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MASTER'S THESIS

THE IMPACT OF CEFTA MEMBERSHIP ON ALBANIA'S IMPORTS

Ljubljana, March 2017 LABEAT MUSTAFA

AUTHORSHIP STATEMENT

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INTRODUCTION

As the pace of globalization is intensifying, free trade agreements (hereinafter: FTAs) are becoming more prevalent. More than 260 FTAs are currently in force, many others are being negotiated and most of the world's countries are part of at least one FTA (WTO, n.d). As a broad range of trade agreements, FTA liberalizes the market of member countries and eliminates barriers (tariff and non-tariff barriers) on trade in goods between them. However, each country maintains its trade policy toward non-member countries.

FTAs are an important determinant of economic integration especially for developing and transition countries. The Central European Free Trade Agreement (hereinafter: CEFTA) is one such agreement which was formed in 1992 by the Visegrad Group countries; that is by Poland, Hungary, and Czech and Slovak Republics. As all founding countries joined the European Union (EU), they left CEFTA, while other countries became members of the CEFTA (Todorovic, 2011).

On December 19, 2006, Albania, Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia, and the United Nations Interim Administration Mission in Kosovo (UNMIK), on behalf of Kosovo, signed a new enlargement agreement of CEFTA and formed a joint market of approximately 27 million consumers (CEFTA, n.d).

In a way, CEFTA is a path on which all countries of the West Balkans prepare themselves to transition toward a potential EU membership (Nikolic, Javanocis, & Todoric, 2011). One of the main objectives of CEFTA is to develop economic relations among the members through the expansion of trade, to raise standards of living, to ensure better employment opportunities, and to increase productivity (Novinite, 2004).

In terms of trade, as most of the western Balkan countries, Albania continues to be an import-oriented economy with a small, narrow, and undiversified export base, while the import base remains large. The EU remains Albania's main trading partner, providing 61.1% of Albania's imports and receiving 77.4% of exports as of December 2014. The other major trading partners are Turkey and China (INSTAT, 2015). Even though the impact of CEFTA in Albania's trade with member countries has been small, there is evidence that imports increased rapidly.

From the beginning of Albania's participation in CEFTA in 2007, until 2014, imports from member countries increased 97 %, while imports from other trade partners for the same period increased by just 47 % (INSTAT, 2015).

Understanding the impact of CEFTA on Albania's imports is very important in order to design proper policies and to reap more benefits. Furthermore, an assessment of the CEFTA's actual versus projected impact is necessary in order to determine whether the objectives have been met or policy adjustments are needed.

Therefore, considering the trends of imports after 2007, my research will focus on the impact of CEFTA on Albanian's imports. The aim of this study is to test the hypothesis that CEFTA has had an impact on the increase of Albanian's import from member countries. Furthermore, I will analyse whether the increase of imports is driven by the implementation of CEFTA, or other factors play role are also relevant. Finally, to the best of our knowledge, this is the first attempt to investigate the role that CEFTA has had on Albania's imports in a panel data framework.

The thesis is organized in four chapters. The first chapter will elaborate CEFTA in term of organization, functioning and mission. Chapter 2 will present an overview of the Albanian economy and its trade trends. Chapter 3 will present the literatures reviewed, methodology used, and results gotten from gravity model estimation. The final section will conclude based on evidence found by my research.

1 CEFTA OVERVIEW

After the collapse of socialism in Eastern Europe, there was a need for important trade reforms as part of their transformation toward market economies. In this context, most of the countries initiated trade liberalization based on their respective economic and political needs. Consequently, on 21 December 1992, the first multilateral trade agreement in eastern Europe was signed by the Visegrad countries: Poland, Hungary, and the Czech and Slovak Republics. However, the implementation of this agreement started just on July 1994. Two years later, four founding members of the agreement were joined by Slovenia, followed by Romania in 1997, Bulgaria in 1999, Croatia in 2002 and Macedonia in 2006. Later on, as most of the members joined EU, they left CEFTA which led to a need for a retooled CEFTA.

1.1 CEFTA 2006

The appearance of the international initiative, known as the Stability Pact for South-East Europe (hereinafter: SPSEE) in 1999, played an important role on the strengthening of peace, democracy, human rights and economy in south east European countries. Important emphasis was also given on trade relations between countries. Particularly important was the influence of SPSEE on the establishment of the CEFTA 2006 (Todorovic, 2011).

By the end of 2004, most of western Balkan countries had signed bilateral trade agreements with each other. But, due to many differences among the signed trade agreements, in terms of their content and preferential volumes, the trade process between countries was not seen as efficient and beneficial for all countries. Therefore, in order to overcome this issue, a new multilateral agreement knows as CEFTA 2006 was established (Todorovic, 2011).

On December 19, 2006, Albania, Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia and the United Nations Interim Administration Mission in Kosovo

(UNMIK) on behalf of Kosovo, under the auspices of the SPSEE and with the support of the European Commission (hereinafter: EC), signed an agreement to substantially amend and enlarge the existing membership of CEFTA. After the ratification process of the agreement by member countries, CEFTA 2006 came into force in July 2007, for five members; Albania, Macedonia, Moldova, Montenegro, and UNMIK/Kosovo. Two months later, Croatia became an official member of CEFTA, followed by Serbia in October and Bosnia and Herzegovina which finalized the process on November 2007. The speed and effort with which the member countries finalized the process of the ratification of the agreement, was a clear indication of the importance of CEFTA for their economies and their way toward the EU (CEFTA, n.d).

CEFTA 2006 is a modern agreement with sustainable rules and objectives, such as the elimination of tariff and non-tariff barriers, protection of intellectual property rights, development of legal infrastructure, improving the business climate and image of the region, attraction of foreign direct investments (FDI), and particularly, providing a cheaper and better quality of services and products to the customers of the member countries. Furthermore, all the rules and procedures of CEFTA are in compliance with WTO and EU regulations (CEFTA, n.d.). Hence, CEFTA provide an excellent platform for member countries, in their way toward EU integration.

In addition to trade relation, establishment of CEFTA has contributed a lot for improving of political relations between members also (Guxholli, 2012). So, no one can deny the positive role that CEFTA has in the political context. Furthermore, CEFTA offered a great opportunity for all countries to improve the competitiveness and to increase their capacities before becoming part of very strict structure such as EU market.

Regarding the CEFTA members, almost all parties were part of the ex-Yugoslav federation, and they used to trade with each other. Consequently, those countries were much better connected in terms of trade and other operational procedures. But the situation was not the same for Albania which was an independent state, and Moldova which was part of Union of Soviet Socialist Republics (USSR). In this aspect, CEFTA was seen as great opportunity for better connection between all members.

According to Article 51 of CEFTA 2006, member countries agree that in the event of any member joining EU, that member will withdraw from CEFTA without having to provide any compensation to other members. Withdrawal from CEFTA shall take place at least one day before a respective member officially becomes an EU member (WIPO, n.d.). Today, CEFTA 2006 has one less member than it had when trade agreement entered into the force. On July 1, 2013, Croatia became EU member and consequently it was obliged to leave CEFTA (UNDA, 2014). For this reason, CEFTA is not a final goal of member countries, but a step toward EU membership.

1.2 Mission and Objectives of CEFTA

In order to create new and more favorable economic environment in the western Balkan countries and Moldova, CEFTA was established. Even though there were a considerable number of bilateral trade agreements between member countries, there were huge differences among them. Thus, among other objectives, CEFTA was mainly created to simplify a complicated matrix of bilateral agreements and to boost trade between member countries (Delević, 2011). As stated under article 1 of agreement, the main objectives of agreement are to:

a) Consolidate in a single agreement the existing level of trade liberalisation achieved through the network of bilateral free trade agreements already concluded between the Parties;
b) Improve conditions further to promote investment, including foreign direct investment;
c) Expand trade in goods and services and foster investment by means of fair, clear, stable and predictable rules;
d) Eliminate barriers to and distortions of trade and facilitate the movement of goods in transit and the cross-border movement of goods and services between the territories of the Parties;
e) Provide fair conditions of competition affecting foreign trade and investment and gradually open the government procurement markets of the Parties;
f) Provide appropriate protection of intellectual property rights in accordance with international standards;
g) Provide effective procedures for the implementation and application of this Agreement and
h) Contribute thereby to the harmonious development and expansion of world trade.

As can be seen by article 1 of CEFTA, the agreement is a modern FTA with multidimensional objectives. In addition to the free trade of goods, CEFTA provides an appropriate protection of intellectual property rights in accordance with international standards. The expansion of trade in services is another objective of CEFTA. Also, the promotion of member countries as an attractive destination for foreign investors remains among the top priorities of the agreement (WIPO, n.d).

In general, CEFTA 2006 was seen as a key instrument by which member countries can attain sustainable long-term growth and improve living standards of member countries (OECD, 2012). The increase of cooperation between member countries is seen as another achievement toward EU accession. As it is believed, the impact of CEFTA goes beyond economic relations. Having in mind the difficult political situation that ex Yugoslavia went through, CEFTA has served as very good initiative for improving of overall situation, including trade, economic, social and political relations.

1.3 Structure of CEFTA

Achievement of full CEFTA objectives is quite challenging task therefore, to ensure implementation of CEFTA's objectives, a number of structures have been established. One of these structures such as the Joint Committee was established under the CEFTA Agreement itself, while others have been set-up more through decisions of the Joint Committees (CEFTA, n.d).

The official bodies of CEFTA include:

a) The Joint Committee, which is chaired by one of the parties on a rotating basis;
b) The Sub-committees on Agricultural and Sanitary and Phytosanitary Issues;
c) The Sub-committee on Customs and Rules of Origin;
d) The Sub-Committee on Technical Barriers to Trade and Non Tariff Barriers;
e) The Working Group on Technical Barriers to Trade;
f) The Working Group on Trade in Services;
g) The CEFTA Secretariat**.**

To ensure progress on FTA implementation of CEFTA, member countries hold regular meetings represented by Deputy Ministers that are responsible for trade. Although not a formal body under the Agreement, the annual meeting of the deputy ministers plays an important role in reviewing annual progress of CEFTA implementation. On occasion, Summits of Prime Ministers are organized to highlight particular achievements and to reiterate the commitment to trade liberalization and investment promotion (CEFTA, n.d).

1.3.1 Joint Committee

The governing body of CEFTA is the Joint Committee, which has been established in accordance with Article 40 of the Agreement. The Joint Committee is composed of representatives of each member countries that usually are ministers responsible for trade issues in respective members. The main function of Joint Committee is to supervise and administer the implementation of the Agreement (CEFTA, n.d.).

The Joint Committee meets regularly, at least once a year and makes decisions by consensus. These decisions and recommendations of the Joint Committee shall take effect upon adoption by representatives of member countries (CEFTA, n.d.). In 2012, the sixth Joint Committee meeting was held on Albania, where the main topic discussed was withdrawal of Croatia by CEFTA, as a consequence of its upcoming accession to the EU. Therefore, this was the last Joint Committee that Croatia participated.

Joint committee is chaired by one of the parties and this function revolves on an annual basis. Each Chairmanship works bases on a system of annual program. (CEFTA, n.d).

1.3.2 Sub-committees

Even though the immediate progress that is made for elimination of tariffs between CEFTA members, there are still concerns related with non-tariff barriers (NTBs). Thus, in order to further enhance the trade between CEFTA members, given the technical nature of NTBs, several sub-committees were established.

On the first meeting of Joint Committee, that was held on 2007, in Macedonia, Joint Committee members agreed to establish three sub-committees that deal with different NTBs issues:

a) The Subcommittee on Agriculture and Sanitary and Phytosanitary (SPS) Issues
b) The Subcommittee on Customs and Rules of Origin.
c) The Subcommittee on Technical Barriers to Trade (TBTs) and NTBs and,

The objective of subcommittee on agriculture and SPS is to facilitate trade in agricultural products within CEFTA members and in the same time to ensure that protection of plant health, animal health and food safety (CEFTA, n.d). Establishment of this committee indicates the importance that agriculture sector plays for CEFTA members.

The subcommittee on customs and rules of origins was established with objective to help the simplification and facilitation of customs procedures through the establishment of a system of integral border control, united customs clearance and data harmonization. While, the subcommittee on TBT and NTB was established with the aim to review and propose measures and deadlines for the elimination of technical barriers among the parties. In addition, this subcommittee deals with complaints made by each member state on the non-tariff barriers created by the other member.

Knowing the importance of trade in services for economies of CEFTA members, on 2014, Joint Committee decided to establish the Sub-Committee on Trade in Services. The main reason behind establishment of this committee is to ensure that implementation of commitments for services and to strengthen and deepen interregional trade in field of (CEFTA, n.d).

All of these subcommittees were established with the aim to overcome NTBs and consequently to further increase intra-trade between CEFTA members. Even though the progress that is made in these issues, there is still work to be made in this respect. In general, the sub-committees meet at least once per year and can also meet on an ad hoc basis if deemed necessary. The Chair of each sub-committee rotates among the member countries on a yearly basis (CEFTA, n.d)..

1.3.3 CEFTA Secretariat

In order to support Joint Committee and other CEFTA structures, in accordance with Article 40.2 of CEFTA agreement, the small permanent secretariat located in Brussels has

been established. The overall role of the Secretariat is to provide technical, administrative and professional support to the Joint Committee, to any sub-committee, expert group or other body established by the Joint Committee (CEFTA, n.d). In addition to technical support, the role of secretariat is to facilitate the negotiations among CEFTA members (European Commission, n.d).

In addition to the CEFTA members and structures, a broad range of international partners support the implementation of the Agreement. In this context, the CEFTA Secretariat maintains close co-operation with the various partners to ensure their involvement as appropriate in different activities and events. The Secretariat is currently financed jointly by the CEFTA members and a number of donors including the European Commission (CEFTA, n.d).

1.4 Challenges of CEFTA Implementation

Signing and ratifying an FTA, is just a ceremonial act. In case those signatory countries do not fully implement the written agreement, it can end just as a piece of paper. As was discussed in the previous section, the achievement of CEFTA objectives is quite a challenging task. It requires a high degree of effort by member countries and at the same time a lot of resources. Even though the progress that is made toward the elimination of tariff barriers between CEFTA members, there is still progress to be made related with the elimination of NTBs. "Previous experiences from regional integrations have shown that customs duties are not necessarily the largest barrier to trade. There are more serious problems in the field of non-tariff barriers such as customs procedures, administrative practice, technical barriers, restrictive trade visa regime etc. These non-tariff barriers are much more restrictive, more complex, less transparent, difficult to define and quantify and as a consequence they are more difficult to eliminate". Furthermore, such barriers can even block trade completely. (Zeljković, 2011)

In general, greater customs liberalization of trade leads to an increase in the importance of non-tariff barriers within member countries of an FTA. A similar practice is also happening in the case of CEFTA. Although it sounds paradoxical, the process of joining the EU did not eliminate barriers between the member countries of CEFTA, furthermore it created new barriers. Non-tariff barriers within CEFTA members has increased due to the fact that CEFTA members are usually at different stages of the harmonization of their legislature with the EU legal system "acquis communautaire" (AC). Thus, strict harmonization of legislation of one CEFTA member with EU standards leads to the increase of the gap with other CEFTA members, in the legislative context. Consequently, trade between CEFTA members sometimes faces difficulties due to unsynchronized harmonization of legislation (Zeljković, 2011). In order to eliminate these barriers between member countries, concrete initiatives should be taken in that direction. Such initiatives require both time and resources.

Although there are many visible results in the implementation of the CEFTA Agreement, there are some ongoing problems, most commonly related to non-tariff barriers (B, Todorovic, 2011). Therefore, to enhance trade between the member countries of CEFTA, further progress needs to be made in the reduction of NTBs. Even though a negotiation framework for the elimination of NTBs has been established between CEFTA members, elimination on a multilateral basis has been unsatisfactory (OECD, 2012).

According to the OECD (2012), the main NTBs of CEFTA are structured around three policy dimensions, which are:

a) Technical Barriers to Trade;
b) Sanitary and phytosanitary measures;
c) Administrative barriers to trade.

In order to eliminate Technical Barriers to Trade (TBTs), the member countries of CEFTA are following EU members' practices which have harmonized their quality infrastructure systems and as a consequence TBTs in the EUs internal market have been practically eliminated (OECD, 2012).

The main issues related with TBTs are to provide services in the area of standardization, accreditation and conformity assessments that are internationally recognized. In this aspect, more constant progress has been made in the field of accreditation. Albania, Serbia, Montenegro, Macedonia have harmonized their legislation and their National Accreditation Bodies (NABs) are full members of European co-operation for Accreditation (EA), implying that documents issued by NABs of respective members, are recognized by all CEFTA members, the EU and worldwide. On the other hand, the NABs of Bosnia and Herzegovina, Kosovo, and Moldova, are only associated members of the EA (EA, 2016). Thus, more progress is needed in this direction in order to overcome trade constraints related with the accreditation by becoming full member of EA.

Less but still significant progress has been made in the field of standardization by member countries. To date, only National Standardization Bodies (NSB) of Serbia and Macedonia have become members of European Committee for Standardization (CEN) while the NSBs of the other CEFTA members remain to improve their legal and technical infrastructure in order to join CEN (CEN, 2016).

Meanwhile, progress in field of conformity assessment has been slower. To date, none of the CEFTA member have signed Agreements on Conformity Assessment and Acceptance of Industrial Products (ACAA), which currently is the largest TBT. The signing of this agreement between the members of CEFTA and the EU would lead to automatic mutual acceptance, without additional testing and conformity assessment procedures. By signing the ACAA, the members of CEFTA would be able to trade their products without additional testing and conformity assessment procedures not only inside CEFTA, but the EU market also (OECD, 2012).

Regarding food and feed safety, animal and plant health, sanitary and phytosanitary (SPS) agencies exist in all CEFTA members, either as independent bodies or within relevant ministries (OECD, 2012). The main objective of those measures is to ensure that food is safe for consumers and to prevent the spread of diseases among animals and plants.

Although, the primary goal of SPS measures is to protect human, animal and plant life, sometimes those measures are used to protect domestic producers from international competition (OECD, 2012). Under Article 12 of CEFTA 2006, the rights and obligations of CEFTA members shall be governed based on the WTO SPS Agreement. This agreement states that economies have the right to set their standards regarding food safety, animal and plant health, but at the same time ensuring that those measures are scientifically justifiable and do not result in unnecessary barriers to foreign trade (OECD, 2012).

With regards to the elimination of Administrative Barriers to Trade (ABT), CEFTA has established a specific sub-committee that deal with these issues. This group of NTBs very often results from bureaucratic procedures that trading companies have to get through when shipping goods from one country to the other. Thus, the main sources of administrative barriers are regulation and laws.

Even though progress that is made by from CEFTA members, there is still work to be done to eliminate NTBs. The fact that all CEFTA members are pursing EU integration individually is making the elimination of NTBs more complex. The multispeed and unsynchronized adaptation of EU regulations is generating additional NTBs for trade between CEFTA members. Products that are coming from economies that are lagging in the implementation of international standards are having difficulties accessing the markets of the more advanced members (OECD, 2012).

Another limitation of CEFTA membership is financial resources. Due to the lack of financing, the number of participants attending CEFTA meetings that are crucial for further progress is limited. Although meetings between member countries are necessary to discuss new initiatives and speed up the process, they still rely on the official CEFTA meetings (OECD, 2012).

Despite financial limitations and other trade constraints such as NTBs, the implementation of CEFTA continues. Significant progress has been made and intra trade between CEFTA members has increased. However, more work remains to be done in order to harmonize members' legislation with the EU, to increase technical capacities and to eliminate NTBs.

2 ALBANIA'S TRADE

2.1 Economic Overview of Albania

Albania, as a former communist state with a centrally-planned economy, went through a difficult transition towards an open-market. After the fall of communism in 1992, important reforms were taken by successive democratic governments that helped the

country get closer to international trade standards. Even though state institutions tried to deal with high unemployment, widespread corruption, and poor physical infrastructure, the transition period had proven challenging for Albania (Central Intelligence Agency, n.d). However, due to many economic reforms, Albania has made considerable progress in macroeconomic and fiscal policies. In addition to that, adequate fiscal reforms have been introduced to attract more foreign direct investments (CIA, n.d.).

Regarding the economic activities, agriculture remains Albania's largest sector which accounts to about one-fifth of its GDP and provides employment for 55% of total workers in the country. However, there are a lot of problems that have limited the agro-capacity of Albania, such as migration from rural areas, smallholder of lands, outdated technology, week organization of agriculture stakeholders, and many other problems that are causing inefficiency in the agriculture sector (European Commission, 2014).

Regarding the manufacturing industries, those remain quite concentrated and mainly based on natural resources. The assortment of Albania's production consists mainly of chemicals, mining, basic metals, oil, hydropower, cement, food processing, textile and clothing, and lumber. Similar to the production assortment, exports of commodities consist of textiles and footwear, asphalt, metals and metallic ores, crude oil, vegetables, fruits, and tobacco.

According to international standards, Albania remains a poor country with 12.4 per cent of the population living below the poverty line. Even though that share of population under poverty line has decreased during last two decades, it remains quite high and one of the main problems of Albania's population (INSTAT, 2013).

The public debt of Albania, continues to be high but, still on acceptable levels. According to Bank of Albania (2012), the public debt of Albania in 2012 was at level of 61 % of GDP. On other hand, the remittances of Albania have played a crucial role for the economy of Albania. It continues to be one of the main sources of financing a huge trade deficit of the country. In 2012, around 6.6 % of Albanian's GDP came from remittances from Albanians working abroad, mostly in Greece and Italy (Bank of Albania, 2012).

Although Albania's economy has not been directly hit by the global financial crisis, the country witnessed slower economic growth. Due to strong trade relations and banking sector ties with Greece and Italy, Albania's economy remains vulnerable to negative cross-border spillover effects. In this direction, Greece's economic crisis has already pushed some Albanian workers to return home, which resulted in a decline of remittances (Barber, 2015).

Regardless of the difficulties of the current economic situation, Albania has a high potential for economic development. It has a strong human base and lots of natural resources including chrome which is one of the most important sources of hard-currency income. At the same time, Albania has more than 400 km of seaside, which is becoming a very attractive destination for international tourist. In addition to that, Albania has an

advantage of a cheap labour force which can be used as a great incentive for attracting more FDI in Albania, especially from EU countries.

The state institutions of Albania are engaged in EU-related reforms and are continuing to make progress in that respect, however there are several issues that Albania has overcome. Therefore, in order to be able to open negotiations for EU accession, it needs to continue reforming of its economic and political system, which is the main objective of country.

2.2 Historical Overview of Trade and Trade Policy of Albania

Since Albania's liberation from German occupation in 1944, the Socialist People's Republic of Albania was established and the country was governed based on socialist principles. Similar to other segments of the economy, trade in Albania was also under strict control by state institutions. When the political situation changed in 1990, the government practiced a monopoly on foreign trade and controlled it through a highly-centralized system. Stalin's model was used as reference point and all external transactions were conducted through foreign trade enterprises, which were under the state umbrella. Any losses that resulted from foreign trade enterprises were covered by the State Bank. The trade balance was strictly maintained through a country-by-country principle until 1990. Therefore, foreign companies won or lost contracts depending on Albania's trade balance with their home country in the respective time (Mongbay, 1992).

After the downfall of the centrally planned economic system in Albania, new methods of conducting foreign trade were established. The strict monopoly that government had on foreign trade was abandoned, allowing state-owned enterprises, and later-on, private companies to conduct foreign trade and to perform all activities related with trade, that were not possible before (Mongbay, 1992).

At the first phase of trade liberalization, the trade regime was characterized by low tariffs. However, due to new economic circumstances, Albania started to suffer a huge trade deficit, which became a chronic problem for the Albanian economy. Incomes from the production sector were limited while state expenditures were increased. In order to balance the budget and to narrow trade deficit, state institutions were obliged to increased import tariffs (Jaupllari, 2013).

On the other hand, the government attempted to stimulate exports by establishing a department which advised state and private enterprises. It provided data on world prices, product availability, and other information that was relevant at the time. Furthermore, information was provided to foreign firms that were interested in investing in Albania (Mongbay, 1992).

2.3 Current Trade Rules in Albania

Since Albania started negotiations for joining international trade organizations, its trade policy underwent radical reforms, mainly on the side of imports. State institutions initiated

comprehensive legal and institutional reforms to establish a trade regime which complies with international standards. Regarding the current laws and regulations that are in force, the export regime in Albania is fully liberalized. Exporting from Albania is free and there is no export duty applied. Furthermore, there aren't any restrictive measures applied such as quotas, prohibitions, or other non-tariff restrictions (CEFTA, n.d).

On the other hand, importing into Albania is subject to customs tariffs which are applied on the 8-digit Combined Nomenclature of Classification of Goods, which is in full compliance with ECCN[1]. The tariff system of Albania is very simple and tariffs are only "ad-valorem" (CEFTA, n.d). As Albania signed different FTAs, preferential import tariffs applied for member countries of CEFTA, EFTA members, EU member countries, and Turkey. Regarding the industrial goods, the tariff is 0%, while agricultural products tariffs are applied depending on relevant agreements. For other partners that do not have an FTA with Albania, the most-favoured-nation tariff system applies: 0%, 2%, 5%, 6%, 10% and 15% (CEFTA, n.d.).

Certain groups of imports that can affect human health, flora and fauna, and integrity and national security of Albania are controlled by laws. Due to the sensitive nature of those goods, an import licensing system, which is laid down on several laws and regulations, is applied.

Groups of goods that are subject to licenses are:

a) Military and strategic materials;
b) Radioactive materials;
c) Dual-use products;
d) Narcotic drugs and psychotropic substances;
e) Products of live flora and fauna.

To acquire a license, traders must submit relevant documents and information that are required by authorities. As far as those requirements are met, import licenses are issued automatically. However, depending on the level of sensitivity for some specific groups of imports there are no automatic issuances of licenses (CEFTA, nd).

2.4 Imports and Exports Procedures

To reap the benefits of international trade, importing and exporting procedures should be simplified. "Extensive document requirements, burdensome customs procedures, inefficient border points, and inadequate infrastructure lead to extra cost and delays for exporters and importers, thus leading to the stifling of trade potential". The importance of the simplification of procedures is shown from the fact that exporters in developing countries gain more from a 10% drop in their trading costs than from a similar reduction in the tariffs applied to their products in global markets (The World Bank, 2012).

[1] ECCN stands for European Community Combined Nomenclature

In this regard, Albania has made significant progress in some areas. Table 1 below shows that the number of documents that are needed for exporting a standard container of goods is 7; a Bill of lading, Customs export declaration, Commercial Invoice, Certificate of origin, Packing list, Cargo release order, and Terminal handling receipts. The time that is needed to complete those procedures takes 19 days and costs $745. Regarding the importing procedure, just one more document (Technical standard certificate) is required in order to import the same container. Completing the procedure takes 18 days and cost $730.

Table 1. Procedures of trading across borders in Albania over time

Indicators	**2006**	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Rank	-	-	-	-	-	76	76
Documents to export (number)	7	7	7	7	7	7	7
Time to export (days)	21	21	21	21	19	19	19
Cost to export (US $ per container)	818	818	745	770	725	725	745
Documents to import (number)	8	8	8	8	8	8	8
Time to import (days)	22	22	22	22	18	18	18
Cost to import (US $ per container)	820	820	750	775	710	710	730

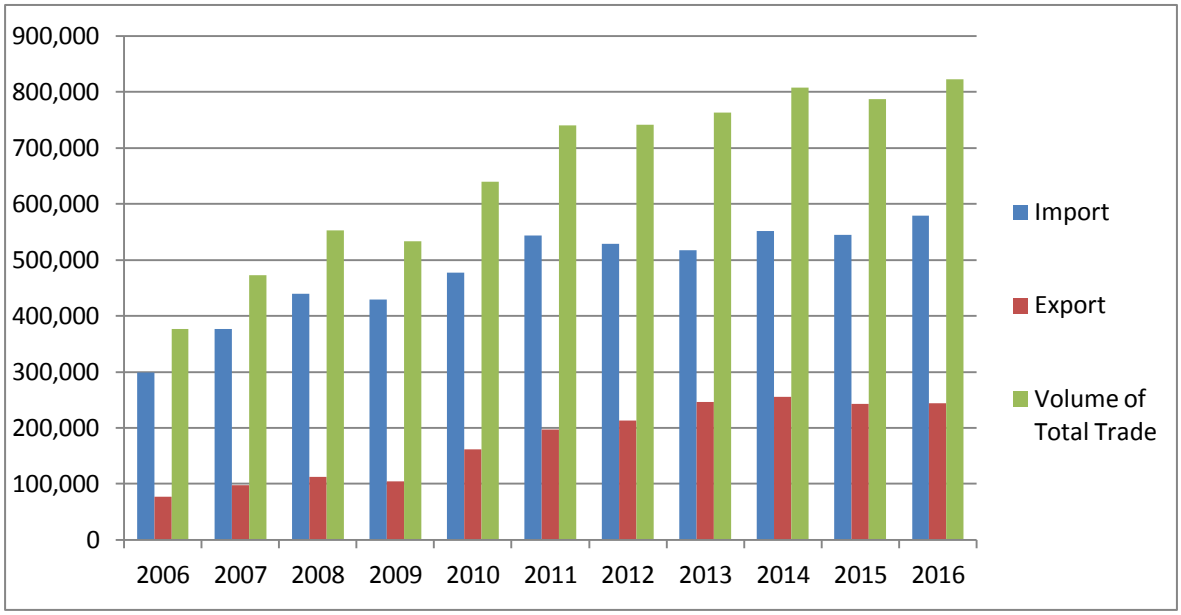
Source: *The World Bank 2012*, p. 76, Table 9.1.

Albania has made an overall progress as the most important factor on import and exports procedure (time and cost) has been reduced, during the past few years. According to the World Bank (2012), Albania stands at 76 in the ranking list of 183 worldwide economies, as per overall procedures of trading across borders.

2.5 Trade Trends

Even with notable progress of trade policy and improvement of overall economic situation, Albania remains an import-oriented economy. Its base remains small, narrow, undiversified, while its import base remains relatively large. Since 2006, Albania has had a generally increasing trend of both imports and exports (see figure 1). However, due to unusual circumstances, some years recorded trade decrease.

Figure 1. Import, Exports and Trade Volume of Albania in mil ALL (2006 – 2016)



Source: *INSTAT 2017.*

In 2016, Albania recorded a trade volume of ALL 823 billion where imports contributed with 69 % while exports with 31%. At the same time, it was the second highest value that Albania had ever traded until now. However, the highest decadal growth of trade flow in terms of percentage was recorded in 2007 with 26% relative to the previous year (INSTAT, 2017).

After a trade contraction in previous year, Albania's trade continued its usual increasing trend of last decade. Comparing with 2006, Albania's trade in 2016 is doubled. Both imports and exports recorded positive growth rates. However, in absolute value the increase of imports was the main driver of increased trade volume.

In 2016, Albania's imports were ALL 579 billion, which was the highest value ever imported until now. In comparison with the previous year, import of goods increased 6%. As per group of goods that dominated imports, table 2 show that "Machineries, equipments and spare parts" is highest group with around 23% of total imports. The second biggest group of imports was "Food, beverages and tobacco" with 17%, "Textile and footwear" was the third one with 14% while the lowest group of import in 2016 was "Leather and leather manufactures" with just 3% in overall import participation. Even though that one of the main production sector of Albania is textile, this group continues to dominate overall imports also.

Table 2. Import by commodity groups (in billion ALL)

Year	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Food, beverages, tobacco	87	92	93	93	94	97	100

continued

table continues

Year	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Minerals, fuels, electricity	74	102	110	93	90	60	50
Chemical and plastic products	56	61	66	68	73	75	80
Leather and leather manufactures	8	9	10	11	14	16	17
Wood manufactures and articles of paper	20	20	18	20	23	22	23
Textile and footwear	46	50	48	54	63	69	80
Construction materials and metals	76	82	68	63	71	68	76
Machineries, equipments and spare parts	93	110	98	99	106	117	131
Others	17	17	17	15	18	21	21
Total Import CIF	477	544	528	517	552	544	579

Source: *INSTAT, 2017*.

Despite the fact that the highest volume of imports in term of absolute value was recorded in 2016, the highest decadal increase of imports in term of percentage was recorded in 2007. Due to the limited and insufficient capacity to produce at home and increased demand for goods in Albania's economy, the overall imports in that year increased 26%, relative to the previous year (Bank of Albania, 2007).

On the other hand, the highest decrease of imports was recorded in 2009. The total value of merchandise imports recorded a decline of about 9% compared with previous year. Slowdown in domestic demand and the low-price levels in the countries of origin were among the main factors that impacted the downward side of overall imports in 2009. The decline in imports was mainly attributed to the "Capital goods" and "Intermediate goods" that decreased respectively by 12.7 % and 12% on an annual basis (Bank of Albania, 2009, p. 46).

Regarding the exports performance of Albania in 2016, it remains in approximate level as in two previous years. The value of goods exported on 2016 was ALL 243 billion and in the same time, it was a second highest value that Albania ever exported. As table 3 show, the group of goods that dominated the Albania's export in 2016 was "Textile and footwear" with ALL 106 billion, or 43.6% of overall exports. The second group with the largest share to total exports in 2016 was "Mineral, fuels and electricity" with 19.3% of overall Albania's exports. Even though this group of exports decreased for second consecutive year, it continues to play an important role on Albania's exports. Meanwhile, the smallest group of Albania's exports was "Leather and leather manufactures" with only ALL 2.6 billion or 1% of overall exports.

Table 3. Export by commodity groups (in billion ALL)

Year	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**
Food, beverages, tobacco	9	11	13	15	17	21	25
Minerals, fuels, electricity	45	59	76	99	86	64	47
Chemical and plastic products	2	3	2	3	3	4	4
Leather and leather manufactures	2	3	3	3	3	3	3
Wood manufactures and articles of paper	5	5	5	8	9	8	8
Textile and footwear	55	64	62	69	85	90	106
Construction materials and metals	32	41	40	36	37	35	32
Machineries, equipments and spare parts	7	8	8	8	9	11	11
Others	3	3	4	4	5	6	7
Total Import CIF	161	196	213	246	255	243	243

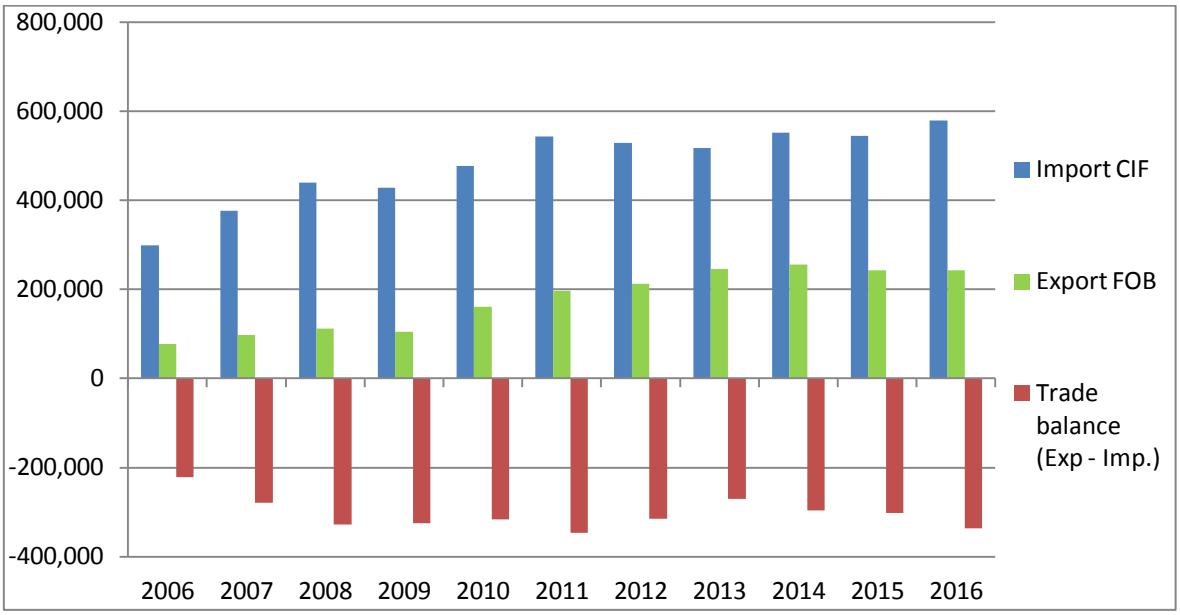
Source: *INSTAT, 2017.*

Export volume analysis indicates that Albania's exports are continuing it increasing trend of last decade. Comparing with 2006, exports of Albania in 2016 are increased by 215%. Despite the increasing volume, Albania's export structure continues to be concentrated.

Even with considerable growth of Albania's exports in last decade, the Albanian economy suffers from a chronic and large trade deficit all over the period of post-communism. Although the coverage ratio of export/import improved in recent years, the trade deficit in 2016 worsened by 11% in comparison with previous year. Comparing with 2013, when trade deficit was narrowed by about 14%, in 2016, trade deficit of Albania increased by 24% relative to trade deficit in 2013.

Given the energetic situation of Albania, trading of electricity is an important factor that affects the performance of the trade deficit and provides a considerable contribution to widening and narrowing of it. Another important factor that plays a significant role on trade deficit of Albania is price of minerals and fuels in international market (Bank of Albania, 2010).

Figure 2. Trade Deficit of Albania in mil ALL (2006 – 2016)



Source: *INSTAT, 2017.*

Figure 2 shows that the highest trade deficit was recorded in 2011. Although both imports and exports increased, the annual growth of imports was quite higher relative to exports. Furthermore, the low base of exports caused the trade deficit to deepen further. Thus, in 2011 it amounted to ALL 347 billion, up by 10% from the previous year (INSTAT, 2016). Since that time, Albania's trade deficit has never achieved that level.

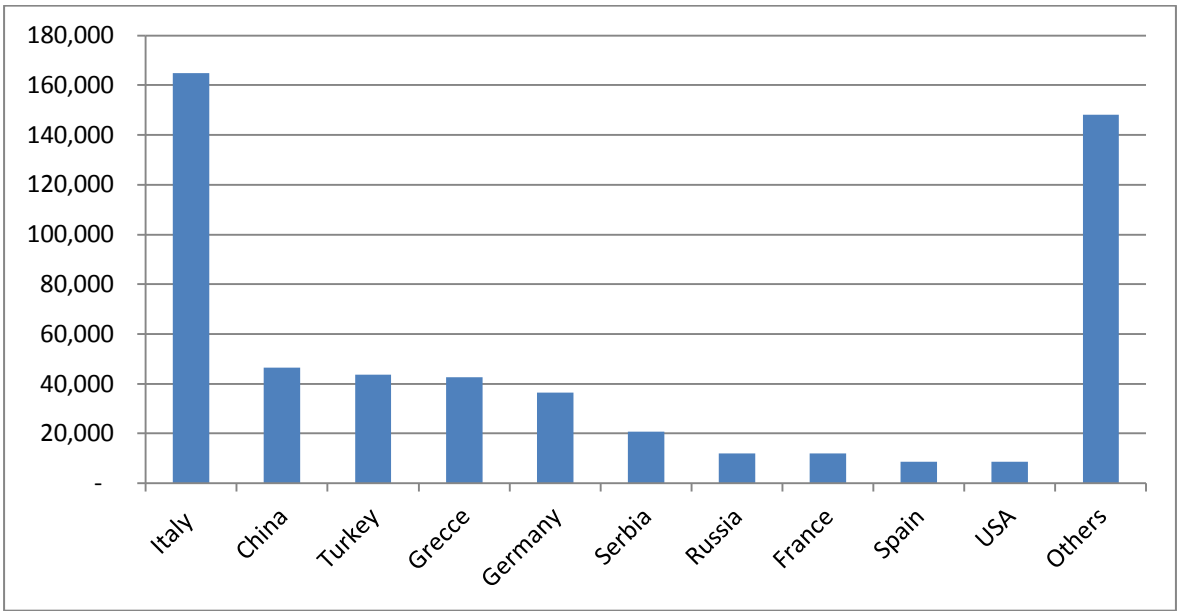
The only group of goods that has influenced positively trade deficit of Albania is "Textile and footwear". In 2016, the trade surplus generated by this group of goods was in amount of ALL 27 billion. Given the long experience of textile's industry, and low labour cost, Albania should increase it focus on this sector, in order to reap more benefits and to narrow its large trade deficit.

On the other side, "Machineries, equipments and spare parts" had a most negative impact on trade balance. The negative balance generated by this group in 2016, was in amount of ALL 120 billion. Having in mind the insufficient capacities of machinery production in Albania, this group of goods is expected to play the major impact on worsening of trade deficit in coming years also. Therefore, in order to neutralize the impact of machineries, more attention should be paid on sectors that Albania has competitive advantage.

2.6 Trade with its Main Trading Partners

Due to geographical position, Albania's trade is term of trading partners is quite spread. As can be seen by figure 3, top 10 main importing countries are from 3 different continents. In addition to European countries, top 10 Albania's importing countries consist of China and USA, as two of the largest exporting economies in the world.

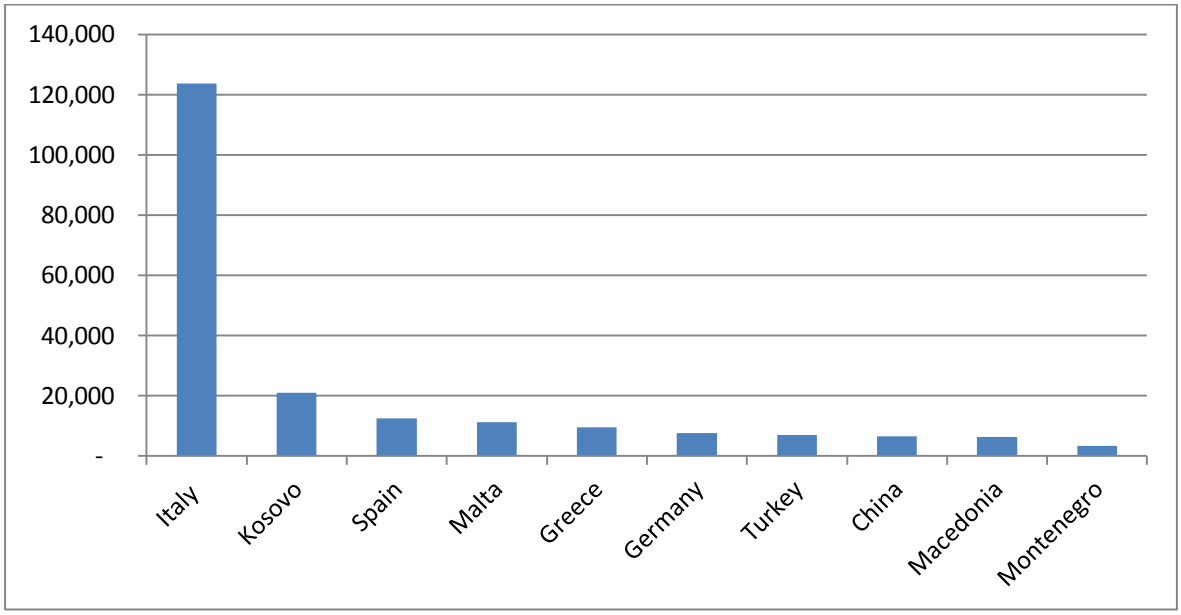
Figure 3. Imports by main partner countries (in billion ALL)



Source: *INSTAT, 2015.*

On the other hand, Albania's exports are mainly focused in Europe. Except China, all other exporting countries are from Europe, where Italy plays a dominant role with 51% of total Albania's exports, followed by Kosovo with 14%, Spain with 9%. Other destinations do not present a significant importance in term of percentage.

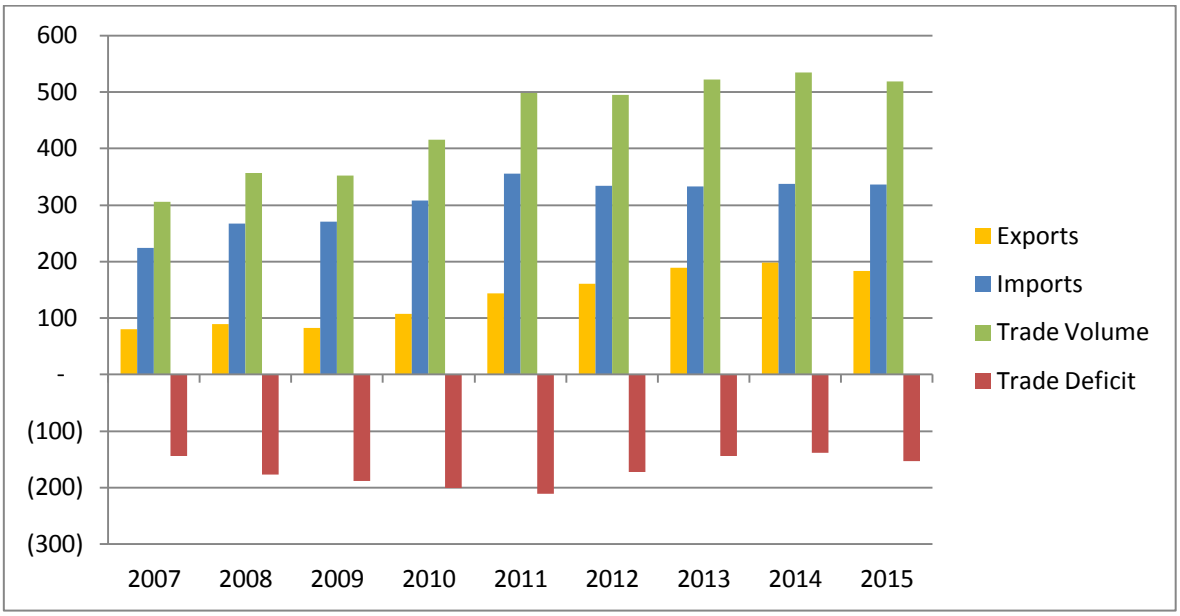
Figure 4. Exports by main partner countries (in billion ALL)



Source: *INSTAT, 2015.*

As it seen by above figures, Albania's trade is mainly concentrated with the EU countries. In 2015, about 71% of Albania's overall trade activity was done with EU countries. Regarding imports, around 61.7% of them came from EU countries, meanwhile about 75.3% of Albania's overall exports were destined for the EU (INSTAT, 2016).

Figure 5. Trade volume of Albania with EU countries (in million ALL)



Source: *INSTAT, 2016.*

Figure 6 show Albania's trade with EU is characterized by increasing trend, especially in last decade. In 2014, trade between Albania and EU recorded trade volume in amount of ALL 535 billion, where imports contributed with 63% while exports with 37%. At the same time, it was the highest value that Albania has traded with EU until then. However, the highest decadal growth of trade flow in term of percentage was recorded in 2011, with 20% relative to previous year (INSTAT, 2016). The increase of prices in EU markets and the upward domestic demand in Albania were among main contributors of import expansion in 2011 (Bank of Albania, 2011).

In 2011, the trade deficit generated by trade between Albania and EU reached the highest level ever, amounting ALL 212 billion. In the same time, it was the main source of overall trade deficit of Albania. After 2011, trade deficit declined for three years in a row, reaching the lowest decadal level in 2014. Increasing of Albania's exports toward EU were the main factors that impacted the downward side of trade deficit.

With regards to exports, EU countries are the main partners which participate with more than 70 percent of Albania's total exports. Overall export participation toward the EU has remained quite similar across the years, with small changes in several countries. However, in terms of absolute value, exports of Albania toward EU countries were generally characterized by steady upward trends.

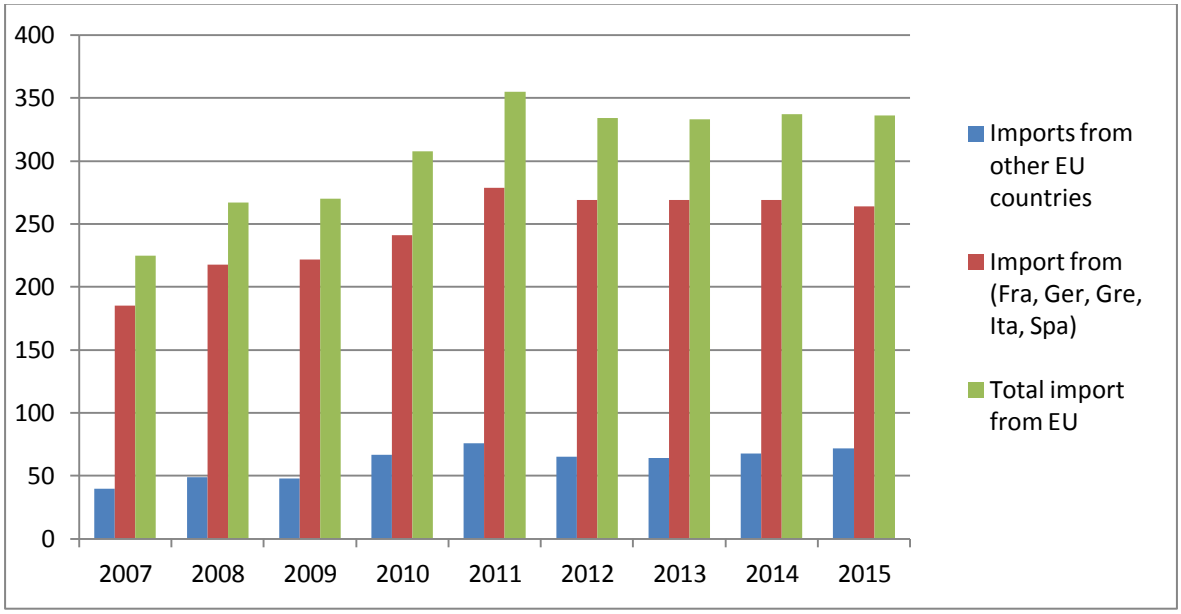
Since 1992, when Trade and Cooperation Agreement between the EU and Albania entered into force, the EU became by far the most important partner of Albania. In 1999, trade relations between the EU and Albania advanced to higher stages as Albania started to benefit from Autonomous Trade Preferences from the EU. A year later, Albanian products began trading in the EU market, without being subject of tariffs (European Commission,

2010). However, for some specific categories of products, tariff continued to be applied and at the same time, some products were under the regime of quotas (European Commission, 2016).

During last decade, Albania's exports toward EU market were characterized by quite stable growth. Without taking into consideration exports in 2009, all other years (2007 -2014) recorded increasing rate. Due to degradation of economic indicators of EU countries in 2009 and slowdown of their domestic demand, Albania's exports toward EU decrease by 9%.

Regarding the imports from EU countries, the main importing partners of Albania are: Italy, Greece, Germany, France and Spain. As can be seen by figure 7, the total goods imported by these 5 countries in 2015 amounted for 79% of total Albania's imports from EU.

Figure 6. Albania's Imports from main EU trading partners (in million ALL)

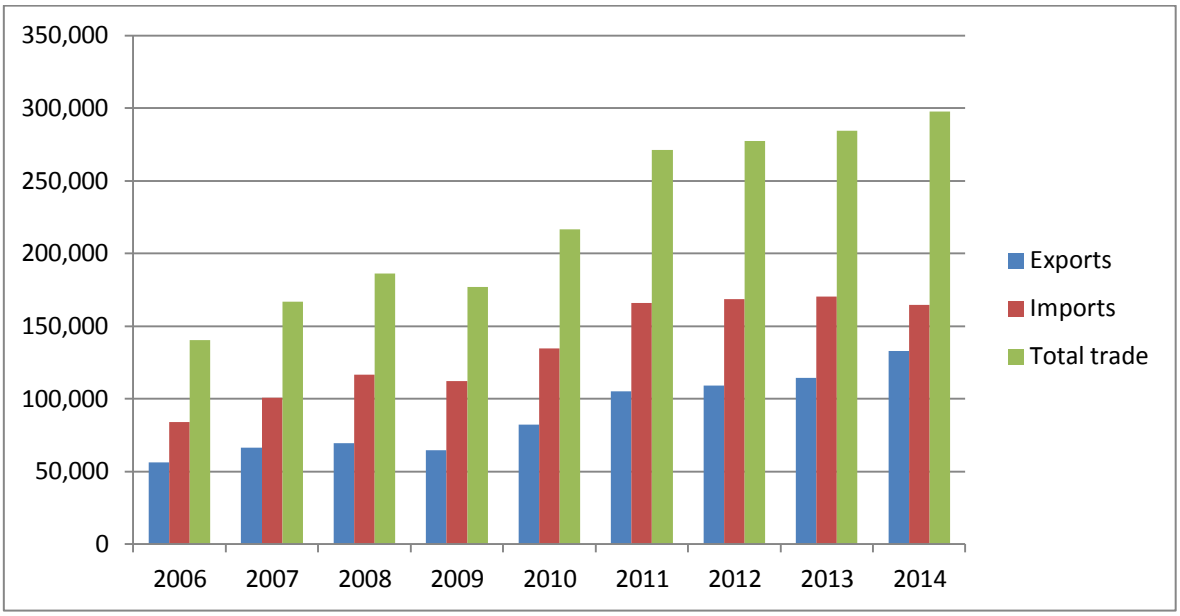


Source: *INSTAT, 2015.*

On the other hand, the main exporting destinations are: Italy, Spain, Malta, Greece and Germany.

Despite the high volume of trade with EU members, Albania's trade with EU remains quite concentrated. Trade with Italy and Greece continues to represent the largest share of trade, with a combined 62 percent of imports and 73 percent of exports in 2015. Italy was by far the main trading partner with around 56 percent of overall Albania's trade with the EU (INSTAT, 2016). This concentration of Albania's trade with Italy is supported by fact that majority of Albania's emigrants live there. Other important factors that are supposed to have impact on Albania's trade with Italy are geographical distance and sea access of both countries.

Figure 7. Trade volume of Albania with Italy (in million ALL)



Source: *INSTAT, 2016.*

During recent years, Albania's trade with Italy was characterized by a steady growth rate. However, degradation of economic indicators of Italy in 2009, had a negative impact on the trade volume between Albania and Italy, which declined by 5%. Even though Albania's trade with Italy in absolute value declined, the overall trade participation remained approximately on the same level.

Table 4. Imports by group of goods with Italy (in million ALL)

Year	**2011**	**2012**	**2013**	**2014**	**2015**
Food, beverages, tobacco	14,389	14,367	14,280	15,173	17,105
Minerals, fuels, electricity	43,294	50,399	47,610	29,291	25,931
Chemical and plastic products	13,272	13,861	13,780	15,032	15,030
Leather and leather manufactures	8,263	8,352	9,648	11,835	12,556
Wood manufactures and articles of paper	4,707	4,781	6,791	8,341	6,940
Textile and footwear	31,073	28,631	31,466	34,618	35,309
Construction materials and metals	17,929	16,722	16,258	17,667	18,670
Machineries, equipments and spare parts	28,378	27,245	26,299	28,005	28,107
Others	4,738	4,027	4,313	4,455	5,342
Total Import CIF	166,045	168,372	170,445	164,419	164,990

Source: *INSTAT 2015*, p 32, Table 22.

As can be seen by table above, the main group of commodities that is imported from Italy is "Textile and footwear". During 2014, 21% of total imports from Italy were composed by

this group. The second largest group of imported commodities was “Minerals, fuels, electricity” with 17.7% of overall imports from Italy. This dominance was mainly supported by unfavourable hydroelectric conditions in Albania that year, and increasing prices of electricity. Machineries, Equipment, and Spare Parts” had a similar participation while other groups had lower importance (INSTAT, 2015).

On the other hand, Albania’s exports toward Italy are mainly dominated by “Textile and Footwear”. This group of commodities has shown the most sustainable trend across years, with a high potential for further increase in the coming years.

Table 5. Exports by group of goods with Italy (in million ALL)

Year	**2011**	**2012**	**2013**	**2014**	**2015**
Food, beverages, tobacco	4,222	4,441	5,520	5,946	6,883
Minerals, fuels, electricity	23,045	29,317	23,009	25,589	12,281
Chemical and plastic products	1,232	586	918	1,107	1,227
Leather and leather manufactures	2,140	2,036	2,326	2,573	2,586
Wood manufactures and articles of paper	2,817	3,032	5,037	6,637	6,320
Textile and footwear	53,937	53,445	59,574	71,555	72,735
Construction materials and metals	10,972	10,096	10,769	11,255	12,941
Machineries, equipments and spare parts	4,894	4,278	5,155	5,837	12,941
Others	1,740	1,664	1,853	2,547	2,694
Total Import CIF	104,998	108,865	114,160	133,046	123,703

Source: *INSTAT 2015,* p 19, Table 9.

As table 5 shows, during 2015, around 59.1% of overall Albania’s exports toward Italy were composed by “Textile and Footwear”. The second largest group of exported commodities was “Construction Materials and Metals” which participated with around 10.4% while "Minerals, Fuels and Electricity” contributed with 9.9%. Other groups of exports toward Italy had far lower and insignificant importance (INSTAT, 2015). Even though Italy is main destination of Albania’s exports, in the same time it remains the main destination of Albania’s imports. Consequently, the trade deficit generated by trade with Italy is only ALL 31 billion.

Greece is right behind Italy as the second largest trading partner of Albania. Located on the south of Albania, Greece benefited by the limited producing capacitates of Albania and since 1992, trade between the two countries was characterized by Greek dominance. After a post-communism period, a large flow of Albanian migrants went to Greece. This massive movement was mainly dominated by workforce who played an important role on the promotion of trade between countries.

Since 1992, trade exchange with Greece was characterized by a steady growth rate. However, at the end of 2008, due to the global financial crisis, the Greek economy began to show its weaknesses which were reflected in deterioration of its macroeconomic indicators. Consequently, the worsened economic situation of the Hellenic country was reflected in the trade exchange with Albania as well.

Figure 8. Trade volume of Albania with Greece (in million ALL)

Source: *INSTAT 2015.*

The highest level of trade between Albania and Greece was recorded on 2008. Since that time, the overall Albania's imports from Greece were characterized by declining trend, except 2014. In the same time, the trade deficit of Albania, generated by trade with Greece, was narrowing as well.

Table 6. Imports by group of goods with Greece (in million ALL)

Year	**2011**	**2012**	**2013**	**2014**	**2015**
Food, beverages, tobacco	12,252	12,398	13,241	13,916	13,090
Minerals, fuels, electricity	11,339	7,666	6,930	14,138	6,298
Chemical and plastic products	7,097	6,621	6,785	7,299	7,067
Leather and leather manufactures	16	20	27	70	95
Wood manufactures and articles of paper	3,696	3,125	2,931	2,908	2,579
Textile and footwear	3,183	2,261	2,345	2,344	3,023
Construction materials and metals	14,360	12,589	9,112	7,380	6,369
Machineries, equipments and spare parts	4,613	3,959	3,242	2,837	2,824

continued

table continues

Year	2011	2012	2013	2014	2015
Others	1,241	1,478	1,105	1,166	1,374
Total Import CIF	57,796	50,117	45,700	52,058	42,718

Source: *INSTAT 2015,* p 34, Table 25.

As can be seen by table 6, the main group of commodities that is imported from Greece is "Food, beverages, tobacco". During 2015, 30.4% of total imports from Greece were composed by this group. The second largest group of imported commodities was "Chemical and plastic products" with 16.3% of overall imports, while other groups had lower importance (INSTAT, 2015).

Table 7. Exports by group of goods with Greece (in million ALL)

Year	2011	2012	2013	2014	2015
Food, beverages, tobacco	1,259	1,839	1,519	1,772	2,187
Minerals, fuels, electricity	188	310	298	393	703
Chemical and plastic products	320	180	322	437	340
Leather and leather manufactures	23	23	55	44	28
Wood manufactures and articles of paper	645	964	931	806	810
Textile and footwear	3,152	2,280	2,497	3,254	3,823
Construction materials and metals	3,784	3,390	1,518	1,645	1,252
Machineries, equipments and spare parts	180	222	382	269	68
Others	427	254	253	228	299
Total Import CIF	9,978	9,461	7,776	8,848	9,511

Source: *INSTAT 2015,* p 34, Table 25.

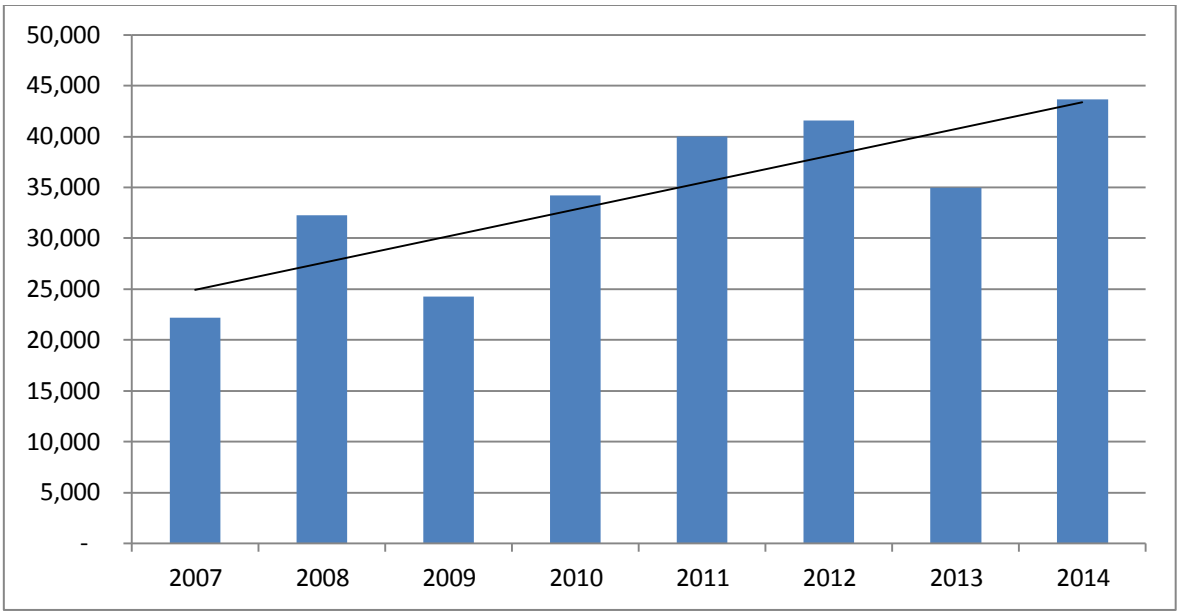
On the other hand, Albania's exports toward Greece are mainly dominated by "Textile and Footwear" with 40.1% in 2015, followed by "Food, beverages, tobacco" with 23% and "Construction materials and metals" with 13.1%.

2.7 Trade with CEFTA Members

Notwithstanding the difficult economic situation, Albania continues to reinforce its trade activity through free trade agreements. Even thought the trade activity of Albania was mainly concentrated in EU countries, trade with regional countries has recorded considerable increase during recent years. Since 2007, when CEFTA entered into force, trade exchange between Albania and other CEFTA members has recorded a positive trend.

According to INSTAT (2015), from the beginning of Albania's participation in CEFTA in 2007 until 2014, imports of Albania from CEFTA members have increased by 97%.

Figure 9. Albania's Imports from CEFTA Members in mil ALL, (2007-2014)



Source: *INSTAT, 2014.*

The considerable increase of Albania's imports from CEFTA members, cannot be completely attributed CEFTA. In this context, I tried to explain the impact that CEFTA could have on Albania's import flow. To prove the hypothesis that CEFTA has an impact on increasing the trend of Albanian's import from member countries, a gravity model that will be explained in next chapter, was conducted.

3 EMPIRICAL ANALYSIS: IMPACT OF CEFTA MEMBERSHIP ON ALBANIA'S IMPORT

3.1 Literature Review and Theoretical Consideration

According to international trade literature, an FTA has the potential to increase trade among partners. But the question of whether FTAs necessarily lead to more trade is still subject to considerable debate. Furthermore, FTAs can be different, for example, in terms of the coverage of tariff and non-tariff elimination, the economic development of the FTA member countries, the size of the market created, and other characteristics of member countries. Thus, the impacts of FTAs on trade flows are likely to be different for different types of FTAs (Shujiro & Misa, 2010).

The first author that used the gravity equation to explain trade flow was Jan Tinbergen (1962). He drew an analogy to Isaac Newton's Law of Gravitation, assuming that bilateral trade flows between any pair of countries i and j could be explained very well using GDP as a proxy for economic sizes of the two countries (GDPi, GDPj) and the distance between the country pairs' major economic centres (DISTij), as a proxy for trade cost.

Despite the high exploratory power of gravity estimates, they lack the theoretical foundation grounded in economic theory. The first attempt to create theoretic foundation for the gravity equation was made by Anderson (1979). He presented a theoretical explanation for the gravity model and applied it to commodities based on constant elasticity of substitution (CES). Anderson (1979) stated that each country produces and sells products that are different from those produced by other countries.

Following Anderson (1979), other authors tried to connect gravity models to economic theory. Bergstran (1985) criticized previous studies for not including price variables. Consequently, he addresses these and other issues by including price variables in his gravity equation. Thus, the distinguishing feature of the gravity equation used by Bergstran (1985) was the explicit presence of prices, which differed across countries owing to trade costs. Later, Bergstrand (1989), argued that even though previous studies have linked trade flow with exporter and importer incomes, exporter and importer per capita incomes were not estimated. He extended the microeconomic foundation of the gravity equation presented in Bergstrand (1985) by incorporating factor-endowment variables in the spirit of Heckscher-Ohlin (H-O) and taste variables in the spirit of Linder (1961). Consequently, Bergstrand (1989) derived the gravity equation based on the monopolistic competition model. Two decades later, Helpman et al. (2004) developed a gravity equation from heterogeneous firm's model of trade. The importance of this derivation relates to three issues that previous models of trade could not explain; zero trade observation, asymmetric trade flow and the extensive margin of trade.

The recent theoretical foundation dealing with gravity equations has highlighted the importance of deriving the specifications used in the gravity model from trade theory in order to accurately measure the trade effects and draw proper conclusion (Bacchetta et al., 2012). In this respect, of particular importance has been the contribution of Anderson & Wincoop (2003). Their work introduced the concept multilateral trade resistance (MTR) for the first time. The development of MTR has given a new dimension to gravity models and has allowed a new interpretation of gravity equations, by taking into consideration the third country effect. According to the authors, multilateral trade resistance represents barriers which each of *i* and *j* countries face in the trade with all their trading partners. Thus, taking into consideration MTR, trade is not solely dependent on bilateral trade flows but on multilateral trading relations between countries. For example, two countries (Netherland and Belgium), that are close to two big economies (Germany and France), are supposed to trade less with each other than two other countries such as Australia and New Zealand that are near each other but surrounded by ocean and relatively far from other trading partners (Bacchetta et al., 2012). This case has to do with natural trading cost which can be a result of geographical distance and not a consequence of tariffs or quotas. Another illustrating example of impact of MTR can be trade between Albania and Greece. In case of the reduction of trade barriers between Albania and a third country such as Turkey, Albania's MTR would be reduced. Although trade barriers between Albania and Greece remain unchanged, the reduction of Albania's MTR as a consequence of declining

of barriers between Albania and Turkey can lead to trade diversion from Albania–Greece towards Albania–Turkey.

Hence, when taking into consideration the impact of MTR on trade between trading partners, it is very important to analyse not just bilateral trade resistance (BTR), but also multilateral trade resistance (MTR). However, due to its complexity in application, the MTR is sometimes neglected in the empirical estimation by researchers. Furthermore, MTRs are not directly observable (Bacchetta et al., 2012).

Recent developments and incorporation of theoretical foundations of gravity models in practice has led to richer and more accurate estimations and interpretations of the spatial relations described by gravity (Anderson, 2010). In this regard, in addition to the above mentioned authors, many others have been attempting to link trade theory with gravity model (Krugman 1980; Helpman and Krugman 1985; Deardorff, 1998; Bernard et al., 2003, etc).

Nowadays, given the wide range of models, the main issue is to ensure that empirical estimation performed by gravity models are well defined by theory and in the same time it can be linked with one of existing theoretical frameworks (Benedictis & Taglioni, 2010).

The number of trade agreements has recently risen, and there has been an increasing need to estimate the potential of these agreements. Particularly, after the 1990 when the number of FTAs increased rapidly. Despite a lack of theoretical foundation of a gravity model in the early stages of its development, the situation has improved in this respect and now, gravity models are widely used in trade flow estimation.

Following Tinbergan (1962), many researchers used gravity models to estimate the determinants of trade flow. In addition to GDPs and distances between trading partners, many authors analysed the fundamental effects of FTAs such and trade creation and trade diversion and different evidence for different cases was found. These terms were initially used by Viner (1950) and since that time many authors have been interested to estimate these two effects.

Bayoumi & Eihengreen (1995) analysed a sample of 21 industrial countries in the period of 1954 to 1992 and they found that the European Free Trade Association (EFTA) was heavily trade creating while the European Economic Community (EEC) had both trade creation and diversion effects. A similar examination of trade effects for EFTA and ECC was done by Frankel, Stein and Wei (1993) by using a gravity model in level form. The authors found the trade creation effect for the ECC, however, in contrast to Bayoumi & Eichengreen (1995), they failed to identify any indication of trade creation for EFTA.

Another interesting area of research that examined trade effects of FTAs was done by Slootmaekers (2004). She examined trade effects of the "transatlantic FTA" between European Union (EU) and Mexico. Despite very long geographical distance between the

EU and Mexico, a positive trade creation effect on imports between Mexico and the 15 members of the EU was found.

By using the gravity model, Wilhelmsson (2006) tried to assess to what extent the EU enlargement has affected trade flow between old and new members and among old members. In addition to trade creation and trade diversion, the author has estimated another effect called trade displacement, which means reallocation of trade of from less efficient sources (old members) to more efficient sources (new members), within the block. According to the author's findings, significant gross trade creation was found between the old and new members and among the old members as well. Trade diversion has been limited, while trade displacement has not been significant.

In contrast to the above-mentioned authors that have estimated trade effects of FTAs on an aggregate level, Korinek & Melatos (2009), went a step forward by estimating the effect of FTAs only on the agriculture sector. The authors made an in-depth examination of the trade effects of three regional trade agreements: ASEAN free trade agreement (hereinafter: AFTA), Common Market for Eastern and Southern Africa (hereinafter: COMESA), and common market between Argentina, Brazil, Paraguay, Uruguay and Venezuela (hereinafter: MERCOSUR). Besides the diversity of the countries, both in terms of their level of development and economic size, the findings were quite similar. Their result from a gravity model suggests that the creation of AFTA, COMESA, and MERCOSUR increased trade in agricultural products between their member countries. However, the extent of trade creation of COMESA in agriculture is lower compared to AFTA and MERCOSUR. The authors did not find strong evidence of trade diversion with respect to imports from outside the region. Therefore, the three agreements were found to be trade creating.

In contrast to the above studies that were focused on total import, for total export or on one specific sector, Shujiro & Missa (2010) go further by analysing the impact of several FTAs (including EU, NAFTA, MERCORUS) on different commodity groups. The authors disaggregated the trade data presuming that the impact of an FTA on trade flows differs by commodities and types of FTAs. By estimating the gravity equation, Shujiro & Missa (2010), analysed trade creation and trade diversion effects at twenty commodity levels. Their analyses on total trade data indicates that FTAs mainly bring a trade creation effect, however analysis of disaggregated trade data shows a different pattern among different products. These findings indicate that the impact of an FTA should not be generalized and its effect varies across sectors.

In addition to the analysis of various sectors, Shujiro & Missa (2010) have estimated the impact of an FTA between developed countries on one hand and between developing countries on the other hand. Interesting results were obtained indicating that number of sectors that exercised trade creation was higher in an FTA among developed countries than in an FTA between developing countries. According to their findings, FTAs among developed countries generate the trade creation effect in almost all commodities except for

wood and organic chemicals, while the trade diversion effect was not found. On the other hand, FTAs among developing countries have the trade creation effect only in 12 commodities while trade diversion was detected on 16 from 20 groups.

All the papers discussed above were focused on the fundamental effects such as trade creation and trade diversion effects. All of them used the gravity model including a set of binary variables in order to separate trade creation effects from trade diversion effects. They extended the standard gravity equation and added an indicator variable that equals one, when both trade partners belonged to the same trade agreement and zero otherwise. A potential positive and significant coefficient of that dummy indicated more trade between partners and was taken as evidence of trade creation. To enable the separation of trade creation and trade diversion, the authors added a second dummy to the gravity equation. This dummy took the value of 1 if only one country of the country pair was a member of the FTA at time t, zero otherwise. A potential negative coefficient of the second dummy was taken as evidence of trade diversion with regards to the rest of the world.

3.2 Methodology and Model Specification

Since Adam Smith published "The Wealth of Nations" in 1776, the vast majority of economists have accepted the proposition that free trade among nations improves overall economic welfare (Irwin, n.d). However, almost two centuries later, Viner (1950) presented his model by assuming that FTAs could also have a negative impact on welfare. Based on Viner's model, an FTA can lead to the displacement of less efficient national production in favour of more efficient partner-country production, which is called trade creation, while, displacement of more efficient non-partner imports in favour of less efficient partner-country is called trade diversion.

Since Viner (1950) introduced the concepts of trade creation and trade diversion, many authors tried to assess these effects by using a gravity equation. The gravity model of trade continues to be an important model in the arena of international economics. It is used as a workhorse for analysing trade, because data for it is widely available and at the same time the model has high explanatory power. As was discussed in the previous chapter, in beginning phase of its development, the gravity equation lacked a theoretical foundation. However, since the late 1970s, many authors provided a different theoretical foundation and consequently the situation has improved in this respect.

The main benefit of the gravity model in the evaluation of FTAs, is that the model can control for other variables besides the FTA as necessary. As explained by (Plummer, Cheong, & Hamanka, 2010), the basic gravity model of trade, which is analogous to Newton's law of universal gravitation in physics, would take the form:

$$M_{ij} = G\frac{Y_i \; Y_j}{D_{ij}} \qquad (1)$$

Where,

M_{ij} = Import of country *i* from country *j*,

Y_i = Gross domestic product (GDP) of the importing country *i*

Y_j = Gross domestic product (GDP) of the exporting country *j*

D_{ij} = distance between country *i* and *j*

G = is constant

The equation (1) shows, imports of country *i* from country *j* (Mij) are positively related to the gross domestic product (GDP) of the importing country (Yi) and the GDP of the exporting country (Yj), but negatively to the geographical distance between the importing and exporting countries (Dij). It is important to explain that G is not a constant as it is in physical area. G is a gravitational un-constant since it includes all bilateral trade costs and GDPs and it varies over time. Exclusion of the gravitational un-constant is the source of a large number of errors (Baldwin & Taglioni, 2006).

Since the gravity model is originally formulated in multiplicative form, following Rahman (2009), we can linearize the model for the estimation purpose by taking the natural logarithm of all variables and obtaining a linear relationship between import flow and other independent variables. Thus, expressed in logarithmic form and attaching a random error term (uij), the basic gravity equation becomes:

$$\ln M_{ijt} = \alpha_1 + \beta_1 \ln Y_{it} + \beta_2 \ln Y_{jt} + \beta_3 \ln D_{it} + \mu_{ijt} \quad (2)$$

where *ln* denotes variables in natural log while, $\beta_1, \beta_2, \beta_3$, are coefficients that are expected to be: $\beta 1 > 0$, $\beta 2 > 0$, and $\beta 3 < 0$. In contrast to model (2), Tinbergen (1962) added three more dummy variables in order to distinguish if trade partners have a common border, if they are members of British Commonwealth and if they are members of BENELUX free trade. Using these specifications, Tinbergen (1962) estimated:

$$\ln PX_{ij} = \ln\beta_0 + \beta_1 \ln GDP_i + \beta_2 \ln GDP_j + \beta_3 \ln DIST_{ij} + \beta_4 \ln ADJ_{ij} + \beta_5 \ln EIA1_{it} + \beta_6 \ln EIA2_{it} + \mu_{ijt} \quad (3)$$

As model (3) shows, the gravity equation used by Tinbergen (1962) was quite simple. Even though it lacked a theoretical foundation, it managed to explain trade flows between countries. By applying dummy variables as indicators for common border, Commonwealth and Benelux membership, Tinbergen (1962) managed to isolate the impact of these specific determinants and to estimate their influence on trade flows.

So far, the gravity model of trade has proven to be rather durable and has had great empirical success in explaining international trade. Since Tinbergen (1962) introduced the gravity equation in international trade, a lot of studies have used it as a tool to find out driving forces of trade. In addition to FTAs, the gravity model has been extensively used to address other issues related with trade flow (Bacchetta et al., 2012).

There are many papers that have used gravity estimations, and some of them have had a similar focus as this paper. By following them, several independent variables were combined, considering their potential impact on this model. As it is described in the second chapter, Albania remains an import oriented country (more than 70% of total trade in 2012), while export remains small and not diversified. Therefore, the focus was concentrated only on Albania's import. In addition to that, Dhar & Panagariya (1994) argue that total trade should not be selected as a dependent variable, since it imposes equality between coefficients of both variables. The same practice was followed by Kandogan (2007), and Rahman (2009). While, on the right-hand-side of equation, several independent variables were added such as the GDP of exporting country, FDI in Albania, and remittances.

In order to capture the effects of CEFTA on Albania's import, which was the main objective of our thesis, the standard gravity equation was extended by adding a dummy variable that equals one if both partner countries belong to the trade agreement and zero otherwise. A positive and significant coefficient, imply that during the years of membership in trade agreement, Albania imports more from trade members of CEFTA than would be suggested by other factors and thus is taken as evidence of trade creation.

A single dummy variable cannot distinguish the trade creation effect from trade diversion effects of the FTA, thus following Frankel (1997) a second dummy was added to the gravity equation. This dummy takes the value of one if only one country is a member of the FTA at time t, zero otherwise. A potential negative coefficient of that variable implies trade diversion regarding the rest of the world. Also, indicators for the FTA with Turkey, Common Border countries, Sea Access, EU membership, and time fixed were used as dummy variables.

For the gravity model of Albanian's imports, the following model is considered:

$$\ln M_{jt} = \alpha_1 + \beta_1 \ln Y_t + \beta_2 \ln Y_{jt} + \beta_3 \ln Yd_{jt} + \beta_4 \ln Remitt_t + \beta_5 CEFTA.cr_{jt} + + \beta_6 CEFTA.di_t + \beta_7 C.Border_{jt} + \beta_8 Sea\_Acc_j + \beta_9 \ln Distance_{jt} + \beta_{10} \ln Export.Al_{jt} + \beta 11 \quad FTA\_Turkey_t + + \beta 12 \quad \ln FDI_{it} + \beta 13 \quad \ln Eu_{jt} + Year.t + \ln \mu_{ijt} \quad (4)$$

Where:

M_{jt} = Flow of Imports into Albania from country *j* at time *t*

Y_t = Gross Domestic Product of Albania at time *t*

Y_{jt} = Gross Domestic Product of country *j* at time *t*

Yd_{jt} = Difference of GDP per capita between Albania and country *j* at time *t*

$Remitt_t$ = Remittances in Albania at time *t*

CEFTA.cr_{jt}	= Membership of Albania and country *j* in CEFTA
CEFTA.di_{t}	= Membership of Albania in CEFTA
C.Border_{jt}	= Dummy that equals 1 if Albania and country *j* have common border, zero otherwise
Sea_Acc_{j}	= Dummy that equals 1 if country *j* has sea access, zero otherwise
Distance_{jt}	= Distance between capital cities of Albania and country *j*
Export.Al_{jt}	= Flow of exports from Albania to country j at time *t*
FTA_Turkey_{t}	= Dummy that equals 1 when FTA between Albania and Turkey entered into the force, zero otherwise
FDI_{t}	= Foreign Direct Investment in Albania at time t
Eu_{jt}	= Membership of country j in EU
Year.t	= Is set of binary variables that specify years
μ_{ijt}	= Normally distributed error term

All variables included in the model apart from dummies are in natural logarithm form. Regarding the model, imports are viewed as being positively affected by the economic mass of the importing country, so the larger GDP of Albania there will be more imports from trading partners. Thus, we expect a positive sign of β_1. Also, a higher GDP in the exporting country indicates a higher level of production, which increases the availability of goods for exports. Therefore, we expect β_2 to be positive also. The difference between per capita GDPs of trade partner countries is considered as indicator of similarities of living standard, tastes, and preferences between countries. The lower the difference between per capita GDPs indicates more similar tastes, preferences, and needs of partner countries, thus higher imports from those countries is expected.

It is obvious that there is a positive correlation between imports and incomes, thus we expect that remittances have influenced the imports of Albania positively. Based on the BA data we noticed an increased trend of Albania's imports from the members of CEFTA after 2007, thus we expect positive sign of β_5, which means that CEFTA has had a trade creation effect. While, the coefficient of trade diversion effects can be either negative or positive. Also, positive coefficients for β_7 (common border) and β_8 (sea access) are expected.

The distance as a proxy for the cost of transport and transactions between trading partners is expected to affect trade negatively (Slootmaekers, 2004). Usually, nearby trade partners develop a more active trade relation with each other. Regarding exports as a determinant of imports, there can be a correlation due to the already existing trade relation between countries and cheaper way of transportation. Usually, transporters of goods from the exporter country to importer country use the opportunity to import some other goods from the importing country without having to pay extra transportation costs. Thus, we expect

positive coefficient for β_{11} (exports of Albania). Also, a positive effect of FTAs between Albania and Turkey, which means a positive sign of β_{12}. The FDI effect on imports can be either negative or positive. In the first case the FDI can replace the imports by producing those goods that were imported before by other countries. In the second case, as soon as the MNCs are established in the host country, they import certain types of supplies like intermediate goods produced by the headquarters, therefore the FDI inflows increase the demand for imports (López, 2005). The last variable included in model is the EU, which indicates membership of a trading partner in the EU. Being a part of the EU obliges member countries to apply unified trade policy against non-members. Even though that Albania signed stabilization and association agreement with EU in 2009, still some group of goods were subject of import-tariffs (Jaupllari, 2013). Consequently, we expect a negative relationship of this variable with imports of Albania.

In addition to the discussed variables, it is obvious that there are many other socio-economic and political variables that could affect imports of Albania. However, the inclusion of them is almost impossible due to the lack of data or the complication of selected models for estimation. On the other hand, there are some other variables (same language, religion, etc) that are believed to have a marginal impact on Albania's import. Therefore, it was decided to exclude them from this model.

By applying this model, an estimated result will help us understand the possible impact of CEFTA membership on Albania's imports. Also, the impact of other determinants included in the model will be estimated. The two most common applied models with panel data estimation are fixed effects (hereinafter: FE) and random effects (hereinafter: RE). The difference between models is that the FE model assumes that individual specific effect is correlated with individual variables while, in contrast with FE, the RE assumes that individual specific effect is not correlated with variables. A Haussman test will be run to decide between FE and RE, and based on the results, a model which is more efficient will be applied on our work.

3.3 Sample Size and Database

The gravity model continues to be used as a workhorse tool for analysing trade, because data for it is widely available and easily accessible to all researchers, however, misleading results can be yielded by the model if the sample of data used is inaccurate, or important variables are omitted from the model (Plummer et al., 2010). Thus, in order to minimize the eventual problems derived by inaccurate data, attention was paid to the data sources and the most reliable statistical data that was available was collected.

The focus of this study is the 49 trading partner countries of Albania, including 6 CEFTA members (see appendix 1). Thus, the dataset used in this thesis covers the 49 trade partners of Albania which were chosen on the basis of trade partnership importance and the availability of data. Among them, the six members of CEFTA (out of eight members, where Serbia and Montenegro are added together) are included, and these countries are:

Albania, Macedonia, Serbia and Montenegro, Bosnia and Herzegovina, Croatia, and Moldavia. While due to the missing data, the Republic of Kosovo is excluded from the estimation. In the selected time period of our sample, Croatia was a member of CEFTA then, on July 1, 2013, Croatia joined the EU, and became part of the EU market. All the data used in this study is secondary data and was collected on an annual basis, 19 years in a row, starting from 1992 up to 2011.

Data on Imports, Exports, Remittances, and Foreign Direct Investment of Albania were collected by the database of the Bank of Albania. GDPs of trade partners, GDP per capita, and population were obtained from database of International Monetary Fund. Data on the distance (in kilometers) between capital city of Albania and other capital cities of trade partners were obtained from Google Maps. While, information of the FTAs used in the study were obtained from the WTO database.

Imports and exports, GDPs, Remittances, FDI in Albania are measured in millions US dollars, populations of all countries are considered in millions, while distance is calculated in kilometres. Considering the reported data, there are some missing values of some countries for various periods, thus we used unbalanced data. The software which was used to analyse the relationships of data is STATA.

Considering the fact that more than 90% of Albania's imports are covered by my sample, I think that selected sample is representative enough to estimate the impact of CEFTA on Albania's imports.

3.4 Results of the Gravity Model

The impacts of CEFTA on Albania's import flows was analysed, with a particular focus on their trade creation and diversion effects, by estimating the gravity model covering 49 trading partners for 19 years, from 1993 to 2011. The reason behind the selection of this period relies on fact that until till 1990, the economy of Albania was governed on socialist principles, where the state has a monopoly on foreign trade. Only after the collapse of communism, Albania began the reform of its economy, including the liberalization of trade its regime, which is the subject of this research.

To analyse the impact of the CEFTA membership on Albania's imports, the empirical model is estimated through a panel regression. Both FE and RE were applied, and based on the Hausman test, it is possible to see which technique is more appropriate for this model. However, initially, this analysis begins by using the OLS technique to generate the benchmark results. Thus, by applying the OLS technique, the following results were obtained:

Table 8. OLS estimations (Imports of Albania)

(Imports_Alb)	**Coef.**
GDP_exp_coun	0.656*** (0.053)

table continues

(Imports_Alb)	Coef	
GDP_Alb	0.262	(0.196)
GDP per capita -diff	0.191***	(0.059)
CEFTA creation	-0.925***	(0.229)
CEFTA diversion	0.354**	(0.154)
Common_Border	0.597***	(0.176)
Sea_Access	0.419***	(0.126)
Remittances	0.343	(0.254)
FDI_alb	-0.017	(0.121)
FTA_TURKEY	0.567	(0.453)
Exports_Al	0.137***	(0.030)
DIstance	-1.842***	(0.152)
EU_members	-0.510***	(0.142)
_cons	-3.246	(2.843)
Observations	408	
Adj R-squared = 0.7174		

Note. legend: * p<.1; ** p<.05; *** p<.01

Source: *Bank of Albania 2012.*

Table 9 shows the results generated by the OLS where 9 coefficients of independent variables included in the model are found to be significant. Although, some coefficients do not have the expected signs.

The coefficient of the GDP of the exporting country is found to be positive and highly significant as expected. This implies that Albania's imports are being positively affected by the economic mass of trading partners. The difference between per capita GDPs of the trading partners and Albania is found to be significant and positively correlated with the imports of Albania as well. Contrary to our expectation, the GDP of Albania is not found to have a significant impact on Albania's import.

Regarding the coefficients of the CEFTA creation and CEFTA diversion, both are found to be significant. Even though, both coefficients have contrary signs relative to our expectation. The coefficient of common border and sea access were found to have a positive impact on Albania's imports, implying that Albania tends to trade more with neighbour countries and countries that have sea access.

Remittances, FDI in Albania, and FTA with Turkey do not seem to have any correlation with Albania's imports. All of them are found to have an insignificant coefficient. Contrary to that, exports of Albania are found to have highly statistical significance. Increasing Albania's exports for 1%, increases Albania's imports by 0.13%, all other things being equal.

As was expected, distance is found to have negative and significant relationship with imports. Similarly, EU membership is found to have a significant, and at the same time, negative relationship with Albania's imports.

As was explained above, OLS was used to generate the benchmark results. In addition to the OLS technique, the empirical model is estimated through a panel regression with both FE and RE estimation techniques. Despite a large number of empirical and theoretical studies, debates continue about the consistent estimation of trade gravity models. On one side, there is research that argues in favour of an RE approach, as it allows an estimation of invariant variables. While, on the other side, there are arguments that support the FE approach, as more of a proper technique for gravity model estimations, because it allows for unobservable country-specific (fixed) effects that can affect trade flows (Baier & Bergstrand, 2007). To ensure it is better to use fixed or random effects, the Hausman test was used.

To ensure an accurate estimation of the results, before running the Hasuman test, a test for multicolliniarity between variables was used first. The first step was the running of a correlation matrix, which indicates a high correlation of the GDP of Albania with the FDI (0.925). The second step, consisted of testing our data for multicollinearity by using a Variance Inflation Factor (VIF) approach. The results that were generated by the VIF, indicated that only the GDP of Albania and the FDI have indexes higher than 10. Therefore, in order to avoid the multicollinearity problem, the FDI in Albania was simply excluded from this model. As can be seen by below table, after repeating the test, the VIF approach generates quite better indexes (including the GDP of Albania), with a mean of 3.73.

Table 9. Variance Inflation Factor

Variable	**VIF**	**1/ VIF**
GDP of Albania	8.99	0.111193
Remittances	7.28	0.137420
Distance	5.45	0.183327
Per Capita Difference	4.77	0.209653
GDP of exporting country	4.71	0.212120
EU Members	2.81	0.356267
Exports of Albania	2.79	0.358669
CEFTA Diversion	2.17	0.460536
Common Border	1.85	0.540793
CEFTA Creation	1.4	0.713443
Sea Access	1.38	0.726393
FTA with Turkey	1.15	0.869640
Mean VIF	3.73	

Source: *Bank of Albania,2012*

After dealing with the multicollinearity issue, Hasusman test was continued. As was discussed above, both techniques (FE and RE) have their advantages and disadvantages and both differ in a way how individual specific effects are treated. In order to choose which technique is more adequate, the properties of the data as well as results of tests need to be considered. Therefore, by applying the Hausman test, we can simply pass up our dilemmas. Based on results of the Hausman test (see table 11), the null hypothesis which assumes that the individual effects are uncorrelated with other regressors can be rejected. Therefore, the FE estimation is accepted in favour of the RE, as a more consistent technique. Thus, by applying FE technique, the following results are obtained:

Table 10. Hausman Test

	Coefficients			
	(b)	**(B)**	**(b-B)**	**sqrt(diag(V_b-V_B))**
	Fixed Effects	Random Effects	Difference	S.E
GDP of exp. countries	0.2213653	0.6980747	-0.4767094	0.2396082
GDP of Albania	0.6341697	0.4095735	0.2245962	0.0332422
Per Capita Difference	-0.105633	0.003378	-0.1090110	0.1080787
CEFTA Creation	0.4910269	0.078014	0.4130129	.
CEFTA Diversion	0.1102149	0.0834725	0.0267424	.
Remittances	0.4221883	0.3461282	0.0760601	.
FTA with Turkey	0.0912572	0.0643398	0.0269174	.
Exports of Albania	0.0650031	0.0793295	-0.0143264	.
EU Members	0.1093251	-0.041583	0.1509081	0.0303069

b = consistent under HO and Ha; obtained from xtreg
B = inconsistent under Ha, efficient under Ho; obtained from xtreg
Test: Ho: difference in coefficients not systematic
chi2(9) = (b-B) [(V_b-V_B)^(-1)](b-B)
= 23.68
Prob>chi2 = 0.0048
(V_b-V_B is not positive definite)

Source: *Bank of Albania, 2012.*

By using the FE technique for estimations of model (4), only 3 independent variables are found to have a significant impact on this model and all of them have the expected signs. Contrary to the OLS, the FE technique excludes all variables that do not vary over time.

As table 12 shows, the GDP of the exporting county is found to be positively correlated with Albania's imports, however, econometrically insignificant. Therefore, there is not enough evidence to explain correlation between Albania's imports and the GDP of its trading partners.

Table 11. Fixed Effect estimations (Imports of Albania)

(Imports_Alb)	Coef.	(Std. Err)
GDP_exp_coun	0.093	(0.271)
GDP_Alb	-0.138	(0.283)
GDP per capita -diff	-0.047	(0.141)
CEFTA creation	0.512**	(0.204)
CEFTA diversion	0.014	(0.210)
Remittances	2.428***	(0.663)
FTA_TURKEY	0.087	(0.368)
Exports_Al	0.058**	(0.030)
EU_members	0.083	(0.166)
_cons	-31.899	(7.960)
Observations	408	
Time FE	YES	
R-sq: within = 0.6541		
between = 0.0809		
overall = 0.3177		

Note. legend: * p<.1; ** p<.05; *** p<.01

Source: *Bank of Albania, 2012.*

Regarding the GDP of Albania, a negative correlation with imports was found. A negative sign of GDP implies that the economic mass of Albania does not have a positive impact on Albania's imports, but in the contrary, it reduces the trade orientation making the economic activity more inwardly oriented. Hoverer, similarly with the OLS, by using the FE we do not find an econometrically significant correlation between variables. Therefore, it can be concluded that there is not enough evidence to explain the relationship between Albania's GDP and its imports. Similarly, the differences of the GDP per capita and imports of Albania are not found to have any relationship between them.

As was already discussed on the previous sections, the main focus of this study was to estimate the impact that the CEFTA membership had on Albania's imports. Therefore, special attention was paid to the coefficients related with CEFTA. Consistent with the hypothesis of this paper, the impact of the CEFTA membership on Albania's imports was found to have a positive correlation with the imports of Albania from CEFTA members. At the same time, the coefficient of the CEFTA creation was found to be significant, at a 5% level. Consequently, the CEFTA creation sign and significance level implies that CEFTA membership has increased imports of Albania from CEFTA members. Based on the FE results, all other things being equal, being a member of CEFTA increased the imports of Albania from CEFTA members by 0.51%.

In contrast to the CEFTA creation, the second dummy variable that was applied in order to estimate trade diversion was found positively correlated and not significant. Therefore, due to an insignificant coefficient, the diversion is excluded from this model. The insignificant impact of the CEFTA diversion indicates that the reduction of tariffs with CEFTA

members did not have any impact on imports from other countries or there was a specific problem in this model, such as omitted variables.

Remittances of Albania are assumed to play a crucial role on foreign currency inflows from abroad. During the post-communist era, Albania received large amounts of remittances which became one of the main sources of high imbalances between its imports and exports. According to the World Bank (2012), remittances represented about 8.3% of Albania's GDP, in 2012. Thus, in consistence with the hypothesis of this paper, the coefficient of Albania's remittances is found to be econometrically significant, at a 1% of level. At the same time, a positive sign of remittance's coefficient was found, implying that the increase of remittances leads to an increase of Albania's imports. All other things being equal, if Albania's remittances increase by 1%, it is estimated to increase its imports by 2.42%. So, it can be stated that the larger remittances, the larger the imports of Albania.

Turkey remains one of the main trading partners of Albania. In addition to the economic relations, both states were part of the Ottoman Empire and used to trade with each other for a long time. The signing of an FTA between Albania and Turkey as one of the main trading partners is assumed to increase trade between countries. As expected, an FTA with Turkey was found to have a positive correlation with the imports of Albania, however, not econometrically significant. So, any relationship between variables cannot be concluded.

The role of exports as a determinant of Albania's imports is found to be significant, at a 5% of level. In addition to that, the exports of Albania are found to have an econometrically significant impact by both techniques, FE and OLS. Thus, it can be concluded that the exports of Albania are strongly correlated with the imports of Albania. The estimated coefficient is 0.058 which implies that Albania's imports increase 1.05% [exp (0.058) = 1.05], with every 1% increase of Albania's exports, other things being equal.

The last independent variable tested by the model was EU membership. Based on the FE results, being an EU member and at the same time a trading partner of Albania, was found not to have any significant impact on Albania's imports. Therefore, there is not enough evidence to conclude any relationship between an EU membership and Albania's imports.

CONCLUSION

The impact of FTAs on trade flow has been largely discussed in the literature of international trade especially after the 90s when the world witnessed an explosion in the number of bilateral and multilateral FTAs. Even though the positive impact of FTA on trade flow is widely proclaimed, the real impact of FTAs continues to be subject of considerable debate. At the same time, many authors try to address this issue through different theoretical and empirical works.

Even though there is a considerable number of research papers estimating the impact of FTAs on trade, there in not enough empirical evidence of CEFTA's impact on member countries, and particularly in Albania's trade. Therefore, an attempt to give a contribution in this respect was made, by providing evidence for the impact of the CEFTA membership in Albania's imports.

As was already discussed in the previous sections, the primary focus of this study was to estimate the impact of the CETFA membership on Albania's imports, with a particular focus on trade creation and trade diversion effects. In order to distinguish the impact of CEFTA from other determinants, the trade gravity model was run, by applying both fixed effects and random effect techniques. Based on the fixed effect technique (suggested by the Hasuman test), the results show that Albania's imports are highly and positively affected by remittances. Another significant relation is found between the imports and exports of Albania. Increasing Albania's exports seems to affect the imports of Albania positively.

Finally, it was possible to prove the hypothesis that the CEFTA membership has a positive impact on Albania's imports. Based on fixed effects, a trade creation effect was proved, however there was not enough evidence to prove trade diversion. Recapitulating the major results pointed out by this model, it is possible to conclude that joining a multilateral trade agreement (CEFTA), has been a right decision by Albania, since it has achieved to increase its trade (imports), which is one of the primary roles of CEFTA. With regards to other determinants, it was not possible to provide any evidence for a relationship with Albania's imports, as most of them were found econometrically insignificant, meanwhile 3 of them were omitted by model estimation.

Before ending this thesis, it must be highlighted that this study had its limitations. It is obvious that in addition to the variables used in this model, there are many other factors that can affect Albania's imports, such as political relations, cultural similarities, MTR, Albanian costumer's preferences, etc. However, due to the lack of such data and the over complication of the model, it was not possible to include all of them in this gravity model.

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APPENDIXES

TABLE OF APPENDIXES

Appendix A. Sample of Trading Partners

Country	Member of
Algeria	
Australia	
Austria	EU
Belgium	EU
Bosnia and Herzegovina	CEFTA
Brazil	
Bulgaria	EU
Canada	
China	
Croatia	CEFTA
Cyprus	EU
Czech Republic	EU
Danimark	EU
Ecuador	
Egypt	
England	EU
Finland	EU
France	EU
Georgia	
Germany	EU
Greece	EU
Hong Kong	
Hungary	EU
India	
Ireland	EU
Islamic Republic of Iran	
Israel	
Italy	EU
Japan	
Macedonia	CEFTA
Moldova	CEFTA
Netherlands	EU
Norway	
Poland	EU
Portugal	EU
Romania	EU
Russia	
Saudi Arabia	
Serbia and Montenegro	CEFTA
Slovak Republic	EU
Slovenia	EU

continued

table continues

South Korea	
Spain	EU
Sweden	EU
Switzerland	
Syria	
Turkey	
Ukraine	
USA	

Appendix B. List of Abbreviations

AC	Acquis Communautaire
AFTA	Asean Free Trade Agreement
BA	Bank of Albania
BTR	Bilateral Trade Resistance
CEFTA	Central European Free Trade Agreement
COMESA	Common Market for Eastern and Southern Africa
EFTA	European Free Trade Association
ECC	European Economic Community
EU	European Union
FE	Fixed Effects
IMF	International Monetary Fond
INSTAT	Institute of Statistics
MERCOSUR	Common market between Argentina, Brazil, Paraguay, Uruguay and Venezuela
MTR	Multilateral Trade Resistance
NTBs	Non Tariff Barriers
OLS	Ordinary Last Square
RE	Random Effects
SAP	Stabilization and Association Process
WB	World Bank
WTO	World Trade Organization