included into our examination of the subject as a reference point that shows us the position of the West Balkan countries compared to the country, which holds the first place on the list. The situation has not significantly changed compared to the previous situation where we analysed the global competitiveness index. Thus, we can conclude that Croatia has the leading position, and then follows Macedonia with Serbia only a few places behind it, while Bosnia and Herzegovina and Albania are at the bottom of the list. Except from Croatia that has the best results in the area of stability of the institutional sector, infrastructural development and the macroeconomic stability, other countries should really put more efforts to enhance the mentioned areas. In this case, we must note that Serbia, besides Croatia, has high quality educational system as well as the considerable scientific and research potential, which contributes to its attractiveness for the investors. The important favourable conditions for investors are flexible wages, favourable employment policy as well as the layoff policy and the low costs for the employers that occur when firing their workers. In this case, it is good to mention one of the many negative characteristics of the foreign direct investments. Namely, the firing of workers by the foreign investor can cause the significant social cost that further manifests in its worst form - the urban violence, crime growth, social and political unrests. Even where there are no such problems, the high costs caused by the unemployment still exist. They include the serious worry even among the workers who managed to keep their jobs; they also cause general feeling of alienation, additional financial burdens for the family members that work, as well as making children to leave the school in order to help the family. (Stiglic, 2002, p. 71)

Table 5: Global Competitiveness Subindex 2008-2009

Country	Efficiency enhancers	
	Rank	Score
United States	1	5,18
Slovenia	37	4,45
Croatia	62	4,08
Montenegro	72	3,95
Serbia	78	3,82
Macedonia	92	3,58
Albania	99	3,44
Bosnia and Herzegovina	102	3,42
Chad	134	2,69

Source: *The Global Competitiveness Report 2008-2009*.

By close inspection of the Table 5 and the following subindex that indicates the possibility for efficiency increase in the analyzed countries, we notice that the situation slightly worsens compared to the previous case. The slight differences and discrepancies are also present here. Serbia is not significantly ranked under Croatia, unfortunately in this respect Macedonia came closer to Albania that together with Bosnia and Herzegovina has the worst results in this area. The examined subindex shows us how much those analyzed countries have advanced in the field of university education, how this educational field functions and whether the service and goods markets, the financial market and the labour market

are sufficiently developed. Furthermore, this analysis helps us to conclude if the countries have achieved the proper level of technological development and readiness. All mentioned indices play a very important role in creation of the attractive investment environment and the attraction of the foreign investors. As the famous Nobel Prize winner claims, it is precisely these indicators that generate growth. Foreign businesses bring about technical expertise and approach to foreign markets, thus creating new employment opportunities (Stiglic, 2002, p 81). Foreign companies also have approach to the financial resources, which is particularly important for the developing countries where the local financial institutions are not strong enough.

Table 6: Global Competitiveness Subindex 2008-2009

Country	Innovation and sophistication factors	
	Rank	Score
United States	1	5,80
Slovenia	33	4,15
Croatia	62	3,70
Montenegro	88	3,33
Serbia	91	3,30
Macedonia	105	3,16
Bosnia and Herzegovina	129	2,80
Albania	130	2,74
Bolivia	134	2,59

Source: The Global Competitiveness Report 2008-2009.

The last subindex in Table 6, points to the possibility for the development of the innovations as well as the business culture, ethics and sophistication in the aforementioned countries. Based on the presented data we can conclude that all examined countries have very poor placement in this respect. Their rank order is not changed but they occupy the second half of the list containing 134 analyzed countries. We can conclude that the lack of funds influenced the fact that this area is always left last to deal with. Investing in this area is very poor and thus the considerable lagging behind even compared to some transitional countries (and especially compared to developed European and world countries) is caused. A number of years must pass before it becomes possible to change people's attitudes and their point of view concerning the research work, patents and science. Moreover, in order to achieve the significant advancements in the mentioned areas, the countries belonging to West Balkan must first reach adequate level of the overall economic development and secure huge funds in order to finance such development. We can only exempt Serbia and Croatia from the mentioned countries as the countries where we notice business sophistication and the readiness to delegate responsibilities between the workers and companies and the increase of the number of women in almost all business areas. These countries possess sound capacities for the development of innovations, distinguished scientific and research institutions, they possess expert scientific staff and constantly improve cooperation between universities and the industry. While speaking about this, as well as the previous two subindices, we stressed the weakness of the analyzed countries, emphasised the necessity and opportunities for achieving advancements in certain areas but also affirmed already familiar fact that only those investment policies which are adequately defined and which are efficient, became key factor for the attraction of the foreign direct investments. (Savić Lj., 2007).

3.2. Analysis of the pillars of competitiveness in particular West Balkan counties in the period from 2008 to 2009

In this chapter, we will briefly analyze current situation in every West Balkan country in terms of its basic pillars of competitiveness and emphasize the particular areas where each country achieved the best position and the best results. We will also examine those areas where the country achieved the worst position and results. Table 7 shows us that Albania has the worst results for all pillars of competitiveness; it has very bad results in the field of innovations while it has slightly better results in the health, services, elementary education and labour market efficiency. Albania had the lowest level of foreign investments inflow compared to the rest of the countries in the region. Lately, Albanian market has started to develop and the economy shows average increase rate of 6% (recorded in the past 5 years). (Hunya G., Geishecker I., 2005). Bosnia and Herzegovina achieved poor results in even 7 out of 12 competitive areas. The most critical situation is in the area of innovations, while only macroeconomic stability can be praised as the area with the best predispositions for future improvements. We can safely say for Croatia that it achieved considerable advancements and that it improved its competitive position. Therefore, Croatia represents very attractive and very interesting investment area. Croatia also has good results in health care, elementary education, high school education and university education, innovations, research and development as well as technological development. Macedonia only has exceptionally good position regarding macroeconomic stability, while it has bad results for all other competitive indices. In this country labour market is significantly inefficient, so the efforts must be directed toward its improvement. In Macedonia, as in the rest of West Balkan countries Western Balkan countries governments often spend much energy on doing things they should not do. This destructs them from what they should really be doing. The problem is not only the fact that the government is too big but also that it does not do the right thing. (Stiglic, 2002). Talking about Montenegro, we cannot have the clear picture of the situation in this country because this country has only recently become independent. The large number of its institutions, markets, health, educational and other infrastructural objects was founded while they were in the same state with Serbia. Also, there is the question if all real values regarding financial responsibilities of this country were considered and if it really achieves better results than Serbia with which it was associated until recently. The comparison with other countries in the region is also questionable. According to the presented indices, Montenegro shows good level of macroeconomic stability and well projected financial market. However, its market size and inadequate infrastructure are very critical areas. When we talk about Serbia, we can say that it is still far away from the attribute of the developed country. Perhaps, from time to time, it might seem that it achieves better results than its neighbours do. However, the data indicates different situation. Serbia achieved significant advancement in the field of the healthcare and lengthening the lifespan of its citizens, as well as in the field of elementary, high and university education. By introducing Bologna system to university education, the educational process has been significantly innovated and the production of the skilled and qualified staff of different profiles has been secured. It is a well-known fact that Serbia has very bad roads and rails. This area needs huge investments if we want to create conditions for normal transportation of both people and goods and thus develop trade and touristic potential of the country. Market for goods is poorly developed; the existence of

monopolistic companies is evident which dictate the prices of numerous goods. Frequent problem in Serbia like in other West Balkan countries is the illegal implementation of privatization process that causes bitterness and dissatisfaction in people, especially the unemployed ones, but also it influences people who managed to keep their jobs. Perhaps the most serious problem regarding the privatization is corruption. The rhetoric of the market fundamentalism claims that the privatization will reduce the activities of „charging rent“ that government officials charge. They also „skim milk“ from the profits of the public companies or give contracts or major jobs to their friends. But contrary to what had been expected, privatization made things much worse, so in many countries privatization is called „bribery“ (Stiglic, 2002). Unfortunately, corruption is present in all West Balkan countries and it represents the key problem that must be urgently solved.

Table 7: The Global Competitiveness index : West Balkan countries

Pillars of competitiveness	Country		Albania		Bosnia and Herzegovina		Croatia		Macedonia, FYR		Montenegro		Serbia	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score
<i>Institutions</i>	109	3,32	123	3,06	74	3,82	90	3,58	59	4,07	108	3,40		
<i>Infrastructure</i>	121	2,22	123	2,20	51	3,98	89	2,90	100	2,72	102	2,68		
<i>Macroeconomic stability</i>	96	4,56	57	5,15	61	5,10	31	5,51	35	5,46	86	4,72		
<i>Health and primary education</i>	69	5,47	82	5,30	41	5,85	82	5,30	42	5,83	46	5,79		
<i>Higher education and training</i>	97	3,40	109	3,13	48	4,36	73	3,58	55	4,18	70	3,91		
<i>Goods market efficiency</i>	119	3,61	123	3,55	76	4,11	98	3,91	69	4,17	115	3,68		
<i>Labor market efficiency</i>	67	4,36	85	4,20	68	4,35	113	3,92	53	4,47	66	4,36		
<i>Financial market sophistication</i>	103	3,70	86	4,00	63	4,37	83	4,04	35	4,96	89	3,94		
<i>Technological readiness</i>	92	2,89	109	2,61	47	3,72	83	3,05	43	3,96	61	3,45		
<i>Market size</i>	106	2,66	92	3,00	66	3,57	104	2,69	125	1,95	65	3,59		
<i>Business sophistication</i>	123	3,27	125	3,23	72	3,98	107	3,45	90	3,71	100	3,51		
<i>Innovation</i>	132	2,22	128	2,37	50	3,41	99	2,86	88	2,96	70	3,09		

Source: *The Global Competitiveness Report 2008-2009*

CONCLUSION

By analyzing general and particular indices as the key pillars of competitiveness in one country, we noticed that the majority of countries were unfavourably ranked, thus the achieved results were not so good. The exception is Croatia, which stands out in many areas compared to other countries in the region. Croatia will certainly achieve strong and stable competitive position in the region in the following period if it continues to follow this direction. Primarily Serbia, and then Macedonia, have considerable potentials that must be improved and directed in the right way in order to create favourable attractive investing environment that would attract foreign investors and thus bring significant advantages to the mentioned countries. Unfortunately, Bosnia and Herzegovina and Albania have the worst ranking and the values of its indices, subindices and pillars of competitiveness are among the lowest in the world. The main reason for falling behind of these countries are numerous political and destabilization problems, as well as their insufficient decisiveness and persistence in implementation and finishing of the transitional process. However, we must emphasize that in the West Balkan countries the different unfavourable influences from the environment are present. The powerful multinational companies, international institutions, governments of the strong and stable countries to whom the developing

countries must adopt to are also aware of this problem. In this case, we agree that small countries are like small boats, even in the best of circumstances they can turn over when caught by a large wave.

In order to reach the desired level of economic development and to join both European and world economic trends, West Balkan countries are currently working on the transformation of their economic and political systems, as well as their infrastructural and legal frameworks. They are making huge efforts in order to increase their competitiveness, attract foreign investors and secure the inflow of the fresh capital. In this paper we emphasised that foreign direct investments also bring significant benefits to the transitional countries - they bring about rapid economic growth, growth of the employment rate, chance to import products and services of the better quality at the better price, introduction of new technologies and methods, improvement of the organizational and managerial skills of the workers etc. However, threats to the national sovereignty, overexploitation of the natural resources and work force, technological and global dependence of the host country upon the foreign investor are only few of the numerous negative effects that can be hardly avoided. Taking both sides of into consideration, we must conclude that the foreign direct investments represent significant and useful form of the foreign capital inflow into the West Balkan countries, but only if these countries follow the adequate legal regulative, properly use the capital and if their spending is constantly checked. By respecting the described conditions we can expect more rapid development of the mentioned countries, as well as their gradual but certain meeting of the status of the developed European countries.

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FOREIGN DIRECT INVESTMENTS FLOWS IN CEFTA COUNTRIES AS A SOURCE OF BALANCE OF PAYMENT DEFICIT FINANCING IN TERMS OF WORLD FINANCIAL CRISIS

INTRODUCTION

Free trade areas are unions of two or more custom areas without custom duties imposed to each other, nor other foreign trade restrictions. Practice of economic integration proved free trade areas either to disintegrate, or to be one of intermediate phases toward further integration on the way to higher forms of integration such as custom unions and economic unions. In theory, Balassa (1962, p. 2) gave most common classification, that recognize:

- free trade areas (liberalization of mutual trade),
- custom unions (unique protection against third countries),
- common markets (freely factor moving inside the integration),
- economic unions (certain degree of national economic policies harmonisation) and
- total economic integrations (unique economic policy and supranational power).

Liberalization in the region of South-Eastern Europe started with signing of Memorandum on liberalization and trade easing among countries in that region in 2001 in Brussels. Countries that signed Memorandum agree to conduct mutual agreements on free trade by the end of 2002, and to liberalize at least 90% of reciprocal trade, together with simplifying custom procedures and intensifying trade legislature synchronization with the EU one. Since implementation lagged behind signing agreements (more than thirty agreements were signed), it became clear that the very idea to establish free trade association was only on paper. Free trade area idea became real instead, so all South-East Europe countries (except Croatia, that had been its member since 2002) on 1st of May 2007 joined CEFTA (Central European Free Trade Agreement), that is qualitatively different in comparison with original agreement signed by three Central European Countries (Hungary, Czechoslovakia and Poland). Due to that fact, in literature present agreement is often called CEFTA 2006 (agreement is negotiated in Zagreb in 2006), and network of 32 bilateral agreements was replaced by multilateral agreement.

At this moment, seven countries are CEFTA members: five of six former Yugoslav republics (all except Slovenia), Albania and Moldova (See table 1). Number of members varied since CEFTA establishing in 1992: foundation members (Poland, Hungary, Czech Republic and Slovakia /then as Czechoslovakia/ in May 2004, in the moment of accession to the EU

abandoned CEFTA membership). Except Croatia, that became member in 2002, all present member countries joined CEFTA during the 2006, while multilateral agreement on free trade became valid on 1st of May 2007.

Table 1: CEFTA member countries

Country	Year of accession	Year of abandoning
Croatia	2002	-
Montenegro	2006	-
Serbia	2006	-
Macedonia	2006	-
Bosnia and Herzegovina	2006	-
Albania	2006	-
Moldova	2006	-
Romania	1997	2006
Bulgaria	1998	2006
Poland	1992	2004
Hugary	1992	2004
Czech Republic (Czechoslovakia)	1992	2004
Slovakia (Czechoslovakia)	1992	2004
Slovenia	1996	2004

CEFTA 2006 has following features that former bilateral agreements had not:

- possibility to apply so-called diagonal cumulating of origin of goods,
- introducing gradual service trade liberalization,
- improved mechanism for disputes resolving,
- intellectual property rights protection, according to the international standards, and
- commitment to apply rules of World Trade Organization (WTO) regardless whether CEFTA country member is or is not member of the WTO.

1. Foreign direct investments role in increasing export of CEFTA members

Cycle of massive foreign capital inflow to the developing countries, including CEFTA member ones, is ending due to financial crisis. Many countries, including Serbia, took for granted – as a result of own successes in attracting FDI (foreign direct investments) and acted as this situation is permanent. Three immediate economic policy options are possible in such circumstances: (1) to reduce public consumption over restrictive budget; (2) to increase interest rate and reduce private consumption mainly over more expensive loans; and (3) to allow controlled depreciation of national currency (Petrovic, 2008 p.5). Decline of export demand, together with high structural dependence of national product from import, means that for keeping growth rate positive necessary either to provide even bigger foreign capital inflow than it was by now, or to stimulate domestic demand, which is typically Keynesian approach applied by all developed economies. The very reason why Serbia cannot apply this approach is because no sources to finance major budgetary deficit. Developed economies can count on domestic or foreign sources borrowing, while

for Serbia both sources are non-accessible or very expensive. Domestic financial market is too small, and increase of public sector demand for money would increase interest rate significantly (Milanovic, 2009, p. 3).

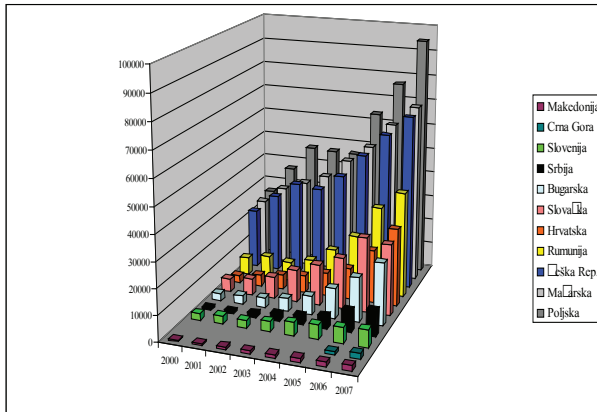
Foreign capital inflow depends on two groups of factors. The first one is related to the favorable global economic conditions and satisfactory global liquidity. Nevertheless, while mentioned group of factors provide only common framework in a meaning that during the global prosperity time mass of foreign investments growth, the second group of factors include internal factors within the national economy such as: structural reform progress, financial integration etc. Therefore, even in the time of global recession, certain (but much lower) quantum of capital available, but only economies with better performances are able to attract it. Aside of positive effects of foreign capital inflows, there are also threats and dangerousness, like overheating of economic activity, competitiveness decline (if monetary reserves sterilization policy is consistent – it implies appreciation of national currency that causes loses of competitiveness and increase of reserves, as the side effect of the process).

IMF team researchers (IMF, 2007, p. 106. Also see: Cardarelli, 2007, p. 203) point out on four main lessons related to big capital inflow that could be highly valuable for CEFTA member countries:

- First, countries that experience more volatile macroeconomic fluctuations – including a sharp reversal of inflows – tend to have higher current account deficits and experience stronger increases in both aggregate demand and the real value of the currency during the period of capital inflows.
- Second, episodes during which the decline in GDP growth following the surge in inflows was more moderate tend to be those in which the authorities exercised greater fiscal restraint during the inflow period, which helped contain aggregate demand and limit real appreciation.
- Third, countries resisting nominal exchange rate appreciation through intervention were generally not able to moderate real appreciation in the face of a persistent surge in capital inflows and faced more serious adverse macroeconomic consequences when the surge eventually stopped.
- Fourth, tightening capital controls has, in general, been associated neither with lower real appreciation nor with reduced vulnerability to a sharp reversal of inflows.

CEFTA member countries are not too successful in FDI attraction in comparison to Central European economies (See Figure 1). Structure of FDI attracted by CEFTA member countries is not as favorable as Central European ones due to high degree of brownfield investments in comparison to greenfield ones.

Experience of more than one former CEFTA member economies (Poland, Czech Republic, Hungary, Slovenia, Slovakia and Romania) proves positive effect of CEFTA agreement on theirs economies: eased accession to the EU, increase of foreign trade and FDI. Trade liberalization, together with trade orientation toward the EU, fast restructuring and rebuilding of market institutions encouraged processes that resulted in increase of export. In the year 2006, for example, those countries attracted almost 1/3 of most successful greenfield global investments!

Figure 1: FDI in selected countries 2000-2007 (cumulative in million US dollars)

Source: according to the WIIW data

South-Eastern European countries – present members of CEFTA – were much slower in trade reform. Today it is widely accepted in those countries that having liberal investment policy only, is not enough to attract sufficient quantity of FDIs. CEFTA membership is precious for gearing up customs and other administrative regulations to be compatible with WTO standards, as well as to create stable, transparent and favorable environment for trade development within the region. The main task for Southern-European economies is to intensify trade and create institutional conditions to attract FDIs, because presently theirs' common characteristic is low level of export concentration, which is consequence of following facts (D. Milenkovic and I. Milenkovic, 2008, p. 71):

- they have no recognizable export products, nor comparative advantages in traditional meaning,
- they developed in the past wide range of industrial products, without specialization in industry, which resulted in low export concentration coefficient,
- except Moldavia (that is not so incorporated into the region), all other CEFTA 2006 member countries have no predominant mutual trade, therefore index of trade complementarities is 30-35. This indicator gives useful information on intraregional trade possibilities, and in this very case shows that Eastern-European economies have relatively less index values in comparison to the former CEFTA members. In following years theirs' production and export supplies will adjust to the import demand of regional partners. Macedonia and Bosnia and Herzegovina have export supplies less adjusted to the import demand of neighboring economies due to high level of export to the EU. By now was recognizing the fact that certain level of complementariness of regional economies, especially of former Yugoslav republic economies, was present, which could be useful as important impulse for further specialization of those economies in the way of better mutual linkage and bigger foreign trade level.

For CEFTA member economies it is important that expected economic growth rate in the EU, as for the rest of the world, is negative, that causes decline of export demand for CEFTA member countries products. This fact, together with high structural dependence of national product from import, means that even more FDIs are needed to provide positive economic

growth rate. For Serbia and other CEFTA member economies foreign loans were most common way or foreign capital inflows. This source in terms of present global economic crisis is under question mark. In given circumstances on favorable business climate in Serbia, CEFTA agreement membership is precious, given that provides more favorable approach to the regional market. Whole region because of CEFTA agreement is more attractive for foreign investors.

For entire CEFTA 2006 region, yearly FDI inflow until 2005 has not exceeded 4 billion dollars (Table 2). Just in 2006 and 2007 FDI inflow became more massive (10.24 and 12,37 billion US dollars, respectively). For comparison, in Poland in 2007 FDI inflow was 17,58 billion US dollars (in Romania and Bulgaria together – 18.2 billion US dollars, not to mention Ireland, where FDI in the same year was 30.59 million USD), that altogether gives clear indication on low FDI level for CEFTA (Mitic, 2008, p. 52).

Table 2: Inflow of FDI to CEFTA member countries (in million USD)

	2000	2001	2002	2003	2004	2005	2006	2007
Albania	143	207	135	180	332	262	325	656
B&H	147	130	265	381	606	595	708	2,022
Montenegro							618	876
Croatia	1,089	1,561	1,124	1,713	1,262	1,788	3,423	4,925
Macedonia	175	442	78	95	157	97	424	320
Moldova	134	146	117	58	154	197	242	459
Serbia*	25	165	475	1,360	966	2,087	4,499	3,110
Total CEFTA	1,713	2,651	2,194	3,787	3,477	5,026	10,239	12,368

Source: UNCTAD, WIR 2004, 2006 i 2008, (adjusted, based on Mitic, B. (2008), p. 53)

Note: * - data for Serbia&Montenegro until the 2006; according for National Banke of Serbia data (balance of payment, 2000-2007), net FDI inflow in Serbia in 2005, 2006 and 2007 respectively 1550, 4264, 2195 million USD.

2. Balance of payment disequilibrium and foreign direct investments

All CEFTA member countries has deficit in balance of payment current and trade account. Surplus that in capital accounts covered current account deficit predominantly was from long-term foreign loans. In case of Serbia for 2008, balance of payments deficit is up to 18% of GDP, or approximately 6 billion euro. Trade deficit in the same year was 8.2 billion euro (import – 15.5, export 7.4).

Big balance-of-payment's current account deficit is consequence of gigantic consumption in comparison to savings. Increase of demand is mainly limited by current account deficit. Exactly import growth relaxing this constrain by allowing other demand components – consumption and investments – to rise by faster pace without having balance-of-payment difficulties. Due to the crisis, Serbia is affected by decline in demand of goods with competitive advantages – basic metals and food, which makes 2/5 of Serbian export (Nikolic, 2008, p. 87). All CEFTA 2006 member countries have relatively big current account deficits in last ten years (Table 3). Having in mind actual crisis, together with misbalances of trade and current account, for CEFTA member countries FDIs (especially greenfield investments could be important leverage.

**Table 3: Balance of payment current accounts of CEFTA members
(in % of GDP)**

	2000	2005	2007	2008
Albania	-5.2	-5.2	-9.2	-9.8
B&H	-17.5	-26.6	-13	-16
Montenegro			-26	-39.6
Croatia	-2.6	-6.3	-8.6	-9
Macedonia	-1.9	-1.3	-3	-9
Serbia*	-2	-9.2	-13	-18

Source: National central banks, (Nikolić, G. (2008), p. 80)

Note: * - data for Serbia&Montenegro until the 2005

Deficit of 8.2 billion euro in 2008 in Serbia is 15.2% bigger than in 2007. Total foreign trade of goods was 23 billion euro, which is 15.4% increase in comparison with 2007. Import is 47.7% covered by export (47.6% in 2007). Similar results shows both import and export of goods: export in 2008 was 7.4 billion euro, 15.4% more than in 2007, while import was 15.6 billion euro, 15.3% more than in 2007. Unfavorable characteristic of foreign trade in 2008 is huge deficit, but favorable one is that export rose slightly bigger than import. The newest data for first four months of 2009 shows that Bosnia&Herzegovina (268.4 million US dollars), Germany (262.6) and Italy (228.1) are still main market for Serbian exporting goods. Main importing countries in the same period are Russia (726.5 million US dollars, mainly due to gas and petrol import), Germany (547.6) and Italy (451.8). After the EU countries (more than a half of foreign trade in first four months of 2009), main foreign trade partner for Serbia are CEFTA member countries, that are especially important due to the fact that with all of them, except with Croatia, Serbia has foreign trade surplus (total of 370.9 million US dollars in first four months of 2009, including Croatia, mainly due to export of agricultural industry products and processed food).

Table 4: Foreign trade of CEFTA member countries (in million euro)

Country		2003	2004	2005	2006	2007	2008 1Q
B&H	Export	1288	1441	1934	2640	3035	801
	Import	4253	4578	5715	5823	7106	1878
	Balance	-3066	-3317	-3781	-3183	-4071	-1077
Croatia	Export	5468	6435	7065	8253	9000	2175
	Import	12546	13343	14935	17104	18826	4845
	Balance	-7079	-6890	-7870	-8851	-9826	-2670
Macedonia	Export	1208	1347	1642	1922	2449	623
	Import	2039	2357	2599	2997	3824	1050
	Balance	-830	-1010	-957	-1085	-1365	-437
Montenegro	Export	271	452	461	627	628	..
	Import	630	896	974	1483	2152	..
	Balance	-359	-416	-514	-855	-1524	..
Serbia	Export	2441	2853	3617	5092	6429	1675
	Import	6603	8697	8470	10448	13338	3621
	Balance	-4262	-5826	-4853	-5356	-6909	-1939
Moldova	Export	698	790	848	983	1194	..
	Import	1237	1419	1837	2780	3346	..
	Balance	-538	-629	-990	1727	-2152	..

Source: WIIW database, including national statistics, (Podkaminer, L., J. Pöschl et al. (2008), p. 85 and The Republic of Moldova Trade Diagnostic Study, p. 1

Serbian export to CEFTA member countries (Table 4) in last three years shows rising trend, both in absolute and relative figures in comparison to the rest of the world export. In 2006, for example, in CEFTA member countries roughly 2 billion US dollars goods is exported; in 2007 – approximately 2.85 billion US dollars; and in 2008 over than 3.6 billion US dollars, which is very high rate of export growth (over 40% in 2007 and over 25% in 2008). If we know that rate of import growth to CEFTA member economies in the same period is lower (more than 35% in 2007 and about 20% in 2008), it is not difficult to conclude that CEFTA countries are very important for Serbian balance of payment. Especially with the regard that with most of them (including the territory of Kosovo and Metohija, which according to the United Nations Resolution 1244 still is part of the state of Serbia, but which unfortunately is aside of balance-of-payment territory of Serbia) Serbia has surplus of foreign trade (import coverage with export is bigger than 200%). So, while Serbia importing twice more than exporting, within the CEFTA region, the situation is just opposite! That is why CEFTA membership is important for Serbia as a source of foreign goods trade surplus, especially with Bosnia&Herzegovina and Montenegro.

Very similar situation to the Serbian case regarding foreign trade deficit is in all other CEFTA member countries, which will be only briefly stated due to the lack of length in this paper (See for more details: Nikolic, 2008, p.80-85). Foreign trade deficit in Croatia in first nine months of 2008 is 8.91 billion euro, 17.9% more than in the same period of 2007 (import is covered by export 45.2%). In the same period, Albanian deficit was 1.8 billion euro (14.4% increases), Montenegrin 1.3 billion euro, while in Bosnia&Herzegovina (in first eight months of 2008) it was 3.21 billion euro (21,8% increases), and in Macedonia 1.58 billion euro.

CONCLUSION

In the paper we discussed importance of foreign direct investments in CEFTA countries to overcome balance-of-payment deficit problems that all countries in the region facing with. After the introductory part, where we presented theoretical background of free trade area and history of forming CEFTA 2006 agreement, in the first chapter we considered foreign direct investments role in increasing export of CEFTA members. In the second chapter of the paper we argued on balance of payment disequilibrium and foreign direct investments relationship, with the special regard on Serbia.

In contrary to the beginning of transition period (1990ies) when negative influence of FDIs were outlined, together with loss of national sovereignty and addiction to foreign capital inflow, today FDIs are seeing as a leverage of export and technological development. It is a long-term interest of every export-oriented economy to attract foreign greenfield investments. Thanks to relatively stable political and judicial environment Central-European economies were far more attractive for foreign investors than South-Eastern European ones. But good progress in legislative adjustment to the EU standards, which is confirmed with announcement by the EU to put Serbia, Macedonia and Montenegro on “White Shengen list” by the end of this year, made CEFTA countries presently more attractive than they use to be in the past. Not to mention free trade area forming, which could be important factor in attraction foreign investments to the Balkan countries.

FDI inflow to the CEFTA agreement countries could help increasing their export capacity, reducing their balance of payment deficit and improving their overall economic characteristics. It is indicative that all CEFTA agreement member countries facing with high deficit of current account, as a result of large foreign trade deficit. In the first quarter of 2009 global recession is visible, which redirect funds that use to inflow from developed countries to others, to developed countries itself, which make those funds more expensive or even non reachable to countries of our region. FDI inflow to the region will certainly influence economic growth in future, but only if they contribute to the processing industries and tradable goods, which will support export expansion. This scenario could

come true if stable political and institutional environment is in place, as well as appropriate economic growth strategy. Main common characteristic of CEFTA agreement countries is uncompetitive export, i.e. uncompetitiveness in the world market, which is a consequence of inherited economic structure during centrally planned economies. Therefore, the need to increase volume of export is among most important goals of economic policy.

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ANALYSIS OF THE STIMULUS AND LIMITATION FOR FOREIGN DIRECT INVESTMENT IN SERBIA

Abstract

Foreign direct investment is the most important international factor in accomplishing the goals concerning the total economic growth and development in Croatia. That's why they make an extra stimulus to important national economic goals referring to development of small and middle companies, development of infra-structure and public sector reform. Drawing benefits from greater number of foreign investment from EU countries, first of all, give the economic strength to the government in carrying out modernization and advancement in other regions. All of this is, of course, in the function of the ultimate goal referring to joining and full membership in the EU. Unfortunately, Croatia did not manage to draw great and continuing income of foreign direct investment, partly because of the bad business environment and manifested weaknesses in carrying out the institutional reforms. Increasing the level of economic freedom and effective use of modern law resolutions can contribute environment business improvement.

Key words: *Investment, GDP, Economic Growth and Competitiveness.*

INTRODUCTION

Attracting and maintaining a high level of foreign direct investment is an important goal for Serbia, since it is clear that it has a complementary role in creation of new employment, increase of export, transfer technology, increase of competitiveness and improvement of the overall production. Creating favorable conditions for foreign investment represents a big challenge for Serbia, in view of the globalization and the pressure to be competitive, which makes a need for constant improvements of the general business environment. At macroeconomic level, in ensuring stability and improving the general business environment, government has the main role, while the market pressures to be competitive require permanent improvement and success of the management structures in the economy.

Business environment development means removing all unnecessary difficulties and excessive government intervention in economy, all this with a goal of providing wider field for trade and developing of entrepreneurship (including lower administrative prices). Goal of the economic politics creator should be continuing advancement of the business environment and rules especially in the field of long-term production investment. Engaging the state into the economy and public sector spending should be considerably reduced, because the activity of developing the state can give results only when clear and effective rules of the market competitiveness are defined.

The task of the effective use of modern law solutions is reducing unnecessary regulations, their transparency and making possible the predictive behavior of the participants in business processes. Improvement of the investment conditions through speeding up reform programs and the institutions of strengthening support on national, municipal and agency level develops faster through better relations with the private sector in solving the problems competitiveness. It implies the constant leading campaign concerning improvement in understanding the importance of foreign investment for developing municipalities and regions and better functioning of the public enterprises. Institutional strengthening and establishing new functions of the state in conditions of market economy should lead to developing market institutions, liberalization, deregulation and foreign capital inflow. All of this would appear as a consequence and condition of the construction and functioning of the economic system which constantly improves and changes with the aim of the market economy, market institutions and recognition mechanisms, which are in the function of motivating the competition.

In Serbia, during the last few years, a significant progress has been made in maintaining stability at macroeconomic level, together with the improvement of legislation in many areas. What is understood and accepted is the fact that this reform process must be speeded up and that it is necessary, especially in conditions of economic crisis, to increase significantly the attraction of new foreign investment in order to improve the export capacity and competitiveness. However, in addition to all the achieved results, the following development restrictions are present:

- Relatively low level of foreign investment, which makes Serbia attracted in comparison with neighboring countries.
- The majority of new foreign investment is mainly focused on the domestic market. For example, the largest single market in Serbia is the market of cars and transport means. Over 1,500,000 passenger cars are registered in Serbia. The average age of passenger cars is over 12 years, while of the cargo vehicles is even more. Starting from the assumption that in the next 10 years the 2 / 3 of all vehicles are replaced, the market of more than 1,000,000 vehicles is made, in other words an average of 100,000 vehicles a year. Production of spare parts and services makes the value of about 2 billion euros per year. Such a market justifies the Italian Fiat as a strategic partner, which would in “Zastava cars” set a final production of vehicles.
- A small number of companies invest in business-oriented to international markets.
- Limited development within the state itself and limited understanding of the need for competitive, modern industry and the possible benefits of direct foreign investment.
- A low level of export and permanent dependence on international assistance and private remittances from abroad as Government support programs, confirm the low level of investment.
- Limited institutional capacity and underdeveloped mechanisms for the support of investors and implementation of their plans.

Weak economic results due to the lack of new investment in productive economic sectors are clearly seen in the relatively slower growth of the total gross domestic product (GDP) and GDP per capita in Serbia in 2008. and the beginning of 2009. In contrast to this, general progress can be seen in those countries which modernized their laws and regulations, provided local support to the creation of benefits for investors and which provide active

help to investors and promote new strategies. Countries in the region, which modernized and provided administrative stability, successfully attract significant new foreign investment directed to export. The priority objective in this regard should be to remove existing weaknesses and create a favorable climate and framework for attracting, retaining and expanding internationally competitive and the export-oriented foreign investment. The main incentive should be accelerating the improvement of business environment in the economy of Serbia, for the benefit of all investors.

1. FDI and the privatization process in Serbia

On the basis of the previous experiences of the fast growing economies, it can be concluded that foreign investment played a large role in encouraging the growth of many economies and solved a number of problems in the creation of new employment and export. Countries which didn't pay attention to encouraging domestic and foreign investment, often in spite of the wealth of natural resources, didn't make progress in economic development. That's why the creators of the economic policy realized that they should encourage investment and seek ways to improve investment. Strong contribution to economic development by attracting new foreign investment is in the following elements:

- Rise of employment.
- Increase of international trade flows.
- Change of regulations and modernization of legislation in improving the management of enterprises.
- Favorable influence on the development of new technologies, skills, management and business knowledge, as well as the infrastructure that is suitable to business.
- Development of entrepreneurship.

All foreign investments are categorized by different criteria. They primarily arise from private sources. By the efficiency of investment, other forms of foreign investment are similar to public investment and are invested in most cases in accordance with the political priorities (e.g., grants or loans of international financial organizations for specific projects). According to the existing classification within the Serbian economy, foreign private investments are divided on the new direct foreign investment (greenfield), direct foreign investment in existing buildings (brownfield), classical buying of companies, joint ventures, re-investment (reinvestment), portfolio investment (investment in valuable papers without the intention of management) and execution of investment commitments in the process of privatization.

General types of foreign direct investments, excluding forms of classical sales (merging, joining and privatization), are classified in the following way:

- Brownfield – a company with foreign investment starts business in the building or in a place that was previously used for production or other activities, on which already exists a certain infrastructure.
- Greenfield - a company with foreign investment starts business in a completely new place.
- Joint ventures - a foreign company invests a significant proportion in the newly established domestic company.

Cooperation between the public and private sector (Public Private Partnership) is one of the forms of joint ventures, while the state authorities, local self-government bodies or public companies make an agreement on cooperation with the companies from the private sector to plan formally, carry out and manage a particular activity or goods. The largest part of FDI inflows in Serbia so far, as well as in other countries in the region, came through privatization. Most activities related to privatization in other Balkan countries were implemented in the second half of the nineties of the twentieth century, during the period of rapid growth of foreign investment in the world. Delayed beginning of privatization in Serbia was followed by a relatively low general level of foreign capital inflow, which in the long-term perspective, is not sustainable. In order to attract significant amounts of new foreign direct investment, it is necessary to improve the cooperation of public and private sectors, improve infrastructure and strengthen the competition. This is the only way to overcome the serious lack of investment and underdevelopment of infrastructure. It should be mentioned that some companies, factories and banks, which now operate in Serbia, were owned by foreign companies even before selling (such as Mobtel, Delta Bank - Banca Intesa). During their sales money goes to the accounts of foreign owners and cannot be considered as the inflow of FDI in Serbia.

Almost the entire inflow of capital from the tender comes from foreign investors, while it is completely reversed in the case of auctions, where a dominant inflow of capital comes from domestic investors. Privatization inflows that come through the capital market, are the same on the origin of capital. Foreign buyers are mostly transnational companies (Philip Morris, Interbrew, Lukoil, Holcim, U.S. Steel, Alpha Bank, Lafarge, Carlsberg, Titan, Henkel, BAT, Galaxy Tire & Wheel, etc.). Many foreign companies have estimated that the general conditions for investment in Serbia are relatively independent of political uncertainty, and for that reason they've neglected shakes in the Serbian political scene. Issues of unsolved political status will not slow down the economic development of the country. There are countries with long-term disputes and unsolved status issues, such as South Korea, Taiwan, Cyprus and Israel, which have created powerful business environment and are among the most successful economies in the world in the last decades.

Bearing in mind the number of privatized companies, the investors were most interested in banking, processing industry and trade. The banking sector, with the sharpening of competition in a growing number of participants in the market, proved very attractive for foreign investors. The main reasons of the attraction of the Serbian banking market lies in the fact that interest rates are on a very high level, in other words the official business perceived risk is very high, and the actual risk in business is still significantly lower (according to the central data bank, Serbia is a country with a very high rate of returned loans from the business with the population). Foreign prominent banks will probably privatize the remaining banks. This will further increase the competition in the banking market, and thus lead to reducing the interest rates. Further concentration of banking markets, through mutual purchases and merger of banks, is expected.

The absence of larger post-privatized investment can be to a certain extent justified by the fact that the new owners (as well as investors in general) aren't provided with adequate after-sales service and support, either from the Agency for Privatization, or any other institutions such as SIEPA (Serbian Investment and Export Promotion Agency). Looking at the course of the privatization process, the government, in order to speed up the privatization process in 2005., proposed, and the National Assembly adopted, amendments to certain laws (on privatization, Agency for Privatization and the Action Fund). The authorities of the Agency

for Privatization are amended, and it performs tasks in bankruptcy if the Bankruptcy Council appoints it to perform the tasks, and in accordance with the law which regulates the bankruptcy proceedings.

The important amendment of the Law on Privatization refers to the large companies that are for sale, to which the state will write off debts to the state funds and public enterprises and make them much more attractive for potential investors. These debts would be settled later from the revenue accomplished by selling these companies. These measures should enable faster privatization of over-indebted companies, which carry most of the burden of excess labor. It is primarily about the public companies, whose successful privatization would provide the success of the entire process of restructuring the economy in Serbia. It is necessary to strengthen these companies and reduce the costs of their business. Therefore, it is necessary that the government and the competent ministries apply the strategy of restructuring public enterprises (the energy sector is the furthest one that they have gone to). The reduction of surplus labor force in these enterprises is announced, as well as in public administration. Social program, i.e. severance pay for these workers would be funded from the Transitional fund.

The total inflow of foreign direct investment recorded by the National Bank of Serbia (NBS) includes revenues from privatization and the new foreign direct investment. The current statistics of foreign investment in Serbia are based on the records of capital transfers led by the NBS on the basis of information supplied by commercial banks and registers them as the inflow of FDI in cases in which the commercial banks, as the basis of payment, specify code 557 (foreign investment). The moment of recording the inflow is the one when the payment is realized, regardless of the contractual obligations. These statistics allow tracking the total inflow of foreign investment from year to year, as well as comparison of foreign investment in Serbia with foreign investment in other countries. However, on the basis of this statistics, the origin of capital by country of payment can be determined, which in many cases is not the actual country of the origin of the capital invested. Companies from the United States are dominant by the amount of investment in Serbia, which is achieved through their own companies - intermediaries. Available data provide analytical monitoring of foreign investment (by country of origin, activities in which foreign capital inflows, regions that are invested in), but still, it is necessary to improve the foreign investment statistics and the methodology of collecting data on foreign investment.

Agency for Privatization notes the data on inflows from the sale of companies in the privatization process, as well as contractual obligations on the basis of investment and social programs. On that occasion, it particularly emphasizes the inflows that came from foreign customers, in other words value of contracts in which the customers are non-residential legal / natural persons. Data on privatization inflows, collected by the Agency for Privatization, do not include the amounts paid on the basis of the sale contracts that were later on broken. On the other hand, once recorded (contracted) investment responsibilities and obligations relating to the social programs are often not respected, especially regarding deadlines. The result of this is the lack of accurate and updated record of privatization inflows. If these data were reliable, from the total annual inflow of FDI the inflows of privatization could be subtracted and in such a way the annual amount of greenfield foreign investment could be received. Taking into account the very small number of greenfield projects, it can be estimated that greenfield investment in Serbia after 2000. has never exceeded the amount of 150 million dollars a year. This is certainly far from the development

needs of Serbia and in that sense, unsatisfactory. Since the domestic capacity of investment is small and the privatization inflows after the restructuring and sale of the following four of large companies will decrease, it is clear that the low level of foreign greenfield investment must be increased. Because of modernization and development, increase of employment and export, the country is obviously referred to a significant increase of the inflow of new foreign direct investment and the creation of the environment in which the existing companies are encouraged and supported to re-invest in activities with higher added value.

Private investors who bought companies from the state in the last few years in a lot of cases do not respect their contractual obligations related to the social and investment programs (as the media widely report). When the investors estimate that further investment is justified, they implement it, otherwise, they cannot be obliged to invest. The state then has two options: either to react and cancel the previous privatization, thus sending a bad message to other potential and existing investors, or to ignore the occurred situation. The first possibility would discourage already low level of investment, and the other one would undermine the credibility of the state. Social programs and investment commitments should therefore be removed from the Law on Privatization and leave the sales price as the only criterion. So, what is really necessary here is to establish a real, and not promised state of affairs which refers to the foreign direct investment. It is important to discover the precise amount of new foreign direct investment, because it is the best indicator of the quality of business environment. Serbia as a country will not increase FDI if the domestic investment does not rise significantly, since they are usually the basis for greater foreign investment.

2. Analysis of advantages and disadvantages in attracting foreign direct investment

In the beginning, the period of a significant increase in FDI was caused by the increased need for integration and quick progress within the privatization program in all the countries of Eastern Europe. The largest part of the new investment flew into the countries that developed economy and succeeded in facing the great challenges of technological development, global restructuring and improvement of logistics and information flow. In this respect, Serbia has had a minimal success so far in comparison with other countries of Central and Eastern Europe, but has made a significant progress in the development of relations with the European Union and the International Community and it is moving forward in the reform process in order to raise its legislative and administrative capacities to the European level. Serbia has the potential to regain a prominent place in the region and affect the development of international trade and seek ways of creating new employment opportunities by improving investment in the private sector. Despite the limitations, there is a clear intention to speed up the legislative reform and to initiate additional activities to strengthen institutional capacities, to solve the problem of competitiveness and improve understanding of the importance of foreign investment in the country and marketing abroad, in order to provide relief and support to investors in the implementation of their investment plans.

The biggest obstacles to foreign direct investment in Serbia are:

- Legislative problems of the ownership of land, especially the reform of the rules that regulate the area of construction

- Lack of need for major improvement and modernization of the judicial system with the establishment of special departments within the courts of a specific areas of law.
- Limited institutional capacities for strategic planning to attract foreign investment, as well as the lack of a national program intended to promote investment.
- Late and inconsistent reforms, infrastructure deficiencies and limited access to measures for the improvement of competitiveness:

Action plans to deal with these problems are stated more thoroughly in the new Strategy and reflect the orientation of the Serbian Government for the improvement of cooperation among all levels of government, with the active participation of the private sector and donors with the aim to accelerate the reform and progress in a relatively short period of time.

General objectives of the Strategy include:

- Increase of the number and value of new, particularly foreign investment in the productive sectors of the economy.
- Facilitate and support to foreign investors in the acceleration of planned investment implementation in the country.
- Support and benefits for existing foreign investors in deepening their involvement in the country and the maximum increase of the level of internationally competitive added value of domestic products and services in the economy.
- Development of effective competition in the market in the sectors and companies in which Serbia can build a competitive advantage.
- Development of methods to attract targeted investors and the creation of stimulating business environment for domestic and foreign investors.
- Satisfaction of the needs of innovative approach and timely reaction to the development of future economic flows.

The strategy supports the existing investors, both foreign and domestic, as well as new direct foreign investment and public-private partnership (concession) by improving general conditions for business and developing established key advantages of Serbia, which include:

- Central, Balkan regional position and access to markets in the East and West.
- Human resources and capabilities - a relatively good education system and knowledge of English among the population of working age.
- Industrial / research tradition and experience in the production.
- Natural resources and comparative advantages for the production of primarily agricultural and forestry products.
- Lower work cost of the qualified workers, as well as the persons who are in managerial positions.

While the investment in all sectors of the economy is very necessary, the following ones are those who could most contribute to the development of competitive advantages:

- Agriculture and food industry: foodstuff and non-food agricultural stuff, with the emphasis on environmental products, products with geographical origin and products from traditional production systems received from the implementation of native and traditional technologies of high quality, as well as the products of

- conventional production and processing for mass consumption with superior qualitative features.
- Car parts: focus on the companies-suppliers of the new car factories and manufacturers of trucks / heavy vehicles.
 - Banking and financial services.
 - Engineering: specialized services, design and construction.
 - Wood industry: above all, making furniture from wood, which is based on handicraft skills.
 - Information-communication technology: products and services with the possibility of making software, administrative-business services, initiatives that are based on the capabilities of the universities and research centers.
 - Pharmacy, health care and clinical researches, as well as the chemical industry.
 - Public-private partnerships: energy, telecommunications, infrastructure, metallurgy, mining and geological researches.
 - Textile industry: short-term production of brand clothes and facing certain markets.
 - Tourism.

In addition to these sectors, further liberalization in the field of the public infrastructure companies and development of the programs for public-private partnerships are seen as the investment opportunities and as important elements for the revival of investment environment.

There is a number of key, serious challenges that are before the economic development of Serbia, and which can be solved by increasing foreign direct investment:

- High and increasing unemployment and further pressures on employment that occur as a result of necessary economic restructuring.
- A significant trade deficit with import which far exceeds export.
- Significant structural and competitive problems facing the Industry of Serbia, whose results are still not over 1989. In spite of that, there is no evidence of significant changes in industrial production in the coming period to 2012.
- Because of weaknesses in the process of reform and modernization, progress cannot be expected without significant new foreign investment in competitive and modern sectors of industry, agriculture and services.
- Serious deficiencies in the institutions that deal with the implementation and management of reforms and modernization.

Serbia is faced with strong competition in order to achieve its goals since the majority of countries have made more significant progress when it comes to the overall economic reforms over the past 10 years, and many of them have already established the base of foreign investors. Many neighboring countries have established strong investment promotion agencies that have both marketing and sector expertise. Many countries have developed industrial parks for new investors who can build their plants there. In most countries, there are mechanisms with which both private owners and local authorities provide land and services. In addition, all countries offer specific investment incentives. This impact is

measured and reflected in the overall increase in FDI, declining unemployment, increasing export activities and various other indicators of economic development.

However, there are some positive signs that Serbia can use its development potential in the next ten years and can achieve economic growth and improve the standard of living of citizens, while turning into a competitive and functioning market economy. For example, the program of reform of laws and other regulations is in progress, in order to meet the standards of the European Union. Macroeconomic and business environment is constantly developing over the last few years, and the Government is passing a large number of new laws, stabilizing the annual budget, and it is achieving formal arrangements with the International Community about the debt and the questions to support the budget. There is more evidence of international and local approval on the progress that has been achieved in the speed and direction of the overall economic reform programs, which is seen in:

- Relative readiness to begin negotiations on EU accession.
- Renewal of credit support from the IMF in 2010.
- Positive evaluation of legislative reforms of the OECD.
- Increased dialogue and support to the Government of the domestic private sector and existing foreign investors.

Positive attitude and active participation of foreign investors is an important factor in the overall business environment in the determination and allocation of priority, key initiatives for the improvement of the overall environment for business development in the country.

CONCLUSION

Competition in new FDI is reflected in the global and rapid technological progress and development of logistics, together with the global need for reduced costs in most industrial sectors, all of which increases competition and raises the internal standards and expectations of the investors. Serbia must make efforts to catch up with the countries in the region. The Government has noted this need and presented it in all its plans and strategies. Therefore, a more active and accelerated approach and commitment for additional resources and initiatives should be adopted, in order to improve and enable the business environment. It is especially important to create conditions for effective application of discoveries and inventions (innovative results) in the economy, so that the time needed from the arising to commercialization of the innovation reduces to the level required in the world market. Innovative activity, together with the scientific research work, is the most important driving force of the total technological and economic development of the country. New knowledge and technologies, based on the inventive and innovative development, applied in the production and the process of creation of new products and services, can only increase the overall competitiveness of Serbian economy in the world frames. It can be concluded that the creation of a favorable environment for domestic and foreign investment is a major challenge for all countries. Competition in attracting FDI grows throughout the world, especially in the countries that have a small and open economy. Encouraging foreign direct investment in Serbia requires at the same time action and partnership relation of all stakeholders: central government, local government and foreign companies.

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FDI IN ROMANIA - ASSESING THE POSSIBLE EFFECTS OF THE INTERNATIONAL FINANCIAL CRISIS

Abstract

Over the last years, Romania has benefited from record FDI inflows which were stimulated by the macroeconomic stabilization, rapid GDP growth and large-scale privatizations. Also, foreign investors were attracted by Romania's relatively low unit labor cost, the improvements in the business environment, the flexible labor market, the low corporate tax level in the region, the proximity to the euro area and its increasing domestic market potential. An important moment was the integration of Romania to the European Union at 1st January 2007.

Romania's patterns of FDI and foreign trade indicate the transition from exploiting low-cost advantages towards services and higher value-added production, following the example of many countries from Central and Eastern Europe.

One of the major factors with influence on the FDI is the international financial crisis. Especially, the indirect effects of the crisis in Romania will concern the availability and cost constraints of external financing, decline in the volume of FDI inflows, negative impact on foreign demand, increased exchange-rate volatility and significant decrease in investors' attitude for risk on emerging markets.

Key words: *foreign direct investment, financial crisis, economic growth*

INTRODUCTION

For all countries, a component of the development strategies and an essential instrument in the development of a strong and dynamic private sector is to attract foreign direct investment (FDI). The FDI facilitates the indirect access to foreign markets through the complementary effect of the related technology and know-how implementation (Blomström et. al 2004).

On its way to a better integration within the international economy, the restructuring and reform process of the Romanian economy requires significant foreign investment flows driven by the increasingly global character of production process. This aspect, together with the already global character of trade, requires a new approach to the identification and distribution of resources. Also, should be taken into consideration that the financial flows, and particularly FDI, show a different regional and country pattern because of various internal and external factors (Daianu and Voinea, 2002).

The Center and Eastern European countries (where Romania is located) registered a positive FDI flows in the last years and the premises of interest for foreign investors were: political

stability and macroeconomic stabilization, including institutional development, low labor cost but educated labor (Masso et. al, 2007), relative high growth rate and increasing market potential, market access considerations (Boeri and Bruecker, 2001), existence of conditions for competitive clusters and innovatory activities (Dunning, 2007). Most of these countries registered in the FDI field a transition from low-cost advantages towards higher value-added production.

Romania has become an appealing target for a large number of foreign investors, in the last years. This is partially due to privatization, but also to the new investment projects in financial services, trade and real estate (Giurca et. al, 2008) and to the integration to European Union (Bevan et al, 2006). The same positive trend was registered by the CEE countries as result of increasing economic growth and progress of transformation. In these countries, FDI has played an important role in the privatization of the state sector, in promoting the market economy and competition (Birsan and Buiga, 2008).

The recent international financial crisis proved that the external disturbing factors should be also considered. The impact on FDI is different, depending on region and sector. Developed countries have so far been the most affected, with a decline in FDI inflows in 2008, due mainly to sluggish market prospects. Flows into developing economies continued to grow in 2008, but at a much lower rate than the year before (UNCTAD, 2009). Among industries, FDI flows to financial services, automotive industries, building materials, intermediate goods and some consumption goods have been the most significantly affected by the financial crisis.

1. Recent evolutions of FDI in Romania

Before 2004, the slow progress in the reform of the public sector and the volatile legislative framework eroded the credibility of the Romanian economy and kept the foreign investors away. Accordingly, FDI remained below its potential level, with inflows derived mainly from the privatization process. But since 2004, Romania has become one of the most important beneficiaries of FDI in the region. After 1st January 2007, when Romania becomes part of the European Union, it has been created a legal framework consistent with a market economy and investment promotion.

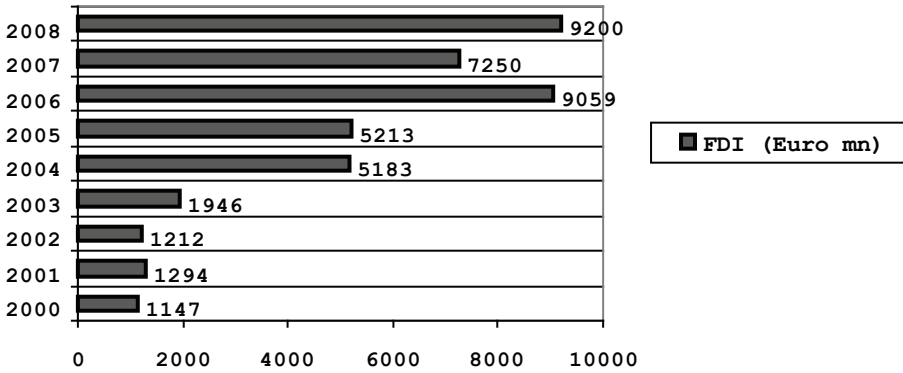
The accelerated economic growth in the last years has placed Romania among the leading FDI destinations in the region. Therefore, the investor's interest for Romania increased in the last years constantly. The cheap and skilled labor force, one of the lowest corporate tax level in the region (16%), the improvements in the business environment, a flexible labor market, a positive attitude from foreign partners, a liberal labor code and a favorable geographical location are Romania's main advantages for foreign investors. Also, the foreign investors in Romania are stimulated and attracted by free access to domestic markets, the possibility of taking part in privatizations, no imposed limits on foreign participation in commercial enterprises.

As result of these measures, in 2006, Romania received about 9,059 million Euro as net inflows (figure 1). But in 2007, even Romania has become the main destination for the foreign direct investments among the new EU member countries, the international circumstances (global crisis and political instability) determined a decrease of FDI to 7,250 million Euro which includes the followings:

- 2,220 million Euro accounted for stakes held in companies (31% of the FDI flows);

- 1,327 million Euro for net reinvested earnings (18% of the total FDI);
- 3,703 million Euro for the net credit received from foreign investors (51% of the total FDI).

Figure 1: The evolution of FDI in Romania - net inflows (2000-2007)

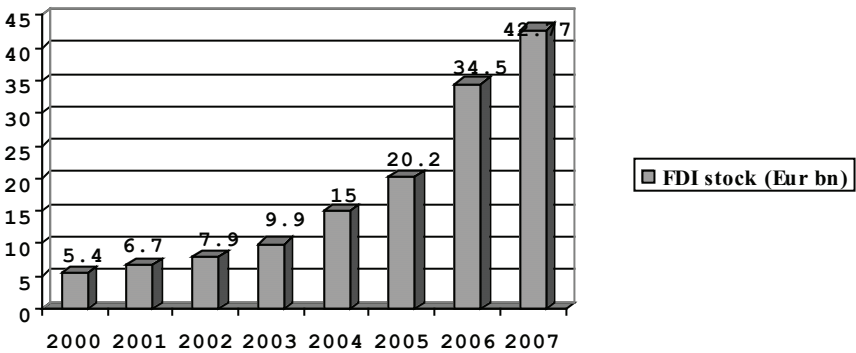


Source: ARIS INVEST - The Romanian Agency for Foreign Investment

In 2008, the foreign direct investments in Romania increased up to 9,2 billion Euro according to the Romanian Agency for Foreign Investments (ARIS) statistics.

The FDI stock registered an increase from 5,4 million Euro in 2000 to 42,770 million Euro in 2007 (figure 2).

Figure 2: Evolution of FDI stock (Eur bn)



Source: National Bank of Romania, Annual Report 2007, ARIS INVEST

The foreign direct investors equity stakes in the share capital of direct investment enterprises in Romania represented 74% of the FDI stock in 2007 and the net credit received from foreign direct investors was 26 % of net flow, including both the medium- and long-term loans and the short-term loans granted by the foreign investors to the direct investment enterprises in Romania.

By economic activity, the most part of FDI in 2007 went to manufacturing (39.2% of total investment) and significant FDI was also channeled into financial intermediation and insurance, (23.3 percent of total FDI), wholesale and retail trade (14 percent), construction and real estate (7.8%) (table 2). Despite their large potential, certain sectors, such as textiles, wearing apparel, leather goods, as well as hotels and restaurants, still hold a rather small share of FDI.

Table 1: FDI - by types (2007)

Activity sector	FDI stock (Euro mn)		% from total	
	2006	2007	2006	2007
Industry, of which:	15,155	17,409	43.9	40.7
- mining	2,105	2,046	6.1	4.8
- manufacturing	11,782	14,071	34.1	32.9
- electricity, heating, natural gas, water	1,268	1,292	3.6	3.0
Financial intermediation, insurance	7,678	9,961	22.2	23.3
Wholesale and retail trade	4,209	5,970	12.2	14.0
Post and telecommunications	2,831	2,784	8.2	6.5
Construction and real estate	2,200	3,329	6.4	7.8
Other activities	2,439	3,317	7.1	7.7
Total	34,512	42,770	100	100

Source: National Bank of Romania, National Institute of Statistics, Foreign Direct Investment (FDI) in Romania as of 31 December 2007

But major shifts are taking place in the sector composition of FDI flows to Romania. Investors' interests are diversifying from exploiting low-cost advantages towards higher value-added production (Pauwels and Ionita, 2008). This is reflected in the rising share of the services sector as a destination of total FDI flows. In the services sector, the large population and rising living standards have attracted significant FDI flows in financial intermediation and insurance.

But the largest single beneficiary in terms of FDI stocks remains the manufacturing sector, which held more than 1/3 of the inward investment positions in 2006 and this trend continued in 2007. The manufacturing sector is also undergoing significant transformations along with some of the CEE countries that have experienced a similar transformation process in the same sector. In the early stages of transition, their industrial base relied more on unskilled-labor-intensive activities but later on, the centre of gravity shifted towards more value-added skill - and capital-intensive sectors such as the automotive and IT industries.

The types of FDI by contribution to the development and renewal of economic assets in the FDI recipient country in 2007 are as follows (table nr. 3):

- *Greenfield*: investment in the establishment and development of enterprises by or together with foreign investors represents 17.3%;
- *Mergers and acquisitions*: partial or full takeovers of enterprises by foreign investors from residents, and their subsequent development. The M&A had 10.5% from the total FDI in 2007;
- *Corporate development*: foreign direct investors' increase in the capital of direct investment enterprises and represents 72.2% from the total FDI (NBR, 2007).

Table 2: FDI in 2007 by type of investment (2007)

Activity sector	Greenfield		Mergers and Acquisitions		Corporate development	
	2006	2007	2006	2007	2006	2007
Industry, of which:	166.83	7.5	140.65	6.3	242.40	10.9
- mining	0.00	0.0	0.00	0.0	4.12	0.2
- manufacturing	160.64	7.2	140.65	6.3	306.19	13.8
- electricity, heating, natural gas, water	6.19	0.3	0.00	0.0	-67.91	-3.1
Financial intermediation, insurance	156.07	7.0	50.30	2.3	856.72	38.6
Wholesale and retail trade	7.91	0.4	0.98	0.00	180.79	8.1
Construction, real estate	14.92	0.7	32.84	1.5	160.24	7.2
Post, telecommunications	0.00	0.0	0.00	0.0	7.89	0.4
Other activities	39.32	1.7	8.61	0.4	153.48	7.0
Total	385.05	17.3	233.38	10.5	1,601.52	72.2

Source: National Bank of Romania, National Institute of Statistics, Foreign Direct Investment (FDI) in Romania as of 31 December 2007

The accumulation of foreign direct investment in enterprises established as Greenfield investment companies, called *greenfield enterprises* was highlighted in order to assess the lasting impact of greenfield investment on the economy.

The activity of foreign direct investment enterprises as a whole had a positive impact on Romania's trade balance, its contribution to total exports and total imports being 70.8% and 59.2% respectively (BNR, 2007).

Regarding the exports, these have traditionally been concentrated in low value added products and raw materials, benefiting from non-market based advantages such as the depreciation of the local currency (table 4).

Exports of traditional products, (i. e. textiles and leather) are by far the most important: they represent more than one third of total exports and almost half of total exports directed to EU-15 countries. But textile products are gradually losing ground in the export structure in favor of higher value added products such as machinery and equipment, transportation vehicles. The current trends – characterized by convergence in wages and increasing competitive pressures from other emerging markets – is expected to support a more visible shift toward higher value added exports.

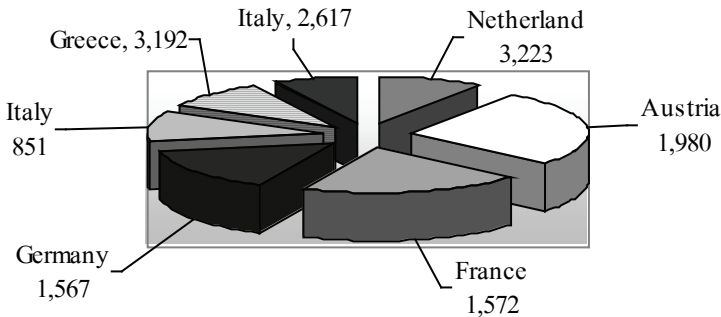
Imports have also followed a robust growth pattern, stimulated by the improved financial standing and expectations for both households and companies. The main drivers of growth include machinery and equipment, oil and oil products as well as road vehicles and accessories.

Table 3: Exports and imports of FDI enterprises (2007)

Activity sector	Exports (FOB)		Imports (CIF)	
	FDI enterprises	% of total sector	FDI enterprises	% of total sector
Industry, of which:	18,273	77.5	18,111	78.2
- manufacturing	17,349	77.2	17,252	78.2
Wholesale and retail trade	1,876	62.7	9,646	47.7
Other activities	414	16.8	1,918	28.5
Total	20,563	70.8	29,675	59.2

Source: National Bank of Romania, National Institute of Statistics, Foreign Direct Investment (FDI) in Romania as of 31 December 2007

Romania is actively integrated into the European economical environment, as reflected by the distribution of FDI per countries of origin (exports and imports). In 2007 the largest foreign investments were attracted from Austria (21.4% from total), Netherlands (16.3%), Germany (11.7%), France (8.8%) and Greece (7.5%) (figure 3).

Figure 3: FDI stock – main investors, EUR mn (2007)

Source: National Statistical Office and Trade Register

In terms of sector attractiveness, most of the FDI was directed toward banking, construction, telecommunications, retail distribution networks, the manufacture of transport vehicles and spare parts, as well as to strategic areas such as the energy and oil sectors.

2. Drivers for FDI in Romania

The significant stabilization of the macroeconomic environment stimulated by the EU convergence process and the gradual harmonization of the legal and institutional framework have played an important role in facilitating the major improvement of the operating environment in Romania.

Also, when considering Romania as a possible location for developing their businesses, foreign investors take into consideration the advantages provided by our country. Accordingly with the Romanian Agency of Foreign Investment (ARIS) these advantages can be grouped as follows:

- *Market & Location Advantage:* Romania is one of the largest markets in Central and Eastern Europe (ranking 7th, with over 21 million inhabitants); a gateway between East and West of Europe; EU market gateway (access to about 500 million consumers);
- *Resource Advantage* such as: highly skilled labor force at competitive prices (solid knowledge in foreign languages, technology, IT, engineering, etc); existence of important natural resources (surface and underground waters, fertile agricultural land, oil and gas) and proximity to energy suppliers; high potential for tourism;
- *Political Advantage:* stability factor in the Area - NATO membership; stability Guarantee in South Eastern Europe; EU membership;
- *International relation advantage,* such as: bilateral agreements between Romania and other countries on investments promotion and protection; free trade agreements with EU, EFTA and CEFTA countries; the association of the government with international financial institutions, such as IMF, EBRD, World Bank and the EU Commission;
- *Economical Advantage* which consist on sustainable economic growth (at least till 2008); increasing interest on behalf of Foreign Investors – leader destination for FDI in the region; sound fiscal policy (16% flat tax);
- *Social Advantage* consisting of: agreement between Government and major unions; no major union movements; labor relations regulated by the Romanian Labor Code;
- *Legislative Advantage* such as: similar legal provisions as in UE (Acquis Communautaire implementation); fiscal policy regulated by the Fiscal Code.

So, fuelled by large privatization programs, foreign investors were attracted by Romania's relatively low unit labor cost, proximity to the euro area, sound macroeconomic fundamentals (successful disinflation, high growth) and its increasing domestic market potential. Also, an important moment was the integration of Romania to the European Union at 1st January 2007.

But in analyzing the FDI in Romania should be taken into consideration the recent changes in the Romanian economic environment and also the international level ones.

At the national level, the boom of privatization-led FDI, which represented about half of the FDI inflows in recent years, is now largely over. Furthermore, Romania's low-cost advantage is gradually eroding in certain sectors. While hourly labor costs remain low, even by Eastern European standards, a tightening labor market and skill shortages, partly due to large outward migration, have contributed to significant increases in private sector wages. Another growing area of concern is that wage developments have outstripped productivity growth in the last years. This has led to a sharp appreciation of the real effective exchange rate, affecting Romania's international competitiveness.

With gradually rising costs and increasing competition from Far East countries, substantial differences emerge among products, even within the same sector. Where standard machinery and the availability of a low/medium qualified labor force are required, competitive pressures are taking shape and companies are starting to look at other attractive markets with lower production costs. The fact that in these sectors the presence of foreign companies is structured very much on contract-work systems represents one of the main weaknesses in the country, as exit costs for a foreign investor or foreign contractor are extremely low.

In the last years, a series of investments with significant impact in Romania took place, in different domains, such as: transport (Renault, Ford, Honsel, Pirelli, Continental), IT (Microsoft, Eriksson and Oracle), electronic industry companies (Nokia, Solectron, Celestica), construction materials producers (Saint Gobain, Holcim, Lafarge and Heidelberg), metallurgy companies (Arcelor Mittal and Samsung Steel), in the banking sector (Erste Bank, BRD-SG, Millennium, ING, ABN Amro), and in the oil industry (OMV, KazMunai). Major FDI has also been attracted in sectors like electrical&optical equipment, telecommunications, ITC, pharmaceuticals or financial services.

In fact, Romania offers significant potential to those industries that use competitive and highly efficient technology such as car and car parts (since this sector has tradition and experience in Romania), electronics and home appliances (due to qualified labor force), construction materials (due to the last years boom in the real estate market), metallurgy and R&D. Also, bio-diesel and wind energy are domains in which foreign investors have expressed interest and intention to develop investment projects, benefiting from opportunities offered by the investment climate in Romania and the EU norms that support development in alternative energy.

Recent experience has proven that many foreign companies which have implemented greenfield projects in Romania decided to expand with new production units. The fact that they decided for expansion and not relocation proves a healthy stable and predictable economic environment that offers high profit margins ensuring that the existing capital is maintained in the economy and new capital is attracted.

In some cases, the choice of investors to move to Romania has been driven by the strategic positioning of the country. This allows other eastern markets to be penetrated where the establishment of a direct presence may still be too risky, due to the relative uncertainty of the operating environment.

An important number of foreign investors are targeting Romania to capture the strong potential connected to the large local demand - (especially in the field of retail sales and financial services) and the need to renovate and build up local infrastructure. Many companies consider Romanian market very appealing in view of its growth potential compared to the much more saturated western markets, targeting it for the commercialization and production of cheap products.

Also, when analyzing the drivers of the FDI, it should be taken into consideration the integration process, Romania being part of the European Union since 1st of January 2007. One of the implications of Romania's accession to the European Union is represented by the increase of the foreign direct investments (FDI) as they represent a main problem around which is placed the entire process of quantifying the costs and advantages while taking into account the present need of capital.

So far, Romania has been one of the main beneficiaries of EU pre-accession funds (some 2 billion EUR in the period 2004 – 2006) and in the 2007 – 2013 period the structural funds are about 19.6 billion Euro. Strong stimulus will come from the launch of large

infrastructure projects connected to the renovation and development of local infrastructure. Some opportunities are also connected to the remaining privatizations in public utilities distribution (gas, oil and electricity), salt and gas exploration, public transportation, banking services or pharmaceuticals.

Given the problems previously encountered as regards absorption and management, the efficiency related to using of the structural funds remains crucial. Significant improvements are required in the area of financial management and controlling structural funds. Therefore it can not be neglected the slowness of the bureaucratic system and the high turnover of personnel as major sources of inefficiency. Additional efforts are required to modernize the public sector and reform public administration as long as one of the key problems which negatively impact the business environment is weaknesses in the public administration, legislation and labor regulation rigidities.

3. Possible effects of the international financial crisis on the FDI

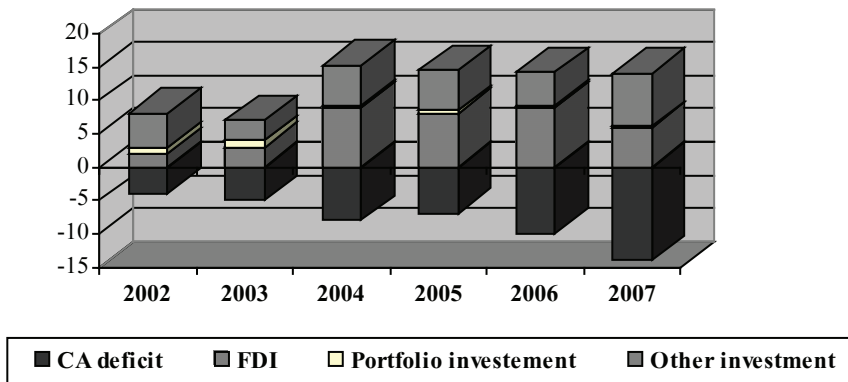
In the last years, the Romanian economy registered a rapid development, with growth rates between 6 % and 9.1 %. But the Romania's impressive annual GDP growth between 2002 and 2007 has gone together with rising external imbalances. The current account deficit widened from 3% to 14% of GDP in the same period, (EC, 2007). The rapid expansion of financial intermediation, combined with steadily increasing income expectations has fuelled a domestic demand boom, for both consumption and investment, leading to a rapid increase in imports.

Between 2000 and 2006, FDI was the principal financing source, covering around 75% of the current account deficit (figure 4).

From 2007 onwards, FDI inflows dropped to roughly 50% of the deficit, as the privatization program of state owned enterprises was coming to an end.

Also the composition of FDI inflows has changed: the share of equity inflows (including privatization receipts) shrank from 59% in 2004 to 13% in 2007, while intercompany loans have become more prominent, rising from 13% to 52% in the same period. The difference, i.e. reinvested earnings, stayed roughly constant.

The rest of the current account deficit was more than covered by "other investment", being mainly loans and currency deposits. The capital account has remained slightly positive and stood at 0.7% of GDP in 2007, partly reflecting the inflow of EU funds.

Figure 4: Balance of payments components (% of GDP)

Source: National Bank of Romania, Annual Reports 2003-2007

The increasing importance of FDI intra-company loans and other investment has resulted in a steady increase in external debt from 30% of GDP in 2000 to 52% of GDP in August 2008. The domestic counterpart of rapidly increasing external debt has been the acceleration of bank lending to households and enterprises.

This was the economic situation of Romania when the international financial crisis appeared. One of the major factors with influence on the FDI is the international crisis. It should be taken into consideration that there are both direct and indirect effects of the crisis (Isarescu, 2008):

a) *Direct effects* from banks' exposure to "toxic assets". But the direct effects are not present in the case of Romania because the banking system is fundamentally sound, which means: lack of exposure to "toxic assets" which lie at the root of the crisis; traditional banking products dominant due to their high profitability;

b) *Indirect effects* caused by changes in the availability of capital and liquidity conditions and which are significant in Romania, as follows:

- availability and cost constraints of external financing because the major impact on the availability of foreign-exchange denominated credit;
- decline in the volume of FDI inflows,
- negative impact on foreign demand, affecting Romania's exports;
- increased exchange-rate volatility amid the significant decrease in investors' appetite for risk on emerging markets.

The slowdown in the growth of domestic credit brings a slowdown in consumption and investment and the growth slowdown in the Western Europe will affect Romania's exports and foreign direct investment (FDI).

Also, a rise in unemployment will follow and inflationary pressures are not likely to subside because the excess demand in personal incomes. In absence of corrective action,

the fiscal position is likely to deteriorate: decelerating economic activity will affect revenue collection.

In these new circumstances, the wide external imbalances are no longer acceptable. High economic growth in recent years and even disinflation have come at the price of an ever larger current account deficit because there is a tight relationship between the fast expansion of domestic absorption, fuelled by rapidly growing personal incomes and credit, and the widening of the external gap.

Also, the crisis will have an ambivalent impact on the magnitude of the current account deficit. Therefore, the exports will decrease following the trend in external demand and the imports will also decrease, as a consequence of the decline in investment activity and exports.

Due to international financial crisis, the inward FDI rhythm will be decreasing on short term. The likely decrease in the FDI flow will make financing more expensive and significantly less available.

Till now the FDI flows to South and Eastern Europe have proved very resilient to the global slowdown. To a certain extent, economic retrenchment in Western Europe has led to a further shift in productive capacity to Eastern Europe. It is generally assumed that FDI flows will hold up much better than other forms of capital flows. Returns in emerging markets, including South and Eastern Europe, will continue to be more attractive than those available in mature markets.

Romania continues to offer good prospects for “greenfield” investment, particularly in the automotive and electronics sectors, which will be essential in assisting long-term development as well as in preserving macroeconomic stability. But sectors with high levels of indebtedness, including real estate developers and construction companies, are likely to be worst-affected by the global financial crisis. Other sectors such as textiles, which are already in decline and operate on low profit margins are vulnerable to the global liquidity crisis.

CONCLUSIONS

Over the past four years, Romania has benefited from record FDI inflows, thanks to macroeconomic stabilization, fast GDP growth, large-scale privatizations and the prospect of EU membership. However, privatization-related FDI flows are slowing down since 2007, which have been an important source of capital inflows over the past decade. Furthermore, successive wage negotiations have driven up unit labor cost, affecting Romania’s international competitiveness, especially in light industry, in favor of low-cost Asian countries.

Romania’s patterns of FDI and foreign trade indicate the transition from a competitive advantage in the lower-end of the value chain (in particular textiles and leather) towards services and higher value-added manufacturing sub-sectors, following the example of many of the Central and Eastern European countries. But this transition is still at an early stage

because the level of per capita FDI stock and the share of high value-added manufacturing exports are still relatively low compared to most of the recently acceded Member States. The forecasts reveal that the financial crisis will slow down FDI in Europe's developing countries and will impact most on those countries that rely on foreign capital. There is a particular cost associated with the slowdown for countries in Eastern Europe as they depend on markets in the Eurozone for the flow of capital.

It should be taken also into consideration that Romania's economic boom has come at the moment of generating imbalances. High external borrowing has led to a rapid build-up of external debt; widespread foreign currency lending has increased households' and companies' balance sheet exposure; and high private sector dissaving was exacerbated by rising fiscal deficits.

The financial crisis and its spillovers to the real economy through currency, trade, financial and confidence channels has made the task of rectifying these imbalances ever more urgent. To rebuild investor confidence, the government will need to ensure a credible fiscal consolidation strategy which will be helped by the implementation of a medium-term fiscal framework and by restructuring fiscal expenditure towards productive investment (including through accelerated EU funds absorption).

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