

## **PART 2:**

### **INTRA REGIONAL AND EUROPEAN TRADE AS ENGINE OF SECURITY AND DEMOCRACY**

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#### **South East Europe and the Trade Potential of Croatia**

##### **Introduction**

The question of the trade regime for Central and Eastern European countries (CEEC) has during the last decade been the subject of an intense discussion amongst the policymakers and academia from both within the region and from the EU. The main issues around which the discussion has concentrated were those of enhancing the catching-up process by the means of trade liberalization, and protection of the “sensitive” industries within the EU.

Regarding the design of the trade regime for the South East European (SEE) countries<sup>13</sup>, the issue of the speed of their accession towards the EU, and/or regional approach has added a new component to the discussion. The current discussion has not been very insightful with respect to the “hard facts” on the present level of integration within the region and

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<sup>12</sup> We would like to thank Ms. Maja Bukovšak on her assistance.

<sup>13</sup> SEE countries are here defined as Croatia, Bosnia and Herzegovina, Serbia and Montenegro, Macedonia and Albania, i.e. "trade isolated" countries that were neither EU candidate countries nor CEFTA members.

its relationship with the EU. An obvious fact is that all countries have in one way or the other been excluded from international trade integration during the nineties. Also, it is obvious that the region is an economic dwarf, which makes any serious competitive threat to the EU highly unlikely.

In this paper we first present some stylized facts on the Croatian trade, and the SEE trade. Second, we analyze the level of trade integration within the region, using simple tools such as trade openness ratio and trade concentration indices. We try to explain why the trade development in Croatia did not observe the expected transitional behavior. Then we observe selected trade issues arising from the specific institutional features of these countries. Finally, we discuss the "correct" design of the trade regime for Croatia and SEE.

## **1. Trade and Transition: The Forces at Work**

A typical transition country can be described as a small and open economy often with a newly (re)gained independence. Croatia, indeed, fits quite well into this definition. At the onset of transition, three distinct forces were shaping the trade pattern of a typical transition country. First was a collapse of the COMECON. Another contribution to a new economic geography was the dissolution of multinational states like the USSR, Czech Republic and Yugoslavia. Third was an increase in trade openness ratio (TOR) as a consequence of policies of stabilization, liberalization and privatization.

Although the former Yugoslavia was not a member of the COMECON, its collapse, which accompanied the fall of the Iron Curtain, led to a diversion of excess trade with that block. Havrylyshyn and Pritchett (1991) suggest on the basis of gravity equations, that during the period 1980-1982 Yugoslav trade with CEE exceeded the "norm" by 13 percentage points of the total trade. At the same time, trade with Northern Europe fell short of "natural" trade by 18 percentage points. This was fairly small in comparison with their estimates of trade reorientation

needed in other CEE countries. For example, it was estimated that Czechoslovakia needed trade reorientation accounting for more than 70 per cent of its total trade. Based again on the gravity approach, Wang and Winters (1994) draw a somewhat different conclusion for the year 1985. Although intra-COMECON trade broadly matched the potential, trade with market economies fell by and large below the potential. Hungary appeared to be the most open of the CEE countries with actual trade with market economies reaching 30% of the potential. Unfortunately, Wang and Winters did not estimate the potential trade for Yugoslavia, but one can assume, based on other studies, that Yugoslavia (Croatia) suffered from less trade bias than other the CEE.

Baldwin's (1994) results for the last pre-transition year 1989 confirmed that there was too much intra-CEEC trade. The extent of trade diversion varied from 160% of excess trade with the East for Romania to 40% for Poland. Potential CEE exports to the EU were 4.8 times higher than the reality, while the potential EU exports to CEE were 2.1 times higher than the reality. Although Croatia was at that time still a part of Yugoslavia, which prevented comparison of potential with actual values, Baldwin has also estimated a pattern of potential Croatian exports. According to these estimates, the EC-12 should in the long run become the destination for around 60% of Croatian exports. If exports to the European free trade area are also added, this increases the share to 76%.

In addition, Baldwin presents a projection of trade pattern in the scenario of partial income catch-up. Although the effects of the partial income catch-up would make the trade amongst the CEEC's remain important, trade with the Western Europe will become dominant with the trade share ranging for different countries between 50% and 70%.

Even though different studies come to different quantitative conclusions with respect to the intra-CEEC trade, they all agree that prior to the collapse of the COMECON there existed a large potential for an increase in trade with the Western countries. The main reason behind the different estimates, apart from the differences in the estimation methods, samples

and periods for which the simulation exercises were run, lies in the great uncertainty about the exact values of the relevant variables. This is especially true for the GDP of the CEE and the value of trade flows that existed amongst them, estimates of which varied a great deal.

Although trade reorientation that was caused by the COMECON collapse led to a slump in demand, it was not necessarily bad since it helped the convergence towards “natural” patterns. Indeed, most of the CEEC’s recovered fairly quickly as their exports to the EU grew at double-digit rates.

The dissolution of the supranational states left the inheritance of large home country biases in trade structure amongst the successor states. Even if the impact of the war that followed the Croatian separation from Yugoslavia is neglected, the emergence of the borders, dividing previously united economic area necessarily leads to a decrease in the level of trade between the newly independent countries. In other words, a division of a country decreases the home bias that existed in trade, although it usually takes a long time before the effect fully takes place. One can observe wide spectrum of opinions with respect to reasons that lead to the fall in trade. While Djankov and Freund (2000) consider home-bias to be mostly a result of tariffs and endogenous historical developments which are specific for each country (e.g. the development of the transport network and other infrastructure, production and consumption chains, and business networks), other researchers add a number of other reasons. Rose (2000) points to the role that common currency has in promoting trade amongst countries (some of the most obvious reasons are disappearance of the costs of exchange as well as exchange rate uncertainty). One also has to take into account the costs of acquiring information, which increases when one is doing business over the border (see, for example, Obstfeld and Rogoff, 2000).

A classical case of secession is the Austro-Hungarian Empire break-up of 1919 (de Ménéil and Maurel). According to their estimates, five years after the break-up trade decreased to 60% of the pre-WW I level, which

was still four times more than what would have been expected according to the gravity model.

Contemporary estimates of home country bias in trade for high-income economies vary across countries as well as across different studies. McCallum (1995), a pioneer on this topic, estimated the bias for Canada using the 1988 data for provinces. He shows that Canadian provinces, after accounting for size and income, used to trade 22 times more amongst themselves than with US federal states.<sup>14</sup> Later studies present somewhat lower estimates. Helliwell (1998) found that during the period 1993-96 Canadian provinces traded 12 times more between themselves than with US federal states. Wei (1996) estimated home trade biases for a number of countries. The average value of bias for an OECD country during the period 1982-94, after controlling for a number of possibly important factors (adjacency, remoteness, language), was about 2.3, which is much smaller than the previous estimates. However, this still means that national borders play an important role in directing trade flows. The estimated home country bias showed a great deal of variation through the sample - USA exhibited the smallest bias of only 1.4, while Portugal came in first with internal trade exceeding external trade by a factor of 5.7.

One cannot look at the home country bias without taking into account the level of openness, which represents the other side of the coin. Since larger countries have a natural tendency to trade less with abroad, in comparison to smaller countries, it is possible to overcome shortcomings of the simple trade openness ratio (TOR) by looking at the home country bias in trade.

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<sup>14</sup> Editor's note: 1988 is the date when the original Free Trade Agreement was signed with the United States. Prior to that, Canada enjoyed protectionist policies which may account for McCallum's results.

Secession, quite naturally, increases the level of openness of the country because it turns previously domestic trade into foreign trade. However, due to a decrease in home country bias, it is quite possible that the post-secession foreign trade separation is smaller than total trade that a country previously conducted, both domestic and foreign.

Before the transition started, except for trade flows that existed amongst them, transition countries were relatively closed economies. This was a consequence of restrictions that central planning imposed, and of the planner's aspirations to insulate the country from influences of the world economy. One of the manifestations of that phenomenon was rather high home country bias, estimated for the successor states.

Former Yugoslavia was, by international standards, not an exception to this rule, although some of the studies mentioned suggest that the quantity of trade distortions in Croatia was lower in comparison to other transition countries. The GDP share of merchandise exports and imports 1987, five years prior to the break-up, was less than 40% (World Development Report, 1989). Croatia accounted for a quarter of Yugoslav GDP (Sirotković, 1996). The data from the 1987 input-output tables reveal that Croatian trade with former Republics was more than two times larger than overall foreign trade. Although detailed estimates of the home country bias in trade for former Yugoslavia are not available, one can guess that trade amongst the former Yugoslav Republics exceeded trade with other countries by a high multiple even after accounting for factors such as income and distance. Abundant foreign trade regulations that existed together with control over foreign exchange were the main impediments to wider foreign trade.

Fidrmuc and Fidrmuc (2000) present a partial piece of evidence on the size of home country bias in former Yugoslavia. According to their study, the level of trade between Slovenia and Croatia in 1990, prior to the break-up, exceeded the normal level 24 times. This figure is rather high in comparison to the above-mentioned estimates of home country biases that are present in high-income countries, but low in comparison

to other transition countries. For example, according to the same study, trade flows amongst the three groups of newly independent countries: the Czech Republic and Slovakia, the Baltic States and the group comprised of Belarus, Russia and Ukraine exceeded the norm by 41-43 times. Even several years after Communism collapsed, the levels of trade still surpassed the effect of PTAs that replaced unitary states. The level of trade between Croatia and Slovenia exceeded the “norm” two times, between the Czech and the Slovak Republics it was seven times, 13 times between the Baltic states and 30 times between Belarus, Russia and Ukraine.

Havrylyshyn (1998) showed that countries that have made the most progress in structural reforms have also gone farthest in diversifying their exports to new destinations - at least regarding the EU. This points to the fact that there is a correlation between domestic policies and the convergence of actual and potential trade structure. The second regularity observed by Havrylyshyn is the relationship between the progress of reforms and the level of openness. This is in concordance with the predictions based on gravity equations and assumed impediments to trade that were present before the reforms took place.

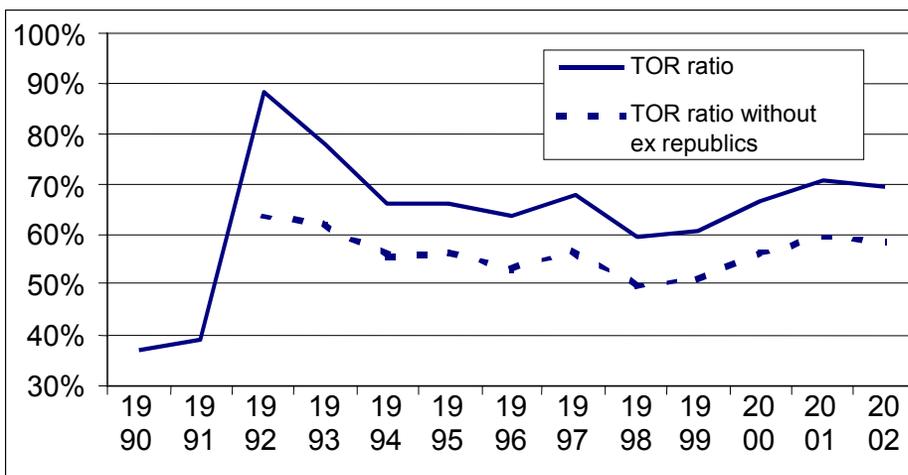
In addition to the three issues mentioned above, which affect trade in more or less unambiguous manner, GDP growth also plays an important role in driving the quantities of international trade and the levels of openness. Those countries that grow faster end up trading more both in volumes and as a share of GDP. Others, less fortunate, may turn out to have lower trade shares and volumes.

## **2. Croatia: A Somewhat Different Story**

At the time of the declaration of independence, with the TOR being as high as 88%, Croatia was an open economy, much more open than former Yugoslavia ever was. Considering the above-mentioned determinants of trade that were expected to increase Croatia’s trade integration with the EU and other developed economies, as well as to further de-

crease a modest (e.g. in comparison with 1987) share of trade with former Yugoslav Republics, one would have anticipated further increase in the level of openness. Yet, contrary to the expectations, quite the opposite happened. In 1993, exactly a year after Croatia became independent, TOR sharply decreased to 78%. The fall continued in 1994, when TOR declined further to 66%. Thereafter TOR remained at the stable level, with the exception of 1998 and 1999, during which imports were reduced due to economic recession.

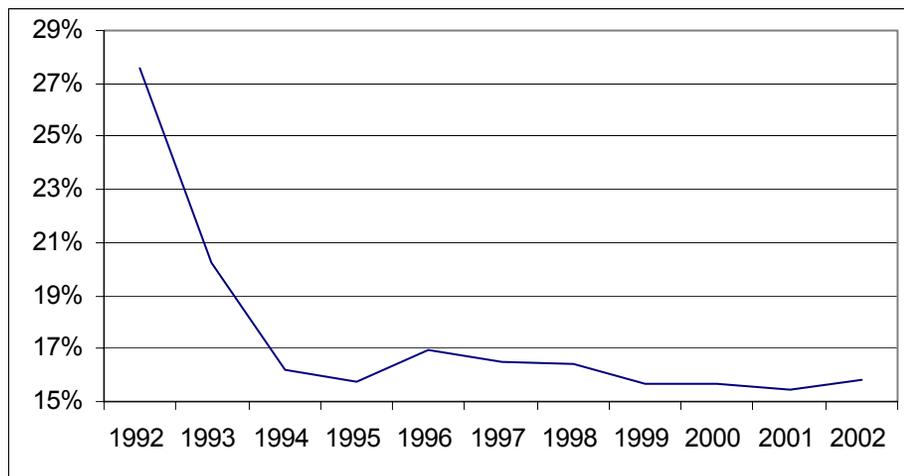
**Figure 1: Trade Openness Ratio (TOR) – Croatia**



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues

It has to be noted that the sharp fall in the TOR was not a result of a decrease in trade with former Republics of Yugoslavia. If one looks at the TOR without taking them into account, a similar trend of decline and stagnation can be observed, although a little less pronounced.

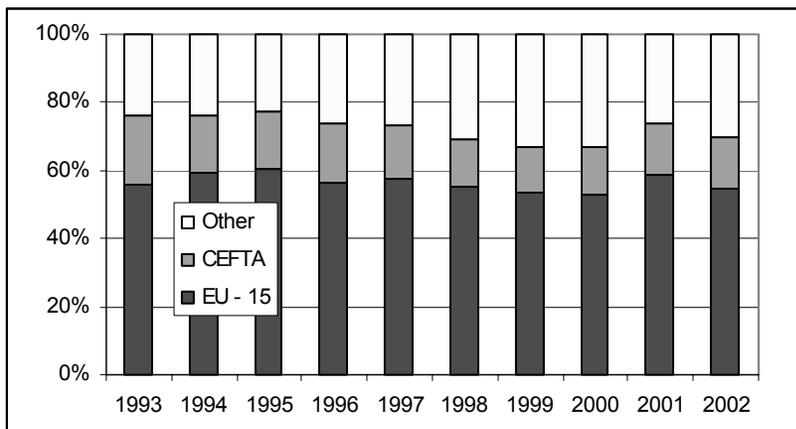
**Figure 2:** The Share of Former Republics in Croatia's Foreign Trade



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues

How can this unusual decline in TOR be explained? Especially having in mind that Croatia, according to the most commonly used indicators (e.g. EBRD), belongs to the group of advanced transition economies, i.e. those countries that are, according to the findings in Havrylyshyn (1998), supposed to make the most progress in opening-up and diversifying their trade? Not only did the TOR not increase, but the regional structure of Croatian trade didn't change either as expected. After the declaration of the independence, the share of trade with the EU was 57%. Ten years later, it was some 2% less. It can be noticed that trade share of countries constituting CEFTA at the same time fell from 23% to 15%. Most of this fall was compensated for by an increase in trade with other former Yugoslav Republics Bosnia and Herzegovina and Macedonia after the end of the war in 1995.

**Figure 3:** Geographical pattern of Croatian trade



Source: Central Bureau of Statistics, Monthly Statistical Report, various issues

So, what are the likely reasons behind the observed fall in openness and stagnant trade structure? In 1993 and 1994, the main reason for the rapid decline in the TOR was break-up of trade links with former Yugoslav republics, as can be seen from the Figure 1 which demonstrates that the decline in TOR was much slower excluding the former Yugoslav Republics. However, even excluding them, TOR recorded a falling trend. The main explanation, along the reasons mentioned in (Vujčić, Presečan, 1999) was the exclusion of Croatia from trade associations in the region. Croatia did not have an association agreement with the EU, was not a member of the CEFTA, and did not even have bilateral trade agreements with its main trading partners except for the bilateral free trade agreements with Macedonia and Slovenia, which have been in force since October 1997, and January 1998 respectively. Bosnia and Herzegovina was the first country with which a free trade agreement was signed, but was broken in 1998<sup>15</sup>, and then renewed on an asymmetrical basis in

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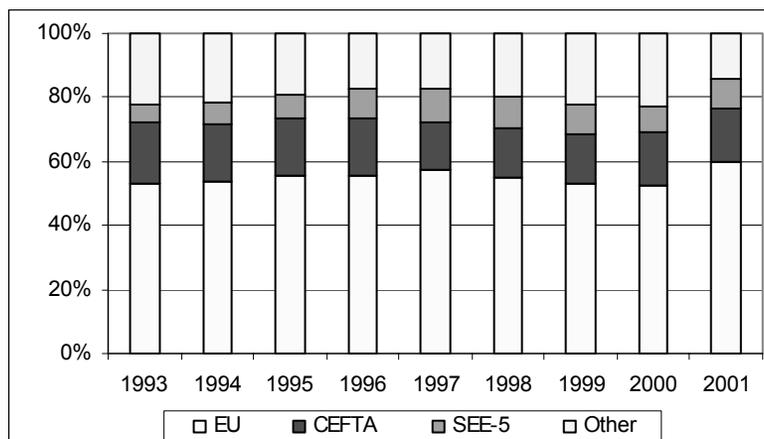
<sup>15</sup> Because of the IMF insistence on higher tariff revenues for Bosnia and Herzegovina.

January 2001. Until mid-2001 Croatia was not even a member of the WTO. These were all huge impediments to trade development and increase in the TOR.

### 3. How does Croatia fit into the region?

After looking at the dynamics of the Croatian trade during the 1990's, we address the question of the present level of Croatian integration with South-East Europe (SEE) and tackle the issue of its future development. The intra-regional trade share of the SEE countries in 1993 stood at 5.6%. This share increased once the war was over in 1995. In 1997 it reached the level of 10.3% and then fell slightly afterwards. The increase was mostly at the expense of CEFTA countries, whose share decreased, as well as the share of trade with other countries, while the trade share of the EU countries remained practically unchanged. Croatia, accounting for over half of total trade of the region and well above the third of intra-regional trade, was the principal force giving the integrative impulse amongst the countries in the region.

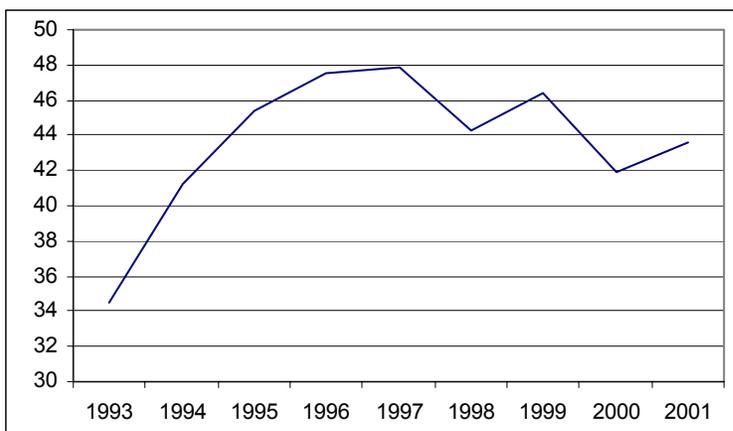
**Figure 4:** The regional Trade Pattern of SEE-5 Countries



Source: IMF Direction of Trade Statistics, 2000

Taking into account the fact that, for example, share of trading conducted within the grouping of the Benelux countries, a highly integrated, and economically much larger region, was 13% (Flörkemeier, 2001), a share of 10% for a much smaller and less integrated SEE group seems to be quite high. Adjusting the intraregional trade shares by a measure of the region's importance in the world trade gives a simple trade concentration ratios (or trade intensity ratios). This indicator shows to what degree the trade between the group of countries is concentrated amongst them.

**Figure 5:** Trade Concentration Indicators for the SEE-5 Countries



Source: IMF Direction of Trade Statistics, 2000 and author's calculations

There was a clear increasing trend in the trade concentration indicator for the SEE-5 countries reaching a value of near 50 at the end of the post war period. This tells us that countries from the region used to trade amongst them 50 times more with any other country anywhere in the world. This indicator has fallen slightly in the following years due to the slightly decreased share of trade among SEE countries, but still remained quite high. In order to compare the SEE countries with some of the well-established regional trading blocks, in Table 1 we present the same indicator for a number of regional trading blocks.

**Table 1:** Trade Concentration Ratios for Different Regions

	1993	1994	1995	1996	1997	1998	1999	2000	2001
SEE	34.5	41.3	45.4	47.5	47.9	44.3	46.4	41.9	43.6
APEC		1.6							
ASEAN		3.6							
EU (after 1995)		1.6							
EU (before 1995)		2.1							
Mercosur		12.8							
Andean Community		12.6							
NAFTA		2.2							

Source: Frankel (1997)

It can be noticed that trade concentration ratios reveal much higher levels of integration amongst the SEE countries in comparison to the existing trading blocks. Although the data on intra-regional trade show that EU countries trade a lot between themselves, the level of actual trade concentration is much smaller in comparison to other trading blocks because of their size and importance in the world economy. Also, one has to be careful when comparing the absolute levels of trade concentration index for countries that differ in the level of development because more developed economies tend to export a wide variety of products and to better diversify their exports geographically (Flörkemeier, 2001). What is more surprising is a very high trade concentration level in the SEE countries even in comparison to smaller blocks such as Mercosur or the

Andean Community. According to the trade concentration indices, the SEE group seems to be very highly integrated.

Trade concentration index indicate the level to which a country is integrated into the world economy, which means that different country sizes and different levels of openness do not influence the result. This index, however, does not take into account the effects of income and transportation costs. Moreover, it can compare across different levels of integration, but it cannot tell anything about the levels of trade creation and diversion that are created with the formation of trading blocks or the performance of the trading structure. Although compatible with a wide range of trade theories, the gravity approach is unable to predict the composition of the goods that are supposed to be imported or exported by a country. One has to look at the underlying theory of trade in order to obtain an answer to that question.

Based on a detailed gravity analysis, Christie (2001) concludes that although there is some fragmentation within the region, overall it seems that intra-regional trade flows are high compared to overall level of their trade. Albania is isolated from the region and trade flows between Croatia and Serbia and Montenegro are low, but most other flows are “unnaturally high”. Since trade flows are on average above the expected, which is in line with conclusion based on presented trade concentration indices, it seems that most of the trade potential for SEE countries lays with the CEFTA and EU member countries.

Another possible way to look for trade potential between those countries is to observe patterns of comparative advantages. If the comparative advantages of these countries differ, it may provide a fertile ground for trade. However, if there is a similarity of their comparative advantages, it may be more beneficial for them to engage in trade with countries endowed with different comparative advantages. As Astrov (2001) notes, manufacturing exports from the region mostly include labor intensive products that require a low or medium/blue collar level of skills. Broad areas of the region’s comparative advantage include textile and textile products, leather and leather products, wood and wood products, basic

metals and fabricated metal products. All countries have comparative disadvantages in chemicals and chemical products, machinery and equipment, electrical and optical equipment and transport equipment. Therefore, CEE economies compete amongst themselves with their products and to the extent their comparative advantages are concerned, it may be more beneficial to seek closer integration with advanced economies, such as EU member countries.

#### **4. Trade and institutional issues**

As was demonstrated in the first chapter, institutional reform has profound impact on trade. EBRD (2002) transition indicators show that there is a lot of variation in the level of institutional development between countries. Therefore, as a consequence of institutional deficiencies, trading with partners from the region is often complicated. Dimitrov and Stanchev (2001) point out a few important obstacles to further regional trade integration based on survey results. First of all, contract enforcement and receiving payments rank high amongst the difficulties faced by the firms engaged in regional trade. Legal procedures in SEE countries are bad and it usually takes unacceptably long period of time before the cases close. Moreover, one third of all transactions are made in cash, which may be connected with illegal funds and certainly makes facilitating the transaction more expensive. Furthermore, barter is involved in 12% of total transaction, which causes difficulties to exporters and may be connected with tax evasion. Further on, even when the financial system transfers facilitates the transactions, banks located outside of the region are frequently used. This complicates matters even further and makes trade more expensive.

Given all the difficulties faced by the companies, it seems that doing business in SEE countries provide only a temporary refuge for selling uncompetitive products. Therefore, a successful exporting strategy cannot be based on penetration of these markets as it may trap exporters into unsustainable market niches.

## **Conclusion**

A question that we attempted to answer in this paper was where does Croatia belong? An answer to that question is important because the design of the “right” trade system can accelerate the convergence process. Often, in an attempt to identify the “functional” regions trade-wise, trade system designers are tempted to rely on the actual trade flows. However, if one seeks the right trade regime to facilitate trade and growth, this approach is misleading due to hysteresis in historical links and complete disregard of trade potentials.

An obvious conclusion from our analysis is that the largest trade potential for Croatia lies with the EU and CEFTA countries. Further on, in terms of specialization, Croatia still does not differ much from other countries in the region, which means that their economies do not complement each other, but rather compete, making them a sub-optimal choice of trading partners. Finally, increasing trade focus on the region may additionally burden exporters with insecurity, contract enforcement problems and hold back the institutional advancement. In terms of trade system design it would, therefore, not be desirable to exclude any of those countries from the pan-European trading arrangements as they pursue further trade liberalization amongst themselves. The correct sequencing of trade liberalization will eliminate current trade biases and contribute most towards realizing potential trade growth.

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