Chapter 4
Free Trade and Gravity Model:
Albania as Part of Central European Free Trade Agreement (CEFTA)

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ABSTRACT

The purpose of this chapter is to build and explain the Gravity Model for the trade flows of Albania and 15 of its trade partners for the period of 2001-2016, both theoretically and empirically. The theoretical development of the subject gives an overview of the economic thought over the years regarding the concept of free trade, its benefits and threats, the Central European Free Trade Agreement (CEFTA), and the Gravity Model in order to be able to explain and interpret the patterns of trade between countries. The econometrical analysis illustrates the impact of gross domestic product (GDP) of partner countries, the distance between them, and CEFTA has on the trade flows of Albania. The Gravity Model built in this study supports the theoretical approach and it shows how GDP has positively affected trade flows, while distance has negatively affected trade flows. The impact of CEFTA is insignificant.

INTRODUCTION

In contemporary globalization, the interaction of people and countries exchanging ideas, values, money, and resources has rapidly grown over the last few decades. The concept of going global shows that our world and society have become borderless, meaning that countries must face various changes such as free trade agreements, trade liberalization theories, and comparative advantage policies. Trade barriers continue to be broken down and economies are opening up to the free flow of labour, capital, goods, and services between countries. Thus, countries have signed different free trade agreements among each other such as European Free Trade Association (EFTA), the ASEAN Free Trade Area (AFTA), the North

American Free Trade Agreement (NAFTA), the Central European Free Trade Agreement (CEFTA) the South Asian Free Trade Area (SAFTA), the East African Community (EAC), the Pacific Alliance Free Trade Area (PAFTA), and the Trans-Pacific Partnership (TPP) among others.

Albania embraced the free market economy in 1990 and passed from a centralized economy in which all assets were publicly owned into an open market, which led to liberalization in foreign direct investment (FDI) and trade. Albania has become part of many trade agreements during the years, being they bilateral or multilateral and today it applies a liberal trade regime under the supervision of the European Union (EU) and the World Trade Organization (WTO). The most known trade agreements that Albania has signed are the free trade agreement with Turkey, the Stabilization and Association Agreement (SAA) with the EU, the FTA signed between the Republic of Albania and EFTA countries and CEFTA, and each one of them has had its impact on the patters of trade of the country.

One of the objectives of the chapter is to define the concept of free trade and the benefits and threats associated with it based on economic thought. Another objective is to analyze the trade relations of Albania with its Intra-CEFTA trade partners and other main trade partners, focusing on the last few years. The extant literature review on the Gravity Model used for the estimation of trade flows has been analyzed to be able to identify the explanatory and explained variables needed to build such a model. In addition, based on the literature review, the aim of the chapter is to estimate the Gravity Model for Albania's trade flows by deriving quantitative conclusions on the effect of the selected explanatory variables and in particular, the impact of the trade agreement of CEFTA on the trade flows of Albania.

In the latest decades, the Gravity Model has been widely used by many authors in order to rate the potential of trade between countries. Even Albanian researchers have used the Gravity Model to measure the trade flow of Albania, but these researchers are limited in number (Agolli & Xhepa, 2003; Kastrati, 2015; Kraja & Sejdini 2014; Mitaj & Osmani, 2017; Pllaha, 2011). The first part of the chapter explains the concept of free trade and makes an analysis of benefits and threats as two contradictory approaches based on the economic thought over the years. In addition, it provides background information on CEFTA agreement and the manner in which Albania finds itself under such an agreement as well as its main trade partners. The second part includes the Literature Review and provides an overview of the Gravity Model and the variables used in similar work. The literature review serves as a starting point for presenting basic theory concepts and research methodologies and it leads the path toward the third part of the study, that of data and the Gravity Model.

The Gravity Model applied to the case of Albania considers 15 partner countries such as Bosnia and Herzegovina, Macedonia, Montenegro, Serbia, Kosovo, Croatia, Bulgaria, Germany, Greece, Italy, Poland, Romania, Spain, Austria and Holland. The last part of the study provides the conclusions derived by combining both the theoretical development of the subject and the empirical results.

BACKGROUND

Free trade is an economic policy which allows buyers and sellers of different nations and countries to freely trade without government interventions in forms of quotas, tariffs, or restrictions on their goods and services (Collins, 2018). Some studies refer to free trade agreements as an easy way to enter and a country can adopt such policies unilaterally or on a bilateral basis by joining a free-trade area (Black, 2009). Some other studies refer to free trade as a way of relaxing from previous government interventions and restrictions on the economic policies of countries involved (Melnikas, 2008). However, the main

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