

## **The Role of Competitiveness for Stability in South East Europe**

### **Introduction**

The Stabilization and Association Process (SAP) was initiated by the EU for countries not covered by European agreements, i.e. Albania, Bosnia and Herzegovina, Croatia, Macedonia and Serbia and Montenegro. The process is realized through Stabilization and Association Agreements (SAA) that the EU already concluded with Croatia and Macedonia, which have important implications for international trade and investment. The SAAs focus on respect for democratic principles and strengthening links of the countries of the region with the single market. They foresee the establishment of a free trade area with the EU and set out rights and obligations in areas such as competition and state aid rules, intellectual property and rights of establishment, which will allow the economies of the region to begin to integrate with the EU. Therefore, the SAP should be regarded as a tool for integration of the countries of South-East Europe into the emerging pan-European free trade area, resulting in removals of trade barriers between all countries that are gaining associate membership status. It should be regarded as a process of transformation of small, closed national economies to countries integrated in a wide area of free movement of goods, services and investment.

This process especially includes regional cooperation. While the SAA provides for individual approaches to the EU, it is also related to regional cooperation defined as a series of bilateral agreements between the SEE countries that have signed the SAA. For example, a “Memorandum of Understanding on Trade Liberalization and Facilitation” was signed on June 27, 2001 between Albania, Bosnia-Herzegovina, Bulgaria, Croatia, Macedonia, Romania and Serbia and Montenegro. Following the Memorandum, free trade between the signatory countries has been realized by completing a network of free trade agreements by 2003. These agreements provide for free trade in at least 90 % of the parties' mutual trade, within a transition period not longer than 6 years.

However, while free trade within South-East Europe could remove significant constraints to intraregional trade, the main focus shall remain on the overall process of integrating these countries in the European Union. The EU remains the main trading partner of all the SEE countries and there is a large potential to increase trade and cooperation between the two, which would also bring to overall development of these countries. Therefore, it is important that all the SEE countries move forward in trade liberalization also within the WTO framework, providing for the opportunities for large scale investment, long-term cooperation and mergers and acquisitions at the regional level.

The purpose of this paper is to help identify the role of increasing competitiveness of the SEE countries within the mentioned framework, in order to make them eligible for the full EU membership as soon as possible. The paper relies on the findings of the Global Competitiveness Report 2003/2004 as the main tool for assessing the standing of competitiveness in SEE countries.

### **The Process – What Can We Expect?**

The importance of regional cooperation in South-East Europe should not be neglected, while stabilization and security is of the utmost importance to boost economic growth. However, the SEE region is rather heterogenous; in terms of GDP per capita and in terms of trade flows Christie (2000) found that while overall trade between the SEE countries is not exceeding normal (non-preferential) trade, South-East Europe cannot be considered a trading region. Gligorov (2000) argues that South-East Europe is not even likely to become a trading region due to many different relations of the countries within SEE with the other countries and regions.

This becomes more evident when referring to the progress of integration with the EU. The EU signed agreements with Bulgaria and Romania in 1993, and the two countries are expected to meet accession criteria by 2007. Croatia signed the Stabilization and Association Agreement (SAA) in October 2001, with the perspective of establishing a free trade area after a transitional period of 6 years. The Interim Agreement, covering trade and trade-related measures, entered into force on March 1, 2002. Croatia submitted its application for EU membership on February 21, 2003 and may prove to be capable of catching up with Bulgaria in its preparations, and

even of going ahead of Romania. However, the three will most likely join the EU at the same time, probably in 2008.

The EU signed the SAA also with FYR Macedonia in April 2001, however with a different transitional period than in the Croatian case. Macedonia shall fully open its market to the EU imports in 2011, 4 years later than Croatia. The other SEE countries are significantly lagging behind. Albania began negotiations on the SAA in February 2003. Under the best scenario, Serbia and Montenegro could sign an SAA with the EU at the end of 2004. Work is also underway on a feasibility study to open negotiations on a Stabilisation and Association Agreement with Bosnia and Herzegovina. In addition, Bosnia and Herzegovina, as well as Serbia and Montenegro have not even become members of the WTO, which is usually the first step towards European integration while incorporating many reforms of the foreign trade system and related laws and institutions.

This diverse integration situation leads to the conclusion that, although the SEE countries have mutually signed bilateral free trade agreements, there is no room to integrate them in a kind of customs union that would provide for identical foreign trade regime towards the rest of the world. The bilateral and multilateral agreements with third parties already created significant differences in the structure and level of custom duties and non-tariff barriers in the countries. By virtue of these agreement, for instance, Bulgaria and Romania have already fully liberalized trade in industrial products with the EU, Croatia and Macedonia are reducing tariffs yearly according to a precise schedule, while other countries of the region have not even started the process. The WTO has also incorporated a trade liberalization schedule specific to each case.

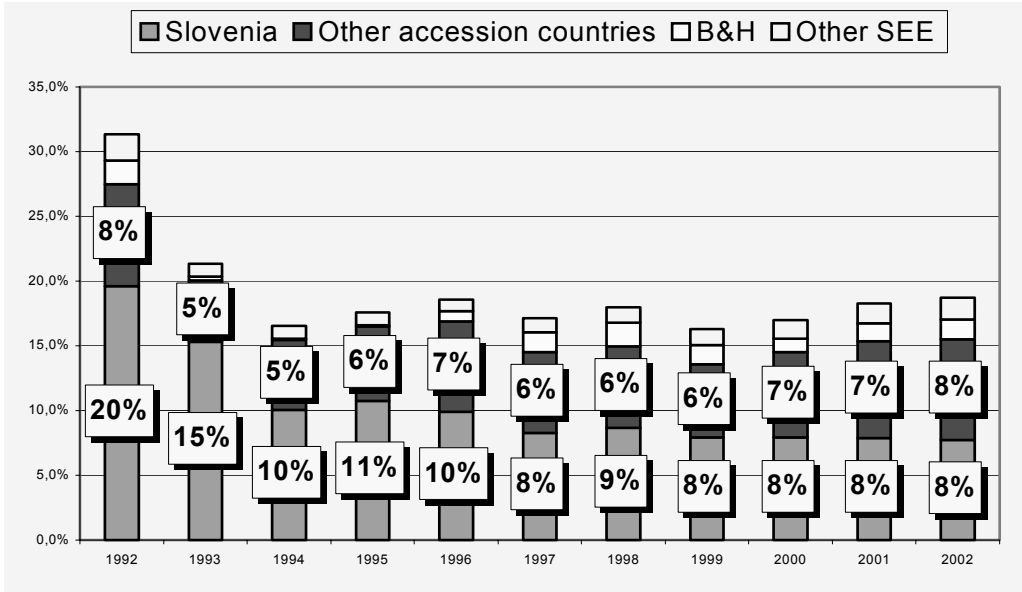
It would be misleading to think that the advanced countries of the region shall wait for the other countries to catch up. While the aforementioned processes are irreversible, this would imply that Bulgaria, Croatia and Romania shall wait many years, until the least developed SEE country becomes ready to join the EU. Even provided a significant acceleration of the integration process for those lagging behind, the advanced countries may fail to benefit from further integration with the EU if they have to wait. Therefore, this paper stands for the fast-track approach meaning that each of the SEE countries shall join the full EU membership when it is ready, pulling the others to follow the path. An optimistic view, based on the author's

educated guess is that Bulgaria and Croatia may be ready for the EU membership in 2008, Macedonia and Romania in 2010, while Bosnia and Herzegovina, Serbia and Montenegro and Albania may become eligible by 2012.

### **Reasons for a fast-track approach**

Why is it important for the SEE countries to urge the EU to use an individual approach to full membership of the SEE countries? The main reason is that the higher the integration level, the stronger the impetus for creating trade and development, which may be noted from the experience of the countries of Central Europe. As evident from figure 1, the average share of total exports of goods and services in GDP of the most successful Central European Countries (Czech Republic, Estonia, Hungary, Slovakia and Slovenia) has increased from 45% in 1994 to as high as 70% in 2000, while the share of Croatian exports in GDP has not surpassed the initial level. Therefore, we can argue that the absence of deeper integration with the EU resulted in a loss of market shares in the most important export markets. Croatian share in imports from the EU fell from 0,34% in 1993 to a mere 0,19% in 2000, while the share of Central European Countries (CECs) almost doubled.

**Figure 1:** Total exports of goods and services as percentage of GDP, selected countries, 1994-2000



Source: Galinec et al. (2002)

Having in mind that the CECs shall become full EU members in 2004, it is of the utmost importance to create opportunities for the increase of SEE trade with the EU, by going on with the integration process. Further integration with the EU shall bring new investment needed for restructuring and transfer of technology, by creating strong ties with the leading EU firms and other developed countries.

However, it is not easy to estimate the trade effects European integrations while the analysis should encompass the overall framework of the process includes the following developments:

Within the SAP, trade liberalization is underway, including elimination of tariffs between the EU and SEE countries, and between the SEE countries themselves;

The European Union shall accept new members among CEE, which shall further stimulate trade and investment flows between them, partly at the expense of SEE countries entering at a lower integration level<sup>16</sup>;

All the countries are liberalizing towards third countries. The EU is lowering its Most Favoured Nation (MFN) tariffs, and negotiates free trade agreements (FTAs) with a number of other countries, including Mediterranean countries. The Central European countries will lower tariffs towards third countries by adopting EU foreign trade regimes, while the SEE countries liberalize non-preferential imports according to WTO schedules.

The EU itself continues its own integration by creating the monetary union and undertaking a number of common policies which shall stimulate its intraregional trade and cooperation.

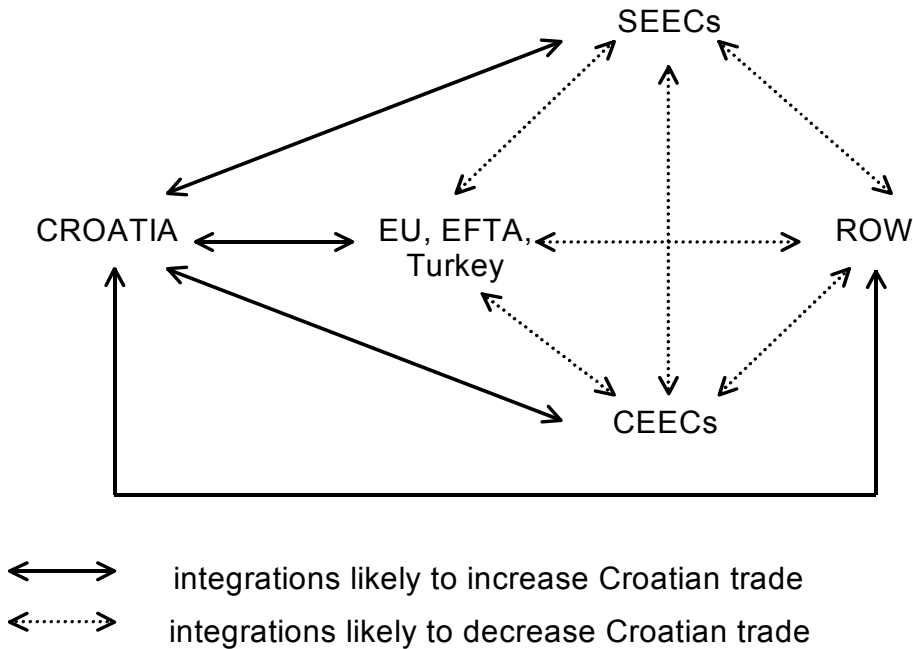
Some of these processes shall stimulate trade from the point of view of individual SEE countries, while others may be detrimental. Figure 2 presents a scheme of the described processes and effects, with a tentative hypothesis of their effect on Croatian trade.

Therefore, it may be wrong to analyze the effects of SAA or regional liberalization using a *ceteris paribus* assumption (i.e. disregarding other simultaneous integration processes). It appears that a multi-country model should be employed to capture most of the mentioned processes. Therefore, it is important to note that the accuracy of predictions of future SEE countries trade flows is very limited.

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<sup>16</sup> While full EU membership implies economic and (typically later) monetary union, association status is somewhat deeper than a simple free-trade area.

**Figure 2: Mid-term integration processes**



In recent literature we found a number of gravity-type analyses focused on the effects of the Europe Agreements (See: Kaminski (2000), Fidrmuc and Fidrmuc, (2000), and Christie (2000)). Generally, these analyses have shown that the advanced CEE countries have quickly approached a “normal” level of trade suggested by models, due to the dismantlement of trade barriers and passed this level through foreign investment that created trade, implying that the EU association status may have increased trade between the associated countries and the EU in the range between 30% and 90% while the full EU membership brings a further increase of trade by some 30-40%.

However, the gravity models used in the aforementioned studies were not able to deal with the complexity of trade relations in South-East Europe, with the significant propensity to trade between the countries of former Yugoslavia, and the very low trade between these countries and Albania, Bulgaria and Romania. To assess potential trade, it may be needed to add additional variables, such as common border, language similarity or com-

patibility of the production structure, due to historical belonging to the same state<sup>17</sup>.

As indicated in figure 3, Croatian trade with the countries of former Yugoslavia in the last decade was significantly below the 1987 figures, when these countries were part of the same federation, with relatively high tariffs versus the rest of the world. Trade with particular countries of former Yugoslavia developed differently throughout the last decade. Trade with Serbia and Montenegro recently emerged from very low figures, only to reach 5% of the pre-war level<sup>18</sup>. Trade with Macedonia seems to have stabilized at 20% of the pre-war level, helped by a free-trade agreement signed in 1996, and moreover by easing transit traffic through Serbia and Montenegro.<sup>19</sup> After falling during the war, trade with Bosnia and Herzegovina started a rise again from 1995, helped by a free trade accord, and an increase of consumption in Bosnia. Low tariffs mean a lot in trade between the two countries, which is evident from the downturn suffered in 1999 and 2000, when the FTA was suspended, and the positive reaction in 2001, when it was reintroduced. The FTA has most likely stopped the downturn trend of trade between Croatia and Slovenia.

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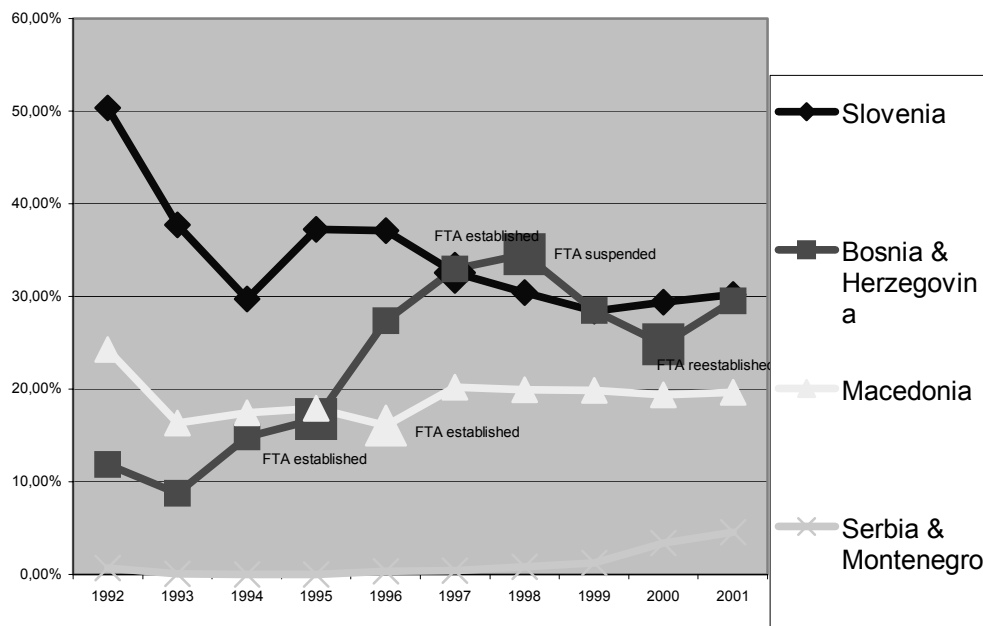
<sup>17</sup> In addition, there is a significant influence of war conflicts on the production and trade in the countries under review. For instance, production capacities of B&H were largely destroyed in war, resulting in enormous trade deficit. Apart from that, there are strong consumer preferences in parts of B&H towards goods from Croatia and S&M. Also, these two countries are the only partners for B&H with functional preferential trading regimes, which may strongly divert B&H from trading with the rest of the world.

<sup>18</sup> This is no surprise knowing that former authorities of S&M were involved in war in Croatia, and were introduced trade sanctions.

<sup>19</sup> Croatia and Macedonia do not have a common border.



Figure 3: Croatian trade with the countries of former Yugoslavia (% of 1987 trade)



Source: Central Bureau of Statistics, 1987 data, based on input-output tables

Generally, in spite of trade liberalization, Croatian trade with Slovenia, Macedonia and Bosnia and Herzegovina virtually stagnated throughout the last 3 years, at a level significantly lower than the pre-war level, however somewhat above the “normal” level, due to cultural and language similarities<sup>20</sup>.

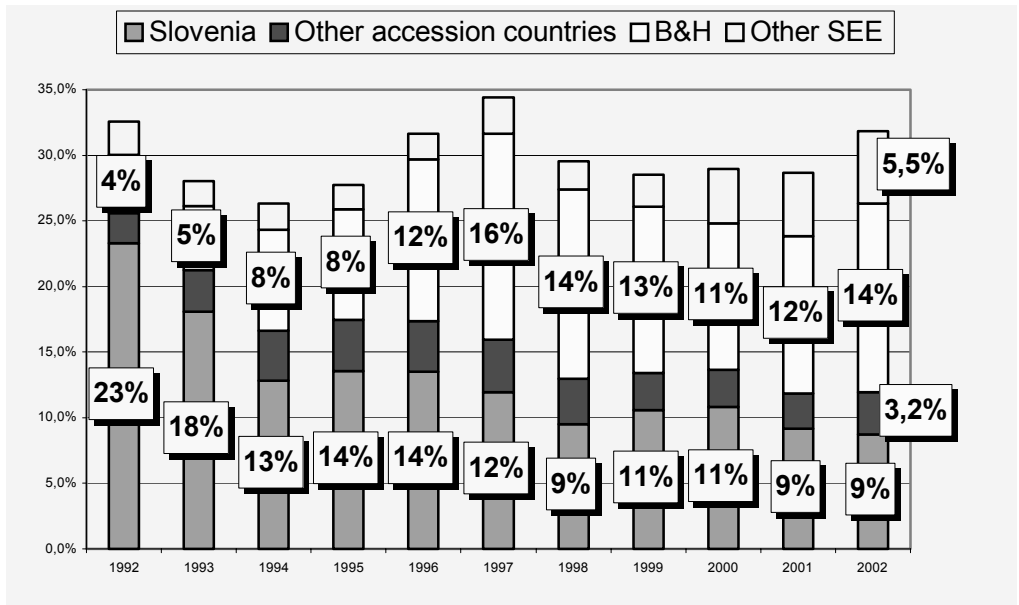
<sup>20</sup> Fidrmuc and Fidrmuc, (2000) found that neighboring countries tend to trade some 50% above the “normal” level, while the countries with common history and similar languages (Austria and Germany, Belgium and the Netherlands, Sweden and Norway) trade 2-3 times more than normal. The authors expect

Hence, it is important to maintain and stimulate trade relations between the countries of former Yugoslavia which may be hindered by different timetable of joining EU. This can be illustrated by describing the consequences of Slovenian gaining full EU membership in 2004 on Croatian imports. As is evident from figure 4, from the total Croatian imports, some 8% originate in Slovenia and an additional 8% in other new EU members, meaning that imports from these countries are rather important for the Croatian economy. When these countries join EU in 2004, they shall adopt the EU foreign trade regime also towards Croatia. While Croatia is a member to the Central European Free Trade Agreement (CEFTA) and has maintained free trade with these countries, there would be a significant deterioration of trade relation by reintroducing tariffs for imports from these countries as towards the existing EU members. However, this has been largely counteracted. By signing the SAA within a very short transition period (that would eliminate more than 90% of tariff protection towards the EU by 2004), Croatia provided for a minimal disruption of trade relation versus new member countries while no significant trade barriers would be lifted.

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that trade between the CEE countries shall remain significantly above the normal level.

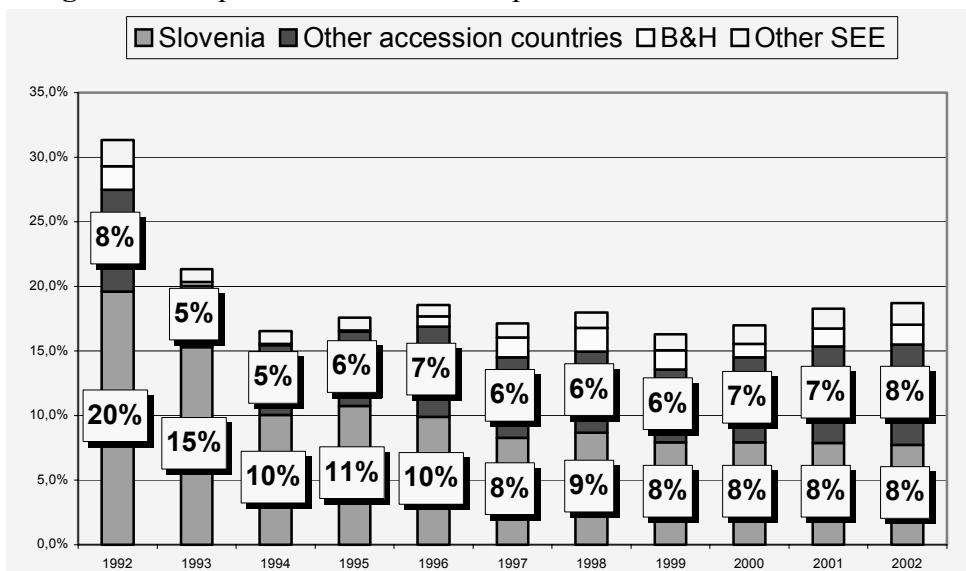
**Figure 4:** Composition of Croatian imports 1992-2002



Source: Central Bureau of Statistics

This problem shall also arise when Croatia becomes a new EU member before some of the other SEE countries because trade with them may be disrupted. While previous figures indicate that Croatian imports from these countries is rather small, exports are significant, making for some 20% of Croatian total in 2002 (Figure 5).

**Figure 5** Composition of Croatian exports 1992-2000



Source: Central Bureau of Statistics

Nevertheless, there is a way how intra-regional trade between the SEE countries will not be discriminated against by first-wave EU applicants who adopt the EU foreign trade regimes; should the other SEE countries conclude their SAAs with the EU with an accelerated liberalization schedule, no significant new barriers should be introduced when other countries go further in the process of European integration. Although the EU may provide certain transitional measures that would maintain preferential trade if these countries failed to conclude such agreements, this would not be the best solution and the EU rejected that approach proposed by Slovenia in the current accession process.

While the aforementioned problems may be solved, it is important to maintain the vision of integrating all the SEE countries as full EU members and their overwhelming role in stimulating economic development, while EU membership shall create a business climate that would enable the economy to take advantage of a whole range of trade and investment opportunities. With this ultimate goal envisaged, all SEE may concentrate on reforms needed to provide economic growth and a thorough transformation into a market economy.

The Role of Competitiveness for the Integration of the SEE countries into the EU

Within the Stabilization and Association Process, the importance of regional cooperation should be given priority, while security is a prerequisite for economic growth. Apart from that, it is important that all the SEE countries move forward in trade liberalization in order to create opportunities for large scale investment, long-term cooperation and mergers and acquisitions at the regional level.

Cooperation between the SEE countries in various fields is very much needed, including elimination of all barriers to regional trade in goods and services, providing for diagonal accumulation of origin, maintaining access to public procurement and regulating state aid and competition policy, which all should stimulate regional cooperation in order to avoid the “hub and spoke” structure versus the EU, moving fast from being a trouble-making area towards a business oriented fast-growing region. Possible ways of partnership in the SAP may also include activities leading to the intensi-

fication of negotiations on SAAs and full EU membership, including promotion of regional security, combating illegal activities, building compatible infrastructure and removing non-tariff trade barriers. However it is essential to create partnerships to enhance the competitiveness of the SEE, at the regional level as well as in individual countries.

The role of competitiveness for the success both in achieving high economic growth and as a prerequisite in the process of European integration is undisputed. There are many studies pointing out the importance of competitiveness for economic development. In a narrow sense, SEE countries have solid competitive advantages, having a well educated workforce and (apart from Croatia) rather low labor costs. Although current EU membership criteria mark low GDP per capita as a negative factor, low labor costs may be a solid starting point for the creation of a competitive production base if these countries are integrated in the EU economic sphere. The SEE countries are by no means basket cases. The countries of former Yugoslavia were in the 80s more advanced in trade relations with the West, having a market-oriented production structure and a sound technological base, better than most of the countries that will become full EU members in 2004. Therefore, these are solid grounds to opt for fast economic growth, provided necessary reforms are made to tackle the problems of high unemployment, due to war, low investment and being left out of the integration processes throughout «the lost decade» of the 90s.

According to the available analyses there is still a long way to go, while the countries of South-East Europe are relatively low ranked in the most popular competitiveness benchmark tables. Although the concept of competitiveness has been a rather controversial topic in the literature, with its tradition of publishing for more than 20 years and a large number of countries included, the Global Competitiveness Report, by the World Economic Forum, a Geneva-based independent international organisation, remains the most comprehensive source for the comparative analysis of positive and negative features of many economies throughout the world, providing a valuable analytical tool for upgrading the framework for economic and social development. The report is commonly used as a benchmarking tool for governments in identifying main impediments to economic growth and also by the business sector when dealing with strategic and investment decisions.

The Global Competitiveness Report 2003-2004 examined the competitive positions of 102 countries, including Bulgaria, Croatia, Macedonia, Romania and Serbia. The main tool for analysing national competitiveness is the Growth Competitiveness Index, consisting of three indicators: level of technology, quality of public institutions and the macroeconomic environment.

**Table 1:** Rank values of the competitiveness of the SEE countries

<b>Growth Competitiveness Index:</b>								
Bulgaria	64							
Croatia	53							
Macedonia	81							
Romania	75							
Serbia	77							
<i>Macroeconomic environment:</i>			<i>Public institutions:</i>			<i>Technology:</i>		
Bulgaria	73		Bulgaria	62		Bulgaria	63	
Croatia	55		Croatia	67		Croatia	41	
Macedonia	80		Macedonia	93		Macedonia	70	
Romania	81		Romania	86		Romania	55	
Serbia	87		Serbia	77		Serbia	66	
	<i>Stability</i>	<i>Credit Rating</i>	<i>Govt. waste</i>	<i>Contracts and law</i>	<i>Corruption</i>	<i>Innovation</i>	<i>ICT</i>	<i>Technology transfer</i>
Bulgaria	76	57	86	92	35	43	49	67
Croatia	51	49	59	81	54	48	39	43
Macedonia	67	83	79	96	86	63	63	59
Romania	81	66	96	83	90	56	54	38
Serbia	86	93	56	77	74	62	55	60

Source: Global Competitiveness Report 2003/2004

The SEE countries are rather low in the global competitiveness list. Out of 102 countries included in this issue of the report, best placed among the SEE countries is Croatia in 53rd place, followed by Bulgaria ranked 64th

while Macedonia has only reached 81st position, and Romania and Serbia placed in between, in 75th and 77th positions respectively.

Generally, these countries do not lag much behind according to the technology index, while the macroeconomic environment and public institutions are more significant obstacles to growth of these countries. This analysis may serve as a basic framework for focusing reforms, backed with the help of EU funds as well as World Bank projects.

There is also scope for regional co-operation in sharing best practices and assisting countries that have more significant problems in certain fields. For instance, countries of the region can learn from the Croatian experience with economic stability, while Serbia may share its experience with low waste of government spending. Bulgaria is a showcase for combating corruption, while Romania seems to have solid technology transfer. Furthermore, cooperative frameworks or regional task forces may be stood up to help individual countries with specific problems.

## **Conclusion**

There is a strong need to follow the fast-track approach of individual accession for SEE countries which have progressed farther in their integration. In that process, it is important that the later entrants do not lag behind significantly, not to disrupt the regional trade and cooperation opportunities. However, full EU membership for all the SEE countries shall be the ultimate goal to exploit the benefits of rounding up the process of European integration. Having that in mind, it is of the utmost importance that the SEE countries work hard and cooperate in eliminating the most significant obstacles of competitiveness both at national and regional levels.

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