

# Free Trade Agreement's economic aspects and impacts with special reference to Albania

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**Abstract**— Free Trade agreement has a crucial role in the openness of Albania economy. They had a positive and a negative impact on economic indicators such as unemployment rate, inflation, trade balance. Despite the inconveniences Albania shows also positive signs regarding FTAs, such as higher trade volume as a consequence of increasing exports and imports. This means that the country has forced its cooperation with partner countries.

**Index Terms**— Albania, advantage, disadvantage, economic aspect, Free Trade Agreement, impact openness.

## 1 INTRODUCTION

After the end of the Second World War many countries understood that by fighting they would ultimately harm themselves more than gain any benefit. They understood that collaboration is the means by which they could benefit more than any other thing. They also realized that trade was one of the key tools to achieve higher welfare levels of their societies. This was the principle behind the 1956 agreement in Italy that was the beginning of the formation of the nowadays European Union (EU). Free trade was seen as the means by which the European countries devastated by war, would rise up again. It was also seen as a means of peace, because countries with strong trade ties had less motives of conflict with each other. Free trade agreements (FTAs) were born out of the desire to increase people's welfare and make them feel more comfortable and in power. But still today many questions are asked regarding the effect of these free trade agreements. These questions were the driving motive that inspired us to write this paper.

The purpose of this paper is to show what FTAs are and what is their role in the economic life of societies. This will be done by assessing the general principles of a FTA and their role in economic life. More particularly, this paper has the intention to show in its final part what has been the impact that FTAs have had on the Albanian economy since their enforcement. This is done by assessing the main ideas in macroeconomics regarding their influence and impact on selected economic indicators of a country's economy. Thus, the 'general theory' part will serve as a basis for the subsequent analysis of the impacts in the local Albanian economy of the FTA's this country has in force.

The methodology used in this paper will be that of literary review of Albanian authors related to the FTA issue combined with a graphical presentation from empirical data of the effects FTAs have had on Albania. In the first chapter of the paper we have presented the main aspects of free trade agreements, focusing on the main definitions related to the topic and on the FTAs objectives. The second chapter focuses more on analyzing the relation between FTAs and selected economic indicators. The final chapter is dedicated to Albania and its FTA's.

## 2. MAIN ASPECTS OF FTAS

As shown in the introduction part this paper aims at showing

some aspects of the free trade agreements and their impact on selected economic indicators. We have tried to deal with the most important aspects of free trade agreements. In order to better understand the issue we have first to define some basic concepts regarding the issue. These definitions are necessary in order to understand the scope and objectives of free trade agreements.

### 2.1 MAIN DEFINITIONS RELATED TO THE TOPIC

The first definition must be that of free trade. It is defined as the flowing of goods and services across countries without barriers of any type [1]. Its aim is to provide quality and affordable goods and services to the markets of the countries that participate in free trade. For this reason we apply free trade agreements between various (two or more) parties. By definition, a free trade agreement is an agreement between countries that seeks to increase the level of free trade [2]. This begins by creating special tax, tariff and regulations that can reduce barriers. A FTA can also come with a guarantee of an investment in one country by another, such as foreign direct investment. It is a form of economic integration. In order to achieve this, these countries need to eliminate any type of barrier regarding trade. Trade barriers are considered to be any sort of government imposed restriction on the free international exchange of goods or services. They are generally classified as (1) import policies reflected in tariffs and other import charges, quotas, import licensing, customs practices, (2) standards, testing, labeling, and various types of certification, (3) direct procurement by government, (4) subsidies for local exporters, (5) lack of copyright protection, (6) restrictions on franchising, licensing, technology transfer, (7) restrictions on foreign direct investment, etc.

A free trade agreement simply encourages trade between two or more countries to establish a free trade area where commerce in goods and services can be conducted across their common borders, without tariffs or hindrances but (in contrast to a common market) capital or labor may (not) move freely. Also, member countries usually impose a uniform tariff (called common external tariff) on trade with non-member countries.

FTAs generate a free trade area which is considered to be a geographical area formed by the national boundaries of two or

more countries belonging to a free trade agreement [2]. The European Union or the countries signatories of NAFTA are examples of such free trade area.

## 2.2 MAIN OBJECTIVES

The next steps are to show which the objectives of a free trade agreement are. There are two types of objectives for FTA's, general objectives and specific objectives. General objectives relate to a theoretical framework in general terms of the FTA's. They are common to all the FTAs existing in the world. Instead, specific objectives are the ones set by different countries in relation to each other. In this paper we will talk about the general objectives of a FTA and will not discuss specific objectives because we have not treated any specific FTA.

The scope of FTAs is the gradual reduction (until total removal) of tariffs and barrier regarding trade between the participating countries [3].

Some important general objectives are as follows:

The primary objective is the enhancement of economic collaboration between countries with the aim of increasing the living standards through increase of real income per capita;

A second objective is the increase of production and employment rates;

Then, gradual elimination of any sort of barrier for trade;

Creating equal opportunities of investment and competition for the companies of all countries involved in the FTA.

As we can see the objectives of a FTA are very important for each individual residing in the countries member of the FTA. They have a heavy influence in our daily lives, on income, employment and consumption. On the next chapter we will treat this influence that FTAs have on our lives by assessing their influence on the economic indicators.

## 3. FTA'S IMPACT ON SELECTED ECONOMIC INDICATORS

The free trade agreements (FTA) have certainly an impact on the economic indicators of a country, being that direct or indirect influence. This impact varies according to the political and economical conditions of each country implemented. For example, developed countries take a different approach on their implementation and the effects FTAs have on them are quite different from the effects on developing countries. One of the reasons for differences in effects is the timeframe on which they are implemented. The longer the timeframe of implementation of a FTA, the more differs it in results. Developing countries need more time to implement the FTA's than developed ones, because they need to make more preparations. Also, the shorter the period of implementation, the more difficult is to make an assessment of its impact. Every economy needs a certain period of time (a maturity timeframe) in order to react and adapt to a FTA.

Since different authors pretend that it is still early to make a proper analysis of the empirical effects of the FTA [3], in this short analysis we will make a theoretical sketch of the impacts a FTA can have on a developing economy like that of Albania.

One thing FTA's directly impact is the volume of interna-

tional trade (foreign trade) of a country, specifically its import and export of different products and services [3]. Trade deficit is the difference between the volume of export and import products. If a country imports more than it exports than it is considered to have a trade deficit. The wider the margin between the volumes of the two, the bigger is the trade deficit which translates in problems for the economy. But, in macroeconomic theory, FTA's can make a country benefit from tariff reduction and so it can increase its volume of exports. If this export increase is associated with a decrease in imports than the trade deficit would also decrease. This decrease in imports volume could come due to an increase in domestic production of the imported products or their substitutes.

Prices are another area where FTA's can have a positive or negative impact. Imported products can be raw materials or finished goods. The removal of tariffs and barriers leads to a lower cost for the local businesses importing raw materials, which in consequence would mean a lower market price for their finished products [3]. This is one of the major positive impacts on prices. On the other hand, we must admit that increase in exports could result with negative consequences if the production capacity of an economy does not also increase. This is because firms will focus on exporting its products and offer less in the domestic market. Assuming that demand will remain constant, this would result in a decline in offer, which means an increase in prices (inflation).

FTAs also have an impact on the level of competitiveness between local and international businesses. If the quality of products imported is higher, the domestic firms would have to raise their standard and quality of production. This would benefit the consumer with better quality products [3]. The business firms will have to make difficult choices. Either they will have to lower their costs, mainly by cutting down the size of their work force, or invest in new technology and production techniques. But if the domestic businesses could not keep up with the required investments in technology and other techniques required for making their products competitive, they will have no choice but to shut down. This means that the level of unemployment will rise. This is a negative consequence that FTA's have on the domestic economy of a country.

At the same time, the market's extension makes the domestic environment more attractive for the foreigners and stimulates them to invest more and more in the hosting country. The new enterprises provide better employment opportunities for local workers causing in this way the reduction of unemployment.

Another important area of impact from FTA's is the state revenues. The state budget relies heavily on tariffs and taxes. FTA's reduce, up to abolishing, tariffs for imported products and even for exported ones, thus impacting negatively the state revenues.

As we realize from this analysis, FTAs may have positive or negative impacts on economic indicators. That is why there are pros and cons regarding the application FTAs.

#### 4. THE CASE OF ALBANIA

The Stabilization and Association process of the Western Balkan countries with the European Union is the final step into total integration into the Union. For this reason, regional integration in trade is a logical step in the future integration to the EU market in particular, and through that, to the world markets. The EU itself is an example of various regional integrations that joined to form a bigger whole. This experience demonstrated over the years that huge gains derive from establishing tight trade links with neighbors, in particular through the creation of a vast and efficient regional market. This was the reasoning behind the bilateral free trade agreements that Albanian signed with its neighbors and with the European Union. An important piece of this puzzle was the membership in the World Trade Organization (WTO) that for Albania became reality in September 2000. At the time, this was commented as a further enhancement of regional and European trade ties for the country. Regional integration was an objective that Albanian could not have afforded to miss.

##### 4.1 TRADE LIBERALIZATION IN ALBANIA

Trade liberalization and facilitation was the kernel for a positive regional integration. Trade liberalization is also essential for economic development. As we have tried to show before it is a prerequisite for foreign direct investments, which are a driving force for economic development. In theory, exposure to foreign competition leads domestic industries to become more efficient and competitive reduces the cost of key inputs and will develop incentives to invest in research and development to become more competitive [4]. Another factor is that openness to imports influences the decrease costs for consumers and increases the variety and quality of the goods available on the market. Overall, trade openness is assumed to increase the welfare of the population [5].

During the last decade Albania made great efforts toward trade liberalization, by opening up the national borders. It signed its first free trade agreement in 1998. Walking on the footsteps of other countries, Albania is trying to open its market to the world but so far the effect of trade liberalization is not being the one the country hoped they would be.

Since 1998 Albania has signed and enforced FTAs with 8 regional countries. These are bilateral free trade agreements with Macedonia, Bulgaria, Romania, Serbia & Montenegro (at the time), Turkey, Croatia and Moldova. Whereas a free trade agreement between Albania and EU was incorporated into the Stability-Association Agreement enforced since 2006.

As far as disadvantages are concerned, the main challenge of FTA posed to the national economy is increased competition in the market. This situation may lead up to bankruptcy for firms which cannot survive such competition. Nonetheless, despite of such short term challenges and costs, in the long term FTA make possible the re-allocation of resources into more effective uses.

"If a company is not able to face competition it should not shield itself behind protectionist measures enforced from the government because there are a string of negative effects as follows:

There is no allocation of investment into the best possible projects;

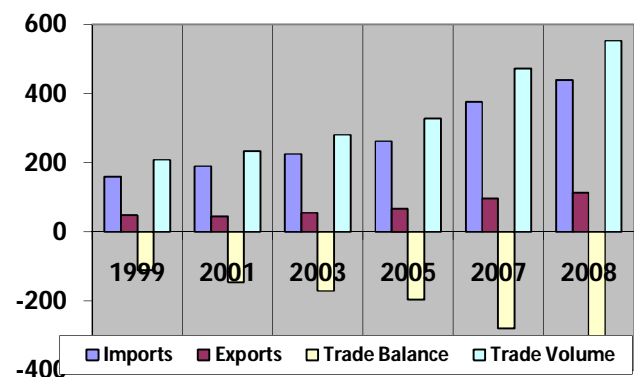
Consumers are penalized through lower quality of products and services;

It is a constraint on economic growth which needs wider market opportunities" [4].

##### 4.2 PROBLEMS OF THE ALBANIAN ECONOMY

Below we are providing a graphical demonstration of the ongoing of the trade flow since 1999.

**Figure 1 Development in time of trade flows in million lek since 1999**



Source: INSTAT (2008), author calculations.

The graphic reflects some positive effects of Albania's regional bilateral FTAs, as can be read from the general trend of increasing exports and imports. This results with a higher trade volume which means that Albanian exchanges with other countries has raised. This occurrence leads to rise of competitiveness in goods and services, better quality of products, decrease in prices for the consumers and also attraction of foreign direct investments.

Although the exports have risen, the trade deficit is still high, which means that Albanian products are not preferred in the international market. In the same time we may say that the high level of imports is because of the fact that the Albanian economy does not have the ability to fulfill the domestic needs.

There are also other factors which affect the amount of imports and exports such as remittances etc, but they are not focus of our paper.

Some reasons why the FTAs may not have generated positive impacts on the Albanian economy are as follows:

1. As a country with a low level of openness prior to 1998, Albania adopted liberalization politics very fast perhaps faster than it should have.
2. It pursued an accelerated price liberalization policy, abolished the state monopoly over foreign trade, and

introduced convertibility of domestic currency [4].

3. Albania fulfilled its obligations from the WTO membership concerning the elimination of custom duties on certain products, such as: alcoholic beverages, wood products, paper products, furniture and various toys at a bound rate of zero percent without countermeasures to protect a fragile home business environment. Albanian companies were not ready to compete when the market opened to foreign products which were cheaper and of a better quality but crashed internal production. Based on old technology producers couldn't produce an amount of product that could supply home demand and the amount of product was also of a lower quality than the import products. Also, being "new" at competing only with the product (because the price was almost the same) Albanian producers weren't able to manage the resources correctly neglecting comparative advantages for certain products.
4. Since there were no created institution to monitor the market, monitoring the demand and supply of different goods and services home producers were slow in their reaction towards the market.

## 5. CONCLUSIONS

The scope of Free Trade Agreements is the gradual reduction (until total removal) of tariffs and barrier regarding trade between the participating countries. The end result of this process is the creation of free trade areas. These agreements are very important to enhance the cooperation between countries in order to raise national welfare of these countries. They may have a positive or negative impact on economic indicators such as unemployment rate, inflation, trade balance.

Free trade agreements have impacts even in other economic indicators such as GDP, Foreign trade investments, purchasing power, etc. Nevertheless these were not focus of this paper due to analysis limitation. Protectionism and openness index are not focus of this paper too. Certainly they are a motivation for subsequent paper.

As Albania's primer goal is European Integration, economy is one of the key factors that can accelerate this process or delay it. Even though Albania has made steps forward by signing many free trade agreements with regional and European countries, the country continues to have a trade deficit which may be a consequence of many reasons. Some of them may be: low level of openness, accelerated price liberalization policy, low level of competitiveness of the Albanian products etc. Home products still feel threatened by the quality and the quantity of foreign products, asking many times for protectionist measures.

Despite these inconveniences Albania shows also positives signs regarding FTAs, such as higher trade volume as a consequence of increasing exports and imports. This means that the country has forced its cooperation with partner countries.

There are lot of ways to improve the economic performance

of trade between Albania and other countries. What we have to do is to start producing and trading according to our comparative advantage.

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