

## **Trade Liberalization Strategies: What Could South Eastern Europe Learn From CEFTA and BFTA**

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### **Abstract**

This paper explores the effectiveness of the Central European Free Trade Area (CEFTA) and the Baltic Free Trade Area (BFTA). Estimates from a gravity model and bilateral trade data support the view that both CEFTA and BFTA helped expand regional trade and limit the emergence of a “hub and spoke” relationship between the CEEC and the EU. These empirical conclusions raise some important policy implications for the “second wave” of EU enlargement countries in South Eastern Europe (SEEC). The paper argues that SEEC should reconsider its bilateral approach to trade liberalization and move towards a multilateral free trade area exemplified by both CEFTA and BFTA

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## I. INTRODUCTION

**During the early 1990s, the Central and Eastern European Countries (CEEC)<sup>3</sup> created two free trade agreements known as the Central European Free Trade Area (CEFTA) and the Baltic Free Trade Area (BFTA).** Both agreements were created in response to a perceived weakness in the case for the eastern enlargement of the European Union. The EU member states were initially sceptical about the CEEC's ability to cope with the cooperative and multilateral structures of the EU. Furthermore, there was an understandable fear that the EU accession process would redirect CEEC exports towards EU, and therefore render the CEEC more vulnerable to adverse shocks coming from the EU (Baldwin; 1993, 1994, 1995). Thus, CEFTA and BFTA had two objectives. First, they were an early and important test of the CEECs capacity to work together within cooperative trade arrangements. Second, they hoped to counter the growing dependence of the CEEC on EU markets through re-establishing regional trade flows.

**How effective were CEFTA and BFTA in achieving these two objectives?** This paper offers a generally positive assessment. Throughout the 1990s, both CEFTA and BFTA became the main vehicles for regional trade liberalization. From an original membership of three, CEFTA gradually enlarged to cover most of central Europe. Although BFTA membership did not increase, the agreement was gradually expanded to cover a number of the politically sensitive areas including agriculture and fisheries. In terms of their impact on trade flows, estimates from our gravity model show that both arrangements had a positive effect on regional bilateral trade. Intra-regional trade increased, and complemented the rapid increase in trade with the EU. Intra-regional market shares held up well within CEFTA and actually increased in the BFTA. To a limited extent, these agreements provided a counterweight to the highly preferential trade agreements offered by the EU.

**What lessons could the South Eastern Europe Countries (SEEC)<sup>4</sup> learn from the experiences of CEFTA and BFTA?** In contrast to their northern neighbours, the SEEC did little during the 1990s to foster regional trade integration. Unsurprisingly, export performance throughout the decade was extremely disappointing. Obviously, a large part of the explanation lies with the horrific conflicts that plagued the region throughout the decade, which alongside the terrible humanitarian consequences, also limited regional integration.

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<sup>3</sup> For the purposes of this paper, the CEEC comprises of the following countries; Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. CEFTA originated in the Visegrad countries—Czechoslovakia, Poland and Hungary. It was later enlarged to include Romania, Bulgaria, Slovenia, as well as the successor states to Czechoslovakia. More recently, Croatia joined, and became the only member that was not an EU candidate country. As the name suggests, Estonia, Latvia, and Lithuania were the three members of BFTA.

<sup>4</sup> The SEEC comprises of Albania, Bosnia and Herzegovina, Croatia, FRY Macedonia, and Serbia & Montenegro.

These conflicts subsided after the 1999 Kosovo crisis, and since then, the SEEC has tried to reinvigorate regional trade integration. However, for a variety of political reasons, the SEEC did not take a multilateral approach. Instead, the SEEC started to negotiate a network of bilateral free trade agreements in the hope of creating a “virtual” regional free trade area. This project is nearly completed. While it is still too early to tell how successful this bilateral approach might be, it is fairly clear that the approach has some severe limitations which may curb further trade reform in the future.

**In the light of the CEEC experience, this paper strongly argues that the SEEC should reexamine its trade liberalization strategy and adopt a more multilateral approach.** The SEEC are now in the same approximate position as the CEEC during the early 1990s. Through the Stability and Association Agreements, the EU are offering the SEEC highly preferential trade agreements, and the possibility of EU accession. Yet the EU member states have serious doubts about the SEEC’s capacity to build sustainable and peaceful economic and political relations with their neighbours. Greater regional integration could provide a valuable test for the SEEC and demonstrate that they are capable of sustaining a closer political and economic relationship with the rest of Europe.

**There are three options available to the SEEC to develop regional integration.** First, CEFTA could be enlarged to include the SEEC. Second, the current system of bilateral free trade arrangements could be harmonized and developed further to cover difficult trade issues such as agriculture, services and “behind the border” issues like public procurement. Third, the SEEC could develop its own comprehensive multilateral free trade agreement along the lines of CEFTA and BFTA. Overall, we believe that a new multilateral free trade agreement —SEEFTA—is the most viable.

## II. TRADE LIBERALIZATION IN THE CENTRAL AND EASTERN EUROPEAN COUNTRIES

**During the early stages of transition, the CEEC moved quickly to liberalize their trade and exchange regimes.** The newly democratized countries quickly discarded the old soviet-led trade agreement, the Council for Mutual Economic Assistance (CMEA). International trade was conducted at world prices and settled in convertible currencies. Tariff rates were lowered. Furthermore, the CEEC removed the plethora of restrictions that had characterized trade in the socialist economies; import and export controls were abolished, licensing regimes were liberalized, and foreign direct investment was permitted. However, these reforms were initially accompanied by dramatic short-term collapse in regional trade flows.

**While transition led to a sharp fall in regional trade, it had also opened up the possibility of EU accession.** However, the EU member states were wary of the idea of an eastern enlargement. The EU member states felt that it would take a considerable length of time before the CEEC had reached a sufficient level of economic and political development to ensure that enlargement would be a success. The EU member states were also worried that the newly democratized governments lacked experience of closely cooperating with their neighbors on economic and trade issues. Therefore, the EU pushed hard for the CEEC countries to establish closer political and economic relationships as a precursor to EU enlargement (for a discussion see Richter, 1998).

**The CEECs responded quickly to the EU's challenge.** The CEEC initiated a variety of economic, political, and diplomatic initiatives to enhance regional cooperation. The region took particular note of the EU's stress on re-establishing regional trade flows. Both the Visegrad and Baltic countries started discussions on creating regional free trade agreements. In December 1992, Hungary, Poland, and Czechoslovakia had signed the Central European Free Trade Agreement (CEFTA).<sup>5</sup> The original members envisaged the creation of a free trade area by 2001. The Baltic States launched their Free Trade Agreement slightly later than CEFTA. They signed BFTA in 1993, and it took effect in April 1994.

**Despite its early reluctance, by the mid-1990s the EU had formulated a road map for the eastern enlargement.** In particular, the EU developed an institutional mechanism for preparing CEEC candidate countries for EU membership—the Europe agreements. These agreements provided for closer political and economic cooperation with the EU. They also specified a timetable for tariff reductions, and prepared the candidate countries for accession through technical assistance, legal approximation to the *acquis communautaire* and financial assistance.

**However, asymmetric trade liberalization was the main innovation of the Europe Agreements.** The EU member states would eliminate trade restrictions faster than the candidate countries. Notwithstanding these generally favorable terms, a number of sensitive areas, such as agriculture and textiles, were exempted from the agreements. In general, these were sectors that the CEEC had comparative advantages (for a discussion of this issue, see Lavigne, 1995).<sup>6</sup> Nevertheless, these agreements were beneficial for the CEEC, and both EU trade and foreign direct investment increased rapidly.

**However, the Europe agreements suffered from a serious weakness; they did nothing to encourage and foster intra-CEEC trade.** Many economists quickly recognized that asymmetric liberalization could create a “hub and spoke” problem (see Baldwin 1994). The Europe agreements would divert trade flows along a “spoke” between the CEECs and the “hub” comprising of the EU member states. The CEECs would become satellite economies orbiting around the EU, with little intra-regional trade. This raised the danger that as trade became increasingly centered on the EU, the CEECs would become vulnerable to adverse shocks from the EU. Furthermore, there was an additional fear that the lack of intra-regional trade liberalization would tend to restrict intra-CEEC competition.

**Ultimately, these hub and spoke considerations may have forced the CEEC countries to accelerate their plans to develop regional trade integration.** As more CEEC countries signed Europe agreements, it became increasingly clear that the EU enlargement would

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<sup>5</sup> For a survey of the post-transition decline of CMEA trade and the creation of CEFTA see Rudka and Mizsei (1994).

<sup>6</sup> For a complete discussion of the impact of EU accession on both the EU member states and the CEEC see Baldwin and others (1997), and Adam and Moutos (2002).

incorporate the majority of eastern European countries. CEFTA was progressively enlarged to include Romania, Bulgaria, and Slovenia. The Czech Republic and Slovakia automatically became members as successor states to Czechoslovakia. Throughout the 1990s, the coverage of both agreements were progressively expanded. The original CEFTA agreement eliminated duties on approximately 40 percent of industrial goods. Through a series of additional protocols, mostly signed in 1994 and 1995, trade in industrial goods and some agricultural products was further liberalized. By 1997, CEFTA had abolished duties on all industrial goods, apart from a minor list of sensitive goods. BFTA did not increase its membership, but the coverage of the agreement was expanded. The Baltic States had always intended to include agriculture and fish products. However, extending the agreement proved more difficult than anticipated, largely because financial support for agriculture was more significant in Lithuania compared to Estonia and Latvia. Nevertheless, by January 1997, the Baltic countries extended the agreement to cover these politically difficult areas. Indeed, BFTA was the first free trade area that had provided for completely liberalized trade in agricultural and food products prior to the formation of a customs union and the harmonization of domestic support and foreign trade policies (Kazlauskienė and Meyers, 1999)

**The Europe agreements, CEFTA and BFTA laid the basis for a period of exceptional CEEC export growth (Table 1).** Between 1993 and 2001, BFTA total exports receipts increased by almost 400 percent, while the CEFTA's receipts benefited from a marginally less impressive growth rate of 250 percent. Between 1993 and 2001, BFTA achieved a three-fold increase in exports to the EU, while CEFTA achieved a two-fold increase (Table 2). Furthermore, both CEFTA and BFTA countries managed to increase their market share within the EU. Over the same period, BFTA's market share increased from 0.11 percent to 0.26 percent, while CEFTA increased its market share from 2.13 percent to 4.08 percent (Table 3).

**Intra-regional trade expanded in both CEFTA and BFTA.** Between 1993 and 2001 intra-regional trade within CEFTA doubled, while market share<sup>7</sup> fell very slightly from 11 percent to just under 10 percent (Tables 4 and 5). However, performance varied within the group. Both the Czech Republic and Slovakia experienced a significant drop in intra-regional market share. However, this was due to a decline in bilateral trade, after Czechoslovakia was dissolved. Hungary, Poland, and Romania all increased their share of intra-regional trade, while Bulgaria and Slovenia largely maintained their respective shares. Both intra-regional trade and market share increased in the BFTA area. Between 1993 and 2001, intra-regional export receipts increased four fold, while intra-regional market share increased from 8.4 percent to 9.6 percent (Tables 6 and 7).

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<sup>7</sup> Intra-regional market share is defined as the proportion of regional imports that originated from other members of the region. For example, in the case of CEFTA, intra-regional market share is the ratio of CEFTA exports to other CEFTA countries as a percent of total CEFTA imports.

**While CEFTA and BFTA sustained and developed intra-regional trade, they did not prevent the CEEC from becoming increasingly dependent on EU markets.** In 1993, CEFTA exports to the EU were 56 percent of total exports; by 2001 that figure had reached 68 percent. In BFTA, that trend was less marked. In 1993, 50 percent of BFTA exports went to the EU; by 2001, that figure had risen to 55 percent (Table 8). Ultimately, the asymmetric liberalization embedded in the Europe agreements proved to be too strong to prevent the CEEC's growing dependence on the EU.

### III. TRADE LIBERALIZATION IN THE SOUTH EASTERN EUROPEAN COUNTRIES

**As far as SEEC trade policy reform was concerned, the 1990s was a lost decade.** As the former Socialist Federal Republic of Yugoslavia (SFRY) dissolved, the successor countries introduced restrictive trade regimes, each with their own tariff schedules, and border controls. Moreover, the various wars that plagued the region during the first half of the 1990s disrupted several important transportation links. Consequently, regional trade flows virtually ceased. As the 1990s progressed, the successor states of the SFRY did little to reverse the decline in regional trade. Authoritarian and nationalist governments dominated the two largest countries in the region—Croatia and Serbia, and they had little interest in reforming regional trade arrangements. Furthermore, both countries were isolated internationally, albeit by different degrees of intensity. As a consequence, the region failed to negotiate preferential trade agreements with the EU. After the Dayton agreement, the political environment prevented any rehabilitation of old trading relationships.

**Regional trade data reflects this lack of progress.** Between 1996 and 2001, the SEEC only managed to increase their total export receipts by just 18 percent (Table 1). Of course, we should treat pre-1996 trade data for the SEEC with some caution. For extended periods, Serbia and Montenegro were placed under sanctions, and the data cannot account for unrecorded sanctions-busting trade. Military conflict played the major role in depressing trade performance, but its significance should not be overstated. Those periods when conflict had subsided—for example 1996–99 and 2000–01—were not marked by a recovery in trade. Intra-regional export receipts and market share fell every year between 1997 and 2000 (Table 9). Furthermore, the SEE had little success penetrating the CEFTA and BFTA markets (Tables 3 and 7). The SEEC only made progress in EU markets, where between 1996–2001 exports receipts increased by 31 percent, albeit from a comparatively low level.

**The aftermath of the 1999 Kosovo crisis marked the first serious attempt to rebuild regional trade relationships.** In June 1999, the international community created the Stability Pact for South Eastern Europe. Both the SEEC governments and the international community were determined to make trade liberalization one of the main pillars of the post conflict recovery of the region. The pact established a “working table” on economic reconstruction, which was given responsibility for regional economic cooperation. The Stability Pact envisaged a two-stage process. During the first stage, the SEEC would eliminate administrative barriers to trade, put a standstill on any new measures to restrict trade, and coordinate a reduction in trade barriers towards each other. During the second stage, the SEEC would accede to the WTO, and establish a free trade area that covered both the region and the EU (Michalopoulos 2002).

**In order to meet its commitments under the Stability Pact, the EU launched the Stabilization and Association Process.** The EU are now negotiating Stability and Association Agreements (SAA) with each of the SEECs, which like the earlier Europe Agreements provides an institutional framework for closer political and economic integration. Like their earlier counterparts, the SAAs also provide for asymmetric trade liberalization. Even before negotiating the Stability and Association agreements, the EU revised its trade preferences with the SEEC and unilaterally offered more generous market access. The new arrangement, known as Autonomous Trade preferences, allowed duty and quota free access for the majority of SEEC exports. Nevertheless, quotas remain on a few sensitive areas such as agriculture, wine, and textiles.

**The Stability Pact led directly to the SEECs signing a Memorandum of Understanding on Trade Liberalization (MoU)<sup>8</sup> in June 2001.** Instead of immediately starting work on creating a regional free trade area, the SEEC decided to create a network of limited bilateral agreements. During the discussions on the MoU, the option of a single comprehensive free trade agreement was proposed. Despite its compelling logic, the SEEC representatives were not persuaded. They believed that the political will to develop a unified agreement did not exist at the time, and that a network of bilateral agreements was a less risky and potentially more productive option (see Wijkman 2003). The memorandum set a target date of December 2002 to finish this work. As of March 2003, out of a total of 21 potential agreements, ten are now fully operational (Table 10). As for the remaining agreements, four are signed and will shortly become fully operational, and the remaining seven agreements are initialed and await ratification. Nevertheless, in the case of those agreements not yet fully operational, tariffs on many items have been already lowered or abolished as a precursor to the agreements becoming effective.

**The bilateral approach is problematic.** Potentially, each bilateral agreement could be different; and therefore this approach could create a rather tangled spaghetti-like trading relationships. The coverage of tariff lines could vary widely, and each agreement may have a different liberalization timetable. The MoU did try to partly address this issue. It laid down some general guidelines to which each agreement should adhere. Most importantly, the memorandum set two targets; tariff rates should be abolished for at least 90 percent of all tariff lines; and tariff liberalization should cover at least 90 percent of bilateral trade by value. By Spring 2003, most bilateral free trade agreements had come close to fulfilling these targets. Messerlin and Miroudot (2003) reported that eleven agreements have already met the 90 percent targets, while in seven cases, bilateral trade flows have reached 85 percent. These early successes in meeting the targets must be interpreted with care. As Messerlin and Miroudot point out, these 90 percent targets are easy to achieve when intra-regional trade flows are still very low, and comprise of a comparatively small number of products. This problem is particularly pressing in the case of agriculture, which is still heavily protected.

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<sup>8</sup> The Memorandum of Understanding was signed by Albania, Bosnia and Herzegovina, the Bulgaria, Croatia, Macedonia, Romania, and Serbia & Montenegro. Later, Moldova also signed the MoU.

The 90 percent targets have not created sufficient incentives for liberalizing trade in agricultural goods. Agriculture comprises of a very small number of tariff lines, and because of the intense protection is not traded much within the SEEC. Therefore, countries can easily meet these liberalization targets without any significant reduction in effective protection for their respective agricultural sectors.

**Despite this progress, a number of problems remain.** The effort to harmonize the agreements has inevitably meant that some important issues have been ignored. In particular, “behind the borders” issues such as public procurement and services have been excluded. In general, the more recently signed bilateral agreements have been broadly similar in terms of their provisions. However, some free trade agreements existed prior to the memorandum, and differ significantly with the general framework outlined in the memorandum. Furthermore, each agreement contains its own specific list of protected items. The bilateral approach does not offer any mechanism for harmonizing and ultimately reducing the list of protected goods. This will ultimately put a break on any further trade reform.

**More importantly, it is still unclear how the SEEC will move from the current bilateral framework, to more comprehensive free trade area with the EU envisaged in the Stability Pact.** Thus, while the Memorandum of Understanding certainly accelerated regional trade liberalization, the project is now coming to an end. If liberalization is to proceed further, then a more ambitious multilateral approach will be required. Three options are available to the SEEC; joining CEFTA; harmonizing and extending the coverage of the current bilateral agreements, possibly on the basis of a new Memorandum of Understanding; or creating a new regional free trade agreement. But before considering these options in detail, it is useful to further assess the impact of CEFTA and BFTA on regional trade flows, using an estimated gravity model. As we shall see, the empirical evidence supports the hypotheses that the asymmetric liberalization reorientates trade towards the EU, but that regional trade agreements can, to some extent, limit that tendency.

#### IV. ECONOMETRIC RESULTS

**In an effort to assess the contribution of CEFTA and BFTA to the strong export performance in the CEEC, we estimated a gravity model comprising of 37 countries for the period 1996–2000.** These 37 countries—primarily OECD, Eastern European and CIS countries—were the main trading partners of the CEEC and SEEC and therefore captures virtually all the export markets for these two regions. The time period was chosen to exclude the conflicts that afflicted the former Yugoslavia. Despite its simplicity, the gravity model is widely used in empirical trade theory; it fits well to any theory of international trade from Heckscher Ohlin to new trade theories (for a discussion see Deardorff, 1995).

**Previous authors have examined trade performance in transition economies using gravity models.** However, the emphasis has tended to be on the effectiveness of the Europe agreements, rather than CEFTA and BFTA (see for example, Enders and Wonnacott, 1996). Some authors have looked at the underlying motivations for CEFTA and BFTA. For example, Paas (2002) found that for the Baltic countries, cultural proximity with its neighbours played an important role in re-establishing regional trade relationships. Others

have used gravity models to examine why SEEC trade performance has been so poor. For example, Christie (2002) used a gravity model to examine SEEC trade performance. He found that in many cases, intra-regional trade was much lower than what his estimated gravity model predicted.

We estimated an equation with the following functional form:<sup>9</sup>

$$EXP_{ijt} = \beta_0 + \beta_1 |GDPCAP_{it} - GDPCAP_{jt}| + \beta_2 \left( \frac{GDP_{it} + GDP_{jt}}{2} \right) + \beta_3 SIM_{ijt} + \beta_4 DIST_{ij} + \beta_5 Dummies + e_{it} \quad (1)$$

Where:

$EXP_{ijt}$	=	exports of country i to country j at time t,
$GDPCAP_{it}$	=	real GDP per capita of country i at time t
$GDPCAP_{jt}$	=	real GDP per capita of country j at time t
$DIST_{ij}$	=	distance in kilometers between the capitals of country i and j
$SIM_{ijt}$	=	A similarity index.

**Size, similarity and proximity are the starting points for gravity models.** The larger and closer two countries are, the more they trade. Therefore trade flows are primarily explained by differences in GDP per capita, the average of GDP of the two countries, distance, and factors proxying for similarity.

**The GDP per capita term of each country is a proxy for capital-labor ratio.** By implication, the absolute difference in GDP per capita between two countries captures the difference in capital-labor ratios, and therefore relative factor endowments. If this difference is large, then inter-industry trade predominates (for a more general discussion, see Hummels and Levinsohn 1995). In general, the closer two economies are to each other, the lower the transportation costs, and the higher the bilateral trade. The distance variable is a proxy for transportation costs. It measures the distance in kilometers between the two capital cities.

**Our specification also allows for the Linder hypothesis, which suggests that countries with similar demand patterns are more likely to trade with each other (Linder, 1961).** In particular, countries with similar manufacturing sectors will typically produce similar products. Therefore, each country produces goods that are demanded by consumers in other countries. The Linder hypothesis is often cited as an explanation for the prevalence of trade between OECD countries; much of which tends to be intra-industry trade. In order to capture the Linder hypothesis, we construct a similarity index that controls for the relative size of

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<sup>9</sup> The bilateral export data is taken from the *IMF Direction of Trade* database. We have taken the exchange rate, price, and real GDP per capita data from the Penn World Tables release 6.1. Distance data is taken from Byers (1999).

partner countries in terms of output and hopefully captures the bilateral intra-industry trade (see Egger, 2000). The index is defined as:

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

This index is bound between 0 and 0.5. The larger the index, the more similar are the countries in terms of output. A positive value of  $\beta_5$  would support the view that more similar countries tend to trade more with each other.

**We captured the effects of the Europe agreements and the regional trade agreements—CEFTA and BFTA—with dummy variables.** These variables account for the deviations from normal trade patterns. As we previously argued, the Europe agreements provided for asymmetric liberalization with the EU liberalizing more quickly than the CEEC. Furthermore, the agreements limited the extent of trade reform in a number of sensitive areas, such as agriculture and textiles, where the CEEC had a comparative advantage. Therefore, the EU agreements will have a different impact on the CEEC and the EU. To control for this, we used two separate dummies; one measuring the impact of the Europe Agreement on CEEC and one measuring the impact of the EU agreements on EU exports. In our regression, we called the first effect *Europe agreements* and the second effect *EU preferential access to the CEECs*.

**To take account of other country specific factors, we used dummy variables for language, common borders, and for EU membership.** We expected that countries with higher linguistic ties to have higher bilateral trade (see for example, Choi, 2000). The border dummy captures the potential common cultural ties between two adjacent countries that could facilitate trade. We also included a dummy variable for EU membership. The EU is a highly integrated bloc, and so we expected a higher than normal amount of trade between EU members.

**Finally, we controlled for the earlier CMEA trade agreements.** Since CMEA was a forced agreement, pre-1990 trade was inefficiently high, there was little competition, and the quality of the products was poor. At the start of transition, few CEEC customers were willing to buy products from their former CMEA neighbors, and they turned to western producers. Thus, intra CEEC trade fell during the early 1990s. Therefore, it is important to establish whether this fall was due to the after-effect of the CMEA agreement or it is simply a return to the normal trading patterns. If the former is true, then the CMEA dummy variable must have a negative sign, if the latter is true, then the variable will be insignificant.

**We estimated our model incorporating all the variables and dummies using OLS, a random effects-GLS estimator, and a fixed effects-within estimator.** We attempted a first interpretation of the results. Based upon the relevant tests, we found that the fixed effect-within estimator appeared to be the correct specification. However, the fixed effect-within estimator cannot give an estimate of the coefficients of the time invariant dummy variables, since they are wiped out in the estimation. To solve this problem, we used a two-step procedure proposed by Hsiao (1986) and Olson and others (2000). We took the estimated

fixed effect of the within estimator and performed a cross-section regression of the latter on the dummy variables discussed above. Since the estimated fixed effect from the first step is unbiased, we can use it for the second step estimation procedure.

**As Mátyás (1997, 1998) argued, the proper econometric specification of a panel data gravity model is a three way error component.** This is because there is a need to take account of exporting as well as the importing country's special features and the time specific effect. However, all the variables in the gravity equation are constructed as measures of country  $i$  relative to country  $j$ . So it seems more natural to us to assume that the specific effect in the error term is also expressed as a measure of country  $i$  to country  $j$ <sup>10</sup>. In other words, in our panel each cross section represents a different bilateral flow. Given the above, it would seem appropriate to estimate a two-way error component model. The Breuch and Pagen test gave a value of 9324.9, so the joint hypothesis that the time specific and the cross section specific effects is rejected. However, if we test the hypothesis that the time specific effect is zero, we get an LM test statistic equal to 1.29, and thus we can not reject the null. In contrast, the hypothesis that the cross section effect is zero is rejected (the respective LM test gave a value of 9323.6). Therefore, the cross section specific effect could not be rejected. So we ended up with a one-way error component model where the GLS estimator is preferred to the pooled OLS estimator.

**In order to choose among alternative specifications, we performed a Hausman specification test (see Baltagi, 1995).** This statistic will help us choose between the within fixed effects and the GLS random effects estimators. The respective  $X^2$  test statistic is 134 and thus the null hypothesis that the GLS estimator was the correct specification is rejected. Consequently, we concluded that fixed effects estimator was the more appropriate specification. Moreover, our findings were broadly consistent with those of Egger (2000).

**Table 11 presents our estimation results.** Since the within-fixed effects appear to be the most appropriate specification, we will focus on the interpretation of these results. All the variables have the expected signs. The coefficient on the GDP per capita variable is positively signed but insignificant. Recall that this variable suggests the predominance of inter-industry trade. The similarity variable is positively signed and statistically significant at the 10 percent confidence interval, suggesting the validity of the Linder Hypothesis and predominance of intra-industry trade in our sample.

**Even though the GLS and OLS estimations do not represent the correct specification, we can use these results to give a preliminary idea about whether the preferential trade agreements** and the other time invariant factors appear to have mattered. All but one of the preferential trade agreements has a positive and statistically significant impact on bilateral exports. The exception is the Europe agreement, which is, in the case of the GLS estimation, a positive but statistically insignificant variable. Furthermore, both the distance and ex-CMEA variables are negative and statistically significant. In the second step of our

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<sup>10</sup> This is consistent also with the trade theoretic methodology where all variables affecting trade are expressed in relative terms.

estimation, we regressed the estimated fixed effect given by the within estimator on a constant and the time invariant variables (see Appendix 1 for technical details). Initially, we performed a simple cross section GLS regression to correct for the heteroskedasticity inherited in this two- step estimator (see Polacheck and Kim, 1994).

**Table 11 also provides the results from the second stage cross section of the two-step within estimator.** All the preferential trade agreement variables are both positive and statistically significant. We therefore concluded that all the agreements were trade creating for their members. The BFTA agreement was more effective than the CEFTA agreement. This is consistent with the fact that the BFTA agreement allowed more liberalized trade between its member states. More surprisingly, the parameter estimate for the Europe agreement is smaller than either the CEFTA or BFTA parameters. Therefore, the bulk of the increase in EU-CEEC trade was due to a return to normal trading patterns, rather than to the specific trade advantages offered by the Europe Agreements. As for all the other time invariant factors, they had the expected signs. However, the language dummy was insignificant, while the Ex-CMEA dummy was negative and significant at a 10 percent confidence interval.

**In order to get a rough idea of any gradual adjustment after the introduction of a preferential trade agreement, we perform a rather un-technical but very informative experiment.** We estimated a cross section variant of equation 1 for each time point of our data set. Although we obtained estimates for all the coefficients for each time-period, we focused our attention on the coefficients for the various trade agreements. With the exception of the variable capturing the effect of EU preferential trade access to the CEEC, the coefficients are rather smooth and stable (Figure 1). The EU preferential trade variable has an initial negative value, but becomes positive for the remainder of the sample.

**We also performed a poolability test to ensure that each cross section did not have specific information that warranted separate empirical investigation.** This test gave an F-statistic of 0.60 compared to an F-critical of 1.5 at the one percent level of significance. This indicated that all the coefficients, including the dummy variables, are equal across time and thus the panel data estimation is appropriate. Given the estimate of the EU preferential trade variable is not constant over time, we examined whether the coefficient derived from the 1996 cross section was significantly different to that derived from the 2000 cross section. The t statistic was -3.31 and therefore we rejected the null hypothesis of equality over time. Therefore, we concluded that there was some evidence for an increasingly positive effect of the EU preferential trade access agreements.

## V. POLICY CONCLUSIONS

**The originators of CEFTA and BFTA can be satisfied with the achievements of these arrangements.** The empirical evidence confirms that both arrangements had a positive effect on intra-regional trade, and they went some way to limit the dangers of the hub and spoke relationship between the EU and the CEEC. Furthermore, these agreements confirmed the capacity of the CEEC to develop cooperative multilateral structures. As time went on, the membership of CEFTA was expanded, and its coverage of goods was increased. While

BFTA did not enlarge, it did tackle some very difficult issues such as agriculture and fisheries.

**The success of the two agreements offers some important lessons for the SEEC.**

Somewhat belatedly, the SEEC has taken a more serious approach to regional trade liberalization. The region is now finishing work on creating a network of bilateral free trade agreements. However, once the network is complete, it is not clear where trade liberalization in the SEEC will go. Ultimately, further progress would require a more multilateral approach. Broadly speaking, the SEEC has three options; a southward enlargement of CEFTA, a further harmonization of the network of bilateral FTAs; and the creation of a new free trade area for the SEEC.

**Accession to CEFTA is an attractive option for the more advanced countries within the SEEC.** In 2004, five of the eight members of CEFTA will accede to the European Union. A further southward enlargement of CEFTA would provide an opportunity to deepen the recent steps made by the SEEC towards regional trade integration. This could provide an opportunity to reconsider the future of CEFTA and even revise the membership criteria. However, a southward enlargement would require a relaxation of the membership rules of the CEFTA. In particular, the requirement of WTO membership as a prerequisite for CEFTA membership would have to be amended. Bosnia and Herzegovina, Macedonia, and Serbia & Montenegro are not yet members of the WTO, and these countries have much to do before WTO accession is a realistic prospect. To some extent, this has already started given Croatia's recent accession to CEFTA. Furthermore, Macedonia has also recently expressed a desire to join.

**If the remaining three CEFTA members choose not to relax the membership criteria, then the SEEC could develop further the existing bilateral approach.** The current agreements could be revised to cover more difficult and controversial areas, such as agriculture, services and public procurement. However, this is unlikely to be achieved simply through the existing MoU. The SEEC could develop a second Memorandum of Understanding. This Memorandum could lay out further guidelines for harmonizing the existing agreements and tackling trade liberalization in sensitive areas. On the basis of a second Memorandum, the existing bilateral agreements could be renegotiated and extended. However, such an approach is likely to be complex and cumbersome, and probably would not yield significant results.

**Creating a more general multilateral agreement would be a more practical approach.** The current network of bilateral free trade agreements have laid the foundations for moving towards a more comprehensive regional free trade agreement. A new general agreement could also offer the opportunity to include more difficult issues such as agriculture, services, and public procurement.

**Within the next ten years there is a realistic possibility that at least some countries within south eastern europe could join European Union.** The Stability and Association process holds out the possibility of a Balkan enlargement. Therefore, the SEEC now face the same challenges that the CEEC faced in the early 1990s. Can the SEEC adopt a more cooperative and multilateral approach to economic policy management, and can the SEEC

develop regional trade as a bulwark against growing dependence on EU markets? Like their northern counterparts, the SEEC may find that further progress towards regional trade cooperation will strengthen and accelerate the case for a southward enlargement of the European Union.

### DESCRIPTION OF THE TWO STEP FIXED EFFECTS ESTIMATION METHOD

Assume we have N bilateral flows and T time periods. In a simple linear panel data model with two variables one of which is constant over time we have:

$$y_{it} = X_{it}\beta + D_i\gamma + e_{it} \quad (A1)$$

where  $y_{it}$  is the NT x 1 column vector of the dependent variable  $X_{it}$  is the NT x 1 matrix of the independent variable and  $D_i$  a time invariant variable,  $\beta$  is a scalar to be estimated and  $e_{it}$  is the disturbances. To decide which is the correct estimator for (A1), we must first determine how  $e_{it}$  is specified.

According to the Breusch-Pagan LM test in  $e_{it}$  there exists a cross section specific but no time specific effect. So the correct assumption for  $e_{it}$  is that:

$$e_{it} = \mu_i + \varepsilon_{it} \quad (A2)$$

where  $\varepsilon_{it}$  is a zero mean, constant variance random error. The  $\mu_i$  represents the unobservable-cross-section (bilateral) specific effect. Further, the Hausman test indicates that  $\mu_i$  is a fixed parameter. Thus in order to estimate (A1) we can simply take the average over time of equation (A1) and subtract it from (A1). This is the so-called within group- fixed effect estimator (see Baltagi, 1995):

$$y_{it} - \bar{y}_i = (X_{it} - \bar{X}_i)\beta + (e_{it} - \bar{e}_i) \quad (A3)$$

In turn, this reduces to:

$$(y_{it} - \bar{y}_i) = (X_{it} - \bar{X}_i)\beta + (\varepsilon_{it} - \bar{\varepsilon}_i) \quad (A4)$$

To estimate  $\beta$  in equation A4 we can simply use OLS. Note that what we have done here is to estimate our model in terms of deviations from the group means. This is done in order to wipe out the fixed effect  $\mu_i$ . However, by differencing from the group average we also wipe out all cross section specific data. With equation (A3), we cannot directly estimate the cross section specific dummies in our model. To overcome this difficulty we subtract  $\bar{X}_i\hat{\beta}$  from both sides of (A4):

$$\bar{y}_i - \bar{X}_i\hat{\beta} = D_i\gamma + \eta_i \quad (A5)$$

where

$$\eta_i = \bar{X}_i(\beta - \hat{\beta}) + u_i \quad (A6)$$

Equation (A6) can be directly estimated to obtain  $\gamma$ .

Table 1. Central and Eastern Europe Total exports (1993-2001)

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(millions of US dollars)									
<b>CEFTA</b>	<b>53,427</b>	<b>65,591</b>	<b>83,184</b>	<b>89,284</b>	<b>98,065</b>	<b>109,873</b>	<b>109,496</b>	<b>124,400</b>	<b>134,523</b>
Czech Republic	11,774	14,281	17,178	22,132	22,504	26,420	26,238	28,941	30,050
Hungary	8,598	10,588	12,861	13,145	19,100	23,005	24,849	28,087	30,153
Poland	14,143	17,240	22,895	24,440	25,751	28,228	27,407	31,644	36,050
Romania	4,892	6,160	8,061	7,644	8,387	8,315	8,509	10,367	11,386
Bulgaria	2,319	3,400	5,220	4,781	4,314	4,150	3,755	4,760	5,062
Slovenia	6,241	7,232	8,389	8,312	8,372	9,034	8,505	8,728	9,189
Slovak Republic	5,460	6,691	8,579	8,831	9,639	10,720	10,233	11,874	12,631
<b>BFTA</b>	<b>3,004</b>	<b>4,330</b>	<b>5,829</b>	<b>6,782</b>	<b>8,464</b>	<b>8,766</b>	<b>7,744</b>	<b>9,502</b>	<b>10,593</b>
Estonia	805	1,312	1,840	2,077	2,931	3,244	3,017	3,828	4,011
Latvia	1,040	990	1,284	1,424	1,670	1,811	1,723	1,865	2,000
Lithuania	1,159	2,029	2,706	3,281	3,862	3,711	3,004	3,808	4,581
<b>SEE</b>	<b>5,171</b>	<b>5,582</b>	<b>6,154</b>	<b>6,730</b>	<b>7,358</b>	<b>8,009</b>	<b>7,111</b>	<b>7,339</b>	<b>7,973</b>
Croatia	3,904	4,260	4,632	4,512	4,332	4,557	4,226	4,071	4,543
Bosnia & Herzegovina	85	36	52	181	381	511	599	669	742
Albania	122	141	202	211	141	206	275	255	319
Serbia & Montenegro	4	57	66	678	1,268	1,424	818	1,025	1,154
Macedonia, FYR	1,055	1,086	1,203	1,148	1,237	1,311	1,192	1,319	1,216
(Index 1996=100)									
<b>CEFTA</b>	<b>60</b>	<b>73</b>	<b>93</b>	<b>100</b>	<b>110</b>	<b>123</b>	<b>123</b>	<b>139</b>	<b>151</b>
Czech Republic	53	65	78	100	102	119	119	131	136
Hungary	65	81	98	100	145	175	189	214	229
Poland	58	71	94	100	105	116	112	129	148
Romania	64	81	105	100	110	109	111	136	149
Bulgaria	49	71	109	100	90	87	79	100	106
Slovenia	75	87	101	100	101	109	102	105	111
Slovak Republic	62	76	97	100	109	121	116	134	143
<b>BFTA</b>	<b>44</b>	<b>64</b>	<b>86</b>	<b>100</b>	<b>125</b>	<b>129</b>	<b>114</b>	<b>140</b>	<b>156</b>
Estonia	39	63	89	100	141	156	145	184	193
Latvia	73	70	90	100	117	127	121	131	140
Lithuania	35	62	82	100	118	113	92	116	140
<b>SEE</b>	<b>77</b>	<b>83</b>	<b>91</b>	<b>100</b>	<b>109</b>	<b>119</b>	<b>106</b>	<b>109</b>	<b>118</b>
Croatia	87	94	103	100	96	101	94	90	101
Bosnia & Herzegovina	47	20	28	100	210	282	331	369	409
Albania	58	67	96	100	67	98	131	121	151
Serbia & Montenegro	1	8	10	100	187	210	121	151	170
Macedonia, FYR	92	95	105	100	108	114	104	115	106
<u>Memorandum Items</u>									
Cumulative Export growth (1993-2001)									
CEFTA	253								
BFTA	398								
SEE	92								

Source: IMF Direction of Trade Database

Table 2. Central and Eastern Europe, Exports to EU, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(millions of US dollars)									
<b>CEFTA</b>	<b>29,712</b>	<b>37,641</b>	<b>48,646</b>	<b>52,438</b>	<b>60,249</b>	<b>72,436</b>	<b>75,747</b>	<b>84,861</b>	<b>91,769</b>
Czech Republic	6,354	7,480	9,273	12,760	13,557	16,976	18,172	19,905	20,490
Hungary	4,982	6,818	8,077	8,234	13,603	16,782	18,927	21,117	22,435
Poland	9,794	11,929	16,039	16,248	16,533	19,285	19,338	22,154	24,995
Romania	2,027	2,970	4,388	4,271	4,752	5,369	5,572	6,630	7,737
Bulgaria	1,090	1,564	2,013	1,913	1,942	2,137	2,035	2,463	2,794
Slovenia	3,847	4,539	5,648	5,369	5,321	5,917	5,625	5,577	5,750
Slovak Republic	1,618	2,340	3,208	3,645	4,540	5,970	6,076	7,015	7,569
<b>BFTA</b>	<b>1,498</b>	<b>1,628</b>	<b>2,557</b>	<b>2,784</b>	<b>3,495</b>	<b>4,223</b>	<b>4,477</b>	<b>5,653</b>	<b>5,819</b>
Estonia	389	628	1,006	1,060	1,424	1,788	1,894	2,623	2,405
Latvia	334	389	568	628	815	1,025	1,078	1,206	1,225
Lithuania	776	610	984	1,096	1,256	1,409	1,505	1,824	2,189
<b>SEE</b>	<b>2,704</b>	<b>3,020</b>	<b>3,308</b>	<b>3,571</b>	<b>4,023</b>	<b>4,230</b>	<b>3,810</b>	<b>4,161</b>	<b>4,671</b>
Croatia	2,214	2,531	2,672	2,302	2,220	2,172	2,088	2,234	2,467
Bosnia & Herzegovina	34	14	29	80	168	253	367	447	498
Albania	89	109	160	181	124	191	258	231	286
Serbia & Montenegro	3	5	38	516	1,055	1,036	564	686	894
Macedonia, FYR	364	361	409	491	456	578	533	561	526
(Index 1996=100)									
<b>CEFTA</b>	<b>57</b>	<b>72</b>	<b>93</b>	<b>100</b>	<b>115</b>	<b>138</b>	<b>144</b>	<b>162</b>	<b>175</b>
Czech Republic	50	59	73	100	106	133	142	156	161
Hungary	61	83	98	100	165	204	230	256	272
Poland	60	73	99	100	102	119	119	136	154
Romania	47	70	103	100	111	126	130	155	181
Bulgaria	57	82	105	100	102	112	106	129	146
Slovenia	72	85	105	100	99	110	105	104	107
Slovak Republic	44	64	88	100	125	164	167	192	208
<b>BFTA</b>	<b>54</b>	<b>58</b>	<b>92</b>	<b>100</b>	<b>126</b>	<b>152</b>	<b>161</b>	<b>203</b>	<b>209</b>
Estonia	37	59	95	100	134	169	179	248	227
Latvia	53	62	90	100	130	163	172	192	195
Lithuania	71	56	90	100	115	129	137	166	200
<b>SEE</b>	<b>76</b>	<b>85</b>	<b>93</b>	<b>100</b>	<b>113</b>	<b>118</b>	<b>107</b>	<b>117</b>	<b>131</b>
Croatia	96	110	116	100	96	94	91	97	107
Bosnia & Herzegovina	42	18	36	100	208	314	456	556	619
Albania	49	60	89	100	68	106	142	128	158
Serbia & Montenegro	1	1	7	100	204	201	109	133	173
Macedonia, FYR	74	74	83	100	93	118	109	114	107
<u>Memorandum Items</u>									
Cumulative Export growth (1993-2001)									
CEFTA	209								
BFTA	288								
SEE	73								

Source: IMF Direction of Trade Database

Table 3. Central and Eastern Europe, Market Share in EU, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(Exports in percent of total EU imports)									
<b>CEFTA</b>	<b>2.13</b>	<b>2.37</b>	<b>2.54</b>	<b>2.68</b>	<b>3.05</b>	<b>3.51</b>	<b>3.51</b>	<b>3.71</b>	<b>4.08</b>
Czech Republic	0.46	0.47	0.48	0.65	0.69	0.82	0.84	0.87	0.91
Hungary	0.36	0.43	0.42	0.42	0.69	0.81	0.88	0.92	1.00
Poland	0.70	0.75	0.84	0.83	0.84	0.93	0.90	0.97	1.11
Romania	0.15	0.19	0.23	0.22	0.24	0.26	0.26	0.29	0.34
Bulgaria	0.08	0.10	0.11	0.10	0.10	0.10	0.09	0.11	0.12
Slovenia	0.28	0.29	0.30	0.27	0.27	0.29	0.26	0.24	0.26
Slovak Republic	0.12	0.15	0.17	0.19	0.23	0.29	0.28	0.31	0.34
<b>BFTA</b>	<b>0.11</b>	<b>0.10</b>	<b>0.13</b>	<b>0.14</b>	<b>0.18</b>	<b>0.20</b>	<b>0.21</b>	<b>0.25</b>	<b>0.26</b>
Estonia	0.03	0.04	0.05	0.05	0.07	0.09	0.09	0.11	0.11
Latvia	0.02	0.02	0.03	0.03	0.04	0.05	0.05	0.05	0.05
Lithuania	0.06	0.04	0.05	0.06	0.06	0.07	0.07	0.08	0.10
<b>SEE</b>	<b>0.19</b>	<b>0.19</b>	<b>0.17</b>	<b>0.18</b>	<b>0.20</b>	<b>0.21</b>	<b>0.18</b>	<b>0.18</b>	<b>0.21</b>
Croatia	0.16	0.16	0.14	0.12	0.11	0.11	0.10	0.10	0.11
Bosnia & Herzegovina	0.00	0.00	0.00	0.00	0.01	0.01	0.02	0.02	0.02
Albania	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01	0.01
Serbia & Montenegro	0.00	0.00	0.00	0.03	0.05	0.05	0.03	0.03	0.04
Macedonia, FYR	0.03	0.02	0.02	0.03	0.02	0.03	0.02	0.02	0.02
<b>Memorandum Item</b>									
Total imports of the EU (billions of US dollars)	1,395	1,588	1,914	1,956	1,974	2,063	2,158	2,287	2,247

Source: IMF Direction of Trade Database

Table 4. Central and Eastern Europe, exports to CEFTA markets, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(millions of US dollars)									
<b>CEFTA 1/</b>	<b>7,775</b>	<b>9,283</b>	<b>12,118</b>	<b>12,874</b>	<b>13,169</b>	<b>14,234</b>	<b>13,226</b>	<b>15,108</b>	<b>16,488</b>
Czech Republic	3,299	3,553	4,405	5,085	4,975	5,301	4,611	4,838	5,032
Hungary	371	989	1,409	1,459	1,748	2,086	1,947	2,289	2,719
Poland	598	735	1,381	1,602	1,802	2,091	2,237	2,662	3,149
Romania	267	379	338	341	403	447	597	848	808
Bulgaria	127	149	193	170	144	212	173	191	247
Slovenia	316	335	437	482	517	607	616	691	739
Slovak Republic	2,797	3,143	3,956	3,734	3,581	3,489	3,044	3,588	3,794
<b>BFTA 2/</b>	<b>153</b>	<b>193</b>	<b>223</b>	<b>209</b>	<b>196</b>	<b>231</b>	<b>261</b>	<b>383</b>	<b>472</b>
Estonia	20	21	31	31	32	31	35	59	70
Latvia	41	26	47	35	35	48	45	59	68
Lithuania	92	146	146	143	129	152	181	265	334
<b>SEE 2/</b>	<b>1,017</b>	<b>1,078</b>	<b>1,180</b>	<b>1,059</b>	<b>1,000</b>	<b>982</b>	<b>841</b>	<b>896</b>	<b>857</b>
Croatia	803	730	795	796	718	561	574	568	563
Bosnia & Herzegovina	15	5	8	18	38	59	62	73	77
Albania	4	3	4	4	3	3	2	2	2
Serbia & Montenegro	0	0	0	105	128	255	129	191	160
Macedonia, FYR	196	341	372	137	113	104	73	62	54
(Index 1996=100)									
<b>CEFTA</b>	<b>60.4</b>	<b>72.1</b>	<b>94.1</b>	<b>100.0</b>	<b>102.3</b>	<b>110.6</b>	<b>102.7</b>	<b>117.3</b>	<b>128.1</b>
Czech Republic	64.9	69.9	86.6	100.0	97.8	104.2	90.7	95.1	99.0
Hungary	25.4	67.8	96.6	100.0	119.8	143.0	133.5	156.9	186.4
Poland	37.3	45.9	86.2	100.0	112.4	130.5	139.6	166.1	196.5
Romania	78.4	111.2	99.0	100.0	118.2	131.1	175.2	248.8	236.8
Bulgaria	74.8	87.5	113.3	100.0	84.5	124.6	101.7	112.0	145.1
Slovenia	65.4	69.4	90.6	100.0	107.1	125.9	127.7	143.3	153.3
Slovak Republic	74.9	84.2	105.9	100.0	95.9	93.4	81.5	96.1	101.6
<b>BFTA</b>	<b>73.2</b>	<b>92.2</b>	<b>106.8</b>	<b>100.0</b>	<b>94.0</b>	<b>110.4</b>	<b>125.0</b>	<b>183.1</b>	<b>226.1</b>
Estonia	63.8	67.4	98.1	100.0	103.5	99.5	112.4	189.6	224.0
Latvia	117.3	74.5	133.3	100.0	99.9	135.3	129.2	167.0	194.8
Lithuania	64.3	102.0	102.1	100.0	90.5	106.6	126.7	185.7	234.2
<b>SEE</b>	<b>96.1</b>	<b>101.8</b>	<b>111.5</b>	<b>100.0</b>	<b>94.4</b>	<b>92.7</b>	<b>79.4</b>	<b>84.6</b>	<b>80.9</b>
Croatia	100.9	91.7	100.0	100.0	90.3	70.5	72.2	71.4	70.7
Bosnia & Herzegovina	82.0	27.3	44.5	100.0	213.6	331.4	353.1	415.6	437.3
Albania	102.3	73.1	119.2	100.0	72.6	94.2	60.8	45.4	54.9
Serbia & Montenegro	0.0	0.0	0.5	100.0	121.8	242.7	122.5	182.0	152.7
Macedonia, FYR	143.6	249.3	272.1	100.0	82.6	76.1	53.5	45.2	39.7
<u>Memorandum items</u>									
Cumulative Export growth (1993-2001)									
CEFTA	112								
BFTA	209								
SEEC	-16								

Source: IMF Direction of Trade Database

1/ Exports of CEFTA member countries to other CEFTA members

2/ Exports of BFTA and SEE to CEFTA members

Table 5. Central and Eastern Europe, Market share in CEFTA countries, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(exports in percent of total CEFTA imports)									
<b>Intra-Regional trade</b>	<b>11.1</b>	<b>11.7</b>	<b>11.8</b>	<b>10.7</b>	<b>10.1</b>	<b>9.8</b>	<b>9.2</b>	<b>9.5</b>	<b>9.7</b>
Czech Republic	4.7	4.5	4.3	4.2	3.8	3.6	3.2	3.0	2.9
Hungary	0.5	1.2	1.4	1.2	1.3	1.4	1.4	1.4	1.6
Poland	0.9	0.9	1.3	1.3	1.4	1.4	1.6	1.7	1.8
Romania	0.4	0.5	0.3	0.3	0.3	0.3	0.4	0.5	0.5
Bulgaria	0.2	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Slovenia	0.5	0.4	0.4	0.4	0.4	0.4	0.4	0.4	0.4
Slovak Republic	4.0	4.0	3.9	3.1	2.7	2.4	2.1	2.2	2.2
<b>BFTA</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.2</b>	<b>0.3</b>
Estonia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Latvia	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Lithuania	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.2	0.2
<b>SEE</b>	<b>1.5</b>	<b>1.4</b>	<b>1.1</b>	<b>0.9</b>	<b>0.8</b>	<b>0.7</b>	<b>0.6</b>	<b>0.6</b>	<b>0.5</b>
Croatia	1.1	0.9	0.8	0.7	0.6	0.4	0.4	0.4	0.3
Bosnia & Herzegovina	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Albania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Serbia & Montenegro	0.0	0.0	0.0	0.1	0.1	0.2	0.1	0.1	0.1
Macedonia, FYR	0.3	0.4	0.4	0.1	0.1	0.1	0.1	0.0	0.0
<b>Memorandum item</b>									
Total imports of CEFTA (millions of US dollars)	69,863	79,474	102,656	120,345	130,499	145,932	143,116	159,754	170,849

Source: IMF Direction of Trade Database

Table 6. Central and Eastern Europe, exports to BFTA markets, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(millions of US dollars)									
<b>CEFTA 2/</b>	<b>103</b>	<b>324</b>	<b>473</b>	<b>680</b>	<b>847</b>	<b>1,065</b>	<b>1,050</b>	<b>1,212</b>	<b>1,516</b>
Czech Republic	10	55	79	125	148	201	153	174	194
Hungary	0	44	66	106	99	96	92	91	119
Poland	74	173	267	368	508	681	728	859	1,089
Romania	2	7	2	3	4	3	2	2	5
Bulgaria	2	13	16	23	17	21	18	16	17
Slovenia	4	9	12	17	19	23	28	28	39
Slovak Republic	10	24	31	39	50	39	29	42	52
<b>BFTA 1/</b>	<b>279</b>	<b>482</b>	<b>577</b>	<b>837</b>	<b>1,056</b>	<b>1,182</b>	<b>1,042</b>	<b>1,293</b>	<b>1,447</b>
Estonia	99	179	213	290	431	457	378	395	443
Latvia	62	80	113	160	195	217	210	240	277
Lithuania	118	223	252	386	430	508	454	658	728
<b>SEE 2/</b>	<b>0</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>3</b>	<b>9</b>
Croatia	0	1	1	1	2	2	2	3	8
Bosnia & Herzegovina	0	0	0	0	0	0	0	0	1
Albania	0	0	0	0	0	0	0	0	0
Serbia & Montenegro	0	0	0	0	0	0	0	0	0
Macedonia, FYR	0	0	0	0	0	0	0	0	0
(Index 1996=100)									
<b>CEFTA</b>	<b>15.1</b>	<b>47.7</b>	<b>69.6</b>	<b>100.0</b>	<b>124.5</b>	<b>156.6</b>	<b>154.5</b>	<b>178.2</b>	<b>222.9</b>
Czech Republic	8.0	43.5	63.3	100.0	118.0	160.7	122.1	138.4	155.1
Hungary	0.0	41.8	62.5	100.0	93.7	90.9	87.5	86.2	112.6
Poland	20.1	47.0	72.4	100.0	138.0	185.0	197.5	233.1	295.7
Romania	96.0	288.0	72.0	100.0	168.0	134.8	85.6	94.0	212.0
Bulgaria	10.2	58.5	69.0	100.0	75.9	91.3	79.7	71.7	74.0
Slovenia	24.8	51.7	74.3	100.0	116.5	137.3	168.5	169.6	233.3
Slovak Republic	25.0	60.6	80.4	100.0	129.7	101.3	74.6	107.3	135.0
<b>BFTA</b>	<b>33.3</b>	<b>57.6</b>	<b>69.0</b>	<b>100.0</b>	<b>126.2</b>	<b>141.3</b>	<b>124.6</b>	<b>154.6</b>	<b>173.0</b>
Estonia	34.1	61.7	73.4	100.0	148.5	157.6	130.1	136.1	152.5
Latvia	38.8	50.3	70.4	100.0	121.9	135.3	131.3	150.1	173.0
Lithuania	30.5	57.7	65.1	100.0	111.3	131.5	117.7	170.3	188.5
<b>SEE</b>	<b>7.6</b>	<b>102.8</b>	<b>99.8</b>	<b>100.0</b>	<b>152.0</b>	<b>158.8</b>	<b>193.9</b>	<b>302.4</b>	<b>822.3</b>
Croatia	0.0	114.8	109.4	100.0	161.6	156.6	190.9	277.8	781.8
Bosnia & Herzegovina	...	...	...	...	...	...	...	...	...
Albania	...	...	...	...	...	...	...	...	...
Serbia & Montenegro	...	...	...	...	...	...	...	...	...
Macedonia, FYR	0.0	0.0	17.9	100.0	49.7	159.9	112.5	367.7	324.0
<u>Memorandum items</u>									
Cumulative Export growth (1993-2001)									
CEFTA	1,377								
BFTA	419								
SEEC	10,748								

Source: IMF Direction of Trade Database

1/ Exports of BFTA member countries to other BFTA members

2/ Exports of CEFTA and SEE to BFTA members

Table 7. Central and Eastern Europe, Market share in BFTA countries, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(exports in percent of total BFTA imports)									
<b>CEFTA</b>	<b>3.1</b>	<b>6.0</b>	<b>5.9</b>	<b>6.9</b>	<b>6.6</b>	<b>7.7</b>	<b>8.8</b>	<b>8.9</b>	<b>10.1</b>
Czech Republic	0.3	1.0	1.0	1.3	1.2	1.5	1.3	1.3	1.3
Hungary	0.0	0.8	0.8	1.1	0.8	0.7	0.8	0.7	0.8
Poland	2.2	3.2	3.3	3.7	4.0	4.9	6.1	6.3	7.2
Romania	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Bulgaria	0.1	0.2	0.2	0.2	0.1	0.2	0.2	0.1	0.1
Slovenia	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3
Slovak Republic	0.3	0.4	0.4	0.4	0.4	0.3	0.2	0.3	0.3
<b>Intra-regional trade</b>	<b>8.4</b>	<b>9.0</b>	<b>7.2</b>	<b>8.4</b>	<b>8.2</b>	<b>8.6</b>	<b>8.8</b>	<b>9.5</b>	<b>9.6</b>
Estonia	3.0	3.3	2.7	2.9	3.4	3.3	3.2	2.9	2.9
Latvia	1.9	1.5	1.4	1.6	1.5	1.6	1.8	1.8	1.8
Lithuania	3.5	4.1	3.1	3.9	3.4	3.7	3.8	4.8	4.8
<b>SEE</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.1</b>
Croatia	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1
Bosnia & Herzegovina	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Albania	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Serbia & Montenegro	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Macedonia, FYR	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>Memorandum Item</b>									
Total Imports of BFTA (millions of US dollars)	3,339	5,383	8,005	9,925	12,801	13,773	11,891	13,657	15,043

Source: IMF Direction of Trade Database

Table 8. Central and Eastern Europe, Exports to EU, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
	(percent of total exports)								
<b>CEFTA</b>	<b>56</b>	<b>57</b>	<b>58</b>	<b>59</b>	<b>61</b>	<b>66</b>	<b>69</b>	<b>68</b>	<b>68</b>
Czech Republic	54	52	54	58	60	64	69	69	68
Hungary	58	64	63	63	71	73	76	75	74
Poland	69	69	70	66	64	68	71	70	69
Romania	41	48	54	56	57	65	65	64	68
Bulgaria	47	46	39	40	45	51	54	52	55
Slovenia	62	63	67	65	64	65	66	64	63
Slovak Republic	30	35	37	41	47	56	59	59	60
<b>BFTA</b>	<b>50</b>	<b>38</b>	<b>44</b>	<b>41</b>	<b>41</b>	<b>48</b>	<b>58</b>	<b>59</b>	<b>55</b>
Estonia	48	48	55	51	49	55	63	69	60
Latvia	32	39	44	44	49	57	63	65	61
Lithuania	67	30	36	33	33	38	50	48	48
<b>SEE</b>	<b>52</b>	<b>54</b>	<b>54</b>	<b>53</b>	<b>55</b>	<b>53</b>	<b>54</b>	<b>57</b>	<b>59</b>
Croatia	57	59	58	51	51	48	49	55	54
Bosnia & Herzegovina	40	40	56	44	44	49	61	67	67
Albania	73	77	79	86	87	93	94	91	90
Serbia & Montenegro	81	9	58	76	83	73	69	67	77
Macedonia, FYR	35	33	34	43	37	44	45	43	43

Source: IMF Direction of Trade Database

Table 9. Central and Eastern Europe, exports to SEE markets, 1993-2001

	1993	1994	1995	1996	1997	1998	1999	2000	2001
(millions of US dollars)									
<b>CEFTA 2/</b>	<b>1,138</b>	<b>1,637</b>	<b>2,210</b>	<b>2,242</b>	<b>2,213</b>	<b>2,259</b>	<b>2,191</b>	<b>2,287</b>	<b>2,545</b>
Czech Republic	0	47	101	214	235	213	202	239	279
Hungary	5	149	178	316	365	382	389	403	481
Poland	58	49	61	66	61	94	107	116	156
Romania	34	41	56	47	44	41	40	57	54
Bulgaria	27	242	512	207	124	141	159	148	155
Slovenia	961	1,029	1,205	1,297	1,282	1,299	1,213	1,239	1,334
Slovak Republic	54	80	97	95	103	88	81	85	86
<b>BFTA 2/</b>	<b>1</b>	<b>2</b>	<b>2</b>	<b>2</b>	<b>1</b>	<b>2</b>	<b>3</b>	<b>3</b>	<b>4</b>
Estonia	0	0	0	1	0	1	2	1	0
Latvia	0	0	0	0	0	1	0	1	0
Lithuania	0	1	1	1	1	1	1	2	3
<b>SEE 1/</b>	<b>353</b>	<b>485</b>	<b>532</b>	<b>773</b>	<b>967</b>	<b>960</b>	<b>814</b>	<b>699</b>	<b>836</b>
Croatia	252	416	455	619	732	719	612	537	617
Bosnia & Herzegovina	13	4	9	61	131	149	113	75	118
Albania	15	7	10	8	10	4	5	3	4
Serbia & Montenegro	0	0	0	0	0	1	0	0	1
Macedonia, FYR	74	58	57	85	94	87	83	84	96
(Index 1996=100)									
<b>CEFTA</b>	<b>50.7</b>	<b>73.0</b>	<b>98.6</b>	<b>100.0</b>	<b>98.7</b>	<b>100.7</b>	<b>97.7</b>	<b>102.0</b>	<b>113.5</b>
Czech Republic	0.0	21.9	47.2	100.0	109.8	99.4	94.4	111.5	130.2
Hungary	1.5	47.0	56.1	100.0	115.3	120.9	123.1	127.5	152.0
Poland	88.4	74.1	92.7	100.0	93.1	142.8	161.8	176.7	237.3
Romania	71.6	86.6	120.3	100.0	93.4	88.3	84.7	120.8	115.6
Bulgaria	13.0	116.7	246.9	100.0	59.6	67.8	76.5	71.5	75.0
Slovenia	74.1	79.4	92.9	100.0	98.8	100.2	93.6	95.6	102.9
Slovak Republic	56.3	84.3	102.1	100.0	108.0	92.8	85.2	89.0	89.8
<b>BFTA</b>	<b>38.2</b>	<b>112.4</b>	<b>98.4</b>	<b>100.0</b>	<b>83.8</b>	<b>109.1</b>	<b>178.5</b>	<b>192.8</b>	<b>254.0</b>
Estonia	19.3	20.9	61.3	100.0	28.9	76.5	228.2	115.5	57.8
Latvia	306.0	109.4	74.4	100.0	49.6	361.5	220.5	365.8	134.1
Lithuania	3.9	197.0	137.1	100.0	140.9	90.3	124.8	230.3	457.4
<b>SEE</b>	<b>45.7</b>	<b>62.7</b>	<b>68.8</b>	<b>100.0</b>	<b>125.1</b>	<b>124.2</b>	<b>105.3</b>	<b>90.4</b>	<b>108.2</b>
Croatia	40.6	67.1	73.5	100.0	118.1	116.0	98.8	86.7	99.7
Bosnia & Herzegovina	20.9	6.1	14.2	100.0	215.7	245.3	186.9	123.1	194.3
Albania	188.7	91.8	128.4	100.0	122.2	54.9	57.7	39.1	49.7
Serbia & Montenegro	...	...	...	...	...	...	...	...	...
Macedonia, FYR	87.2	68.3	67.8	100.0	111.3	102.6	98.3	98.6	113.6
<u>Memorandum items</u>									
Cumulative Export growth (1993-2001)									
CEFTA	124								
BFTA	565								
SEEC	137								

Source: IMF Direction of Trade Database

1/ Exports of SEE countries to other SEE countries

2/ Exports of CEFTA and BFTA to SEE members

Table 10. South Eastern Europe, Status of June 2002 MoU Bilateral Free Trade Agreements  
(As of March 14, 2003)

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Macedonia, FYR	Romania
Bosnia and Herzegovina	Initialled					
Bulgaria	Initialled	Initialled				
Croatia	Signed	In operation	CEFTA			
Macedonia, FYR	In operation	In operation	In operation	In operation		
Romania	Signed	Initialled	CEFTA	In operation	Signed	
Serbia and Montenegro 1/	Initialled	In operation	Initialled	Signed	In operation	Initialled
<b>Memorandum Items</b>						
Agreements in Operation	8					
Signed Agreements	4					
Initialled agreements	7					
Bilateral CEFTA agreements	2					
Total	21					

Source: Stability Pact.

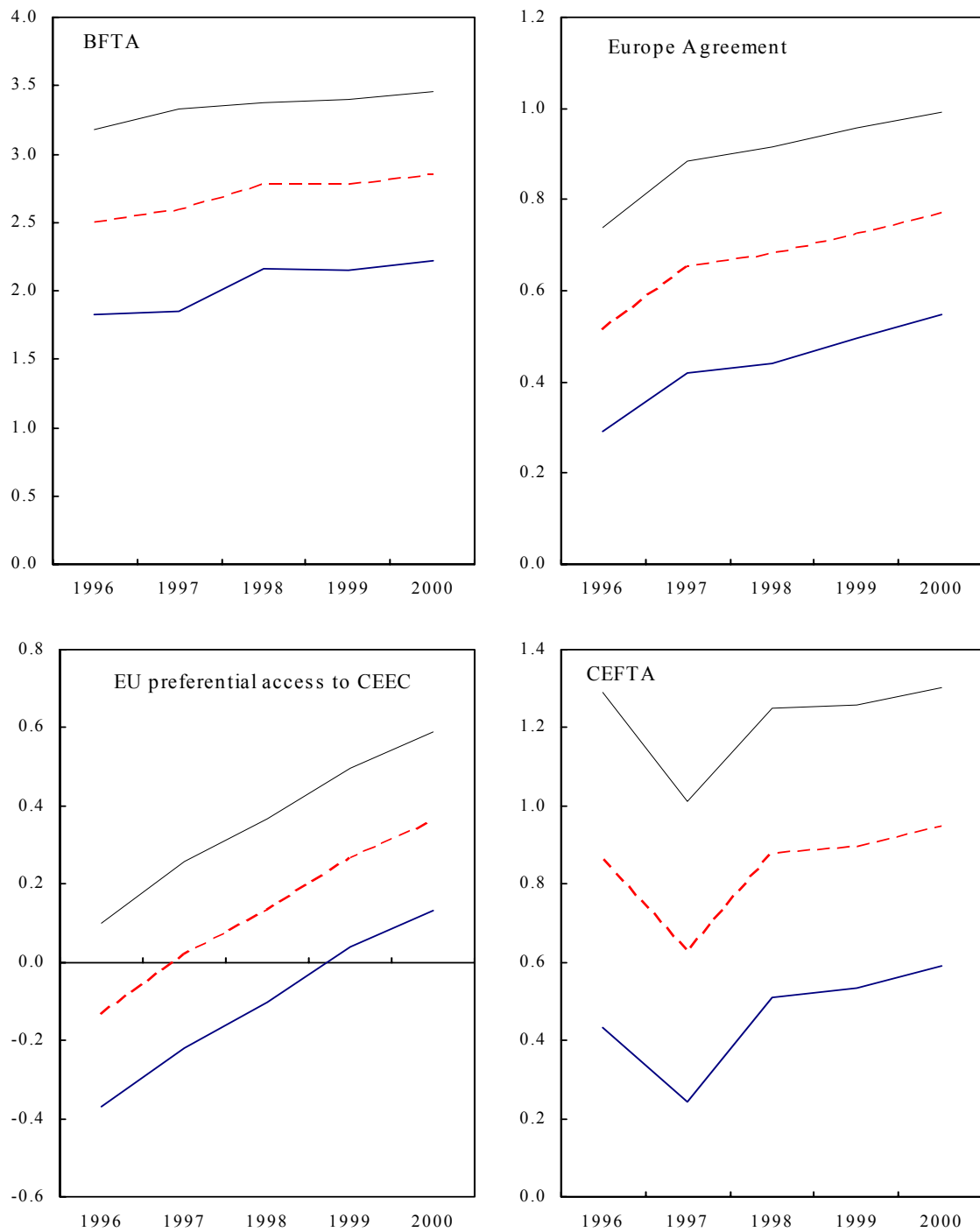
1/ Serbia and Montenegro started negotiation process when it was know as FR Yugoslavia; therefore, both names may appear in the agreements.

Table 11. Model Estimation

	Fixed Effects	Random Effects	OLS	Second Stage Cross Section
Constant	-30.42 (-12.38)	-32.1 (-36.68)	-30.38 (-63.51)	0.541 (4.69)
Difference in GDP per capita	0.0523 (0.44)	-0.867 (12.95)	-1.269 (-30.33)	... ...
Average GDP	1.797 (14.44)	1.9 (43.45)	1.833 (78.16)	... ...
Similarity	1.56 (1.73)	4.87 (17.79)	4.801 (37.12)	... ...
Distance	... ...	-0.0006 (-15.52)	-0.0006 (-28.36)	-0.0008 (-15.70)
Language	... ...	0.497 (2.05)	0.549 (5.92)	0.059 (0.35)
BEFTA	... ...	2.89 (4.89)	2.69 (18.02)	3.69 (10.26)
CEFTA	... ...	0.4823 (4.92)	0.825 (9.65)	1.521 (7.65)
Europe Agreement	... ...	0.201 (1.49)	0.13 (2.46)	0.277 (2.21)
EU preferential access to CEEC	... ...	0.73 (5.52)	0.67 (12.84)	0.787 (6.37)
EU	... ...	0.817 (6.06)	0.531 (10.05)	1.84 (16.20)
Ex-COMECON	... ...	-0.442 (-3.54)	-0.67 (-9.23)	-0.245 (-1.66)
Border	... ...	1.384 (8.97)	1.234 (30.28)	1.224 (10.68)
R <sup>2</sup>	0.04	...	...	0.61
Hausman	134	...	...	...
LM <sub>1</sub> (cross section effects)	9324	...	...	...
LM <sub>2</sub> (time effects)	1.3	...	...	...

Numbers in brackets are t statistics

Figure 1. Cross sectional estimated parameter values for trade agreements, 1996-2000



1/ Intervals around the parameter value are confidence intervals at the 95 percent level of significance.

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