CHAPTER 2

Trade Trends and Patterns and Labor Competitiveness

Introduction

The previous chapter indicated that the problem of low exports is at the heart of concerns relating to sustainable growth in most SEE countries. This chapter frames the problem in a comparative context and analyzes trends in trade flows, direction and patterns of trade, and labor competitiveness.

The analysis finds that exports from SEE have been growing, especially in services, in which the trade balance is positive. However, low merchandise exports have been a major problem, and could be an important factor in the unemployment problems of many countries. Despite strong service exports, overall export levels still fall significantly short of potential and needs. Albania, Bosnia and Herzegovina, and Serbia and Montenegro are laggards on almost all fronts. Bulgaria and Croatia are strong performers. Romania, the largest country by far, has somewhat lower export intensity than Bulgaria and Croatia, but its exports have been growing faster than either countries' exports.

Regional trade has been influenced by two exogenous forces. States of the former SFRY trade significantly with each other, the exception being trade between Serbia and Croatia. Bosnia and Herzegovina, Serbia and Montenegro, and FYR Macedonia are the largest intraregional traders.

In addition, the EU has encouraged trade between SEE and EU countries through its Stabilization and Association Agreements (SAAs) and within SEE through the Stability Pact-induced free trade agreements (FTAs), which culminated in a single FTA for the region (known as CEFTA 2006). Analysis shows that overall intra-SEE trade is higher in 2003 than what gravity models would predict, even though "overtrading" has declined compared with earlier periods. In any case, most countries have not been able to take advantage of fast-growing regions such as East Asia and South Asia. Also, further economic integration within SEE is likely to be driven by FDI rather than through trade.

Overall patterns of trade in the region are not favorable, and are inimical to sustainable growth of exports. Albania is an outlier in most respects. It has high product concentration and almost 90 percent of its exports are unskilled-labor or natural-resource-intensive products. Most countries have moved only slowly away from such exports and are vulnerable to low-wage competition from Asia and other regions.

The shift from "buyer-driven" to "producer-driven" networks has also occurred slowly, and is dominated by Romania (at the same time, Bosnia and Herzegovina has seen a recent surge, but it is too soon to tell if this growth is sustainable). This implies that, overall, SEE is not participating at its potential level in the international division of labor. Much of this network trade can be explained by FDI stocks and inflows, as can overall export performance.

Labor costs in the region, along with a large share of unskilled and natural-resource products, mean that lower-wage countries can undercut SEE countries. This has happened already in apparels. Albania is especially vulnerable here. Bulgaria, with similar wage levels as Albania, is in a better position to face low-wage competition and move up the value chain. Of the higher-wage countries, Croatia has wage levels that are considerably higher than in the Slovak Republic, according to one data set (MIGA 2006); whereas less than 40 percent of Croatia's exports are in capital-intensive or skilled-labor (SL)-intensive products (compared with 71 percent of the Slovak Republic's). According to official data comparisons, Bosnia and Herzegovina is a relatively high-wage country within SEE5, but only about 33 percent of its exports are capital-intensive (CI) and skilled-labor-intensive products (similar to Bulgaria). However, different (nonofficial) data sets also indicate that FYR Macedonia, and Serbia and Montenegro are higher-wage countries within SEE5.

Skill acquisition is clearly an urgent need. With a high share of unskilled and natural-resource-intensive exports, SEE is vulnerable to competition from Asian countries. The skill content of exports from Bosnia and Herzegovina and Croatia is not aligned (i.e., it is much lower) with their wage levels. In general, the transition to more skill- and capital-intensive exports is complicated by a shortage of skilled workers in many of these countries, which is reflected partly in high skill premia. The percentage wage differentials between SEE5 and EU8 countries appear to reduce as skill content increases. All this points to the need for more emphasis on human development in the region, but this will not be easy (see also chapter 5).

Governments may also wish to consider whether or not labor taxes are too high in the overall context of competitiveness of gross wages and increasing competition from Asia. This consideration would also require an examination of the overall tax strategy and tax administration in each country, as well as the mix between labor taxes (health, social security, personal income taxes, and so on) and general taxes such as VAT and excise.

The rest of this chapter elaborates on the above themes. The next section focuses on trends and directions of trade, key developments in trade policy, and trade within SEE and with the EU. The third section looks at composition of trade and the fourth analyzes the role of production networks and FDI. The final section looks at labor costs and competitiveness.

Trends and Direction of Trade in SEE Countries

Trends in Merchandise and Services Trade

Overall trade flows of SEE countries have steadily grown, despite disruptions from regional conflicts and sanctions during the 1990s. The value of total exports and imports of goods and services has steadily expanded over the past decade, and most of the growth has occurred after 2000 during a period of relative political stability. Trade flows (in dollar terms) tripled in SEE countries over 1996–2005, with growth somewhat faster in Romania and Bulgaria than growth in the Western Balkans as a whole. However, Bosnia and Herzegovina and Albania witnessed faster growth than all other countries, at least partly because of their low starting point (see table 2.1).[1]

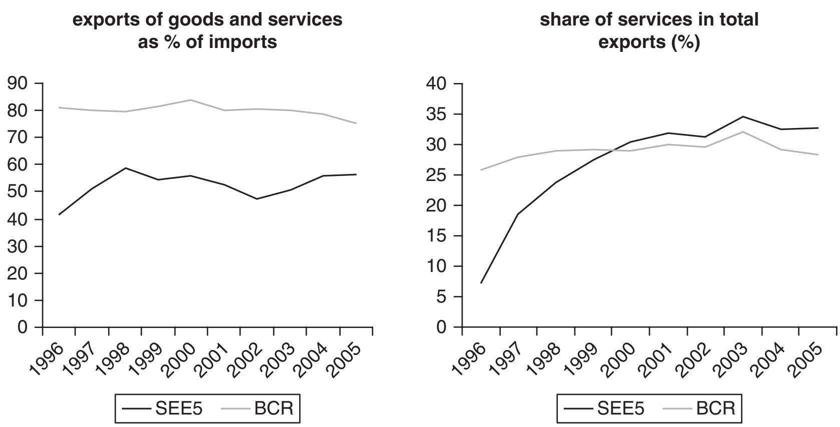
Services have performed better than goods, but the growing net surplus in services exports has been insufficient to cover the growing goods deficit. The export to import coverage of goods and services remains below 60 percent in SEE5 (see figure 2.1), compared with an average of about 95 percent in the Slovak Republic and Slovenia, 89 percent in Tunisia, and 84 percent in Turkey. Despite a small decline in this coverage for Bulgaria, Croatia, and Romania (BCR), their average 75 percent ratio

Table 2.1. Growth of Goods and Services Trade in SEE

	Export growth (%)		*Import growth (%)*		*Total trade ($ millions)*		
	1996–2005	*2000–05*	*1996–2005*	*2000–05*	*1996*	*2000*	*2005*
Albania	22.9	19.8	17.3	20.0	1,468	2,228	5,844
Bosnia and Herzegovina	14.6	19.9	12.0	18.4	2,592	4,269	10,960
Bulgaria	10.9	18.2	14.2	20.6	12,576	15,171	37,608
Croatia	10.2	17.4	9.2	17.6	17,200	18,211	40,653
Macedonia, FYR	5.6	10.1	6.4	11.6	3,238	4,001	6,247
Romania	14.2	20.9	14.1	23.0	23,031	27,161	78,582
Serbia and Montenegro	10.4	22.5	10.4	20.1	5,944	6,339	17,796
Western Balkans	10.8	18.0	9.9	17.9	30,441	35,047	81,501
SEE	12.0	19.2	12.1	20.3	66,048	77,379	197,691

Source: World Bank World Development Indicators database and IMF Balance of Payments Statistics.

Figure 2.1. Export Coverage of Imports and Share of Exports in Total Trade, Bulgaria, Croatia, and Romania (BCR) and SEE5, 1996–2005



Source: World Bank World Development Indicators database and IMF Balance of Payments Statistics.

in 2005 is much higher than for SEE5. Merchandise exports coverage has steadily deteriorated in BCR and FYR Macedonia, but has improved significantly in Serbia and Montenegro. The worst performers remain Albania and Bosnia and Herzegovina, and their coverage ratios do not exceed 25 and 35 percent respectively. Services performance is much stronger. Export to import coverage ratios average 157 percent in BCR and 135 percent in SEE5 for the period 2000–05. These exceed levels achieved in the Slovak Republic and Slovenia (117 and 133 percent respectively) but remain lower than those registered in Turkey and

Tunisia (221 percent and 194 percent respectively). Indeed, the share of services in total SEE exports rose substantially from 23 to 29 percent between 1996 and 1999. However, this share has stagnated at 29 percent since then. The relative importance of services is also reflected in a growing surplus, which helps partially offset the widening deficit of goods trade (see table 2.2), most prominently in Croatia.

Merchandise exports remain very low in most countries, which may also account for their high unemployment rates. As seen in chapter 1, low exports to GDP ratios are a major issue in SEE. Table 2.3 shows that the ratio of goods and service exports to GDP (in PPP terms) in 2005 varied from highs of 32 and 23 percent in Croatia and Bulgaria respectively, to 17 percent for Romania and FYR Macedonia, and to only 11 percent for Albania, Bosnia and Herzegovina, and Serbia and Montenegro (the latter figure is comparable to Turkey's in 1996). The state of merchandise exports presents an even worse picture than do overall exports. The region's average merchandise exports accounted for only 13 percent of PPP-GDP, which was a third of the Slovak Republic's ratio in 2005 and even below its ratio in 1996 (15 percent). Albania, Serbia and Montenegro, and Bosnia and Herzegovina were again at the bottom of the table and had ratios of 4 to 8 percent of GDP. This most likely creates problems with employment generation, given the employment-intensity of merchandise (especially manufacturing) exports. In services, the region performed better, and services exports accounted for about 5 percent of PPP-GDP. Croatia's 17 percent ratio was the highest, followed by 6 to 7 percent in Albania and Bulgaria.

Thus, despite good recent growth, overall export and trade volumes, especially in SEE5, fall short of their potential (based upon comparator performance) and the need for export-led growth. A recent World Bank study used a gravity model to predict trade openness in the region and compared the results with actual trade. In 2003, SEE was trading at only 77 percent of its potential (EU8 at 133 percent); Albania was at 53 percent; Bosnia and Herzegovina was at 56 percent; FYR Macedonia was at 61 percent; and Bulgaria, Croatia, and Romania were at 94, 98 and 102 percent respectively (Broadman 2005, chapter 2). Exports of goods and services per capita in SEE5 countries in 2005 ($887 on average) were much lower than the comparative figure for the Slovak Republic in both 2005 ($5,940) and in 1996 ($1,778). Albania, Bosnia and Herzegovina, and Serbia and Montenegro again brought up the low end. Thus, despite strong recent export performance, SEE5 countries must traverse some distance in order to reach their export potential and

Table 2.2. Developments in Trade in Goods and Services in SEE Countries, 1996–2005

	1996	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*Growth (%)*	
SEE7					*($ millions)*						*1996–05*	*2000–05*
Exports of goods and services	27,517	30,018	30,890	28,942	33,644	36,523	41,841	54,478	70,699	82,068	12.0	19.2
of which services	6,406	7,855	8,573	8,354	9,832	11,055	12,486	17,656	20,975	23,953	14.4	19.2
Imports of goods and services	38,531	41,338	41,880	38,760	43,735	49,776	58,094	74,101	96,428	115,622	12.1	20.3
of which services	5,400	6,099	6,161	6,279	6,738	7,124	8,343	10,831	13,822	16,039	11.7	18.8
Total trade balance	–11,014	–11,320	–10,990	–9,818	–10,091	–13,252	–16,254	-19,623	–25,730	–33,554	—	—
Balance of goods	–12,020	–13,076	–13,402	–11,894	–13,185	–17,184	–20,396	-26,449	–32,883	–41,468	—	—
Balance of services	1,006	1,756	2,412	2,076	3,094	3,932	4,142	6,825	7,153	7,914	—	—
					(in %)						*Average share (%)*	
Exports of goods and services in % of imports	71	73	74	75	77	73	72	74	73	71	73.3	73.4
Exports of goods in % of imports	64	63	62	63	64	60	59	58	60	58	61.2	60.0
Exports of services in % of imports	119	129	139	133	146	155	150	163	152	149	143.5	152.5
Share of services in total exports	23	26	28	29	29	30	30	32	30	29	28.7	30.1

Source: IMF Balance of Payments Statistics.
Note: — = not available.

Table 2.3. Exports and Total Trade in Goods and Services as Percent Share of GDP-PPP (Openness) by SEE Country, 1996–2005

	Exports as % of GDP (PPP)									*Total trade as % of GDP (PPP)*									*Exports of goods and services per capita*	
	Merchandise			*Services*			*Goods and services*			*Merchandise*			*Services*			*Goods and services*				
	1996	*2000*	*2005*	*1996*	*2000*	*2005*	*1996*	*2000*	*2005*	*1996*	*2000*	*2005*	*1996*	*2000*	*2005*	*1996*	*2000*	*2005*	*2000*	*2005*
Albania	2.4	2.3	4.0	1.45	3.95	7.00	3.8	6.3	11.0	12.9	11.9	19.8	3.57	7.74	15.31	16.4	19.7	35.1	232	584
Bosnia and Herzegovina	3.5	4.4	8.2	—	2.22	3.40	3.5	6.7	11.6	21.5	17.6	31.8	—	3.53	4.93	21.5	21.1	36.8	350	883
Bulgaria	11.3	10.0	17.2	3.15	4.51	6.25	14.4	14.5	23.5	23.0	23.5	43.9	6.03	7.98	11.31	29.0	31.5	55.2	868	2065
Croatia	13.1	10.6	15.0	9.25	9.74	16.95	22.3	20.3	31.9	35.6	29.5	46.7	14.20	14.09	22.76	49.8	43.6	69.5	1941	4206
Macedonia, FYR	11.5	10.9	14.0	3.25	2.60	3.25	13.0	13.5	17.3	27.8	28.1	36.3	4.65	4.80	6.73	32.4	32.9	43.0	816	1236
Romania	5.9	7.8	13.9	1.55	1.32	2.49	7.0	9.2	16.4	14.2	17.7	34.2	2.55	2.83	5.22	16.7	20.6	39.5	540	1511
Serbia and Montenegro	3.9	5.8	7.6	1.44	2.11	3.49	5.3	7.9	11.1	12.6	18.4	22.8	2.08	3.11	5.75	14.7	21.5	28.5	287	848
Western Balkans	7.2	7.5	10.3	3.09	4.59	6.91	10.3	12.1	17.2	22.0	22.6	32.8	5.05	7.01	10.07	27.0	29.7	42.8	678	1541
SEE	7.2	8.1	12.9	2.18	3.12	4.85	9.4	11.2	17.8	18.5	20.6	35.1	4.02	5.30	8.11	22.5	25.9	43.2	648	1607
Slovakia	15.0	19.5	36.1	4.14	3.68	—	19.2	23.2	—	33.9	40.5	74.9	8.21	6.64	—	42.1	47.1	—	2621	5940
Slovenia	31.8	26.0	43.3	8.16	5.63	8.96	39.9	31.7	52.3	67.8	56.2	89.0	13.87	9.92	15.43	81.6	66.1	104.4	5339	11649
Tunisia	12.0	9.8	12.6	5.73	4.63	4.81	17.7	14.4	17.4	28.8	24.1	28.5	8.44	6.67	7.44	37.2	30.8	35.9	901	1447
Turkey	6.4	6.3	12.0	3.72	4.65	4.22	10.1	10.9	16.2	18.3	18.6	31.1	5.59	6.72	6.16	23.9	25.3	37.2	711	1368

Source: UN COMTRADE database, World Bank World Development Indicators database, and IMF Balance of Payments Statistics.

Notes: — = not available.

match the performance of countries such as the Slovak Republic (even to reach its level eight years before it entered the EU). Finally, sustainable growth for the mostly-small SEE5 countries demands a strong rate of growth in net exports.

Below-potential export performance in SEE5 can be attributed to conflicts and sanctions, as well as to delayed transition in some countries. The loss of markets of the former Yugoslav Republics[2] following the breakup of the SFRY was aggravated by the effects of conflicts, by economic sanctions, and by the destruction of infrastructure following the NATO bombings of Serbia and Montenegro in 1999. This seriously disrupted commercial and economic links among several former SFRY neighbors and their main trading partners, as well as with international production and distribution networks.[3] These effects were compounded by delayed transition and poor economic management in some countries, including increased government intervention in markets (for example, through price and exchange controls), lack of market-oriented ownership structures, protectionism, and repressive regulation and taxation, all of which hampered the development and performance of export-oriented industries.

Expanding the industrial base and deepening services-sector liberalization appear to be the core elements of a sustainable growth strategy for SEE5 countries. The experience of EU8 countries demonstrates that an expansion of merchandise exports may be necessary for job creation, but would need to be accompanied by modernization of the services sector. Liberalization in services (see chapter 4) is necessary not only to improve the growth of services, but also to increase the competitiveness and efficiency of the manufacturing sector and aid its rapid integration with international production and distribution chains.

Main Developments in Trade Policy

Trade reforms accompanied other market-oriented reforms in the Western Balkans. Policy reforms accelerated during the last five years and included numerous early measures to liberalize the trade and foreign exchange systems. For example, in December 2000, the Serbian authorities unified the exchange rate, restored current account convertibility, removed bureaucratic trade and foreign exchange restrictions (including almost all licensing and quantitative restrictions), and reduced tariff dispersion and average tariffs. For the Western Balkans, average tariffs were reduced from 8.8 percent to 5.3 percent (see table 2.4). Agricultural tariffs, however, stayed at about 11 percent in the Western Balkans and even

Table 2.4. Comparisons of Applied Tariff Rate (Simple Average in %) on SEE Imports, by Product Type

Product	*Reporter*	*2001*	*2005*
All goods	Western Balkans	8.8	5.3
	Albania	11.6	6.3
	Bosnia and Herzegovina	5.3	n/a
	Bulgaria	8.4	10.6
	Croatia	7.6	2.4
	Macedonia, FYR	10.3	4.1
	Romania	11.6	6.6
	Serbia and Montenegro	9.1	8.2
Agricultural products	Western Balkans	11.0	11.2
	Albania	12.7	8.3
	Bosnia and Herzegovina	4.3	n/a
	Bulgaria	21.9	21.4
	Croatia	8.8	6.7
	Macedonia, FYR	15.4	12.9
	Romania	24.5	18.8
	Serbia and Montenegro	13.7	16.8
Industrial products	Western Balkans	8.6	4.7
	Albania	11.5	6.0
	Bosnia and Herzegovina	5.4	n/a
	Bulgaria	7.3	9.9
	Croatia	7.5	2.1
	Macedonia, FYR	9.8	3.5
	Romania	10.6	5.6
	Serbia and Montenegro	8.7	7.3

Source: UNCTAD TRAINS database.
Note: Applied tariffs include MFN and preferential tariffs.

rose in Serbia and Montenegro. Also, nontariff barriers on selected products continue to be significant.

Market reforms were accompanied by policy-induced trade integration, both with the EU and with neighboring countries, which further improved opportunities for export growth. As of 2000, the Stabilization and Association Process (SAP) launched by the EU provided all Western Balkan countries with nonreciprocal free access to EU markets through autonomous trade preferences (ATPs). Access to EU markets was free of tariffs and quantitative restrictions for almost all products, except for a few products regulated by preferential tariff quotas.[4] The ATPs were fully extended to Serbia and Montenegro in November 2003.

In parallel, the SAP explicitly linked liberalization of trade with the EU to regional cooperation and liberalization among the countries of SEE.[5] All SEE countries completed their commitments under the

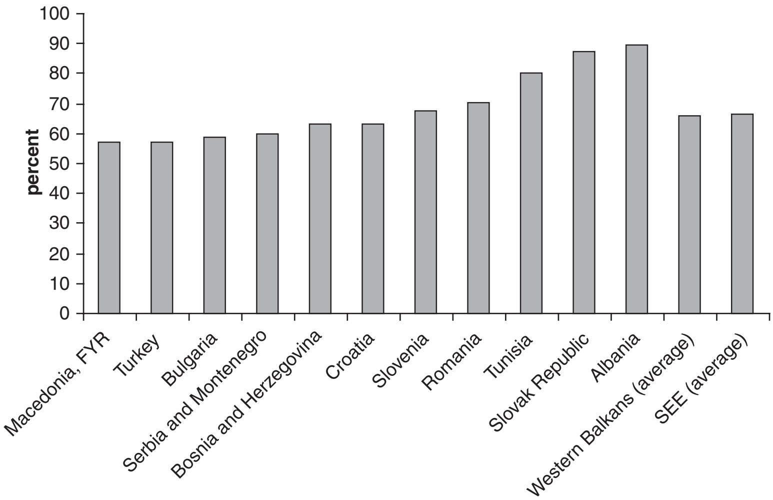
"Balkan" Stability Pact Memorandum of Understanding (MOU) on Trade Liberalization and Facilitation in 2005.[6] By the end of 2005, 32 bilateral free trade agreements (FTAs) were being implemented within the group. These FTAs liberalized almost all trade in industrial products between the parties and significantly reduced tariffs and nontariff barriers on agricultural products. In 2006, all SEE countries agreed to establish a single FTA among themselves by expanding and negotiating terms and provisions of a new CEFTA (see box 3.2).

Trade within SEE and with the EU

Over the decade 1996–2005, SEE countries saw their share of exports to the EU15 growing, but this change was more dramatic in some countries. The share of SEE merchandise exports sold in EU15 rose over the decade from 48 to 54 percent. This was particularly pronounced for Bosnia and Herzegovina, Serbia and Montenegro, and FYR Macedonia, is more dramatic over 1996–2003, and arose at least partly from the EU's generous trade preferences for the Western Balkan countries (see annex table 2.1). This is in line with the experience of Central European economies of similar size, in which preferential market access to the EU under the Generalized System of Preferences and later under the Europe Agreements (EAs) contributed significantly to export expansion to the EU and compensated for the collapse of their exports to former CMEA countries (World Bank 2000). Albania presents an extreme case: it exports about 90 percent of its products to the EU, but more than 75 percent go to Italy and Greece (see annex table 2.1 and figure 2.2).

SEE exports have not been able to penetrate fast growing markets in East and South Asia. Annex table 2.1 shows that the share of North American Free Trade Agreement (NAFTA) countries in SEE exports has expanded marginally, whereas the already low shares in the two fastest growing regions in the world, East Asia and South Asia, have fallen. In this context, Turkey's experience is instructive. Turkey had similar dollar exports ($23 billion) as SEE ($21 billion) in 1996, but much larger exports by 2005 ($74 billion versus $58 billion). Although diversification is not the only factor in this export growth, Turkey did spread its exports to a much wider set of countries, including EU27, North America, MENA, and SEE. In SEE, the one country that appears to have taken advantage of East Asia's fast growth is Bosnia and Herzegovina, in which the share of exports to East Asia rose from 0.1 to 3.9 percent over 1996–2005.

Figure 2.2. Share of Exports Destined for EU27 in 2005



Source: UN COMTRADE database.

On the other hand, SEE countries are sourcing imports from a more diversified base, including from East Asia. Annex table 2.2 shows that SEE countries have been taking increasing advantage of competitive imports from East Asia, whose share increased from 4.3 to 7.7 percent of SEE imports over 1996–2005. All countries of SEE increased their imports from East Asia except Serbia and Montenegro, whose dominant change over this period was to increase imports from the new member EU8 countries.

Within SEE, merchandise trade flows more than doubled over the past five years in dollar terms. This has occurred both on the import and the export side, with growth particularly high for Romania for exports to SEE, and for Croatia, Romania, and Bulgaria for imports from SEE (see table 2.5). In terms of nominal dollar values, Croatia, Romania, and Serbia and Montenegro contributed to about 65 percent of total intraregional exports, and Bosnia and Herzegovina contributed to about 30 percent of intraregional imports in 2005.

Sharp recent growth has helped to reverse the 1996–2003 decline in the share of intra-SEE trade in total trade. Trade preferences partly helped increase the share of EU15 exports in total exports of SEE from 48 to 63 percent over 1996–2003, and to a lesser extent were mirrored in EU15 share of imports (see annex tables 2.1, 2.2, and table 2.5 in this

Table 2.5. Intraregional Merchandise Exports and Imports by SEE7 Country, 1996–2005

											Growth rate (%)	
Country	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*1996–2005*	*2000–05*
Intraregional exports ($ millions)												
Albania	11	10	5	8	11	16	12	14	12	22	8.6	8.2
Bosnia and Herzegovina	298	435	423	319	273	275	414	314	611	944	7.3	23.8
Bulgaria	514	329	289	370	612	494	526	717	961	1,144	12.2	15.5
Croatia	624	777	752	652	679	787	973	1,226	1,647	1,873	11.5	21.5
Macedonia, FYR	372	407	375	365	447	373	360	408	538	699	4.7	9.9
Romania	257	241	238	262	484	411	381	611	1,041	1,489	19.2	25.4
Serbia and Montenegro	725	814	939	533	530	521	675	428	1,123	1,488	3.3	20.0
Western Balkans	2,030	2,443	2,495	1,878	1,939	1,972	2,434	2,390	3,930	5,026	7.3	19.5
SEE	2,801	3,014	3,021	2,510	3,035	2,877	3,342	3,718	5,932	7,660	9.5	19.7
Intraregional imports ($ millions)												
Albania	97	35	43	66	77	77	107	102	122	177	12.1	15.7
Bosnia and Herzegovina	952	1,132	1,302	889	794	848	1,079	750	1,603	2,335	5.1	19.8
Bulgaria	163	124	140	113	285	216	221	352	561	901	19.6	26.0
Croatia	131	233	256	215	194	264	347	557	848	1,206	21.0	37.5
Macedonia, FYR	341	399	416	359	368	325	394	455	653	671	6.1	15.0
Romania	125	137	129	126	170	199	179	282	471	710	17.8	29.1
Serbia and Montenegro	799	824	682	584	817	723	773	969	1,401	1,828	8.3	17.8
Western Balkans	2,321	2,622	2,699	2,113	2,250	2,238	2,700	2,833	4,627	6,218	8.4	20.9
SEE	2,610	2,883	2,968	2,352	2,705	2,652	3,101	3,467	5,660	7,829	9.8	22.0
Intraregional export share in total exports (%)												
Albania	5.3	7.3	2.6	2.3	4.2	5.3	3.9	3.2	2.0	3.4	–6.1	–11.8
Bosnia and Herzegovina	70.1	61.3	52.5	38.0	30.4	29.2	36.8	25.2	30.9	38.8	–8.4	2.9

Bulgaria	10.5	6.7	6.7	9.4	12.7	9.7	9.2	9.5	9.7	9.8	2.0	–3.6
Croatia	13.8	17.9	16.6	15.2	15.3	16.9	19.8	19.8	20.5	21.3	4.0	6.4
Macedonia, FYR	32.4	32.9	28.6	30.7	33.8	32.3	32.3	29.9	32.1	34.2	0.4	–0.1
Romania	3.2	2.9	2.9	3.1	4.7	3.6	2.7	3.5	4.4	5.4	4.9	4.4
Serbia and Montenegro	39.4	34.4	32.8	35.6	30.9	27.4	29.7	17.7	27.8	31.3	–4.4	–1.2
Western Balkans	24.9	27.8	25.7	23.0	22.5	22.0	25.0	20.5	24.1	26.9	–0.7	2.8
SEE	13.3	13.6	13.5	12.2	12.7	11.3	11.4	10.1	11.9	13.2	–1.7	0.6
Intraregional import share in total imports (%)												
Albania	10.3	5.6	5.1	5.7	7.1	5.8	7.1	5.5	5.4	6.7	–2.0	–2.1
Bosnia and Herzegovina	43.9	41.9	44.9	33.2	29.9	30.1	32.1	20.9	32.5	33.1	–5.0	0.9
Bulgaria	3.2	2.5	2.8	2.1	4.4	3.0	2.8	3.2	3.9	5.0	4.9	4.5
Croatia	1.7	2.6	3.1	2.8	2.5	2.9	3.2	3.9	5.1	6.5	11.4	19.4
Macedonia, FYR	21.0	22.4	21.7	20.2	17.6	19.3	19.7	19.8	22.5	20.8	–0.3	3.7
Romania	1.1	1.2	1.1	1.2	1.3	1.3	1.0	1.2	1.4	1.8	3.2	5.7
Serbia and Montenegro	19.5	17.2	14.1	17.7	22.0	15.0	12.2	15.1	16.0	19.3	–1.0	-0.7
Western Balkans	14.0	13.8	14.3	12.7	12.9	11.3	11.3	10.0	13.0	15.2	–1.1	3.2
SEE	7.9	8.2	8.3	7.2	7.3	6.2	6.2	5.5	6.9	7.9	–2.4	1.5
Share of intraregional exports in SEE (%)												
Albania	0.4	0.3	0.2	0.3	0.4	0.6	0.4	0.4	0.2	0.3	–0.9	–11.5
Bosnia and Herzegovina	10.6	14.4	14.0	12.7	9.0	9.6	12.4	8.4	10.3	12.3	–2.2	4.1
Bulgaria	18.4	10.9	9.6	14.7	20.2	17.2	15.7	19.3	16.2	14.9	2.7	–4.2
Croatia	22.3	25.8	24.9	26.0	22.4	27.3	29.1	33.0	27.8	24.5	2.0	1.8
Macedonia, FYR	13.3	13.5	12.4	14.6	14.7	13.0	10.8	11.0	9.1	9.1	–4.7	–9.8
Romania	9.2	8.0	7.9	10.4	15.9	14.3	11.4	16.4	17.6	19.4	9.8	5.6
Serbia and Monte	25.9	27.0	31.1	21.2	17.4	18.1	20.2	11.5	18.9	19.4	–6.2	0.3
Western Balkans	72.5	81.1	82.6	74.8	63.9	68.5	72.8	64.3	66.3	65.6	–2.2	–0.3
SEE	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	—	—

(continued)

Table 2.5. Intraregional Merchandise Exports and Imports by SEE7 Country, 1996–2005 *(continued)*

Country	*1996*	*1997*	*1998*	*1999*	*2000*	*2001*	*2002*	*2003*	*2004*	*2005*	*Growth rate (%) 1996–2005*	*Growth rate (%) 2000–05*
Share of intraregional imports in SEE (%)												
Albania	3.7	1.2	1.4	2.8	2.8	2.9	3.4	2.9	2.2	2.3	2.2	–6.3
Bosnia and Herzegovina	36.5	39.3	43.9	37.8	29.4	32.0	34.8	21.6	28.3	29.8	–4.7	–2.2
Bulgaria	6.3	4.3	4.7	4.8	10.5	8.1	7.1	10.2	9.9	11.5	9.7	4.0
Croatia	5.0	8.1	8.6	9.2	7.2	9.9	11.2	16.1	15.0	15.4	11.2	15.5
Macedonia, FYR	13.1	13.8	14.0	15.2	13.6	12.3	12.7	13.1	11.5	8.6	–3.7	–7.0
Romania	4.8	4.8	4.3	5.3	6.3	7.5	5.8	8.1	8.3	9.1	8.0	7.1
Serbia and Montenegro	30.6	28.6	23.0	24.8	30.2	27.3	24.9	28.0	24.8	23.4	–1.5	–4.2
Western Balkans	88.9	90.9	90.9	89.8	83.2	84.4	87.1	81.7	81.8	79.4	–1.4	–1.1
SEE	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	—	—

Source: UN COMTRADE database.
Note: — = not available.

chapter). This came at the expense of intra-SEE exports and imports, which fell over this period by 2 to 3 percentage points. However, between 2003 and 2005, intra-SEE trade increased sharply, and its share in total exports and imports increased by 2 to 2.5 percentage points. The signing of bilateral FTAs within SEE, as well as recovery from post-conflict situations, may explain some of this reversal.

However, the importance of intra-SEE trade in total flows varies significantly across countries and reflects a legacy of the past. Trade flows among the successor states of the SFRY are higher. The SEE region absorbs about 30 to 35 percent of exports of Bosnia and Herzegovina, Serbia, and FYR Macedonia, and 20 to 35 percent of their imports. On the other hand, only 5 percent of Albania's trade flows are to SEE countries. Similarly, Bulgaria has developed greater ties with the rest of the world (including Turkey), and Romania with the EU (see annex tables 2.1, 2.2). In this context, a gravity model analysis found that in 2003, SEE countries were already "overtrading" with each other, compared with the intra-SEE trade predicted by the model. However, the extent of overtrading had reduced from a factor of 3.5 in 1994 to 1.8 by 2003 (Broadman 2005).[7] Given this, it is likely that further economic integration within SEE will be driven by FDI rather than by trade, which in turn would be attracted by a more integrated regional economic market (see the next section).

Composition of Trade

Albania is an outlier in terms of product concentration of its export basket. Annex table 2.3 shows that the top three products of Albania (at the three digit level) made up one-third of exports, the top 10 made up 59 percent, and the Hirschman concentration index (which varies from 0 to 1 as concentration increases) was 0.23 in 2005. Textiles and footwear dominate Albanian exports. For other SEE countries, the index is lower or slightly higher (FYR Macedonia) than comparator countries like the Slovak Republic.

Most of the SEE countries have experienced significant restructuring in the commodity composition of foreign trade. Table 2.6 shows that all countries have moved away from agricultural exports. The share of food and agricultural raw material exports in total SEE exports has declined from 18 percent in 1996 to 10 percent in 2005, offset by an increase in the share of ores and metals and fuel exports from 12.6 to 17.8 percent. The positive development was an increase in the share of manufacturing exports for most countries. Import structures also changed, and a sustained

Table 2.6. The Structure of SEE Exports by Major Product Category, 1996 and 2005

		Share of total exports (%)											
Exporter	*Year*	*Food & feeds*	*Agricultural raw materials*	*Ores & metals*	*Fuels*	*All manufactures*	*Chemicals*	*Leather & rubber*	*Wood & papers*	*Textiles & clothing*	*Machinery excl. auto*	*Motor vehicles and parts*	*Misc. manufac- turing*
Albania	1996	11.1	9.0	11.6	3.0	65.3	1.4	20.2	1.9	25.0	1.7	0.0	15.1
	2005	5.7	4.4	7.4	2.6	79.8	0.5	19.9	2.3	30.4	3.8	0.3	22.6
Bosnia and	1996	15.2	20.2	6.0	3.3	54.4	2.9	3.9	3.8	8.9	8.8	4.7	21.4
Herzegovina	2005	4.6	7.1	24.0	6.5	57.6	2.7	2.8	3.1	7.5	15.4	1.5	24.6
Bulgaria	1996	18.1	2.9	9.7	6.5	60.2	18.3	1.8	1.8	9.4	11.7	0.8	16.4
	2005	10.5	1.6	14.2	10.4	59.5	7.5	1.2	1.9	17.6	13.6	0.7	17.0
Croatia	1996	11.4	4.7	2.2	9.2	72.4	14.1	2.3	2.7	16.5	20.0	1.4	15.4
	2005	10.5	3.4	3.8	13.9	68.2	9.8	1.7	3.0	7.7	27.0	2.0	17.0
Macedonia, FYR	1996	21.2	3.5	9.5	0.9	64.8	5.9	0.7	0.9	27.9	5.9	1.8	21.7
	2005	16.3	0.8	3.0	8.0	71.6	4.3	1.2	0.5	26.9	4.0	1.4	33.5
Romania	1996	8.5	3.4	3.2	7.4	76.7	9.8	3.6	1.7	21.4	11.7	2.1	26.4
	2005	2.9	2.3	4.2	10.7	79.2	5.7	3.6	2.4	19.1	21.1	4.7	22.5
Serbia and	1996	28.2	4.0	14.8	2.2	48.9	8.9	3.8	1.4	5.6	10.3	1.7	17.3
Montenegro	2005	19.0	3.1	12.7	2.9	61.9	10.2	5.5	3.6	6.5	8.3	1.6	26.3
Western Balkans	1996	16.8	5.3	6.5	6.0	64.9	10.9	3.0	2.2	15.5	14.7	1.6	17.0
	2005	12.3	3.5	8.7	9.1	66.0	8.1	3.4	2.9	10.3	17.4	1.7	22.4
SEE	1996	13.9	4.0	6.0	6.6	68.4	12.2	3.0	1.9	16.3	12.9	1.6	20.5
	2005	7.5	2.6	7.7	10.1	71.0	6.8	3.1	2.4	16.0	18.4	2.9	21.4
EU-8	1996	10.1	3.1	4.0	5.2	77.3	9.4	2.3	4.7	10.4	19.8	7.3	23.4
	2005	6.5	1.7	2.7	5.0	81.6	6.9	2.2	3.6	4.4	32.1	12.9	19.5

Source: Computations based on UN COMTRADE statistics.

increase in the share of machinery and equipment since 2000 could be one sign that obsolete production capacity is being replaced, at least to some extent. However, this should be kept in perspective because the EU8 is increasing its already-large share of machinery imports twice as fast as SEE.

Export and import structures for SEE have, on the average, moved slowly toward more skill- and/or capital-intensive products, but there are wide variations among countries. Annex table 2.4 shows that Romania, Croatia, and Serbia and Montenegro had the highest share of SL-intensive and CI exports. Both Serbia and Montenegro and FYR Macedonia recorded a major jump in the share of SL-intensive exports between 2003–05, while Bosnia and Herzegovina did the same for CI exports. All countries except Albania have a SL and CI export share of between 33 and 46 percent. Bulgaria is the only country to record a drop in the share of both SL and CI exports over 1996–2005. Albania is again the extreme case, and has only a 10 percent share of SL and CI exports. With respect to merchandise imports, the restructuring has been stronger and homogeneous. SEE is shifting toward more SL-intensive and CI imports, which account for 56 percent of total exports in 2005 versus 50 percent in 1996. Nevertheless, the share of capital-goods imports (30 percent) remains much lower than that of EU8 countries (40 percent).

The example of the Slovak Republic highlights the distance that most countries in SEE need to traverse. The Slovak Republic's share of SL exports grew by 13 percentage points to 48 percent of exports by 2005. This is by far the highest share of any country included in annex table 2.4, and again points to the importance of human capital in sustaining export growth (see chapter 5). Starting from a significant export base in 1996, the Slovak Republic managed to sustain an export growth rate of more than 15 percent over the decade to 2005, and even accelerate the growth rate to 22 percent over 2000–05. The only other comparable country in SEE is Romania, which started from a similar export base and sustained a growth of over 14 percent. Other countries with a reasonable base level of exports, Croatia and Bulgaria, could not sustain such growth rates (Bosnia and Herzegovina exports grew at almost 16 percent over the period, but the base was very low).

By contrast, the continued concentration of exports in unskilled-labor (UL)- and natural-resource (NR)-intensive products puts future export growth prospects at risk in some SEE countries. In SEE countries, UL- and NR-intensive products formed an average of over 60 percent of exports in 2005, ranging from 89 percent for Albania to 53 to 67 percent for other countries (annex table 2.4). In Albania, 15 years after the transition, the share of SL and CI products has barely increased, despite starting from a very low base. The high share of UL- and NR-intensive products in the export basket of all SEE countries contrasts with the experience of the new member states. For example, as early as 1996, eight years prior to accession, the share of UL- and NR-intensive products in EU8's exports was 48 percent, which reduced further to 33 percent by 2005. The experience of the EU8 countries shows that a rapid shift toward SL-intensive and CI exports (which followed completion of their free trade agreements with the EU and WTO accession, and was also accompanied by growing FDI) can contribute to more integration with EU markets at more sophisticated levels.

The factor content of exports matters for several reasons. First, SL-intensive and CI industries tend to pay higher wages, and growth of exports in these sectors would likely lead to an increase in the standards of living of the population. On the other hand, excessive reliance on exports of natural-resource-based products that involve little processing[8] (which is the case in some SEE countries) may not have the same effect on wages. Second, labor costs in many SEE countries are relatively high (see the concluding section) and therefore, reliance on unskilled-labor-intensive exports, such as textiles and footwear, may not be sustainable in the long run, given the increasing competition from low-wage countries like China, India, and Bangladesh. Third, the lower return to labor in UL products, for example, and the large weight of such products in export production reduces the incentive of workers to invest in their own human capital.

Global Production Sharing Networks and FDI

SEE economies have been active in buyer-driven production chains but have not yet managed to make a significant transition toward producer-driven supply chains. During the initial phase of the transition, most SEE countries relied on unskilled-labor-intensive exports associated with buyer-driven production chains in clothing and furniture (in which global buyers, typically large retailers, branded marketers, and manufacturers create a supply base without direct ownership). A few of these countries have managed to shift toward SL and CI exports through producer-driven networks encompassing automotive and information technology industries (in which there is common ownership of vertically-integrated stages of production, and emerge usually as a result of FDI). On the other hand, EU8 countries made this transition successfully, and, over time, have increased their dominance in such producer-driven supply chains, i.e., goods that are part of production-sharing networks.[9] Annex table 2.6 shows that the share of parts and components (P&C) trade in their manufactured exports rose from 12 to 20 percent, with their dollar value growing from $8 billion to $50 billion over 1996–2005.[10] In this process, the EU8 countries exploited the somewhat faster growth in world trade in P&C over 1996–2005. World-manufactured exports grew by an annual average rate of 6.6 percent, whereas P&C exports grew by 7.3 percent.

The aggregate data for SEE reveals increased participation in producer-driven networks, but this has been dominated by Romania. Over 1996 to 2005, SEE exports of parts and components grew fivefold in dollar terms, and from 6 to 11 percent of manufactured exports (see table 2.7). However, this performance is propped up largely by Romania, which provided 60 percent of regional P&C exports in 2005, significantly more than its 36 percent contribution in 1996.

Performance in such network trade is highly variable. Albania, Serbia and Montenegro, FYR Macedonia, and Bulgaria are the underperformers

Table 2.7. Trade in Parts and Components by SEE Country and Other Selected Comparators, 1996–2005

Reporter	*Year*	*Exports of P&C ($ millions)*	*Imports of P&C ($ millions)*	*P&C as % total exports*	*P&C as % total imports*	*P&C as % manufac. exports*	*P&C as % manufac. imports*
Albania	1996	2	52	1.0	5.6	1.5	9.1
	2005	18	152	2.7	5.8	3.3	8.2
Bosnia and	1996	13	114	3.0	5.2	5.5	9.4
Herzegovina	2005	336	426	13.8	6.0	23.9	9.3
Bulgaria	1996	130	254	2.7	5.0	4.4	10.4
	2005	497	1,078	4.2	5.9	7.1	9.0
Croatia	1996	321	448	7.1	5.8	9.8	8.4
	2005	762	1,275	8.7	6.9	12.7	9.4
Macedonia,	1996	29	84	2.5	5.1	3.9	7.9
FYR	2005	46	126	2.3	3.9	3.2	6.2
Romania	1996	314	862	3.9	7.5	5.1	11.7
	2005	2,664	3,870	9.6	9.6	12.1	12.6
Serbia and	1996	52	247	2.8	6.0	5.8	10.1
Montenegro	2005	160	745	3.4	7.9	5.4	10.2
Western Balkans	1996	416	945	5.1	5.7	7.9	8.9
	2005	1,322	2,725	7.1	6.7	10.7	9.3
SEE	1996	861	2,060	4.1	6.2	6.0	10.1
	2005	4,482	7,673	7.7	7.7	10.9	10.7

(continued)

Table 2.7. Trade in Parts and Components by SEE Country and Other Selected Comparators, 1996–2005 *(continued)*

Reporter	*Year*	*Exports of P&C ($ millions)*	*Imports of P&C ($ millions)*	*P&C as % total exports*	*P&C as % total imports*	*P&C as % manufac. exports*	*P&C as % manufac. imports*
Memo Items:							
EU8	1996	7,702	11,277	9.4	10.3	12.2	13.8
	2005	49,520	48,566	16.1	14.5	19.8	19.3
CIS12	1996	2,120	4,293	1.9	5.0	6.0	11.4
	2005	4,418	13,325	1.5	8.2	5.5	12.5
Slovak	1996	659	836	8.8	8.9	11.0	12.7
Republic	2005	3,679	5,481	11.5	15.9	13.7	21.3
Slovenia	1996	954	890	11.5	9.4	12.7	12.4
	2005	2,782	2,099	14.4	10.3	16.4	13.8
Tunisia	1996	187	585	3.4	7.6	4.2	10.1
	2005	954	1,501	9.1	11.4	12.1	15.8
Turkey	1996	664	3,053	2.9	7.1	3.9	10.2
	2005	4,057	9,635	5.5	8.3	6.8	12.4

Source: UN COMTRADE database.

in P&C exports. Serbia and Montenegro and FYR Macedonia have low and even declining shares of such exports in total manufactured exports. Albania's share is also very low. Bulgaria's network trade share does increase from 4.4 to 7 percent of manufactured exports, but this is still a low share and starts from a small base. Croatia's share is larger and rose to 12.7 percent in 2005, but the starting base was small and the value of its exports in 2005 amounted to only $760 million. Bosnia and Herzegovina witnessed a jump from 5.5 percent to 22.5 percent over 1996–2005 in its network trade share, but the small base does not enable certainty as to whether such growth will be sustained. Only Romania holds both a significant share (12 percent in 2005) and a significant volume ($2.6 billion) of network trade.

FDI explains much of the P&C trade. In the experience of most EU8 countries and Turkey, FDI has been found to be strongly correlated with network export performance (Broadman 2005). This is not surprising, given the higher technological content of such trade and the production and distribution networks that multinational corporations are able to marshal.[11] In SEE, this holds in most cases. In Romania, although the FDI per capita is not as large as in Croatia and Bulgaria (because of Romania's higher population), its sheer volume ($24 billion FDI stock as of 2005, compared with Croatia's stock of $13 billion) and sustained inflows have allowed it to dominate network trade in SEE. Croatia's large inflows of FDI have helped it increase its network exports. In Bulgaria, although FDI flows have been sustained and significant, they have largely occurred in sectors not directly related to P&C trade, such as finance, electricity, telecom, and so on. For Albania, Serbia and Montenegro, and FYR Macedonia, network trade remains quite insignificant and FDI volumes also remain low. Bosnia and Herzegovina's surprising export surge in network exports, accompanied by a doubling of dollar merchandise exports over 2003–05, may be attributed in part to a fivefold jump in cumulative FDI over 2000–05 (see also box 2.1). Annex table 2.6 shows the details of export performance for each of the SEE countries as well as for the world as a whole.

FDI is crucial for boosting export performance and technology absorption. Whether FDI is attracted by the domestic market, or is seeking the most efficient production base as part of a production network, it brings in technology and organizational skills, and in the process also creates positive spillovers to domestic firms. The experience of transition economies linking trade and FDI is documented in Broadman (2005).

Box 2.1

Network Trade Helps but Is Not the only Source of Skills and Technology

Countries with participation in network trade have benefited in terms of knowledge and capital, but network-related investment is not the only source of technology and skills. For example, although the network share of manufactured exports from Serbia and Montenegro and FYR Macedonia is negligible, the skill content of their overall exports is 29 to 30 percent. This is possible because some of the non-network portion of manufactured exports can also be skill-intensive (or capital-intensive)—a point illustrated by the fact that the fastest growing exports from these countries, such as ferro alloys, bars of waste metal, and scrap in the case of FYR Macedonia, and hydrocarbons, acids, and alcohol in the case of Serbia and Montenegro, appear to fit this description. Moreover, FDI also occurs in non-network sectors, such as infrastructure.

Other SEE countries fit the model more easily. Romania and Croatia have a higher share of skilled-labor and capital-intensive exports, and also have more network exports. Albania (at one extreme) and Bulgaria (at the other) have low network exports and low skilled-labor and capital-intensive exports. The Bosnia

(continued)

and Herzegovina case is very interesting. Its surge in the share of network exports from 9 percent in 2000 to 23 percent in 2005 arises from some of its fastest growing products. Between 2000–05, for example, its exports of parts of internal combustion engines and parts of compressors rose from $0.6 and $0.5 million to $165 and $64 million respectively. These are annual growth rates of 125 and 93 percent respectively versus their overall export growth of 23 percent. At least some of this may owe to the recent increased activity of an oil and water pump manufacturer, established in 1954, which now exports to 22 countries.

Note: Privatization of this company began in 2003 and was completed in 2006. It received the ISO 9000 certification in 1998, and ISO 14000 certification in 2005. According to the company's website, sales rose from 10 million KM in 2004 to 13.5 million KM in 2005. See http://www.pobjeda-tesanj.ba for details.

In general, foreign firms are more export-oriented than domestic firms.[12] Although it is true that countries can develop and grow without significant inflows of FDI, these tend to be the exception rather than the rule. An example in the region is Slovenia, which has the lowest stock of FDI to GDP (21 percent in 2006) among the countries of Central and South East Europe.[13] However, it seems unlikely that SEE5 countries could increase exports and grow in a sustainable manner without significant increases in FDI inflows, given their product mix and low participation in producer networks.

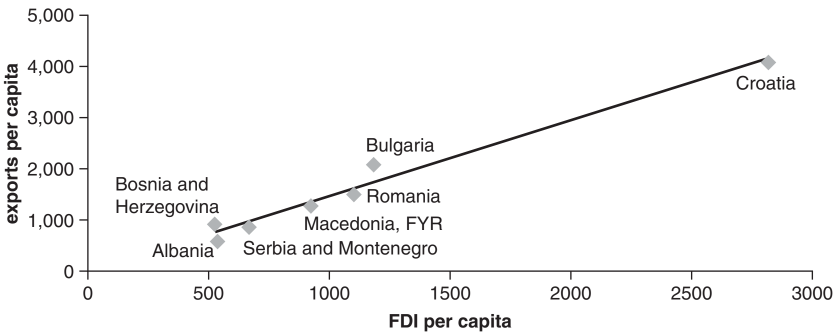
Unfortunately, most countries in the region have received lower FDI flows than their potential or comparators. Table 2.8 below shows the very low FDI per capita of countries in SEE5. The cumulative FDI in SEE5 countries (more than 17 million people) was $11 billion in 2005, significantly less than in smaller countries such as the Slovak Republic (population: 5.4 million) and Tunisia (population: 10 million). Moreover, much of the FDI inflows into SEE5, including a recent surge, have arisen from a few large privatization deals, which are not sustainable sources of FDI growth (World Bank 2004b). Fortunately, SEE can do more to attract FDI. An IMF paper on FDI in SEE shows that the gap between actual and potential non-privatization-related FDI stock in 2003 was very high for most SEE countries: 82 percent for Bosnia and Herzegovina, 68 percent for Albania, 66 percent for Croatia, 64 percent for FYR Macedonia, and 50 percent for Serbia and Montenegro versus 31 percent for the Slovak Republic and 38 percent for Romania (Demekas et al. 2007).

Table 2.8. Stock of Foreign Direct Investment (FDI) by SEE Country and Other Selected Comparators, 1995–2005

	Cumulative FDI ($ millions)			*2005 index*		*FDI stock per capita*			*2005 index*		*2006 FDI stock*
Country	*1995*	*2000*	*2005*	*1995=100*	*2000=100*	*1995*	*2000*	*2005*	*1995=100*	*2000=100*	*(% GDP)*
Albania	201	568	1,680	836	296	64	185	537	837	290	26
Bosnia and Herzegovina	9	398	2,067	22546	520	3	103	529	19736	512	29
Bulgaria	445	2,257	9,173	2059	406	53	280	1,185	2235	423	63
Croatia	478	3,523	12,516	2620	355	102	804	2,816	2753	350	59
Macedonia, FYR	160	538	1,880	1176	350	81	268	924	1135	345	42
Romania	821	6,480	23,818	2901	368	36	289	1,101	3042	381	32
Serbia and Montenegro	329	1,319	5,428	1648	411	31	162	665	2129	410	33
Western Balkans	1,177	6,345	23,571	2003	371	50	296	1,087	2192	367	38
SEE	2,443	15,083	56,562	2315	375	45	290	1,108	2485	382	41
Montenegro	—	—	—	—	—	—	—	—	—	—	69
Comparator											
Slovak Republic	810	3,733	15,324	1891	411	151	693	2,845	1883	411	41
Slovenia	1,886	2,894	8,064	428	279	948	1,455	4,036	426	277	21
Tunisia	10,967	11,545	16,924	154	147	1,224	1,207	1,689	138	140	—
Turkey	14,977	19,209	42,170	282	220	243	285	581	239	204	—

Sources: UNCTAD World Investment Report Web data (FDI data); World Bank World Development Indicators database (population data).
Note: — = not available.

Figure 2.3. FDI and Exports in SEE, 2005



Source: UNCTAD World Investment Report Web and World Bank World Development Indicators database.

The general experience of FDI and exports is closely replicated in SEE, with SEE5 countries performing poorly. Figure 2.3 shows the very close correlation between FDI per capita and export performance (per capita) in SEE countries. With poor FDI inflows, Albania, Bosnia and Herzegovina, FYR Macedonia, Serbia, and Montenegro are faced with the problem of weak export capacity.

The question then remains as to what can be done to attract more FDI, which is the subject of much of this report. SEE countries have the potential to exploit new opportunities for the relocation and fragmentation of production, given that their location is at the heart of the transit corridor between the EU, Eastern Europe, Turkey, and the Middle East. A more integrated SEE market can help to attract FDI that seeks to exploit larger domestic markets. Beyond that, each individual country needs to strive to improve its policies and investment climate in a focused and prioritized manner, but priorities will differ for each country. To the extent that some general statement can be made about common constraints, this report argues that SEE countries would be better prepared for future firm growth and for the inevitable increased competition from lower-wage countries by developing human capital, further reducing telecommunications costs, and removing potential constraints to power supply.

Labor Costs and Competitiveness

This section reviews labor costs and labor costs per unit of output, and also attempts to relate wages to ongoing developments in trade. In the discussion on labor costs, the SEE situation is compared with the Slovak Republic and some other EU8 countries. The section tries to show that wage levels are inconsistent with the content of exports and raises concerns about the sustainability of export growth.

Introduction

Wages are a significant element in investment decisions. In the business press and management consultants' reports, wages are often seen as the driver of investment decisions (box 2.2 provides an example). Whereas wages are only one factor in investment decisions (other factors include the investment climate, exchange and interest rates, and agglomeration effects), this section reviews some evidence on wage levels in SEE to provide an indication of whether these are constraining investment and growth. In general, low value-added products (which include most of unskilled-labor-intensive products) have thin profit margins, and wages can make a big difference in the decision to invest.

Box 2.2

Eastern Europe Hit by Shortage of Workers[a]

Growing labor shortages are now affecting Eastern Europe too. These shortages in the new member countries of the EU arise from a combination of three primary factors: emigration, uneven distribution of skills, and lack of labor mobility. While investment in Eastern Europe is still on the rise, companies find that they have to either increase pay or look well beyond local labor markets for qualified workers (with some employers turning to Uzbekistan and Tajikistan, and even considering China as a possible source for labor). One Swiss textile company in fact employs over 800 Chinese workers in eastern Romania.

Despite the relatively high unemployment rate in new member states (for example, 13 percent in Poland), companies often struggle to fill positions. Interviews with firms suggest that attempts to encourage labor mobility in countries such as Hungary and Czech Republic have failed, owing to traditional unwillingness to move for jobs. Furthermore, throughout Eastern Europe the educational and vocational training systems are unable to keep up with the rapid growth in inward investment and resulting labor demand.

Economists warn that labor shortages in the new member states can ultimately constrain growth. Until now, robust growth was promoted by investment attracted by low wages. However, if the continuing labor shortages lead to wage increases that outpace productivity gains, the region will become less attractive for foreign investment.

a. This is a summary of a Financial Times article by Condon and Cienski (2007).

There is concern about the export structure of SEE countries, as seen earlier, and the increasing possibility of getting squeezed out by lower-wage countries. The share of SL-intensive and CI products only gradually rose over 1996–2005 in all SEE countries except in Bulgaria and Serbia and Montenegro. Thus, in 2005, a very large share of merchandise exports continued to be based on natural resources or unskilled labor: an average of 60 percent for SEE versus 33 percent for EU8 in 2005 (and 48 percent in 1996). The lack of restructuring in exports leaves the region vulnerable to competition from low-wage countries.

Indeed, competition in the most visible low-wage product, apparel and clothing, is already felt. The abrogation of the Agreement on Textiles and Clothing on January 1, 2005, led to a dramatic increase in imports from Asia, especially from China (see table 2.9). With tariffs already at levels of less than 10 percent, quotas were the major source of protection for SEE countries. Despite examples in the region of apparel companies

Table 2.9. Trends in EU27 Market Shares of Apparel and Clothing by SEE and Other Selected Countries, 1996–2005

Partner	*1996*	*2000*	*2001*	*2004*	*2005*
World ($ millions)	38,363	43,250	44,242	67,183	74,124
Western Balkans	2.53	2.27	2.57	2.08	1.95
SEE	7.71	9.93	11.93	11.80	10.52
Albania	0.19	0.21	0.27	0.21	0.19
Bosnia and Herzegovina	0.06	0.22	0.26	0.21	0.21
Bulgaria	1.04	1.70	2.10	2.17	2.06
Croatia	1.54	1.05	1.14	0.87	0.74
Macedonia, FYR	0.54	0.55	0.57	0.52	0.51
Romania	4.15	5.96	7.26	7.55	6.51
Serbia and Montenegro	0.20	0.24	0.32	0.27	0.30
CIS12	1.53	1.81	1.88	1.67	1.54
Middle East and North Africa & Sub-Saharan Africa	27.79	26.37	27.72	27.63	24.98
Turkey	12.73	12.74	13.49	15.82	14.79
Morocco	5.93	5.40	5.72	4.88	4.25
Tunisia	6.79	6.02	6.46	5.19	4.50
East Asia & South Asia	49.29	51.74	51.40	55.17	61.09
Bangladesh	3.97	5.74	6.16	7.64	6.61
China	16.48	21.23	22.16	27.67	35.86
Hong Kong, China	11.67	7.76	6.42	4.72	3.86
India	6.89	5.79	5.94	5.89	6.85
Indonesia	3.66	4.41	4.26	3.01	2.52
Pakistan	2.41	2.06	2.13	2.29	1.90

Source: Based on EU data from UN COMTRADE database.

who succeeded in the new competitive environment (see chapter 5), the region is unlikely to see future gains in market share in low-skill products such as apparels and clothing. Even the lower-wage countries such as Albania, Bulgaria, and Turkey lost market share in 2005, whereas China and India were the notable gainers.

Measuring Wage Competitiveness

A number of different measures of wage competitiveness are used in the literature. In the business press, the most popular measure is the average wage measured in an international currency. Further refinement is obtained by comparing wages at different skill or responsibility levels, or by industry. Thus, the Federation of European Employers maintains a database that provides salary data for 48 European countries within 32 standard categories for small and large companies. A midpoint and range is provided for each job. Although wages measured in international currency provide an intuitive and easily understandable measure, they do not account for productivity differences between workers. For example, although workers in the United States are paid more than those in Vietnam, potential investors may be looking at comparisons of wages per unit of output, rather than wages alone.

The focus of this study is on a comparison of gross wages in Euros. One reason for this is that productivity-adjusted wage comparisons across countries are notoriously hard to interpret, given that the denominator is a heterogeneous mix of different products of varying quality. The other reason is that for many reasons, productivity differences should in fact not be considered: a German company investing in Serbia might believe that it can achieve German productivity levels when operating in Serbia, assuming that it largely controls its own operating environment. For this company, existing productivity levels in the countries it is investing in may not be relevant, but the wage levels will matter.

Although aggregate wage data is always subject to measurement error, the data used here is subject to a particular bias that suggests caution in interpreting the results. The primary sources of data are the official data published by the statistical offices. This data might be increasingly less representative for several countries. For example, in the case of Serbia, a recent World Bank Labor Market Study noted that the RAD-1 Survey has not been redone since 2001. The sample size in the meantime has fallen from 13,000 reporting units in 2001 to 8,500 units in 2005. Because the sample consists entirely of survivor firms, with weak firms dropping out due to restructuring, privatization, or liquidation, and of public sector firms which pay higher wages than private sector firms, the wage data is expected to systematically overestimate wages. Estimates of wages from tax data appear to confirm that the enterprise data bias wages upwards in Serbia. This problem also exists in Bosnia and Herzegovina. Ongoing work in the World Bank confirms that this bias is most clear for Serbia and Bosnia and Herzegovina. In Albania, published wages, which refer to public sector wages, appear to be about 25 percent higher than economy-wide wages. FYR Macedonia, on the other hand, appears to be improving the representativeness of its wage data (Arandarenko and Vukojevic 2007). As a check, gross wage data from alternative sources is also presented, including data from a MIGA study and from World Bank salary surveys across different countries.

Labor Costs and Competitiveness

Wages are highly variable in SEE. Gross labor costs (wages plus employer and employee contributions for social security) in Euros are presented in table 2.10 for the countries of SEE as well as a few new member states for

Table 2.10. Gross Labor Costs
(in euros)

		2003	*2004*	*2005*
Albania	All sectors	134	148	161
	Industry	132	138	155
	Services	144	151	173
Bosnia and Herzegovina	All sectors	395	402	420
	Industry	307	318	344
	Services	409	426	451
of which Federation of Bosnia and Herzegovina	All sectors	394	401	419
	Industry	332	331	352
	Services	436	446	464
of which Republika Srpska	All sectors	294	329	362
	Industry	243	281	322
	Services	335	365	392
Macedonia, FYR	All sectors	322	335	343
	Industry	323	337	349
	Services	374	387	403
Montenegro	All sectors	271	303	326
	Industry	217	271	303
	Services	307	332	355
Serbia	All sectors	255	281	307
	Industry	205	252	269
	Services	306	336	367

(continued)

Table 2.10. Gross Labor Costs *(continued)*
(in euros)

		2003	*2004*	*2005*
Bulgaria	All sectors	142	150	161
	Industry	128	136	148
	Services	149	152	163
Croatia	All sectors	740	794	841
	Industry	734	787	842
	Services	815	870	925
Hungary	All sectors	541	578	638
	Industry	488	538	583
	Services	582	610	678
Poland	All sectors	497	501	586
	Industry	486	489	570
	Services	516	517	596

Source: Official data from country statistical offices.

comparison. Albania and Bulgaria are the lowest-wage countries in SEE. Average monthly wages are almost half of the next lowest country Serbia. According to the data, Bosnia and Herzegovina and FYR Macedonia are the two high-wage countries in SEE5. However, wages are appreciably higher in Croatia, Hungary, and Poland than in Bosnia and Herzegovina or FYR Macedonia. Although Romania gross wage data could not be obtained, other wage information indicates that Romania wages are about the level of Serbia. There appears to be some trend toward wage equalization. Wages over 2003–2005 grew slowly in FYR Macedonia and Bosnia and Herzegovina and much faster in the lower-wage countries, especially Serbia and Montenegro. Albania's wages grew faster than Bulgaria's over the same period, resulting in an apparent parity between the two countries' wages by 2005.

A recent MIGA study (2006) provides data on gross wages based on interviews with a limited number of firms in the industrial sector. Although the data are from a very small sample (80 firms in the Western Balkans) relative to the official sources presented above, and collected through a nonstandardized methodology, they provide a useful check on the gross-wage data, especially considering the bias mentioned above. Data are not available for all comparator countries, and it should be noted that the data for Serbia and Montenegro are reported together. The data are collected for skilled and unskilled workers and presented in table 2.11. The official data from table 2.10 are presented here for comparison.

For Bosnia and Herzegovina, the MIGA study indicates that wages in industry are higher than those reported in the official data, whereas for

Table 2.11. Alternative Sources for Gross Wages in Industry
(*in euros for 2005*)

	Official data	*MIGA study*	
	Average	*Skilled*	*Unskilled*
Albania	155	239	149
Bosnia and Herzegovina	344	515	367
Macedonia, FYR	349	383	274
Serbia and Montenegro[a]	269/303	384	289
Croatia	842	767	518
Hungary	583	588	512
Slovak Republic	—	345	248

Sources: Statistical offices and MIGA (2006).
Note: — = not available.
a. For official data, Serbia and Montenegro are reported separately.

Table 2.12. Ratios of Cost of Labor Relative to Albania, 2005

	Unskilled	*Skilled*	*Management*
Albania	100	100	100
Bosnia and Herzegovina	247	215	166
Croatia	348	320	261
Macedonia, FYR	184	160	194
Serbia and Montenegro	194	160	
Comparators			
Czech Republic	297	263	157
Hungary	344	246	275
Slovak Republic	167	144	157
Average comparators	269	218	196
Average comparators and Croatia (A)	289	243	212
Average SEE5 (B)	181	159	153
Ratio B to A	0.63	0.65	0.72

Source: MIGA (2006).

Croatia, the wages reported to MIGA are lower than the official estimates. For the other countries, the officially reported average wage lies in between the wages for skilled and unskilled workers, as might be expected. For Serbia, there is some ambiguity because the MIGA study reports Serbia and Montenegro data together. If the MIGA study represents mostly Serbian data, it suggests that the official wages may be underreported, which would be contrary to the World Bank study discussed earlier.

The MIGA data also indicate some change in the comparative rankings. In the official data, Albania is listed as a low-wage country; Croatia and Hungary are listed as high-wage countries; and Bosnia and Herzegovina follows closely behind. According to the MIGA data, wages in FYR Macedonia appear lower and in Serbia and Montenegro higher than in the official data.

Yet another data source on wages uses the World Bank's comparative salary surveys across countries. Table 2.13 shows the index of skilled and highly-skilled wages for World Bank positions across the countries of SEE, Poland, and the Slovak Republic. The table presents wage indexes for individual countries over the years 2006–08, and the index is constructed by normalizing against skilled wages in Bulgaria in each time period. The data provide a valuable perspective on the cross-country differences in wages because the job positions are fully harmonized across countries so that the data bear minimum noise. The data confirms that Croatia is the highest-wage country in the region for skilled labor, even higher than in Poland and the Slovak Republic. Within SEE5, Serbia and Montenegro have the highest wages for skilled and highly-skilled labor. On the other hand, Bulgaria, followed by Albania, FYR Macedonia, and Kosovo, has the lowest wages for skilled labor. In the highly-skilled category, the most competitive wages in SEE5 are found in Albania, followed by Kosovo, Bulgaria, and FYR Macedonia. Serbia and Montenegro turn out to be the highest wage-paying countries in SEE5, both in the skilled and highly-skilled category in SEE5.

Differences are to be expected in the results of the official data and the World Bank surveys. The job descriptions are highly specific to the needs of the World Bank and may not represent the economies as a whole.

Table 2.13. Index of World Bank Wages

	Skilled			*Highly skilled*		
Country	*FY08*	*FY07*	*FY06*	*FY08*	*FY07*	*FY06*
Albania	n/a	130	133	n/a	441	475
Bosnia and Herzegovina	187	176	191	629	605	486
Kosovo	166	167	159	522	489	397
Macedonia, FYR	161	166	198	628	587	563
Serbia	209	197	169	936	807	565
Montenegro	196	197	169	877	807	565
Bulgaria	100	100	100	618	578	505
Croatia	231	244	293	886	810	743
Romania	147	127	125	1,195	918	773
Poland	194	184	176	1,250	1,164	1,240
Slovak Republic	166	144	151	1,256	1,043	1,061

Source: World Bank data.
Note: In the index, Bulgaria skilled = 100 for the respective years.

However, a major advantage of that data is that they are comparable, because uniform job descriptions are followed across countries. Despite these differences, there appear to be some broad patterns in the wage data. Albania and Bulgaria are confirmed as having the most competitive wages for unskilled and skilled labor. Romania and the Slovak Republic are also highly competitive in the skilled-wage segment. Within SEE5, the official data reports that Bosnia and Herzegovina and FYR Macedonia are the higher-wage countries, but Serbia and Montenegro wages are higher on the World Bank salary scales.

The overall weight of evidence (giving more weight to the official data) seems to suggest that Bosnia and Herzegovina should be worried about its wage competitiveness within the region. On the other hand, Albania and Bulgaria have the most competitive wages in SEE. The other countries, FYR Macedonia, Serbia, and Montenegro (we do not have enough data for Kosovo) appear to fall between Bosnia and Herzegovina and Albania.

The relative wage differential between countries appears to reduce with higher skill content. Table 2.12 is calculated from the MIGA data and presents wages in different categories of employment. Wages are calculated relative to Albania, the country with the lowest wages in the MIGA data. Relative to Albania, the higher-wage countries (Croatia, Czech Republic, Hungary, and the Slovak Republic) have an average index of 289 for unskilled labor, but this reduces to 243 on average for skilled labor and to 212 for management. This pattern is repeated in most cases. Within SEE5, Bosnia and Herzegovina, for example, has unskilled-wage levels at 2.5 times that of Albania, but only at 1.7 times at the management level.

A rough and ready "returns to skills" story shows that in general, there appears to be a higher premium to acquiring skills in the developing countries of SEE5.[14] The returns are computed simply by calculating the higher wages paid to skilled workers and those in management, relative to the wages of unskilled workers in each country (see table 2.14). On average, returns to skilled workers are 41 percent in SEE5, but as high as 418 percent to management. The average returns are 36 percent and 349 percent respectively for the three EU8 countries and Croatia. The highest returns to management (544 percent) are in FYR Macedonia, which, given relatively slow growth and hence low growth in demand, seem to arise from a shortage of management skills. In Albania, the high returns of 511 percent possibly arise from both high demand and short supply. The Slovak Republic's case is interesting as well as instructive. Despite

Table 2.14. "Returns" to Skills

	Skilled	*Management*
Albania	61%	511%
Bosnia and Herzegovina	40%	312%
Croatia	48%	359%
Macedonia, FYR	40%	544%
Serbia and Montenegro	33%	
Comparators		
Czech Republic	43%	222%
Hungary	15%	388%
Slovak Republic	39%	473%
Average comparators	30%	344%
Average comparators and Croatia (A)	36%	349%
Average SEE5 (B)	41%	418%
Ratio B to A	1.04	1.15

Source: Calculated from MIGA (2006).

its high education outcomes and strong supply of skills, the Slovak Republic appears to have a very high demand for management, which leads to returns of 473 percent.

These numbers support the argument that attracting investment in higher-skilled activity will not be easy. The high skill premia signal a shortage of relevant skills in many SEE countries. This theme will recur in chapter 5. Although high skill premia do send the right signals to individuals to acquire scarce skills, the skill shortage is a current reality for investors. In addition, higher profit margins in skilled-labor-intensive products presumably mean that, at least at the margin, factors other than wages could play a more important role than in the case of products with low profit margins.[15] And if workers in richer countries are more productive, it further cuts the unit labor cost differential between countries (moreover, most richer countries will be better off in nonwage elements of the business environment). The bottom line is that SEE countries may not find it easy to move up the value chain, and will need to invest urgently in skill acquisition.

In terms of the skill content, exports of Bosnia and Herzegovina and Croatia appear misaligned with their wage levels; Bulgaria appears fine; but the Slovak Republic appears to point the possible way ahead. With its lower wages, Bulgaria appears best positioned in the region to keep lower-wage competition at bay, but even here there is cause for concern because of a decline in the share of CI and SL-intensive exports over 1996–2005 (see table 2.15). Albania's situation is illustrated well by

Table 2.15. Wages and Capital- and Skilled-Labor Intensity of Exports

	CI + SL (%)	*Official wages (2005)*
Albania	10.9	165
Bosnia and Herzegovina	33.2	408
Bulgaria	34.2	161
Croatia	39.3	841
Macedonia, FYR	35.2	348
Serbia and Montenegro	46.8	307
Slovak Republic	71.0	296

Sources: UN COMTRADE database; official data from country statistical offices.
Note: The Slovak Republic' wages are based on an average of MIGA data.

comparison with the similar-wage country, Bulgaria. Albania's share of CI + SL intensive exports is only 11 percent, compared with 34 percent for Bulgaria, whereas Bulgaria also has other attractions, namely, a stronger investment climate. Even if competition from outside SEE is neglected, wages in Bosnia and Herzegovina and Croatia appear misaligned with the skill and capital intensity of their exports. To put all this in perspective, however, it is worth noting again that the Slovak Republic has 71 percent of its exports in the CI+SL category, and its wages (according to MIGA data) appear to be lower than in several SEE countries and substantially lower than in Croatia. The Slovak Republic is thus well-positioned to compete in high-skill segments, while at the same time its competitive wages (at least until 2005) suggest that it can still compete in low-skill exports as well.

Labor taxes have led to high tax wedges in the region. In 2003, the tax wedge in SEE countries (over 35 percent, based on average wages) was found to be higher than in low-income OECD countries. Although most countries have since embarked on reforms of their labor and/or personal income taxes, the tax wedge on labor in SEE5 countries remains high, varying in 2007 from 32.4 percent (Bosnia and Herzegovina) to 41 percent (Montenegro) of average wages. Only in the case of Albania does the tax wedge of 29 percent (2007) appear lower than the corresponding figure for low-income OECD countries (2003).[16]

In the short run, reducing labor taxation can help to at least partially address problems of high wages and informality. Although SEE5 wages may not be high compared to the EU, the product composition of exports leaves these countries vulnerable to lower-wage competition from Asia. In this situation, reducing labor taxes aimed at reducing gross wages and costs to business may provide at least a partial and temporary palliative to this problem, even as the long-run solution will continue to lie in accelerated skill acquisition. In addition, lowering labor taxes is expected to help reduce the pervasive informality of the work force in most SEE countries (recognizing that labor taxes are only one reason labor/firms choose to remain informal).

Employment Protection Legislation

In addition to the direct labor costs of hiring workers, firms also have to bear the costs of complying with regulations in hiring and firing workers. These regulations are meant to protect workers from the risk of losing their jobs. Although they may work toward reducing the probability of an employed worker being fired, they may also reduce the probability of new workers being hired. Table 2.16 presents summary data on employment protection legislation. The indexes are scored from 0 to 100, with higher scores representing more rigid legislation. The rigidity of the employment index is the average of the three subindices indicated in the table.[17]

Within the West Balkans, Croatia and FYR Macedonia have the strictest employment protection legislation, followed by Bosnia and Herzegovina and Serbia. For Bosnia and Herzegovina, this rigidity along with its relatively high wages creates disincentives for investment and job creation. This is also true for FYR Macedonia. Its relatively high employment rigidity index combines with wages that, on several measures, are second only to those in Bosnia and Herzegovina. As table 1.1 showed, Bosnia and Herzegovina and FYR Macedonia have the highest rates of unemployment in the region. Albania and especially Bulgaria have relatively flexible employment regimes, which add to their wage cost advantage.

Table 2.16. Employment Protection Legislation, 2007

	Difficulty of hiring index	*Rigidity of hours index*	*Difficulty of firing index*	*Rigidity of employment index*
Albania	44	40	20	35
Bosnia and Herzegovina	67	40	30	46
Macedonia, FYR	61	60	30	50
Montenegro	33	40	40	38
Serbia	67	40	30	46
Bulgaria	17	60	10	29
Croatia	61	40	50	50
Hungary	0	80	10	30
Poland	11	60	40	37
Slovak Republic	17	60	30	36

Source: World Bank and International Finance Corporation (2008).

Conclusion

Bosnia and Herzegovina appears to be the high-wage country of SEE5, and Albania as well as Kosovo are the low-wage countries. FYR Macedonia, Serbia, and Montenegro fall in between, with relative rankings among them differing according to the data source. Among other SEE countries, Bulgaria is a low-wage country and this, along with its overall stronger investment climate, can be expected to continue to pose serious competition to SEE5 for investments. Employment protection legislation is least flexible in FYR Macedonia, followed by Serbia and Bosnia and Herzegovina. The combination of relatively high wages and employment rigidities is also reflected in high unemployment rates in FYR Macedonia and Bosnia and Herzegovina.

Skill acquisition is an urgent need. With a high share of unskilled and natural-resource-intensive exports, SEE is vulnerable to competition from Asian countries, which has already happened in apparels. The skill content of exports from Bosnia and Herzegovina and Croatia is not aligned to wage levels. In general, the transition to more skill- and capital-intensive exports is complicated by the shortage of skilled workers in many countries, which is reflected partly in high skill premia. The percentage wage differentials between SEE5 and EU8 countries appear to reduce as skill content increases. All this points to the need for a greater emphasis on human development in the region (see also chapter 5).

The implications of this section are that policy options could focus on ways to improve labor force skills and at the same time keep wages in check. In terms of the latter, it should be noted that gross wages can be kept in check through lower wage increases (i.e., not above inflation levels) and can also be reduced by lowering labor taxes, which on the whole account for a relatively high share of GDP in SEE5 and are even higher than in low-income OECD countries. It is therefore suggested that each country take another look at its overall tax package and consider lower labor taxes within the bounds of overall fiscal sustainability.

Although wages are a significant element in investment decisions, there are many other elements as well, including productivity, the business climate, infrastructure, and so on. The fact that FDI flows in SEE5 have been low and below potential does imply that their lower wages compared with EU8 countries or Croatia have not helped to overcome other disadvantages compared with these countries. Reducing labor taxes and labor costs can at least help to make the wage component of the investment decision more attractive to investors.

Notes

1. The Western Balkans is SEE5 plus Croatia, a grouping used often in this chapter since Croatia is part of CEFTA 2006, whereas Bulgaria and Romania, as EU members, are no longer part of it. The trade data for Serbia and Montenegro includes Montenegro.
2. Trade between Serbia and Montenegro and Croatia was especially hard hit, whereas Serbia and Montenegro's trade with Bosnia and Herzegovina and FYR Macedonia was less affected, partly because such trade was used to bypass the sanctions.
3. For example, prior to the dislocation of the SFRY, Serbia and Montenegro's exports and imports were 42 and 48 percent of GDP in 1989 respectively, comparable to those of other countries of similar size. (In 2005, the ratios fell to 11 and 28.5 percent respectively). Inter-republican trade amounted to 54 percent of GDP, while trade with the rest of the world was only 36 percent of GDP.
4. The only exceptions apply to the following: wine, certain fisheries, and sugar are subject to preferential tariff quotas; "baby beef" is no longer subjected to the specific import duty, but the ad-valorem duty of 20 percent continues to apply; quotas still apply to imports of textile products originating in the customs territories of Montenegro and Kosovo. In 2005, the ATPs were extended until the year 2010 (taken from the DG Trade website: http://ec.europa.eu/trade/ issues/bilateral/regions/balkans/index_en.htm).
5. EU council regulation (No. 2007/2000) of September 2000: "The entitlement to benefit the preferential arrangement shall equally be subject to their readiness to engage in regional cooperation with other countries concerned by the EU's SAP, in particular through the establishment of free trade areas in conformity with Article XXIV of the GATT 1994 and other relevant WTO provisions."
6. Signed in Brussels on June 27, 2001, by Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, and Serbia and Montenegro. Moldova joined in 2003. The MoU calls for trade liberalization of at least 90 percent of all tariff lines as well as 90 percent of the value of bilateral imports.
7. See also EC (2006a, chapter 4). The EC report points to some commonalities in different model estimates regarding trade within SEE: i) significant under-trading among the three subregions of Albania; former Yugoslavia; and Bulgaria and Romania; ii) under-trading between Croatia and Serbia, the largest Western Balkan countries; and iii) over-trading between Croatia and Bosnia and Herzegovina, and between Serbia and Bosnia and Herzegovina.
8. Natural resource products can also have high value added, as shown by Australia and Chile in mining products (see de Ferranti et al. 2002). Also, in recent times, high commodity prices have helped to improve returns to producers.

9. The indicator of participation in producer-driven networks is the share of parts and components exports in manufacturing exports (excluding chemicals). See notes in annex table 2.6 for details.
10. Kaminski and Ng (2001) categorize P&C trade into three broad networks: automotive products; telecommunications equipment, office equipment, and automatic data processing machines; and furniture. They show how these EU-based networks played a growing role in Central European countries' trade with the EU. Specific industries in which production sharing arrangements are common across the globe include, among others, television and radio receivers, sewing machines, calculators, office equipment, electrical machinery, power and machine tools, typewriters, cameras, and watches.
11. See OECD (2001), which analyzes the broader economic gains of production sharing from FDI, including diffusion of technologies, management, labor skills, and information about world markets. FDI flows in turn stimulate trade.
12. For example, in the 2002 BEEPS survey for the Europe and Central Asia region, exports to sales ratios for foreign firms was 20 percent, compared with 12 percent for state-owned firms, 15 percent for privatized firms, and 9 percent for *de novo* firms (Broadman 2005, p. 191).
13. Of course, per capita FDI is relatively higher, given Slovenia's small population, but still lower than in Hungary, the Czech Republic, the Slovak Republic, Estonia, and Croatia. See Mrak et al. (2004) for a comprehensive discussion on Slovenia's development strategy. Data for FDI is partly drawn from the Vienna Institute for International Economic Studies.
14. The analysis on skills as well as on wage differentials is based on an admittedly thin sample of firms, but the results appear important and warrant more in-depth work.
15. In labor-intensive exports, profit margins are usually very thin (Radelet and Sachs 1998).
16. See Rutkowski et al. (2005) for 2003 data and OECD comparisons. See Arandarenko and Vukojevic (2007) for 2007 data.
17. The difficulty of hiring index measures: (i) whether term contracts can be used only for temporary tasks; (ii) the maximum cumulative duration of term contracts; and (iii) the ratio of the minimum wage for a trainee or first-time employee to the average value added per worker. The rigidity of hours index has five components: (i) whether night work is unrestricted; (ii) whether weekend work is unrestricted; (iii) whether the workweek can consist of 5.5 days; (iv) whether the workweek can extend to 50 hours or more (including overtime) for 2 months a year; and (v) whether paid annual vacation is 21 working days or fewer. The difficulty of firing index has eight components: (i) whether redundancy is disallowed as a basis for terminating workers; (ii) whether the employer needs to notify a third party (such as a

government agency) to terminate 1 redundant worker; (iii) whether the employer needs to notify a third party to terminate a group of 25 redundant workers; (iv) whether the employer needs approval from a third party to terminate 1 redundant worker; (v) whether the employer needs approval from a third party to terminate a group of 25 redundant workers; (vi) whether the law requires the employer to consider reassignment or retraining options before redundancy termination; (vii) whether priority rules apply for redundancies; and (viii) whether priority rules apply for reemployment.