A FREE TRADE AREA IN SOUTH EASTERN EUROPE? PROSPECTS AND PROBLEMS

By Per Magnus Wijkman[1]

Introduction

In January 2001 the Stability Pact for South Eastern Europe proposed the creation of a free trade area in South Eastern Europe. The response of the seven countries concerned was hesitant. Their primary aim was not regional integration but accession to the European Union. Those countries that had travelled furthest in their pursuit of EU accession were most hesitant, while those countries that were not yet WTO members were more enthusiastic. Nevertheless, in a relatively short period of time the seven countries overcame the initial hesitancy and negotiated a network of 21 bilateral free trade agreements, most of which were being applied at the start of 2003.

The question facing the countries today is whether the momentum they have built up to date will enable them to implement these agreements successfully and broaden and deepen their integration, regionally and in the world economy. The mere signing of trade agreements is insufficient by itself to generate trade. The agreements must also be implemented fully and effectively. They must be supported by numerous other measures to facilitate trade, from improving customs procedures to reconstructing transport and energy infrastructures. Trade-related institutions must be strengthened. Macro- and microeconomic policies must be right. All of this takes time and requires sustained and co-ordinated financial and technical assistance by donor countries. Most importantly, a common political will in the participating countries is required to bring the process to a successful conclusion. Donor countries will only provide assistance if there is clear evidence of political will in the SEE countries to implement trade liberalisation.

This paper deals with this Stability Pact initiative, the promises it holds out and the problems it has encountered. It starts with a brief historical and institutional background of the initiative, recalling the driving forces in integrating the Balkans, regionally and globally. It describes how initial difficulties were overcome. It points to remaining problems that must be resolved to make the process of regional integration a success. The countries can see regional free trade as an important economic means to achieve the political goal of EU accession. In spite of their different trajectories to EU accession, all seven countries can speed up accession by first creating an effective free trade area in South East Europe. The SEE can thus act as a "training school" in European integration. Seen in this light, the Stability Pact initiative provides a unique window of opportunity for the countries in SEE to train their civil servants and institutions in key factors qualifying for EU accession. This applies equally to those countries that already are candidate countries.

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1 A Master Strategy for Integration into European Structures

All countries on the Balkans aspire to become members of the European Union (EU). Their interest in purely regional integration is limited. However, accession to the EU is a long way off for many of them. It presumes that relations between the Western Balkan countries themselves are normalised and that they make significantly more progress towards becoming market economies than they have achieved to date.[2] Both tasks will take time, given the countries' recent history of bitter conflicts and planned economies. While the EU has an interest in fostering political stability and economic prosperity on its Eastern border, its members' primary consideration is to maintain the Union's institutional integrity and internal cohesion. It will not admit countries with unresolved conflicts, either internally or with each other, which like a Trojan horse once within the city walls may threaten the economic and political stability of the Union itself.

If the countries of South Eastern Europe and the European Union are each to realise their respective objectives, they must find a mutually acceptable sequencing of these key political and economic elements. The SEE free trade area provides a master strategy for doing this. It can foster economic reconstruction and growth and prevent an already difficult economic situation from becoming worse. It can expand trade and foreign direct investments, important contributions to growth. By improving economic prosperity and contributing to post-war reconciliation in SEE, a regional free trade area constitutes an unique window of opportunity to integrate the countries not only with each other but also into European and global structures. The components of this structure are indicated in this chapter.

In 1999 the Stability Pact for South Eastern Europe (SP) and the EU initiated a process aimed at achieving two mutually dependent goals: regional reconciliation and European integration. EU accession is not possible without post-war reconciliation among the countries of SEE and such reconciliation is more easily achieved in a broader European context. The SP initiative aims to link the seven countries of the region to each other through the creation of a free trade area, while simultaneously linking the countries of the Western Balkans to the EU, through Stability and Association Agreements (SAA):[3] These interrelated events, if successfully completed, will be first steps to the accession of the SEE countries to the European Union. [4]

1.1 Free Trade Agreements in South Eastern Europe

In June 2001, seven SEE-countries signed a Memorandum of Understanding to initiate negotiations within the framework of the Stability Pact to create a network of 21 bilateral free trade agreements covering the region.[5] These agreements were to

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[2] The Western Balkans are here understood to consist of Albania, Croatia, Bosnia and Herzegovina, Macedonia, and the union Serbia and Montenegro. The Eastern Balkans consist of Bulgaria, Romania and in this essay also Moldova.

[3] Bulgaria and Romania are already linked to it through Europe Agreements (EA).

[4] This essay is based on work done for the Swedish International Development Cooperation Agency (Sida) *An Overview of Trade and Trade Policy Developments in South Eastern Europe 2001-2003*, ECON Report 2004-007 and *The Emergence of a Free Trade Area in South Eastern Europe*, ECON Notat 12/03, 2003.

[5] The countries are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Romania, and the Federal Republic of Yugoslavia, thereafter the Union of Serbia and Montenegro (USM), now Serbia and Montenegro (SaM). Moldova expressed its intention to join in June 2001 when it became a member of the

be negotiated by 2002 and to enter into force in the course of 2003. The participating countries were initially sceptical and it was the SP that acted as the driving force. In spite of modest resources, the SEE countries negotiated a network of 21 bilateral free trade agreements on time.

This significant achievement, realised against the odds, was a remarkable demonstration of political will by the seven countries. Fully and effectively implemented, the agreements hold out the prospect of improved political stability and economic prosperity in the region and concomitantly of integrating the region more closely into European and international structures.

1.1.1 The institutional framework

The Stability Pact was adopted in Cologne in June 1999 at the initiative of the EU.[6] The wars accompanying the break-up of the Federation of Yugoslavia had triggered international interventions in Bosnia and Herzegovina and in Kosovo.[7] These military interventions convinced the international community of the need to develop a proactive strategy to deal with the root causes of the economic and political turmoil on Europe's doorstep. Over 40 countries and major international organisations and institutions committed themselves through the signing of the SP document to assist the countries of the region "in their efforts to foster peace, democracy, respect for human rights and economic prosperity in order to achieve stability in the whole region".

The SP is little more than a declaration and a framework in which the Signatory States commit themselves to work together to achieve the goals of peace, democracy, human rights and economic prosperity. In addition to the countries of the region and Member States of the EU, Canada, Japan, Norway, Russia, Switzerland and the United States participated actively from the outset. Important international bodies also took part, such as the World Bank (WB), the World Trade Organisation (WTO), the European Commission (EC), the European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD).

The SP has no financial resources of its own to disburse to beneficiary countries. It has a headquarters in Brussels with a staff of about 30 experts, seconded from their national governments and headed by a Special Co-ordinator. As the title indicates, his task is to *co-ordinate* the activities of the participating States so as to achieve the common objectives without duplication of efforts. This co-ordination is conducted at the highest level through the so-called Regional Table chaired by the Special Co-ordinator, who since 2002 has been Dr Erhard Busek, Austria. Three Working Tables report to the Regional Table.

Working Table II, chaired by Mr. Fabrizio Saccomanni, took the initiative to liberalise trade in the region, setting up a Working Group on Trade Liberalisation and Facilitation (the Trade Working Group, TWG) in 2000. Ms. Adriana Civici, Ministry of Economy, Albania, chairs the Group. Modest Secretariat services are available to assist the Working Group's Chairperson, including special support facilities based in Skopje. Funding is provided by a grant from the Department for International Development (DfID), UK. Important financial assistance to the work of the Group is also provided by the Swiss Foreign Ministry and by the United States. Nevertheless, the financial resources available to support the work of the Working Group were modest and remain so.

Stability Pact and was welcomed by the other countries. However, it has not progressed as far as them in the transition to market economy.

[6] The European Council adopted a proposal to this effect on 17 May 1999.

[7] An international intervention was to follow in Macedonia in 2001, when unrest in Kosovo spilt over there

1.2 Stabilisation and Association Agreements with the EU

The SEE countries themselves did not view creation of the regional network of free trade agreements as their main priority. For Bulgaria and Romania, already engaged in negotiations with the EU on membership, the prime objective was rapid accession. The five countries in the Western Balkans also nourished the hope of EU accession, but in a different time perspective. Most of them viewed regional free trade in SEE not as a priority objective but at best as a means to an end: it provided the "perspective of full integration into [the] structures" of the EU. The EU held out this prospect, which was understood by many to include association and eventually even full membership, in the founding document of the SP. As a stepping-stone in this process, the EU offered those countries, which did not already have Europe Agreements, Stabilisation and Association Agreements (SAA).[8]

The EC offered the SEE countries closer integration with the EU in the form of an SAA but emphasised that this was to be concomitant with regional integration within SEE itself.[9] A country with an SAA was expected to form a free trade area with other countries with SAAs. The EU introduced this important policy innovation in order to avoid a "hub-and-spoke" pattern of free trade agreements. In such a pattern, investment tended to flow to the EU hub, from which all the spokes could be supplied, and shun the bilateral spokes, from which only the hub – and not the other spokes - could be supplied.[10] Thus, establishing free trade in SEE was clearly defined by the EC at the outset as part and parcel of closer relations with the EU. The EC repeatedly made it clear in the Working Group that a regional free trade area in SEE is a key part of the process of European integration. Regional free trade and the SAAs were to be the two legs for a country in SEE to walk on in its approach to Europe.

The SAAs are more than free trade arrangements. They encompass also such issues as competition policy, environmental issues, standards, and investment conditions. They aim at harmonisation of legislation with that of the EU and assistance in institution building in order to implement the relevant legislation. Hence, the SAAs are an important instrument for integrating the countries in the Western Balkans into European structures.

The EU signed an SAA with Macedonia in April 2001 and with Croatia in October 2002. These took approximately one year to negotiate in each case. The EU took a decision in late 2002 to negotiate an SAA with Albania. The negotiations are likely to take two years. Discussions have started with the Union of Serbia and Montenegro and with Bosnia and Herzegovina on when to start negotiations. The two countries will first have to establish a functioning federal structure.

Moldova belongs in the TACIS group of republics of the former Soviet Union and is not eligible for an SAA. It has made insufficient progress in transition to market economy. In part, this reflects its failure to determine clearly its future orientation: toward the east or to the west, toward plans or markets. The EU is currently negotiating a co-operation agreement with Moldova. However, to achieve a

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[8] Moldova had not acceded to the SP at the time.

[9] Conclusion of an SAA was to be dependent on the SEE country's "readiness to engage … in regional cooperation with other countries concerned by the EU's Stabilization and Association process, in particular through the establishment of free trade areas in conformity with 'Article XXIV of the GATT 1994 and other relevant WTO provisions." Council Regulation No 2007/2000 of 18 September 2000.

[10] This was emphasised already in 1991 by Richard Baldwin, *Towards an Integrated Europe*, Centre for Economic Policy Research, London, 1991.

trade agreement with the EU comparable to a SAA, Moldova must speed up progress toward a market economy and political democracy.

1.3 Europe Agreements

Bulgaria and Romania have been candidate countries since the mid-1990s and have Europe Agreements with the EU. They did not qualify to be included in the first wave of Central and Eastern European countries to be admitted to the EU. They will accede in 2007 at the earliest. Croatia submitted its application for membership in fall 2002, after signing its SAA. The EC will deliver its opinion on Croatia's application in March 2004 and the European Council take a decision in July 2004 on whether or not to open negotiations. Hence, three countries look forward to accession to the EU in about four years.

1.4 WTO membership

The Memorandum of Understanding of the Stability Pact stresses the importance of WTO. Membership binds tariff rates, locks in economic reforms, and provides a universal system of rules governing trade. WTO rules concerning the valuation of goods is important to prevent arbitrary treatment of goods at the border. Three countries were not WTO members at the outset of the SP negotiations: Bosnia and Herzegovina, FR Yugoslavia and Macedonia.[11] Albania became member in September 2000, Croatia in November 2000 and Moldova in July 2001. Of the three countries seeking WTO accession in June 2001, Macedonia completed its negotiations in January 2002, and the Union of Serbia and Montenegro and Bosnia and Herzegovina submitted accession memoranda in July 2002 and August 2002 respectively. Difficulties related to the latter two countries' federal structures will have to be overcome prior to accession and this may take time. Most SEE countries have FTAs also with the EFTA countries. The status of these accessions is summarized in Table 1.1. It indicates that the countries have made significant progress in integrating into international and European structures.

[11] The former Yugoslavia was a member but none of its successor states could "inherit" its membership and all have had to apply anew.

Table 1.1 *Overview of trade agreements*

Country	WTO	Europe Agreement	SAA	EU Application
Albania	Sept 2002	-	Negotiation started 2003	-
BiH	Accession memo August 2002	-	-	-
Bulgaria	Dec 1996	Into force February 1995	-	
Croatia	Nov 2000	-	Signed Oct 2001	Fall 2002
Macedonia	Jan 2002	-	April 2001	-
Moldova	July 2001	Partnership and Cooperation Agreement Nov 1994		
Romania	Jan 1995	May 1993	-	Feb 1995
Serbia and Montenegro	Accession Memo July 2002	EU feasibility study to start September 2003	Jan 2001 SAA being considered	-

2 Economic Prospects: Trade Potential

For most of the 20th century political factors split the countries on the Balkans into separate blocs. This seriously prejudiced the development of intra-regional trade. A regional free trade area that overcomes these political divisions makes good economic sense. Countries trade with their neighbours. Good neighbours make good traders. That is the experience of the Nordic countries, of Western Europe and of North America. Transaction costs for trade tend to be low between countries that share common borders, common languages and common cultures. Realising this trade potential, requires establishing "good neighbour" relationships. The potential for intra-regional trade should not be obscured by the current predominance of the EU as a trading partner in almost all these countries.

2.1 The economic disruption of the Balkan wars

The massive economic destruction and dislocation caused by the wars accompanying dissolution of the former Yugoslavia had dramatic consequences for trade and income. Gross Domestic Product in the seven countries as a group was lower in 2000 than ten years earlier. It was dramatically lower in FR Yugoslavia and Bosnia and Herzegovina and significantly lower in Croatia and Macedonia. Only in Albania was GDP higher, and then but marginally.[12] Imports and exports fell dramatically and have not yet recovered. The free movement of goods and services, of people and capital that had existed within the former Yugoslavia, was replaced by national regimes in the new States, with a further fragmentation in those that – like Bosnia and Herzegovina and the Federal Republic of Yugoslavia - were federations. Each republic adopted its own tariff schedule and customs stations arose at the main border crossings. A brain drain afflicted the region.

Economic growth needs to be significant to regain what has been lost. It will have to be export-led and fuelled by foreign direct investment in the region. Most countries in the region have large trade deficits. Exports have failed to grow while imports

[12] Constance Michalopoulos and Visileiso Pandusopoulos, Trade in Services, World Bank.

have boomed in the past 3-4 years, once reconstruction started. Most countries' trade is highly concentrated on a few countries and on a few goods. They need to diversify their exports in both respects to accelerate the growth of exports.

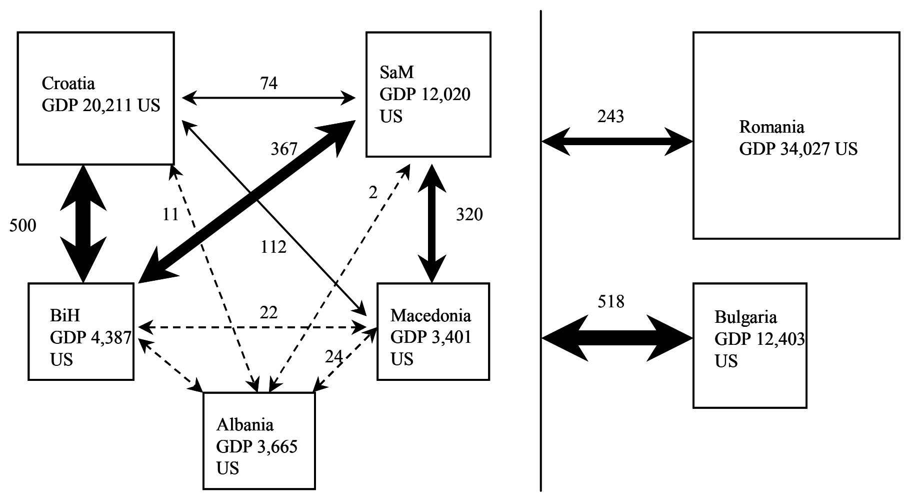
Trade with the EU has expanded but free trade within the region remains important. Regional free trade can help prevent the non-economic diversion of historical trade flows and attract foreign direct investments aiming to supply the whole region from an establishment in it.[13] Together with assured market access for exports to the EU, regional free trade is the key factor in enhancing the region's competitiveness as a production base. Both foreign investors and domestic producers stress this point.

Today, intra-regional trade is significantly below its potential. Economic reconstruction together with the abolition of trade barriers can therefore help realise the region's trade potential. A rough indication of the possible increase in intra-regional trade is given by comparing current and potential trade flows.

2.1.1 Current trade flows in South Eastern Europe

The volume of actual trade between seven countries on the Balkans in the year 2000 is schematically illustrated in *Figure 2.1*. It is significantly below the volume of trade flows before the Balkan wars.

Figure 2.1. Intra-regional trade flows in South East Europe in 2000, in million USD.



Note: Rectangles and arrows are roughly proportional to GDP and to trade (exports plus imports) respectively.

Source: Schematic adaptation from Kaminski and de la Rocha in "Trade Policies and Institutions in the Countries of South Eastern Europe" in *The EU Association and Stabilization Process*, World Bank Document, 2002.

For the republics of pre-war Yugoslavia, the figure shows very low trade between Croatia and Serbia and Montenegro, mainly reflecting the disruptions of the most recent wars. Conversely, the embargo on FR Yugoslavia has most likely inflated its trade with Macedonia and Bosnia and Herzegovina, which acted as transit countries. Albania has little trade with the countries listed here. However, its trade with Greece is significant and its rapid growth recently shows that a long tradition of autarchy cannot be the main reason for the low trade flows with its neighbours. Trade between the Western Balkans on the one hand and Bulgaria and Romania on

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[13] The role of liberal trade and investment policies had been stressed by the World Bank in *The Road to Stability and Prosperity in South Eastern Europe*, 2000.

the other is likely to be significantly constrained both by decades of planned economy, by the cold war and by the most recent Balkan wars.

2.1.2 Potential trade flows in South Eastern Europe

Potential trade flows are difficult to estimate. However, a study by the World Bank using a gravity model calculates what trade would be like in the absence of trade barriers given the economic size of the economies and the economic distance between them.[14] The result is summarised in Figure 2.2. Comparison of the two figures suggests that:

- intra-regional trade in SEE could triple (plus 3.5 billion USD.[15]
- Trade between the Western and the Eastern Balkans could quadruple (plus 2.6 billion USD). Romania's trade with the Western Balkans could be eight times larger (plus 1.6 billion USD). Bulgaria's trade with the Western Balkans could be three times larger (plus 1.0 billion USD).
- Trade between the five countries of the Western Balkans could double (plus 1.0 billion USD), albeit with a significant rerouting of trade flows. Albania would be the big winner. It could significantly increase its trade flows with Macedonia, Serbia and Montenegro and Croatia (plus 0.7 billion USD). Bosnia and Herzegovina could see significant reallocations of trade but the net effect would be minor.[16] Macedonia could see its trade with Serbia and Montenegro fall, while its trade with Albania, Bosnia and Herzegovina and Croatia would increase (plus 0.4 billion USD net). Serbia and Montenegro could see large reallocations of trade flows but only a small net increase (plus 0.4 billion USD).

Even allowing for uncertainties inherent in these types of calculations, the WB study suggests that a major trade potential exists. The relative importance of these flows is greater for the smaller Western Balkan countries than for Bulgaria and Romania. This may help explain why the smaller countries appear to be avid supporters of a free trade area in SEE. However, the large potential for increased trade flows between the Eastern and the Western Balkans has not yet been reflected in strong support in the former for a free trade area in SEE.

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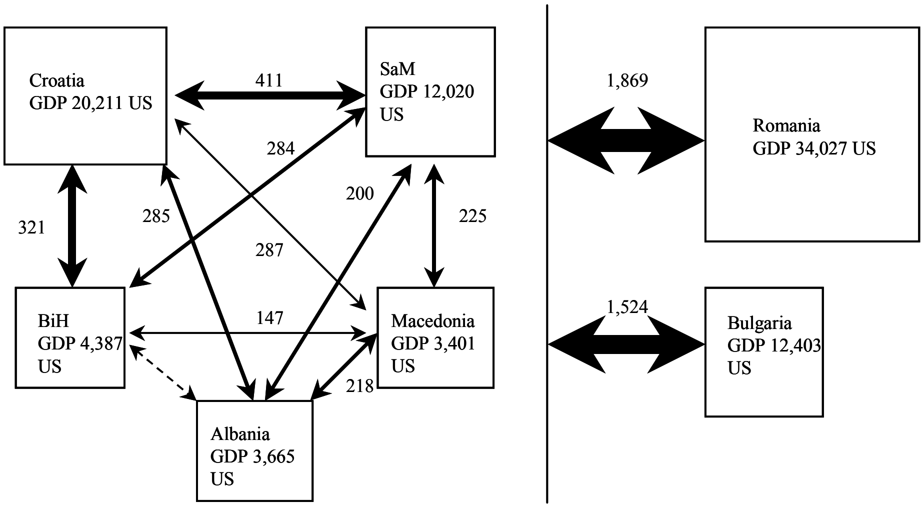
[14] Bartlomeij Kaminski and Manuel de la Rocha, "Policy-Induced Integration in Balkans: Policy Options and their Assessment", in *Trade Policies and Institutions in the Countries of South Eastern Europe in the EU Association and Stabilization Process*, World Bank, 2002.

[15] 2,193 million USD actual trade compared to 5,793 potential. Including the trade of Greece with these countries the figures are 3.8 billion USD and 9.5 billion respectively. See "Policy-Induced Integration in Balkans".

[16] During the embargo some of the FR Yugoslavia's trade appears to have transited through Bosnia and Herzegovina and this trade would now cease.

Figure 2.2. Potential intra-regional trade flows in South East Europe, in million USD.



Note: Rectangles and arrows are roughly proportional to GDP and to trade (exports plus imports) respectively. Source: See Figure 2.1.

2.2 Realising potential trade requires more than free trade

Freeing trade from tariff and non-tariff restraints is not sufficient, in itself, to realize the full potential for increased intra-regional trade. More needs to be done. In particular, governments must ensure that trade-related infrastructures and institutions are effective. This is no simple matter and the Stability Pact initiative supports a number of measures to facilitate trade.

In almost all countries, the infrastructure is ill-adapted for trade with contiguous neighbours. An example is Albania, where the roads were said “to stop at the borders” during the era of enforced autarchy. The consequences of a long tradition of self-sufficiency, of poor transport infrastructure, and of ethnic tensions along its borders need to be addressed if trade volumes are to realise their potential. In the case of Romania and Bulgaria, the trade embargo on FR Yugoslavia and the destruction of east-west transport lanes have played a major role in limiting trade flows both with the Western Balkans and in transit to the West. In general it is true for all countries, that while the region’s trade potential is considerable, realising it will require first and foremost improving transport infrastructure and simplifying customs procedures.

Improving the transport infrastructure will require funding from international financial institutions. To obtain this, the SEE governments must make their intention to realize a free trade area credible. This is a necessary but not sufficient to obtain major funding for regional infrastructure projects.

Procedures to *simplify customs procedures* and improve the efficiency of border crossings are essential in most of the countries of the region. While the Trade and Transport Facilitation in South East Europe (TTFSE) programme of the World Bank has made important progress, this progress is as yet insufficient to realise fully the trade potential created by trade liberalisation.

3 The Negotiating Process and Reasons for Success

The driving factors behind both the SP’s initiative and the EU’s Stability and Association Agreements were to restore peace and political stability to a turbulent region on the EU’s doorstep. The tense political relations between the countries made economic integration in SEE difficult to achieve in isolation. The countries did not view regional economic integration as a beneficial end in itself. However, they accepted it to achieve the greater political goal of accession to the EU and thus overcame their initial hesitancy.

3.1 Overcoming initial hesitancy

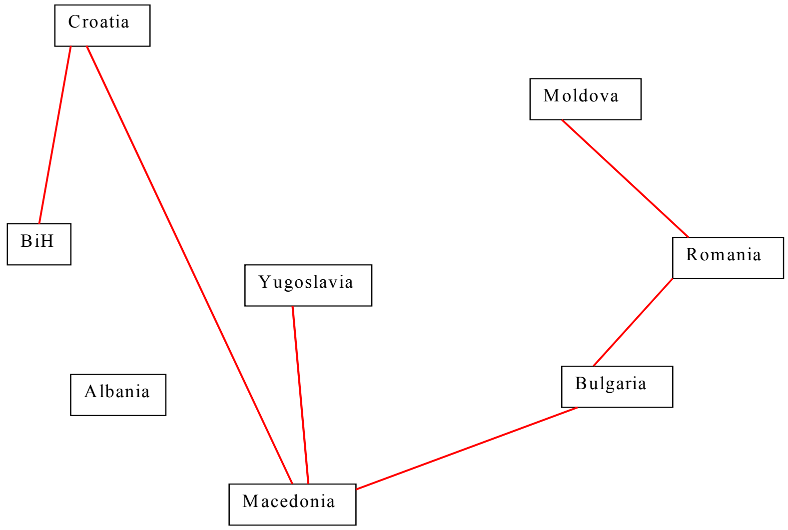
At a Trade Policy Forum on trade liberalisation in Geneva on January 17-18, 2001, organised by the Stability Pact, Ministers of the SEE countries had to make a strategic choice whether to create a free trade area by negotiating a *single* agreement to be signed by all seven States or a *network* of bilateral free trade agreements between them. A single free trade agreement would be cheaper for the countries both to negotiate and to administer and significantly more transparent for businesspeople because of its uniformity.[17] Therefore, Professor Messerlin, Groupe d'Economie Mondiale, Institut des sciences politiques, Paris, in a report commissioned by the Stability Pact, recommended a single agreement (the "Big Bang" approach).

Nevertheless, Ministers chose the network alternative at the Ministerial meeting on the 18 January 2001 in Geneva. This choice reflected the investments already made in five pre-existing bilateral agreements (excluding Moldova). Each country except Albania had at least one such bilateral agreement and four of them had two (Figure 3.1). More importantly, it reflected scepticism that all seven countries would be able to agree on a single treaty. Risk-adverse governments preferred an incremental approach to an all-or-nothing approach. Finally, each country gave greater priority to integrating further into EU structures than pursuing regional integration.[18] The Ministers signed a Joint Statement of Intent in Geneva in which they committed themselves to negotiate a Memorandum of Understanding (MoU) to create a free trade area in the region through a network of bilateral free trade agreements.

[17] A network of free trade agreements between seven States would require 21 free trade agreements and by the very nature of the exercise these would not be identical. Moldova is not included in this number, having started later than the original seven, both in acceding to the MoU and in moving to a market economy. Including Moldova, 28 bilateral agreements would be required of which 6 pre-existed (Moldova already had one with Romania); thus, 22 bilateral agreements would have had to be concluded in 16 months.

[18] At the outset, considerable uncertainty prevailed as to whether the two SEE countries negotiating EU membership (Bulgaria and Romania) would sign the MoU. In their absence, all remaining countries except one (Albania) would have been former republics of Yugoslavia. They may well have been hesitant to negotiate such a geographically limited free trade arrangement among themselves given the shadows of history.

Figure 3.1 Bilateral Free Trade Agreements Existing prior to June 2001



During the next five months, the Working Group met almost monthly. On 27 June 2001 in Brussels Ministers signed a Memorandum of Understanding, defining the terms and provisions of the FTAs to be negotiated. The most immediate task facing Ministers was to fulfil the MoU's tight deadline to complete all negotiations before the end of the year 2002. This was a daunting task due to the sheer volume of negotiations: 16 agreements to be completed in 18 months (which included two summer recesses). It implied an awesome meeting schedule for the few key people involved in the respective Ministries. To meet this deadline the Working Group should reasonably aim to have opened negotiations on all 21 agreements and to have concluded at least half of them by June 2002, on which date the MoU obligated them to report to Ministers.[19]

Prospects for success were dim. The negotiations started slowly and took time to gather momentum. During the fall of 2001, only two additional agreements were concluded (Croatia - Bulgaria, Bosnia and Herzegovina - FR Yugoslavia) while eight other negotiations had been opened and were in progress. Five further negotiations remained to be opened. Most negotiating activity took place in the countries of the Western Balkans while Bulgaria and Romania demonstrated little activity. Both the low overall level of negotiating activity and its uneven geographic distribution were causes for concern.

However, when the Working Group met in Washington D.C. in May 2002, just one month prior to the second Ministerial meeting, a break-through could be discerned. Two more agreements had been concluded and three more negotiations had been opened, all by Romania. It was now possible to see greater balance between the countries in the Western and Eastern Balkans. Concern about meeting the deadline now focussed on FR Yugoslavia and Bulgaria.

The Working Group was unable to report to Ministers in June 2002 that negotiations on all 21 agreements had been opened and that at least half of them had been concluded. It looked increasingly doubtful that all countries would meet the year-end deadline, given that the coming summer recesses would slow down progress. It was not until the October 2001 meeting of the Working Group that the June 2001 target (to have opened all negotiations and to have concluded at least half)

[19] A more extensive description of the negotiations is provided in ECON Notat 12/03 *The Emergence of a Free Trade Area in South Eastern Europe*.

was finally met. To an important extent this was due to the progress made by the FR Yugoslavia.[20] By mid-October 2002, FR Yugoslavia had opened negotiations with all countries and was progressing rapidly in many of them. For the first time, and at the last moment, it seemed that success was possible.

Nevertheless, a large number of negotiations remained open as the year-end deadline approached. Therefore, in November 2002, the Chairman of Working Table II, Mr. Saccomanni called an extra high-level meeting to assess what measures would be necessary to meet the deadline. By the time of the meeting in early December an important turning point had occurred. Much remained to be done, certainly, but the situation was now dramatically changed. About half of the ongoing negotiations were reported to be close to completion. Success was suddenly in sight. The question was no longer which countries would live up to their commitments but which of a very few countries would not.

The result of this sea change was a rapid acceleration of progress following the call for a special meeting by Mr. Saccomanni. By the end of 2002, the seven countries had effectively completed all 21 bilateral agreements except that between Bulgaria and Bosnia and Herzegovina. This testified to the increased political commitment of governments to the free trade area.

3.2 Reasons for success

Factors behind this success were: limited and concrete goals, determined chairmanship, high-level representation by participating parties, and ownership of the process by the seven Signatory States.

At the outset, the Working Group set a limited and concrete goal (a network of bilateral free trade agreements) with a specific deadline (by end of 2002) and defined milestones en route (the June 2002 target). The Working Group was endowed with efficient chairmen.[21] Countries and organisations provided high-level and highly competent representatives. The donor countries Switzerland, the United Kingdom, and the United States participated actively from the outset and were joined en route by Germany and Sweden. Representatives of the EC, the WB, and the WTO also played an important role. Outstanding professional expertise assisted in questions involving technical issues.[22] A small but entreprising Secretariat serviced the Group and checked observance of the milestones.[23] At decisive moments in the process, those responsible in the SP for the liberalisation and facilitation of trade provided critical support at the highest level.

In addition, "ownership" of the Working Group was in the hands of the seven Signatory States from the outset. Adjacent States, in particular Hungary, Slovenia and Turkey, attended most meetings, but the traditional initial *tour de table* was explicitly reserved for the seven countries. They were quick to realize that they had to speak up if they were to influence developments, indeed if there were to be

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[20] Following the downfall of the Milosevic Government, FR Yugoslavia had intensified its efforts to open and conduct negotiations on bilateral FTAs with the other countries in the region. These efforts were now starting to pay off. The change in government in October 2000 had led to a normalisation of its international relations and national policies. The Yugoslav government radically reformed its overall trade policy, eliminating most licensing requirements and simplifying and reducing tariff rates.

[21] Mr. Jani Bogoevski, the Ministry of Economy of Macedonia, chaired the Working Group until mid-2002 when he was succeeded by Ms. Violetta Mazdova, Deputy Minister of Economy, Macedonia. In May 2003 she was succeeded by the current chairperson, Ms. Adriana Civici, Ministry of Economy, Albania. The Director initially responsible for Working Table II in the SP headquarters was Mr. Didier Fau, France, who was succeeded in mid-2002 by Mr. Bernard Snoy, Belgium.

[22] In particular, the Groupe d'Economie Mondiale, Institut des sciences politiques, Paris, headed by Professor Patrick Messerlin.

[23] These services were supplied by the TDI Group, Dublin.

any developments at all. It did not take many meetings until the seven were driving the agenda. International organisations and countries from outside the region played a supporting – but not determining - role.

The smaller countries were most active in the process. Macedonia was the front-runner from the start to the end of the negotiations. Likewise, Albania and Bosnia and Herzegovina both actively pursued the negotiations, even though both had limited trade-policy expertise and lacked developed trade-policy institutions. The SEE countries appeared to realise that the SEE free trade area was a complement to, indeed a precondition for, any country's integration into European structures in a reasonable period of time.

The international community contributed most effectively when acting together, in particular, when the EC and the United States worked in concert. The EC provided important technical and financial assistance to implement the process, the United Kingdom gave financial support to the Secretariat in an expeditious manner and Germany and Sweden increasingly provided financial support for major projects. Switzerland provided both financial support and political leadership. The WB and the WTO both played a strong supporting role, especially in the drafting phase of the negotiations.

The combination of these success factors created sufficient progress to make the exercise credible. Nothing succeeds like success. When the scent of success spread in the air, a bandwagon effect replaced the heel-dragging effect. At a certain point, countries faced the prospect that they might be alone in *not* fulfilling the commitments made by their respective Ministers and climbed on the bandwagon.

4 Political and Economic Problems

While significant steps have been taken, much remains to be done. Three serious political problems threaten continued progress: continued scepticism of regional integration, constitutional reforms in federal states, and the status of Kosovo. These problems distract attention from the practical problems of implementing the bilateral agreements and ensuring their conformity with the MoU.

4.1 Three major political problems

The first problem is that EU candidate countries remain hesitant about broadening and deepening integration in SEE. The European Commission has to repeatedly convince them that the regional exercise will not slow down EU accession and in fact could even speed it up. In addition, the Stability Pact had no funds to disburse at the outset. So why should the candidate countries participate in the Working Group?[24] It took a couple of years for the Stability Pact to mobilise sufficient funds to impress countries that they could actually benefit. The hesitancy of the candidate countries was gradually overcome but the closer EU-accession looms, the more their interest in the SEE may wan.

A second problem concerns constitutional reform in Montenegro and Serbia. The Constitution of the Federal Republic of Yugoslavia, agreed in 2000, states that the two republics will conduct a common commercial policy, and hence harmonise their external tariffs and provide the same preferences to their partners in the SEE.[25] Doing this has been a complex process. In December 2002, Montenegro indicated

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[24] They were the only two *candidate* countries in the Working Group that were classified as *beneficiaries* of assistance. Hungary and Slovenia also attended the meetings but were not eligible for technical or financial support.

[25] However, in 2000 Montenegro had introduced its own customs tariff and collected revenues at its own customs stations. It adopted the D-mark, later replaced by the euro, as legal tender. Montenegro's tariff schedule differed from Serbia's.

that it wished to exempt more products from liberalisation than those previously agreed by the Federal Government in the bilateral free trade agreements. This wish to renegotiate the balance of rights and obligations put the ratification of agreements on ice. During 2003 the parties agreed on new terms, but the time-consuming process set back the liberalisation process by about one year and damaged the credibility of Serbia and Montenegro as a reliable negotiating partner. Since Serbia and Montenegro is a core country in SEE, this was a serious setback to the whole liberalisation process.

The third problem concerns how to include Kosovo in the network of free trade agreements. Its is formally a part of Serbia administered by the United Nations Mission in Kosovo (UNMIK). Under UNMIK, Kosovo has applied a different trade regime than FR Yugoslavia and other countries do not recognize products from Kosova as originating in "Yugoslavia" and hence entitled to preferential treatment under their bilateral treaties with Serbia and Montenegro. In effect therefore, Kosovo is excluded from the free trade area. UNMIK, an observer in the Working Group, has declared that it has the authority to negotiate free trade agreements on behalf of Kosovo. It signed such an agreement with Albania on June 30 2003. Serbia and Montenegro has objected to this procedure on formal grounds relating to sovereignty. One way to avoid this sensitive issue could be for UNMIK negotiate temporary agreements for Kosovo as a customs territory. To avoid a time-consuming negotiating round, these agreements with all partner countries should be based on a uniform text. The energy and attention of the few civil servants must be focused on implementing the existing agreements.

4.2 Ensuring conformity with the MoU

The most urgent economic challenge facing the seven countries is to implement the free trade agreements fully and to ensure conformity with the Memorandum of Understanding. This specifies the standards concerning liberalisation to which the countries must comply. Representatives of the WB and the WTO stressed the need to adhere to the standards set out in Article 1.2.

All bilateral free trade agreements – those already existing in June 2001 and those negotiated thereafter - must *inter alia* cover substantially all trade (MoU Article 1.2.2). Liberalisation must occur early in the six-year transition period, i.e. be front-loaded (Article 1.2.3). The MoU (Article 1.3) specifically requires the parties to review that all agreements are in full conformity with these provisions. Ensuring conformity of the agreements with the MoU is a major challenge for the countries and will require governments to resist protectionist pressures at home. The following two sections indicate in which countries and sectors these pressures might be strongest.

4.2.1 Liberalisation of intra-regional trade

The MoU specifically states that 90 per cent of bilateral trade must be liberalised on a preferential basis, measured in terms of both tariff lines and trade flows. Fulfilling *both* criteria is important to prevent countries from eliminating tariffs primarily on goods, in which the countries do not trade. An extensive review by Professor Patrick Messerlin and Sébastien Mirodout at Groupe d'Economie Modiale (GEM), Institut des sciences politiques, Paris, draws the following conclusions for the 21 bilateral agreements.[26]

[26] The GEM report has not yet been finalised. The text above is based on versions of the GEM report that were available prior to its meeting on 24-25 September 2003 in Tirana. The results presented here will not necessarily conform with the results in the final GEM report. For this reason they should be considered as tentative and purely illustrative. In borderline cases I have given countries the

1. **All twenty-one bilateral agreements provide virtually complete elimination of tariffs on trade in manufactures.** This holds whether trade coverage is measured by per cent of harmonised system product lines or of import-weighted lines. The seven countries have thus created a free trade area in manufactures, an EFTA in South East Europe. This is a remarkable achievement in itself.
2. **Liberalisation of agriculture is limited in almost all countries.** Only five of the agreements evidence more or less complete liberalisation of trade in agricultural products on a preferential basis. This applies to both criteria of trade coverage. The majority (13) of the agreements fail to liberalise even half of the agricultural product lines. The percentages of product lines liberalised on an *import-weighted* basis is much lower, indicating that tariffs tend to be eliminated on agricultural product lines in which there is little intra-regional trade.
3. **About eight agreements pass the 90 per cent import-weighted coverage criteria on *total* trade with flying colours. These are those agreements where both countries have liberalised more than half the agriculture product lines.** Finally, five to six agreements, where only around 10 per cent of agricultural product lines have been liberalised, evidence a total commodity coverage, which is too low to pass the total 90 per cent criterion, especially on an import-weighted basis.

It is likely that about 5-6 treaties are in danger of not fulfilling the 90 per cent trade coverage requirement of the MoU. They are first and foremost those agreements that fail to fulfil *both* the tariff lines *and* the import-weighted 90 per cent coverage criteria. At least three treaties fall in this category. The agreements involve Albania, Bulgaria, Croatia, Macedonia and Romania. These three treaties need to be examined to determine if additional products need to be liberalised so they meet the terms of the MoU.

4.2.2 The need to liberalise agriculture further

With the exception of the agreement of Bosnia and Herzegovina and Bulgaria, manufactures are virtually completely liberalised in all agreements. Hence, additional liberalisation to meet the 90 % coverage criteria will have to focus on agricultural goods. This may be politically difficult in those countries that protect agricultural heavily. However, since agricultural tariffs on average are about twice the level of those on industrial goods in these countries, the benefits will be correspondingly larger.

As previously noted five to six agreements liberalise only about 10 per cent of agricultural product lines. Hence, considerable scope exists for additional liberalisation. The work of GEM suggests that about 30 - 40 per cent of product lines would need to be liberalised in order to meet the overall 90 per cent trade coverage criteria. The Working Group could aim to establish a minimum list of agricultural products that all countries agree to liberalise preferentially.

4.3 The existing tariff structure

The difficulties that some countries encounter in fulfilling the trade coverage criteria can reflect their different trade policy stances. This section therefore summarizes these briefly. The eight countries can be divided into two groups (high-tariff and low-tariff countries) based on their unweighted average *ad valorem* MFN tariff rates on all tariff lines.[27] Romania has the highest level of overall protection (17.1 %) and Croatia and Moldova the lowest (5.0). In between these extremes,

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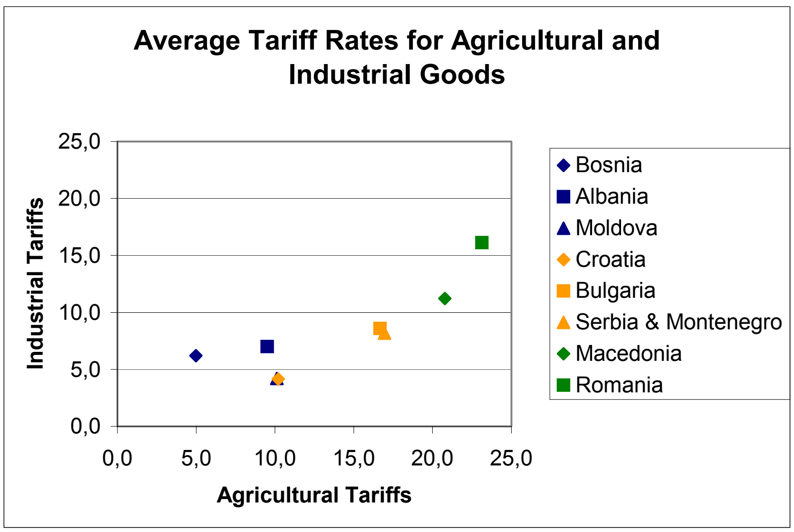
"benefit of the doubt". The picture presented should be viewed as a "best-case scenario" to be modified by the final GEM report.

[27] Romania (17.1 %), Macedonia (12.6 %), Bulgaria (9.7 %) and Serbia and Montenegro (9.4 %) are in the former group and Albania (7.4 %), Bosnia and Herzegovina (6.0 %), Croatia (5.0 %), and Moldova (5.0 %) in the latter.

tariffs rise from Bosnia and Herzegovina (6.0%) to Macedonia (12.6 %). Although high-tariff Romania appeared more reluctant to liberalise trade in the negotiations, there is no clear connection between the overall level of tariffs in a country and its willingness to liberalise. A more important impact on countries' willingness to liberalise is its level of agricultural protection and the occurrence of tariff peaks.

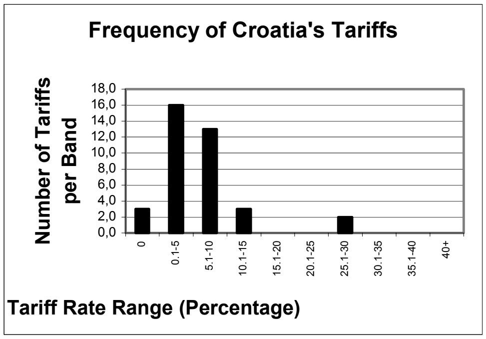
All countries except Bosnia and Herzegovina protect agriculture more than industry (the observations in Figure 4.1 lie under the diagonal). The level of tariffs on agriculture tends to determine the overall level of protection. Thus, while Macedonia and Romania have high tariffs on both agricultural and industrial products, SaM and Bulgaria wind up among the high-tariff group in spite of relatively low tariffs on manufactures. The countries with the lowest tariffs on agriculture are in the low-tariff group. Bosnia and Herzegovina has low tariffs in both sectors. Moldova and Croatia with the lowest level of overall protection even though tariffs on agricultural goods are twice as high as in Bosnia.

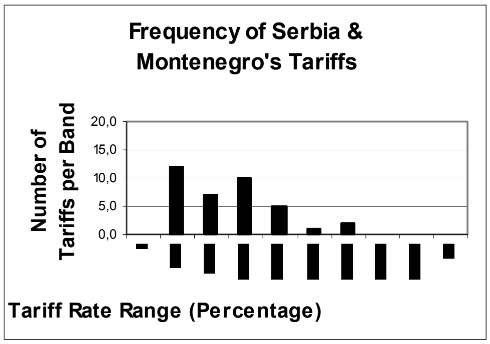
Figure 4.1 *Countries grouped by level of agricultural and industrial tariffs*

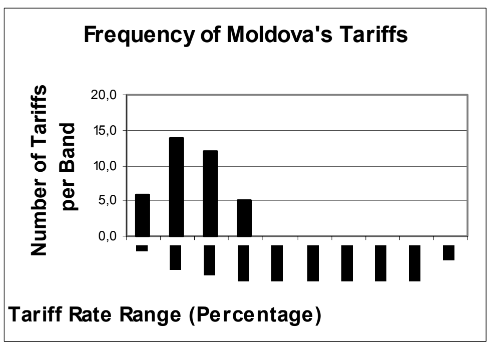


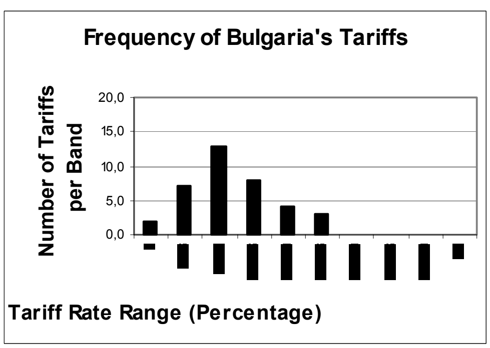
The four high-tariff countries are also those with the highest (and the most) peaks in their tariff structure. This means that reducing tariffs to zero on high-peak products gives partner countries a significant preferential margin, which can generate trade. The low-tariff countries – Albania, Bosnia and Herzegovina, Croatia and Moldova - have no commodities with tariffs over 15 % (see Figure 4.2).[28] The two countries with the highest average tariff rates (Romania and Macedonia) both have the greatest number of commodity groups with average tariff rates of 15 per cent or more. The other two high-tariff countries (Bulgaria and Serbia and Montenegro) also have a relatively large number of products with tariffs higher than 15 per cent (see Figure 4.3). Most countries have high tariffs on textiles and apparel and on simple labour intensive manufactures. Since these are precisely the commodities in which the SEE countries have a comparative advantage, it is likely that removing these tariff peaks vis-à-vis each other will stimulate trade. Domestic producer interest may precisely for this reason lobby against liberalisation in some countries.

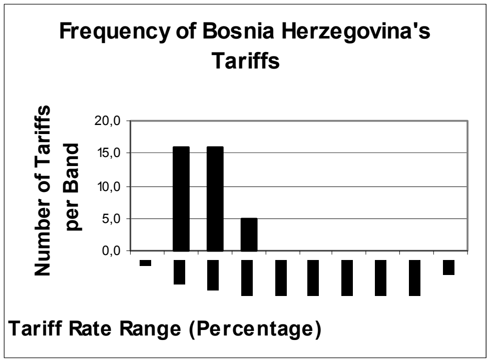
[28] There is one exception: rates on beverages and tobacco in Croatia are above 25 %. These two commodity groups constitute tariff peaks in all countries.

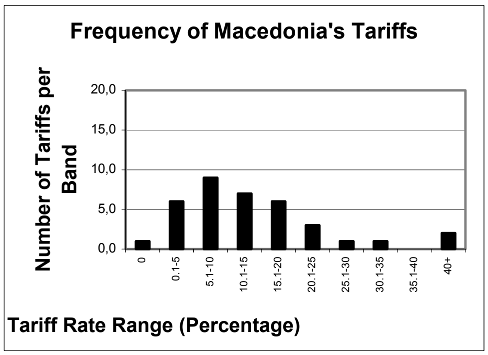

Frequency of Croatia's Tariffs
Number of Tariffs per Band
18,0
16,0
14,0
12,0
10,0
8,0
6,0
4,0
2,0
0,0
0
0.1-5
5.1-10
10.1-15
15.1-20
20.1-25
25.1-30
30.1-35
35.1-40
40+
Tariff Rate Range (Percentage)

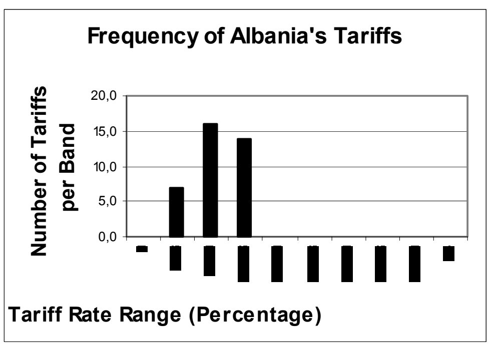

Frequency of Serbia & Montenegro's Tariffs
Number of Tariffs per Band
20,0
15,0
10,0
5,0
0,0
Tariff Rate Range (Percentage)


Frequency of Moldova's Tariffs
Number of Tariffs per Band
20,0
15,0
10,0
5,0
0,0
Tariff Rate Range (Percentage)


Frequency of Bulgaria's Tariffs
Number of Tariffs per Band
20,0
15,0
10,0
5,0
0,0
Tariff Rate Range (Percentage)

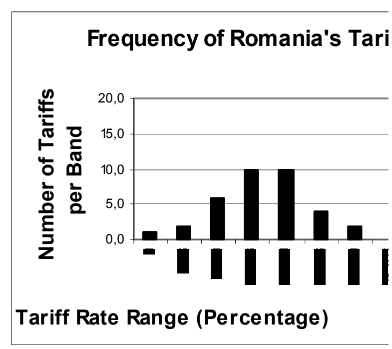






Frequency distribution of tariff levels in “low tariff” countries

Frequency distribution of tariff rates in “high tariff” countries



5 The SEE as ‘training school’ for EU

The key institutions of a market economy are too weak in most countries of South Eastern Europe to qualify them for consideration for EU accession for some time. In the Eastern Balkans, not even a candidate country qualifies as a functioning market economy. The MoU requires countries to harmonise rules and procedures with those of the EU. Hence, institution building is an important component of regional free trade area. In this respect, the SEE process functions as a ‘primary school’ for the EU. Indicators prepared by the European Bank for Reconstruction and Development (EBRD) suggest how well prepared a country's institutions are.[29] These indicators for nine trade-related institutions[30] are graphically summarised for three groups of countries in Figure 5.1.

5.1 A diagnosis of institutional weakness and strengths

Those countries that will be joining the EU in 2004 score notably higher on all indicators than the SEE countries. Almost by definition (in fact a condition of entry), the first wave accession countries score close to EU standards (a four plus). By contrast, SEE-countries on average score little better than ten CIS states.[31] The fact that they are so much worse than the accession countries and so little better than the CIS countries, should be a cause for serious concern for each SEE government. It must make special efforts to improve trade-related institutions, if the country is to integrate into European structures in the foreseeable future.

Characteristic of the SEE-countries is that they score especially poorly in *governance and restructuring of enterprises,* in *financial sector reform (non-bank)* and in *competition policy.* They perform best in *price liberalisation* and in *liberalisation of trade and foreign exchange dealings*, in fact on par with the first wave accession countries. One conclusion is that the SEE countries have done better in areas where there is a structured programme of co-operation between transition and market economies such as in the Stability Pact Trade Working Group. An implication of this is that the SEE countries could do just as well in other fields, such as competition policy, should the donor countries fund such a programme.

Among the South East European countries, EU-applicant countries Bulgaria, Croatia and Romania lie well above the SEE average. Croatia, actually leads on most scores. Surprisingly, Moldova scores close to the SEE average. All countries perform extremely poorly in competition policy and in governance and enterprise restructuring. The smaller countries – Albania, Bosnia and Herzegovina and Macedonia - fall well below the SEE average as does Serbia and Montenegro. Among these, Bosnia and Herzegovina and Serbia and Montenegro score worst. They must now resolve the constitutional issues that are seriously slowing down institutional reform in these countries. They need to take special measures in the following fields: *large scale privatisation, governance and enterprise restructuring, competition policy, financial sector reform* and *infrastructure reform*. The conclusion is that all SEE countries must make major efforts at building institutions in general, and in competition policy and infrastructure reform in particular. This can be more easily achieved in a cooperative undertaking where key political officials and policy experts from different countries can together benefit from the expertise of international experts. This will require support from donor countries to achieve this in a reasonable period of time. Also the applicant countries could benefit from SEE capacity training and institution-building activities in the field of competition policy. The Stability Pact is a good framework for such activities.

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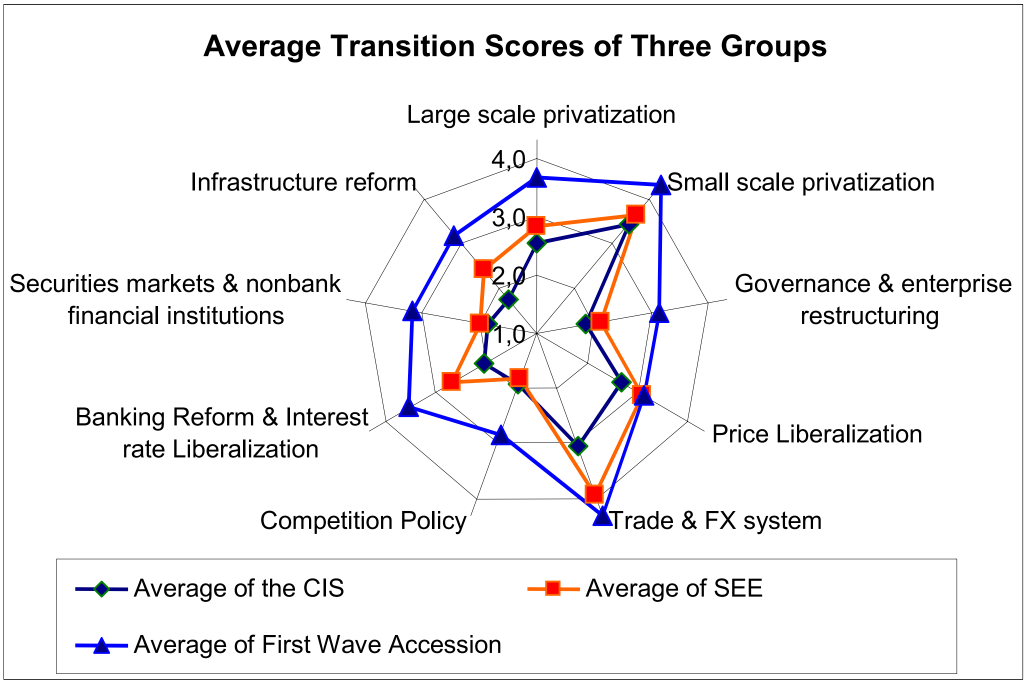
[29] The indicators range from a score of 1 (indicating no change from a planned economy) to 4 (which represents a fully functional level on par with the most advance market economies of Europe).

[30] The institutions concern enterprise policies, markets and trade, financial institutions and infrastructure

[31] In fact, Russia scores better on all but 3 indicators than the "average" SEE-country. Russia's scores are in EBRD's *Transition Indicators Report for 2002*.

Figure 5.1: Average EBRD scores for CIS, SEE, and first wave candidate countries on major institutions.



5.2 The need to combat corruption

A key element in good governance is the absence of corruption. The weak institutions of the "soft state" invite corruption, giving rise to a vicious circle. Once corruption has taken root in a society, it spreads rapidly and is difficult to eradicate. Dishonest firms put honest firms at a competitive disadvantage forcing them either to resort to bribes or to disappear. When citizens no longer believe that others play by the rules, the social trust, which constitutes the fabric of a civil society, erodes. As organised crime grows it creates power centres that threaten state institutions. Foreign direct investment suffers. Reputable foreign investors are at a competitive disadvantage compared to less reputable domestic firms.perceive corruption to be in about 100 countries. The results for EU members, EU accession countries (those joining 2004) and SEE-countries are summarized in Table 5.1. Five SEE-countries average a score of 3, placing them among the bottom half of the 102 countries surveyed.[32] This average is much lower than the first-wave accession countries, which in turn score somewhat lower than EU members. The majority of the SEE countries will have to make strenuous efforts to combat corruption if they are to approach EU standards in this respect.

With international support, Stability Pact countries have recently made special efforts to combat corruption (Box 5.1). Agencies particularly plagued by corruption are those dealing with customs, privatisation, public procurement and banking (money laundering).[33] Combating corruption in each of these sectors in a co-ordinated manner is especially important.

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[32] Transparency International's results for the SEE countries should be treated with caution. Bosnia and Herzegovina, Macedonia and the Union of Serbia and Montenegro are excluded since the surveys provided insufficient data. Including them would in all likelihood reduce the average for the SP countries further.

[33] For instance, the Bosnian Serb minister of finance resigned in a case of customs fraud in March 2002; The top customs official in Kosovo was arrested on charges of fraud May 2002 but later released.

The Stability Pact set up its Anti-Corruption Initiative (SPAI) in Feburary 2000 together with the Council of Europe (CoE), the EC, OECD, USAID and the World Bank. In September 2001 SPAI agreed on three priorities in its anti-corruption compaign for 2002. These are to assist governments and civil society on *key reform issues;* to *involve civil society* in all phases of anti-corruption reform efforts; and to promote and *monitor reform progress*.[34] Combating corruption in customs fulfils all the requirements for a SPAI project: involvement of civil society, inter-regional and inter-sectoral complementarities, need for government ownership of the process and transparent monitoring of progress. Hopefully, the Stability Pact will obtain the increased international support necessary for such an initiative to be effective.

Box 5.1 Anti-Corruption Programmes in SEE Countries

Albania, Special oversight body to be set up based on anti-corruption bill drafted in June 2002.

Bosnia and Herzegovina, Working Group to fight corruption and organized crime, February 2002. National Anti-corruption Action Plan proposed inh March 2002.

Bulgaria, Inter-Ministerial Anti-Corruption Commission (White Commission) chaired by Minister of Justice and financially supported by the World Bank. February 2002.

Croatia, Office for Fighting Corruption and Organmised Crime (OFOC/USKOK), Autumn 2001.

Serbia, The Council for the Fight Against Corruption (October 2001) and the Committee for the Fight Against Corruption. Chaired by Prime Minister

Montenegro, Limited information about decided action plan

Romania, National Anti-Corruption Prosecution, Spring 2002

[34] SPAI helps governments identify and develop key reform projects and liaise with donors to secure funding. Key characteristics of these projects are: local ownership, civil society involvement, inter-regional cooperation, inter-project complementarity and synergy and transparent monitoring.

Table 5.1 Rank and Score of Corruption Perceptions Index 2002 by European Countries

Rank	EU members	EU accession countries	SEE-countries
1.	Finland 9.7		
2.	Denmark 9.5		
5.	Sweden 9.3		
7.	Luxembourg 9.0		
7.	Netherlands 9.0		
10.	UK 8.7		
15.	Austria 7.8		
18.	Germany 7.3		
20.	Belgium 7.1		
20.	Spain 7.1		
23.	Ireland 6.9		
25.	France 6.3		
25.	Portugal 6.3		
27.		Slovenia 6.0	
29.		Estonia 5.6	
31.	Italy 5.2		
33.		Hungary 4.9	
36.		Lithuania 4.8	
44.			
45.			Bulgaria 4.0
45.		Poland 4.0	
51.			Croatia 3.8
52.		Czech Republic 3.7	
52.		Latvia 3.7	
52.		Slovak Rep 3.7	
77.			Romania 2.6
81.			Albania 2.5
93.			Moldova 2.1
	Group Average 6.9	**4.5**	**3.0**

Source: Transparency International, *Global Corruption Report,* 2003. The score 0 indicates highly corrupt and 10 highly clean.

Note: Transparency International was unable to collect sufficient survey results for all SP countries in 2002.

5.3 Competition Policy

All SP countries score very poorly in terms of the legislation and institutions necessary for implementing a competition policy consistent with European norms.

The MoU commits the signatory countries to "harmonize their competition law with that of the EU….[and to] further strengthen, where necessary, the enforcement capacity of relevant Authorities, including competition or similar bodies, and establish such authorities where none exist." (Article 9). In addition, the MoU requires the provisions concerning trade remedies and competition policy to be consistent with the provisions of the WTO (Article 4).

Most signatory countries will have to make special efforts in order to fulfil this Article. For this reason, The Stability Pact provides the SEE countries with necessary assistance. In 2001 the OECD initiated a programme in Competition Policy to strengthen both the competence for civil servants and institutions in SEE.countries.[35] The OECD discontinued the programme at the end of March 2002 for budgetary reasons. At a follow-up meeting,[36] representatives of national competition institutions of the SEE countries and participants from the EU, Italy, Slovenia, Turkey and the OECD called for the "establishment of a Network of competition authorities in SEE [….] to hold annual meetings to review progress in the implementation of competition law and policy through the region, organise thematic workshops on competition issues and competition law enforcement including training activities, serve as a platform among participating countries for exchange of information and experiences, and for co-operation on competition law enforcement.". The donor countries of the Stability Pact should support this initiative.

5.4 Attracting foreign direct investment

A functioning free trade area in SEE can help attract foreign direct investments to the region. Foreign investors want to supply the whole region from an investment in one country. Thus, fostering perception of the SEE as a functioning free trade area can have a positive impact on FDI. FDI in SEE is far below its potential. All SEE-countries except Croatia lie far below the first wave accession countries in terms of FDI-inflows in terms of per capita or of GDP (Figure 5.2). Croatia experienced significant inflows since 1996 and is the only SEE country close to the leading accession countries. By contrast, Serbia and Montenegro, Bosnia and Herzegovina, Moldova and Albania are roughly comparable to the CIS countries. Bulgaria and Macedonia lie about half way between the CIS and first wave accession countries.

This poor performance of the SEE-countries is probably due largely to poor host-country conditions. It may also reflect a lack of knowledge about the improving possibilities for foreign investors. FDI has picked up during the 2001 and 2002 in SEE putting a number of SEE countries close to the countries of central Europe and the Baltics in those years. Most of the countries have now set up government Agencies to promote foreign investments and/or exports. Such agencies fulfil an important function by informing the international business community of the conditions for investing and by acting as an advocate in domestic discussions for appropriate macro and micro policies. In many cases, these agencies still remain "shells" which need to be filled with competence and policies. Most countries will require technical assistance to do this. The same argument for assistance in developing investment promotion agencies applies to exports and especially to exports of agricultural goods.

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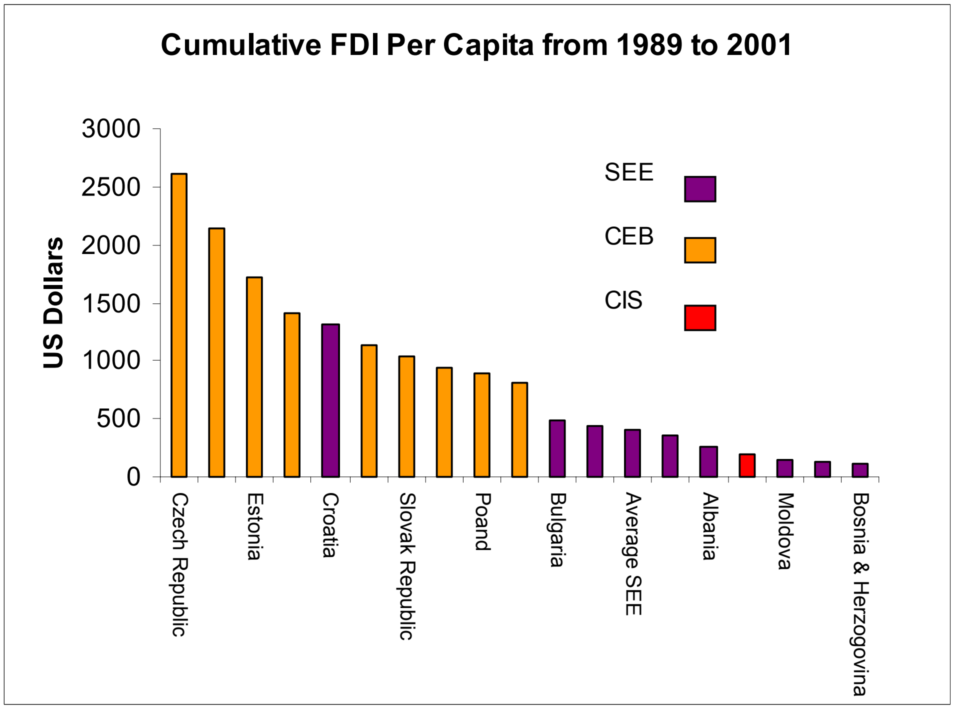
[35] The manager of this programme was Lennart Göranson, Principal Administrator of the OECD Secretariat's Competition Division.

[36] Held at the OECD Centre for Private Sector Development in Istanbul on 26-27 May, 2003.

Figure 5.2: *Amount of foreign direct investment per capita since 1989.*



Source: Data from EBRD, Transition report 2002.

6 Conclusions

Despite differing initial conditions and a lack of communality, the countries in SEE have made surprising progress. They have succeeded in negotiating a network of bilateral free trade agreements covering the area and started the process of harmonising their legislation in key trade-related areas to that of the EU. The initiative to do this came from outside the region and had to overcome an initial hesitancy in many countries. Realization that a regional free trade area could be a step towards EU accession, the goal of all countries, helped overcome this hesitancy.

The EC made it clear that a SAA was a precondition for EU accession and that countries with a SAA with the EU had to have free trade also with each other. With time it became clear that all countries in the Western Balkans, subject to appropriate progress, could qualify for a SAA. Hence, free trade between the countries in SEE became a natural development, something that would eventually be realised. It could provide important economic benefits to the countries. Intra-regional trade could be expected to treble, providing highly needed gains from trade. Establishing awareness of the existence of a free trade area in SEE in the minds of foreign businessmen could attract foreign direct investment and accelerate economic growth. In addition, it was understood that normalising political as well as economic relations between the countries in SEE was a precondition for EU accession. Post-war reconciliation in SEE was necessary for accession: if two countries recently entangled in war could not get along with each other outside the Union, how would they be able to get along in side the Union? The EU, built to achieve post-war reconciliation and economic reconstruction, could hardly be expected to admit members that were ticking problem bombs.

Co-operation in the SEE context provides an important stimulus to institutional reform and economic transition, preconditions for EU accession. The MoU specifies a number of areas where countries are to harmonize their laws and procedures on those of the EU. The SEE free trade area thus constitutes an important training school for European integration.

The seven countries have confounded most sceptics by successfully establishing a network of regional free trade agreements on time. However, questions marks remain as to whether they together constitute an effective free trade area. The difficulties are both political and practical. Three political difficulties have been stressed in this paper. First, the progress of the working group slowed down in 2003 due to the difficulties experienced by Serbia and Montenegro to harmonize their commercial policies. All "renegotiations" of the relevant bilateral agreements were not even completed in time for the Ministerial on 13 November 2003. Montenegro's attempts to "renegotiate" the lists of exceptions also damaged the union's credibility as a negotiating partner. Secondly, the interests of the applicant countries to participate in the work of the Working Group may wan as their accession date approaches. This risks slowing down the progress of implementing the agreements. Finally, the status of Kosovo in the free trade area remains to be solved.

The major practical problem facing countries is to fulfil the 90 per cent trade coverage criteria. This may require liberalising additional agricultural product lines. While the adjustments appear marginal, the political costs may appear high to a number of governments. But failure to meet the conformity criteria will damage the credibility of the Stability Pact exercise.

The difficulties above could well bring the SEE trade liberalisation process to an early end. If the process is to be kept alive, the countries must individually and together show sufficient political will and ingenuity to include Kosovo, implement a common commercial policy in Serbia and Montenegro, and maintain the interest of the EU applicant countries. Political will is the wind in the sails that moves the process forward.