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Chapter 6

THE EUROPEAN UNION AS DETERMINANT OF CROATIAN TRADE POLICY

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ABSTRACT

This paper identifies the degree to which the Republic of Croatia is prepared for EU integration in the area of trade and trade policy. According to a comparative analysis of the extent of integration into the European market, of Croatian trade policy and the policies of applicant countries, as well as of the conditions placed before the applicants by the EU, and the specific features of the EU trade regime, we determine where Croatia is relative to the other applicants. The next section identifies the key measures that need passing in the Republic of Croatia for adjustment to the EU and its trade institutions and to facilitate the free movement of goods between Croatia and the EU. The conclusion is that during the transition period, the reforms necessary for joining the EU were not carried out, and that progress is slower than in the other applicant countries. However, since Croatia started the EU convergence process at a higher level of development than some of the applicants, this lagging behind in the preparations for accession have not entirely wiped out the “first-mover” advantages of Croatia. The question arises, however, as to whether these will completely disappear with the first phase in the imminent enlargement of the EU.

Key words:

Croatia, EU, WTO, trade, tradepolicy, natural trading partner

INTRODUCTION

The focus of this paper is on the impacts of EU-related factors on trade policy in the Republic of Croatia. This impact will be gauged by an analysis of the intensity of Croatian trade and integration into the EU, by an analysis of the adjustment of Croatian trade policy and regulations for the purpose of preparation for association, and an identification of the specific features of the EU trade regime with third countries. The paper starts with a determination of the criteria for EU membership, and a review of the level to which these criteria are met in the Republic of Croatia. On the basis of this review, which, to the extent possible, is founded on quantitative indicators, the initial situation in Croatia with respect to the EU is determined, i.e., how much Croatia meets those conditions for membership that relate to trade policy. The identification of the current situation serves as a point of departure for an analysis of the further preparations of the Republic of Croatia for joining the EU, primarily those capable of enabling the free movement of goods between Croatia and the EU, and adjustment with the EU trade regime with third countries. And then based on this analysis, we identify the factors that are slowing down integration of the Republic of Croatia into the European market and follow this up with recommendations for those responsible for trade and economic policies in the country.

TRADE POLICY AND CRITERIA FOR MEMBERSHIP IN THE EU

A trade policy is the system of laws, regulations, international agreements and negotiating positions that some state applies in order to be able to provide a legally binding market approach for domestic producers. The trade policy of each country is always, by definition, nationalistic, because the foreign product or producer is always discriminated against for the benefit of the domestic. One of the important tasks of the international trade system (GATT/WTO) is to minimise and forestall the uncontrolled employment of the discriminatory trade

policies of given countries. For this reason, member states of WTO do not have full freedom from the point of view of formulating their own trade policies, but have to follow the principles, rules and obligations agreed upon among member countries and translated into agreements.ⁱ These agreements, of course, do allow every state to a certain extent to respect distinct national (social and economic) interests.ⁱⁱ This goes for both the Republic of Croatia and for the EU. Thus the trade policy of the EU (ever since its origins in the Treaty of Rome) has been guided by: a) the need to accept GATT/WTO rules; b) the need to satisfy the objectives of common policies at EU level (such as the CAP); c) the need to replace the long-term non-existing common foreign policy; d) the need to satisfy the general goals of EU growth and development (including the narrower goals of protecting employment and economic structure). Similarly, Croatian trade policy is given shape within the context of the restrictions that are laid down by membership in the WTO and in regional trade agreements, and by its expressed intention to join the EU.

Trade integration into the EU and a specific kind of trade policy are not imposed as economic conditions for membershipⁱⁱⁱ, but do serve as elements for an evaluation of the level of preparation for membership in line with the methodology developed by the European Commission in the document *Agenda 2000* (European Commission, 1997). Through this methodology, the Commission regularly, once a year, monitors the level to which applicants have met the membership criteria and their progress.^{iv}

Price and trade liberalisation, the existence of a legal system, sustainable public finances and external accounts are some of the indicators according to which the first economic criteria about the establishment of an effective market economy in an applicant country are evaluated.^v

The other economic criteria are a developed capacity to cope with competitive pressures and market forces within the Union. Meeting this criterion requires a minimum level of competitiveness in the main economic sectors of the candidate country. It means, among other things, the existence of an effective market economy; appropriate measures of government policy and legislation to stimulate competitiveness (trade policy, competition policy, state aids, support for SMEs), and the degree and the pace of trade integration a country achieves with the Union before the enlargement (the volume and nature of traded goods).^{vi}

CONVERGENCE OF CROATIA WITH THE EU: ILLUSION OR REALITY

The remainder of this paper will analyse three groups of factors that are crucial in finding answers to the question posed in this heading. First is an analysis of the quantitative indicators of the degree of Croatian integration into the EU market. After that the formal, institutional indicators of the effects of trade and general economic policy are analysed: price and trade liberalisation, the existence of a system of trade laws and the implementation of adjustments for access to the single internal market. These indicators are selected in line with the methodology that is used by the European Commission in its Regular Reports on candidates' progress towards accession (see for example European Commission, 2002b); they are also defined as key areas for the implementation of the SAA (see for example Vlada RH, 2002, European Commission, 2002e).

The third group of factors that might reflect Croatia's degree of preparation for membership relates to other elements of the trade regime of the EU towards third countries and a comparison with the Croatian regime.

Trade integration

The EU is the most important trade partner of Croatia – 54% of the total foreign trade of the Republic of Croatia is with member states (Figure 1 and Table 1). However, the share of imports from Croatia in total EU imports in the transitional period (1993-2000) fell from 0.4 to 0.2%, without any sign of improvement in the structure and scope. The structural change index for Croatian exports altered less than in the applicant countries (Table 2), and it is still mostly textile and chemical products that are exported. The value of exports to the EU rose by 12.4%, while that of imports almost doubled, which led to a rise in the bilateral trade deficit (Figure 1).

Figure 1. Croatian imports and exports, 1993-2001 (billion USD)

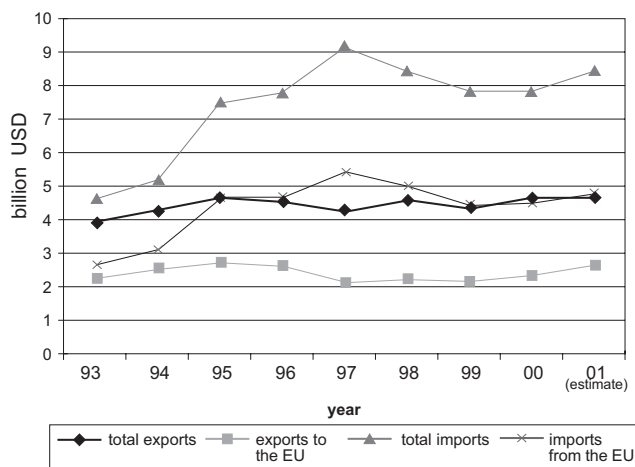


Table 1. Croatian imports and exports, 1993-2001 (billion USD)

	1993	1994	1995	1996	1997	1998	1999	2000	2001 (estimate)
Total exports	3.9	4.3	4.6	4.5	4.2	4.5	4.3	4.6	4.6
Exports to EU	2.2	2.5	2.7	2.6	2.1	2.2	2.1	2.2	2.5
Total imports	4.7	5.2	7.5	7.8	9.1	8.4	7.8	7.8	8.4
Imports from EU	2.6	3.1	4.7	4.6	5.4	4.9	4.4	4.4	4.7

Source: DZS, 2002.

Volume of trade, i.e., the changes in market share, structural changes of an export sample and the redirection of exports towards more demanding markets are some of the indicators that are used to measure the level of competitiveness. Since the share of Croatian products in the EU markets is falling (see column 4 of Table 2), and the structure (column 2 of Table 2), or the size is not taking a desirable direction (Table 1 and Fig. 1) it can be concluded that the competitiveness of Croatian products in the EU market is diminishing too, which necessarily weakens the degree to which Croatia meets the membership criteria.

As against this, the countries of CEE have increased their shares in total EU imports, from 7.8% to 13%, they have changed the structure of exports (Table 2), i.e., increased their ability to meet the com-

petitive pressures on the EU market and have thus come closer to meeting membership conditions. For example, Hungary, which in the last Commission reports was placed among the most successful applicants, increased its exports to the EU from 4.9 billion euros in 1993 to 24.2 billion euros in 2001. Alongside volume, the nature of trade is also a measure of trade integration with the EU. Thus more vigorous intra-industry trade in products with a high degree of value added is an indicator of similarity of productive structures (Landesmann, 1995), and is followed with fewer troubles (lower adjustment costs) when a country joins the EU. For this reason, the extent to which total trade is based on intra-industry trade can be considered to indicate a higher level of satisfying the conditions for membership. The level of intra-industry trade can be estimated by the Grubel-Lloyd index.^{viii} According to this indicator, Croatia can be considered comparable with the second round of applicants (see column 3, Table 2).

Table 2. Selected trade indicators^{vii}

Candidate country	EU export structural change index	Grubel-Lloyd index (%)	Exports to the EU as a share of total EU imports (%)		Imports from the EU as a share of total EU exports (%)		Relative trade balance (%)
			1993	2000	1993	2000	
	1994-1998	1998					2000
Hungary	5.3	73.37	1	2.4	1.4	2.4	-6.20
Poland	4.3	49.63	1.8	2.6	2.4	3.6	-21.16
Estonia	0.8	45.86	0.1	0.3	0.1	0.3	-13.45
Slovenia	1.1	71.93	0.7	0.6	0.8	0.9	-6.20
Czech R.	4.6	70.13	1.2	2.5	1.5	2.8	-9.24
Bulgaria	0.7	40.77	0.2	0.3	0.3	0.4	14.27
Latvia	0.5	26.78	0.2	0.2	0.1	0.2	-26.14
Lithuania	0.6	30.23	0.1	0.3	0.1	0.3	-8.76
Romania	1.7	35.88	0.4	0.9	0.5	1.1	-11.48
Slovakia	2.0	60.79	0.3	0.8	0.3	0.8	-10.86
Macedonia	-	24.46	0.1	0.1	0.1	0.1	-22.48
BH	-	23.61	0.007	0.05	0.02	0.12	-58.95
Albania	-	36.85	0.02	0.03	0.1	0.1	60.27
Croatia	0.5	36.85	0.4	0.2	1.8	0.5	-30.77
FRY	-	-	0.0004	0.1	0.01	0.02	-52.34

Source: COMEXT, 2002

In its trade with the EU, Croatia has a relative trade deficit larger than all the applicants. The Czech Republic, Hungary and Slovenia have relative trade deficits comparable with the EU overall trade deficit^{ix}, while the indicators for Croatia are comparable with Latvia, and just somewhat better than the other countries of the western Balkans (see column 6 in Table 2).

At the same time, the applicants have mainly increased their shares in the EU market, the increase being correlated with a change in export structure (columns 4 and 2 of Table 2) and with the level of intra-industry trade. Commission reports show a strong positive correlation between change of export structure and level of GL index on one hand and applicant progress on the other. As for Croatia, its market share has dropped, export structure has remained unchanged, and its exports are less differentiated than in the more advanced applicant countries. It is mainly traditional, labour-intensive products with low value added that are exported from Croatia to the EU (textiles, timber, wood products and so on).

In accordance with this it can be concluded that our progress towards satisfying the criteria for membership is very meagre and that Croatia is at the level of the less advanced applicants.

Other indicators, for example openness indicators, also lead to the same conclusion about Croatian non-convergence with the EU. In line with the traditional theory of international trade, openness implies rationalisation of the productive system and enables optimal resource allocation, and suggests a potential for rapid growth and restructuring. Total trade as a proportion of GDP [(export + import)/GDP] is one of the indicators of the degree of openness of an economy. Other applicants mainly show a high degree of openness, which also has a tendency to rise, while the degree of openness of Croatia is comparable with that of Romania and Poland (Table 3). The signs of a rise in openness and of other indicators (which could not have been encompassed by this paper) in 2000, may indicate that stagnation has ended and reform started.

Table 3. Degree of openness of Croatia and some other applicant countries, 1997-2001 (%)

	CRO	LIT	LAT	EST	BUG	POL	ROM	SVK	SLO	HUN	CR
1997	65	120	111	168	112	55	65	122	116	91	119
1998	59	112	116	170	94	62	53	129	115	103	119
1999	60	99	98	159	95	59	61	126	109	109	123
2000	69	95	100	192	117	66	72	146	122	127	143
2001	-	102	101	185	119	63	75	161	121	123	145

Source: Calculated by A. B. according to DZS (2002) and DG Trade (2002)

Is the EU a natural trade partner for Croatia?

According to the basic idea of the “theory” of natural trade partners, regional trade liberalisation among countries that are “natural” trade partners will not lead to any considerable “trade diversion”.^x A natural trade partner is defined as that with which some country (Croatia, for example) has ample bilateral trade without there being any trade policy incentives. Hence it is necessary to define the determinants that enable a large volume of trade among countries. For an analysis of the volume of trade, the so-called gravity model is used. This model, by the simplest specification, explains the volume (and geographical structure) of the bilateral trade flow for a given country (or region) with different partners, using a series of explanatory variables: a) GDP or per capita GDP of the trade partner countries, b) trade barriers such as transport and other *trading costs* (defined by the distance between the countries), and c) factors that foster trade, such as a common border, common language, common legislation and so on.

By testing the gravity model^{xi}, however, it is impossible to determine with a high degree of confidence that geographical closeness or distance is a key variable in determining the natural trade partner. Accordingly, when the Republic of Croatia decides on trade liberalisation with the existing regional blocs, the crucial factor in the choice of bloc to which one ought to open up cannot be distance but the economic strength of the bloc itself. The higher level of GDP in EU members than in members of CEFTA and the western Balkans shows that the EU is the regional bloc with which liberalisation of trade would lead to a greater increase of national prosperity. What is more, with EU enlargement, this partner will become still more natural.

Institutional indicators of convergence

Price liberalisation

The use of administered prices in Croatia is limited to agricultural products, energy and transport. This level of price liberalisation, according to the criteria of the European Commission, is considered advanced, and is comparable with applicant countries that meet the criteria for the existence of an effective market economic (European Commission, 2002e).

Trade liberalisation

Liberalisation of trade in the Republic of Croatia to date is a reflection of membership in the WTO and the conclusion of free trade agreements (bilateral^{xiii} and with EFTA) and the intention to join the EU.

By joining the WTO, Croatia bound itself to gradually reduce its customs duties on industrial and agricultural products to the level that is applied in OECD countries by the year 2005. Export and quantitative restrictions or measures that have a similar effect have been abolished.

Trade with the EU is regulated by the Interim Agreement that enables application of the commercial provisions of the SAA until the process of ratification is completed. The Interim Agreement contractually regulates trade preferences somewhat more favourably than those that were applied to Croatia from the collapse of the SFRY onwards. That is, the institutional links between Croatia and the European Community were regulated up to 1992 by the same instruments that were joining the SFRY and the Community. Pursuant to the Cooperation Agreement Croatia had preferential access to the market of the European Community, and also a preferential position vis-à-vis other states in the region (cf. Samardžija, 1994; 160-169).

According to the currently valid Interim Agreement, Croatian industrial products, all processed agricultural products, apart from wine, baby-beef and beef products, have duty-free access to the EU market without any quantitative restrictions. Croatia bound itself to liberalise access to its market gradually, over a period of six years; since 1 January 2002, about 77% of trade in industrial products has been liberalised; trade in textile and steel products will gradually be liberalised by 1 January 2006, and by 1 January 2007 trade in all other industrial products. With respect to agricultural products, 75% of the trade will be liberalised by 1 January 2006, 41% by the abolition of customs duties and 34% by preferential treatment covering traditional trade. By the end of the transitional period, trade in processed agricultural and fish products will have been totally liberalised (European Commission, 2002e).

States that are applicants for membership liberalised their trade with the EU in line with the provisions of the Europe Agreements by 1 January 2002. To reach this level of integration with the EU, in line with the provisions of the SAA, Croatia will need another five years.

Along with liberalisation of trade with the EU and attempts to enter CEFTA, Croatia has bound itself to join in regional free trade zones in the west Balkans. The establishment of regional cooperation

became a standard provision of agreements between the EU and third countries (e.g., the European Agreements, the Euro-Mediterranean Agreements concerning associated membership, the Cotonou Convention^{xiii}, for more see below). This form of cooperation was achieved by applicants by the creation of CEFTA, and completion of negotiations about a free trade agreement with FRY and Albania is awaiting Croatia, and perhaps the making of the bilateral free trade agreements multilateral.

The system of trade laws

The basis of the EU is a single market, in which, in conditions of free competition, there is a free movement of goods, services, capital and people. Hence, for convergence with the EU, application of the rule of market competition on the one hand, and transparent, limited state aid on the other, are crucial. Like the states of CEE, Croatia is faced with difficulties in the establishment and implementation of a legislative and institutional framework necessary to set up an effective market economy.

According to the provisions of the SAA (Article 70), in the trade relationships between the EU and Croatia, the rules of market competition and state aid according to Union legislation will be applied. Most applicants, in this area, have to develop or adjust their rules about the allotment of state aid and step up provisions for the prevention of the restriction of competition and the abuse of a dominant position on the market. For the sake of a satisfactory implementation of the SAA, Croatia ought by the end of 2002 to have set up an independent agency for state aid, and an agency for the protection of market competition should have been expanded and be able to control mergers.

Preparation for integration into the internal market

Since through the Europe Agreements the applicants set up free trade zones with the EU, further liberalisation measures mainly relate to integration into the single European market. Future measures will relate to the abolition of border non-tariff barriers: physical, technical and fiscal. The further integration of candidates takes for granted the adjustment of economic policy with that of the current member states and the acceptance of the standards and rules of the Union (the *acquis*).

Gradual adoption of EU legislation in the area of standardisation, metering, certification and accreditation is an obligation that Croatia took upon itself by signing the SAA. The State Bureau for Standardisation and Metering, in cooperation with the Ministry for European Integration and the Legislation Office, is drawing up a national strategy for the adoption of the technical legislation, while the application of standards is not obligatory.

It took Austria, Sweden and Denmark three years before joining the EU to adopt measures of this kind (Baldwin; Francois, Portes, 1997).

EU trade policy

The current common trade policy of the Union is mostly beyond the control of the member states (although the effects of the policy have of course a direct effect on their economies).^{xiv} Following the principle of creating “an open market economy with free market competition” the policy has a different effect on the member economies with different economic structures and various degrees of dependence on trade with the world (for more detail, cf. Messerlin, 2001). The common trade policy can be analysed from several aspects: the level of protection that is afforded to member states, its use for the purposes of other Union policies (agriculture, industry, development, competition, foreign policy), the preferential nature of the policy and so on. Although all aspects of trade policy are very important for applicant states, here we shall deal only with the nature of trade policy towards non-member countries as well as with the possibility that applicant countries make an impact on adjustment of this regime to meet their goals and strategies in the current round of negotiations within the WTO.

The widely-popularised characteristic of Union trade policy is dependence on *discriminatory* or *preferential* trade agreements that started to develop as early as the Treaty of Rome. Thus in 1999 the EU had contractual and reciprocal bilateral agreements with 22 countries and contractual but non-reciprocal bilateral agreements with 77 countries. This means that the EU is the source of 40% of all preferential trade agreements reported to the WTO, and if EFTA and CEFTA are included, the common contribution to the creation of preferential arrangement grows to two thirds of all such agreements in the world (Messerlin, 2001; 197). A particular feature of these agreements is their differentiated levels of preference, which has become known as the trade preferences

pyramid. The pyramid contains six levels: trade partners without most favoured nation treatment (MFN), the then socialist countries that were non-members of GATT; trade partners with GATT MFN status – members of the OECD outside the Union; trade partners to which the General System of Preferences, GSP, was applied; trade partners in the Mediterranean; trade partners with the status of developing countries – ACP states and, finally, trade partners with the highest preferences – EFTA countries the only ones that had reciprocal preferences (a free trade area for industrial products).^{xv} This pyramidal structure was greatly modified by a change in the EU regime towards the central European countries (but then again, not so much to disappear completely – see Table 4 which illustrates the remains of the pyramidal construction of import tariff protection in the EU). Candidates for EU membership have gone from the lowest preference status to practically the highest level along with EFTA and members of the European Economic Area, EEA, which has had an adverse effect on the relative position of the groups of countries who previously had greater margin of preference than them. At the same time, the character of the regime was changed, and no longer had dominantly non-reciprocal preferences but instead it had dominantly reciprocal preferences (except for the least developed countries – with no time limit, and for ACP starting in 2008 with a 12 year transition period) consistent with WTO rules.^{xvi}

Table 4. Remains of the trade preferences pyramid of the Community, 1999.

Product	Simple average of import tariff rates (%)						
	MFN related	MFN applied	GSP +MFN	FTA +MFN	LDCs +MFN	Lomé ^c +GSP +MFN	Lomé ^c +LDCs +MFN
All products	7.0	6.9	4.9	3.5	1.9	1.9	1.8
Agricultural products ^a	17.4	17.3	15.7	16.7	10.3	10.3	9.5
Non agricultural products ^b	4.6	4.5	2.3	0.5	0.0	0.0	0.0

FTA - free trade area.

GSP - general system of preferences.

LDC - least developed countries.

Lomé - ACP countries (African, Caribbean, Pacific countries).

MFN - most-favoured nation.

^a *As defined in the Annexe I WTO agriculture agreement.*

^b *Remaining products.*

^c *From 2000, the Lomé Convention was renamed the Cotonou Partnership Agreement.*

Source: WTO, Trade Policy Review: The European Union, 2000 (cf Messerlin, 2001)

Notwithstanding the “promotion” in their trade status, the candidate countries are faced with very high costs (related to the static effects of liberalisation on the creation and diversion of trade) for two reasons. Firstly, the *real* improvement in preferential treatment (difference between the MFN customs rate and the 0% rate) is not particularly important, because a large number of such countries already had a relatively free approach to the EU market for non-sensitive products. One exception, of course, is textile products and clothing, which for six central European countries have since 1997/987 been exempt from customs and quotas. At the same time, a positive effect of the preferences is derogated by the complex rules of origin.^{xvii} Another cause of the high costs of liberalisation is change in applicants’ trade policy towards the non-EU countries in the pre-accession period. Candidates, that is, have reduced trade barriers against EU member states (and against other candidates in their trade with each other) but have often compensated for this by increasing the level of protection vis-à-vis countries that are not members of the EU. Since the likelihood of the trade diversion effect is thus increased, this approach to liberalisation does clearly not have to have a positive effect on the welfare of the candidates.^{xviii}

All candidate countries, after entry into the EU, have to accept all the existing regulations, but will be able to take part in the making of any new rules. For this reason it is in the interest of the current members to make sure that new agreements within the WTO include provisions which assure the accomplishment of their objectives in the future, provisions that do not necessarily suit the candidates. For this reason one has to consider how much does the stance of the candidates with respect to multilateralism and the functioning of the WTO coincide with that of the EU. If the degree of concurrence is not great, to what extent can the candidates have an impact on the modification of the European position?

An EU delegation went to the ministerial meeting in Doha (November 2001) with clearly delineated objectives for the new round of negotiations within the WTO. These, put most concisely, include (cf. European Commission, 2000) further liberalisation of and access to the market for goods and services *not* relying on a sectoral approach, improvement of WTO rules by the inclusion of new areas such as investment, competition and advancement of trade, promotion of sustainable development and the more direct regulation of matters that arouse public interest, such as the effect of trade on the environment.

Unlike the EU, the candidate countries (including Croatia) did not have in Doha any *formal* common position (except informally, e.g., CEFTA plus). From the published positions of each individual country (www.wto.org) it would appear that their goals in the new round of negotiations are close to EU objectives. Taking into account the very different levels of development and of economic structures of the candidates as compared to the EU mean, this relative overlap of goals shows that the candidates are not ready, or are not powerful enough, to initiate questions in a multilateral forum that are in their interests and might be against the stated aims of the EU (for instance, in the area of investment, TRIPS and so on).^{xix} From a review of the trade policies of the candidates, it would seem that they are trying to replicate EU trade policy not only in the area of protective instruments but also in forming bilateral preferential arrangements (as against relying on multilateral liberalisation). The level of protection, though, is not in agreement with the EU level (although similar, they are on average very different for individual groups of products). When the level of protection in the candidate country is higher than in the EU, a good strategy in this round of negotiations would be to approximate to a lower EU level. If the candidate already has protection equal to or lower than the EU, the question arises of whether the candidates can “force” the EU, while negotiating the accession, to come down to their level of protection, or leave it the option of paying compensation to WTO members when acceding candidates will have to adopt the higher level of the EU protection.

CHALLENGES IN ADJUSTMENT TO THE EU

The preceding analysis leads to the conclusion that Croatia is slower than the other applicants in carrying out reforms necessary for accession to the EU. From this analysis it also derives that the EU is a “natural” market for Croatia and that it, like the candidates, is not willing at the moment to carry out any particularly different trade policy than that being run by the EU.

For this reason we shall identify the factors that might positively or negatively affect the further convergence of Croatia to the EU. The imminent process of EU enlargement is very important. Although it is not clear what the EU will be like after this enlargement, one of the possible scenarios is that the willingness of a new EU with 20 mem-

bers for new enlargement will be much smaller. Taking this scenario as a possible one could well reduce Croatian motivation for the implementation of reforms already provided for. In addition, the most marked comparative advantages of producers in Croatia lie in the production of traditional products (fisheries, wood and textile products), in which the competition will be increased with the accession of new transitional members.

For this reason, during the period of adjustment to the EU, it is necessary to consider adjustments to an enlarged EU, i.e., an EU of 20 to 28 members, and of acceding to this much larger union when the conditions are met.

In spite of the high possible costs of integration (restructuring costs), the establishment and consistent implementation of obligations taken on can help in the creation of favourable investment conditions. The establishment of free trade zones in the region will make it possible for transitional economies to prepare to face the competitive pressures on the EU market. The strengthening of inter-regional trade can make specialisation possible and facilitate its heading in the direction of activities with greater value added.

Although access to the EU market is unlimited and duty-free for *most* of the Croatian products, this kind of regime of access to the EU market does not make it possible to adjust the export structure of the Republic of Croatia in accordance with its comparative advantages. That is, Croatian producers have their greatest comparative advantages in sectors in which access to the EU market is limited. These are fisheries and the production of tobacco products.

Regional cooperation, which Croatia is obliged to carry out by the SAA, can help in the process of restructuring. At the same time, the introduction of the regular reports made by the European Commission enables unbiased and consistent monitoring of the implementation of reforms.

RECOMMENDATIONS

- Work on the achievement of status of full member as fast as possible, because this will minimise the static costs that derive from partial liberalisation through implementation of the SAA. The proviso is that the implementation of the SAA and other international obligations and reforms already launched is a necessary condition for transformation.

- As opposed to the position of Croatia in Doha, not to enter into numerous bilateral preferential arrangements, especially if each of them has separate rules of origin – this only increases the transaction costs and trading costs. Existing bilateral agreements could be made multilateral, which would reduce the administrative costs of implementing and monitoring them.
- If the trade policy of the EU is accepted, it should be used, as in the member states, as a support for development, industrial and competition policies and not as a merely passive protection policy.

i The basic agreements are those of trade in goods (GATT), in services (GATS), the protection of intellectual rights (TRIPS) and the settlement of disputes (DSM).

ii This is put into practice by devices ranging from exceptions to the need to respect the basic principles of the most favoured nation and national treatment (e.g., Article 24, Special and Differential Treatment for Developing Countries) to failure to respect recommendations about not using quotas, standards and so on for the protectionist purposes.

*iii Of course, by associating, an applicant country obliges itself gradually to create a free trade zone and adjust its trade policy with the common trade policy of the Union. The adjustment of applicants to the EU trade policy is monitored in the context of the general legal adjustments. Accession negotiations progress according to the pace of harmonisation to the *acquis*. Acceptance and implementation of the *acquis* implies that the applicant has developed the ability to take on the obligations that arise from membership. The negotiation chapters that relate to trade are: the free movement of goods (Chapter 1), the free movement of services (Chapter 3), the free movement of capital (part of Chapter 4), the negotiations of some states about the protection of intellectual property (TRIPS, Chapter 5), and the establishment of the customs union (Chapter 25). Most of the applicants have provisionally completed negotiations about these chapters, which means that they will in the event that they do join the EU, be involved in the single market and apply the common customs tariff with respect to third countries, i.e., they will become a member of the customs union.*

iv It also issues the Regular Reports as they are called. For more details see: <http://europa.eu.int/comm/enlargement/report2001/index.htm#/Regular%20%20Reports>

v Other elements according to which the European Commission evaluates the effectiveness of a market economy are: the equilibrium between supply and demand established by the free interplay of market forces; absence of significant barriers to market entry (establishment of new firms) and exit (bankruptcies, liquidations); the legal system, including the regulation of property rights; macroeconomic stability achieved, including price stability, sustainable public finances and external accounts; the existence of a broad consensus about the essentials of economic policy, and a sufficiently developed financial sector to channel savings towards productive investment.

vi The other elements according to which the capacity to cope with competitive pressures within the Union are evaluated are the sufficiency of available resources with acceptable costs (human potential, capital and infrastructure) with the possibility of their being developed and built upon (education, research), as well as a considerable proportion of SMEs being involved in EU trade, because according to experience to day, such companies tend to benefit more from improved market access, and partly because a dominance of large

firms could indicate a greater reluctance to adjust. (European Commission, 1997).

^{vii} The figures given in the table are illustrative, and selected on the basis of a large number of figures from the 1993-2000 period.

^{viii} This index, for some industrial product or economic activity "i", is usually defined as $GL_i = 1 - [|Ex_i - Im_i| / (Ex_i + Im_i)]$ where Ex indicators exports and Im imports. The closer the index is to 1, the greater the level of intra-industry trade.

^{ix} Relative trade deficit is defined as $(x-m)/(x+m)$, where x is exports, and m is imports, expressed in percentages.

^x Trade diversion is expressed as the cost for a country that, because of the existence of a formal trade agreement, diverts imports from a country that produces them efficiently to a member country that is less efficient, and at the same time ceasing to charge import duties therefore forgoing import tariff revenue.

^{xi} More about the model used and the econometric results of the test available from the authors.

^{xii} In spite of the fact that bilateral agreements have not been ratified, the following agreements are being provisionally applied: with BH (from 1 January 2001), Macedonia (1 July 2002), Slovenia (1 July 2002), Hungary (1 April 2001), Czech R (1 January 2002), Slovakia (1 January 2002) and EU member countries (from 1 January 2002). Agreements have been signed with Turkey and Poland, and negotiations with Albania, FRY and Romania are under way.

^{xiii} In 2000, the IV Lomé Convention ceased to exist, and the EU signed a new agreement, the Cotonou Partnership Agreement, with African, Caribbean and Pacific (ACP) countries.

^{xiv} Trade policy, in line with the Treaty Establishing the European Community, consolidated version after the Treaty of Amsterdam, 1997, OJ C 340/173 or europa.eu.int/eur-lex/en/treaties/dat/ec_cons-treaty-en.pdf is considered one of the forms of commercial policy and is clearly defined with respect to wider commercial policy. Control of trade policy is within the jurisdiction of the Union, i.e., member states do not have a direct control over it. EU institutions can carry out trade policy measures independently without consulting the member states, and trade agreements are ratified only at the level of the Union (there is no need for members to ratify them). As against this, control of commercial policy is divided between the Union and the member states, which have more freedom in the area of regulation commercial presence and trends in production factors (cf. Messerlin 2001 Chapters 4 and 5).

^{xv} The first three levels were set by the EU unilaterally, and any of the more advanced status was conditional upon contractual relations with the EU. The ACP developing countries were given trade preferences within the context of the EU development policy.

^{xvi} The transformation of the regime, from non-reciprocal to reciprocal preferences, is based upon the formation of new bilateral or regional preferential arrangements consistent with WTO rules (especially Article 24).

^{xvii} For example, it is sometimes cheaper to pay a tariff than to bear the costs of proving the origin of the goods (Mayhew, 1998).

^{xviii} The level of protection against non-members of the EU may rise because of the process of joining the EU. For example, when Slovenia joins the EU, the provisions of the free trade agreement between Croatia and Slovenia that enable the duty free and unlimited imports of wine from Croatia into Slovenia will have to be abolished.

^{xix} This is a judgement that still needs support in a more thorough analysis, which alas could not be included in this paper.

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