

**The Black Sea Economic Cooperation Project:  
A Substitute for or A Complement to Globalization Efforts  
in the Middle East and the Balkans?**

Serdar Sayan\*  
Department of Economics  
Bilkent University  
06533 Ankara, Turkey

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**ABSTRACT**

This paper evaluates Black Sea Economic Cooperation (BSEC) from the perspective of globalization efforts in the Middle East and the Balkans, the regions that future expansion scenarios are most likely to cover. For this purpose, the paper investigates the economic rationale behind the desire to seek/maintain membership, with special reference to the trade creation and diversion effects it could generate. A major challenge here is the size and the quality of data. In addition to the relatively short history of BSEC, the exchange rate and GDP/GNP data are unreliable due to the transition state status of most of the current members (Albania, Armenia, Azerbaijan, Bulgaria, Greece, Moldova, Romania, Russia, Turkey and Ukraine). To overcome this problem, a version of the so-called gravity model is employed to estimate trade patterns. In addition to trade among current members, the paper considers the implications of membership by Iran, Egypt, Iraq, Jordan, Lebanon, Syria and by the newly independent republics of former Yugoslavia.

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\* **Phone:** +90(312)290-2071  
**Fax** : +90(312)266-5140

**E-mail:** sayan@bilkent.edu.tr  
**URL:** <http://www.bilkent.edu.tr/~sayan>

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# **The Black Sea Economic Cooperation Project: A Substitute for or A Complement to Globalization Efforts in the Middle East and the Balkans?**

Serdar Sayan  
Bilkent University  
06533 Ankara, Turkey

## **1. Introduction**

Economists have been preaching free trade for centuries: From the perspective of welfare maximization on a global scale, the complete absence of barriers to/restrictions on flows of goods, services and factors of production is the best of all possible worlds as has been shown numerous times both theoretically and empirically. Yet, the nations of the world have kept acting against this basic result and formed regional blocs to coordinate protectionist practices against third parties, and preferential treatments to other members. For most of post-World War II history, free trade has been a public good everybody wants to benefit without paying for: The best world for an individual nation would be the one where it could sell its products freely without facing any barriers, while it would have the liberty to impose restrictions on its imports. This would be the best but obviously not possible. So, the next best solution for individual nations would be to sign economic integration agreements with a group of other nations, and that is what they actually did. This led to an increased segmentation of the world economy among regional blocs raising fears that the world would have to pay a welfare cost due to trade wars between blocs.

The Uruguay Round helped tone down the fears creating a more optimistic atmosphere to evaluate the prospects for the global trading system. Since the Uruguay Round did not make the regional blocs disappear, however, the question remains as to whether such regional initiatives prevent or delay progress towards globalization. While the regionalism vs. globalism debate created around the issue has not ended, a growing number of recent works challenge the conventional wisdom that the advance of regionalism will hurt globalization. By even more optimistic viewpoints, increased regional integration must, on the contrary, be expected to enhance efforts towards globalization. In his prize winning essay where he seeks an answer to whether emerging regional arrangements are building or stumbling “blocks”, Robert Z. Lawrence (1991) presents convincing arguments to qualify his optimistic perspective on the overall direction of the trend towards globalization.<sup>1</sup> Given the fast growth in the volume of trade and capital flows in the world over the past decades, and the rate at which new technologies become available across nations, the evidence supports the views that regionalism did not (could not) stop or turn down the rising trend of globalization.<sup>2</sup> Yet, a definitive answer to whether the process of globalization would have gained or lost momentum without

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<sup>1</sup> See also OECD (1996).

<sup>2</sup> The ever increasing popularity of the term globalization used to describe the whole, interactive process that led to the growth in the volume of trade and capital flows and the spread of technology in the world (Safadi, 1997) is perhaps another indicator that the globalization is on the rise.

regionalism is still difficult to find. Then, it is perhaps better to focus on particular regional arrangements and to seek case-specific answers to such questions as whether the regional initiative in question will facilitate or hurt globalization efforts in its region. The answer in this case would depend ultimately on the nature of the arrangement and its performance, and the compatibility of regional arrangement with globalization efforts would need to be judged through an evaluation of its performance relative to its ability to create more trade than it diverts, to stimulate growth, to facilitate flows of capital into where it is needed the most, and to strengthen market forces. Admittedly, these criteria are not mutually independent but it is possible, at least in principle, that such a performance evaluation can be carried out within a well-defined framework of investigation.

The present study considers the experience of Black Sea Economic Cooperation (BSEC) project as a rather special case in point, and discusses its compatibility with the globalization efforts in member countries.<sup>3</sup> The purpose of the paper is to evaluate the performance of BSEC, and to determine whether BSEC has created, or likely to create, a bias in either direction and to decide if BSEC has been a substitute for or a complement to globalization efforts in the Middle East and the Balkans. For this purpose, the effects that BSEC has had on trade flows within its region and the surrounding parts of the world (including parts of Eastern Europe and the Middle East) are taken as an indicator of the direction and the size of any such bias BSEC might have created. The contribution of BSEC to globalization efforts in the area is then evaluated in the light of the results from the investigation of these effects.

The plan of the paper is as follows. The next section presents a brief overview of regionalism vs. globalism debate. Section 3 discusses the BSEC experience and describes its structure following a brief history. Section 4 develops the conceptual framework to evaluate BSEC and its position relative to globalization. Section 5 outlines the techniques used to estimate the effects of BSEC on regional trade flows, and presents empirical results. Finally, Section 6 discusses the findings and concludes the paper with concluding remarks.

## **2. A Brief Overview of Regionalism vs. Globalism Debate**

The formation first of EC and then NAFTA, and regional integration initiatives in Asia raised concerns that the global economy would be divided into three trading blocs with the possibility of costly trade wars among them. Even in the absence of openly declared trade wars, the potential effects of such a move towards regionalization were reason to some to worry about the future course of globalization. The coordination of protectionist practices within each block vis-a-vis the others was likely to cause welfare losses for the entire world, with possibly disastrous effects on the countries that were left out of each. In addition to such welfare losses that would potentially result from interrupted flows of trade, the emergence of separate currency areas around each bloc would have prevented the international financial system from operating smoothly, causing, in turn, a distorted

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<sup>3</sup> Albania, Armenia, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russian Federation, Turkey and Ukraine.

allocation of capital and a waste of global resources. Although many of the attempts towards regional integration by countries facing the risk of being left out of major blocks later turned out to be failures, their search, under this fear, for alternatives had the potential to promote further segmentation of the global economy.

Fortunately, the fears have not so far been fulfilled, and the growth of regionalism did not stop the general progress towards globalization. While conventional wisdom still points at least to a slow down in the pace of globalization as compared to the case under the historically counterfactual scenario of no regionalism, there are also well-formulated arguments to the contrary.

By these arguments, regional arrangements stimulated growth and by increasing the demand for imports, created extra trade not only among the members, but also between members and non-members. In some cases such as Mexico's, the membership in regional initiatives helped members increase their credibility in world financial markets enabling them to attract more foreign investment than they could otherwise have. An increased capacity to attract foreign investment would increase growth rates in these countries and would allow them to run trade deficits vis-a-vis the rest of the world including non-members.

Moreover, by the views that defend the compatibility of regionalism with globalization, regional agreements do not necessarily imply increased protection against the rest of the world. To the contrary, open regional blocs such as the EU could promote liberalization by forcing relatively more protectionist members as well as non-members and prospective members to liberalize their trade. In fact, the argument goes, France and Italy, for example, would have resisted to trade concessions in the 1960s had they not been members of the EC back then. The special arrangements that the EU has with the Mediterranean and Magreb countries also helped these non-members move towards a more liberal trade regime (Lawrence, 1991). Likewise, partly due to its aspiration to become a member of the EU, Turkey has not only liberalized its own trade regime and foreign investment regulations considerably, but also acted as a role model to some of the transition states in its region and helped them follow suit through its special relations with them within BSEC and other forums.

The extra-bloc trade is vitally important to US, Japan and the larger members of the EU as reflected by their role as major traders on the global, rather than the regional, scale with or without their regional attachments. This leads their smaller regional partners to develop contacts through new initiatives outside the bloc so as to countervail their dependence on these economies. Mexico, for example, became a member of the OECD, and negotiated its own free trade agreements with such non-NAFTA members as Venezuela and Chile (Lawrence, 1991). Similarly, even though it signed a Customs Union Agreement with the EU, Turkey is continuously trying to diversify its trade links outside the EU area: In addition to the leadership role it assumed in the formation of BSEC, it obtained membership in such regional organizations as ECO, and signed bilateral free trade agreements with such countries as Hungary.

It is further argued that the motivation behind the nations' desire to participate in regional initiatives is drastically different today than the protectionist motives that dominated the interwar period. That motivation today is not to provide easy access to member country exporters through a preferential treatment, but rather to facilitate the movement of goods, services and factors of production within the bloc so as to increase efficiency and promote competition. Regional arrangements towards a deeper integration within this context are likely to facilitate not only trade among members but also that with outsiders. Stopping the member country governments from providing export subsidies, for example, would help the competitors located outside as well as inside the bloc. Similarly, a common set of product standards would make selling to the bloc easier for member and non-member producers alike and would serve to global integration (Lawrence, 1991; Safadi, 1997).

To summarize, as long as regional initiatives aim to encourage cooperation and improved market access rather than protection and preferential treatment, they might help member countries improve their ability to link up with the global economy. For this reason, even such pro-free trade, non-regional organizations as OECD recently began to provide support to regional integration efforts under special circumstances –as in the case of integration between transition states in Europe and their more developed neighbors. It is argued in OECD (1996), for example, that since trade flows and foreign direct investment in neighboring countries act as powerful engines for economic growth and development of integrating economies, regional integration could serve to globalization by helping these countries integrate into the global economy. Even though it did not emerge as a regional integration per se, this was one of the goals that was explicitly set for BSEC at the time of its formation. BSEC Summit Declaration, the document that formally established BSEC, reflected an early awareness, in fact, of the potential role that regional cooperation could play in this area, and assigned a high priority to assistance to transition members struggling to get connected to the world economy.

### **3. The Establishment of BSEC and Its Purposes**

The end of the 1980s and the beginning of the 1990s was a period of major changes that dramatically upset strategic balances, built up tensions in international relations and substantially increased the need for peace and stability. The disintegration of the Soviet Bloc was followed first by the outbreak of Gulf War and then, by the formal dissolution of the Soviet Union. While these developments forced almost all nations to reconsider political and economic priorities in their relations with other nations, they posed an even more special challenge before the countries in Europe and the Middle East: The part of the world around these nations was rapidly changing, and there was a clear need for adjustment. In this chaotic environment, one country in the region, Turkey, chose to meet this challenge by contributing to the restoration of regional peace and stability through the development of stronger economic ties and vested interests among countries around the Black Sea. A regional arrangement for economic cooperation would not only serve effectively to increased stability but would also put an end to animosities, and lead to welfare gains for all parties involved. With Turkey taking the

initiative and actively pursuing a leadership role, the representatives of Armenia, Azerbaijan, Bulgaria, Georgia, Moldova, Romania and Russia were brought together in December 1990 in Ankara, Turkey.<sup>4</sup> At the end of the Ankara meeting, the representatives declared officially that they agreed to form a Black Sea Economic Cooperation (BSEC) zone together with Turkey. After three other rounds of talks and with Ukraine also joining in later, the Foreign Ministers got together in February 1992 in Istanbul and agreed to sign the declaration of the agreement establishing BSEC. Following the approval of the application for membership of Greece and Albania, the agreement (Black Sea Economic Cooperation Summit Declaration) was signed on June 25, 1992 in Istanbul by the Presidents or Prime Ministers of 11 states (Sayan and Zaim, 1998).

The Summit Declaration made it clear through various articles addressing peace and security concerns of the participants that economic cooperation within BSEC is viewed as a means to add, first and foremost, to the restoration of peace and security in the region. The intention of participating states was to develop economic cooperation in accordance with the principles of the CSCE (Conference on Security and Cooperation in Europe) process. Within this framework, BSEC was also meant to contribute to the establishment of a Europe-wide economic area, as stated in Article 5 of the Summit Declaration. The cooperation within BSEC itself would be based on "(...) the potential of the Participating States and the opportunities for enhancing the mutually advantageous economic cooperation arising from their geographic proximity and from the reform process and structural adjustments" (Article 3), and would not require strong commitments from the members. It was, in fact, recognized during the multilateral talks preceding the establishment of BSEC that full economic integration would not be an *a priori* commitment for the participants, even though consideration to such integration could be given later. By the Article 10 of the Summit Declaration, the economic cooperation would be promoted gradually, and the determination of the priorities in this process would take into consideration "the specific economic conditions, interests and concerns of the countries involved, and particularly the problems of the countries in transition to market economy." Instead of foreseeing a regional integration, therefore, the agreement aimed at "the achievement of a higher degree of integration of the Participating States into the world economy" through cooperation within BSEC (Article 5). The priorities for different areas of cooperation would be determined in the process with BSEC acting as a channel for the integration of its members into the global economy. In addition to this clear indication of the commitment to globalization through regionalism, the Summit Declaration made it absolutely certain that BSEC would not prevent members from developing relations with "third parties, including international organizations as well as the EC," nor would it prevent participation of its members in other regional initiatives (Article 7).<sup>5</sup>

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<sup>4</sup> The formation of a regional organization for economic cooperation among countries around the Black Sea had been suggested first by Ambassador Elekdag, former head of the Turkish mission in Washington, DC (Togan, 1994). Prior to the Ankara meeting, Bulgaria, Georgia, Moldova, Romania and Russia expressed support for the project. Despite their lack of Black Sea coast lines, Armenia and Azerbaijan, also wanted to join, and got together with the representatives from the other six in Ankara for the first round of talks.

<sup>5</sup> At the time of the formation of BSEC, Greece was already a full member of the EU, and Turkey was aspiring to become one –and has signed a Customs Union Agreement with the EU since then.

## 4. The Framework for Evaluation of BSEC's Performance

### 4.1. The Conceptual Framework

The fundamental motivation behind any form of regional economic integration is to improve welfare of the members through a reduction or elimination of barriers to trade in the region. The welfare gains that would accrue to members would, in the static sense, depend on the relative magnitudes of *trade creation* (TC) effects that tend to improve welfare, and *trade diversion* (TD) effects that tend to decrease welfare.<sup>6</sup> Trade creation arises when domestic production in a certain sector of a member country is replaced, partly or entirely, by imports from another member which has a *comparative advantage* in the production of that sector's output. Since the member with a comparative advantage is, by definition, a country which produces that output more efficiently, i.e., at a lower cost, there are welfare gains associated with trade creation. However, the integration may also create trade diversion with welfare reducing effects. Trade diversion follows when the elimination of barriers upon imports from members lowers the cost of those imports below the cost of imports from more efficient third parties simply because the maintenance of restrictions on third party imports artificially increases their cost. Naturally, such a switch from more to less efficient producers decreases the welfare of importing member but as long as the size of trade creation effect exceeds that of trade diversion, the integration would produce net welfare gains for the members. These net welfare gains of regional members, however, are not without costs on a global scale: The trade diversion effect reduces not only the importing member country's welfare but also that of the third parties, i.e., non-member countries that lose their export markets to less efficient producers that happen to sign the economic integration agreement with the importing country.

The question, then, is whether regional economic integrations are welfare improving on a global scale, or they simply improve the welfare of its members at the expense of reducing the welfare in the rest of the world. There is no simple answer to this question other than saying that the global welfare implications of a regional integration would again depend on the relative magnitudes of trade creation and trade diversion effects. But since what needs to be evaluated now is the welfare implications of the integration for the world rather than the members alone, the trade creation effects need to be redefined distinguishing Gross Trade Creation (GTC) effects on the members, from so-called External Trade Creation Effects (ETC) on the third parties. Following Balassa (1967), GTC is used here to refer to total increase in trade between *members* resulting from integration, regardless of whether extra trade created replaces relatively inefficient domestic production or not. ETC, on the other hand, refers to total increase in trade between members and non-members following integration. Within this framework, the difference between the magnitudes of ETC and TD effects would give the net effect of the integration on the rest of the world (Aitken, 1973). So, any regional arrangement that leads to a net welfare gain for the world as a whole could be considered as complementary to, rather than a substitute for, globalization of the economies in the region.

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<sup>6</sup> The concepts were developed in the 1950s by Jacob Viner who used them as analytical tools for investigating the welfare effects of customs unions—see, Viner (1953). For a more contemporary discussion, see, for example, P. Asheghian (1995).

However useful this criterion may be in deciding whether the existence of a particular trading community discourages or promotes globalization in its region, it is based on the theory of economic integration developed to analyze issues related to trade among countries forming an integration through a set of well-defined rules and regulations. The special status of BSEC as a regional cooperation organization (as opposed to a regional trade arrangement regulating the commercial policies of member countries vis-a-vis the outside world) may therefore justify skepticism about the usefulness of this criterion in the present context, but the discussion in the following section explains why the criterion would be appropriate to use here.

#### **4.2. Cooperation through BSEC: Is It Likely to Create Any TD or TC Effects?**

As the respective definitions of the concepts would clearly indicate, what causes GTC, ETC and TD effects to arise is the elimination of barriers to trade that existed prior to the formation of economic integration among the group of nations in question. In the conventional trade theory sense of the term, the barriers here refer to tariff and non-tariff tools of commercial policy. In the light of the fact that BSEC has so far not required its members to eliminate any barriers of this kind, the conventional trade theory would not predict any GTC, ETC and TD effects to arise as a result of the formation of BSEC. Thus, caution is required in evaluating the performance or the structure of BSEC by using an analytical/conceptual framework developed for existing forms of regional integration arrangements as a reference.

Even though the BSEC agreement did not exclude the possibility that consideration to stronger forms of integration could be given later on, a closer examination of the literature reveals that it would be very difficult to treat the *current* state of BSEC as a regional arrangement similar to the ones varying from preferential trade agreements to economic unions.<sup>7</sup> For this reason, trade diversion effects in the sense described above are not likely to arise due solely to BSEC membership.<sup>8</sup> In the case of trade creation effects, on the other hand, BSEC has the potential to create some for it aims to lower barriers to trade between its members. But unlike those analyzed in the existing integration literature, the barriers in this context are not of the type of barriers the nations artificially erect by introducing tariff and non-tariff measures of protection which, once decided, could be removed instantaneously. Instead, the barriers to trade between BSEC members are structural barriers that have been formed over long periods of time, and even if desired, most of them can not be eliminated as quickly as conventional barriers (Sayan and Zaim, 1998).

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<sup>7</sup> This point has previously been made in both Balkir (1993), and Gultekin and Mumcu (1996) following a comparative evaluation of BSEC against the known forms of regional integration arrangements in the literature. Although a "Declaration of Intent for the Establishment of BSEC Free Trade Area" was signed in February 1997, the actual formation of such a free trade area is not likely in the near future. (For the text of the "Declaration of Intent," see PABSEC, 1997)

<sup>8</sup> As to be discussed later, there is some diverted trade currently going on between ex-Soviet Bloc members of BSEC, but as pointed out by Gultekin and Mumcu (1996), this should be viewed as a continuation of a trend that started before the formation of BSEC, rather than as a result of its formation.

By signing the Summit Declaration, the participating states agreed (Article 14) to promote cooperation by contributing, among others,

... to the expansion of their mutual trade in goods and services and ensuring conditions favorable to such development by continuing their efforts to further reduce or progressively eliminate *obstacles* of all kinds, in a manner not contravening their obligations towards third parties. [Emphasis Added.] (BSEC, 1995: 5)

Despite its reference to the reduction/elimination of "obstacles", this statement must not be viewed as a call for a removal of conventional barriers to trade: BSEC does not require strong commitments towards harmonization of commercial policies vis-a-vis third parties, or reductions in tariff or non-tariff measures for trade among members. Thus, the statement in Article 14 must be viewed, instead, as a call for cooperation towards a relaxation of structural constraints that played a more important role in preventing larger volumes of pre-BSEC trade between members –especially between transition economies joining BSEC, on the one hand, and Greece and Turkey, on the other. Given that Greece is a full member of the EU and Turkey is in a Customs Union with it, there is actually little leeway for BSEC to set the levels of conventional barriers independently and "without contravening the commitments with third parties." Hence, BSEC has a potentially significant effect on trade flows in its area only through its contribution to the removal of structural "obstacles" that has prevented larger volumes of trade between members. In other words, the potential of BSEC to generate any trade creation effects, or to reverse the diversion of trade between ex-COMECON partners joining BSEC would mainly depend on its ability to tackle the structural obstacles that existed prior to its formation.

Some of these structural obstacles have to do with the lack or inefficiency of channels for trade, and act to suppress all bilateral trade flows between members (with the possible exception of trade between Greece and Turkey). The others cover ideological differences once existing between members that belonged to different alliances of the Cold War era, and the associated differences in their trade regimes. Coupled with the artificially created complementarity or interdependence between the economies of ex-socialist members, these structural factors had effectively created two different patterns of pre-BSEC trade between current members: i) the sizable but largely diverted trade among former Soviet Bloc countries, and ii) relatively insignificant volumes of trade these countries had with Greece and Turkey, despite the geographic proximity between the two groups.

Given the initial lack of private capital accumulation, and the absence of private trading companies and commercial banks, there were no barriers that could easily be removed by BSEC for the purposes of welfare gains through increased trade. In fact, part of the pre-BSEC trade that happened to take place between pairs of current members (e.g., Turkey and Romania, or Greece and Bulgaria) was trade between NATO and Warsaw Pact members that was carried out despite serious difficulties posed by regulations restricting trade across blocs in some sectors; differences in property rights and trade regimes (forcing Greek and Turkish exporters to deal only with inefficiently operating state trading companies and

banks), and hard currency constraints that the then-centrally planned members faced.<sup>9</sup> Likewise, the lack of common product standards prevented trade in many sectors, limiting it to mostly raw materials and primary commodities.

As for the role of structural factors that result from the lack or the inefficiency of trade channels, the meager state of transportation and communications infrastructure that is still common to many areas of ex-socialist members needs to be considered. Under the circumstances, increasing the volume of trade would again take more than a(n) reduction/elimination of tariff and non-tariff barriers through a trade liberalization agreement. Even in the complete absence of such conventional measures of protection, the poor infrastructure for transportation and a lack of dependable communications facilities would have imposed structural barriers, physically preventing larger volumes of bilateral trade between any pair of the members, including those Warsaw Pact/COMECON members (Sayan, 1996).

While some of these structural barriers such as ideological differences had been removed before the establishment of BSEC,<sup>10</sup> others remained. The special nature of the structural obstacles assigned BSEC special roles no regional organization assumed before. The absence of a private sector and the associated lack of private capital accumulation in ex-socialist members posed special difficulties. As this could act as a major hindrance to economic cooperation, the organization assumed the task of helping the structural transformation of these members by contributing to the creation of a market economy led by the private sector: Article 13 of the Declaration required cooperation in all fields to be achieved by identifying, developing and carrying out projects of common interest through an active participation of *private enterprises* and *firms*, reflecting the organization's commitment to the market economy.

The fields of cooperation were identified through a rather extensive list. While the establishment of BSEC economic area was meant to serve first to the promotion of economic cooperation (especially trade and industrial cooperation), it would also cover science and technology, and the environment as well as the following areas where concrete steps towards cooperation were required: transport and communications, including their infrastructure; informatics; exchange of economic and commercial information, including statistics; standardization and certification of products; energy; mining and processing of mineral raw materials; tourism; agriculture and agro-industries; veterinary and sanitary protection, and health care and pharmaceuticals (Article 13).

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<sup>9</sup> Even shortly after the emergence of BSEC, the lack of banking regulations for the financing of international trade in some of the ex-socialist members of BSEC proved to be a major obstacle causing many Turkish exporters to ignore orders from these countries (Sayan and Zaim, 1998).

<sup>10</sup> As a matter of fact, BSEC could not have been formed, had these ideological differences remained.

### 4.3. BSEC Structure

The steps that BSEC has so far taken to help overcome the structural obstacles can best be described in reference to its organizational structure. In order to secure the active participation of private sector in accomplishing the projects of mutual interest, the BSEC Council (BSECC) was founded in 1992. The purpose of BSECC is to provide open channels for regular interaction between national business communities of the members and governmental bodies of the BSEC. For this purpose, the BSECC develops and maintains a network of useful contacts through bilateral business councils and chambers of commerce and similar national organizations.<sup>11</sup> The Council operating through the Permanent Secretariat based in Istanbul is currently active in identifying private and public investment projects that are of common interest to members.<sup>12</sup>

The BSECC acts as the business component of a larger organizational structure which also includes governmental, parliamentary, and financial components, and a permanent international secretariat working under the supervision of the BSEC Sessional Chairman. The Parliamentary Assembly (PABSEC), the parliamentary component of BSEC, was created in 1993 by the representatives of member countries other than Bulgaria and Greece. The governmental component consists of the decision-making body, i.e., the Meeting of the Ministers of Foreign Affairs (MMFA), the Sessional Officials Meeting, and the Working Groups (WGs) of Experts. These WGs are subsidiary bodies established by the MMFA to deal with concrete issues of cooperation in the areas listed above. Some of the WGs established so far are: WG on Agriculture and Agro-Industry, WG on Banking and Finance, WG on Energy, WG on Environmental Protection, WG on Exchange of Statistical Data and Economic Information, WG on Promotion of Technology Transfer, WG on Cooperation in Science and Technology, WG on Cooperation in Tourism, and WG on Avoidance of Double Taxation. These WGs have been instrumental in completion of several projects designed to develop cooperation in respective fields including the establishment of the BSEC Coordination Center for the Exchange of Statistical Data and Economic Information, and the Black Sea Trade and Development Bank (BSEC, 1995). Headquartered in Salonica, Greece, the bank represents the financial component of the BSEC structure and is in the process of becoming the principal source of financing for implementation of joint regional projects (Sayan and Zaim, 1998).

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<sup>11</sup> National and bilateral organizations with which the BSECC maintains regular contact are as follows: Albania-Chamber of Commerce and Industry; Azerbaijan-State Committee of Foreign Economic Relations; Bulgaria-Bulgarian-Turkish Business Council; Georgia-State Committee of Foreign Economic Relations; Greece-Council for Greek-Turkish Economic Cooperation; Moldova-Ministry of Trade and Material Resources; Romania-Romanian Electricity Authority; Russian Federation-Ministry of Foreign Economic Relations; Turkey-Foreign Economic Relations Board; and Ukraine-Chamber of Commerce and Industry.

<sup>12</sup> For example, the Council reviewed project proposals for the modernization of small and medium-sized enterprises in Bulgaria so as to recruit international partners to carry out the promising ones.

Joint regional projects mostly focus on areas which will help relax structural constraints affecting the efficiency of channels for trade. Considering the importance of the issue, a Working Group (WG) on Transport and Communications was set up very early at the beginning of the cooperation through BSEC. Later in December 1993, this WG was divided into two as the Working Group on Transport and the Working Group on Communications. Some of the projects recommended by these WGs have already been completed, including the establishment of fiber optic communications networks and radio link systems to connect Turkey to i) Bulgaria, Romania and Moldova (KAFOS); ii) Italy, Ukraine and Russia (ITUR), and iii) Azerbaijan and Georgia (DOKAP). The work on other projects aiming to integrate highways, railways and maritime lines so as to improve the efficiency of transportation networks among members is currently under way. (Sayan, 1996).<sup>13</sup>

To summarize, BSEC has so far used its limited financial resources to help its members in the process of both socio-economic transformation and the improvement of infrastructure, by initiating cooperation in a number of fields, some of which would probably not be typical priority areas for other regional organizations formed by market economies.<sup>14</sup> The question now is whether cooperation in such areas is likely to have affected the patterns and volumes of trade within the BSEC area in a way compatible with globalization. This question is taken up in the next section which investigates the potential of regional cooperation through BSEC to generate trade creation and trade diversion effects.

## 5. The Effects of BSEC on Regional Trade Flows

### 5.1. The Choice of the Empirical Model

In this section, possible effects of BSEC on regional trade flows are investigated using a simple gravity model. Inspired by the Newtonian laws of gravity,<sup>15</sup> the model is based on the argument that trade flows between two countries must be positively related to their

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<sup>13</sup> In addition to such major projects whose sizable financing needs require governmental agreements, private sector initiatives were encouraged as in the case of the proposal considered by the BSECC for the construction of a viaduct to connect Romania and Bulgaria over the Danube (Sayan, 1996).

<sup>14</sup> Such as establishing a parliamentary assembly like PABSEC to work for strengthening the pluralistic democratic structure and political stability in the BSEC area. Other fields of cooperation that are more directly related to the trade potentials of members included the standardization of products to be traded, and harmonization of customs regulations. BSEC had also to form an *ad-hoc* WG (WG on Travel of Businessmen) to assure speeding up of customs formalities, and easing national visa regulations and the like so as to facilitate travel in the BSEC area by businessmen of member countries.

<sup>15</sup> The Newtonian Law of Universal Gravitation states that two particles with masses  $m_1$  and  $m_2$ , and separated by a distance "d" are attracted to each other by a force, F, acting along the line joining the particles, and the degree of attraction between two objects is directly proportional to the product of their masses and inversely proportional to the square of the distance between them, i.e.,

$$F = G \cdot (m_1 \cdot m_2) / d^2$$

where G is a universal constant having the same value for all pairs of particles.

economic "masses" represented by their GDPs, and inversely related to the distance between them.<sup>16</sup> From an economic point of view, the rationale behind the argument is that the potential of a country to supply (export) products demanded by others depends on its own size as measured by its GDP, whereas the foreign demand for these products itself depends, to a large extent, on the income (size) of the demanding (importing) country. Thus, demand and supply potentials of trading partners can be measured by their respective GDP's. For any given pairs of respective GDPs, the bilateral trade potential will also be affected by the geographical distance between the countries: Trade volumes will vary inversely with the distance since longer distances will increase the transportation costs in terms of both freight charges and transportation time. So, in its simplest form, the model can be represented by the following equation:

$$E_{i,j} = \alpha \cdot Y_i^b \cdot Y_j^c \cdot \text{DIST}_{ij}^d \quad (1)$$

where  $E_{i,j}$  is the value of exports from country  $i$  to country  $j$  ( $i \neq j$ );  $Y_{i(j)}$  is the GDP of country  $i$  ( $j$ );  $\text{DIST}_{ij}$  is the distance between the countries (usually between major ports or capitals of each country),<sup>17</sup> and  $\alpha$ ,  $b$ ,  $c$ , and  $d$  represent parameters. Given cross-section data on exports, respective GDP's and the distances between the economic centers of  $n$  countries, parameters of the equation can be estimated. The estimated parameters are expected to be positive for  $\alpha$ ,  $b$  and  $c$ , and negative for  $d$ .

Despite a lack of solid theoretical foundations (Bikker, 1987), the simple gravity model has performed well empirically, and proved to be popular tool for empirical analysis in a variety of circumstances. It is especially useful when trade flows among a large number of countries need to be considered. Furthermore, its simplicity makes it particularly attractive when data on other variables that are thought to have a significant effect on trade patterns are either not available or not reliable as in the case of transition economies. The central planning practices previously employed in these countries made relative price signals and market determined exchange rates irrelevant to resource allocation decisions thereby rendering conventional trade theory inapplicable. This unreliability of exchange rate and price information for these countries imposed the choice of the gravity framework here, which, for the purposes of empirical investigation in this section, was extended in two directions.

First, to be able to estimate any trade creating effect the establishment of BSEC might have created on regional flows, a dummy variable was introduced to distinguish BSEC members from other countries in the sample (Aitken, 1973). Likewise, in order to see whether

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<sup>16</sup> The gravity model as a tool for the analysis of trade flows between countries was first introduced in the 1960s. For an early example, see Tinbergen (1962). A brief survey of gravity literature can be found in Deardorff (1984). An application of the gravity framework to trade flows within BSEC area can be found in Togan (1994) where the estimation was based on-cross section observations alone.

<sup>17</sup> As in the original Newtonian formulation given in Footnote 9, the masses of the bodies could be treated as concentrated at their centers so that the distance between two bodies is measured by the distance between their centers.

BSEC might have played a role to reverse the diverted trade that had been going on among its ex-socialist members, another binary variable was used as a dummy to differentiate ex-COMECON partners from others. Secondly, the estimation was carried out by pooling cross-section and time series data so as to enable the model to capture the possible trade effects resulting from the dynamic nature of structural transformation that ex-communist members of BSEC have undertaken. The general form of the equations used for parameter estimation is given below:

$$E_{ij,t} = \alpha \cdot Y_{i,t}^b \cdot Y_{j,t}^a \cdot \text{DIST}_{ij}^d \cdot \prod_k (\text{DMY}^k)_{i,t}^{m(k)} \quad (2)$$

where  $E_{ij,t}$  : Exports of the BSEC member  $i$  to country  $j$  in year  $t$  (in millions of US dollars);  
 $Y_{i,t}$  : GDP of the BSEC member  $i$  in year  $t$  ;  
 $Y_{j,t}$  : GDP of country  $j$  in year  $t$  ;  
 $\text{DIST}_{ij}$  : The distance between the capital of country  $i$  and that of country  $j$  (in hundreds of miles);  
 $(\text{DMY}^k)_{i,t}$ : The value at time  $t$  of the  $k^{\text{th}}$  dummy variable distinguishing country  $i$  from others by some criterion;  
 $\prod_k$  : Product sign indexed over  $k \in \{0,1,2\}$ .

and the Greek characters represent parameters to be estimated.

## 5.2. Data and Estimation

The data problems posed special difficulties in carrying out the estimation. The unreliability of exchange rate data, in particular, made it impossible to use dollar values of GDPs based on exchange rate conversions.<sup>18</sup> To assure comparability of GDP data across countries, Purchasing Power Parity (PPP) equivalents of GDPs were used for all countries in the sample. PPP equivalents of GDP (in billions of dollars) were obtained from various issues of the country reports published by the Economist Intelligence Unit (EIU), and from various on-line editions of the World Fact Book published by the U.S. Central Intelligence Agency (CIA).

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<sup>18</sup> During the relatively short period of time since they put an end to central planning practices, transition economies in BSEC have experienced a sharp decline in the value of their domestic currencies and real GDPs. Wildly fluctuating exchange rates for some countries implied a nominal depreciation against the dollar of local currencies by hundreds of times a year. In addition, six of the eleven members of BSEC are brand-new economies that used to be regions within another country (i.e., Soviet Union) just before the establishment in 1992 of BSEC. Some of them issued their own currency to replace the ruble which itself fluctuated wildly over the sample period. Thus, reliable GDP data in dollars were not available for these economies, and it was impossible to convert GDP data measured in domestic currency terms into common dollar terms by using exchange rates.

The impossibility of finding complete data on bilateral flows after 1994 restricted the time period under consideration to 1992-1994. The time index,  $t$ , in equation (2) was chosen accordingly so as to have  $t \in \{1992, 1993, 1994\}$ . Annual data on values of exports could be found for only three of the BSEC members, Greece, Romania and Turkey, over the entirety of 1992-1994 period and for all countries of destination in the sample, i.e., the set of importing partners both within and outside BSEC.<sup>19</sup> The set of reporting countries,  $i$ , was therefore chosen such that  $i \in \{\text{Greece, Romania, Turkey}\}$ . In choosing non-BSEC countries to be included in the sample, two criteria were observed: i) comparability of their distances to exporting countries as importer partners within BSEC, and ii) availability of data. Based on these criteria, the following countries were included in the sample: Hungary and Poland that used to be partners with ex-socialist members of BSEC within COMECON, and Egypt, Iran, Israel, Jordan and Syria, Middle Eastern countries that have maintained relatively strong trade ties with both Greece and Turkey.<sup>20</sup> So, the set of importing partners,  $j$ , is such that

$j \in \{\text{Albania, Azerbaijan, Bulgaria, Georgia, Greece, Moldova, Romania, Russian Federation, Turkey, Ukraine, Hungary, Poland, Egypt, Iran, Israel, Jordan and Syria}\}$ .

Linearizing equation (2) and adding the stochastic disturbance term,  $u_{i,t}$ , yield the estimable form below:

$$\ln E_{ij,t} = \alpha + \beta \ln Y_{i,t} + \gamma \ln Y_{j,t} + \delta \ln DST_{ij} + \sum_k m(k) \ln(DMY^k)_{i,t} + \ln u_{i,t}$$

Two dummy variables indexed by  $k$  ( $k \in \{\text{BSEC, COMECON}\}$ ) were allowed to take the value of either  $e$  (the base to the natural logarithm) or one. The BSEC dummy took  $e$  if country  $i$  is a BSEC member at time  $t$ , and 1 if not. The COMECON dummy (that was introduced to take the possibility of continuation of diverted trade between Romania and other ex-COMECON members into consideration) was allowed to take the value of  $e$  for the countries that are not former COMECON members, and 1 for others. Different versions of the model were estimated using a combination of variables using pooled data over the 1992-1994 period with 48 cross-section observations for each year. The results from estimation of each version are presented in Table 1 below.

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<sup>19</sup> The data on Turkish exports were obtained from the Web site of Turkish State Institute of Statistics (SIS) at <http://www.die.gov.tr/BSEC/bsec.html>, and were also available in various issues of *Foreign Trade Statistics* published by the SIS. For Greece and Romania, exports figures reported in the 1995 edition of the PC/TAS data base of the WTO were used.

<sup>20</sup> This set of countries includes two (Egypt and Poland) with observer status in BSEC, one (Jordan) that seeks the observer status and one (Iran) that seeks full membership.

### 5.3. The Effects of BSEC on Trade Flows

The results indicate that the simple gravity model (the first line in the table) explains bilateral exports between the reporting BSEC members and the set of importing countries in the sample quite well. Moreover, the BSEC membership has a positive effect (that is statistically significant at the 95% confidence level) on exports of BSEC members considered (the second line in the table). The results in the third line of the table are for the case where the only binary variable introduced is the COMECON dummy. In that case, the sign of COMECON dummy is positive but the estimated parameter is not significantly different from zero at a confidence level of 90% or higher –implying that COMECON membership in the past does not affect BSEC exports. When both dummy variables are introduced simultaneously, on the other hand, the estimated parameters for both turn out to be positive and significantly different from zero, at least at the 95% level (the last line in the table). Given that the value of COMECON dummy is higher (at  $e$ ) for the countries that are *not* former COMECON members, these results provide additional evidence that the formation of BSEC tends to help offset trade diverting effects of COMECON over time.<sup>21</sup>

**TABLE 1.** Estimation Results Based On Pooled Time Series And Cross Section Data: 1992-1994 with 48 Cross Section Observations (Dependent Variable:  $\ln E_{ij,t}$ )

<i>Constant</i>	<i>ln GDP of the Reporting Country</i>	<i>ln GDP of the Partner</i>	<i>ln DST</i>	<i>Ln BSEC Dummy</i>	<i>ln CMCN Dummy</i>	<i>R<sup>2</sup> (BUSE R<sup>2</sup>)</i>
13.611 (19.77)***	0.7268 (5.683)***	0.7681 ( 9.023)***	-1.2577 (-4.374)***			0.997 (0.50)
14.148 (28.60)***	0.6886 (7.471)***	0.8855 (11.760)***	-1.7361 (-7.980)***	0.2018 (2.564)**		0.999 (0.67)
13.624 (15.87)***	0.7246 (4.432)***	0.7115 (8.076)***	-1.1717 (-3.571)***		0.3341 (1.366)#	0.995 (0.40)
14.298 (17.73)***	0.6781 (4.346)***	0.7160 (7.744)***	-1.4808 (-5.059)***	0.2174 (2.688)***	0.4394 (2.008)**	0.996 (0.42)

\*\*\* : Significant at 99%

\*\* : Significant at 95%

\* : Significant at 90%

# : Not significant at a level, 90% or higher.

As for trade creation (TC) by BSEC, the calculations below distinguish two types of effects resulting from regional cooperation within BSEC: Gross Trade Creation (GTC) effects upon the members, and External Trade Creation Effects (ETC) on the third parties. Following Balassa (1967), GTC is used here to refer to total increase in trade between *members* resulting from cooperation, regardless of whether extra trade created replaces relatively inefficient domestic production or not. ETC, on the other hand, refers to total

<sup>21</sup> This point could have been made more strongly if the set of reporting countries included other ex-COMECON members joining BSEC than Romania.

increase in trade between members and non-members following the formal establishment of cooperation. With these definitions in mind, the results in the first two lines of Table 1 were used to calculate the estimated values of GTC and ETC effects of BSEC in a similar way to Aitken (1973). Since the ETC effects are defined, in the present context, as the BSEC-caused increases in the exports of BSEC members to non-members, the parameter estimates from the simple gravity equation without the BSEC dummy were substituted into equation (1) so as to project the values of BSEC-exports that would have been observed had BSEC not been formed.<sup>22</sup> Subtracting the resulting export values from actual exports would yield ETC estimates presented in Tables 2a and 2b.

**TABLE 2a.** Estimates of External Export Creation 1993 (Millions of Current USD)\*

<i>Countries</i>	<i>Projected Values of Exports</i>			<i>Estimates of ETC</i>		
	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>
Hungary	43.4	66.4	80.1	-5.5	50.6	-42.6
Poland	64.7	92.5	152.2	-7.5	-72.3	82.6
Egypt	84.0	39.3	204.1	-7.1	61.7	-12.7
Iran	56.9	46.1	220.2	-42.6	35.7	69.3
Israel	43.1	23.7	150.1	50.5	30.2	-69.9
Jordan	10.4	6.0	37.7	14.9	36.9	67.3
Syria	49.6	29.9	213.0	-11.8	102.8	25.8
<b>TOTALS</b>	<b>352.1</b>	<b>303.9</b>	<b>1057.4</b>	<b>-6.7</b>	<b>142.8</b>	<b>94.0</b>

\* Actual exports minus the projected value of exports that would have been observed in the absence of BSEC, as given in columns 2 to 4 (estimated using pooled data for 17 countries over the 1992-1994 period without the dummy variable for BSEC membership).

**TABLE 2b.** Estimates of External Export Creation 1994 (Millions of Current USD)\*

<i>Countries</i>	<i>Projected Values of Exports</i>			<i>Estimates of ETC</i>		
	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>
Hungary	44.7	68.8	80.6	-5.1	92.1	-22.3
Poland	67.9	97.7	156.4	-0.1	-83.8	93.0
Egypt	90.1	42.4	214.4	12.6	115.4	-19.9
Iran	58.1	47.4	220.4	-49.0	-18.8	29.5
Israel	45.5	25.2	155.2	60.7	69.9	22.9
Jordan	14.0	8.1	50.0	14.9	27.5	61.7
Syria	46.4	28.1	194.9	2.5	117.7	59.0
<b>TOTALS</b>	<b>366.7</b>	<b>317.7</b>	<b>1071.9</b>	<b>36.5</b>	<b>320.0</b>	<b>223.9</b>

\* Actual exports minus the projected value of exports that would have been observed in the absence of BSEC, as given in columns 2 to 4 (estimated using pooled data for 17 countries over the 1992-1994 period without the dummy variable for BSEC membership).

<sup>22</sup> Similar gravity exercises have been carried out to estimate the trade patterns of transition economies that would have resulted, had they switched to market orientation earlier than they actually did (see, for example, Éltető and Szemlér, 1996).

In calculating GTC estimates, on the other hand, the parameter estimate for BSEC dummy is needed. Given that the GTC effects are defined as the BSEC-caused increases in the exports of BSEC members to other members, the estimated coefficient of BSEC dummy (0.2018) would be interpreted as the factor by which exports of three reporting countries to other members is increased. So, dividing actual exports through the base of natural logarithm (i.e., the value of the dummy for members) raised to 0.2018 would give the projected values of exports under the counterfactual assumption of no cooperation through BSEC. The differences between actual and projected values show the estimated values of GTC effects and are reported in Tables 3a and 3b.

**TABLE 3a.** Estimates of Gross Export Creation 1993 (Millions of Current USD)\*

<i>Countries</i>	<i>Projected Values of Exports</i>			<i>Estimates of GTC</i>		
	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>
Albania	107.4	2.5	30.9	24.0	0.6	6.9
Azerbaijan	0.2	0.8	55.7	nil	0.2	12.5
Bulgaria	257.9	83.6	70.5	57.7	18.7	15.8
Georgia	1.4	1.1	28.2	0.3	0.3	6.3
Greece	-	55.6	96.5	-	12.4	21.6
Moldova	2.0	77.0	0.3	0.5	17.2	nil
Romania	75.9	-	123.9	17.0	-	27.7
Russian Federation	157.8	180.1	412.4	35.3	40.3	92.2
Turkey	126.2	245.8	-	28.2	55.0	-
Ukraine	26.9	85.6	32.2	6.0	19.1	7.2
<b>TOTALS</b>	<b>755.7</b>	<b>732.1</b>	<b>850.6</b>	<b>169.0</b>	<b>163.8</b>	<b>190.2</b>

\* Actual exports minus the projected value of exports that would have been observed in the absence of BSEC, as given in columns 2 to 4 (estimated using pooled data for 17 countries over the 1992-1994 period using the estimated value of the dummy variable for BSEC membership).

**TABLE 3b.** Estimates of Gross Export Creation 1994 (Millions of Current USD)\*

<i>Countries</i>	<i>Projected Values of Exports</i>			<i>Estimates of GTC</i>		
	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>	<b>Greece</b>	<b>Romania</b>	<b>Turkey</b>
Albania	169.2	3.8	48.5	37.8	0.9	10.8
Azerbaijan	0.0	2.1	108.0	0.0	0.5	24.1
Bulgaria	327.8	83.5	109.2	73.3	18.7	24.4
Georgia	3.1	7.9	54.8	0.7	1.8	12.3
Greece	-	115.4	138.0	-	25.8	30.9
Moldova	3.1	39.1	3.0	0.7	8.7	0.6
Romania	73.0	-	143.3	16.3	-	32.0
Russian Federation	192.9	169.4	670.4	43.1	37.9	149.9
Turkey	85.9	187.1	-	19.2	41.8	-
Ukraine	64.6	77.5	62.3	14.4	17.3	13.9
<b>TOTALS</b>	<b>919.6</b>	<b>685.8</b>	<b>1337.5</b>	<b>205.5</b>	<b>153.4</b>	<b>298.9</b>

\* Actual exports minus the projected value of exports that would have been observed in the absence of BSEC, as given in columns 2 to 4 (estimated using pooled data for 17 countries over the 1992-1994 period using the estimated value of the dummy variable for BSEC membership).

## **6. Concluding Remarks**

The purpose of this paper was to evaluate the performance of BSEC with special reference to regionalism vs. globalism debate, and to discuss, whether BSEC has created, or likely to create, a bias in either direction. For this purpose, the direction of the bias any regional integration/cooperation arrangement might create was defined on the basis of the net change in the world's welfare resulting from its formation. It was argued that whether such an arrangement could be considered as complementary to or a substitute for globalization efforts of the economies in the region, would depend on the direction of this bias. Then, the effects that BSEC has had on trade flows within its region and the surrounding parts of the world (including parts of Eastern Europe and the Middle East) were taken as an indicator of the direction and the size of any such bias BSEC might have created. The contribution of BSEC to globalization efforts in the area was then evaluated in the light of the results from an empirical investigation of these effects. The discussion in the paper and the results from this investigation showed that due to the nature of regional cooperation it was created to serve to, BSEC is not expected to generate any trade diversion, suppressing the possibility of any welfare reducing effects that stronger forms of regional integrations may create upon individual members as well as nations outside the trading bloc. The results of the empirical analysis showed further that BSEC is likely to have caused welfare improving trade creation implying, in turn, that it supports, or is a complement to globalization efforts in its region.

The empirical results obtained within the framework of gravity model revealed that total value of actual exports by BSEC members to non-members in the sample exceeded the total projected values for both 1993 and 1994 indicating that the formation of BSEC led to external export creation (Tables 2a and 2b). As for external export creation by the individual members considered during the 1993-1994 period, Turkey managed to increase its exports by 462.8 million dollars over the value it would have received from exports to non-BSEC members in the sample. During the same period, the value of Romania's actual exports to these countries exceeded the value of export earnings this country would have collected in the absence of BSEC by 317.9 million dollars. Even Greece which, in 1993, earned slightly less than it would otherwise have, had net gains of 29.8 million dollars as the additional 36.5 million it received due to external export creation in 1994 offset its 1993 loss of 6.7 million dollars.

In terms of gross trade creation, all three countries enjoyed higher values of exports to other BSEC members in both 1993 and 1994 (Tables 3a and 3b). Of the three BSEC members considered, Turkey had the highest value gains with a two-year total of 389.1 million dollars. The corresponding gains for Greece were estimated to be 374.5 million whereas Romania's estimated gains stood at 317.2 million dollars.

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