

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

Executive summary

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Executive summary

Background

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

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

The work on this report (autumn 2006) coincided with the final stage of the negotiations on a multilateral trade agreement (CEFTA 2006) that is to replace the network of above 30 bilateral FTAs. Therefore, the policy recommendations emerging from this work will not be directly applicable to the functioning of FTAs but rather to new CEFTA. They will still be actual for the reason that many features of the current FTAs will be preserved in the CEFTA. Moreover, we are convinced that the recommendations are still valid in a broader policy context.

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

Experience of trade integration in the EU neighbourhood

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

Possible effects of forming a free trade area

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

FTA coverage

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

Intra-Balkan trade liberalisation – experience to date

The assessment of the early experience of the whole network of FTAs in the SEE region is difficult for a number of reasons, including the very short period of their operation. We conclude that one could not expect too dynamic increase in intra-SEE flows following the implementation of the network of the regional FTAs, at least not immediately. Similarity of the majority of SEE countries with respect to factor endowments and small differences in technologies imply that in the short- to medium-term one cannot expect any major boost in intra-industry trade. It is rather inter-industry trade based on relative factor endowments (described by the neo-classical trade theory) that can be expected. Besides, trade flows between some (but not all) of the considered countries by 1999-2002 were already quite high and probably around their potential levels. In some instances (primarily the case of Serbia and Montenegro) trade with some SEE partners might have been artificially boosted due to suppressed economic relations with other partners. Thus, some reorientation of Serbia and Montenegro trade away from (some) FTA partners towards other countries (in particular the EU and Croatia) should have been expected anyway, irrespective of the FTA process.

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

BiH trade policy

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

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

However, there are still substantial institutional impediments to foreign trade. Institutions and legislation dealing with technical regulations, conformity assessment, sanitary and phytosanitary, and veterinary issues are generally not sufficiently developed and harmonised with EU standards.

The perspective of negotiations with the EU on the Stabilisation and Association Agreement has helped to work out compromises and accelerated institutional reforms, which, however, yet need to be accomplished to bring economic effects. An important obstacle is limited capacity to deal with complicated technical trade-related matters in the Ministry of Foreign Trade and Economic Relations and other relevant institutions.

Liberalisation of BiH regional trade

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

Relative to other countries in the region BiH initially pursued quite vigorously with opening its agricultural markets. However, later BiH unilaterally introduced protective measures on a few selected agricultural products (mainly milk and meat products) from Croatia and Serbia and Montenegro. This has caused quite some problems and was continuously raised by BiH trade partners, who have been pointing out to a unilateral character of BiH policies and to the fact that BiH has never presented convincing evidence that could back suspending of a few elements of FTAs.

BiH trade flows

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

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

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

Determinants of BiH export and import

The gravity model for BiH foreign trade estimated in the report indicates that BiH trade relations with its ex-Yugoslavia neighbours are very intensive. In fact, they seem to be more intensive than the geographical proximity and the partners' economic potentials would indicate. This can be explained by the strength of historical industrial relations within one country, as well as common border and common language effects that are often found to positively affect trade volumes between countries. In contrast, the EU does not seem to account for a larger share of BiH exports than predicted by the basic specification, despite granting trade preferences for BiH products. The

explanation may lie in non-tariff barriers protecting EU markets or it may be that eased market access takes quite some time to translate into higher BiH export flows. Interestingly, the EU appears to be (slightly) underrepresented among BiH import markets, as indicated by the negative sign on the EU dummy variable in the import equation.

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

Effects of regional trade on BiH welfare

Looking at the FTA effects from another perspective, we see some (weak) indication of trade expansion taking place, although definite assessment is not feasible due to lack of relevant data. We see no reasons to expect trade diversion in case of BiH FTAs of any magnitude that could harm the BiH economy. What regards trade deflection there seem to be more arguments supporting the view that if it occurs, BiH is more likely to serve as an entry point for third countries' products that are finally sent to other SEE countries than being a 'victim' of trade deflection importing third countries products without duties via its FTA partners.

Non-tariff barriers to trade with SEE partners

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

Analysis of other trade-related services suggests that the (under)development of the domestic financial sector does not seem to be a major obstacle to trade. Although it seems that bulk of trade has been conducted neither with any kind of financial insurance nor with adequate financial guarantees. This clearly limits possibilities for new trade contacts and quickly growing trade turnover. Given the supply-side constraints and the fact that small BiH firms operate on tight margins, the gradual development of the sector is of crucial importance for the further support of BiH exports. Regional statistics also point to the telecommunication infrastructure that is lagging behind some other SEE countries and high costs of telecommunication services.

General policy recommendations

Several problems hindering development of BiH foreign trade are related to general economic and institutional framework, investment climate and conditions for entrepreneurship. In other words, the first set of key barriers to improved trade performance is of domestic nature. The first recommendation calls for simplification of the institutional framework for economic policy management and – to the extent it is possible – the need to opt for simple regulations so that inefficiencies in implementation are not magnified. The capacity of BiH institutions, both those dealing with general economic policies and trade policy-specific institutions (e.g. negotiations on

WTO accession, SAA, trade disputes, etc.) needs to be improved. Delays in privatisation and very slow restructuring of state-owned companies hinders productivity gains. Privatisation may also help in attracting FDIs that are vital for the upgrade of competitiveness of the BiH manufacturing sector. FDIs could be a very important catalyst for the development of competitive advantages in various sectors of the BiH economy and integration of BiH companies into supply chains of regional and transnational companies (mostly with EU headquarters).

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

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

Recommendations for BiH trade policy

One key trade policy issue that emerged prominently in the debate on the functioning of BiH FTAs and the optimal shape of the new CEFTA agreement concerned the extent of liberalisation of agricultural trade. Voices have been risen in favour of exclusion of liberalisation of agricultural trade. On the side of BiH these were based on the perception of unfair competition from a few agricultural goods (e.g. meat, milk) being produced in the key trade partners – Croatia and Serbia. In our view BiH should not expect any strong gains from attempts to protect and develop selected domestic sectors by means introducing or raising of trade barriers. Taking into account institutional capacity of BiH and the international consequences of trade policies we conclude that protecting agriculture by raising trade barriers appears to go against overall BiH interests. A similar reasoning can apply to other industries.

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

BiH tariff structure, while relatively simple and generally avoiding high rates has nevertheless some weaknesses. A broad vision on tariff policy is needed to avoid a situation where some specific elements of the policy are set under influences of lobbies without taking into account broader economic impact. One issue concerns custom tariffs on some raw materials and intermediate products that are not produced in BiH (and neither in the FTA countries) but are used in production processes in BiH. This reduces the effective rate of protection for processed products and may be detrimental to domestic production capacity.

The export / import procedures at the borders could also be simplified and made more predictable (in terms of waiting times). In this view, the reform of the customs service should be continued.

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

Sectoral recommendations

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