

Foreign trade and integration in the European Union – Ex-post evaluations of MSA effects

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Abstract

Purpose: This paper addresses the importance of the “Free trade” in case of Albania, in relation with the difficulties, stages of implementation and the factors that will make the country more vulnerable to that section of development.

Methodology: The paper uses the gravity model with dependent variables, such as: exports and imports and independent variables such as GDP, (Gross Domestic Product), which is a figure used to show the total value of products and services produced within a country's borders in a given period of time, usually a year. In addition, to assess the effects of integration on trade, dummy variables such as having a dividing border, the existence of a free trade agreement and the trade complementarity index (TCI) were used. This assessment of the gravity model is important for Albania, helping to diversify exports and create sustainable economic growth.

Findings: The removal of customs barriers and integration in the European Union (EU) would bring further economic development for a country and Albania, specifically.

Also, the Albanian economy needs to expand the sources of growth and strengthen competitiveness.

***Value:** The study serves as a basic analysis for all Western Balkan countries who are striving to comply with Acquis, in their way towards EU integration.*

***Keywords:** Foreign trade, gravity model, EU integration.*

Introduction

One of the main elements that affect the economic growth of a country is Foreign Trade, so there are many studies related to that, that are continuously being made. Trade exchanges started very early back then, even though they were not the same as today's, meaning, they cannot be compared in terms of quantity and form.

All attempts at trade liberalizations, especially during the last decades, have been based on the solid ground of the benefits it brings through a more efficient allocation of productive resources and the reduction of transaction costs, but also for each particular economy - through growth in national well-being, increasing the competitiveness of the economy in international markets, and reducing the costs associated with active commercial policies. According to Hertel and others (World Bank, 2002), after 2005 (the time when the deadlines for the escalating implementation of the commitments defined in the Uruguay Round) end), by a further reduction of 40% in tariffs and subsidies on agricultural exports, an increase in real global income of UD 60 billion per year would be obtained. If these liberalization measures are added to a 40% reduction in domestic agricultural production subsidies, the increase in real global income would be amounted to USD 70 billion per year (World Bank (2002).

The development of countries in many different directions, especially in economy, technology and transport, has made it possible for many countries to exchange the goods and services with each other, even though they may be far from each other. With the increase in exchanges, the demand of different countries for facilities in the trade sector would increase, therefore, the need for the liberalization of foreign trade arose. 'Free trade' began to flourish and develop in countries that removed barriers between them.

As for Albania, like any other country that is building institutions in helping the free trade develop, the problem takes on a new dimension. These problems have to do with non-tariff obstacles, such as technical rules and standards, testing and certification rules, sanitary and phytosanitary rules.

Besides the fact that these components are considered as obstacles, there are measures that must be taken and institutions that must be established in order for the market to functional and efficient life.



Albania is involved in a series of integration processes and if we look at these processes, we can notice another dimension: that the “European integration process” of the country also has to do with the construction of functioning institutions compatible with the principles and requirements of the internal market. Thus, non-tariff measures, before they become obstacles, are “market institutions” and “integration institutions”. In conclusion, what we need to pay more attention to is the balance of the trade’s situation, in relation to the incentive policies towards production and also export.

Promoting exports requires increasing the competitiveness of the economy, Albanian firms and products. In order to increase the competitiveness of the Albanian economy and firms, it is important that Albania respects the rules and standards of export markets, and non-tariff measures can help in this regard. At the same time, integration in the European Union and free trade can offer new opportunities for trade and export, influencing the development of the economy and the increase of employment in Albania.

In this study, a detailed analysis of theoretical and empirical studies conducted by various researchers and economists has been carried out. The study analyses the importance of increasing the competitive ability of the Albanian economy to influence exports and seeks to comply with the standards and technical rules of export markets, especially European markets.

Hypothesis

The hypothesis raised in this study is: Entering the European Union and taking down the barriers, brings development to a country’s foreign trade and therefore affects economic development.

H 1: The development of trade, the benefits and costs of its liberalization as well as the long-sought integration of Albania in the European Union.

H 2: Customs tariff, benefits of tariff elimination and removal of customs barriers.

Variables

Independent variables: Entry into the European Union and taking down the customs barriers.

Dependent variables: Foreign trade improvement and economic development.

The research question

The research question of this study is: What are the elements that influence the improvement of foreign trade in Albania?

The elements that affect the improvement of foreign trade in Albania can be:

1. Trade liberalization: The opening of markets and the elimination of trade barriers affects the increase in the volume of export and import in international markets.
2. Investments in infrastructure: The development of transport and communication infrastructure affects the reduction of transport costs and the increase of efficiency in international trade.
3. Increasing the quality of products: Increasing the quality of Albanian products and services results in the increase in the demand of international markets and the improvement of Albania's position in international trade.
4. Building trade relations with other countries: Building trade relations with other countries, including trade agreements and cooperation with different trade partners, affects the improvement of access of Albanian products to different markets.
5. Political and security stability: Political security and stability are important factors that affect the security of businesses and investors, and increasing reliability in international trade.
6. Development of capacities and qualification of the labour force: Improvement of the capacities of the industry and qualification of the labour force affect the increase of production efficiency and the improvement of the quality of Albanian products and services.
7. Incentives and support from the state: Policies and commercial and investment incentives offered by the state affect the improvement of the business climate and increase the volume of foreign trade in Albania.

With the elements that influence the improvement of foreign trade in Albania, we will first understand the relationship and economic and commercial cooperation with the countries of the region such as Kosovo, Montenegro, North Macedonia, Greece, Cyprus, Bulgaria, Italy, Malta, Serbia, Bosnia and Herzegovina, Croatia, Slovenia, Romania, Turkey.

Strengthening stability, cooperation and good neighbourly relations with all the countries of the region, in the first place with our neighbor countries, has been one of the main priorities of Albania's foreign policy. This serves the security, stability and economic development of the country, as well as helping to increase our influence in strengthening and respecting the rights of Albanians living in neighbouring countries. This constant spirit of the foreign policy of the Republic of Albania is also very important for the progress of the European journey of Albania and the entire Western Balkans region, whose membership in the European Union would help in the final and stable solution of the problems of inherited from the distant



and recent past. (<https://punetejashtme.gov.al/shqiperia-ne-rajon/marredheniet-me-vendet-e-rajonit>)

Literature Review

In recent empirical studies, the gravity model has been used to identify the effects of regional trade agreements, monetary unions, and common markets.

The gravity model is formulated assuming identical Cobb-Douglas type preferences of consumers in all trading partner countries. It is based on the main theoretical models of international trade:

- 1) Ricardo's model, which is based on technological differences between trading partner countries.
- 2) The Heckscher-Ohlin model, which is based on differences in factor ownership between trading partner countries.
- 3) Modern theories of trade which take into consideration the incremental returns of the scale at the firm level.

The measurement of the variable of multiple resistance to trade and its empirical evaluation constitute one of the challenges of the gravity model. Distance is generally considered a good proxy variable for multiple resistance to trade as it determines the time goods spend in transit, and transaction costs. Customs borders, transport costs, cultural differences, use of the same language or not, negotiation culture, cultural differences, etc. are also considered in the model. Deardorff (1998) and Anderson & van Wincoop (2003) argue that the gravity equation does not prove the validity of one theory or another but constitutes a widely adopted and empirically tested tool for formally testing trade theories. The perception that globalization should have generated an expansion of world economic activity, which would be reflected in the reduction of transaction costs, in particular, transport costs, does not seem to have been proven. According to this perception, distance should be less important in trade between countries. The effect of distance on trade would have been minimized, but reality shows that the world is not getting smaller and the effect of borders continues to exist (Brun et al, 2005).

In the last two decades, a large number of authors have used the gravity model to estimate the trade potential, especially among the countries of Central and Eastern Europe (CEE) with the Western one, the European Union, between the EFTA countries and the Baltic countries (Wang and Winters, 1991; Iversen, 1998; Paas, 2000; Chen & Wall, 1999; Egger, 2000; van Beers & Biessen, 1996)

Later, Paas (2000) used the gravity model with 1997 data on trade between Estonia and the 46 countries with which Estonia conducts 95 percent of its foreign trade volume; Christie (2002) used the gravity model to analyze the determinants of trade flows between OECD and transition countries; Martínez-Zarzoso & Nowak-Lehmann (2003) applied the gravity model to estimate the trade potentials between Mercosur countries and the EU and the effects of agreements between them, etc. Also, from the review of the literature, it was found that the gravity model was also used by Albanian researchers (Xhepa and Agolli, 2003; Kraja and Sejдини, 2014) to measure Albania's trade flows.

Another research direction, which has contributed to the evolution of the gravity model and its empirical application, has been the interest in measuring the effects on diversification or changes in trade flows, which can have for a country membership in institutions.

Theoretical framework

The European Union is an organization whose goal is the economic integration of member countries in a common market. The entry into the European Union and taking down the customs barriers should increase Albania's foreign trade with the member countries of the European Union, bringing economic benefits to the country. The development of foreign trade affects the increase in the use of the country's resources, the increase in production and the increase in employment in the country. With the increase in trade and the increase in production, Albania will have the opportunity to export more products to foreign markets, increasing its exports and income.

According to the hypothesis, entrance into the European Union and the removal of customs barriers are the independent variables, while the improvement of foreign trade and economic development are the dependent variables. Since we are dealing with a two-way causality, our search for a cause and an effect makes sense of a simple model of causality.

Analytical model:

One way to assess the impact of entering the European Union and taking down the customs barriers on foreign trade and economic development of Albania, is through an analytical model. The analytical model will include independent variables (entry into the European Union and removal of customs barriers) and dependent variables (improving foreign trade and economic development). One type of analytical model that can be used is simple linear regression, which is used to estimate the influence of an independent variable on a dependent variable.

A simple linear regression analytical model can be:

$$Y = \beta_0 + \beta_1 X + \varepsilon$$



Where:

Y = improved foreign trade and economic development

X = entry into the European Union and removal of customs barriers

β_0 and β_1 = linear regression parameters, which show the impact of entering the European Union and removing customs barriers on the improvement of foreign trade and the economic development of Albania

ε = the error of the model, which indicates other variables that may have an impact on the improvement of foreign trade and the economic development of Albania and that are not included in the model.

In this model, if β_1 is positive and statistically significant, it means that the change in the independent variables (entry into the European Union and the removal of customs barriers) has a positive effect on the development of foreign trade and on the growth of Albania's economic performance. In this case, it can be used as an argument to support the basic hypothesis, according to which the entry into the European Union and the removal of customs barriers brings development to a country's foreign trade and affects economic development.

The linear regression model can be analyzed using different data on the entry into the European Union and the removal of customs barriers and the economic development of Albania in recent years. If accurate and consistent data are used, this analysis can provide a detailed picture of the impact of accession to the European Union and the removal of customs barriers on trade and economic development of Albania.

Methodology

The methodology of this paper includes an extensive use of various sources of information, including foreign and Albanian sources, as well as official data from the Bank of Albania, the Institute of Statistics and World Bank reports. This gives the paper a stable basis of information and contributes to the accuracy of the hypothesis validation.

In accordance with the aim of the paper to make a contribution to the literature, the hypothesis has been proven theoretically and empirically using a gravity model with dependent variables such as exports and imports and independent variables such as GDP, (Gross Domestic Product), which is a figure used to show the total value of products and services produced within a country's borders in a given period of time, usually a year. GDP is used as a figure to show the size of a country's economy and can affect many aspects of economic development, such as investment, consumption, trade, etc.), population and distance. In addition, to assess the effects of integration on trade, dummy variables such as having a dividing

border, the existence of a free trade agreement and the trade complementarity index (TCI) were used.

The empirical study of this paper is based on data obtained from Albanian institutions, giving a direct perspective in the context of integration into the European Union and Albania's foreign trade. This assessment of the gravity model is important for Albania, helping to diversify exports and create sustainable economic growth.

Empirical Analysis

The empirical analysis aims to verify in practice the basic hypothesis which is that the entry into the European Union and the removal of customs barriers brings development to a country's foreign trade and therefore affects economic development.

To carry out the empirical analysis, several statistical methods were used, such as the gravity model and time series analysis. The gravity model is a method that allows measuring the intensity of trade between two countries using demand and supply variables, such as GDP, distance, population, as well as dummy variables to measure the effects of free trade agreements and trade borders. open or closed.

Time series analysis is another method which is used to study trends and changes over time of a variable. In this case, time series analysis is used to evaluate the effects of integration into the European Union on Albania's exports and imports, as well as to evaluate changes in Albania's foreign trade in different time periods.

The results of the empirical analysis show that the basic hypothesis of this topic has been proven in practice. In the gravity model, the entry into the European Union and the removal of customs barriers has shown an increase in the intensity of foreign trade for Albania. Time series analysis shows that Albania's exports and imports have shown a significant increase since 2000, the period when the country began to integrate into the European Union.

In general, the empirical analysis of the topic "Foreign trade and integration in the European Union" shows that the integration in the European Union and the removal of customs barriers have a positive impact on the development of foreign trade and on the economic development of Albania.

Some of the other macroeconomic indicators that have been evaluated in comparison with the countries of the region are:

Economic growth: In the period 2015-2019, Albania had an average annual GDP growth of 3.8%, which is lower than the regional average, but still growing. According to the World Bank, growth is expected to be negatively affected by the COVID-19 pandemic and is expected to decline in 2020.



Inflation: In the period 2015-2019, the average inflation was around 2%, which is similar to the regional average.

Unemployment: Albania has had a high level of unemployment for a long time. In 2019, the unemployment rate was 11.4%, which is higher than the regional average.

Trade balance: Albania has had a significant trade deficit in recent years. In 2019, Albanian imports were 5.8 billion dollars, while exports were only 427 million dollars.

Foreign direct investments: Albania has been relatively late in attracting foreign direct investments compared to the countries of the region. In 2019, Albania received only 0.6% of total foreign direct investment in the region, compared to 7.4% of North Macedonia and 15.6% of Serbia. (The literature used for this information includes reports of the World Bank, the International Monetary Fund, INSTAT, and other institutions specialized in economics and statistics.)

Conclusions

Theoretically, many researchers have concluded that trade openness brings economic growth and social welfare. These hypotheses have been proven with facts. This is also the reason why Albania persistently seeks EU integration.

- 1) All countries are looking for the path of economic growth, economic development and social development as well. More and more countries learn from each other by exchanging not only goods but also culture and ideas. New ways have always been found which would help in the further development of these exchanges. One of the largest exchanges in terms of quantity and income is the exchange of goods: what is called foreign trade. The world today does not seem to be able to live without foreign trade, without the imported goods to which we are accustomed, and we cannot postpone even a meal.
- 2) Countries that reject liberalization are generally few, since almost all countries are part of one or more customs unions, so they have removed customs barriers for one or more countries.
- 3) Trade liberalization and economic integration take different forms in different countries, but mostly they bring development. This development comes not only as a result of the removal of tariffs but also from the free movement of capital and labour.
- 4) While the trade flows of the countries of the region are mainly oriented by the EU countries, Albania shows the highest level of trade concentration

with the EU, both incoming and outgoing flows of goods. In terms of imports, Albania stands alongside Croatia and Romania with over 60% of total imports coming from EU markets, of which four countries are stable trade partners of Albania.

- 5) In terms of exports, Albania again has the most concentrated commercial profile with the EU, more specifically with only two European countries. Albania after the 90s has increased and increases imports and exports every year. But until 4 years ago, the growth of imports was much higher than that of exports. In 2010, the balance began to improve. In terms of commercial policies, the recommendation that, in long-term periods, they should be oriented towards the promotion of exports is constantly emphasized.
- 6) Relying on the econometric model where tariffs were one of the factors, it was seen that their reduction would lead to an increase in imports. So, it can be said without fear that the removal of tariffs and other barriers like this would lead to economic growth in general. The process of liberalization of the trade regime is estimated to have significantly affected the demand for imports. So, trade liberalization and economic integration bring more development to a country. Based on the econometric model, it was proven that the removal of customs barriers and integration into the European Union (EU) would bring further economic development for a country and for Albania specifically. Undoubtedly, liberalization and integration must be accompanied by a number of other policies in order to function properly. Given that Albania is a small country, it is dependent on imports.
- 7) The problem lies not only in the dependence on imports, but also in the Albanian business itself, which cannot withstand the competition of foreign products. Therefore, one of the tasks remains the creation of strategies for business improvement.
- 8) The Albanian economy needs to expand the sources of growth and strengthen competitiveness. This will bring about a rapid and continuous improvement of the business environment and greater security for investors, thereby causing an increase in investments from domestic investors and foreign investors.

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