

Moga, Teodor Lucian; Fotea, Alexandru Cristian

Article

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CES Working Papers

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Suggested Citation: Moga, Teodor Lucian; Fotea, Alexandru Cristian (2012) : Enhancing Regional Integration Through Commercial Ties in the Eastern Neighbourhood of the Eu, CES Working Papers, ISSN 2067-7693, Alexandru Ioan Cuza University of Iasi, Centre for European Studies, Iasi, Vol. 4, Iss. 1, pp. 76-87

This Version is available at:

<https://hdl.handle.net/10419/198157>

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ENHANCING REGIONAL INTEGRATION THROUGH COMMERCIAL TIES IN THE EASTERN NEIGHBOURHOOD OF THE EU

Teodor Lucian **Moga**^{*}
Alexandru Ioan Cuza University of Iași
teomoga@yahoo.com
Alexandru Cristian **Fotea**[†]
Alexandru Ioan Cuza University of Iași
alexandru.fotea@uaic.ro

Abstract: *Economic unification across Europe has been the main impetus for the European integration process and this rationale stood also behind the European Union (EU) approach towards its neighbourhood. Since the launch of the European Neighbourhood Policy (2004), the economic incentives have been the most effective instruments for generating structural change in the neighbourhood, taking into account the fact that EU membership has not been yet considered. Our research will aim at investigating the potential of the European Union to promote economic cooperation in its Eastern vicinity by seeking to include the Eastern Partnership states into a network that shares the same economic principles and values. Among these values, we argue that deep economic engagement through bilateral and multilateral frameworks of trade relations has played a major in enhancing the economic development of the six-Post Soviet states: Ukraine, Moldova, Belarus, Azerbaijan, Georgia and Armenia.*

Keywords: European Neighbourhood Policy, Eastern Partnership, Eastern Europe, trade relations
JEL Classification: F15

INTRODUCTION

Since the inception of the European Community, the economic unification has represented one of the main goals of the European integration process. Constituent treaties of the European Union (EU) listed the following core objectives of this type of economic unification: the harmonious development of the economic life, stable and balanced economic growth, raised standards of living and unemployment reduction. All these economic principles have stood behind both the conceptualisation of the European Neighbourhood Policy (ENP) and the EU approach to its immediate neighbourhood.

^{*} ACKNOWLEDGEMENT: This paper is made within “The Knowledge Based Society Project – researches, debates, perspectives”, supported by the Sectoral Operational Programme Human Resources Development (SOP HRD), financed from the European Social Fund and by the Romanian Government under the contract number POSDRU ID 56815.

[†] ACKNOWLEDGEMENT: This work was supported by the European Social Fund in Romania, under the responsibility of the Managing Authority for the Sectoral Operational Programme for Human Resources Development 2007-2013 [grant POSDRU/88/1.5/S/47646].

The ENP was launched in 2004 and it was designed to foster political dialogue, strengthen economic prosperity, stability and regional cooperation at the southern and eastern borders of the EU.

From an economic perspective, the ENP is a complex project, giving particular attention to the implications of the economic integration initiatives – i.e. economic and social development of its neighbours, the possibility of obtaining access to the EU internal market, trade liberalisation in line with the EU and WTO rules, participation in various EU programmes (transport, energy etc.).

The economic incentives are the most effective instruments for generating structural change in the neighbourhood, since the EU membership has not been yet considered; for the time being the declared objective of the ENP is to offer partner states the perspective to integrate into the EU internal market - “a stake in the EU market” (Ferrero-Waldner, 2006). These economic incentives could deter the creation of divisive gaps in living standards among the neighbouring nations. The prospect of having access to the EU internal market is a major aspect of ENP. Although it is a progressive and long-term goal, this part (“stake”) in the domestic market has not been clearly defined in the EU official documents, but it is understandable it refers to a substantial reduction of tariff and non tariff barriers in many aspects of the internal market, the opportunity to participate in the future in an area of free movement of goods, services and factors of production. This would require the gradual convergence with the EU internal market rules, enhanced regional cooperation and integration and adjustment to the European standards and institutional practices, similar to a certain extent to those existing in the European Economic Area.

We have chosen to analyse the countries from the Eastern vicinity of the EU, because in comparison to the other neighbouring countries from the Mediterranean Basin, Moldova, Ukraine, Belarus, Georgia, Armenia and Azerbaijan (the Eastern Partnership (EaP) states) display a *European sense of belonging*, due to their inclusion into the conventional geographic boundaries of the European continent.

Despite having a weaker impact on the neighbouring states, due to the lack of EU membership promise, the EU conditionality could still have a considerable influence on the EaP states from an economic perspective; through the ENP strategy the EU is offering the Eastern countries at the time being the possibility to participate in the EU internal market, provided that they implement the necessary reforms. Thus, further integration with the EU countries can positively influence the economies of the EaP countries in several ways: through trade, foreign direct investment (FDI), financial flows etc.

This paper aims to examine, in particular, the impact of trade relations with the EU on the above-mentioned six countries. As such, the main questions this study seeks to answer are the following:

- 1) Does the EU have the economic potential to consolidate the ENP?
- 2) To what extent is trade one of the main ways of deepening economic integration with countries located in the eastern proximity of the EU?

1. THE ECONOMIC PLATFORM OF THE EUROPEAN NEIGHBOURHOOD POLICY

The ENP economic agenda was adjusted through a series of consultations with the partner states; thus, the action plans and the priorities for reform fall into three major thematic areas:

- Structural reforms;
- Macroeconomic policies;
- Elimination of trade barriers and facilitation / increase of trade.

There is a broad consensus in the economic literature that structural reforms, sound macroeconomic policies and trade liberalisation are beneficial for economic growth.

In addition to stimulating structural reforms, the ENP contributes to the improvement of the macroeconomic system, especially given the negative experience during the global economic downturn. Action plans bring about the adoption of fiscal and monetary policies, as these commitments are vital for having a sustainable growth.

In addition to the favourable impact of growth, macro stability may also increase the positive effects of the economic liberalisation in the neighbouring states, while levelling out the economic gaps. Indeed, it is often argued that economic liberalisation cannot be achieved in the absence of macroeconomic stabilisation. (Nsouli, Rached and Funke, 2002) Despite an ambitious process of constant liberalisation and macroeconomic stabilisation in recent years, the EaP states still need to increase the pace of reforms. As such, the EU has recently launched a new project for the upcoming years – “A new and ambitious European Neighbourhood Policy”^{*} which will hopefully bring an enhanced involvement of the EU in the region.

The benefits of trade liberalisation are well known and will be detailed below. Commercial ties are currently the most important in the context of the relationship between the EU and ENP partner states from Eastern Europe. Trade liberalisation will depend on the degree to which the ENP

^{*} This document was launched on the 25th of May, 2011, in Brussels.

can effectively reduce tariff and non-tariff barriers and contribute to concluding free trade agreements. In particular, the effects of trade liberalisation will be stronger if liberalisation also includes agricultural products and services.

Susanne Micher and Ben Slay have investigated the potential economic impact of the ENP both on the EU and on its neighbours. (Milcher and Slay, 2005) In particular, the two researchers have sought to develop an answer to the question whether ENP is sufficiently attractive to influence the governments of the neighbouring countries to adopt or to step up the implementation of the economic and political reforms.

The two scientists have found that the ENP has a significant impact, but it risks losing its intensity, if it does not provide the states from Eastern Europe with a clearer motivation: such as the prospect of becoming in the near future EU members. From an economic perspective, the ENP aims to simplify trade restrictions by including the EaP states in a framework of legislative harmonization and convergence with the European standards. Granting access to the European common market could improve significantly under the umbrella of the ENP. Having the experience of the Central and Eastern European states as a template, FDI and commerce are very effective tools in transforming the EaP economies. The ENP could also represent an umbrella under which investor's confidence is reinforced. The new European Neighbourhood and Partnership Instrument (ENPI) can add much more coherence in the field of technical assistance and can provide enhanced financial support for capacity building for trade and infrastructure both for the development of the private and public sector (Milcher and Slay, 2005).

From an economic point of view, the ENP is many times perceived as a significant extension of the EU neo-functionalist model which has stood behind the European project since its commencement as a source of opportunities for integration with the EU market in order to achieve the four fundamental freedoms of movement (people, goods, services and capital).

From a technical and institutional standpoint, the EU has economic potential to support Eastern European neighbours, but these states should be given perhaps a status similar to the non-EU members from the European Economic Area.

2. COMMERCIAL TIES – THE MAIN INSTRUMENT FOR STRENGTHENING THE ECONOMIC RELATIONS BETWEEN THE EU AND ITS EASTERN NEIGHBOURS

The ENP has positively influenced the relations between the EU and its neighbours. Since its launch in 2004, political contacts have increased in intensity and profile. Commercial ties, in

particular, have improved considerably due to an ongoing process of liberalisation and convergence laws. The EU trade with the ENP region (both Eastern and Mediterranean partners) grew during 2004-08 by 63% (exports) and by 91% (imports). Moreover, EU trade with its Eastern partners has had a highly dynamic evolution, although it had a low starting point: the share of EU exports to the EaP region has almost doubled from 1.26% to 2.1% and the level of imports increased from 0.8% to 1.4%. The economic recession has also hit hard the partner countries from Eastern Europe, strongly interconnected with the European economy, which led to a contraction of trade in 2009. (European Commission, 2010) As illustrated in the tables below, trade policies are the most important test in determining the ability to create solid long-term cooperation and regional integration between EU and Eastern Europe.

Opening up markets has brought advantages for both the EU and the EaP members, because liberalising sectors where economic partners have a competitive advantage is essential for boosting growth. Therefore, the establishment of a new generation of trade agreements – the so-called *Deep and Comprehensive Free Trade Agreements* (DCFTA) will be the next step in the integration of the EaP states into the European market. The EU is currently seeking to deepen its commercial links with the countries from its Eastern vicinity; negotiations with Ukraine and Moldova to complete a DCFTA are about to be completed, while negotiations with South Caucasus states were launched in 2010. Belarus is the only country which has not yet expressed its interest in creating a free trade agreement with the EU, the regime in Minsk opting for strengthening its bilateral relations with Russia.

Unlike a conventional free trade agreement, which would eliminate solely tariff and non-tariff barriers, a DCFTA will also include the liberalisation of services and expand to the neighbouring countries a considerable degree of institutional harmonization based on the EU internal market *acquis*. As soon as the agreements with Ukraine and Moldova will enter into force, the Commission plans to use this experience as a blueprint to include the other four eastern European states in a network of cooperation and regional economic integration which could follow the example of the European Economic Area established between the European Free Trade Agreement and the EU member states in the 1990s.

2.1 The structure of commerce in the ENP states from Eastern Europe

Owing to the contribution of ENP and thanks to a propitious economic environment until 2008/2009, trade with neighbouring countries from Eastern Europe has significantly increased.

Subsequently, the EU imports are currently twice as much as the ones coming from the neighbouring states. The magnitude of imports from the EU countries indicates in the region the EU is the most important trading actor. Currently the EaP economies depend hugely on the trade with Europe, the EU being the main commercial partner of the EaP countries (with the exception of Belarus). Below recent data concerning the trade balance of the six countries representing Eastern dimension of the ENP are included, which indicates that, at least from an economic perspective, the EU is an influential player in this region. This gives Brussels enough regional leverage; the EU, through its commercial power, seeks also to promote and export its normative system abroad.

Belarus

Although trade relations between the EU and Belarus increased in the last couple of years, the EU has temporarily suspended closer economic partnership until the government of Minsk is able to demonstrate a greater commitment to promote democracy, civil and political rights. In response to internal political deterioration in Belarus, the EU has not ratified the bilateral Partnership and Cooperation Agreement, signed with Belarus in 1995. Therefore, bilateral trade and economic relations remain governed by the Trade and Cooperation Agreement, concluded by the European Community with the Soviet Union in 1989 and subsequently approved by the government of Minsk. Belarus applied for WTO membership in 1993, but the process is far from being complete.

However, bilateral trade increased steadily in the last five years, and the EU is now the second trade partner of Belarus as shown in Table 1. As regards exports to Belarus, the EU ranks first, but it is surpassed by higher imports from Russia. (Belarus - European Commission, 2011)

Table 1 - Belarus' trade balance

Exports	2010	Imports	2010
EU	43.6	Russia	58.5
Russia	31.5	EU	22.9
Ukraine	8.0	Ukraine	4.5
India	2.3	China	3.8
Brazil	2.1	USA	1.5

Source: World Trade Organisation (2010). *Statistics Database*,
<http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=AM,AZ,BY,GE,MD,UA>.

The evolution of commercial ties between the EU and Belarus has been positive, especially after the launch the ENP in 2004, despite the sinuous political dialogue under the Lukashenko leadership.

However, on January 1, 2010, the customs union between Belarus, Russia and Kazakhstan came into force, which means that, at least under Lukashenko, the economic integration with the EU is seen as second alternative.

Moldova

Bilateral trade between the EU and Moldova have shown an upward trend over the past five years, the most highly dependent country on trade with the EU from the group of six. The EU is Chisinau's most important commercial partner, as shown in Table 2, with a share of about 50% of its foreign trade. The EU is followed by Russia with a 16.6% share of its foreign trade (2009). (Moldova - European Commission, 2011)

Table 2 - Moldova's trade balance

Exports	2010	Imports	2010
EU	51.9	EU	43.4
Russia	22.3	Ukraine	14.0
Ukraine	6.3	Russia	11.4
Belarus	6.3	China	7.5
Turkey	2.6	Turkey	5.3

Source: World Trade Organisation (2010). *Statistics Database*, <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=AM,AZ,BY,GE,MD,UA>.

Commercial ties have experienced a growing trend since the launched of the ENP, the EU offering Moldova a wide range of facilities and commercial preferences.

Ukraine

The EU is Ukraine's main trading partner representing about one third of its foreign trade, as it results from the latest statistical data presented in Table 3. The EU was a staunch supporter of Ukraine's accession to WTO, which came into force on 16 May 2008. As a result, the EU and Ukraine launched negotiations for a DCFTA, negotiations which are still ongoing and expected to be concluded in 2012. The EU is followed by Russia with 24.4% share of Ukraine's foreign trade.

Until the commencement of the economic crisis, FDI flows to Ukraine have rapidly increased: from 2007 to 2008, FDI in Ukraine grew by 75%, while the period 2004-2005 saw a spectacular jump of nearly 400% (Ukraine - European Commission, 2011).

Table 3 - Ukraine's trade balance

Exports	2010	Imports	2010
EU	27.2	Russia	35.4
Russia	24.4	EU	31.8
Turkey	5.9	China	8.6
Belarus	3.5	Belarus	4.7
Kazakhstan	2.6	USA	2.6

Source: World Trade Organisation (2010). *Statistics Database*, <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=AM,AZ,BY,GE,MD,UA>.

Ukraine is the second country after Moldova, whose economy hugely depends on its commercial ties with the EU. Trade volume has increased massively after the launch of the ENP, primarily due to the ambitious reform process started under the orange movement led by the former president Victor Yushchenko. Because of its close economic relation with the EU, Ukraine has been among the countries which experienced most severely the economic crisis shock, which has naturally brought about also a decrease in trade since 2008.

South Caucasus

Since 2004, the EU has become the main trading partner of each of the three South Caucasus countries (in 2009 the EU accounted for 30.4% of global trade of Armenia, Azerbaijan and 42.8% to 29.4% for Georgia).

Moreover, the first round of negotiations on the possibility of deepening the free trade agreement with Georgia, Azerbaijan and Armenia has already taken place. These agreements are based on a set of shared values and cover a wide range of areas including political dialogue, justice, freedom and security and cooperation in trade and sectoral policies.

Georgia

As reflected in Table 4, the EU has become the main trade partner of Georgia. Despite the fact that, for Brussels, Georgia is a marginal trading partner, the EU has strengthened its commercial links with the government of Tbilisi; the EU exports mainly machinery and transport equipment,

whereas the most important Georgian exports are mineral fuels, which represent approximately 60% of its exports to the EU, and agricultural products, which stand for approximately 17%. (European Commission - South Caucasus, 2011).

Table 4 - Georgia's trade balance

Exports	2010	Imports	2010
EU	22.3	EU	27.4
Turkey	17.6	Turkey	15.1
Azerbaijan	13.7	Ukraine	10.8
Ukraine	9.0	Azerbaijan	10.0
Canada	8.8	Russia	7.0

Source: World Trade Organisation (2010). *Statistics Database*, <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=AM,AZ,BY,GE,MD,UA>.

Trade between EU and Georgia has seen a significant increase from 2003-2004 and this was due to the constant pro-market policies and to a growing trend of liberalisation initiated by the president's Miheil Saakashvili political movement and also owing to a favourable economic context which flourished under the umbrella of the ENP.

Armenia

After the collapse of Soviet Union, the EU has become the main trade partner for Armenia, as shown in Table 5. On the one hand, the EU exports mainly machinery and transport equipment to Armenia. On the other hand, Armenia exports mainly base metals and products made of them, which represent more than 60% of the total exports to the EU; diamonds and precious stones account for about 25% of total exports. The bilateral trade relations between Armenia and the EU are regulated under the Trade and Cooperation Agreement (TCA), which entered into force in 1999. The TCA provides a framework of progressive approximation of legislation with regards to the most important commercial areas: industry standards, sanitary and phytosanitary measures, intellectual property rights, customs procedures, procurement etc. In addition, Armenia is a beneficiary of the EU Generalised System of Preferences (European Commission – South Caucasus, 2011).

Table 5 - Armenia's trade balance

Exports	2010	Imports	2010
EU	45.2	EU	26.4
Russia	15.6	Russia	24.8
USA	9.7	China	9.0
Georgia	7.1	Ukraine	6.4
Canada	5.0	Turkey	5.6

Source: World Trade Organisation (2010). *Statistics Database*, <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=AM,AZ,BY,GE,MD,UA>.

The evolution of trade between Armenia and the EU grew spectacularly in the past; however, since 2008 commercial links have been severely affected by the adverse consequences of the global economic crisis.

Azerbaijan

After the disintegration of the Soviet Union, the EU has become the main trading partner of the Republic of Azerbaijan (Table 6). Although Azerbaijan is a marginal trading partner for the EU, their commercial ties experienced a spectacular development in the last couple of years. The EU exports mainly machinery and transport equipment to Azerbaijan, whereas for the Caucasian state particularly fuel accounts for much of its total exports to the EU. (European Commission – South Caucasus, 2011)

Table 6: Azerbaijan's trade balance

Exports	2010	Imports	2010
EU	43.7	EU	26.7
USA	11.9	Russia	17.5
Israel	8.4	Turkey	14.8
Russia	5.1	Ukraine	8.4
China	4.6	China	7.9

Source: World Trade Organisation. (2010). *Statistics Database*, <http://stat.wto.org/CountryProfile/WSDBCountryPFView.aspx?Language=E&Country=AM,AZ,BY,GE,MD,UA>.

As shown in the above tables, the EU's economic presence through trade in the eastern neighbourhood has increased in recent years, especially since the launch of the ENP in 2004, which strengthened the role of EU in the region. Moreover, during the economic boom years experienced between the 2005 and 2007, European companies - UniCredit, BNP Paribas, BP, France Telecom, Mittal and Heineken - made substantial profits in the region.

CONCLUSIONS

Further integration of the EaP economies into the European market could generate the following three effects: the first one will contribute to the elimination of administrative barriers (such as the costs related to border crossing), the second would lead to the reduction of risks and uncertainties existing in the domestic business environment, and the third one would lessen the technical barriers (tariffs) to trade.

The emphasis on promoting economic relations, especially through commerce, reflects an increased interdependence between the EU and the countries situated in its eastern vicinity, especially because trade represents a very important contributor to economic growth. As such, on the one hand, enhancing trade relations is a top priority for any of the six EaP given the current economic circumstances. On the other hand, the EU should increase the financial stabilization efforts and investment support for its neighbours in order to overcome the current economic recession. Despite the fact both the EU and Russia compete in the shared neighbourhood, the EU is currently the only international actor with a comprehensive strategy for its immediate proximity.

The pace of progress depends on the benefits offered to the EaP partner states in a reasonable time (such as the confirmation of participating in the near future in the EU internal market). However, EU's reluctance to meet the aspirations of some of the countries constituting the Eastern dimension of the ENP will continue to hinder the development of further relations. And this is relevant to how the EU political and economic mechanisms are developed and to how the future free trade agreements will be structured.

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