



Center for Social and Economic Research

CASE Reports

Regional Free Trade Agreements of Bosnia and Herzegovina: analysis and policy recommendations

**Amir Hadžiomerađić
Małgorzata Jakubiak
Nermin Oruč
Wojciech Paczyński**

No. 69/2007

Warsaw 2007

This study has been produced with the assistance of the project European Union Support to the Economic Policy Planning Unit. The content of this publication is the sole responsibility of the authors and can in no way be taken to reflect the views of the European Union, Economic Policy Planning Unit, CASE or other institutions the authors may be affiliated to.



This project was funded by
the European Union



EU support to the EPPU
ECONOMIC POLICY RESEARCH UNIT

Keywords: Bosnia and Herzegovina, trade, FTA.

© CASE – Center for Social and Economic Research, Warsaw 2007

ISBN 978-83-7178-426-2

EAN 9788371784262

Publisher:

CASE – Center for Social and Economic Research

12 Sienkiewicza, 00-010 Warsaw, Poland

tel.: (48 22) 622 66 27, 828 61 33, fax: (48 22) 828 60 69

e-mail: case@case.com.pl

<http://www.case.com.pl/>

Table of Contents

Regionalni sporazumi o slobodnoj trgovini Bosne i Hercegovine: analiza i preporuke u pogledu politika. Sažeti pregled	9
Executive summary	18
Introduction.	26
1. Free Trade Agreements – a snapshot	28
1.1. FTAs as a precondition of deeper integration	28
1.2. The experience of EU trade integration with neighbouring countries	29
The early years of CEFTA: the Central European Free Trade Agreement	29
Typical EU's FTAs	30
EEA: European Economic Area	31
1.3. Effects of forming an FTA	31
2. Lessons to be learnt from other existing and past FTAs in Europe and close neighbourhood: determinants of success and failure	33
2.1. The early years of Central European Free Trade Agreement (CEFTA).	33
2.2. Selected examples of EU FTAs with neighbouring countries:	
Morocco and Egypt	36
2.3. Effects of other FTAs in South East Europe	38
A difficult assessment	38
The coverage of FTAs in SEE	38
FTAs monitoring	39
Intra-SEE trade.	39
Is trade boosted?	40
Conclusions	43
3. The BiH economy, trade flows and regional trade agreements	44
3.1. An overview of the BiH economy	44
3.2. Evolution of BiH trade policy and future directions	44
Foreign Trade Institutions.	45
Legislative Process	47

Tariffs and Related Charges	47
Trade integration negotiations.	48
3.3. Description of existing FTAs and their coverage	51
3.4. BiH trade flows	54
3.5. Summary.	60
4. Existing problems hampering full exploitation of BiH FTAs' potential	62
4.1. RCA indices.	62
4.2. Determinants of BiH trade flows - a gravity model	64
Theoretical foundations	64
Data and methodology.	64
Estimation results	68
Potential trade.	72
4.3. Estimates of trade creation, trade diversion and trade deflection effects.	74
Trade creation	74
Trade diversion	75
Trade deflection.	77
4.4. Non-tariff barriers to trade (NTB)	79
4.5. Backbone service sectors.	83
4.6. Internal factors and issues specific to the BiH market	87
4.7. Summary.	87
5. Policy recommendations	90
5.1. Recommendations for general economic policies in the BiH	91
5.2. Recommendations for specific trade-related policies.	94
5.3. Sectoral recommendations	98
Annex 1: Trade flows of early CEFTA members	100
Annex 2: Intra-Balkan trade shares, 1999-2005.	101
Annex 3: BiH external trade by goods in 2003-2006	102
Annex 4: MFN tariff rates in BiH and in other SEEs	104
Annex 5: Explanation of data sources	105
Annex 6: Revealed comparative advantage indices of BiH by export market.	106
Annex 7: Results of diagnostic tests	108
Annex 8: Structured questionnaire used in interviews about NTBs.	109
Annex 9: List of non-tariff barriers reported by BiH actors.	112
Annex 10: Examples of trade deflection	119
References	120

Index of Figures

Figure 1. Intra-CEFTA trade as a share of total trade of early CEFTA members, 1993-2005 34

Figure 2. Share of SEE8 region in total exports, 1999-2005 (%) 40

Figure 3. Share of intra-SEE trade in total SEE imports, by commodity, 2004 (%) 42

Figure 4. Structure of BiH exports, 2006 56

Figure 5. BiH Trade Deficit with FTA countries, 2001-2006 (million EUR) 58

Figure 6. Structure of BiH imports from Croatia and Serbia and Montenegro, SITC classification. 59

Figure 7. Structure of BiH exports to Croatia and Serbia and Montenegro, SITC classification. 59

Figure 8. EBRD transition indicators of financial sector - BiH in the regional perspective, 2002 and 2006 84

Figure 9. Selected telecommunication indicators, 2005 86

Figure 10. Exports to other early CEFTA members in USD millions, 1993-2005 100

Figure 11. Imports from other early CEFTA members in USD millions, 1993-2005 100

Figure 12. RCA for BiH-Croatia trade in 2005 106

Figure 13. RCA for BiH-Slovenia trade in 2005 106

Figure 14. RCA for BiH-EU-25 trade in 2005. 107

Figure 15. RCA for BiH-Serbia trade in 2005 107

Index of Tables

Table 1. Selected characteristics of BiH FTAs, 2001-2006 52

Table 2. Trade coverage in the agricultural and manufacturing sectors of BiH FTAs. 52

Table 3. Selected data on BiH foreign trade 2001-2006 55

Table 4. BiH main trade partners, 2003-2006 55

Table 5. BiH exports by goods, HS classification, 2003-2006. 56

Table 6. Annual growth o BiH foreign trade rates (% per annum), 2003-2005. 57

Table 7. RCA indices, 2005. 63

Table 8. Results of REM estimation of BiH export equations, 1998-2005. 70

Table 9. Results of REM estimation of import equations, 1998-2005 71

Table 10. Actual and potential BiH exports, 1999-2005 73

Table 11. Actual and potential BiH imports , 1999-2005 73

Table 12. Similarity indices of BiH imports from some FTA countries, 2005. 76

Table 13. Duration of trade procedures in BiH and in other FTA countries, 2006 81

Table 14. Intra-regional export shares of FTA countries, 1999-2005	101
Table 15. BiH export and import of goods, by HS chapters, in KM thousands, 2003-2006	102
Table 16. BiH export structure, by main trading partners, 2005	103
Table 17. BiH import structure, by main trading partners, 2005	103
Table 18. Average MFN applied tariffs in SEE, in percent, 2002	104
Table 19. Average MFN applied tariff in BiH, by HS2, 2005	104
Table 20. Results of diagnostic tests, BiH export equation	108
Table 21. Results of diagnostic tests, BiH import equation.	108
Table 22. Correlation matrix	108

The Authors

Amir Hadžiomerađić holds master degree in economic policies from Columbia University (USA, 2001). He has worked as senior advisor for Bosnia and Herzegovina government on international economic and trade issues for 10 years . In 2000, he worked in the World Bank. In 2003, he joined the Central Bank of BiH as Head of Economic Research and Statistics Department. His main areas of interest are monetary policy, trade policy, economic statistics, financial sector and EU integration. He contributed to preparation of the national medium term development strategy.

Małgorzata Jakubiak graduated from the University of Sussex (UK; 1997) and the Department of Economics at the University of Warsaw (1998). Her main areas of interest include foreign trade and macroeconomics. She has published texts on trade flows and exchange rates in emerging or transition economies, EU integration with its neighbours and CIS economies. During 2000-2001 she was working at the CASE mission in Ukraine as resident consultant. She has collaborated with the CASE Foundation since 1997.

Nermin Oruč holds MSc in Economics for Business analysis from Staffordshire University, UK. His research interest includes international trade, migration, spatial economics and gravity modelling. He has published on spatial analysis of retail networks.

Wojciech Paczyński has been an economist at CASE since 2000. His research interests include applied macroeconomics, international economics, international relations, game theory and economics of education. He has published on EU integration, EU enlargement, EU relations with neighbouring countries, monetary policy, and currency crises. He holds MA in International Economics from University of Sussex, MA in Economics from Warsaw University and MSc in Mathematics from Warsaw University.

List of acronyms

BEEPS	EBRD-World Bank Business Environment and Enterprise Performance Survey
BiH	Bosnia and Herzegovina
CAFAO	EU programme for technical assistance in custom and fiscal issues
CAP	Common Agricultural Policy
CEE	Central and Eastern Europe
CEECs	Central and Eastern European countries
CEFTA	Central European Free Trade Agreement
COMECON	Council for Mutual Economic Assistance
DOTS	Direction of Trade Statistics
EEA	European Economic Area
EU	European Union
FTA	Free trade agreement
IGA	Investment Guarantee Agency
IMF	International Monetary Fund
ITA	Indirect Taxation Authority
SAA	Stabilisation and Association Agreement
SEE	South-Eastern Europe
SPS	Sanitary and phytosanitary standards
TRIPS	Trade-related aspects of intellectual property rights
VAT	Value added tax
WP	Working Party
WTO	World Trade Organisation

Regionalni sporazumi o slobodnoj trgovini Bosne i Hercegovine: analiza i preporuke u pogledu politika. Sažeti pregled

Historijat

Ovaj izvještaj analizira funkcioniranje Sporazuma o slobodnoj trgovini (FTA), koji je Bosna i Hercegovina (BiH) potpisala sa svojim regionalnim partnerima u okviru procesa Pakta stabilnosti za Jugoistočnu Europu (Albanija, Bugarska, Hrvatska, Makedonija, Moldavija, Rumunija i Srbija i Crna Gora). Cilj ove studije, kako ga je definirao EPPU, jest da formulira zaključke u pogledu politika jačanja djelotvornosti navedenih sporazuma.

Izvještaj ne razmatra detaljno trgovinske i druge odnose između BiH i EU. Ipak, date su reference na ove važne procese gdje god je to relevantno za cilj ovog rada. Nekoliko preporuka je primjenjivo i na ukupni učinak vanjsko-trgovinske politike BiH. Vrijedi upamtiti, međutim, da se integracija unutar Jugoistočne Europe zahtijeva kao dio integracijskog procesa u EU.

Rad na ovom izvještaju (jesen 2006.) poklapa se sa konačnom fazom pregovora o multilateralnom trgovinskom sporazumu (CEFTA 2006.), koji u maju 2007. godine treba da zamijeni mrežu od preko 30 bilateralnih sporazuma o slobodnoj trgovini. Stoga preporuke u pogledu politika koje proizlaze iz ovog rada nisu zamišljene kako bi se direktno primjenjivale na one FTA koje su sad na snazi. Međutim, lekcije i preporuke koje proističu iz ove analize relevantne su za novu CEFTA-u, ako ništa drugo onda stoga što su mnoge karakteristike FTA sačuvane u CEFTA 2006. Štaviše, neke preporuke su zapravo mnogo šire u svom opsegu te ostaju relevantne u okviru opće trgovinske politike bez obzira na njihovu specifičnu institucionalnu strukturu.

Opći zaključak koji proističe iz analize predstavljene ovim izvještajem je da, dok su regionalni FTA mogli imati neki pozitivan efekat na ekonomiju BiH, taj efekat nije bio posebno velik a potencijal regionalnih aranžmana o slobodnoj trgovini nije još uvijek potpuno ostvaren. Razlozi za to su mnogostruki, uključujući malu ekonomsku snagu regiona Jugoistočne Europe i kratko vrijeme proteklo od početka provedbe FTA. Štaviše, postoje dva slučaja u kojima bilateralno smanjenje tarifa još nije ni dovršeno. Iskustvo CEFTA-e od početka 1990-tih ukazuje na to da možda treba više vremena da regionalni trgovinski tokovi značajnije osnaže kako bi donijeli dobrobit svim stranama i da dublja ekonomska integracija sa EU igra u tome važnu ulogu.

Iskustvo trgovinske integracije u susjedstvu EU

Analiza BiH FTA treba da se pozicionira u širi kontekst regionalnih trgovinskih sporazuma, pogotovo onih u kojima učestvuju evropske zemlje. Stoga, poglavlja 1 i 2 razmatraju glavne karakteristike FTA, sa posebnom pažnjom usmjerenom na prva iskustva CEFTA-e (sklopljene početkom 1990-tih između Poljske, Mađarske, Češke Republike i Slovačke) te neke FTA između EU i njenih susjednih zemalja.

Mogući efekti formiranja zone slobodne trgovine

Mogući efekti FTA su višestruki. Postoje mogućnosti za efekte pokretanja trgovine, njenog preusmjeravanja i skretanja. Oni počinju sa promjenama u trgovinskim tokovima koji rezultiraju iz smanjenja trgovinskih barijera prema zemljama članicama FTA, ali ne i prema ostatku svijeta. Time što uvećavaju tržište, FTA mogu snažiti i priliv direktnih stranih investicija. Nadalje, FTA mogu donijeti pozitivne socijalne efekte (niže cijene, otvaranje radnih mjesta, smanjivanje siromaštva) te podrazumijevaju intenziviranje političke saradnje, dok zauzvrat utječu na nekoliko drugih sfera mimo ekonomske politike. Štaviše, uzajamno dogovorene odluke da se uspostave specifične institucije ili uvedu posebni mehanizmi (npr. standardi) mogu biti djelotvorni instrumenti koji daju poticaj reformama.

Obuhvat FTA

Obuhvat svakog pojedinog FTA može biti odlučujući faktor u pogledu njegovih efekata na zemlje potpisnice. Općenito govoreći, za zemlju koja ima komparativne prednosti u proizvodnji hrane i poljoprivrednih proizvoda, te u drugim radno-intenzivnim sektorima, jedan tipičan – opsegom ograničen – FTA koji obuhvata trgovinu nepoljoprivrednim robama, te ima dugi prijelazni period za neke «osjetljive» radno-intenzivne sektore, može donijeti malu korist. Druga važna stavka odnosi se na nivo zaštite od trećih zemalja. Visoke uvozne dažbine za treće zemlje mogu dovesti do toga da FTA rezultira značajnim preusmjeravanjem trgovine i gubicima na socijalnom planu.

Unutarbalkanska trgovinska liberalizacija – dosadašnje iskustvo

Procjena prvih iskustava ukupne mreže FTA u regionu Jugoistočne Europe teško je moguća iz cijelog niza razloga, uključujući veoma kratak period djelovanja.

Zaključujemo da se ne može očekivati previše dinamično povećanje tokova unutar Jugoistočne Europe koje bi uslijedilo nakon implementacije regionalnih FTA - barem ne odmah. Sličnost, između većine zemalja Jugoistočne Europe, u faktorima prirodnih bogastava i male razlike u tehnologijama podrazumijevaju da se kratkoročno i srednjoročno ne može očekivati bilo kakav rast trgovine unutar pojedinih industrija. Prije se može očekivati jača trgovina između industrija zasnovanih na relativnom faktorima prirodnih bogatstava (kako to opisuje neoklasična teorija trgovine). Pored toga, trgovinski tokovi između nekih (ali ne svih) zemalja o kojima je ovdje riječ od 1999. do 2002. godine bili su već sasvim visoki i vjerovatno blizu svog potencijalnog maksimalnog nivoa. U nekim slučajevima (prvenstveno u slučaju Srbije i Crne Gore), trgovina sa partnerima u Jugoistočnoj Europi možda je vještački ojačana uslijed potisnutih ekonomskih odnosa sa drugim partnerima. Stoga u svakom slučaju treba očekivati izvjesno preusmjerenje trgovine Srbije i Crne Gore od nekih partnera u FTA ka drugim zemljama (posebno EU i Hrvatskoj), bez obzira na proces FTA.

No, jednostavna analiza geografske strukture trgovine unutar regiona Jugoistočne Evrope ukazuje na to da su FTA mogli u nekim slučajevima biti uspješni. Trgovina između zemalja Jugoistočne Europe je rasla ujednačeno, a u nekim slučajevima i brže od ukupne trgovine, što je dovelo do toga da udio trgovine u Jugoistočnoj Europi ostane u velikoj mjeri sličan ili čak bude u porastu.

Trgovinska politika BiH

BiH od 1997. godine ima relativno liberalan trgovinski režim. Odluka da se značajno smanje uvozne barijere bila je motivirana sa tri faktora: (1) domaća proizvodnja i proizvodni kapaciteti su bili vrlo niski odmah nakon rata 1990-tih, te se u to doba nije mogla opravdati zaštita bilo koje pojedine industrijske grane, (2) od međunarodnih donatora se očekivala velika pomoć u obnovi pa bi carinske tarife smanjile stvarne efekte te pomoći, i (3) administrativni kapaciteti (uključujući graničnu kontrolu), te javne finansije bile su u lošem stanju, što znači da prihodi vezani za carine nisu bili na ispravan način prikupljeni, praćeni niti alocirani.

Obnova poslijeratne državne strukture izazvala je porast broja entitetskih zakona, institucija i praksi koji su imali tendenciju zanemarivanja potrebe za koordinacijom i odnosima između entiteta i države, te između dva entiteta. Vanjskotrgovinski zakoni i propisi su donošeni na nivou države, ali su ih doskora implementirali entiteti, bez jasnog praćenja njihovog poštivanja (posebno je bitno da su postojale nezavisne carinske uprave). Državna granična služba stvorena je 2000. godine, dok je djelotvorna kontrola graničnih prijelaza uspostavljena tek 2004. godine. Objedinjavanje carinskih

uprava 2004. godine te formiranje Uprave za indirektno oporezivanje (UIO) na nivou države znatno su poboljšali uslove za vanjsku trgovinu.

Međutim, još uvijek ima dosta institucionalnih prepreka za vanjsku trgovinu. Institucije i zakonodavstvo vezani za tehničke propise, procjenu usklađenosti, sanitarna i fitosanitarna te veterinarska pitanja općenito nisu dovoljno razvijeni i usaglašeni sa standardima EU. Perspektiva pregovora sa EU o Sporazumu o stabilizaciji i pridruživanju pomogla je da se postignu kompromisi i ubrzaju institucionalne reforme koje, međutim, još uvijek treba u potpunosti implementirati kako bi uistinu donijele ekonomske efekte. Važnu prepreku čini ograničena sposobnost rješavanja kompliciranih tehničkih pitanja vezanih za trgovinu u Ministarstvu vanjske trgovine i ekonomskih odnosa, te drugim relevantnim institucijama.

Liberalizacija regionalne trgovine BiH

Trgovinska integracija sa partnerima u Jugoistočnoj Europi potaknuta je Memorandum o razumijevanju Pakta stabilnosti iz 2001. godine, koji je predvidio zaključivanje niza bilateralnih sporazuma između zemalja Jugoistočne Europe (Albanije, BiH, Bugarske, Hrvatske, Bivše Jugoslavenske Republike Makedonije, Moldavije, Rumunije, Srbije i Crne Gore, a odskora i UNMIK-a/Kosova). BiH je brzo zaključila FTA sporazume sa svim zemljama Jugoistočne Europe (u nekoliko slučajeva su ti sporazumi bili asimetrični), čime je smjesta dobila pristup drugim tržištima, dok su se njene tarife trebale postepeno uklanjati.

U odnosu na druge zemlje regiona, BiH je prvobitno sasvim snažno sprovela otvaranje svog tržišta poljoprivrednih proizvoda. No, kasnije je BiH unilateralno unijela zaštitne mjere za nekoliko odabranih poljoprivrednih proizvoda (uglavnom mliječne i mesne proizvode) iz Hrvatske te Srbije i Crne Gore. Ovo je izazvalo neke probleme, te su trgovinski partneri BiH stalno ukazivali na unilateralni karakter politike BiH te na činjenicu da BiH još uvijek nije dala uvjerljive dokaze koji bi potkrijepili njenu suspenziju nekih elemenata FTA. Problemi u postizanju kompromisa u vezi s ovim doveli su u posljednjem trenutku, u decembru 2006. do teških pregovora o pridruživanju BiH svim ostalim potpisnicama koje su se složile o formi CEFTA 2006. BiH je ponovo, unutar CEFTA 2006., među zemljama sa najliberalnijim trgovinskim režimima.

Trgovinski tokovi BiH

BiH je relativno otvorena za vanjsku trgovinu. U posljednjih 10 godina to je bilo prvenstveno uzrokovano obimom uvoza, ali od 2003. godine učinci na polju izvoza

također su znatno poboljšani zahvaljujući aktuelnom restrukturiranju određenih sektora i prilivu direktnih stranih investicija. U periodu 2002-2005. BiH je zabilježila veliki trgovinski deficit od 45% BDP-a (manji, ako se računa i siva ekonomija). Rast izvoza će se vjerovatno nastaviti i u bliskoj budućnosti, zahvaljujući nekolicini velikih investicijskih projekata, pogotovo onim u metalurgiji (proizvodnja čelika i aluminija).

Izvoz BiH je u praksi ograničen na tržište EU (oko 55%) i region Jugoistočne Europe (35-40%), odnosno na ona tržišta koja su geografski najbliža i gdje robe BiH uživaju preferencijalni status. Uvoz je donekle više diversificiran, sa udjelom zemalja koje nisu u EU i nisu u Jugoistočnoj Europi od oko 20%.

BiH ima veoma usku proizvodnu i izvoznju bazu i to je ključni problem, zbog kojeg je zemlja izložena oscilacijama na međunarodnom tržištu. Izvoz je u velikoj mjeri usmjeren na eksploataciju prirodnih resursa i radno-intenzivnu proizvodnju roba u granama koje zapošljavaju niskokvalificiranu radnu snagu. Bazni metali i proizvodi od metala dominiraju u strukturi izvoza a njihov udio je odskora u daljnjem porastu. Poljoprivredni proizvodi predstavljaju tek mali dio izvoza (oko 6%), a ti proizvodi su gotovo u potpunosti usmjereni na tržište Jugoistočne Europe, pošto BiH nema relevantne institucije (sanitarne i fitosanitarne inspekcije) za izvoz poljoprivrednih proizvoda u EU.

Determinante izvoza i uvoza BiH

Gravitacijski model vanjske trgovine BiH, izračunat u ovom izvještaju, ukazuje na to da su trgovinski odnosi BiH sa susjedima iz bivše Jugoslavije veoma jaki. Čini se da su intenzivniji nego što bi ukazivala geografska bliskost i ekonomski potencijal partnera. To se može objasniti snažnim historijskim industrijskim odnosima u okviru ranije jedinstvene države, kao i zajedničkim granicama i efektom sličnosti jezika koji često pozitivno utječu na obim trgovine između zemalja. Nasuprot tome, čini se da EU ne predstavlja veći udio u izvozu BiH kao što bi se moglo predvidjeti na temelju osnovnih specifikacija, unatoč tome što je EU dala trgovinske preferencijale za proizvode iz BiH. Objasnjenje za ovo možda leži u netarifnim barijerama koje štite tržišta EU ili je potrebno da prođe određeno vrijeme da bi olakšan pristup tržištu rezultirao većim izvoznim tokovima iz BiH. Zanimljivo je da se čini da je EU (blago) manje zastupljena među uvoznim tržištima BiH, na što ukazuje negativna indikativna varijabla za EU u uvoznju jednačini.

Konačno, gravitacijska specifikacija ne može potvrditi hipotezu da FTA dodatno ojačava trgovinu sa partnerskim zemljama Jugoistočne Europe. Nekoliko upozorenja treba dodati takvom tumačenju. Prvo, FTA sporazumi su relativno novi i za ostvarenje njihovog efekta na trgovinske tokove možda treba više vremena. Drugo, moguće je i da su neki FTA možda bili djelotvorni u pogledu smanjenja trgovinskih barijera za

izvoz iz BiH, dok neki drugi (iz razloga vezanih za njihov sadržaj i/ili implementaciju) nisu odigrali takvu ulogu.

Efekti regionalne trgovine na socijalne prilike u BiH

Posmatrajući efekte FTA iz druge perspektive, vidimo neke (slabe) indikacije trgovinske ekspanzije do koje je došlo, mada definitivna procjena zbog nedostatka relevantnih podataka nije moguća. Ne vidimo nijedan razlog za očekivanje da se u slučaju FTA BiH desi preusmjerenje trgovine koje bi bilo takvih razmjera da bi moglo naškoditi privredi BiH. U pogledu skretanja trgovine također se čini da ima više argumenata koji podržavaju gledište da će BiH, ako do toga i dođe, vjerovatno služiti kao ulazna tačka za proizvode trećih zemalja koji se kasnije prosljeđuju dalje drugim zemljama Jugoistočne Europe, nego da će biti «žrtva» skretanja trgovine tako što će partneri FTA iz trećih zemalja uvoziti proizvode u BiH bez plaćanja dažbina.

Netarifne trgovinske barijere sa partnerima iz Jugoistočne Europe

Brojne su netarifne barijere koje škode trgovini. Razgovori sa poduzetnicima u BiH, sa onima koji definiraju politike, te sa analitičarima, uz analizu nekih komparativnih statističkih podataka, ukazuju na to da se ozbiljne trgovinske barijere javljaju na sljedećim poljima: nepriznavanje u inostranstvu fitosanitarnih i veterinarskih certifikata koje izdaje BiH, korupcija i niska kvalificiranost carinske službe BiH (mada su sagovornici ukazali na nedavna velika poboljšanja u toj sferi), slaba transportna infrastruktura (pogotovo željeznice), pretjerano licenciranje u nekim sektorima, te problemi vezani za dobijanje potvrda o porijeklu (vrijeme čekanja, nedostatak informacija, problemi sa prihvaćanjem potvrda). Sasvim neočekivano, sagovornici su pokazali tendenciju da ne navode tehničke standarde među glavne trgovinske barijere. Moguće je da u ovom trenutku oni predstavljaju značajne barijere trgovini isključivo sa EU. Neki sagovornici u BiH su također ukazali na postojanje "mekih" graničnih taksi na određanim tržištima te su se žalili na funkcioniranje carine u nekim stranim zemljama.

Analiza drugih usluga koje se tiču trgovine ukazuje na to da se ne čini da nedovoljna razvijenost domaćeg finansijskog sektora predstavlja veliku prepreku trgovini. No, čini se da se veliki dio trgovine dešava bez bilo kakvog finansijskog osiguranja ili adekvatnih finansijskih garancija. To jasno ograničava mogućnosti novih trgovinskih kontakata te onemogućava brzi rast trgovinskog prometa. S obzirom na ograničenja na strani ponude te zbog činjenice da male firme u BiH rade s niskim maržama, postupni razvoj tog sektora je od ključnog značaja za daljnju

podršku izvozu iz BiH. Regionalna statistika također ukazuje na telekomunikacijsku infrastrukturu, koja zaostaje za nekim drugim zemljama Jugoistočne Europe, te na visoke troškove telekomunikacijskih usluga.

Opće preporuke u pogledu politika

Neki problemi koji onemogućavaju razvoj vanjske trgovine BiH su vezani za opći ekonomski i institucionalni okvir, investicijsku klimu te uslove za poduzetništvo. Drugim riječima, prvi set ključnih prepreka poboljšanju trgovinskih rezultata je domaće prirode. Prva preporuka poziva na pojednostavljivanje institucionalnog okvira za upravljanje ekonomskom politikom, te – u mjeri u kojoj je to moguće – na potrebu da se ide na jednostavne propise kako ne bi došlo do veće neefikasnosti u njihovoj implementaciji. Treba poboljšati kapacitete institucija BiH, kako onih koji se bave općim ekonomskim politikama, tako i specifičnih institucija koje se bave trgovinskom politikom (npr. pregovori o pristupanju Svjetskoj trgovinskoj organizaciji, Sporazum o stabilizaciji i pridruživanju, trgovinski sporovi itd.).

Kašnjenja u privatizaciji, te veoma slabo restrukturiranje državnih kompanija onemogućavaju veću produktivnost. Privatizacija bi također mogla pomoći u privlačenju direktnih stranih investicija koje su od vitalnog značaja za poboljšanje konkurentnosti prerađivačkog sektora BiH. Direktno strane investicije mogle bi biti važan katalizator razvoja konkurentskih prednosti raznih sektora privrede BiH i integracije njenih kompanija u logističke lance regionalnih i transnacionalnih kompanija (uglavnom sa sjedištem u EU).

Motiviranje kompanija da se restrukturiraju treba da prate reforme čiji je cilj veća fleksibilnost tržišta rada. Potrebna je i povoljna klima za funkcioniranje malih i srednjih preduzeća, a ona zahtijeva pojednostavljivanje procesa registracije preduzeća, pojednostavljenu poresku strukturu i skraćene inspeksijske procedure. Iz perspektive međunarodne konkurentnosti BH proizvodnje, čini se da visoke domaće realne plaće, kada se porede s drugim zemljama u regionu, predstavljaju važnu prepreku. Smanjenje poreznih opterećenja te bolja kvalificiranost radnika trebalo bi da pomognu rješavanju tog problema.

Pristup infrastrukturi je važna determinanta za investicijske odluke i konkurentnost preduzeća. S obzirom na nerazvijenost infrastrukture u BiH, poboljšanja na ovom polju mogla bi imati značajnog utjecaja na konkurentnost kompanija u BiH. Prioritet treba dati stvaranju odgovarajućeg okruženja za razvoj infrastrukturnih službi koje su u privatnom vlasništvu ili privatno funkcioniraju. Transparentna privatizacija komunalnih službi i uspostavljanje pravih investicijskih poticaja, te regulatornog okvira obećavaju bolje rezultate.

Preporuke za trgovinsku politiku BiH

Ključno pitanje trgovinske politike koje se izuzetno ističe u debati o funkcioniranju FTA BiH i o optimalnom obliku novog sporazuma CEFTA tiče se nivoa liberalizacije trgovine poljoprivrednih proizvoda. Čuju se glasovi u prilog isključivanju bilo kakve liberalizacije na planu poljoprivredne trgovine. Za BiH, tendencija je da se to temelji na percepciji nelojalne konkurencije za nekoliko poljoprivrednih roba (npr. meso, mlijeko) koje se proizvode u zemljama trgovinskim partnerima BiH – Hrvatskoj i Srbiji. Po našem mišljenju, BiH ne treba očekivati bilo kakve velike dobitke iz pokušaja da štiti i razvija odabrane domaće sektore time što će uvesti ili povećati trgovinske barijere. Uzevši u obzir institucionalne kapacitete BiH te međunarodne posljedice trgovinskih politika, zaključujemo da se čini da je zaštita poljoprivrede time što će se povećati trgovinske barijere u krajnjoj instanci protiv interesa BiH. Slično razmišljanje se može primijeniti i na druge grane industrije.

Efikasno funkcioniranje međunarodno priznatih institucija za certifikaciju, akreditaciju, mjeriteljstvo i standarde trebalo bi da ojača izvozne kapacitete domaćih kompanija i promovira razvoj prerađivačkog sektora.

Tarifna struktura u BiH, mada relativno jednostavna i takva da općenito izbjegava visoke stope, ipak ima neke slabosti. Potreban je širi pogled na tarifne politike kako bi se izbjegla situacija u kojoj se neki specifični elementi politika utvrđuju pod utjecajem lobbyja, bez uzimanja u obzir šireg ekonomskog efekta. Jedno se pitanje tiče carinskih tarifa za neke sirovine i poluproizvode koji se ne proizvode u BiH (ili zemljama potpisnicama CEFTA 2006), ali se koriste u proizvodnim procesima u BiH. To smanjuje učinak zaštite za proizvode prerađivačke industrije te može biti štetno za kapacitet domaće proizvodnje.

Granične procedure za izvoz/uvoz mogle bi se također pojednostaviti i učiniti predvidljivijim (u smislu vremena čekanja). U tom pogledu, treba nastaviti reformu carinske službe.

Čini se da postoji prostor za veću promociju izvoza i usluge informiranja za kompanije zainteresirane da šire svoje aktivnosti na strana tržišta. Ovdje je ključno pitanje da se osigura da te usluge budu visokog kvaliteta i da budu po razumnoj cijeni.

Sektorske preporuke

Konačno nudimo neke specifične sektorske preporuke vezane za grane sa visokim izvoznim potencijalom: metalurgiju, proizvodnju automobilskih dijelova, proizvodnju hrane i pića, te proizvoda od drveta. Zajednička karakteristika ovih preporuka uključuje potrebu za stvaranjem povoljne klime i informiranjem potencijalnih stranih

investitora, pružanjem pomoći u uspostavi kontakata između proizvođača u BiH i potencijalnih klijenata/investitora, podrškom marketingu BH proizvoda, dostupnošću obuke za male proizvođače, podrškom spajanju (ili stvaranju grupa proizvođača) malih preduzeća u grupe proizvođača tako da mogu uživati u prednostima ekonomije obima u pogledu marketinga, izgradnje brendova, ambalaže, dizajna i ulaganja u modernu proizvodnu tehnologiju.

Translation: *Senada Kreso*

Executive summary

Background

This report analyses the functioning of free trade agreements (FTAs) signed by Bosnia and Herzegovina (BiH) with its regional partners in the SEE Stability Pact process (Albania, Bulgaria, Croatia, Macedonia, Moldova, Romania, and Serbia and Montenegro). The objective of the study, as defined by the EPPU, was to formulate policy conclusions on enhancing the effectiveness of these FTAs.

The report does not discuss in any detail trade and other relations between BiH and the EU. Nevertheless, references to these important processes are made whenever it is relevant for the objective of this work. Also, several recommendations are applicable for the overall performance of BiH foreign trade policy. It is worth remembering, though, that intra-SEE integration is required as part of the EU integration process.

The work on this report (main bulk done in autumn 2006) coincided with the final stage of negotiations on a multilateral trade agreement (CEFTA 2006) that is to replace the network of over 30 bilateral FTAs in May 2007. Therefore, the policy recommendations stemming from this work are not designed to be directly applicable to the functioning of FTAs. However, the lessons and recommendations arising from this analysis are also relevant for the new CEFTA, if only because many features of the FTAs were preserved in the CEFTA 2006. Moreover, several of recommendations are in fact much broader in scope and remain relevant in the context of general trade policies irrespective of their specific institutional set-up.

The general conclusion emerging from the analysis presented in this report is that while the regional FTAs might have had some positive impact on the BiH economy, this effect was not particularly strong and the potential of the regional free trade arrangement has not yet fully materialised. The reasons for this are manifold, including the small economic size of the SEE region and the short time that has passed since the FTA was implemented. Moreover, there are two cases in which bilateral lowering of tariffs has not yet ended. The CEFTA experience from the early 1990s suggests that it may take longer before regional trade flows are boosted more substantially to the benefit of all sides and that deeper economic integration with the EU plays a role in this.

The experience of trade integration in the EU neighbourhood

Analysis of BiH's FTAs needs to be positioned in the wider context of regional trade agreements, particularly those where European countries participate. Therefore, chapters 1 and 2 review the major features of the FTAs, focusing on the early experience of CEFTA (in the early 1990s, comprising Poland, Hungary, the Czech Republic and Slovakia) and some FTAs between the EU and its neighbouring countries.

Possible effects of forming a free trade area

The possible effects of FTAs are multiple. There are possibilities for trade creation, diversion, and deflection effects. These start with changes in trade flows resulting from lowering of trade barriers towards FTA partners but not towards the rest of the world. FTAs, by enlarging the size of the market, may foster FDI inflows. Furthermore, FTAs may bring positive welfare effects (lower prices, job creation, alleviation of poverty) and imply intensified political co-operation, in turn affecting several other spheres beyond economic policy. Moreover, mutually agreed decisions to set-up specific institutions or introduce particular mechanisms (e.g. standards) may be effective tools motivating reforms.

FTA coverage

The coverage of any particular FTA can be decisive in terms of its effects on its signatories. Generally speaking, for a country possessing comparative advantage in food and agricultural production and other labour-intensive sectors, a typical – limited in scope – FTA covering trade in non-agricultural goods and including long transition periods for some of 'sensitive' labour-intensive sectors may bring little gains. Another important point relates to the level of protection against third countries. High import duties for third countries may lead to an FTA resulting in substantial trade diversion and welfare losses.

Intra-Balkan trade liberalisation – experience to date

An assessment of the early experience of the overall network of FTAs in the SEE region is difficult for a number of reasons, including the very short period of their operation. We conclude that one cannot expect an over-dynamic increase in intra-SEE

flows following the implementation of the network of regional FTAs, at least not immediately. Similarity, for the majority of SEE countries, factor endowments and small differences in technologies imply that in the short- to medium-term one cannot expect any major boost in intra-industry trade. One can rather expect stronger inter-industry trade based on relative factor endowments (as described by neo-classical trade theory). Besides, trade flows between some (but not all) of the countries under consideration here by 1999-2002 were already quite high and probably around their potential levels. In some instances (primarily the case of Serbia and Montenegro) trade with SEE partners may have been artificially boosted due to suppressed economic relations with other partners. Thus, some reorientation of Serbia and Montenegro trade away from (some) FTA partners towards other countries (in particular the EU and Croatia) should have been expected anyway, irrespective of the FTA process.

However, simple analysis of the geographical structure of trade within the SEE region suggests that the FTAs could have been successful in some cases. Trade between SEE countries has been growing on a par with and in some instances faster than overall trade, leading to SEE trade shares staying broadly similar or even increasing.

BiH trade policy

Since 1997 BiH has had a relatively liberal trade regime. The decision to substantially lower barriers to imports was primarily motivated by three factors: (1) domestic production and production capacity was very low immediately after the 1990s war and could not be justified in terms of protecting any particular industry at that time, (2) very large reconstruction assistance from international donors was expected and custom tariffs would reduce actual effects of such assistance, and (3) administrative capacities (including border controls) and public finances were in poor condition, meaning that custom-related revenues were not properly collected, monitored or allocated.

The reconstruction of post-war state structures caused a proliferation of entity-related legislation, institutions and practices that tended to disregard the need for co-ordination of relations between entities and the state and between entities. Foreign trade laws and regulations are passed by the state, but until recently have been implemented by the entities themselves, without clear monitoring of compliance (in particular, there were independent custom administrations). The State Border Service was created in 2000 and effective control of border crossings was established only in 2004. Unification of custom administration in 2004 and creation of the state-level Indirect Taxation Authority (ITA) substantially improved conditions for foreign trade.

However, there are still substantial institutional impediments to foreign trade. Institutions and legislation dealing with technical regulations, conformity assessment,

sanitary and phytosanitary, and veterinary issues are generally not sufficiently developed and harmonised with EU standards. The prospect of negotiations with the EU on the Stabilisation and Association Agreement has helped to work out compromises and accelerated institutional reforms, which, however, still need to be accomplished to bring economic effects. An important obstacle is the limited capacity to deal with complicated technical trade-related matters in the Ministry of Foreign Trade and Economic Relations and other relevant institutions.

Liberalisation of BiH's regional trade

Trade integration with SEE partners has been driven by the 2001 Stability Pact Memorandum of Understanding (MoU), which foresaw the conclusion of a series of bilateral agreements among the SEE countries (Albania, BiH, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Romania, Serbia and Montenegro, and more recently also UNMIK/Kosovo). BiH quickly reached FTA agreements with all SEE countries (in a few cases these agreements were asymmetrical), getting immediate access to other markets, while its tariffs were to be removed gradually.

Relative to other countries in the region BiH initially quite vigorously pursued an opening of its agricultural markets. However, BiH later unilaterally introduced protective measures on a few selected agricultural products (mainly milk and meat products) from Croatia and Serbia and Montenegro. This has caused some problems and has been continuously raised by BiH's trade partners, who pointed to the unilateral character of BiH's policies and to the fact that BiH has not yet presented convincing evidence to back up suspending some elements of the FTAs. Problems in finding a compromise on this point led to difficult last-minute negotiations in December 2006 on BiH joining all the other parties that had agreed on the shape of CEFTA 2006. Finally, BiH signed CEFTA, but reserved the right to use safeguard measures in agricultural trade.

BiH trade flows

BiH is relatively open to foreign trade. In the past 10 years this has been primarily driven by import volumes, but since 2003 export performance has also improved considerably on the back of ongoing restructuring in certain sectors and foreign direct investment inflows. In 2002-2005, BiH recorded large trade deficits of 45% of GDP (less, if the unregistered economy is accounted for). Export growth is likely to continue in the near future, driven by a few large investment projects, particularly in the metal industry (steel and aluminium).

BiH's exports are in practice limited to the EU market (around 55%) and SEE region (35-40%), i.e. those markets that are geographically closest and where BiH goods enjoy preferential access. Imports are somewhat more diversified, with the share of non-EU and non-SEE countries at around 20%.

BiH's very narrow production and export base are key problems, exposing the country to volatility in international markets. Exports are largely concentrated on exploitation of natural resources and low-skill labour-intensive goods. Base metals and metal products dominate in the export structure and their share has been growing recently. Agricultural products account for only a small fraction of exports (around 6%) and these products are almost entirely directed to the SEE market, since BiH does not have relevant institutions (SPS inspections) for agricultural exports to the EU.

Determinants of BiH exports and imports

The gravity model for BiH foreign trade estimated in the report indicates that BiH trade relations with its ex-Yugoslavia neighbours are very strong. They seem to be more intensive than the geographical proximity and the partners' economic potential would indicate. This can be explained by the strength of historical industrial relations within the previously united country, as well as common borders and language effects that are often found to positively affect trade volumes between countries. In contrast, the EU does not seem to account for a larger share of BiH exports than would be predicted by the basic specification, despite granting trade preferences for BiH products. The explanation for this may lie in non-tariff barriers protecting EU markets or it may be that eased market access takes some time to translate into higher BiH export flows. Interestingly, the EU appears to be (slightly) underrepresented among BiH's import markets, as indicated by the negative sign on the EU dummy variable in the import equation.

Finally, the gravity specification cannot confirm the hypothesis that FTAs with SEE partner countries additionally boost trade. There are several caveats that need to be added to the interpretation. Firstly, FTA agreements are relatively new and their impact on trade flows may take longer to materialise. Secondly, it may well be that some of the FTAs might have been effective in reducing trade barriers for BiH exports, while other agreements (for reasons related to their design and / or implementation) have not played such a role.

Effects of regional trade on BiH welfare

Looking at FTA effects from another perspective, we see some (weak) indication of trade expansion taking place, although a definite assessment is not feasible due to

lack of relevant data. We see no reasons to expect trade diversion in the case of BiH's FTAs of any magnitude that could harm the BiH economy. With regards trade deflection there would seem to be more arguments supporting the view that if it occurs, BiH is more likely to serve as an entry point for third countries' products that are finally sent to other SEE countries than being a 'victim' of trade deflection importing third countries' products without duties via its FTA partners.

Non-tariff barriers to trade with SEE partners

There exist numerous non-tariff barriers hampering trade. Interviews with BiH entrepreneurs, policy makers and analysts, together with some comparative statistics, suggest that severe barriers to trade are related to the following issues: lack of recognition of BiH phytosanitary and veterinary certificates abroad, corruption and low qualifications of BiH's customs (although respondents noted strong recent improvements in this sphere), poor transport infrastructure (especially railways), over-licensing in some sectors and problems related to getting certificates of origin (waiting time, lack of information, problems with acceptance of certificates). Quite unexpectedly, the respondents tended not to list technical standards among the major trade barriers. Possibly, at the moment these pose a significant barrier in trade with the EU only. Some of the BiH respondents also indicated the existence of some 'soft' border taxes in the destination markets and complained about the functioning of customs in selected foreign countries.

Analysis of other trade-related services suggests that the (under)development of the domestic financial sector does not seem to be a major obstacle to trade. However, it seems that the bulk of trade has been conducted without any kind of financial insurance or adequate financial guarantees. This clearly limits possibilities for new trade contacts and impedes rapid growth in trade turnover. Given the supply-side constraints and the fact that small BiH firms operate on tight margins, the gradual development of the sector is of crucial importance for the further support of BiH's exports. Regional statistics also point to telecommunication infrastructure, which lags behind some other SEE countries, and the high costs of telecommunication services.

General policy recommendations

Several problems hindering the development of BiH's foreign trade are related to the general economic and institutional framework, investment climate and conditions for entrepreneurship. In other words, the first set of key barriers to improved trade

performance is of a domestic nature. The first recommendation calls for simplification of the institutional framework for economic policy management and – to the extent it is possible – the need to opt for simple regulations so that inefficiencies in implementation are not magnified. The capacity of BiH's institutions, both those dealing with general economic policies and trade policy-specific institutions (e.g. negotiations on WTO accession, SAA, trade disputes, etc.) needs to be improved.

Delays in privatisation and very slow restructuring of state-owned companies hinder productivity gains. Privatisation may also help in attracting FDI that are vital for upgrading the competitiveness of the BiH manufacturing sector. FDI could be a very important catalyst for the development of competitive advantages in various sectors of the BiH economy and integration of BiH companies into supply chains of regional and transnational companies (mostly with EU headquarters).

Motivating companies to restructure needs to be accompanied by reforms aiming at bringing more flexibility to the labour market. A favourable climate for the functioning of small and medium enterprises is also needed, and calls for the simplification of the business registering process, a simplified tax structure and streamlined inspection procedures. From the perspective of the international competitiveness of BiH's production, high domestic real wages, when compared to other countries in the region, would seem to pose an important obstacle. Reduction of the tax wedge and improvement of skills should help in tackling it.

Access to infrastructure is an important determinant of investment decisions and competitiveness of businesses. Given the underdevelopment of BiH's infrastructure, improvements in this field could have a substantial impact on the competitiveness of BiH companies. Priority should be given to creating an appropriate environment for development of privately owned or operated infrastructure services. Transparent privatisation of utilities and setting the right investment incentives and regulatory framework promise the best outcomes.

Recommendations for BiH's trade policy

One key trade policy issue that emerged prominently in the debate on the functioning of BiH's FTAs and the optimal shape of the new CEFTA agreement concerned the extent of liberalisation of agricultural trade. Voices have been raised in favour of excluding any liberalisation of agricultural trade. For BiH, these have tended to be based on the perception of unfair competition from a few agricultural goods (e.g. meat, milk) produced in BiH's key trade partners – Croatia and Serbia. In our view, BiH should not expect any strong gains from attempts to protect and develop selected domestic sectors by means of introducing or raising trade barriers. Taking into account

BiH's institutional capacity and the international consequences of trade policies, we conclude that protecting agriculture by raising trade barriers appears on balance to go against BiH's interests. A similar reasoning can apply to other industries.

Efficient functioning of internationally recognisable institutions for certification, accreditation, metrology and standards should boost the export capacities of domestic companies and promote development of the manufacturing sector.

BiH's tariff structure, while relatively simple and generally avoiding high rates, nevertheless has some weaknesses. A broad vision on tariff policy is needed to avoid a situation where some specific elements of the policy are set under the influences of lobbies, without taking into account the broader economic impact. One issue concerns custom tariffs on some raw materials and intermediate products that are not produced in BiH (or in the CEFTA 2006 countries) but are used in production processes in BiH. This reduces the effective rate of protection for processed products and may be detrimental to domestic production capacity.

Border procedures for exports / imports could also be simplified and made more predictable (in terms of waiting times). In this view, the reform of the customs service should be continued.

There seems to be scope for enhanced export promotion and information services for companies interested in expanding their activities on foreign markets. The key issue here is ensuring that these services are of high quality and carried out at reasonable cost.

Sectoral recommendations

Finally, we provide some specific sectoral recommendations related to branches with high export potential: metal, automotive parts, food and beverage processing and wood products. The common features of these recommendations include the need to create a favourable climate and provision of information to prospective foreign investors, help in establishing contacts between BiH producers and potential clients / investors, support for the marketing of BiH products, availability of training to small producers, support for merging (or creating producer groups) of small enterprises into producer groups so that they can reap economies of scale in terms of marketing, building brand names, packing, design and investing in modern production technology.

Introduction

The terms of reference for this study requested an analysis of the functioning of the free trade agreements (FTAs) signed by BiH with its regional partners in the SEE Stability Pact process (Albania, Bulgaria, Croatia, Macedonia, Moldova, Romania and Serbia and Montenegro (since mid-2006 two independent countries)) and suggestions regarding policy measures for overcoming their perceived low effectiveness in promoting foreign trade. The network of regional FTAs was described as giving “unsatisfactory results” in the ToR.

The research team chose a strategy of avoiding *ex ante* assumptions as to the relative success or failure of FTAs, but rather to start with an in-depth analysis and only later to come up with an overall assessment and practical policy recommendations. We also tried to position the BiH FTAs with its SEE partners in the wider context – BiH general trade policies (in particular integration with the EU), other domestic policies potentially affecting trade performance, on the one hand, and the experience of various trade integration initiatives in Europe and neighbouring countries on the other.

The recommendations follow from a review of theoretical and practical aspects of FTA functioning (chapter 1), the analysis on the strengths and weaknesses of existing FTAs throughout Europe and in the region (chapter 2), the description of the FTAs concluded by BiH in the context of its overall trade policy, institutions and trade flows (chapter 3), a quantitative analysis of BiH trade flows, including estimates of determinants of BiH’s imports and exports (chapter 4), and from in-depth interviews with BiH stakeholders (also chapter 4).

The research team carried out a field mission to BiH in September 2006, when most of the interviews with companies, policy makers, analysts and other stakeholders were conducted. The results of the interviews were important in shaping the final recommendations.

The short duration of the project and several other objective factors imply that the report’s analysis and conclusions should be treated as preliminary and subject to verification. Nevertheless we hope that the report will highlight some of the key issues affecting BiH’s trade integration with its South-Eastern neighbours and will spur a lively debate (the creation of CEFTA 2006 can be an additional motivation for carrying out such a debate).

The authors of this report are grateful to Jan J. Michalek, Michael Emerson and Fikret Causevic for their insightful comments on the earlier version of this work. Responsibility for the quality of the report rests solely with the authors.

The views expressed in the report are those of the authors and should not be attributed to the European Commission, Economic Policy Planning Unit or other institutions the authors may be affiliated to.

I. Free Trade Agreements – a snapshot

This chapter explores the issues related to trade liberalisation that may be relevant for intra-regional trade in South Eastern Europe (SEE). The discussion starts with a description of the textbook free trade area and then turns to locating regional trade integration in the Balkans in the broader perspective of integrating with the EU. It also uses examples of scenarios that can be considered ‘minimum’ and ‘maximum’ degrees of regional integration. There is also a short overview of possible welfare effects of forming a free trade area.

1.1. FTAs as a precondition of deeper integration

The typical sequencing of regional economic integration may pass through the following stages: granting bilateral trade preferences, setting a FTA and then possibly creating a customs union, or even a common market and monetary union. The two last stages require quite substantial unification of rules pertaining to various aspects of economic activity, a common monetary policy (in a monetary union) and at least some fiscal co-ordination rules. The recent decade or so has seen a proliferation of regional integration initiatives, in particular in Europe. The creation of free trade areas has been used as an initial step, potentially important in itself but also in facilitating further development in this regard.

A textbook free trade area means liberalisation of trade on a reciprocal basis. It implies that both trading partners decide to eliminate tariffs and quotas on imports from the territory of the other partner. Although border controls remain in place, the cost of access to a trading partner’s market falls as a result of zero tariff rate and the lack of quantitative restrictions.

A free trade area is relatively easy to agree on and implement since it does not require common policies towards third countries (such as in the case of customs union with common external tariffs). Moreover, once approved, it requires minimal common decision making during its functioning¹.

¹ With the exception of harmonisation or mutual recognition of rules of origin, standards etc.

1.2. The experience of EU trade integration with neighbouring countries

The European Union has a long history of trade integration with its neighbours. Additionally, having an attractive normative reputation with its neighbours – from multiple angles such as honest business methods, technical modernity, economic ideals for Europe, etc. – it is a natural model to follow from the perspective of several countries. Moreover, the creation of the set of regional FTAs in the SEE has taken place in the context of further integration with the EU, and the provisions of the FTAs closely follow the usual EU trade integration practices. Therefore, before moving to the BiH FTAs, it is useful to briefly review some other regional integration histories in Europe and also those FTAs signed between the EU and its neighbour countries.

The early years of CEFTA: the Central European Free Trade Agreement

CEFTA – the Central European Free Trade Agreement – was signed in December 1992 and was designed to re-build economic integration between Poland, Hungary and Czechoslovakia (and later the Czech Republic and Slovakia) and to revive trade between these countries after they had collapsed with the dissolution of the Council for Mutual Economic Assistance (COMECON), an economic organisation made up of several communist countries (Yugoslavia was not a member). This resulted in a massive reduction in trade between ex-communist countries, relative to 1980s (especially in relative terms)². The CEFTA was in many respects similar to the current network of FTAs in the SEE region (although it was a multilateral agreement from the very beginning). Several years have passed since CEFTA's creation, and so one may analyse its effects and draw some lessons from it. Below, we briefly summarise the main conclusions that may be relevant from a BiH's perspective.

After signing the agreement at end-1992, the CEFTA started to be implemented in 1994. In practise, the coverage of the agreement limited to non-agricultural goods, tariffs for which were eliminated in 1994. Initially, agricultural trade was also supposed to be fully liberalised, starting from the beginning of 1998. However, all the parties recorded surpluses in agricultural production in the mid-1990s and all subsidised agriculture, although in different ways. They were therefore unwilling to risk similar products from neighbouring countries crowding out domestic agricultural production. Moreover, the opening of the sectors to external competition would have meant harmonising agricultural policies (in order to avoid subsidised production from one country crowding out non-subsidised production in other countries). The

² In some cases, the nominal fall in trade between early 1980s and early 1990s (measured in US dollars) was as large as 50% (based on data from IMF DOTS).

signatories decided not to do this and barriers for agricultural trade were lowered only partially starting in the second half of the 1990s (Chmielewska et al., 2004). Still, relatively high barriers in agricultural trade persisted³.

The geographical scope of the agreement changed later on and also started to cover some Balkan countries. Slovenia joined the CEFTA in 1996, Romania in 1997, Bulgaria in 1998, Croatia in 2002 and the Republic of Macedonia in 2006. After 2004 (when the Czech Republic, Hungary, Poland, Slovakia and Slovenia left the CEFTA and became members of the EU) the name CEFTA became relevant for intra-Balkan integration, finally leading to the signing of the CETA 2006 agreement in December 2006 (see more on this in chapter 3).

It would seem that repetition of the experience of the early years of the CEFTA is the minimum achievement BiH can attain in the medium-term. However, BiH (and countries in the region) could probably reap higher benefits by going beyond the provisions of the early CEFTA and deepening integration (e.g. by more comprehensive liberalisation of agricultural trade), especially given that CEFTA 2006 (a new multilateral trade agreement in SEE) builds on several years experience of the regional network of FTAs.

It should be also underlined that the formation of the CEFTA paralleled another significant process of initiating institutional integration with the EU, the signing of Europe Agreements in mid-December 1992. This latter process was much more important from the perspective of Central and East European (CEE) countries, among other things due to the size of the EU market, relations with which had been artificially depressed prior to 1989.

Typical EU's FTAs

A free-trade agreement of the type that the EU usually signs with its neighbours (e.g. Europe Agreements with ex-communist countries signed in the early 1990s) falls short of creating truly free trade. The coverage of such agreement is limited to non-agricultural goods only, with high protection remaining in agricultural trade. This was the case with FTAs with the ten new EU member states from Central and Eastern Europe and also with FTAs signed more recently by the EU with Morocco and Egypt, as well as those signed between the EU and Croatia and the EU and Macedonia (as part of the Stabilisation and Association Agreement – SAA). This limitation in product coverage results from the complicated structure of the Common Agricultural Policy (CAP).

Moreover, a typical FTA can take as long as 10 years to be fully implemented. However, the EU is usually willing to front-load the elimination of its tariffs, while

³ Agriculture was excluded also for the reason that it was excluded from Europe Agreements and free trade agreements with EFTA countries.

partner countries may benefit from gradual tariff reduction (this is typically carried in the framework of Interim Agreements). The other important positive side of FTAs signed by the EU, is that they typically include a number of provisions (e.g. related to capital flows, standards, political dialogue, etc.) that could lower non-tariff barriers to trade. Provided that the whole liberalisation program is attractive and strict but a realistic timetable is set, such wider in scope FTAs could bring substantial gains, which would stem mainly from domestic reforms in the EU partner countries.

EEA: European Economic Area

Perhaps the deepest and most effective example of trade integration in Europe (excluding the EU itself) is provided by the European Economic Area. It goes well beyond simple free trade in manufacturing, effectively extending the common internal market beyond EU borders. The EEA was formed by the EU, Norway, Iceland and Lichtenstein and assures four freedoms of movement in: manufacturing goods (agricultural trade is excluded), services, capital and people. Norway, Iceland and Lichtenstein have the right to participate in the formulation of European Community legislation, but not the right to a voice in the decision-making process, which is reserved exclusively for the Member States. Because the countries are very closely linked to the EU, some of their national legislation is taken over by the EC rules (particularly issues pertaining to trade and movement of people and businesses, but also company law) and their laws, especially those regarding economic activity, are harmonised with the EU.

Integration of this type can be used as an example of how an ideal EU-SEE integration may look like, even if some of the ex-Yugoslav countries choose not to become EU members in the future. Ideal intra-SEE integration may aim at achieving a similar model in the future but assuring more symmetry in the decision making process⁴.

1.3. Effects of forming an FTA

When considering welfare changes that may follow the formation of a free trade area, economists usually distinguish the following effects:

- Trade creation, when – after lifting customs duties – cheaper imports replace more expensive domestic production and/or exports are boosted, as

⁴ However, also taking into account future integration with the EU, it seems rational to believe that intra-SEE integration will be largely determined by the process of integration with the EU. Among the ideas that have been discussed, at least among expert circles, the idea of SEE countries joining the EU-Turkey customs union has been proposed (see e.g. Kernohan, 2006).

domestically manufactured goods become less expensive on a partner's market. This may be accompanied by so-called 'trade expansion', where falling prices lead to higher demand.

- Trade diversion, when, due to the effects of trade liberalisation toward partner countries, relative changes in external tariffs imply that more efficient production from non-FTA countries becomes more expensive and is therefore replaced by less cost-effective production from an FTA partner country.
- Trade deflection, which can arise when in the absence of effectively implemented rules of origin the country with the lowest custom tariffs is likely to serve as an entry point into its partner's market (with higher tariffs) for the goods originating in non-member countries.

The possibilities of the occurrence of these three effects in the BiH economy as a result of regional trade integration are explored in section 4.3 of the report.

2. Lessons to be learnt from other existing and past FTAs in Europe and close neighbourhood: determinants of success and failure

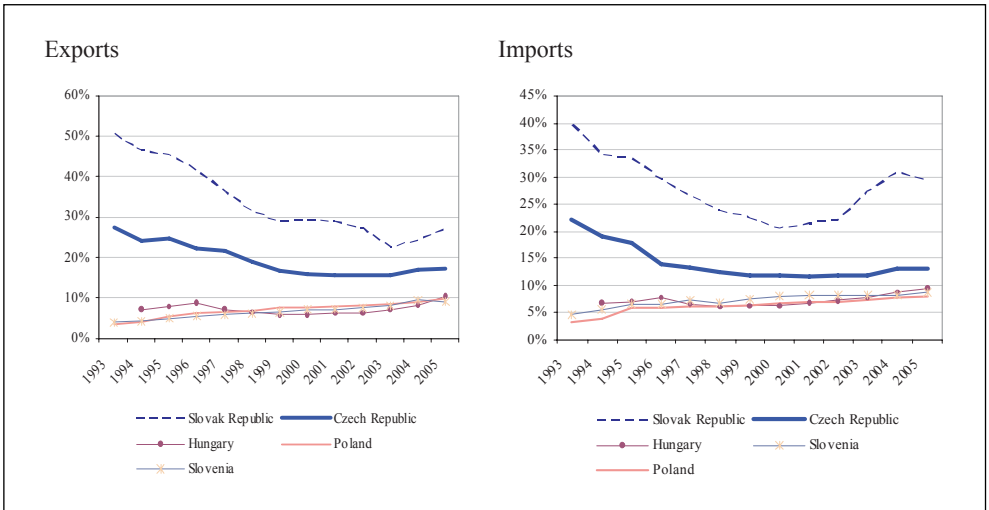
This chapter reviews the experience of selected trade integration episodes between the EU and its less developed neighbours and between emerging European economies that may be relevant from the perspective of BiH's FTAs and CEFTA 2006. The focus is not on a detailed description of these arrangements, which one can easily find elsewhere, but rather on identification of key lessons and mechanisms that determine the success or failure of particular regional trade integration initiatives.

2.1. The early years of Central European Free Trade Agreement (CEFTA)

The elimination of tariffs for manufacturers in the first half of the 1990s within the CEFTA had no significant immediate impact on bilateral trade flows. The starting point – the beginning of the 1990s – was characterised by the collapse of trade among CEFTA members. Trade shares were much lower than geographical proximity and previously partially integrated production structures would suggest. During the 1990s, after the creation of the CEFTA one could observe a gradual and rather slow increase of intra-CEFTA trade shares in the case of Poland and Slovenia. However, the trade shares of the other CEFTA partners showed a reverse pattern. The most striking decline was registered in Slovakia and the Czech Republic, mainly reflecting the disintegration of their markets that had been parts of the same economy until end-1992 (see Figure 1). Hungary also diverted its trade away from the other CEFTA members. Analysis of nominal trade flows leads to similar conclusions. Although trade values for all countries in CEFTA (with the exception of former Czechoslovakia) increased, these increases were not large and fell short of expectations at that time (see Annex 1).

In general, trade flows among the early CEFTA members started to grow intensively in the 2000s, with the early CEFTA members starting to gain higher shares of each others' trade (see and Annex 1).

Figure 1. Intra-CEFTA trade as a share of total trade of early CEFTA members, 1993-2005



Source: Own calculations based on IMF DOTS database.

What was happening in the 1990s was that all these countries started to trade very intensively with the EU and with other developed economies (the opening of EU markets for non-agricultural products played a role in this), which is why the trade shares of other CEFTA members were almost stagnant or even declining at the time. The increase in trade with more developed economies was much more dynamic than intra-CEFTA flows⁵.

What were the reasons for this? First of all, they were connected with the external situation. The dissolution of the COMECON market, coupled with the fall in domestic production and initial lowering of trade barriers with the EU, the CEFTA and WTO members, were enough to make trade with 'troubled' neighbours unattractive and to re-direct trade towards (newly opened for CEECs) developed markets.

It is worth considering the domestic supply capacities of the countries that formed the CEFTA in the early to mid-1990s. These economies were recovering after deep transformational recessions and had only just begun to restructure. Although they were able to compete on each others' markets in price terms they could not compete in terms of quality or technological-intensity of traded goods vis-à-vis the EU or other developed markets' products. The majority of trade between CEFTA and EU countries

⁵ And much more important to changes in the structure of production for the CEFTA members.

was based on relative factor endowment, in accordance with neo-classical Heckscher-Ohlin theory. Similar factor endowments and the low development level limited the scope for expanding intra-industry trade between CEFTA members quite severely. However, once the GDPs of the CEFTA partners and their production capacities increased, these countries started to trade more intensively among themselves (around 2000, see Figure 1 and Annex 1). In the case of the Czech Republic and Slovakia, another difficult moment came after 1997, as a consequence of the Czech currency crisis and the slowdown in the real sphere.

What lessons can one draw from this to use with regard to countries such as Bosnia and Herzegovina? Lesson number one is that trade values reflect the effects of complex interactions of domestic and neighbouring market conditions and trade liberalisation. A lowering of trade barriers among relatively poor partners may result in little immediate gains (no chances for modern intra-industry trade). However, once this is coupled with the overall opening of an economy and domestic reforms building conditions for sustained economic growth, medium-term welfare gains can be substantial.

Another important observation is that the effects of the early years of CEFTA's functioning were not limited to trade in goods. The regional trade agreement brought other indirect gains as early as the 1990s. For example, it facilitated inflows of foreign direct investment (FDI) from developed economies (Dangerfield, 2004). These FDIs have had many positive effects in terms of increasing production and modernisation of technologies in the CEECs. In the case of smaller countries, like Hungary or the Czech Republic, FDI has been primarily export-oriented with foreign investors often targeting the regional CEE markets. With a free trade area in place, producers have been able to serve all CEE markets from a single location. Damijan et al. (2006) document the importance of structural reforms and FDIs that - combined with improved market access - are a major factor explaining the remarkable export performance of CEECs. Moreover, the existence of the CEFTA allowed for the development of vertical production chains, with plants located in different CEE countries. The development of the automotive industry in the region is a good example. These investments were behind the boost in intra-CEE trade in the 2000s.

Another example of positive indirect effects of the CEFTA is of a political nature. The CEFTA's functioning has allowed its signatories to gain experience in multilateral decision making. This experience could later be used during the EU accession process and in subsequent participation in EU institutions (Dangerfield, 2004) - even though CEFTA countries did not co-operate much between themselves in the EU accession process.

Another important lesson is related to the fact that the original CEFTA agreement excluded agricultural trade. Agricultural production had a large share of the partner countries' GDPs at the end of the 1980s and it therefore appears that CEFTA could

have played a much more important role if agricultural markets had been liberalised at an early stage and not only in 2004, when the four initial signatories of the CEFTA joined the EU⁶.

2.2. Selected examples of EU FTAs with neighbouring countries:

Morocco and Egypt

The recent decade or so has seen a proliferation of free trade agreements throughout the world, with the EU playing a particularly active role in this process. The EU's interest in promoting FTAs (including those in the SEE region) have stemmed from a combination of economic and political factors including attempts to ensure stability and peace, support for democratic and market reforms, deepening of trade and investment liberalisation in partner countries and accessing new markets (Francois et al, 2005). There are clearly several advantages for EU partner countries in signing FTAs with the EU, including preferential access to the EU market and prospects of increased EU aid.

The experience of some of these FTAs may be relevant for BiH in that the mechanisms making particular FTAs more or less advantageous, or perhaps disadvantageous, for partners are similar across various agreements. Therefore, below we briefly review two examples of FTAs between the EU and Morocco and Egypt⁷.

While discussing the expected effects from any form of trade integration, such as an FTA, it is important to take into account the difference between its ideal version (full liberalisation) and a more typical version where only some sectors (e.g. manufacturing goods) are covered⁸. The difference between the two can be substantial and in particular the coverage of an FTA can be decisive in terms of the advantages and disadvantages it affords less developed EU partners. Generally speaking, for a country possessing comparative advantage in food and agricultural production and

⁶ Apparently, none of the similar agreements in Europe in the 1990s covered trade in agricultural goods. It is likely that a comprehensive approach to agricultural liberalisation is a key factor in determining the shape of particular agreements.

⁷ The EU's policy towards the Mediterranean region, including Morocco and Egypt, is governed by the Euro-Mediterranean Partnership launched at the 1995 Barcelona summit between the EU and 10 Mediterranean countries. The so-called "Barcelona Process" involves extending free trade across the Mediterranean region through a network of bilateral agreements between the EU and individual Mediterranean partners, together with free trade agreements between the partners themselves, with the objective of eventually creating a Euro-Mediterranean Free Trade Area by 2010. Morocco and Egypt actively participate in the process. The trade liberalisation process is asymmetric, with the EU already offering tariff-free access for industrial products (but not – more importantly from the perspective of some Mediterranean countries – agricultural products), and the gradual opening of Mediterranean markets.

⁸ See also the description of typical EU FTAs in section 1.2 of this report.

other labour-intensive sectors, a typical EU FTA covering trade in non-agricultural goods and including long transition periods for some of the “sensitive” labour-intensive sectors may fall short of creating free trade⁹.

Interestingly, assessment of the consequences of current and planned trade liberalisation steps differs between Egypt and Morocco¹⁰. Morocco is typically considered a potential success story, while the FTA with Egypt can be seen as a potential failure.

The implementation of typical “partial” FTAs is expected to lead to important welfare gains for countries such as Morocco, which is expected to realise productivity gains in labour-intensive sectors such as textiles and chemicals very quickly, once access to the EU market is granted. Thus, even a partial EU-Morocco FTA can be welfare improving for Morocco. Realisation of trade induced technical change is believed to be important in determining the scope of gains (also in social terms – e.g. the impact on poverty). Without this mechanism, the welfare impact, while positive, is expected to be rather small (Evans et al, 2006).

A possible problem with the EU-Egypt FTA is that it envisages for Egypt faster elimination of tariffs on capital goods and intermediates, areas that were initially less protected anyway, and a far more gradual removal of protection of domestic production of consumer goods. Thus, Egyptian domestic price distortions during the transitory period can lead to inadequate preparations for competition with EU producers once the FTA is fully implemented (Francois et al, 2005). Furthermore, the tariff structure towards third countries matters quite substantially. In Egypt, high levels of protection from competition from third countries risks substantial trade diversion during the implementation of the FTA with the EU (in Morocco this risk is much smaller). For these reasons, Evans et al (2006), Francois et al (2005) and several other studies conclude that a partial FTA can be welfare reducing for Egypt (while having an overall negligible impact on the EU).

Negative consequences for Egypt can be mitigated by liberalisation of trade with third countries (to avoid trade diversion) and a deepening of integration with the EU (to include the agricultural sector, provisions for services and other mechanisms facilitating trade).

The lessons from these examples are that the impact of FTAs depends crucially on the overall environment in which it is implemented. The coverage of an FTA, the level of protection towards third countries (and thus the risk of trade diversion), and the inclusion of mechanisms that can motivate productivity-enhancing domestic reforms (little advanced in most of the North African countries) are among the key determinants of the overall impact of particular bilateral or regional trade liberalisation initiatives.

⁹ See Jakubiak and Paczynski (2007) for more detailed discussion.

¹⁰ Much more detailed information on up to date developments in the Barcelona process is available at: <http://www.femise.org/Pub-indic/index.html>

2.3. Effects of other FTAs in South East Europe

A difficult assessment

Analysis of the functioning of other FTAs in the SEE region is scarce. This may not be overly surprising given the objective difficulties in carrying out such assessments. Firstly, the agreements are relatively new and there is simply too little hard evidence on the period after the implementation of FTAs to analyse their functioning in more detail. Secondly, some effects may simply fail to materialise since two large countries (Romania and Bulgaria) joined the EU in January 2007. For them the impact of the FTAs is probably less relevant and more difficult to disentangle from the impact of the pre- and post-accession period. Other countries in the region signed a new multilateral agreement (CEFTA 2006) in December 2006, which will replace the current network of FTAs from mid-2007. Thus, the full effects of regional trade liberalisation that started with FTAs will probably only materialise in CEFTA 2006.

Another issue making the analysis quite complicated is that bilateral FTAs are very different with respect to the scale of trade between the signatories. Registered trade between some pairs of countries has been negligible, to the tune of 1 million euro (and only a few 6-digit HS product lines), while some other pairs of countries are very important trade partners with the value of their annual exchange measured in hundreds of millions of euros (and hundreds of 6-digit HS product lines). For example, Moldova trades heavily with Romania, but has negligible trade flows with all other FTA partner countries. Albanian exports are concentrated on Italy (70% of the total) and Greece (10%) and exports to the whole group of FTA partners are very small.

Furthermore, it is difficult to establish benchmarks against which an assessment of FTAs can be made, given the turbulent recent economic and political histories of the countries in question (e.g. security crises in Macedonia in 2001, the still unresolved status of Kosovo, occasional political tensions in BiH) and differences in their relations (including trade relations) with the EU. An example is provided by the *de facto* economic partitioning of Serbia and Montenegro, eventually leading to the formation of independent countries in the course of 2006. Last but not least is that the quality of regional trade statistics is far from adequate.

The coverage of FTAs in SEE

The first step in assessing FTA's functioning is provided by analysis of their coverage. This exercise is already far from being simple, as illustrated by the work of Messerlin and Miroudot (2004). Selected findings from their analysis can be

summarised as follows. Firstly, the coverage of FTAs justifies thinking about the network as creating a system close to a *de facto* free trade area in industrial goods. In contrast, the abolition of tariff barriers in the agricultural sector has proved much more difficult to accept for (some) parties, as evidenced by the varying and not always sufficient (to meet formal coverage criteria set in the 2001 Memorandum of Understanding) level of coverage of agricultural and food trade. Another interesting observation is that FTAs appear to have quite extensive safeguard provisions, as measured by how much space is devoted to these issues in the texts of the agreements.

FTAs monitoring

The monitoring of FTA implementation issues has been carried out by the Stability Pact Trade Working Group, which issues regular “Progress Reports”. However, these reports have had a natural tendency to concentrate on formal and more general issues and are thus of limited value for an assessment of specific FTAs. For example, the reports have regularly expressed concerns over BiH’s unilateral actions in suspending parts of its FTA with Serbia and Montenegro, because the rules agreed in the FTAs had not been followed (safeguard procedures were not applied).

Intra-SEE trade

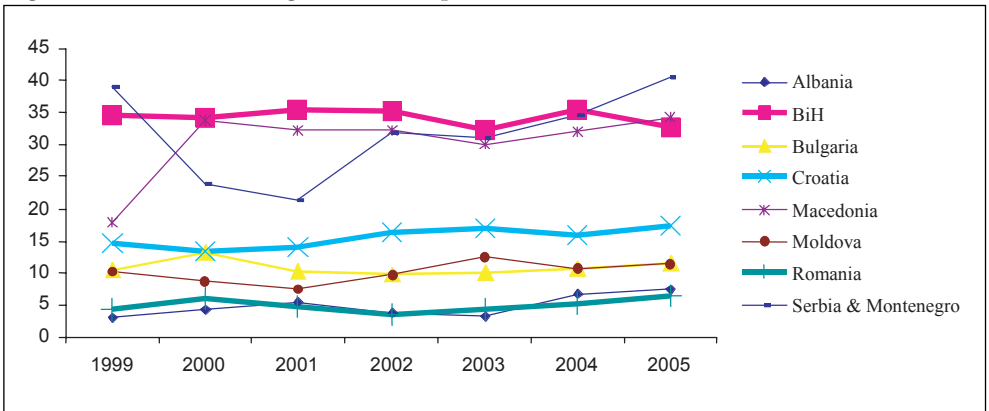
A key question in assessing the effects of FTAs is the extent to which the agreements may have helped create trade between the countries involved. It is therefore useful to analyse the intensity of trade in the region. Annex 2 and Figure 2 show some data on intra-regional exports of the 8 countries involved¹¹. Three countries stand out with a very high share of intra-regional trade – in the case of BiH, Serbia and Montenegro and Macedonia exports to the region account for over 30% of total exports. For Croatia, the share is below but close to 20%, although lack of data on Croatian exports to Serbia and Montenegro makes direct comparison difficult. Bulgaria and Moldova both send around 10% of their exports to the region – in the case of Moldova almost all of this is accounted for by exports to Romania. Romania and Albania have the lowest shares, well below 10%. It is evident that trade among ex-Yugoslav countries (and within the group consisting of Romania and Moldova) is much stronger than among other countries. This confirms the importance of historical developments underpinning economic relations. Uvalic (2005) documents strong

¹¹ Serbia and Montenegro ceased to exist in 2006 with the announcement of Montenegro’s independence. However, no sufficient historical foreign trade data exist separately for Serbia and Montenegro. Also, the availability of trade flows with Kosovo does not allow presentation of a similar trade matrix – Kosovo’s trade is not included in Serbia and Montenegro data.

trade integration within Yugoslavia in the 1980s and relatively weak trade relations between the then-Yugoslav republics on the one hand and Romania, Bulgaria, and Albania on the other.

The importance of imports from the region in overall imports is significantly lower than in the case of exports. This is because several countries in the region, and particularly BiH, Serbia and Montenegro and Macedonia, are characterised by very large trade deficits with imports (from the EU and other markets) far exceeding exports¹².

Figure 2. Share of SEE8 region in total exports, 1999-2005 (%)



Source: Own calculations based on IMF DOTS. BiH – Serbia & Montenegro trade flows were taken from BiH Central Bank database, Serbia & Montenegro trade flows with Croatia, Macedonia were taken from Central Bank of Serbia (2002-2005 data) and Christie (2002) – 1999 data.

Is trade boosted?

From the perspective of this report, a key question is whether the intensity of intra-regional trade before the implementation of FTAs was close to ‘potential’ and whether FTAs implementation coincided with any significant changes in trade patterns. Some sources (e.g. Commission, 2003; World Bank, 2005) claimed that the importance of intra-regional trade was very small during 2001-2002. Also, some documents of the Stability Pact Trade Working Group observed that “trade flows among the countries of the region are low” (Trade Working Group, 2005). However, it appears that such opinions have been drawn from analysis based on incomplete data or on not fully justified generalizations. Indeed, export shares presented above confirm that already by 1999-2001 intra-regional trade was quite important for the ex-Yugoslav countries, and to somewhat lesser extent also for Bulgaria and Moldova.

¹² This also makes them similar to the early CEFTA signatories in the 1990s.

The question whether FTAs have had an impact on trade flows between signatories is far from trivial. Most FTAs entered into force during 2003-2004. Subsequent period (2004-2005) witnessed a relative increase in bilateral trade (i.e. increase in trade shares) between Bulgaria and Romania. However, this cannot be attributed to the FTA, but rather to processes related to the upcoming EU accession (both countries liberalised bilateral trade already in late 1990s). Similarly, a slight increase in the share of Moldovan exports directed to Romanian market in 2003-2005 cannot be attributed to the FTA, which was in operation since 1994. It was rather the effect of the rebound of Moldovan economy (after a prolonged recession throughout most of the 1990s). In contrast, increasing share of Bulgarian exports going to Croatia (and to a lesser extent – Croatian exports to Bulgaria) coincided with implementation of the FTA. One could also notice a relative increase in Albanian exports to Serbia and Montenegro (from 2-3% share in total Albanian exports during 2000-2003 to 5% in 2004-2005), coinciding with implementation of an FTA, although the increase was from a very low base.

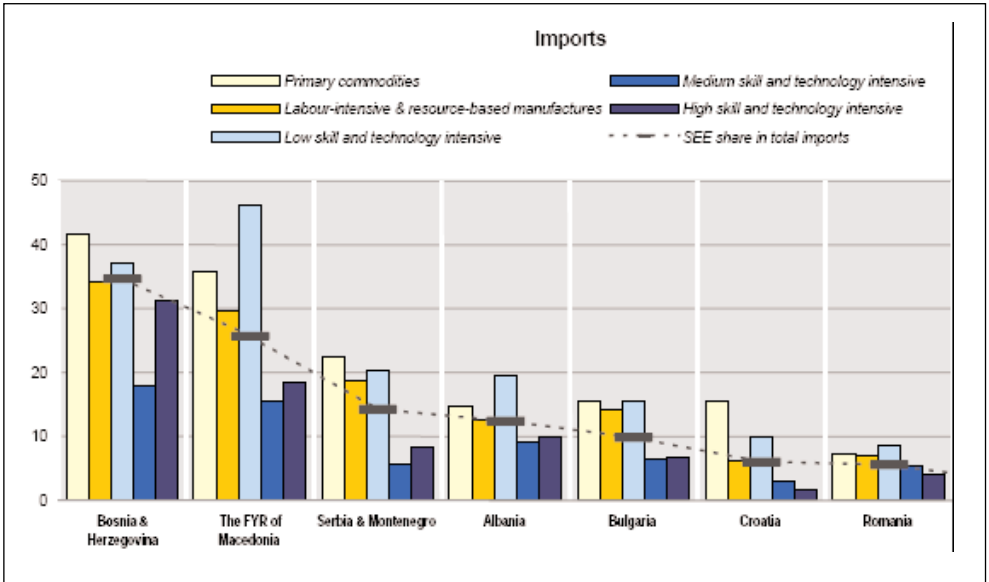
The analysis of Serbia and Montenegro trade flows is particularly difficult not only because of the low quality of available trade data, but because very volatile past patterns of trade were to a large extent determined by developments in international political scene with Serbia and Montenegro trade diverted from 'natural' trade partners (as determined by geography and economics) to 'friendly' trade partners as determined e.g. by attitudes to economic sanctions (see also Christie, 2002). Consequently, trade patterns from 1990s cannot be considered as being anywhere close to normal or equilibrium levels and some reorientation from partners with then-high shares in trade towards other countries (e.g. Croatia, EU) should have been expected anyway, irrespective of the FTA process.

A few countries have minimally increased the share of their exports to BiH market during 2004-2005, albeit often from very low base (Albania, Bulgaria, Macedonia, Romania). The value of Serbia and Montenegro exports to BiH have roughly doubled between 2002-2003 and 2004-2005, and Croatia also saw a significant increase in exports to BiH, although in this last case the market share of BiH in total exports stayed roughly unchanged during 2002-2005. BiH increased the share of exports going to Croatia and Romania, while the dynamics of registered exports to Serbia and Montenegro was slightly lower than growth rate of total exports resulting in a reduction of Serbia and Montenegro share in total BiH exports. A more detailed analysis of BiH trade flows is carried in section 3.4.

Gaucaite Wittich (2005) carry an analysis of relative factor endowments of SEE countries to conclude that similarity of the majority of SEE countries with respect to these endowments and small differences in technology levels make the potential for a significant boost in intra-regional trade rather limited (see also Figure 3).

However, economies of scale and product differentiation could provide a basis for increased trade flows at a later date provided that good conditions are created for regional trade integration¹³.

Figure 3. Share of intra-SEE trade in total SEE imports, by commodity, 2004 (%)



Source: Excerpted from Gaucaite Wittich (2005), p. 13.

Generally, the creation of the network of FTAs is perceived as a success by most sources. World Bank (2005) finds no evidence of any increase in non-tariff trade barriers following abolition of tariffs. This confirms the view that effective barriers to trade decreased. However, there appears to be a broad consensus (also among the involved countries) that substantial further effort is needed to remove existing non-tariff barriers and facilitate trade. Also, that replacement of the network of FTAs with a single regional agreement could simplify the trade regime and thus have chances to positively affect trade¹⁴. This last point is certainly only relevant if the CEFTA 2006 goes significantly beyond a combination of all bilateral agreements and exemptions to them as annexes to the new CEFTA agreement.

¹³ Then these flows will most likely include significant share of intra-industry trade (two way trade in similar products). This view is consistent with the “new trade theory” initiated by Helpman (1981) and Krugman (1979) claiming that factor endowments similarities, technologies plus product differentiation and scale economies facilitate development of intra-industry trade between developed countries.

¹⁴ For example, through the diagonal cumulation of origin across all CEFTA signatories.

Conclusions

Perhaps one cannot expect too dynamic increase in intra-SEE flows following the implementation of the network of the regional FTAs, at least not in a very short-term. First of all, it is possible that similarity of the majority of SEE countries with respect to factor endowments and small differences in technology levels make the potential for a significant boost in intra-regional trade rather limited. This is because in the short- to medium-term one cannot expect any major boost in intra-industry trade, but rather inter-industry trade based on relative factor endowments (described by the neo-classical trade theory). Also, trade flows between some of the considered countries by 1999-2001 could have been already close to their potential levels¹⁵. Additionally, one should note specific developments in Serbia and Montenegro, which saw its trade flows in the 1990s much distorted and thus some reorientation away from (some) FTA partners towards other countries (in particular the EU and Croatia) should have been expected anyway, irrespective of the FTA process.

However, simple analysis of trade shares within the SEE region suggests that the FTAs have been already successful in some cases. The implementation of FTAs coincided with the intensification of trade between Bulgaria and Croatia, as well as between Albania and Serbia and Montenegro. Besides, there is evidence suggesting that the effective trade barriers indeed decreased in the region. Still, some examples of increases in trade shares between countries in the region can be attributable also (or almost exclusively) to other factors (e.g. Bulgaria-Romania, Moldova-Romania).

When making conclusions about the effectiveness of the regional network of FTAs, one should remember about several limitations. Agreements are relatively new and there is simply too little hard evidence on the period after implementation of FTAs. Two large countries will leave the network in 2007, making the analysis of effects of FTAs and these countries' becoming EU members impossible to disentangle. The scale of trade flows differs largely among FTA partners, and it is difficult to find benchmarks for comparison. Declared liberalisation of agricultural trade proved to be too difficult, safeguard provisions in the FTAs are rather extensive, and some countries opted for rising barriers without referring to these safeguard provisions, especially in agricultural trade. Lastly, there are reservations connected with quality of some data, which makes the overall assessment less reliable.

¹⁵ Given their low levels of production (Serbia until 2000, Macedonia in 2001, Kosovo). Naturally, with non-distorted production and higher GDPs, potential for bilateral trade would have been higher.

3. The BiH economy, trade flows and regional trade agreements

3.1. An overview of the BiH economy

Most of the recent economic developments in BiH were determined or exacerbated by the 1992-1995 war, which had a devastating impact on the country's people, institutions and infrastructure. BiH went through a period of post-war rehabilitation when basic infrastructure and social services underwent recovery, with substantial international assistance. The war and its aftermath caused a delay in the process of transition to a market economy, relative to other Central and East European countries and as such some important economic reforms have not yet been completed. An uncoordinated process of nation-building, that was reflected in a fragmented economic space and the non-existence of key institutions for efficient economic management, has proved to be an obstacle for the development of the BiH economy.

The Dayton Accord created a unique administrative and governance structure in BiH and its implementation has since been subject to numerous controversies. The country consists of two entities (The Federation of Bosnia and Herzegovina and Republika Srpska), enjoying high levels of autonomy in creating and implementing economic policies, while state-level government was initially assigned with very few responsibilities¹⁶. Only recently have state-level institutions been strengthened and some responsibilities shifted from the respective entities to the state.

3.2. Evolution of BiH trade policy and future directions

Trade performance and issues related to trade policies have been among the most important economic issues in recent years. Very large and persistent trade (and current

¹⁶ Apart from the two entities the small Brčko District also has a special status and was – and sometimes still is – running its own policies in several fields. For the sake of simplicity we do not discuss issues pertaining to Brčko in the remainder of this report.

account) deficits have been among the country's key macroeconomic vulnerabilities. At the same time, trade policy has been at the centre of serious internal political as well as diplomatic misunderstandings and discussions. The conduct of foreign trade policy has been heavily determined by the post-war state structure and fragmented institutional set-up. Foreign trade policy has been one of the very few areas that is the exclusive responsibility of the state. However, actual implementation has been delegated to the entities', with different institutional structures and non-harmonised practices and entity legislation. Under such circumstances it has been very difficult to conduct a unified and consistent foreign trade policy. Until 1999 the Federation of BiH had a free trade agreement with Croatia, while Republika Srpska had a similar agreement with Serbia and Montenegro. This was quite an unusual arrangement, with the two constituent parts (entities) within the same customs territory trading under different trade regimes with neighbouring countries. This was possible due to the fact that BiH's economic space was practically split along the entity borderlines and the entities were strongly integrated with their respective neighbouring economies.

The Law on Foreign Trade Policy (FT Law) from 1997 established a relatively liberal trade regime, which was not typical for countries at such a low development level. There were three main reasons for such an approach at that time: (1) domestic production and production capacity were very low immediately after the war and protection of any industry could not be justified at the time, (2) very large donor assistance (amounting to USD 5.1 billion from 1996 to 2001) was expected and customs tariffs would have reduced the effects of such assistance, (3) administrative capacity, e.g. related to border controls and public finances, were in poor conditions, meaning that customs-related revenues were not properly collected, monitored or allocated.

The FT Law established no quantitative trade restrictions. Prohibitions or restrictions on international trade may be put in place only in extraordinary circumstance in order to protect or preserve public policy or public security, health and human lives, animals or plants, historical or archaeological treasures, or industrial commercial property. There is a rather short list of products (weapon, medicines, poisons) subject to export licensing, which is in line with international practice.

Foreign Trade Institutions

The building of post-war government structures has caused a proliferation of entity-level legislation, institutions and practices that have largely disregarded the need for co-ordination in entity-state or inter-entity relations. As a result, the existing foreign trade regime has some peculiar features. Foreign trade laws and regulations are passed by the state, but implemented by the entities, without clear monitoring of compliance. Until recently both entities had customs administrations collecting

customs duties, which went to each respective entities' budgets, leading to enormous losses of public revenues and widespread smuggling and under-valuation in customs declarations (ADE, 2003). The State Border Service was created in 2000 and effective control of around one hundred border crossings was established only in 2004, when BiH's customs territory became much better protected and monitored.

Unification of the customs administration in 2004 was an important step in the process of building a system for more coherent implementation of trade policies. Under the earlier arrangement neither entities' customs administration applied trade or customs regulation in a harmonised way, which not only resulted in inefficient collection of budget revenues but also led to distortions in trade flows. Merging the customs authorities of the two entities into the Indirect Taxation Authority (ITA) substantially improved conditions for foreign trade by reducing the number of customs clearing houses, rigorous selection of staff, introduction of single standards for imports and exports, etc. Since the creation of the ITA, customs revenues have increased significantly together with a reduction in customs' services staff.

Institutions and legislation (technical regulations, conformity assessment, sanitary and phytosanitary, veterinary issues) for efficient international trade of goods are generally not sufficiently well developed. Their functioning has been problematic for many years and they have been considered important obstacles in improving quality controls of imported goods and serious obstacles for expanding exports. Protracted internal discussions on how to organise these institutions and how to split competencies between the central state and two entities have been going on for some time. The perspective of negotiations with the EU on the Stabilisation and Association Agreement has helped to work out compromises and accelerate work on the creation of these institutions and drafting appropriate legislation.

Technical regulations and standards are still mostly based on ex-Yugoslavia regulations while new regulations based on the relevant EU directives are expected to be gradually adopted in the coming years. The Ministry of Foreign Trade and Economic Relations (MoFTER) has been authorised to lead the process on transposition of EU legislation. However, the MoFTER's technical capacity is rather limited and coordination with other institutions is not always adequate, and as such the whole process is still at an early stage.

At present, there are four separate institutions for standardisation and conformity assessment: the Institute for Accreditation, the Institute for Standardisation, the Institute for Metrology and the Institute for Intellectual Property. The Institute for Accreditation was created in 2000 and was endowed with relatively strong capacity, but the other three institutes have been created more recently (by splitting the former Institute for Standardisation, Metrology and Intellectual Property) and at the time of writing this report still did not have sufficient resources (staff, equipment) or expertise

needed for normal operations. These institutions are to receive extensive technical assistance (mostly from the EU) in order to increase their capacity to support BiH's external trade.

Since 2002 there has been important progress on veterinary issues and the BiH Veterinary Office has become fully functional (including border veterinary inspections). The 2002 Veterinary Law provides clear regulations governing imports and exports of live animals. These are generally allowed only from facilities approved by EU institutions. However, BiH still can not export animal products to the EU market, due to the lack of veterinary control facilities dealing with exports that satisfy EU standards.

Phytosanitary and food quality issues are regulated in two separate laws, which were adopted in 2003 and 2004. These laws assign authorities in these areas to the respective agencies at the state level, but these agencies are still at an early stage of creation and will need more time to become fully operational.

Legislative Process

The BiH Parliament has exclusive authority to pass legislation on foreign trade policy and the Council of Ministers passes the ensuing decisions and regulations required for implementation of the Law on Foreign Trade Policy. However, the implementation of these laws is the responsibility of the entity governments (i.e. below the national level). The MoFTER is assigned to coordinate and supervise implementation of the Law on Foreign Trade and other international trade affairs.

Previously the entities themselves had passed their own legislation and regulations and established their own implementing institutions, but recent years have witnessed some unification in this sphere. Setting tariff rates in the Customs Tariff Law is also a responsibility of the state authorities, i.e. the MoFTER, but the Governing Board of ITA needs to approve it before submission to the BiH Parliament. The Governing Board comprises ministers of finance from both entities who can veto these drafts. Such powers result from a political arrangement to shift authority on indirect taxes (VAT, custom duties, excises) from the entities to the state level.

International trade agreements are being negotiated in close cooperation between the BiH Presidency and the BiH Council of Ministers, with a high level of transparency in the process. Final authorisation is assigned to the BiH Parliament.

Tariffs and Related Charges

BiH's customs tariff is regulated by the Customs Tariff Law. Its aims are protection of the local economy, generation of budget revenues and creation of preconditions for

development. The HS-based tariff is relatively simple with a scale of four different ad valorem duties: 0, 5, 10 and 15 percent with relatively modest dispersion. In 2002, the average MFN applied tariff rate was the lowest in the SEE region – a total of 6%, agriculture 5% and industry 6.2% (World Bank, 2005). However, analysis of the Customs Tariff Code reveals that surcharges for some agriculture products (HS chapters 1-24) are very high and are paid as specific rates (per kg). Consequently, in some instances compound customs tariff rates exceed even 100% of the ad valorem value, which can be considered a protective measure for local agriculture production¹⁷. A customs registration fee (1% ad valorem) is levied on all imported goods regardless of country of origin and these revenues are supposed to finance customs administration.

Certain imported goods (tobacco, alcohol, fuel, beverages) are subject to excise taxes, which are identical to excises for locally produced goods, meaning that imported goods are not discriminated against. In the past, there were some problems related to excise taxes, which distorted domestic production and favoured imported goods.

Trade integration negotiations

Any future foreign trade regime will be partly determined by the outcomes of two ongoing and one recently completed trade negotiations processes related to accession to the World Trade Organisation (WTO), conclusion of the Stabilisation and Association Agreement with the EU (SAA), and the creation of the free trade area in the South East Europe (SEE) region – CEFTA 2006. The three processes started at different points of time but are currently interrelated in many aspects.

Accession to the WTO

The process of accession to the WTO has been quite slow, as much attention has been given to regional trade liberalisation. While it would appear that WTO accession has been given the appropriate political support and has not been questioned by the major political stakeholders, it was not really very high on the political agenda. The process started in 1999. In the same year BiH was granted an observer status in the organisation. It took next three years before BiH submitted its Memorandum on Foreign Trade Regime as a basis for negotiations to the Working Party (WP). The first and second rounds of formal negotiations were held in 2003 and 2004, and the third session is still pending. WTO negotiation are proving to be somewhat complicated by the future possible accession of BiH to the EU, as BiH needs to get clearance for its negotiation offer from the European Commission before starting negotiations with the WTO WP. BiH's initial WTO offer included far reaching provisions on liberalising

¹⁷ Milk, meat and meat products (after BH Custom Tariff Code and MFTEO).

agricultural and services trade. The EC asked BiH to reduce them, because they were seen as being beyond the EU provisions¹⁸. Future membership in the WTO will have a limited impact on the BiH trade regime since a large majority of BiH foreign trade is liberalised through other regional and EU trade deals. However, WTO membership will provide access to some important WTO institutional instruments, such as the dispute settlement mechanism, and will facilitate access to other markets.

The Stabilisation and Association Agreement (SAA) with the EU

After the European Commission approved progress on fulfilment of the conditions of the Feasibility Study in late 2005, BiH started Stabilisation and Association Agreement (SAA) negotiations. Trade negotiations are one of the key areas of interest for both sides, although at present the most difficult negotiation fields are not related to trade issues. These negotiations are of enormous importance for future potential EU accession and BiH officials consider the SAA process as a top priority. Negotiations for Title IV started in March 2006. As BiH goods already enjoy a liberalised (customs free) regime in the EU market, negotiations are focused on the terms and conditions of future trade between BiH and the EU as well as BiH's tariff concessions for EU goods imported to BiH. In the framework of a future SAA, BiH would gradually grant customs free access to almost all trade in industrial goods with the EU.

For industrial products, transitional periods for different product groups are being negotiated. For the agricultural sector, given its greater sensitivity in almost every country, negotiations are slightly different. In SAA negotiations, this group is divided into three sub-groups: basic agricultural products, processed agricultural products and fish and fishery products. Unlike in the case of industrial products, dynamics as well as the level of liberalisation are being negotiated.

An important aspect of trade liberalisation with the EU concerns non-tariff barriers for BiH exports. Lack of conformity assessment capacities with legally binding technical requirements on product safety in BiH may pose a serious obstacle for BiH exports to the EU. In other words, despite a zero duty regime BiH would face major obstacles to its exports. Therefore, capacity building of relevant institutions is essential for facilitating stronger BiH export.

CEFTA negotiations – a single regional free trade agreement

The formal initiative for negotiations on a single multilateral free trade agreement started in April 2006, when the prime ministers of SEE countries (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Moldova, Romania, Serbia and Montenegro) plus representatives of UNMIK/Kosovo, the

¹⁸ And once BiH joins the EU, the Commission would be obliged to compensate for the difference.

European Commission and Stability Pact, adopted a Joint Declaration on launching negotiations¹⁹. This stemmed from considerations on the need to ensure greater harmonisation of the network of 32 bilateral FTAs.

After the parties had decided to proceed through joining and amending the existing CEFTA, new areas were included: investments, services, government procurement and intellectual property rights. The new agreement was to cover existing bilateral concessions for goods with additional concessions to be negotiated. In order to improve trade in the region, specific attention is being paid to creating effective procedures to remove the various trade obstacles, such as technical barriers to trade.

The primary declared goal of CEFTA 2006 is to improve trade conditions (in the sense of trade coverage, removal of non-tariff barriers, transparency of rules and regulations, etc.), increase market size for potential investors, the introduction of the so-called 'diagonal cumulation of origin' among contracting parties and sub-cumulation of origin with the EU. An efficient dispute settlement mechanism is another feature that should provide easier implementation relative to the situation currently in bilateral FTAs.

BiH expressed its readiness to complete these negotiations by the end of 2006 (when other parties also planned conclusion of talks), but declared at the same time that various important issues would also need to be resolved. In particular, BiH demanded that annexes with Croatia and Serbia concerning trade in agricultural products (milk, dairy products, meat and meat products) effectively introducing some trade barriers in these sectors for imports to BiH, become an integral part of the new CEFTA agreement. On 9 November 2006, following several rounds of negotiations, CEFTA 2006 was initiated by 8 partners (Albania, Bulgaria, Bosnia and Herzegovina, Croatia, Moldova, Montenegro, Romania, Serbia, the Former Yugoslav Republic of Macedonia, and UNMIK/Kosovo). BiH and Serbia were not satisfied with the outcome of the negotiations and did not sign the joint declaration, but retained the right to join at a later date. BiH has retained reservations on the rules for trade in agricultural goods with Croatia and Serbia.

Subsequently, Serbia stated its readiness to drop its reservations and sign the Agreement. BiH remained the only country declaring it would stay outside the new CEFTA unless it reaches a satisfactory compromise. The final week before the signing ceremony was extremely tense with intensive negotiations at various levels eventually leading to a last minute deal. The compromise can be summarised as follows: BiH resigned from its protective measures for selected agricultural products in return for ensuring that the Articles of CEFTA 2006 allow special safeguard measures enabling the introduction of protective measures (especially in agriculture) in the event of any significant market disturbance caused by excessive imports from another party.

¹⁹ Up-to-date information and documents related to the negotiation process can be found at <http://www.stabilitypact.org/>

The agreement on CEFTA 2006 was signed in Bucharest on 19 December 2006 and is scheduled to enter into force in May 2007, provided the ratification process is completed earlier. The new agreement, which built upon the experience of already functioning FTAs, indeed appears to be an improvement over the network of bilateral FTAs, with modernisation of several instruments and inclusion of the new ones. It remains to be seen whether CEFTA 2006 will be truly efficiently implemented.

3.3. Description of existing FTAs and their coverage

The 2001 Stability Pact Memorandum of Understanding (MoU) on liberalisation of trade initiated conclusion of a series of bilateral agreements among the SEE countries (Albania, BiH, Bulgaria, Croatia, The Former Yugoslav Republic of Macedonia, Moldova, Romania, Serbia and Montenegro, and more recently also UNMIK/Kosovo). The MoU imposed three requirements:

- That all quantitative restrictions and measures be abolished
- That import duties be eliminated on 90% of bilateral trade with a double criterion: 90% of HS tariff lines and 90% of trade value
- That liberalisation covers the majority of goods upon entry into force and that transition periods should not exceed 6 years

BiH reached FTA agreements with all SEE countries as the first in the group and later also concluded a similar FTA with Turkey. BiH was able to secure asymmetrical treatment in implementation of the FTAs with Croatia, Serbia and Montenegro and Macedonia, where BiH exports to these countries were immediately granted tariff-free access, while tariffs on imported goods were gradually reduced over 4 to 5 year periods. Only agreements with Albania and Moldova were symmetrical, since these two countries were at a similar development level and trade volumes with BiH were very low. FTAs with Albania, Bulgaria and Romania were limited to only industrial products and did not cover agriculture products, meaning these agreements did not conform to the 90% trade coverage rules.

Still, BiH stands out among SEE countries in its serious attempts to opt for FTAs with wide product coverage. Out of only 8 FTAs fulfilling both the 90% trade coverage criteria from the MoU, BiH concluded four such FTAs (with Croatia, Macedonia, Moldova and Serbia and Montenegro). Only two FTAs (with Macedonia and Moldova) did not foresee future liberalisation of trade in services, while other countries agreed to liberalise trade in services in line with WTO rules and Romania opted to implement EU rules as well. Details are given in Tables 1 and 2.

Table 1. Selected characteristics of BiH FTAs, 2001-2006

Start of liberalisation	Country		Coverage	Pace of liberalisation (Art. 1.2.3)		Quantity Restrictions (Art. 1.2.1)	
			Percentage of liberalised HS lines (%)	Percentage of liberalised HS lines on the day of entry into force (%)	End of transition period	Number of lines with QR	Date of cancellation
2001	Croatia	M	100	25.6	1.1.2004	-	-
		X	100	100	Entry into force (start date)	-	-
2002	Serbia& Montenegro	M	100	25.6	1.1.2004	18	Not spec.
		X	100	99.9	Entry into force*	-	-
2002	Macedonia	M	100	25.6	1.1.2005	-	-
		X	100	99.9	Entry into force**	2	31.2.2003
2003	Romania***	M	91.8	27.1	1.1.2005	-	-
		X	88.7	88.7	Entry into force	-	-
2003	Bulgaria***	M	91.5	27.2	1.1.2005	-	-
		X	88.9	88.9	Entry into force	-	-
2003	Albania	M	100	88.6	1.1.2008	-	-
		X	100	4.7	1.1.2008	-	-
2003	Moldova	M	100	26.2	1.1.2006	-	-
		X	100	44.9	1.1.2006	-	-

Note: X – BiH exports; M – BiH imports.

* – with some exceptions (fuels, gum) liberalised at later date

** – with some exceptions (milk, cheese, oil, some carton and paper products) liberalised at later date

*** – tariffs phased out for industrial goods only

Source: Messerlin and Miroudot (2003) and MoFTER (www.mvteo.gov.ba).

Table 2. Trade coverage in the agricultural and manufacturing sectors of BiH FTAs

		Share of HS tariff lines freed (%)		
		All products	Agriculture HS Chapters 1-24	Manufacturing HS Chapters 25-97
Albania	M	91.0	51.4	99.5
	X	93.0	38.8	99.7
Bulgaria	M	91.5	42.0	99.5
	X	88.9	24.6	99.3
Croatia	M	100.0	100.0	100.0
	X	100.0	100.0	100.0
Macedonia	M	100.0	100.0	100.0
	X	100.0	100.0	100.0
Moldova	M	100.0	100.0	100.0
	X	100.0	100.0	100.0
Romania	M	91.8	42.3	99.6
	X	88.7	28.4	98.5
Serbia and Montenegro	M	100.0	100.0	100.0
	X	100.0	100.0	100.0

Note: X – BiH exports; M – BiH imports.

Source: Messerlin and Miroudot (2003).

The process of negotiations on bilateral FTAs by several SEE countries was not very efficient and took much longer than had been initially foreseen. The final results were not fully in line with the MoU, since many countries were not ready for full liberalisation of trade. The outcome of the whole process – a series of bilateral agreements with different levels of liberalisation – can be described as a “quasi-free trade area” for industrial products. By contrast, agriculture still faces many trade barriers (only 6 out of 23 FTAs introduce free-trade in this sector) with a great variety of instruments for granting preferences.

The MoU specified several rules on contingent protection, public procurement, competition, services and TRIPS. It used references to WTO agreements and to EU regulations (rules of origin and sanitary and phytosanitary standards). In most cases BiH’s FTAs include these references, but in principle these issues have not been tackled with much accuracy and solutions have often been vague, leading to problems in implementation. Lack of properly designed dispute settlement mechanisms in the FTAs have also added to the difficulties the parties were facing while trying to solve their disputes, in some instances leading to unilateral decisions.

An example of such unilateral action relevant for BiH occurred when the country said imports of selected agriculture products from neighbouring countries were excessive and the Council of Ministers decided to introduce the following measures suspending some elements of the FTAs:

- introduction of a 40% MFN customs rate for milk, dairy products, meat and meat products from Croatia in March 2005; this measure was later changed to have the same effect as measures against Serbia and Montenegro and has remained in place (more recently only applying to Serbia),
- introduction of an ad valorem customs rate equal to export subsidies for meat, meat products, milk, dairy products, fruits, vegetables, flour, soya oil, wine and alcohol from Serbia and Montenegro in March 2005; this measure was later applied only on milk, dairy products, meat and meat products (and only to Serbia, after the process of separation of Serbia and Montenegro had started),
- Serbia complained about restrictions on meat exports to BiH since BiH insisted that facilities for meat imports in BiH needed to be certified by the EU. Later such strict conditions were changed and Serbia gained approval to continue meat exports to BiH.

These measures have become a part of negotiations on the new CEFTA after BiH insisted such limitations on imports become part of a multilateral agreement. The compromise solution that was reached did not transfer these measures to parts of the CEFTA 2006, while extending the safeguard provisions in the new agreement

enabling the protection of the domestic market (in particular agricultural markets) from disturbances related to imports from trade partners.

BiH also encountered other problems in the implementation of the FTAs:

- issues related to rules of origin have not been resolved and the FTAs have not been properly amended in this respect,
- The FTAs required follow-up on mutual recognition of quality certificates, but this has not yet been implemented,
- Free trade with Montenegro could not be established simultaneously with Serbia and it took 15 months before Montenegro started to implement the FTA on its territory
- The FTA with Serbia and Montenegro could not be applied to Kosovo customs territory so BiH was not able to freely export to Kosovo.

3.4. BiH trade flows

BiH is relatively open to foreign trade if this is measured by the share of total trade in GDP at over 80% (more recently close to 100%). In the past 10 years this was primarily driven by import volumes. However, import growth rates have not been particularly high in recent years (except in 2005, when massive advance imports of goods occurred before the introduction of VAT), bearing in mind rising world prices of fuel and the high import dependency of the BiH economy. Export levels have been significantly lower than imports with a trade deficit of over 45% of GDP leading to a persistently high current account deficit. However, after a period of decline in 2001 and 2002, export performance improved considerably in 2004-2006 on the back of ongoing restructuring in certain sectors and foreign direct investment inflows. This may also be partly associated with liberalised trade regime in the region and the EU. Export growth is likely to continue since large investment projects, particularly in the metal industry (steel and aluminium) are underway and production levels in these sectors are expected to substantially increase in the next 2 years (IMF, 2006; Causevic and Domazet, 2006). The effect of the introduction of VAT made 2006 export figures higher and not fully comparable with past data, partly because a shifting of transaction reporting between the last quarter of 2005 and early 2006 and partly because increased incentives to report exports.

The bulk of BiH foreign trade is realised with countries within a relatively small geographical vicinity in accordance with a “standard geographical model” (a gravity model of BiH trade is presented in section 4.2 of this report), similarly to what is

Table 3. Selected data on BiH foreign trade 2001-2006

	2001	2002	2003	2004	2005	2006
Import (billion euro)	3.748	4.114	4.253	4.757	5.715	5.823
Import – annual growth rate (%)	11.4	9.8	3.4	11.9	20.1	1.9
Export (billion euro)	1.152	1.068	1.187	1.441	1.934	2.640
Export – annual growth rate (%)	-0.5	-7.3	11.1	21.3	34.2	36.6
Trade balance (billion euro)	2.595	3.046	3.066	3.317	3.781	3.183
Trade deficit (% GDP)	42.6	47.1	45.0	44.2	46.9	-
Current account balance (% GDP)	-13.6	-19.4	-21.2	-19.2	-21.1	-
Openness (X+M)/GDP	80.5	80.1	79.9	82.7	95.0	-

Note: There are two series of trade data that can be used. One is original trade statistics (used here) and the other one is trade data based on BoP. Later one includes some additional substantial adjustments (fob/cif, undervaluation etc.). In addition, these adjustment "spoil" breakdown by commodities and countries, since these are being applied on aggregates only. Another dataset is constructed from data obtained by the BiH Chamber of Foreign Trade.

Source: BiH Agency for Statistics, Central Bank of BiH, authors' calculations.

observed in other emerging European economies. The most important trade partners are neighbouring countries (Croatia, Serbia and Montenegro) and close-by EU countries (Germany, Italy, Slovenia, Austria). BiH's exports are in practice limited to the EU market (over 55%) and the SEE region (close to 40%), i.e. the markets where BiH goods enjoy preferential trade regime. Imports are somewhat more diversified as the share of non-EU and non-SEE countries is around 20%. There are various historical reasons, amongst others, for such a structure. Before the war, around 72% of BiH's exports was sold within the former Yugoslavia and these business relations still play an important role – although trade is currently concentrated on only three regional partners – Slovenia, Croatia and Serbia (which is also related to the past and current political relations among SEE countries). Ongoing FDI inflows from the EU are likely to improve BiH's integration with the EU market since BiH companies will gradually become part of supply chains of large EU-based multinational companies, similar to the experiences of the new EU member states.

Table 4. BiH main trade partners, 2003-2006

	Export shares (%)				Import shares (%)			
	2003	2004	2005	1-9/2006	2003	2004	2005	1-9/2006
EU 15	38.1	38.4	35.5	37.9	34.2	33.2	35.3	31.0
Germany	12.4	9.5	11.3	12.6	12.1	11.8	14.4	11.5
Italy	14.7	17.4	13.1	12.4	10.2	9.1	8.9	8.7
SEE FTA	35.3	38.8	38.6	33.3	26.8	29.4	30.4	28.5
Croatia	17.5	21.6	20.5	18.8	17.4	17.6	16.9	17.2
Serbia & Montenegro	16.5	15.8	15.5	13.5	7.9	10.2	10.1	10.2
CEE*	12.6	14.3	16.2	22.0	20.9	16.7	17.1	21.6
Slovenia	10.8	9.1	9.6	12.5	9.3	5.3	7.0	7.4
Others	14.0	8.5	9.7	6.8	18.1	20.7	17.2	18.8

* includes Poland, Slovakia, Slovenia, Czech Republic, Hungary (Bulgaria and Romania are within the SEE FTA countries)

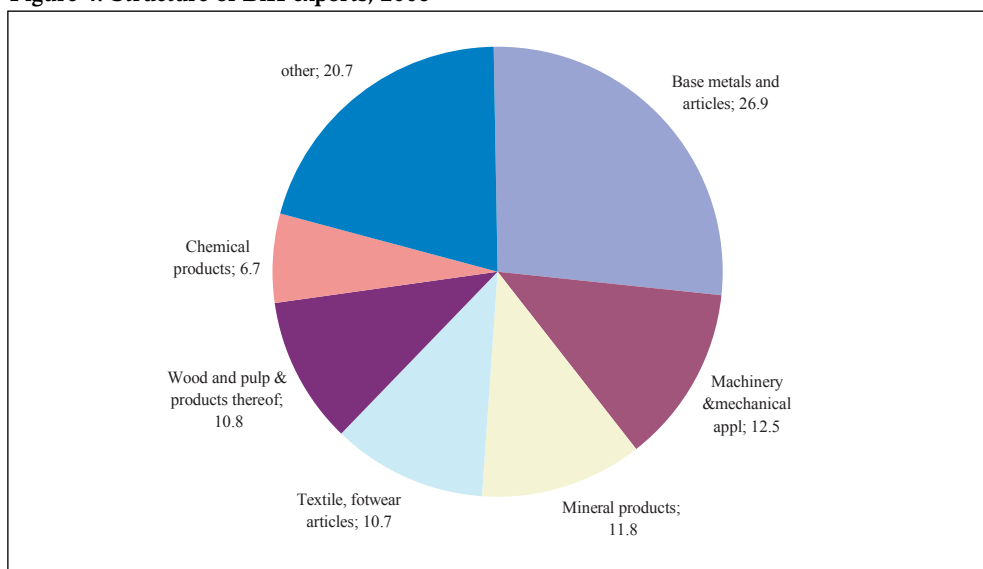
Source: BiH Agency for Statistics, Central Bank of BiH, authors calculations.

Table 5. BiH exports by goods, HS classification, 2003-2006

HS	Description	2003	2004	2005	2006
XVI	MACHINERY & MECHANICAL APPLICANCES	8.2	7.2	14.4	12.5
V	MINERAL PRODUCTS	9.5	11.8	13.3	11.8
IV	PREPARED FOODSTUFF	3.7	3.4	3.2	2.8
XV	BASE METALS & ARTICLES THEREOF	22.4	24.9	25.0	26.9
VI	CHEMICAL PRODUCTS	2.7	7.5	7.6	6.7
XVII	TRANSPORTATION EQUIPMENT	2.9	1.8	2.4	1.9
XI & XII	TEXTILE & TEXTILE ARTICLES & FOOTWEAR, HEADWEAR	12.1	9.6	7.3	10.7
IX & X	WOOD, WOOD & PULP PRODUCTS	19.2	17.8	12.0	10.8
	Other	19.3	16.0	14.7	16.0

Source: Central Bank of Bosnia and Herzegovina, authors' calculations (full tables are in Annex 3).

Figure 4. Structure of BiH exports, 2006



Note: numbers are % shares in total exports

Source: Calculations based on Central Bank of Bosnia and Herzegovina data.

Exports started to grow from a very low base and with a very narrow range of products. Most exported goods are commodities and manufactured goods with low added value. Exports are largely concentrated on exploitation of natural resources and low-skill labour intensive goods (clothing, shoes, etc.). Base metals are the most important exported items, accounting for a quarter of total exports. The share of wood products in total exports has been declining in recent years. Electricity energy (see HS chapter V) has been an important export item, although at present can be only transmitted to adjacent markets since BiH has only recently started to integrate into the wider European electricity market. The metal processing industry, mainly production of car spare parts, has expanded very rapidly in recent years, with exports

of these goods tripling in just two years, and this trend is likely to continue as BiH producers are joining supply chains of the large car manufacturers in the EU. Agriculture products account for only small fraction of exports (around 5-6%) and these products are almost entirely directed to the regional market, since BiH does not have relevant institutions (SPS inspections) for agricultural exports to the EU. Exports of ammunition and weaponry were very significant in the 1990s as BiH had extensive capacities for military production. Ammunition and weaponry exports doubled between 2004 and 2005 and there is some potential for a further increase, though by 2006 they accounted for only 0.5% of total exports.

The BiH economy is very import-dependent in many areas, including consumer goods, raw materials and energy. Merchandise imports include a very wide spectrum of goods. Machinery and transportation equipment are related to investment in re-starting domestic industrial production and together have accounted for up to 25% of total imports in recent years.

Food imports (including prepared foodstuff, animal products and vegetable products) have been relatively large, accounting for 16% of total imports in 2006 (down from over 20% in 2004), but their dynamics has recently slowed compared to total imports. Mineral product imports are almost entirely related to oil imports since BiH does not have local resources and rising world prices (and rising demand due to rebounding economic activity) have affected the country's trade deficit over the last few years (with the share of mineral products in total imports rising from below 13% in 2004 to above 16% in 2006). Base metal industries (steel and aluminium production) also heavily rely on imported raw materials. Imports of base metals have been growing steadily and accounted for over 10% of total imports in 2006.

There had been a general expectation that FTAs may encourage regional trade and thus spur total foreign trade volumes. So far, it is difficult to estimate volume growth, due to the lack of data. What has been observed so far, however, is that trade growth with FTA partners has been broadly in line with average growth of trade.

While export growth has surpassed import growth for the last 4 years, with the coverage of imports by exports increasing from 26% in 2003 to 34% in 2005 and over 45% in 2006, very small initial values of exports implied that BiH's trade deficit was deepening in absolute terms and – to a smaller extent – also relative to GDP until

Table 6. Annual growth o BiH foreign trade rates (% per annum), 2003-2005

	Exports			I mports		
	2003	2004	2005	2003	2004	2005
Croatia	29.6	50.2	27.1	8.7	13.0	15.5
Serbia & Montenegro	-18.0	16.7	31.8	-5.9	44.2	19.9
Other FTA countries	16.8	14.9	34.8	2.7	7.9	18.5
Rest of the world	11.2	21.4	34.2	3.4	11.9	20.1

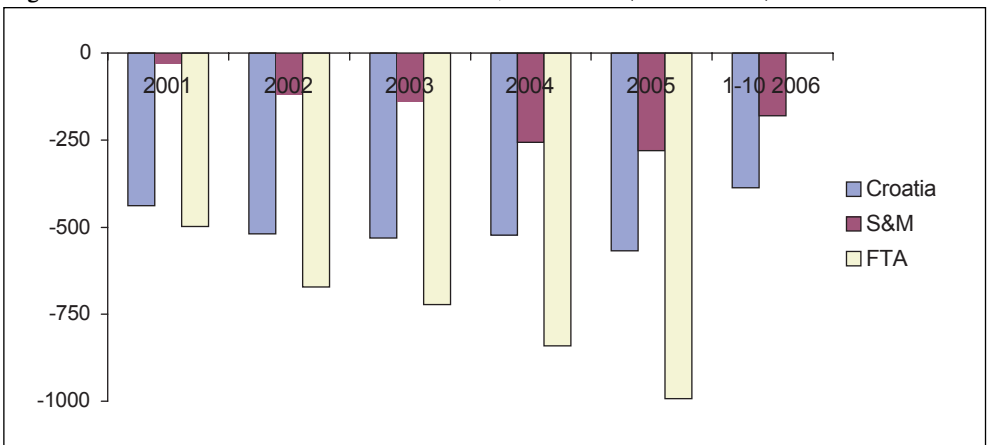
Source: BiH Agency for Statistics, Central Bank of BiH, authors' calculations.

2004. However, 2005 and 2006 saw a reversal of this trend²⁰. The largest deficit has since being recorded in trade with the EU, while FTA countries account for approximately 18% of the total deficit (as of 2005).

Export and import dynamics with BiH's two main FTA partners, Croatia and Serbia (until recently Serbia and Montenegro) have shown different trends. Between 2001 and 2005 exports to Croatia increased by 313% and to Serbia and Montenegro by 126%. In the same period, imports from Croatia grew by 170% and from Serbia and Montenegro by 217%. Thus, the trade deficit with Croatia has been broadly stable over the past 5 years and in relation to the total trade deficit has gradually declined to around 15%. By contrast, the trade deficit with Serbia and Montenegro has been rapidly expanding, albeit from a very low 2001 level, reaching 7.4% of the total trade deficit in 2005 (Figure 5). Preliminary data for the first 10 month of 2006 suggest a continued increase of exports to Croatia but also a revival of exports to Serbia and Montenegro accompanied by stagnating imports from both countries. This implies declining absolute values of trade deficits with both countries, in line with trends observed in trade with BiH's other partners.

Imports from Croatia are dominated by oil derivatives (28.8%) and manufactured goods (17%). Imports of food and beverages (group 0 and 1) are important segments of imports from both countries, with 21-22% shares. Imports of raw materials are very small from both countries (Figure 6).

Figure 5. BiH Trade Deficit with FTA countries, 2001-2006 (million EUR)

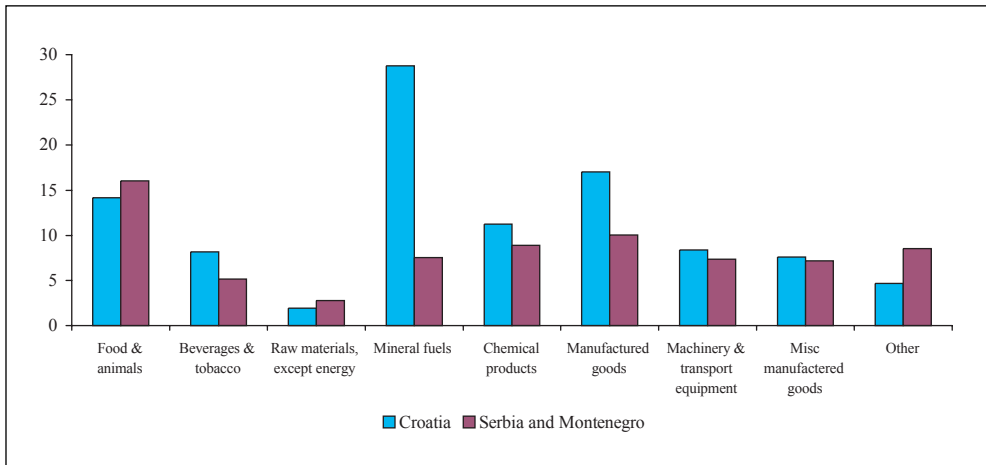


Note: 2006 data refer to the period January-October.

Source: Authors' calculations based on Central Bank BiH and Agency for Statistics of BiH data.

²⁰ Analysis of trade data for 2005 and 2006 is further complicated by the introduction of VAT in January 2006. This provided incentives for reporting imports in late 2005 and reporting exports in 2006. Thus, the comparability of data is affected by shifting (in timing) of actual trade flows and reporting and possibly also by registering part of exports that had earlier been in the grey economy.

Figure 6. Structure of BiH imports from Croatia and Serbia and Montenegro, SITC classification

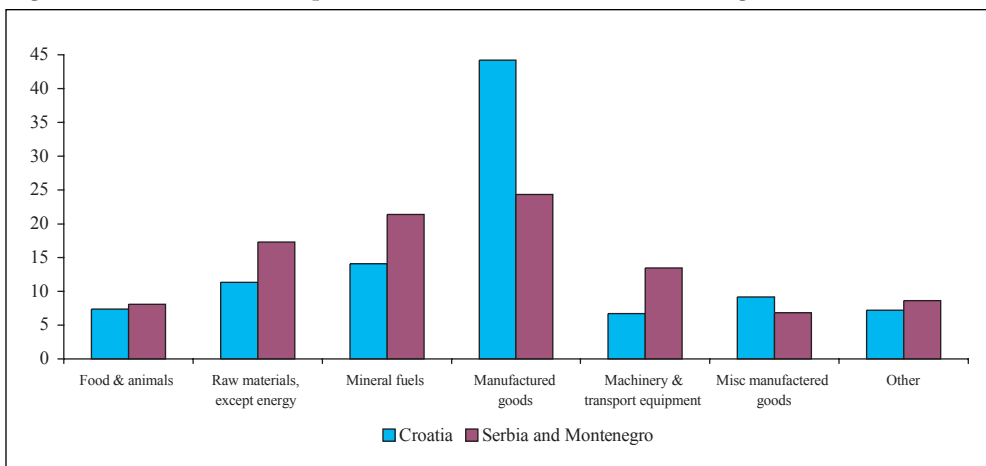


Note: % share in total imports from respective country

Source: BiH Agency for Statistics, authors' calculations.

Exports to Croatia and Serbia and Montenegro are more concentrated on just a few product groups. The bulk of exports to Croatia are classified as various manufactured goods (over 40%), mostly aluminium and steel. Exports to Serbia and Montenegro are concentrated on wood and iron (various manufactured goods account for 24.3%) and mineral fuels (including electric power) 21.4%. Exports of agriculture products account for less than 10% of BiH's total exports to both Croatia and Serbia and Montenegro (see Figure 7).

Figure 7. Structure of BiH exports to Croatia and Serbia and Montenegro, SITC classification



Note: % share in total exports to respective country

Source: BiH Agency for Statistics, authors' calculations.

3.5. Summary

Since 1997, BiH has had a relatively liberal trade regime. However, the creation of its trade institutions has encountered several problems. The building of post-war government structures led to proliferation of entity legislation, institutions and practices disregarding the need for co-ordination between entities and the state and inter-entity relations. As a result, the existing foreign trade regime has had some peculiar features. Foreign trade laws and regulations are passed by the state, but until recently have been implemented by the entities, without clear monitoring of compliance. Until not so long ago there were two customs administrations, one for each entity, collecting custom duties which went to both budgets, leading to losses of public revenues, widespread smuggling and undervaluation in customs declarations. The State Border Service was created in 2000 and effective control of border crossings was established only in 2004. On a positive note, the unification of the customs administration in 2004 and creation of the state-level Indirect Taxation Authority (ITA) substantially improved conditions for foreign trade.

However, there are still substantial institutional impediments to foreign trade. Institutions and legislation dealing with technical regulations, conformity assessment, sanitary and phytosanitary and veterinary issues are generally not sufficiently developed. The prospect of negotiations with the EU on the Stabilisation and Association Agreement has helped to work out compromises and accelerated institutional reforms, although they have yet to be fully accomplished and bear fruit. An important obstacle is limited capacity to deal with complicated technical trade-related matters at the Ministry of Foreign Trade and Economic Relations and other relevant institutions.

Trade integration with SEE partners has been driven by the 2001 Stability Pact Memorandum of Understanding (MoU), which foresaw the conclusion of a series of bilateral agreements among the SEE countries (Albania, BiH, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, Moldova, Romania, Serbia and Montenegro, and more recently also UNMIK/Kosovo). BiH relatively quickly reached FTA agreements with all SEE countries. The country was able to secure asymmetrical treatment in implementation of FTAs with Croatia, Serbia and Montenegro and Macedonia, where BiH exports to these countries were immediately granted tariff-free access, while tariffs on imported goods were gradually reduced over 4 to 5 years.

Relative to other countries in the region BiH initially quite vigorously pursued an opening of its agricultural markets. However, BiH later unilaterally introduced protective measures on a few selected agricultural products (mainly milk and meat products) from Croatia and Serbia and Montenegro. This has caused some problems and has been continuously raised by BiH's trade partners, who point to the unilateral character of BiH's policies (dispute settlement mechanisms were not used, although

these were arguably not well defined in the FTAs) and to the fact that BiH has never presented convincing evidence to justify suspending of a few elements of the FTA. Following a last-minute compromise on the shape of CEFTA 2006, compared to other signatories, BiH will again be the country with probably the most liberalised market access for agricultural goods.

BiH is relatively open to foreign trade. In the past 10 years this was primarily driven by import volumes, but since 2003 export performance has improved considerably on the back of ongoing restructuring in certain sectors and FDI inflows. In 2002-2005, BiH recorded large trade deficits to the tune of 45% of GDP (less, if GDP figures are augmented to take into account the unregistered economy). Export growth is likely to continue since large investment projects, particularly in the metals industry (steel and aluminium) are underway and production levels in these sectors are expected to substantially increase in the next 2 years.

BiH exports are in practice limited to the EU market (around 55%) and SEE region (35-40%), i.e. the markets where BiH goods enjoy preferential access. Imports are somewhat more diversified as the share of non-EU and non-SEE countries is around 20%.

BiH's very narrow export base is an important problem exposing the country to volatility in international markets. Exports are largely concentrated on exploitation of natural resources and low-skill labour intensive goods. Base metals and metal products dominate in the export structure and their share has been growing recently. Agricultural products account for only a small fraction of exports (around 5-6%) and these products are almost entirely directed to the SEE market, since BiH does not have relevant institutions (SPS inspections) for agricultural exports to the EU.

4. Existing problems hampering full exploitation of BiH FTAs' potential

This chapter takes a closer look at BiH's trade. It aims to find the key determinants of BiH's trade flows and capture the effects of creating a network of regional FTAs on BiH's trade, by applying various analytical approaches. It starts with comparative advantages revealed in different product groups, then moves on to estimating BiH's trade equations and concludes with a qualitative analysis of non-tariff barriers to trade.

4.1. RCA indices

Conventional neo-classical trade theory argues that foreign trade happens mainly because countries have comparative advantages in production of particular goods or services. These comparative advantages are not directly observable (although in some instance may be guessed). However, one can use data on actual trade patterns to form measures of so-called revealed comparative advantages (RCA). RCA indices can indicate sectors and markets where BiH exports are more (or less) competitive in relation to the other trading partners present on a given destination market.

$$RCA_{ij} = \frac{x_{ik} / X_{it}}{m_{jk} / M_{jt}}$$

Where:

x_{ik} – the value of BiH's exports of products from the SITC section k to market j ,

X_{it} – the total value of BiH's exports to market j ,

m_{jk} – the value of imports of products from the SITC section k to market j (Croatia, Serbia, etc.),

M_{jt} – the total value of imports to market j .

In other words, the measure shows if for a given product category (and given destination country) its BiH export share is higher than the destination market import share (averaged across all of the trading partners on that destination market). RCA values of well above 1 may indicate BiH's comparative advantage revealed on a particular foreign market segment.

Table 7. RCA indices, 2005

SITC section	Croatia	Serbia	Slovenia	EU25
0 – Food and live animals	1.02	1.05	0.52	0.46
1 – Beverages and tobacco	2.39	0.13	0.13	0.10
2 – Crude materials, inedible, except fuels	5.55	4.08	4.44	6.05
3 – Mineral fuels, lubricants and related materials	0.93	1.47	0.09	0.06
4 – Animal and vegetable oils, fats and waxes	5.02	0.01	1.48	0.57
5 – Chemicals and related products, n.e.s.	0.19	0.37	0.08	0.24
6 – Manufactured goods, classified chiefly by material	2.32	1.31	1.01	1.79
7 – Machinery and transport equipment	0.20	0.32	1.07	0.66
8 – Miscellaneous manufactured articles	0.79	0.78	1.01	1.79
9 – Commodities n.e.c.	41.76	0.50	101.42	1.58

Note: RCA values above (below) 1 indicate revealed comparative (dis)advantage. EU25 includes Slovenia. High RCA values for SITC 9 category may suggest problems with classification of BiH exports to respective markets. Source: own calculations based on Central Bank of BiH and Statistical Office of the Republic of Serbia data.

The indices were obtained on the basis of historical data (2005) for BiH trade with its key trade partners: Croatia, Serbia, the EU25 and Slovenia, and for BiH partners' trade with the rest of the world. The level of aggregation is unusually high, due to the lack of more detailed data.

The above table reveals the strong comparative advantages of BiH's exports on all four markets in crude materials (SITC 2) and manufactured goods (SITC 6). Besides this, BiH also appears to have comparative advantages in animal and vegetable oils (SITC 4) on Croatian and Slovenian markets, in beverages and tobacco (SITC 1) on the Croatian market, in mineral fuels, lubricants and related materials (SITC 3) on the Serbian market, and in miscellaneous manufactured articles (SITC 8) on the EU25 and (to a lesser extent) Slovenian market. In some other sectors BiH's RCA is just above one, suggesting a slight comparative advantage. This applies to food and live animals (SITC 0) on Croatian and Serbian markets, as well as machinery and transport equipment (SITC 7) on the Slovenian market. RCA indices are also presented as charts in Annex 5.

One can see that, as opposed to trade with the EU, BiH reveals more diversified comparative advantages in trade with Croatia. This suggests that BiH's potential has started to be realised in exports to Croatia²¹. The falling BiH trade deficit with respect to Croatia in 2005 (see chapter 3) further supports this view. It is clearly not yet the case with Serbia.

²¹ It may also suggest complementarities in the partners' structures of production.

4.2. Determinants of BiH trade flows – a gravity model

Theoretical foundations

For a long time, the gravity model has been widely used for analyses of international trade flows. Gravity trade models draw analogy from physics and the Newton's theory of gravitation. Similarly to the Newton's equation, the gravity models tries to explain international trade flows by "economic mass" of countries and distance between them. The economic mass of a country is usually measured by a country's GDP and distance is measured as distance between capital cities, although other measures, particularly for distance variable, have also been used. Thus, the basic gravity model is expressed by the following equation:

$$TRADE_{ij} = \beta_0 \times \frac{GDP_i^{\beta_1} \times GDP_j^{\beta_2}}{D_{ij}}$$

Where β_0 , β_1 , β_2 are constants and D_{ij} denotes distance between two countries.

Empirical models often include additional variables into the basic model in order to capture influences of other factors that may promote or impede the international trade, beyond the effects of countries' GDPs and distance.

Although this model has a long ago proved its usefulness as an empirical tool for the analyses of international trade, many economists cast doubts on the theoretical justification of gravity specification. However, several works have brought the gravity model on very stable theoretical grounds²². The generalised versions of the model have proven the possibility to analyse theories of international trade beyond basic model's direct relation to geography and spatial issues, such as Heckscher-Ohlin's theory, Linder hypothesis and Helpman-Krugman hypothesis (Helpman and Krugman, 1985, p. 167).

Data and methodology

The availability and quality of BiH economic data from local sources is a well-known problem. Therefore we have had to rely mainly on data from external sources. The main source of data was the IMF, with its DOTS and IFS databases. Data on trade flows, GDP, GDP per capita and population were collected from these sources. Some data missing in these databases were collected from other sources. Details can be found in Annex 4.

²² See, for example, Anderson (1979).

Data for Serbia and Montenegro were only available at the aggregate level of this federal country, even though the economies of two member states, Serbia and Montenegro, have been separated since 1999 when border check points were established on the internal border. Furthermore, Montenegro has not recognised the Serbian dinar and uses the euro as legal tender. Quite literally, all monetary and fiscal policies were run separately in the two member states. Therefore, the drawback of this type of analysis was that it considered these two countries as one, while considering them as two separate countries would be much closer to reality. The most striking example are values on exchange rate variability, where the variability between BiH and Serbia was significant during the analysed period, and the same values for Montenegro were zero for most of the period (all years, except 1998). Due to the data availability, we were not able to overcome this problem, which is why we are just mentioning it here as a weakness of the analysis that readers of this report should be aware of. We believe that this drawback does not significantly impinge on our final results.

The availability of data has a key influence on our choice of time span for conducting this analysis. In order to have balanced panel data we were forced to choose a list of 33 partner countries and an eight-year period, between 1998 and 2005. These 33 countries accounted for 93% of BiH's exports and 96% of BiH's imports during the period under consideration, so that they may be considered as representative for almost all of BiH's trade flows.

The basic gravity model posits that the chief determinants of international trade are supply/demand conditions in the analysed countries involved and the distances between them. There is a vast range of empirical models, using different variables to capture the influences of supply/demand conditions of countries. Most of these models capture these influences using two variables, one for "economic mass" and the other for income differences. As a proxy for the "economic mass", we have considered several possible solutions. One is GDP, as in the basic gravity model, and other is a product of BiH's and its partner countries' GDP, as proposed by Xhepa and Agolli (2004). We considered the following proxies for income differences: GDP per capita, absolute differences between BiH's and partner countries' GDPs per capita, as suggested in a paper by Pugh and Tyrrall (1999), and a so-called similarity index comparing two countries' GDPs.

We have tested three specifications with different combinations of variables for supply/demand factors affecting international trade. The first uses GDP as the only variable for these effects, as proposed in the basic gravity equation. The second incorporates two variables, GDP and the Linder effect variable (the absolute difference of two countries' GDPs per capita), after Pugh and Tyrrall (1999). The third uses the product of the two countries' GDPs and a similarity index, as in Xhepa and Agolli (2004). Analysis of formal and informal diagnostics tests carried out on these different

specifications revealed that the gravity model with products of GDPs and similarity index variables as proxies for the calculation of the “economic mass” and income differences is the most appropriate for the purpose of our analysis²³. The model is:

$$Y_{ijt} = \beta_0 + \beta_1 Y_{ij(t-1)} + \beta_2 GDP_{it} GDP_{jt} + \beta_3 SIM_{ijt} + \beta_4 DIST_{ij} + \beta_5 TRijt + \sum_{k=1}^k \beta_k DV_{kijt}$$

Where:

i = Bosnia and Herzegovina,

j = 1, 2, ... 33 – partner country,

t = 1998, 1999, ... 2005 – year

Y_{ijt} – the value of exports (imports) from BiH to partner country j in year t , in million US\$,

$GDP_{it} GDP_{jt}$ – the product of GDPs of BiH and partner country j in year t ,

SIM_{ijt} – similarity index,

$DIST_{ij}$ – the distance between Sarajevo and a partner country's j capital city, in kilometres,

$TRijt$ – trade resistance measure (volatility of bilateral exchange rate),

$\sum_{k=1}^k DV_{kijt}$ – the set of dummy variables, $k = 1, 2, \dots 4$.

The model is defined in a log-linear form, which means that values of all quantitative variables, except similarity index and trade resistance variables²⁴, were transformed into natural logarithms.

Apart from variables capturing economic mass and the distance between trading partners, we followed the empirical literature in including several other variables commonly found to play a significant role in explaining trade patterns (Oguledo and MacPhee, 1994; Thursby and Thursby, 1987) Firstly, trade patterns exhibit significant persistence over time, thus we include the lagged dependent variable in the model.

The similarity index is used to measure the similarity between two countries in terms of their GDPs. The rationale behind the inclusion of such variables may be found in Helpman and Krugman (1985), who found that countries with similar levels of income tend to trade more (the so-called Helpman-Krugman hypothesis; see also Helpman 1987, Feenstra 2004, p. 147.). The formula used for the index is:

²³ Detailed results of specification and diagnostics tests are available on request.

²⁴ The values of these variables were already transformed into logarithms by the original equation.

$$SIM_{ijt} = \log \left[1 - \left(\frac{GDP_{it}}{GDP_{it} + GDP_{jt}} \right)^2 - \left(\frac{GDP_{jt}}{GDP_{it} + GDP_{jt}} \right)^2 \right]$$

The similarity index gives better results when used at the disaggregated level (i.e. for sectors, with definitions of sectors matching trade data). Unfortunately, this is not feasible for BiH, so we rely on an aggregate index comparing the size of partner countries' economies. The index (in its log form) ranges from minus infinity to log (0.5), taking a value of log (0.5) for countries with equal GDPs, and declining to minus infinity with an increasing difference in GDP levels.

The trade resistance variable captures the effects of the variability between the two countries' exchange rates on their trade values and it is calculated as 1+ standard deviation of difference between the actual and previous month's logged values of exchange rates (Tenreyro, 2006). Existing literature on the effects of exchange rate variability on trade affords mixed results (Thursby and Thursby, 1987; Rose, 2000; Baldwin, 2005; Tenreyro, 2006). Hence, the sign of the trade resistance variable cannot be predicted. Pugh and Tyrrall (1999) argue that the actual effects of the variations in bilateral exchange rates on trade flows depend mainly on the degree of risk aversion among business people in those countries.

Additionally the model includes a set of four dummy variables on the countries' characteristics that are typically found highly relevant determination of foreign trade flows. These are dummy variables for countries that were, together with BiH, members of Yugoslav Federation (EXYUDV), dummy for EU member states (EUDV), dummy for countries sharing a common border and language with BiH (COMDV)²⁵, and dummy for countries that have signed free trade agreements with BiH (FTADV). The variable EXYUDV should capture effect of the "path-dependency" for these countries, which were members of the same country (Yugoslavia) for 70 years and it is clear that some trade linkages still remain (Gligorov, 2001).

The dummy variable for FTAs, which will be of key interest from the perspective of this report, was created by assigning the value of 1 to pairs of countries that signed bilateral FTAs in the year after it was implemented (the implementation year in the case of the BiH - Croatia agreement which entered into force in February) and subsequent years. We have not assigned a value of 1 for the years when agreements were entering into force to take into account the fact that many of these agreements actually lowered trade barriers gradually rather than immediately. Also, the implementation of some agreements started in the middle of a calendar year rather

²⁵ In our case, common border and common language effect were presented by the same dummy, since the countries sharing these characteristics with BiH are the same ones, namely Croatia and Serbia and Montenegro. Inclusion of two separate dummies into equation would cause perfect multicollinearity problem.

than at the beginning. We believe that our approach to the creation of FTA dummies stands good chances of capturing the effects of FTA agreements. However, some of the agreements were implemented asymmetrically (e. g. export liberalised faster than imports), which could have created effects on BiH imports and exports at different times. Therefore, additional set of dummies were created: separate for import and export. They have values of 1 in the years where the majority of tariffs on BiH import/export were already freed (in some cases, lowering of tariffs took quite a few years), and values of 0 otherwise (prior to liberalisation). The equations including these FTA dummies are included below, denoted as “model 5”. As can be seen in the following section, they do not change the results, when compared with a single FTA dummy, being an average for lowering of tariffs on both import and export.

Following the model specification, various choices were needed on the estimation approach. Diagnostic tests (reported in Annex 6) strongly suggested that one-way models were preferred over two-way models and OLS. Regarding the choice between fixed and random effects models, we could not rely on the Hausman test since the difference between variance matrices was not positively defined. Therefore, following the suggestion of Greene (2002b; E8-47), we opted for a random effects model.

Estimation results

Export equation

In order to ensure the robustness of the analysis we carried out estimations for 4 specifications of the model, with the first specification using only one dummy variable for FTA, and subsequent specifications introducing other dummies. Thus, the fourth (most comprehensive) of the estimated models looked as follows:

Model 4:

$$EXPORT_{ijt} = \beta_0 + \beta_1 LAGEXP_{ij(t-1)} + \beta_2 GDP_{it} GDP_{jt} + \beta_3 SIM_{ijt} + \beta_4 DIST_{ij} + \beta_5 FTADV_{ijt} + \beta_6 EXYUDV_{ij} + \beta_7 EUDV_{ijt} + \beta_8 COMDV_{ij} + u_{ijt}$$

Where $EXPORT_{ijt}$ denotes aggregate BiH exports to country j at time t .

The point estimates for values of coefficients for all four models, along with indication of their statistical significance levels, are presented in Table 8.

The signs and magnitudes of the coefficient estimates are consistent with the underlying theory of gravity models in international trade. The results remain very similar in all four models, so we can say that our model is robust in that sense. The regressors included are jointly significant and explain around 86 % of total variation of the dependent variable.

As we can see from the table, the product of GDPs and distance variables retain their signs and statistical significance throughout these different specifications of model. The range of point estimates for GDP product is between 0.428 and 0.523. The interpretation can be that *ceteris paribus*, a 1% increase of the product of GDPs of partner countries raises BiH's exports to a partner country by around 0.5%, on average.

The impact of distance to destination markets on BiH's exports is, as expected, strongly negative. A 1% increase in distance is associated with around a 1% decline in BiH's exports to the market, *ceteris paribus*. This is typically explained by transportation and other transaction costs, that can increase with distance as well as the availability and ease of exchange of information between potential exporters and importers. This is also the usual value of distance coefficient often found in gravity equations.

The statistically significant and negative coefficient on trade resistance variable measured by the volatility of exchange rates confirms the role of exchange rate variability in deterring BiH exports. Indirectly, this result may be taken as a (weak) indication that the current foreign exchange rate regime serves the BiH export sector well (any other exchange rate regime would likely result in larger average volatility of exchange rates *vis-à-vis* the main trading partners).

Among all dummy variables, it is only the variable for former member states of the Yugoslav Federation that emerges as statistically significant (positive) throughout all models. This confirms our hypothesis that strong trade relations among countries of former Yugoslavia positively affect BiH's exports beyond the effects explained by GDPs and geographic proximity.

The estimate of the coefficient on the FTA dummy (and FTA export dummy as in model 5), of key interest from the perspective of this report, is not statistically different from zero in all specifications. This suggests that FTAs have not (yet) played a role in boosting BiH's exports to countries with which agreements have been signed. There are a few caveats which need to be added to the interpretation. Firstly, FTA agreements are relatively new and their impact on trade flows may take longer to materialise. Secondly, it may well be that some of the FTAs might have been effective in reducing trade barriers for BiH exports while other agreements (for reasons related to their design and / or implementation) have not played such a role.

Interestingly, EU markets do not seem to be better penetrated by BiH's exports beyond the impact of other variables included in our gravity model. This is despite the abolition of customs duties on BiH's exports (autonomous trade preferences since 2000). The explanation may lie in non-tariff barriers in EU markets or it may be that eased market access takes some time to translate into higher BiH export flows (a similar mechanism that we discussed in the case of FTA functioning). Part of this (although limited, given BiH's supply-side constraints) may also be due to the lack of access to the EU market for BiH's agricultural products.

Table 8. Results of REM estimation of BiH export equations, 1998-2005

Variable	Model 1	Model 2	Model 3	Model 4	Model 5
Constant	2.533*** (0.503)	1.759*** (0.469)	1.875*** (0.483)	1.846*** (0.478)	1.855*** (0.479)
LAGEXP	0.582*** (0.048)	0.507*** (0.053)	0.501*** (0.053)	0.497*** (0.054)	0.507*** (0.054)
GDPiGDPj	0.428*** (0.106)	0.523*** (0.107)	0.497*** (0.110)	0.487*** (0.110)	0.488*** (0.113)
SIMIND	-0.021 (0.140)	-0.060 (0.132)	-0.063 (0.132)	-0.075 (0.132)	-0.067 (0.133)
DIST	-1.150*** (0.199)	-1.002*** (0.181)	-1.031*** (0.184)	-1.017*** (0.182)	-1.019*** (0.184)
TR	-2.489*** (0.890)	-2.437*** (0.884)	-2.408*** (0.884)	-2.452*** (0.886)	-2.383*** (0.888)
FTADV	0.080 (0.114)	0.032 (0.114)	0.051 (0.115)	0.051 (0.115)	0.055 (0.101)
EXYUDV		0.611*** (0.148)	0.615*** (0.148)	0.526*** (0.164)	0.593*** (0.153)
EUDV			0.081 (0.077)	0.088 (0.076)	0.085 (0.077)
COMDV				0.208 (0.183)	
R²	0.859	0.869	0.869	0.900	0.899
Adj. R²	0.856	0.865	0.865	0.878	0.878
F stats	226.94 (.0000)	209.94 (.0000)	183.98 (.0000)	41.07 (.0000)	42.14 (.0000)
Autocorr. ρ'	0.077	0.077	0.072	0.072	0.071
No. of observations	229	229	229	229	229

Note:

Standard errors are in parentheses

*** Statistically significant at 1 % level

¹ The rule of thumb is that value of $\rho < 0.3$ indicates that there is not serious problem with autocorrelation in the model. The value obtained from the Durbin – Watson d- based test for autocorrelation. Calculated by the following formula: $\rho = 1 - DW/2$.

Model 5 includes different formulation of FTADV (which takes into account asymmetry in implementation of regional FTAs).

Source: Own calculations.

As could have been expected, the inclusion of a dummy variable for countries that share a common border and language with BiH, along with dummy variable for ex-Yugoslav countries, leads to a problem of near multi-collinearity. Among the ex-Yugoslavia and common border & language dummies we opt to keep the ex-Yugoslavia dummy as ex-Yugoslavia had a common official language that is still fluently understood and spoken by the majority of the population in all ex-Yugoslavia countries. Thus, model 3 can be taken as our preferred specification.

Import equation

Identical models were estimated for BiH imports from its partner countries. The results are summarised in Tabale 9.

Table 9. Results of REM estimation of import equations, 1998-2005

Variable	Model 1	Model 2	Model 3	Model 4	Model 5
Constant	1.459 (0.377)	0.254 (0.238)	0.904 (0.397)	0.901 (0.399)	0.899** (0.396)
LAGIMP	0.741*** (0.034)	0.894*** (0.029)	0.684*** (0.038)	0.684*** (0.038)	0.686*** (0.038)
GDPiGDPj	0.271*** (0.060)	0.153** (0.064)	0.370*** (0.067)	0.370*** (0.067)	0.355*** (0.067)
SIMIND	0.023 (0.084)	0.074 (0.071)	-0.009 (0.085)	-0.009 (0.085)	-0.025 (0.086)
DIST	-0.610*** (0.144)	-0.143 (0.092)	-0.503*** (0.144)	-0.502*** (0.145)	-0.495*** (0.144)
TR	-0.107 (0.455)	-0.162 (0.543)	-0.031 (0.457)	-0.031 (0.458)	0.005 (0.457)
FTADV	0.064 (0.059)	0.050 (0.070)	0.020 (0.061)	0.021 (0.061)	0.065 (0.062)
EXYUDV		0.105 (0.072)	0.404*** (0.188)	0.399*** (0.136)	0.395*** (0.118)
EUDV			-0.098* (0.050)	-0.098* (0.050)	-0.093* (0.050)
COMDV				0.010 (0.154)	
R²	0.953	0.954	0.954	0.954	0.975
Adj. R²	0.952	0.952	0.952	0.952	0.970
F stats	762.55 (.0000)	657.24 (.0000)	577.90 (.0000)	511.42 (.0000)	185.34 (.0000)
Autocorr. ρ^1	-0.137	-0.137	-0.139	-0.139	-0.137
No. of observations	229	229	229	229	229

Note:

Standard errors are in parentheses

*** Statistically significant at 1 % level

** Statistically significant at 5 % level

* Statistically significant at 10 % level

¹ The rule of thumb is that value of $\rho < 0.3$ indicates that there is no serious problem with autocorrelation in the model. The value obtained from the Durbin – Watson d- based test for autocorrelation. Calculated by the following formula: $\rho = 1 - DW/2$.

Model 5 includes different formulation of FTADV (which takes into account asymmetry in implementation of regional FTAs).

Source: Own calculations.

Again, the signs of the obtained coefficients are consistent with the underlying theory of gravity models. The key results remain broadly unchanged in all 4 specifications, so we can say that our model is robust in that sense. The regressors included are jointly significant and explain around 95 % of the total variation of BiH's imports²⁶.

Generally, our interpretation of the results for the export equation can also be applied in the case of the import equation. Economic mass and distance between partner countries do indeed appear as important determinants of BiH's imports. The

²⁶ We recognise that this value is higher than could be expected. It may suggest some problems within the model. Unfortunately, diagnostics tests for panel data analyses are still not well enough developed to allow proper identification of the problem that causes such a high value of R².

only difference between the export and import equations is that values of coefficients on lagged dependent variables are higher, and on GDPs and distance lower in the import equation. This suggests that imports may be more persistent and that economic mass and particularly distance of import markets appear to play a smaller role in explaining BiH imports that was the case for BiH exports.

The estimated coefficient on the FTA dummy variable is again very small and not significantly different from zero in all model specifications (including the one with more precise construction of import FTA dummy; model 5). Again, this result may possibly be explained by the short time that passed since the FTAs implementation.

Interestingly, the EU appears to be (slightly) underrepresented among BiH import markets, as suggested by the negative sign of the coefficients on the EU dummy variable. In contrast, strong linkages with ex-Yugoslav countries are also confirmed in the import equation.

Potential trade

The gravity equation for BiH trade estimated above allows calculating “normal” or “potential” levels of trade, i.e. levels that are predicted by the model. From this one can compare the difference between these predicted and actual trade values to identify the scope of potential trade gains. This type of analysis has been widely used in many contexts for both developed and developing countries.

For both export and import equations a third (“preferred”) specification was employed²⁷. All the coefficients from this specification were used for calculating the potential values²⁸. For ease of interpretation the results are presented in Tables 10 and 11 as ratios of actual over potential trade values. Only FTA signatories and selected other most important trade partners are shown for the ease of exposition. A ratio of around 1 indicates that the gravity model has closely predicted values of trade in a particular year and for a particular partner country. Ratios above 1 indicate “over-performance”, i.e. actual trade flows exceeding those predicted by the model. Similarly, ratios below 1 indicate under-performance.

There is one caveat related to our approach to calculating potential trade. The gravity equation on which it is based was calculated only for BiH trade with other countries and not for all bilateral flows within a group of analysed countries. This implies that over- and under-performance is a relative concept, i.e. we can only observe that BiH trade with one country is relatively higher than with some other country. By

²⁷ Primarily for the reason that statistics between the third and the fourth specifications were comparable, and adding a common border/language dummy (in the fourth specification), did not add any statistically significant information. Neither alternative FTA dummy (specification 5) did it.

²⁸ These were variables LAGEXP (or LAGIMP), GDPiGDPj, SIMIND, DIST, TR, FTADV, EXYUDV and EUDV.

construction, BiH is on average trading at its potential in this specification. Thus, we cannot use these results to see how far is BiH from potential trade with its partners relative to, for example, how far Croatia is from its potential trade.

Table 10. Actual and potential BiH exports, 1999-2005

Importer	1999	2000	2001	2002	2003	2004	2005
ALBANIA	0.45	0.73	0.54	1.41	1.03	0.96	0.87
BULGARIA	0.84	1.08	0.86	0.93	0.69	0.77	0.71
CROATIA	0.98	0.89	1.18	1.14	1.17	1.24	1.17
GERMANY	1.00	1.02	1.11	1.00	1.19	1.21	1.03
ITALY	1.03	1.09	1.03	1.05	1.02	0.92	0.95
MACEDONIA	0.95	0.75	0.74	0.78	0.77	0.75	0.73
MOLDOVA	-	-	0.50	1.77	1.31	1.26	1.89
ROMANIA	1.13	1.65	1.25	0.39	0.68	2.70	1.30
SERBIA & MONTENEGRO	0.96	1.44	1.42	1.07	0.94	0.99	1.04
SLOVENIA	1.03	1.05	1.05	1.01	0.98	0.93	1.38
TURKEY	1.81	1.01	1.10	1.24	1.18	1.10	1.09

Note: Shaded cells present data for years after a particular agreement with BiH entered into force (the same years used for creation of an FTA dummy). Values are ratios of actual over potential exports. Values above (below) 1 indicate that in a particular year BiH exports to a given country exceeded (were below) levels predicted by the model.

Source: Own calculations.

The results for export potential suggest that we can divide BiH's partner countries into three groups. The first group comprises countries to which BiH has constantly "over-performed" in exports, that is it has exported more than would be predicted by the gravity model. The group is comprised of Germany and Turkey for the whole period, but also Slovenia, Croatia, Moldova and Romania for most of the years under consideration. The second group of countries that absorbed much less BiH exports than predicted by the

Table 11. Actual and potential BiH imports, 1999-2005

Row Labels	1999	2000	2001	2002	2003	2004	2005
ALBANIA	-	0.20	1.15	0.59	0.43	0.54	0.51
BULGARIA	1.01	1.09	1.10	1.04	0.94	1.04	0.97
CROATIA	1.01	1.02	1.12	1.14	1.13	1.09	1.09
GERMANY	1.02	1.02	1.08	1.08	1.04	1.07	1.01
ITALY	0.96	0.99	1.00	0.99	0.94	0.92	0.92
MACEDONIA	0.91	1.00	0.81	0.90	0.91	0.90	0.86
MOLDOVA	-	0.62	2.25	1.80	0.95	0.57	1.28
ROMANIA	0.93	1.08	0.99	1.04	0.99	1.31	1.09
SERBIA & MONTENEGRO	0.70	0.98	1.00	1.03	0.89	1.01	0.95
SLOVENIA	1.11	1.12	1.10	1.13	1.04	1.20	1.07
TURKEY	1.08	0.89	1.06	1.22	1.16	1.16	1.06

Note: Shaded cells present data for years after a particular agreement with BiH entered into force (the same years used for creation of an FTA dummy). Values are ratios of actual over potential exports. Values above (below) 1 indicate that in a particular year BiH imports from a given country exceeded (were below) levels predicted by the model.

Source: Own calculations.

model is comprised of Macedonia, Albania and Bulgaria. BiH exports to other countries do not reveal any clear trend of either relative “over-“ or “under-performance”.

A similar grouping can be done for BiH’s imports. The first group of countries that “over-perform” in the BiH market includes Croatia, Germany, Slovenia and Turkey. Albania, Italy and Macedonia can be described as relative underperformers.

The tables also allow for a visual inspection of developments around the dates when FTAs were implemented. Comparison of pre-FTA and FTA periods (shaded cells) does not reveal any clear patterns. Countries which tended to over- or under-perform usually stay in the same group after FTA implementation. The only exception seem to be BiH export to Croatia, which tend to over perform after implementation of the FTA. Among FTA countries’ trade flows with Albania and Macedonia (in the case of exports also Bulgaria) are below potential suggesting existence of some other barriers in relations with these countries but also the possibility for improvement once the barriers are eased.

4.3. Estimates of trade creation, trade diversion and trade deflection effects

Estimation of possible trade diversion and trade creation effects is a natural step that one would want to carry out in a study like this. However, in the case of BiH it proved difficult to assess these effects given the lack of sufficient trade volume data needed to calculate unit values, i.e. the prices of BiH’s trade flows. Moreover, trade data broken down both by commodity and partner country have existed only since 2005, which makes comparisons with pre-FTA periods impossible. Finally, the introduction of VAT in January 2006 was a major policy change affecting incentives to declare exports and imports, which resulted in a significant increase in the declared value of exported goods. It affected trade data for 2005 and 2006, thus making a comparison doubtful (see also section 3.4 of this report). Nevertheless, below we speculate on the possibility of trade creation and trade diversion effects on the basis of available evidence.

Trade creation

Trade creation occurs when – after lifting customs duties – cheaper imports replace more expensive domestic production. Looking from another perspective, it takes place when exports to a partner country are boosted, as domestically manufactured goods become less expensive on a partner’s market. This may be accompanied by so-called trade expansion, where falling prices lead to higher demand.

It is difficult to estimate the extent of trade creation resulting from the implementation of regional FTAs, due to the lack of price / volume data²⁹. What one can do, however, is to check whether demand for BiH exports increased in the SEE region and whether demand for imports from the FTA countries increased in BiH. Indeed, we can see that exports to the region³⁰ substantially increased during 2004-2006. As a result, the share of FTA countries in total BiH exports rose from 36% in 2003 to 39% in 2005. Although the demand for regional imports in BiH was a bit less dynamic, it also grew (and its values were higher; there is still a trade deficit in regional trade, see chapter 3 for details). In effect, the share of the FTA region in total BiH imports increased from 33% in 2003 to 36% in 2005. Increasing regional trade played some role in raising BiH's export/import ratio³¹. In the first 3 quarters of 2006, however, while exports to regional markets continued to expand by above 20% (particularly to Serbia and Montenegro), they somewhat lagged behind exports to the EU, leading to a decline in the share of SEE in total exports. One would need to wait for more data to find out whether this trend will continue or whether it was linked to other factors.

Summing up, there are grounds to believe that some expansion occurred with respect to BiH's trade with its FTA partner countries, which was rapidly growing after FTA introduction. However, lack of price (volume) data makes the estimate of trade creation somewhat difficult for the time being.

Trade diversion

In the context of this paper, trade diversion can be of particular significance to BiH's imports. This is because BiH has a huge trade deficit and about half of this deficit is due to trade with its SEE partners³². The danger of diversion of imports lies in the possibility of importing goods produced more expensively in other SEE countries (parties to BiH's bilateral FTAs) and not subject to customs duties, rather than cheaper products from the rest of the world burdened with tariffs. Theoretically, this possibility could have occurred due to the phasing out of tariffs on imports from the FTA region, with unchanged protection towards third parties.

Trade diversion can be expected if BiH's imports from third countries (in some sectors) are similar to BiH imports from any of the SEE countries and when tariff barriers towards third countries are relatively high (see e.g. Finger and Kreinin,

²⁹ If imports from FTA markets were an important part of domestic consumption of some goods one could look at domestic prices. However, the high level of data aggregation and use of incompatible trade and economic activity classifications for external trade and domestic production makes such a comparison impossible.

³⁰ Albania, Bulgaria, Croatia, Macedonia, Romania, Serbia and Montenegro

³¹ Such an approach to trade creation effects was carried out e.g. in early analyses of the European Community, e.g. Balassa (1974).

³² About 50% of the overall BiH trade deficit in 2005 was in trade with the FTA partners.

1979). The first of these factors can be analysed using the similarity index for imports, comparing the structure of BiH's imports from a given partner country, p , with those of any other supplier of imports to the BiH market, j ,

$$S_{pj} = \sum_{i=1}^n \text{Min}(w_{pi}, w_{ji}) * 100$$

where w_{pi} is the share of product i in total BiH imports from a given SEE partner country p , and w_{ji} is the share of the same product in BiH's imports from country j . Table 12 presents the indices calculated for four FTA partner countries (including the two main partners – Croatia and Serbia and Montenegro) relative to 3 other regions that are relatively important sources of BiH's imports: EU25 (over 50% of BiH imports in 2005), Russia (3% of BiH imports in 2005), and Turkey (3% of BiH imports in 2005)³³.

Table 12. Similarity indices of BiH imports from some FTA countries, 2005

FTA partner	relative to BiH imports from EU25	relative to BiH imports from Russia	relative to BiH imports from Turkey
CROATIA	66	46	56
SERBIA & MONTENEGRO	68	28	63
MACEDONIA	57	13	42
ALBANIA	61	28	54

Note: Indices range from 1 to 100. Higher number represents more similar product structure. Calculations were done at SITC section level (1-digit).

Source: Own calculations based on data from Agency for Statistics of BiH.

Similarity indices for BiH's 2005 imports show that there is little possibility for diversion of imports away from Macedonia (and perhaps Albania). Overall, small import values from both partners (which are also confirmed by the gravity model described in section 4.2) suggest that there is still a lot of unused potential for boosting imports to BiH from these two countries.

It would appear that slightly higher chances for trade diversion exist in relation to BiH's trade with Serbia and Montenegro and Croatia. The structure of BiH's imports from these countries seems to resemble the structure of imports from the EU25 and (to a lesser extent) Turkey, which as of 2005 were still protected by MFN custom duties³⁴. However, one should be very careful drawing such a conclusion, as the calculations were made at a quite aggregated level. Particular categories are broad and may include products that are not similar. Calculations of similarity indices at a much lower level of aggregation would be needed to confirm the results.

³³ The criterion was that a comparator should not be a partner in the Stability Pact for SEE, but should be a significant source of BiH imports.

³⁴ BiH's import tariffs for Turkey were liberalised in 65% in 2005. The elimination of tariffs on Turkish goods entering the BiH market is scheduled for 2007.

The relative similarity of BiH's imports from Croatia to BiH imports from Russia comes from the fact that mineral resources have been bought from these two sources.

There are also various other reasons that incline us towards scepticism as to the probability of trade diversion effects playing any significant role. Firstly, imports from Serbia, Montenegro and Croatia on one hand and the EU on the other – even if falling into similar categories of classification of goods – are probably of different type and quality when it comes to individual products. Moreover, this difference will likely persist for the few years. Secondly, BiH will soon fully liberalise its imports from Turkey (actually, the FTA agreement foresees this already in 2007) and in a few years also with imports from the EU, so that any incentives to divert imports from these two partners will disappear. Finally, the level of BiH's MFN tariffs is already now rather low, making trade diversion forces rather weak.

One may also see the possibility of diverting BiH exports too much to the FTA region, as a result of eliminating tariffs. In the future the BiH economy may be negatively affected if by the time its FTA partners open up their markets for imports from third countries BiH producers have not restructured and adjusted their businesses to gain international competitiveness. In other words, the danger of too much exports diverted toward the SEE region would be translated into a lack of motivation to restructure. However, one important precondition for this to happen is that BiH exports react to the implementation of the regional FTAs. The estimates of the determinants of BiH exports in 1999-2005 (see section 4.2 of this report) show that this has not yet been the case. Therefore, so far there are no grounds to believe that BiH's exports have been artificially diverted to the region.

Summing up, we do not see reasons to expect trade diversion effects resulting from implementation of regional FTAs of any magnitude that could harm the BiH economy.

Trade deflection

Trade deflection can arise when in the absence of effectively implemented rules of origin the country with the lowest external tariffs is likely to serve as an entry point into its partner's market (with higher tariffs) for the goods originating in non-member countries.

When analysing possibilities for trade deflection, it is worth looking at tariff protection of FTA partners from the third countries. Firstly, it is already clear from the discussion in chapter 3 of this report that other SEE trade partners have higher protection of agricultural trade than BiH (see also Annex 4). Therefore, it is very unlikely to expect agricultural imports from third countries to reach the BiH market duty-free through its SEE trading partners, due to weakly implemented rules of origin.

However, such an option appears somewhat more feasible in the case of manufacturing imports. The data on average manufacturing tariff rates from 2002³⁵ (see Annex 4) suggest that Croatia, Serbia and Montenegro and Moldova could theoretically serve as possible entry points for industrial goods. These three FTA partners had lower average tariff protection for manufacturing goods imported from third countries. High transportation costs would likely make the procedure of duty-free imports through Moldova prohibitively expensive. Therefore, the only important import sources that could have served as entry points remain Croatia and Serbia and Montenegro. Looking at the average third country import tariffs for industrial goods, this could be more important for imports from Croatia³⁶.

Indeed, there have been claims from BiH market participants and BiH government representatives that specific third-country products were entering the BiH market through Croatia duty-free (oil, beer, see Annex 10). However, so far the BiH government has presented no convincing evidence of the violation of rules of origin.

What is more probable is that BiH sometimes serves as an entry point for duty-free third party imports. Even looking at BiH's average MFN tariff one can think of several potentially profitable possibilities (see Annex 4). Moreover, there have been claims from some of BiH's FTA partners (Macedonia, Croatia, Serbia, see Appendix 10) that BiH origin certificates are faked. In addition, one of the interviewed BiH market players admitted exporting to a final destination via another country precisely to avoid specific protection measures that the destination country was applying on goods from BiH. Taking into account the relative low level of institutional development and relatively high corruption in BiH (even relative to the regional average, see also section on rules of origin in part 4.4 of this report), it would be more probable to expect trade deflection to occur with BiH being the regional entry point.

Anyway, it is hard to gather convincing evidence based only on the average tariff rates and a limited number of interviews. To address the issue properly one would need to carry out a large number of interviews with exporters from all the countries concerned. However, it seems rather logical to expect that if trade deflection occurs in the region BiH is more likely to be a convenient point of entry and less a 'victim' of trade deflection, i.e. a country importing 'rest of the world' production with no tariffs through the FTA partners.

³⁵ Tariffs have remained broadly stable since then.

³⁶ Serbia and Montenegro at various stages ran different tariff policies and then harmonised their tariffs, bringing the average common tariff rate for industrial products to between 5% and 6%. This was relatively close to the BiH tariff (about 6.7% in 2005), which makes the profitability of faking rules of origin low, on average. After the break-up in 2006, Serbia and Montenegro started to run independent trade policies.

4.4. Non-tariff barriers to trade (NTB)

This section relies heavily on the opinions of stakeholders from BiH. For the purpose of this report, the research team carried out in-depth interviews with 8 BiH companies involved in foreign trade operations with the use of a structured questionnaire (see Annex 7). The questions covered licensing, quotas, additional levies on trade, technical regulations and standards, sanitary and phytosanitary measures, issues connected with rules of origin, functioning of customs services and any other policy measures affecting trade. While drafting the questionnaire, existing methodologies and results of the studies conducted so far for BiH were used as a starting point (for the latter, see for example Causevic 2006, SP Trade Working Group, 2005). The reader is directed to Annex 8 for more detailed information.

As popular opinion on the 'ineffectiveness' of the regional network of FTAs is that the agreements have not facilitated trade, and as BiH has a large trade deficit, the focus was on interviewing exporters. Out of 8 companies, 6 exported to the FTA countries and 2 to the EU (but considered selling also to the SEE region). The companies were mostly private (5, of which 3 had foreign ownership), 1 was state-owned and two had a mixed form of ownership (private and state capital). Some of them imported some inputs from the EU or SEE region. The firms were differentiated in size: 2 were very large (3,000 workers), 4 were of 'medium' size (140-500 workers), and 2 were small (50 workers). They were also chosen to represent various manufacturing sectors. The selection criteria required that companies should be either large exporters, producing commodities that have a significant share of BiH's total exports or/and having large export potential. This resulted in a sample of enterprises producing the following commodities: metals, car parts, wood, furniture, paper, and pharmaceuticals³⁷.

In addition to interviews with the enterprises, the research team interviewed representatives of business associations (the Foreign Trade Chamber, BiH Associations of Employers), representatives of the BiH government and central administration (Ministry of Foreign Trade and Economic Relations, the Central Bank of BiH, Indirect Tax Authority, Export Credit Agency – IGA), advisory/technical assistance programmes/business development agencies (IMF, EU TDI – EU Capacity Building Initiative for Trade Development and FDI Attraction to BiH, EU programme for technical assistance in custom and fiscal issues – CAFAO), and analysts and researchers (Economics Institute Sarajevo, Faculty of Economics in Sarajevo, EPPU). The other stake-holders were also interviewed with the use of the structured questionnaire, whenever it was rational and possible to do so.

³⁷ The authors of this report are aware that the sectors differ with respect to regulations. The pharmaceuticals industry, in particular, is expected to be the most regulated.

In general, the respondents were asked about:

- identification and estimates of the ‘magnitudes’ of barriers to trade,
- changes compared to the pre-FTAs period,
- the priority of barriers,
- proposed policies to cope with them.

Questions were differentiated according to the occupation and activity of respondents.

Licensing

While import licensing is in practice restricted to specific sectors only, this was reported as an additional burden in terms of waiting time. For example, the need to deal with two ministries (of Health and Foreign Trade) in the case of imports of pharmaceuticals was perceived as particularly difficult. External observers noted that sometimes imports were over-licensed, and gave the example of retail consumer-imports (e.g. of cars) that cannot be carried out by a physical person. However, 6 companies out of 8 reported no problems related to licensing.

Quotas/limitations for export/import

There were no problems reported with regard to quotas³⁸.

Import levies in destination countries

When asked about additional import levies in BiH and at destination markets, some respondents noted that the transition periods for the FTAs with Albania and Moldova were still not over. The FTA with Kosovo was signed in October 2006. Therefore, tariffs on goods shipped to these destinations are still applied.

The respondents also indicated the existence of ‘small’ or ‘soft’ border taxes in the FTA countries (such as payments for transit). These are not very regulated, and sometimes are paid and sometimes not.

Rules of origin

When asked about the difficulties connected with certifying origin of goods, some companies complained about the costs of obtaining relevant certificates (EUR1 certificate in most cases), and on lengthy procedures, lack of information and corruption. However, sometimes the reported problem with the BiH origin certificate is

³⁸ Import quotas for fresh meat were briefly introduced in 2005, to be abolished in 2006, but the sample of interviewed companies did not include firms active in trade in agricultural products.

that it is not always recognised beyond the ex-Yugoslav market (for example in Romania and Bulgaria). In this way, it limits possibilities to use the full potential of the FTAs.

Experts added that without diagonal cumulation of origin, at least among the other SEE countries, fewer BiH products can qualify as of BiH origin. Therefore, origin requirements in the present form create significant barrier for exports (CEFTA 2006 should improve the situation).

BiH Customs

BiH customs were characterised by complicated and lengthy procedures, the insufficient knowledge of staff and corruption, according to the representatives of 3 companies. They gave examples of lack of expertise (wrong classification of transported goods, attempts to impose tariffs on already tariff-free imports, different treatment of the same goods and documents at different border crossings). However, five companies did not complain about the BiH customs service.

In fact, much in this sphere has improved recently (see chapter 3 for details). Time spent on customs clearance and technical control in BiH (2 days, see Table 13) – although longer than in Serbia or Romania – is the same or significantly shorter than in the other FTA countries.

Respondents from the BiH central administration still see a lot of room for further improvement of technical skills and reduction of corruption at border crossings. This is because there is still evidence of corruption, including numerous cases of undervaluation of imports and “preferences” for particular customs clearing houses. As for reform of the customs service itself, the main issues are related to further improvement of capacity of customs administration and harmonisation with EU standards.

Customs of other FTA countries

Three companies out of 8 complained also about Romanian and Moldovan customs. Data from Table 13 suggests that there should be relatively little room for

Table 13. Duration of trade procedures in BiH and in other FTA countries, 2006

Duration (days)	BiH	Croatia	Serbia	Montenegro	Macedonia	Albania	Moldova	Bulgaria	Romania
Export procedures:									
Documents preparation	11	7	2	2	19	11	22	15	9
Inland transportation and handling	4	8	3	5	3	16	3	4	1
Customs clearance and technical control	2	3	1	7	7	2	3	2	..
Ports and terminal handling	5	8	5	5	3	5	5	5	4
Totals:	22	26	11	19	32	34	33	26	14
Number of documents needed for export	5	7	6	6	10	7	7	7	4
Import procedures:									
Documents preparation	11	11	5	5	20	23	21	13	9
Customs clearance and technical control	2	1	2	7	5	2	7	4	1
Ports and terminal handling	8	3	2	3	6	5	5	6	2
Inland transportation and handling	4	3	3	2	4	4	2	2	2
Totals:	25	18	12	17	35	34	35	25	14
Number of documents needed for import	7	9	8	8	10	12	7	10	4

Source: World Bank, Doing Business 2007.

corruption in the Romanian service (the small number of documents needed, relatively little time spent waiting at the border).

Technical standards

Interviewed companies did not perceive technical standards as an obstacle to trade. All of them had to adhere to the technical standards required by their foreign partners and saw the procedure as unavoidable (although costly). However, several companies interviewed for a study by Causevic (2006) did point to the lack of institutions dealing with quality control and technical standards as an important factor determining BiH's large trade deficit.

Policy makers stressed that although the agreements on mutual recognition of technical standards have not yet been ratified either by Serbia or Croatia, both trading partners recognise some BiH standards related to specific products. On the import side they complained that effective lack of BiH standards allows a low quality of imported products to penetrate the market. More discussion on progress in creating internationally recognised institutes for certification of technical standards can be found in chapter 3. It appears that the still largely dysfunctional institutions dealing with standards are a more important obstacle for exports to the EU than to the SEE partners. However, in the near future, as other FTA partners harmonise their standards with the EU, these may become a significant barrier in intra-regional trade.

Sanitary and phytosanitary regulations

Two companies complained about the necessity of obtaining a BiH phytosanitary certificate that is not recognised even in ex-Yugoslavia. They also needed to get a Croatian one, thus increasing costs. However, it is difficult to draw any conclusions as to the significance of this barrier, since half of the interviewed companies were not able to answer this question.

The policy makers emphasised that the phytosanitary certificates are a problem for agricultural trade and that BiH certificates have been questioned several times by other SEE countries. The relevant bodies are slowly becoming operational now (see chapter 3 for details), so an improvement will hopefully be seen in the future. At the moment, a BiH certificate just adds costs and creates bureaucracy, while not being recognised abroad.

4.5. Backbone service sectors

There is a link between the functioning of services such as transport, utilities, finance and telecommunications and the FDI and trade performance of countries. The current state of such services and reforms aimed at reducing the costs and increasing the availability of such services may play an important role in improving linkages to global markets and production networks. In other words, sound regulation and competition in trade-related services can strengthen the export response to trade liberalisation, such as FTAs, and increase the welfare gains from liberalisation (Eby Konan and Van Assche, 2006). Also, better functioning backbone services can increase the attractiveness of the economy in question for foreign investments, which in turn may also have a strong impact on exports. For these reasons, we briefly summarise the barriers related to the functioning of trade-related services in BiH below.

Financial intermediation

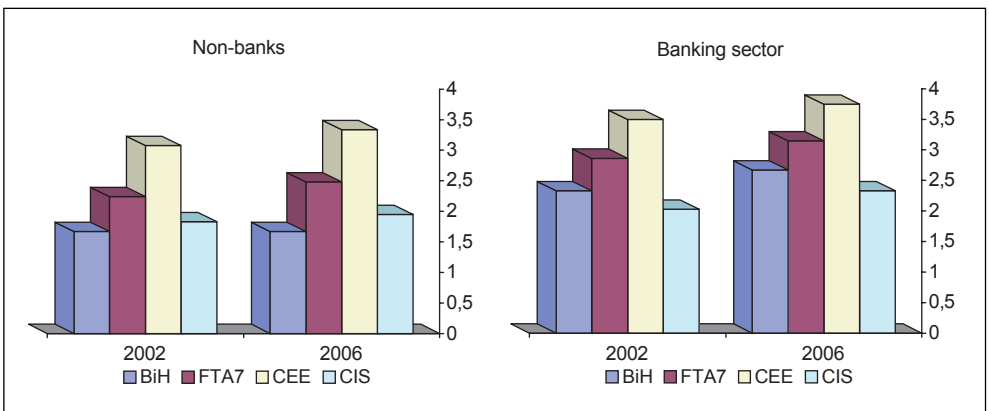
Interviewed companies have often complained about the costs of their operating capital. BiH firms (especially small ones) operate on tight margins, so the costs of capital is a very important question for their business operations. This also has consequences for insuring their exports. Small companies often do not insure them since they perceive the costs (interest rates) as too high. Exporting companies also noted that their clients from the ex-Yugoslav market face similar problems. They cannot afford financial guarantees, which makes them either pay in cash, and freeze their money, or resign from transactions, leading to lower demand in the region.

Almost completed privatisation, strong foreign investment and restructuring of the banking sector are widely regarded as BiH's key achievements. They are clearly playing a positive role in improving the quality of financial services that BiH companies have access to. Indeed, between 2002 and 2005 waves of EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS), the share of companies indicating access to financing as an important barrier to operations, declined, although even in 2005 it was still above average for the SEE region.

The rapid credit growth observed in recent years can be regarded as a positive phenomenon, although it certainly poses policy challenges. In particular, it becomes evident that more effective supervision and banks' more reliable credit risk assessment capacity is important in ensuring that the current boom supports a sustainable development of BiH business and avoids instability of the financial sector, which would be transmitted to production sectors. One of the recommendations raised by the IMF was unification of banking supervision. This was rather uncontroversial as far as the general principles are concerned, although BiH authorities remained divided on important practical issues concerning the institutional set-up (IMF, 2006).

However, overall progress in financial sector reform still appears to be lagging behind BiH’s competitors in the SEE region. While EBRD transition indicators suggest a slight improvement in the scores in the field of banking reform and interest rate liberalisation between 2002 and 2006, other countries also recorded an improvement along this dimension, leading to the gap to the SEE average as well as other benchmark groups remaining unchanged (Figure 8). On a positive note, two strengths of the BiH banking sector are its efficient and simple payments abroad through local banks and a relatively liberal capital account regime for import payments and export proceeds.

Figure 8. EBRD transition indicators of financial sector - BiH in the regional perspective, 2002 and 2006



Note: FTA7 denotes a group of SEE countries with FTA agreements which BiH that are studied in this report (Serbia and Montenegro are treated separately). CEE denotes 8 EU member states that joined the EU in 2004. CIS denotes 12 CIS member countries. Simple averages plotted for all groups.
 Source: EBRD.

The spreads between lending and deposit rates in BiH are broadly similar to the SEE average (6.1% in BiH vs. 7.1% SEE average in 2005), and somewhat higher than in the CEE countries (4.2% in 2005; Investment Compact, 2006), while the inflation rate in BiH was very low relative to other SEE and CEE countries. The perceived difficulty in accessing capital and its cost differs between the interviewed companies (both in our survey and in the survey carried out by Causevic, 2006). The interviews confirm that access to capital is relatively easy for larger, well-established companies and particularly for those with foreign investors. In contrast, smaller newly established companies as well as state owned enterprises more often report problems of access to capital and perceive banks as not much interested in co-operation with them. A much larger BEEPS survey indicated that over 60% of companies perceived the cost of financing as a problem and close to 50% viewed access to capital as difficult.

Summing up, problems related to financial sector development do not at present appear to be playing a key role hindering the development of companies involved in foreign trade operations, although smaller companies experience problems with access to capital, which is also rather costly. However, in the longer run it is essential that financial sector reforms is accelerated, keeping pace with rising demand for high quality financial services from domestic companies. The competitiveness of the BiH financial sector in the region will have an impact on the competitiveness of the BiH's exports, so reforms in the field should try to make up the gap that can currently be observed relative to regional competitors.

While several interviewed companies reported problems related to insurance of foreign trade transactions, the Investment Guarantee Agency (IGA), which provides export credit insurance, reports relatively modest demand for its services. This is probably related to lack of information in companies on such possibilities and the fact that many BiH exporters operate on small margins and try to avoid additional costs. With increasing value added of BiH exports this may be changing and IGA capital may prove insufficient to meet demand. More generally, difficulties in availability of reasonably priced insurance of foreign trade transactions appear to be a significant barrier to BiH's trade.

Transport

Interviewed respondents complained about the quality of BiH's railways and roads. They tended to stress that railway transport is not always available, is slow and expensive. Road transport therefore remains as the only alternative, although it is also quite expensive and not particularly fast given the quality of the road network. The condition of the roads, especially those in the East-West direction, is considered sub-optimal. BEEPS survey confirmed that between 2002 and 2005 the share of companies reporting transportation as a problem for their operations increased to around 25%, which is significantly higher than the SEE average.

The average waiting time at border crossings (as in other SEEs) is very high compared to the average waiting time in Western Europe before 1992 (World Bank, 2004). A survey indicated that on average 24% of travel time is spent at borders, while a reasonable waiting time should be about 2% (pre-Schengen crossing time). The World Bank and the EU have made serious investments in border crossing construction in recent years, but further improvements are needed to make border crossing easier and cheaper.

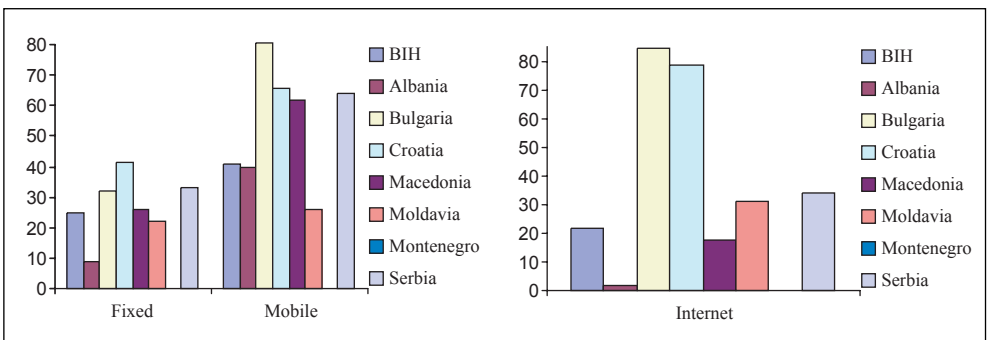
The BiH transport infrastructure was heavily damaged during the 1990s war and in subsequent years support from external donors has helped in gradual improvements. The road network has been much reconstructed since then, but its development has lagged behind the pace of increase in traffic. Improvements in road

infrastructure would be an important factor improving the competitiveness of companies based in BiH in the longer-term. The railways are in a worse condition than road transport infrastructure. Before the war they functioned reasonably well, but since then the railways have not returned to efficient operations, thus losing almost all of its share in both freight and passenger transport. While in 1990 railways accounted for 34% of freight transport, in 2000 this had collapsed to below 4%³⁹. One specific complication in this sphere relates to fragmentation of the rail network between entities. This adds to inefficiencies in maintenance and operation costs and contributes to railways making losses. Unification would theoretically appear the easiest thing to fix (as it does not require costly investments in physical infrastructure), but the solution hinges on political will.

Telecommunication

BEEPS shows that the share of BiH companies indicating telecommunications as an obstacle to their functioning is higher than the regional average. Analysis of sectoral indicators in a regional perspective confirms the relative backwardness of the sector in BiH (Figure 9). Also, reforms of the sector are lagging behind other countries. The EBRD index of reforms in telecommunication for BiH has stayed unchanged since 2000, whereas most other transition economies have recorded substantial progress in this sphere. In 2006, even the average score for CIS countries (2.4) surpassed the result for BiH (2.3) and FTA partner countries were well ahead (3.2). This leads to relatively high costs of telecommunication services (Investment Compact, 2006).

Figure 9. Selected telecommunication indicators, 2005



Note: Phone penetration lines per 100 inhabitants. Internet penetration per 10,000 inhabitants.

Source: EBRD.

³⁹ Data provided by the World Bank in an undated note available at <http://wbln0018.worldbank.org/ECA/Transport.nsf/Countries/Bosnia%20&%20Herzegovina?Opendocument>

4.6. Internal factors and issues specific to the BiH market

Government interventions

There was only one change in domestic policy that was reported to influence trading conditions for the surveyed BiH exporters. This was the additional burden put on exporters in early 2006 after the introduction of VAT. Since then exporters have needed to prove that their merchandise has been exported in order to qualify for a VAT refund. The required proof is in the form of returned invoices stamped by foreign clients. The Indirect Tax Authority maintains that it is too early to lift this requirement, as the possibility for faking exports in order to get VAT refunds is still high. There was also one complaint about BiH's public procurement favouring foreign companies (by requiring standards that were easier to obtain abroad).

There was also one complaint about public procurement abroad, resulting from the action of a strong destination country lobby. The lobby perceived a BiH producer as a tough competitor, and managed to partially close the market for a specific BiH product. The refusal of Serbian (and earlier Croatian) authorities to recognise BiH origin certificates was also quoted as an example of foreign government intervention hampering trade.

Supply side constraints

Some of the interviewed companies pointed to the need for privatisation and restructuring. State-owned companies face higher uncertainty as to their future and firms that have been for years 'in the process of restructuring' face high credit costs. More generally, private agents typically make more optimal economic decisions than the state in BiH as well as elsewhere. The BiH private sector accounted for 55% of the GDP in 2006, which was still much lower than the average for the eight new EU members (76%), and the SEE average (BiH excluded; 66%, EBRD, 2006).

Another constraint is related to the production structure inherited from ex-Yugoslavia. BiH's export flows broken down by commodity still reflect this. Due to unfinished restructuring, a large part of production is still composed of metals and other commodities with a low level of processing, leading to a narrow export base.

4.7. Summary

The analysis of BiH's revealed comparative advantages does not give very strong results, partly because of the unusually high level of data aggregation for which the

calculations are possible. BiH appears to reveal more diversified comparative advantages in trade with Croatia, relative to its trade with the EU.

Gravity equations for BiH trade flows indicate the following pattern: both BiH's exports and imports seem to be strongly influenced by the size of the destination or origin market and by geographical distance. These relationships seem to be stronger in the case of exports. Trade relations with other ex-Yugoslav markets enhance both export and import flows. Exports to the EU are in line with basic gravity specification, while imports are lower than predicted by the basic specification. The effects of regional trade liberalisation were not found to significantly affect trade flows either in the export or import equation. This suggests that FTAs have not (perhaps not yet) played a role in boosting BiH trade with countries with which the agreements have been signed. There are a few caveats that need to be added to this interpretation. Firstly, FTA agreements are relatively new and their impact on trade flows may take longer to materialise. Secondly, it may well be that some of the FTAs might have been effective in reducing trade barriers for BiH's exports while other agreements (for reasons related to their design and / or implementation) have not played such a role.

Irrespective of lowering tariffs, there exist numerous non-tariff barriers that hamper trade. Interviews with BiH entrepreneurs, policy makers and analysts, together with limited comparative statistics, suggest that severe barriers to trade are related to the following issues: lack of recognition of BiH phytosanitary certificates abroad, corruption and the low qualifications of BiH customs (although respondents noted strong recent improvements in this sphere), poor transport infrastructure (especially railways), over-licensing in some sectors, and obtaining certificates of origin (waiting time, lack of information, problems with acceptance of certificates). Regional statistics also point to telecommunications infrastructure, that is lagging behind some other SEE countries, and the costs of telecommunication services. Quite unexpectedly, respondents did not list technical standards among the major trade barrier. Possibly, at the moment these pose a significant barrier in trade with the EU only. Analysis of other trade-related services suggests that the (under)development of the financial sector does not seem to be an important obstacle to trade. However, given the supply-side constraints and the fact that small BiH firms operate on tight margins, the gradual development of the sector is of crucial importance for further support of BiH's exports. Some BiH respondents also indicated the existence of some 'soft' border taxes in the destination markets and complained about the functioning of customs in selected foreign countries.

Estimation of possible trade diversion and trade creation effects is a natural step that one would want to carry out in a study like this. However, in the case of BiH it has proved difficult to assess these effects given the lack of sufficient data.

There are grounds to believe that some trade expansion happened with respect to BiH's imports and exports from the FTA region. However, one needs to confirm this

once volume data are available. The possibility of trade diversion was checked with the use of similarity indices for imports for the most important FTA partners. The analysis showed that, contrary to popular opinion, there are no reasons to expect trade diversion effects resulting from the implementation of regional FTAs of any magnitude that could harm the BiH economy. As to the possibility of getting third-country imports tariff-free due to violation of rules of origin, BiH may often be a convenient point of entry and less the 'victim' of trade deflection, i.e. a country importing 'rest of the world' production with no tariffs through the FTA partners.

5. Policy recommendations

The general conclusion emerging from the analysis presented in this report is that while the regional FTAs might have had some positive impact on the BiH economy, this effect was not particularly strong and the full potential of the FTAs has not yet fully materialised. The reasons for this are manifold, including the small economic size of the SEE region relative to the EU and the short time that has passed since the FTAs were implemented. One should remember that the regional liberalisation has been overshadowed by growing trade with the EU countries. The CEFTA experience from the early 1990s suggests that it may take longer before regional trade flows are boosted more substantially to the benefit of all sides and that progress in economic integration with the EU plays a role in this. Several non-tariff barriers to trade between SEE countries are still in place and although there is some evidence of their decrease after the implementation of FTAs, their elimination has been relatively slow and uneven. The outlook for the future depends on the effectiveness of policies in removing the remaining barriers to trade and the ability of BiH companies to meet the challenges of increasing international competition. This section summarises the recommendations related to such policies and not only to the implementation of FTAs, which was the core of analysis in this paper. The focus is on trade potential with regional SEE partners, although most of the issues discussed below are in fact relevant for all foreign trade. Since completion of the report coincided with the conclusion of negotiations on the multilateral regional trade agreement (CEFTA 2006), which replaces all bilateral FTAs, our recommendations are no longer related to the future functioning of FTAs. However, the lessons and recommendations from this analysis are relevant for the new CEFTA, if only because many features of the FTAs were preserved in CEFTA 2006. Moreover, several of the recommendations are in fact much broader in scope and remain relevant in the context of general trade policies irrespective of their specific institutional set-up.

There are clearly several trade-specific policies that could help in utilising the potential of the FTAs with BiH's regional partners and CEFTA 2006. However, one key conclusion emerging from our analysis is that several problems hindering the development of BiH's foreign trade are related to the general economic and institutional framework, investment climate and conditions for entrepreneurship. In other words, the first set of key barriers to improved trade performance is of a domestic nature.

Therefore, recommendations on general BiH economic policies are an important part of this section. It is also important to realise the interrelations between various policies. While some policy measures discussed below may have a positive effect irrespective of decisions in other spheres, other will only work if implemented as a package. The coherence of the overall policy stance is very important from this perspective.

5.1. Recommendations for general economic policies in the BiH

The first, very general, recommendation concerns the need for simplification of the institutional framework for economic policy management and – to the extent this is possible – the need to opt for simple regulations so that inefficiencies in implementation are not magnified. It has been widely recognised that the extremely complicated governing structure of BiH implies certain costs – in terms of fiscal expenditures on the functioning of the large administration at various levels, but also in terms of co-ordination problems in defining and implementing policies. Additionally, bargaining power in various levels of government delays economic reforms and sometimes leads to deadlocks.

Some specific examples concern the lack of functioning of state level ministries that could take a leading role e.g. in defining BiH's agricultural policy. The creation of these ministries would help ensure coherence between policy making (which at the moment remains at the entity levels), its implementation and other policies, notably those related to foreign trade in industrial and agricultural products (which is set at the state level).

Implementation of the above recommendations is quite difficult for purely political reasons (although it seems that a ministry of agriculture will be created in the near future). Different stakeholders use the debate on shifting powers between institutions and governance levels as an element of the bargaining process on other issues. Wider public support may be needed to eventually force decision makers at various levels of government to reach a compromise. In order to build such public pressure it would be advisable to ensure wide dissemination of analysis on the implications of alternative institutional set-ups. The international community may play a role in this process and this may prove a more efficient strategy than direct external pressure on domestic policy leaders, which has already been used quite extensively for the last decade or so. The EU accession process should also be used as a catalyst for improvement and simplification of economic policy management, since BiH's integration with the EU will require better economic coordination and harmonisation with the relevant EU institutions.

The capacity of BiH institutions is a problem in itself. This applies to general economic policies as well as to trade policy-specific institutions (e.g. those dealing with negotiations on WTO accession, the SAA, trade disputes, etc.) where anecdotal evidence suggests that relevant ministries have not always been prepared to deal with international trade disputes on a technical level and have not provided support for the legitimate claims of BiH traders. The recruitment and training strategy may need to be revised to ensure improvement in this sphere.

Disappointing export results in some sectors are down to the weak competitiveness of these branches. This in turn is directly linked to delays in privatisation and very slow restructuring. A serious acceleration of privatisation and restructuring is needed if the BiH export base is to be widened to include more capital- and technology-intensive products with higher value added. Privatisation may also help in attracting FDI, which is vital for the upgrade of the competitiveness of the BiH manufacturing sector. Also, the closure of loss-making enterprises (mostly state-owned) through the bankruptcy procedure would be necessary to make the real sector more productive and based on sound corporate governance.

One priority area where well designed state support is needed is the creation of a favourable climate for the functioning of small and medium enterprises. Among other measures, there is room for substantial simplification of business registering process (this should also be accompanied by harmonisation of some of the rules between the entities), a simplified tax structure and streamlined inspection procedures.

Motivating companies to restructure needs to be accompanied by reforms aimed at bringing more flexibility to the labour market. The problems are related to the fragmentation of labour markets, the large unregistered economy and high tax wedge on (registered) labour. A change in the set of incentives is needed to increase the attractiveness of registered employment (this will likely require a reduction of the tax wedge for labour) and reducing barriers to labour mobility. Several detailed recommendations concerning the labour market can be found in World Bank (2005). It should also be noted that BiH's average gross wages are higher than in Bulgaria, Romania, Macedonia and Serbia and unit labour costs have been recently rising faster than in neighbouring countries (IMF, 2006). Reduction of the tax wedge could be one mechanism helping to solve this problem, as well as improving the skills (and therefore the productivity) of the labour force. However, the most important challenge, related at the same time to the labour market and to the competitiveness of the economy, is unification of the two entities' social security systems. If done this would most likely improve labour mobility.

Broad economic policies should avoid creating incentives excessively supporting the current leading export branches (e.g. metals, etc.) at the expense of other sectors. The attraction of FDI could be a very important catalyst for the development of

competitive advantages in various sectors of the BiH economy and integration of BiH companies in supply chains of regional and transnational companies (mostly with EU headquarters). It would help to boost exports both to the SEE region and to the EU, since deepening trade integration in the SEE region and with the EU builds a large market for foreign investors. Thus, policies stimulating FDI inflows are a very important element of any foreign trade promotion strategy.

Access to infrastructure is an important determinant of investment decisions and the competitiveness of businesses. Given underdevelopment in infrastructure provision in BiH, improvements in this field could have a substantial impact on the competitiveness of BiH companies. Taking into account the central state's budget constraints and at other government levels, priority should be given to creating an appropriate environment for development of privately owned or operated infrastructure services, such as telecommunications, rather than making heavy public investments in infrastructure projects. Transparent privatisation of utilities and setting the right investment incentives and regulatory framework would promise the best outcomes. Improving the reliability of the power supply appears important for some companies, including some of the largest exporters. On-going road transport projects should in the medium- to long-term have a positive effect on business conditions. Reconstruction and increasing capacities of railways is necessary for further expansion of merchandise trade, especially for the metal sector and oil derivatives. The existing road network is unlikely to be much expanded in the medium term, so railways should play a more important role for bulk transport in the region. Additionally, there are some operational and procedural issues that could be tackled rather easily thus reducing costs and time of transport within the region. These measures include: harmonisation and simplification of documentation at border crossings, signing and implementation of international customs conventions (Kyoto, ATA , 1984 UN convention), and more efficient system for bilateral trip permits (see also World Bank, 2004).

Analysis of other trade-related services suggests that the (under)development of the domestic financial sector does not seem to be a major obstacle to trade. Although it seems that the bulk of trade has been conducted without any kind of financial insurance or adequate financial guarantees. This clearly limits possibilities for new trade contacts and quickly growing trade turnover. Given the supply-side constraints and the fact that small BiH firms operate on tight margins, the gradual development of the sector is of crucial importance for the further support of BiH's exports.

From the foreign trade perspective, one relevant fiscal policy issue concerns excise taxes. The whole system would need to be adjusted so that it does not send counterproductive incentives to firms. Also, given the constraints on implementation capacity, it needs to be easy to monitor/implement. One example of ineffective regulation in this sphere is excise taxes on coffee, alcohol and regulations for retail

sales in duty free zones. Problems with wrongly drafted excise legislation have caused problems for local producers. It took some time before this issue was resolved. Some problems related to excise tax functioning were still being reported – these concerned e.g. the lengthy procedure to get a waiver from excise duties on alcohol to be used as an intermediate input in the production process (e.g. in the pharmaceuticals industry).

5.2. Recommendations for specific trade-related policies

One key trade policy issue that emerged prominently in the debate on the functioning of BiH's FTAs and the optimal shape of the new CEFTA agreement concerned the extent of liberalisation of agricultural trade and the perceived unfair competition from a few agricultural products (e.g. meat, milk) from producers in BiH's key trade partners – Croatia and Serbia and Montenegro (and more recently Serbia). This has led BiH to act unilaterally on introducing market protection measures on selected imports from these two FTA partners and to demand that these measures become part of the new CEFTA agreement. Lack of consensus on this last point resulted in BiH not joining the 8 other SEE countries that initiated the CEFTA 2006 agreement on 9 November 2006 and nervous last-minute negotiations before signing CEFTA 2006 on 16 December 2006. As a result, BiH agreed to abandon its protective measures while retaining the right to react in the future if imports cause serious disturbances to its markets. We believe this is a good compromise from BiH's perspective and below, we suggest a way of thinking on the more general issues related to regional trade liberalisation.

In our view, BiH should not expect any strong gains from attempts to protect and develop selected domestic sectors by means of trade barriers. The example of selected agricultural products is telling – while BiH decided to set tariffs on Croatian and Serbian imports it still lacks any coherent strategy for the development of its agricultural sector and has so far been unable even to set up a ministry that could work out such a strategy at the state level. Running efficient sectoral policies is difficult everywhere and requires strong institutional capacity to carry out the necessary analysis to support informed policy choices that then need efficient implementation tools. Otherwise, sectoral policies are likely to end up being influenced by the lobbying of interest groups without considering of the interests of the whole economy. It seems that BiH's authorities have no clear strategy for market protection and foreign trade. The general orientation is to diversify exports by increasing the share of goods with higher added value, while at the same time protective measures were designed for small-scale agriculture producers with low productivity.

Another risk with setting protective measures is that it provides arguments for partner countries to raise protection of their domestic markets. In other words, with rather limited institutional resources, concentrating them on selected sectoral policies may not be optimal, and without such resources sectoral policies may end up being highly inefficient and protectionism may only motivate other countries to raise barriers to BiH's exports. In this context, it is important to remember that BiH had a revealed comparative advantage in agricultural trade with Croatia (chapter 4), even at times when trade barriers were in place. Additionally, the BiH economy does not exhibit production surpluses in any segment, so "protection of domestic production" is likely mainly to lead to higher prices and lower the purchasing power of consumers. Therefore, protecting agriculture and raising other barriers appears to go against BiH's overall interests. A similar reasoning can apply to other industries.

Balkan trading partners (Croatia, Serbia and Montenegro) indeed appear to subsidise their economies, including the agricultural sector, more than in the case in BiH. In our view the best response to this could be an attempt to promote harmonisation of rules on state aid at the regional level (and signs of this can indeed be seen in the CEFTA 2006 agreement) and proceed with full liberalisation of trade. Persuading partners to agree on state aid rules will certainly be very difficult (also because of the pressures of interest groups in these countries), but only wide coverage and efficient implementation of CEFTA 2006 can ensure the agreement is relevant for the overall development of the economies (see chapter 2).

Summing up, while past trade relations with Croatia and Serbia and Montenegro in some sectors might have been perceived – perhaps rightly so – as 'unfair' from BiH's perspective, it is debatable whether BiH would improve its situation by trying to retaliate with protectionist measures. Unilateral moves in this respect are very unlikely to produce desirable results, especially that FTAs provide dispute settlement mechanisms (although there have been doubts as to its functionality). New rules included in CEFTA 2006 should bring an improvement in this sphere. This whole problem can also be taken as another argument favouring early WTO accession, which could help resolving issues related to state aid and dumping.

The preceding analysis has confirmed the existence of several technical barriers to trade, complicating relations between BiH and its partner FTA countries. In particular, problems related to certification and standards are among the key obstacles to expanding BiH's export potential (although the relative importance of this appears higher in the case of expansion to EU markets than for trade creation among the FTA signatories covered in this report). Therefore, we see a need to concentrate efforts on creating fully operational and effective institutions and to adopt modern standards and legislation, since the bulk of current regulations are outdated and not in line with the EU. Internationally recognisable institutions for certification,

accreditation, metrology and standards should boost the export capacities of domestic companies and promote the development of the manufacturing sector. So far, progress on agencies responsible for standardisation, metrology, intellectual property and accreditation has been rather slow and no clear plan for capacity building is easily visible. Progress to date has been mostly driven by EU requests, but very often newly established or reformed institutions have not been able to provide basic services for traders, although the functioning of the Veterinary Institute has been better. EC (2006) also underlines the need for further development of the market surveillance system, which remains weak.

One general recommendation related to the making of trade policy is that it could be improved by making the whole process more transparent and therefore limiting the scope for 'unfair' lobbying by interest groups. Forcing them to switch to more transparent lobbying by requiring that they openly present and motivate their positions would be beneficial, although arguably very difficult. A counterpart to this is the need to build stronger analytical capacity within the government and in independent institutions to be able to verify the claims of lobby groups. This analytical capacity can perhaps be supported from sources outside the government sector, e.g. it should be easy to ensure financing – even from external, e.g. EU sources – for local economic analytical centres. It would also be helpful if all exporters and importers had a platform to exchange their views on the obstacles to trade they face. This could help in collecting such vital information in one place, to motivate action from the government when necessary and limit the scope for the lobbying of the most powerful and well connected (but not necessarily representative) groups.

An important related issue is the need for improved collection of foreign trade data and making them publicly available. Recent developments in data collection appear to be moving in the right direction. The poor quality of past data is a reality one cannot do much about, but an important improvement, and an easy one to implement, would be to ensure that all existing data are freely available in the public domain. The same applies to better quality data now collected primarily from the ITA. The authors of this report have encountered peculiar problems in trying to access to existing datasets, which were deemed 'unofficial' and therefore 'not to be revealed'. Such an approach may benefit narrow circles of institutions or people with insider access to data, but is surely detrimental to the quality of the policy making of the country as a whole. For BiH, the more independent the analysis (by academic, research and other institutions), the better are the options for the country's trade policy – and authorities should in fact try to promote such research and at the very least try to facilitate it by freely publishing all existing datasets.

BiH's tariff structure, while relatively simple and generally avoiding high rates, nevertheless has some particularities that may harm trade and domestic production.

It appears that a broad vision on tariff policy is needed to avoid a situation where some specific elements of the policy are set under the influences of lobbies without taking into account the broader economic impact. One issue concerns custom tariffs on some raw materials and intermediate products that are not produced in BiH (and not in the FTA countries) but are used in production processes in BiH. This reduces the effective rate of protection for processed products and may be detrimental to domestic production capacity.

The export/import procedures at the border could also be simplified and made more predictable (in terms of waiting times). In particular, it would be advisable to limit the possibility to apply various small fees. Some of these fees (a fee for processing customs declarations) need to be dismantled in relation to the negotiation process with the EU given that they are not compatible with the relevant EU *acquis*. A related issue concerns the way these fees are collected. The present system, in which sometimes very small amounts need to be transferred by separate bank transfers (in some instances leading to bank fees exceeding the value of transfers), could be improved by replacing the fees with stamp taxes (apart from reducing the number of fees to be paid).

There have been numerous complaints about corruption in the customs service and lengthy customs procedures. Long waiting times and the low number of cases per day per customs officer also reflect this. Also, there have been complaints from the central administration about undervaluation of imports and smuggling. Much has improved in this area recently (see section 3.2.1 of this report). However, efforts still need to be put into further strengthening of the capacity of customs, including better coordination between different custom offices and moving more customs offices to the border (which should limit 'local' corruption). Gains may be seen in higher budget revenues (also in VAT and excise⁴⁰ – due to correct valuation).

There seems to be scope for export promotion and information provision services for companies interested in expanding their activities in foreign markets. The key issue here is ensuring that these services are of high quality and carried out at reasonable cost. The most natural approach for BiH would be to try to learn from the best practice in such services (e.g. Ireland, Slovenia, perhaps Turkey) taking into account the limited capacity of the BiH administration.

Issuance of certificates of origin does not appear to be among the key issues hindering BiH companies' foreign trade operations, but is nevertheless causing some problems. The problems appear to be related to negative past experience with faked certificates. Simplification and unification of procedures, strengthening the credibility of issuance of EUR1 certificates and better controls of foreign certificates (also by closer co-operation with relevant institutions in the SEE region) may be the best way to proceed.

⁴⁰ Especially when tariffs will be lower in the future (at least *vis-a-vis* the EU).

5.3. Sectoral recommendations

For the last 2 years or so the metal industry has been among the key drivers of BiH's export performance. This trend is likely to continue at least in the near future as recent foreign investments boost production capacity. While this is clearly a positive phenomenon, increasing the concentration of exports in a sector very vulnerable to international cyclical swings exposes the country to the risk of macroeconomic instability. BiH comparative advantages in the metal sector will be explored, but government policies should avoid attempts to give disproportional support for this sector. Efforts to improve general conditions for investors, simplification of foreign trade formalities, improvements in the transportation sector (particularly railways) and the reliability of electricity provision should be particularly welcomed by the sector.

One sector where, according to the consensus view, BiH may have substantial potential is production of automotive parts. This follows both from the strong tradition of the sector during the Yugoslavia period (and thus the abundance of technical and engineering skills in the labour force and established co-operation with key global players, e.g. the strong presence of Volkswagen in BiH) and from the experience of several ex-CEFTA members, now EU member states, such as Czech Republic, Slovakia and Poland, that have been attracting growing flows of FDI in the sector and have become important European players in the production of several automotive components.

The problems hindering faster development of the sector are not that different from those observed elsewhere. An in-depth study by the World Bank (2006) identified that the most important perceived problems relate to the high cost of labour (high social security contributions), lack of harmonisation of several economic policies and implementation practice between entities, reservations towards FDI among some stakeholders and outdated technology at some plants. Interviews with selected companies from this sector (mostly foreign-owned) carried out as part of this project confirmed their strong reliance on imported inputs and in some cases only limited the level of processing taking place locally (see also Causevic and Domazet, 2006). On the other hand, these firms are characterised by high quality output, they do not face problems with certification (as this is done using the established practice of parent companies abroad) and have large potential for expansion. In this view, attracting more FDI to the sector is vital for its future development and could lead to strong export expansion in the medium- to long-term. The provision of information for prospective investors, help in establishing contacts between BiH producers and potential clients / investors and support for marketing of BiH products are important elements of the strategy supporting the sector. Similar objectives motivated the creation of the Automotive Cluster BiH⁴¹, which was supported by foreign donors

⁴¹ See <http://www.ac-bih.ba/index.php?language=eng>

(GTZ). The creation of such self-organised producer groups appears to be a potentially promising option also for other sectors, as it allows explorations of economies of scale in activities such as marketing, information exchange, etc.

Yet another sector with particularly strong export potential is food and beverage processing. BiH has very favourable natural conditions for cultivation e.g. of fruits and vegetables. Also, there appear promising opportunities in the expansion of low-tech organic produce and ethnic products (World Bank, 2006). The barriers to faster development of the sector appear to be related to sector fragmentation, lack of capital to invest in high-tech processing, lack of promotion and marketing strategy and lack of information on existing opportunities for potential investors, producers and clients. The development of the sector and its exports hinges on the attraction of investments, particularly foreign investments, export promotion, information provision on existing opportunities to SMEs, the availability of training to small producers, support for merging (or creating producer groups) of small enterprises into farming and producer groups so that they can reap economies of scale in terms of access to credit, marketing, building brand names, packing, investing in production technology (new processing lines, new crops). All these actions could become part of a simple and coherent agricultural development strategy that is still missing in BiH. Complete alignment with EU sanitary and phytosanitary standards is an essential part of the package.

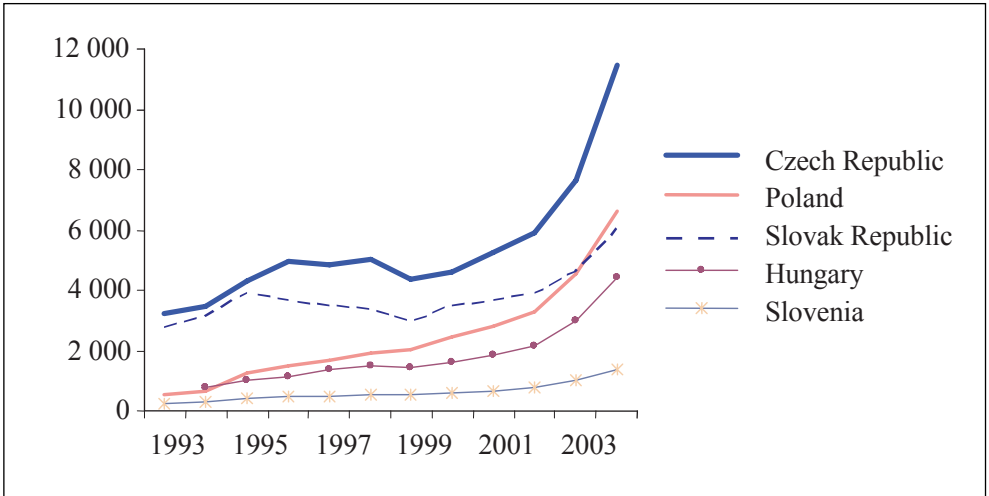
Another sector with a somewhat similar characteristics to food processing is production of wood products. Again, the advantage is abundance of material (wood, particularly hard wood – this differentiates BiH from CEE countries), a tradition of development in the sector and relatively cheap labour force. The current problem is concentration of production and exports of wood with only very limited processing. The suggested solutions are similar to the ones for food processing. Know-how on design, high-tech processing equipment and marketing of products is needed. This requires both capital (which may need to come from abroad) and self-organisation of the industry to explore economies of scale and facilitate information flows.

Yet another issue pertains to the pharmaceuticals sector. One specific obstacle identified here is related to the licensing of exports of medicines that is perceived by companies as too cumbersome, bureaucratic and time consuming (licenses must be approved by both Ministry of Health and the MoFTER). Simplification of the procedure for domestic producers (without compromising on prevention of narcotics trade) could be contemplated.

Annex I.

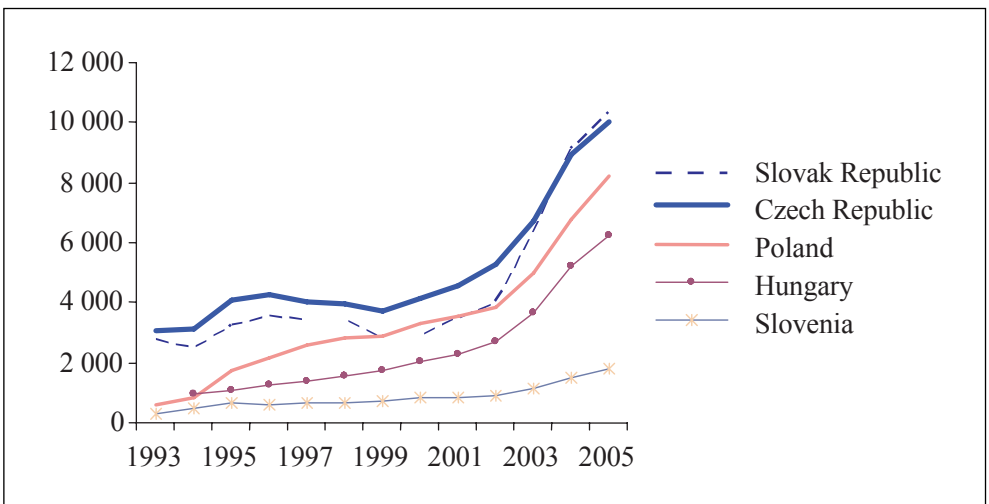
Trade flows of early CEFTA members

Figure 10. Exports to other early CEFTA members in USD millions, 1993-2005



Source: IMF DOTS.

Figure 11. Imports from other early CEFTA members in USD millions, 1993-2005



Source: IMF DOTS.

Annex 2.

Intra-Balkan trade shares, 1999-2005

Table 14. Intra-regional export shares of FTA countries, 1999-2005

1999	Albania	BiH	Bulgaria	Croatia	Macedonia	Moldova	Romania	Serbia & Montenegro
Albania		0.0	0.9	0.2	1.1	0.1	0.1	0.0
BiH	0.0		0.2	12.8	1.5	0.0	0.1	17.0
Bulgaria	0.0	0.0		0.0	2.0	1.1	1.6	1.1
Croatia	0.1	14.4	0.1		3.7	0.0	0.1	2.0
Macedonia	1.5	1.1	3.0	1.5		0.0	0.1	14.7
Moldova	0.0	0.0	0.5	0.0	0.0		1.2	0.0
Romania	0.0	0.8	1.4	0.1	0.1	8.9		4.1
Serbia & Montenegro	1.2	18.2	4.3	NaN	9.3	0.0	1.0	
EU	94.4	57.9	58.2	67.3	45.2	28.2	71.4	51.2
SEE8	2.9	34.5	10.4	14.6	17.8	10.2	4.3	39.0

2002	Albania	BiH	Bulgaria	Croatia	Macedonia	Moldova	Romania	Serbia & Montenegro
Albania		0.1	0.7	0.3	1.2	0.0	0.1	0.6
BiH	0.0		0.2	14.4	1.6	0.1	0.1	16.6
Bulgaria	0.0	0.1		0.2	2.0	0.5	1.3	1.1
Croatia	0.0	14.3	0.3		5.3	0.0	0.3	2.1
Macedonia	1.5	1.2	2.2	1.2		0.0	0.1	10.2
Moldova	0.0	0.0	0.3	0.0	0.0		0.8	0.1
Romania	0.0	0.1	2.8	0.2	0.1	8.8		1.1
Serbia & Montenegro	2.2	19.5	3.1	NaN	22.1	0.1	0.9	
EU	92.8	60.0	59.7	65.1	53.8	26.6	72.6	63.4
SEE8	3.8	35.2	9.6	16.4	32.3	9.6	3.5	31.8

2005	Albania	BiH	Bulgaria	Croatia	Macedonia	Moldova	Romania	Serbia & Montenegro
Albania		0.1	0.5	0.2	1.3	0.0	0.1	0.7
BiH	0.2		0.6	14.7	2.5	0.0	0.5	21.1
Bulgaria	0.5	0.2		0.5	3.7	0.7	2.7	2.3
Croatia	0.0	15.8	1.4		4.0	0.0	0.8	5.8
Macedonia	1.6	0.8	2.0	0.9		0.0	0.2	7.7
Moldova	0.0	0.0	0.2	0.0	0.0		1.2	0.1
Romania	0.2	1.6	3.8	1.0	0.2	10.6		2.8
Serbia & Montenegro	5.0	14.2	3.0	NaN	22.5	0.0	1.1	
EU	88.7	58.2	56.6	62.0	53.1	27.4	67.8	49.3
SEE8	7.5	32.8	11.4	17.3	34.2	11.4	6.5	40.6

Notes:

- Problems with foreign trade data for Serbia & Montenegro imply that shares of reported estimates of SEE8 trade are likely somewhat overestimated for Serbia & Montenegro and underestimated for Croatia.
- Exports of a column country to row countries in % of total exports

Source: Own calculations based on IMF DOTS with the exception of BiH - Serbia & Montenegro trade flows which were taken from BiH central bank database, Serbia & Montenegro trade flows with Croatia, Macedonia which were taken from Central Bank of Serbia (2002-2005 data) and Christie (2002)-1999 data.

Annex 3.

BiH external trade by goods in 2003-2006

Table 15. BiH export and import of goods, by HS chapters, in KM thousands, 2003-2006

		EXPORT				IMPORT			
		2003	2004	2005	1-3Q 2006	2003	2004	2005	1-3Q 2006
	TOTAL	2 322 846	2 818 780	3 783 280	3 793 085	8 318 941	9 305 942	11 178 545	8 130 574
I	ANIMALS & ANIMAL PRODUCTS	16 976	24 497	35 421	29 224	282 450	265 025	300 405	168 179
II	VEGETABLE PRODUCTS	38 662	34 495	43 335	34 535	459 461	492 526	489 955	332 376
III	ANIMAL OR VEGETABLE FATS	1 796	11 680	24 335	16 884	97 472	110 170	96 819	66 798
IV	PREPARED FOODSTUFF	84 864	96 412	120 238	103 753	1 028 338	1 090 883	1 094 461	834 326
V	MINERAL PRODUCTS	220 207	332 422	503 060	443 662	913 850	1 181 196	1 585 540	1 387 583
VI	CHEMICAL PRODUCTS	62 076	210 352	286 550	281 376	790 215	876 964	1 037 509	770 335
VII	PLASTIC AND RUBBER	38 356	43 152	61 924	74 729	403 631	446 086	518 272	382 142
VIII	HIDES & SKINS	60 067	69 826	69 591	78 299	96 285	114 971	147 918	183 347
IX	WOOD & WOOD PRODUCTS	390 987	429 256	376 614	329 031	93 550	100 497	124 466	88 056
X	WOOD & PULP PRODUCTS	55 963	73 024	78 158	68 539	270 706	295 873	321 845	233 466
XI	TEXTILE & TEXTILE ARTICLES	167 296	163 505	157 575	184 973	465 038	488 395	574 568	433 596
XII	FOOTWEAR, HEADWEAR	113 249	107 779	119 918	222 176	143 551	157 490	178 615	140 445
XIII	ARTICLES OF STONE, PLASTER, CEMENT, ASBESTOS	21 494	25 982	30 713	30 232	337 634	312 926	319 205	216 327
XIV	PEARLS, PRECIOUS METALS OR SEMI-PREC. STONES	174	72	503	1 287	4 099	5 243	6 161	5 853
XV	BASE METALS & ARTICLES THEREOF	520 895	701 903	946 988	1 027 988	695 504	838 098	1 068 844	835 551
XVI	MACHINERY & MECHANICAL APPLIANCES	191 494	202 793	543 973	465 848	1 278 647	1 447 067	1 980 797	1 238 479
XVII	TRANSPORTATION EQUIPMENT	67 001	51 434	92 588	73 337	596 980	702 498	911 419	560 212
XVIII	INSTRUMENTS MEASURING, MUSICAL	16 925	15 873	18 659	10 771	115 621	125 078	157 100	88 355
XIX	ARMS AND AMMUNITION	15 845	17 808	35 613	20 324	4 917	4 107	6 359	2 906
XX	MISCELLANEOUS	207 908	201 344	231 367	294 567	208 828	215 714	235 980	160 039
XXI	WORKS OF ART, COLLECTORS' PIECES AND ANTIQUES	222	415	1 458	865	4 703	3 999	836	361
	UNCLASSIFIED	30 387	4 756	4 700	688	27 460	31 137	21 471	1 844

Source: BiH Agency for Statistics.

Table 16. BiH export structure, by main trading partners, 2005

	EU 25	Russia	Turkey	Croatia	Serbia & Montenegro	Macedonia	Albania
BiH export in 2005, in KM millions	2023	3	23	775	587	35	8
Food and live animals	3%	10%	1%	7%	8%	1%	2%
Beverages and tobacco	0%	0%	0%	2%	1%	0%	0%
Crude materials, inedible, except fuels	19%	0%	17%	11%	17%	6%	72%
Mineral fuels, lubricants and related materials	3%	0%	1%	14%	21%	0%	0%
Animal and vegetable oils, fats and waxes	0%	0%	0%	1%	0%	0%	0%
Chemicals and related products, n.e.s.	3%	1%	28%	2%	6%	2%	7%
Manufactured goods classified chiefly by material	24%	27%	17%	44%	24%	39%	11%
Machinery and transport equipment	23%	11%	31%	7%	13%	14%	3%
Miscellaneous manufactured articles	21%	37%	6%	9%	7%	37%	2%
Commodities and transactions, n.e.c.	3%	13%	1%	2%	2%	0%	3%

Source: Own calculations based on data from Agency for Statistics of BiH.

Table 17. BiH import structure, by main trading partners, 2005

	EU25	Russia	Turkey	Croatia	Serbia & Montenegro	Macedonia	Albania
BiH import in 2005, in KM millions	5 664	322	314	1 886	1 135	99	2
Total	100%	100%	100%	100%	100%	100%	100%
Food and live animals	12%	5%	14%	14%	23%	0%	40%
Beverages and tobacco	2%	0%	0%	8%	7%	0%	0%
Crude materials, inedible, except fuels	2%	0%	0%	2%	4%	2%	0%
Mineral fuels, lubricants and related materials	4%	82%	1%	29%	11%	0%	10%
Animal and vegetable oils, fats and waxes	0%	0%	0%	0%	1%	0%	0%
Chemicals and related products, n.e.s.	11%	0%	6%	11%	13%	4%	16%
Manufactured goods classified chiefly by material	21%	6%	21%	17%	14%	8%	18%
Machinery and transport equipment	35%	5%	21%	8%	10%	78%	10%
Miscellaneous manufactured articles	9%	1%	30%	8%	10%	6%	4%
Commodities and transactions, n.e.c .	3%	0%	7%	2%	7%	2%	1%

Source: Own calculations based on data from Agency for Statistics of BiH.

Annex 4.

MFN tariff rates in BiH and in other SEEs

Table 18. Average MFN applied tariffs in SEE, in percent, 2002

Country	All goods	Agriculture	Industrial goods
Albania	7.4	9.5	7
BH	6	5	6.2
Bulgaria	9.7	16.7	8.6
Croatia	5	10.2	4.2
Macedonia, FYR	12.6	20.8	11.2
Moldova	5	10.1	4.2
Romania	17.1	23.1	16.1
Serbia	7.4	15.7	6.2
Montenegro	6.1	12.2	5.2
comparator: European Union	4.4	9.4	4.2

Source: Excerpted from WB (2004), p. 31.

Table 19. Average MFN applied tariff in BiH, by HS2, 2005

HS	Description	Simple average tariff
I	Live animals and animal products	5.8
II	Vegetable products	3.7
III	Fats and oils	2.5
IV	Processed foodstuffs, beverages and tobacco	9.9
V	Mineral products	1.1
VI	Chemical products	2.7
VII	Plastics, rubber and related products	7.2
VIII	Leather, skin and related products	6.4
IX	Timber and timber products	3.7
X	Wood pulp, paper and board	5.8
XI	Fabrics and fabric products	10.5
XII	Shoes, hats, and cups	13.8
XIII	Glass, stone products, cement	7.9
XIV	Pearls, precious stones	5.4
XV	Non-precious metals	5.8
XVI	Machinery and equipment	6.6
XVII	Transport equipment	6.0
XVIII	Measure and controlling equipment	4.4
XIX	Arms and ammunition	11.2
XX	Various manufactures	9.4
XXI	Works of art	2.1
	Total	6.4

Source: Own calculations on the basis of data provided by the EU Capacity Building Initiative for Trade Development and FDI Attraction to BiH

Annex 5.

Explanation of data sources

These are the data used for the gravity model of the chapter 4.

Data for trade flows between BiH and Serbia & Montenegro for the period 1999-2005 were taken from BiH Central Bank's Annual Reports. These data were expressed in convertible marks figures. Therefore, we have used average annual BiH/USA exchange rates to recalculate these figures. Trade flows for 1998 were obtained from the UN COMTRADE database. Data for the population of Serbia & Montenegro for the period 1998-2001 were available at the Serbian Statistics Office. The data for the rest of period we have obtained from the CIA Factbooks.

Distance has been measured as the distance between Sarajevo and partner countries' capital cities, in kilometres. For collecting the data on these distances our source was www.indo.com/distance, which measures them using the "great circle distance" formula. It takes into account the shape of the Earth and calculates the minimum distance between two places "as the bird flies".

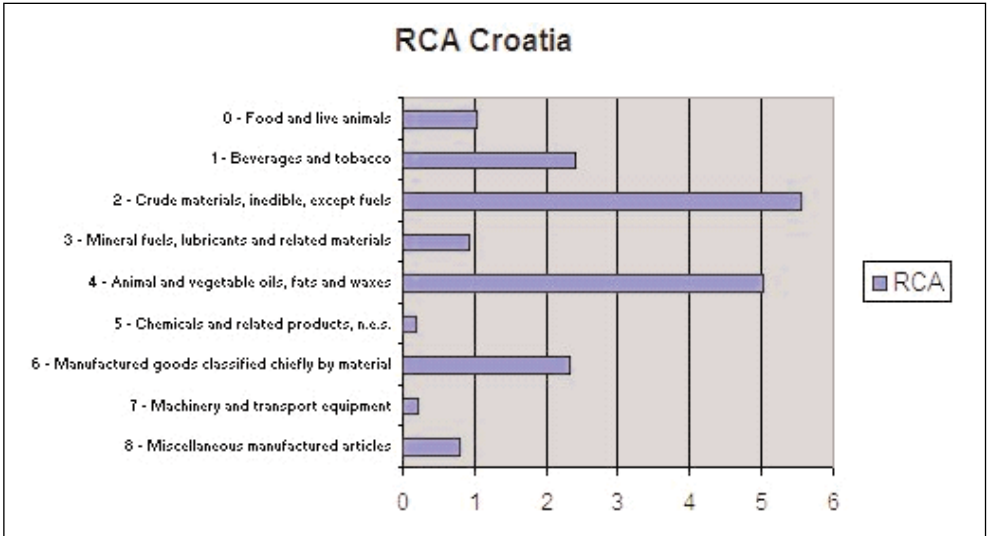
For the calculation of exchange rate variability we have used nominal bilateral exchange rates between BiH and partner countries. We obtained these data from the Pacific Exchange Rates Service, but only for EU members and several other countries. The same data for Albania, Croatia, Lithuania, Serbia and Montenegro, Slovenia and Ukraine for the period May 2000 - December 2005 and for Macedonia and Moldova for the period November 2001 - December 2005, were obtained from www.fxtop.com. For the rest of the period for these countries we have obtained daily exchange rates from www.oanda.com, and then calculated monthly averages.

Along with these data that were be used for the creation of variables for the model a set of dummy variables were created. The data for dummy variables that aim to capture the effect of bilateral free trade agreements, namely the dates of implementation of the FTA agreements, were collected from BiH Ministry of Foreign Trade and Economic Relations sources.

Annex 6.

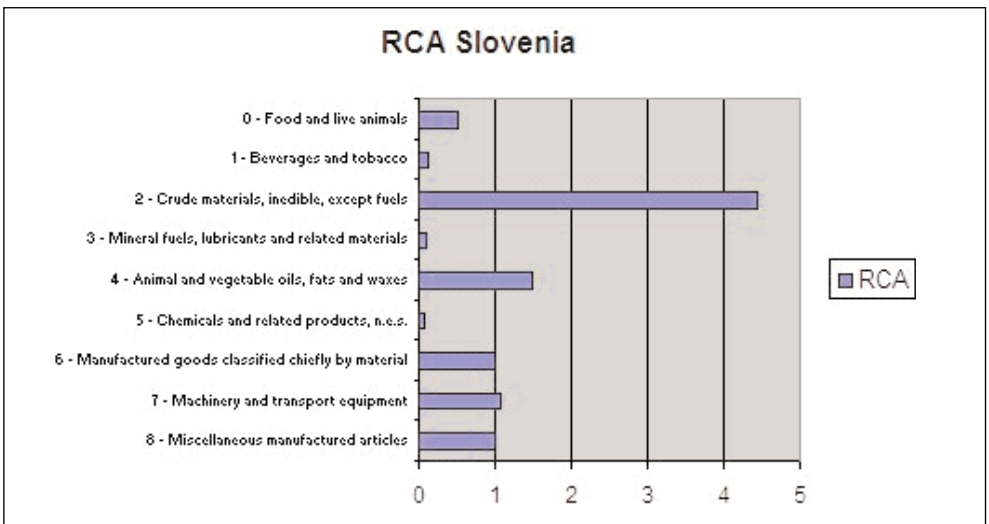
Revealed comparative advantage indices of BiH by export market

Figure 12. RCA for BiH-Croatia trade in 2005



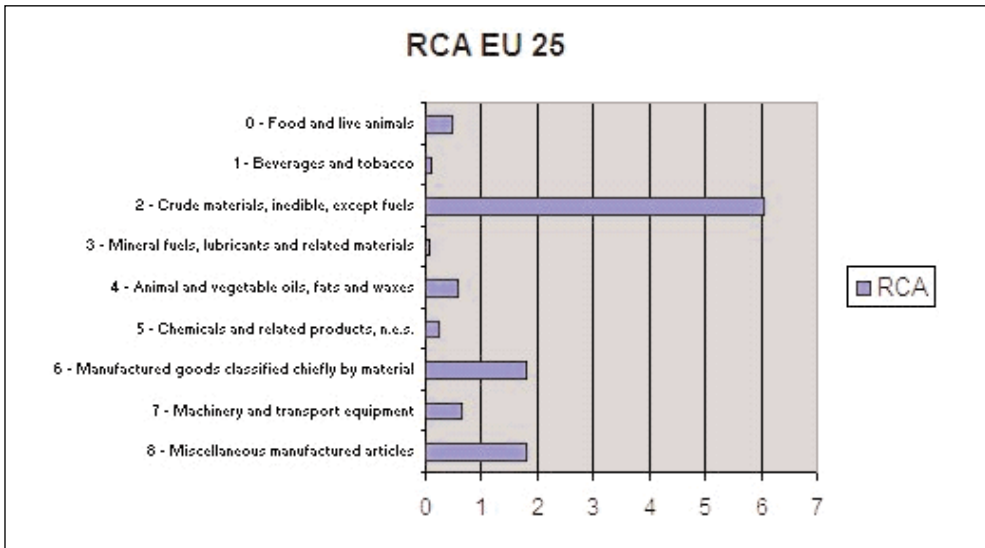
Source: Own calculations.

Figure 13. RCA for BiH-Slovenia trade in 2005



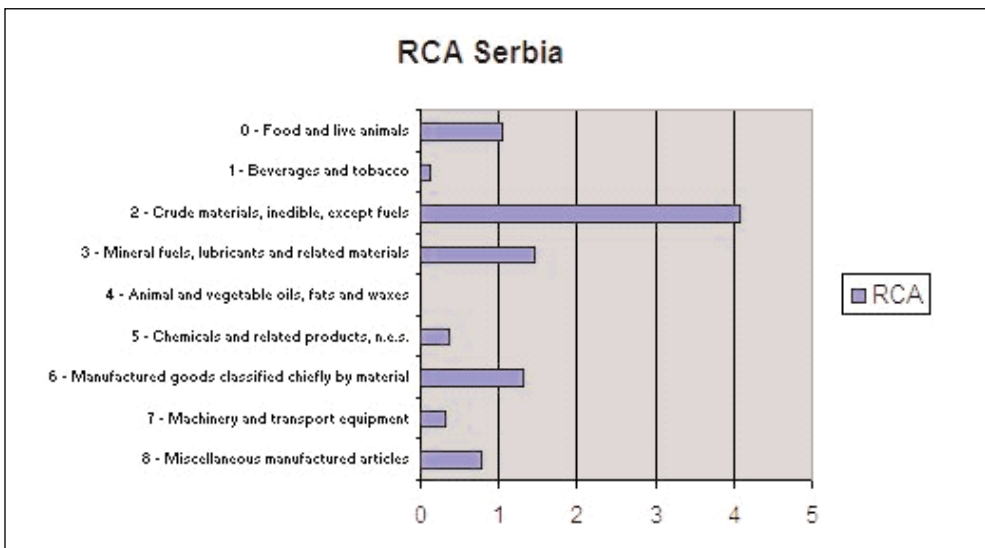
Source: Own calculations.

Figure 14. RCA for BiH-EU-25 trade in 2005



Source: Own calculations.

Figure 15. RCA for BiH-Serbia trade in 2005



Source: Own calculations.

Annex 7.

Results of diagnostic tests

Table 20. Results of diagnostic tests, BiH export equation

Hypothesis test	Likelihood Ratio test			F test				Model favoured
	Chi-squared	d.f.	Prob.	F value	num.	denom.	Prob value	
Models compared								
One-way vs OLS	60.22	32	0.001	1.76	32	188	0.010	One-way
Two-way vs OLS	66.90	39	0.003	1.58	39	182	0.023	Two-way
Two-way vs One-way	6.67	6	0.352	0.89	6	182	0.498	One-way

Source: Own calculations.

Table 21. Results of diagnostic tests, BiH import equation

Hypothesis test	Likelihood Ratio test			F test				Model favoured
	Chi-squared	d.f.	Prob.	F	num.	denom.	Prob value	
Models compared								
One-way vs OLS	138.13	32	0.000	4.86	32	188	0.000	One-way
Two-way vs OLS	165.12	39	0.000	4.93	39	182	0.000	Two-way
Two-way vs One-way	13.41	6	0.062	1.620	6	188	0.131	One-way

Source: Own calculations.

Table 22. Correlation matrix

	GDP	GDPIGD PJ	GDPC	LIN	SIMIND	POP	DIST	TR
GDP	1.00000	<u>.99070</u>	<u>.72806</u>	.67847	<u>-.94846</u>	.69914	.50831	-.17490
GDPIGD PJ	<u>.99070</u>	1.00000	<u>.73167</u>	.67509	<u>-.92069</u>	.68229	.49566	-.18528
GDPC	<u>.72806</u>	<u>.73167</u>	1.00000	<u>.92747</u>	-.64246	.01977	.46268	-.21547
LIN	.67847	.67509	<u>.92747</u>	1.00000	-.63569	.02581	.54369	-.26158
SIMIND	<u>-.94846</u>	<u>-.92069</u>	-.64246	-.63569	1.00000	<u>-.71504</u>	-.50525	.14746
POP	.69914	.68229	.01977	.02581	<u>-.71504</u>	1.00000	.25821	-.03328
DIST	.50831	.49566	.46268	.54369	-.50525	.25821	1.00000	-.13597
TR	-.17490	-.18528	-.21547	-.26158	.14746	-.03328	-.13597	1.00000
	GDP	GDPIGD PJ	GDPC	LIN	SIMIND	POP	DIST	TR
TRDV	-.47801	-.49080	-.46310	-.45076	.47011	-.21764	-.28659	.10478
EUDV	.63539	.64120	.70099	.68795	-.61982	.19890	.42786	-.15208
EXYUDV	-.40973	-.39948	-.24415	-.29938	.42037	-.33301	-.62129	.08558
COMDV	-.23897	-.23299	-.21907	-.26286	.28262	-.09862	-.49725	.03913
FTADV	-.18294	-.13411	-.18795	-.25594	.20576	-.06278	-.26010	-.01629
	TRDV	EUDV	EXYUDV	COMDV	FTADV			
TRDV	1.00000	-.61643	.21875	.14961	.13405			
EUDV	-.61643	1.00000	-.30840	-.24271	-.21746			
EXYUDV	.21875	-.30840	1.00000	.68392	.29095			
COMDV	.14961	-.24271	.68392	1.00000	.23567			
FTADV	.13405	-.21746	.29095	.23567	1.00000			

Note: values above 0.7 were underlined, since such high values may indicate possible correlations between variables

Source: Own calculations.

Annex 8.

Structured questionnaire used in interviews about NTBs

Identity of respondent:

- Area of activity:
 - Government
 - Industrial or commercial association representative
 - Importer (indicate sector)
 - Exporter (indicate sector)
 - Researcher/analyst
 - Other (please specify)
- If enterprise, then:
 - Employment (<9; 9-50, >50)
 - Ownership (private, public, foreign)
 - Exporter/importer to what countries, regions
 - What % of total production is exported (rough estimate)
- Geographical location of firm's BiH headquarter

Questions for exporters/importers:

- Quotas existing in destination countries (in BiH for importers):
 - which sectors
 - how much it costs you: in extra days spent etc.
 - did it change in comparison to pre-FTA (years...)
- Export/import limitations in BiH? Export/import quotas?
- Export/import licensing:
 - which sectors
 - how much it costs you: in extra days spent etc.
 - did it changed in comparison to pre-FTA (years...)
- Import prohibitions (like safeguard actions to restrict imports):
 - What sectors
 - When

- Were such measures in use before FTAs? More/less intensively?
- Import levies in BiH (Rep. Srpska towards Serbia and Montenegro?):
 - Magnitude
- Import levies in destination country/BiH (or border taxes):
 - magnitude
 - sectors
 - did it change in comparison to pre-FTA
- Rules of origin certificates (for exporters):
 - do you possess?
 - is it difficult to obtain?
 - is it costly?
 - are there any other difficulties connected with it? Please, specify
- (for importers) How effectively implemented are the rules of origin? Is it possible to overcome them and import from a third country (through a partner with the lowest external tariff) at a lower price?
- Technical standards (safety and industrial standards, regulations, packaging and labeling regulations) at export markets/BiH:
 - which sectors
 - how difficult to cope with (extra time and money spent)
 - did it change in comparison to pre-FTA
- Sanitary and phytosanitary regulations of export markets/BiH:
 - which (groups of) goods
 - how difficult to cope with (extra time and money spent)?
 - are they mutually recognizable?
 - did it change in comparison to pre-FTA?
- How would you evaluate your capacity to follow the rules of origin and technical regulations, safety standards, conformity assessment etc. in your export markets?
 very good, good, satisfactory, poor.
- Currency exchange or financial requirements affecting trade:
 - which ones
 - how much costs in terms of money and extra days spent, lost opportunities etc.
 - did it changed recently?
- Burdensome customs procedures: if so, explain which ones...

- Other administrative requirements and procedures: explain which ones:
 - uncertainty regarding law and regulations
 - weak access to information
 - extra expenses (corruption)
 - other:
- Government intervention in trade, restrictive practices and more general policies:
 - Subsidies and other aids to industry
 - Government procurement (like “buy national”)
 - State trading, government monopolies etc.
 - Other national regulations that discriminate between domestic and imported products
 - Competition policies
- Problems with visa requirements. Explain:...
- Poor infrastructure:
 - Underdeveloped local banking system
 - Credit and insurance markets
 - Poor transport infrastructure
- Please name 3 main obstacles to export to your destination markets. Why these? How did they change during the last years (specifically, relative to pre-FTA period)?
- What policies would – in your opinion – address these drawbacks efficiently:
 - Sectoral policies (which sectors)
 - Specific trade-promotion policies (like credits for export insurance etc.)
 - General economic policies in BiH
 - General economic policies of BiH trading partners
 - Other – explain which...

Annex 9.

List of non-tariff barriers reported by BiH actors

This annex summarises the complaints about NTBs registered during interviews with 8 BiH companies involved in foreign trade, representing the most important manufacturing sectors, representatives of industrial lobbies, policy makers, advisors and analysts. Perceptions on NTBs are classified by topic and within each topic answers given by firms are presented separately from opinions of other stake-holders.

Licensing:

Companies:

- Need to get import licences every year (for exports of pharmaceuticals products). It is a lengthy procedure (especially for a company located outside the capital).
- Registration of some products (even if they are only for exports) is compulsory in BiH. In spite of this, there exists an export licence for medicines (in place for 3 years already). This has no sense, since: i) it duplicates the registration of products and ii) importing countries are already protecting their markets and do not check BiH's licence. Importers need a destination country licence for every product anyway. Licences require the agreement of the Ministry of Health and the Ministry of Foreign Trade, which makes it lengthy (5-15 days, too long to be able to respond to demand from some clients).
- There is also a need to have a license on the production of alcohol. Irrespective of the additional surcharge paid (excise, even if alcohol is used only for production), it takes 25 days to get this license, because the alcohol content in every product has to be checked.

Licences are not a problem for 6 companies

Other stake-holders:

- There exist licences for importers. Sometimes it is an exaggeration: if you want to import a car, you have to do it through a licensed company, not as in the case of physical persons.

Quotas/limitations for export/import:

Companies:

Not a problem

Other stake-holders:

Not a problem

Import levies in destination countries:

Companies:

- There are still tariffs charged in Albania (2%), Kosovo (10%) (no FTA implemented yet)
- There are tariffs in Kosovo (10%), but the company exports through Macedonia, which has an FTA with Kosovo)
- There are tariffs charged in Moldova – 10%.
- There are also sometimes ‘small’ or ‘soft’ border taxes in the FTA countries (like payment for transit). These are not very regulated, and sometimes you pay, and sometimes not.

Other stake-holders:

Not a problem.

Rules of origin:

Companies:

- Certificates are costly (Bosnian EUR1 is more expensive than in the neighbouring countries)
- Complicated procedure, lack of information (also to when a certificate will be issued), long waiting times, corruption (certificates have to be stamped by the Ministry of Foreign Trade)
- There is no database with payments for the rules of origin. If any delay in bank transfer occurs, it is hard for a company to prove that they paid it.
- Not a problem for Ex-Yugoslav countries, problem with the recognition of BiH rules of origin certificates in Bulgaria and Romania

Not a problem at all for 3 companies.

Other stake-holders:

- Without diagonal cumulation of origin, at least among other Balkan countries, not many BiH products can qualify as of BiH origin. Therefore, rules of origin requirements in the present form create a significant barrier for exports (de facto limiting the coverage of FTAs).

- Domestic institutions are sometimes unable to determine BiH rules of origin, and as a consequence they are often not respected abroad.

BiH Customs:

Companies:

- Differential treatment of the same goods and documents at different border crossings.
- Corruption (sometimes SAD are kept at customs offices for a long time for no particular reason; it then becomes difficult for the producer, because it cannot claim a VAT refund without them).
- Complicated procedure of paying some stamp taxes (one transfer per each document required; it is inefficient and costly if several documents are following goods together)
- Customs procedures (when you import machinery) are lengthy. Sometimes customs clearance may take several days and it stops production.
- Long and complicated procedures, insufficient qualifications of customs officers (often make errors when classifying goods, in one customs office they wanted to put a tariff on already tariff-free imports from Romania).

Not a problem for 5 companies

Other stake-holders:

- Corruption is still a problem. One can observe for example that merchandise from large producers uses very remote border crossings that are not optimal from the point of view of travel distance and time spent when exporting. Probably, corruption is higher there. There is also evidence that when functioning of a given border crossing is improved and possibilities for having unofficial payments reduced, large amounts of traffic suddenly prefer to use others. Other examples include: smuggled cigarettes and alcohol present on the BiH market, oil, and even livestock (from Republika Srpska). There are also cases of violating property rights (fake copies of known apparel and shoe brands present in large quantities in BiH). There are also numerous cases of undervaluation of imports (although here the situation is improving).
- Reform of the customs service has been going in the right direction. However, the main remaining problem is the speed of unification of the customs service and improving its capacity.

Customs of other FTA countries:

Companies:

- The low quality of Romanian customs, lack of information exchange (BiH official stamps refused by Romanian customs)
- Moldovan customs are corrupt.
- Goods destined to Moldova go through Ukraine. Ukrainian customs are corrupt and ask for a number of additional documents to force the company to pay unofficially

Not a problem for 5 companies.

Other stake-holders:

Not reported.

Technical standards:

Companies:

- Just adds time and money, but inevitable
- In the case of products that are usually licensed, every country has different standards according to the product. But it is impossible to avoid.

Costs excluding, all companies did not perceive this as a problem. One company noted that since the FTA's implementation they no longer need to send samples for inspection in destination country.

Other stake-holders:

- The agreements on mutual recognition of technical standards have not been yet ratified either by Serbia or Croatia. However, both trading partners recognise some standards related to specific products.
- There are still problems with mutual recognition of standards with Serbia (in the past also with Croatia).
- It will still take time before standardisation bodies will become operational. Currently, they are not. And it is not yet clear whether they will operate efficiently thus lowering TBTs and boosting trade, or whether they will just end as weak regulators creating unnecessary burdens.
- The lack of BiH standards allows for low quality of imported products to penetrate the market.
- It is also a big barrier to exporters; they have to certify their products abroad, which raises costs.
- EU pressure on separation of the once unified Institute for Standardisation, Metrology and Intellectual Property into three separate agencies has proved

counterproductive in the short-term as the old institution stopped normal operations before new institutions became operational.

Sanitary and phytosanitary regulations:

Companies:

- Croatia does not recognise the BiH certificate, so there is a need to get a Croatian one. Adds time and costs.
- BiH requires one, although it is not required by the Croatians. It adds costs.

For 2 companies it is no problem.

4 companies did not answer this question.

Other stake-holders:

- It is still big problem in agricultural trade.
- The agency for phytosanitary standards was established some months ago. However, it is not yet operational (no staff, no budget).
- The most needed at the moment are food safety and veterinary agencies, which did not exist in the past. Their weakness is a huge barrier.
- Veterinary agency works best compared to other agencies.
- Sanitary certificate in BiH is required but it is not recognised abroad. At present it just adds costs and creates more bureaucracy.

Government policies and government interventions in trade:

Companies:

- In BiH: introduction of VAT proved to be costly for exporters in terms of additional papers. Exporters need to prove that the merchandise was exported, in order to qualify for the VAT refund. Therefore, they need to send back invoices stamped by foreign clients. It would be easier if these invoices were stamped only at the border and then sent from there by the drivers.
- In Serbia: Serbia removed a product (medicine) of a BiH company from the list of refunded medicines for no reason (the result of a domestic producer lobby).

Other stake-holders:

- Serbia did not recognise the origins of BiH goods (predominantly processed food, beer) that were entering through Montenegrin border crossings. It added costs, since BiH trucks had to go around and enter through the BiH-Serbia border.
- BiH public procurement in some instances appears to give preferential treatment to foreign companies as they require certificates that are easier to obtain abroad than in BiH

Access to information about regulations:

Companies:

- Weak access to information about procedures required by other countries. As a result trucks can wait at a border due to change in regulations and lack of requires documents.

Not a problem for 7 other companies (although one of them said it was a problem in the past)

Other stake-holders:

Not reported

Visa requirements:

Companies:

- there were visas with Albania until August 2006
- visas needed for Bulgaria, Romania and Moldova
- visas are barriers but more for clients/partners from Moldova

Other stake-holders:

Not reported

Exchange or financial requirements affecting trade:

Companies:

Not a problem for all companies

Other stake-holders:

Not reported

BiH financial intermediation:

Companies:

- Capital is still expensive, and it is very costly for clients to insure their credits so they have to pay in advance
- Credit is expensive, and (small) clients on ex-Yugoslav markets have problems getting financial guarantees. Because the other option for them is to pay in cash and freeze their money, this translates itself into lower demand in the region.
- Also, it is difficult to get access to export credit (capital is expensive)

Other stake-holders:

- The price of credits is still high. The same for export credit insurance. So the result is that usually producers (operating on tight margins) do not insure themselves.

Transport infrastructure:

Companies:

- The railway line to Serbia still does not operate at full capacity
- The railway network within BiH is not fully integrated – division along entity borders causes problems
- Transport costs are still high (roads, railways)
- The railway from Zenica in the direction of Rijeka is very slow and inefficient, therefore cannot be used to ship large quantities.
- Bad roads (takes a long time to transport merchandise)
- Bad condition of the Jajce – Banja-Luka road
- The quality of roads abroad (Ukraine, Moldova) also creates a barrier if they supply faraway markets like Moldova

Other stake-holders:

Transportation is still an obstacle because railways are still not working properly.

Annex 10.

Examples of trade deflection

This annex collects anecdotal evidence on examples of trade deflection that were gathered during interviews on NTBs in BiH. The validity of claims has not been verified and the examples cannot be treated as representative for the trade deflection trends.

Good entering BiH from FTA partners (despite different true origin):

- There have been claims that Slovenian beer comes from Croatia, using BiH-Croatian FTA. However, BiH government has so far failed to provide convincing evidence on the issue.
- Croatian oil imported to BiH may be of different than declared origin. It comes as Croatian, although it is only refined there.

Goods entering markets of other FTA countries as made in BiH (despite different true origin):

Trade experts assess that taking into account low BiH tariffs and weakly implemented rules of origin *vis-a-vis* main trading Balkan partners, trade deflection occurs rather through BiH market. Examples of such procedures include:

- Own production of one interviewed BiH firm was transported to Kosovo through Macedonia (that has an FTA with Kosovo) avoiding Kosovo custom tariffs.
- Macedonia complained about milk imported from BiH, claiming it was not really made in BiH.
- Croatia complained about foodstuff coming from BiH, claiming that rules of origins were not effectively implemented.
- Serbia complained about origin of BiH processed food and beer that were entering through Montenegro. BiH may be a good entry point for agricultural products from third countries that could then go to Serbia and Montenegro, rather than the other way round (since custom duties on agricultural goods are lower in BiH).

References

- ADE (2003), *Study on Potential Revenue Sources for the Institutions of Bosnia and Herzegovina*, European Commission Delegation to BiH, Sarajevo.
- Anderson, James E. (1979) *A Theoretical Foundation for the Gravity Equation*, American Economic Review, March 1979, 69, 106 – 16
- Baldwin, R. (2005) *The Euro's Trade Effects*, paper prepared for the ECB Workshop on June 16, 2005
- Causevic, Fikret (2006), *Foreign trade policy and trade balance of Bosnia and Herzegovina*, Economics Institute Sarajevo.
- Causevic, Fikret and Anto Domazet (2006), *Export Potential and Competitiveness of the Metal Sector in Bosnia and Herzegovina*, mimeo, Economics Institute Sarajevo.
- Central Bank of BH (2006), *Annual Report 2005*.
- Chmielewska-Gill, W., Korona, B., Poślednik A., Zielinska W. (2004), Liberalizacja handlu spożywczego w ramach CEFTA w latach 1993-2003. Raport Podsumowujący (*Liberalisation of food trade within CEFTA during 1993-2003. Summary Report*; in Polish). E-paper of (Polish) Foundation for Aid Programmes in Agriculture, Department of Economic Analyses and Agricultural Policy. Available at http://www.fapa.com.pl/saepr/rap/cefta_calosc_pl.pdf
- Christie, Edward (2002), *Potential Trade in Southeast Europe: a Gravity Model Approach*, WIIW Working Paper No. 21
- Commission (2003), *Report from the Commission – The Stabilisation and Association process for South East Europe - Second Annual Report*, Brussels, March 26, COM (2002) 139 Final.
- Damijan, J, M. Ferjancic, and M. Rojec (2006), *Growing Export Performance of Transition Economies: Where does it come from?*, paper presented at EACES 9th bi-annual conference in Brighton, UK, September
- Dangerfield, M. (2004), CEFTA: Between the CMEA and the European Union. *Journal of European Integration*, Vol. 26, No. 3, pp. 309-338.
- Eby Konan, Denise and Ari Van Assche (2006), *Regulation, Market Structure and Service Sector Liberalization*, CIRANO Scientific Series 2006s-18.
- Evans, D., M. Gasiorek, S. McDonald, and S. Robinson (2006), *Trade Liberalisation with Trade Induced Technical Change in Morocco and Egypt*, Paper prepared for the Middle East Economic Association Conference, January 6-8 2006, Boston, MA.
- EBRD (2006), *Transition Report 2006*
- EC (2006), *Bosnia and Herzegovina 2006 Progress Report*, SEC (2006) 1384, Commission Staff Working Document, Brussels, 8 November.

- Feenstra, R. (2004), *Advanced International Trade. Theory and Evidence*, Princeton University Press.
- Francois, J.F., M. McQueen and G. Wignaraja (2005), European Union – developing country FTAs: overview and analysis, *World Development*, Vol. 33, Issue 10, pp. 1545-1565.
- Gaucaite Wittich, V. (2005), Some Aspects of Recent Trade Developments in South-East Europe, *UNECE Discussion Paper Series No. 7*.
- Greene, W.H. (2002a), *Econometric Analysis*, Fifth edition, Prentice Hall, Upper Saddle River, New Jersey, USA.
- Greene, W.H. (2002b), LIMDEP, version 8.0. *Econometric Modeling Guide*, Vol 1. Plainview, NY: Econometric Software, Inc.
- Gligorov, V. (2001), Trade and Investment in the Balkans, Research paper, Vienna Institute for International Economic Studies
- Helpman, E. (1981), International Trade in the Presence of Product Differentiation, Economies of Scale, and Monopolistic Competition: A Chamberlin-Heckscher-Ohlin Approach, *Journal of International Economics*, 11, pp. 305-340
- Helpman, E. (1987) Imperfect Competition and International Trade: Evidence form 14 countries, *Journal of Japanese and International Economics*, 1: 62-82
- Helpman, E. and P. Krugman (1985), *Market Structure and International Trade*, MIT Press
- Investment Compact (2006), Regional Priorities to Improve the Business Climate in SEE, Regional Reality Check on Progress in Policy Reforms and Implementation in South East Europe, presentation at the Ministerial Conference in Vienna, 26 June.
- IMF (2006), 'Bosnia and Herzegovina: 2006 Article IV Consultation', *IMF Country Report No. 06/371*, October.
- Jakubiak, M. and W. Paczynski (eds.) (2006), Economic Integration in European Neighbourhood: the EU perspective, forthcoming in *CASE Reports* series
- Kernohan, D. (2006), 'Reverse Balkanisation? Trade Integration in South-East Europe', *CEPS Working Document No. 249*
- Krugman, P. (1979), Increasing Returns, Monopolistic Competition, and International Trade, *Journal of International Economics*, 9, pp. 469-479
- Messerlin, P. A and S. Miroudot (2004), *Trade Liberalization in South East Europe: Review of conformity of 23 FTAs with the MoU*, mimeo
- Messerlin, Patrick A. and Sebastien Miroudot (2003), *Trade Liberalisation in South East Europe: From a Network of 23 FTAs to a Full Free Trade Area*
- Oguledo, V. and C. MacPhee (1994), 'Gravity models: a reformulation and an application to discriminatory trade arrangements'. *Applied Economics*, Vol. 26, pp. 107-120.
- Pugh, Geoff and Tyrrall (1999), *Intra-European Trade, Exchange Rate Variability, and Monetary Cooperation in Europe: Some quantitative evidence for the single currency debate*, ESRC International Economics Study Group Conference, Prague, Working paper
- Rose, A (2000), 'One Money, One Market: Estimating the Effect of Common Currencies on Trade', *Economic Policy* 15(30) (April), 7-46

- SP Trade Working Group (2005), *Helping to Tackle Non-Tariff Barriers in the Western Balkans*, Final Report to the Trade Working Group, Project No. 2003/74631
- Tenreyro, Silvana (2006), *On the Trade Impact of Exchange Rate Volatility*, forthcoming in *Journal of Development Economics*
- Thursby J. and Thursby, M. (1987), 'Bilateral Trade Flows, The Linder Hypothesis, and exchange risk', *Review of Economics and Statistics*, Vol. LXIX, No. 3, pp. 488-95.
- Trade Working Group (2005), *Boosting Trade and Investment in SEE Trade Liberalisation – The Regional Approach*, Trade Working Group Summary Progress Report May-November 2005
- Uvalic, M. (2005), *Trade Liberalisation in Southeast Europe – Recent Trends and Some Policy Implications*, paper presented at the UNECE Spring Seminar 2005
- World Bank (2004), *Reducing the “Economic Distance” to Market – A Framework for the Development of the Transport System in SEE*, December
- World Bank (2006), *Benchmarking FDI Opportunities. Investment Horizons: Western Balkans*.
- World Bank (2005), *Bosnia and Herzegovina Economic Memorandum*, Report No. 29500-BA.
- World Bank (2005), *From Disintegration to Reintegration. Eastern Europe and the Former Soviet Union in International Trade*, Washington.
- World Bank (2004), *Reducing the ‘Economic Distance’ to Market – A Framework for the Development of the Transport System in South East Europe*, The World Bank, Washington.
- World Bank (2003), *Trade Policies and Institutions in the Countries of South Eastern Europe in the EU Stabilisation and Association Process*.
- Xhepa, Selami and Agolli, Mimoza (2004) *Albania's Foreign Trade through a Gravity Approach*, *Albanian Centre for International Trade Research Paper*.