Overview

As the world marketplace becomes increasingly globalized, much is at stake for the prosperity of hundreds of millions of people in Eastern Europe and the Former Soviet Union (the Region), now in their second decade of transition from Communism to capitalism. One hallmark of the transition is the Region coming almost full circle in reintegrating into international commerce, albeit not precisely where it started with the onset of Communism near the beginning of the twentieth century. A decade and a half after the disintegration of the Soviet trade bloc, the Region as a whole has experienced rapid trade flows and now trades largely in line with comparable regions in the world. But two new intra-Regional trade blocs are emerging. One is tending toward trade with the advanced countries in Western Europe and enjoying relatively high national incomes. The other bloc is significantly poorer, and tending to pull back toward a Russia-centric sphere. Its economies are still dominated by commodity trade, and risk non-participation in the modern international division of labor. The formation of the second bloc is not inevitable, however. As has happened elsewhere in the world, transition countries in the Region that have opened trade and judiciously implemented complementary domestic or "behind-the-border" policies have been more effective in leveraging international integration to raise growth rates. Nevertheless, virtually all of the countries in the Region need to pursue further trade policy reforms, and some still require fundamental liberalization. The bigger—and largely Region-wide—unfinished agenda, *however, concerns behind-the-border reforms. These include enhancing domestic interenterprise competition and market flexibility, strengthening basic market institutions and incentives for sound governance, developing trade-facilitating infrastructure, deregulating services sectors, and attracting cutting-edge foreign direct investment (FDI). While meeting these challenges will require policy reforms by developed countries and assistance from international donors, the lion's share of actions will need to come from the Region's countries themselves.*

A decade and a half have passed since the disintegration of the Soviet trade bloc. For 70 years the bloc had interrupted the Eurasian continent's long economic history of international commerce with much of the rest of the world, thus largely isolating almost half a billion people in the 27 "transition" countries of Eastern Europe and the Former Soviet Union (the Region)[1] from the modern global marketplace. With the fall of the Berlin Wall, the dissolution of the Soviet Union, and the breakup of Yugoslavia, the Council for Mutual Economic Cooperation (CMEA)—the key central planning mechanism that managed how the countries of the Region traded with each other as well as with the outside world—no longer had any obvious purpose, and was terminated.

The implication of CMEA's demise was more than symbolic. It meant that, in practice, the Region's global trade was no longer channeled through administrative functions. At the same time, transactions that had previously been essentially domestic within an integrated region suddenly became international trade, conditioned by market forces and international trading practices and rules. Where previously such transactions had been mediated across different territories through one currency and under common laws and regulations, now they cut across new national boundaries, were paid for in different currencies, and were subject to new national customs authorities and procedures.

The dismantling of the Soviet bloc brought economic chaos and a collapse of trade flows that compelled countries in the Region to begin to reintegrate into the global economy. By the mid-1990s, the transition of an increasing number of countries to market economic systems began to take hold and, today, most of the Region's countries are significantly better integrated into the global economy than at any time since the Russian Revolution. The Region now sends and receives more than two-thirds of its goods and services to and from the rest of the world (EBRD 2003) and, since the mid-1990s, trade growth has been faster than in any other region worldwide.[2] The Region's exports have tripled and imports increased two and one-half times.

Open Trade: The Critical First Step

Without open trade, none of this could have occurred. Liberal trade has propelled growth in the Region, as has been the case elsewhere in the world (Frankel and Romer 1999, Dollar and Kraay 2002).

In the early years of the transition, many countries in the Region adopted liberal import policies in short order. However, a domestic institutional bias against competition and enterprise restructuring discouraged exports, with the result that the increased flows (of imports) did little to enhance productivity and increase growth. In fact, they created distortions and exacerbated poverty. In time, however, the countries that responded to increased import flows by allowing resources to be flexibly reallocated throughout the economy, facilitating the ability of firms to compete with one another, and eliminating disincentives to export, engendered a supply response where prices of tradable goods rose, new jobs were created, and growth increased.

At present, the Region comprises economies with fairly open trade policies. On average, tariffs range from 3.3 to 11.6 percent.[3] Much of this trade policy liberalization was carried out autonomously by the countries themselves in the early years of the transition, albeit with encouragement and support (and discipline) by the international development community. In subsequent years, such liberalization has been occurring through the European Union (EU) accession process and through the fashioning of various bilateral and regional trade agreements (RTAs). Moreover, 17 countries of the Region, as well as Turkey, are now members of the World Trade Organization (WTO), with most of the others—all in the Commonwealth of Independent States (CIS)—in various stages of the WTO accession process.

Leveraging International Integration into Economic Growth: A Reciprocal Process

The most prosperous countries of the Region are those that found ways to leverage greater international trade into more rapid growth. They have not accomplished this by liberalizing formal trade policies alone, however. They have also instituted complementary behind-the-border (domestic) structural and institutional reforms that foster trade. These countries include the Czech Republic, Hungary, and Slovenia. Of such reforms, several that stand out for their effectiveness are those that promote competition between enterprises and sound governance; deregulation of services sectors; development of infrastructure systems that facilitate trade; attraction of FDI; and reallocation of labor and other resources when market conditions change.

These reforms can conflict with vested interests and have not always been easy. However, establishing trade links, especially under international commitments and agreements, has helped lock in these hard-won domestic reforms. The converse is also true: countries in the Region that have been most successful in implementing internal market reforms have also tended to be the ones that were most effective in integrating into the world marketplace. In short, growth during the transition has been engendered through a mutually reinforcing two-way effect between international integration and domestic structural reforms.

Thus, while the reform of trade policies is necessary to ensure sustainable growth, it is not sufficient. For most of the countries in the Region this leaves a significant behind-the-border reform agenda unfinished. Moreover, several, such as Belarus, Tajikistan, Turkmenistan, and Uzbekistan, are still relatively closed and have yet to put in hand fundamental trade policy reforms.

The Challenge for the Region and the World

Much is at stake for the prosperity of hundreds of millions of people of the Region. Thus, understanding the dynamics that are shaping the contours of international integration that have emerged—and are likely to emerge—in the Region is a crucial challenge for the medium-term economic development agenda. This is true not only for these countries' policy makers and trading partners, but also for international financial institutions and the donor community; indeed for the future of the world trading system as a whole.

Addressing this challenge raises several questions:

- Why have some countries in the Region integrated internationally to a greater extent and in different ways than others, and what do the current trends portend for the future? How have the Region's goods and services, their production, and trading methods changed among the countries over the course of the transition, and what are the implications for competitiveness and growth?
- How does trade performance of the Region of today compare with that of other regions of the world? What factors in the Region are most important in conditioning the relationships among greater international integration, geography, policy reforms, and growth?
- Which policy reforms are likely to be most effective in using trade as a lever to enhance growth in the Region? Is the Region's trade policy too restrictive? What is the impact of developed country

protectionism? What are the priority policy issues that governments in the Region should focus on, and what can the international community do to be most effective?

This study seeks to answer these questions.[4]

Summary of Principal Findings

Two trading blocs are emerging. The countries of Eastern Europe and the Former Soviet Union are becoming more like a "typical" region regarding trade, with most of the economies registering merchandise trade flows as a share of gross domestic product (GDP) largely in line with other countries of comparable size and levels of development.[5] However, the pace, nature, and extent of the Region's international reintegration differ strikingly from its earlier historic pattern of integration—both among the constituent countries and with the rest of the world. Moreover, it is characterized by pronounced variations that, in effect, are forming the countries into two new trading blocs. One is Euro-centric, comprising the eight new members of the European Union (EU-8),[6] Turkey, and, gradually, the seven Southeastern European (SEE) countries.[7] The other is "Russia-centric," largely comprising the 12 countries of the CIS.[8]

The two blocs have begun to coalesce in terms of:

- Volume and direction of trade flows
- Commodity composition and factor intensity of trade
- Export competitiveness
- Development of trade facilitation institutions and infrastructure
- Extent of intraindustry trade, both in the services sectors and by participation in global production-sharing networks through FDI
- Extent to which trade flows enhance domestic competition and governance, and vice versa.

But the blocs' boundaries are soft. Of course this admittedly sharp binary prism masks the more complex realities. There is a sizeable difference in scale between the emerging blocs, and there is significant intra-bloc heterogeneity. Total merchandise trade flows of the EU-8 and SEE are almost twice the size of those of the CIS. At the same time, while the wealthier and larger CIS countries, such as the Russian Federation and Ukraine, have some trading attributes akin to those of the EU-8 or SEE, the smaller and poorer CIS countries show decreasing participation in the modern international division of labor. By the same token, some of the SEE countries, such as Bosnia and Herzegovina, the Former Yugoslav Republic of (FYR) Macedonia, and Serbia and Montenegro, exhibit trade patterns more along the lines of CIS economies. Indeed, while the overall group of SEE countries is increasingly gravitating toward the Euro-centric pole, in fact they are doing so at different rates. Consequently, at this point, along some dimensions the SEE countries form a "middle ground" between the two poles.

A dichotomous region is not inevitable. The emerging differences in the present pattern of international integration in the Region could continue for the foreseeable future. So, too, could differences in the countries' prospects for economic growth and prosperity. But the formation of the second bloc is not inevitable; the alternative is the direction taken by the transition countries that have already been able to leverage international integration to raise growth rates through complementary behind-the-border reforms. A detailed summary of the policy actions to achieve the desired results appears at the end of this Overview.

The unfinished policy agenda. Some actions will require significant measures by developed nations, such as improving market access in agriculture and removing the "nonmarket" designation they apply to transition countries in antidumping cases. Technical assistance is also needed from the donor community to strengthen trade-related institutions in the Region, especially for the low income CIS countries. Because they are neither classified as "least developed" countries nor have realistic prospects for EU accession, they tend to get overlooked in qualifying for certain aid.

In the end, however, much will depend on reform actions undertaken by the countries in the Region themselves. In the area of trade policy, needed reforms include further tariff reductions; elimination of nontariff barriers (NTBs); reduction of disincentives to export; aggressive pursuit of WTO accession (especially where EU accession is unrealistic); and rationalization, harmonization, and consolidation of existing RTAs.

Arguably the more challenging tasks would be vigorous implementation of economywide behind-the-border reforms. Particularly important are policies that foster greater competition and sound governance, that improve trade facilitation mechanisms, that liberalize services sectors, that improve the climate to attract FDI, and that create greater flexibility in labor and capital markets.

Coming "Full Circle?" The Reemergence of Eastern Europe and the Former Soviet Union in International Markets

In the aftermath of the dissolution of the Soviet bloc, economies conditioned by command and control regimes began a transformation into economies based on market institutions and incentives. The changes unfettered firms' and consumers' economic decisions, which increasingly came to be determined more by the forces of supply and demand than by administrative fiat. The result was to unleash a drive for international reintegration.

Two "Poles" Emerging: Trade Patterns and Performance of the Reintegrated Region

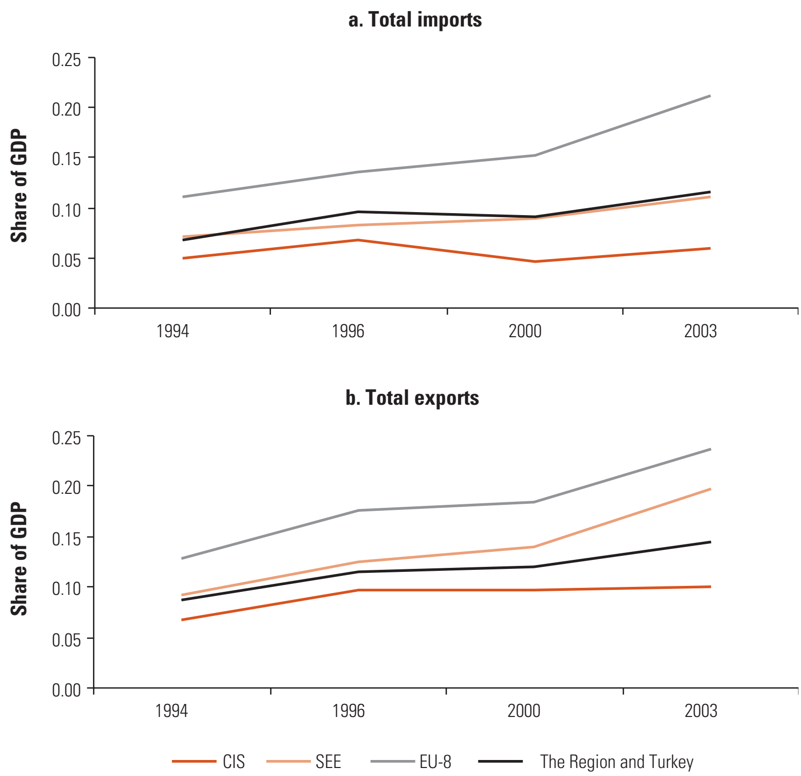
A dichotomy in merchandise trade growth. Total merchandise trade of countries in the Region since the start of the transition has grown significantly, but exhibits a highly heterogeneous pattern, both over time and across subregions; see figure 1.[9] For the Region as a whole, merchandise trade flows (in dollar value and in real terms) have grown significantly since 1993: exports almost tripled and imports increased by a factor of 2.5.[10] Trade growth was greatest for the EU-8, where exports and imports increased by factors of 3.6 and 4.1, respectively. The CIS is at the other end of the spectrum: exports and imports expanded by factors of 2.1 and 1.5, respectively. In between is SEE, where exports grew by 3.5 and imports increased 2.7 times.

Services trade growth. A similar picture emerges of the Region's growth of trade in services. Services industries were accorded low priority under central planning. They were not considered a productive activity. But as part of the process of the transition to modernized economies, the services sectors have begun to emerge as a dynamic force in economic growth in the Region. In recent years, telecommunications, transportation, and energy services, among other network industries, as well as banking, have been core targets of domestic reform in the Region. As in other regions of the world, international trade (and investment) in such services sectors also has begun to increase in countries located in the Region.[11]

The growth in the value of both exports and imports of services for the overall Region in 1993–2003 significantly exceeds that of comparable regions in the world. Not surprisingly, however, at present, the Region's volume (by $ value) of services trade as a share of global services trade of exports and imports of services generally remains small.

FIGURE 1

Eastern Europe and the Former Soviet Union's Merchandise Exports and Imports as a Share of GDP PPP, 1994–2003



Source: International Monetary Fund (IMF) Direction of Trade (DOT) Yearbook.

Note: CIS = Commonwealth of Independent States; EU-8 = European Union-8; GDP = gross domestic product; PPP = purchasing power parity; SEE = Southeastern Europe.

There are significant differences within the Region, however. Services trade flows—whether in terms of exports or imports—grew fastest in the SEE countries between 1993 and 2003, followed by those in the EU-8. In contrast, the CIS economies' services sectors remain largely closed. Their services sectors are heavily burdened by regulation, protection from the competitive pressures that accompany exposure to international trade.

There are few data available on the direction of trade in services for the Region. But telecommunications traffic flows suggest that much of the Region's trade in services, largely by the EU-8 and SEE, is oriented toward Western Europe. More than half of all outgoing telecommunications traffic originating in the eight new EU members states and in SEE goes to the EU. This compares to less than 2 percent for Central Asia and the Caucasus, and 8 percent for Russia, Ukraine, and Belarus. This effective bifurcation of the Region's countries—in this case in terms of services trade—is a characteristic increasingly endemic along multiple dimensions of the overall pattern of international integration in the Region.

Patterns of the destination and origin of merchandise exports. Over the course of the transition there have been significant changes in the destination and origin markets of both the exports and imports of merchandise by the Region. While age-old destination and origin markets on the Eurasian continent still figure prominently for most of these countries, less traditional, newer locations have been gaining strength in certain instances. Most striking is the increasing bifurcation of the Region into two trade "poles": the geographic pattern of trade flows is moving toward a Euro-centric clustering and a Russia-centric clustering.

On a *global* basis—that is, considering the countries' trade flows *both* outside and inside the Region—for the most developed economies of Eastern Europe and the Former Soviet Union, the EU-8, the major export destination market today remains the more advanced countries in Europe (figure 2). The EU-15 comprises the 15 EU member states prior to May 1, 2004: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the UK. Indeed the share of the EU-8's global exports sold in the EU-15 rose over the decade, while their corresponding export share within the Region fell. The EU-8's share of exports to the rest of the world (ROW) increased sizably over the decade, another indicator of the EU-8's increased international integration.

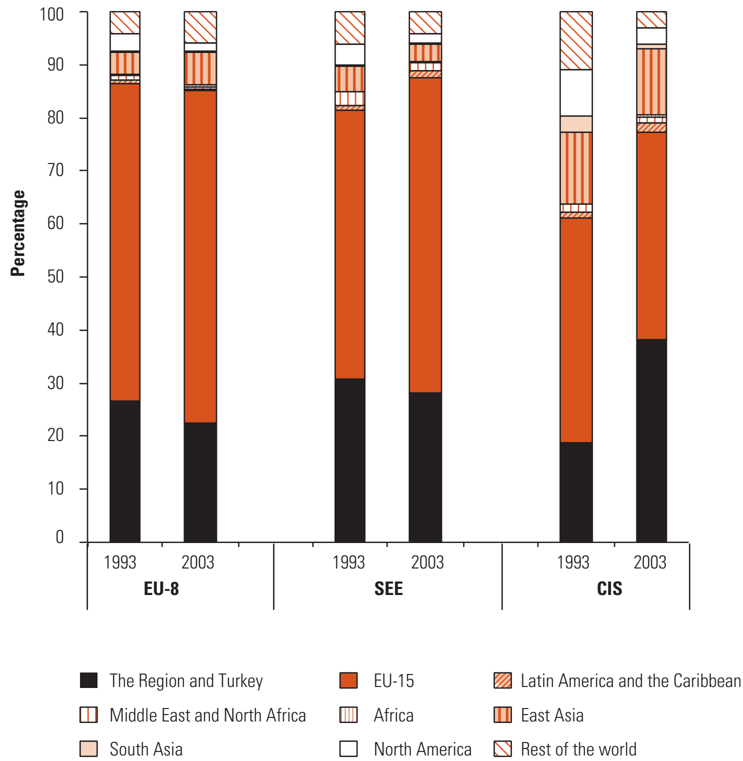
Over the course of the decade, the geographic spread of CIS merchandise exports has become more concentrated. The CIS's largest destination market for its merchandise exports in 2003 was the same as it was in 1993—the EU-15—but only marginally so. In fact, the share of CIS exports shipped to the Region's countries grew substantially, while the share of exports shipped to the EU-15 declined substantially. Latin America and the Caribbean (LAC) and, to a much lesser extent, Africa, have proven to be new markets for CIS exports, with a doubling of the export shares over the decade.

The global pattern of merchandise export penetration for the SEE countries falls somewhere in between that of the EU-8 and CIS. The largest shares of SEE exports are accounted for by EU-15 and the Region's customers. Like their wealthier EU-8 counterparts, the SEE countries sold proportionally more exports in EU-15 markets than in the Region's markets between 1993 and 2003. On the other hand, as in the case of the CIS, the share of exports from the SEE group of countries destined for the LAC markets has substantially increased. At

FIGURE 2

Eastern Europe and the Former Soviet Union's Share of Total World Merchandise Exports

Share of Total World Merchandise Exports



Source: IMF DOT Statistics.

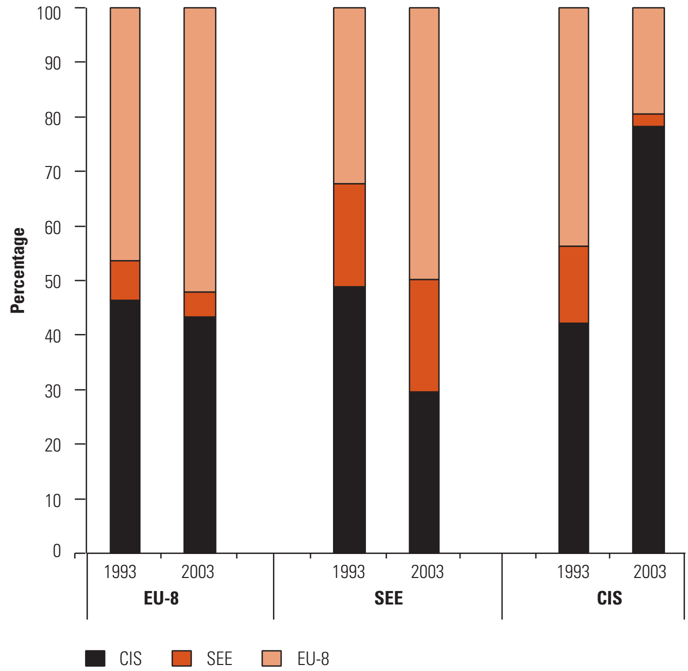
the same time, SEE export shares in North America (U.S., Canada, and Mexico), South Asia, and East Asia declined.

On an *intra-Regional* basis, the destination patterns of merchandise exports of countries in the Region are particularly revealing (figure 3). While the major destination market for intra-Regional merchandise exports by the EU-8 in 1993 was the CIS, today, following a major locational shift over the decade, most of the intra-Regional exports sold by EU-8 countries are to other EU-8 countries. This natural change in the trade pattern is a hallmark of the EU-8 countries' development success, particularly the restructuring and modernization of their enterprise sectors.

The pattern of intra-Regional merchandise exports for the CIS is just the reverse. Rather than enlarging the share of their intra-Regional exports to the wealthier countries in the Region, the CIS's share of intra-Regional exports in the EU-8 market decreased while it increased in the CIS market itself. The share of CIS exports within the

FIGURE 3

Shares of Intra-Regional Merchandise Exports in Eastern Europe and the Former Soviet Union



Source: IMF DOT Statistics.

Region also declined in the SEE market. Taken together, these data suggest that CIS exports within the Region have become more (sub-) regionalized and concentrated.

For the SEE economies, like the EU-8 grouping, there has been a significant shift over the period 1993–2003 as the EU-8 surpassed the CIS in being the dominant destination for intra-Regional merchandise exports originating in SEE. Indeed, the share of SEE intra-Regional exports rose in the EU-8 market and fell—even more dramatically—in the CIS market. The share of intra-Regional exports sold in the SEE market by SEE producers remained relatively the same over the decade.

Patterns of the destination and origin of merchandise imports. The emerging two-pole paradigm is equally evident on the import side of the equation. On a *global* basis, the share of EU-8 imports purchased from the EU-15 rose and purchased from the Region fell. There also was significant growth in the corresponding share of EU-8 merchandise imports from North America, which has remained the EU-8's largest non-European import market. As in exports, the CIS tends to have a pattern of global import markets that is the most diversified compared to the other country groups in the Region. But in contrast to its exports, CIS global import shares have become somewhat more diversified. Importantly, the CIS's largest origin market for imports worldwide is now the Region, whereas it used to be the EU-15. As in exports, the global pattern of merchandise import sourcing for SEE falls somewhere in between that of the EU-8 and CIS. The largest shares of SEE global imports are accounted for by EU-15 producers.

The EU-8 market remains the primary origin of *intra-Regional* EU-8 merchandise imports. However, the CIS's share of intra-Regional imports from the EU-8 market decreased and it increased in the CIS market. Again, as in exports, these data suggest that CIS trade has become more concentrated. For the SEE economies, there was a significant shift: whereas in 1993 the EU-8 was the major origin market, most SEE intra-Regional imports now come from the SEE market itself. At the same time, as is the case for their wealthier EU-8 counterparts, the share of SEE intra-Regional imports purchased from the CIS has declined.

Clustering in product concentration, commodity composition, and factor intensity of trade. Typically, with greater economic development, diversification of the composition of a country's trade increases. Has the Region's transition from central planning to market-oriented development resulted in increased diversification of exports? Overall, the Region's progress in product diversification of exports has been limited and, in some cases, commodity concentration of trade has worsened. In the aggregate, the number of exported products for the Region declined between 1993 and 2003, and the share accounted for by the largest 3 as well as the largest 10 products in total exports has increased. The CIS countries are the least diversified; indeed, their product diversification has substantially deteriorated over time, notably after 1996. This has been most striking in Azerbaijan, Georgia, Kazakhstan, and Russia, where oil and gas are increasingly the prominent exports.

Product concentration of trade has also been increasing, though in a different form, in the EU-8 countries, notably Hungary and the Slovak and Czech Republics, and particularly in heavy industries such as automotive production and parts. The Baltic countries, particularly Latvia and Lithuania, have managed nevertheless to improve their export diversification profiles. The SEE countries, on the other hand, remain the most diversified, due to an increase in low value-added exports, such as textiles, among other factors.

The concentration of exports in primary commodities remains large and is increasing in the CIS countries, where the average share of ores, metals, and fuels (oil and natural gas) in total exports increased from 38 percent to 47 percent over the period 1996–2003. With the collapse of manufacturing exports following the breakup of the Union of Soviet Socialist Republics (USSR), most of these countries had shifted toward commodity exports. In the natural resource-rich countries such as Azerbaijan, Kazakhstan, Russia, and Turkmenistan, trade in energy and raw materials experienced a boost and compensated for the decline in manufacturing trade. By the same token, Tajikistan's exports are dominated by aluminum, and Kyrgyzstan relies extensively on exports of gold.

Differences among the Region's countries in factor endowments, initial conditions, and level of development have largely conditioned the factor intensities of the Region's exports and imports. The variation in the factor composition of merchandise exports falls along two lines.[12] In less developed, resource-rich and labor-endowed countries, such as the Central Asian Republics and the Caucasus, exports of labor-intensive products tend to be dominant. Merchandise exports of the more developed economies—the EU-8—are on average more capital intensive. Indeed, many of the more developed countries in the Region have increased the technological content of their traded goods: the EU-8 countries have more capital-intensive exports than other countries in the Region.

However, some EU-8 exports, such as textiles and footwear, are, on average, more *unskilled*-labor intensive than exports of the CIS. This characteristic—if sustained—poses risks to both the wage regime of workers entering the EU-8 labor market in trade-related sectors and the incentives conditioning workers' investment in human capital. Moreover, because labor costs in these countries are relatively high, reliance on unskilled labor-intensive exports may not be sustainable in the long run, given the growing competition from low-wage countries in Asia and elsewhere.

In the main, while there has been substantial change over the course of the transition in the commodity composition and factor intensity of trade by the EU-8 and the SEE economies, relatively little has changed in these regards among the CIS countries, which effectively have been frozen in time. The result is that these countries are not active participants in the evolving international division of labor. The existing composition and factor intensity of exports puts the future growth prospects of the CIS at risk.

A dichotomy in the interactions between trade intensity and domestic competition and governance. The interactions between the extent of international integration and of domestic competition in the Region's countries over the course of the transition have manifested themselves in several ways. On the one hand, in the countries where import penetration has been greatest, firms have been most prone to reducing production costs and innovating. This finding is strongest for firms of smaller scale and those with greater private ownership. Particularly telling is that private foreign-invested firms operating in "host" markets have been more likely to react to import competition than have their domestically owned counterparts. Importantly, in the countries where there has been less progress in fostering a competitive market environment—especially in the CIS—the effects of imports on business decisions have been more muted than in countries, such as the EU-8, where markets are more competitively structured as a result of more advanced reforms (see table 1).

On the other hand, the state of competition domestically has affected the extent of international integration. Two pieces of evidence are telling in this regard. In the Region's countries where there has been greater introduction of private sector participation in the economy, whether through privatization of existing firms or through de novo investment, the export intensity by businesses—the percentage of export revenues as a share of total sales revenues—is much higher (see figure 4). Moreover, the export intensity tends to be greater for foreign invested firms than for domestically owned businesses.

These pieces of evidence suggest a two-way relationship between international integration and behind-the-border conditions, such as greater competition: foreign firms investing in the Region are more prone to react to import competition than are their domestic counterparts, and at the same time are more likely to further their host countries' integration into world markets than are domestic businesses. In part, this may be due to the fact that foreign firms are more likely than domestic firms to have superior management skills.

However, the effect on domestic competition of the presence of foreign firms depends on the way they enter the market. If entry is

TABLE 1

Importance of Competition from Imports to Businesses of Eastern Europe and the Former Soviet Union

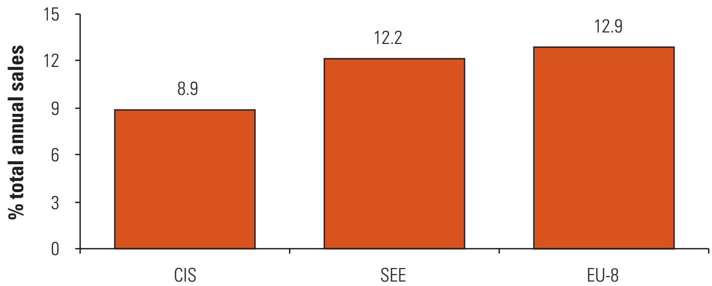
	CIS	SEE	EU-8	The Region
Domestic	27.1	37.6	30.5	31.3
Foreign	27.3	48.5	40.0	35.2

Source: Business Environment and Enterprise Performance Survey (BEEPS2).

Note: Percentage of surveyed firms in 2002 indicating that competition from imports is very or extremely important. Preliminary results from the new BEEPS 2005 are broadly consistent with those reported in this table. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

FIGURE 4

Export Intensity of Businesses Is Greater in the More Advanced Countries of Eastern Europe and the Former Soviet Union



Source: BEEPS2.

Note: Average export revenues as a share of total annual sales, 2002. Preliminary results from the new BEEPS of 2005 are broadly consistent with those reported in this figure. However, some changes may have occurred for individual countries or subgroups of countries in the Region.

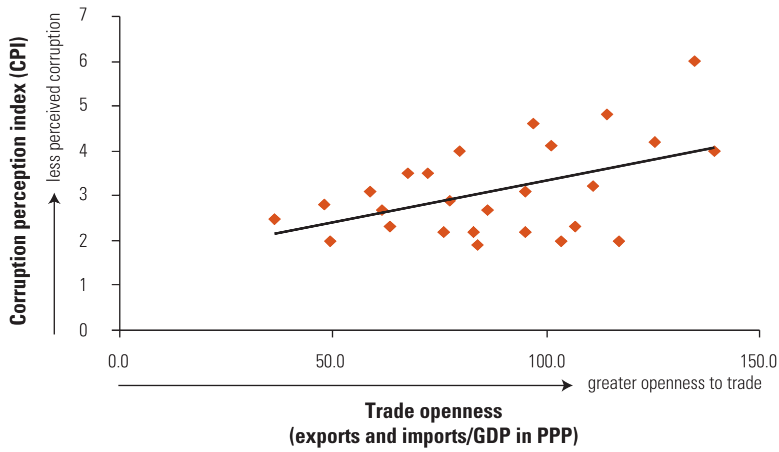
accomplished through establishment of wholly new ("greenfield") businesses, with all other things being equal, competition is generally enhanced, since the number of sellers operating in the domestic market has increased. But if entry occurs through the acquisition of two or more incumbent businesses that are then consolidated under one corporate roof, again, all other things being equal, competition is generally diminished, since the number of sellers in the market is reduced. (When entry results simply in a one-for-one change of ownership of a single business, all other things being equal, the effect on competition in the market is neutral.)

The interactions between the extent of international integration and of domestic governance share the same attributes. For example, the ability to resolve effectively commercial disputes associated with international trade transactions "at home" is greatest in the Eurocentric pole and weakest in the Russia-centric pole. Not surprisingly, firms in the CIS rely on bribes to overcome institutional hurdles in international transctions to a greater extent than those in the rest of the Region.[13] This evidence implies that there might be an important relationship between the sophistication and availability of instruments for dispute resolution and international integration.

The incidence of corruption among countries in the Region is quite varied. Importantly, there is now evidence that these differences appear to be associated with the extent of international integration—independent of the level of a country's development—among the countries in the Region (see figure 5). In particular, countries where corruption is more prominent tend to be those with the least amount of integration into the world economy.[14]

FIGURE 5

Corruption Perception Index and International Integration, 2003



Source: CPI index from Transparency International; export and import in output (PPP) data from World Bank World Development Indicators.

Note: CPI ranks countries in terms of degree to which corruption is perceived to exist among public officials and politicians. It is a composite index, drawing on corruption-related data in expert surveys carried out by a variety of reputable institutions. It reflects the views of business people and analysts from around the world, including experts. The higher the CPI, the lower the level of perceived corruption. Each diamond represents one country in the Region.

Subregional differences in trade and transport facilitation infrastructure and institutions. The institutional and physical capacity for trade facilitation are significantly heterogenous across the Region. Broadly, the trend toward two poles is evident with respect to the state of customs, development of trade-related transport facilities, level of technical product standards, and use of modern mechanisms, such as information technology (IT), in carrying out logistical operations.[15]

The most serious problem in customs—the incidence of unofficial payments needed to move goods across national borders—is extraordinarily pernicious in Central Asia and the Caucasus, and to a lesser extent in certain areas of SEE. This handicap compounds other customs impediments, such as the lack of coordination among border-related agencies, the complexity of customs procedures, unclear customs codes and regulations, and the low utilization of IT in customs operations. Most importantly, perhaps, some of these countries are still experiencing political tensions with neighboring countries, and therefore the level of regional cooperation in trade facilitation remains low. In contrast, in the EU-8, among the "EU accession" countries (Bulgaria and Romania) and the "EU candidate countries" (Croatia and Turkey), customs administration has significantly improved over the last decade. This is at least in part due to the reforms necessary to accede to the EU, although to be sure, more progress is needed to adopt and fully implement relevant EU legislation.

In trade-related transport, much of the Caucasus and most of the CIS countries confront poor quality of service and high costs. Many of these countries are landlocked, making it important to extend their transport infrastructure to neighboring countries. For the Caucasus and the Balkans, war-damaged infrastructure and inoperable links from the transport network inherited from the Soviet period are especially problematic.

In the EU-8 countries, by comparison, the transport systems have been well maintained and have benefited from new investment over time. The result is lower transport costs and better service quality. In part, the improved quality of the transport networks in the EU-8 is rooted in the adoption of market-oriented policies, including bringing rates more in line with costs, reducing subsidies, and privatization. Nonetheless, while trade-related transport privatization has been most widespread among the EU-8 compared to other areas of the Region, the level of private sector participation in these countries is still low by global standards.

Low product standards and technical barriers to trade are also important contributors to high trade logistics costs, especially as they relate to border crossing procedures and administrative rules. On a cross-country basis, there is empirical evidence that they play a key role in export performance in the Region. By dint of complying with EU accession requirements, the EU-8 countries have adopted world class standards. Increasingly, the two EU accession and two EU candidate countries will also do so. In contrast, the remaining SEE countries, the Central Asian Republics, and the Caucasus are still at an early stage of reform in standardization.

The development of e-commerce and adoption of IT in trade transactions are low in the Region relative to other regions of the world. But, again, there is a marked bifurcation among the countries. While significant advances have been made in the EU-8, the development of trade-related Internet infrastructure in the CIS, and to a more limited extent in SEE, is subpar to support effective use of e-commerce in international trade.

Can FDI enable mobility between the two trade poles? Intraindustry trade and participation in global production-sharing networks. As in other regions, the increasing globalization of the world economy and the fragmentation of production processes have changed the economic landscape facing the nations, industries, and individual firms in Eastern Europe and the Former Soviet Union. Through FDI, multinational corporations have been key agents in this transformation, creating international production and distribution networks spanning the globe. In essence, network trade in parts and components, where countries complete different stages of final products, is the internationalization of the manufacturing process.

Production sharing involves the development of specialized and often skilled-labor-intensive activities within a vertically integrated international network. Such production sharing has been growing rapidly on a global scale, with growth rates that have exceeded other dimensions of manufacturing trade. The result has been the growth of intraindustry or increasingly intraproduct trade at the expense of traditional interindustry trade.[16]

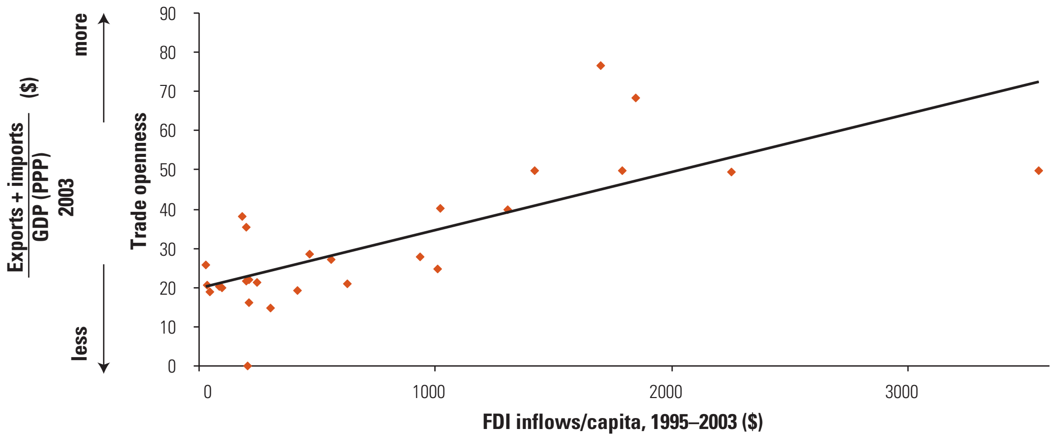
Trade in parts and components (P&C) in the Region has increased in importance in the Region's global trade. The Region's trade in goods used in production sharing grew at an annual rate of 17 percent from 1996 to 2003. Today, trade in parts and components by countries in the Region accounts for 9 and 12 percent of total exports and imports, respectively, up from 5 and 10 percent in 1996. While most of the EU-8 and, to a lesser extent, SEE countries, have been heavily involved in network trade, most successor countries of the Former Soviet Union (FSU)—the CIS—have been left out of this process.[17]

The Czech Republic, Estonia, Hungary, Poland, the Slovak Republic, and Slovenia, for example, have become successful in network trade. During the initial phase of the transition, most of these countries relied on unskilled-labor-intensive exports associated with "buyer-driven" production chains in clothing and furniture. However, rising wages have prompted these countries to shift toward skilled-labor and capital-intensive exports conducted through "producer-driven" networks encompassing automotive and information technology industries. The sizeable FDI inflows to these countries have been instrumental in this shift. In fact, the countries that experienced the largest FDI inflows have registered the largest increases in exports of network products, components, and parts. Indeed, as is the case elsewhere in the world, trade and FDI flows in the Region are complements (see figure 6).

Most other countries in the Region have been active in buyer-driven production chains but have not managed to make a transition toward producer-driven supply chains. Countries in this group largely include the SEE economies, along with Armenia (which is engaged in the diamond supply chain), Belarus (which participates in the furniture network), and the Kyrgyz Republic, Moldova, and Turkmenistan (all of which are still heavily involved in the clothing network). The remaining CIS countries have largely stayed outside any network trade.

FIGURE 6

Trade and FDI Inflows Are Complements in Eastern Europe and the Former Soviet Union



Source: IMF DOT Statistics.

Note: Each diamond represents one country in the Region; Turkey is also included.

These stylized facts suggest once again that the Region has an emerging bifurcated pattern of international integration: the countries that have integrated more into the global economy through producer-driven production-sharing networks have significantly advanced developmentally, whereas those not participating in such networks and hence less integrated internationally are generally poorer. Participation in producer-driven production-sharing networks has enabled countries in the Region to shift output from lower to higher skilled-labor-intensive products. It has also provided gains to these economies in terms of transfers of advances in technology and productivity growth.

Importantly, global production sharing can provide the opportunity for mobility from the Russia-centric to the Euro-centric pole. By attracting FDI, countries can engage in network trade, capitalize on their comparative advantage, and proactively break out from their trade block. While, many countries in the Region have attracted sizeable inflows of FDI, the cross-country differences in the amount of FDI received are striking. While Tajikistan received only $35 of FDI per capita at the end of 2003, for example, the corresponding figure for Estonia is 138 times larger, at $4,823. Generally the EU-8 countries have attracted the largest stock of FDI per capita within the Region, while among CIS countries, only Azerbaijan and Kazakhstan have managed to attract significant FDI, albeit mainly in their oil sectors.

This suggests an important policy challenge for the less developed countries in the Region is to attract FDI. For this to happen, several critical ingredients are needed. Industry investment location decisions to engage in international production sharing depend on countries' having in place market-oriented, open-trade policy regimes. In this regard, it is important for countries to provide for ease of exportation and importation of parts and components, as well as assembled, "final" products. Well-developed trade-facilitation systems and related institutions (such as customs) as well as modernized services sectors (such as the transport and communication infrastructure) also will be key. But, perhaps most important, countries need to create a favorable behind-the-border business environment. This means establishing incentives and institutions that will foster domestic markets that are competitively structured, with low barriers to entry and exit, rules-based checks on anticompetitive conduct and undue government interference in commercial decisions, and adherence to the rule of law, protection of property rights, and good governance.

Qualifications on the two-bloc paradigm. Overall, the portrait that emerges of the Region's international trade landscape is one depicting a movement from "integration" to "disintegration," and now "reintegration." But the "new" integration differs significantly from the old. Virtually all of the EU-8 have substantially integrated into the global marketplace and moved away from the old structures. An increasing proportion of the SEE countries are not far behind, although some, notably Bosnia and Herzegovina, FYR Macedonia, and Serbia and Montenegro, are much less internationally integrated. In contrast, the CIS has, with a few important exceptions, such as Russia and Ukraine, largely tended to stay together. Indeed, in several respects there is actually an *increasing* amount of subregionalized trade among the CIS.

To be sure, the reality is more complicated than this simple dichotomized portrait. There is a sizeable difference in scale between the two trade blocs. Total merchandise trade flows for the EU-8 and SEE are almost twice the size of those of the CIS. Moreover, there is significant heterogeneity *within* each bloc. For example, some of the larger CIS countries, such as Russia and Ukraine, have trading attributes akin to those of the EU-8 or SEE. At the same time, some of the SEE countries exhibit trading patterns that resemble those of the CIS countries. Indeed, while the overall group of SEE countries is increasingly gravitating toward the Euro-centric pole, they are in fact doing so at different rates. Consequently, at this point, along some dimensions, the SEE countries form a "middle ground" between the two poles. Nonetheless, there are unmistakable trends toward a "bifurcated Region" in international trade among the countries of Eastern Europe and the Former Soviet Union.

The Region's Openness to Trade Today: How Does It Compare with the Rest of the World?

In light of the rapid growth in trade flows for the Region over the last decade, how significant today is trade in the overall economic activity of the Region's countries? One way to measure this is through the conventional "output-based" metric of "trade openness," calculated as the sum of a nation's total exports and imports as a percentage of GDP.

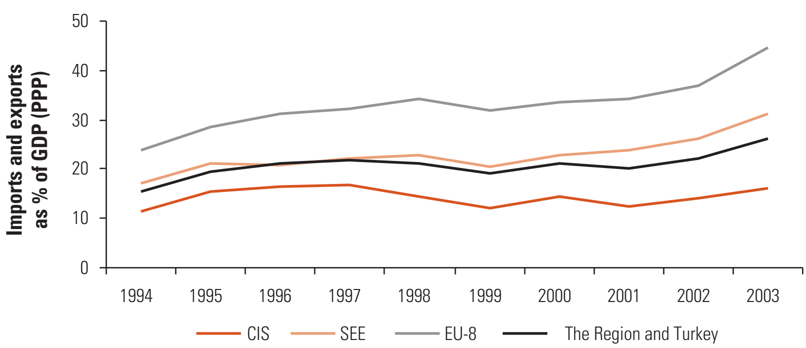
In terms of merchandise trade, on average the Region's total merchandise exports and imports today account for more than 25 percent of GDP, as compared to about 15 percent in 1994.[18] But there is significant variation across the countries, with trade openness in the EU-8 reaching almost 45 percent, while the corresponding measure for the CIS is only 5 percent; openness in the SEE countries lies somewhere in between (see figure 7).

In services trade, the extent and pattern of openness is quite different (see figure 8). Today, on average, services trade accounts for about 4 percent of GDP in the Region. But SEE's services trade accounts for about 8 percent of GDP on average—the highest in the Region. Until 2000, the EU-8's services trade openness was the highest. For the CIS countries, services trade stayed more or less flat over the decade; today, on average, services trade among the CIS accounts for only about 3 percent of GDP.

How open are the Region's countries compared to other nations worldwide? A rigorous assessment of this question comes from an econometric "openness model" developed for 149 countries, including the 27 countries in the Region (plus Turkey). The model was designed to determine the broad association between a country's trade openness in the aggregate—that is, its gross trade flows, regardless of their

FIGURE 7

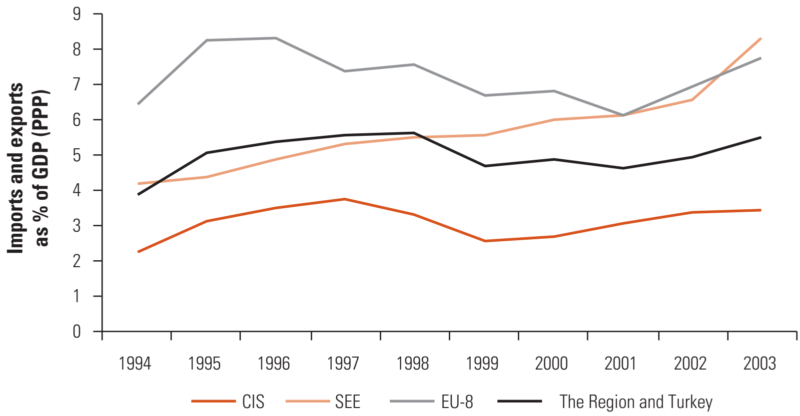
Openness in the Region's Merchandise Trade



Source: IMF DOT Statistics.

FIGURE 8

Openness in the Region's Services Trade



Source: IMF DOT Statistics.

destination or origin[19]—and the level of its national income. In the model, trade openness is regressed on GDP per capita as well as population (which is a proxy for country size) and geographic distance to major markets (a measure of market access). The hypothesis underlying this approach is that richer countries trade more (as a percentage of their GDP), while larger counties and those that are relatively far away from major markets trade less.

Both the theoretical and the empirical literature suggest a positive correlation between openness (trade integration) and income levels. This positive correlation can be attributed to the increasing diversification of an economy and its deepening international specialization in the course of development. At the same time, as the recent literature suggests, both income and trade are dependent on the quality of local institutions. Thus, income level may be viewed as a proxy for institutional variables that underlie trends in both overall economic development and international trade.[20] On the other hand, a country's large size (the number of domestic economic agents and consumers) creates larger opportunities for within-country trade, so these countries will be less open.

The empirical results confirm that, for all 149 countries, all other things being equal, larger countries and those further from major markets on average tend to trade less, and countries that are more advanced economically and institutionally tend to trade more. With respect to the Region, the results indicate that most of the 27 transition economies, on average, tend to trade largely in line with other countries worldwide that have similar income levels, size, and geographic distance from major markets; the only exception is many (though not all) countries in SEE, where there is evidence of "undertrading." In other words, more than a decade into the transition, most of the Region's countries as a whole trade generally in line with the global cross-country norm: they neither under- nor overtrade.

How does the actual trade openness of the Region's countries, which reflects their actual income level, size and access to markets, compare with their "theoretical" openness, which is based on the estimates corresponding to the regression line in the model? (See table 2.)

The data show that there is significant variation among the countries within the Region. The CIS countries—as a group, not necessarily every country individually—are actually trading broadly in line with their current potential (as reflected by the estimated model). On the other hand, most of the EU-8 countries appear to be measurably overtrading; on average the subregion overtrades by one-third. In contrast, the estimation results suggest that a core group of the SEE countries— especially Albania, Bosnia and Herzegovina, and FYR Macedonia—are undertrading such that, on average, SEE is trading at just over three-quarters of its potential.[21]

A similar pattern emerges from a "gravity model" where the units of analysis are the bilateral trade flows between the origin and destination countries (rather than the aggregate trade flows of a country as just discussed). Despite theoretical controversies surrounding gravity models since their inception (which have been somewhat alleviated recently),[22] they have proven to be the most accurate tool for the explanation and prediction of bilateral trade flows. A number of studies have applied gravity models to assessing trade flows among various countries in the world, including the Region.[23] In this study, we perform a new analysis applying the gravity model developed by Frankel (1997).

Based on this analysis, although total world trade flows of the CIS were significantly lower than their potential in the early 1990s (owing to the collapse of CMEA), over the course of the decade, the CIS countries steadily and sizably exploited their global trade opportunities. The bulk of these trade flows, as noted earlier, have been largely in the natural resources sectors. In contrast, the results suggest that

TABLE 2

The Region's Actual vs. Theoretical Trade Openness

Merchandise Exports plus Imports to GDP in PPP $

Averages	2003 Realization Ratios (actual/predicted by the model)
The Region	1.37
CIS	0.96
SEE	0.77
EU-8	1.33
The Region and Turkey	1.35

Source: Author's calculations.

the EU-8 and SEE countries largely maintained their pattern of total world trade flows during the same period.

Importantly, the "reconstitution" of a Russia-centric CIS trading bloc that has been taking place over the course of the decade is also clearly discernable in the gravity model empirical results. In contrast to the EU-8 and SEE countries, where the ratio of actual to potential trade among the countries within each of these two subregions declined over the 1994-2003 period, for the CIS countries, the comparable ratio steadily increased; that is, the ratio of actual to potential intra-CIS trade flows has been rising over time.

Interpretation of empirical results of openness and gravity models—both in the literature and in this study—must be done with care. In part this stems from the complexity of the reality that is being modeled econometrically. In particular, it is important to realize that institutional and policy-related variables do not likely play an exogenous role; rather, such variables are often endogenous and directly related to the level of trade. Some steps have been taken in this analysis to deal with this problem, but data availability limits the sophistication of the approach that can be taken.

Moreover, as is the case in almost all similar analyses in the literature, institutional and policy-related variables in such models have very strong—sometimes the greatest—explanatory power. This suggests that the most acute barriers to trade expansion may not rest in "fixed" factors, such as geography. Rather, trade performance may be more greatly influenced by actions taken (or not taken) at home. It is in this context that policy makers need to interpret these empirical results and recognize that behind-the-border reforms are likely to be critical in complementing trade-related policy actions if international integration of the Region is to deepen.

All this is not to suggest that improving most of the Region's countries' *trade* policy regimes is unlikely to induce greater international integration to facilitate increased growth. On the contrary, the evidence points to the importance of improving these countries' *behind-the-border* production structures and institutional regimes and to do so in concert with further reform of trade policies.

How Have the Region's Countries Opened Trade and Increased International Integration? The Role of Trade Policy

Many countries in the Region—either early on in the transition process or over time—have cut tariffs and reduced or eliminated nontariff barriers. As a result, at present, the Region as a whole comprises economies with relatively liberal formal *trade policies*. By easing policy restrictions at the border, governments have shaped the incentive framework that affects trade flows. Today, the weighted average applied tariff rate on all goods for all of the Region's countries is 5.8 percent. These tariff rates compare favorably with those of developing countries at comparable income levels. Very few of the countries have maintained the patterns of trade control that characterized central planning. Nonetheless, some countries in the Region still maintain high tariffs and appreciable NTBs. This includes some Central Asian Republics and others in the CIS such as Belarus.

The basic reforms in the Region's countries' trade policies have taken place through three avenues: (i) *unilateral* trade policy reforms; (ii) *bilateral or regional* trade agreements; and (iii) *multilateral* trade commitments.

Virtually all of the countries have undertaken formal tariff reductions *unilaterally* as part of achieving national economic reform objectives rather than as a result of specific bilateral/regional or multilateral trade commitments. Importantly, much of this liberalization was carried out autonomously by the countries, albeit with the encouragement and support (and discipline) of the international development community in the early years of the transition. In comparison to developing countries of similar income levels, the Region's tariff protection of domestic industry and agriculture is on average lower, the extent of protection through nontariff barriers appears to be no greater, and there is less recourse to contingent protection. On the other hand, most countries in the Region have done little to encourage and have often discouraged exports. This remains a major item on the trade policy reform agenda.

All of the Region's countries are party to (sometimes several) *bilateral or regional* trade agreements—including free trade areas and customs unions—that have provided for reciprocal tariff reductions, preferential market access, and other forms of trade policy liberalization. Of course the most prominent example of regional trade liberalization is that provided through EU accession, which eight of the Region's countries completed in May 2004. Two more of the Region's countries (Bulgaria and Romania) are "EU accession countries" and one other (Croatia) is an "EU candidate country." (Turkey is also an "EU candidate country.") In Southeast Europe, most other countries are participating in a stabilization and association process that ultimately is expected to lead them to EU membership.

Myriad other regional free trade agreements or customs unions has also been forged, among them the 29 bilateral free trade agreements (FTAs) among the SEE economies and the various trade agreements within the CIS, such as the CIS FTA, the Eurasia Economic Community, and the Central Asian Cooperation Organization. The agreements in the SEE appear to involve greater mutual trade liberalization than those of the CIS. Both, however, are complex and are focused primarily on the exchange of trade preferences. The main challenges faced by both groups of countries are how to rationalize the large number of bilateral FTAs to regionwide agreements, as well as how to extend regional cooperation beyond preferences in merchandise trade, and include such matters as transit facilitation as well as liberalization of services.

To date, the majority of the Region's countries have liberalized trade policies *multilaterally* by becoming members of the WTO, with most of the others in various stages of the WTO accession process. Accession to the WTO has generally meant liberalized market access for the Region's firms in global markets and, conversely, significant reductions in NTBs, as well as adherence to internationally accepted rules-based disciplines for dispute settlement regarding dumping, intellectual property protection, and government procurement, among others. Market access is not a serious, generalized problem affecting most of the Region's countries' exports—especially in comparison to domestic, behind-the-border restraints to international trade. There are, however, serious market access problems in particular sectors stemming in part from extensive use of antidumping actions against transition economies, as well as developed countries' protectionist agricultural policies. Some of these market access problems will be addressed by WTO accession and hopefully by progress achieved in the ongoing Doha Round of WTO negotiations. In that regard, WTO accession is important in order to improve and secure market access abroad. However, it is even more important because it forces countries in the Region to strengthen their domestic institutional capacity to trade, introduce stability in their trade regimes, and lock in internal reforms.

Overall, for most of the Region's countries, large-scale liberalization of "first-generation" merchandise trade policies, including lower tariffs, reduction of NTBs, and eased market access, has been accomplished, resulting in greater openness. But for a few countries, such as Belarus, Turkmenistan, and Uzbekistan, even these "first-generation" trade-policy reforms are still needed. Yet even for the Region's countries that have already substantially liberalized, greater fine-tuning of merchandise trade policy is in order. There is still a large gap between bound and applied tariff rates in some countries, and in certain cases, for example Russia, tariff rate schedules are greatly dispersed, creating opportunities for discretion and corruption. There also remain disincentives to exporting, which results in lost opportunities for growth and job creation. In numerous instances, overlapping bilateral or sub-Regional free trade agreements incorporating complex rules of origin reduce clarity of trade rules, hindering commercial decisions by traders and investors. While preferential provisions of some of these agreements in the Region create trade, some also divert trade. Greater harmonization and consolidation of such agreements into a uniform agreement, such as the one being pursued among the SEE economies, would be highly beneficial.

How has increased openness to trade enhanced growth and reduced poverty in the Region? Trade performance is one of many factors that affect GDP growth, and through growth, the reduction of poverty. Trade performance in turn is affected, in part, by trade policy. The beneficial effect of trade policy on poverty via its effect on growth is, necessarily, more complicated. The transmission is indirect and manifests generally only over a relatively long term. At the same time, however, trade policy results in changes in relative prices, which will have a short-term impact on the welfare of the poor, by affecting their employment and income prospects as well as the prices of the goods they consume. Based on experiences of trade policy reform in developing countries, a great a deal of analysis has been carried out in recent years exploring the impact of liberal trade regimes on economic growth. The preponderance of empirical evidence from developing countries worldwide suggests that, on average, growth will be enhanced in the long run as a consequence of liberal trade regimes.[24]

As is the case elsewhere in the world, disentangling the linkages between trade and poverty reduction in the Region is complex. As is well known, there was, for several reasons, a massive increase in poverty in the Region at the onset of the transition.[25] Despite the fact that most of the Region's countries adopted early on (and have largely maintained) relatively liberal formal trade regimes and that, moreover, substantial progress in poverty reduction has been made in the Region in recent years, nevertheless, today, more than a decade after the onset of transition, widespread poverty persists in several the Region's countries, especially, but not exclusively, in Central Asia and the Caucasus.[26]

There have been some efforts to analyze through simulations the implications of specific trade policy reforms on poverty in individual countries in the Region. However, there is no aggregate assessment of the experience for the group as a whole. The individual countries for which assessments have been made are Bulgaria, Moldova, Romania, and Russia.[27] These analyses generally find that the effect of trade liberalization on the poor as a group would tend to be positive.[28] However, there is also evidence that trade liberalization would likely reduce the well-being of some people, at least in the short term, and some of these would be the poor, who can ill afford it.[29]

On the other hand, the absence of trade liberalization does not always translate into the poor becoming better off. The case of the slowest reforming countries—such as Belarus and Uzbekistan—is instructive in this regard. Although their declines in output and increases in poverty have been more limited than those of other countries in the Region, in part because of the maintenance of relatively closed trade regimes, they have nonetheless engaged in policies, such as the protection and state control of the cotton sector in Uzbekistan, which in fact have been adverse to the welfare of the poorest elements of society.

Although the assessment of the implications of trade reform on poverty in the Region's transition economies is sobering—in the sense that in the short run poverty will likely increase in certain segments of society—it is not inconsistent with the analysis in other countries worldwide. Retrospectively, greater exposure to trade may well have exacerbated poverty in the CIS countries. The situation was much better in EU-8 and SEE economies, however, probably because many of these countries quickly pursued policies that provided for greater flexibility in resource allocation. These policies permitted workers displaced by imports as well as labor force entrants to be employed in new labor-intensive activities; they also focused on facilitating exports. Thus, in the absence of effectively flexible product and factor markets, the adjustment to trade reforms in the CIS has been very protracted. In consequence, the "short run" for these countries may still be lingering.

There is a general consensus that, for the poor to gain from trade liberalization, actions that complement trade reform are needed. The main conclusions of individual country case studies—as well as cross-country econometric studies—that have looked at experiences with trade liberalization at the country level worldwide point to the importance of enhancing flexibility in labor markets and facilitating the flow of investment from sectors that are contracting to those that are expanding. In short, a policy of import liberalization alone is not sufficient to promote the strong trade performance that could be beneficial to output growth and indirectly to poverty reduction.

Overall, without open trade, the Region's transition to market economic systems could not have transpired. As illustrated in figure 9, as has been the case elsewhere in the world, trade and behind-the-border reforms in the Region have been mutually reinforcing. The economies that have had the most international integration have made more progress in implementing enduring domestic structural and institutional policy reforms and vice versa.

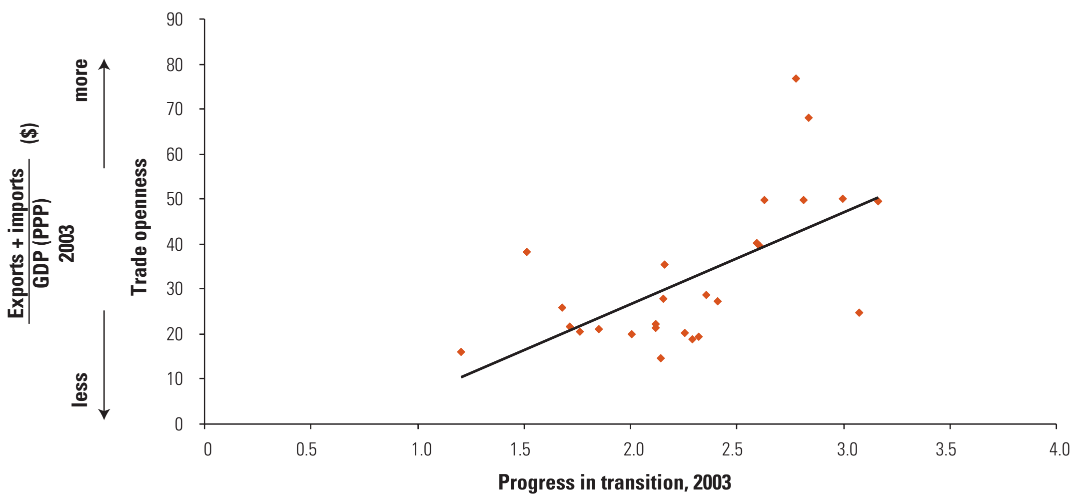
Beyond Trade Policy: The Pivotal Role of Behind-the-Border Reforms in the Region's International Reintegration

If international integration of the Region's countries is not solely the result of changes in trade policy at the border, which behind-the-border policies and market institutions have been most important in furthering integration and harnessing the ways in which trade can leverage growth and reduce poverty? The evidence from the Region suggests a multifaceted set of such reforms is key, notably: (i) ensuring competitively structured domestic markets, reinforced by a policy regime that disciplines anticompetitive behavior and attracts investment—from both domestic and foreign sources—as well as promotes sound governance; (ii) developing a modern infrastructure and related institutions for trade facilitation; and (iii) liberalizing private investment in and regulatory reform of backbone and network services sectors.

Domestic market competition, investment climate, and governance. Vibrant domestic competition and favorable conditions for business investment have played an important role in fostering the international

FIGURE 9

Trade Openness and Transition: A Mutually Reinforcing Relationship



Source: World Bank, using IMF DOT data and EBRD Transition Index.

Note: Each diamond represents one country in the Region; Turkey is also included.

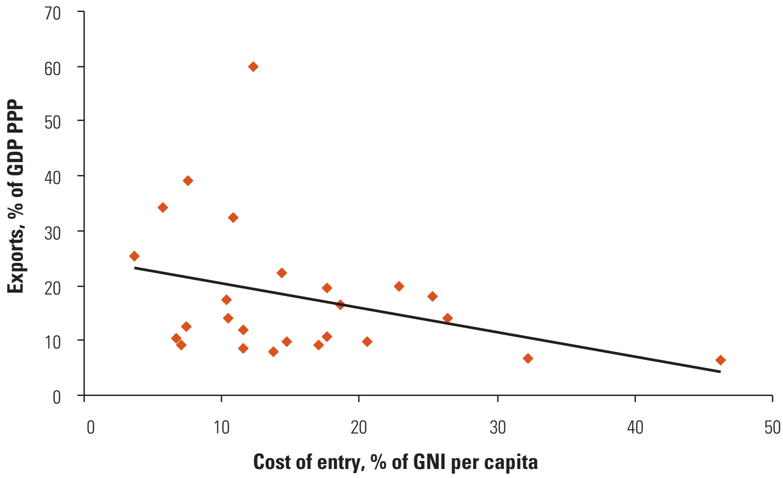
integration of the Region over the course of the transition. Among other pieces of evidence, statistical analysis covering all of the Region's countries between 1995 and 2003 suggests a positive association between a country's trade performance and its competition regime and the extent of FDI inflows as a percentage of GDP, after controlling for tariff levels.[30]

How do the underlying structural parameters that determine the intensity of competition in domestic markets relate to the extent of international integration by businesses in the Region? The countries that have relatively high barriers to entry for business start-ups or high barriers to exit for money-losing firms tend to be less integrated internationally and less able to capitalize on the reallocation of capital and human resources that stem from exposure to trade in order to promote growth and reduce poverty.

The empirical evidence suggests that in the Region's countries where the cost of *entry* is highest—measured, for example, by the time and resources required to get a new business license and registration—international integration is being hindered: import and export performance as well as FDI inflows are relatively low (see figure 10). Importantly, different factors appear to give rise to barriers to entry for domestically owned firms than for foreign-owned firms in the Region. Data collected through recent business surveys suggest that, while economic policy uncertainty, macroeconomic instability, high tax rates, and poor access to financing are seen as the most severe entry barriers by domestic firms, anticompetitive business behavior, contract violations, lack of skilled labor, and delays and complexities in obtaining business licenses and permits are the greatest barriers to entry for foreign firms. This finding suggests important policy implications for deepening integration in the Region: an emphasis on different reforms to reduce barriers to entry may well be needed if countries are to be more successful in attracting foreign investors.

There is abundant evidence over the course of the transition suggesting that where the *exit* of money-losing firms in the Region is likely to be impeded most is where there are "soft budget constraints" arising from two factors: (i) sizeable arrears in taxes, wages, utility payments, and payables to input suppliers, and (ii) subsidies to businesses. Recent data indicate that the incidence of arrears is greatest among firms in Central Asia and other CIS countries. Across firms of different ownership forms, arrears are least among firms with significant private ownership, including foreign-invested businesses. Significantly, there is new evidence that in the countries where arrears are largest, export performance (measured by the share of exports in

FIGURE 10
Export Levels and Cost of Entry in the Region, 2003



Sources: Export data based on UN COMTRADE Statistics and IMF DOT Statistics; cost of entry data from Doing Business (2004).

Note: GNI = gross national income. Each diamond represents one country in the Region; Turkey is also included.

GDP) is worst. This suggests another direct linkage between behind-the-border conditions and success in the Region in international integration: where there is a lack of domestic competition, firms' ability to penetrate foreign markets is dulled. Among firms in the Region, the incidence of direct business subsidies is greatest in the CIS, with average direct subsidies amounting to more than 20 percent of sales revenue.[31]

These findings corroborate the notion that the CIS countries have been much less vigorous than other countries in the Region in implementing measures to induce competitive restructuring and ownership change in the enterprise sector. Given that the CIS countries on average have privatized fewer corporate assets than other countries in the Region, it is not surprising that available evidence indicates that the least competitively structured markets in the Region are those that are heavily populated by state-owned firms, whereas the most competitively structured markets are those in which a greater number of de novo private and foreign firms operate. Firms' commercial ties with the state, for example through participation in "state orders" or public procurement, are also more extensive in the CIS countries, compared with other parts of the Region.

At the same time, from a sectoral perspective, the Region's markets in energy and natural resources as well as in infrastructure tend to have the fewest competitors. To be sure, this is due to the fact that it is in these sectors where state ownership is dominant and private sector entry is blocked. Of course on the other hand, in a small number of these sectors, such as the local distribution of electricity or natural gas, the scarcity of competitors may well be socially desirable due to inherent "natural monopoly" conditions; nevertheless, these market segments are decreasing in number worldwide as a result of technological changes. In contrast, markets in the trade and retail sectors, where private ownership is the rule and state ownership the exception, are populated by the greatest number of competitors.

An important linkage between the extent of behind-the-border competition and international integration of the Region's countries confirmed by empirical evidence is that firms that have achieved larger market shares in their domestic markets have a higher propensity to engage in exports. As observed above, this finding suggests that "competitive success at home breeds competitive success abroad," a conclusion consistent with the broader economics literature. Indeed, as new econometric analysis suggests, the Region's firms that have achieved relatively dominant market positions tend to be more profitable, holding constant other factors, including overall scale, ownership form, softness of budget constraints, and technological prowess.

Moreover, consistent with the evidence that less competition exists in CIS domestic markets are data indicating that, over the past decade, firms located in the EU-8 countries have exported to more numerous "new" markets than have firms in Central Asia and the Caucasus. By the same token, countries in the Region whose markets are more competitively structured—measured by the number of competitors—tend to have more firms integrating into global markets through outward direct investment than do countries where markets are less competitively structured; in addition, on average, foreign-owned firms located in "host" markets in the Region have more extensive direct investments abroad than do counterpart domestic firms.

Enhancing domestic competition in the Region's markets is thus likely to be an important element not only to enhance deeper international integration but also to capitalize on and leverage the economywide benefits that integration can engender. If this conclusion is correct, the implication for domestic policy makers is clear: in an increasingly globalized economy, where competition among countries for investment resources and international market share for business is ever more intense, steps to increase national welfare should focus squarely on policies to: reduce barriers to entry and exit; prevent restrictive and anticompetitive business practices; privatize incumbent state-owned firms where little or no rationale for public ownership exists; and take concrete steps to improve the climate for investment—from domestic as well as foreign sources.

Moreover, a central policy lesson from the experiences of the successfully reforming countries in the Region (and elsewhere in the world) is that governments should design reforms to improve domestic competition so that they are mutually reinforcing with international trade agreements and commitments. This will help to lock in such reforms, to ensure that greater integration fosters the competitiveness of businesses located behind the border and vice versa. This objective should be pursued at a variety of levels: globally through WTO accession; regionally through EU membership and other RTAs; or bilaterally through free trade agreements.

In pursuit of the goal of encouraging entry, the Region's governments also should work toward eliminating not only barriers to establishment of a business and the entry of new rivals, but also barriers to the ongoing challenges that businesses face behind the border on a day-to-day basis. Reducing "administrative barriers" for business start-ups and postestablishment operations is still an important "first-generation" reform for certain countries in the Region, largely in the CIS, but also in some SEE countries. For other countries in the Region, such barriers have either been largely implemented or are well into the process of being so. For these countries there is now the need for "second-generation" competition reforms—ones that actually deal with the fundamental challenges in the industrial structure of the national economy.

Although an increasing number of the Region's countries have sound competition laws, there is almost universally weak enforcement of these instruments. Thus, competition authorities in every country should have sufficient competencies to assess and penalize dominant firms' structures and behavior, as well as restrictive business practices that harm competition.

With respect to exit, the restructuring or liquidation of large loss-producing enterprises that take up resources and economic space have not been sufficiently facilitated—particularly, but not exclusively in the CIS—in part because sound legislation has not been implemented or because vested interests, including the politically well-connected, stand to lose. Developing an effective bankruptcy process is critical to improving the competitiveness of viable firms and to liquidating or reorganizing firms that are no longer commercially viable. This will strengthen creditor rights, which in turn will improve the climate for investment. Equally important, it will facilitate the reallocation of resources—human as well as financial—to engender greater flexibility in the economy, which is the key to ensuring growth as well as poverty reduction as the process of international integration continues.

Some of the Region's governments have extended preferential treatment to select market participants to encourage development of "strategic sectors." While such industrial policies need not be always harmful to economic development, depending on how they are designed and implemented (including their longevity), they can undermine the competitive nature of markets and ultimately distort the pattern and extent of a country's international integration. Although the opposition of political and vested interests may be considerable, government reform in various countries in the Region should focus on eliminating tax support, tolerance of arrears, subsidies, and distortionary investment or export incentives—not only to incumbent domestic firms but also to foreign entrants. The long-run net benefits to the domestic economy from the establishment of special export-processing zones or preferential tax concessions in the Region—as elsewhere in the world—may be limited, in part because such regimes can—but need not—result in enclave markets with limited positive spillovers to the rest of the economy and the creation of opportunities for corruption.

Related to industrial policy is the manner in which the Region's governments conduct their public procurement with, and grant contracts to, the "outside" business world. Adherence to WTO-based rules regarding government procurement that provide for open competition, transparent procedures, and nondiscriminatory treatment to domestic and foreign firms alike can be an important reform in minimizing existing distortions in international trade and investment in the Region and fostering international integration.

Weak governance and corruption are also critical behind-the-border impediments to the international integration of the Region's countries. At the end of the day, consumers pay higher prices as the costs of corruption are internalized into the final cost of internationally traded products or services. In addition, corruption affects the end user not only by increasing prices, but also by reducing the quality and diversity of available products and services.

Asymmetric information among market players caused by a lack of transparency in transactions negatively affects international exchange. To this end, it is important to investigate how the quality of domestic governance institutions relates to international integration. There is a statistically significant positive association between government effectiveness/quality of institutions and trade openness. Stated differently, countries that engage in freer trade tend to have better quality of institutions, which leads to better governance (see figure 5).

While progress has been made in some of the Region's countries regarding the establishment of relatively well-functioning, market-based legal institutions that facilitate resolution of domestic commercial problems associated with international trade and investment, in many countries this is an unfinished agenda item. There is throughout the Region a general lack of security in the commercial contracting process. Businesses—not only foreign, but also domestic—have "voted with their feet" and traded or invested elsewhere to get around this obstacle, but in so doing, there also has been a loss of efficiency in the transactions process and, ultimately, resources have been diverted from more productive activities.

Trade facilitation infrastructure and institutions. Integration into global markets will, over time, involve reform in trade facilitation and logistics. Meeting the behind-the-border trade-facilitation challenge places enormous importance on the need for setting priorities if for no other reason because of the resources often required. EU membership, for example, will make it possible to move goods freely between member states without the need to complete formal import and export documentation or pay import value added tax (VAT) or customs duties. But the harmonization and implementation of the EU's *acquis communitaire* require new member countries to make major improvements in their overall economic environment—both at the border and behind the border.[32] As countries in the Region—and the international donor community—decide on how best to deploy resources, a critical policy question arises: what is the relative impact of improvements in trade facilitation compared with gains from lowering traditional trade barriers, such as tariffs and quotas?

New empirical analysis provides one indication of the potential benefits of reform in trade facilitation. Estimates, on a global basis, suggest that improvements in four areas—port efficiency, customs regimes, regulatory policy, and information technology infrastructures—can lead to significant trade gains. The global analysis indicates that, for 75 sample countries, raising capacity halfway to the world average would yield a $377 billion gain to world trade.[33]

Region-specific work has been carried out, building on the global analysis, incorporating the indexes utilized for measuring trade facilitation development.[34] It focuses on simulation of improvements in trade facilitation in 15 countries in the Region (plus Turkey) which are fairly representative of the Region and comprise about 95 percent of the Region's GDP.[35] As a group, the countries exhibit a much lower level of performance in all four areas of trade facilitation relative to the EU-15. The analysis projects the gains in trade that could be realized in two situations: how would *intra-Regional* trade change if all of the Region's countries improved their capacities in trade facilitation and how would trade with the *rest of the world* change? In both cases it was postulated that the Region's countries would improve their trade facilitation capacities to half of the EU-15 average.

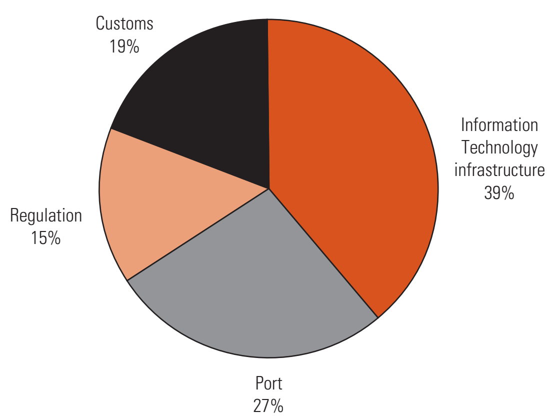
In the first case, the total estimated gain from capacity building in all four categories of trade facilitation would be approximately $94 billion in the Region. The country with the largest projected gains would be Russia, where trade flows would be expected to increase by $19 billion, and improvements in IT would contribute the most to those gains. Trade volumes of Lithuania, Poland, (as well as Russia), and Ukraine would rise more than 100 percent. Improvements in port efficiency would raise trade volumes significantly in Croatia, the Czech Republic, FYR Macedonia, Serbia, the Slovak Republic, and Slovenia. In contrast, improvements in IT would generate trade gains in Bulgaria, Hungary, Latvia, Lithuania, Poland, Russia, and Ukraine. Improvements in customs would yield the second largest trade gains.

In the second case, the total gains to the Region are estimated at approximately US$178 billion (see figure 11). This represents about 50 percent of the Region's trade with the rest of the world. Eighty-seven percent of the total gains to the Region are generated from the Region's own moves to upgrade infrastructure in ports and information technology, harmonize regulations, and improve customs.

Overall, the results demonstrate the importance of capacity building in trade facilitation in the Region as a means of strengthening trade ties globally—as well as fostering intra-Regional trade. Gains would be greatest from improvements in IT infrastructure and port efficiency. The results from the simulation suggest that the principal

FIGURE 11

Gains from Improving Trade Facilitation in Eastern Europe and the Former Soviet Union



Source: Wilson, Luo, and Broadman 2004.

priorities should focus on port and IT infrastructure improvements, complemented by reforming customs and streamlining regulations.

Services sector liberalization and regulatory reform. An increasing number of countries in the Region—notably the EU-8 and, to a much lesser extent, SEE—have come to recognize that greater and more sustainable growth will come from liberalization of their services sectors. Indeed, in some of these countries the increased efficiency in the services needed for export production has been a contributing factor to the rapid expansion in merchandise exports, for example, the liberalization of Hungary's financial sector. At the same time, certain countries have embraced a strategy of boosting trade and investment in the services sectors in their own right and have experienced significant services export growth; these include, for example Croatia's and FYR Macedonia's software sectors. Other countries in the Region, however, typically the less developed ones in the CIS, still treat services as "nonproductive" activities, a legacy from the mindset during the era of central planning.

Policy developments (or the lack thereof) help explain the differences in services-related trade performance and FDI flows. In many FSU countries (with the exception of the Baltics), bureaucratic impediments, the lack of competition as a result of public or newly established private monopolies, and slow progress in privatization have impeded services trade and FDI. Most lagging are Belarus, Tajikistan, Turkmenistan, and Uzbekistan. As FDI is an important source of new technologies and know-how, and the cost and variety of services that are available in an economy are an important determinant of the competitiveness of firms, the greater service intensity is likely to help explain the differential growth performance among countries in the Region.

This proposition is supported by econometric evidence that assesses the links between investment, services sector development and economic growth using cross-country growth regressions. The analysis reveals the importance for economic growth of sound policies that promote the efficient functioning of the services sectors.

The reform challenges today are not as simple in many services sectors as they used to be, however. Scale economies and high sunk costs of investing in infrastructure or banking do not necessarily call for regulated monopolies. New technologies often make large fixed investment either reversible or allow for a separate role of service provision (for example, in telecommunications). The ensuing policy challenge is the need for achieving a balance between traditional regulation and the introduction of competition.

In the telecommunications sector, the EU-8 countries have reformed the most extensively, including significant private participation in service delivery, followed by Southeastern Europe. Regulatory reform, including rate setting and establishment of independent regulatory authorities, however, is still very much underway, with further progress required. In the CIS, fixed-line services are still quite underdeveloped, and state control and monopolies still prevail. Where privatization of incumbents has occurred in the CIS, its objective has often been the maximization of revenue. As a result, some private investors have been granted monopoly status for significant periods of time. Armenia, for instance, provided a Greek investor with a 15-year exclusivity clause.

In the banking sector, a similar pattern is observed. In the EU-8, the sector is generally characterized by only small shares of credit allocated through state-owned banks, high foreign participation, and stronger regulatory regimes. Evidence from these countries indicates that foreign banks have been contributing to the modernization of the sector. However, bottlenecks relevant to sustained financial development often persist in the legal framework (within the tax system, creditor rights, and, the bankruptcy code, for example). Banking markets in the CIS tend to be relatively closed, in both formal and informal aspects. In this regard, Belarus, in spite of its relative proximity to the EU in terms geographic location, is one of the least advanced countries, as are most Central Asian republics. Actual and potential limits on foreign participation (both economywide and in individual banks) play an important role, but bureaucratic impediments seem to play a more prominent role in inhibiting foreign participation; these include limitations on bringing in foreign staff, lengthy licensing procedures, financial repression, public ownership of dominant banks, and inadequate regulatory practices. In general, the banking sector in these countries suffers from weak capital bases and lack of confidence.

The picture is not very different in rail and road and rail transport. Progress in the reform of railways is greatest in the EU-8, with the SEE countries not too far behind. Estonia, for instance, has fully privatized its railway system, and network maintenance is carried out privately in the Czech Republic, Poland, and Romania. With few exceptions, such as Russia and Kazakhstan, the CIS countries have, by far, done the least to improve the policy framework for such services. Reforms in road transport are lagging behind the railway sector in most countries of the Region and private sector participation remains limited. Only some EU-8 and SEE countries, such as Croatia, Hungary, and Poland, have introduced private sector participation through toll roads. Success, however, has been mixed so far due to traffic diversion to alternative roads and high risks associated with private investment. Toll-based concessions in Hungary have therefore been converted into payments to the private investors via the public budget. This transfers traffic risk back to the state while maintaining the character of the public-private partnership.

The incentive to adhere to international trade commitments, especially the EU *acquis*, has been a key driver in bringing about behind-the-border liberalization and deregulation of the services sectors in the Region. Indeed, for the EU accession countries, the *acquis* sets a relatively strict policy framework for acceding countries to abide by in a short time with little flexibility. In contrast, countries without the prospect of EU accession have made much less progress on liberalization of services trade and FDI regimes, thereby lowering growth prospects. Emulating the liberalization that has been implemented by the other countries in the Region is therefore a priority, all the more so as the environment for FDI and investment generally is now much more competitive than it was at the beginning of the transition.

The WTO's General Agreement on Trade in Services (GATS) can be used as a substitute instrument to drive services reform. However, the evidence to date suggests that the countries that have joined the WTO have not made significant commitments on services. Moreover, WTO membership is not sufficient, in part because the disciplines currently imposed by the WTO are relative weak, relying on dispute settlement for enforcement. Most of the countries concerned are too small to make this attractive. The result is that the burden of reform of the services sectors falls squarely on individual governments. However, deeper regional cooperation among countries, as is beginning to occur in transport and energy in SEE, could help reduce implementation costs and increase the benefits of regulatory reform.

Overall, pursuing services sector reforms in the Region in parallel with merchandise trade liberalization and trade facilitation will facilitate entry by new firms and generate employment opportunities for both skilled and unskilled workers who currently may be employed by the public sector or in import-competing private manufacturing, or who are unemployed. Because certain services cannot be traded, despite the increasing impact of the Internet, obtaining access to new technologies and products by necessity must involve FDI in services. Many countries in the Region have proceeded to liberalize their FDI policy regimes to this end, but prevailing policies in many countries outside the EU-8 continue to be unduly restrictive.

Conclusion: Policy Agenda, Reform Linkages, and Action Plan

Market opportunities for trade in the world economy will no doubt continue to grow for the countries of Eastern Europe and the Former

Soviet Union as the transition process in the Region continues. But as the international economy continues to globalize, market competition from other regions in the world will only become stronger. This poses a challenge to the Region's countries' abilities to use trade and international integration as an engine for growth and the reduction of poverty.

Absent policy reforms, the differences in the present pattern of international integration within the Region could continue for the foreseeable future. So, too, could the countries' prospects for economic growth and prosperity, with the attendant emergence of a bifurcated region—punctuated by a bloc of relatively wealthy countries and a bloc of relatively poor countries. But the formation of the second bloc is not inevitable. Experience in the Region to date, as well as in other regions of the world, shows that success in this environment requires a *combination* of not only implementing sound, market-based trade policies and trade-related related institutions, but also establishing a strong, complementary behind-the-border incentive framework in the domestic sphere.

To this end, the study of which this *Overview* is a part develops a detailed set of such policy recommendations. Below, the principal recommendations that deserve priority attention are outlined, as well as linkages among the reforms and how they might best be sequenced in their implementation. The division of labor for the responsibilities of the various stakeholders with policy-making roles in furthering the Region's transition is identified, as is an action plan. A one-page Policy Matrix that summaries this information is found at the end.

Priority Policy Recommendations

Priority Trade Policy Reforms

- *WTO accession is a critical policy objective for the 10 countries in the Region that are not yet members.* Many countries in the Region—especially in the CIS and SEE—must *address the challenge of how to rationalize the large number of existing bilateral FTAs* and to *broaden them to include such matters as trade facilitation as well as liberalization of services*.

- In a few countries—notably in the CIS—trade is restricted by high average tariffs and nontariff barriers (NTBs). *These should be appreciably reduced over the medium term*.

- In several other countries, there is still a large gap between "bound" and "applied" tariff rates: *all tariffs in the Region should be bound closer to the level of applied tariffs*. Not doing so undermines the economic effectiveness of commitments already made in trade agreements.

- *Tariff regimes also should be simplified and the structure of rates reduced* *in dispersion*. This will make customs administration more transparent and improve the predictability of the trade policy regime. It will also reduce opportunities for discretionary behavior and incentives for corruption.

- Reforms are needed to reduce the bias in investment decisions across sectors and reduce disincentives for greater product diversification. To this end, *the widespread practice of discrimination against export activities that exists in many countries of the Region should be eliminated*.
- To improve market access, reforms are needed in developed countries' *extensive use of "nonmarket"-designated antidumping actions against the Region's economies*, as well as in their *protectionist agricultural policies.*

Priority Behind-the-Border Reforms

Enhancing Competition and Governance

- The Region's governments should work toward *eliminating fundamental economic and policy barriers to new business entry, especially structural conditions that engender a lack of or weak competition among businesses.*
- *Barriers to exit of commercially nonviable firms also need to be eliminated*, through reducing subsidies and eliminating the practice of tolerating arrears (with the government, banks, and among firms).
- *Competition authorities should be given greater authority and competencies to assess, penalize, and, if necessary, remedy dominant firm structures, as well as other forms of restrictive business practices, such as collusion, anticompetitive mergers and acquisitions, and predatory pricing.*
- Improving governance will require efficient institutions that facilitate effective resolution of commercial disputes. *Policies aimed at the simplification and cost reduction of formal legal procedures as well as bolstering out-of-court mechanisms will strengthen contract sanctity and property rights and improve the level of investor confidence in the Region*.
- Sound governance will also require mechanisms to ensure *greater transparency and accountability of public officials' conduct*.

Improving Trade Facilitation

- In trade facilitation institutions, the priority reforms are *to improve coordination among agencies, both within and across countries; simplify customs procedures; make customs codes and associated regulations, rules-based, transparent and commercially oriented, with proper incentives for employees; and introduce the use of IT into customs systems*.

- As to further development of trade-related infrastructure, the critical areas for improvement are *modernization of ports and IT capacity*. *Meeting this challenge will require continued privatization or private-public partnerships* to entice new investments.

Liberalization of Services Sectors

- *Deregulation of services* should be the rule rather than the exception, and include the implementation of market-reinforcing reform of regulatory procedures and rules, including rate levels and structures. Where regulation is warranted, *independent regulatory authorities* with the proper competencies and resources should be established.
- *Territorial restrictions or other artificial barriers to competition either within a services sector or across services sectors, for example for intermodal competition, should be eliminated.*
- *Private participation in the provision of services*, either through greenfield investment or privatization of incumbent providers should be encouraged. This will require reductions in or elimination of limits or prohibitions on trade and private investment (whether from domestic or foreign sources) in network services.
- Deeper cooperation between the countries in the Region, such as in *regional approaches to deregulation (or more efficient regulation) of utility services*, could help reduce implementation costs and increase the overall benefits of regulatory reform.

Enhancing Intraindustry/Network Trade through Greater FDI

- The policy regime governing FDI should be *brought in line with international best practice,* which typically includes (i) adhering to "national treatment" for foreign investors; (ii) prohibiting the imposition of new, and the phasing out of existing, trade-related investment measures (TRIMs), for example, local content measures; and (iii) providing for binding international arbitration for investor-State disputes.
- Actions should be taken that ensure *transparency, predictability, and consistency of the FDI policy framework across different levels of government* and different industry sectors.

Fostering Resource Flexibility in Markets

- To reduce poverty impacts from changes in prices and outputs engendered by trade flows, measures should be implemented to *promote labor mobility* (for example, enhancing wage differentiation and adaptability and improving the effectiveness of social safety nets) *and to facilitate the reallocation of capital* so as to encourage new investment and job-creating opportunities.

Linkages Between and Sequencing of Reforms

- Many of the *policy reforms are mutually supportive and reinforcing.* Their implementation should capitalize on these linkages. For example, further tariff reform will enhance import competition, which in turn improves efficiency and increases export penetration.
- *Some policy actions can be done in the short term.* These include, for example, increasing Technical Assistance (TA) for institutional capacity building in the poor CIS countries.
- *Other reforms require balancing "winners and losers" or the marshaling of significant resources. These necessarily can be implemented only in the medium term.* For example, a few powerful vested interests will stand to lose from competition as liberalization in certain services sectors takes place and these losses must be balanced against the diffused gains enjoyed by the public. Investment in the modernization of ports will require large amounts of capital resources.
- *Sequencing of reforms can be critical, not only for their proper implementation, but also to build public support for the reform program and to maintain its momentum.* For example, steps should be taken to enhance labor mobility and strengthen social safety nets while liberalizing imports, or regulatory reform and strong competition policy institutions should be established as services sectors are liberalized.

Division of Labor among Stakeholders

What the Developed Countries Can Do

- Improve market access for many of the Region's countries' agricultural products through reform of the EU's Common Agricultural Policy (CAP) program and of other related Organisation for Economic Co-operation and Development (OECD) programs; rationalizing the Generalized System of Preferences (GSP) program.
- Change the "nonmarket" designation for several of the Region's countries—primarily in the CIS—in enforcement of antidumping (AD) policies to reduce excessive, protectionist use of AD procedures.

- Facilitate WTO accession for current non-Members. The CIS countries have fewer trade preferences from the EU, for example. However, the solution is not enlargement of the number of such preferences. Rather, it is for these countries to liberalize multilaterally through WTO accession and thus enjoy the benefits of "most favored nation" (MFN) treatment.

What the International Community (Donors and International Organizations) Can Do

- Many countries in the Region, apart from the EU-8 and the two EU accession and EU candidate countries, are in need of technical assistance and capacity building to strengthen trade-related institutions and policy implementation and management, for example, in customs regimes; in WTO and EU accession; in the harmonization of regional trade agreements (for example the 29 bilateral FTAs in SEE); in competition policy; and in governance reform.
- Special attention for TA should be paid to the poor countries in the CIS, which "fall through the TA cracks." Because they are neither classified as "least developed countries" nor have realistic prospects for EU accession, they are often overlooked in qualifying for such assistance.

What the Region's Governments Can Do

- Virtually all of the remainder of the reform agenda will largely depend on the implementation efforts of the Region's countries themselves.
- In the area of trade policy, this would include tariff reductions; termination of NTBs; elimination of disincentives to exporting; pursuit of WTO accession; and rationalization, harmonization, and modernization of existing RTAs.
- The more challenging tasks will be the vigorous implementation of economywide behind-the-border reforms to: enhance competition and governance in domestic markets and foster greater flexibility in labor and capital markets; improve trade facilitation infrastructure and institutions; liberalize the services sectors and reform of associated regulation; and improve the climate to attract FDI.

SUMMARY OUTLINE OF PRIORITY POLICY RECOMMENDATIONS

Region's Subregion*	REFORM AREAS I. Trade Policy Regime		
	Reform	Principal Responsibility	Term
EU-8	As part of EU WTO negotiation objectives, push proactively to reduce global trade barriers in manufacturing, services, and agriculture in Doha Round	EU-8 governments	S/M
SEE	Bosnia and Herzegovina and Serbia and Montenegro: pursue WTO accession vigorously	BiH/SaM governments	S/M
	Bulgaria, Croatia, and Romania: align tariffs with EU/pursue EU accession vigorously	BG/CR/RM governments	S
	Bind *all* tariffs at applied levels	SEE governments	S
	Eliminate remaining NTBs; also policies that create anti-export bias	SEE governments	S
	Rationalize, consolidate, and modernize 29 bilateral FTAs	SEE governments, w donor TA	S
	Strengthen regional cooperation on Trade and Transport Facilitation (TTF) utilization (for example, customs)	SEE governments, w donor TA	M/L
CIS	AZ, BEL, KZ, RU, TAJ, TKM, UKR,UZ: pursue WTO accession vigorously	Named CIS gov'ts w donor TA	S/M
	Non-WTO members: appreciably reduce tariffs; bind at applied levels; simplify tariff design; and reduce dispersion of rates	CIS governments	S
	Eliminate NTBs; also policies that create anti-export bias	CIS governments	S
	Rationalize, consolidate, and modernize CIS/CAR (Central Asian Republics) RTAs and bilateral FTAs	CIS governments w donor TA	S/M
	Establish mechanism for regional cooperation on TTF development and utilization	CIS governments w donor TA	M/L
	Reform of nonmarket antidumping designation and reduce protectionist policies (for example, in agriculture)	EU, OECD, other governments	S

	II. Behind-the-Border Policy Regime		
	Reform	Principal Responsibility	Term
EU-8	Continue to strengthen competition policy agencies' competencies and resources; focus on anticompetitive conduct (for example, mergers, pricing)	EU-8 governments	S/M
	Continue to improve judicial-legal institutions to protect property rights and resolve commercial disputes and public administration reform to reduce corruption	EU-8 governments	S/M
	Continue modernization of TTF infrastructure	EU-8 governments	S/M
SEE	Increase removal of economic and policy barriers to entry and exit (for example, subsidies; arrears)	SEE governments	S
	Strengthen competition policy agencies' competencies and resources; focus on anti-competitive structures (for example., dominant firms) as well as on conduct (mergers; pricing)	SEE governments	S/M
	Ensure public procurement is transparent and open to foreign competition	SEE governments	S
	Improve judicial-legal institutions to protect property rights and enhance public administration reform to reduce corruption	SEE governments w donor TA	S/M
	Implement reforms for greater labor and capital mobility to enhance flexibility in factor markets (for example, wage-setting rules/social benefits/pension and corp. governance)	SEE governments	S
	Further develop TTF infrastructure (esp. ports and IT applications to customs)	SEE governments	S/M
	Cont. reg. reform, public-private partnerships, privatization/liberalization of services	SEE governments	S/M
	Establish mechanisms for regional cooperation in infrastructure/services regulation	SEE governments	S/M
	Improve FDI policy regime to comport w. int'l. best practice (for example, national treatment)	SEE governments	S
CIS	Systemic removal of economic and policy barriers to entry and exit (for example, subsides; arrears)	CIS governments	S
	Establish modern bankruptcy/insolvency institutions, including judges, trustees	CIS governments w donor TA	M
	Build independent competition policy agencies w. political teeth, legal basis, adequate competencies/resources: focus on anticompetitive structures as well as conduct	CIS governments w donor TA	M
	Establish judicial and legal institutions to protect property rights and resolve disputes	CIS governments w donor TA	M
	Reform public administration system to reduce corruption	CIS governments w donor TA	M
	Open up public procurement to competition—private domestic and foreign vendors	CIS governments	S
	Develop and implement reforms for labor and capital mobility for flexible factor markets (for example, reform wage-setting rules/social benefits/pension and corp. governance)	CIS governments	S
	Develop TTF infrastructure (esp. ports and IT applications to customs) and institutions	CIS governments	M
	Establish independent regulatory agencies; liberalize/deregulate services sectors	CIS governments w donor TA	M
	Privatize "nonstrategic" services sectors (for example, telecom, transport, energy, banking)	CIS governments	S
	Reform FDI policy regime to comport w. int'l. best practice (for example, national treatment)	CIS governments	S

Note: * Summary policy recommendations do not necessarily apply equally to all countries in each group. S=short-term (1-2 yrs); M=medium term (3-5 yrs); L=longer term (5-10 yrs). AZ = Azerbaijan; BEL = Belarus; BiH = Bosnia and Herzegovina; FDI = foreign direct investment; FTA = free trade agreement; IT = information technology; KZ = Kazakhstan; NTB = non-tariff barriers; OECD = Organisation for Economic Co-operation and Development; RTA = regional trade agreement; RU = Russian Fed.; SaM = Serbia and Montenegro; TA = technical assistance; TAJ = Tajikistan; TKM = Turkmenistan; UKR = Ukraine; UZ = Uzbekistan; WTO = World Trade Organization.

Notes

1. In addition to the 27 countries of Eastern Europe and the Former Soviet Union in (various stages of the) "transition" from Communism to capitalism specified below—which we define as "the Region"—the analysis in this monograph also covers Turkey. This coverage is done to be consistent with the World Bank Group's organizational definition of the "Europe and Central Asia Region" (ECA), which includes the full set of 28 countries. Therefore, when we use the term "Region" or "Transition countries," we are referring only to the group of 27 countries, and when we use the term "ECA" we are referring to all 28 countries.
2. Unless otherwise indicated, the most recent data cited pertain to year-end 2003. International Monetary Fund 2004.
3. See chapter 3.
4. Systematic cross-country analyses of international trade in the transition economies of Eastern Europe and the former Soviet Union have been surprisingly few in number (see, for example, EBRD 2003). This study contributes to the small stock of knowledge in several ways. First, the country coverage in the analysis is comprehensive, and is based on the most recent and complete trade data available for the entire Region. Second, previous studies of the Region's international integration have given only relatively limited attention to assessing behind-the-border institutions and how they interact with trade policies to affect the process of transition and the prospects for growth. Third, although the study's findings on whether or not the Region is overtrading or undertrading relative to countries in other regions mirror earlier assessments, the evidence presented that two trade blocs appear to be emerging is a new insight. Finally, the policy recommendations developed in this study are more comprehensive and given greater specificity than heretofore has been the case in analyses of this kind.
5. The statistical analysis undergirding this point is presented below.
6. The EU-8 are the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, the Slovak Republic, and Slovenia.
7. SEE comprises Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, and Serbia and Montenegro. Kosovo, although part of Southeastern Europe, is not covered in the analysis.
8. The CIS includes Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, the Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.
9. It is important to bear in mind that the data for the pre-1993 period are necessarily fraught with imperfections and based, in large part, on estimates precisely because market valuations were not made during that period.
10. In comparison, over the same period, exports and imports for the EU-15 roughly doubled; in Latin America and the Caribbean, exports rose two and one-half times while imports doubled, and in East Asia, exports and imports doubled.
11. Trade and investment in services are the focus of chapter 6.
12. With respect to the factor composition of the Region's merchandise imports, roughly the same broad dichotomy holds, but the differences across the country groupings is less significant.

13. This conclusion draws from data in chapter 4, which focuses on competition and governance.
14. The scatter plot indicates a positive association between greater international integration and less (perceived) corruption. These results are bolstered by multivariate regressions that indicate this positive association remains statistically significant even when the level of a country's development (measured by GDP per capita) is taken into account.
15. Chapter 5 focuses on trade facilitation and logistics.
16. Globally, the many industries where major parts of a production process have been internationalized include television and radio receivers, sewing machines, calculators, office equipment, electrical machinery, power and machine tools, typewriters, cameras and watches, among others.
17. Global production sharing and network trade are the focus of chapter 7.
18. Trade openness is calculated using GDP in purchasing power parity (PPP).
19. We also assess the Region's countries' trade performance based on the specific destination and origin of trade flows bilaterally (see below).
20. We note the likely critical role of institutional and policy factors as determinants of trade performance *apart* from income. Indeed, our estimation methodology employs an approach that uses institutional variables to combat endogeneity problems. The empirical analysis presented her draws from chapter 2.
21. These results are in line with earlier statistical analysis of the determinants of openness for the CIS countries alone by Freinkman, Polyakov, and Revenco, 2004. Statistical analysis carried out by the EBRD, 2003 on most of the Region's countries yields roughly similar conclusions to those of this study with respect to the CIS and SEE countries. However, the EBRD analysis does not find evidence of overtrading by the EU-8.
22. See Bergstrand 1985; Helpman and Krugman 1985; Deardorff 1997; and Feenstra, et al. 2001 for different theoretical justifications of the gravity model.
23. See Wang and Winters (1991), Hamilton and Winters (1992), Baldwin (1994), Frankel (1997), EBRD (2003), and Freinkman et al. (2004).
24. Over the 1990s, the proposition that trade openness is good for economic growth was advanced by a number of cross-country studies (Sachs and Warner 1995; Edwards 1998; Dollar and Kraay 2001). But the findings of some of these studies have been subjected to serious criticism: restrictiveness of trade policy is difficult to measure and the openness indicators used to show links to growth are not good proxies for trade policy. Institutional development, in a broad sense, has been proposed as a factor that explains both trade and output growth (Rodriguez and Rodrik 2001). Experience has shown that in the long term, countries need an open economy to sustain growth. But developing country experience has shown that, for a time, countries have expanded their exports and trade under different kinds of trade regimes. Some, like China, the Republic of Korea, and Taiwan (China), have done so under complex trade regimes that provided extensive import protection while at the same time providing very substantial stimulus to export industries. Successful implementation of such complex policies involving both import protection and

stimulus to exports places great demands on foreign trade policy design and trade institutions, which few developing or transition countries can meet (World Bank, 2002d). Others, like Chile, Hong Kong (China), and Singapore, have expanded exports while maintaining a very liberal regime on imports. Still others, like Mauritius and El Salvador, have used export processing zones to stimulate growth in trade, while maintaining substantial import controls.

25. World Bank 2005b and World Bank 2000b.
26. World Bank 2005b.
27. See Rutherford, Tarr, and Shepotylo 2004; Porto 2004a; Csaki et al. 2000; Csaki et al. 2002.
28. See, for example, Winters et al. 2004.
29. See, for example, IIED 2004; World Bank 2003c; Nicita 2004; Chen and Ravallion 2004.
30. The analysis is reported in chapter 4.
31. Importantly, these data show that the majority of such subsidies come from regional or local, rather than central, governments, making the task of their reduction more challenging.
32. The *acquis* is the body of EU legislation that candidate countries must adopt to become EU members.
33. Wilson, Mann, and Otsuki 2004.
34. Wilson, Luo, and Broadman 2004 which serves as the basis for the empirical core of chapter 6.
35. The EU-8 countries, the four EU candidates, and FYR Macedonia, Russia, Serbia and Montenegro, and Ukraine.