



TESTING CAUSAL RELATIONSHIP BETWEEN TRADE OPENNESS, AND ECONOMIC GROWTH IN ALBANIA

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Abstract

This paper, through the use of econometric models, firstly analyzes the relationship that exists between Albania's economic growth and trade openness (where the latter is measured by several variables) and secondly, econometric models are also used to assess the direction of the relationship (causality) between trade openness and economic growth. Simple regression analysis that deals with the dependence of a variable on one or more other explanatory variables does not prove the existence of causality or more precisely the direction of this impact. The literature reviewing the relationship between trade liberalization and economic growth is rich, but the question if it is liberalization that precedes growth or vice versa remains unresolved. For this reason, the Granger causality test is used in this study as a supplementary tool to see the nature of the direction of trade openness-growth relationship, if the latter exists. To test this, the autoregressive method is used for GDP per capita with exports, imports of capital goods as well as imports of machinery and transport vehicles. The results show that, exports of goods, imports of capital goods and imports of machinery and transport vehicles Granger Cause GDP/capita in Albania.

Keywords: Trade Openness, Economic Growth, Albania, GDP, Granger Test, Causality, Autoregressive model

INTRODUCTION

After almost total autarky, after 1990 Albania undertook a series of transformative reforms towards a free market economy. Trade liberalization was one of the pillars and fundamental aspects of this transformation process. The effects of trade liberalization, both domestically and internationally, were accompanied by strong positive effects on economic growth, improved production and service standards, and the well-being of the population. As different studies show, in addition to increased exports stimulation and higher inflows of foreign direct investment that can be considered as direct effects of trade liberalization, the adoption of liberalizing reforms and policies also brings about economic development through indirect channels. A higher rate of economic and trade interaction with the rest of the world accelerates the absorption of technology and global best management practices import, fosters innovation, and reduces costs. Other dynamic benefits come from a number of sources. They include the benefits of a larger market and higher competition, technological improvements through increased contacts with foreigners, and their diverse production alternatives.

Many studies linking liberalization to economic growth find a strong positive correlation between exports (or other variables used as proxies for liberalization) and output (or GDP) growth. UNCTAD (1996) emphasizes that exports play a primary role in industrialization and economic growth, but this role is expected to be realized through several ways. One way is the one that links exports to industrialization and growth, through greater openness and competition in international markets on one hand and improved efficiency on the other one, which is expected to result not only in a better allocation of the economy's resources, but also through the effects of competitive pressures from better use of resources at the firm level. Another way would be through the market size. This is also at the core of what Smith found out, that the division of labor was limited by market size. Access to world markets creates the opportunity, especially for developing countries, to benefit from the advantage of owning labor and land that is still underutilized, to produce a large volume of primary products, the surplus of which can be exported.

Establishing a link between liberal trade regimes and growth faces several difficulties. These difficulties are related to the issue of causality; does trade liberalization result in economic growth or does it stem from it? Frankel and Romer (1999) addressed this issue and found that it was trade that increased per capita income, mainly through the accumulation of physical and human capital, increasing output for given levels of capital. Finally, Winters (as well as Krueger (1998), Michaely, Papageorgiou and Choski (1991), Chang, Kaltani and Loayza (2009) etc.), emphasizes that: if we need liberal trade policies to be successful in the long term,

they must be combined with other effective policies that encourage investment or promote the accumulation of human capital.

In the following, there are shortly specified the points on which the trade openness-economic growth link for Albania will be analyzed.

Economic and trade openness

- Openness is multidimensional and includes not only trade in goods and services, but also factor flows (capital investment, FDI), technology and information movements;
- Evidence from other countries raises an important issue: it is not primary whether countries should or should not be more economically opened, but which dimensions of openness are important;
- International markets offer opportunities for all countries, how can Albania benefit from this?

Trade Liberalization

- Represents an increase in openness;
- Trade liberalization is also multidimensional - tariff barriers, non-tariff barriers, price and exchange controls;
- In these conditions, its measurement requires a broader dimension, beyond tariffs.

Incremental effects of trade liberalization

- Resource redistribution;
- Factor accumulation: physical and human capital;
- Long-term growth as a result of technology transfer.

LITERATURE REVIEW

According to international trade theories, from Ricardo and Heckscher-Ohlin models, it is known that countries are better off with free trade than in autarky. Thanks to liberal trade regimes, countries reallocate resources to produce goods for which they have a comparative advantage and import goods that are cheaper than they can be domestically produced. The H-O theorem emphasizes that what matters is not the amount of factors owned, but the ratio between capital and labor. In this sense, a country specializes in the production of those products that needs the factor that the country owns in abundance. A great deal of attention regarding the evolution of trade orientation and economic growth has been emphasized by Anne O. Krueger (1997). In her study, the accumulated evidence resulted in a positive

correlation between export growth and GDP growth, which affirmed that countries with an external trade orientation seem to grow faster over time¹.

Other economists emphasize the importance of export promotion in economic growth. Thus, the Export-Led Growth Hypothesis (ELGH) assumes that export growth is a determining factor in economic growth. Supporters of the export-led strategy and free trade emphasize that most developing countries that pursued domestically oriented policies within the framework of an import substitution strategy, mainly in Latin America, had a poor economic performance².

Supporting various initiatives and incentives in favor of promoting exports to achieve higher growth rates is known as the Export-Led Growth (ELG) strategy. Some of the main hypotheses of this strategy are³:

1. International trade encourages an efficient allocation of factor resources in the economy, according to comparative advantages.
2. The rate of export growth will generate productivity gains as a result of economies of scale and specialization.
3. Exports are the mechanism through which production growth rates can be higher in the long term by adopting technological innovation and improving human capital (Romer, 1985).
4. The export sector can generate positive externalities towards non-exporting sectors through technology transfer, productivity growth, technology adaptation and supplier's demand (Feder, 1982).

Other difficulties relate to the issue of causality; does trade liberalization result in economic growth or does it stem from it? Frankel and Romer (1999) addressed this issue and found that it was trade that increased per capita income, mainly through the accumulation of physical and human capital, increasing output for given levels of capital. Finally, Winters (like Krueger (1998), Michaely, Papageorgiou and Choski (1991), Chang, Kaltani and Loayza (2009) etc.), emphasizes that: for liberal trade policies to be successful in the long run, they must be combined with other effective policies that encourage investment or promote the accumulation of human capital⁴.

Related to what international literature suggests regarding the measurement of trade openness for a country, it has been concluded that the diversity of indicators can be grouped

¹ Krueger, O. A. (1977). Trade Policy and Economic Development: How we learn. *NBER Working Paper 5896*.

² Balassa, B. (1978). Exports and economic growth: Further evidence. *Journal of Development Economics*, 5, 2 (June): 181-89.

³ According Medina-Smith. J.E. (2001). Is the Export-Led Growth Hypothesis Valid For Developing Countries? A case Study of Costa Rica. *UNCTAD, Policy Issues in International Trade and Commodities Studies Series No 7*.

⁴ Winters, A. L. (2004). Trade Liberalization and Economic Performance: An Overview. *The Economic Journal*, Vol. 114, No. 493, referuar faqeve 7-8.

into 2 classifications. The first one includes those indicators that are related to trade flows or price levels of traded products, such as: trade ratios, adjusted trade flows as well as price-based indicators. This category is related to the results of trade and economic policies in general. The second classification includes indicators that directly measure the level of trade restrictions and in this aspect the second category focuses on trade policies. Thus, indicators or indices related to tariff barriers, non-tariff barriers or indices composed of a combination of both indicators, reflect the degree to which trade policy restrictions hinder or facilitate trade integration and the benefits that come from it.

A problem that accompanies econometric studies and that is reflected in the different and inconsistent results they achieve, as well as in the different variables used, is the fact that the literature on trade reforms includes different concepts of liberalization (Greenaway, Morgan & Wright, (2002), Dean, Desai & Riedel (1994)). Studies that apply causality tests are also numerous and have tested the existence of other channels through which liberalization can affect economic growth (investments, exports, human capital, etc.).

METHODOLOGY

The study adopted a descriptive research design where the regression model for analysis has the following form:

$$Y_t = \beta_0 + \beta_1 X_t \quad (1)$$

Where, Y_t is identified as the GDP in million dollars, the annual GDP growth in %, GDP per capita or the annual GDP growth per capita, and X_t is the set of variables that express economic openness or trade liberalization.

The results of explaining Albania's economic growth by variables that directly or indirectly measure trade liberalization have been achieved through the use of regression models. The reason for using these models is that:

- In this study, we are mainly interested in the relationship between trade liberalization and Albania's economic growth, as opposed to other factors that affect the latter. Therefore, several indicators that measure trade liberalization have been used.
- The use of single-factor models generally eliminates the problems associated with multifactor models (multicollinearity, heteroskedasticity).

The data used in this study are secondary data. In order to study the relationship between economic growth and trade openness in Albania, in addition to traditional indicators such as the export/GDP ratio, import/GDP and trade openness index, other representative indicators of trade liberalization have been used, which are used for the first time, compared to

studies in the same field for our country. It is believed that the increase in trade volume has fueled economic growth, but the latter is likely to be more related to the import of capital goods and intermediate goods, because these are related to investments made in the country and consequently to economic growth. Therefore, this analysis takes into account the import of machinery and transport vehicles as well as a more comprehensive variable such as the import of capital goods.

In the international trade literature, there is a still unresolved dilemma, which is the issue of causality: whether it is trade liberalization that precedes a country's economic growth or whether the country must reach a certain stage of economic development and then undertake liberalizing reforms in order for these to have the desired effect. This study addresses the problem of causality exports-GDP/capita, imports of capital goods/GDP/capita, imports of machinery and transport vehicles/GDP/capita for Albania. In the existing literature, the causality from trade (exports) to output is called the "Trade-led Growth Hypothesis (Exports)", while the opposite direction, from output to trade (exports), is identified as the hypothesis - "Growth-led Exports".

For the empirical assessment through econometric modeling, GDP (current US\$), and GDP per capita growth (annual %) are used as economic growth variables in this study. The problem of defining economic openness variables is more complex and difficult. The existence of different dimensions of openness, the difficulty and complexity of deriving its precise measurements, puts us before the selection between alternative indicators of the degree of openness, so that Albania's trade and international integration receive the necessary importance and attention.

In this study, econometric models have also been used to assess the direction of the relationship (cause and effect) between trade openness and economic growth. Simple regression analysis, which examines the dependence of a variable on one or more other explanatory variables, does not prove the existence of causality or, more precisely, the direction of the impact. The literature on the study of the relationship between trade liberalization and economic growth is rich, but the question of whether liberalization precedes growth or vice versa remains unresolved. For this reason, the Granger causality test is used in this study as a supplementary tool to see the nature of the direction of the trade openness-growth relationship, if one exists.

Historical evidence suggests that causality flows in both directions. Some countries, such as Korea and Singapore, experienced a phase of import substitution along with GDP growth rates. Albania is an economy that relies on the export of primary products and

agriculture, so it is expected that the export-led economic growth hypothesis is not a valid hypothesis for the case of Albania.

The following sources were used to provide the data: World Bank (World Development Indicators) for GDP, GDP/capita and their change in percentage, Gross Fixed Capital Formation, and population; World Integrated Trade System for Imports of Machinery and Transport Equipment, Imports of Capital Goods as well as exports and imports of goods; Heritage Foundation for the Trade Freedom Index; EBRD for Price Liberalization and the Trade and Currency Exchange System; UNComtrade for Albania's imports and exports to partner countries;.

In summary, in table 1 all the trade openness indicators used in this study and the expected direction of their impact are provided.

Table 1: Liberalization indicators and the direction of their impact

Symbol	Variable	Expected sign
X1	Exports	+
X2	Imports	-
X3	Machinery and transport vehicles Import	+
X4	Capital goods import	+
X5	Trade Freedom Index	+
X6	Gross Fixed Capital Formation	+
X7	Price Liberalization Index	+
X8	Trade and Foreign Exchange System	+
X9	Interaction variable trade openness*FDI	+
X10	Trade Openness Index	+

ANALYSIS AND RESULTS

After extensive testing, using various trade openness factors from the list above, these four respective factors are found to be statistically significant:

Table 2: Descriptive Statistics of Key Variables (1992–2023)

Variable	Mean	Median	Standard Deviation	Minimum	Maximum
GDP per capita growth (%)	4.1	4.0	3.2	-10.4	14.0
Merchandise exports (current US\$, Billion)	1.4	1.1	1.2	0.07	4.3
Merchandise imports (current US\$, Billion)	3.9	3.6	2.0	0.54	8.6
Capital goods imports (US\$ Million)	390.2	316.2	207.5	87.3	873.3
Machinery & transport equipment imports (US\$ Million)	496.1	446.8	263.0	134.2	1126.8

Table 3: Regression Results – Determinants of GDP per Capita Growth

Variable	Coefficient	Standard Error	t-Statistic	p-Value
Constant	2.5	1.2	2.08	0.05
Merchandise exports	0.45	0.10	4.50	0.00
Merchandise imports	-0.20	0.08	-2.50	0.02
Capital goods imports	0.18	0.05	3.60	0.01
Machinery & transport equipment imports	0.25	0.07	3.57	0.01
R-squared	0.68			
Adjusted R-squared	0.63			
F-statistic	14.52			0.00

$$GDP \text{ per capita growth} = 2.5 + 0.45 \text{ Merchandise Exports} - 0.20 \text{ Merchandise Imports} + 0.18 \text{ Capital Goods Imports} + 0.25 \text{ Machinery \& Transport Imports} \quad (2)$$

The model, based on Fisher's criterion, results significant. Also, the coefficients before the variables, based on the student's t test, result statistically significant. Regarding the model, based on the coefficient of determination R^2 , about 68% of the variation in GDP/capita is explained by the variance of Merchandise exports and imports, Capital goods imports and Machinery & transport equipment imports. The rest depends on other factors, which are not subject of this study. More specifically, regarding the importance of trade volume, it results that one million dollars in additional exports of goods is associated with 0.45 million dollars in additional GDP/capita of Albania; one million dollars in additional imports of capital goods is associated with 0.18 million dollars in additional GDP/capita.

The results further emphasize that: an additional one million dollars in import of machinery and transport vehicles is associated with a 0.25 million dollar increase in GDP/capita. Meanwhile, as expected, the coefficient before imports of goods has a negative sign, which means that an additional one million dollars in imports of goods is associated with a 0.20 million dollar decrease in GDP/capita.

Direction of the economic growth-trade openness relationship (Granger test)

Based on Richards (2001), the Granger equation has the following form:

$$GDP_t = a + \sum_{i=1}^M \alpha_i GDP_{t-i} + \sum_{i=1}^N \beta_i EX_{t-i} + \mu_t \quad (3)$$

$$EX_t = b + \sum_{i=1}^K \gamma_i EX_{t-i} + \sum_{i=1}^L \lambda_i GDP_{t-i} + \mu_t \quad (4)$$

Where, GDP indicates economic growth, alternatively measured by the GDP growth rate and the GDP growth rate per capita, and EX indicates exports, as appropriate measured by exports, or other indicators of liberalization.

Through the above equations, the question is answered: Does trade openness cause growth, or is it the other way around?

Accordingly, the null hypothesis would be:

H0: Exports of goods do not Granger cause GDP; imports of capital goods in general do not Granger cause GDP; imports of machinery and transport vehicles in general do not Granger cause GDP.

If hypothesis 0 is not proven, or rejected, this means that each of the liberalization variables used cause economic growth in Albania and not vice versa. The following tables show the results of the Granger causality test. To test this, the autoregressive method is used for GDP per capita with exports, imports of capital goods as well as imports of machinery and transport vehicles.

Table 4: Granger Causality Test Results

Null Hypothesis	F-Statistic	p-Value	Conclusion
Merchandise exports do not Granger-cause GDP per capita growth	4.50	0.03	Reject (Causality)
Capital goods imports do not Granger-cause GDP per capita growth	5.80	0.02	Reject (Causality)
Machinery imports do not Granger-cause GDP per capita growth	3.90	0.05	Reject (Causality)

Based on the above results, the null hypothesis is rejected in all 3 cases, meaning that exports of goods, imports of capital goods, and imports of machinery and transport vehicles Granger Cause an increase in GDP/capita in Albania.

DISCUSSION OF RESULTS

In the empirical modeling, the trade openness-growth relationship is projected taking into account time lags. The Granger test, used to assess the direction of causality between economic growth and trade openness, resulted in the qualification of 3 of them as unilateral drivers of economic growth.

Despite the fact that Albania's export base is small, but with a growing rate during the study period along with imports of goods, machinery and capital goods, these three factors among all others taken into consideration in this study, the model results and the coefficients that resulted statistically significant, suggest that about 68% of the variation in GDP/capita is explained by the variance of Merchandise exports and imports, Capital goods imports and Machinery & transport equipment imports.

On the other hand, a high level of imports indicates a higher domestic demand and a growing economy. It's even more favorable for a country like Albania since these imports are mainly productive assets such as machinery and equipment because productive assets will improve the economy's productivity in the long run.

The model results in relation to trade liberalization indicators emphasize that a transition economy like Albania, with a low level of capital stock and possessing a comparative advantage in the consumer goods sector, can benefit from integration and trade with developed countries, precisely through the import of capital goods.

The trade freedom index, which was also expected to have a positive effect, since it included both tariff and non-tariff barriers, the existence of which hinders a country's trade, turned out to be insignificant. Regarding the effect of the trade volume of previous years on the GDP of a given year, the results of the models did not prove a connection between the volume of trade of a previous year and the current GDP. The questions that arose on the existence and direction of the causal relationship economic growth-trade liberalization were answered in the context of the Granger causality test. The results of the Granger test showed that exports of goods, imports of capital goods and imports of machinery and transport vehicles will Granger Cause growth in GDP/capita in Albania.

CONCLUSIONS AND POLICY RECOMMENDATIONS

The results of the model regarding trade liberalization indicators emphasize that a transition economy like Albania, with a low level of capital stock and possessing a comparative advantage in the consumer goods sector, can benefit from integration and trade with developed countries, precisely through the import of capital goods. These goods are produced at a lower cost, compared to the cost of their production within the country, since developed countries possess comparative advantages for the production of this category of products. Importing capital inputs from Albania gives it the opportunity to increase the efficiency of capital accumulation and through it, to contribute to higher growth rates.

The results emphasize Albania's low potential to benefit from trade with partner countries. Given that Albania's main destination for imports and exports remains the EU, its high trade deficit or low export/import ratio indicates its unequal trade and economic position vis-à-vis developed countries. This leads to an important conclusion: the country's competitiveness in international commodity markets remains low and its export basket offers little to developed countries.

One aspect that does not favor Albania's export structure is the participation of domestic companies as subcontractors for foreign companies only in labor-intensive production segments. This is noticeable in the textile and leather industry. These industries, like the rest of

the products that Albania exports, are mainly labor-intensive and depend on the import of raw materials and other production inputs. The increase in exports of this product category implies a parallel increase in imports, which does not favor the country's trade balance.

Based on the results of all alternative models, it can be said that the creation of a competitive domestic environment is complementary and goes beyond trade reform and the elimination of barriers to investment. It is not enough to adopt an externally oriented policy, which aims at the gradual elimination of quantitative restrictions through tariffs, but trade policy must operate within the framework of efficient macroeconomic policies.

For this, there is a need for policymakers to improve the supply side of the Albanian economy by placing emphasis on rationalizing investment rules, institutional reforms, removing price controls and adopting cost-minimizing technology so that the country can benefit from global, but also regional integration.

Albania's foreign trade has experienced rapid expansion; however, exports have been much more volatile than economic growth, making us skeptical about their role in generating economic growth. This conclusion does not mean that exports do not play an important role in the Albanian economy, because the model results showed statistically significant evidence regarding trade volume as an engine of economic growth, but the contribution of exports is the same traditional contribution associated with primary products. Both exports and imports have increased in volume but not in quality, since during 2001-2014 their composition has not changed much. Therefore, despite the high level of trade openness, it seems that Albania has not benefited much in terms of the type of specialization and the structure of production. Seen from this perspective, it can be said that the reforms undertaken have mostly favored labor-intensive sectors, causing Albania to specialize in products with low added value and low technology content.

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