# FOREIGN TRADE LIBERALISATION AND ECONOMIC GROWTH: THE CASE OF THE REPUBLIC OF SRPSKA

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## ABSTRACT

This paper assesses the impact of trade liberalisation on the economic growth of the Republic of Srpska (RS). The aim of the research is to prove the hypothesis that trade liberalisation and export orientation positively impact on GDP growth. RS has characteristically small and open economies. The degree and character of the connections between the observed variables was determined by means of regression analysis. Regression analysis indicates that there is a positive connection between the total trade and GDP growth. Further, there is a marked positive correlation between export and GDP, that is, export growth contributes to GDP growth. Foreign trade deficit stands in a negative correlation with GDP. Lastly, regression analysis points to the connection between the Republic of Srpska economic growth and openness of its economy. However, uncontrolled opening and exposure to foreign competitiveness can also bring about problems which in certain circumstances lead to long-term macroeconomic instability.

# INTRODUCTION

The Republic of Srpska (RS) and the Federation of Bosnia and Herzegovina constitute the state union of Bosnia and Herzegovina (B&H). Like other countries of the Balkan Peninsula it is involved in the European integration process. For the path towards the European Union (EU) there is agreement of policies, public and citizens. Today (2018), B&H is a potential candidate for EU membership. It is undergoing the Stabilisation and Association Process (SAP) through the Stabilisation and Association Agreement (SAA). In the SAA and annexes thereto, a significant role is played by trade liberalisation and creation of free trade zone between B&H and the EU (Vukadinović and Vukadinović-Marković 2016: 398).

 A question arises: to what extent does trade liberalisation impact on small economies such as the RS and B&H? It is hard to find a general and internationally accepted definition of a small country (Lopandić 2010: 82), but there are certain criteria, standards and definitions of small countries. For the World Bank and International Monetary Fund, small countries are those that have less than 1,5 million inhabitants. Accordingly, B&H is not a small country, whereas the RS as an entity satisfies the criterion for a small country. In terms of the Balkan region, this criterion is also met by Montenegro. Likewise, the definition proposed by Simon Kuznets, to the effect that the criterion for a small country is population under 10 million, has been accepted (Kuznets 1960: 14). After the appearance of numerous countries in Europe and the world, the said limit of 10 million has become questionable as well. In this respect, in 2017 there were 144 small countries (World Meters, 2017). By this definition, most countries of the Western Balkans (WB) are actually small countries.

# 1. PREVIOUS RESEARCH

Trade growth and export orientation have a positive impact on production, economic growth and welfare. For example, during the times governed by GATT, the world trade growth was faster than production growth (Stiglitz and Charlton 2005: 59). This pertains to all the countries, regardless of their state of development and size. Foreign economic and economic balance are interdependent (Meade, 1955). The Balkan countries see their chance for faster economic growth and development in economic liberalisation and togetherness with the EU, finding the European Union to be safer economic and social "shelter" (Popović, 2016). The European economic integrations have a geopolitical dimension too, but they are directed economic changes nonetheless (Stanivuković and Đajić 2008: 398). In addition to benefits from intra-trade exchange, the future member states see the advantages of specialisation, effects of economies of scope, as well as an easier access to the global market for goods and financial services (Mardas and Nikas, 2008: 511–523), etc. Further, the European funds are attractive sources for favourable development financing (Berthomieu et al. 2016: 144–145). A good example is Slovenia, which liberalised trade, stabilised economy and attained the average level of EU development. This is an example/model for how small economies can exploit their potentials and export as the strongest economic weapon. The very process of European integrations implies changes of national legislations and harmonisation with acquis communautaire, the EU legal heritage (Vukadinović 2004: 55). Thus, the candidate member states quickly liberalise trade, deregulate markets and reduce the role of the state (segments of SAA). Also important in this respect is CEFTA, an agreement which many European states have been through. The economies of candidate states are facing radical liberalisation for the first time in this free trade zone. Owing to CEFTA, the Western Balkans Countries have accelerated growth of trade exchange (Petreski 2013: 26–44).

Economic growth depends on a series of factors which in macroeconomics can mainly be classified as labour, capital and technological progress. World exchange and trade liberalisation have become the conditions for economic growth (Krugman & Obstfeld 2009).

The majority of small countries have insignificantly higher growth rates in relation to developed

countries. However, they mainly have a weaker industrial base, deficient economies of scope and structural disproportions, and they adjust to the requirements of the global demand more slowly. What the small economies lack is openness toward the world markets of goods, services and money, a greater inflow of FDI, etc. (Mehic et al. 2013: 5–20). The problem is limited offer and an unequal distribution of income, as well as vulnerability to climate changes, diversification and sustainable development (Peretz et al. 2001: 607–608). The majority of these factors impact on the economic growth. However, there are examples showing that small economies develop using other development potentials: efficient institutions, good economic policy, quality natural and human resources, etc. (Buterin et al. 2017: 1572–1593), since growth depends on public institutions, democratisation and other factors as well (Pere, 2015: 25–45).

Integration and liberalisation are prerequisites for the industrial growth and comparative advantage (Balassa, 1967). The integration levels in early phases are bound with free trade zone, customs union, common market and economic union. Then follow the monetary, fiscal and finally political union (Balassa, 1965). Crowley expands the integration scheme by Balassa (Crowley, 2002) and proves that growth rates in new, smaller EU members are faster than those in old members. New members also have a greater investment rate. Upon accession to the EU, their unemployment rates drop too. The integrations bring about greater social distortions as well, but these are secondary nonetheless (Popović, 2016: 80–81).

Liberalisation of trade exchange has a big impact on every country's economy, while export orientation has become the requirement for faster economic growth (Mahmoodi & Mahmoodi 2016: 938–949). Export-oriented companies give rise to stronger internal competition. Numerous researches have confirmed positive correlation between export (and trade exchange) as the independent variable and small country economy growth rates as the dependent variable (Siddiquia and Ahmedb 2013: 18–33).

Economic liberalisation has its limitations too. Small countries have high costs of the public sector and higher average costs in the private sector. Likewise, access to the world financial markets is more difficult, etc. Governments of these countries often "resuscitate" economies, and start economic cycles thereby impacting on the investment activity. Small countries use mechanisms of adjustment to external shocks despite mostly lacking all the necessary instruments (Prasad et al. 2003: 8). And generally, there occur in the course of development of efficient monetary, fiscal and other policies certain restrictions, which is why governments of small countries often turn to liberalisation of trade, for all the risks of such policy.

Taking all the facts into consideration, trade liberalisation and export orientation have become the bases for faster economic growth. Export is all the more frequently accompanied by "hidden" stimulations and other forms of support. By an optimal selection of products companies take their positions on the world markets. Liberalisation and export orientation form a strategy for achieving faster growth, macroeconomic stability and growth of economic welfare (Mano-Bakalinov 2016: 48–60).

## 2. RESEARCH METHODOLOGY

The subject of this paper is analysis of the impact of trade exchange and export on the Republic of Srpska's economic growth. According to all the indicators, this B&H entity meets the criteria for a small economy (WB reports, IMF and other). The connection between trade liberalisation and GDP trends will be analysed by means of simple linear regression analysis. For this purpose, foreign trade exchange, export and foreign trade balance will be explanatory variables, whereas GDP will be the dependent variable, that is:

$$Y = f(T, X) \qquad (1)$$

where: Y - GDP; T - scope of foreign trade exchange; X - export
The simple linear regression model has the following form[1]:

$$Y_i = \beta_0 + \beta_1 \cdot x_i + \varepsilon_i \ (i = 1,..., n) \quad (2)$$

where: $Y_i$ - i-dependent variable; $x_i$ - i-independent (explanatory) variable; $\beta_0$, $\beta_1$ - regression parameters to be estimated; $\varepsilon_i$ - stochastic member (random error); n - size of the basic set.
Use is made of estimated function of the simple linear regression on the basis of the sample:

$$\hat{Y}_i = b_0 + b_1 x_i \qquad (3)$$

where: $\hat{Y}_i$ - the value of the dependent variable on the best adjusted regression line; b0 and b1 - estimations of unknown regression parameters of the basic set.
The results of the regression analysis show the degree of impact of trade liberalisation on GDP growth. Regression analysis is the standard statistical procedure (the Least Square Method/OLS)[2]. This method is simple and reliable (for example, it mutually excludes positive and negative errors). For the purpose of quantification of approximately linear connection the best direction for the presentation of the observed variables is constructed. The analysis also contains standard deviation, medium, maximum and minimum value, asymmetry of distribution and measure for the tendency of series distribution. Regression analysis provides the estimation of the statistical significance of the following variables: probability (p), t - statistics, standard estimation error and determination coefficient $R^2$.
The statistical base is made of the data of the RS Republic Institute of Statistics (the period from 2005 to 2018). This relatively short time span (13 years) in the regression model is a result of limited availability of data sources for the observed variables.

## 3. TRADE LIBERALISATION AND THE REPUBLIC OF SRPSKA ECONOMIC GROWTH: STATISTICAL ANALYSIS

### 3.1. ANALYSIS OF GDP TREND

As a consequence of the crisis in 2008, the Republic of Srpska has since recorded unequal and lower growth rates. Apart from the lower growth rates, the tendencies of the GDP structure are unfavourable too. In 2016, trade, industry, public administration, agriculture, forestry, etc. have the greatest share in GDP. Production and supply of electric energy have the greatest impact on growth, followed by agriculture, forestry, industry and civil engineering. Growth is slowed down by

1 Simple linear regression model has a deterministic and stochastic segment. The deterministic segment pertains to the average impact of the independent (x) on the dependent (y) variable; parameter β0 is the free member, and β1 slope coefficient.
2 The best adjusted direction of linear connection as determined by the least square method gives the regression line.

information and communication technologies sectors, as well as public services (administration, auxiliary service activities, and other).

**Graph 1.** Real GDP growth rates trend for the Republic of Srpska (2006–2017)
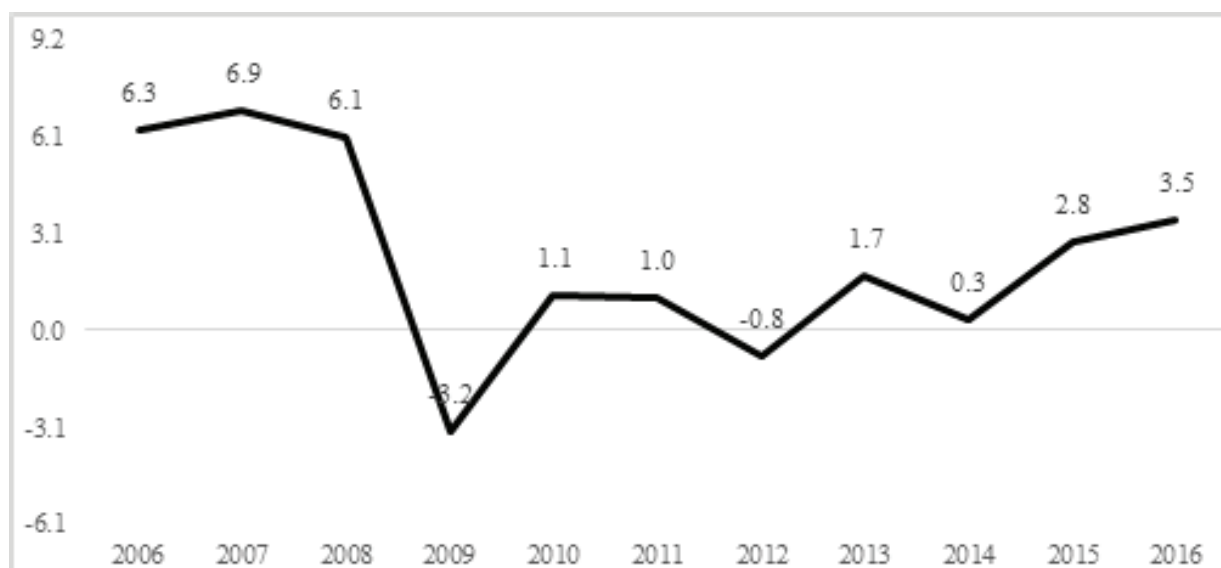


Source: The Republic of Srpska Institute of Statistics

Until the 2008 crisis the Republic of Srpska records high growth (it drops from 6,3% in 2008 to -0,3% in 2009). The European Union records a fall by 4,4%, and the situation is the same in other countries with which the RS and B&H have the greatest cooperation: Germany - 5,6%, Italy -5,5%, Austria -3,8%, Croatia -7,4% and Serbia -3,1%. These negative trends slow down GDP growth and trade exchange, and it is only in 2015 and 2016 that there occurs recovery (2,8% and 3,5%), associated with a significant growth of export (9,8% in 2016).

**3.2. ANALYSIS OF FOREIGN TRADE EXCHANGE**

Liberalisation of foreign trade is important for open, smaller and weaker economies (Krugman & Obstfeld 2009). The share of foreign trade in the world GDP is increasing, because exchange grows faster than production[3]. The following table shows the share of export and import in the Republic of Srpska GDP.

**Table 1.** The share of import and export of goods in the Republic of Srpska GDP (GDP = 100)

| Years | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Export of goods and services | 29 | 26 | 20 | 22 | 23 | 28 | 30 | 30 | 28 | 30 | 35 | 35 |
| Import of goods and services | 45 | 49 | 43 | 49 | 53 | 52 | 52 | 55 | 47 | 46 | 49 | 49 |

Source: Authors' analysis (data obtained from RIS RS, CB B&H, AS B&H, FIS)
Export of the Republic of Srpska goods makes 20-35% of GDP. And while this share oscillates, export values point to reserves and potential growth possibilities. There exist conditions for the

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3 In EU, Slovenia, Austria and Germany (average: 65,1%, 50,5%, 41,3%) have the greatest share of export in GDP. In 2016, Slovenia had the share of export in GDP of an even 77,7%.

Republic of Srpska to strongly focus on export. This takes industries that are competitive both on the local and world market. On the other hand, excessive import endangers production which is insufficient, non-elastic or non-competitive even on the local market.

Foreign trade exchange of the Republic of Srpska is shown in the following table.

**Table 2.** Foreign trade of goods in the Republic of Srpska, 2005-2018 (million BAM/ %[4])

| Years | Export | Import | Volume | Balance | Export (%) | Import (%) | Volume (%) | Coverage (%) |
|---|---|---|---|---|---|---|---|---|
| 2005. | 1.131 | 2.953 | 4.084 | -1.822 | 4,1 | 9,3 | 15,2 | 38,3% |
| 2006. | 1.540 | 2.760 | 4.300 | -1.220 | 36,2 | -6,5 | 5,3 | 55,8% |
| 2007. | 1.672 | 3.348 | 5.020 | -1.676 | 8,5 | 21,3 | 16,7 | 49,9% |
| 2008. | 1.922 | 4.147 | 6.068 | -2.225 | 15 | 23,9 | 20,9 | 46,3% |
| 2009. | 1.673 | 3.568 | 5.241 | -1.894 | -13 | -14 | -13,6 | 46,9% |
| 2010. | 2.178 | 4.053 | 6.231 | -1.875 | 30,2 | 13,6 | 18,9 | 53,7% |
| 2011. | 2.561 | 4.578 | 7.138 | -2.017 | 17,6 | 12,9 | 14,6 | 55,9% |
| 2012. | 2.375 | 4.488 | 6.862 | -2.113 | -7,3 | -2 | -3,9 | 52,9% |
| 2013. | 2.604 | 4.558 | 7.162 | -1.954 | 9,7 | 1,6 | 4,4 | 57,1% |
| 2014. | 2.692 | 4.946 | 7.638 | -2.254 | 3,4 | 8,5 | 6,7 | 54,4% |
| 2015. | 2.614 | 4.369 | 6.983 | -1.755 | -2,9 | -11,7 | -8,6 | 59,8% |
| 2016. | 2.869 | 4.427 | 7.296 | -1.558 | 9,8 | 1,3 | 4,5 | 64,8% |
| 2017. | 3.476 | 4.900 | 8.376 | -1.424 | 21,2 | 10,7 | 14,8 | 71% |
| 2018. | 3.742 | 5.222 | 8.964 | -1.480 | 7,6 | 6,6 | 7,02 | 71,7% |

Source: The Republic of Srpska Institute of Statistics

The table shows growth of all the favourable indicators, except for the balance of exchange with the countries abroad, which oscillates during the period 2005-2018. The average growth of export of 7,6% in 2018 and import of 6,6% show continuity of positive trends. In the period from 2005 to 2018, export and import follow GDP trends. At the end of the period, that is in 2018, GDP growth of 3,9% is accompanied by growth of export of 7,7%. The coverage of import by export is 71,7%. It can be concluded from the data that the Republic of Srpska's economy is open, because it is obvious that the scope and direction of trade exchange with the world impact on the level of GDP.

### 3.3. REGRESSION ANALYSIS OF FOREIGN TRADE EXCHANGE AND THE RS ECONOMIC GROWTH

In this part the connection between the foreign trade exchange as the explanatory variable and GDP growth as the dependent variable in the model is estimated. Table 3 shows that the determination coefficient is 0,80. Therefore, 80% of variations in GDP is explained by changes of foreign trade exchanges with the countries abroad. The results of F test and the probability lower than 1% provide arguments for the significance of predictor variable in explaining growth rates, yet under the other circumstances unchanged. It should be pointed out here that the impact of other factors on growth has been excluded from this analysis.

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4 The official currency in B&H and RS is convertible mark (BAM). The value of convertible mark is fixed for Euro in the ratio of 1 EUR (€) = 1,9558 BAM.

**Table 3.** Results of simple regression analysis - foreign trade exchange and GDP

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| b0 | 6641152 | 322036.8 | 20.62234 | 0.0000 |
| Foreign trade exchange | 0.224666 | 0.039010 | 5.759107 | 0.0004 |
| R2 | 0.805671 | Mean dependent variable | 8479473. | |
| Adjusted R2 | 0.781380 | S.D. dependent varable | 288333.8 | |
| S.E. of regression | 134815.7 | | | |
| Sum squared resid | 1.45E+11 | | | |
| Log likelihood | -131.1903 | | | |
| F-statistic | 33.16731 | | | |
| Prob(F-statistic) | 0.000425 | | | |

Source: Author's data analysis

The simple regression equation: Y = 6.641.152 + 0,224666·(trade exchange) shows that a change of foreign trade exchange of 1 BAM leads to a GDP change of 0,225 BAM. Therefore, direct linear connection between the foreign trade exchange and GDP is observed, yet under the other conditions unchanged, as the other factors that can lead to change in Gross Domestic Product have not been included.

In what follows (Table 4) the results of simple linear regression of export as the explanatory variable and GDP as the dependent variable have been presented. The determination coefficient amounts to 0,65, which means that 65% of GDP variations is determined by changes in export, yet without the inclusion of other factors that can impact on GDP changes. The results of F test (14,86) and the probability lower than 1% provide arguments for the significance of export in explaining GDP growth rates, though with the other conditions unchanged.

**Table 4.** The results of the simple regression analysis - export and GDP

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| b0 | 6990155. | 390590.3 | 17.89639 | 0.0000 |
| export | 0.441044 | 0.114421 | 3.854569 | 0.0048 |
| R2 | 0.650009 | Mean dependent variable | 8479473. | |
| Adjusted R2 | 0.606260 | S.D. dependent varable | 288333.8 | |
| S.E. of regression | 180925.8 | | | |
| Sum squared resid | 2.62E+11 | | | |
| F-statistic | 14.85771 | | | |
| Prob(F-statistic) | 0.004846 | | | |

Source: Author's calculations

The regression equation in this case runs as follows: Y = 6.990.155.000 + 0,44·(Export)
And shows that changes in export of 1 BAM lead to changes in GDP of 0,444 BAM. It can therefore be concluded that there exists a direct linear connection between export and GDP, that is, the growth of export impacts on the growth of GDP (other factors that could lead to changes in the dependent variable have not been included in the model).

Table 5 gives the results of the simple linear regression of foreign trade deficit as the predictor variable and GDP as the dependent variable. The determination coefficient shows that 52% of GDP variations is determined by changes of deficit, yet without the inclusion of other factors that can impact on GDP. The results of F test (8,55) and the probability lower than 5% provide arguments for the significance of the explanatory variable - foreign trade deficit - in explaining the economic growth rates (under the other conditions unchanged).

**Table 5.** Results of simple regression analysis - foreign trade deficit and GDP

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| b0 | 7323061. | 401055.1 | 18.25949 | 0.0000 |
| Trade deficit | -0.809313 | 0.276706 | -2.924810 | 0.0191 |
| R2 | 0.516748 | Mean dependent variable | 8479473 | |
| Adjusted R2 | 0.456342 | S.D. dependent varable | 288333.8 | |
| S.E. of regression | 212597.7 | | | |
| Sum squared resid | 3.62E+11 | | | |
| Log likelihood | -135.7452 | | | |
| F-statistic | 8.554516 | | | |
| Prob(F-statistic) | 0.019150 | | | |

Source: Authors' calculations

From the regression equation that runs as follows: Y = 7.323.061.000 - 0,809313·(Trade deficit)
It can be concluded that changes in the trade deficit of 1 BAM alter GDP for about 0,809 BAM. It should be pointed out that this connection is negative, that is, that changes in GDP are in correlation of an extremely strong intensity with the changes in the variable (Deficit), yet with reversed direction.

## CONCLUSION

Numerous factors impact on the development of small countries. A globally competitive economic structure and export orientation are the basis for the development of the most dynamic economies. Apart from numerous factors sublimed as capital and technological progress, foreign trade exchange can be crucial for accelerating the economic growth as well. It is well known that a reduction of unit costs, growth of economies of scope effects, etc., can increase productivity and competitiveness. These are certainly prerequisites for faster GDP growth.

Therefore, export, import and trade balance are crucial for GDP growth, regardless of the size of an economy and/or its structure.

The Balkan countries are completing the transition process. Each country is going through a certain phase of the association process. Through the stabilisation and association process trade exchange with the Union is liberalised. Despite the fact that they are achieving slightly higher growth rates in relation to the developed countries, at this stage they are insufficient for overcoming inherited economic and social problems. Therefore, they are liberalising trade with the world, in which they see their chance for faster economic growth. These countries are liberalising trade relations with the European Union through SAA (and the relevant annexes). A certain degree of liberalisation is also present in the exchange between CEFTA countries.

In the long term, the Republic of Srpska records negative exchange with the countries abroad. Not only does it have negative balance with the EU and CEFTA, but with the rest of the world too. However, despite this huge deficit in the exchange with the world (and the EU), the Republic of Srpska records continuous growth of export, which grows faster than import and is faster from GDP growth too.

The question was raised: To what extent does foreign trade exchange impact on the Republic of Srpska GDP growth? Regression analysis points to a positive correlation between the total trade exchange and GDP growth. Furthermore, there is a marked positive correlation between export as the independent variable and GDP as the dependent variable, that is, growth of export contributes to GDP growth. Foreign trade deficit stands in negative (reverse) correlation with GDP; therefore, foreign trade deficit slows down GDP growth. Finally, regression analysis points to a connection between the Republic of Srpska economic growth and the openness of its economy.

Liberalisation of trade, proximity to the European Union, trade with CEFTA, etc., can bring certain advantages, above all in terms of increasing trade and accelerating growth. However, immoderate opening and exposure to foreign competition can bring about some problems that in certain circumstances may lead to long-term macroeconomic instability as well.

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