The First Round of Eastern Enlargement of the EU – Possible Implications for Croatian Trade

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Abstract

The objective of the paper is to examine possible impact of the next EU enlargement on Croatia's trade links, and to analyse alternative options for Croatia's participation in the integration process. Trade integration opportunities within the region (Western Balkans), with "would-be" EU members and "pre-in" countries is examined.

The paper rests on the hypothesis that the EU will start adhering new members from the year 2002. It identifies candidates that have the best prospects for joining the EU in the first round of eastern enlargement. Than it analyses the possible effect of enlargement on Croatian economy as a whole and on sectoral level. Finally, it examines different options for participation in the integration process.

The candidates that have the best prospects for joining the EU are identified on the grounds of their recent performance towards meeting EU membership criteria, as formulated in the Commission's regular reports and on the grounds of the EU's possibility to adhere them.

Possible effects of enlargement on the most important sectors for Croatia's export to the EU is analysed on the grounds of relative comparative advantages of producers from Croatia compared with the candidates and achieved level of inter-industry trade (RCA and GL indices). The same method is used in examining trade integration opportunities.

Key words: Croatia, EU, enlargement, trade

1. The Challenge of Eastern Enlargement

Preconditions for Eastern enlargement of the EU have been gradually created since 1993. They are basically threefold: the financial framework, institutional reform and the conclusion of negotiations with those candidates who fulfil all the membership criteria. Berlin European Council (March 1999) adopted the financial framework, which should allow smooth functioning of the EU comprising 21-member state. Nice European Council (December 2000) agreed on the necessary institutional reforms for inclusion of candidates that are presently negotiating about membership. It also adopted a strategy to take the negotiations into a more substantial phase and point the way towards their conclusions. Thus the EU should be in position to welcome new member states from the end of 2002. Candidates have to fulfil membership criteria contained in the Founding Treaties, as well as those defined by Copenhagen European Council[1].

Progress towards meeting membership criteria i.e. alignment of the candidates with the EU requirements, and the EU's capacity to adhere them will be criteria on which the EU will decide which country or group of countries will become member(s) of the EU in the next round of enlargement.

According to the last Regular Reports[2], candidate countries should now concentrate on how to meet fully the Copenhagen economic criteria[3]. At present only Cyprus and Malta have fulfilled both economic membership criteria. Apart from Bulgaria and Romania, all candidates can be regarded as functioning market economies. Estonia, Hungary and Poland should be able to cope with competitive pressure and market forces within the Union in the near term provided they maintain their current reform path. The Czech Republic and Slovenia should also be able to meet the second criterion in the near term, provided that they complete and implement remaining reforms. Latvia, Lithuania and Slovakia should be able to meet the second criterion in the medium term, provided that they implement current structural reform programmes and undertake further reforms where necessary.

The EU should be in position to start adhering new members as from the end of the year 2002 (provided that Nice Treaty will be ratified by all the member states). All the "first round" candidates (Hungary, Poland, Estonia, Slovenia, Czech Republic) should by this target date fulfil necessary conditions.

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[1] Amsterdam Treaty defines that *"Any European state which respect the common principles may apply to become a Member of the Union (*Article 49). Liberty, democracy, respect for human rights and fundamental freedoms and the rule of law are principles which are common to all Member States (Article 6(1)).
"Copenhagen Criteria" cover economic, political and legal aspects. For full membership candidates are required to have stable institutions guaranteeing democracy, the rule of law, human rights and the protection of minorities; the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union; the ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union (adoption of the *acquis communautaire*).
At the same time, the European Union has to be ready to accept new members.
[2] Regular Reports, COM (2000) 700-713 final, 8.11.2000.
[3] Meeting the political criteria is precondition for opening negotiations.

However, it is not likely that EU will be ready to adhere them all at once. Poland, due its size and especially size, structure and importance of its agriculture[4] could impose significant budgetary burden to the EU, if included in full membership. Therefore its inclusion could be postponed, mostly because the EU is not ready to adhere it.

The EU underlines that progress of each candidate towards meeting the membership criteria is key element on which decision for inclusion of new members will be taken. Therefore, the lack of the EU readiness to adhere Poland could postpone membership of the candidates that, at the time of the first accessions, would have achieved less progress towards fulfilment membership criteria than Poland.

On the grounds of present performance of the candidates, it seems that the best chances to become full EU members among Central and Eastern European countries (CEECs) in the next round of enlargement have Hungary and Estonia. The European Commission reported that they (together with Poland) have progressed the most towards fulfilment membership criteria. In addition to the good performance, due to their size and output structure, their eventual inclusion into the EU does not pose significant (financial or other) problems to the EU.

Inclusion of Malta and Cyprus into the EU was not considered here in spite of the fact that they are asessed as the most advanced candidates. Firstly, they are small economies, so impact of their inclusion into the EU membership would be small. In addition, they have created customs union with the EU. Since economic effects of the enlargement can be basically classified as effects of creation of a customs union, inclusion into the single market, and at a later stage into economic and monetary union (EMU) the effects of inclusion of these two economies are expected to be smaller than the effect of inclusion of CEECs.

Further, Malta might be dropped out from first round of enlargement because it lags behind in alignment its legislation with the necessary pre-accession EMU *acquis.* Cypriotic membership to the EU could be postponed due to political reasons.

2. Economic Effects of the Enlargement

Major achievements of the process of European integration in economic terms are creation of the single market and gradual establishment of economic and monetary union. Inclusion of new member states to the EU will increase the size of the single market. On accession, new Member States will have to bring their trade regimes and other external economic policies into line with the Community's. They will have to ensure compatibility with the Community's international (multilateral and bilateral) commitments, by adjusting their own commitments or, in some instances, by adopting those of the EC in their entirety[5]. The EC will also have to adopt adjusting measures to avoid the potential reverse impact on third countries. For instance, the EC should adjust its remaining quantitative restrictions to take the acceding Member States into account.

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[4]According to the Commission (2000), in order to improve its chances to become EU member in the first round of enlargement, Poland should implement structural reforms in agriculture (e.g. farm size, processing sector, marketing channels, land market).

[5] For instance, the need to adopt the Common External Tariff (CET). Once Hungary becomes EU member it will have to suspend the free-trade agreement with Croatia and align customs duties on Croatian exports to Hungary in line with regime that governs EU-Croatia trade (at moment, these are unilateral trade preferences). This implies increase of protection for export of agricultural products to Hungary.

However, the third countries concern about the EU enlargement is not so much the potential of losing the markets of present candidates, because these countries are, in general, small traders, but the exclusion from trade in the enlarged block. This means that new members can displace the exports in third markets (trade diversion effect).

Since the EU trade in most industrial products is liberalised, this is particularly relevant for "sensitive" goods (farm products, textile, steel, chemicals), as the transition countries have comparative advantage in the production of these goods[6].

Analyses[7] of possible economic effects of enlargement lead to the conclusion that the direct effects from enlargement tend to be limited. Effects on the present Member States are expected to be small and positive, on the new Member States greater and positive, and on the third countries small. Still, whether these limited effects will be welfare-enhancing depend on sector, region and a number of factors, such as the cost structure of member and competing third countries, price relative competitiveness, the tariff level before integration, etc.

Generally, third countries can expect negative impacts of the EU enlargement in agriculture, traditional industries, and sensitive sectors[8]. Possible positive impacts on non-included regions are result of improved access to the markets of new member states, and increased demand in both present and new members.

In order to help avoiding negative effects of the enlargement in the neighbouring countries, the EU has been developing relations with them. It established new types of contractual relations: Partnership and Association arrangements with countries of former Soviet Union, new Euro-Mediterranean association agreements with Mediterranean countries and Stabilisation and Association Agreements with countries of south-eastern Europe. These agreements seek to create conditions for political stability and economic growth, improve regional co-operation between the EU and its partners.

Still, proliferation of such agreements, in parallel with inclusion of some countries into the full EU membership, can have negative impact on economic relations between the EU and not included third countries, such as Croatia.

3. Croatia: regional integration issues

Croatia has only recently became a WTO member and finalised the negotiations about Stabilisation and Association Agreement (SAA) with the EU. In the past years absence of agreement with the EU and non-membership to the WTO has impeded Croatia's inclusion into CEFTA and probably adversely affected Croatian exports to the EU and candidate countries in three ways. First, the majority of CEEC's products have been subject to lower EU tariffs than Croatian exports, which has raised the price of Croatian exports relative to these produced in CEECs. Second, the harmonisation of product

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[6] Jovanovic (1998)

[7] Such as European Commission (1997), Bayar (1999), Frandsen, Jensen, Vanzetti (1998), Liapis, Tsigas (1999)

[8] Namely, non-agricultural EU trade with both candidate and other third countries already is or is in the process of becoming extensively liberalised through implementation of Europe Agreements, Uruguay Round decisions and other existing and planned free trade zones.

standards and the elimination of other non-tariff trade barriers, called for upon Europe Agreements have put Croatian products to a further disadvantage relative to the other CEECs. Third, the strict rules of origin clauses included in the Europe Agreements have likely diverted trade away from Croatia and toward CEECs[9]. In addition, lack of institutional links with the EU excluded Croatia from aid programmes (such as PHARE). For foreign investors it indicated lack of credibility and as such was an obstacle for a greater inflow of international capital through foreign direct inflow (FDI). This led to growth on the basis of domestic consumption alone, rather than export based economic growth. Consequently, Croatian economy is less integrated into the EU than economies of candidate countries (Table 1).

Table 1. Export and import to the EU as share of total exports and imports and trade balance with the EU (in %)

	Import from the EU	Export to the EU	Trade balance
Hungary	64,4	76.2	-7.13
Poland	64.9	70.5	-27.05
Estonia	65.0	72.7	-20.91
Slovenia	68.6	66.0	-12.67
Czech Republic	64.0	69.2	-7.80
First Round Average	65.5	70.9	-15.11
Bulgaria	48.6	52.6	-0.04
Latvia	54.5	62.5	-13.23
Lithuania	49.7	50.1	-25.64
Romania	60.4	65.5	-10.13
Slovak Republic	51.7	59.4	-2.92
Second Round Average	53.0	65.0	-10.39
FYR Macedonia	36.0	43.0	-19.76
BiH	40.5	49.6	-54.86
Albania	82.5	92.5	-43.88
Croatia	58.0	48.8	-41.49
Western Balkans Average	54.3	58.5	-40.00

Source: own calculations based on COMEXT data, 1999**.**

Croatia's export share to the EU is smaller than in the "first round" of candidates, and below average of the "second round". It is comparable with Bosnia and Herzegovina, Bulgaria and Lithuania.
Further, while the candidates during the period 1994-1998 increased their exports and the market share in the EU (in average for 25.5%), in the same period Croatia decreased its exports to the EU, which resulted in 33% loss of market share[10].
In addition, structure of Croatian exports, especially to the EU, has changed the least among the CEECs (Table 2).

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[9] IMF (2000).
[10] op. cit

Table 2. Export structure change indices (to the EU, 1994-1998)

Bulgaria	0.7
Croatia	0.5
Czech Republic	4.6
Estonia	0.8
Hungary	5.3
Latvia	0.5
Lithuania	0.6
Poland	4.3
Romania	1.7
Slovakia	2.0
Slovenia	1.1

Source: IMF, Staff Country Report No 22/00.

This may have reflected a slower pace of restructuring of the Croatian economy as a whole compared with other transition economies. Slow and inefficient restructuring have impeded the adaptation of Croatian products to the demand in industrial countries, which resulted in increasing trade deficit. Relative trade deficit (41.49%) is greater than in any of candidate countries. It is comparable with BiH and Albania.

In spite of decrease of total exports to the EU and decrease of market share, the EU is still the most important market for Croatian products. In 1999, almost a half (48.8%) of total Croatian exports (worth US$ 4.3 bn) was to the EU. Countries of south-eastern Europe absorbed 16.5 % of Croatian exports and CEFTA states 13%[11].

Therefore, the changes on these markets, induced by the EU enlargement, can significantly impact Croatia's trade performance. In addition, commodity composition of exports to the EU shows that "sensitive sectors" (agriculture, textile, footwear, iron and steel, wood) account for 49.3% of total exports to the EU[12]. This, according to the already mentioned analyses , indicates that the enlargement can have negative impacts to the Croatia's trade performance.

In order to improve its access to the most important export markets, Croatia has started establishing free trade zones. So far, free trade is established with Slovenia, Bosnia and Herzegovina, Macedonia and Hungary. FTA negotiations are concluded with the EU, Czech Republic, Slovak Republic, Poland; and EFTA. Negotiations with Bulgaria, Romania and Turkey should be finalised by the end of the year. Croatian goal is to become a member of CEFTA as well as to join the pan- European diagonal cumulation of origin. Having established a network of FTAs, more than 80% of Croatian trade will be subject to the free trade regime[13].

Creation of FTAs is certainly an important issue for the speeding up the transition process through fostering export-based economic growth. However, choice of partner and scope of libealisation significantely impacts its effectiveness. Empirical and theoretical studies[14] show that number of elements determine whether a regional arrangement would be beneficial for involved economies. These element include openness, size and distance

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[11] Croatian Bureau of Statistics, 2000.

[12] Comext, European Commission ,1999.

[13] This represents significant progress since 1997, when the only free trade agreement was concluded with Federation Bosnia and Herzegovina

[14] Such as Shiff (1996), Shiff, Winters (1998), Fernandes, Portes (1998), Puga, Venables (1998), Vamvakidis (1998), Olarreage, Soloaga (1998)

between economies that form a regional arrangement, level of their development, trade structure and level of market protection before and after creation of arrangement. Generally, integration with near, open, big and more developed economy may lead to faster growth. More significant reduction of trade barriers leads to the more significant effect of the regional arrangement. Different trade structures enable specialisation, and therefore are also regarded as element that contributes to the success of regional arrangement.

In spite of generally positive long-term effects of trade integration, short-term effects can be negative for economy as a whole or some of its sectors. In the process of integration towards the EU, CEECs have experienced increasing trade deficit. This short-term negative effect, however, contributed to some positive developments, such as speeding up transition process. Similar effects can also be expected in the process of Croatia's integration towards the EU and also during the process of trade liberalisation through establishment of FTAs. The foreseen FTA with the EU, which is to be created gradually during the 6-year transition period, can also lead to further increase of imports from the EU (up to 12%).[15]

The same conclusions can be drawn from the analysis of above mentioned elements (size, openness, level of development, share of imports from partner, distance, level of protection before and after liberalisation and length of transition period). Namely, due to low level of present protection of EU market and high share of imports from the EU, short-term effects of FTA between Croatia and EU tend to be negative. However, high level of EU's development (as compared with Croatia), small distance, huge size and sufficiently long transition period allow for fostering Croatian economic growth, speeding-up transition process and as a result beneficial long-term effects.

Trade integration with "would-be" members (Hungary and Estonia) can be regarded as integration towards the EU, since these countries have the best chances to become full EU members. Significant share of imports from Hungary indicates that short-term FTA's effect can be negative. The FTA with Hungary has already led to increase of Croatia's trade deficit. But in the longer run, small trade costs between Croatia and Hungary and differences in trade sturcutres can increase specialisation and contribute to the positive economic developpments in both parthers. Effects of an FTA between Estonia and Croatia are expected to be small. Basically, because Croatia and Estonia are small and distant economes.

Integration towards the rest of "first round" candidates (Slovenia, Poland and Czech Republic) can have limited beneficial effect. A FTA with Slovenia led to increase of imports, but due its small size, beneficial long term effect tend to be limited. Trade costs with Poland are more significant, and its trade structure is quite similar to Croatian.

Effects of a FTA with Czech Republic are also expected to be limited. Namely, Czech trade structure is similar to Croatian one, these two countries are not neighbouring so the trade costs are bigger, and both countries can be regarded as small economies.

Similarly, inclusion into CEFTA can have negative short-term effects (namely due to effects of imports from Slovenia and Hungary) and in longer run increase intra-industry trade and contribute to the product differentiation.

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[15] This is in accordance with analyses of FTA between Croatia and the EU. Samardžija (1998), Samardžija, Stanicic, Nikic (2000).

Effects of FTAs with the second round candidates will be smaller, since they are small, more distant, and less developed economies. Their export structure to the EU is similar to Croatian, so they compete on the EU market. Mutual FTAs should lead to increase of intra-industry trade, but it is not likely that they can foster growth and development.

Creation of FTAs with countries of western Balkans (Bosnia and Herzegovina, FRY, FYR Macedonia and Albania) also can have only limited effects, since all the economies are small and relatively undeveloped. The producers from countries of Western Balkans (i.e. Croatia, BiH, FYR Macedonia, FR Yugoslavia and Albania) in the process of market liberalisation could exploit lower marketing costs in the region than on the EU market. Namely, producers from these countries (exception are producres from Albania) used to belong to one, fairly well-operating domestic market. Further, regional integration through decrease of trade cost should help in combating smuggling, and could accelerate normalisation of trade structure. Normal trade structure for countries of SEE would mean that 50-60% of trade is with the EU, 20-30% within the region, and 10-20% with rest of the world. Empirical evidence, as form FTA between Croatia and Macedonia, shows that there is a scope for trade integration.Despite having a FTA, only 1% of total Croatian trade is directed towards Macedonia.

In addition, most of the SEE countries lack credibility, which is a precondition for establishment of efficient agreements. So they need economic and institutional reforms are needed in order to be included in global trading system. However, due to the low level of development and similar production structures, FTAs alone cannot solve problems the economies in the region are facing.

4. Effects of the EU Enlargement: Quantitative Estimate

Possible impacts of the enlargement are analysed under presumption that Croatia will develop regional co-operation at the time of the first round of Eastern enlargement. This implies that bilateral conventions with other countries having signed a Stabilisation and Association Agreement will be concluded.Croatia shall also engage in regional co-operation with candidate countries.

The EU enlargement is expected during the establishment of free trade zone between Croatia and the EU and at the beginning of FTA implementation with other important Croatian trade partners. Therefore, trade diversion effect caused by the EU enlargement, coupled with the negative short-term effects of creation of FTAs with most advanced candidates, can induce significant problems for already weak Croatian economy.

Inclusion of Estonia and Hungary into full EU membership tend to have limited effects on EU trade in general. In comparism with the EU, they are relatively small traders. The EU trade with Estonia and Hungary contributes 2.48 % to the extrenal trade of the EU (2.6% exports and 2.3% imports). But, since Croatia trades with the EU much less (exports to the EU are almost 10 times smaller, Table 3), even very small effects of the EU enlargement can be quite significant for Croatia.

Table 3. Shares of Croatia, Hungary and Estonia in extra-EU trade

	Hungary and Estonia	Croatia

EU Export	2.6%	0.6%
EU Import	2.3%	0.26%
Exchange	2.49	0.43%

Source: Own calculations, based on COMEXT data 1999

For quantifying the possible enlargement effects I use one of the methods from research on the "cost of non-Europe" (Cecchini Report[16]) for *ex-ante* evaluation of single market programme. It is based on the presumption that inclusion of new members, due to removal of existing trade barriers, leads to the decrease of unit costs for the company's typical or average products for 2%. These expected decrease in costs mainly constitutes the static effect, i.e. the direct cost consequences of removing border barriers.[17] Effects on sales volume is expected around 5%, which include not only the immediate effects due to the removal of barriers but also dynamic effects in the course of the adjustment process.[18]

The 5% increase of demand and 2% decrease of prices equals 28.77% vale of Croatia-EU trade. Increased demand in present member states is worth 44.83% of Croatian exports to the EU, as shown in Table 4.

Table 4. Size of additional demand compared with EU-Croatia trade

1	2	3	4	5	6	7	8	9	10
2		**CEE-2**		**Croatia**		**p'$_{2\%}$**	**Q'$_{5\%}$**	**V'**	**V'/hrv**
3		value EUR 000	quantity metric tons	value EUR 000	quantity metric tons				
4	**EU export**	19508816	8487941	4407000	2909981	2,30	424397	975441	0,2234
5	**EU import**	16339860	18017192	1822578	3201401	0,91	900860	816993	0,4483
6	**Trade**	35848676	26505133	6229578	6111382	1,35	1325257	1792434	0,2877

Source: own calculations based on COMEXT data 1999

Columns 3-6 present EU export, import and exchange between EU-15 and Hungary and Estonia (labelled as CEE-2, columns 3 and 4), and EU and Croatia (columns 5 and 6). In column 7 is calculated new unit price for average export/import product. The new price, tat takes into account removal of trade barriers is 2% lower than the present one. It is calculated as

$$p'_{2\%} = V/Q * 0,98$$

V value of export/import to CEE-2
Q quantity of export/import CEE-2

In column 8 additional demand is calculated, as 5% increase of quantity exchanged before enlargement. In the fourth row is additional demand of new member states and in 5th row additional demand in present member states. 10th column presents additional demand as share of trade between the EU and Croatia. It shows that additional demand is worth 44.84% of present Croatian exports to the EU. This indicates that there is a possibility to expand Croatian exports.

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[16] European Commission (1998)

[17] The reducioni in costs will be mainly due to lower distribution costs, lower costs of imported material, higher productivity in the production process, and lower insurance, marketing and banking costs.

[18] op.cit.

Even if Croatian products satisfy a small share of additional demand, effects of enlargement can be rather big and positive for Croatian economy. For instance, if app. 8% of additional demand were satisfied by increase of imports from Croatia, the export growth induced by enlargement would be comparable with estimated effects of creation of free trade zone with the EU (estimated at 3.6%).[19]

However, the enlargement can also cause trade diversion effects and increase of imports from the EU. Namely, cheaper products from new member states, as well as less delays caused by border controls can displace some of Croatian products on EU market. Similarly, decrease of prices of EU products (caused by increased productivity, and lower insurance, marketing and banking costs) can increase demand for EU product on Croatian market and increase imports.

In quantifying possible enlargement effects on Croatian trade with present EU member states, I classify them as trade expansion, trade creation and trade diversion. Possible increase of Croatian exports to the EU is labelled as trade expansion effect, increase of imports form the EU as trade creation effect, and decrease of exports trade diversion effect. Trade creation and trade expansion are calculated with Cecchini Report estimates of cost reduction and demand increase. Trade diversion effect is calculated under presumption that Croatian exports to the EU, in sectors in which Croatian producers do not have comparative advantages, will be replaced by products from new members, provided that producers originating from Estonia and Hungary have comparative advantages. Table 5 summarises results of simulation.

Table 5. Croatian trade with the EU, possible effects of enlargement

1			2	3	4	5	6	7	8	9	10
			present	Trade creation		Trade Expansion		Trade Diversion		TOTAL	
			EUR 000	EUR 000	% change	EUR 000	% change	EUR 000	% change	EUR 000	% change
2	export	value	1822578	1822578		2623231	143.93	1511797	82.95	1845602	101.26
3		quantity	3201401	3201401		4102261	128.14	1559398	48.71	2067386	64.58
4	import	value	1822578	4534803	102.90	1822578	100	1822578	100	4534803	102.90
5		quantity	3201401	3810841	130.96	3201401	100	3201401		3810841	130.96
6	exchange		6229578	6357381	102.05	7030231	112.85	1952497	95.01	6380405	102.42
7	rel. trade deficit		-0.415	-0.427	102.84	-0.254	61.16	0.548578	117.91	-0.421	101.59
8	terms of trade		0.38	0.48	127.27	0.42	112.32	6.401527	170.29	5.80	199.57

Trade creation

Trade creation is simulated by 2% decrease of prices of EU products on Croatian market, which is followed by 5% increase of imports. This leads to 2,9% increase of value of imports from EU and 2,05% increase of trade (considering both, exports and imports). Lower unit import prices contribute to improvement of terms of trade (from 0.38 to 0.48), while trade deficit increases (from 41,5% to 42,7%), as shown in Table 5, columns 5 and 6.

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[19] 3.6% estimate is taken from Samardžija, Nikic, Stanicic (2000)

Trade expansion

Additional demand in present Member States, if satisfied by increased import from Croatia, can lead to 1,43 times increase of Croatian exports to the EU. This decreases relative trade deficit from current 41.5% to 25.37%. Since the additional export is considered to be export of similar products that Estonia and Hungary trade with the EU, terms of trade improve.

Trade diversion

Trade diversion is estimated under presumption that all Croatian exports to the EU in sectors in which Croatian producers do not have comparative advantages is replaced by exports from new Member States, provided that they have comparative advatnages. Comparative advantages are identified on the grounds of RCA indices calculated on the 2-level CN nomenclature and shown in Table 6.

Table 6. Sectors affected with trade diversion

CN code	01	02	04	05	06	07	08	14	20	22	26	27	28	67	72	84	85	86

The effect of trade diversion is estimated 17%, which increases relative trade deficit to 48.9%. However, if products from new member states replace exports of products that do not have comparative advantages, terms of trade improve significantly

Overall effects

Simulation that takes into account all the three effect (trade expansion, trade diversion and trade creation) shows that enlargement is likely to stimulate trade (Table 5,columns 11 and 12). Export growth is estimated at 1.26% and import at 2.9%. Relative trade deficit increases (from –41.49% to –42.14%), but terms of trade improve significantly. Improvement of terms of trade is primarily result of trade diversion effects. This shows that certain weak sectors (primarily agriculture, electrical and mechanical appliances, some chemicals and iron and steel, Table 6) will need restructuring.

Nevertheless, while the assumptions used are rather strong, the above results are very approximate, and should be used only as a rough estimate of possible developments.

5. *Sectoral analysis*

The estimate of potential impact of enlargement is based on the "traditional" approach that does not take into account sectoral variation in trade costs, nor demand elasticities. Therefore, it represents only a "best-guess" of possible developments. Further, simultaneous establishment of FTAs can, depending on the sector and partner, intensify of diminish enlargement effects. Therefore, in order to identify possible sectoral effects of the EU enlargement, comparism of selected indices between Croatia, Estonia and Hungary, rest of "first round" candidates, "second round" candidates and countries of western Balkans is made.

Integration towards the EU

Ten sectors: 62, 44, 39, 64, 95, 61, 84, 94, 73 and 76 account for 73.94% or Croatian export to the EU. Therefore, sectoral analysis is focussed on these sectors.
The basic indices for these sectors is shown in Table 7.

Table 7. Top 10 export products

CN code	Export		Import		relative trade balance		Export price index	Import price index	terms of trade	GL	RCA
	value	quantity	value	quantity	value	quantity					
39	160385	217855	170485	84832	-3,05	43,95	0,74	2,01	0,37	96,95	2,27
44	165253	533904	38729	74495	62,03	75,51	0,31	0,52	0,60	37,97	10,32
61	132586	7101	95427	4236	16,30	25,27	18,67	22,53	0,83	83,70	3,36
62	318094	8309	71566	1979	63,27	61,53	38,28	36,16	1,06	36,73	10,75
64	154923	7797	93481	7693	24,73	0,67	19,87	12,15	1,64	75,27	4,01
73	58989	63260	120179	60713	-34,15	2,05	0,93	1,98	0,47	65,85	1,19
76	39608	16822	36094	9546	4,64	27,59	2,35	3,78	0,62	95,36	2,65
84	107413	24322	698065	73083	-73,33	-50,06	4,42	9,55	0,46	26,67	0,37
85	132728	15861	363610	28388	-46,52	-28,31	8,37	12,81	0,65	53,48	0,88
94	77555	33677	112298	28486	-18,30	8,35	2,30	3,94	0,58	81,70	1,67

Croatian producers do have comparative advantages (on the grounds of RCA indices) to the EU in production of all these goods but machinery and mechanical appliances (84) and electrical machinery and equipment (85). Relative trade deficit in these sectors reaches 73.33% and 46.52%, respectively. In spite of comparative advantages in other sectors, Croatian exporters to the EU could face difficulties in integration process towards the EU. Namely, relatively low levels of GL indices suggest that national barriers to trade have not been eliminated, and that adjustments should be made in order to utilise possible positive impacts of free trade agreement implementation.
Therefore, positive effects of integration towards the EU can expect Croatian exporters of 39, 76, 61, 94 and 64. Producers of 73 can also exploit positive effects, under condition that necessary adjustments are made. Sectors that are likely to could face problems are 44, 62, 84 and 85.

Enlargement Impact

On the grounds of share in exports to the EU, the strongest export sectors of Estonia and Hungary are, by far, electrical and mechanical machinery and equipment, which represent 47,5% of total CEE-2 exports to the EU, and 43,8% of total trade with the EU. In these sectors CEE-2 also have high GL indices and relative comparative advantages towards the EU producers. On the other hand, 84 and 85 are the weakest among top 10 Croatian export sectors. Therefore, the enlargement can have strong and negative impact on Croatian producers in these sectors.
Croatia and perspective EU members export similar articles of apparel and clothing accessories (62) and footwear (64) to the EU. Therefore the enlargement effects in these

sectors can be, depending on preparations of Croatian producers positive or negative., Namely, enlargement, due the reduction of trade costs between new and present EU members can cause trade diversion effects. On the other hand, there is possiblity emerging from trade expansion to intensify the exports to the EU.

The EU enlargement offers also possibilities for increase of exports to Croatian producers of plastics (39) and articles of iron and steel (73). This is quite significant, since in iron and steel trade diversion is expected to happen (Table 6). So in this sector, Croatian producers have possibilities to specialise in products with higher unit value and which require higher share of human capital[20]. This is an important issue having in mind long-term prospect for specialisation in sectors that require higher technology, and consequently foster development and growth. For (94) enlargement could cause trade diversion effects for Croatian producers in favour of Estonian: Producers from both countries do have comparative advantages towards the EU, comparable import price index, but Estonian producers have lower index of export prices and greater amount of export. Enlargement intensifies possible effects of creation of FTA between Croatia and the EU.

Sectoral Impacts of FTAs

Croatian producers, as compared to the rest of first round candidates, should specialise in production of 39, and is relatively stronger in producing of 94. For the rest of products that are amongst most important Croatian exports to the EU, RCA and GL indices are at comparable level with Croatia (Table 9). Croatia and these CEFTA members have comparative advantages towards the EU in 44, 61, 62, 64, 73, 76 and 94, but relatively high GL indices have been acheived in producing 61, 64,73, and 75. This indicates that trade integration has not (yet) been acheived in these sectors and that significant barriers are still present. Therefore, there is a scope for mutual elimination of these barriers and possiblle creation of intra-industry trade of these goods.

The analysis of the same indicators for the second round candidates and countries of Western Balkans show that, since their trade structures are similar, there is less scope for specialisation.

Table 8. Estonia and Hungary- selected indicators

CN Code	Exports to the EU		Imports		relative trade balance	Export price index	Import price index	terms of trade	GL	RCA
	Value	quantity	value	quant.						
39	391519	426670	807373	365247	-34,69	0,92	2,21	0,42	65,31	0,58
44	574877	5251165	120606	137449	65,32	0,11	0,88	0,12	34,68	5,69
45	223	26	6578	1196	-93,44	8,58	5,50	1,56	6,56	0,04
61	382491	18452	187255	9397	34,27	20,73	19,93	1,04	65,73	2,44
62	763849	24341	192102	7098	59,81	31,38	27,06	1,16	40,19	4,75
64	301344	16208	164603	15167	29,35	18,59	10,85	1,71	70,65	2,19
73	320044	275415	497985	250758	-21,75	1,16	1,99	0,59	78,25	0,77
76	354195	155091	166509	50384	36,04	2,28	3,30	0,69	63,96	2,54
84	4324496	458805	3895727	1236131	5,22	9,43	3,15	2,99	94,78	1,33
85	3431663	260977	3790169	211998	-4,96	13,15	17,88	0,74	95,04	1,08
94	460858	175941	296984	70744	21,62	2,62	4,20	0,62	78,38	1,85

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[20] According to the Legler-Schulmeister technological classes

Table 9 Rest of "first round" candidates – selected indicators

CN Code	Exports to the EU value	quant.	Imports value	quant.	relative trade balance	Export price index	Import price index	terms of trade	GL	RCA
39	887030	761852	3038665	-54,81	-29,86	1,16	0,25	4,64	45,19	0,42
44	1585448	6102642	436461	56,83	68,91	0,26	13,98	0,02	43,17	5,24
61	589892	34444	365039	23,55	24,04	17,13	0,09	181,50	76,45	2,33
62	2136032	74705	436058	66,09	65,14	28,59	0,17	166,90	33,91	7,07
64	342843	27763	318840	3,63	-0,28	12,35	0,09	141,82	96,37	1,55
73	1807893	2048391	1631577	5,13	34,65	0,88	1,26	0,70	94,87	1,60
76	575855	283637	640060	-5,28	16,89	2,03	0,44	4,58	94,72	1,30
84	3368991	879012	9986326	-49,55	-8,75	3,83	0,09	43,54	50,45	0,49
85	4248829	636357	6316809	-19,57	18,16	6,68	0,10	66,28	80,43	0,97
94	2560787	1134398	938386	46,37	63,23	2,26	1,21	1,87	53,63	3,94

Table 10. Second round candidates- selected indicators

CN Code	Exports to the EU value	quantity	Imports value	quantity	relative trade balance	Export price index	Import price index	terms of trade	GL	RCA
39	291879	413488	705815	312253	-41,49	0,71	2,26	0,31	58,51	0,50
44	1066446	7790947	87027	80661	84,91	0,14	1,08	0,13	15,09	14,68
61	768001	57689	299201	27127	43,93	13,31	11,03	1,21	56,07	3,07
62	2491980	113983	354450	23424	75,10	21,86	15,13	1,44	24,90	8,42
63	124343	28986	69552	60842	28,26	4,29	1,14	3,75	71,74	2,14
64	832600	65822	316670	42124	44,89	12,65	7,52	1,68	55,11	3,15
73	397135	535925	415591	232705	-2,27	0,74	1,79	0,41	97,73	1,14
76	384191	263716	171405	41775	38,30	1,46	4,10	0,36	61,70	2,68
84	845601	257226	3126380	326543	-57,42	3,29	9,57	0,34	42,58	0,32
85	1005829	146973	2153114	160382	-36,32	6,84	13,42	0,51	63,68	0,56
94	618311	405050	253043	68668	41,92	1,53	3,69	0,41	58,08	2,93

Table 11. Countries of western Balkans –selected indicators

CN Code	Exports to the EU value	quant.	Imports value	quant	relative trade balance	Export price index	Import price index	terms of trade	GL	RCA
39	5211	5548	63990	36050	-84,94	0,94	1,78	0,53	15,06	0,18
44	56897	164002	15095	27548	58,06	0,35	0,55	0,63	41,94	8,17
61	72398	7265	38789	3943	30,23	9,97	9,84	1,01	69,77	4,04
62	286136	16426	50207	4382	70,15	17,42	11,46	1,52	29,85	12,35
64	125922	8827	71278	8653	27,71	14,27	8,24	1,73	72,29	3,83
73	17267	20536	43158	28517	-42,85	0,84	1,51	0,56	57,15	0,87
76	31507	21875	32302	7547	-1,25	1,44	4,28	0,34	98,75	2,11
84	18167	5195	264046	47160	-87,13	3,50	5,60	0,62	12,87	0,15
85	19814	7873	129123	12534	-73,39	2,52	10,30	0,24	26,61	0,33
94	9475	6896	36396	12899	-58,69	1,37	2,82	0,49	41,31	0,56

6. Main Challenges and Opportunities for Croatia

The EU enlargement brings both, challenges and opportunities for Croatian economy as a whole. Preliminary analyses of Croatian present trade links show that positive impacts of enlargement can expect Croatian producers (exporters to the EU) of plastics and plastic products, while trade diversion effects can prevail for producers of machinery and mechanical appliances, in agriculture, traditional industries (textile, iron and steel, some chemicals). However, the effects of enlargement will depend on its timing and success of (internal) reforms conducted until then. The adjustment to the enlarged EU comprises of transition and integration specific measures that should be introduced at local, regional and European level.

Compared to the present trade with the EU, enlargement can cause increase of imports, and exports. The enlargement impact on increase of imports is assesed at 2.9%, but it has to be considered together with possible increase of imports caused by creation of a FTA with the EU, which is estimated up to 12%. Increase of export is assesed assesed at 1.26% (and the FTA with the EU can bring additional 3.6%). Therefore, the enlargement can be seen as a process that itensifie effects of integration towards the EU. This conclusion holds also on the sectoral level.
Further, it seems that regional integration, although does not bring significant long-term positive effects can contribute to the inclusion into the EU. In this context, it should be regarded as supportive measure in the process of transition and integration.
The reluctance to conclude some of regional FTAs, can, to the certain extent, be compared with the emegring of CEFTA, which was supported by statements that arguee that transition economies were not in position to fully liberalise their trade regimes as there was a threat of "trapping failure". However, empirical evidence from candidate countries shows that overall balance has been positive and can be so for the countries of the SEE.[21] Further, liberalisation at the regional level should be seen as complementary to the wider EU integration. Terms of regional liberalisation, integration and co-operation should be gradual and clearly defined so to facilitate achievement of a common interest of countries of the region, which is the full EU membership.

Therefore, FTAs are one of the instruments for achieving sustainable growth in the South Eastern Europe. They are also of significance for integration of SEE countries into the global economic system. However, since national markets in SEE are small, regional free trade areas alone cannot solve the problems the economies in the region face, since the region alone cannot act as the main engine for growth. Therefore access to, and integration into a wider European free trade area, is the key for economic growth and successful transition of these economies.

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[21] Wilton Park Conference (2001)

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Annex: Two digit Combined Nomenclature

Product	Title
01	LIVE ANIMALS
02	MEAT AND EDIBLE MEAT OFFAL
03	FISH AND CRUSTACEANS, MOLLUSCS AND OTHER AQUATIC INVERTEBRATES
04	DAIRY PRODUCE; BIRDS' EGGS; NATURAL HONEY; EDIBLE PRODUCTS OF ANIMAL ORIGIN, NOT ELSEWHERE SPECIFIED OR INCLUDED
05	PRODUCTS OF ANIMAL ORIGIN NOT ELSEWHERE SPECIFIED OR INCLUDED
06	LIVE TREES AND OTHER PLANTS; BULBS, ROOTS AND THE LIKE; CUT FLOWERS AND ORNAMEN0TAL FOLIAGE
07	EDIBLE VEGETABLES AND CERTAIN ROOTS AND TUBERS
08	EDIBLE FRUIT AND NUTS; PEEL OF CITRUS FRUITS OR MELONS
09	COFFEE, TEA, MATE AND SPICES
10	CEREALS
11	PRODUCTS OF THE MILLING INDUSTRY; MALT; STARCHES; INULIN; WHEAT GLUTEN
12	OIL SEEDS AND OLEAGINOUS FRUITS; MISCELLANEOUS GRAINS, SEEDS AND FRUIT; INDUSTRIAL OR MEDICAL PLANTS; STRAW AND FODDER
13	LACS; GUMS, RESINS AND OTHER VEGETABLE SAPS AND EXTRACTS
14	VEGETABLE PLAITING MATERIALS; VEGETABLE PRODUCTS NOT ELSEWHERE SPECIFIED OR INCLUDED
15	ANIMAL OR VEGETABLE FATS AND OILS AND THEIR CLEAVAGE PRODUCTS; PREPARED EDIBLE FATS; ANIMAL OR VEGETABLE WAXES
16	PREPARATIONS OF MEAT, FISH OR CRUSTACEANS, MOLLUSCS OR OTHER AQUATIC INVERTEBRATES
17	SUGARS AND SUGAR CONFECTIONERY
18	COCOA AND COCOA PREPARATIONS
19	PREPARATIONS OF CEREALS, FLOUR, STARCH OR MILK; PASTRYCOOKS' PRODUCTS
20	PREPARATIONS OF VEGETABLES, FRUIT, NUTS OR OTHER PARTS OF PLANTS
21	MISCELLANEOUS EDIBLE PREPARATIONS
22	BEVERAGES, SPIRITS AND VINEGAR
23	RESIDUES AND WASTE FROM THE FOOD INDUSTRIES; PREPARED ANIMAL FODDER
24	TOBACCO AND MANUFACTURED TOBACCO SUBSTITUTES
25	SALT; SULPHUR; EARTHS AND STONE; PLASTERING MATERIAL, LIME AND CEMENT
26	ORES, SLAG AND ASH
27	MINERAL FUELS, MINERAL OILS AND PRODUCTS OF THEIR DISTILLATION; BITUMINOUS SUBSTANCES; MINERAL WAXES
28	INORGANIC CHEMICALS: ORGANIC OR INORGANIC COMPOUNDS OF PRECIOUS METALS, OF RARE-EARTH METALS, OF RADIOACTIVE ELEMENTS OR OF ISOTOPES
29	ORGANIC CHEMICALS
30	PHARMACEUTICAL PRODUCTS
31	FERTILIZERS
32	TANNING OR DYEING EXTRACTS; TANNINS AND THEIR DERIVATIVES; DYES, PIGMENTS AND OTHER COLOURING MATTER; PAINTS AND VARNISHES; PUTTY AND OTHER MASTICS; INKS

33	ESSENTIAL OILS AND RESINOIDS; PERFUMERY, COSMETIC OR TOILET PREPARATIONS
34	SOAPS, ORGANIC SURFACE-ACTIVE AGENTS, WASHING PREPARATIONS, LUBRICATING PREPARATIONS, ARTIFICIAL WAXES, PREPARED WAXES, SHOE POLISH, SCOURING POWDER AND THE LIKE, CANDLES AND SIMILAR PRODUCTS, MODELLING PASTES, DENTAL WAX AND PLASTER-BASED DENTAL
35	ALBUMINOUS SUBSTANCES; MODIFIED STARCHES; GLUES; ENZYMES
36	EXPLOSIVES; PYROTECHNIC PRODUCTS; MATCHES; PYROPHORIC ALLOYS; COMBUSTIBLE MATERIALS
37	PHOTOGRAPHIC OR CINEMATOGRAPHIC PRODUCTS
38	MISCELLANEOUS CHEMICAL PRODUCTS
39	PLASTICS AND PLASTIC PRODUCTS
40	RUBBER AND ARTICLES THEREOF
41	HIDES AND SKINS (OTHER THAN FURSKINS) AND LEATHER
42	ARTICLES OF LEATHER; SADDLERY AND HARNESS; TRAVEL GOODS, HANDBAGS AND SIMILAR CONTAINERS; ARTICLES OF ANIMAL GUT (OTHER THAN SILK-WORM GUT)
43	FURSKINS AND ARTIFICIAL FUR; ARTICLES THEREOF
44	WOOD AND ARTICLES OF WOOD; WOOD CHARCOAL
45	CORK AND ARTICLES OF CORK
46	WICKERWORK AND BASKETWORK
47	PULP OF WOOD OR OF OTHER FIBROUS CELLULOSIC MATERIAL; WASTE AND SCRAP OF PAPER OR PAPERBOARD
48	PAPER AND PAPERBOARD; ARTICLES OF PAPER PULP, PAPER OR PAPERBOARD
49	BOOKS, NEWSPAPERS, PICTURES AND OTHER PRODUCTS OF THE PRINTING INDUSTRY; MANUSCRIPTS, TYPESCRIPTS AND PLANS
50	SILK
51	WOOL, FINE AND COARSE ANIMAL HAIR; YARN AND FABRICS OF HORSEHAIR
52	COTTON
53	OTHER VEGETABLE TEXTILE FIBRES; PAPER YARN AND WOVEN FABRICS OF PAPER YARN
54	MAN-MADE FILAMENTS
55	MAN-MADE STAPLE FIBRES
56	WADDING, FELT AND NONWOVENS; SPECIAL YARNS; TWINE, CORDAGE, ROPE AND CABLE AND ARTICLES THEREOF
57	CARPETS AND OTHER TEXTILE FLOOR COVERINGS
58	SPECIAL WOVEN FABRICS; TUFTED TEXTILE PRODUCTS; LACE; TAPESTRIES; TRIMMINGS; EMBROIDERY
59	IMPREGNATED, COATED, COVERED OR LAMINATED TEXTILE FABRICS; ARTICLES FOR TECHNICAL USE, OF TEXTILE MATERIALS
60	KNITTED OR CROCHETED FABRICS
61	ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, KNITTED OR CROCHETED
62	ARTICLES OF APPAREL AND CLOTHING ACCESSORIES, NOT KNITTED OR CROCHETED
63	OTHER MADE UP TEXTILE ARTICLES; SETS; WORN CLOTHING AND WORN TEXTILE ARTICLES; RAGS
64	FOOTWEAR, GAITERS AND THE LIKE; PARTS OF SUCH ARTICLES
65	HEADGEAR AND PARTS THEREOF
66	UMBRELLAS, SUN UMBRELLAS, WALKING-STICKS, SEAT-STICKS, WHIPS, RIDING-CROPS AND PARTS THEREOF

67	PREPARED FEATHERS AND DOWN AND ARTICLES MADE OF FEATHERS OR OF DOWN; ARTIFICIAL FLOWERS; ARTICLES OF HUMAN HAIR
68	ARTICLES OF STONE, PLASTER, CEMENT, ASBESTOS, MICA OR SIMILAR MATERIALS
69	CERAMIC PRODUCTS
70	GLASS AND GLASSWARE
71	NATURAL OR CULTURED PEARLS, PRECIOUS OR SEMI-PRECIOUS STONES, PRECIOUS METALS, METALS CLAD WITH PRECIOUS METAL, AND ARTICLES THEREOF; IMITATION JEWELLERY; COIN
72	IRON AND STEEL
73	ARTICLES OF IRON OR STEEL
74	COPPER AND ARTICLES THEREOF
75	NICKEL AND ARTICLES THEREOF
76	ALUMINIUM AND ARTICLES THEREOF
78	LEAD AND ARTICLES THEREOF
79	ZINC AND ARTICLES THEREOF
80	TIN AND ARTICLES THEREOF
81	OTHER BASE METALS; CERMETS; ARTICLES THEREOF
82	TOOLS, IMPLEMENTS, CUTLERY, SPOONS AND FORKS, OF BASE METAL; PARTS THEREOF OF BASE METAL
83	MISCELLANEOUS ARTICLES OF BASE METAL
84	NUCLEAR REACTORS, BOILERS, MACHINERY AND MECHANICAL APPLIANCES; PARTS THEREOF
85	ELECTRICAL MACHINERY AND EQUIPMENT AND PARTS THEREOF; SOUND RECORDERS AND REPRODUCERS, TELEVISION IMAGE AND SOUND RECORDERS AND REPRODUCERS, AND PARTS AND ACCESSORIES OF SUCH ARTICLES
86	RAILWAY OR TRAMWAY LOCOMOTIVES, ROLLING-STOCK AND PARTS THEREOF; RAILWAY OR TRAMWAY TRACK FIXTURES AND FITTINGS AND PARTS THEREOF; MECHANICAL, INCLUDING ELECTRO-MECHANICAL, TRAFFIC SIGNALLING EQUIPMENT OF ALL KINDS
87	VEHICLES OTHER THAN RAILWAY OR TRAMWAY ROLLING-STOCK, AND PARTS AND ACCESSORIES THEREOF
88	AIRCRAFT, SPACECRAFT, AND PARTS THEREOF
89	SHIPS, BOATS AND FLOATING STRUCTURES
90	OPTICAL, PHOTOGRAPHIC, CINEMATOGRAPHIC, MEASURING, CHECKING, PRECISION, MEDICAL OR SURGICAL INSTRUMENTS AND APPARATUS; PARTS AND ACCESSORIES THEREOF
91	CLOCKS AND WATCHES AND PARTS THEREOF
92	MUSICAL INSTRUMENTS; PARTS AND ACCESSORIES FOR SUCH ARTICLES
93	ARMS AND AMMUNITION; PARTS AND ACCESSORIES THEREOF
94	FURNITURE; MEDICAL AND SURGICAL FURNITURE; BEDDING, MATTRESSES, MATTRESS SUPPORTS, CUSHIONS AND SIMILAR STUFFED FURNISHINGS; LAMPS AND LIGHTING FITTINGS, NOT ELSEWHERE SPECIFIED; ILLUMINATED SIGNS, ILLUMINATED NAME-PLATES AND THE LIKE; PREFABRICA
95	TOYS, GAMES AND SPORTS REQUISITES; PARTS AND ACCESSORIES THEREOF
96	MISCELLANEOUS MANUFACTURED ARTICLES
97	WORKS OF ART, COLLECTORS' PIECES AND ANTIQUES
98	COMPONENTS OF COMPLETE INDUSTRIAL PLANTS OF CHAPTER 63: POWER PRODUCTION, INCL. PRODUCTION AND DISTRIBUTION OFSTEAM AND HOT WATER
99	OTHER PRODUCTS