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## **Key issues in multilateral trade liberalization of economies in transition**

In early 1990s all transitional economies faced the need to perform excessive trade reforms under an overall framework of switching to market economy and integration with the world - international economy and particularly trade rules. Among first steps in these efforts were liberalization policies that gave different results, many of them undertaken autonomously and closely related to individual economic and political conditions in the country. This endogenous trade liberalization process has generally proceeded simultaneously with the so-called exogenous trade liberalization, i.e. acceptance of trade liberalization commitments within preferential regional integration agreements and/or multilateral obligations.

External commitments have been critical to the success of trade policy reform, because they have increased its internal and external credibility and contributed to maintaining the momentum for trade liberalization in the face of protectionist resistance.

Regional integration under the auspices of the EU, with perspective of a full membership in the EU, has proved to be a particularly efficient instrument to support trade policy reform. The EA have not only led to the removal of tariff barriers but steered the development and rationalization of trade regimes and the harmonization of legal and institutional structures with the existing EU framework. The success of this strategy is illustrated by a relatively rapid recovery of most Central and Eastern European countries (CEECs) from post-transformation recession and by their integration into international trade and foreign investment flows.

### **I. Trade policy reform in transition economies**

#### ***1.1. Main stages of trade liberalization in transition economies***

Trade liberalization has been an integral part of the transition process undertaken by former centrally planned economies at the beginning of 1990s. Trade liberalization was expected to deal rapidly and most efficiently with two major flaws of the centrally planned economic system:

1. the distorted price structure, resulting from the previous system of administered prices, and
2. the centralized and highly integrated production system formed by large monopolistic enterprises.

In other words, trade opening was designed to “import” world prices and to “inject” more competition into national economies that were dominated by a few large domestic producers.

Economic theory provides a straightforward rationale for trade liberalization. In the first stage, they suggest to replace implicit or quantitative trade restrictions with tariffs and limiting administrative restrictions on trade transactions. In the subsequent stages, it is recommended to rationalize of the tariff structure, in particular reduce average tariffs, limit the number of different tariff levels and avoid tariff peaks. Negotiations on these topics that have been held within the WTO, either in the process of accession to this organization or through regular rounds of multilateral negotiations for those who have already been members of the WTO, helped to steer the efforts into globally supported rules and disciplines.

The first liberalization measures consisted of phasing out the state foreign trade monopoly, allowing registered operators to carry out foreign trade transactions and freeing their access to foreign currency for trade purposes. The opening to foreign direct investment (FDI) was mainly seen as a means to expand and upgrade export capacities.

During the first years of trade reform in transition economies, the competition-enhancing effect of import liberalization and its contribution to general economic efficiency have generally been underestimated. Still, the role of trade liberalization in facilitating economic restructuring is particularly important in the context of transition economies.

### ***1.2. Main factors explaining different outcomes of trade liberalization in transition economies***

Three main categories of factors influence outcomes of trade liberalization in different transition economies:

- macroeconomic variables,
- structural policies (including external liberalization) and
- initial conditions in different transition countries.

Many analysts emphasize the critical importance of political factors, especially the timing of the reforms and success in maintaining of public support. As regards inflation, all transition economies were confronted with the one-time jump in prices that accompanies price liberalization carried out at the beginning of the transition process.

Unemployment is generally higher at the beginning of the restructuring process. This fact has been proved on a case of the CEECs in comparison with the CIS, confirming that the painful restructuring process has not yet started in the latter economies. However, in several transition countries, in particular Hungary, Poland and Slovenia, unemployment has recently started to decrease. This is also the case in Serbia with the unemployment decreased from 21,6% in 2006 to 18,8% in 2007.

The transition countries having adopted a rapid and radical reform approach have been able to deal more rapidly and efficiently with post-transformation shocks and imbalances. Recent developments in transition economies also show a clear parallel between recent GDP performance and trade openness in transition economies.

## **II. Measuring the impact of trade liberalization**

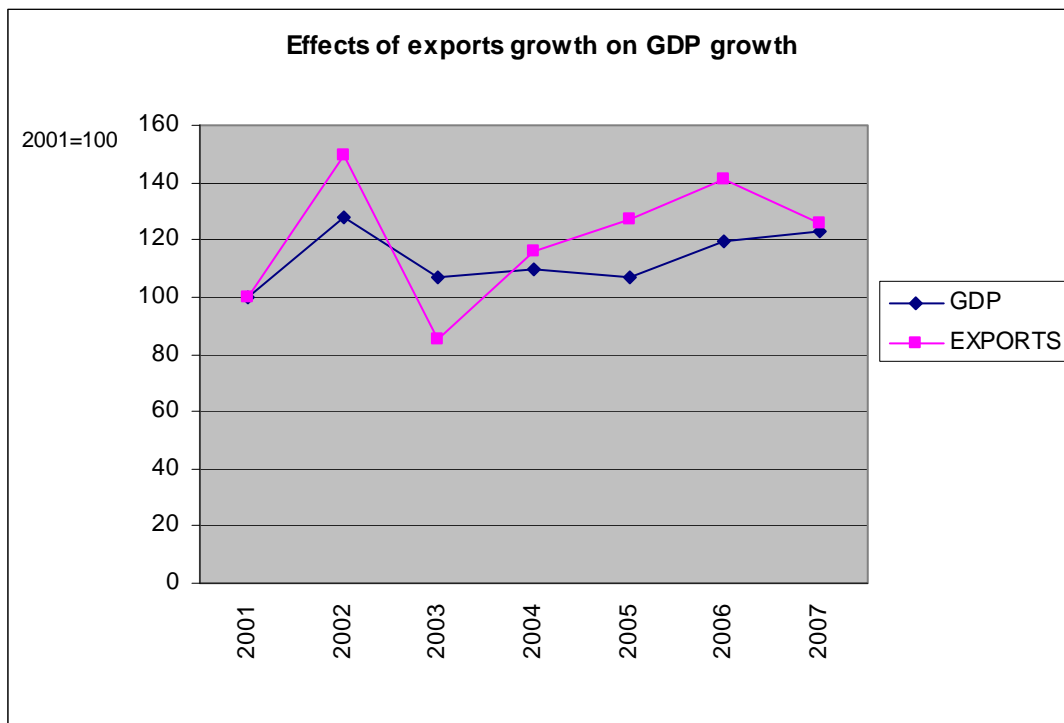
## 2.1. Trade liberalisation and economic growth

Economic theory and factual analysis converge in recognizing a growth stimulating effect of trade and investment, due to their role as a major vehicle for technological progress, exploitation of economies of scale and for enhancing competition. Trade liberalization is usually part of a broader economic package, including macroeconomic stabilisation and other structural adjustment policies.

The recent experience of transition countries also confirms that successful reformers generally put in place a “virtuous” association of these various positive elements. The countries that overcame the post-transformation recession most rapidly and experienced dynamic economic growth adopted a coherent reform strategy, combining broad trade opening with rapid macroeconomic stabilisation and development of market oriented institutions.

Available data clearly show that the transition countries with the best GDP performance also have the highest trade openness, measured by the share of exports in GDP.

This is also the case with Serbia and the following graph shows the export growth that goes generally in parallel with the GDP growth.



In addition to trade openness, outward economic orientation could also be measured by the amount of foreign direct investment attracted by different countries. FDI represents a good synthetic indicator that reflects the deliberate policy of the authorities

and, at the same time, expresses the result of this policy, indicating the overall perception of the economic and political situation by external operators.

## ***2.2. Trade liberalization and trade flows***

The most common indicator measuring achievements of trade liberalization is the increase in trade openness. Trade reform has also been expected to accelerate the transformation of the commodity structure of transition countries' foreign trade in line with their comparative advantages.

The impact of trade liberalization is also visible on trade flows. In economies in transition we are witnessing a reorientation of trade towards new partners, but also a different structure of GDP and exports.

Developments in trade in services also reveal the impact of trade reform. Progress in economic restructuring usually results in an increase in service sector activities and more active participation in foreign trade in services.

The structure of GDP of Serbia has been changing from 2003 to 2006 recording decrease of agriculture and industry and the growth of services; namely, the share of agriculture decreased from 13.6 % in 2003 to 12.6% in 2006, the share of industry decreased from 26.2% to 24.3% and the share of services increased, from 60.2% to 63.1% in respective years.

However, the Services Balance of Payments has been in deficit of 27 million US dollars from January 2005 to August 2007. Looking at services sectors, travel, communication and construction services recorded surplus while transportation, insurance and financial services recorded deficit.

<b>Share of the aggregated sectors in GDP 1999 - 2006</b>								
	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>
<b>Agriculture</b>	16.2	13.6	15.5	14.9	13.6	15.0	13.5	12.6
<b>Industry</b>	28.0	30.6	28.2	27.0	26.2	25.7	24.6	24.3
<b>Services</b>	55.8	55.8	56.3	58.1	60.2	59.3	61.9	63.1
<b>TOTAL</b>	100	100	100	100	100	100	100	100

## ***2.3. Trade liberalization and adjustment costs***

The most serious adjustment costs associated with the transition process and trade liberalization are social costs reflected in different indicators of poverty or measured by the level of unemployment. Recent experience of transition economies also confirms the importance of better public and private governance and a favorable business climate for reducing poverty. Trade liberalization is often made responsible for the deterioration in

the trade balance and fiscal problems stemming from the contraction of foreign trade related taxes in budget revenues.

### *2.3.1. Social costs*

Social costs are rightly considered the **most politically and economically harmful element accompanying trade liberalization**. The countries adopting radical reform, including rapid trade liberalization, were confronted in the first years of their transition process with rapidly escalating unemployment, but in general, they started more quickly to reduce it in further stages of their reform.

In the field of employment, Serbian government faces a very serious challenge with a continuous unemployment situation with the number of employed persons decreasing. However, in 2007 **unemployment rate** decreased from 21.6% in 2006 to 18.8%, which is a result of active employment measures. It is important to mention that there is a difference between the official and real unemployment rate, which represents the size of gray economy in Serbia.

These figures still reflect the difficulties and challenges which our society is facing in the overall attempt to accomplish political and economic consolidation and modernization, after 55 years of socialism, dirigiste economy and the devastating 1990-ties.

A rapid expansion of the private sector and development of new activities allowed fast-reforming countries to create additional job opportunities in export oriented sectors and in new activities, such as services.

### *2.3.2. Fiscal constraints of trade reform*

The impact of trade liberalization on the budget depends on the type of trade reform and the role of tariff proceeds in tax revenues.

If trade reform led to the replacement of quantitative measures by customs duties, corresponding tax revenue would increase.

In contrast, a **reduction in tariffs**, even though they may be partially offset by an increased volume of trade transactions, **often leads to a loss in tax revenues, thus threatening the fiscal balance** and therefore macroeconomic stability.

**In order to minimize negative effects of trade liberalization and preserve fiscal equilibrium, trade reform should be accompanied by a tax reform especially aiming at diversification of tax revenues and narrowing tax exemptions.**

### *2.3.3. Trade imbalances*

In addition to social costs and possible fiscal problems, trade liberalization might also exert an adverse impact on foreign trade balances. At the beginning of the transition

process, many of transition economies recorded a trade surplus, due to drastically devalued exchange rates. Later, exchange rate appreciation and a revival of domestic demand fuelled import growth. As a result of these cumulative effects, **most transition economies faced serious deterioration of their trade balance.**

In Serbia, despite very high foreign trade deficit amounting, as mentioned above, 6.9 billion EUR in 2007, total foreign trade amounted 19.7 billion EUR in 2007 which is 27% higher in comparison to 15.5 billion EUR in 2006.

The balance of payments improved, including the growth of foreign exchange reserves. In 2007, foreign exchange reserves of the National Bank of Serbia amounted 12.9 USD billion which is 27% higher compared to the same period in 2006.

Most countries reacted by imposing import restrictions, and other countries, especially among the CIS, have responded to the risk of the trade balance deterioration by adjusting tariff levels.

A large and persistent trade deficit can have negative consequences for the overall macroeconomic situation and for the attitude of international financial markets. It may also generate political resistance to trade reform.

If the trade deficit is mainly due to imports of machinery and equipment, it can be justified by ongoing restructuring and related modernisation needs. In contrast, if the trade deficit is due to large-scale imports of consumer goods, the trade deficit may reflect a short-sighted solution to the problem of domestic producers' inability to respond to internal demand.

If a current account deficit is financed mainly by FDI inflows, the situation is sustainable and, if it reflects mainly a country's modernisation needs, also economically sound. However, a lasting gap between the level of the trade deficit and net FDI inflows indicates growing risks for the country's macroeconomic stability and external financial situation.

In Serbia, in 2007 the inflow of FDI reached USD 1.05 billion with largest FDIs coming from Norway, Germany and Greece.

### **III. Role of regional integration in trade liberalization of transition economies**

#### ***3.1. Trade effects of preferential trade agreements***

Regional integration has become an increasingly influential factor in the international trading system and in the trade regimes of most countries. Trade effects of different regional agreements depend primarily on the scope of agreed mutual preferential trade concessions and the timetable of their implementation.

**The Europe Agreements** rapidly liberalized the access of transition countries' exports to the EU market, but introduced a longer transitional period for dismantling tariffs by transition countries on their imports from the EU. During the first years of the application of the EA, most transition economies succeeded in boosting significantly their exports to EU partners. With a certain time lag, transition countries' imports from the EU have become more dynamic.

The large scope of the preferential treatment and the rapidity of its implementation thus led to a considerable increase in the volume of mutual trade. The asymmetric approach characterising the EA was replaced by mutual and simultaneous trade concessions among the parties. In general, these agreements succeeded in stopping the post-transition decline in mutual trade and contributed to revive regional trade flows. The example of Serbia in this respect is evident to support the mentioned trends.

**Trade Serbia – EU Mill EUR**

Year	Exports	Index E	Imports	Index I	Trade Balance	Coverage of imports by exports
2000	862	144	1,717	125	-855	50.2
2001	1,037	120	2,385	139	-1,348	43.48
2002	1,214	117	3,274	137	-2,059	37.08
2003	1,204	99	3,611	110	-2,408	33.34
2004	1,457	121	4,677	130	-3,221	31.15
2005	1,939	135	4,233	91	-2,294	46.44
2006	2,681	138	5,078	120	-2,397	52.8
<b>2007</b>	<b>3,603</b>	<b>122.9</b>	<b>7,356</b>	<b>129.1</b>	<b>-3,753</b>	<b>48.98</b>

The trade between Serbia and EU is constantly growing, on both import and export side especially after introducing Autonomous Trade measures by EU, in year 200 giving Serbian exports duty free access to their market. But at the same time trade deficit is also growing and amounted 3.8 billion EUR in 2007, which is 57% higher in comparison to 2006.

The trade liberalization measures **in regional context** became extremely important for SEE countries

In 2001 we started with the Memorandum of Understanding on trade liberalization under the auspices of Stability Pact for South East Europe, leading to 32 bilateral FTAs and eventually to today's entry into force of multilateral agreement **CEFTA 2006**.

Since under the current network of bilateral FTAs, almost 90% of bilateral imports have been liberalized, on average, the share of Serbia trade with the countries in the region of SEE grew from 15.8% in 2004 when the majority of FTAs entered into force to 21.3% in 2006.

Total trade with region increased from 1, 6 billion USD in 2004 to 4.3 billion USD in year 2007.

Total Trade Serbia - CEFTA countries in period 2004 - 2007 in mil USD								
CEFTA	2004		2005		2006		2007	
	TOTAL TRADE	INDEX	TOTAL TRADE	INDEX	TOTAL TRADE	INDEX	TOTAL TRADE	INDEX
Albania	17	100	25	150.9	38	152.4	92	242.1
B&H	861	100	1,036	120.3	1,092	105.4	1560	142.9

<b>Croatia</b>	353	100	454	128.6	585	128.8	862	147.4
<b>Moldova</b>	4	100	12	280.0	12	103.4	17	141.7
<b>Macedonia</b>	420	100	429	102.1	500	116.5	746	149.2
<b>Montenegro</b>					765	100.0	1084	141.7
<b>Total CEFTA:</b>	<b>1,655</b>	<b>100</b>	<b>1,956</b>	<b>118.2</b>	<b>2,992</b>	<b>153.0</b>	<b>4,361</b>	<b>145.8</b>

In period 2004-2007 there is a constant, annual growth of exports and of imports but at the same time Serbia is constantly recording an overall trade surplus in trade with CEFTA Parties

Exports and Imports Serbia - CEFTA countries in period 2004 - 2007 in mil USD														
CEFTA	2004			2005			2006			2007				
	Exports	Imports	Trade balance	Exports	Imports	Trade balance	Exports	Imports	Trade balance	Exports	Index	Imports	Index	Trade balance
<b>Albania</b>	16	1	15	22	3	19	33	5	28	81	238	11	243	70
<b>B&amp;H</b>	626	235	390	744	292	456	749	343	406	1042	139	518	149	524
<b>Croatia</b>	149	205	-56	196	258	-59	251	334	-83	331	132	531	145	-200
<b>Moldova</b>	2	2	1	3	9	-6	4	8	-4	5	119	12	149	-7
<b>Macedonia</b>	257	163	94	261	168	95	300	200	100	437	146	309	153	128
<b>Montenegro</b>							616	149	467	951	154	133	88	818
<b>Total CEFTA:</b>	<b>1,050</b>	<b>606</b>	<b>444</b>	<b>1,226</b>	<b>731</b>	<b>504</b>	<b>1,953</b>	<b>1,039</b>	<b>914</b>	<b>2,847</b>	<b>146</b>	<b>1,514</b>	<b>146</b>	<b>1,333</b>

### *3.2. Impact of regional integration on trade policy in transition economies*

The role of regional cooperation in trade liberalization should be assessed not only strictly in trade terms but also from the trade policy perspective. In this respect, the EA played a crucial role for the CEECs, as well as for the Western Balkans, providing legal, regulatory and institutional guidance and a strong monitoring mechanism. Policy makers in the CEECs and Western Balkans have thus benefited from EU policy support for designing trade and other related policies. The mechanism for controlling implementation of agreed commitments has guaranteed a thorough application and prevented backward revisions of trade liberalization targets.

## **IV. Role of multilateral trade disciplines in the trade policy reform of transition economies**

### *4.1. Transition economies and the WTO*

The multilateral trading system and related trade disciplines were enhanced and reinforced after the acceptance of the Uruguay Round Agreements and the creation of the WTO in 1995. Like other country groups, transition countries benefited from the trade liberalization achievements of the Uruguay Round, either directly as WTO members or indirectly as beneficiaries of MFN treatment granted by bilateral agreements. As WTO founding members or newly acceding members, transition countries generally accepted significant trade liberalization commitments and participated actively in recent liberalization initiatives.

For reform-advanced transition countries participating in ambitious regional trade agreements, the acceptance of multilateral trade disciplines has generally not posed serious problems. These countries have already been subject to regular monitoring and surveillance, in some respects stricter than current WTO mechanisms for controlling the implementation of multilateral commitments.

Nevertheless, certain countries, especially among the new WTO members, have encountered some difficulties, in particular relatively high administrative costs related to the compliance with specific requirements such as notification procedures.

The situation is radically different for other transition economies that are still in the initial stages of their market reform process. The acceptance of multilateral trading disciplines is for them a very demanding task, especially because the areas and disciplines covered by the WTO have been considerably broadened. **Countries in accession process to the WTO are facing difficulties in taking on firm and ambitious commitments, since such commitments reduce their room for maneuver at a time when their domestic economic situation is still not stabilized.**

Multilateral disciplines are also often seen by some countries as a policy tool for imposing standstill commitments and existing possibilities to use available procedures for “locking in” further trade liberalization target are not always fully exploited. In some areas, the WTO disposes of efficient surveillance mechanisms. In particular, tariff binding and notification procedures contribute significantly to transparency and predictability of WTO members’ trade regimes.

However, in some other areas, the WTO procedures do not allow to address directly the source of implementation problems. For example, customs valuation procedures are subject to the WTO implementation control mechanisms, but the shortcomings in their effective application are often due to administrative deficiencies or lack of qualified staff.

Obviously, in this area additional mechanisms are required, in particular adequate technical assistance, whether international or bilateral. This is of paramount importance for acceding countries as Serbia.

***Main lessons from the trade liberalization experience of transition economies that are important for domestic policy and decision-makers:***

**First**, radical and fast trade liberalization initiated in the early stages of the reform process has been more successful in overcoming initial distortions and brought more rapidly positive results in the trade area, including trade re-orientation and a more efficient use of comparative advantages of individual countries.

**Second**, the trade liberalization experience of transition economies clearly demonstrates the critical role of legal, regulatory and institutional settings for the success of trade reform.

**A third** observation based on the experience of transition economies is the essential contribution of an “external anchor” to the success of trade reform. The acceptance of external commitments and a political will to pursue that course helps countries to boost the internal and external credibility of reforms and combat pressures to revising existing trade liberalization achievements.