

No Nation Was Ever Ruined by Trade: South-Eastern European Trade Analysis

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Non-technical summary

The objective of the paper is to analyze the Central European Free Trade Agreement 2006 (CEFTA-2006) impact on trade and provide quantitative comparison with the original CEFTA and with the trade liberalization under the EU integration process. In 2006, eight South-East European countries (SEE) joined the Central European Free Trade Agreement (CEFTA): Albania, Bosnia and Herzegovina, Croatia, Kosovo, Macedonia, Moldova, Montenegro and Serbia. Given the original CEFTA members (mainly Central European countries) left the agreement due to their joining of the EU, what in 2006 left to be CEFTA, entirely differed from the original CEFTA formed in 1992, and became known as CEFTA-2006. Similarly as the original CEFTA, CEFTA-2006 aimed to increase the intraregional trade of the South-East European (SEE) countries, so that they would be able to cope with the competitive pressure once they become a part of the European Union (EU) single market. However, CEFTA-2006 has been still a response to some fears that the EU accession will divert SEE's export to the EU and render SEE countries more vulnerable to shocks coming from the EU. Hence, CEFTA-2006 started operating with two basic objectives: i) it had to test the SEE's capacity to work together within a regional agreement and build their competitiveness; and ii) it had to oppose the growing dependence of these countries on the trade with the EU by re-establishing the regional market. However, bringing SEE countries under single umbrella has likely political side also: working together would enable those countries to join the EU faster and hence prevent further political tensions and conflicts in the Balkan, which earmarked the last decade of the XX century.

The paper belongs to the strand of the literature analyzing a free trade agreement in a gravity framework, but treating it as being potentially endogenous. In a simple gravity framework, the trade between two countries depends positively on their incomes and negatively on the distance between them. The paper argues that, for the case of CEFTA-2006, not only the economic similarity and geographical proximity forced countries to self-select into a free trade agreement, but also that their will to join EU as soon as possible and, in that way, to prevent further conflicts in the Balkans, acted as a crucial *spiritus movens* to engage into a free trade agreement. Consequently, the paper sets a gravity equation, whereby the main variable of interest – CEFTA-2006 – is treated as being potentially exogenous. The potential endogeneity is addressed with a selection of observable variables (incomes and geographical distance) and with a selection of unobservable variables. The latter is econometrically achieved by instrumenting CEFTA-2006 with an indicator of the democracy in the member countries. The indicator is a rough approximation of the will of those countries to join the EU – the sooner they become more democratic, the sooner they will be able to join the EU – and hence, can serve as an instrument (i.e. affects the bilateral trade only through CEFTA-2006 and not directly). CEFTA-2006 has

been formed once all conflicts in the Balkans have been settled down and has been considered a vehicle to getting prepared for the fiercer competition on the EU market and, hence, for entering the EU. The Generalized Method of Moments has been used to estimate the gravity equation, given these considerations.

The empirical evidence suggests that CEFTA-2006 exerted positive, significant and large effect on trade in South-East Europe. This finding can be largely attributed to the distracted trade flows in the region over the 1990s, given it was a decade of wars, embargoes, hyperinflation and social unrest. The effect of CEFTA-2006 has been estimated to be larger than the effect of the Stabilization and Association Agreements, which counteracts the concern that the European Union and the South-Eastern European countries formed a 'hub-and-spoke' structure in terms of trade. Findings also suggest that CEFTA-2006 in South-East Europe exerted considerably larger influence on trade than the original CEFTA in Central Europe.

The success of CEFTA-2006, no matter the comparative context, brings an important lesson for the South-East European economies. It suggests that if they want to work together with a big light-motive - joining the European family - they can achieve a lot. On this road, increasing the further cooperation - reducing the non-tariff barriers to trade, coordination in the process of attraction of foreign direct investment, harmonizing the rules for public procurement and so on - will likely bring significant benefits to the region and will further boost its integration into the European Union and the world economy, in general.

Keywords: CEFTA-2006; Stabilization and Association Agreements, trade agreements' endogeneity