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Serbia, European Union, Russia

- an Analysis of Economic Relations -****

Abstract

The text analyses economic relations of Serbia with the European Union and Russia, economic relations between the European Union and Russia, as well as implications of Russia's accession to the World Trade Organization (WTO) on its trade exchange with Serbia. Analysis of Serbia's economic cooperation with the EU and Russia and analysis of mutual cooperation between the EU and Russia were used to reach arguments which answer the question of which strategic direction Serbia would need to follow in the future.

The conclusion is that Serbia's commitment to becoming a member of the European Union (EU) is necessary, not only because of the estimate that full integration into the EU is the best framework for dynamic development, modernization and protection of the country's national interests, but primarily due to the fact that the EU is Serbia's key trade and investment partner and thus one of the most important factors of the country's economic stability. What is also one of the most significant conclusions is that Serbia's commitment to becoming a member of the EU does not rule out further development of economic cooperation with the Russian Federation. On the contrary, it is a prerequisite for increase of the extent of cooperation. Additional recommendations for the Government of Serbia were defined based on the presented analysis and proposed strategic direction for Serbia's path towards EU membership, with the aim of improving Serbia's economic cooperation with the EU and the Russian Federation and thus improving long-term economic development of Serbia in the geopolitical context in which the country is at the moment: 1) Strategy and program of measures for the country's reindustrialization need to be developed immediately; 2) All necessary support measures to agriculture need to be taken in order to use potentials provided by SAA and Free Trade Agreement between Serbia and the Russian

Federation for export of agricultural products; 3) Specific measures for increase of the extent of Serbia's export to the Russian Federation's market need to be taken and those measures refer to lowering the risk of trading with the Russian Federation due to the fact that the agreement is not ratified by Russia and to construction of an efficient transport system using the Danube; 4) All necessary activities for diversification of Serbia's gas supply sources need to be conducted through Serbia's participation in construction of a gas ring in South-Eastern Europe.

Keywords:

trade, European Union, Russia

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Introduction

Even though the current foreign policy orientation of Serbia seemingly stands firmly on the “four pillars” which are the EU, USA, Russia and China, which is also the case in the foreign policy domain and in public opinion, there is an almost fatalistic dilemma in terms of which allies to choose because they, as a rule, exclude each other, i.e. they are alternatives to each other. Two centuries of history of diplomatic relations between Russia and Serbia have been full of ups and downs, good times and times that are not so good, but, in spite of that, Russia is often said to be a traditional and reliable Serbian friend, while relations between Serbia and Russia are defined as traditionally friendly ones. However, the dilemma related to becoming increasingly closer to Russia has been present in Serbia for more than two centuries.

After democratic changes in 2000 to the present, those relations have been slowly, but constantly improving, while they have been significantly intensified since the outbreak of world economic crisis. Thanks to a number of mutual visits at the highest level, today’s relations between Serbia and Russia are “crisscrossed” with bilateral agreements and the umbrella Agreement on Strategic Partnership from 2011, which opens up possibilities for comprehensive cooperation in the best interest of both countries. The political dimension of these relations has undoubtedly been defined by Russian support to Serbia in solving the problem of Kosovo and Metohija. Matters which are in the focus of the field of economics are financial support to Serbia by crediting and the infrastructure project of the South Stream gas pipeline. A bilateral agreement on military cooperation which almost does not exist is being prepared and there are announcements about cooperation in the field of defence industry and providing equipment for the Serbian Army. When presidents Putin and Nikolic were elected in 2012, the beginning of a new stage of relations between Serbia and Russia was announced, for which ambassador Konuzin said in his last interview in this capacity that they are at their “historical peak”. However, Serbia is on the verge of historical beginning of negotiations on accession to the European Union. Therefore it is not surprising that relations between Serbia and Russia are one of the current topics in Serbia’s public discourse, which only illustrates the fact that the Serbian society is still looking for its place in the modern Europe. Important elements of discussion about whether Serbia should enhance its cooperation with Russia or Western Europe embodied in the European Union are often based on metaphysical arguments (such as slavophilia, similar language, culture and orthodox tradition, historical closeness, etc.), while very few of them are based on the logic of rational mutual interest and benefit.

Slowing down of the process of Serbia’s accession to the EU due to failure to meet necessary requirements to get the starting date of negotiations, the issue of the status of Kosovo as the key condition for progress in the process of European integration on one hand and announcement of strategic Russian investments in the Serbian economy and

existence of a “unique” free trade agreement between Serbia and the Russian Federation on the other hand, again brought the issue of Serbia and Russia becoming closer into the focus of the Serbian public.

This paper is an attempt of its authors to contribute to a substantiated democratic debate about Serbia’s strategic decisions in the environment of the world economic crisis, through a realistic perception of the environment, but also through the perception of own political, cultural, demographic, geopolitical and primarily economic capacities. This policy paper is structured in a way which analyses Serbia’s trade exchange with the world, economic relations between Serbia and the European Union and Russia, but also their mutual cooperation. What is also analysed are implications of Russia’s accession to the World Trade Organization (WTO) on its trade exchange with Serbia. The last part of concluding remarks provides specific recommendations for improvement of Serbia’s economic relations with the EU and Russia, and thus for Serbia’s long-term economic development.

1. Serbia’s Trade Exchange with the World

Republic of Serbia has trade relations with a large number of countries from all parts of the world, but we should point out that most of Serbia’s trade is done with a small number of countries. Republic of Serbia also has a structural deficit in its foreign trade which is inherited from the time of SFRY. It was aggravated by the fact that complete economic transformation of the country did not happen and the fact that the country is insufficiently involved in global division of labour, because it was left out of the world’s main integrative processes (World Trade Organization, European Union).¹ There are numerous factors which cause such trend, such as the demographic structure (large number of dependents), high unemployment rate among active population (about 25.5%), poor educational structure of the population (only 6.5% of university-educated people), significant technological obsolescence of the Serbian economy (measured in average age of machinery and energy efficiency), all of which causes low competitiveness of the Serbian economy in foreign markets. Standard International Trade Classification (SITC) of Serbia’s export products shows the actual state of Serbian economy, especially poor state of its industry, low level of development and poor competitiveness in production of sophisticated and value-added goods. Products which are mostly manufactured in Serbia at the moment are raw materials and semi-manufactured goods which are then exported in order to be finally processed somewhere else, as well as agricultural and food products.

¹ Crnomarkovic, J., *Overview of External Trade of the Republic of Serbia in the Period of 1988 – 2009*, Statistical Office of the Republic of Serbia.

Table 1. Serbian export according to SITC classification

SITC Classification	Value of exports in 2011 in millions of USD	Percentage
Food and live animals	2091	20.0
Beverages and tobacco	274	0.2
Crude materials, inedible, except fuels	656	5.6
Mineral fuels, lubricants and related products	496	4.2
Animal and vegetable oils, fats and waxes	201	1.7
Chemicals and related products	1001	8.5
Manufactured goods classified by material	3481	29.6
Machinery and transport equipment	1959	16.6
Miscellaneous manufactured articles	1509	12.8
Products not classified elsewhere in the SITC	106	0.9
Total	11775	100

Source: Statistical Office of the Republic of Serbia, Statistical Yearbook of the Republic of Serbia 2012, pg. 62

This state becomes even more apparent when we look at data for 10 products which have the biggest share in export – 3 products belong to agricultural production, while 4 of them are semi-manufactured goods.

Table 2. Domestic products which have the largest share in trade exchange

Products by national classification	Value of exports in millions of USD	Percentage of total exports
Maize	432	3.7
TVP iron and coiled unalloyed	423	3.6
Pneumatic car tyres	236	2.0
Sets of conductors for airplanes, vehicles, boats	204	1.7
Electrical energy	180	1.5

VP iron and unalloyed tin-coated steel	177	1.5
Frozen raspberries	176	1.5
Sugar produced from sugar beet	160	1.4
Copper sheets, foils and strips	157	1.3
Retail medicaments	150	1.3
Total	2295	17.5

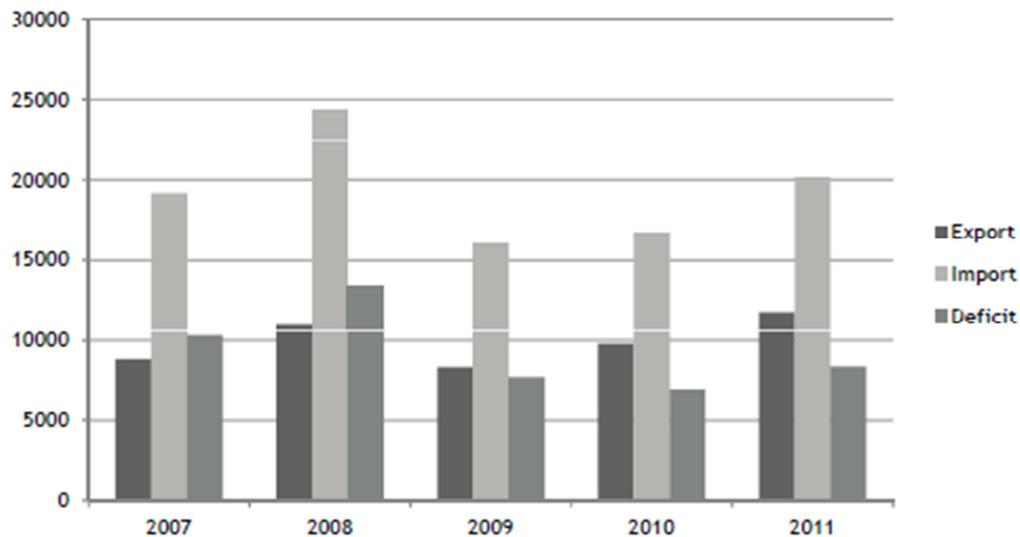
Source: Statistical Office of the Republic of Serbia, Statistical Yearbook of the Republic of Serbia 2012, pg. 64

When it comes to volume of foreign trade, we should say that there are evident growth trends both on the export and the import side, except that the world economic crisis has had an extremely negative influence – the crisis led to greater percentage of decline of import than export. Foreign exchange started increasing after 2009, but it still has not reached the extent it had before the crisis. Foreign trade deficit is present in exchange with the European Union, Russian Federation and China, while trade surplus is present in exchange with Bosnia and Herzegovina, Montenegro and Macedonia.

However, we should point out that most of Serbia's trade is done with a small number of countries. The biggest market for Serbia's export products is the common market of the European Union where half of Serbia's exported products is sold. Markets that follow the EU market in terms of Serbia's export are markets of CEFTA member countries and then members of the Customs Union of the Russian Federation.

Serbia's export to the EU in 2011 was eight times greater than its export to Russia. The disproportion in significance of these two markets is additionally illustrated by the fact that Serbia's export to the European Union is 57.6% of its total export to the world, while export to Russia is only 6.2%. In 2011 Serbia exported almost 6 billion USD worth of goods with 61% of imports covered by exports, compared to export to Russia which was 853 million USD and had coverage of only 29.1%.

Chart 1. Volume of foreign trade exchange of the Republic of Serbia²



If we take into consideration both data about the EU and data about those Western Balkans countries³ which will certainly become members of the EU in the near future, i.e. Western Balkans countries which are currently CEFTA members (all countries except Moldova), as well as other countries of the European Economic Area (EEA), Norway, Iceland, Liechtenstein, then Serbia's export is even more dominantly related to the common European market with exactly four fifths of its total value (80%). On the other hand, we should add other member countries of the Customs Union, Belarus and Kazakhstan, to the Russian Federation, but it still does not significantly change original data, from 6.7% to 7% of Serbia's total exports.

When we take a closer look at the value of goods exported to the EU market according to Standard International Trade Classification (SITC), we can conclude that the largest share of our exports are Manufactured goods classified by material (6) with 35.08%, Machinery and transport equipment (7) with 20.02% and Miscellaneous manufactured articles (8) with 14.37%, as well as Food and live animals (0) with 12.42%, while shares of other products are significantly lower and together account for only 18.11%.

² Source: Statistical Office of the Republic of Serbia (2012), Statistical Yearbook of the Republic of Serbia 2012, Belgrade, 2012, pg. 61

³ Long-term interest of countries of the Western Balkans is accession to the European Union. Some countries have progressed faster while some others have had slower progress on this path, so Macedonia, Serbia and Montenegro are candidate countries at the moment, while Albania and Bosnia and Herzegovina are waiting to be granted that status as they are potential candidate countries. Turkey is also a country that has membership candidate status and has had the status for a long time, but there is a big question mark over its accession due to opposition of some member countries. However, Turkey is a member of a customs union with EU member countries, which allows it to have a broad economic cooperation on the European continent through external membership in the European common market. On the other hand, Croatia completed accession negotiations with the EU and its full membership is expected to start on July 1, 2013.

Serbia's export to CEFTA member countries according to SITC shows different trends, because the largest share of exports are Food and live animals (0) with almost a quarter of the total value of exports – 23.32%, followed by Manufactured goods classified by material (6) with 19.39%, while Chemicals and related products (5), Machinery and transport equipment (7) and Miscellaneous manufactured articles (8) also have a share of over one tenth.

Export to the Customs Union of the Russian Federation, Belarus and Kazakhstan primarily consists of Manufactured goods classified by material with a third (33.38%) and Machinery and transport equipment with a quarter (25.25%) of total value, while products from the Food and live animals group are also present with 18.17%.⁴

When making a comparison according to product classification and groups of countries to which they are exported, we reach the conclusion that there is no big difference by destinations. Precisely, main export products to the European common market and the customs union of Russia, Belarus and Kazakhstan are those classified by material, machines and transport equipment (in almost identical percentages), followed by food and live animals (there is a slightly bigger percentage of export to Russia). The only difference is that Serbia exports a slightly bigger percentage of miscellaneous manufactured articles to the European market. On the other hand, Serbia's top-selling products in CEFTA member countries are agricultural products and products of the food industry, followed by other types of products, with the addition of chemical products. As far as import is concerned, Serbia mostly imports from EU member countries (over a half of total imports), but the country with the largest share of imports is still Russian Federation with about 13.2% of Serbia's total imports in 2011.⁵

When we take a look at the structure of Serbia's imports according to Standard International Trade Classification (SITC), we notice that the biggest part of it are Machinery and transport equipment (22.79%), followed by almost equal shares of Manufactured goods classified by material and Mineral fuels, lubricants and related products (19.35 and 19.96% respectively), there is a significant share of Chemicals and related products (14.98%), while all other categories individually are significantly less present and together account for less than a quarter of Serbia's total imports. When classified by countries of origin, import from the EU or CEFTA is much more diversified by product types than import from the Russian Federation which primarily consists of oil and natural gas.

Serbia's import from the Customs Union of Russia, Belarus and Kazakhstan primarily consists of mineral fuels (more than three quarters or 76.05% of total imports from this group of

⁴ Database of the Statistical Office of the Republic of Serbia, website: <http://webzrs.stat.gov.rs/WebSite/>

⁵ Statistical Office of the Republic of Serbia (2012), Statistical Yearbook of the Republic of Serbia 2012, Belgrade, pg. 61

countries). Other sectors except for products classified by material (with 11.41%) are getting closer to values of statistical error, compared with total value of Serbia's imports.

2. Economic Relations between Serbia and the EU

After democratic changes in 2000, Serbia has sought to develop as intensive relations with the European Union as possible. In order to provide support to democratic changes, the EU unilaterally gave Serbia duty-free access to the market and thus virtually allowed Serbia to enjoy the privileges and export to the EU without paying customs duties even before signing the SAA. The agreement which regulates Serbia's relations with the EU today is the Stabilisation and Association Agreement (SAA), which was signed at the same time with the Interim Trade Agreement in 2008. According to provisions of the SAA, Serbia is granted duty-free export to the EU market for all products (industrial and agricultural ones) from the moment of beginning of its implementation, December 8, 2009. Serbia, on the other hand, is supposed to abolish customs duties on goods imported from the EU in stages until January 1, 2014, except for the fact that customs duties that remain after that period are those for 23% of agricultural products. Serbia's concessions on industrial products are reflected in the fact that customs duties on import of products originating from the EEC, except for those listed in Annex I, will be abolished when the SAA enters into force. Duties that have the same effect as customs duties on import of industrial products originating from the EEC to Serbia are also abolished by coming of the SAA into force, as well as quantitative restrictions and measures that have the same effect. The field of agriculture has an important role in the SAA, Annex III⁶, due to the importance of export of these products for both contracting parties. Since we are dealing with trade of agricultural products, this group of products received special protection. Abolishment of customs duties for agricultural products, processed agricultural products, fish and fish products will also be done gradually, during a transitional period of six years, while retaining customs protection for certain products (about 20% of products) even after the transitional period. It has been agreed that sensitive products such as meat, milk and grain stay at a high level of protection during the five-year-long transitional period. What was also provided is that seasonal protection is retained for a number of sensitive products, fruit and vegetables such as tomatoes, paprika, plums and apples.⁷ Based on implementation of the Interim Trade Agreement between the EU and Serbia, as of February 1, 2010, Serbia began its fourth year of liberalization of trade exchange with the European Union. Average customs duties on import of goods to the EU are 1.8% (general average customs duty in Serbia is 6.2%). That amount is even lower in the field of industrial products – only 0.82%.⁸

⁶ http://www.siepa.gov.rs/files/pdf2010/sporazumi_EU_Aneks_3.pdf

⁷ <http://www.siepa.gov.rs/site/sr/home/2/sporazumi/eu/>

⁸ *ibid.*, pg. 15

What is still a big problem is the inability of our agriculture to make full use of preferential treatment, i.e. quotas for export to the EU. So the level of fulfillment of export quotas for baby beef to the EU keeps decreasing every year: in 2008 it was 20.4%, in 2009 it was 11.3%, in 2010 it was 9.4%, while in the first 10 months of 2011 it was only 7.2%⁹. Besides, fulfillment of quota for duty-free export of wine was about 50% in 2009 and 2010, while it was completely used for wine in bulk in the period of January - November 2011 (10,000 hl). Fulfillment of quota for bottled wines is only 17%. From the beginning of implementation of the agreement, the only quota that is used up to its maximum extent every year is the sugar export quota¹⁰.

Table 3. Trade between Serbia and the EU 2001-2012/9 months of the year (in millions of EUR)

Year	Exports	Imports	Coverage of imports by exports %
2001	1,104	2,740	40.3
2002	1,305	3,530	37
2003	1,316	3,842	34.2
2004	1,604	5,000	32.1
2005	2,116	4,577	46.2
2006	2,962	5,696	52
2007	3,603	7,687	46.9
2008	4,029	9,073	44.4
2009	3,196	6,533	48.9
2010	4,235	7,069	59.9
2011	4,866	8,035	60.6
2012/9 mo.	3,682	6,275	58.68

Source: Statistical Office of the Republic of Serbia

What the SAA also made possible for Serbia besides trade benefits is the guarantee of unrestricted transit of goods across the territory of EU member countries. This is very important for our trade with Russia, because transit was limited by a system of permits which used to be granted on bilateral reciprocal basis before the beginning of implementation of the Interim Trade Agreement. Transit permits for transport of goods across the territory of EU member countries were eliminated by signing of the SAA. This agreement enabled the initiation of negotiations with Turkey which has already established

⁹ *Informacija o odnosima Srbije i Evropske unije i njihova perspektiva u 2012. godini*, (January 2012), European Integration Office of the Government of the Republic of Serbia, available at: http://www.seio.gov.rs/upload/documents/nacionalna_dokumenta/info_odnosi_srbije_eu/odnosi_srbije_eu_prezentacija.pdf, pg. 7

¹⁰ *Ibid.*, pg. 8

a customs union with the EU for the purpose of establishing a free trade zone. At the Economic Summit in Istanbul, Serbia and Turkey signed the Free Trade Agreement on June 1, 2009. This agreement caused an increase in Serbian exports by 95% – from 109.5 million USD in 2010 to 213 million USD in 2011.¹¹

We should point out that total customs revenues in Serbia have decreased due to implementation of the SAA. According to estimates, budget loss caused by uncollected customs duties for import of goods from the EU is 466 million EUR. However, this loss of budget revenues should be regarded as a consumer surplus for the people in Serbia and that the amount of money was used for additional personal spending instead of being paid to the budget. Besides, that additional personal spending by citizens has led to additional collection of VAT on those products, so even from that aspect budget loss due to reduced customs revenue is not at the level which is presented to the public. Normally, customs revenues are not an economic instrument which is intended for revenue inflow into the national budget, but an economic instrument used to protect domestic production in the initial stages of development of a sector of the economy. Having the structure of Serbia's economy in mind, as well as competitiveness of certain sectors, that was taken into account during negotiations on the SAA.

Benefits for exporters from Serbia and the EU due to reduced customs duties and preferential exports are also increasing from year to year. In the period from 2009 to December 31, 2011, European exporters had total profit from export to the Serbian market in the amount of 466 million EUR. On the other hand, profits made by Serbian exporters are increasing from year to year and are on average three times bigger than those made by European exporters. Since the beginning of implementation of the agreement until December 31, 2011, total profits from preferential exports made by Serbian companies is 1,488 billion EUR.¹²

Table 4. Profits made by exporters thanks to implementation of the ITA 2009–2011 (in millions of EUR)

Year	Profits made by European exporters	Profits made by Serbian exporters
2009	78	40
2010	14	52
2011	24	56
Total	466	1.488

¹¹ <http://setimes.com/cocoon/setimes/xhtml/hr/features/setimes/features/2012/02/24/feature-02>

¹² See: European Integration Office of the Government of the Republic of Serbia, *Informacija o odnosima Srbije i Evropske unije i njihova perspektiva u 2012. godini*, available at: http://www.seio.gov.rs/upload/documents/nacionalna_dokumenta/info_odnosi_srbije_eu/info_odnosi_srbije_eu.pdf, January 2012

Source: European Integration Office of the Government of the Republic of Serbia, Informacija o odnosima Srbije i Evropske unije i njihova perspektiva u 2012. godini, Belgrade, 2012

When it comes to economic aspects of the SAA, apart from trade liberalization we should point out that, according to article 49 of the SAA, workers who are Serbian nationals and are legally employed in the territory of EU member countries cannot be discriminated based on nationality, as regards working conditions, remuneration or dismissal, compared to nationals of that member country. The SAA thereby provided legal protection to Serbian nationals who are employed abroad.

As far as investments from 2001 to this day are concerned, about 17 billion EUR of direct foreign investments was invested into Serbia, while 60% of that amount are investments from countries of the EU, which additionally proves that there is a high level of economic integration between Serbia and the EU. It is safe to conclude that we moved from the stage of trade relations to the stage of more intensive economic integration which is primarily exemplified by the aforementioned level of investments.

Finally, economic relations between Serbia and the EU are also characterized by donation of EU development grants to Serbia. It is important to remind that the European Union is the leading development partner in terms of providing grants to the Republic of Serbia in the amount of 2.2 billion EUR from 2001 to the present and an additional 5.8 billion EUR of concessional loans. Other bilateral donors are individual countries, first amongst which are Germany (1.1 billion EUR), USA (800 million USD), Norway (182 million EUR), Sweden (142.5 million EUR), Switzerland (116.3 million EUR). Serbia will, as a candidate country, be entitled to use EU grants in the new budget period of 2012–2014 as well, which is the amount of at least 200 million EUR per annum.

When it comes to losses suffered by Serbia due to the fact that it is not a member country of the EU, the example of use of EU Structural Funds is the best illustration for that. Precisely, the European Commission has, in accordance with the mid-term financial perspective of the EU for the period of 2007–2013, set the upper limit according to which each EU member country can get funding from structural funds in the total amount of not more than 3.6% of its GDP. Serbia is presently using EU grants whose total amount is 200 million EUR per year, which is 0.7% of its national GDP at the moment. Considering the maximum of funds which any EU member country can get from EU structural funds, we can calculate that Serbia could theoretically, as an EU member country with the current level of GDP, get at most 1.2 billion EUR per year. This simple calculation shows that Serbia suffers loss of 1 billion EUR of grants per year only on this ground, due to the fact that it is not an EU member country.

It is also important to highlight that implementation of the Free Trade Agreement between Serbia and Russia from 2000 will have to stop when Serbia joins the EU, as well as the CEFTA agreement, agreement with Turkey and EFTA countries and Serbia will join the trade regime which the EU has with these countries. On the other hand, we should point out that by joining the EU, Serbia will be implementing the Partnership and Cooperation Agreement between the EU and Russia which has been effective since 1997. Before Serbia's accession to the EU it can be expected that the EU and Russia will enter into a new agreement which currently being negotiated and which will further liberalize mutual trade. Russia is the third most significant import partner of the EU and participates in total EU imports with 10.6% according to data from 2010. When it comes to exports, Russia is the EU's fourth biggest partner and its share in total exports is 6.4%. The exchange between these two economies used to show a significant growth until mid-2008, when this trend was stopped due to the economic crisis and unilateral protectionist measures taken by Russia which had negative impact on bilateral trade. The new agreement which is currently being negotiated by the EU and Russia, Partnership for Modernisation, is designed to enhance cooperation between the EU and Russia. The agreement will be created in accordance with the rules of the WTO and will contain provisions on bilateral trade and investments. The EU exported 86.1 billion EUR worth of goods to Russia in 2010, while it imported 158.6 billion EUR worth of goods. The EU exported 22.6 billion EUR worth of services, while it imported 14.2 billion EUR worth of services. It is also estimated that 75% of direct foreign investments in Russia comes from the EU.¹³ Energy-generating product have the largest share in the structure of Russia's export with about 80%, which is why Russia has a significant surplus in exchange with the EU, primarily thanks to big export of energy-generating products. When it comes to imports, products that Russia mainly imports from the EU are machinery, transport equipment and chemicals (44.7%), production equipment and food. The above structure of trade exchange between the EU and Russia is very similar to the structure of exchange between Serbia and Russia. When Russia joined the World Trade Organization (WTO) in 2011, it provided access to its market to all WTO member countries under the principle of most favoured nation (MFN), so further trade liberalization between the EU and Russia can be expected, bearing in mind the importance of mutual trade between the two parties.

3. Economic Relations between Serbia and Russia

Foreign trade has undergone significant changes and transformations both in Serbia and Russia during the last couple of decades. However, Serbia's traditional dependence on Russian energy-generating products has remained to the present day. Export of what used to be world-famous products of the "Yugoslav industry" in which the export of Serbian companies was 50% of total export in SFRY, was reduced to a catastrophic level in only a couple of years, while the energy policy was balanced.¹⁴ The contract which currently

¹³ Source: <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/countries/russia/>

¹⁴ Bozovic, M., *Nova ekonomska diplomatija, Rusija*, pg. 135

regulates Serbia's trade relations with Russia is the Free Trade Agreement which was signed in 2000. The Free Trade Agreement with Russia provides that goods which can be proved to originate from Serbia (contain more than 50% of components made in Serbia), are not subject to customs duty when exported to the Russian market, unless the goods are exempt from the free trade regime. Objectives of the agreement which were specified are expansion and incentive to mutual trade and economic relations, improvement of living and working conditions and increase of employment level of the population. The agreement also provides that conditions for fair competition between business entities of the two countries need to be provided, as well as harmonization of customs procedures and ways in which regulations on origin of goods are implemented. The agreement provided for ratification by parliaments of both countries. The Parliament of the Federal Republic of Yugoslavia ratified the agreement in May 2001. Even though the Russian Government sent the Agreement to be ratified in the State Duma in August 2001, that has not happened to the present, while the agreement has been implemented freely all the time on a temporary basis. This is a very important issue, especially from the aspect of Russia's accession to WTO in August 2012, which will be discussed in more detail later on.

The Protocol between the Government of the Republic of Serbia and the Government of the Russian Federation on Exceptions from the Free Trade Regime and Rules on Determination of the Country of Origin of Goods to the Free Trade Agreement from 2000 was signed in July 2011. This protocol liberalized about 99% of trade with the Russian Federation and provided for payment of customs duties for a number of products in our exports, precisely: Meat and edible poultry offal, certain types of cheese products, sugar, sparkling wine, undenatured ethyl alcohol, cigarettes, cotton yarn, cotton fabric, some types of compressors, tractors, passenger cars and used motor vehicles. The basic principle of the Free Trade Agreement with Russia is that trade is free, with the exception of the list of goods which are still subject to customs duty. The list contains 39 products from Serbia which are subject to customs duty when imported in Russia and only 17 products which are subject to customs duty when imported from Russia to Serbia. Signing of the Protocol also introduces the option of using diagonal cumulation of origin of goods in trade between Serbia and Russia, where parties involved in cumulation of origin of goods are Serbia, Kazakhstan, Russia and Belarus. This protocol ended the process of harmonization of trade between the Republic of Serbia and the Customs Union of Russian Federation, Belarus and Kazakhstan.

It is worth noting that the importance of this agreement was constantly emphasized in the Serbian public, since the agreement was expected to increase competitiveness of Serbian economy and to enhance trade exchange with a big market such as the market of the Russian Federation. However, even though the agreement was often emphasized primarily by Serbian politicians as a unique instrument that will enable more rapid economic development in Serbia, effects of this agreement are unfortunately very humble, especially when it comes to Serbian export. The volume of trade between Serbia and Russia in the first

six months of 2012 was 1.45 billion USD and it was 14.7% lower than volume in the same period of the previous year, while Serbia's export grew by about five percent and was worth 375 million USD, while import dropped by about 20% compared to the same period in 2011. The value of exports was 1.07 billion USD, so the negative balance in Serbia's trade with Russia was 701.2 million USD.¹⁵ Russia is in the sixth place on the list of countries to which Serbia exports, while it is in the first place as the biggest importer to Serbia. There are 648 Serbian companies which export to the Russian market, while 565 companies import goods from Russia to Serbia¹⁶. What is particularly worrying in Serbia's trade exchange with the Russian Federation is low coverage of imports by exports which is currently around 35%.

Even though growth rates of export to Russia have been very high during the last 10 years (about 30% on average), the value of exports is still significantly lower than the value of exports to the European Union.

Table 5. Trade between Serbia and Russia 2002-2011 (in millions of EUR)¹⁷

Year	Exports	Imports	Coverage of imports by exports
2002	68.10	583.88	11.66%
2003	98.55	767.48	12.84%
2004	114.75	1,047.08	10.96%
2005	170.63	1,255.58	13.59%
2006	235.58	1,607.03	14.66%
2007	337.95	1,969.43	17.16%
2008	413.25	2,619.00	15.78%
2009	262.05	1,476.68	17.75%
2010	401.03	1,617.90	24.79%
2011	594.08	1,992.83	29.81%
2012 (January - July)	292.96	781.25	35%

There are numerous reasons for that, but one of the most important reasons is that key products of the Serbian economy which could find its way to customers easily are not on the lists of products which are free of customs duty when imported to Russia.¹⁸ Secondly, an important limitation is the level of production which can be achieved by companies in Serbia. A thing that is also important is that Serbian companies were in practice often faced with obstacles when trying to enter the Russian market (uncertain payment for goods, difficult access to retail chains), while many of those companies, truth be told, did not have an adequate approach to the very demanding Russian market.

¹⁵ Source: Tanjug, August 6, 2012

¹⁶ Source: Tanjug, August 6, 2012

¹⁷ Data of the Statistical Office of the Republic of Serbia

¹⁸ Meat, cheese, sugar, sparkling wine, cigarettes, tyres, cotton fabric, compressors used in refrigerating equipment, tractors and cars

However, one of the key limitations which has had a long-term impact on Serbia's export are high transport costs. Goods are currently exported from Serbia mostly using road transport (95%), which is the most expensive way of transporting goods. Railway transport is also not competitive due to the fact that railroad standards in the Russian Federation are different from European ones, which requires reloading of goods and additional costs, while the railway infrastructure is old, poorly maintained and requires large quantities of energy. Given the structure of goods which are exported from Serbia to the Russian market, transport costs play the crucial role in creation of terms of trade. i.e. price competitiveness of our products on the Russian market. In other words, more serious development of trade with the Russian Federation will not even be possible without establishment of an efficient transport system. The most efficient mode of transport of goods intended for export to the Russian market would be transport on the Danube. The reason for not using this mode of transport is that Serbian exporters usually do not have enough goods to fill capacities of barges used for transport of goods (5,000 tons). Development of an efficient transport system on the Danube includes several factors, most important of which is to legally regulate free use of waterways for a larger number of countries in the region, development of multimodal transport infrastructure, as well as development and standardization of fleet and other elements of water transport. In this context, the EU Strategy for the Danube Region Development in whose text and implementation Serbia plays an important role, is an instrument which can have decisive influence on development of water transport on the Danube and can thus contribute to growth of Serbia's trade exchange with the Russian Federation.¹⁹

When it comes to investments into Serbian economy, Russia is at the eighth place on the list of countries from which direct foreign investments originated with 465 million EUR in the period of 2005–2010, primarily thanks to acquisition of Naftna industrija Srbije (Petroleum Industry of Serbia), while other significant Russian investments were realized by acquisition of Beopetrol, Putnik, investment in Gosa and Copper Tubes Plant in Majdanpek.

Russia, as opposed to the EU, has not given any development grants to Serbia. Instead, Russia announced in 2008 that it would grant a loan for railway infrastructure in Serbia in the amount of 800 million USD. Funds from that loan are planned to be used for construction of a new single-track electrified railway from Valjevo to Loznica which is 68 kilometres long, construction and electrification of the second track on the Belgrade-Pancevo railway which is 16 kilometres long and reconstruction of the Serbian part of Belgrade-Bar railway which is about 200 kilometres long. It is planned that participation of Russian companies in reconstruction jobs on railway infrastructure in Serbia is 70 percent,

¹⁹ You can find out more details about these issues in the following papers: Kovacevic, A., (1998), *Kreiranje konkurentne prednosti planiranjem prostora u Podunavlju*, Institute of Architecture and Urban and Spatial Planning, Use of Resources, Sustainable Development and Spatial Planning, Belgrade; Kovacevic, A., (2000), *Pravno i komercijalno uredjenje plovnih puteva radi razvoja novih tehnologija plovidbe*, Annual Conference on Water Traffic, Faculty of Traffic and Transport Engineering, Belgrade.

while participation of Serbian companies is supposed to be 30 percent. The loan was finally granted in November 2012, its repayment period is 20 years, the interest rate is 4.1 percent annually and grace period is four years. All terms of this loan are very unfavourable, having in mind that this loan is more expensive than loans which are already being repaid by Serbia and it is also more expensive than loans from European development banks which are granted for similar infrastructure projects.

The protocol on Russian loan of 300 million USD for support to Serbia's budget was signed in the beginning of September 2012, while there was also a request for 700 million USD of budget support for the next year's budget. However, talks related to realization of this loan have not started yet, so it is still uncertain whether it will actually be granted.

The public in Serbia has highest expectations from construction of the South Stream gas pipeline which would transport gas from Russia to the EU market and whose one section needs to go through Serbia. It was announced that construction work on the Serbian section of the South Stream gas pipeline which is 411 kilometres long would start in December 2012, while the estimated value of those works is 1.9 billion EUR. According to the project design, the capacity of the gas pipeline through Serbia is supposed to be between 36 and 41 billion of cubic metres per year and it is estimated that in 25 years Serbia will earn about 4 billion EUR from transport, which is 160 million EUR per year.

However, it is important to remind that Serbia made big trade-offs in the process of negotiations on accession to the South Stream project by selling the public company NIS at a preferential price to the Russian partner, Gazprom Neft state-owned company in 2008, and that it had to settle for 49% of participation in the prospective gas trading company. On the other hand, Bulgaria, an EU member country since 2007, had a much better outcome of these negotiations with 51% of ownership in the future company and without having to make any other economic trade-offs. Russian gas is imported to Serbia via an intermediary called Jugorosgas in which Serbia has minority interest of 25 percent via its company Srbijagas. At the beginning of this year, price of natural gas for the Serbian market was 478 million USD for 1,000 cubic metres. The price of Russian gas for countries of the EU was 384 USD until this year and it will be 415 USD this year.

In order to provide alternative stable sources of gas supply²⁰ in the future, it is extremely important that Serbia continues to provide support to realization of the Southeastern Europe gas ring project. The gas ring is a preliminary project for gasification of Southeastern Europe, which is proposed by the Energy Community with the idea of performing gasification of former SFRY republics and Albania using the existing gas systems and by building new ones. This ring would be supplied from multiple sources, which would

²⁰ Apart from the Southern Stream, construction of several other regional gas projects is planned in Serbia's immediate environment and the purpose of those projects is to transport gas from Azerbaijan to the EU market. Those projects are NABUKO and TAP-IAP (*Trans Adriatic Pipeline – Ionian Adriatic Pipeline*).

significantly increase the security of supply with energy. What is encouraging in this initiative is the fact that Feasibility Study of Gas Interconnections between Nis and Dimitrovgrad which connect Serbia and Bulgaria has already been completed and that an agreement on construction of gas interconnection between Serbia and Bulgaria has been signed.

4. Implications of Russia's Accession to the World Trade Organization (WTO)

After 18 years of negotiations, the Working Party on Russia's accession to the WTO approved the package on Russia's accession to WTO on November 10, 2011, which now means that WTO will cover 97% of world's trade. The lower house of the Russian Parliament ratified the protocol on July 10, the upper house did the same on July 18, while the Russian president signed the law which ratified the protocol three days later, which created all conditions for Russia to officially become the 156th member of the World Trade Organization (WTO) on August 22, 2012. Russia is the world's largest economy which was not a member of the global trade organizations after China's accession in 2001. By becoming a member of the WTO, Russia committed to harmonize its own legislation in the field of trade with the rules of the WTO, as well as to open its market for products from other countries. Russia's commitments according to the Protocol of Accession to the WTO include²¹:

- non-discriminatory treatment of imports of goods and services;
- reduction of customs duties and mandatory tariff levels;
- ensuring that there is transparency when implementing trade measures;
- limiting subsidies to agriculture;
- enforcement of intellectual property rights (IPR) of foreign holders of such rights
- prohibition of setting conditions of having local content or any other investment measures which limit import of products and
- giving foreign companies the option to participate as tenderers in public procurement.

By its accession to the WTO, Russia also committed to accept WTO dispute resolution procedures. On the other hand, Russia will participate in formulation and implementation of international trade rules which regulate, as it has already been stated, 97% of global trade. Besides, it is expected that membership in the WTO will contribute to Russia becoming an even more attractive location for foreign investors, which could increase Russia's economic growth. By becoming a member of the WTO, trade relations between Russia and its

²¹ 21 Source: http://www.wto.org/english/news_e/news11_e/acc_rus_10nov11_e.htm

international partners will be more predictable and stable, which will also have a positive effect on economic growth of the Russian economy.

As far as lowering of average customs duties on import of goods is concerned, Russia's accession to the WTO will cause lowering of import duties in Russia from current 10% to average 7.8%. Average customs duties for agricultural products will be 10.8%, which is lower than the current average of 13.2%. Maximum average customs duties for products made in the manufacturing industry will be 7.3% instead of the current 9.5%. By ratifying the Protocol, Russia agreed to reduce customs duties on a wide range of products. Average duties after full implementation of tariff reductions will be²²:

- 14.9% for dairy products (current tariff is 19.8%)
- 10.0% for cereals (current tariff is 15.1%)
- 7.1% for oilseeds, fats and oils (current tariff is 9.0%)
- 5.2% for chemicals (current tariff is 6.5%)
- 12.0% for cars (current tariff is 15.5%)
- 6.2% for electrical machinery (current tariff is 8.4%)
- 8.0% for wood and paper (current tariff is 13.4%)

One third of agreed tariff reductions will be in place from the date of Russia's accession to WTO for more than a third of national tariff lines, while tariff reduction for a quarter of products will come into force after 3 years. The longest period of using reduced tariffs is 8 years for pork and 7 years for motor vehicles, helicopters and civil aircrafts.

It is important to highlight that, by becoming a member of the WTO, Russia commits to respect provisions of the Agreement with the WTO when implementing preferential trade agreements without making any differences between those agreements which are already in effect and those which will come into force in the future.

As far as the influence of Russia's accession to the WTO on Serbia is concerned, it is important to highlight a couple of things. Firstly, we should say that the aforementioned reduction of average customs duties for import of products in Russia will expose Serbian products to bigger price competition than it was the case so far. That is why it can be expected that modest results in trade exchange with Russia enter into a period of stagnation or decline. We can illustrate that using the example of Serbia's main export asset, fresh apple, for which customs duty on import from WTO member countries was reduced from 0.1 EUR per kilogram to 0.06 EUR immediately after Russia's accession to the WTO and it is to be additionally lowered to 0.03 EUR by 2017. This fact will certainly be used by world's largest apple producers - China, France and Chile and their price competitiveness will have

²² Source: http://www.wto.org/english/news_e/news11_e/acc_rus_10nov11_e.htm

significant impact on the volume of export of Serbian apples to the market of the Russian Federation.

A fact that is also worrying is that Russia did not report the existence of a trade agreement with Serbia during negotiations with the WTO (nor did Serbia report that this agreement exists to the WTO), which may cause negative consequences on Serbia's export to the Russian market. In such situation, Russia can unilaterally stop implementing a part of the agreement or the entire free trade agreement with Serbia in case that one of WTO member countries initiates proceedings before bodies of the WTO because of unfair treatment of their products resulting from implementation of the agreement with Serbia, whose existence was not reported to members of the WTO. Cancellation of implementation of a part of the agreement or the entire agreement with Serbia would not be a problem for Russia, having in mind that it has not even been ratified in the Russian Duma, so it is not even legally binding for Russia. This state of affairs results in big additional risks primarily for Serbian companies which might be intending to sell a part of their production on the Russian market.

5. Concluding Remarks and Recommendations

Serbia is a small, economically, politically and militarily weak country in which transition has been going on for too long. Serbia's foreign policy orientation on EU membership is a result of the estimate that full integration into the EU is the best framework for dynamic development, modernization and protection of national interests of the country. As much as the political dimension and the price of this integration today is a matter of dispute in the Serbian political and general public, economic arguments must be considered as primary ones. Results of public opinion polls best illustrate the extent to which those arguments are neglected.

In spite of the crisis, the EU is Serbia's key trade and investment partner. The SAA allowed Serbian exporters free access to the EU market which has half a billion people. The volume of trade and profits made by the Serbian economy from liberalization of the EU market due to implementation of the SAA could have been even bigger if quotas for export of agricultural products (baby beef, fish wine) had been used to the maximum.

Further increase of the volume of trade between Serbia and the EU imposes the question of strengthening of competitiveness of the Serbian economy in order for it to be able to cope with competitive pressure on the EU market. If Serbia gives up on the EU integration process, i.e. on the aforementioned instruments of strengthening the competitiveness, the process of modernizing its national economy and strengthening of competitiveness would be far more difficult and uncertain.

One of the practical consequences of Serbia's accession to the EU is termination of the Free Trade Agreement with the Russian Federation. However, that fact will not cause economic loss for the Serbian economy due to several reasons. Firstly, if Serbia eventually joins the EU, it will do business with Russia under the terms defined in the Partnership and Cooperation Agreement between the EU and Russia which has been effective since 1997. Before Serbia's accession to the EU, there will be a new strategic agreement between the EU and Russia which will additionally liberalize bilateral trade and Serbia will automatically become one of its signatories. Secondly, the previous analysis has shown that the Free Trade Agreement between Serbia and Russia unfortunately did not yield expected results for the Serbian economy and the fact that Russia became a member of the WTO this year will additionally reduce its importance. Until Serbia joins the EU, Russia will, due to its commitments resulting from WTO membership, significantly reduce tax duties for all WTO member countries, so the Free Trade Agreement, even if it is not unilaterally terminated, will not secure a special competitive position for the Serbian economy. On the other hand, Serbia's export from Russia largely consists of strategic resources – oil and natural gas – and that fact is widely used as the key proof that higher economic integration with Russia is necessary. When it comes to import of energy-generating products which are the most significant part of Serbia's import, and their transport from Russia to Serbia, the regime of oil and gas import would not be changed by Serbia's accession to the EU (EU tariff on import of oil and gas from Russia is 0%). On the other hand, very little attention is paid to the fact that those resources are not donated, but publicly traded at market prices on the world market. So, whether the level of economic integration with Russia was lower or higher, those goods would still be purchased at the same price or at a similar one. Besides participation in construction of the South Stream gas pipeline, what is very important for Serbia in order to secure alternative stable sources of gas supply in the future is to continue its activities in the process of realization of the gas ring project in Southeastern Europe.

Finally, we should point out that it is very important and beneficial for Serbia to keep improving its economic relations with Russia, but it is necessary that the Government has a more rational perception of the country's economic interests and objective obstacles for more intensive development of economic relations and to avoid politicization of purely economic categories which regulate economic relations between the two countries in that process.

The following recommendations for the Government of Serbia were defined based on the presented analysis, with the aim of improving Serbia's economic cooperation with the EU and the Russian Federation and thus improving long-term economic development of Serbia in the geopolitical context in which the country is at the moment.

- 1. Continue the process of European integration and do everything to create conditions for the start of negotiations on Serbia's membership in the EU.** The

process of European integration, besides increase of the volume of trade between the EU and Serbia, will have an impact on strengthening of competitiveness of the Serbian economy and increase of Serbia's export on the market of the EU and even on the market of the Russian Federation. Experiences of Central and Eastern European countries which joined the EU during the previous decade have shown that effective use of development grants from the EU and harmonization of national legislation with the EU legislation is the most efficient model of reforming the society and strengthening of competitiveness of the domestic economy. It is very important to point out that the only way for Serbia to increase its export to the Russian market, in the circumstances of liberalization of the Russian market for the rest of the world as a consequence of its commitments resulting from membership in the WTO, is to improve competitiveness of the Serbian economy.

2. **Strategy and program of measures for the country's reindustrialization need to be developed immediately.** The structure of Serbia's export shows the actual state of the Serbian economy, especially poor state of its industry, low level of development and poor competitiveness in production of sophisticated and value-added goods. The only way to change such state is to start the process of reindustrialization of the country immediately. New industrial policy in Serbia needs to be based on implementation of structural reforms and investments into all types of infrastructure. It is also necessary to significantly increase budget resources for research and development as well as for education. Also in this case, the process of European integration is an irreplaceable framework for efficient implementation of the country's policy of reindustrialization.
3. **All necessary support measures to agriculture need to be taken in order to use potentials provided by SAA and the Free Trade Agreement with the Russian Federation for export of agricultural products.** What is still a big problem is the inability of our agriculture to make full use of preferential treatment for export to the EU. Data on the level of fulfillment of export quotas for baby beef to the EU shows that this results in reduction of allocated quotas from year to year. Besides, data on usage of quotas for duty-free export of wines and fish also shows that these quotas have not been used to the maximum. Certain ranges of agricultural products also have the option of being sold on the Russian market, but the quantities of their production at the moment are not sufficient to make those products competitive on the Russian market. Having Serbia's potential in agricultural production in mind, such losses would have to be stopped in the future.
4. **Take specific measures for increase of the volume of Serbian export to the market of the Russian Federation.** The first activity which is necessary is to reduce the risk of unilateral termination of the Free Trade Agreement with the Russian Federation for

Serbian companies which export or plan to start an investment activity in order to make a successful appearance on the Russian market. Even though the Russian Government sent the Agreement to be ratified in the State Duma in August 2001, that has not happened to the present. Having in mind that constant dialogue between Serbia and Russia in terms of economic cooperation has been established, it is necessary to ask the Russian party to finally ratify the Free Trade Agreement with Serbia. This issue is especially important due to the worrying fact that Russia did not report the existence of a trade agreement with Serbia during negotiations with the WTO (nor did Serbia report that this agreement exists to the WTO). In such situation, Russia can unilaterally stop implementing a part of the agreement or the entire free trade agreement with Serbia in case that one of WTO member countries initiates proceedings before bodies of the WTO because of unfair treatment of their products resulting from implementation of the agreement with Serbia, whose existence was not reported to members of the WTO.

Another activity that can significantly enhance export to the Russian market is development of an efficient transport system on the Danube as the most efficient one for goods from Serbia, which involves several factors, most important of which is to legally regulate free use of waterways for a larger number of countries in the region, development of multimodal transport infrastructure as well as development and standardization of fleet and other elements of water transport. In this context, the EU Strategy for the Danube Region Development in whose text and implementation Serbia plays an important role, is an instrument which can have decisive influence on development of water transport on the Danube and can thus contribute to growth of Serbia's trade exchange both with the EU and the Russian Federation.

5. **Take all necessary actions to diversify sources of Serbia's gas supply by participating in construction of the gas ring in Southeast Europe.** Apart from construction of the South Stream gas pipeline as an extremely important infrastructure project for our country, Serbia also needs to think strategically about alternative stable sources of gas supply in the future. Therefore it is extremely important that Serbia continue activities needed for implementation of the gas ring project in Southeast Europe as well as activities of connecting to neighbouring countries. A section of the gas ring whose construction has already been defined by a signed contract is the interconnection between gas installations of Serbia and Bulgaria, which needs to go from Nis over Dimitrovgrad to Sofia. Gas interconnections with neighbours are supposed to ensure stable alternative gas supply to Serbia from other gas sources, which will increase energy security of the country in the future.

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