

Astrov, Vasily et al.

**Research Report**

## European Neighbourhood - Challenges and Opportunities for EU Competitiveness

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September  
2012

*Peter Havlik et al.*

## **European Neighbourhood – Challenges and Opportunities for EU Competitiveness**

 **R**



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*Peter Havlik et al.*

**European Neighbourhood – Challenges and Opportunities for EU Competitiveness**



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## **Summary**

*Countries belonging to the European neighbourhood are highly diverse. Their diversity is multidimensional (geographical, socio-economic, political, cultural, religious, etc.) and the individual dimensions all have important implications for EU policies towards the region(s), for EU institutional relations with individual neighbourhood countries and for these countries themselves – including their competitiveness. After mapping the economic situation and the competitiveness of the countries in European neighbourhood, the paper proceeds to an analysis of the selected aspects of these countries' competitiveness:*

- *The economic impacts of existing agreements between EU Member States and neighbouring countries. A simulation of various scenarios covering free trade in goods between the EU and some of its neighbours is attempted.*
- *Where possible, the effects of bilateral agreements on the growth and productivity of small and medium-sized enterprises (SMEs) in the Rim countries are investigated.*
- *The economic impact and the impact on competitiveness of migration and remittances flows between Rim countries and EU Member States are investigated, as is the effect these have on the labour market.*
- *Conclusions are drawn and policy recommendations made on the basis of the analysis; these cover the challenges and opportunities for the competitiveness of EU enterprises and sectors in the neighbouring countries.*

**Keywords:** *European Union, EU Neighbourhood, competitiveness, foreign trade, FDI, labour market, migration, remittances*

**JEL classification:** *D60, E2, F15, F21, F22, F55*



*Peter Havlik, Vasily Astrov, Mario Holzner, Gábor Hunya, Isilda Mara, Sándor Richter, Roman Stöllinger and Hermine Vidovic*

## **European Neighbourhood – challenges and opportunities for EU competitiveness<sup>1</sup>**

### **I. Introduction**

Reflecting the diversity of countries in its neighbourhood, the European Union (EU) has established different cooperation processes, institutional arrangements and forums for discussion, notably in the framework of the European Neighbourhood Policy (ENP). This latter includes a large number of diverse partner countries to the south and east of the EU's external borders. Other geographic neighbours of the EU are outside the scope of the ENP: Russia, with which the EU has formed a Strategic/Modernization Partnership; Norway and Liechtenstein, which are party to the European Economic Area (EEA) agreement with the EU; Switzerland, which is a member of the European Free Trade Association but is not part of the EEA; EU membership candidate countries and potential candidate countries in Southeast Europe. Each form of cooperation is characterized by its own dynamics, institutional set-up and instruments, procedures, long-term objectives and problems.

The various forms of cooperation between the EU (and/or its Member States) and neighbouring countries reflect also the importance of those countries for the competitiveness of the EU and its Member States. Moreover, the form of cooperation is affected by the size and structure of the economy of the neighbouring country, its geographical location, geopolitical situation and the level of economic development, by bilateral trade and investment flows, and migration flows between the country concerned and the EU. This study analyses these differences, the dynamics of each form of cooperation with a neighbouring country, and the importance of each country to the competitiveness of the EU.

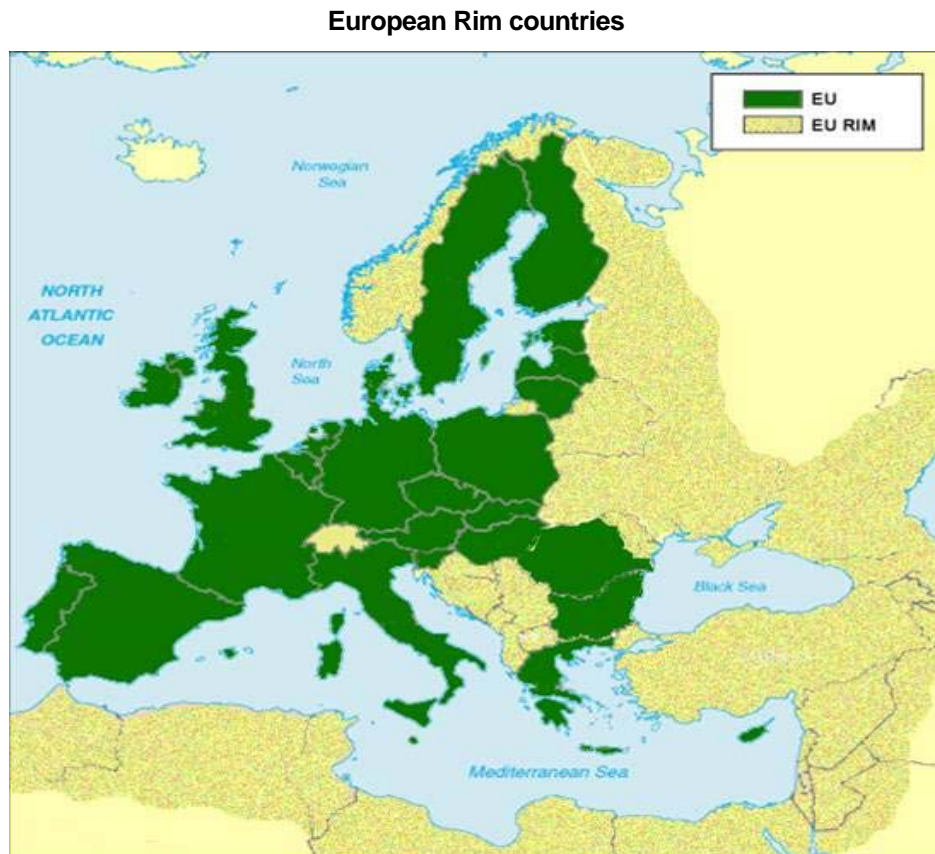
The ENP has frequently been criticized as ineffective in promoting democracy in most countries around the EU and as a weak institutional anchor to support market-oriented reforms (Havrylyshyn, 2008). Even the EU trade policies over the past decade have had many pitfalls. This criticism became even more pronounced after the Arab Spring, and a number of improvements were suggested (Grant, 2011; Emerson, 2011a; van Elsuwege, 2011; Ülgen, 2011; Ghoneim, 2011; Ghilès, 2011b etc.). Indeed, the recent events in the Southern Mediterranean underlined the need for 'a new response to a changing neighbourhood'. The High Representative of the EU, Baroness Ashton, formulated this new response in the joint communication to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions in May

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<sup>1</sup> The authors wish to thank Beate Muck, Renate Prasch, Barbara Swierczek and Galina Vasaros (all wiiw) for statistical assistance.

2011 (European Commission, 2011b). The new approach aims to provide greater support to partners in building democracy, inclusive economic development and to strengthen the two regional dimensions of the ENP – the Eastern Partnership and the Southern Mediterranean. It outlines in more detail the main principles of how to develop partnerships with each neighbour that would lead to economic integration in the single market (see European Union, 2011, COM(2011)303).

Map I.1



Source: <http://www.erpic.eu/>

Because of the special connotation of the term ‘European Neighbourhood’ in the EU and its diversity, this study instead uses the term ‘European Rim’ (or just ‘Rim’ – see Map I.1) for the countries covered.<sup>2</sup> Following a mapping of the economic situation and competitiveness of each neighbouring country, the study proceeds to an analysis of the following aspects of importance to the competitiveness of EU firms and sectors:

<sup>2</sup> We borrow the term ‘European Rim’ from ERPIC (The European Rim Policy and Investment Council – see [www.erpic.eu](http://www.erpic.eu)). However, the country coverage in our definition of the ‘European Rim’ – in line with the study specification in the terms of reference drafted by DG ENTR – is different. European Rim countries covered by the present study are: Norway, Switzerland, Liechtenstein (EFTA); Russia (Strategic Partner); Ukraine, Belarus, Moldova, Armenia, Azerbaijan, Georgia (Eastern Partnership Countries); Albania, Bosnia-Herzegovina, Kosovo (under UN Security Council Resolution 1244), Serbia (Western Balkan countries); Syria, Jordan, Palestinian Authority, Lebanon, Israel (Middle East); Egypt, Libya, Tunisia, Algeria, Morocco (North Africa). Turkey and Southeast European candidate countries are not covered.

- The economic importance of institutional arrangements and instruments for cooperation between the EU and its Rim (e.g. ENP, EEA, Free Trade Agreements, Strategic Partnership), as well as any shortcomings in existing institutional arrangements and instruments; their causes will be identified and possible solutions presented.
- The economic impacts of existing agreements between EU Member States and Rim countries, including in terms of foreign direct investment (FDI) and trade flows. Moreover, trade similarities and complementarities between the EU and the Rim countries are investigated and put in the context of trade agreements. A simulation of a scenario assuming free trade in goods between the EU and some of its neighbours is attempted.
- Where possible, the effects of bilateral agreements on the growth and productivity of small and medium-sized enterprises (SMEs) in the Rim countries are investigated. Results of this analysis are constrained by data availability, varying definitions and data quality.
- The economic and competitiveness impact of migration between Rim countries and EU Member States is investigated, as is the situation on the labour market.
- On the basis of the analysis, conclusions are drawn and policy recommendations made regarding the challenges and opportunities for the competitiveness of EU enterprises and sectors in the Rim countries (and groups thereof).

## II. Mapping the economic situation and competitiveness of European Rim countries

Countries belonging to the 'European Rim', as defined in this study, differ greatly. In economic terms, most of them are small (except Egypt, Russia and Ukraine) and have less developed, emerging economies (apart from the members of EFTA/EEA: Norway, Switzerland and Liechtenstein, which are all among the most affluent countries in the world, and Israel, which has GDP per capita at purchasing power parity (PPP) close to the EU average – see Table II.1). On the other hand, a number of Eastern Partnership countries (e.g. Armenia, Georgia, Moldova), as well as several Middle East and North Africa (MENA) countries (e.g. Morocco, Jordan and Syria), are rather poor, with estimated GDP per capita at PPP amounting to less than 20% of the EU average (Table II.1). However, in terms of population the total of the 'Rim' countries is close to the EU (87% of the EU: 435 million and 501 million inhabitants, respectively), while in terms of total GDP at exchange rates their overall economy is rather small (23% of the EU's: EUR 2,790 billion and 12,260 billion, respectively – all figures are estimates for the year 2010, Table II.1). Even at PPPs, the estimated aggregate GDP of the Rim countries represents just about a third of the EU's – still a potentially huge market, especially when its growth potential is taken into account.<sup>3</sup>

The above wide-ranging diversity in economic characteristics notwithstanding, one has to add that the European Rim is dominated by large countries: Russia and Ukraine in the Eastern part of the Rim; Egypt in the Southern Mediterranean. The economic size of the Rim would be much smaller without these three big countries – together they account for more than half of the Rim's population and for about half of its GDP. On the other hand, there are a number of small countries – especially in the Eastern part of the Rim (Armenia, Georgia, Moldova, Albania, Bosnia-Herzegovina (BiH) and Kosovo) – which all have less than 5 million inhabitants. In the South, only Lebanon and the Palestinian Authority are among the small countries according to this yardstick (Norway and, of course, Liechtenstein are also small, though in terms of GDP Norway has the third largest economy in the Rim – after Russia and Switzerland).

From the structural point of view, the majority of Rim countries are service-based economies. Industry (gross value added) accounts for more than 50% of GDP only in energy-exporting countries: Azerbaijan (52%), Algeria (55%) and Libya (78% – see Figure II.1; country codes are listed in Table II.1).<sup>4</sup> On the other hand, the majority of Rim countries

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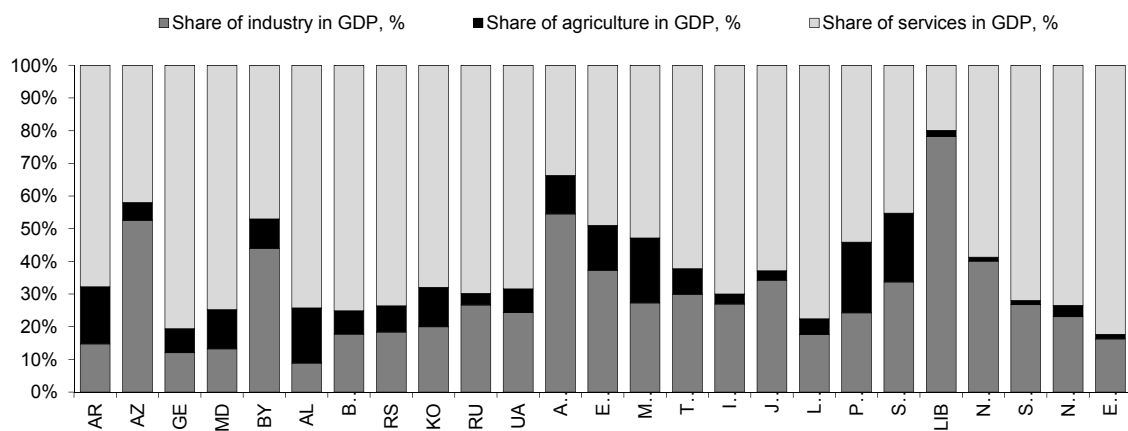
<sup>3</sup> The latest forecast of GDP growth rates shows the majority of Rim countries above 3%, much higher than in the EU – see IMF, WEO Update, April 2012. A comprehensive overview of the Neighbourhood region covering the Mediterranean and Eastern neighbours (but neither the Southeast European countries of Albania, BiH, Serbia and Kosovo, nor Norway, Switzerland and Liechtenstein) was published recently (November 2011) in European Economy (2011). Apart from short individual country reports and the overview of macroeconomic developments, that study also addresses issues of economic governance, investment climate, exchange rate policies and external competitiveness. As far as Norway is concerned, a comprehensive and critical review of country's economic links with the EU ('A review of the European Economic Area agreements') was published in January 2012 (Outside and Inside, 2012).

<sup>4</sup> The share of industry in Norway is also fairly high – more than 40% of GDP. For a comparison, in the EU, industry accounts on average for less than 17% of GDP; in the new EU Member States (NMS) – for 23% of GDP.

have a relatively large agricultural sector; only Israel, Libya, Norway and Switzerland have an agricultural sector which in size (in terms of its value-added share in GDP) is comparable to the EU average. Very large agricultural sectors (more than 15% of GDP, compared to the EU average of just 1.5% of GDP) exist in Armenia, Albania, Morocco, Palestine and Syria. However, neither a large services sector nor, for that matter, a small agricultural sector indicates unequivocally a country's development level or (industrial) competitiveness. On the contrary: a number of very poor Rim countries (Georgia, BiH, Moldova, Albania, etc.) report very high shares of services, yet still they are very poor (in terms of GDP per capita at PPP – Figure II.2).

Figure II.1

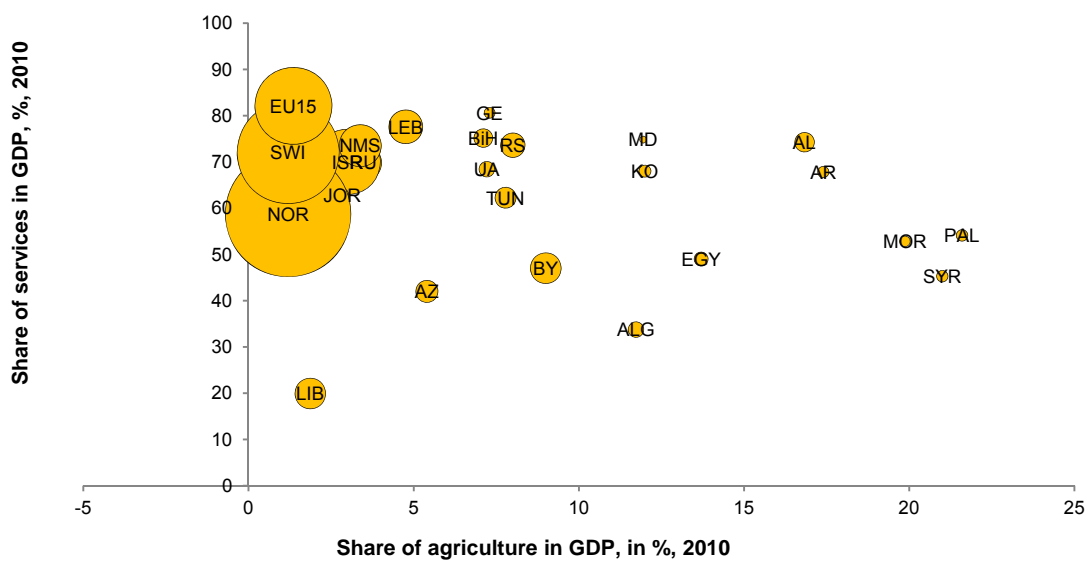
### Share of key economic sectors in GDP, 2010



Source: Table II.1.

Figure II.2

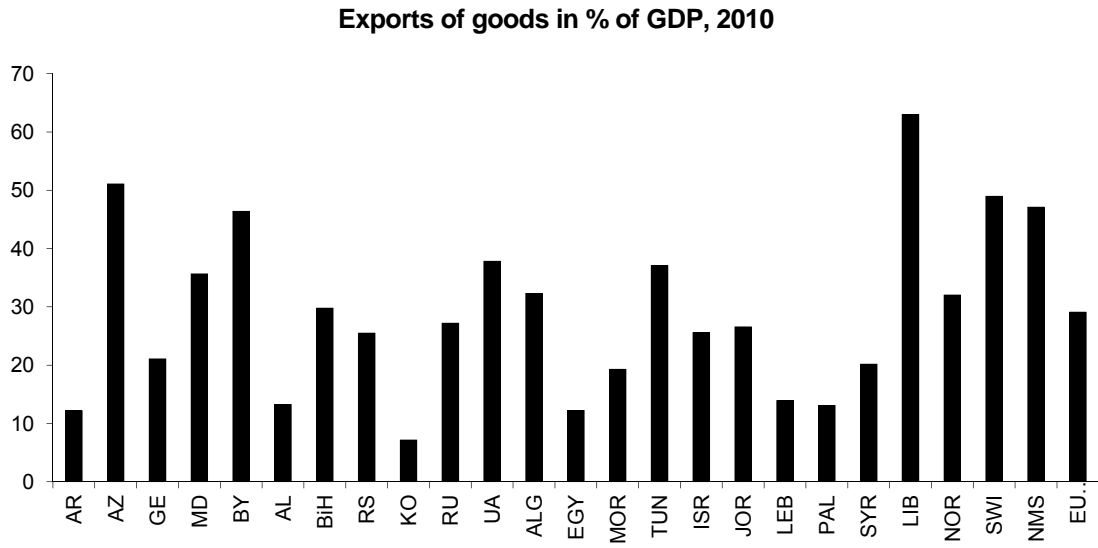
### GDP structure and development level (bubbles are proportional to GDP per capita at PPP, EUR), 2010



Source: Table II.1.

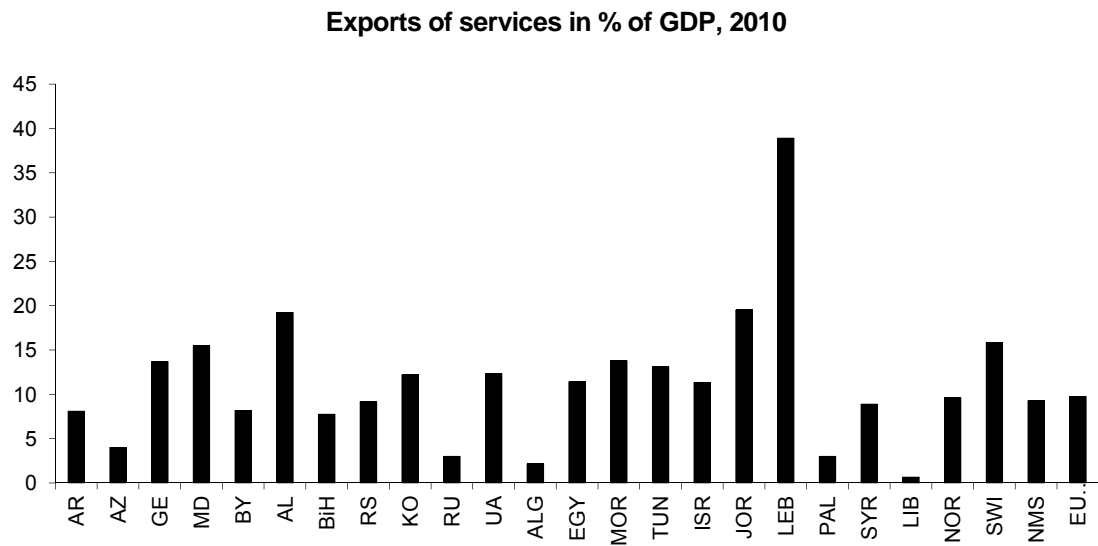


Figure II.3



Source: Table II.1.

Figure II.4



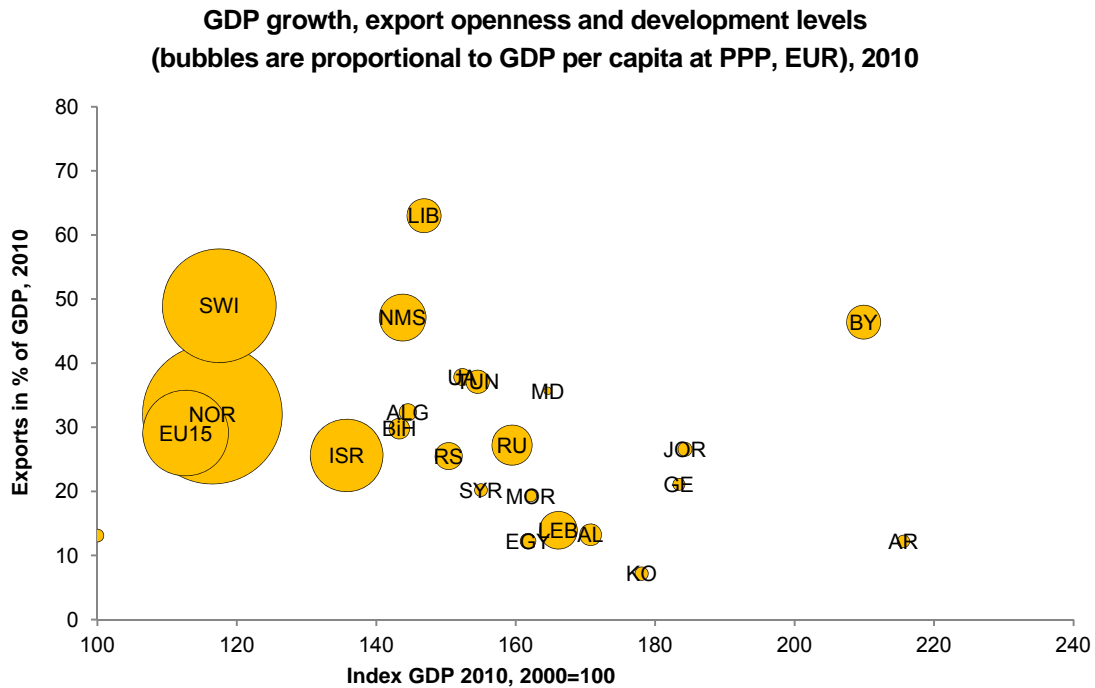
Source: Table II.1.

The majority of Rim countries do not have very open economies either (in terms of goods export shares in GDP) and, from that point of view, are therefore not very competitive. Compared to the EU average (including intra-EU trade the share of goods exports in the EU's GDP is around 30%), trade openness is higher only in Azerbaijan, Moldova, Belarus, Ukraine, Algeria, Tunisia and Libya (as well as Norway and Switzerland – see Figure II.3). Regarding trade openness, only Azerbaijan, Belarus, Libya and Switzerland are comparable to the new EU Member States (Azerbaijan and Libya are energy exporters). At the same time, many Rim countries specialize in service exports: in many Rim countries the share of service exports in GDP is bigger than in the EU (where it is less than 10% of GDP on average – Figure II.4). The Rim's service exports represent a mix of transport, tourism

and financial services. The last mentioned is important in Lebanon and Switzerland, whereas tourism plays an important role in a number of Southern Rim countries (Egypt, Morocco and Tunisia). Transport services are fairly important in Georgia and Ukraine (oil and gas pipelines).<sup>5</sup>

In any case, more rapid GDP or industrial growth has not necessarily been associated with high export openness: in a number of Rim countries, relatively fast GDP growth in the past decade (2000–2010) occurred without particularly high export openness. The cluster of medium- and less-developed Rim countries – that is essentially all Rim countries bar Norway, Switzerland and Israel – recorded cumulative GDP growth of 40–80% during 2000–2010 (3.5–6% per annum on average) with less than a one-third export share in GDP (Figure II.5). In contrast to most new EU Member States and emerging markets, Rim countries’ economic catching-up (if any) resulted not from export-led growth but from booming domestic demand, frequently financed from transfers (Armenia, Georgia, Kosovo). A similarly inconclusive association between export openness and the growth of industry in the past decade is illustrated in Figure II.6.<sup>6</sup>

Figure II.5



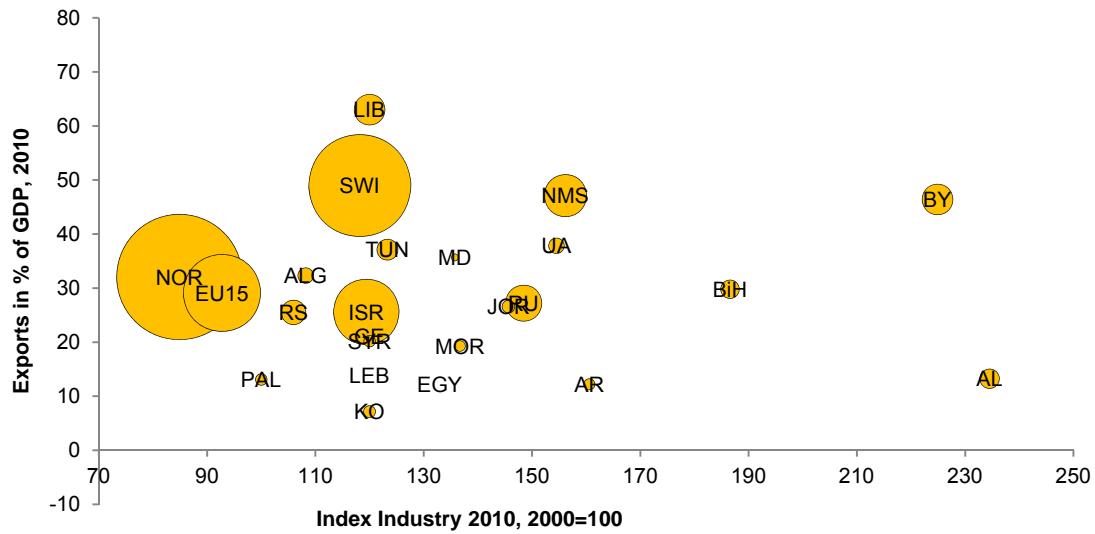
Source: Table II.1.

<sup>5</sup> Unfortunately, more detailed and comparable data on the composition of service exports for a number of Rim countries are missing. In particular, it is not clear how to explain relatively high service exports in Moldova, Albania and Jordan. For a more detailed analysis of tourism in MENA, see Lanquar (2011).

<sup>6</sup> The association between export openness and economic growth is even weaker over the longer term (i.e. 1990–2010). For additional arguments related to a low export competitiveness of MENA countries, see Malik and Awadallah (2011); for more details on trade see Section III.

Figure II.6

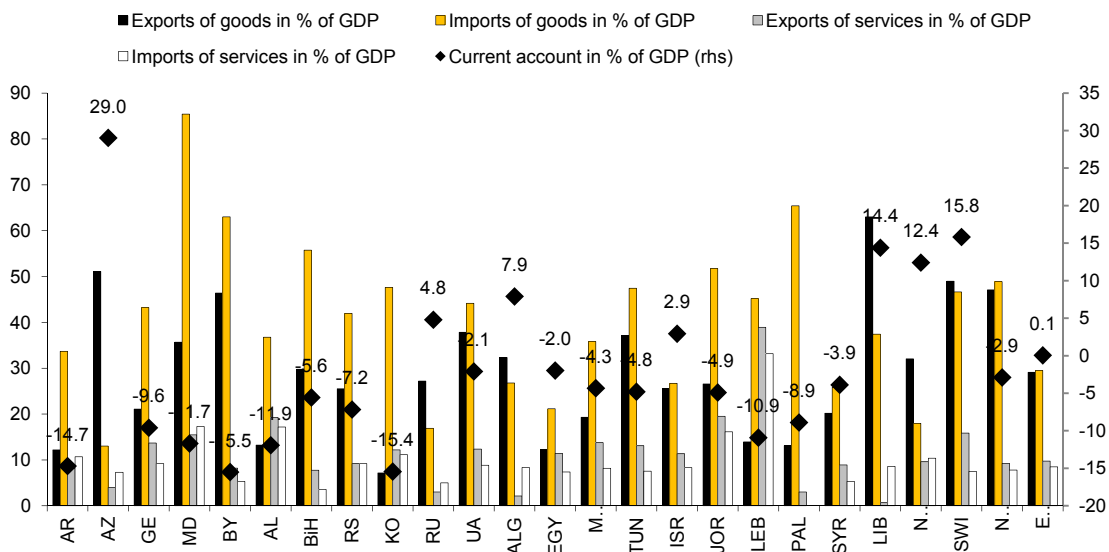
**Industry growth, export openness and development levels  
(bubbles are proportional to GDP per capita at PPP, EUR), 2010**



Source: Table II.1.

Figure II.7

**Components of the current account, in % of GDP, 2010**



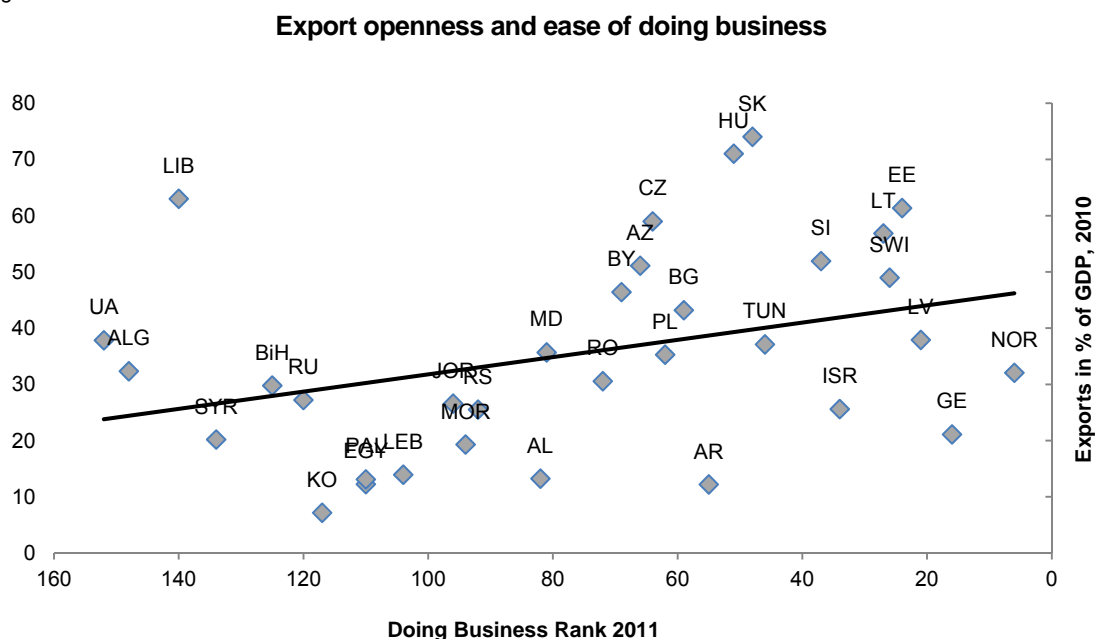
Source: Table II.1.

The common feature of the Rim countries is a fairly high external imbalance: energy exporters (Azerbaijan, Russia, Algeria, Libya and Norway) record huge trade and current account surpluses (close to 30% of GDP in the case of Azerbaijan), whereas the majority of resource-poor Rim countries report high or even very high (and probably unsustainable) external deficits (Armenia, Georgia, Albania, Kosovo, Lebanon and Palestine – Figure II.7).

Large current account surpluses may result in an upward pressure on the exchange rate and lead to a ‘Dutch Disease’ syndrome, with adverse consequences for export competitiveness (of the non-oil sector).<sup>7</sup> The recent experience of Southeast Europe (including Greece, Portugal and Spain) illustrates that countries which failed to build up a viable export sector have been particularly vulnerable to the effects of the global crisis and will have to adjust their economic policies accordingly (Gligorov et al., 2012).

Turning to trade with the EU, the first fact to be mentioned is that the Rim countries are relatively minor EU trading partners: less than 10% of total EU exports and less than 11% of total EU imports were traded with the Rim countries in 2010. Taking out Russia, Norway and Switzerland (which together account for 6.5% of EU total exports and 7.8% of EU total imports) the trade importance of the ‘rest of the Rim’ for the EU is even smaller. Even without intra-EU trade (which accounts for 65% of total EU exports and 62% of total imports), the importance of external trade with the whole Rim would not be overwhelming (27% of extra-EU exports and 29% of imports – for details, see Section III, and in particular Table III.2.1a and III.2.1b). But the EU is a trading giant and there is a huge asymmetry in the importance of EU–Rim trade: for the majority of Rim countries, the EU represents by far the most important export and import partner. This is valid especially for the Eastern part of the Rim (with the possible exception of Georgia), as well as for Jordan and Palestine in the Southern Mediterranean. Distinct EU–Rim geographical trading patterns exist at the sub-regional level as well (the Eastern EU trades more with Russia and Eastern Partnership countries; the Southern EU more with North Africa – see Section III for details).

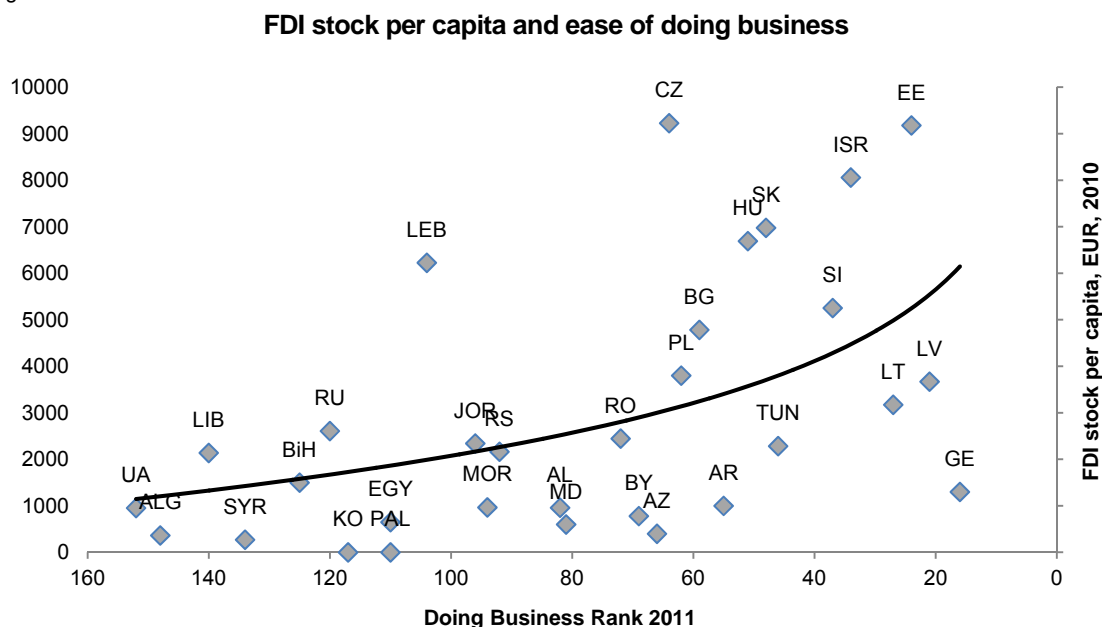
Figure II.8



Source: Table II.1.

<sup>7</sup> See, for example, Magud and Sosa (2010).

Figure II.9



Source: Table II.1.

The above trade asymmetry also has important consequences for the Rim's competitiveness: in general, any EU policy or measure that affects trade relations with the Rim countries has a disproportionately greater impact on the latter, since, for those countries, trade with the EU represents a much stronger transmission channel due to its greater macro-economic and structural importance. Thus, for example, any preferential or free trade agreement (FTA) with a particular Rim country has potentially a much bigger impact on the latter than on the EU. This is also valid for individual EU Member States, which may have a greater than average intensity of trading links with a particular Rim country (e.g. Poland–Ukraine, France–Egypt, Portugal–Morocco, etc.) or a particular sector (with the possible exception of energy).<sup>8</sup>

Likewise, from the EU's point of view, assessment of the competitiveness of Rim countries depends, *inter alia*, on their investment climate and other conditions for doing business and trade. Again, the Rim countries differ widely in these respects. According to the latest World Bank Doing Business ranking (for 2011), the majority of Rim countries do not score particularly well (in the majority of cases they score worse than EU countries).<sup>9</sup> Figure II.8 shows the overall Ease of Doing Business ranking of individual Rim countries, together with rankings of the new EU Member States, and their export openness (measured as the share of exports in GDP). Norway, Georgia, the Baltic States, Switzerland and Israel score highest, whereas Russia, BiH, Syria, Libya, Algeria and Ukraine have the worst conditions

<sup>8</sup> For more details on the regional trade specialization and effects of trade agreements, see Section III below.

<sup>9</sup> However, a number of new EU Member States, as well as Italy (rank 87) and Greece (rank 100), do not score particularly well either – see Doing Business 2012 (<http://www.enterprisesurveys.org>).

for doing business. As expected, there is a correlation, albeit weak, between export openness and the Ease of Doing Business ranking: as a rule, greater export openness is associated with better (lower score) business ranking (Figure II.8).<sup>10</sup> Not surprisingly, a better ranking in Doing Business indicators is also associated with higher FDI stock per capita (even after excluding Norway and Switzerland, which are again outliers with respect to both indicators, in particular regarding the accumulated per capita FDI stock – see Table II.1). In general, Eastern European and Central Asian countries not only rank better than MENA in terms of FDI stocks, but have recently been doing better than the Middle East and North Africa in the Ease of Doing Business rankings as well. However, according to the latest survey, both regions lag in this respect behind both the high-income OECD countries (which have an average score 30) and the EU average (average score 37).<sup>11</sup> Compared to 84% of Eastern European and Central Asian countries which, in 2009/2010, implemented at least one reform to make it easier to do business, only 50% of countries in the Arab world undertook a similar reform. Morocco, Moldova and Armenia are among the countries that improved ease of doing business most across several areas of regulation. SMEs that ‘benefit most from these improvements are the key engines for job creation’, according to the World Bank (2011g).

Apart from overall rankings, the World Bank’s Enterprise Surveys provide a large number of additional detailed results that are relevant for the assessment of business environment and competitiveness – in particular of SMEs.<sup>12</sup> These indicators evaluate several areas that are relevant for entrepreneurship and competitiveness of firms (such as regulations and taxes, access to finance, corruption, crime, infrastructure, various characteristics of firms and labour, innovation and technology, etc. – see [www.enterprisesurveys.org](http://www.enterprisesurveys.org) for definitions of indicators and other details). In each country covered by the surveys, several hundred firms – usually domestically owned SMEs operating in the non-agricultural, formal private economy – are surveyed. The latest available results (as of March 2012) refer mostly to surveys conducted in 2009.<sup>13</sup> Figures II.10–II.16 provide a selection and evaluation of the detailed survey results for the Rim countries that are relevant for an assessment of competitiveness of firms (in particular SMEs) operating in the Rim region.

First, Figure II.10 lists the eight biggest obstacles to ease of doing business in the Rim (out of 15 obstacles surveyed), as identified by respondents (firm owners or managers) in indi-

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<sup>10</sup> In general, there is a robust positive relationship between economic performance and trade openness – see, for example, Lim and Saborowski (2012).

<sup>11</sup> See *Doing Business in South East Europe* (2011); *Doing Business in the Arab World* (2011).

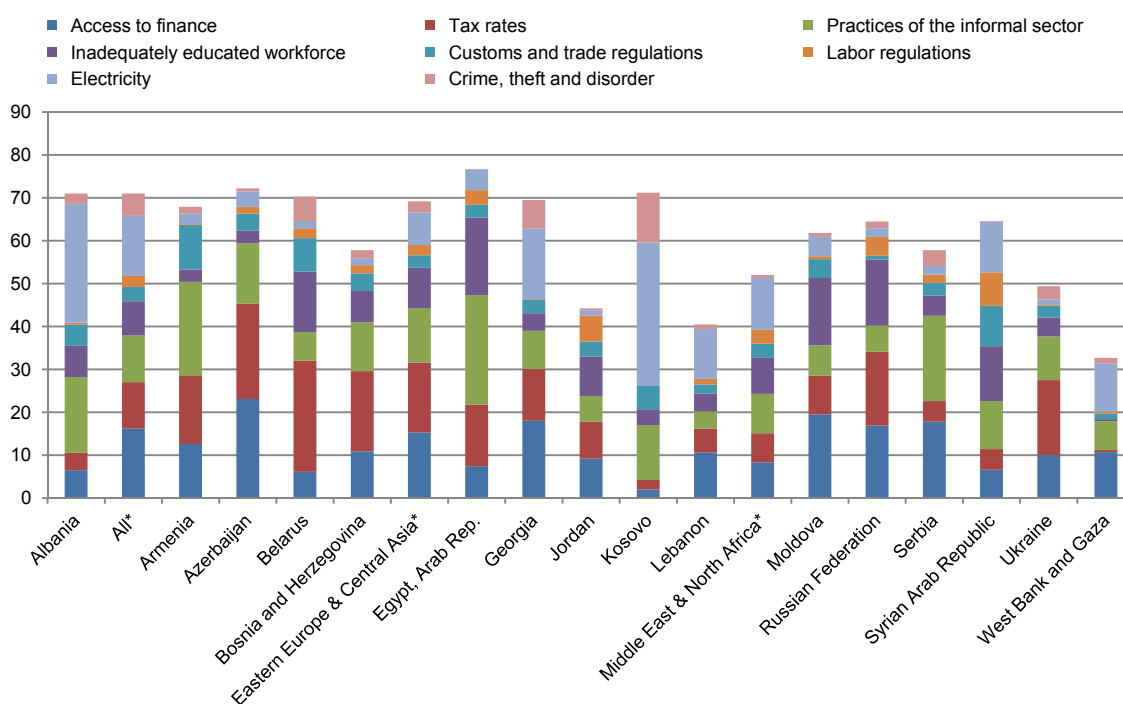
<sup>12</sup> SMEs employ 25% of the labour force in the Southern Mediterranean (European Parliament, 2012). For a recent study employing business survey indicators in the analysis of firms’ performance in the case of Morocco see Augier et al. (2012).

<sup>13</sup> Unfortunately, detailed survey data are not available for Tunisia, Israel, Libya, Norway and Switzerland. However, all new EU Member States are covered (data for 2009), from the ‘old’ EU Member States only Ireland, Germany, Greece, Portugal and Spain (all data for 2005) are available – see <http://www.enterprisesurveys.org>, World Bank.

vidual Rim countries. These eight 'biggest' obstacles account for 60–70% of all obstacles surveyed in most Rim countries covered (except for Jordan, Lebanon, Ukraine, the West Bank and Gaza).<sup>14</sup> Access to finance, tax rates, practices of the informal sector and disruption to electricity were among the most frequently mentioned general business obstacles – especially in the Eastern part of the Rim.<sup>15</sup>

Figure II.10

**Biggest obstacles to ease of doing business, 2009 (% of firms surveyed)**



Note: \*\* indicate group average.

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), World Bank.

Looking in more detail at individual key business obstacles, access to finance was a constraint to doing business that was more frequently mentioned by firms from MENA than by those in Eastern Europe and Central Asia (35% of MENA respondents, compared to 25% – see Figure II.11). This obstacle was particularly formidable in Algeria (in 2007), Syria and the West Bank and Gaza (in 2006). Perhaps surprisingly, this constraint was not felt to be that strong in the Eastern part of the Rim – even at the peak of the financial crisis (2009). Still, the bulk of investment in most Rim countries was financed internally; in the Eastern

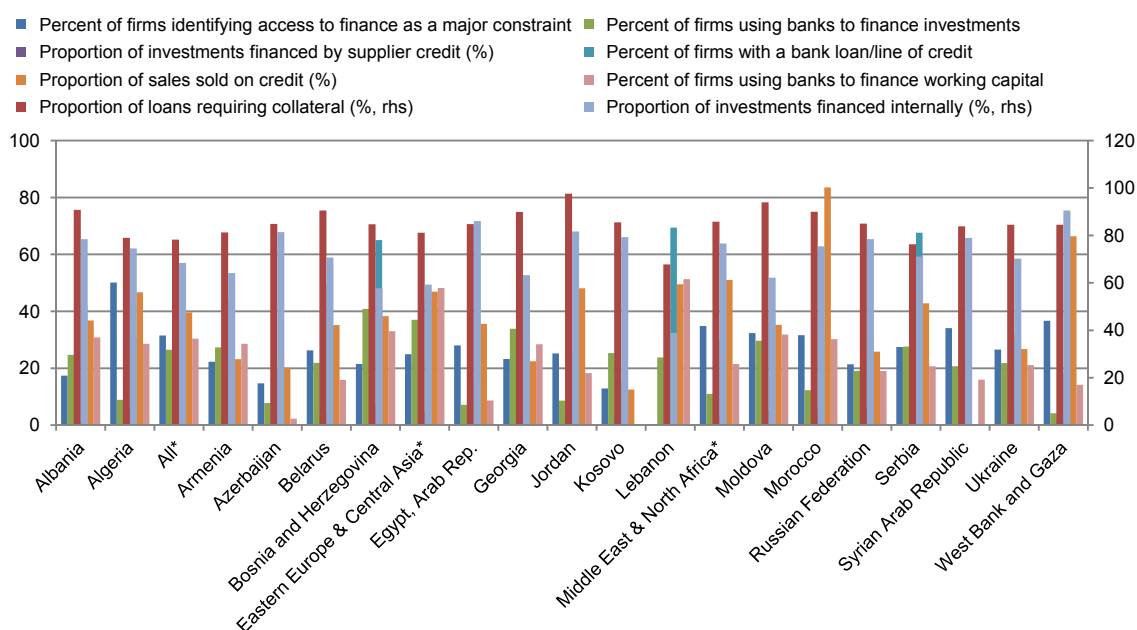
<sup>14</sup> The remaining being access to land, business licensing and permits, corruption, courts, political instability and transport infrastructure.

<sup>15</sup> In addition, in Bosnia-Herzegovina, Lebanon and Ukraine political instability was seen as the key obstacle in 2009. However, we can assume that the political instability and related business obstacles increased in most Southern Rim countries after the Arab Spring (whereas it may have improved in Ukraine since) – as evidenced, for example, by the recently declining FDI inflows – see Section IV below. In the West Bank and Gaza, transport infrastructure is mentioned as an obstacle by 11% of firms.

Rim countries, banks were used in less than half the instances of investment financing, and the figure was even lower in the MENA region.<sup>16</sup> In most Rim countries, the banks require collateral before providing a loan; such collateral must usually cover about 80% of the loan extended. Financial intermediation is generally underdeveloped in the Rim countries – as evidenced, for example, by a relatively low percentage of firms that operate with a bank loan or a credit line. Lending practices thus pose a serious obstacle to doing business and to competitiveness in the Rim – a fact that is particularly relevant for the development of SMEs (see also Akhtar and Pearce, 2010; Alvarez de la Campa, 2011).

Figure II.11

### Ease of doing business: Finance, 2009



Note: \* indicate group average.

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), World Bank.

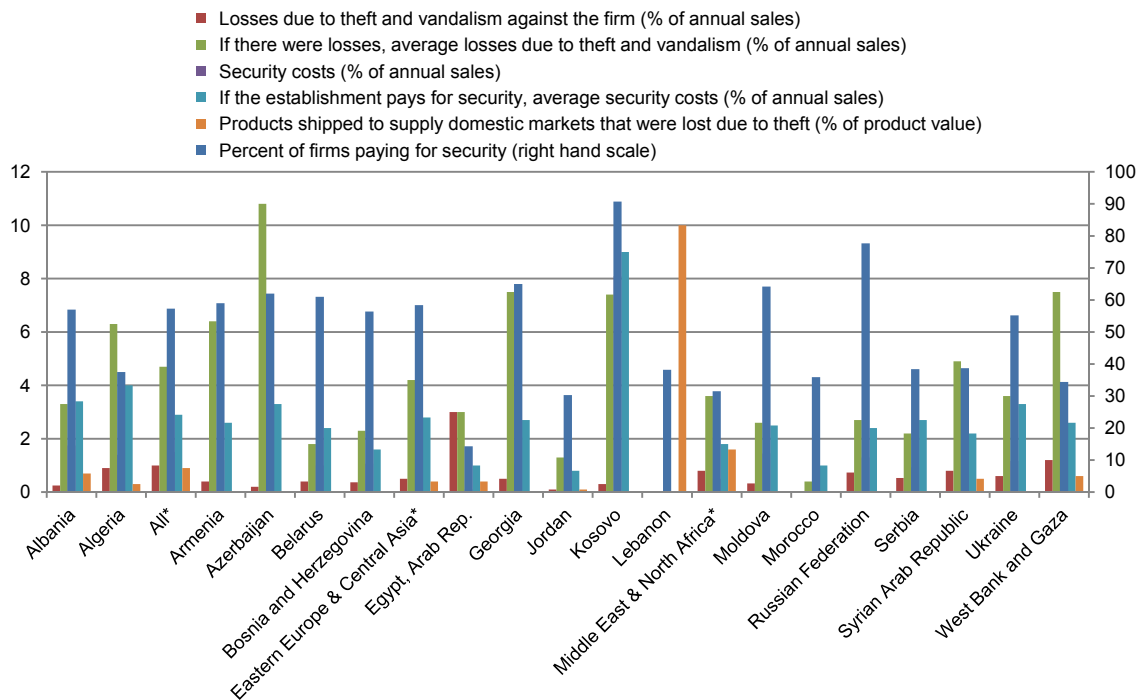
The practices of the informal sector (corruption) and crime are frequently mentioned as important business obstacles, especially in the Eastern part of the Rim. Figures II.12 and II.13 look in more detail at these obstacles. Strikingly, the majority (57%) of firms in the Rim pay for security, and in a number of Eastern Rim and Western Balkan countries (Albania, Azerbaijan, Belarus, Georgia, Kosovo, Moldova and Russia), the security costs and the associated losses are particularly high (Figure II.12). Related to crime, widespread corruption represents another serious obstacle to business. Corruption is more common in the Southern part of the Rim (Algeria, Egypt, Syria), which is in line with findings regarding the reasons behind the recent Arab Spring revolutions (Ghoneim, 2011). A large proportion of firms in the MENA region are confronted with corrupt practices, whether to obtain an import licence, a construction permit, an electricity connection or a government contract (Figure II.13).

<sup>16</sup> In MENA countries, 'Islamic finance' has been growing rapidly recently – see Mohieldin (2012).



Figure II.12

### Ease of doing business: Crime, 2009

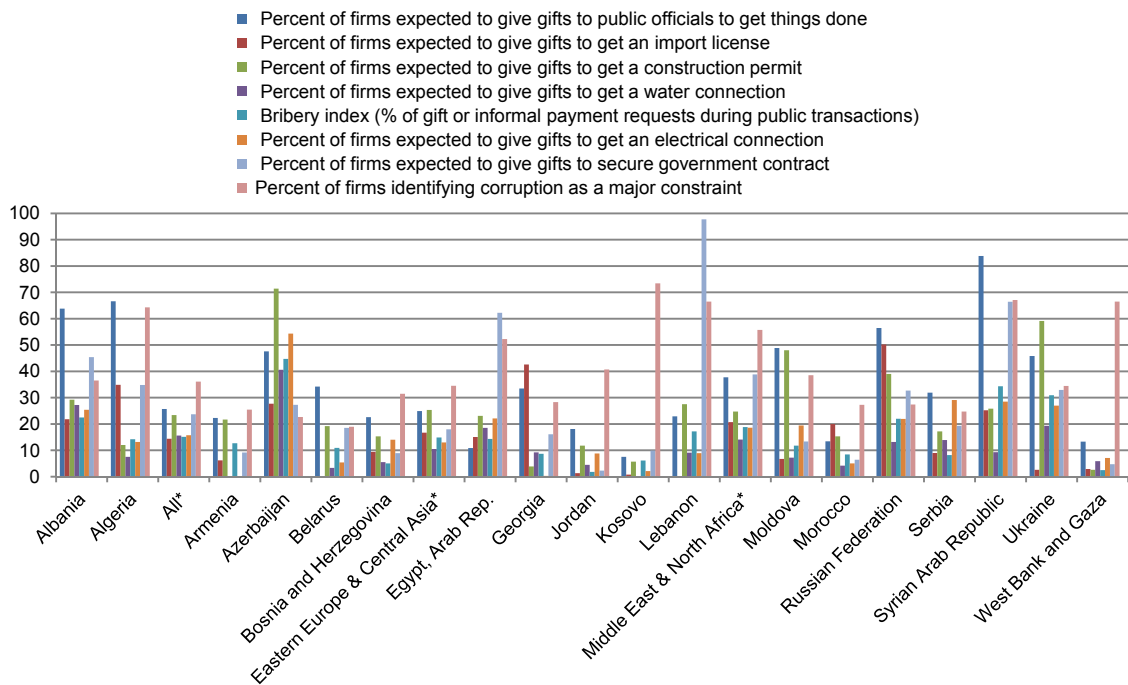


Note: \*\* indicate group average.

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), World Bank.

Figure II.13

### Ease of doing business: Corruption, 2009

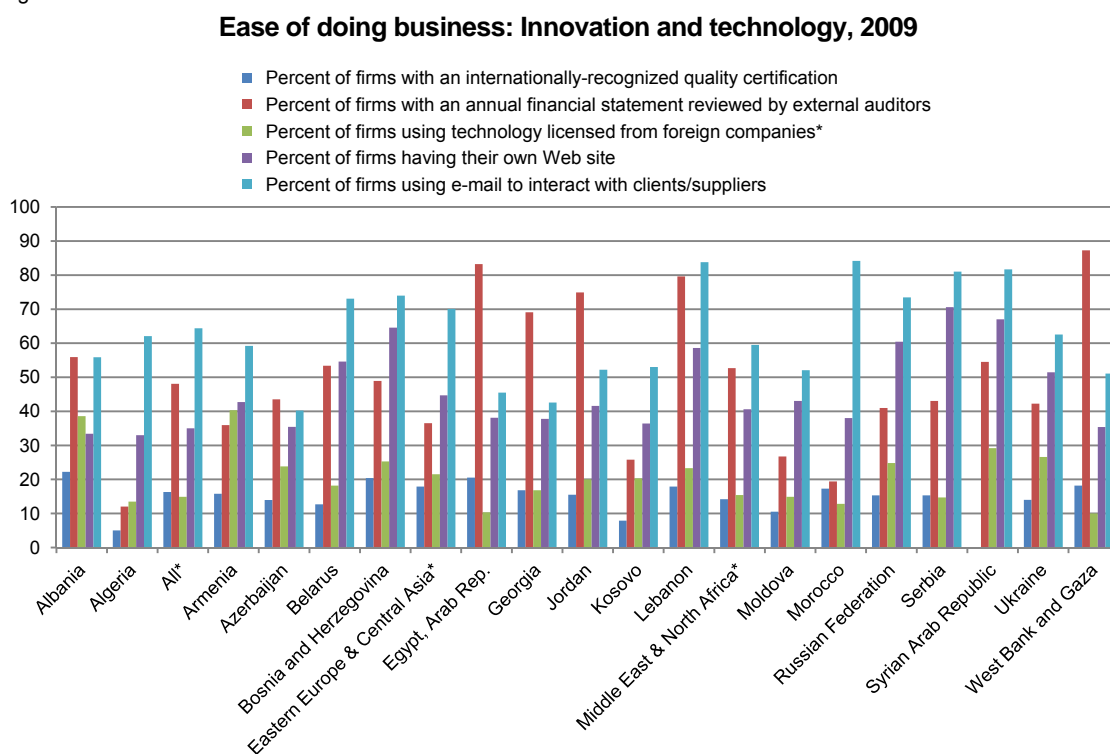


Note: \*\* indicate group average.

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), World Bank.

How innovative and technologically advanced are firms in the Rim region? Survey results exploring these issues are summarized in Figure II.14. Whereas only a minor proportion of Rim firms possess an internationally recognized quality certificate (just about 16%, though one has to take into account that mostly domestically owned and domestically operating SMEs that are covered by the sample do not require such a certificate), a relatively high proportion use internet and have their own email address (slightly more in the Eastern part of the Rim than in MENA). A relatively high percentage of firms employ external auditors (especially in Georgia, Egypt, Jordan, Lebanon and the West Bank – often countries where corruption was identified as a major obstacle). In contrast, only a small percentage of firms use technology licensed from abroad. Again, there are relatively more such firms in Eastern Europe than in the MENA region, indicating a relative backwardness and lower competitiveness of firms in the latter region.

Figure II.14



Note: \* indicate group average.

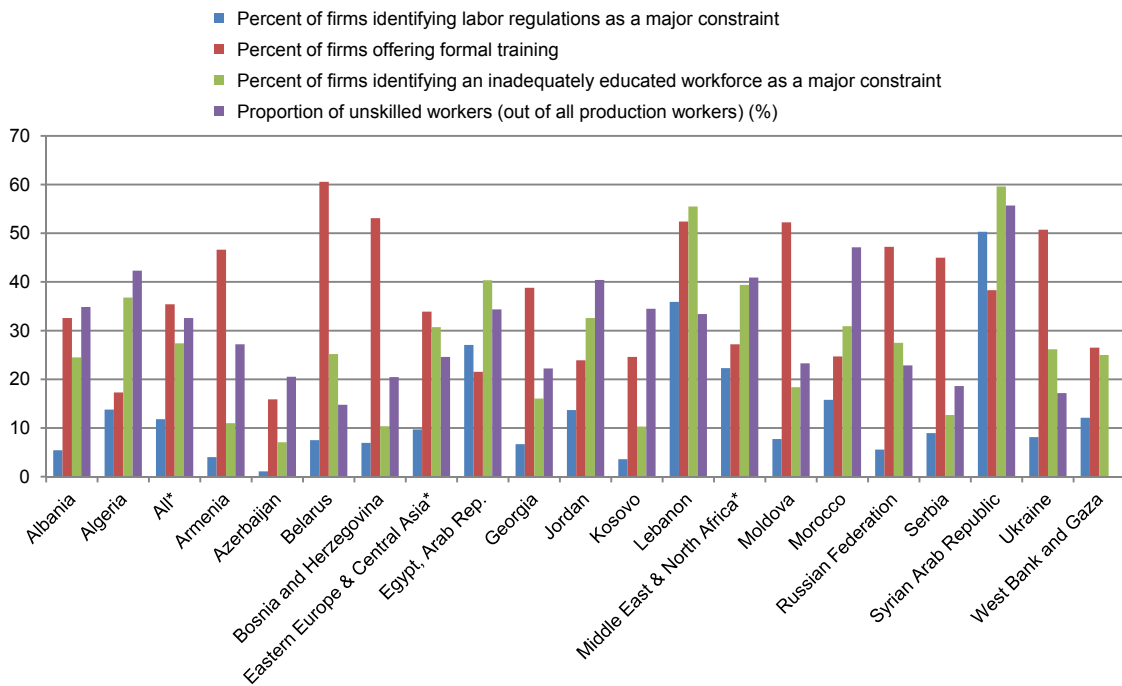
Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), World Bank.

Last but not least, Figure II.15 shows some characteristics of the labour market and workforce in the Rim (see Section VI for details). As already mentioned above, labour regulations are not perceived to be a major constraint by the majority of firms, especially in the more ‘liberal’ Eastern part of the Rim, in contrast to ‘more regulated’ pre-revolutionary Egypt and Syria. An inadequately educated workforce is perceived to be a constraint by a substantial percentage of firms in the MENA region, in particular in Algeria, Egypt, Lebanon and Syria. In the Eastern part of the Rim, lack of education is regarded much less as a

constraint; the firms in these countries also employ fewer unskilled workers and – most important for competitiveness – a higher proportion of Eastern firms offer their workers formal training (e.g. 46% of firms in Armenia, 61% in Belarus and about 50% in Moldova, Russia and Ukraine). The fairly high qualifications of the labour force – one of the few positive inheritances from the previous system – also represents one of the key competitive advantages of firms in the Eastern part of the Rim, despite worsening quality of education since the end of the Soviet Union (OECD, 2011).

Figure II.15

**Ease of doing business: Labour market and workforce, 2009**



Note: \* indicate group average.

Source: Enterprise Surveys (<http://www.enterprisesurveys.org>), World Bank.

Table II.1

## European Rim (neighbourhood) countries: an overview of economic fundamentals, 2010

	Armenia AR	Azerbaijan AZ	Georgia GE	Moldova MD	Belarus BY	Albania AL	Bosnia and Herzegovina BiH	Serbia RS	Kosovo KO	Russia RU	Ukraine UA	NMS-10 <sup>1)</sup>	EU-15	EU-27 <sup>2)</sup>
GDP in EUR at exchange rates, EUR bn	7.06	39.22	8.79	4.46	41.27	8.85	12.52	29.02	4.26	1115.05	103.92	919.8	11314.1	12257.5
GDP in EUR at PPP, EUR bn	12.85	69.31	17.11	8.40	101.45	21.70	24.91	62.34	9.31	1807.74	248.82	1502.1	10729.6	12257.5
GDP in EUR at PPP, EU-27=100	0.10	0.57	0.14	0.07	0.83	0.18	0.20	0.51	0.08	14.75	2.03	12.25	87.54	100.00
GDP in EUR at PPP, per capita	3900	7700	3800	2400	10700	6800	6500	8500	4200	12600	5400	14700	26900	24400
GDP in EUR at PPP per capita, EU-27=100	16	32	16	10	44	28	27	35	17	52	22	60	110	100
GDP at constant prices, 1990=100	146.2	237.0	68.8	57.2	107.6	197.0	.	.	.	107.2	65.8	160.8	140.1	143.1
GDP at constant prices, 2000=100	215.6	402.5	183.4	164.6	203.9	170.8	143.3	150.4	178.1	159.5	152.4	143.8	112.7	115.8
Industrial production real, 2000=100	160.6	326.1	130.0	135.8	224.9	234.5	186.6	106.0	120.0	148.5	154.5	156.2	92.7	102.6
Share of industry in GDP, %	14.8	52.6	12.1	13.2	44	8.9	17.8	18.4	20	26.7	24.4	23.1	16.3	16.8
Share of agriculture in GDP, %	17.4	5.4	7.3	11.9	9	16.8	7.1	8.0	12	3.5	7.2	3.4	1.4	1.5
Share of services in GDP, %	67.8	42.0	80.6	74.8	47.0	74.3	75.1	73.6	68.0	69.8	68.4	73.5	82.4	81.7
Population – thousands, average	3255	9047	4453	3562	9481	3210	3843	7300	2210	142938	45871	102021	398230	501465
Population 1990=100	90.0	124	81	92	94	99.9	.	.	.	96.6	88.4			
Population 2000=100	101	113	100	98	94.9	104.9	101.6	97.1	.	97.5	93.3			
Employed persons – LFS, thousands, average	1104	4329	1628	1143	4666	1100	843	2396	.	69803	20266	43058	172798	216405
Unemployment rate – LFS, in %	7.0	5.6	16.3	7.4	0.7	15.0	27.2	19.2	45	7.5	8.1	9.9	9.6	9.7
General gov. revenue, nat. def., in % of GDP	21.6	27.4	28.2	38.3	42.0	26.6	42.5	39.5	27.7	35.3	29.0	37.8 <sup>3)</sup>	44.6 <sup>3)</sup>	44.1 <sup>3)</sup>
General gov. expenditure, nat. def., in % of GDP	26.5	28.3	26.4	40.8	43.8	29.7	47.0	43.9	29.9	38.9	34.6	44.3 <sup>3)</sup>	51.2 <sup>3)</sup>	50.6 <sup>3)</sup>
General gov. balance, nat. def., in % of GDP	-4.9	-0.9	-4.5	-2.5	-1.8	-3.1	-4.5	-4.4	-2.2	-3.6	-5.9	-6.4 <sup>3)</sup>	-6.6 <sup>3)</sup>	-6.6 <sup>3)</sup>
Public debt, nat. def., in % of GDP	39.4	7.4	36.7	26.3	45.1	61.0	39.1	36.0	6.1	8.6	39.5	47.1 <sup>3)</sup>	82.9 <sup>3)</sup>	80.2 <sup>3)</sup>
Price level, EU-27=100 (PPP/exch. rate)	55	57	51	53	41	41	50	47	46	62	42	61	105	100
Average gross monthly wages, EUR at exchange rate	219	307	258	195	308	246	622	461	.	526	213	898 <sup>4)</sup>	3217 <sup>4)</sup>	2776 <sup>4)</sup>
Average gross monthly wages, EU-27=100	7.9	11.0	9.3	7.0	11.1	8.9	22.4	16.6	.	18.9	7.7	32.3 <sup>4)</sup>	115.9 <sup>4)</sup>	100 <sup>4)</sup>
Exports of goods in % of GDP	12.2	51.1	21.1	35.7	46.4	13.2	29.8	25.5	7.2	27.2	37.8	47.1 <sup>5)</sup>	29.1 <sup>5)</sup>	30.4 <sup>5)</sup>
Imports of goods in % of GDP	33.7	13.0	43.2	85.4	63.0	36.8	55.7	42.0	47.6	16.9	44.2	48.9 <sup>5)</sup>	29.5 <sup>5)</sup>	30.9 <sup>5)</sup>
Exports of services in % of GDP	8.1	4.0	13.7	15.5	8.2	19.2	7.8	9.2	12.2	3.0	12.4	9.3 <sup>5)</sup>	9.8 <sup>5)</sup>	9.7 <sup>5)</sup>
Imports of services in % of GDP	10.7	7.3	9.2	17.3	5.3	17.2	3.6	9.2	11.1	5.0	8.8	7.8 <sup>5)</sup>	8.5 <sup>5)</sup>	8.4 <sup>5)</sup>
Current account in % of GDP	-14.7	29.0	-9.6	-11.7	-15.5	-11.9	-5.6	-7.2	-15.4	4.8	-2.1	-2.9 <sup>5)</sup>	0.1 <sup>5)</sup>	-0.17 <sup>5)</sup>
Trade with the EU														
Exports to the EU (% share of total exports)	49.6	47.6	18.7	51.9	49.1	70.1	54.5	57.3	44.7	52.6	25.4	77.4	63.4	65.0
Imports from the EU (% share of total imports)	23.0	25.3	28.3	43.4	46.2	64.6	45.9	56.0	38.3	41.6	31.4	70.3	60.8	61.9
Share in the EU total exports, in %	0.01	0.06	0.03	0.04	0.17	0.05	0.08	0.19	0.02	2.23	0.45	8.8	56.3	100
Share in the EU total imports, in %	0.01	0.25	0.01	0.02	0.07	0.02	0.05	0.10	0.00	3.92	0.29	8.3	53.7	100
World Bank Doing Business rank 2011	55	66	16	81	69	82	125	92	117	120	152			
Type of institutional arrangement (ENP, PCA, FTA, etc.)	ENP	ENP	ENP	ENP	ENP	SAA	SAA	SAA	.	PCA	ENP			
FDI stock per capita in EUR, 2010	1000	400	1300	600	780	960	1500	2164	.	1750	954	4681	11366	10251

Table II.1 (contd.)

	ALG	EGY	MOR	TUN	ISR	JOR	LEB	PAL	SYR	LIB	NOR	SWI	Year 2009	NMS-10 <sup>1)</sup>	EU-15	EU-27 <sup>2)</sup>
	Algeria	Egypt	Morocco	Tunisia	Israel	Jordan	Lebanon	Palestinian Authority	Syria	Libya	Norway	Switzerland	Liechtenstein			
GDP in EUR at exchange rates, EUR bn	119.00	164.79	68.74	33.40	164.02	19.95	29.60	5.57	44.75	53.81	311.85	398.88	3.46	919.8	11314.1	12257.5
GDP in EUR at PPP, EUR bn	194.14	385.09	117.77	76.89	169.65	27.19	45.93	.	83.08	70.07	213.62	286.50	.	1502.1	10729.6	12257.5
GDP in EUR at PPP, EU-27=100	1.58	3.14	0.96	0.63	1.38	0.22	0.37	.	0.68	0.57	1.74	2.34	.	12.25	87.54	100.00
GDP in EUR at PPP, per capita	5400	4900	3700	7300	22800	4400	11800	.	4000	10700	43700	35600	.	14700	26900	24400
GDP in EUR at PPP per capita, EU-27=100	22	20	15	30	93	18	48	.	16	44	179	146	.	60	110	100
GDP at constant prices, 1990=100	170.0	247.9	204.8	244.9	238.1	292.1	330.8	.	247.5	149.3	167.6	130.6	.	160.8	140.1	143.1
GDP at constant prices, 2000=100	144.5	161.8	162.2	154.5	135.7	184.3	166.1	.	155.0	146.9	116.5	117.5	.	143.8	112.7	115.8
Industrial production real, 2000=100	108.2	132.9	136.7	123.3	119.4	145.6	110.0	106.8	120.0	140.0	84.9	118.2	.	156.2	92.7	102.6
Share of industry in GDP, %	54.5	37.3	27.3	30.0	27.0	34.3	17.7	24.3	33.7	78.2	40.1	26.8	36	23.1	16.3	16.8
Share of agriculture in GDP, %	11.7	13.7	19.9	7.8	3.0	2.8	4.8	21.6	21.0	1.9	1.2	1.2	6	3.4	1.4	1.5
Share of services in GDP, %	33.7	49.0	52.8	62.3	70.0	62.9	77.6	54.1	45.3	19.9	58.7	72.0	58.0	73.5	82.4	81.7
Population – thousands, average	36134	77800	31851	10544	7430	6113	3908	4000	21016	6561	4889	7786	36	102021	398230	501465
Population 1990=100	144.4	151.5	132.5	129.3	164.6	176.3	138.1	.	165.2	150.3	115.0	116.0	.			
Population 2000=100	118.8	122.9	111.9	110.2	122.1	125.9	109.7	.	127.3	122.7	108.6	108.4	.			
Employed persons – LFS, thousands, average	9472	22975	10284	3277	2841	1053	1270	717	4822	.	2501	4281	33	43058	172798	216405
Unemployment rate – LFS, in %	10.0	9.0	9.1	13.0	6.7	12.5	6.4	24.0	8.4	.	3.5	4.6	2.8	9.9	9.6	9.7
General gov. revenue, nat. def., in % of GDP	37.3	25.1	25.5	29.6	40.0	24.8	21.4	26.1	21.8	62.0	56.5	34.8	.	37.8 <sup>3)</sup>	44.6 <sup>3)</sup>	44.1 <sup>3)</sup>
General gov. expenditure, nat. def., in % of GDP	38.5	33.4	29.0	30.9	44.1	30.2	28.7	41.6	26.9	53.4	45.9	34.2	.	44.3 <sup>3)</sup>	51.2 <sup>3)</sup>	50.6 <sup>3)</sup>
General gov. balance, nat. def., in % of GDP	-1.1	-8.3	-3.5	-1.3	-4.1	-5.4	-7.3	-15.5	-5.1	8.7	10.6	0.6	.	-6.4 <sup>3)</sup>	-6.6 <sup>3)</sup>	-6.6 <sup>3)</sup>
Public debt, nat. def., in % of GDP													.	47.1 <sup>3)</sup>	82.9 <sup>3)</sup>	80.2 <sup>3)</sup>
Price level, EU-27=100 (PPP/exch. rate)	61	43	58	43	97	73	64	.	54	77	146	139	.	61	105	100
Average gross monthly wages, EUR at exchange rate	.	.	.	.	.	.	.	.	.	.	5819	5055	4182	898 <sup>4)</sup>	3217 <sup>4)</sup>	2776 <sup>4)</sup>
Average gross monthly wages, EU-27=100	.	.	.	.	.	.	.	.	.	.	209.6	182.1	150.6	32.3 <sup>4)</sup>	115.9 <sup>4)</sup>	100 <sup>4)</sup>
Exports of goods in % of GDP	32.3	12.2	19.3	37.1	25.6	26.6	13.9	13.1	20.2	63.0	32.1	49.0	.	47.1 <sup>5)</sup>	29.1 <sup>5)</sup>	30.4 <sup>5)</sup>
Imports of goods in % of GDP	26.8	21.2	35.8	47.4	26.7	51.7	45.2	65.4	25.8	37.4	18.0	46.6	.	48.9 <sup>5)</sup>	29.5 <sup>5)</sup>	30.9 <sup>5)</sup>
Exports of services in % of GDP	2.1	11.4	13.8	13.1	11.4	19.5	38.9	.	8.9	0.7	9.6	15.8	.	9.3 <sup>5)</sup>	9.8 <sup>5)</sup>	9.7 <sup>5)</sup>
Imports of services in % of GDP	8.4	7.4	8.2	7.6	8.3	16.1	33.2	.	5.3	8.6	10.4	7.5	.	7.8 <sup>5)</sup>	8.5 <sup>5)</sup>	8.4 <sup>5)</sup>
Current account in % of GDP	7.9	-2.0	-4.3	-4.8	2.9	-4.9	-10.9	-8.9	-3.9	14.4	12.4	15.8	.	-2.9 <sup>5)</sup>	0.1 <sup>5)</sup>	-0.17 <sup>5)</sup>
Trade with the EU																
Exports to the EU (% , share of total)	52.0	35.5	59.3	72.1	26.0	4.2	15.3	2.1	35.6	75.7	80.9	58.7	.	77.4	63.4	65.0
Imports from the EU (% , share of total)	52.9	27.1	51.8	57.3	35.0	20.9	36.5	8.1	25.0	48.3	63.3	77.5	.	70.3	60.8	61.9
Share in the EU total exports, in %	0.54	0.19	0.22	0.26	0.31	0.01	0.01	0.00	0.09	0.74	2.04	2.18	.	8.8	56.3	100
Share in the EU total imports, in %	0.41	0.39	0.36	0.29	0.38	0.07	0.12	0.00	0.10	0.18	1.09	2.76	.	8.3	53.7	100
World Bank Doing Business rank 2011	148	110	94	46	34	95	104	131	134		6	26				
Type of institutional arrangement (PCA, FTA, EFTA, etc.)	FTA	FTA	FTA	FTA	FTA	FTA	FTA	FTA	FTA	FTA	EEA	EFTA				
FDI stock per capita in EUR, 2010	364	650	967	2285	8060	2341	6226	.	272	2138	26970	53150		4681	11400	10251

*Notes:* NMS-10: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia. PPP: Purchasing power parity, wiiw estimates for Armenia, Azerbaijan, Belarus, Georgia, Moldova, Albania, Bosnia-Herzegovina, Serbia, Kosovo, Russia, Ukraine.

1) wiiw estimates. 2) wiiw estimates and Eurostat. 3) EU definition: expenditure and revenue according to ESA'95, excessive deficit procedure. 4) Gross wages plus indirect labour costs, according to national account concept. 5) Data for NMS-10, EU-15 and EU-27 include flows within the region.

*Sources:* national statistics, wiiw estimates, Eurostat, AMECO, IMF, UNCTAD and UN Comtrade.

### III. Trade relations between the EU and the European Rim

#### *III.1 Positioning the 'European Rim' countries in global trade*

The countries belonging to the 'European Rim', as defined in this study, are mainly small economies and, with the exception of the members of the European Economic Area (EEA) and Israel, they are emerging economies.<sup>17</sup> Therefore their role in global trade is rather limited. With the exception of Russia and Switzerland, none of these countries account for more than 1% of world import demand. Typically, the countries of the Western Balkans that are potential candidate countries, the Eastern Partnership and the Mediterranean Middle East are even smaller, with a share of global imports of 0.1% or less (notable exceptions are Ukraine and Israel).

To take the European Rim at a (sub-)regional level, dividing it into the European Economic Area excluding Iceland, the potential EU candidate countries of the Western Balkans, the Eastern Partnership countries, the Mediterranean Middle East (except Israel), North Africa, Russia and Israel shows that the first three of these country groupings still account for only 0.2–0.5% of global exports (2010, WTO figures). Compared to these regions, Israel's imports, which totalled USD 79 billion in 2010 (0.4% of global imports), are remarkable. This comparatively high level of imports shows that Israel, unlike its neighbouring countries in the region, is an industrialized country – a fact that was also reflected in Israel's accession to the OECD in 2010. North Africa accounts for roughly 1% of global import demand, with its share increasing slightly since 2006. The largest importers within the European Rim are the EEA (excluding Iceland, which is not covered by this study) and Russia, with approximately 1.7% of global imports apiece.

Given the absence of any 'export-led growth miracle' like the ones observed in Southeast and East Asia, the countries of the European Rim are also mostly small exporters (Figure III.1.1). Despite considerable liberalization efforts in the past decade in the Eastern and Southern EU neighbourhood (European Economy, 2011) none of the European Rim countries implemented an extensive and successful export-led growth strategy that would diversify and upgrade their export base and integrate these economies deeply into global trade networks.<sup>18</sup> As a result, the countries of the European Rim did not experience a strong increase in their market share of global exports. A noteworthy exception is Russia (and to a lesser extent North Africa); but in these cases the growth of exports is mainly based on the rising export prices of raw materials (energy in particular). All other Rim regions show a much more modest increase in export market shares, though the trend is

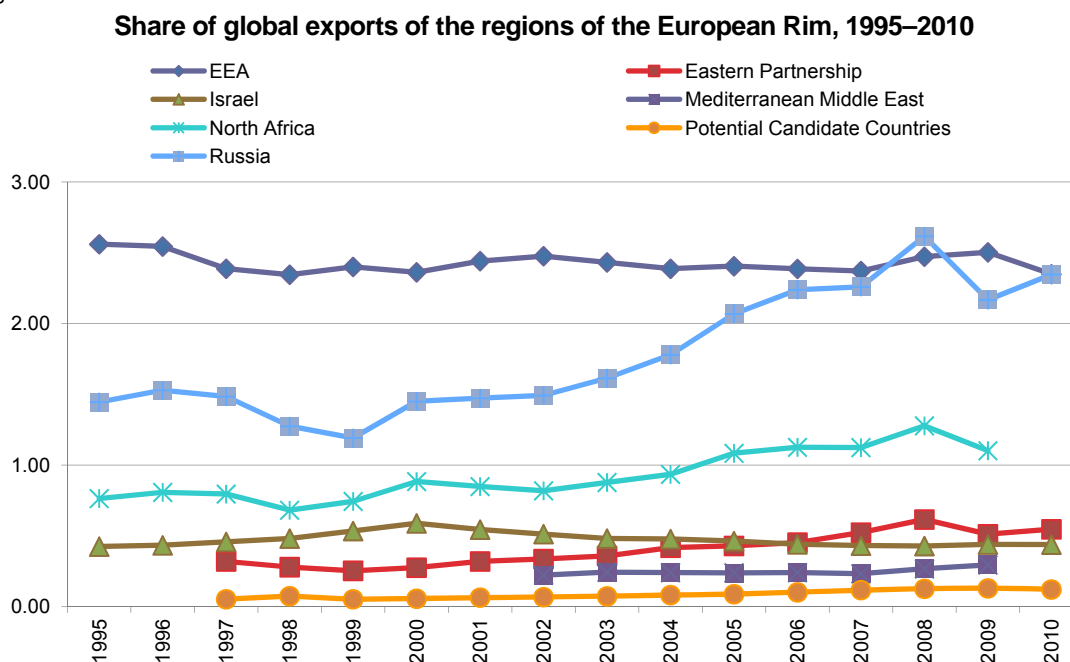
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<sup>17</sup> Emerging economies implies that they are neither industrialized countries nor 'failed' states, with the possible exception of Bosnia-Herzegovina, Kosovo, Libya and Syria.

<sup>18</sup> Switzerland and Norway are among the richest countries in the world. Both are highly integrated into global markets and have already achieved quite high export intensity. Therefore no drastic increase in export market share is to be expected.

clearly positive in all cases, which also justifies categorizing all the regional groupings as 'emerging economies', again with the exception of Israel and the EEA countries.

Figure III.1.1



*Note:* Exports are the sum of merchandise exports and service exports. Data for Liechtenstein, Kosovo and the Palestinian Authority are not available.

*Source:* WTO database; wiiw calculations.

One major reason for the mediocre development of the European Rim countries' share of world exports is that most countries have a relatively small share of manufactured goods in their exports, compared to the world average (Figure III.1.2). Looking at broad economic sectors, manufacturing exports are most underdeveloped in North Africa and Russia (just 18% of the total in both cases), followed by the Mediterranean Middle East (21%). The share of manufactured goods in total exports is also below the global average in the EEA, due to Norway's large energy exports, which account for almost two-thirds of the country's exports. The opposite, however, is true of Switzerland, whose export structure is highly geared towards manufactured goods (63% of total exports in 2010).

Due to their energy resources and the small export manufacturing base, North Africa and Russia depend mainly on commodity exports, which account for more than 70% of Russia's total export revenues. At the country level, extreme dependence on the export of commodities (again mainly oil and gas) is found in Libya (97%), Algeria (94%) and Azerbaijan (91%). These countries are obviously caught in a type of resource-trap, where rents from natural resources turn out to be detrimental to export diversification and structural upgrading. In contrast, of the Mediterranean Middle East countries, only Syria relies heavily on oil for export revenues, while the other countries of the region have an astonishingly

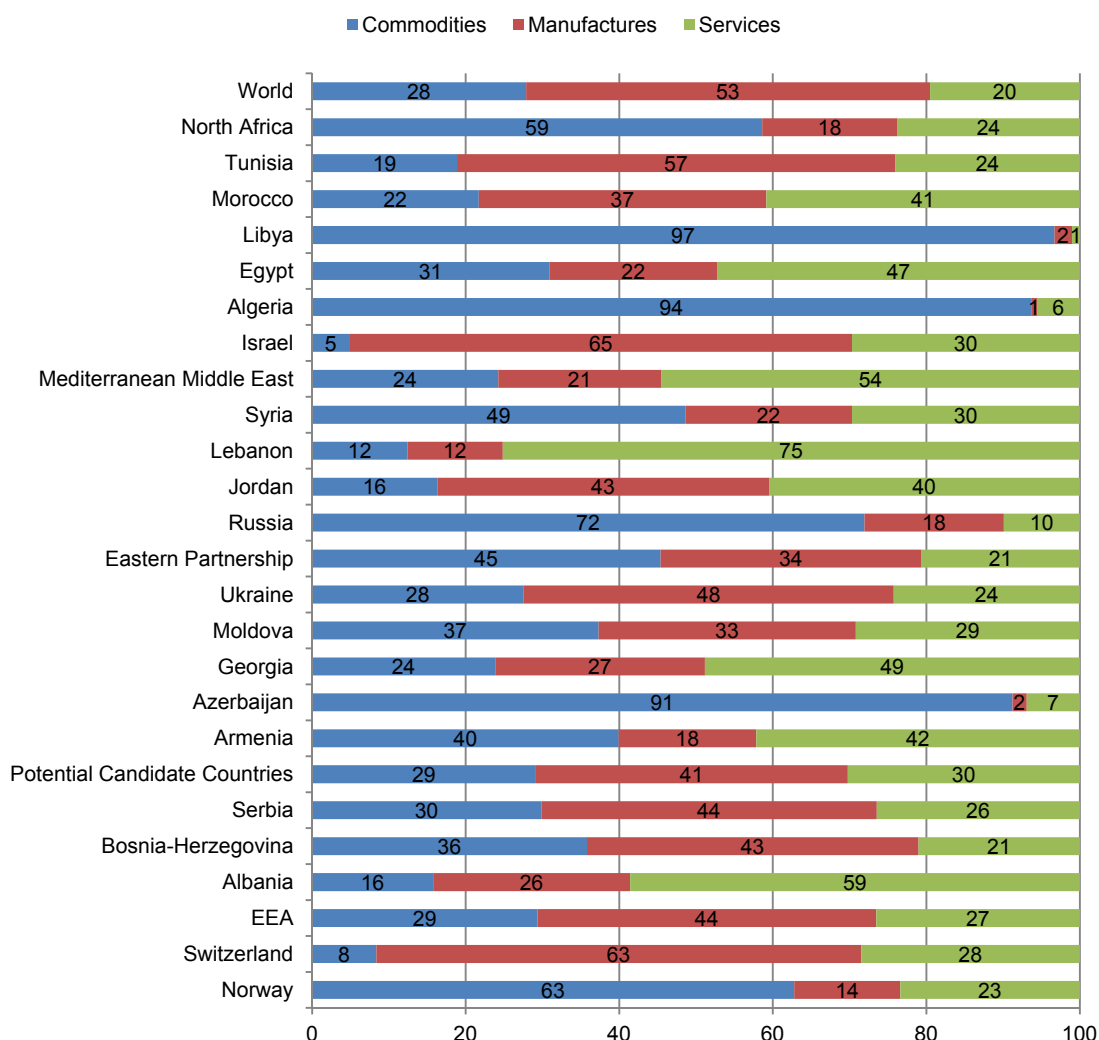


high share of services in their export basket. The bulk of the revenues from service exports comes from the ‘traditional’ services sectors, i.e. travel (tourism) and, to a lesser extent, transport services. This pattern – a more than proportional share of services in overall exports – is also to be observed in several other European Rim countries outside the Mediterranean Middle East, including Albania (59%), Armenia (42%), Georgia (49%), Moldova (29%), Egypt (47%), Morocco (41%) and Tunisia (24%).

Something of an exception in this respect is Lebanon, where services make up three-quarters of exports, but where (instead of travel) financial and other business services also play a large role.

Figure III.1.2

### Export structure of the Rim countries by broad sectors, 2010



Note: Commodity exports are calculated as merchandise exports less manufacturing exports. Data for Liechtenstein, Kosovo and the Palestinian Authority are not available. For Syria and Libya data refer to 2009, and therefore the regional average for the Mediterranean Middle East and North Africa also refers to 2009.

Source: WTO database; wiiw calculations.

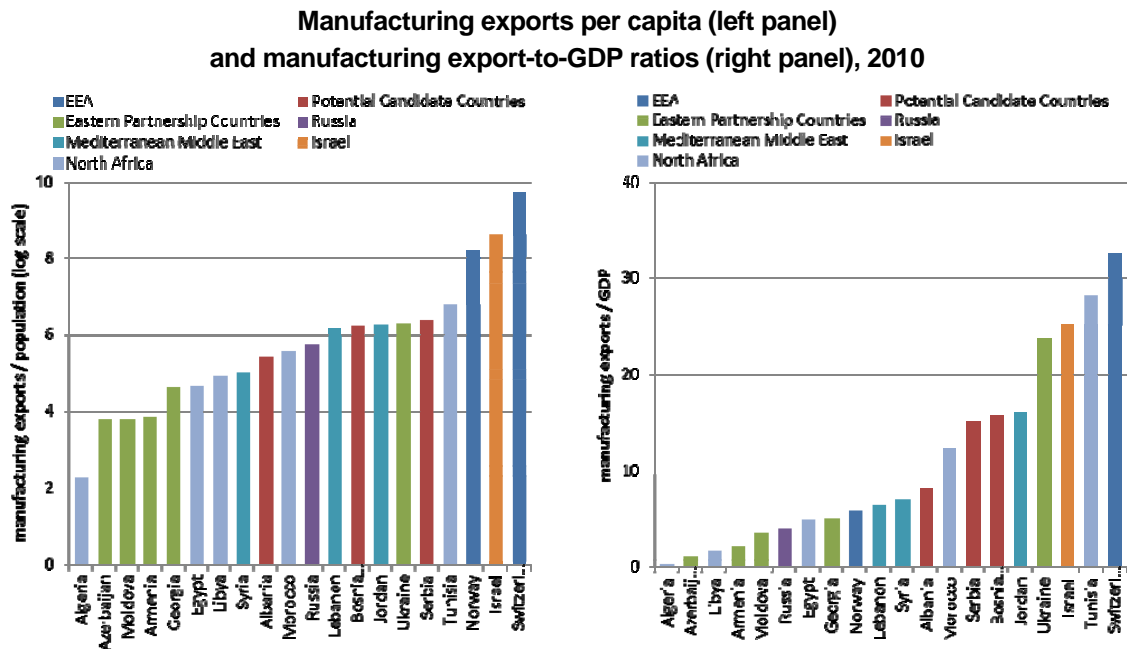
The export structure of most countries in the Rim appears to be quite balanced at this broad level of aggregation. However, this may be a bit misleading, hiding severe shortcomings in the various regions' export capacities and international competitiveness. First of all, the regional averages can mask huge differences, which are mainly due to entirely different export structures of the resource-rich and resource-scarce countries within each European Rim region. Secondly, the fact that services play a big role in exports reflects the weakness of the manufacturing sector, rather than a comparative advantage in services. Put differently, the lack of any significant manufacturing export base makes tourism (travel services) the single most valuable export item in resource-scarce less-developed countries. This means that even most of the resource-scarce countries of the European Rim – which should be more inclined to develop manufacturing capacities because they cannot rely on rents from natural resources – did not manage to diversify their exports and move into manufacturing (see Masood, 2010; Eurochambres, 2011, Lopez-Cálix et al., 2010).

The lack of manufacturing export capacities is also revealed by the low value of manufacturing exports per capita (intensity of manufacturing exports) and low manufacturing exports-to-GDP ratios for the European Rim countries in 2010 (Figure III.1.3). The manufacturing exports per capita – which, according to UNIDO 'indicate the relative capacity of countries to intermediate competitively with the global economy' (Bartels and Lederer, 2009) – range from only EUR 10 per capita in Algeria and Libya to about EUR 16,800 per capita in Switzerland. In Figure III.1.3 (left panel) the intensity of manufacturing exports is shown in a log scale. It clearly indicates the very low presence of North African and Eastern Partnership countries in international trade in manufactured goods. A notable exception among the Eastern Partnership countries is Ukraine, which has EUR 539 worth of manufacturing exports per capita, thanks to some export capacity in the metallurgical industry. Tunisia has considerably higher manufacturing export intensity (EUR 893) than its North African peers, and it also outperforms in this respect vis-à-vis the Western Balkan countries, whose manufacturing export intensities range from EUR 604 in Serbia to just EUR 226 in Albania. The manufacturing export intensity of Switzerland, Israel and Norway far exceeds that of all other European Rim countries because they are developed countries, mainly competing in manufacturing industries on international markets (though for Norway this is only partially true). However, the manufacturing export intensity reflects not only the income level of a country. Figure III.1.3 (right panel) also shows the manufacturing export-to-GDP ratios of the European Rim countries, taking into account income level. The sorting of countries is fairly similar, though Norway and Libya move well down the ranking because their high levels of GDP are based on the export of petroleum.

The lack of an export manufacturing base is an essential feature that has to be taken into account when analysing the competitiveness of the European Rim countries. We associate competitiveness with the ability of firms to provide products and services more efficiently than their competitors (price competitiveness) or to offer qualitatively superior products and

services (quality competitiveness), leading to success in international markets (without protection or subsidies). Most of the elements in this concept of competitiveness are relevant for manufacturing goods and services because there is much more scope for product differentiation and qualitative upgrading than in the case of (standardized) commodities. Hence, it is common to think of competitiveness as industrial competitiveness, which features industrial capacity, manufactured export capacity, industrialization intensity and export quality as the four main dimensions (UNIDO, 2002). However, as we have seen, for many countries commodities represent their main pillar of exports. Therefore most European Rim countries, particularly the North African and the Eastern neighbourhood countries are forced to compete mainly on price in areas with static comparative advantages owing to natural resource endowments. Hence, their competitiveness in international markets is currently based on the resource abundance. In accordance with this, the North African (bar Tunisia) and Eastern neighbourhood countries are characterized as countries that are still in the transition from ‘factor-driven’ economies to ‘efficiency-driven’ economies (World Economic Forum, 2010). Efficiency-driven economies are dependent less on static factor endowments, and more on endogenous and dynamic factors that can be influenced by economic policy, such as product and labour market efficiency, as well as technological capability (mainly in the sense of absorptive capacity) and the educational attainments of the workforce. In contrast, in developed economies, such as the EU but also the EEA countries, innovation and resulting technological leadership in products and services are key factors for success in international markets – factors which are presently of no (or only very limited) relevance to most European Rim countries.

Figure III.1.3



Note: Manufacturing export values for Libya and Syria are World Trade Organization (WTO) estimates.

Source: UN Comtrade, WTO database, IMF, wiw calculations.

## **III.2 Trade relations between the EU and the European Rim countries**

### *III.2.1 The role of the European Rim in EU merchandise trade*

The EU is the senior partner in trade relations with the European Rim, in the sense that the EU is a major trading partner for all countries of the European Rim, but in most cases not vice versa. In many instances, the EU is the number one merchandise exporter and importer in these markets. This is particularly true, for example, of trade with North Africa, where the EU typically accounts for about 50% of the countries' merchandise imports, ranging from 60% in Tunisia to about 27% in Egypt.<sup>19</sup> The same is true of North African exports, though, in the case of Algeria, the USA is the major export destination at the country level. Taken as a whole, however, the EU is again out in front, absorbing more than half of Algerian exports. Given the geographical proximity and high degree of trade integration, the EU is also the main market for the exports of EEA countries (absorbing 58% of Swiss and 80% of Norwegian exports); the EU is also their leading import partner, accounting for 77% of Swiss and 63% of Norwegian imports (see Table II.1 above).

On average, the EU is less important as a trading partner in the Mediterranean Middle East countries and Israel, and also in the smaller Eastern Partnership countries such as Armenia or Georgia, with the latter exporting only 19% of its total to the EU and sourcing about 30% of its imports from the EU. The EU's share in the Israeli market is also comparatively low – about 35% – and (at 26%) it accounts for an even lower share of Israel's total exports.

A more detailed overview of the bilateral trade relations between the EU and the European Rim countries is presented in Tables III.1a (EU exports) and III.1b (EU imports). First of all, the tables confirm that the European Rim regions are less important for the EU as a trading partner than vice versa – not surprising, given the EU's weight in international trade. Taken as a whole, the European Rim countries account for approximately 27% of the EU's extra-EU merchandise exports and 29% of extra-EU merchandise imports.

On the EU's export side, the most important trading partners are the EEA countries (11%), Russia (6%) and North Africa (5%) (Table III.2.1a). The remaining regions, however, are only minor export destinations for the EU, with shares of less than 1% in the potential candidate countries and the Mediterranean Middle East. While these shares are still higher than these country groups' share of global imports, from the EU's point of view these regions are currently not pivotal for the EU's export development. Note, however, that the growth of EU exports to these two regions in the past decade (i.e. from 2000 to 2010) was stronger than overall extra-EU exports. The same is true of all other European Rim regions, with the exception of the EEA (where bilateral export intensity is already high, so that above-average growth rates are not to be expected) and Israel (where actually negative growth rates are recorded).

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<sup>19</sup> Figures based on UN Comtrade data (goods trade) for 2010. Data for Egypt are based on mirror statistics, i.e. the trading partners' exports are Egypt's imports.

Table III.2.1a

### EU merchandise exports to the European Rim countries, 2010

destination region:												2010					
Exporter	European Economic Area		Potential Candidate Countries		Eastern Partnership Countries		Russia	North Africa	Mediterranean Middle East		Israel	extra-EU 27					
<b>EU27</b>	value (mill EUR)	148198	(100.0)	13253	(100.0)	22936	(100.0)	86131	(100.0)	61882	(100.0)	11236	(100.0)	14405	(100.0)	1349610	(100.0)
	share of exports	10.98		0.98		1.70		6.38		4.59		0.83		1.07		100	
	export growth	4.03		8.97		12.48		14.25		6.68		5.44		-1.22		4.74	
<b>Core EU</b>	value (mill EUR)	70976	(47.9)	3790	(28.6)	8595	(37.5)	38705	(44.9)	15084	(24.4)	3782	(33.7)	6559	(45.5)	596105	(44.2)
	share of exports	11.91		0.64		1.44		6.49		2.53		0.63		1.10		100	
	export growth	4.61		9.40		12.31		14.34		7.33		5.64		-1.85		6.25	
<b>Northern EU</b>	value (mill EUR)	20038	(13.5)	158	(1.2)	934	(4.1)	8179	(9.5)	2677	(4.3)	547	(4.9)	636	(4.4)	100352	(7.4)
	share of exports	19.97		0.16		0.93		8.15		2.67		0.54		0.63		100	
	export growth	3.66		-0.48		9.1		9.45		5.09		3.60		-1.95		3.34	
<b>Western EU</b>	value (mill EUR)	13918	(9.4)	216	(1.6)	1154	(5.0)	3960	(4.6)	3171	(5.1)	1008	(9.0)	1692	(11.7)	178043	(13.2)
	share of exports	7.82		0.12		0.65		2.22		1.78		0.57		0.95		100	
	export growth	1.98		7.79		11.78		12.27		2.40		4.51		-5.10		1.39	
<b>Southern EU</b>	value (mill EUR)	34884	(23.5)	3759	(28.4)	3304	(14.4)	16639	(19.3)	38151	(61.7)	4961	(44.2)	4190	(29.1)	375763	(27.8)
	share of exports	9.28		1		0.88		4.43		10.15		1.32		1.11		100	
	export growth	2.68		6.80		9.65		12.27		6.68		5.00		-0.31		3.35	
<b>Eastern EU</b>	value (mill EUR)	8382	(5.7)	5330	(40.2)	8949	(39.0)	18649	(21.7)	2800	(4.5)	938	(8.4)	1328	(9.2)	99347	(7.4)
	share of exports	8.44		5.36		9.01		18.77		2.82		0.94		1.34		100	
	export growth	18.84		11.82		22.68		26.65		16.94		11.75		17.38		17.81	

*Notes:* Share of total exports means the share of the respective European Rim region in the EU's (or an EU sub-region's) total exports; export growth means average annual growth of exports between 2000 and 2010. The figures in brackets indicate the respective EU sub-region's share of EU exports to the regions of the European Rim. Core EU: Austria, Belgium, Germany, Luxembourg, Netherlands; Northern EU: Denmark, Finland, Sweden; Western EU: Ireland, United Kingdom; Southern EU: Cyprus, France, Greece, Malta, Portugal, Spain; Eastern EU: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

*Source:* COMEXT database; iiw calculations.

Table III.2.1b

### EU merchandise imports from the European Rim countries, 2010

source region:												2010					
Importer	European Economic Area		Potential Candidate Countries		Eastern Partnership Countries		Russia	North Africa	Mediterranean Middle East		Israel	extra-EU 27					
<b>EU27</b>	value (mill EUR)	163687	(100.0)	7152	(100.0)	22587	(100.0)	160058	(100.0)	74801	(100.0)	4213	(100.0)	11087	(100.0)	1509090	(100.0)
	share of imports	10.85		0.47		1.50		10.61		4.96		0.28		0.73		100	
	import growth	3.99		13.77		13.37		9.64		5.22		0.46		0.45		4.28	
<b>Core EU</b>	value (mill EUR)	76196	(46.5)	2038	(28.5)	4411	(19.5)	60028	(37.5)	14324	(19.1)	1998	(47.4)	4969	(44.8)	622667	(41.3)
	share of imports	12.24		0.33		0.71		9.64		2.3		0.32		0.80		100	
	import growth	5.73		14.81		8.82		11.11		3.06		0.99		-0.56		5	
<b>Northern EU</b>	value (mill EUR)	16467	(10.1)	53	(.7)	219	(1.0)	15247	(9.5)	400	(.5)	23	(.5)	232	(2.1)	74488	(4.9)
	share of imports	22.11		0.07		0.29		20.47		0.54		0.03		0.31		100	
	import growth	2.24		2.00		13.56		12.14		9.46		2.86		-3.17		3.86	
<b>Western EU</b>	value (mill EUR)	30688	(18.7)	118	(1.7)	524	(2.3)	5888	(3.7)	4327	(5.8)	91	(2.2)	1661	(15.0)	220122	(14.6)
	share of imports	13.94		0.05		0.24		2.67		1.97		0.04		0.75		100	
	import growth	4.96		12.51		10.41		6.07		4.79		-5.66		-1.38		0.87	
<b>Southern EU</b>	value (mill EUR)	35056	(21.4)	2586	(36.2)	11016	(48.8)	37630	(23.5)	54833	(73.3)	2002	(47.5)	3338	(30.1)	453528	(30.1)
	share of imports	7.73		0.57		2.43		8.30		12.09		0.44		0.74		100	
	import growth	1.13		9.64		16.59		8.36		5.86		0.03		2.52		4.18	
<b>Eastern EU</b>	value (mill EUR)	5280	(3.2)	2357	(33.0)	6417	(28.4)	41265	(25.8)	916	(1.2)	99	(2.3)	887	(8.0)	138288	(9.2)
	share of imports	3.82		1.70		4.64		29.84		0.66		0.07		0.64		100	
	import growth	9.08		22.82		18.43		14.65		9.95		11.82		10.39		14.39	

*Notes:* Share of total imports means the share of the respective European Rim region in the EU's (or an EU sub-region's) total imports; import growth means average annual growth of imports between 2000 and 2010. The figures in brackets indicate the respective EU sub-region's share of EU imports from the regions of the European Rim. Core EU: Austria, Belgium, Germany, Luxembourg, Netherlands; Northern EU: Denmark, Finland, Sweden; Western EU: Ireland, United Kingdom; Southern EU: Cyprus, France, Greece, Malta, Portugal, Spain; Eastern EU: Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia.

*Source:* COMEXT database; iiw calculations.

The relatively low level of EU exports to Israel (EUR 14.4 billion) and the negative export trend is somewhat surprising. The highest annual export growth rates during the period 2000–10 are recorded for Russia (+15%) and the Eastern Partnership countries (+13%), followed by the potential candidate countries (+9%) and North Africa (+7%). These growth rates hint at the potential of these emerging regions as trading partners for the EU.

Turning to EU imports, the same ranking of partner regions as in the case of exports emerges, though, with a share of 10.6% of total extra-EU imports, Russia is almost as important as the EEA countries (10.9%), largely owing to EU energy imports (Table III.2.1b).

Moreover, growth of EU imports from the European Rim regions also tends to be above average, with the highest growth in imports from the potential candidate countries (+13.8%), closely followed by the Eastern Partnership countries (+13.4%) and Russia (+9.6%). Notable exceptions to this are again the Mediterranean Middle East and Israel with a disappointing expansion in EU imports of a mere 0.5% over the last decade (2000–10). Finally, note that the EU is running a trade deficit with the EEA partners, Russia and North Africa, while it is in a surplus position in trade with the potential candidate countries, the Eastern Partnership countries, the Mediterranean Middle East and Israel. The most sizeable deficit exists in trade with Russia, where the trade deficit amounted to EUR 74 billion in 2010, or about 0.6% of EU GDP. The surpluses in trade with the potential candidate countries and the Mediterranean Middle East are, from the point of view of the EU, fairly small in absolute values (EUR 6 billion and EUR 7 billion, respectively).

While so far only trade of the entire EU with the European Rim regions has been considered, Tables III.1a and III.1b also show bilateral trade relations between sub-regions of the EU and each of the regions in the European Rim. These EU sub-regions are defined as: a Core EU bloc consisting of Austria, Germany and the Benelux countries; the Northern EU comprising Denmark, Finland and Sweden; the Western EU which is Ireland and the United Kingdom; the Southern EU which includes all EU Member States bordering the Mediterranean Sea (Spain, France, Italy, Malta, Greece, Cyprus) and Portugal; and the Eastern EU Member States comprising the ten ‘new’ EU Member States. This division shows that the importance of the European Rim regions as trading partners varies considerably across these sub-regions. In Tables III.1a and III.1b this variation can be seen from the EU sub-regions’ shares of total EU-27 trade with the European Rim compared to their shares of total EU-27 trade (extra-EU-27 trade).

The first point to be mentioned here is that the European Rim is not necessarily a focus area for the Core EU. Concentrating on EU exports, Table III.2.1a shows that the Core EU’s share of total extra-EU exports is 44%, which is (roughly speaking) also its share of total EU-27 exports to the EEA, Russia and Israel. In the other four regions, however, the Core EU is strongly underrepresented, with a share of total EU exports ranging from only

24.4% in North Africa and 37.5% in the Eastern Partnership countries. Qualitatively, the same is true for Northern Europe, though it is clearly overrepresented in trade with the EEA (due to Norway) and strongly underrepresented in trade with Israel. The Western EU is underrepresented in exports to all European Rim regions, as its trade is more concentrated on the USA and Japan. In contrast, parts of the European Rim are important export destinations for the Southern EU countries and also for the Eastern EU. In the case of the Southern EU, North Africa and the Mediterranean Middle East are particularly important export destinations. The Southern EU accounts for no less than 62% of total EU exports to North Africa. In comparison, its share of extra-EU exports stands at 28%. The strong trade links between these EU countries and North Africa manifest themselves in the very high share of exports that is absorbed by North Africa – 10%, which is more than the Southern EU exports to any other European Rim region, including the EEA. The two most obvious reasons for this pattern are, of course, geographic proximity and the colonial heritage, despite the contentious relationships implied by that. The role of former colonial ties also becomes apparent when it is considered that Italy is the primary exporter to Libya, while France is the number one exporter to Morocco, followed by Spain.<sup>20</sup>

Another obvious pattern discernible is the Eastern EU's export orientation towards the Eastern Partnership countries and Russia, a heritage of the previous economic relations between the members of the Council for Mutual Economic Assistance (CMEA or COMECON – see Havlik, 1991 and Havlik, 2008). Of course, in this case, too, geographical proximity must be expected to play a role. Almost a fifth (19%) of Eastern EU exports are destined for Russia, and another 9% for the Eastern Partnership countries. Therefore, while the Eastern EU accounts for only 7.4% of total extra-EU exports, it contributes 39% and 21.7% to the EU's exports to the Eastern Partnership countries and Russia, respectively. The share of the Eastern EU's exports in total EU-27 exports to the potential candidate countries' markets is even higher (40%), which is again explained by geographical proximity and former close trade relations between COMECON and the former Yugoslavia.

In summary, while the EEA, Russia and, to some extent, North Africa are important EU trading partners, the other European Rim regions constitute neither important export destinations nor important sources for imports for the EU as a whole. However, each of the European Rim regions is of major interest as a trading partner for at least one of the EU sub-regions (maybe with the exception of Israel). Moreover, apart from the EEA and Israel, EU exports to and EU imports from the European Rim regions grew more than average, with particularly strong growth in the Eastern Partnership countries, Russia and the potential candidate countries of the Western Balkans.

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<sup>20</sup> Based on data from UN Comtrade for the year 2010. Data for Libya are based on mirror statistics.

### *III.2.2 Trade structures and export concentration*

It was mentioned above that most of the European Rim countries are small economies with low levels of export diversification. We quantify the export concentration of the European Rim countries using the Herfindahl–Hirschman Index (HHI – see Annex 1) for their exports to the EU over time.

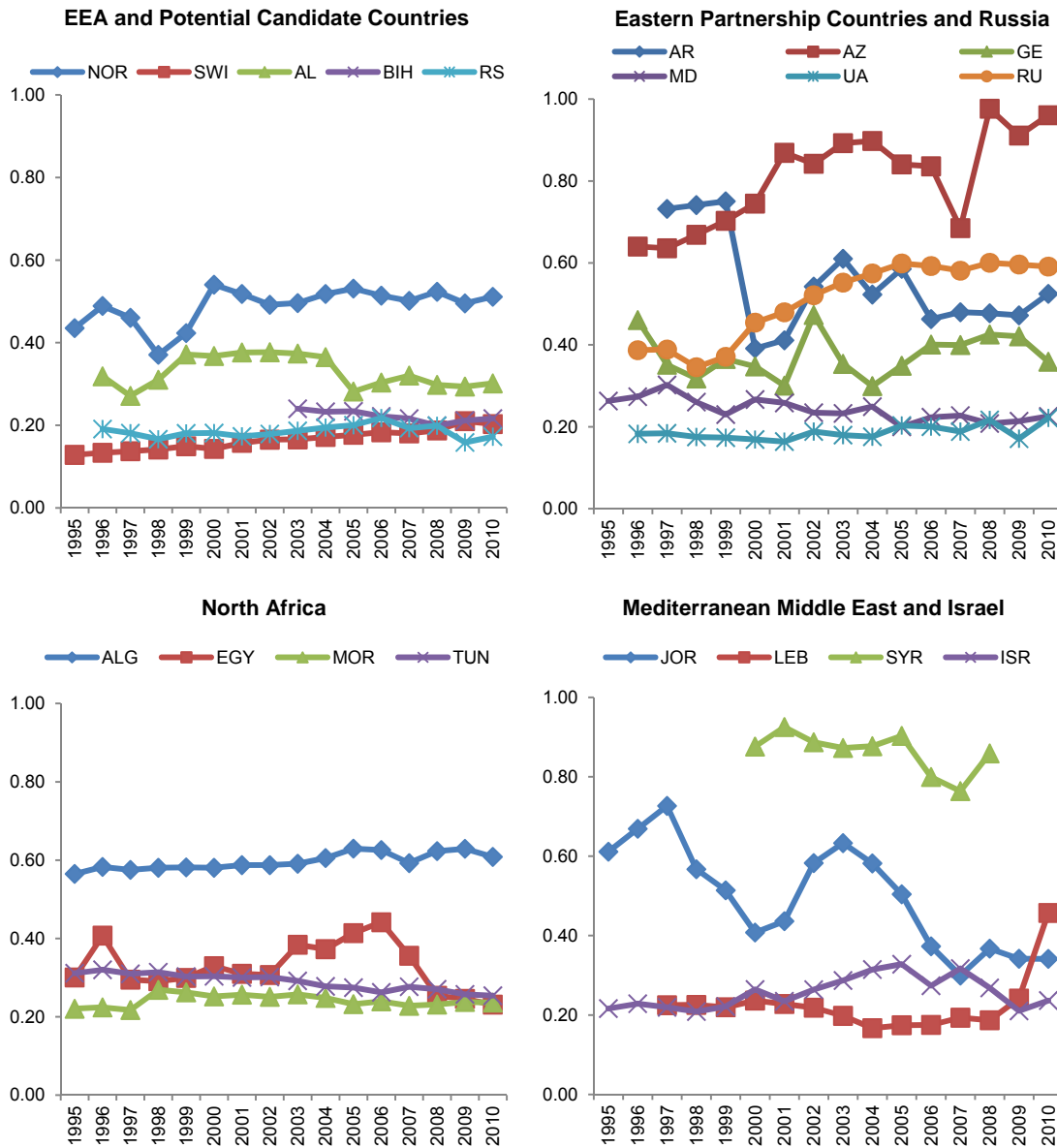
Since developed countries typically have more diversified economies, it is not surprising that Switzerland and Israel are among the countries with the lowest export concentration index. The most diversified economies in 2010, according to the Herfindahl–Hirschman index, however, were Serbia and Bosnia-Herzegovina. The Eastern Partnership countries and Russia tend to have the highest export concentrations. The regional averages, however, can be misleading, as the variation in the Herfindahl–Hirschman index shows more intra-regional than extra-regional variation. For example, Norway has a much higher export concentration than Switzerland, and Syria's export concentration index is also much higher than that of the other countries in the Mediterranean Middle East. This is because a country's export concentration depends to a large degree on its resource abundance, which tends to make diversification into manufacturing more difficult. Therefore, within each region it is primarily the oil-exporting countries – Norway in the EEA, Azerbaijan among the Eastern Partnership countries, Algeria and Libya in North Africa and Syria in the Mediterranean Middle East, as well as Russia – that have the highest export concentration rates. Hence, a defining characteristic of the European Rim countries is whether they are resource-rich or resource-poor (compare O'Sullivan, Rey and Mendez, 2011). In principle, revenues from oil exports could provide the necessary wealth for countries to diversify and invest in new areas of competitive advantage (Bonaglia and Fukasaku, 2003), especially in manufacturing industries. However, among the European Rim countries so far only Norway has been able to seize this opportunity provided by resource wealth. The drain on export diversification constituted by natural resource abundance has a 'Dutch disease' flavour, but of course the oil-rich countries of North Africa still have higher GDP per capita than the non-oil countries of the region.

Figure III.2.1 also shows that the European Rim has not experienced a significant diversification process since 1995 (see De Melo and Ugarte, 2012 for a comparison with other middle-income countries), so concentration ratios have not declined. This is in line with the results of other reports on export diversification in European neighbourhood regions. For example, Gourdon (2010) also finds only very limited export diversification for the countries of the Middle East and North Africa. Moreover, this small increase in diversification is found to be due not to the addition of new products to the export basket, but rather to a decline in the concentration of the most important export items.



Figure III.2.1

**Export concentration of the European Rim countries' exports to the EU,  
(Herfindahl–Hirschman Index), 1995–2010**



*Note:* The concentration measure is the Herfindahl–Hirschman Index ranging from 0 (least concentration) to 1 (highest concentration) based on SITC 3 product classification (3-digit level of aggregation). Data for Liechtenstein, Kosovo and the Palestinian Authority are not available.

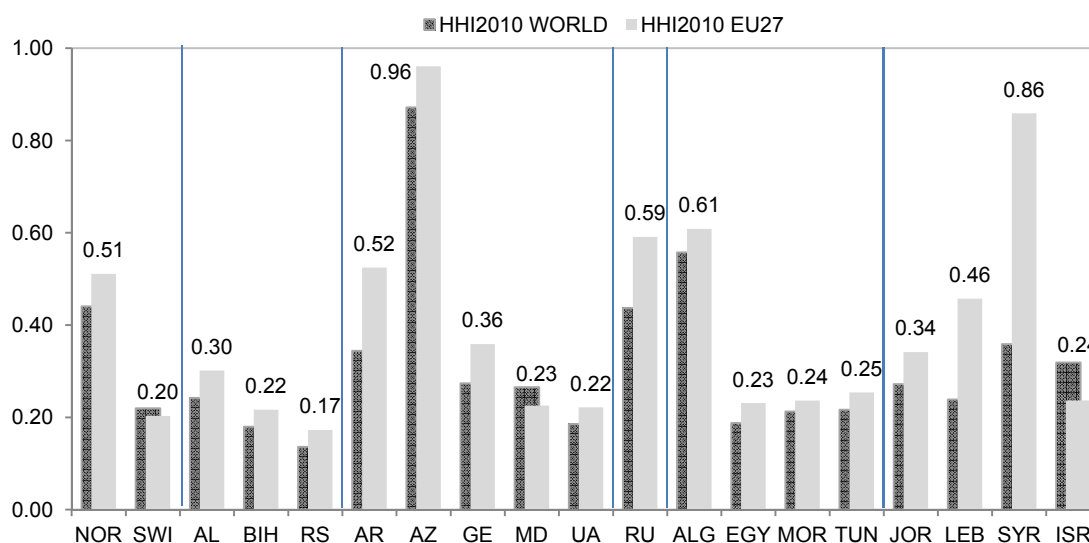
*Source:* UN Comtrade database; wiiv calculations.

In some European Rim countries, particularly in the Eastern Partnership countries and in Russia, export concentration has even increased over the past 15 years. The persistently high export concentration of the resource-rich European Rim countries make them highly dependent on fluctuations in commodity prices, and the oil price in particular. This increases the volatility of export earnings and makes the countries vulnerable to external

shocks, as was made obvious in the economic crisis of 2008/09, when commodity prices plummeted and countries like Ukraine and Russia suffered severe declines in export revenues. Arguably, countries forgo increases in productivity and hence international competitiveness if they do not diversify their export basket (Feenstra and Kee, 2008) because of absence of learning effects and inter-industry spillovers. However, the main causality must be assumed to run from productivity to export diversification and not vice versa, so that countries cannot diversify their exports because they lack the capacity to develop competitive industries. Export diversification – or more precisely the lack thereof – is an important aspect in the discussion of the European Rim’s competitive situation, but it is a manifestation of hitherto rather unsuccessful industrial and – to some extent – also trade policies. As a result, most European Rim countries, apart from the EEA countries, have still developed only very few or no internationally competitive manufacturing industries and trade does not act as an engine of growth (Masood, 2010; Lopés-Calix et al., 2010; European Economy, 2011; Eurochambres, 2011), as it does in other emerging countries.

Figure III.2.2

**Export concentration of the European Rim countries: Comparison of global exports with exports to the EU (Herfindahl–Hirschman Index), 2010**



Note: The concentration measure is the Herfindahl-Hirschman Index ranging from 0 (least concentration) to 1 (highest concentration) based on SITC 3 product classification (3-digit level of aggregation). Data for Syria are for 2008. Data for Liechtenstein, Kosovo and the Palestinian Authority are not available.

Source: UN Comtrade database; wiiw calculations.

It is worth mentioning that the concentration of some European Rim countries’ exports to the EU is higher than their export concentration in global exports (Figure III.2.2). This is particularly true of Lebanon and Syria, which seem to have a broader export base than is suggested by their HHIs for exports to the EU. To some extent this is also true of Russia. This indicates that these countries have export items that they do not market or are not able to market in the EU due to a lack of competitiveness (compare e.g. Lorca and Escri-

bano, 2000; Havlik, 2008) or remaining trade barriers (e.g. Francois, McQueen and Wignaraja, 2005).

Table III.2.2

**EU imports from the European Rim countries, by industry, 2010**

2010 exporter	EU imports of:	Manufacturing														Other	
		Agriculture and Mining		Manufacturing										Other			
		agriculture	mining	petroleum	food	textiles	wood & paper	refined petroleum	chemicals	rubber & plastics	metals & minerals	machinery	electronics	transport	manuf. n.e.c.	other	
AL	value (in EUR mill.)	23.7	6.7	149.3	29.5	400.9	23.3	10.1	4.1	7.4	120.4	7.7	57.1	3.8	12.4	35.0	
	share	2.7	0.8	16.8	3.3	45.0	2.6	1.1	0.5	0.8	13.5	0.9	6.4	0.4	1.4	3.9	
BA	value (in EUR mill.)	49.8	24.4	0.0	84.8	379.1	136.9	42.5	104.8	35.3	488.3	203.4	83.5	80.1	288.9	9.2	
	share	2.5	1.2	0.0	4.2	18.8	6.8	2.1	5.2	1.8	24.3	10.1	4.1	4.0	14.4	0.5	
KO	value (in EUR mill.)	1.1	9.1	0.0	9.4	4.4	0.6	0.0	0.2	4.1	94.4	5.6	2.3	11.4	0.9	0.2	
	share	0.8	6.4	0.0	6.5	3.1	0.5	0.0	0.2	2.8	65.7	3.9	1.6	7.9	0.6	0.1	
RS	value (in EUR mill.)	169.9	42.4	0.0	506.8	404.0	164.6	31.6	304.9	231.0	1196.4	217.8	371.2	153.4	92.2	156.4	
	share	4.2	1.0	0.0	12.5	10.0	4.1	0.8	7.5	5.7	29.6	5.4	9.2	3.8	2.3	3.9	
AR	value (in EUR mill.)	1.7	27.6	0.0	4.2	17.0	0.2	0.0	3.3	0.0	164.8	0.2	2.4	0.1	35.0	0.1	
	share	0.7	10.8	0.0	1.6	6.6	0.1	0.0	1.3	0.0	64.3	0.1	0.9	0.0	13.6	0.0	
AZ	value (in EUR mill.)	12.8	0.0	9548.5	4.7	0.4	1.0	79.0	10.7	0.0	10.4	19.0	5.6	9.7	0.1	0.0	
	share	0.1	0.0	98.4	0.0	0.0	0.0	0.8	0.1	0.0	0.1	0.2	0.1	0.1	0.0	0.0	
GE	value (in EUR mill.)	37.8	163.4	178.2	20.0	10.6	2.2	57.4	35.6	0.4	33.9	3.2	1.9	6.2	0.6	0.1	
	share	6.8	29.6	32.3	3.6	1.9	0.4	10.4	6.5	0.1	6.1	0.6	0.3	1.1	0.1	0.0	
MD	value (in EUR mill.)	78.8	0.0	0.0	79.4	258.6	6.6	2.0	3.7	5.9	58.7	10.9	37.3	2.3	20.5	14.7	
	share	13.6	0.0	0.0	13.7	44.6	1.1	0.3	0.6	1.0	10.1	1.9	6.4	0.4	3.5	2.5	
UA	value (in EUR mill.)	847.5	1839.6	243.9	852.6	475.8	373.8	691.4	517.9	62.6	3639.0	219.0	882.2	159.9	116.5	32.7	
	share	7.7	16.8	2.2	7.8	4.3	3.4	6.3	4.7	0.6	33.2	2.0	8.1	1.5	1.1	0.3	
RU	value (in EUR mill.)	395.1	6088.0	89925.1	785.5	182.7	1711.1	25601.4	3969.2	270.0	11542.9	333.8	356.5	356.8	378.1	727.5	
	share	0.3	4.3	63.1	0.6	0.1	1.2	18.0	2.8	0.2	8.1	0.2	0.2	0.3	0.3	0.5	
ALG	value (in EUR mill.)	18.2	49.8	16837.7	16.3	11.7	3.6	3318.7	284.4	0.4	133.7	18.4	15.2	14.7	0.1	0.0	
	share	0.1	0.2	81.3	0.1	0.1	0.0	16.0	1.4	0.0	0.6	0.1	0.1	0.1	0.0	0.0	
EGY	value (in EUR mill.)	439.2	82.3	2725.8	178.9	886.7	61.3	727.9	773.7	107.5	687.7	83.1	229.1	68.3	20.8	2.0	
	share	6.2	1.2	38.5	2.5	12.5	0.9	10.3	10.9	1.5	9.7	1.2	3.2	1.0	0.3	0.0	
LIB	value (in EUR mill.)	7.1	3.7	26257.6	1.0	1.9	0.1	2096.0	308.4	1.5	102.6	13.3	4.2	3.0	0.4	0.0	
	share	0.0	0.0	91.2	0.0	0.0	0.0	7.3	1.1	0.0	0.4	0.0	0.0	0.0	0.0	0.0	
MOR	value (in EUR mill.)	955.0	414.5	58.5	1016.5	2578.3	55.5	112.4	495.2	39.4	218.3	43.5	1325.7	196.7	67.2	1.0	
	share	12.6	5.5	0.8	13.4	34.0	0.7	1.5	6.5	0.5	2.9	0.6	17.5	2.6	0.9	0.0	
TUN	value (in EUR mill.)	150.0	95.3	1379.9	283.8	3180.7	48.0	116.3	304.5	143.6	410.0	147.7	2687.0	418.9	125.4	0.3	
	share	1.6	1.0	14.5	3.0	33.5	0.5	1.2	3.2	1.5	4.3	1.6	28.3	4.4	1.3	0.0	
JOR	value (in EUR mill.)	16.8	19.8	0.0	1.5	12.0	0.7	17.4	57.8	8.8	50.6	9.0	11.1	20.1	11.2	1.6	
	share	7.1	8.3	0.0	0.6	5.0	0.3	7.3	24.2	3.7	21.2	3.8	4.7	8.4	4.7	0.7	
LEB	value (in EUR mill.)	18.8	45.1	0.0	36.3	15.6	22.4	0.0	37.0	10.9	62.0	6.9	23.6	20.2	23.3	1.1	
	share	5.8	13.9	0.0	11.2	4.8	6.9	0.0	11.5	3.4	19.2	2.1	7.3	6.3	7.2	0.3	
PAL	value (in EUR mill.)	3.6	0.2	0.0	2.0	0.1	0.0	2.4	0.2	0.0	0.5	0.0	0.1	0.0	0.0	0.0	
	share	39.4	2.1	0.0	21.4	1.2	0.3	26.5	2.6	0.0	5.4	0.0	0.8	0.0	0.3	0.0	
SYR	value (in EUR mill.)	42.7	97.8	3157.1	34.9	125.2	4.4	29.8	10.5	9.4	33.6	7.3	12.8	16.9	4.1	0.1	
	share	1.2	2.7	88.0	1.0	3.5	0.1	0.8	0.3	0.3	0.9	0.2	0.4	0.5	0.1	0.0	
ISR	value (in EUR mill.)	754.2	826.3	0.0	268.1	266.7	96.2	966.7	2893.0	639.1	637.8	580.7	1958.3	373.3	620.8	18.8	
	share	6.9	7.6	0.0	2.5	2.4	0.9	8.9	26.5	5.9	5.9	5.3	18.0	3.4	5.7	0.2	
SWI	value (in EUR mill.)	116.9	246.3	17.5	3284.6	1826.9	2157.0	165.7	28634.1	2241.8	12883.8	8751.6	14796.6	2161.1	1876.7	3126.8	
	share	0.1	0.3	0.0	4.0	2.2	2.6	0.2	34.8	2.7	15.7	10.6	18.0	2.6	2.3	3.8	
LI	value (in EUR mill.)	0.6	0.1	0.0	113.9	6.9	7.1	19.1	112.6	17.3	262.9	175.0	142.4	164.3	19.9	15.8	
	share	0.1	0.0	0.0	10.8	0.6	0.7	1.8	10.6	1.6	24.9	16.5	13.5	15.5	1.9	1.5	
NOR	value (in EUR mill.)	2514.0	727.7	40712.2	1814.5	124.6	1349.4	3887.8	2886.1	253.7	5930.6	1246.7	1733.3	1701.1	379.8	415.5	
	share	3.8	1.1	62.0	2.8	0.2	2.1	5.9	4.4	0.4	9.0	1.9	2.6	2.6	0.6	0.6	
EXTRA	value (in EUR mill.)	46478.6	50791.3	275737.7	56479.3	108588.1	25726.6	66730.9	132783.0	26259.0	115479.0	78791.0	296359.6	121521.1	46217.8	7164.8	
	share	3.2	3.5	18.9	3.9	7.5	1.8	4.6	9.1	1.8	7.9	5.4	20.4	8.4	3.2	0.5	

Note: Based on NACE Rev. 1 industry classification. Agriculture: NACE 1, 2, 5; Mining: NACE 10, 12, 13; Petroleum: NACE 11; Food: NACE 15, 16; Textiles: NACE, 17, 18, 19; Wood & paper: NACE 20, 21, 22; Refined petroleum: NACE 23; Chemicals: NACE 24; Rubber & plastics: NACE 25; metals & minerals: NACE 26, 27, 28; Machinery: NACE 29; Electronics: NACE 30, 31, 32, 33; Transport: NACE 34, 35; Manufacturing n.e.c.: NACE 36; Other: NACE 40, 41, 45 and all services industries.

Source: COMEXT database; wiiw calculations.

Investigation of the EU's imports from the European Rim countries at the industry level gives a deeper insight into the export structure of these countries and why some of them end up having high export concentration indices (Table III.2.2). The prime illustration of this is Azerbaijan, which exports basically only oil to the EU (98% of total exports), worth EUR 9.5 billion in 2010. This is a considerable amount, given the size of Azerbaijan's economy, and is equal to roughly a quarter of Norway's oil exports to the EU. Mirroring the results from the export concentration index above, we also find high dependence on the export of oil and gas for Libya and Syria, where the oil extraction industry (NACE 11) accounts for 91% and 88% of exports to the EU. The respective shares of Russia, Algeria and Norway are somewhat lower, but they still depend highly on oil and the price of oil. For Russia and

Algeria, a positive aspect in this respect is that they also export refined petroleum (NACE 23), which makes up 18% and 16%, respectively, of those countries' exports to the EU. This implies that they have refining facilities, which allows them to capture additional value added (compared to only exporting crude oil), though they may still depend on foreign technology, i.e. multinationals, for this. The flip side of this kind of move into manufacturing is that it does not really constitute a diversification away from oil. Adding up Algeria's oil-extraction industry and the petroleum industry leads to a share of more than 97% – a dependence on oil that matches Libya's (and Azerbaijan's).

Primary exports apart from oil account for a significant share of exports to the EU in a number of European Rim countries (including Kosovo, Armenia, Georgia and Ukraine, which all export metal ores to the EU). For the Mediterranean Middle East and Israel, Tunisia and Morocco, as well as Moldova, Ukraine and Georgia, exports from the agricultural sector account for a large share of exports to the EU (for instance 14% in Moldova). However, agricultural exports from these countries to the EU may be hindered by the continuing trade barriers (Eurochambres, 2011).

Turning to the manufacturing industries, bilateral trade relations between the EU and resource-rich European Rim countries mirror the general export structure of the latter, which is characterized by an almost total lack of manufactured goods. With the notable exceptions of Switzerland and Israel, the European Rim countries generally have industrial export capacities in 'early-stage' manufacturing industries with low technology intensity, such as food and textiles. The textile industry, for example, contributes 45% to Albania's total exports to the EU; the share is similar for Moldova, and somewhat lower (around 34%) for Morocco and Tunisia. The food industry is a strong export sector in Serbia (13% of total) and in Lebanon (11% of total), and it is also important for Ukraine and Kosovo.

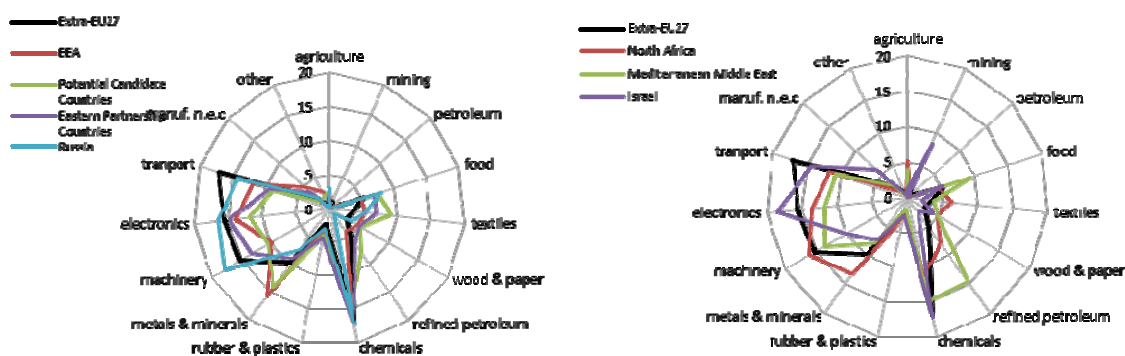
Developing export capacities in the textile, leather and food industries is the typical way in which countries start their move into manufacturing, because these sectors depend less on technology and more on cheap labour. It should be noted, however, that with the increased opportunity for multinational firms to move certain parts of their production processes (primarily labour-intensive stages of production) abroad, it is possible for countries that attract foreign direct investment implied by such offshoring activities to 'jump' straight into more technology-intensive industries. This has happened, for example, in the Central and Eastern European EU Member States, which have been integrated into the European car industry networks, as well as in China, Malaysia and Thailand, which have become part of the Asian electronics cluster initially created by Japan. Such developments are currently discernible only to a very small extent and also only in a small group of European Rim countries, such as Serbia and Bosnia-Herzegovina among the potential candidate countries, and arguably Tunisia and Morocco.

Apart from food and textiles, some of the resource-rich countries have industries directly linked to their commodities, such as a petroleum refining industry, a chemical or a metallurgy industry. This is, for example, the case in Ukraine, Bosnia-Herzegovina, Serbia and Kosovo, where the basic metals industries account for up to two-thirds of total exports to the EU market (Table III.2.2).

While the EU's imports from the European Rim countries are characterized by some extreme concentrations, mainly in primary commodities, the EU's exports to the European Rim countries are well diversified and strongly reflect the general export structure of the EU. There is a focus on the export of manufactured goods related to transport equipment, chemicals and machinery, as well as electronics (Figure III.2.3). In the new EU Member States there is no longer the great dichotomy in export structures with respect to different markets (e.g. exports in and outside the EU) that is typical of many Rim countries – see Havlik (2008). This is a result of more advanced trade integration, industrial upgrading (including activity by foreign investors) and improved competitiveness on the part of the new EU Member States.

Figure III.2.3

### EU exports to the European Rim countries, by industry, 2010



Note: Industry classification according to NACE Rev. 1. Agriculture: NACE 1, 2, 5; Mining: NACE 10, 12, 13; Petroleum: NACE 11; Food: NACE 15, 16; Textiles: NACE, 17, 18, 19; Wood & paper: NACE 20, 21, 22; Refined petroleum: NACE 23; Chemicals: NACE 24; Rubber & plastics: NACE 25; metals & minerals: NACE 26, 27, 28; Machinery: NACE 29; Electronics: NACE 30, 31, 32, 33; Transport: NACE 34, 35; Manufacturing n.e.c.: NACE 36; Other: NACE 40, 41, 45 and all services industries.

Source: COMEXT database; wiiw calculations.

The main difference between EU exports to the European Rim countries and overall extra-EU exports is that, in relative terms, the EU exports to the former, with the exception of the EEA, are less technology intensive – something that is evidenced by lower shares of the transport and the electronics industries in total exports. In return, industries with relatively low technology intensity (such as the food and the textiles industries) are overrepresented in bilateral exports to the European Rim regions. This bias towards more basic manufactured goods in EU–European Rim trade may, to some extent, reflect the development level of European Rim countries. Another contributing factor is that the overwhelming majority of

the European Rim countries (at least so far) do not seem to be closely integrated into the European production networks. That said, some differentiation is required here, because the potential candidate countries, notably Serbia and Bosnia-Herzegovina, and (to some extent) Tunisia and Morocco do seem to be engaged in vertical trade with the EU. In general, however, none of the European Rim countries is a preferential location for outsourcing, as evidenced by the fact that none of the European Rim countries is a major destination for efficiency-seeking (i.e. vertical) foreign direct investment by European multinationals.<sup>21</sup> This indicates that the European Rim has missed one of the major developments in the global economy – the emergence of international supply chains (López-Cálix, Walkenhorst and Diop, 2010), which characterize twenty-first-century trade relations (Baldwin, 2011). Deep trade integration in the form of international production sharing is a formidable opportunity to upgrade and diversify existing production and export structures. For example, the internationalization of production networks within Europe has helped the new EU Member States to upgrade their production structures. This has also led to a convergence of their export structures with that of their main trading partner, i.e. the core European countries (Stöllinger, 2011). As discussed above, in most European Rim countries there are no signs of such a move towards more technology-intensive industries, and in some cases not even towards basic industries. But by leaving out the European Rim as a location for FDI and by keeping the Rim's countries outside their international supply chains, EU multinationals are also missing out on an opportunity. They are key actors in European production networks because they are typically at the centre of European production networks and are in charge of coordinating and managing the supply chain (Gereffi, Humphrey and Sturgeon, 2005).

### *III.2.3 Comparative advantages in EU-27–European Rim bilateral trade*

Finally, we take a look at the revealed comparative advantages (RCAs) of the EU in trade with the European Rim countries. In particular, we differentiate industries by their technology content, using the OECD technology classification of industries. Leaving aside the EEA countries for a moment, distinct revealed comparative advantages emerge in EU–European Rim trade. The patterns of these RCAs are not surprising, given the preceding analysis of trade flows. The EU has a pronounced comparative disadvantage in primary industries, including agriculture, fishing, and mining and quarrying. By contrast, the EU has a strong RCA in high-technology industries. The sole exception here is Israel, which exports relatively more products from high-tech industries to the EU than vice versa. This can be explained by the fact that Israel is the country with the highest R&D intensity in the world.<sup>22</sup> The EU also has a huge comparative advantage in medium-technology industries, because these industries include the strongholds of the EU economies, such as chemicals (except pharmaceuticals), the machinery and the automotive industry.

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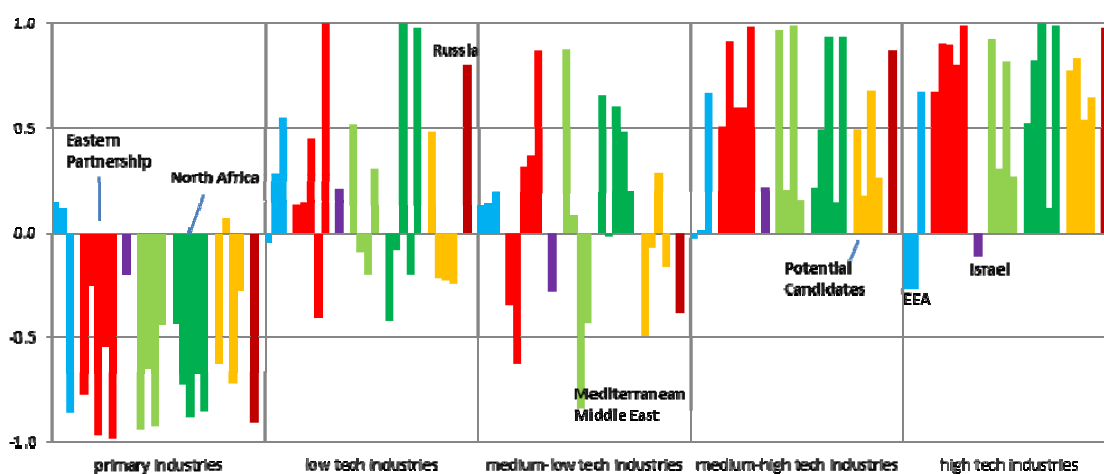
<sup>21</sup> Switzerland and Russia are important destinations for European FDI (see Section IV on foreign direct investment), but this appears to be predominantly a market-seeking type of FDI.

<sup>22</sup> The R&D intensity is defined as the expenditure on research and development (R&D) over GDP.

Mixed results are found in the low-tech and the medium-low-tech industries. Generally, the EU has revealed comparative disadvantages in these industries in bilateral trade with countries with some manufacturing capacity. In the low-tech industries, the EU's revealed comparative disadvantage is mainly due to the fact that several European Rim countries (Albania, Bosnia-Herzegovina, Moldova, Morocco, Tunisia, Egypt) have substantial textile industries. In the medium-technology industries, the metals and mineral industries explain the RCAs of Armenia and Ukraine. In the case of Russia, it is mainly the petroleum refining industry that explains the EU's revealed comparative disadvantage.

Figure III.2.4

**Revealed comparative advantages (RCAs) of EU-27 trade with the European Rim, industries by technology content, 2010**



Note: Industry grouping according to OECD technology classification (OECD, 2003).

Source: Eurostat COMEXT database, wiiw calculations.

Coming back to the EEA countries, the EU is almost in the opposite position – at least in trade with Switzerland and Liechtenstein, where it has an RCA in low-tech industries and a comparative disadvantage in high-tech industries.

### **III.3 Conditions for trade integration: export similarity and trade complementarity**

There is a bi-directional causality between trade and trade liberalization and trade integration. On the one hand, effective trade liberalization typically has an impact on trade structure and the growth of trade flows (see Sections III.4 and III.5 below). On the other hand, the EU, as any other trading nation, is interested in deepening trade relations with countries that have high and growing demand for EU exports. Similarly, the possibility of increased competition from trading partners has to be taken into account when trade barriers are further dismantled. Fierce competition is to be expected when the EU liberalizes trade with countries that have similar products in their export basket. Hence, trade structures are likely to influence which countries conclude free trade agreements (FTAs).

The trade similarity index reveals how similar (or distinct) the export patterns of two countries or regions are (see Annex 1 for definitions). That is, the exports of the European Rim countries to the EU are compared with intra-EU exports. Generally, this index is used to measure potential competition between the trading partners considered. At the same time, the overlap of exports also reflects the extent of vertical trade between the trading partners. In Table III.3.1 we show the trade similarity index for the EU and the European Rim countries for exports to the EU market.

The index indicates that the degree of overlap varies considerably across the European Rim countries, ranging from more than 50 for Israel, Switzerland and Serbia to only 3 for Azerbaijan (2010). The overlap of export structures is also very low between the EU and Algeria, Libya, Syria, Armenia, Georgia and Russia. In most cases the reason for the pronounced differences in the trade structure is again the high export concentration on energy carriers in these countries.

There is also some variation in the export similarity index over time, with the overlap of structures increasing for most countries. Strong increases in this index are observable for Serbia and Bosnia-Herzegovina, and also for Tunisia. For most countries, however, the increase in the overlap of their export structures with that of the EU has been rather modest.

Table III.3.1

**Export similarity index between the EU-27 and the European Rim countries, 2000–10**

		2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
EEA	SWI	54.5	56.6	56.5	56.7	55.9	57.5	55.4	56.0	55.4	54.7	53.2
	LI	36.6	39.0	37.7	38.8	38.0	38.1	38.0	33.3	39.7	42.9	44.7
	NOR	29.2	29.6	29.1	28.6	27.4	26.1	26.4	27.6	26.5	26.3	26.4
Eastern Partnership	AR	7.3	11.2	8.3	7.1	8.7	6.2	8.0	8.9	10.3	10.8	10.2
	AZ	7.8	7.8	7.5	8.5	9.3	9.5	8.8	6.2	5.9	4.7	3.3
	GE	17.3	16.7	20.8	14.8	16.8	21.7	17.0	18.6	17.1	16.3	17.2
	MD	20.1	21.6	20.2	19.8	22.2	23.5	23.6	25.2	28.3	29.8	27.7
	UA	32.5	30.7	30.1	32.9	32.5	34.7	37.0	38.7	35.8	34.5	36.0
Israel	ISR	50.5	50.0	50.1	51.6	51.1	50.8	52.2	52.5	53.3	57.2	54.4
Mediterranean Middle East	JOR	30.8	34.9	27.5	34.1	28.6	22.7	27.1	29.8	21.8	26.4	31.8
	LEB	29.5	34.2	34.4	38.0	37.9	40.7	38.0	37.8	35.6	36.3	34.4
	PAL	6.8	4.9	5.4	4.6	5.8	5.8	6.9	7.3	6.6	12.2	14.0
	SYR	9.2	9.2	8.8	9.6	12.9	10.2	11.1	13.2	11.2	11.2	8.1
North Africa	ALG	7.0	8.8	8.7	9.1	9.3	9.7	9.5	8.6	9.3	7.3	8.7
	EGY	28.2	29.9	28.4	29.1	29.4	29.6	28.7	30.1	29.8	26.4	29.2
	LIB	6.5	6.5	6.6	7.3	7.9	8.5	9.0	8.1	9.0	7.3	8.5
	MOR	25.6	24.7	22.8	23.1	24.4	22.7	24.8	22.2	22.7	24.3	24.7
	TUN	27.3	28.8	28.0	28.8	29.3	31.0	31.7	33.1	34.2	37.3	35.4
Potential Candidate Countries	AL	21.2	21.8	22.4	23.9	23.8	24.3	26.0	29.3	29.7	27.8	29.2
	BiH	24.8	25.9	29.3	31.5	31.0	34.6	35.6	38.7	40.9	39.3	41.4
	KO						22.6	21.9	21.6	14.2	16.9	22.9
	RS	38.7	38.1	36.7	39.7	40.2	36.7	37.9	42.0	44.3	49.0	50.1
Russia	RU	19.1	18.9	18.0	18.0	18.4	18.7	19.4	19.2	19.0	16.2	18.1
EU-27	EU-27	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Note: Grey shaded cells indicate that there was an FTA in operation between the EU-27 and the respective partner country in that year. Based on Combined Nomenclature, 3-digit (HS-3). Export similarity is between exports of the European Rim countries to the EU and the exports of the EU to the EU (=intra-EU exports). Serbia (RS) includes Kosovo for 2000–04. FTA according to the definition of the WTO.

Source: COMEXT database; wiiw calculations, WTO FTA database.



In Table III.3.1, shading is used to indicate those European Rim countries with which the EU has a free trade agreement. In this context, the World Trade Organization definition of an FTA (WTO, 2011), based on work by Acharya et al. (2011), is used, and this includes only a subset of preferential trade agreements (PTAs). In particular, a PTA is considered to be an FTA if tariffs and other trade barriers are eliminated on all or most trade, and if the countries keep their own tariffs vis-à-vis third countries. Otherwise (i.e. if trade concessions are only granted on a selected number of products), the PTA is referred to as a partial scope agreement (PSA). Hence, according to this terminology, the Eastern Partnership agreements do not qualify as FTAs.

In those cases where the EU has concluded an FTA with European Rim countries, no huge changes in the overlap of exports are discernible. However, it seems that, on average, the overlap of exports is considerably higher in the group of countries where an FTA with the EU is in force.

Table III.3.2

**Relationship between export similarity index and FTA agreements between the EU-27 and the European Rim countries, 2000–10**

	Fixed effects			Random effects		
	Dependent variable: Export Similarity Index			Dependent variable: Export Similarity Index		
	(1)	(2)	(3)	(1)	(2)	(3)
FTA <sub>t</sub>	3.1256 ***			3.2245 **		
	0.9570			1.6040		
FTA <sub>t-1</sub>		1.6071 *			1.7454	
		0.8450			1.2990	
FTA <sub>t-2</sub>			0.5286			0.6986
			0.8560			1.0790
oil <sub>t</sub>	-16.6776 ***	-18.0271 ***	-15.9191 ***	-16.1793 ***	-16.5426 ***	-16.8023 ***
	0.9180	1.0170	1.1880	4.1960	4.2800	4.3370
constant	23.9793 ***	25.1771 ***	26.0905 ***	28.1659 ***	29.1920 ***	29.8844 ***
	0.6870	0.7760	0.9230	3.0390	3.1480	3.1790
R <sup>2</sup> - overall	0.96729	0.96704	0.96876	0.3328	0.3123	0.2975
	248	226	204	248	226	204

Note: Standard errors are shown below coefficients. \*\*\*, \*\*, \* indicate statistical significance at the 1%, 5% and 10% level, respectively.

Source: COMEXT database; wiiw calculations, WTO FTA database.

It is clear that the motivations for the EU to conclude PTAs with the European Rim are not mainly based on the consideration of export structures, because political and security considerations and broader economic factors are key drivers for the integration efforts by the EU. Nevertheless, in a simple regression framework, a positive relationship emerges between the export similarity index and FTAs (the latter represented by a dummy variable which takes the value 1 if a country has an FTA with the EU and 0 otherwise) (Ta-

ble III.3.2). Hence, the EU tends to have FTAs in force with countries that have similar export structures. This suggests, on the one hand, that an FTA may lead to an increase in the overlap of exports, possible through the emergence of vertical trade. On the other hand, it could also imply that more similar export structures increase the probability that the EU signs a PTA with a European Rim country.<sup>23</sup>

Table III.3.3

**Trade complementarity index between the EU-27 and the European Rim, 2010**

	NOR	SWI	AL	BIH	RS	AR	AZ	GE	MD	UA	RU
<b>EU-27</b>	<b>60.1</b>	<b>65.4</b>	<b>45.5</b>	<b>52.6</b>	<b>54.2</b>	<b>42.6</b>	<b>40.6</b>	<b>47.2</b>	<b>47.1</b>	<b>46.2</b>	<b>58.9</b>
Core EU	56.4	62.2	42.2	49.5	51.0	40.7	40.1	44.7	44.6	43.8	57.4
Northern EU	51.9	50.0	40.0	44.1	45.8	38.1	36.9	41.0	41.3	38.8	47.8
Western EU	43.2	53.9	33.8	41.8	42.7	33.1	30.4	37.9	35.5	40.1	41.9
Southern EU	52.8	53.9	45.1	48.9	47.6	40.3	36.7	43.7	44.9	40.8	50.9
Eastern EU	52.3	49.4	42.6	48.1	49.7	39.1	35.9	43.3	41.8	40.0	50.1

	JOR	LEB	ISR	ALG	EGY	MOR	TUN
<b>EU-27</b>	<b>41.5</b>	<b>45.9</b>	<b>52.2</b>	<b>41.2</b>	<b>41.9</b>	<b>44.9</b>	<b>48.2</b>
Core EU	39.7	43.7	50.3	39.6	39.9	41.9	45.2
Northern EU	36.2	37.7	40.4	36.2	38.1	38.0	40.7
Western EU	36.8	37.6	45.3	30.3	34.2	36.5	35.6
Southern EU	37.6	42.1	42.1	39.7	37.4	40.2	45.2
Eastern EU	35.8	37.2	42.4	36.7	36.7	39.3	42.3

*Note:* Trade complementarity index calculated as the match between EU exports and European Rim countries' imports (see Annex 1). Based on SITC classification (5-digit level). Data for Liechtenstein, Kosovo and the Palestinian Authority are not available.

*Source:* UN Comtrade database; wiiw calculations.

With respect to further trade integration, it is not just the overlap of trade structures that is of interest, but also the complementarity of trade flows. Table III.3.3 shows the trade complementarity indices of the EU-27 and five sub-groups of the EU with each of the European Rim countries. The index is calculated on the basis of global EU exports and global imports from the European Rim countries (see Annex 1). The larger the index, the better the match between EU exports and imports from the European Rim countries, implying that further liberalization steps within an existing FTA, or the conclusion of an FTA, should have a greater impact on trade flows.

The trade complementarity indices are rather high for all countries, ranging from 65 in Switzerland to 41 in Azerbaijan. To some extent, the trade complementarity index is overstating the match of the export and import structures of the EU and the European Rim

<sup>23</sup> A modified regression framework which uses the FTA dummy as the dependent variable and the export similarity index also finds a positive and statistically significant relationship. The difficulty in this set-up is that the FTA dummy variable is highly dependent on its lag values. However, including lagged values of the dependent variable poses methodological difficulties for the panel probit estimator.

countries because of the huge discrepancy in the size of the economies. This means that, even if the export structure fits exactly the import structure of the partner country (index of 100) but that partner country is very small, the likely impact in case of trade liberalization will still be limited. Nevertheless, the high values for the complementarity index between EU-27 exports and European Rim imports suggest that it is rather the lack of market size of the European Rim economies than a mismatch between their import demand and the EU's export structure that hampers trade flows.

The following two sections will analyse the potential impacts of further trade integration and liberalization between the EU-27 and the European Rim countries.

### ***III.4 Measuring the effects of EU trade liberalization with the European Rim countries***

#### *III.4.1 Introduction*

Almost all the countries of the European Rim have some sort of free trade agreement with the EU, or else there are EU autonomous trade measures (ATMs) or an EU generalized system of preferences (GSP) in place.<sup>24</sup> Hence, by 2010 import-weighted tariff rates for EU imports from the European Rim were very low: no European Rim country faces more than a 5% tariff rate. In fact, the average EU tariff rate vis-à-vis the European Rim is only 0.4%. It is considerably different the other way round. EU exporters face an average weighted tariff rate of 5% for exports to the European Rim countries, with peaks of up to 19% for some countries. As a core component of the EU's 2020 strategy, the EU trade policy pursues 'deep and comprehensive FTAs' (DCFTAs) within the frameworks of the Eastern Partnership and the Euro-Mediterranean Partnership. The aim is to bring all neighbours gradually closer to the single market. The average tariff faced by EU exports of industrial products would fall to about 1.7%. Taken together, various FTAs would add up to 0.5% to EU GDP in the longer run (European Commission, 2010a; European Union, 2011).

Therefore this section simulates the effects of further trade liberalization between the EU and the European Rim. Three scenarios will be considered in order to check for different trade liberalization strategies. First, a unilateral EU trade liberalization will be tested – all EU tariff rates for imports from the European Rim will be set to zero. Second, a bilateral trade liberalization scenario will be simulated – all EU tariff rates for imports from the European Rim and vice versa will be set to zero. Third, a customs union will be assessed – trade between the EU and the European Rim countries faces no tariff barriers and the European Rim countries take over the EU tariff rates against the rest of the World and have to give up their tariff protection against the EU.

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<sup>24</sup> Countries in the Eastern part of the Rim are in the process of negotiating FTAs (DCFTA) – except Russia.

### III.4.2 The Model

The model that will be applied is the global simulation model (GSIM) for the analysis of global, regional and unilateral trade policy changes proposed by Francois and Hall (2003). This model has been used in a number of trade analysis papers, especially where data are scarce (see e.g. Vanzetti, de Córdoba and Chau, 2005; Mutambatsere, 2006; Serletis and Fetzer, 2008; Hess and Cramon-Taubadel, 2008).

To avoid unmanageable complexity, the solution set of the model is reduced to those global prices that clear global markets. Having a global set of equilibrium prices allows 'backsolving' for national results. The representation of import demand is log-linearized and combined with generic export-supply equations (Francois and Hall, 1997).

One of the basic assumptions of the model is national product differentiation, as imports are imperfect substitutes for each other. Across products from different sources, the elasticity of substitution is held to be equal and constant. Also the elasticity of demand in aggregate is held constant. Similarly import supply elasticity is constant, too. This approach is consistent with the Armington (1969) approach to product differentiation at the national level.

The core equation for the global market clearing condition for each export variety is the following:

$$\begin{aligned} \hat{M}_{i,r} = \hat{X}_{i,r} \Rightarrow \\ E_{X(i,r)} \hat{P}_{i,r}^* = \sum_v N_{(i,v),(r,r)} \hat{P}_{(i,v),r} + \sum_v \sum_{s \neq r} N_{(i,v),(r,s)} \hat{P}_{(i,v),s} = \sum_v N_{(i,v),(r,r)} [P_r^* + \hat{T}_{(i,v),r}] \\ + \sum_v \sum_{s \neq r} N_{(i,v),(r,s)} [\hat{P}_s^* + \hat{T}_{(i,v),s}], \end{aligned}$$

where  $\hat{\phantom{x}}$  denotes a proportional change,  $r$  and  $s$  the exporting regions,  $v$  the importing regions and  $i$  the industry designation.  $M$  and  $X$  represent imports and exports in quantities, respectively.  $E_{X(i,r)}$  is the elasticity of export supply and  $P_{i,r}^*$  the world price for exports from region  $r$ .  $N_{(i,v),(r,r)}$  is the own price demand elasticity,  $P_{(i,v),r}$  is the internal price for goods from region  $r$  imported into region  $v$  and  $N_{(i,v),(r,s)}$  is the cross-price elasticity. Finally,  $T_{(i,v),r}$  is the power of the tariff,  $T=(1+t)$ . For any set of  $R$  trading countries, this equation can be used to define  $S \leq R$  global market clearing conditions with  $R$  exporters. If also domestic production is modelled, there are exactly  $R=S$  market clearing conditions. A more detailed description and definition of the relevant own- and cross-price elasticities, global supply and demand definitions can be found in Francois and Hall (2003).

Using a full-fledged general equilibrium model (which would have to include a full endogenization of income and expenditure levels across the region) is not possible because many European Rim countries lack the necessary input-output tables. However, even the partial

equilibrium approach implies useful advantages, because it allows for a rapid and transparent analysis of a wide range of commercial policy issues with a minimum of data and computational requirements. Moreover, results can be interpreted as rather short-run effects, as compared to general equilibrium long-run effects.

Having the limitations of the partial equilibrium approach in mind, useful insights can be made with regard to complex, multi-country trade policy changes. The results of the GSIM allow for the assessment of importer and exporter effects related to tariff revenues, exporter (producer) surplus, and importer (consumer) surplus.

The model requires the input of a bilateral trade matrix at world prices, an initial matrix of bilateral import tariffs in ad valorem form, a final matrix of bilateral import tariffs in ad valorem form, export supply elasticities, aggregate import demand elasticities and elasticities of substitution. Using additional data, domestic production effects can also be fitted into the framework.

#### *III.4.3 The data*

The data necessary to run the GSIM model are tariff (as well as data on subsidies if they exist) and trade data (including data for trade with self, i.e. production less exports), as well as estimates of demand, supply and substitution elasticities. Data on trade and import-weighted average applied tariff rates were partly taken from Kosovo Customs, Liechtenstein, Moldova, Syria and Ukraine Statistical Offices, as well as (in the majority of cases) from the UN Comtrade and the UNCTAD TRAINS (Trade Analysis and Information System) database. Data were aggregated at the total level and stem in general from the year 2010. For some countries, however, data from earlier years had to be taken, for reasons of availability. These are mostly export data for the economy in question, but in some cases mirror statistics (i.e. import data) had to be taken instead.

However, with regard to trade with self (gross output less exports) most countries have not yet published 2010 data. It was thus decided to use pre-crisis 2007 data instead. This should be a good proxy for the year 2010. For EU trade with self, the data come from Eurostat. National statistical office data were taken for the majority of countries. For a few countries where output data were not available, UNSD National Accounts data were applied to average intermediate consumption coefficients from comparable countries.

Non-tariff barriers (NTBs) such as quotas were not included on account of a lack of data. The export supply elasticity (1.5), aggregate import demand elasticity (-1.25) and the elasticity of substitution (5) were adopted from Francois and Hall (2003). However, in the case of the EU and the rest of the world (ROW) an 'infinite' export supply elasticity (9999999) was assumed. This flattens out the supply curves and is in line with a small versus large country assumption.

Table III.4.1

## Simulation effects of EU trade liberalization scenarios

	EU tariff rates vs European Rim, in %	European Rim tariff rates vs EU, in %	Unilateral scenario			Bilateral scenario			Customs union scenario		
			Change in tariff revenue, in USD mn	Change in Consumer price, in %	Change in gross output, in %	Change in tariff revenue, in USD mn	Change in Consumer price, in %	Change in gross output, in %	Change in tariff revenue, in USD mn	Change in Consumer price, in %	Change in gross output, in %
European Union	-	-	-572	-0.0	-0.0	-572	-0.0	0.8	-572	-0.0	0.8
Switzerland	0.0	0.0	0	0.0	0.0	0	0.0	-0.1	746	0.3	-3.6
Liechtenstein	0.0	0.0	0	0.0	0.0	0	0.0	-0.0	3	0.1	-2.1
Norway	0.1	0.5	0	0.0	0.2	-276	-0.1	-0.0	-125	-0.1	-2.4
Albania	0.4	5.3	0	0.0	0.3	-147	-1.6	-4.4	-163	-1.8	-4.8
Bosnia-Herzegovina	0.0	0.7	0	-0.0	-0.0	-28	-0.2	-0.8	-30	-0.2	-2.6
Serbia	0.0	6.9	0	-0.0	-0.0	-726	-1.3	-4.2	-787	-1.4	-4.6
Kosovo	0.4	7.1	0	0.0	0.1	-61	-1.2	-3.9	-84	-1.7	-5.0
Armenia	2.0	2.0	0	0.0	0.3	-15	-0.1	-0.1	-17	-0.2	-0.7
Azerbaijan	0.0	5.3	0	0.0	0.0	-166	-0.5	-1.1	-241	-0.8	-3.6
Georgia	0.0	0.5	0	0.0	-0.0	-7	-0.1	-0.5	15	0.2	-0.4
Moldova	0.0	3.2	0	0.0	-0.0	-64	-1.0	-2.6	-67	-1.0	-3.8
Russia	0.1	6.5	0	0.0	0.1	-7,270	-0.6	-1.6	-8,803	-0.8	-3.8
Ukraine	0.7	3.2	0	0.0	0.3	-718	-0.4	-1.2	-871	-0.5	-2.6
Algeria	0.0	6.8	0	-0.0	-0.0	-1,431	-1.3	-2.8	-2,284	-2.2	-8.6
Egypt	0.0	12.4	0	0.0	0.0	-2,484	-1.7	-4.9	-3,988	-2.9	-10.0
Israel	0.1	3.9	0	0.0	0.1	-752	-0.7	-1.2	-1,079	-1.0	-7.3
Jordan	0.0	7.6	0	0.0	-0.0	-288	-1.2	-3.0	-489	-2.1	-9.8
Lebanon	0.0	5.9	0	0.0	0.0	-389	-1.7	-4.1	-533	-2.4	-9.4
Libya	0.0	0.0	0	0.0	0.0	0	-0.0	-0.1	118	0.2	-2.2
Morocco	0.7	5.8	0	0.0	0.4	-1,038	-1.1	-2.8	-1,411	-1.5	-5.1
Palestinian Authority	4.7	3.9	0	0.0	0.1	-4	-0.1	-0.4	-5	-0.1	-0.5
Syria	0.0	7.9	0	0.0	0.0	-389	-0.8	-2.5	-749	-1.6	-6.0
Tunisia	0.1	19.2	0	0.0	0.1	-2,907	-4.9	-12.3	-3,287	-5.8	-15.3
Rest of the World	1.6	4.0	0	-0.0	-0.0	-0	-0.0	-0.0	10,025	0.0	0.1

Source: UN Comtrade, UNCTAD TRAINS, national statistics and own calculations, base year 2010.

These are certainly very simplified assumptions. However, due to the scarce data it would be impossible to estimate 'true elasticities'. An alternative approach would be to employ average elasticities as, for example, is described in 22 industry studies by Messerlin (2001). There, especially the elasticities of substitution seem to be in general much lower than 5. However, in the literature an elasticity of substitution of 5 is used quite often (see also Fujita, Krugman and Venables, 2001).

#### *III.4.4 The results*

After feeding the model step by step with the initial bilateral trade matrix (including trade with self), at world prices in USD, the initial matrix of bilateral import tariffs in ad valorem form, the final matrix of bilateral import tariffs in ad valorem and the elasticities, the following output was estimated: trade effects, welfare effects (producer surplus, consumer surplus and change in tariff revenue) and price and output changes. This was executed for the three chosen scenarios.

All the results of this exercise have to be treated with caution, because they are generated with the help of a partial equilibrium model instead of a general equilibrium model. Better performances of the general equilibrium model if the respective data were available might have helped us to find a shift from import-competing and protected sectors to export sectors and non-tradable sectors, with potentially significant output increases in some of them. It is not possible to observe this in a partial equilibrium model.

Table III.4.1 presents the most important results for the three scenarios, as well as the 2010 import-weighted average tariff rates of the EU vis-à-vis the European Rim and vice versa in the first two columns. The following columns show some of the major simulation results (i.e. changes in tariff revenues, in consumer prices and output) for the three scenarios.

Current (2010) EU import-weighted applied tariff protection against imports from the European Rim countries is very low: on average only 0.4%. In the opposite direction, EU exports face an average tariff rate of 5%, with some considerable peaks above 7% for exports to Tunisia, Egypt, Syria, Jordan and Kosovo.

In the unilateral scenario, where the EU slashes its import tariffs to zero, hardly anything changes, since the applied tariffs are already very low. The only major effect is a loss of about USD 570 million in tariff revenues for the EU. Most of this constitutes a welfare gain for EU consumers, who can consume slightly cheaper imports from the European Rim. However, the change in EU consumer prices is negligible. Given the low level of current protection, European Rim producers can hardly increase their production. Gross output change is minimal.

In the bilateral scenario, where both the EU and the European Rim countries cut their tariffs to zero, changes are more substantial. Apart from the EU's loss of tariff revenue, several of the European Rim countries also have to bear considerable losses of tariff revenues, depending on their level of tariff protection against EU imports and the value of these imports. Tariff revenue losses of more than a billion USD are estimated for Russia (USD 7.2 billion), Tunisia (USD 2.9 billion), Egypt (USD 2.5 billion), Algeria and Morocco. Most of this loss is again a gain for consumers. However, net welfare effects from bilateral liberalization are mainly negative. Consumer price changes are highest in Tunisia, Lebanon, Egypt and Albania (a drop of between 5% and 1.5%). These are also the countries that would suffer the largest gross output losses (between 12% and 4%). On the other hand, the EU could increase its total gross output by some 0.8% (about USD 73 billion) by again accepting tariff revenue losses of some USD 570 million.

Finally, in the customs union scenario, where, in addition to the second scenario, the European Rim countries take over the EU tariff rates against the rest of the world and give up their tariff rates against the EU, effects are similar to the second scenario, just a bit more pronounced, as the EU also tends to have lower tariff protection against the rest of the world than do the European Rim countries. The highest tariff revenue losses would again occur in Russia (USD 8.8 billion), Egypt (USD 4.0 billion) and Tunisia (SD 3.3 billion). The largest price changes would occur in Tunisia, Egypt, Lebanon, Algeria and Jordan (a decline of between 6% and 2%). This set of countries would also have the largest gross output drop – between 15% and 9%. As in the second scenario, the EU could increase its total gross output by some 0.8% by again accepting tariff revenue losses of some USD 570 million. Interestingly, in this scenario the drop in consumer prices due to cheaper imports is strong enough in most countries to increase the consumer surplus above the level of tariff revenue drop. Hence most countries would experience a net welfare gain, which would be quite considerable in Egypt (USD 140 million), Russia (USD 130 million), Tunisia (USD 100 million) and Algeria (USD 75 million). In all three scenarios, the net EU welfare loss would be below USD 5 million.

#### *III.4.5 Conclusions*

Overall, for the EU, losses from trade liberalization with the European Rim in whatever way performed (unilateral, bilateral or customs union) would cause only negligible costs, mainly in the form of tariff revenue losses of about USD 570 million, which would mostly represent a gain for the EU consumer in terms of lower prices for imports from the European Rim. Also, tariff losses could be compensated for by a considerable increase in EU gross output of 0.8% in the bilateral and customs union scenarios.

For the European Rim countries, the gain from unilateral EU trade liberalization would be almost non-existent, as the current EU protection in terms of tariff rates is already negligible. Bilateral tariff cuts would mainly harm the European Rim countries, as tariff revenue



losses for some of these countries would be quite considerable, and similarly falling prices would cause certain output losses. Most European Rim countries would be net losers. This would change in the case of a customs union, where the consumers of the European Rim countries would gain strongly from larger price drops.

Given that, in most cases, tariff rates are already low, especially small and medium-sized enterprises engaged in exporting in both the EU and the European Rim could presumably gain much more from a bilateral reduction of non-tariff barriers. Further research should draw attention to the issue of NTBs (see also Eurochambres, 2011; Galal and Reiffers, 2011).

### **III.5 The effects of free trade agreements**

#### *III.5.1 Introduction*

In the context of the analysis of trade liberalization, it is interesting to check whether the trade agreements that have been concluded so far have had a significant effect on the trade flows between the EU and the European Rim countries. In this respect, we estimate econometrically a gravity model that allows us to check for the effects of the agreements on both EU exports to and EU imports from the European Rim region. Therefore we will apply a fixed-effects-panel version of the single-country-gravity-model following the cross-sectional approach in Summary (1989), Depken and Sonora (2005) and Sonora (2008).

#### *III.5.2 The model*

The estimated equation is the following:

$$EUtrade_{it} = GDP_{it} + Tariff_{it} + FTA_{it} + \alpha_i + \varepsilon_{it},$$

where  $EUtrade$  stands for either exports in specification 1 or imports in specification 2,  $i$  represents the respective European Rim country and  $t$  the year. Among the explanatory variables on the right-hand side we have a control variable that is typically to be found in a gravity model – GDP. Another traditional trade-explaining variable, Distance between capital cities, is not explicitly employed, but this information is covered among others in the country fixed effect  $\alpha$ . Finally, we include the average weighted Tariff rate for EU exports to the European Rim countries in specification 1 and EU imports from the European Rim countries in specification 2 and a dummy variable for FTAs. The expected coefficients for GDP and Tariff are straightforward. It is, however, interesting to see whether the FTAs, apart from lowering tariffs, have been able to reduce additional non-tariff barriers. The  $\varepsilon$  represents the error term.

#### *III.5.3 The data*

The panel includes available data for the period 1995–2010. GDP in USD is taken from the UNSD National Accounts database. EU exports and imports data in USD come from the

UN Comtrade database. Appropriate time series data for EU trade with Liechtenstein and Kosovo are missing. The average import-weighted tariff rates for EU exports to the European Rim countries, as well as the EU tariff for imports from the European Rim are from the UNCTAD TRAINS database. Missing observations of up to three consecutive years in the European Rim tariff variable were interpolated using the averages of the nearest observations. The FTA dummy variable was constructed using information from the WTO FTA database.

### III.5.4 Results

Both export and import specifications were estimated in a robust way as heteroskedasticity in the data was detected. In order to control for non-linearities – and also for the sake of better interpretation – export, import and GDP variables were transformed in logs. The results acquired are summarized in Table III.5.1.

Table III.5.1

#### Robust fixed-effects estimation results of the EU exports and imports specifications

	log EU exports	log EU imports
log GDP	1.0393 (0.000)***	1.3601 (0.000)***
Tariff rate	-0.0002 (0.974)	-0.0285 (0.107)
FTA dummy	0.0951 (0.128)	-0.0428 (0.710)
Constant	-2.3827 (0.039)**	-6.1331 (0.000)***
Overall R <sup>2</sup>	0.86	0.79
Observations	216	330
Countries	21	21

Note: P-values in parentheses. \*\*\*=significant at 1% level, \*\*=significant at 5% level, \*=significant at 10%.

Under conventional significance levels, only the coefficients for the European Rim countries' GDP remain significant (having the expected positive sign) in both the EU exports and the EU imports specifications. A 1% higher GDP level of an EU partner country from the European Rim increases trade levels by even more than 1%. The coefficients of the other explanatory variables (i.e. tariff rate and FTA dummy) do not prove to be significant. However, it could be argued that the sample analysed is almost identical to the total population, given some restrictions in data availability (e.g. lack of data for Liechtenstein and Kosovo), and thus statistical levels of significance could be somewhat lowered. Applying a 15% level of significance, we find two more interesting results.

In the EU exports regression, the coefficient of the FTA dummy is positive. The interpretation goes as follows. If the EU has a free trade agreement with an EU Rim country, EU exports to that country are expected to be about 10% higher than if it does not. In this specification, the tariff rate is completely insignificant (also when estimated without the FTA dummy). In the case of the EU imports specification it is vice versa. The FTA dummy is completely insignificant (also when estimated without the tariff variable), while the coefficient of the tariff rate shows a negative sign and is significant at the 15% level. The interpretation here is that an increase in the EU tariff rate of 1 percentage point results in a 3% reduction in EU imports from the European Rim countries.

### *III.5.5 Conclusions*

Unsurprisingly, the main conclusion is that the EU trades more with larger economies from the European Rim. EU exports and imports increase at least linearly with the size of the European Rim countries' GDP. Relaxing statistical significance levels, it is interesting to note that EU exports to the European Rim are quite sensitive to free trade agreements, while changes in tariff rates have no measurable impact. In the case of EU imports from the European Rim, it is exactly the other way around. EU tariff reductions over the last decade and a half have increased imports from the European Rim, while FTAs have had no measurable additional effect in terms of reducing, for example, non-tariff barriers. Therefore it seems reasonable to assume that it is in the interests of EU exporters for the EU to conclude FTAs with the remaining European Rim countries as well, since FTAs seem to be correlated with more exports, but not necessarily with more imports.

### **III.6 Summary and policy implications**

Trade flows between the EU and the European Rim are sizeable, but are also characterized by a great asymmetry and underutilization of the huge trade potential provided by the geographical proximity and historical and cultural ties. In particular for the European Rim countries, the proximity of the huge EU market can be regarded as a locational competitive advantage – so far largely unexploited.

As for the asymmetry, the European Rim countries absorb 27% of extra-EU exports and are the origin of 29% of extra-EU imports. However, about two-thirds of both bilateral exports and imports are due to trade with Switzerland, Norway and Russia. The remaining regions in the European Rim are not pivotal for the EU, given their limited market size and/or lack of competitiveness. However, each of the regions within the European Rim is a focus area in terms of trade flows for at least one sub-region of the EU. For example, the Southern EU has strong trade links with North Africa and the Mediterranean Middle East, and the Eastern EU with the Eastern Partnership countries, Russia and the potential candidate countries in the Western Balkans. On the other hand, for most European Rim coun-

tries the EU is the main trading partner, and their market share in the EU tends to be larger than their global share.

One of the greatest structural shortcomings in EU–European Rim trade relations is that trade diversification in most European Rim countries, except for the EEA and Israel, is low – or even very low. Many European Rim countries have relied heavily on natural resources, primarily oil and natural gas. This is reflected in high export concentration indices – something that is also strongly related to the lack of internationally competitive manufacturing industries in many European Rim countries’ export baskets. When dealing with the competitiveness of the European Rim countries, it must be kept in mind that several of the European Rim countries are in a situation where competitive advantages are not yet shaped by efficiency considerations, but primarily by available natural resources. Hence, market-based measures to improve the efficiency and international competitiveness of the countries – such as product and labour market reforms, but also liberalization efforts and improvements in the business climate in general – may not so far have had the desired positive effects. This is because these economies still lack the industrial capacity and the necessary structural flexibility to respond successfully to competitive pressures; this results in high adjustment costs and low gains from liberalization in terms of the increased emergence of new firms and new export products. This interpretation of the competitive situation of the majority of European Rim countries (again except for the EEA) fits the results from the trade simulation exercise, which predicts significant output losses in the European Rim countries in the bilateral liberalization scenario.

The lack of competitive manufacturing industries is, first and foremost, a problem for the economies in the European Rim; but it also represents a hindrance to EU companies. First of all, the development of industrial capacity in the European Rim would increase demand in these countries and would create additional export opportunities for EU companies. Both the gravity estimation and the trade complementarity indices suggest that trade between the EU and the European Rim countries is not hindered by a mismatch of EU exports and import demand by the European Rim or by tariff barriers. Rather it is the limited market size of the European Rim countries (and resulting low levels of import demand) that matters most.

The inability of many European Rim countries to diversify their export structures and to move into manufacturing causes them to miss a great growth potential, and thereby indirectly causes trade opportunities for EU companies to go begging. Moreover, EU companies could benefit from industrial development in the European Rim, as this would make the countries of the Rim presumably more attractive for outsourcing, potentially leading to a much more intensive integration into European production networks than is currently the case. While EU multinationals would be the primary beneficiaries of such a development, it would also provide fresh opportunities for SMEs both in the EU and in the European Rim –

especially if they were able to find a niche within international supply chains. In particular, modular supply chains offer great opportunities for SMEs to develop new technological and organizational skills, and also enable them to capture a higher share of the value added created, as is the case in captive supply chains. However, in order to exploit these opportunities a number of existing obstacles to trade and investments need to be overcome (see Section II above).

## Annex 1 – Definition of indices

The export diversification index of the European Rim countries is calculated according to the Herfindahl–Hirschman index:

$$HHI_{RIM}^{EXPORT} = \sqrt{\sum_{i=1}^N \left[ \frac{X_{i,RIM}}{\sum_{i=1}^N X_{i,RIM}} \right]^2}$$

where  $X$  denotes exports and  $i$  is an industry/product index. The higher the index, the more concentrated the country's exports

**Revealed comparative advantages (RCAs)** in trade between the EU-27 and the European Rim countries in industries  $i$  are calculated as:

$$RCA_{EU,RIM} = \frac{\frac{\left(\frac{X_{i,EU}}{M_{i,EU}}\right)}{\left(\frac{\sum_{i=1}^N X_{i,EU}}{\sum_{i=1}^N M_{i,EU}}\right)} - 1}{\frac{\left(\frac{X_{i,EU}}{M_{i,EU}}\right)}{\left(\frac{\sum_{i=1}^N X_{i,EU}}{\sum_{i=1}^N M_{i,EU}}\right)} + 1}$$

where  $X$  denotes exports,  $M$  denotes imports and  $i$  is an industry/product index. The index ranges from -1 to +1, with positive (negative) values indicating revealed comparative advantages (revealed comparative disadvantages).

The **export similarity index (ES)** between the EU-27 and the European Rim countries is calculated as:

$$ES_{EU,RIM} = \sum_{i=1}^N \min(X_{i,EU}, X_{i,RIM}) \cdot 100$$

where  $X$  denotes exports and  $i$  is the product index. The index ranges from 0 to 100.

The **trade complementarity index (TC)** between the EU-27 and the European Rim countries takes the form:

$$TC_{EU,RIM} = \sum_{i=1}^N 100 - \min\left(\frac{|X_{i,EU} \cdot M_{i,RIM}|}{2}\right)$$

where  $X$  denotes exports,  $M$  denotes imports and  $i$  is an industry index.

## Annex 2 – Classification of NACE industries by technology intensity

Industry	NACE Rev. 1.1 code
<b>High technology</b>	
Pharmaceuticals	24.4
Computer, office machinery	30
Electronics and communications	32
Scientific instruments	33
Aerospace	35.3
<b>Medium-high technology</b>	
Motor vehicles	34
Electrical machinery	31
Chemicals	24 (except 24.4)
Other transport equipment	35 (except 35.3 & 35.1)
Non-electrical machinery	29
<b>Medium-low technology</b>	
Petroleum refining	23
Rubber and plastic products	25
Non-metallic mineral products	26
Basic metals	27
Fabricated metal products	28
Shipbuilding	35.1
<b>Low technology</b>	
Food and beverages	15
Tobacco	16
Textiles	17
Wearing apparel	18
Leather	19
Wood	20
Pulp and paper	21
Publishing and printing	22
Other manufacturing n.e.c.	36
Recycling	37

Source: OECD (2003).

## **IV. Growth and Productivity Effects of FDI flows between the EU and the Rim countries**

### ***IV.1 Introduction***

Foreign direct investment (FDI) explains the intensity of firm-level integration between countries. Multinational companies (MNCs) have been engines of global economic development, technological transfer and deepening globalization. International corporate networks have grown by setting up subsidiaries in host economies and by purchasing subsidiaries through mergers and acquisitions (M&As). This section looks at the changing role of the EU-based internationally operating companies (including SMEs) in the European Rim countries.

Attracting FDI inflows indicates the competitiveness of a host country location for production and services. The intensity of FDI outflows, on the other hand, indicates the competitiveness of home country MNCs to capture foreign markets. FDI stocks indicate the size of established positions of MNCs in another country. Companies expand abroad to capture new markets (horizontal or market-seeking FDI) or to optimize their production by allocating stages of production to the most efficient location (vertical or efficiency-seeking FDI). Both types of FDI have important growth effects by increasing production for new markets and by reducing production costs. FDI also has productivity effects due to economies of scale and the utilization of lower production costs. In addition, FDI may help to access scarce natural, human and R&D resources (resource-seeking FDI).

Distance plays an important role in the regional distribution of global FDI, especially of the efficiency-seeking type. This can put limits on the international segmentation of production. Transportation and other transaction costs increase with distance and may make longer-distance sourcing of bulky goods expensive. Research on international sourcing by EU firms (Alajääsko, 2009) concludes that international activity is not very widespread among companies, and that sourcing is more regional than global. Company plans do not indicate major future changes in these respects. Controlling the supply chain to prevent interruptions is found to be a cumbersome task, and bad experience has already caused the return of some outsourced businesses (Capgemini, 2010). Overall, outsourcing activity declined in the course of the recent crisis and near-shoring may be preferred to far-shoring in the future. This has opened up opportunities for the Rim countries in the European neighbourhood to benefit from offshoring from Europe.

IT outsourcing and business process outsourcing are the two main areas of services outsourcing for which distance does not matter all that much in terms of transport cost, but only in terms of management cost, while unit labour cost is the decisive location factor. For such activities, skills, language skills and development of IT infrastructure are the main locational advantages of host countries. For other services (like banking or telecommunications) market seeking is the main FDI motivation, and exports take the form of FDI.



In the following, we investigate the size of FDI between the EU countries and the European Rim countries with the aims of seeing the existing intensity of direct investment links, exploring the impact of these links on the EU countries' competitive position and looking for location advantages in the region that could be utilized by EU firms in the future.

Box IV.1.1

#### **Notes on the data**

This section relies on two main data sources. The first is the Eurostat Foreign Direct Investment Database (henceforth 'Eurostat'), which provides consistent data on aggregate and bilateral FDI flows and stocks. Eurostat data are based on national statistics compiled by EU Member States following balance of payments principles and international benchmark definitions of FDI. In order to ensure that FDI activities, as measured by Eurostat data, really do reflect the economic activities of multinational firms in foreign markets, we made an effort to avoid as far as possible flows related to Special Purpose Enterprises (SPEs) which are characterized by little physical presence in the host economy and no (or just a few) employees (Eurostat, 2011a). To restrict the influence of SPEs we made some adjustments to the Eurostat data. In particular, we downsized the intra-EU flows of Luxembourg, because, according to the Eurostat Manual, 85–90% of those are generated by SPEs. With respect to extra-EU flows, we excluded flows to and from offshore financial centres, such as the British Channel Islands, the British Virgin Islands or the Cayman Islands.

The second major data source tapped for this chapter is the FDI Intelligence database of the Financial Times Ltd (<http://www.fdimarkets.com>), which allows a most up-to-date analysis of greenfield FDI flows. The information is based on press reports, and thus the data can be taken as investment commitments in greenfield investment projects. While balance of payments data are published with a delay of one or two years, the FDI Intelligence database is updated monthly. The number of greenfield investment projects is especially important for information about services with low capital intensity, which are underrepresented in the balance of payments statistics. The FDI Intelligence database lacks the amount of pledged investment to be generated by greenfield FDI, as data of this kind are only sporadically reported and are often estimated. That is why the indicated (and partly estimated) investment amounts are referred to here as 'pledged capital'. Each of the two main data sources – Eurostat and the FDI Intelligence database – has its merits and shortcomings; these two high-quality but methodologically very distinct data sources help to generate a realistic picture of EU-related FDI.

#### **IV.2 Size of FDI inflows and outflows**

FDI activities on the part of the EU have intensified with the countries outside the EU in recent years. FDI inflows to the EU from the outside comprised 20–30% of the total FDI inflows reported by the Member States in the early and mid-2000s, and this share had increased to about 40% by 2009–10 (the rest being intra-EU FDI). This shift was primarily shaped by rising investments from the US, other developed countries and West Asia, and not by the European Rim countries. Inflows from the Rim fluctuated sharply around the ten-year average of EUR 16.9 billion or 24.4% of total extra-EU inflows. In the peak year of FDI inflows to the EU, 2007, the Rim countries contributed 21% (EUR 38.4 billion) followed by

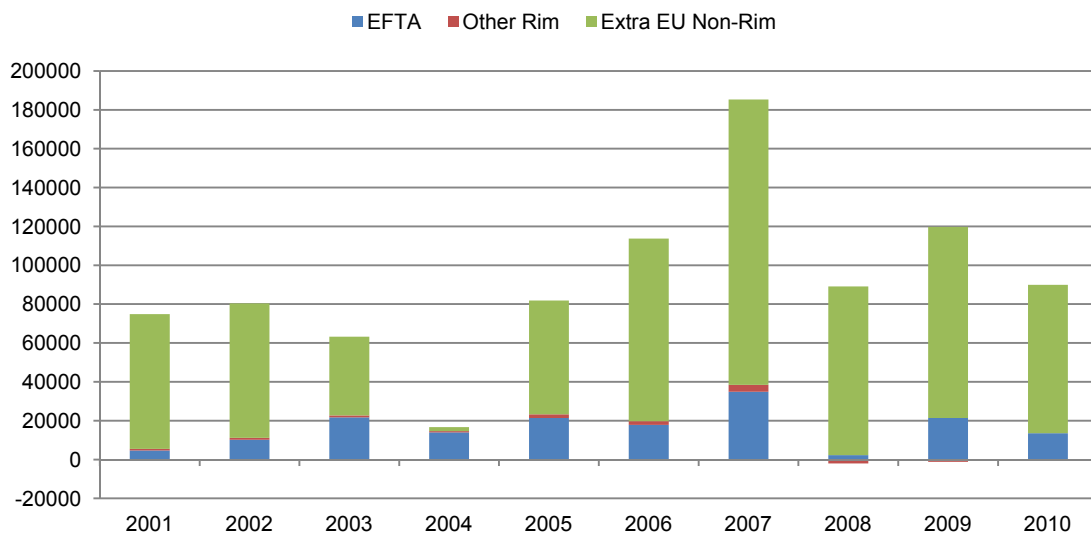
almost no inflow in the subsequent year. In 2010, Rim countries contributed 15% (EUR 14.5 billion). The most recent three years point to lower than average inflows from the Rim, which may indicate a loss of competitiveness of this region on European markets compared to the rest of the world.

In terms of the EU's outward FDI, the share of extra-EU flows comprised 30–40% of the total through most of the 2000s, but of late has increased to 50%. European Rim countries had a rising share in the extra-EU outward flows, especially in 2009–10, when the overall flows declined substantially compared with the peak years of 2007–08. The share of the Rim in the extra-EU outflows reached 42% (EUR 84.6 billion) in 2009 and 28% (EUR 55.2 billion) in 2010 – well above the ten-year average of 17%. The Rim countries have thus benefited from the shift of EU-related FDI to extra-EU countries. In the absence of comparable host country information, we cannot tell whether the EU has gained in its share of the inward FDI of the Rim.

Most of the European Rim-related extra-EU FDI flows are to and from the European Free Trade Association (EFTA) countries, in which Switzerland features prominently (Figures IV.1 and IV.2). Almost all the inflows from the Rim to the EU originate from the EFTA; inflows from the rest of the Rim were of a small positive sum in 2001–07, to be followed by years of disinvestment.

Figure IV.2.1

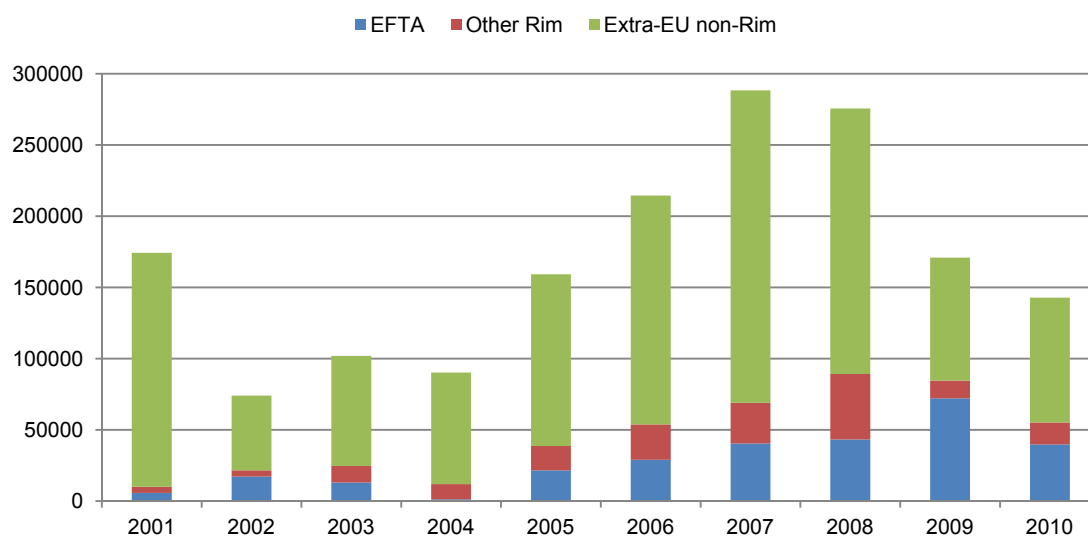
**FDI inflows to EU Member States from countries outside the EU, million euro**



Source: Eurostat, wiiw calculations. EU is EU-27 for 2004–07 and EU-25 for 2001–03. EU flows calculated as the sum of EU Member States. Intra-EU flows to Luxembourg are adjusted downwards by 90% in order to exclude activities of Special Purpose Enterprises (SPEs). Extra-EU flows exclude offshore centres (Guernsey, Jersey, Isle of Man, Gibraltar, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Netherlands Antilles).

Figure IV.2.2

**FDI outflows from EU Member States to countries outside the EU, million euro**



Source: Eurostat, wiiw calculations. EU is EU-27 for 2004–07 and EU-25 for 2001–03. EU flows calculated as the sum of EU Member States. Intra-EU flows to Luxembourg are adjusted downwards by 90% in order to exclude activities of Special Purpose Enterprises (SPEs). Extra-EU flows exclude offshore centres (Guernsey, Jersey, Isle of Man, Gibraltar, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Netherlands Antilles).

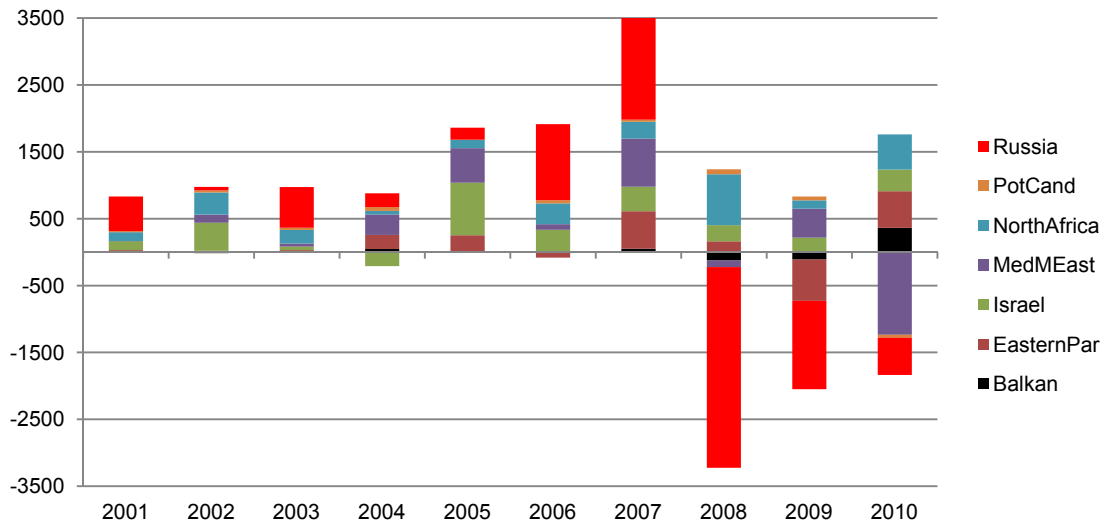
The share of EFTA countries in the European outward investment flows to the Rim hovered around 50% in 2002–07, except in 2004, when it was negligible due to some capital withdrawals in the wake of corporate restructuring. By the end of the decade, EFTA's share in the outflow to the Rim had climbed to three-quarters. The great significance of the EFTA countries is quite natural, as they are at a similar stage of development as the EU, and companies from both areas have a long history of cooperation with each other. In addition, Switzerland is the location of several holding companies and is regarded as a tax haven. Also the other EFTA countries have advantageous regulatory provisions, which may attract capital from EU members. As a sign of strong regional integration, EU Member States account for 71% of the total FDI stock in Switzerland. Intensive FDI flows and high shares in mutual FDI point to advanced integration between the EU and EFTA.

Non-EFTA Rim countries are negligible investors in the EU, but they have received significant FDI flows from the EU. Especially high amounts of EU outflows to the region were recorded in the boom years of European (and global) FDI, reaching an all-time high of EUR 48 billion in 2008. The following figures demonstrate which countries and regions have been the major investors and hosts of extra-EU FDI.

As for inward FDI to EU members from the non-EFTA European Rim countries, the main investor is Russia (Figure IV.2.3). Russian firms invested the major part of the non-EFTA FDI in the peak years of 2006 and 2007. They were also responsible for the massive capital withdrawals afterwards.

Figure IV.2.3

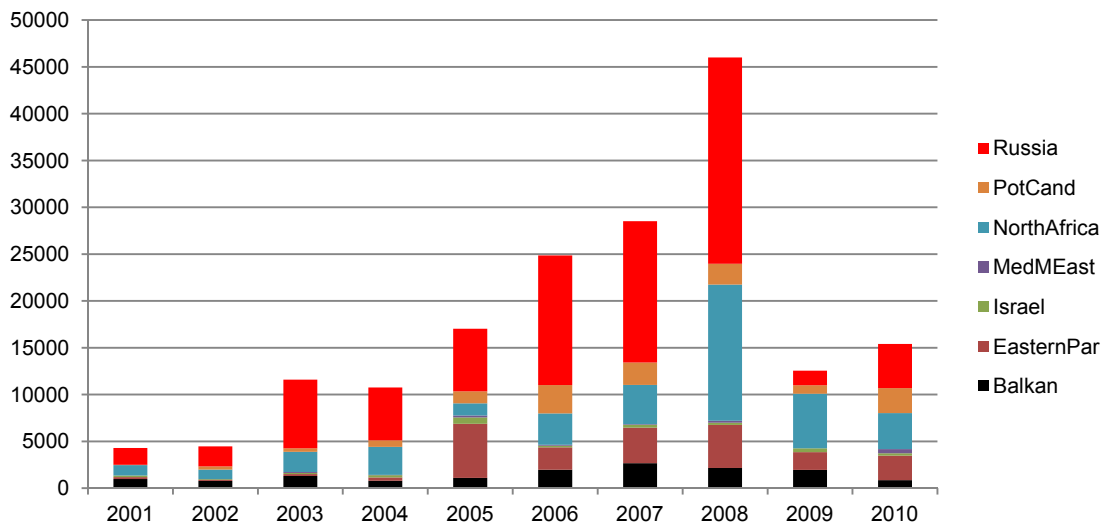
**FDI inflows to EU Member States from Rim countries (except EFTA), million euro**



Source: Eurostat, wiiw calculations. EU is EU-27 for 2004–07 and EU-25 for 2001–03. EU flows calculated as the sum of EU Member States. Intra-EU flows to Luxembourg are adjusted downwards by 90% in order to exclude activities of Special Purpose Enterprises (SPEs). Extra-EU flows exclude offshore centres (Guernsey, Jersey, Isle of Man, Gibraltar, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Netherlands Antilles).

Figure IV.2.4

**FDI outflows from EU Member States to Rim outside EFTA, million euro**



Source: Eurostat, wiiw calculations. EU is EU-27 for 2004–07 and EU-25 for 2001–03. EU flows calculated as the sum of EU Member States. Intra-EU flows to Luxembourg are adjusted downwards by 90% in order to exclude activities of Special Purpose Enterprises (SPEs). Extra-EU flows exclude offshore centres (Guernsey, Jersey, Isle of Man, Gibraltar, Bahamas, Bermuda, British Virgin Islands, Cayman Islands, Netherlands Antilles).

In terms of EU outward FDI, until 2008 Russia was the prime destination, with half or more of non-EFTA flows (Figure IV.2.4). In particular the European oil companies invested massively at times of high energy prices, but their investment subsided later, as did the interest

of consumer goods producers in years when market expansion came to a halt. With 83% of the total FDI stock in 2010, EU companies account for an overwhelming share of total FDI stocks in Russia. EU investment proper may, however, be overstated, because a third of the EU's FDI stock in Russia is owned by Cyprus (which makes it the largest investor in Russia). These flows constitute mainly round-tripping Russian capital channelled back via Cyprus for tax purposes (Hunya and Stöllinger, 2009). The second largest investor in Russia (with over a quarter of the stocks) is the Netherlands, another host of multinational holdings (Antilles).

Another important destination for EU investments in the non-EFTA neighbouring countries is the Southern Rim. Here two countries stand out. Egypt has received about EUR 1 billion of FDI annually over the past 10 years (more in the second half of the decade than in the first); 2008 was a one-off peak, when the country received FDI amounting to EUR 10 billion. The other major recipient of EU FDI is Morocco, with about EUR 1 billion annually most years of the 2000s. Three other countries – Algeria, Libya and Tunisia – have received more European FDI recently than before: about half a billion euro each year in 2007–09. Flows turned negative in 2010 for Libya and Tunisia, while they boomed in Algeria (EUR 1.6 billion). We know from host-country statistics that FDI in Algeria, Egypt and Libya went primarily into the petroleum industry.<sup>25</sup> FDI inflows into the manufacturing sector were rather small (between 4% and 8% of the total).

Europe is the leading investor (based on announced projects recorded on [www.animaweb.org](http://www.animaweb.org)) in the Southern Rim region, followed by the Gulf States. Europe's strong role can be attributed to geographical closeness and historical ties. France has retained strong positions in its former colonies of Morocco and Tunisia, while British and US firms have leading positions in Egypt.

Since the mid-2000s, significant liberalization measures for the entry of FDI boosted FDI, especially during 2006–08. Investment boom was followed by a setback – first the global crisis, and then, in 2011, the Arab Spring events. Economic reforms sought to reinforce the attractiveness of countries to FDI. These included a wave of privatization in the telecoms and banking sectors, which peaked in 2005–06. In addition, the inflow of petrodollars from the Gulf States led to a boom in the real estate sector. For example, increasing amounts of FDI in Egypt's energy and services sectors followed a change of policy in 2006, when the country became more FDI friendly and also sold some state-owned assets to foreign private investors. Similar policy changes took place in Tunisia, giving a boost to FDI in 2006. But even in these countries, several business sectors still remain restricted to foreign investors, most widely the media, air transportation and natural resources. The Investing

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<sup>25</sup> In Egypt, for example, 46% of the USD 17.8 billion total FDI inflow in the fiscal year 2007/2008; 75% of the USD 12.8 billion in the fiscal year 2008/2009 and 69% of the USD 11 billion inflow in the fiscal year 2009/2010.

across Borders database of the World Bank (2011h) places Tunisia first for openness to foreign investment, followed by Morocco and Egypt.

The Arab revolutions of 2011 interrupted the period of economic growth and had a negative economic impact on both trade and FDI. 'Businesses have suffered from problems of supply and temporary shutdowns, jobs have been destroyed and certain investment projects have been postponed, so much so that FDI announcements have dropped abruptly (-25% for the first six months of 2011), tending to suggest a rather mediocre result in 2011.'<sup>26</sup>

It is a widespread phenomenon in the region that 'in addition to existing restrictions, a number of sectors are dominated by government monopolies, which together with a high perceived difficulty of obtaining required operating licences, represent a potential obstacle for foreign companies to engage' (World Bank, 2011d). In Syria, for example, public holdings are dominant in several industrial sectors. The private sector did expand in non-core industries and services, which resulted in an economic boom for several years. In 2007, a new investment law came into force, which allowed companies to be set up without a Syrian partner and dividends and invested capital to be repatriated ([www.animaweb.org](http://www.animaweb.org)). Private banks have been established since 2004 and private insurance companies since 2005. New FDI comes mainly from neighbouring countries. In Morocco, where the state was not so dominant, development programmes were implemented to diversify the economy and attract foreign investments. The main restriction applies to the oil and gas sector, where a public share of 25% is condition of any exploitation permit.

Table IV.1.1

**Number of greenfield investment projects and pledged investment amounts by EU MNCs in European Rim countries**

Year	Number of projects	Pledged investment USD million
2011	670	2109
2010	718	1326
2009	759	1276
2008	1020	5050
2007	695	12837
2006	639	4044
2005	653	2385
2004	476	2417
2003	514	1041
Total	6144	32485

*Note:* pledged FDI partly estimated.

*Source:* FDI Intelligence.

<sup>26</sup> See [www.animaweb.org](http://www.animaweb.org). Data refer to announced FDI projects, both greenfield and takeovers covered by the ANIMA-MIPO database ([www.animaweb.org](http://www.animaweb.org)). ANIMA is the leader of the MED Alliance consortium, which implemented the Invest in the MED project (75% financed by the EU) in the period 2008–11. The programme contributed to boosting FDI and improving the business framework.

The environment for foreign business is also quite diverse in the Eastern Rim countries. Transformation to a market economy and the opening up to FDI started a decade earlier there than in the Southern Rim, but few of the countries reached complete liberalization. The country most open to FDI is Georgia, which has no restricted sectors, followed by Serbia. A number of activities are restricted in Armenia and Azerbaijan, while Belarus has the most restrictive environment for FDI in the region (World Bank, 2011g). As in Russia, FDI of EU origin dominates the FDI stock in Ukraine (some 70%). In this country, too, Cyprus is the primary investor, which probably reflects round-tripping of Ukrainian and Russian investment flows.

Table IV.1.2

**Number of greenfield investment projects and pledged FDI from the EU to European Rim countries, 2003–11**

	Number of EU projects	Pledged investment USD million	EU projects, % of total in the country	EU pledged capital, % of total in the country
Russia	2451	102557.4	61	47
Ukraine	582	11235.6	62	52
Switzerland	581	3991.1	54	71
Serbia	468	10060.9	87	62
Morocco	368	6807.4	68	27
Tunisia	225	4613.8	71	11
Egypt	187	7445.7	33	10
Norway	167	1691.0	64	53
Bosnia-Herzegovina	157	5431.4	72	78
Algeria	151	12392.8	46	29
Georgia	96	783.4	45	20
Belarus	93	2970.9	46	72
Azerbaijan	85	14388.6	35	82
Israel	70	711.2	28	69
Albania	56	8665.8	67	91
Lebanon	55	239.7	30	6
Moldova	52	305.2	55	28
Jordan	50	90.8	20	5
Libya	40	10820.4	29	23
Armenia	39	210.4	31	8
Syria	34	927.7	20	4
Liechtenstein	4			
Palestine	1			
Total	6100	209000		

*Note:* pledged FDI excluding estimated values.

*Source:* FDI Intelligence.

Another way of looking at the development of foreign investment is to see when and where new greenfield projects have been announced. The number of greenfield FDI projects (as

recorded in the FDI Intelligence database) of EU-based MNCs spikes in 2008, with fairly level (smaller) figures in the three years before and after (Table IV.1.1). The impact of the recent crisis has so far not been very strong, but the number of new projects has declined in each of the past three years. By contrast, the amount of pledged investment fell back sharply after 2008, but has shown a modest year-on-year recovery over the past three years. Low average capital of new projects indicates that, as a consequence of the recent crisis, projects were initiated only to express interest without risking too much capital. As a whole in the Rim, the main EU investor is Germany (with one-fifth of the projects), followed by France and the UK. The Netherlands does not feature strongly in this comparison (unlike in FDI statistics), as the greenfield data capture the ultimate home country of investors more correctly.

The EFTA countries – most notably Switzerland and Norway – are important destinations for EU greenfield investments, especially in terms of the number of projects (though less in terms of the size of the invested capital) (Table IV.1.2). On the whole, the greenfield project analysis indicates a lower FDI intensity for Switzerland in its relationship with the EU than did the FDI data based on the balance of payments. Beyond differences in the coverage of entry modes, an important gap appears due to the treatment of holding companies. FDI data overestimate this form of investment, attributing to it large flows; meanwhile the greenfield database covers only the capital directly involved in setting up the holding, but not the flow through it. Still, compared to the relatively small size of these countries, both the number and the capital of greenfield projects indicate quite a close integration into the EU area. In Switzerland, the US has the highest number of investment projects, followed by Germany and France; while in Norway, the US is followed by Great Britain. The number of Swiss greenfield projects in the EU is quite high (1,399), while Norwegian firms established 393 projects in the EU. Both figures are higher than the number of inward projects, which is hardly surprising, bearing in mind the larger size of the EU market. In terms of both inward and outward projects, the EU's share is smaller in later years than in the first half of the decade, indicating a diversification and globalization of both these highly developed EFTA countries.

The biggest interest of European MNCs over the past 11 years has been in Russia, where they announced almost half of the projects and pledged somewhat over half of the capital investment in the Rim. These ratios are similar to those obtained using FDI flow data and are, in fact, in keeping with the large size of Russia. The confirmation of the close direct investment ties provided by the greenfield data is important, as those data exclude round-tripping – Cyprus does not show up under the investing countries at all.

Ukraine attracted 11% of the projects and 6% of the investment capital – relatively little considering the size of the country. Also the other Commonwealth of Independent States (CIS) countries show a relatively low number of EU greenfield projects.



In contrast to the Eastern Rim, the Western Balkan countries (especially Serbia) have a remarkably high number of projects relative to their size. Since these projects are in very diverse sectors, this is an indication that Serbia is on its way to a very close corporate integration with the EU and that investors have anticipated its EU candidate status, in much the same way as with the NMS in the past. Among the Southern Rim countries, Morocco and Tunisia also have fairly large numbers of projects in diverse industries, confirming that these are countries that have had a relatively liberal attitude to FDI for some time. Geographical and historical proximity (France, Spain) play a role in defining the main home countries. EU members are engaged in more than 70% of the greenfield investment projects in Serbia, Tunisia, Morocco and Bosnia-Herzegovina. The most important investors in the Western Balkan countries are Germany, Austria and Italy; in the case of Morocco the most important are France and Spain; while in Tunisia, France is by far the most frequent investor. While EU firms dominate in terms of the number of projects, they pledged only a small part of capital in the cases of Morocco and Tunisia. This means that the average project is small, indicating the strong presence of SME projects. A further characteristic is the relatively large number of manufacturing projects (about 40% in the West Balkans and Tunisia; 25% in Morocco).

Egypt is a special case, as it combines a late opening of a large market with an important oil sector. Projects in this country are of diverse origin: only 37% come from the EU, while the US and the UAE are the most important investors (other Gulf States also have a major presence). A similar range of investors is to be found in Algeria and Libya. The big oil producers of the European neighbourhood – Azerbaijan, Algeria and Libya – have attracted small numbers of projects with high amounts of capital. The other, smaller Rim countries and those that provide a less liberal environment attract most of their new projects from historical, geographical and ideological allies – the Arab countries from the Gulf States and the CIS countries from Russia.

### ***IV.3 Conclusions***

According to all the indicators analysed in this section, European FDI plays a primary role in the European Rim region, which is justified by geographical proximity and the technological superiority of EU firms. The Rim does not constitute a challenge to European firms, and nor do they gain much competitiveness by investing in the Rim. The Rim is an important supplier of energy and is a large and expanding market for EU firms. FDI by European MNCs can exploit these locational benefits. It is primarily the cumbersome local business environment in the Rim countries that limits FDI inflows. But the reforms undertaken in the mid-2000s have improved the conditions for doing business in several countries and have contributed to an upswing in FDI. Especially Serbia, Morocco and Tunisia, but also the other Western Balkan countries, have attracted some FDI in the manufacturing sector and a relatively large number of greenfield investment projects, often undertaken by SMEs.

Countries with less liberalized FDI regimes receive less FDI in total, but also less capital from the EU. European policies that foster free trade and FDI and that support the liberalization process have been beneficial both for the Rim countries and for European MNCs (and also SMEs), which have been able to expand their activities in the region. Supporting open and fair competition and breaking local (often state-supported) monopolies could increase the opportunities for further FDI and SME development in the Rim.

## V. Institutional Relations Between the EU and Rim Countries

### V.1 *The EU and the Southern Rim: fostering North–South and South–South economic integration*

#### V.1.1 *Free trade agreements between the EU and Southern Rim countries and Israel*

The Euro-Mediterranean Partnership gained momentum in 1995 with the 'Barcelona Declaration', when the establishment of a common area of peace, stability and shared prosperity in the Euro-Mediterranean region was set out as the goal of the countries involved. The next stage in the cooperation began with the start of the European Neighbourhood Policy (ENP). The third stage was launched with the announcement that a 'Union for the Mediterranean' was to be set up. Fostering trade has always been a key component of the partnership. Here the new goal set is the creation of a deep Euro-Mediterranean free trade area, aimed at a substantial liberalization of trade both between the EU and Southern Mediterranean countries (North–South) and between Southern Mediterranean countries themselves (South–South) (European Commission, 2012a).

The main regional forum is the Union for the Mediterranean. Nevertheless, in practical terms **bilateral** relations play a decisive role in the cooperation. Accordingly, EU–Southern Mediterranean relations are currently organized mainly through the bilateral Euro-Mediterranean association agreements. Apart from Syria, every Mediterranean country that belonged to the Euro-Mediterranean Partnership (now integrated into the Union for the Mediterranean) has concluded association agreements with the EU. Libya belongs to the Union for the Mediterranean, but was not a member of the Euro-Mediterranean Partnership: negotiations are currently proceeding on a Framework Agreement between the European Union and Libya.

Table V.1.1

#### **Euro-Mediterranean bilateral association agreements\***

<b>Country</b>	<b>Status</b>	<b>Date signed</b>	<b>Entry into force</b>	<b>Reference</b>
Algeria	Signed	April 2002	September 2005	OJ L 265
Egypt	Signed	June 2001	June 2004	OJ L 304
Israel	Signed	November 1995	June 2000	OJ L 147
Jordan	Signed	November 1997	May 2002	OJ L 129/02
Lebanon	Signed	June 2002	April 2006	OJ L 143/06
Morocco	Signed	February 1996	March 2000	OJ L 70/00
Palestinian Authority	Signed	February 1997	Int. Agr. July 1997	OJ L 187/97
Syria	Initiated (Dec. 2008)			
Tunisia	Signed	July 1995	March 1998	OJ L 97/98

\*Note: As of August 2011.

Source: [http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/euromed/index\\_en.htm](http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/regions/euromed/index_en.htm) (downloaded 16.02.2012).

The association agreements principally cover trade in goods. Complementary agreements are being negotiated to open up agricultural trade and to liberalize trade in services and investment. A further goal is the establishment of bilateral conflict-resolution mechanisms for trade issues.

The latest chapter in the Euro-Med cooperation was begun on 14 December 2011. The EU Foreign Affairs Council authorized the European Commission to open up a new round of trade negotiations with Egypt, Jordan, Morocco and Tunisia. The Commission's mandate is to start negotiations to establish deep and comprehensive free trade areas (DCFTAs). The DCFTAs will go further than the current trade relationship between the EU and these countries, not only removing tariffs, but also covering all regulatory issues pertinent to trade, such as investment protection and public procurement (European Commission, 2012b).<sup>27</sup>

Egypt, Jordan, Morocco and Tunisia are WTO members and in years gone by have already implemented free trade areas with the EU through the Euro-Mediterranean association agreements. These agreements, which cover essentially trade in goods, are being (or have been) complemented with a number of additional measures in the areas of liberalization of agriculture, processed agriculture and fisheries products, liberalization of trade in services, the establishment of bilateral dispute-resolution mechanisms for trade matters, and conformity assessment and acceptance of industrial products. Building on the progress already made, the main objective behind the negotiation of DCFTAs is the progressive integration of the economies of these partners into the EU single market. The future DCFTAs will be part of the existing Euro-Mediterranean association agreements, and will cover a full range of regulatory areas of mutual interest, such as trade facilitation, technical barriers to trade, sanitary and phytosanitary measures, investment protection, public procurement and competition policy. The different economic development and regulatory priorities of the EU's Southern Mediterranean partners will be taken into account during the negotiations. The EU will also support capacity building linked to the negotiation and implementation of future commitments undertaken by those countries involved in the DCFTAs. In the context of these negotiations, the EU intends to pay particular attention to measures that can enhance regional economic integration, and in particular the process launched within the framework of the Agadir Agreement, a free trade agreement between Egypt, Jordan, Morocco and Tunisia.

The commitment of each of the four partner countries to implement far-reaching regulatory reform, as well as their interests and priorities in future negotiations, will be assessed on a case-by-case basis during a thorough preparatory process, which is due to be launched in early 2012. The negotiations will be coupled with progress in reform in these countries. The

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<sup>27</sup> It is important to mention that Jordan and Tunisia joined the EBRD at the beginning of 2012. The EBRD has the capacity to invest, in the medium term, up to EUR 2.5 billion a year across the Southern Rim.

EU's approach will be based, as the Commissioner for Enlargement and European Neighborhood Policy emphasized, on the principle of 'more for more': greater access to the EU market will be made available to countries engaged in genuine political reforms (Füle, 2012).

#### *V.1.2 Main areas influenced by the Euro-Med association agreements*

##### V.1.2.1 Trade and growth

Some observers raise the question of whether the current association agreements (AA) are fostering economic growth (Eurochambres, 2011; Kuiper, 2006). The main line of their argumentation is that trade agreements with many and substantial exemptions provide few dynamic gains. Export benefits cannot be realized as the AAs usually exclude agricultural and textile products, both of which are of vital importance to the Southern Rim countries. The combined effect of reducing tariffs on manufactured products and at the same time omitting agriculture will hinder Southern Rim countries from exploiting their comparative advantages in agriculture. Furthermore, European businesses criticize the fact that the AA is too much focused on the input side instead of growth-generating projects. They advocate greater involvement of the private sector in framing of the priorities (ANIMA et al., 2010).

##### V.1.2.2 Trade in agricultural products

That only a small part of agricultural goods is covered by the AAs puts a brake on inward FDI in agriculture, though the sector's contribution to GDP production is relatively high (over 10%) in many countries of the Southern Rim region (see also Section II). The situation reflects the defensive attitude of the EU, as a significant liberalization in agricultural trade would increase competitive pressure on agricultural producers in Southern Europe, whose supply largely overlaps with that of the Southern Rim countries (Kuiper, 2006).

##### V.1.2.3 Services

Further liberalization of trade in services is proposed by observers. Both the EU and the Southern Rim countries are thought to benefit from that. The EU's share in the total export of services to the Mediterranean countries was only 18% in 2000, while the share in exports of goods was much higher – 78%. The difference hints at a potential for increase in services trade (Brenton and Manchin, 2003). Liberalization of IT services has been lagging behind in the Southern Rim countries. That hinders the exploitation of their comparative advantages (their cultural and geographical proximity to Europe and their young, educated workforce) by participating in the ever-increasing outsourcing of traditional IT jobs in Europe. While tourism is the most liberalized services sector in the Southern Rim, there is still room for further progress in this segment, including the development of infrastructure and the liberalization of air transport. Business Europe stresses that service liberalization is a top priority for the firms exporting to the Southern Rim region (ANIMA et al., 2010). There

is a demand for reforms in order to facilitate and safeguard investment and to ensure legal certainty.

#### V.1.2.4 Rules of origin

In the context of the pan-European-Mediterranean system, diagonal cumulation means that products that have obtained originating status in one of the 42 signatory countries<sup>28</sup> may be added to products originating in any other one of the 42 without losing their originating status within the Pan-Euro-Med zone. In the Pan-Euro-Med zone, the opportunity to cumulate origin diagonally is based on a 'variable geometry' rule. It means that participants in the Pan-Euro-Med zone can only cumulate originating status of goods if the free trade agreements including a Pan-Euro-Med origin protocol are applicable between them. Consequently, a country of the zone that is not linked by free trade agreements with the others finds itself outside the scope of cumulation's benefits. The matrix indicating the protocols that are applicable between various partner countries is published in the EU Official Journal and is regularly updated (European Commission, 2012b).

In parallel, full cumulation is currently operated by the EEA, comprising the European Community, Iceland, Liechtenstein and Norway, and between the EU and Algeria, Morocco and Tunisia. These countries apply full cumulation between themselves and diagonal cumulation with the other pan-Euro-Med countries. According to the results of a computable general equilibrium (CGE) modelling exercise, the effects of a completed pan-Euro-Med cumulation of origin would likely be significant and positive. Coupled with capital mobility, in the cases of Egypt, Israel, Morocco and Tunisia it is estimated that this would increase manufacturing production from between 2% and 12%, and welfare would rise by between 0.6% and 1% relative to GDP (Augier et al., 2011; see also estimates in Section III above).

#### V.1.3 *Practical problems impeding competitiveness*

##### V.1.3.1 Barriers at the borders

Customs clearance in the Southern Rim generally takes a long time. According to a survey of companies importing to eight Arab countries, the average time required to release imported goods is 2–5 days for air freight, 2–10 days for sea shipments, and 1–3 days for road transport. This is extremely long relative to benchmark values. Additionally, between 10 and 20 signatures are needed to clear goods (air freight) at the border, and there are many other impediments to trade (see also Section II).

The complex system of rules of origin impedes trade in the region. Various inconsistent provisions result in high transaction costs for businesses. These complicated rules also diminish the attractiveness of the Southern Rim countries for inward FDI (Eurochambres, 2011).

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<sup>28</sup> The 42 countries are the EU, the EEA/EFTA countries, the signatories to the Barcelona Declaration (Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, the Palestinian Authority, and also the Faroe Islands and Turkey).

#### V.1.3.2 Public procurement

Of the Southern Rim countries, only Israel is a party to the Government Procurement Agreement (GPA) in the WTO; Jordan is in the negotiating phase, while some countries (like Egypt, Morocco and Tunisia) have no intention of joining (De Wulf and Maliszewska, 2009). Accordingly, discrimination in public procurement procedures is widespread in the Southern Rim region. National companies often enjoy a price preference, which thus places them in a better competitive position vis-à-vis foreign bidders. Also lack of transparency is reported as a general problem.

#### V.1.3.3 Technical barriers

In Euro-Med cooperation, the aim is to conclude bilateral agreements on conformity assessment and acceptance of industrial products with approximation of the partner countries' regulations (Eurochambres, 2011).

The existing AAs have been criticized for lack of ambition in the field of technical regulations and conformity assessment systems. Compared to the association agreements between the EU and the countries of Central and Eastern Europe (CEE) that were in force from the early 1990s up to the 2004 and 2007 EU enlargements, the current Euro-Med AAs were found to be less bold (Brenton and Manchin, 2003).

#### V.1.3.4 Sanitary and phytosanitary measures

Exports of European food are impeded by complicated sanitary and phytosanitary (SPS) measures, which vary from country to country, and concerns are raised about whether national treatment of similar products can be assured (Eurochambres, 2011).

#### V.1.3.5 Protection of intellectual property rights

The protection of intellectual property rights is unsatisfactory in the Southern Rim region. Though most countries have adequate legislation in place, the real problem is the inefficient enforcement of that legislation. Counterfeiting of products, infringements of trademark rights and piracy are widespread. Trademark protection is an important problem for the IT sector, for textiles and industrial design (Eurochambres, 2011).

#### V.1.3.6 Administration and corruption

Weak legal systems and deficiencies in the business climate have been identified as among the most pressing obstacles to exports and investment (see also Section II). Poor results with regard to corruption indicate a major problem that is damaging the business climate in the Southern Rim region (Transparency International, 2010).

#### V.1.3.7 State intervention

State intervention in the Southern Rim countries has a negative effect on business. Production controlled by the state is significant – it amounts to 30% of GDP in Egypt and Tunisia, and in Algeria the proportion is close to 60%. The Euro-Med AAs do not include a definition of state monopoly. One widespread form of state intervention is price control, as price ceilings are often important means of social policy. This may be a problem for foreign companies in these countries, if price ceilings are inadequately adjusted to inflation. In some Southern Rim countries there are restrictions on foreign ownership of land and real estate (Eurochambres, 2011).

#### V.1.3.8 Competition policy

In general, the regulatory framework for competition policy is weak in the region, and in some countries is inadequate. Competition policies in place vary greatly by country. Anti-competitive behaviour is widespread in the Southern Rim, and the enforcement of existing competition regulations is ineffective. There are many exemptions applied within competition policies in place with regard to the big role of the state in the economy and the extensive use of public aid. The authorities in charge of supervising competition are, in many cases, insufficiently powerful to independently control the initiation of investigations and to enforce the rules; they often operate on a small budget and with inadequately trained staff (Eurochambres, 2011).

#### V.1.3.9 Dispute settlement

Unpredictability is an important stumbling block in Euro-Med trade relations. This is especially true of economic transactions with Southern Rim countries that are not yet WTO members. A region-wide dispute-resolution mechanism is an important goal for the future (Eurochambres, 2011).

### V.1.4 *Regional integration in the Southern Rim*

Fostering regional (South–South) economic integration is one of the key goals of the Euro-Mediterranean trade partnership. It is an essential element in the establishment of a full-fledged Euro-Med free trade area. However, regional economic integration between Southern Mediterranean countries is still limited: the volume of intra-regional trade indicates one of the lowest levels of regional economic integration in the world.

EU support for the strengthening of trade relations among Southern Mediterranean countries has had some important recent results (European Commission, 2012a):

- The Agadir Agreement between Tunisia, Morocco, Jordan and Egypt, in force since 2007, remains open to other Arab Mediterranean countries.
- Israel and Jordan have signed a free trade agreement.



- Egypt, Israel, Morocco, the Palestinian Authority, Syria and Tunisia have signed bilateral agreements with Turkey.
- Negotiations are under way between other Mediterranean countries to establish similar agreements.

#### V.1.4.1 Maps of regional integration in the Southern Rim

When we address here regional integration, our focus is trade among the Southern Rim countries, but that should be supplemented by an analysis of **intra-Maghreb** and **intra-Mashreq** trade, as the members of these sub-groups typically have much closer geographical proximity and more cultural features in common with one another than with members of the other sub-group. Egypt is located – and not only geographically – between these two groups, though it is sometimes placed in the group of Mashreq countries.<sup>29</sup> It must be added that the Southern Rim is also part of a greater Arab region, which includes, besides the Southern Rim, member countries of the Gulf Cooperation Council (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates), plus Iraq and Yemen.

There are a number of economic and integration blocs that involve one or more Southern Rim countries, but there is no single overarching agreement that covers the whole Southern Rim region (see Figure V.1.1).<sup>30</sup> Moreover, there are several bilateral cooperation, trade, free trade and investment agreements in force in the Southern Rim region (see Table V.1.1). As illustrated by Figure V.1.1, Southern Rim members are typically partners in several agreements simultaneously. The high number of agreements is, however, no predictor of the intensity of actual trade relations across the Southern Rim.

Intra-Southern Rim trade is a small fraction (5.9% of exports, 5.1% of imports) of the Southern Rim countries' total trade (see Table V.1.3a and V.1.3b).<sup>31</sup> Exports to the EU are ten times more relevant than intra-Southern Rim trade flows, and imports from the EU eight times more important. However, the diversity lurking behind the group average is significant: with the Southern Rim absorbing more than 10% of their total exports, it has been a more relevant export destination for Egypt, Jordan, Lebanon and Syria than for the rest of the group. Nevertheless, in terms of imports, only Libya purchases from the Southern Rim more than 10% of the country's total imports. For individual Southern Rim countries, trade with the EU is clearly more significant than intra-Southern Rim trade: in terms of exports, only Jordan, Lebanon and the Palestinian Territories trade more with the Southern Rim than with the EU; while in terms of imports, none of the Southern Rim countries purchases more from that region than from the EU.

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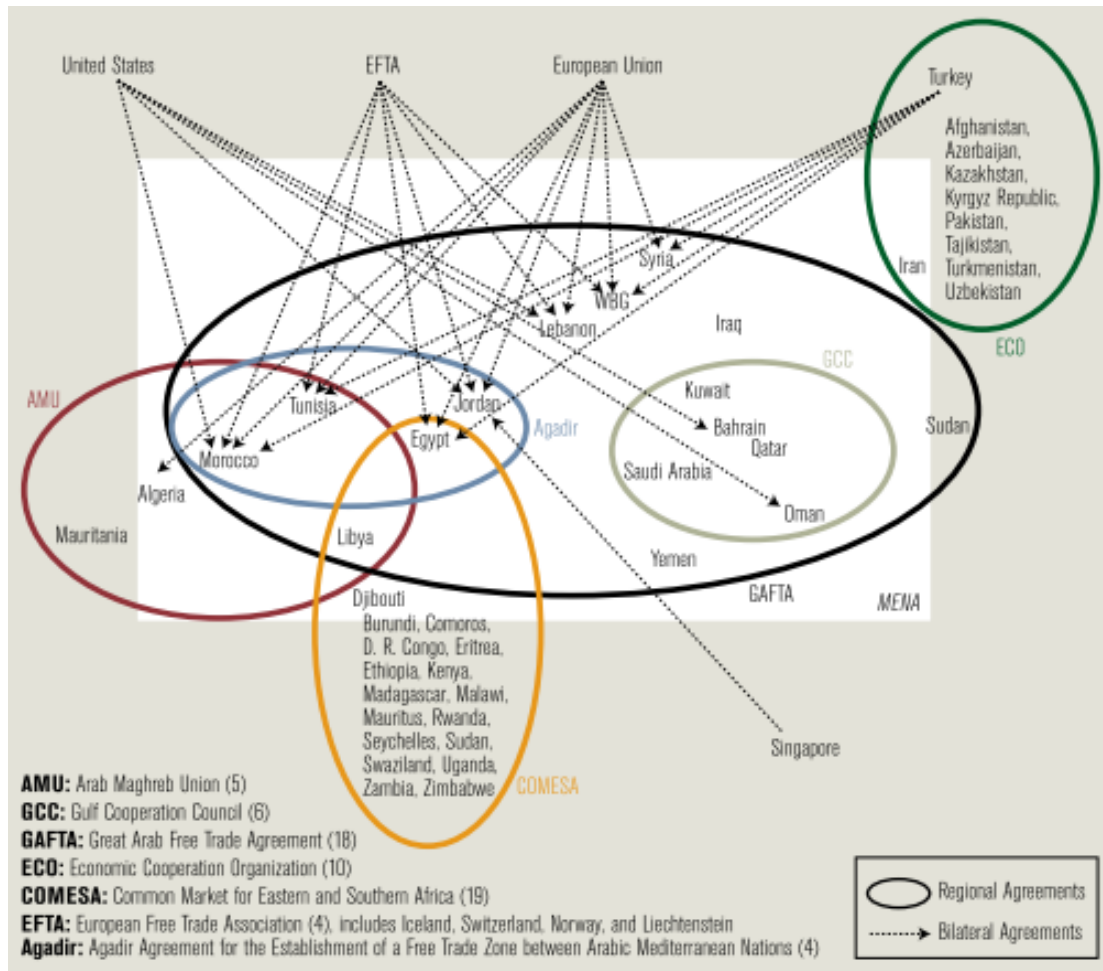
<sup>29</sup> Additionally, sometimes Iraq is seen as a Mashreq country and Mauritania as a Maghreb country.

<sup>30</sup> For an overview of the history of regional integration in the Middle East and North Africa, see Galal and Hoekmann (2003) and Shui and Walkenhorst (2010).

<sup>31</sup> Trade data for 2008 .

Figure V.1.1

Maps of regional integration in the Southern Rim



Source: World Bank (2008).

Table V.1.2

Bilateral treaties within MENA

	Algeria	Egypt	Jordan	Lebanon	Libya	Morocco	Occ.Pal.Terr.	Syria	Tunisia
Algeria									
Egypt	BIT, TA								
Jordan	BIT, TA	BIT, FTA							
Lebanon	TA	TA, BIT	TA, BIT, FTA						
Libya	none	BIT, TA	BIT, FTA	none					
Morocco	TA	BIT, FTA	BIT, FTA	FA, BIT	BIT, TA				
Occ.Pal.Terr.	none	BIT, TA	TA	none	none	none			
Syria	BIT(a), TA	BIT, TA	BIT, FTA	BIT, TA	BIT, TA	BIT, FA	none		
Tunisia	BIT(a), TA	BIT, FTA	BIT(a), TA	BIT	BIT(a), TA	BIT(a), TA	none	TA	

Notes: FA=Framework Agreements (call for cooperation and exchange of information and expertise); FTA=Free Trade Agreements (involve broad tariff reductions on a preferential basis); TA=Trade Agreements (less demanding than FTAs but more concrete than FAs, e.g. TA may include tariff reductions, special exemptions or the creation of a free trade zone); BIT=Bilateral Investment Treaties (provide investor protection). (a) = not enforced.

Source: Shui and Walkenhorst (2010).

#### V.1.4.2 Sub-regions Maghreb and Mashreq

Within the Southern Rim, intra-sub-region trade (intra-Maghreb and intra-Mashreq trade) reveals diverging patterns. Intra-Maghreb exports (2.5% of total Maghreb exports) are negligible, except for exports from Tunisia. In the case of imports, the share of Tunisia and Libya in total intra-Maghreb purchases is somewhat above the low average intra-Maghreb share (3.7%). Intra-Mashreq exports are more intense than intra-Maghreb exports: they amount to 10.4% of total Mashreq exports. In imports the share of intra-group trade is very low (2.3%).

The results of various gravity model calculations suggest that intra-Southern Rim trade is below its potential (Péridy, 2005; Bolbol and Fatheldin, 2005). It is important to add, however, that these and other gravity model results also indicate that the Southern Rim's participation in *world trade* is also below the potential. In the global economy, the number of regional integration agreements (and of the countries involved in these agreements) has been growing since the Second World War, and this growth has accelerated in the last 20 years. The growing number and importance of integration blocs in which Southern Rim countries are not involved, and the subsequent deterioration in the global competitive position of 'outsider' Southern Rim exporters (coupled with insufficient intra-Southern Rim integration), present a double constraint on successful export-led growth in the economies concerned. The stagnation of the region's share in global non-oil exports and the steadily low (about 7%) ratio of the region's non-oil exports relative to GDP are unambiguous indications of missed diversification and growth (Iqbal and Nabli, 2010; Masood, 2010).

Although there has been some progress in intra-Southern Rim integration, the region lags behind the level achieved in middle and high-income regional blocs, according to Akhtar and Rouis (2010) and World Bank (2010a). There are various explanations offered in the literature for the low intensity of intra-Southern Rim integration, as displayed below (see also Malik and Awadallah, 2011).

Table V.1.3a

## MENA TOTAL exports, 2008

Reporter	TOTAL exports, 2008, USD million									
	World	MENA	Partner			EU-27	USA	China	Turkey	Rest of the World
			of which:							
			MAGHREB	MASHREQ	Egypt					
1 Egypt	25,966.8	3,263.2	1,507.3	1,755.9	0.0	9,211.4	1,255.0	341.5	770.3	11,125.4
2 Algeria	79,297.6	2,284.6	1,623.6	54.1	606.9	41,245.4	18,952.5	503.3	2,919.7	13,392.0
3 Libya	62,817.8	1,584.2	1,163.7	159.8	260.7	47,526.4	4,350.0	1,584.2	336.3	7,436.7
4 Morocco	20,305.7	432.3	268.9	114.9	48.5	12,032.7	793.7	162.8	295.6	6,588.5
5 Tunisia	19,320.0	1,678.2	1,513.5	35.9	128.9	13,920.2	323.1	59.1	309.4	3,030.0
6 <b>MAGHREB (2+3+4+5)</b>	181,741.1	5,979.4	4,569.6	364.8	1,045.0	114,724.7	24,419.2	2,309.5	3,861.1	30,447.2
7 Jordan	6,177.0	683.0	203.6	375.4	103.9	258.6	1,037.2	110.2	27.9	4,060.0
8 Lebanon	3,478.3	538.1	68.3	342.7	127.1	533.5	49.5	55.6	206.9	2,094.8
9 Palestina (Gaza+Jericho)	389.9	34.1	0.8	32.4	1.0	8.1	3.6	0.0	0.5	343.5
10 Syria	14,380.0	3,250.0	738.3	1,781.3	730.4	5,114.3	380.2	20.8	635.4	4,979.3
11 <b>MASHREQ (7+8+9+10)</b>	24,425.2	4,505.2	1,011.0	2,531.8	962.3	5,914.5	1,470.5	186.6	870.8	11,477.7
12 <b>MENA (1+6+11)</b>	232,133.1	13,747.8	7,088.0	4,652.5	2,007.3	129,850.6	27,144.7	2,837.6	5,502.2	53,050.2

## MENA SHARES in total exports in %

Reporter	MENA SHARES in total exports in %									
	World	MENA	Partner			EU-27	USA	China	Turkey	Rest of the World
			of which:							
			MAGHREB	MASHREQ	Egypt					
1 Egypt	100.0	12.6	5.8	6.8	0.0	35.5	4.8	1.3	3.0	42.8
2 Algeria	100.0	2.9	2.0	0.1	0.8	52.0	23.9	0.6	3.7	16.9
3 Libya	100.0	2.5	1.9	0.3	0.4	75.7	6.9	2.5	0.5	11.8
4 Morocco	100.0	2.1	1.3	0.6	0.2	59.3	3.9	0.8	1.5	32.4
5 Tunisia	100.0	8.7	7.8	0.2	0.7	72.1	1.7	0.3	1.6	15.7
6 <b>MAGHREB (2+3+4+5)</b>	100.0	3.3	2.5	0.2	0.6	63.1	13.4	1.3	2.1	16.8
7 Jordan	100.0	11.1	3.3	6.1	1.7	4.2	16.8	1.8	0.5	65.7
8 Lebanon	100.0	15.5	2.0	9.9	3.7	15.3	1.4	1.6	5.9	60.2
9 Palestina (Gaza+Jericho)	100.0	8.8	0.2	8.3	0.3	2.1	0.9	0.0	0.1	88.1
10 Syria	100.0	22.6	5.1	12.4	5.1	35.6	2.6	0.1	4.4	34.6
11 <b>MASHREQ (7+8+9+10)</b>	100.0	18.4	4.1	10.4	3.9	24.2	6.0	0.8	3.6	47.0
12 <b>MENA (1+6+11)</b>	100.0	5.9	3.1	2.0	0.9	55.9	11.7	1.2	2.4	22.9

Source: UN Comtrade.

Table V.1.3b

## MENA TOTAL imports, 2008

Reporter	TOTAL exports, 2008, USD million									
	World	MENA	Partner			EU-27	USA	China	Turkey	Rest of the World
			of which:							
			MAGHREB	MASHREQ	Egypt					
1 Egypt	52,751.0	1,473.4	887.4	586.0	0.0	14,296.3	5,673.1	4,432.0	1,174.7	25,701.4
2 Algeria	39,474.7	816.8	381.7	239.6	195.6	20,867.3	2,197.6	4,066.9	1,345.8	10,180.3
3 Libya	17,411.6	1,925.4	987.4	164.4	773.6	8,411.6	703.5	1,640.4	1,074.3	3,656.4
4 Morocco	42,322.0	1,791.5	1,314.1	68.4	408.9	21,914.3	2,162.7	2,406.7	1,079.0	12,967.7
5 Tunisia	24,638.4	2,194.4	1,887.5	57.3	249.6	14,112.0	748.8	919.6	732.3	5,931.3
6 <b>MAGHREB (2+3+4+5)</b>	123,846.7	6,728.1	4,570.7	529.7	1,627.7	65,305.2	5,812.6	9,033.7	4,231.4	32,735.8
7 Jordan	16,871.6	1,307.3	78.8	498.6	729.9	3,529.2	773.7	1,750.1	437.3	9,073.8
8 Lebanon	16,136.5	941.8	106.0	377.7	458.1	5,885.7	1,848.6	1,390.9	698.5	5,371.0
9 Palestina (Gaza+Jericho)	3,568.7	76.1	0.3	52.2	23.5	289.1	37.7	126.0	68.5	2,971.3
10 Syria	18,104.7	1,161.3	236.3	304.5	620.6	4,522.7	354.4	1,978.4	498.7	9,589.2
11 <b>MASHREQ (7+8+9+10)</b>	54,681.5	3,486.6	421.5	1,233.0	1,832.1	14,226.8	3,014.3	5,245.4	1,703.0	27,005.3
12 <b>MENA (1+6+11)</b>	231,279.2	11,688.1	5,879.5	2,348.8	3,459.8	93,828.3	14,500.1	18,711.1	7,109.2	85,442.5

## MENA SHARES in total exports in %

Reporter	MENA SHARES in total exports in %									
	World	MENA	Partner			EU-27	USA	China	Turkey	Rest of the World
			of which:							
			MAGHREB	MASHREQ	Egypt					
1 Egypt	100.0	2.8	1.7	1.1	0.0	27.1	10.8	8.4	2.2	48.7
2 Algeria	100.0	2.1	1.0	0.6	0.5	52.9	5.6	10.3	3.4	25.8
3 Libya	100.0	11.1	5.7	0.9	4.4	48.3	4.0	9.4	6.2	21.0
4 Morocco	100.0	4.2	3.1	0.2	1.0	51.8	5.1	5.7	2.5	30.6
5 Tunisia	100.0	8.9	7.7	0.2	1.0	57.3	3.0	3.7	3.0	24.1
6 <b>MAGHREB (2+3+4+5)</b>	100.0	5.4	3.7	0.4	1.3	52.7	4.7	7.3	3.4	26.4
7 Jordan	100.0	7.7	0.5	3.0	4.3	20.9	4.6	10.4	2.6	53.8
8 Lebanon	100.0	5.8	0.7	2.3	2.8	36.5	11.5	8.6	4.3	33.3
9 Palestina (Gaza+Jericho)	100.0	2.1	0.0	1.5	0.7	8.1	1.1	3.5	1.9	83.3
10 Syria	100.0	6.4	1.3	1.7	3.4	25.0	2.0	10.9	2.8	53.0
11 <b>MASHREQ (7+8+9+10)</b>	100.0	6.4	0.8	2.3	3.4	26.0	5.5	9.6	3.1	49.4
12 <b>MENA (1+6+11)</b>	100.0	5.1	2.5	1.0	1.5	40.6	6.3	8.1	3.1	36.9

Source: UN Comtrade.

### V.1.5 *Key reasons for a low level of intra-Southern Rim trade*

#### V.1.5.1 Uneven level of import protection

Import protection via tariffs is uneven in the region. Eliminating tariffs between partners with very different tariff levels on external imports will have different consequences for the sectors exposed to changed conditions of import competition in the individual countries. Opening up to regional partners may divert trade flows from more efficient third-country exporters to less efficient trading-bloc-partner exporters. Though most favoured nation (MFN) tariffs in the Southern Rim have been reduced and are converging to the global level, they are still high, and the spread of average tariffs remains considerable (Shui and Walkenhorst, 2010). Furthermore, certain industries in individual countries may be politically important, and thus the readiness to expose them to increased competition from regional firms may be limited.

#### V.1.5.2 Non-tariff barriers to trade

Kee, Nicita and Olarreaga (2005) analysed the role of non-tariff barriers and came to the conclusion that they are higher in the Southern Rim region than anywhere in the world; moreover, non-tariff barriers contribute to restrictiveness more than tariffs do. Free trade stipulations frequently exist only on paper, not in real life. In some cases, special import permits are required for goods entering the country of destination, and if an import-competing industry is thought to be harmed by such imports, the permission may be refused...

#### V.1.5.3 No coverage of trade in services

Regional trade agreements in the Southern Rim typically omit trade in services or include it to only a marginal extent (World Bank, 2010a). Research by Konan (2003) suggests that, for Egypt and Tunisia, a comprehensive reform of services and a simultaneous opening up to competition would yield results that are two to three times more significant than tariff removal alone. Due to intra-Southern Rim differences in regulations, restrictions on currency convertibility and physical movement of people, it is often easier for a Southern Rim services provider to operate outside the region than inside it (Shui and Walkenhorst, 2010).

#### V.1.5.4 Diversified and complicated rules of origin

The highly diversified and complicated sets of rules of origin in the Southern Rim countries displace foreign investments to the Northern rim of the Mediterranean (Ülgen, 2011). A foreign investor operating from an EU Member State can easily serve the individual Southern Rim markets, unlike a Southern Rim investor, who is handicapped by the lacunae in the set of individual trade agreements across the Southern Rim countries, coupled with complications in the diverging rules of origin.

#### V.1.5.5 Unfavourable investment climate

The high costs of transport, logistics and communications, coupled with the lack of adequate infrastructure, are factors impeding trade in the Southern Rim region. The institutional framework does not align prices with costs, and an enabling environment that would permit and entice private provision is also missing. According to the World Bank, the conditions for doing business in the region are rather poor (see Section II for details).

#### V.1.6 Alternative scenarios for intra-Southern Rim trade

The Eastern European NMS and candidate countries had the option of EU accession, and these countries clearly subordinated their intra-regional cooperation to that opportunity. For the Southern Rim, the EU accession option is not available, and therefore there is sufficient room for creative solutions concerning Southern Rim regional integration. Drawing on the work of Casero and Seshan (2010), we outline five major directions for future developments:

- **Status quo** – no change from the current situation;
- **Shallow regional integration** – regional trade agreements help dismantle most tariffs and other trade barriers in merchandise trade;
- **Deeper regional integration** – Southern Rim countries move beyond shallow integration and liberalize the services sector, introduce investment climate reforms and make efforts to improve intra-regional physical infrastructure;
- **Wider integration** – Southern Rim countries enter a trading bloc with the EU;
- **Deeper regional integration cum wider integration** – combining the advantages of the two previously mentioned options

The progress from lower stages of integration toward higher ones may be slow and not necessarily desirable for each individual Southern Rim country. A critical issue here will be to find the common denominator for the minimum required level of regional integration. Simultaneously, for those countries or groups of countries that are ready and able to move to a higher level of integration, rapid progress should be secured. Nevertheless, any rapid progress by a group of Southern Rim countries towards wider individual (or group) integration with the EU before intra-Southern Rim integration is stepped up may prove a major obstacle to fostering intra-Southern Rim integration. The reason for this is a potential crowding-out of intra-regional trade through obstacle-free trade flows with the EU.

#### V.1.7 SMEs and the vision of a deep Euro-Mediterranean free trade area

According to a description in a World Bank report, the Southern Rim region is one of the least business-friendly regions in the world (World Bank, 2011d; see also Section II). Private-sector investment, in terms of both the share of total investment and the growth rate, is the lowest among the developing regions (World Bank, 2009). That means that SMEs

located either in one of the Southern Rim countries or in one of the EU-27 Member States, have to face extraordinary challenges when establishing a new business or when maintaining or extending an existing one.

SMEs provide the overwhelming majority of enterprises in the Southern Rim countries, and in this there is no difference between the Southern Rim and the EU-27. However, there is an important asymmetry: in the Southern Rim region, within the category labelled 'SME', self-employment and micro-firms predominate and medium-sized enterprises are under-represented, compared to the respective proportions in the EU. The density of newly registered companies (the number of newly registered corporations divided by the number of total working-age population) is substantially lower in the Southern Rim region (1.6) than in the OECD countries (6.7) (OECD, 2010).

Given the preponderance of SMEs in the economies of the Southern Rim region, SME policies should be of outstanding importance. However, SME policies have focused on microfinance schemes (reflecting a primarily subsistence entrepreneurship) and have received less attention than FDI and large-scale projects (Stevenson, 2010). While the specific policy responses should be adapted to individual countries, reforms of the regulatory business environment need to be supplemented by micro-level policies. These should include business development services, skills development, access to markets and creation of linkages to large enterprises.

Nevertheless, SMEs have a key importance in the Southern Rim region in two specific areas: job creation and economic diversification. The labour force is growing in the region by an average of 3.4% annually, and in order to maintain the 2003 employment levels, an additional 100 million jobs need to be created in the region. The latest global economic and financial crisis has highlighted the necessity of structural reforms, so that vulnerability can be reduced and flexibility in responding to future shocks can be improved. SMEs may become the key stakeholders in diversification away from reliance on natural resources and public works, as fiscal constraints do not allow further expansion of the public sector (OECD, 2010).

Providing appropriate financing for SMEs in the Southern Rim region is a precondition for more dynamic development of this segment of the economy in these countries. The European Commission established a special instrument to foster financing of the private sector and, within this, of SMEs. The Facility for Euro-Mediterranean Investment and Partnership (FEMIP) was created in October 2002 within the European Investment Bank (EIB), following the Barcelona European Council, to stimulate economic growth and private-sector development in the Mediterranean region (European Commission, 2012b). The operations of the European Bank for Reconstruction and Development (EBRD) are being extended to the Southern Rim region as well.



In a Commission Staff Working Document, the European Commission provided a detailed evaluation of FEMIP. The main finding was that FEMIP had been instrumental in channeling substantial funding to the Southern Rim region and in improving the conditions for economic growth, through financial support for infrastructure, FDI and local companies, including SMEs. Nevertheless, the Commission proposed a better matching of private-sector needs through a wider range of financial instruments and services, with added focus on SMEs. The better to address the difficulties faced by private companies – and especially small companies – in accessing finance, it was recommended that the range of FEMIP instruments should be revised, with a view to encouraging more risk-taking and a better targeting of smaller SMEs. Risk capital resources were able to continue the support of a wide range of activities with a higher risk profile, including instruments in local currency, without large collateral requirements. This should be useful for private companies, and especially for SMEs. In this respect, FEMIP could further continue to support the development of SME loan-guarantee schemes. By providing guarantees to local banks for new SME loans, the credit risk of the local bank would be partly covered, thus lowering the need for collateral requirement and increasing access to finance for SMEs. Another advantage is that this instrument does not generate exchange-rate risks, and thus is suitable for smaller SMEs without export earnings.

A further field recommended for support was micro-finance activities – participation in new or existing micro-finance institutions, or provision of guarantees or loans to these institutions – to be combined with technical assistance, if required. Micro-finance institutions could, with FEMIP support, broaden their client base, extend their range of services, introduce new technologies, or find new delivery channels and bridge the gap between micro-finance and regular bank loans (European Commission, 2012b). Moreover, the potential of Islamic finance could be used more efficiently according to some (Mohieldin, 2012).

In order to target SMEs better, the sector's special difficulties could be addressed by encouraging financial intermediaries to cater for smaller SMEs' needs better. To achieve this, the global loan instrument could be further improved, along the lines set out in the last few years. First, in order to stimulate competition between local banks and to reach more SMEs, global loans could continue to be extended to several intermediary banks in each country; targets could be included in global loan agreements to focus more on smaller SMEs (or the incentive system could be changed to reward this); or more intermediaries could be targeted that specialize in smaller SMEs or micro-finance sectors and provide a wide range of instruments. In order to overcome local financial institutions' risk aversion and SMEs' often non-transparent management, the EIB could also devote more technical assistance to local banks and, indirectly, SMEs. This should include technical assistance for intermediary banks to help develop systems to assess SME credit risks better, to streamline procedures and to introduce new products for SMEs (including methods to ease transfers of remittances to Mediterranean countries). The expertise of SME-oriented banks

in Europe and candidate countries could be shared with banks in the Mediterranean. A further opportunity would be to provide technical assistance to SMEs indirectly, especially smaller companies, to assist them in drafting business plans, and to improve their reporting skills and overall transparency, which would make them more desirable clients for financial institutions. The EIB could channel this technical assistance through local business/SME organizations.

In the Southern Rim region, the private sector finds it harder to access credits than does its counterpart in Europe, and SMEs have even fewer opportunities for financing than the larger firms (see also Section II). A working group of experts from the Southern Rim countries, the EIB and the European Commission listed several explanations for this phenomenon:

- Lack of collateral, while collateral requirements are even higher for SMEs;
- Lack of transparency within SMEs, due to missing reliable financial statements and business plans;
- Mixture of personal and company assets, weak financial structure and management; credit agencies to administer companies' track records and credit history are rare;
- Financial institutions face higher administrative costs when they provide small loans (as the costs for assessment of the credit request, monitoring of the loan, etc. are the same as for larger loans);
- Newly established SMEs may not be profitable from the beginning, so there may not be sufficient cash flow to start repaying loans immediately.

#### *V.1.8 Conclusions*

After various earlier steps towards a more intensive economic integration between the Southern Rim and the EU, the proposed new framework for the Euro-Med cooperation – the deep and comprehensive free trade agreements – will open up new dimensions for mutual trade in goods and services, investment and further economic interaction. A precondition for proper utilization by the Southern Rim countries of the opportunities now opening up will be the removal of stumbling blocks in problem areas like border control, public procurement, technical barriers, administration and corruption, state intervention and competition policy (see Section II). Legal aspects like dispute settlement and protection of intellectual property rights will also play an important role.

Fostering regional integration of the Southern Rim countries is a critically important aim of the Euro-Med cooperation. Intra-Southern Rim trade is currently low and definitely below its potential. The reasons for this are an uneven level of import protection, non-tariff barriers to trade, no coverage of trade in services in regional trade agreements, and varied and complicated rules of origin.

Currently, the Southern Rim is one of the least business-friendly regions in the world. That also means that SMEs located in a Southern Rim country or an EU-27 Member State have to face extraordinary challenges when establishing a new business or when maintaining or extending an existing one. However, SMEs have a key importance in the Southern Rim region in two specific areas: job creation and economic diversification. Providing appropriate financing for SMEs is a precondition for more dynamic development of the region. The European Commission has established a special instrument to foster financing of the private sector and, within this, of SMEs. Both the EIB and EBRD will step up their activities in the Southern Rim.

## **V.2 The EU and the Eastern Rim: Hesitant integration and rivalry with Russia**

### *V.2.1 Partnership and cooperation agreements*

This section covers the European Rim countries located to the East of the EU: Armenia, Azerbaijan, Belarus, Georgia, Moldova, Russia and Ukraine. All of these are former Soviet republics, and all – except Russia – are covered by the EU Eastern Partnership (EaP) Initiative, whereas Russia is a ‘strategic partner’ of the EU.

The main institutional arrangements underlying relations between the EU and Eastern Rim countries (except Belarus),<sup>32</sup> are bilateral partnership and cooperation agreements (PCAs) – see Table V.2.1. A PCA is typically concluded for ten years, with an option to automatically prolong it if neither party wishes to withdraw. In each case, a PCA provides a framework for political dialogue between the two sides and is aimed at supporting the Eastern Rim country’s efforts to achieve democracy and to approximate its legislation to EU standards. In the sphere of the economy, PCAs are aimed at fostering trade, creating a level playing field for investments through the principle of ‘national treatment’ (i.e. non-discrimination against foreign investments), and promoting cooperation in a number of priority areas.

PCAs do not automatically envisage a free trade regime between the Eastern Rim countries and the EU.<sup>33</sup> They only offer the ‘most favoured nation’ (MFN) treatment of Eastern Rim countries’ exports to the EU, which is simultaneously also provided by the various countries’ WTO membership (except Azerbaijan and – for the time being – Russia).<sup>34</sup> This makes PCAs essentially obsolete, at least when it comes to provisions affecting trade.

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<sup>32</sup> Although negotiations on a partnership and cooperation agreement between Belarus and the EU were completed in 1995, the agreement has not been ratified for political reasons. Instead, EU–Belarus relations are governed by successive resolutions of the Foreign Affairs Council.

<sup>33</sup> The prospects of free trade with the EU are explicitly stated in various PCAs, provided the country in question has joined the WTO and ‘made sufficient progress towards common values and principles’.

<sup>34</sup> Russia’s WTO accession negotiations were finalized in December 2011, and the country is expected to formally join in mid-2012, following ratification by the Russian parliament.

However, a number of goods from the Eastern Rim countries that enter EU markets qualify for the generalized system of preferences (GSP); this offers a level of protection that is, on average, 2 percentage points lower than the MFN level. Armenia, Azerbaijan and Georgia qualify for GSP+ (as of October 2010), which offers additional tariff reductions, while Moldova enjoys EU Autonomous Trade Preferences (duty- and quota-free access) for industrial and many agricultural goods, under a WTO waiver that expires in December 2013. Finally, in the cases of Azerbaijan and Russia, their main export products to the EU – oil and gas – enter EU markets duty free (there are, however, export duties, e.g. on the Russian side). All this explains why the EU effective import tariffs for imports from the Eastern Rim countries are generally very low (see Table III.4.1 in Section III.4), although Armenia, whose main export item to the EU is precious metals, is something of an exception.

Conversely, the Eastern Rim countries' level of protection against imports from the EU is considerably higher (Table III.4.1), up to 6.5% on the trade-weighted basis in Russia – although it will progressively go down in coming years, as Russia implements its WTO-related obligations. At the other extreme, Georgia is the most open country to imports from the EU (as well as from elsewhere), since it has radically liberalized its foreign trade regime as part of a broader economic reform package implemented following the 'rose revolution' of 2004.

Table V.2.1

**Partnership and cooperation agreements between the EU and Eastern Rim countries**

Country	Entry into force	Reference
Armenia	1.7.1999	OJ L 239
Azerbaijan	1.7.1999	OJ L 246
Belarus	PCA signed in 1995, but not ratified for political reasons	
Georgia	1.7.1999	OJ L 205
Moldova	1.7.1998	OJ L 181
Russia	1.12.1997	OJ L 327
Ukraine	1.3.1998	OJ L 049

Source:

[http://europa.eu/legislation\\_summaries/external\\_relations/relations\\_with\\_third\\_countries/eastern\\_europe\\_and\\_central\\_asia/r17002\\_en.htm](http://europa.eu/legislation_summaries/external_relations/relations_with_third_countries/eastern_europe_and_central_asia/r17002_en.htm)

**V.2.2 Eastern Partnership and 'deep and comprehensive free trade'**

All Eastern Rim countries except Russia are also covered by the EU Eastern Partnership (EaP) initiative that was launched in May 2009, largely thanks to the efforts of Poland and Sweden. EaP aims to 'create necessary conditions to accelerate political association and further economic integration' with the EU on the part of Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine. Cooperation within the framework of EaP has concentrated around the four broad areas: democracy and governance, economic integration,

energy security, and contacts between people (including issues of visa liberalization). On the basis of these four areas, a number of flagship initiatives have been launched, such as on integrated border management, SMEs support, energy efficiency, civil protection, and the environment (European Commission, 2010d). Right from the start, Russia has not been covered by EaP,<sup>35</sup> while the implementation of EaP in Belarus has stalled for political reasons.

The current EU strategy towards EaP countries is to negotiate deep and comprehensive free trade agreements (DCFTAs), which are seen as part of broader association agreements. The aim is the integration of EaP countries into the EU single market. In December 2011, the EU finalized DCFTA negotiations with Ukraine and opened them with two other EaP countries: Georgia and Moldova (with Armenia and, potentially, Azerbaijan still pending). DCFTAs are aimed at liberalizing trade in goods and services, but also at ensuring an approximation of the EaP country's legislation to EU standards in areas that have an impact on trade, such as competition policy, public procurement, customs and border procedures, certification standards, sanitary and phytosanitary rules, animal welfare and intellectual property rights. The idea is to create, via the adoption of these reforms, a conducive business climate that can accelerate the inflows of FDI into the country, particularly from the EU (De Gucht, 2011<sup>1</sup>).

The impact of 'deep' free trade with the EU should be much greater, and more positive, for the EaP countries than 'simple' free trade (which may even turn out to be negative). This is due to the potential benefits of structural reforms in the EaP countries which are stipulated by the 'deep and comprehensive' free trade agreements with the EU. Francois and Manchin (2009), who analysed the effects of EU integration for individual CIS countries and for the CIS as a whole, found that a simple FTA with the EU would lead to a decline in the CIS's GDP of between 0.1% and 0.4%, depending on whether or not trade in agricultural and food products is liberalized (in the former case, the negative effect is paradoxically more pronounced). Our CGE-based estimations presented in Section III.4 generally confirm this finding and suggest even stronger GDP declines, which are due to domestic producers losing out to more competition from EU imports as a result of trade liberalization.

In contrast, according to Francois and Manchin (2009), a DCFTA with the EU would boost the CIS's GDP by 1.2%.<sup>36</sup> Maliszewska et al. (2009) also expect 'deep' integration with the EU to have positive effects on the EaP countries. It should bring the biggest benefits to

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<sup>35</sup> In fact, Russia has viewed the Eastern Partnership initiative with suspicion, accusing the EU of seeking to develop a 'sphere of influence' in the Russian neighbourhood – see e.g. Wallace (2009). Instead, Russia seeks a 'special' Strategic Partnership with the EU as a follow-up to the expired PCA.

<sup>36</sup> For Ukraine, Francois and Manchin (2009) found, however, a negative effect (-0.4%) even under a 'deep' free trade scenario. They attribute this to welfare-reducing trade-diversion effects of EU integration: Ukraine is reducing its trade barriers with the EU, but not with the rest of the world.

Ukraine, whose GDP should be boosted in the long run by 5.8%,<sup>37</sup> followed by Armenia (3.1%), Azerbaijan (1.8%) and Georgia (1.7%). These overall gains, however, will be accompanied by a profound structural change, and the output of some sectors will contract dramatically. The Kiev-based Institute for Economic Research and Policy Consulting (Movchan and Guicci, 2011) has found that a DCFTA with the EU should boost Ukraine's welfare by nearly 12% in the long run – more than twice the figure that could be expected in the case of a simple FTA with the EU. In another study, Jensen and Tarr (2011), who investigate the EU integration of Armenia, find that the strongest positive effects would derive from the 'deep' aspects of integration, whereas a simple FTA would result in small losses for Armenia. Finally, the earlier experience of Turkey, whose entry into the Customs Union with the EU in 1995 was accompanied by the approximation of its various regulatory border and 'behind-the-border' policies to EU standards, suggests strongly positive restructuring and modernization effects (Togan, 2011).

Another finding (resulting from the above-mentioned trade asymmetry) is that the impact on the EaP countries will be much greater than on the EU: available CGE estimates suggest that the cumulative long-term welfare gain to the EU should be less than 1% – compared to, for example, 5–10% in the case of Ukraine (Dabrowski and Taran, 2012). This is because the EaP countries have much smaller economies, and also because the bulk of both tariff and especially non-tariff adjustments in the wake of the implementation of DCFTAs would fall on the EaP countries rather than the EU.

While the long-term economic benefits of 'deep and comprehensive' free trade with the EU are generally acknowledged, they may prove an insufficient incentive for EaP countries to implement the necessary (and costly) reforms – so long as the EU is unwilling to offer them more formal membership prospects. In other words, DCFTA – like WTO membership – may be only a weak institutional anchor that is insufficient to pursue consequent reforms (see Havrylyshyn, 2008). This particularly applies to Georgia and Moldova, both of whom are long-time WTO members with official EU accession aspirations. Ukraine, whose DCFTA with the EU has been finalized, may not be willing to implement the already agreed obligations without the 'carrot' of EU accession. This arguably places in question the efficiency and wisdom of the whole EU Neighbourhood Policy strategy with respect to EaP countries (see e.g. Grant, 2011). The reason is that the EU essentially requires the country in question to adopt the bulk of EU *acquis communautaire*. In the cases of Georgia and Armenia, this has reportedly been even a precondition for starting DCFTA negotiations. The costs of compliance with *acquis* may be prohibitively high<sup>38</sup> and may outweigh the potential benefits of the DCFTA – which are anyway smaller than those of full-fledged EU membership. A

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<sup>37</sup> In contrast, a simple FTA with the EU would only boost Ukraine's GDP by 1.7%.

<sup>38</sup> For instance, according to some estimates, adoption of the EU's stringent sanitary and phytosanitary measures in Georgia would raise the price of some of its food products by 90%. Also other EU demands on Georgia appear to be excessive, and arguably go far beyond strictly trade-related issues – see e.g. Messerlin et al. (2011).

similar approach applied earlier by the EU to Central and Southeast European countries who later joined the EU worked precisely because they were given the prospect of accession. Against this background, Emerson (2011a) argues that a more fruitful strategy towards the EaP countries would be to replicate the earlier EU policy towards MENA: negotiate simple FTAs first, and ‘deepen’ them later.<sup>39</sup>

Another problem area is that the already negotiated DCFTA with Ukraine only partly incorporates agricultural and food products.<sup>40</sup> This is also likely to be the case with DCFTAs with other EaP countries. Meanwhile, given the region’s generally mild climate and the black soil, agriculture is identified as an area of comparative advantage not only for the time being, but even in the longer term. Examples are grain in the case of Ukraine, and wine in the cases of Georgia and Moldova (OECD, 2011). In a way that is similar to the situation in the MENA countries (see above), leaving agriculture outside of the scope of free trade agreements may dampen the EaP countries’ growth prospects and even reduce their interest in concluding a DCFTA with the EU to start with.

A failure of DCFTAs between the EU and the EaP countries would have negative consequences for both sides: the EaP countries may find themselves stuck in the current low-competitiveness and instability trap. Again, the earlier experience of the new EU Member States of Central and Eastern Europe suggests that the massive inflows of FDI from the ‘core’ EU which boosted their competitiveness, economic restructuring and quality upgrading were, to a large extent, thanks to legislative harmonization and institutional reforms underpinned by the adoption of *acquis*. However, the competitiveness of EU businesses in the EaP countries may potentially suffer as well. For instance, the unreformed (and in many cases highly corrupt) system of public procurement in EaP countries will further disadvantage foreign suppliers, including those from the EU.

### V.2.3 *Russia: the EU’s ‘strategic partner’*

Not only is Russia by far the biggest economy in the Eastern Rim, but it is the EU’s second-largest export destination and the third-largest source of EU imports, in particular of energy (see Section III). However, the EU’s integration with Russia in institutional terms is not very advanced. As already mentioned, Russia is not covered by the EU Eastern Partnership initiative, partly because the country sees herself as ‘special’ (see e.g. Havlik, 2010). The EU–Russia partnership and cooperation agreement (PCA) which has been in force since 1997 is still the main document underlying bilateral relations (it will become largely obsolete – and even redundant – once Russia formally joins the WTO in mid-2012). For instance, the MFN treatment of Russian exports to the EU envisaged in the PCA will

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<sup>39</sup> However, the experience of MENA suggests that this approach has not been particularly successful either (see Section V.1).

<sup>40</sup> For many agricultural products, there are tariff quotas; these quotas are reportedly particularly low (with respect to Ukraine’s export potential) for vegetables and eggs.

automatically be provided by Russia's WTO membership. Within the framework of the PCA, in May 2003 the EU and Russia agreed to work towards establishing in the long term 'four common spaces': a common economic space; a common space of freedom, security and justice; a space of cooperation in the field of external security; and a space of research, education and cultural exchange. However, the progress in the implementation of these has been tepid at best, not least due to the profound differences in approaches between the two sides. Finally, in 2010 the EU and Russia signed a 'Partnership for Modernization' agreement, which is, however, more or less declaratory in nature.

It is sometimes argued that an important factor complicating EU–Russia relations is the lack of clearly defined goals (Kaveshnikov and Potemkina, 2009). Negotiations over a new contractual document underlying EU–Russia relations, which could have replaced the current PCA, have been blocked at different stages and for assorted reasons by various EU Member States, and received a major setback after the Russian-Georgian war over Abkhazia and South Ossetia in August 2008. The EU's eastern enlargement in 2004/2007 brought additional complexity to EU–Russia relations. Under these circumstances of EU disunity, it was often easier for Russia to cooperate with individual European countries (especially Germany and Italy) than with the EU Commission in Brussels. Russia's forthcoming WTO accession potentially opens the door to free trade negotiations with the EU – a possibility explicitly envisaged by the current PCA. However, given a number of contentious issues – such as the EU's reluctance to abolish visas for Russians and the ongoing dispute over 'values' – any progress in negotiations is unlikely to be fast. In addition, Russia–EU relations are clouded by the Third Energy Liberalization Package of the EU (which undermines the positions of Gazprom in the European energy market), as well as by perceived restrictions on Russian investments in the EU.

In the short term, a free trade regime between the EU and Russia would benefit primarily the EU. As can be seen from Table III.4.1, Russian exports to the EU already face fairly low tariffs (except for metals, which face anti-dumping measures in the EU). In particular, oil and gas exports face no import barriers at all. At the same time, EU exporters face relatively high import duties in Russia and would benefit from their elimination (although part of this benefit will accrue from Russia's forthcoming WTO accession – see, e.g. Astrov, 2012). In the longer run, however, provided the Russian economy becomes more diversified and manufacturing products gain a higher share of its exports, open access to EU markets for these products may become crucial.

The estimates of Maliszewska et al. (2009) suggest that 'deep' free trade with the EU would boost Russia's GDP by 2.8% in the long run (10–15 years) by contributing to the diversification and modernization of the Russian economy and by incorporating it into European production networks. However, Russia is reluctant – to a much greater extent



than the EaP countries – to unilaterally adopt the EU standards required for this.<sup>41</sup> Instead, it advocates a ‘symmetrical’ approach in its relations with the EU, implying that the two sides should have equal rights and obligations. In practical terms, such an approach would involve, for example, mutual recognition of standards, or at least (as is the case in EU relations with Israel) efforts towards legislative approximation undertaken by *both* sides.<sup>42</sup> The latter is, however, rejected by the EU. Given the fundamental divergence between the positions of Russia and the EU on how to pursue mutual legislative harmonization in trade-related areas, the prospects for ‘deep free trade’ between Russia and the EU currently look bleak. This implies, in turn, that Russia’s competitiveness in EU markets will be further largely confined to commodities (particularly oil and gas), while the benefits to EU producers on the Russian market are unlikely to go beyond those deriving from Russia’s forthcoming WTO accession.

#### *V.2.4 Regional integration in the post-Soviet space: implications for the EU*

Unlike MENA, the Eastern Rim countries are relatively well integrated (arguably even ‘over-integrated’) with one another (see e.g. Elborgh-Woytek, 2003). This is, of course, a legacy of their common Soviet past, and is also a product of the fact that a large part of the unrestructured manufacturing sector in these countries is not competitive outside the post-Soviet space (Belarus, with its dual export structure, is a case in point – see Havlik, 2008). The dependence of several EaP countries on Russia as the main export market and the principal energy source (particularly in view of inefficient energy use in many Eastern Rim economies) is sometimes viewed as a risk factor. This does not mean that intra-regional trade in the Eastern Rim has reached its full potential. On the contrary, it is argued that deeper intra-regional integration could, for instance, benefit local SMEs through economies of scale and could provide incentives for the modernization of the EaP countries’ traditional industries (such as the metals industry in Armenia, Georgia and Ukraine) (OECD, 2011).

All Eastern Rim countries, except Georgia,<sup>43</sup> are members of the CIS and are formally signatories to the CIS-wide free trade agreement. In reality, the free trade regime is indeed being applied to a large number of (mostly manufactured) goods; but there are a number of ‘exemptions and limitations’, mostly concerning agricultural products, food and metals. Protectionist instruments typically applied against these goods in intra-CIS trade include anti-dumping duties and quotas.

The most advanced integration block in the post-Soviet space is the Russia–Belarus Union State, which has formally existed since 1999. The treaty governing this envisaged a high degree of economic integration, including a common economic space and a monetary un-

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<sup>41</sup> The Russia–EU PCA stipulates that ‘Russia shall endeavour to ensure that its legislation will be gradually made compatible with that of the Community’, but the soft wording makes it non-binding on Russia (Matta, 2009).

<sup>42</sup> This is provided in the Euro-Med Agreement with Israel (Matta, 2009).

<sup>43</sup> Georgia left the CIS after the Russian-Georgian war over Abkhazia and South Ossetia in August 2008.

ion. Trade regimes between the two countries have indeed been largely harmonized, a common labour market has been implemented, and border controls have been largely abolished (although the planned introduction of the Russian rouble on the territory of Belarus has repeatedly been delayed).

On a wider scale, in 2009 Belarus, Russia and Kazakhstan initiated a Customs Union (CU). The CU's participant countries have eliminated all remaining non-tariff barriers in their mutual trade, unified their trade regimes vis-à-vis third countries, and adopted a common customs code. In January 2012, the CU was further upgraded to a Common Economic Space (CES). The underlying idea is that the CES should offer deeper integration than DCFTAs initiated by the EU: it is supposed to provide not only the free movement of goods, services and capital, but also of labour (which is not covered by DCFTAs). The CES also envisages harmonization of national legislation in the areas of macroeconomic and competition policies, subsidization, public procurement, intellectual property rights, transportation and electricity tariffs, and technical regulations. In principle, it also stipulates convergence of energy prices across member states. Individual sectoral agreements within the framework of the CES will enter into force after transition periods lasting until 2015. In the medium term, it is envisaged that Kyrgyzstan and Tajikistan will join the CES as well.

Among the EaP countries, the Belarus–Russia–Kazakhstan CU project is potentially relevant also for Ukraine. This has, on several occasions, raised concerns on the part of the EU. Russia has been trying to lure Ukraine into the CU, *inter alia* by offering it the prospect of cheaper gas – a sensitive issue for Ukraine, given the extremely high energy intensity of its economy and the high price it is currently paying for Russian gas. However, Ukraine has been insisting on the '3+1' formula of cooperation, rather than full-fledged CU membership. One reason is Ukraine's WTO commitments. Largely because of Ukraine's WTO membership, its average tariff level (4.5%) is lower than the Common External Tariff of the CU (above 6%).<sup>44</sup> If Ukraine raises its customs duties for imports from third countries to the CU level, these countries – most of which are WTO members – would surely demand compensation (see Astrov, 2011). The Institute for Economic Research and Policy Consulting (2011) has estimated that Ukraine's membership of the CU would entail welfare losses of up to 4% in the long run. In addition, it would be incompatible with its forthcoming DCFTA with the EU, since the latter would generally require *zero* duties on Ukraine's imports from the EU.

Under these circumstances, Ukraine's full-fledged membership of the CU is only realistic if: (1) the Common External Tariff of the CU does not exceed Ukraine's level, and (2) the CU members – and first of all Russia – advance their own integration with the EU at least to the stage of a free trade area. As argued above, the prospects for the latter are currently

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<sup>44</sup> Simple averages of effectively applied rates based on HS two-digit level – wiiw calculations based on UNCTAD TRAINS data.

bleak. However, EU–Russia integration is a potentially preferred option in the future; when accompanied by a parallel integration of the EaP countries, this would lay the foundation for a Pan-European Economic Space.<sup>45</sup>

Box V.2.1

### **Estimating the economic effects of the Belarus–Russia–Kazakhstan CU/CES**

The estimates of the economic effects of the Belarus–Russia–Kazakhstan CU/CES differ greatly. According to Dyner (2010), it may boost the participating countries' GDPs by about 15% up until 2015, when the transition provisions are phased out. Belarus and Kazakhstan, which are located on the outskirts of the CU and transit a large number of goods from third countries into Russia, should benefit from the expansion of logistics centres related to the CU customs clearance. Although 88% of revenue from customs duties imposed on imports from third countries will be transferred to the Russian budget, this does not apply to other customs-related payments (such as customs clearance fees, fees for customs escort and customs storage), which will stay with the national budgets. Glazyev (2011) comes to similar conclusions; according to his estimates, the implementation of the CU and the CES should boost the participating countries' GDPs by between 12% and 18% over a ten-year period.

On the contrary, Vinhas de Souza (2011) has found that the CU is a welfare-reducing arrangement, first of all for Belarus, whose GDP may decline by up to 6%. The effects of the CU on Belarus have also been analysed by Tochitskaya (2010), who found that the main effect would derive from the upward adjustment of customs duties on second-hand cars imported from third countries to Russia's (effectively prohibitive) level. She also found a similar effect, albeit on a much smaller scale, for trucks, buses, sugar, meat and aluminium, while the imports of investment goods into Belarus should, conversely, be boosted by lower import duties. In Kazakhstan, where import duties on many investment goods have increased and those on food products have declined, the effect of the CU is expected to be largely the opposite to the effect on Belarus (ATF Bank, 2010)

So long as this is not the case, the EU often perceives the regional integration steps of EaP countries with Russia as *alternative* to rather than *complementary* to EU integration (as is the case with Ukraine). In this geopolitical rivalry, the EU effectively discourages any intra-regional integration in the Eastern Rim involving Russia (and there is hardly any integration in the Eastern Rim without Russia, given its economic size).<sup>46</sup> This is the opposite of EU policies in the South Mediterranean, where advancing 'South–South' integration is seen as highly instrumental in bringing these countries closer to the EU single market (see Section V.2), and may ultimately undermine the success of the EU's own integration efforts.

<sup>45</sup> This option is recommended, e.g. in Havlik (2010) or Glinkina and Kulikova (2007).

<sup>46</sup> The only integration project in the post-Soviet space not to have involved Russia is GUAM (Georgia–Ukraine–Azerbaijan–Moldova), largely conceived to ensure energy exports to Europe by circumventing Russian territory; but this has remained largely confined to paper.

### V.2.5 *Conclusions*

The present EU strategy towards the European Rim countries – the new EU Neighbourhood Policy – is to advance trade and institutional integration with both MENA and Eastern Rim countries. From the institutional point of view, MENA countries are relatively more integrated with the EU than is the Eastern Rim. Nearly all MENA countries have free trade agreements with the EU – even if important sectors (such as agriculture, textiles and services) are often omitted, which constrains the MENA countries' competitiveness and dampens their growth prospects. Another major problem – also from the EU point of view – is the low level of MENA intra-regional integration, which is due to institutional reasons (no multilateral free trade agreement encompassing all or most MENA countries), infrastructural bottlenecks, and a generally poor business climate, which hinders FDI and competitiveness.

Unlike MENA, the Eastern Rim countries do not yet have free trade regimes with the EU, although in reality their products generally face low barriers to entering the EU markets and are, in general, more competitive. The currently ongoing or forthcoming 'deep and comprehensive' free trade negotiations between the EU and most Eastern Rim countries are expected to bring them long-term benefits (and to a lesser extent – in a strictly economic sense – should also benefit the EU). However, the initial costs of associated structural adjustments in the Eastern Rim countries may in some cases be prohibitively high and may arguably jeopardize the effectiveness of the EU strategy in the region. In addition, the deadlock in EU–Russia integration makes the Eastern Rim countries (above all Ukraine, which remains 'sandwiched' in between) face difficult choices and may constrain further intra-regional integration, with potentially detrimental effects for the EU's own integration efforts, due to the instability of the neighbourhood.

## **VI. Labour market and migration issues in European Rim countries**

### ***VI.1 Introduction***

In the past two decades, the majority of countries in the EU neighbourhood have experienced a rapid deterioration in people's living standards, political instability and (in some cases) descent into authoritarianism, demographic challenges from a shrinking and ageing population, and military conflict. Since 2000, enhanced economic performance and increasing remittances have contributed to an improvement in living conditions, but also to growing inequality in terms of employment opportunities, access to education, regional disparities in development and large income differences between urban and rural areas.

In the context of the European Neighbourhood Policy (ENP), the impact of increased labour migration from neighbourhood countries is of particular interest to EU policymakers. The Middle East and North Africa (MENA) is recognized as region of emigration, with first-generation emigrants numbering 10–13 million (World Bank, 2011j). The increasing differences in economy, demography, politics and security, plus its geographical proximity, make the EU the main destination for migrants from the MENA region. Immigration from the MENA countries accounts for 20% of the 30 million immigrants in the EU and 6% of the population of the European Union (EU-27); and in particular after the Arab Spring, the flow of migrants from the region is expected to rise (see below). Moreover the MENA region is a transit route for migrants from more distant regions. Recent events in North Africa have increased migratory flows to Europe, and the EU's migration policy towards this region can be expected to evolve significantly.

The promotion of the mobility of citizens from the Eastern Partnership (EaP) countries represents one of the EU's main commitments in the Prague Declaration of the Eastern Partnership Summit. As a contribution to a more ambitious partnership with its Eastern neighbours, this commitment builds upon the three pillars of the EU's Global Approach to Migration: promoting mobility and legal migration, optimizing the link between migration and development, and preventing and combating irregular migration.

The Western Balkan (WB) countries, some of which are candidates or potential candidates for EU membership and most of which (except Kosovo) have recently benefited from visa liberalization, are experiencing a new migration developments, since their citizens have started to travel to the EU without a visa.

As was shown above, the neighbourhood countries of the European Union have considerable diversity in economic performance and in the extent of their structural market reforms (see also European Economy, 2011). The development of migration management systems has been uneven across the regions, not least due to differences in available resources and in the general development of the quality of public policy institutions. In particular, the

links between migration and employment or education policies remain vague in all countries of the region (ETF, 2011); but these links are very relevant to these countries' competitiveness.

In particular, the high level of emigration is linked to economic hardship and unemployment in these countries. Labour migration represents an alternative mechanism for employment and is a reaction on the part of the population to social and economic crisis and internal conflict. Migrants from these countries have been moving mainly toward countries with which there are established historical, social, cultural and economic ties; there are a variety of reasons for this, not least the increased demand for labour migrants and the increased availability of low-skilled jobs in the countries of destination. The role of ties established between the diasporas and the home countries is very significant in migration processes, and established migration networks make the process of migration easier and stimulate the inflow of new migrants.

Although the upcoming demographic challenges for European labour markets have been widely recognized, the recent financial and economic crisis has reduced the momentum of labour migration policy, both within and outside the EU. In a longer-term perspective, however, the Europe 2020 strategy has recognized the need for a comprehensive labour migration policy and better integration of migrants in order to meet the Union's goals for smart, sustainable and inclusive growth.

In the following, we examine the labour market developments in the European Rim countries and provide an overview of the main characteristics of migration over the past decade.

## ***VI.2 Labour markets in European Rim countries***

This section analyses the key labour market characteristics in the EU's neighbouring regions (Eastern Partnership countries and Russia, Southern Partnership countries, selected Western Balkan and EFTA countries – the European Rim). It examines recent labour market developments, including demographic aspects, labour force participation, employment features, unemployment and the informal economy in the individual groups of countries. Finally, it summarizes the main findings and identifies the differences and similarities across the regions. The situation and conditions on the labour markets in the individual regions play an important role in people's decisions on whether to stay in the domestic labour market or to migrate.

For the labour market analysis, we employ primarily data obtained from the Labour Force Surveys (LFS) of individual countries, which are supplemented by registration data and by data obtained from Eurostat. In addition, we use data provided by the ILO (the database on labour statistics LABORSTA and Key Indicators of the Labour Market (KILM)). In a number

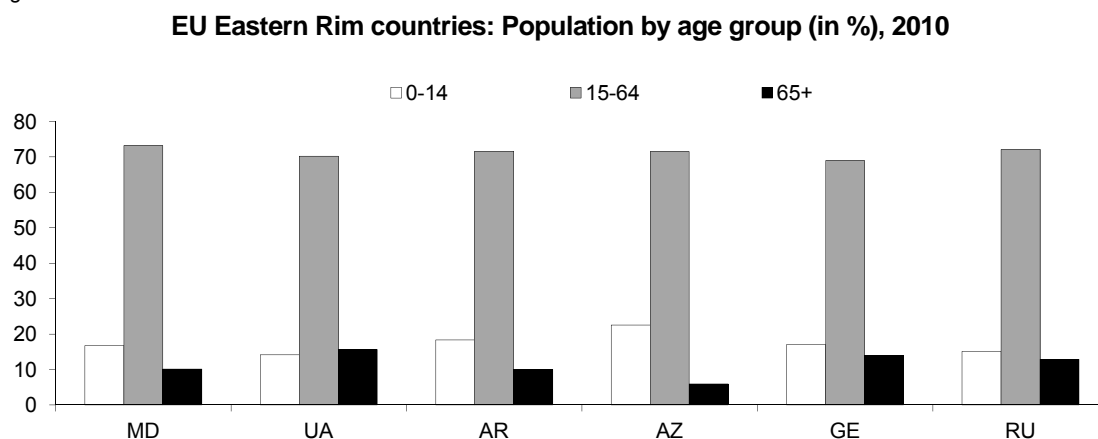
of countries, the consistency and comparability of data are hampered by methodological issues, breaks in time series or delay in the availability of data. Thus, data limitations may impede the analysis of labour markets in the four regions considered, and the outcome might be controversial in some cases, depending on the data source used.

## VI.2.1 Eastern Partnership countries (EaP) and Russia

### VI.2.1.1 Demography

The population structure in the six Eastern Partnership countries (and Russia) is very heterogeneous. Armenia and Azerbaijan have a very young population, with the age group up to 14 years accounting for around 30%, while this share is only 14% in Ukraine (Figure VI.2.1). With the exception of Georgia, all countries have experienced a demographic transition over the past 20 years, with the proportion of young people declining by 10 percentage points. The share of the population over 65 years is particularly high in Ukraine (16%), Georgia (14%) and Russia (13%). Almost all countries (except Russia and Azerbaijan) have been facing high outward migration over the past 20 years. Emigration, together with low fertility rates and rising life expectancy, will lead to significant changes in the age structure of these countries (European Commission, 2011). Population ageing in these economies will pose a serious risk to the welfare system.

Figure VI.2.1



Source: Eurostat.

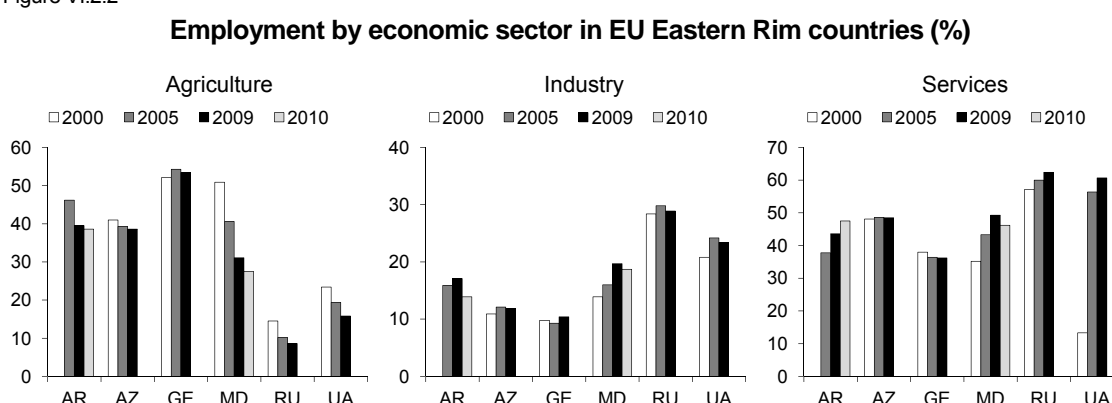
With the exception of Russia, the economic activity rates (labour force as percentage of working-age population aged 15–64) are below the EU-27 average of 71%, but are similar to, or higher than, the rates in some new EU Member States. The relatively high levels have to be treated with some caution, given the high share of agricultural self-employment and the high degree of small-scale activities in informal activities (ETF, 2011). Moldova's activity rate has been in steady decline since the beginning of the 2000s and sank below the 50% mark in 2010. Here, the decrease in the activity rate was mainly a result of a strong reduction in agricultural employment during the 1990s, which could not be offset by

employment creation in the other two sectors. In addition, a large proportion of the population has left the country for employment abroad. A salient feature of the labour market in the Eastern Rim countries is the high activity rate of females – in most cases comparable to the EU-27 (and distinctly higher than in MENA – see below). There are also huge discrepancies between male and female activity rates – particularly in Georgia, where the male–female activity gap is about 20 percentage points, but also in Ukraine and Russia (about 10pp each).

### VI.2.1.2 Employment structure

With the exception of Russia (and to a lesser extent Ukraine), agriculture is an important employer in the Eastern Rim countries, though its share has been declining everywhere (Figure VI.2.2). In Georgia, agriculture accounts for more than half of total employment. In Armenia and Azerbaijan it accounts for about 39% each, and in Moldova for about 30%; in these three countries productivity in agriculture is very low due to outdated technology and declining investments.<sup>47</sup> ETF (2010) concludes that agriculture in Moldova, Azerbaijan and Armenia can hardly be regarded as an economic sector (as in developed economies), since the ‘preponderance of subsistence farming on small scale plots has made this activity a buffer for employment lost during restructuring of industrial enterprises and small scale farms’. The relevance of industry is highest in Russia and Ukraine, whereas the industrial base is very low in Georgia and Azerbaijan, accounting for only 10–13% of total employment. The share of service sector employment has been rising steadily in Armenia, Ukraine and Russia. In the latter two countries, the service sector absorbs about 60% of total employment. Services are still underdeveloped in Armenia and Georgia.

Figure VI.2.2



Source: KILM database.

A feature of employment status is the low share of wage and salary workers particularly in Georgia (36%), Azerbaijan (42%), Armenia (61%) and Moldova (71%). Only the proportions of salaried workers in Ukraine and Russia (82% and 93%) approximate to the EU

<sup>47</sup> In Azerbaijan, Georgia and Moldova, half of the population still lives in rural areas.

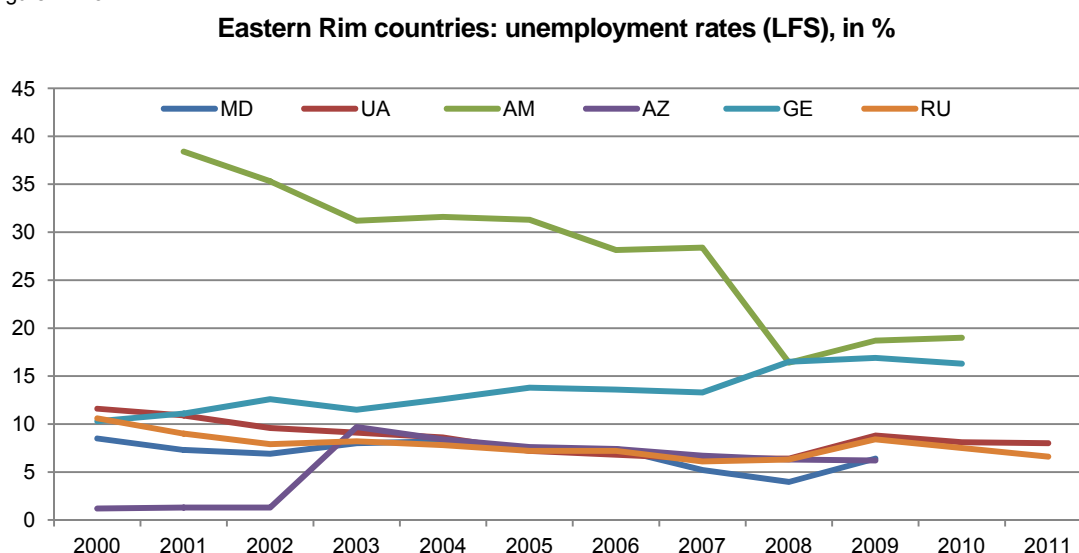


average of 87%. The fragility of the labour market in some countries of the region is highlighted by the high share of self-employment, which accounts for 64% in Georgia, 58% in Azerbaijan, 39% in Armenia and about 33% in Moldova (though it is decreasing in the latter two countries).

### VI.2.1.3 Unemployment

Unemployment has been relatively low in most Eastern Partnership countries, which display unemployment rates comparable to the EU-27 average. The only exceptions are Georgia and Armenia, where the unemployment rates were between 16% and 19% in 2010 (Figure VI.2.3). However, given the high share of the self-employed (subsistence agriculture or involuntary self-employment outside agriculture) in these countries, unemployment is probably much higher (European Economy, 2011). The low levels of unemployment in Moldova and Ukraine might be explained by the slow speed of structural reform, a decline in the working-age population or the large-scale outward migration (European Commission, 2010b).

Figure VI.2.3



Source: wiiw database, Eurostat.

With regard to the structure of the unemployed, those with secondary education and (in some countries, e.g. Georgia) even with the highest level of education are particularly affected by unemployment. This is in contrast to most EU countries, where the incidence of unemployment among highly skilled people is considerably lower than among the low skilled (but is similar to MENA countries – see below). The reasons for this are the low job-creation potential in the formal sector of the economy generally, and the skills mismatch in particular. In all countries considered, youth unemployment is at least double the overall unemployment rate; in Armenia and Georgia it reaches alarming heights of about 40%

(similar to some EU countries). Long-term unemployment has become a major challenge in Armenia and Azerbaijan, where the proportion of persons unemployed for more than one year has risen to 60% and 66%, respectively; by contrast, long-term unemployment is of less significance in Ukraine, Moldova and Russia.

#### VI.2.1.4 Informal employment

Labour markets in the Eastern Rim countries are characterized by a high level of employment in the informal sector, which impacts negatively on state revenues, the welfare system, competitiveness, etc. The incidence of informality has been growing in these countries during transition, driven by incentives to evade taxes and avoid labour regulations. Lately a reversal of the trend has been observable in Moldova, Ukraine and Georgia. Informality has, together with emigration and subsistence agriculture, been an important coping strategy for the poor (ETF, 2011). As in other transition economies, weak state structures and a lack of formal sector employment are the main drivers behind informal employment. Self-employment is the most common type of informal sector employment, attracting mainly women, young people and the poorly educated. Estimates of the size of the informal sector in 2007 indicate that the largest employment share in the unofficial economy was in Azerbaijan (66%), Armenia (50%), Moldova (33%) and Georgia (26%) (ETF, 2011).

#### VI.2.1.5 Impact of the economic crisis on the labour market

The recent economic crisis affected the labour markets in the region to varying extents. In general, the rise in unemployment was less dramatic than in some EU countries or in the Western Balkan countries. The strongest increase was reported for Armenia (2.6pp) between 2008 and 2010, with job losses mainly in construction. In Russia, unemployment rose by 2pp between 2008 and 2009, but recovered thereafter. In Azerbaijan, the labour market situation even improved during the crisis. Young people were disproportionately hit by unemployment in all countries, but particularly in Moldova, where the youth unemployment rate increased by 6.6pp between 2008 and 2010.

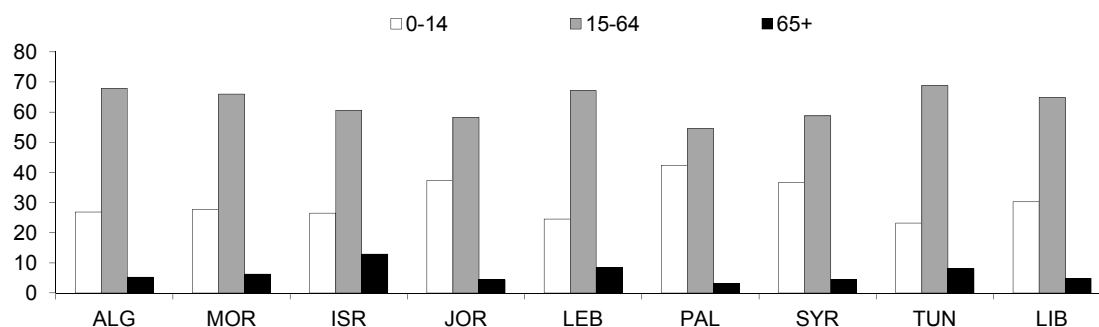
### VI.2.2 *Southern Rim*

#### VI.2.2.1 Demography

MENA countries are characterized by a high but declining share of young people in their population: almost a third of the population is younger than 14 (down from 40% in the 1980s). This is double the figure for the EU-27 countries. Conversely, the proportion of the post-productive age group (over 65 years) in the MENA countries is low (about 5%), compared to 10% in the EU-27 (Figure VI.2.4). Age-dependency ratios are relatively high throughout the MENA region. The ratio of dependants (i.e. people younger than 15 or older than 64) to the working-age population (those aged 15–64) stands at 50% in the MENA region. MENA societies are still growing by about 1.5% per year, though this will slow to 1% over the next two decades (Galal and Reiffers, 2011).

Figure VI.2.

**EU Southern Rim countries: Population by age group (in %), 2010**



Source: UN population statistics.

As a consequence, the working-age population in the MENA region will continue to grow in the next 30 years or so. The large inflow of new labour market entrants, combined with a lower rate of workers retiring and new job creation, has and will put enormous pressure on the MENA countries' labour markets. Thus, job creation will remain a top priority in the coming years if the countries are to retain their current unemployment levels. Estimates made by international organizations of the need for additional jobs in the next decade range from 25 million (MENA-OECD Investment Programme) to 50–75 million jobs (World Bank, 2011d), which would require (most likely unrealistic) annual GDP growth rates of 6.5%.

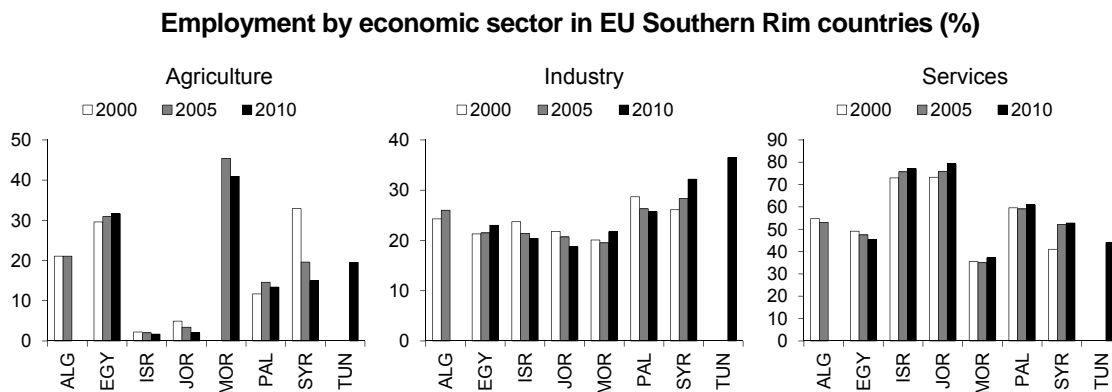
High GDP growth prior to the financial crisis has not translated into much employment growth in the Southern Rim countries. With the exception of Israel, activity rates are very low in the MENA region and have grown only modestly, if at all. The Palestinian Authority, Syria, Jordan and Algeria exhibit activity rates below or close to 45%; in Tunisia, Morocco, Lebanon and Egypt only about half of the working-age population participates in the labour market. This is mainly due to low female activity rates, which range from 14% in Syria to 32% in Libya (and which contrast with the situation in the Eastern Rim). Israel is the only country in the region where female labour force participation (61%) is comparable to EU levels. By contrast, male activity rates are high, at close to 80% in Egypt, Libya and Morocco. Only in Israel, Jordan and the Palestinian Authority is the participation rate of males below 70%. In most countries of the region, activity rates have remained flat during the past couple of years; they increased in Lebanon, but fell for both sexes in Syria, Morocco and the Palestinian Authority. With the exception of the Palestinian Authority and Syria, female participation rose somewhat in all countries.

#### VI.2.2.2 Structure of employment

Employment patterns by broad economic sector vary substantially across the region, but agriculture is still an important employer almost everywhere. As is shown in Figure VI.2.5, this is particularly the case in Morocco and Egypt, where the agricultural sector absorbs 30–40% of total employment, in Algeria 20%, and in Syria and the Palestinian Authority

about 15%. Exceptions are Israel and Jordan, where agricultural employment accounts for only 2% of the total workforce. In all countries bar Egypt, the share of agricultural employment has been on the decline in the past decade.

Figure VI.2.5



Source: KILM database.

Industrial employment is highest in Tunisia (35%) and Syria (32%), while Israel, Jordan and Morocco show the lowest shares (around 20% each). Overall, employment in industry has been growing in Syria, Morocco and Egypt, while it has declined elsewhere. Israel and Jordan are the most developed and steady growing service economies in the region, with the proportion of people employed in this sector approaching 80% of total employment. Morocco exhibits the least developed service sector, absorbing only 37% of the workforce. A breakdown of service sector employment shows that administration (government services) accounts for more than half of the sector's employment in Jordan, Algeria, Syria and Egypt, while its share is relatively small in Morocco. Within the market service sector, trade, tourism and communications are the major employers (World Bank, 2011d). Together with construction (and in some cases agriculture) these sub-sectors have also been the major drivers of employment creation in the past couple of years.

MENA countries tend to be quite militarized. Almost 4% of their labour force is employed in the armed forces. For comparison, in the EU-27 this share is quite constant at between 1% and 1.5%. The public sector accounting for up to 35% of total employment – including government agencies and state-owned enterprises – is the preferred source of employment for female graduates in the MENA countries. Employment in the public sector offers higher wages, employment protection, shorter working hours and other social benefits. In the past, the rise in public sector employment was driven by governmental social contract obligations, which guaranteed all graduates a state job; this led to a concentration of highly skilled people in the state sector. Consequently 'guaranteed employment without concern for productivity in the public sector led to the prevalent rent-seeking behaviour among graduates and created strong disincentives for work in the productive sectors' (European Commission, 2010c). Thus, governments were forced to terminate the system of guaran-

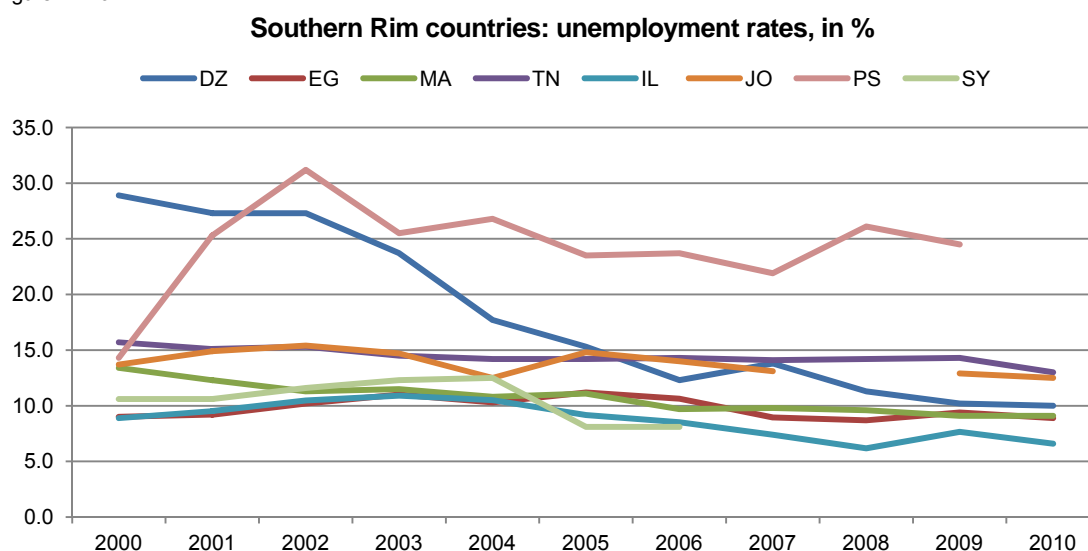
tees; yet despite reforms, the public sector's wage bill still accounts for 8–10% of GDP in most countries (European Economy, 2011).

In terms of employment status, in 2009 a high proportion of employed people in the Southern Rim countries had a vulnerable job, working either as unpaid family workers or own account workers. The share is highest in Morocco, where about half of those employed had a vulnerable job, and in Syria (about a third). The share of females working under such conditions is traditionally higher than the share of men, mainly because of the high share of female agricultural employment. The proportion of waged and salaried workers has remained almost unchanged for the past decade, though it varies substantially among the individual countries, ranging from 44% in Morocco to 87% in Israel.

### VI.2.2.3 Unemployment

In 2010, the unemployment rate in the MENA countries reached about 10% – similar to the EU. As is illustrated in Figure VI.2.6, however, the incidence of unemployment differs from country to country: levels are particularly high in the Palestinian Territories (24%) and Tunisia (14%), while the figure is only 6.6% in Israel. Unemployment is highest among young people and women. Despite the low activity rates of females, there is a significant gap between female and male unemployment rates; this is highest in Egypt (where female unemployment is four times male unemployment), Algeria and Tunisia. Moreover, unemployment among persons with university (and secondary) education is considerably higher than among people with low or no education at all (European Commission, 2010c). This represents a particular challenge, though the number of university graduates is still very low in the MENA region. Rural areas are better off than urban regions in terms of unemployment, as agriculture absorbs a large number of workers as an employer of last resort.

Figure VI.2.6



Source: KILM database and Eurostat.

Youth unemployment is considered to be one of the major challenges in the region: youth unemployment is highest in the Palestinian Authority (39%) and Tunisia (31%), and is in the range 14–18% in Israel, Lebanon and Morocco. In the remaining countries, youth unemployment stands at about 20%. Young females are worse off than men in almost all countries, and are disproportionately hit by unemployment in Egypt, where the unemployment rate of young females reached 56% in 2009 (males: 15%), and the Palestinian Authority – 47%, as against 37% of males. In Morocco, male unemployment is higher than female, and in Tunisia young females and males are equally affected by unemployment. Youth unemployment is much more prevalent in urban than in rural areas.

#### VI.2.2.4 Informal sector employment

A high degree of informal sector activity is another important feature of the MENA. Though estimates of the size of this sector are very sensitive to the method used, all studies indicate a large share of the unofficial economy in the region. The proportion of informal employment in non-agricultural employment is estimated at between 35% and 55% by European Commission (2010c), while other estimates (e.g. Heintz and Chang, 2007) range from 30% in Syria to 67% in Morocco. Informal employment is highest among the young (waiting for public sector employment) and the working poor. The mobility from informal to formal jobs is very low (World Bank, 2011i). According to ILO (2011), the majority of new jobs have been low-productivity jobs created in the informal sector of the economy. Though the informal sector acts as a buffer against unemployment, as everywhere else such jobs tend to be of lower quality, with lower wages and poorer working conditions. In Syria, Jordan and Egypt, some 70% of working young men and 60% of women are not covered by an employment contract.

#### VI.2.2.5 Impact of the economic crisis on the labour market

Labour markets of the Southern Rim countries have been less affected by the recent economic crisis than most EU Member States or the Western Balkan countries. Between 2008 and 2010, activity rates fell in Morocco, the Palestinian Authority and Syria. Unemployment grew moderately in some countries because of poorer job prospects abroad and because of the regional crisis (European Economy, 2011). The crisis has affected mainly export-oriented firms in some Southern Rim countries (Egypt, Syria and Tunisia). On top of the huge pressure of young cohorts entering the labour market, revolutions have brought about additional rises in unemployment, as numerous migrants have returned (e.g. from Libya) and the private sector has laid off temporary workers (Egypt) (Galal and Reiffers, 2011).

### VI.2.3 *Western Balkan countries*

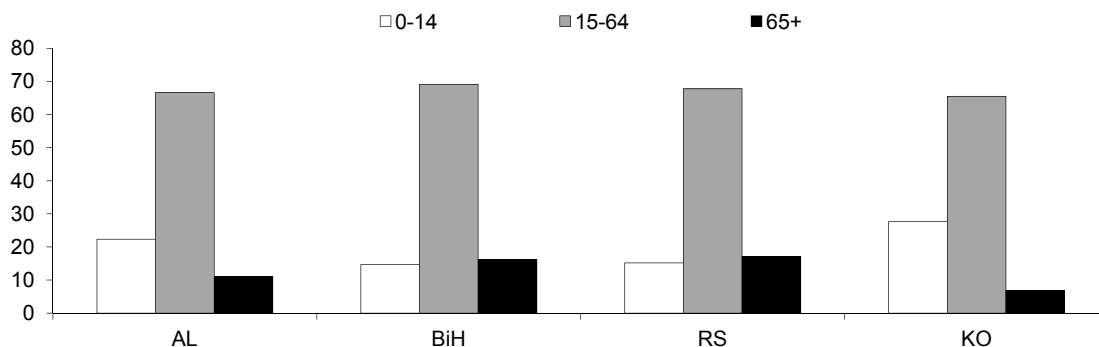
#### VI.2.3.1 Demography

Almost the entire region is characterized by demographic contraction, high outward migration and an ageing population. Only Albania and Kosovo have a high share of the popula-

tion aged up to 14 years (Figure VI.2.7). The ratio of dependants (i.e. people younger than 15 or older than 64) to the working-age population (those aged 15–64) stands at between 41% in Bosnia-Herzegovina and 49% in Albania. Life expectancy is high in the region (though below the EU average), ranging from 69 years in Kosovo to 77 years in Albania.

Figure VI.2.7

**Western Balkan countries: Population by age group (in %), 2010**



Source: Eurostat.

The entire region is characterized by low activity rates, with extremely low levels in Kosovo (below 50%) and Bosnia-Herzegovina; the figure for Albania and Serbia is about 60%. Levels are lower than the EU average for both sexes; for cultural reasons, female participation in the labour force is particularly low in Kosovo and Bosnia-Herzegovina among certain ethnic groups.

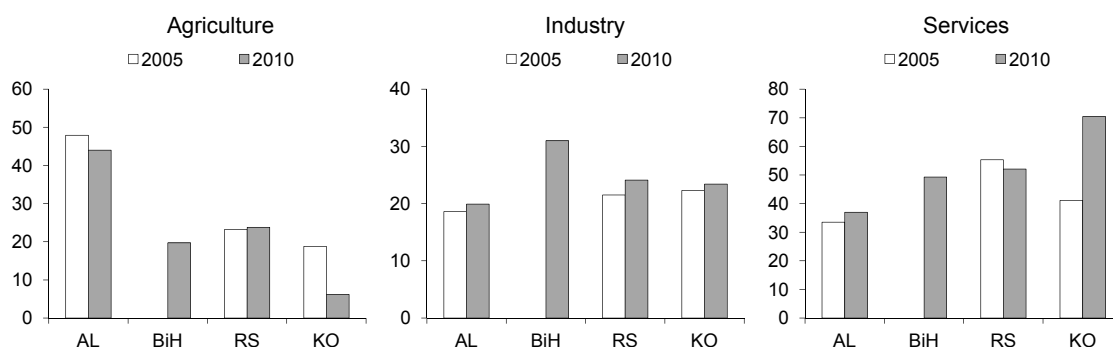
### VI.2.3.2 Employment structure

Western Balkan countries still exhibit a high share of agricultural employment. Albania is the extreme case, where 44% of the total workforce is employed in agriculture (similar to Georgia and Morocco in this respect). But in Bosnia-Herzegovina and Serbia, too, agriculture accounts for 20% of total employment (Figure VI.2.8). By contrast, the share is small in Kosovo (6%). Employment in industry is highest in Bosnia-Herzegovina (31%) and is about 25% in Serbia and Kosovo. In Albania, the share of industrial employment is below 20%. The service sector is less developed in the Western Balkan countries, comprising about half of total employment in Serbia and Bosnia-Herzegovina, and only 37% in Albania. Kosovo is a special case, where recent statistics report the service sector employment accounting for 70% of total employment.

As regards employment status, the available data for Bosnia-Herzegovina and Serbia indicate that around 70% of the employed are wage and salary earners. In Serbia, nearly 30% of the employed had a vulnerable job in 2009 (either self-employed or unpaid family worker).

Figure VI.2.8

### Employment by economic sector in selected Western Balkan countries



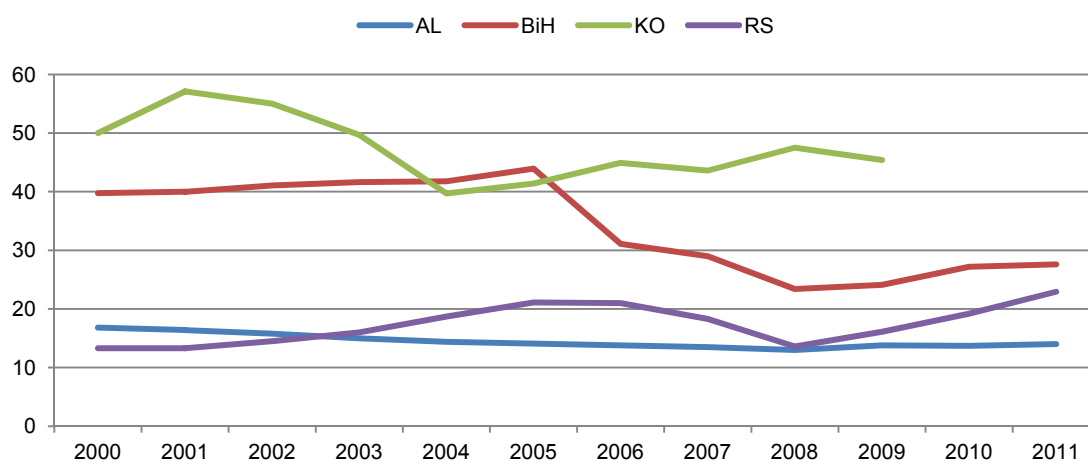
Source: wiiw database; LFS Kosovo (data for 2010 refer to 2009).

#### VI.2.3.3 Unemployment

Unemployment in the Western Balkan countries is very high by European standards, and is the highest of the European Rim countries. Apart from the extreme of Kosovo, where the unemployment rate stands at 45%, the incidence of unemployment is highest in Bosnia-Herzegovina. In Serbia, the unemployment rate started to rise again with the onset of the financial crisis. Albania is the only country where unemployment has remained flat for the past couple of years. With the exception of Albania unemployment measured by registration is (much) higher in Serbia and Bosnia and Herzegovina than data obtained by the LFS, by 4pp and 16pp respectively in 2011.

Figure VI.2.9

### Unemployment in the Western Balkan countries (%)



Source: wiiw database and Eurostat.

Unemployment has a disproportionate impact on young people. As in other European Rim countries in the East, there is a sizeable and persistent regional imbalance in unemployment in most Western Balkan countries, which suggests that there are strong barriers to



regional labour mobility. In most countries of the region, the unemployment rate among people under 25 is more than double the overall unemployment rate (which itself is much higher than in other European countries). The high rates of 73% in Kosovo, 58% in Bosnia-Herzegovina and 51% in Serbia indicate the quite critical situation facing young people on the Western Balkan countries' labour markets. In many cases, young people lack the skills and professional experience for employment, so their options are either to emigrate or to enter the informal economy (Vidovic, 2011). Long-term unemployment has become a persistent and salient feature of the Western Balkan labour markets and is much more severe than in other transition countries – and the proportion of those affected is far higher (e.g. 90% of total unemployment in Kosovo is long-term, 80% in Bosnia-Herzegovina). It can be assumed, however, that these high shares of long-term unemployment are distorted due to the large flows between the informal sector, employment and unemployment.

#### VI.2.3.4 Informal sector employment

In the Western Balkan countries, large informal sectors with important ties to the state have developed, due to the weakness of the state structures and the way in which the formal sector functions (Vidovic, 2011). Most estimates point to about one-third of GDP being produced informally; in some cases (such as in Kosovo or Albania), that share is even higher. In terms of employment, the informal sector's share varies from 30% to 60% of total employment. According to the 2007 HBS (Household Budget Survey) data, about 30% of the labour force in Bosnia-Herzegovina classified itself as informally employed. Most informal sector employment (about 60%) is concentrated in rural areas, while formal sector employment is equally split between urban and rural areas (World Bank, 2009). More than two-thirds of those informally employed are men, while in the formal economy that figure is somewhat lower, at 63%. With regard to Serbia, a large part of the workforce in the informal sector consists of young workers and males with low educational attainment levels (Ognjenovic, 2008).

#### VI.2.3.5 Impact of the economic crisis on the labour market

The impact of the recent economic crisis on the labour market has varied significantly across the Western Balkan countries. In Albania, employment even increased in 2009 and 2010, while Bosnia-Herzegovina and particularly Serbia suffered from a substantial reduction in employment. In Serbia alone, 400,000 jobs were lost during the crisis. In general, employment falls in the region were most pronounced in construction, manufacturing and retail trade, and in Serbia also in agriculture, which could not be offset by new job creation in other sectors. Young people are disproportionately affected by the economic crisis. As in the new EU Member States, the incidence of job reduction was felt acutely by the low skilled. Strong employment declines translated into soaring unemployment, particularly in Serbia, where the unemployment rate rose by 10 percentage points between 2008 and 2011, and in Bosnia-Herzegovina (4pp), while it remained almost static in Albania. LFS

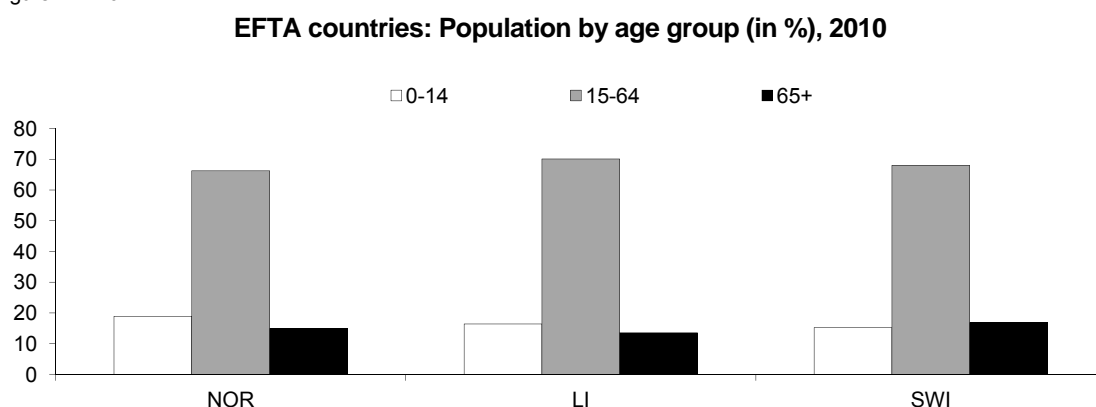
data on Kosovo are not yet available.<sup>48</sup> Overall, labour market problems in the Western Balkan countries are rather of structural than of cyclical nature and are connected with the process of transition.

#### VI.2.4 EFTA countries: Norway, Switzerland and Liechtenstein

##### VI.2.4.1 Demography

All three EFTA countries under consideration – Norway, Switzerland and Liechtenstein – have experienced a population growth over the past decade. As is shown in Figure VI.2.10, compared to the EU average Norway has a high population share of the pre-productive age group (up to 14 years) and a stagnating proportion of the old age group (15% over the last decade). Switzerland, on the other hand, resembles the EU pattern, with a relatively low share of the young and a growing proportion of the old age groups (over 65 years). Liechtenstein is different, in the sense that the share of the productive age group (15–64 years) is higher than in the other two countries (70% in 2010), while the proportion of the post-productive age group is below the level of Norway and Switzerland.

Figure VI.2.10



Source: Eurostat.

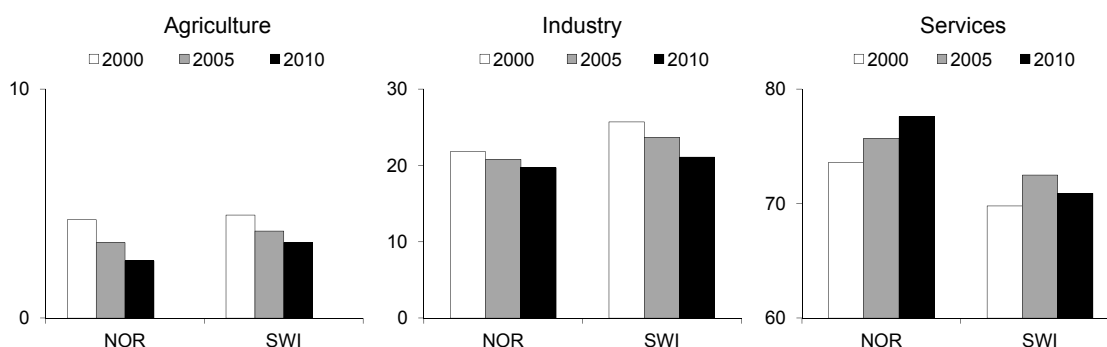
The labour markets of Liechtenstein, Norway and Switzerland are characterized by low unemployment and by high activity and employment rates (the figure for employment reaches over 75% throughout the region). In all three countries, unemployment is very low compared with the EU – another feature of the Rim’s diversity.

As is illustrated in Figure VI.2.11, employment patterns have changed in Norway and Switzerland (no data are available for Liechtenstein) over the past decade, with a declining share of people working in agriculture and industry, and a rise in service sector employment.

<sup>48</sup> According to official records, the number of unemployed increased only slightly during 2008 and 2009, and even fell by 1.1% in 2010, representing an unemployment rate in the range of 37–41% .

Figure VI.2.11

### Employment by economic sector in EFTA countries (%)



Source: KILM database.

In the wake of the economic and financial crisis, unemployment rates increased by about 1 percentage point, but still remained exceptionally low at 3.6% in Norway and 4.2% in Switzerland in 2010. Female unemployment in Norway is lower than both the male and the average unemployment rate, while in Switzerland the incidence of unemployment is higher among females, who had an unemployment rate at 4.8% in 2010. Young people are less affected by unemployment than in the EU-27 on average; at below 10%, their unemployment rates are comparable with the rates to be found in Austria, Germany and the Netherlands.

#### VI.2.5 Summary findings

The European Rim is (partly) characterized by large informal sectors and large-scale migration, which makes labour market analysis difficult. Bearing these caveats in mind, a number of differences and common features can be found in the regions under consideration:

- The MENA countries, Armenia, Azerbaijan, Albania and Kosovo all have a high share of young people, and thus large cohorts enter the labour market every year. All other countries face ageing populations; this exerts serious pressure on the welfare systems and impedes competitiveness.
- Activity rates are below 50% in all MENA countries (except Israel) and in Kosovo; the low rate in Moldova is due to low activity rates among both males and females. Labour force participation in the Eastern Rim countries is similar to that in new EU Member States, and may even exceed the EU average (as in Russia).
- The employment gap between males and females is substantial in some Western Balkan countries and in the MENA region; particularly the latter countries are characterized by exceptionally low participation by women on the labour market. On the other hand, female labour force participation in the Eastern Rim countries is traditionally high and is comparable to that in the EU.
- Agriculture is still the major source of employment in a number of countries – particularly in Georgia, where half of the total workforce is engaged in agriculture, and also in Armenia, Azerbaijan, Albania, Morocco and Egypt (about 30–40%). Only in Israel, Jordan,

Russia and Kosovo does it account for a very small share (below 10%). The service sector is most developed in Israel and Jordan, employing almost 80% of the workforce, and in Russia, Ukraine and the Palestinian Authority (60%).

- In terms of employment status, most Eastern Rim countries (with the exception of Russia and Ukraine) show a high share of people employed in vulnerable employment (self-employed and unpaid family workers), particularly in Georgia (close to two-thirds) and Azerbaijan. In the Southern Rim countries, Morocco stand out: about half of the workforce had a vulnerable job in 2009.
- High informal sector employment is another feature of the European Rim labour markets, accounting for up to 70% of the employed in Syria, more than half in Armenia and about a third in most Western Balkan countries.
- Western Balkan countries have been suffering from high and persistent unemployment for years (between 20% and 30%), the extreme being Kosovo (45%), while the incidence of unemployment has been comparatively low in the Eastern Rim countries (10% or so on average), except Georgia and Armenia. Unemployment in the Southern Rim countries reaches its highest levels in the Palestinian Authority, Jordan and Tunisia, while unemployment stands at about 10% in the remaining countries of the region.
- Young people are particularly at risk in all groups of countries, but especially in the Western Balkans, with Kosovo reporting over 70% youth unemployment and Bosnia-Herzegovina and Serbia 53% and 58%, respectively, in 2011. In the Southern Rim region, Tunisia and the Palestinian Authority have the highest levels of youth unemployment – 30% and 45%, respectively; this hits young females above all.
- Long-term unemployment has become a persistent and salient feature of the Western Balkan labour markets, and is much more severe than in other transition countries considered. Those affected run the risk of skills degradation and permanent exclusion from the labour market.
- The incidence of unemployment by educational attainment differs significantly across the regions; the most striking feature is the high unemployment among graduates in most Southern Rim countries, while in other regions the low-skilled are most affected by unemployment.
- The economic crisis has affected the labour markets in the individual regions to varying extents. The Western Balkan countries have been hardest hit, e.g. in Serbia about 400,000 jobs were lost during the crisis, and the unemployment rate went up by 10pp.

### ***VI.3 Migration and remittances in European Rim countries***

#### *VI.3.1 Introduction*

The impacts of labour migration are of particular interest to EU policymakers. The Middle East and North Africa (MENA) is recognized as a region of emigration, with first-generation emigrants numbering 10–13 million (World Bank, 2011j).

Some of the Western Balkan (WB) countries (Albania, Bosnia-Herzegovina, Kosovo and Serbia) are candidates or potential candidates for EU membership and have recently benefited from visa liberalization; they are experiencing new migration developments, since their citizens have started to travel to the EU without a visa.

The development of migration management systems has advanced unevenly across these regions, not least due to differences in available resources and in the general development of the quality of public policy institutions. In particular, the links between migration and employment or education policies remains vague in all countries of the Rim region. The high level of emigration is linked to economic hardship and unemployment in these countries: labour migration represents an alternative mechanism for employment and is a reaction by the population to social and economic crisis and internal conflicts. Migrants from these countries have mainly been moving to countries with which there are established historical, social, cultural and economic ties; the increased demand for labour migrants and the increased availability of low-skilled jobs in the countries of destination also play a part. The role of ties established between the diasporas and the home countries is very significant in migration processes, and established migration networks make the process of migration easier and stimulate the inflow of new migrants.

The turmoil of the Arab Spring generated a new wave of mass migration, particularly from Tunisia, where illegal attempts to reach Italy increased significantly at the end of 2010 and the beginning of 2011 (Frontex, 2011). The sizeable movement of irregular migrants induced those governments directly involved to sign bilateral agreements with the most likely countries of migration, with the aim of ceasing the irregular crossing of coastal borders. Moreover, climate change and environmental disasters have generated another flow of migrants who have little choice but to migrate because of the unsustainable conditions.

Considering the potential impact of migration from Rim countries to the EU, this section focuses on the migration patterns of Rim countries by analysing the trend of stocks and flows of migrants, particularly during the last decade; the trend in remittances and the impact on sending countries; figures on irregular migration by unauthorized migrants and asylum-seekers, especially during the last two years; and finally the impact of labour migration on the competitiveness of the EU as a host. We have explored different data sources, e.g. World Bank statistics on migration and remittances data in the Rim countries, Eurostat and Frontex evidence, with the aim of painting a broad and comparative picture of migration developments in Rim countries.

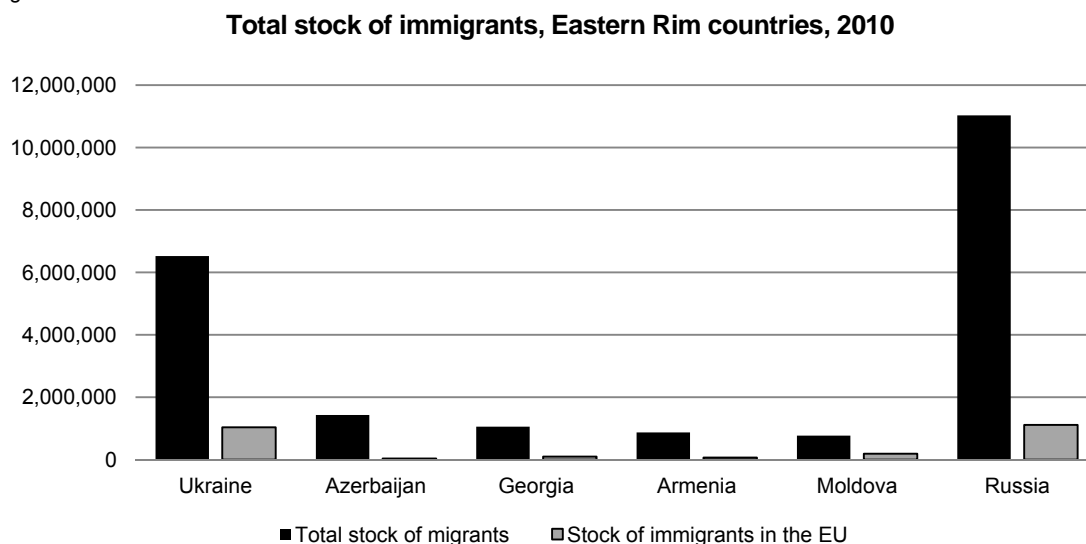
### *VI.3.2 Migration trends: stock and flows of migrants*

#### *VI.3.2.1 EaP countries and Russia*

The latest data available for the stock of migrants from the EaP region, by country of origin and main destination regions, shows that in 2010 the number of migrants reached almost

11 million, a figure slightly below the total stock of immigrants from Russia (Figure VI.3.1). Among the EaP countries the largest contributor to this stock is Ukraine, as more than half of EaP migrants originate from this country. Of the other countries, Azerbaijan and Georgia have a stock of migrants above 1 million; Armenia and Moldova do not reach that level (Figure VI.3.1).

Figure VI.3.1



Source: Own elaboration using World Bank (2011j).

In particular, the preferred destinations are Russia and the region itself, which hosts more than half of immigrants from the EaP countries. Figure VI.3.2 shows that 12% of immigrants, including from Russia, have moved to the EU. In absolute numbers, the EU hosts around 1.4 million migrants from the EaP region and 1.1 million from Russia. Another 14% are located in other neighbourhood countries such as Kazakhstan, Uzbekistan, Turkmenistan, Tajikistan and the Kyrgyz Republic. The other destination regions include the Southern Rim countries (5%), other southern countries (9%) and the United States (4%).

Interestingly, Russia and Ukraine have more than a million immigrants residing in the EU, but these figures represent, respectively, only 10% and 15% of migrants from those countries. The EaP country with the largest share of its migrants in the EU is Moldova, with more than 24%, while only 2% of Azerbaijan's migrants reside in the EU (Figure VI.3.3).

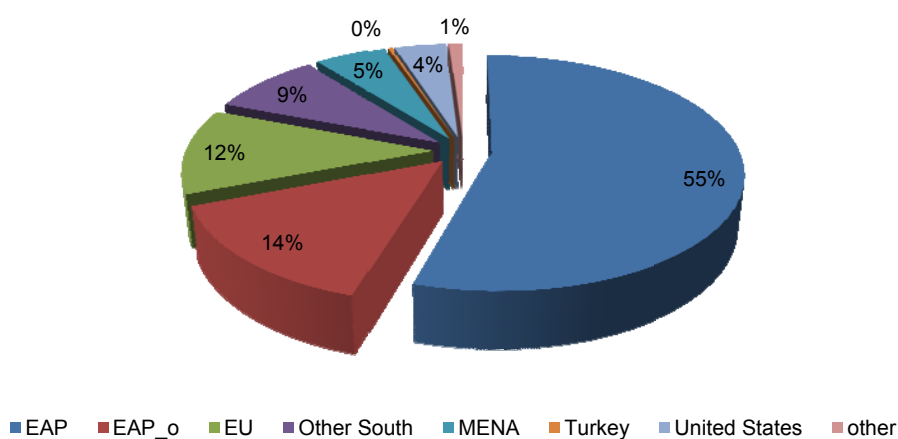
Thus, the EU is among the top three destinations for migrants from the EaP region. The EU countries that host the largest number of EaP migrants are Germany, Poland, Spain, Greece, Italy, Estonia and Latvia.

As concerns the inflow of migrants from EaP and Russia to the EU over the last decade (including the period before and since the international financial crisis), Figure VI.3.4

(based on Table 4 in the Annex) demonstrates that before the crisis the inflow was 80% higher than in 2001, whereas in 2009, during the economic downturn, the influx dropped significantly to close to the 2001 level. The inflow of migrants from Russia and Ukraine predominated throughout the decade. However, while the inflow of Russian immigrants has diminished significantly, dropping to a level 60% lower than in 2001, the inflow of Ukrainians – which had more than doubled – dropped again during the financial crisis to close to the level of 2001. Thus, during the financial crisis the inflow of migrants from Eastern Rim countries has been significantly affected, particularly regarding the main contributors, Russia and Ukraine.

Figure VI.3.2

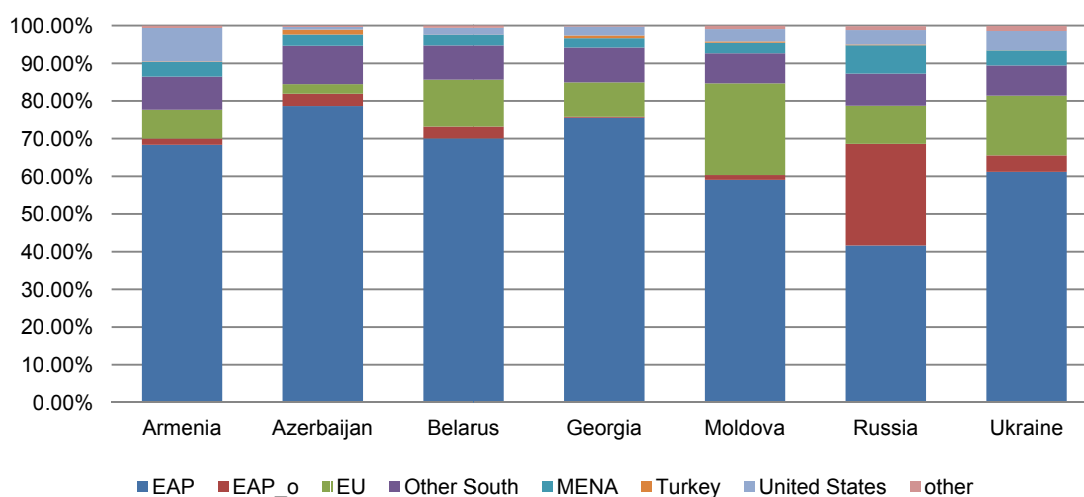
**Main destination regions of EaP and Russian immigrants**



Source: Own elaboration using World Bank (2011j).

Figure VI.3.3

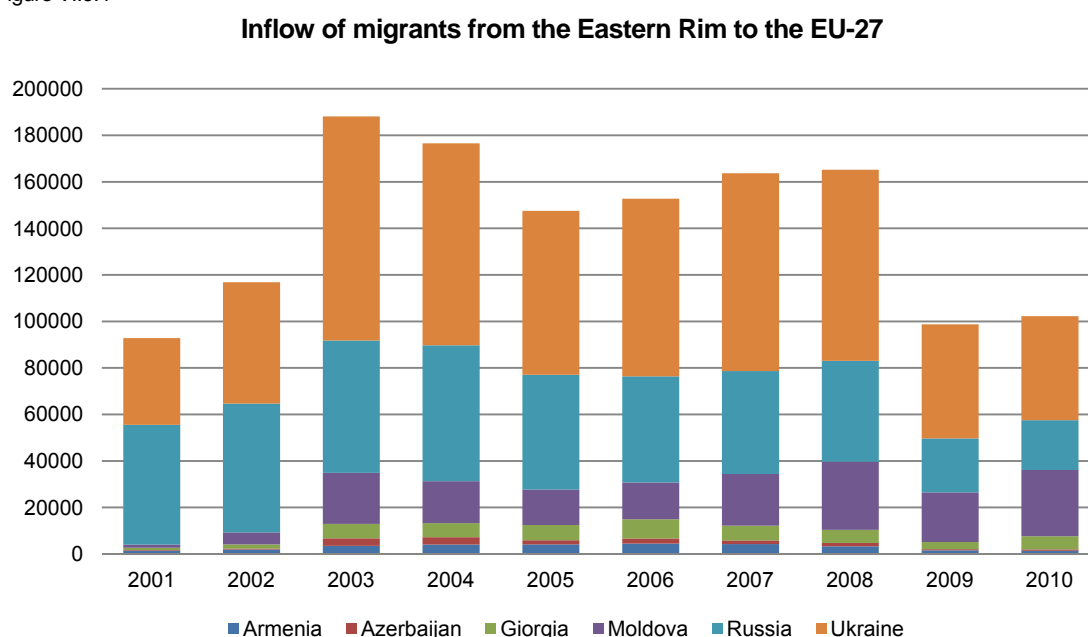
**Share of EaP and Russian immigrants by main destination area**



Source: Own elaboration using World Bank (2011j).

Migration from the main sending EaP countries to the EU and Russia is mainly temporary in nature (IOM, 2008). During the last decade **Ukraine** has emerged as a major country of origin, transit and destination for migrants. According to World Bank estimates, the migration stocks stand at 6.6 million emigrants (14.4% of the population, 2010). The main countries of destination for Ukrainian migrants appear to be the Russian Federation (3.6 million) and the EU (more than 1 million). Economic and job-related reasons are the main factors for Ukrainian migrants. Until recently, most migrants went abroad to earn more money and accumulate savings. Thus, the lack of opportunity on the local labour market to achieve higher earnings has been the main reason for migrating. Nevertheless, the number of returning migrants has been steadily increasing, and the outflow of emigrants has reduced significantly. As for **Moldova**, the main drivers of migration have also been the lack of employment opportunities at home and higher income expectations abroad. In most cases, those who migrate to the EaP region engage in seasonal work, while those who move to the EU – due to the risks and high costs associated with frequent travel (visa) – choose to stay abroad for a longer period, and a significant number of them have settled permanently in the destination country. Increased emigration from other EaP countries, particularly **Armenia** and **Azerbaijan**, has been triggered not only by a deterioration in socio-economic conditions, but also by the Nagorno-Karabakh conflict, which led to significant numbers of internally displaced persons.

Figure VI.3.4



Source: Own elaboration using World Bank (2011j).

### VI.3.2.2 EU Southern Rim countries

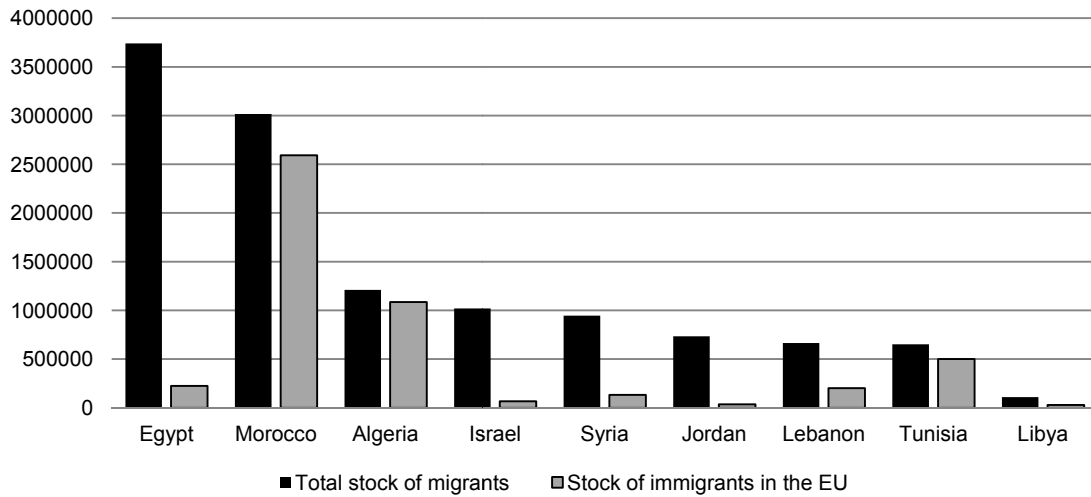
The Southern Rim countries have a very dynamic population and large migrant stocks; furthermore, several countries serve not only as sending and receiving countries, but also



as transit countries. Table 2 in the Annex and Figure VI.3.5 demonstrate that before the Arab Spring the stock of migrants was above 12 million, the highest of all Rim regions. The countries with the largest stocks of migrants are Egypt and Morocco, with, respectively, 3.5 million and 3 million migrants worldwide. Algeria and Israel have a stock of migrants of over 1 million, while the other countries are below this level.

Figure VI.3.5

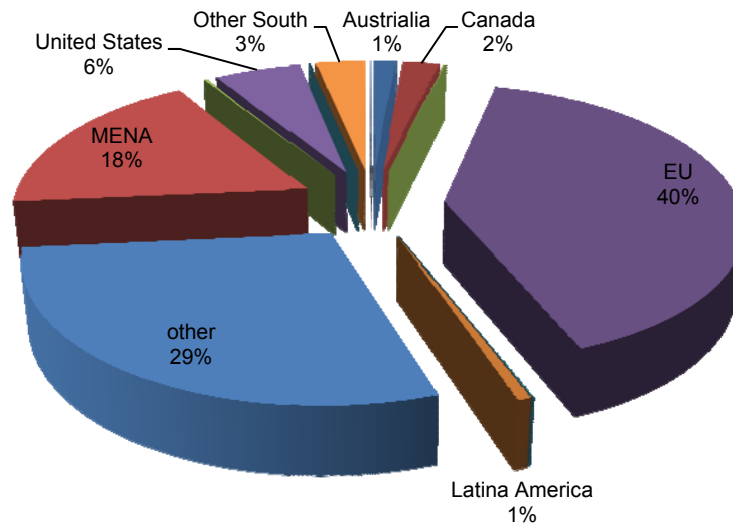
**Total stock of migrants, Southern Rim countries, 2010**



Source: Own elaboration using World Bank (2011j).

Figure VI.3.6

**Main destination regions for Southern Rim migrants**



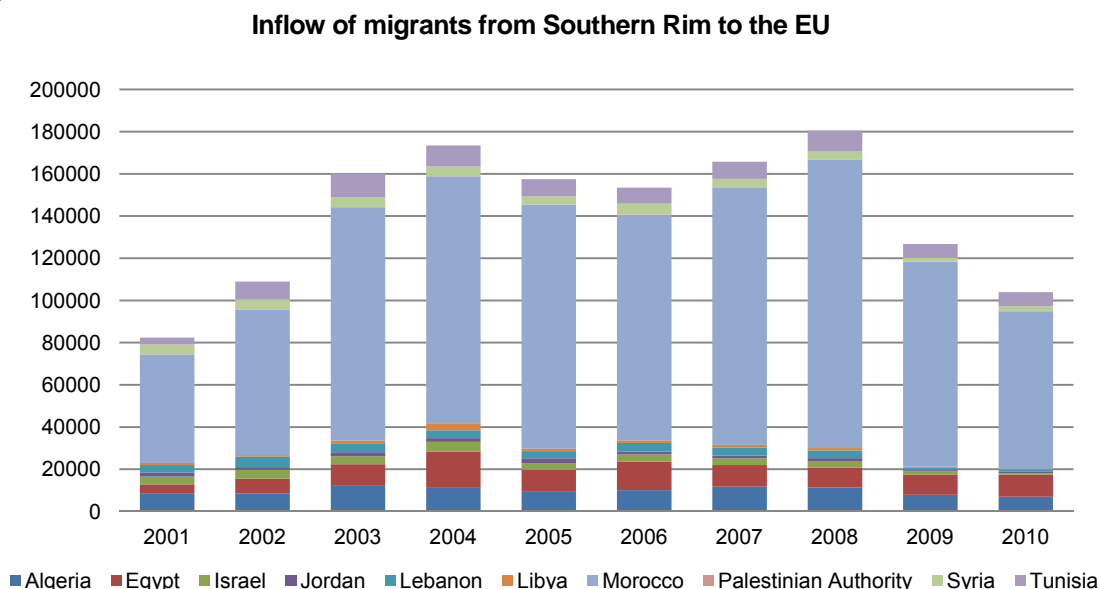
Source: Own elaboration using World Bank (2011j).

The EU is the main destination region, hosting more than 40% of migrants from Southern Rim countries (Figure VI.3.6), followed by other African and Middle East countries, which

host 29% of migrants. The region itself is the main destination for 18% of migrants; the US receives 6% of migrants. The EU is the preferred region particularly for migrants from Algeria, Morocco and Tunisia (respectively 90%, 86% and 76% of migrants from these countries are settled there). In addition, almost a third of migrants from Lebanon and Libya have moved to the EU, while the figure for migrants from Egypt, Israel and Jordan does not exceed 7%. The main destination countries for Morocco's migrants are France, Italy, Belgium, Germany and the Netherlands, and more than 80% of Algerian and Tunisian migrants are located in France.

The flow of migrants from Southern Rim countries in the direction of the EU showed a rising trend, reaching a peak of 180,000 in 2008. However, as with the inflow of migrants from the Eastern Rim, so the flow from Southern Rim countries to the EU reduced significantly after the international financial crisis struck, dropping to approximately the level of 2002 (Figure VI.3.7, Table 4 in the Annex).

Figure VI.3.7



Source: Own elaboration using Eurostat data (online data code: migr\_imm1ctz), Extracted on 10.04.12.

The inflow of migrants from the Southern Rim countries to the EU is dominated by Moroccans (more than 70%). Lately, the political transitions in MENA have had a strong impact on mobility within and out of the region. The Arab Spring generated large outflows of migrants towards neighbouring countries, especially the EU. According to IOM (2012) the most intensive mobility was recorded on the border with **Tunisia** (256,000 migrants) and **Egypt** (184,000 migrants); however a large number of migrants also originated from **Libya**. Besides, in 2011 more than 43,000 migrants reached Lampedusa (off the coast of Sicily) – 19,200 from Libya and 24,100 from Tunisia. By contrast, other countries have experienced less intense exodus. To some extent this undermines the argument that increased irregular

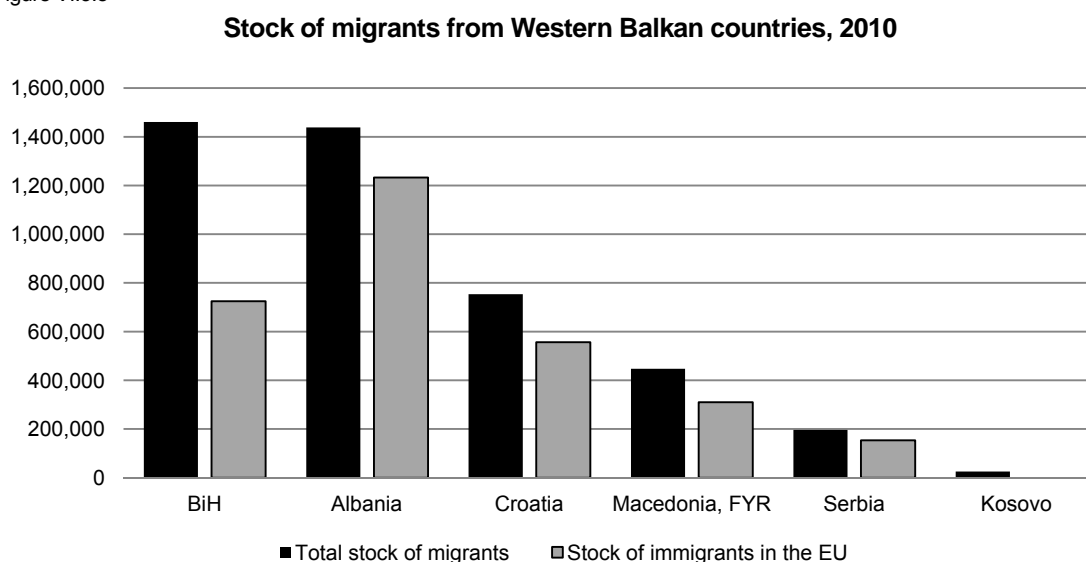
migration would flow to the EU because of the turbulent political situation in the MENA region (though a large number of migrants have left Syria for Turkey).

### VI.3.2.3 Western Balkan countries

The Balkan area has a rich experience of migration. The Balkan countries share common borders and cultural ties with the old and new EU Member States. In recent decades, many events such as wars, the break-up of former Yugoslavia and the end of the Soviet sphere of influence have created direct pressure on the labour markets, and an additional large flow of migrants from this region has been generated. The total stock of migrants from the Western Balkans is around 4.5 million, and the main sending countries are Bosnia-Herzegovina and Albania, with stocks of migrants of over 1.4 million. However while 85% of migrants from Albania have migrated to the EU, only half of Bosnia-Herzegovina migrants have chosen an EU country as their destination (Figure VI.3.8, Table 3 in Annex).

Other countries in the region have smaller stocks of migrants, but – as with the Albanian migrants – sizeable numbers are located in the EU. More than two-thirds of emigrants from Western Balkan countries are hosted in the EU, and the EU is the primary receiver of migrants from the region (Figure VI.3.9 and Table 3 in Annex). The main destination countries for **Albanian** migrants are Greece and Italy; for **Bosnians** – Germany, Austria, Slovenia and Sweden; and for **Croats** – Germany, France, Austria (and also Italy, Belgium and the Netherlands).

Figure VI.3.8



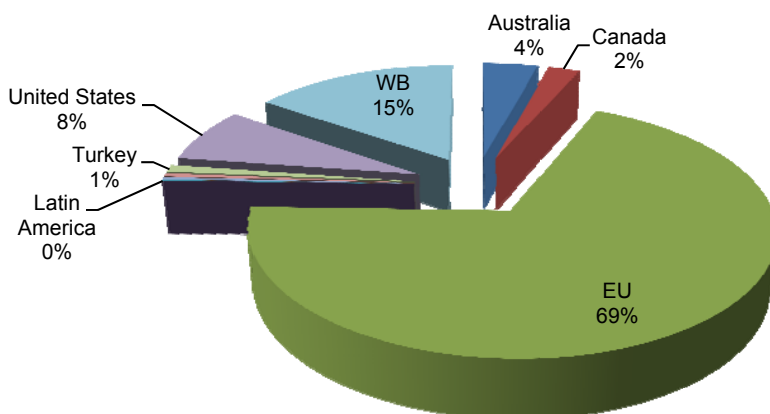
Source: Own elaboration using World Bank (2011j).

The attractiveness of the EU for immigrants from Western Balkan countries is also reflected in the inflow of migrants. In 2007, the inflow of migrants from the region in the direc-

tion of the EU was more than triple the figure for 2001 (Figure VI.3.10, Table 4 in the Annex). However, as with the rest of the Rim countries, there has been a decline in the flow of migrants to the EU; however, in the case of the Western Balkan countries the decline started at the beginning of the financial crisis, not in the middle, and the drop has been more remarkable (Figure VI.3.10, Table 4 in Annex).

Figure VI.3.9

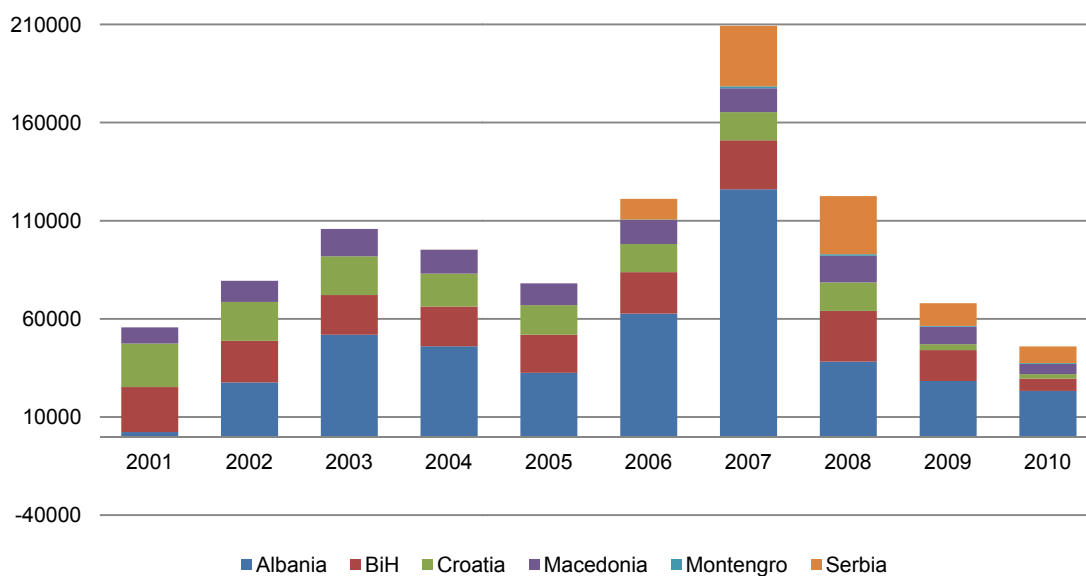
**Main destination regions for migrants from Western Balkan countries**



Source: Own elaboration using World Bank (2011j).

Figure VI.3.10

**Inflow of migrants from the Western Balkans to the EU**

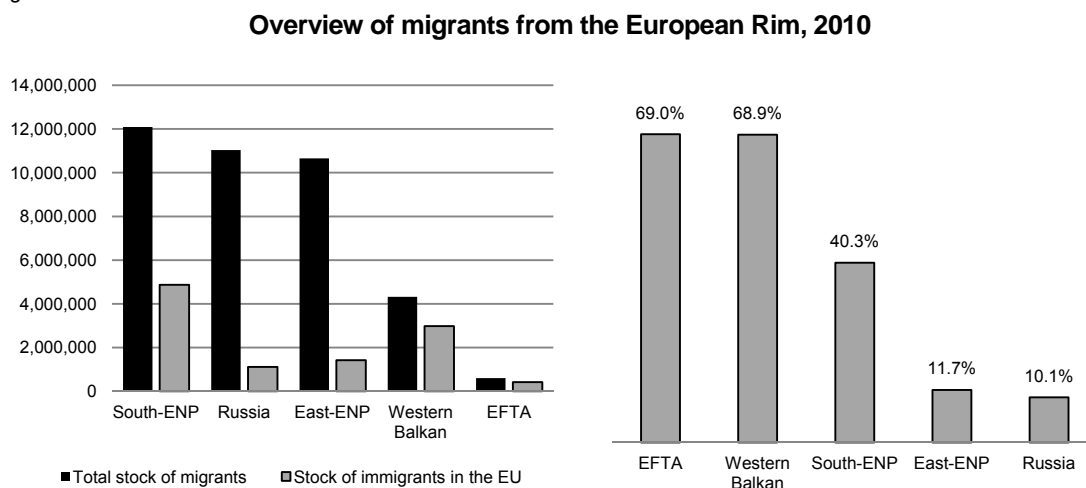


Source: Own elaboration using Eurostat data (online data code: migr\_imm1ctz), Extracted on 10.04.12.

Visa liberalization, which started in 2011, has contributed to an intensification of circular migration and a reduction in illegal migration to EU countries. According to Frontex (2011), there have been fewer cases of Albanian migrants illegally crossing the EU border and overstaying their visa in one of the EU countries. However, there has been an increase in the number of applications for international protection (asylum) submitted in the EU, particularly by migrants from Serbia and Macedonia. The difficult economic situation, particularly in Greece, has obliged many Albanians to return home – many for good, but some temporarily.

Overall, the migration records of Rim countries confirm that this phenomenon is a crucial factor in the growth and development of all the countries in the region. The large outflows of population have brought – and will continue to bring – significant changes to the socio-economic composition and demographic trends of both the sending and the receiving countries (Figure VI.3.11).

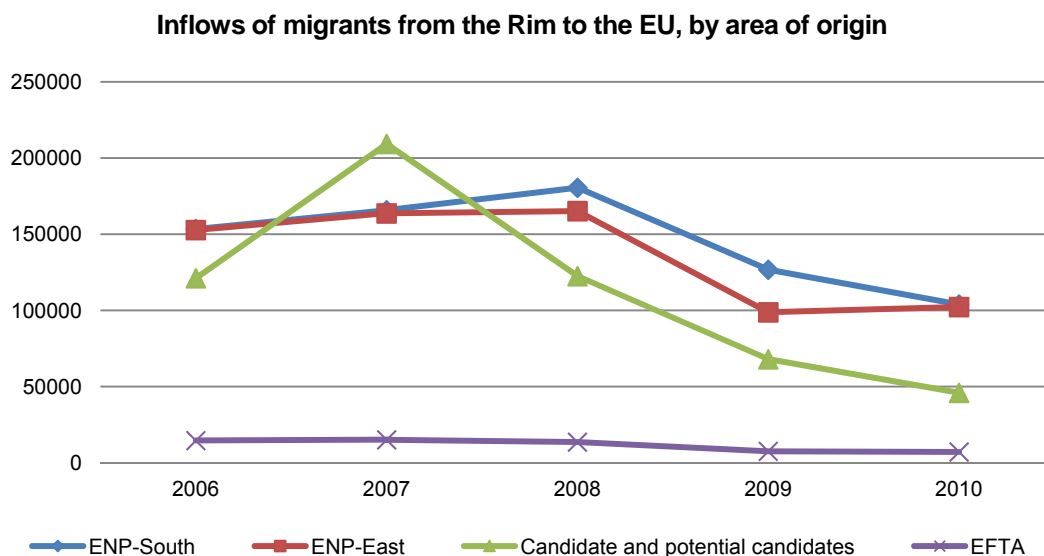
Figure VI.3.11



Source: Own elaboration using World Bank (2011j).

Emigration to the EU from the Southern Rim countries is one of the main features. The flow has intensified and continues to increase significantly, especially from Lebanon, Egypt, Tunisia and Algeria toward the southern EU countries. Moreover, emigration from Algeria, Libya, Morocco and Tunisia is mainly toward the EU and is considered to be more permanent, whereas migration from Egypt, Jordan, Lebanon, the Palestinian Authority and Syria tends to be toward other MENA countries and is classified as temporary (Fargues, 2008). In addition, the intensification of migration from the former to the latter group of countries might serve as a transit route to the EU, considering the proximity of those countries to the EU. In contrast, for Eastern Rim countries, even though they already have large stocks of migrants in the EU, this is not the main destination region.

Figure VI.3.12



Source: Own elaboration using Eurostat data (online data code: migr\_imm1ctz), Extracted on 10.04.12.

In terms of migration inflows to the EU (Figure VI.3.12) the various groups of countries recorded a significant decline, which coincides with the period of international financial crisis. Migrant workers happen to be in the front line and have borne the brunt of the financial crisis, as they are the first to be made unemployed (according to the 'last in, first out' rule) and were employed in those sectors that are strongly affected by economic downturns. According to the ILO, the international financial crisis has hit migrant workers hard, especially those who were working informally. Those migrants who continue to work have experienced a reduction in wages and working hours and have had to accept working conditions below the required standards. The predicted return migration, particularly of migrants who had irregular employment or who have been long-term unemployed, has not been very considerable, despite voluntary return programmes offered by different EU countries. The domino effect of economic downturn – not only the host country is hard hit, but also the country of origin – renders return migration unattractive and also discourages emigration. The lack of opportunities for work in the local labour markets of the sending countries means that return migration would damage the position of migrants, and would also place non-migrants at home under pressure, as there are fewer employment options to go around. Besides, remittances from abroad – which are key to the support and survival of family members left behind, and to the prosperity of the local community and the economy – would shrink further, thus resulting in a further deterioration in the situation in the country of origin.

#### **VI.4 Irregular migration in the EU**

Irregular migration represents a notable share of migrants from the Rim countries to the EU. The removal of internal borders in the Schengen Area and visa-free mobility for most

Western Balkan countries (except Kosovo) has contributed significantly to the reduction in the number of unauthorized migrants in the EU. As for citizens of the Eastern and Southern Rim regions, the visa requirements for entering the EU entail continuous and increasing irregular migration to the EU. It is also one of the important bottlenecks in raising the competitiveness of these countries (Eurochambres, 2011).

According to Frontex (2012), unauthorized migration into the EU from the Rim countries takes place along the **Central** and the **Western Mediterranean route**, which represent the corridor between North African countries (e.g. Tunisia, Libya and Egypt, through Italy and Malta) and the corridor between Morocco and Algeria to Spain; the **Eastern Mediterranean route**, which is the corridor between Greece and Turkey and is used by irregular migrants mainly from Asian, North African and sub-Saharan countries; the **Eastern border route**, which is used as a corridor from Eastern Rim countries such as Moldova, Georgia, Russia and Ukraine into EU Member States such as Lithuania, Slovakia, Romania, Hungary, Poland, Estonia, Finland and Latvia; and finally the **Western Balkans route**, which is a corridor especially for circular migration between Albania (and other non-EU countries) and Greece, and from Greece to other EU Member States.

The most recent statistics from Frontex show that most unauthorized migration is channelled through the Eastern and the Central Mediterranean routes, which account for 50% and 33%, respectively, of the migrants who irregularly cross the EU's borders. On the Eastern Mediterranean route, the detection rate of illegal border crossings is continuing to rise (nearly 20,000 attempts detected in 2011). The Western Balkans route has seen less illegal traffic – mainly due to visa liberalization, which has contributed to a reduction in the number of Western Balkan citizens who cross the border illegally or overstay their visa.

Frontex (2012) reports that the top ten nationalities detected in illegal border crossing in 2011 include Tunisians – in the first quarter of 2011 more than 20,000 attempts were detected (this figure then dropped to 3,573 in the third quarter of 2011, but that is still four times greater than the level in 2010). Also high on the list are Algeria (with more than 1,600 illegal border crossings detected – almost three times more than the previous year) and Morocco (more than 1,000 detections – six times more than in 2010). The figures for illegal overstaying in 2011 indicate a slight decline compared to 2010. As for asylum applications, in 2011 there were nearly 65,000 – almost 20% more than the previous year. The Top Ten list includes Russia, Serbia and Syria. More than 20% of asylum applications were made in Germany, and these included applications from nationals originating from Western Balkan countries, such as Serbia and Macedonia. However, the number of asylum seekers from these countries declined after visa liberalization. Among the main nationalities that witnessed an increase in asylum requests were Syrians and Russians in Germany, and Libyans in Italy.

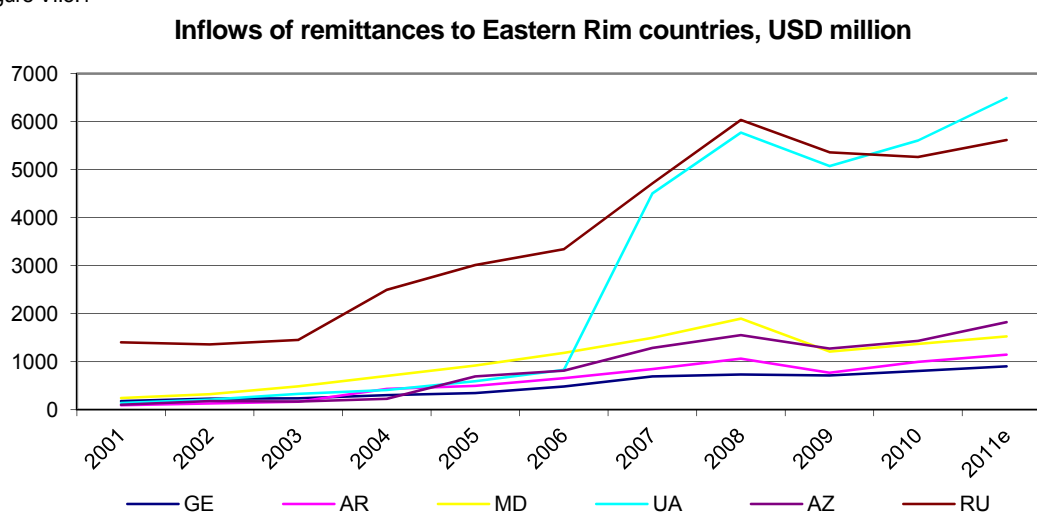
The above figures indicate that unauthorized migration to the EU remains relatively high, though visa liberalization has contributed to a reduction in the number of irregular migrants from the Western Balkans. The current unstable and turbulent political developments, especially in MENA countries, have generated large flows of illegal border crossings. As for Eastern Rim countries, illegal migration is not very intensive, mainly because of the distance of the land and sea borders. However, Ukraine and Russia remain among the top ten nationalities that illegally overstay their visas in the EU, and in addition Russian nationals are among the top ten asylum seekers.

## VI.5 Trends in remittances in the European Rim

### VI.5.1 EaP countries and Russia

Migration and remittances have shown an increasing trend over the last 20 years, generating significant welfare gains either for the home country of the migrants or for the migrants themselves. While in 2000 the amount of remittances sent to the EaP group of countries was around USD 769 million, in 2011 the estimated amount was 16 times higher, at around USD 12.3 billion (Figure VI.5.1). All Eastern Rim countries have been characterized by increases in the amount of remittances (except for a decline between 2008 and 2009 due to the global financial crisis). Ukraine is the country with the highest inflow of remittances – USD 6.5 billion in 2011. The decline in the level of remittances during the financial crisis was reversed, mainly due to outward flows from Russia that benefited from high oil prices.

Figure VI.5.1



Source: Own elaboration using World Bank (2011j).

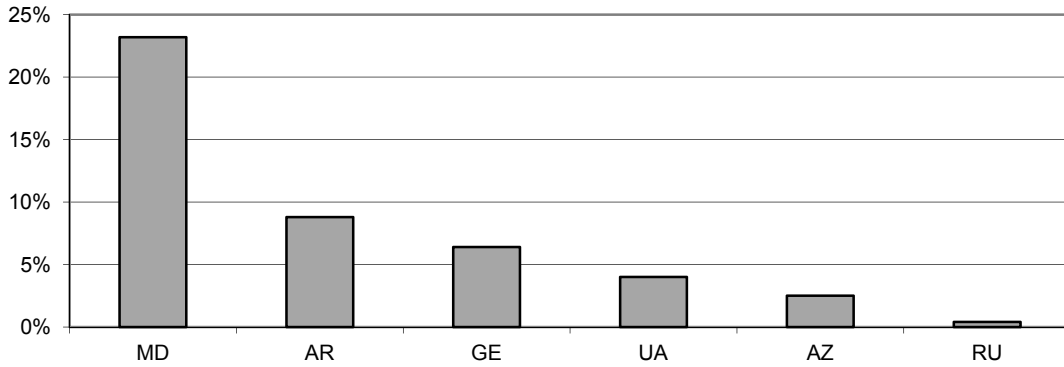
As for the GDP share of remittances, this amounts to 23% in Moldova (Figure VI.5.2). Particularly in Moldova, remittances are among the main contributors to developments on the labour market – first, because a high number of labour emigrants are recorded as inactive in the national statistics, and second, because the remittances discourage the recipients



from taking low-wage jobs so long as they can rely on financial support from family members working and living abroad.

Figure VI.5.2

**Remittances as a share of GDP in Eastern Rim, 2010 (%)**



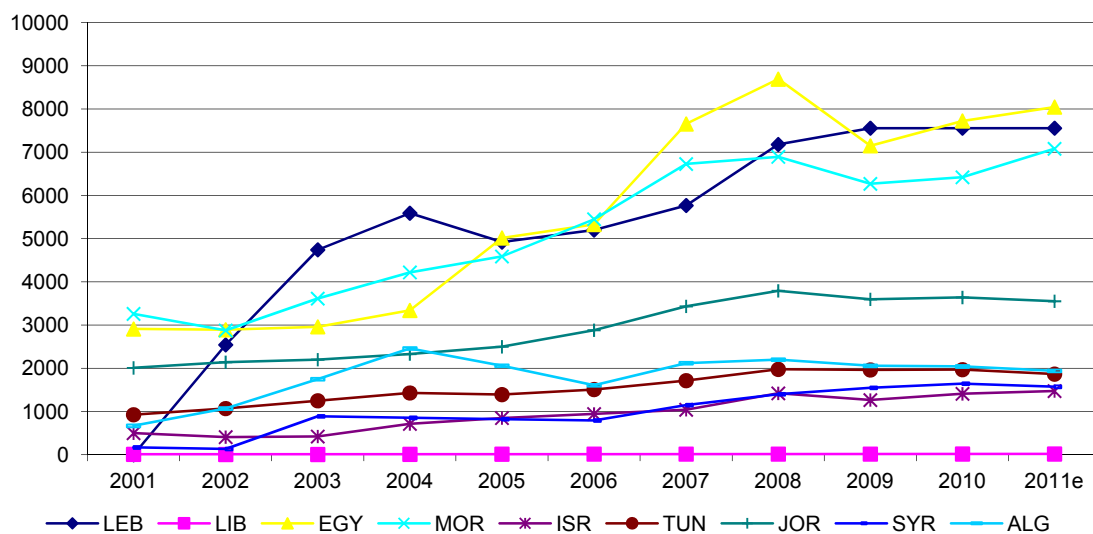
Source: Own elaboration using World Bank (2011j).

*VI.5.2 Southern Rim countries*

The EU is the main destination region of migrants from the Southern Rim, and consequently also the main source of remittances for this group of countries. The trend of remittances shows that the overall amount in 2011 was around USD 33 billion – three times higher than in 2001 (Figures VI.5.3–4, Table 6 in Annex). The main receiving countries are Lebanon, Egypt and Morocco. In particular, Morocco has the highest level of remittances as a share of GDP (20%), while Egypt is the country that has recorded the most significant increase over the past ten years and the highest level of remittances in 2011.

Figure VI.5.3

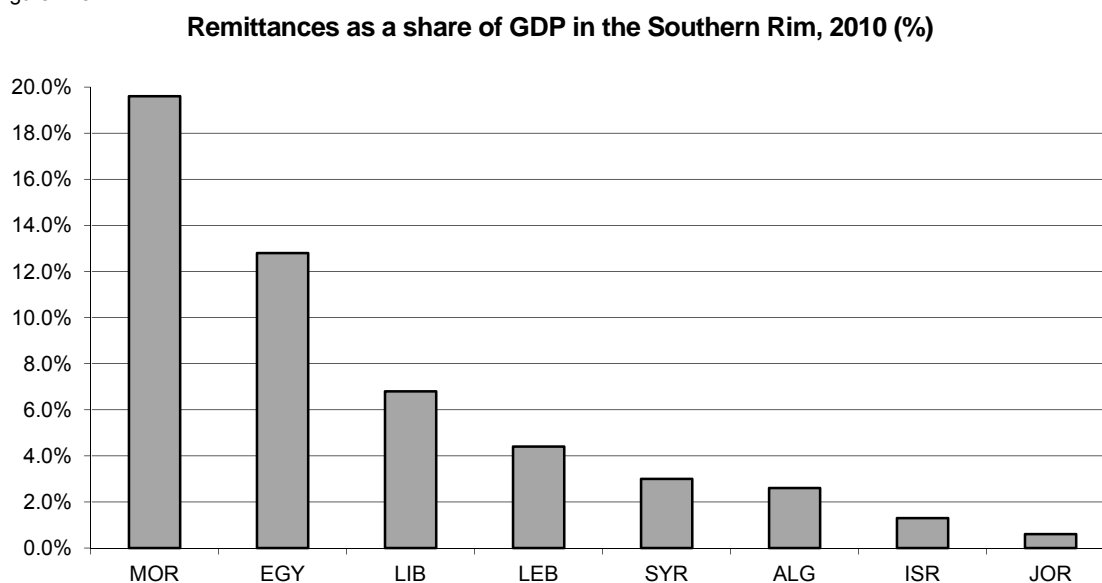
**Inflows of remittances to the Southern Rim, USD million**



Source: Own elaboration using World Bank (2011j).

However, the forecasts are for a downward trend because of persistent unemployment in Europe and precarious employment prospects of existing migrants, as well as rigid immigration policies aimed at new immigrants (Mohapatra et al., 2011a, b). The statistics for 2011 show that remittances increased by 2% over 2010. However, because of turbulent events related to the 'Arab Spring' this might change. In Libya, Tunisia and Egypt, a huge number of migrants returned home or were deported to their countries of origin. Thus such developments might negatively affect the future flow of remittances to the country of origin.

Figure VI.5.4



Source: Own elaboration using World Bank (2011j).

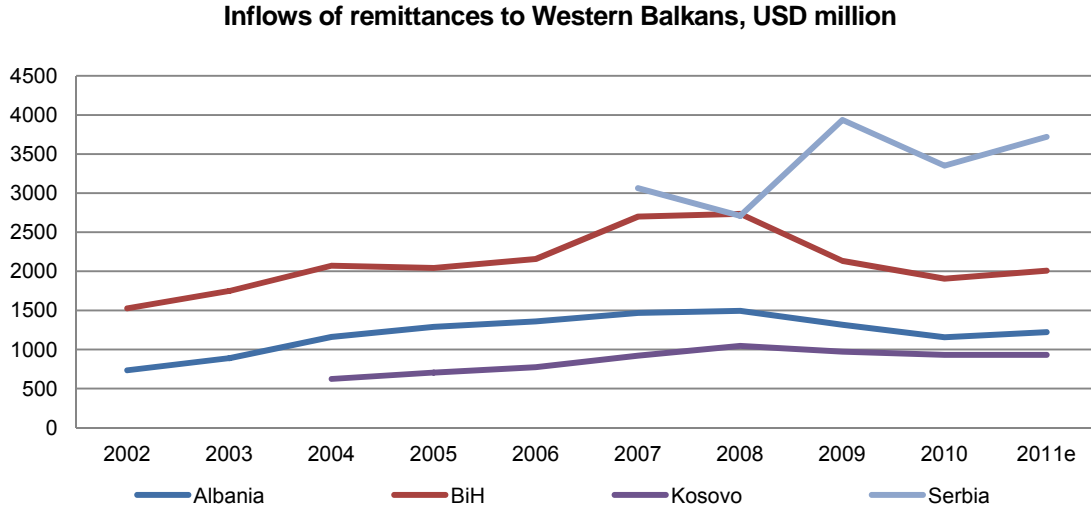
### VI.5.3 Western Balkan countries

Remittances strongly affect the economic development of the Western Balkan region, in particular Kosovo, Bosnia-Herzegovina and Albania, where the GDP share of remittances is 18%, 13% and 11%, respectively (Figure VI.5.5–6). In 2011, the flow of remittances to the Western Balkan countries reached nearly USD 10 billion – three times higher than 2002.

As in other regions, most of the Western Balkan countries recorded a decline in the flow of remittances during 2008–09. An exception was Serbia, which – apart from being the country that receives the highest level of remittances in the region – demonstrated a counter-cyclical trend compared to the other Western Balkan countries. The statistics for the flow of remittances in 2011 reveal an increase of 6% over 2010. But, as for the other Rim regions, the difficult economic situation in the EU – in particular in Greece, Spain and Italy – raises the concern that there will be less demand for migrant workers, more unemployment (which might generate a massive return of migrants to their country of origin) and accord-

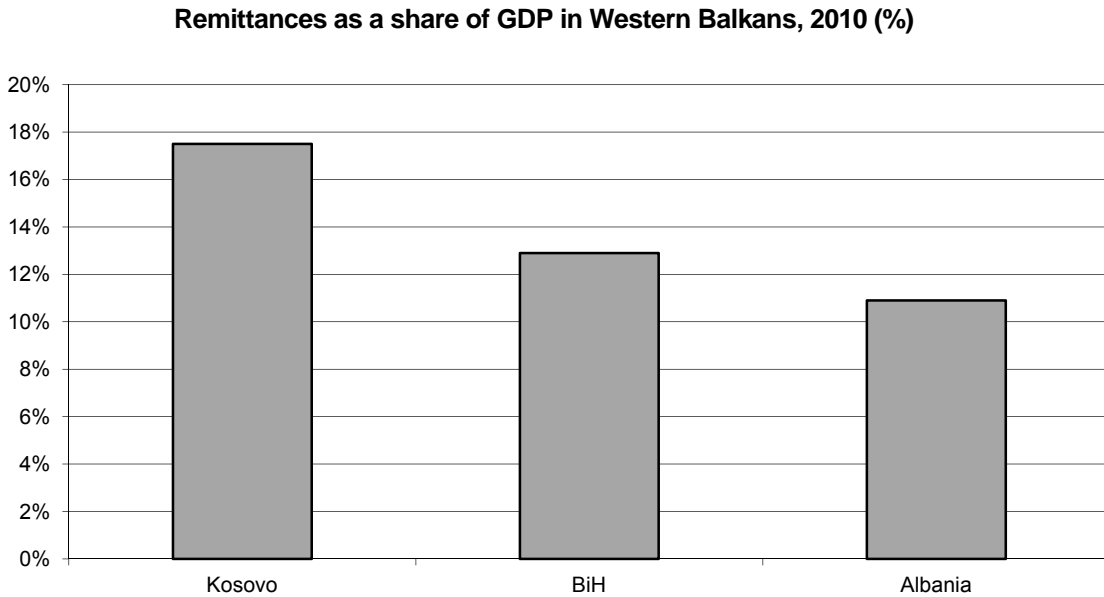
ingly depressed remittance flows. In particular, the forecasts for Albania are that remittances will continue to fall if the return of migrants from Italy and Greece (the main destination countries) persists at the current pace.

Figure VI.5.5



Source: Own elaboration using World Bank (2011j).

Figure VI.5.6



Source: Own elaboration using World Bank (2011j).

#### VI.5.4 Summary

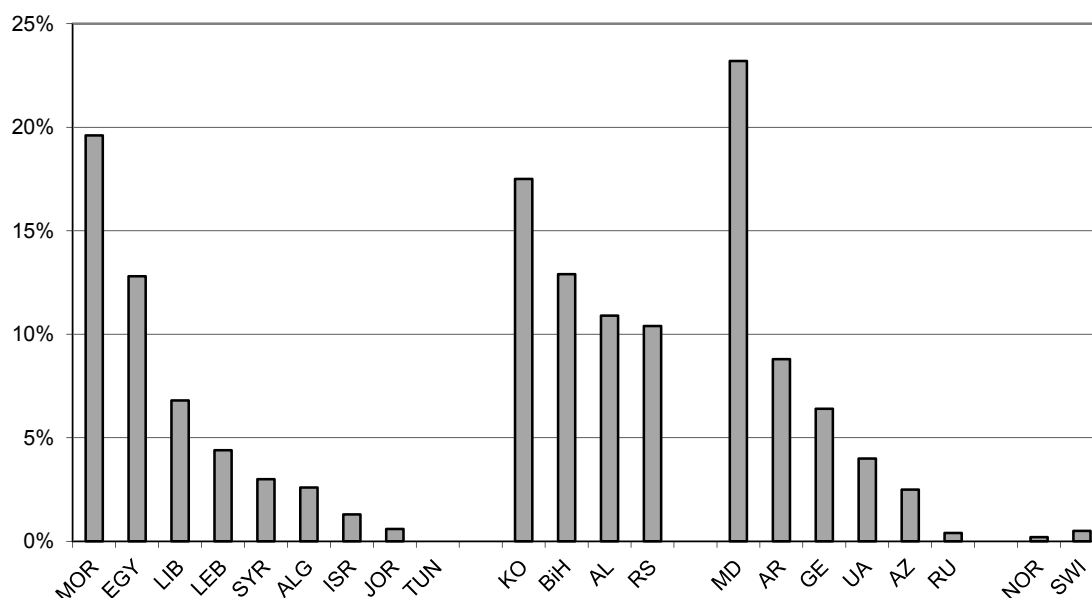
In summary, it is well documented that one of the main benefits of migration for the source country is the volume of remittances. This is not static and has been affected by the crisis. As concerns the Southern Rim countries, the volume of remittances in 2011 is put at al-

most three times the figure for 2001. In line with the stock of migrants, during the last decade the volume of remittances has trended upwards (except for during the international financial crisis, though it started to rise again in 2010 and 2011). The main receivers are countries such as Lebanon, Egypt and Morocco, which in 2011 received a volume almost three times greater than in 2001. However, in terms of the ratio of remittances to GDP, Morocco is in first place. Apart from the significant role of remittances as drivers of economic growth, they also contribute to enhancing consumption and alleviate the poverty of recipients. Even though the estimates of remittances indicate that the 2011 volume has not reached the 2008 level, remittances have fluctuated less dramatically with the economic cycle than have other capital flows.

In the Western Balkan countries, the volume of remittances in 2011 more than quadrupled over the figure for 2001, reaching nearly USD 10 billion. During the last decade, the volume of remittances has grown, except for the decline during the economic downturn. However, in some countries, such as Albania and Bosnia-Herzegovina, the volume of remittances has increased but is still below the level of 2005, while for Kosovo the volume is below the level of 2008. In terms of volume, Serbia and Bosnia-Herzegovina are the largest receivers; in terms of the ratio of remittances to GDP, Kosovo, Bosnia-Herzegovina and Albania are the main countries.

Figure VI.5.7

**Remittances as a share of GDP in the European Rim, 2010 (%)**



Source: Own elaboration using World Bank (2011j).

At the macro level, the effect of remittances on economic growth could prove positive, by contributing to increased consumption and investments, especially in those economies which have weak financial systems (Giuliano and Ruiz-Arranz, 2009). World Bank (2011j)

argues that in many African countries, including the Southern Rim region, remittances are a stable source of external finance, in many cases exceeding FDI and in others equalling official aid. However, evidence of the remittances to support business activities, especially to microenterprises, is limited for the Southern Rim countries. Other studies have shown that remittances serve as one of the main sources to finance the deficits in the trade of goods and services and that they play an important role for foreign exchange revenues, especially of the Western Balkan and Eastern Rim countries (Mansoor, 2007).

At the micro level, remittances alleviate the liquidity constraints for family members in the country of origin, increase investment in education, boost expenditure on health and improve the standard of living. In other cases, remittances are invested in physical capital, e.g. building a new house, buying land or starting a new small business.

The impact of the decline in the inflow of remittances has already jeopardized the fragile economic recovery that the region experienced in recent years. If this trend continues at this speed, then the economic recovery will enter a sluggish phase. Thus, the decline in remittances will make the financial situation of recipients at home more vulnerable and will increase the risk of poverty; it will have a negative impact on their standard of living. Directly, the reduction in remittances will have major consequences at the economic level; indirectly it may create further social and political tension as a result of lack of opportunities at home and limited support from migrants abroad.

In conclusion, the growth in remittance flows to some Rim countries is expected to continue, but this trend is uncertain especially for those countries that have a large stock of migrants in the EU. High unemployment in the EU will further aggravate the employment position of immigrants, who will suffer further losses of employment and earnings; consequently they will have fewer savings and the level of remittances sent home will fall. In addition, the financial instability, the uncertainty about oil prices and the high transfer cost of remittances may damage the flow of remittances to Rim countries. As well as the EU, Russia plays a significant role especially for the EaP countries, which have the largest share of migrants to that region. The outflow of remittances from Russia to the EaP countries serves as a cushion for remittances sent to these countries (World Bank, 2011b). In this context, the development of oil-related sectors and investments in infrastructure are attracting more and more migrant workers to Russia.

## ***VI.6 Impact of labour migration on competitiveness***

One of the objectives of the EU is the reinforcement of competitiveness on the international arena. Such a target can be achieved by higher rates of economic growth, which can be attained if the EU Member States adopt a dynamic knowledge-based economy. In this respect, human capital and the full employment of capacities is a crucial area. In view of

the latest developments in the EU – e.g. shrinking of the population and consequently the number of working-age people, the potential labour market shortages of young, skilled and unskilled workers – the economic competitiveness of the EU is at risk. In this context, labour migration becomes a focal area that could contribute to meeting the objectives of restoring full employment, reducing unemployment, satisfying labour demand for highly skilled workers and filling sectoral labour market shortages with migrant workers.

Fargues (2008, 2011) argues that from 2005 to 2030 the working population of the EU is set to decline by 24 million, in contrast to an increase in the MENA countries of 156 million. The EU will see a shrinking of the workforce, labour market shortages and unsustainable social security systems. Moreover, the recent economic crisis has put EU Member States under pressure to introduce severe measures. Unattractive working conditions and lower wages offered by employers have resulted in quantitative labour market shortages, especially among native workers (EMN, 2011). Qualitative shortages are also the result of an inadequate number of highly skilled natives with the appropriate level of qualifications and skills to engage in certain occupations. Moreover, migration within the EU-27, particularly migration from the new EU Member States towards the EU-15, has generated labour market shortages in several of the new EU Member States, where the outflows exceed the inflows of migrant workers.

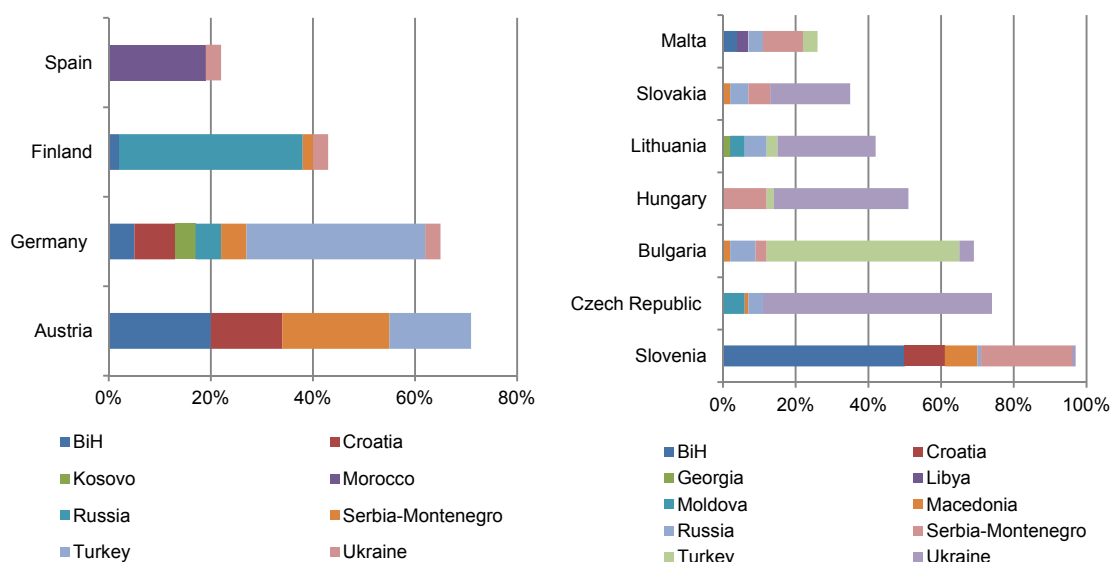
By contrast, the demographic trends indicate that Southern Rim countries will experience a significant increase in the working-age population, such that it will easily exceed demand in the labour market. It is highly probable that a considerable number of young, particularly well-educated people, will not find a place in the domestic labour market. Apart from Morocco, Jordan, Lebanon and the Palestinian Authority, the Southern Rim countries are oil producers. Moreover, a lot of intra-regional migration is generated within this area. Nevertheless, unemployment is increasing, and the economy has not come up with sufficient jobs to meet the supply, especially among the young and the well educated. In line with labour market developments and demographic changes, emigration from Southern Rim countries has intensified, especially from Lebanon, Egypt, Tunisia and Algeria towards the southern EU. Migration from Egypt, Jordan, Lebanon, the Palestinian Authority and Syria is more intensive towards other Southern Rim countries and it is classified as temporary (Fargues, 2011).

In practice, the EU Member States are experiencing significant labour market shortages in several sectors. Different governments have adopted national strategies that aim to mitigate the excessive labour demand through the migration of third-country nationals, and in particular migrant workers from Rim countries. In order to meet the labour market shortages with migrant workers from neighbourhood countries – in both low-skilled and high-skilled jobs – a number of EU Member States have undertaken clear actions and have introduced labour mobility programmes, e.g. a Mobility Partnership signed with Moldova,

Georgia and Armenia that aims to manage the migration flows and fight illegal migration. In particular, Germany has signed bilateral agreements with most of the Central and Eastern European countries, introducing a quota system and allowing the employment of guest workers for a limited period of time; Slovenia has signed bilateral agreements with Bosnia-Herzegovina and Macedonia; Italy has signed agreements with Moldova, Morocco and Egypt to first regulate entry flows for the purposes of work (including all types of workers), and then to meet local labour market requirements. Through the EU Mobility Partnership, Lithuania has concluded an agreement with Moldova and Georgia, and another agreement has been signed with Ukraine governing reciprocal employment in both countries. Meanwhile an agreement has been reached with Russia for the temporary employment of highly skilled workers. The Czech Republic has also signed a number of agreements with Ukraine, with the aim of targeting potential immigrants from Ukraine and providing them with information and support with respect to employment on arrival (EMN, 2011).

Figure VI.6.1

**Migrant workers from the Rim in selected EU countries, 2009**



Source: Own elaboration using EMN (2011).

The figures available (at least for some EU countries – Figure VI.6.1) on the presence of third-country workers in the EU-27 demonstrate that Rim countries form a large share of this group. For example, in Austria more than 70% of third-country migrant workers originate from Rim countries, particularly from the Western Balkans (21% from Serbia and 20% from Bosnia-Herzegovina). In Germany, a third of migrant workers originate from Rim countries, mostly the Western Balkans, Russia and Ukraine. In Spain we also find a large proportion of migrants from Morocco (almost a fifth of third-country migrant workers), while Russian migrant workers in Finland represent 36% of this group. In the group of new EU Member States, a good proportion of third-country migrant workers originate from Rim

countries, mostly the Western Balkans and the Eastern Rim countries. In Slovenia, more than 97% of third-country migrants are from Western Balkan countries – the majority from Bosnia-Herzegovina, Serbia, Macedonia and Croatia. The Czech Republic also has more than 63% of its migrants originating from Ukraine, 6% from Moldova and 4% from Russia. Apart from the Czech Republic, Slovakia, Hungary and Lithuania also host a large number of migrants from Ukraine.

The statistics available show that the contribution of migrant workers from the Rim countries, especially from the Western Balkans, Russia and Ukraine, is very important for a number of old and new EU Member States. Consequently, the impact of labour migration from Rim countries on growth and competitiveness is very important in terms of meeting labour market shortages for both low-skilled and high-skilled workers and contributing human capital – provided the migrant workers are highly skilled and bring their own knowledge, experience and skills.

Nevertheless, because of recent demographic developments in Eastern Rim countries, it is hard to expect such countries to sustain large-scale migration, since they have already entered the phase of population ageing, which will take time to reverse. Consequently, the closest alternative to ensure the sustainability of EU economic competitiveness and to deal with the shrinking of the working-age population would appear to be migration, particularly from southern Rim countries, which have an abundant supply of young and working age, well-educated people who are motivated to move abroad (Fargues, 2008).

Meeting the shortfall in the supply of labour in the EU with the excess supply of labour in the southern Rim countries would result in an ideal match that would sustain the economic competitiveness of the EU at an international level. The promotion of circular migration in the EU and different programmes that induce temporary migration are challenging options for satisfying labour shortages through labour migration from Rim countries. Besides, temporary migration has been the norm for a number of intra-regional migrants from Southern Rim countries (Fargues, 2008). The lack of work opportunities for highly skilled people in Southern Rim countries is a resource that the EU should not pass up. But to be competitive in the battle to attract talent, the EU should offer not only qualified jobs but also protection for the rights of migrants.



## Annex

Table 1

### Bilateral estimates of migrant stocks in 2010 for EAP countries and Russia

Destination country (across) - Source country (down)	in % Destination country (across) - Source country (down)														
	Asia	Australia	Canada	EaP	EaP_o	EU	Japan	Latin America	Other	Other South	MENA	Turkey	United States	Western-Balkans	Total
<b>Armenia</b>	0	1,192	2,555	594,989	14,604	66,535	32	454	1,389	76,329	34,279	891	77,208	0	870,458
<b>Azerbaijan</b>	1	374	2,631	1,127,654	46,816	36,471	48	138	2,181	145,784	42,921	18,807	9,689	0	1,433,513
<b>Belarus</b>	1	1,659	8,463	1,237,420	55,623	219,101	269	214	37	160,969	49,778	337	32,007	0	1,765,877
<b>Georgia</b>	1	509	1,781	799,657	2,635	96,506	49	370	34	98,123	26,032	7,295	25,310	0	1,058,300
<b>Moldova</b>	0	821	6,112	455,242	9,693	187,655	140	136	17	61,430	21,389	2,614	25,280	0	770,528
<b>Russian Federation</b>	6,585	24,189	74,655	4,595,516	2,975,030	1,114,066	7,431	18,179	1,148	944,471	829,653	22,246	421,459	53	11,034,681
<b>Ukraine</b>	3	17,552	69,218	3,993,513	284,273	1,033,805	1,560	5,143	198	523,587	259,404	4,682	332,155	50	6,525,145
<b>Total</b>	6,590	46,297	165,415	12,803,991	3,388,673	2,754,138	9,528	24,635	5,004	2,010,694	1,263,456	56,871	923,106	104	23,458,503
<b>Armenia</b>	0.00%	0.14%	0.29%	68.35%	1.68%	7.64%	0.00%	0.05%	0.16%	8.77%	3.94%	0.10%	8.87%		100.00%
<b>Azerbaijan</b>	0.00%	0.03%	0.18%	78.66%	3.27%	2.54%	0.00%	0.01%	0.15%	10.17%	2.99%	1.31%	0.68%		100.00%
<b>Belarus</b>	0.00%	0.09%	0.48%	70.07%	3.15%	12.41%	0.02%	0.01%	0.00%	9.12%	2.82%	0.02%	1.81%		100.00%
<b>Georgia</b>	0.00%	0.05%	0.17%	75.56%	0.25%	9.12%	0.00%	0.03%	0.00%	9.27%	2.46%	0.69%	2.39%		100.00%
<b>Moldova</b>	0.00%	0.11%	0.79%	59.08%	1.26%	24.35%	0.02%	0.02%	0.00%	7.97%	2.78%	0.34%	3.28%		100.00%
<b>Russian Federation</b>	0.06%	0.22%	0.68%	41.65%	26.96%	10.10%	0.07%	0.16%	0.01%	8.56%	7.52%	0.20%	3.82%	0.0005%	100.00%
<b>Ukraine</b>	0.00%	0.27%	1.06%	61.20%	4.36%	15.84%	0.02%	0.08%	0.00%	8.02%	3.98%	0.07%	5.09%	0.0008%	100.00%
<b>Total</b>	0.03%	0.20%	0.71%	54.58%	14.45%	11.74%	0.04%	0.11%	0.02%	8.57%	5.39%	0.24%	3.94%	0.0004%	100.00%

Note: EaP\_o includes Kazakhstan, Kyrgyz Republic, Tajikistan, Turkmenistan, Uzbekistan.

Source: Own elaboration of data downloaded from World Bank (2011j).

Table 2

### Bilateral estimates of migrant stocks in 2010 for Southern Rim countries

Destination country (across) - Source country (down)

	Australia	Canada	EaP	EU	Japan	Latin America	Other	MENA	Turkey	United States	Western Balkans	Other South	Other North	Total
<b>Algeria</b>	2,070	37,543	0	1,086,202	155	6,893	3,644	63,447	726	7,306	0	3,133		1,211,118
<b>Egypt, Arab Rep.</b>	43,089	47,234	0	224,970	1,750	4,779	1,828,654	1,281,125	863	132,513	0	176,077		3,741,055
<b>Israel</b>	11,812	24,819	972	66,468	758	7,546	655,846	12,922	3,047	149,039	100	82,453	4,782	1,020,565
<b>Jordan</b>	5,279	8,661	0	34,970	172	1,024	557,363	7,078	1,006	72,286	0	46,273		734,113
<b>Lebanon</b>	95,786	87,635	2,123	201,570	99	32,159	81,485	22,350	1,268	130,237	0	9,362		664,073
<b>Libya</b>	2,004	3,050	0	28,829	40	566	12,536	44,921	3,442	10,754	0	3,938		110,080
<b>Morocco</b>	2,002	45,465	0	2,592,895	369	2,018	27,793	258,639	527	84,496	0	2,428		3,016,631
<b>Syrian Arab Republic</b>	9,427	21,885	6,065	132,342	173	19,996	293,168	337,945	6,006	67,370	0	50,722		945,099
<b>Tunisia</b>	992	8,620	0	499,935	336	545	19,327	101,512	570	8,480	0	11,420		651,737
<b>Total</b>	172,460	284,912	9,160	4,868,181	3,852	75,525	3,479,817	2,129,939	17,455	662,482	100	385,806	4,782	12,094,471

in %

	Australia	Canada	EaP	EU	Japan	Latin America	other	MENA	Turkey	United States	Western Balkans	Other South	Other North	Total
<b>Algeria</b>	0.17%	3.10%	0.00%	89.69%	0.01%	0.57%	0.30%	5.24%	0.06%	0.60%	0.00%	0.26%		100.00%
<b>Egypt, Arab Rep.</b>	1.15%	1.26%	0.00%	6.01%	0.05%	0.13%	48.88%	34.25%	0.02%	3.54%	0.00%	4.71%		100.00%
<b>Israel</b>	1.16%	2.43%	0.10%	6.51%	0.07%	0.74%	64.26%	1.27%	0.30%	14.60%	0.01%	8.08%	0.47%	100.00%
<b>Jordan</b>	0.72%	1.18%	0.00%	4.76%	0.02%	0.14%	75.92%	0.96%	0.14%	9.85%	0.00%	6.30%		100.00%
<b>Lebanon</b>	14.42%	13.20%	0.32%	30.35%	0.01%	4.84%	12.27%	3.37%	0.19%	19.61%	0.00%	1.41%		100.00%
<b>Libya</b>	1.82%	2.77%	0.00%	26.19%	0.04%	0.51%	11.39%	40.81%	3.13%	9.77%	0.00%	3.58%		100.00%
<b>Morocco</b>	0.07%	1.51%	0.00%	85.95%	0.01%	0.07%	0.92%	8.57%	0.02%	2.80%	0.00%	0.08%		100.00%
<b>Syrian Arab Republic</b>	1.00%	2.32%	0.64%	14.00%	0.02%	2.12%	31.02%	35.76%	0.64%	7.13%	0.00%	5.37%		100.00%
<b>Tunisia</b>	0.15%	1.32%	0.00%	76.71%	0.05%	0.08%	2.97%	15.58%	0.09%	1.30%	0.00%	1.75%		100.00%
<b>Total</b>	1.43%	2.36%	0.08%	40.25%	0.03%	0.62%	28.77%	17.61%	0.14%	5.48%	0.00%	3.19%	0.04%	100.00%

Source: Own elaboration of data based on World Bank (2011j).

Table 3

## Bilateral estimates of migrant stocks in 2010 for Western Balkan countries

	Australia	Canada	EaP	EaP_o	EU	India	Japan	Latin America	Other	Other North	Other South	Jordan	Turkey	United States	Western- Balkans	Total
<b>Albania</b>	3,471	11,985	0	0	1,233,004	0	56	391	0		11,624	0	3,712	83,018	91,191	1,438,451
<b>Bosnia and Herzegovina</b>	40,264	33,445	0	0	724,959	0	26	1,368	0		856	0	2,653	121,495	535,574	1,460,639
<b>Croatia</b>	76,368	45,692	0	0	556,650	0	97	2,779	7	13,723	1,731	0	250	46,499	9,734	753,529
<b>Kosovo</b>	0	0	0	0	0	0	0	0	0		0	0	0	25,252	0	25,252
<b>Macedonia, FYR</b>	59,883	9,901	0	0	309,854	0	30	613	0		5,133	0	35,308	7,892	18,525	447,138
<b>Montenegro</b>	0	0	0	0	35	0	1	0	0		0	0	0	0	0	36
<b>Serbia</b>	0	0	0	0	153,671	0	23	0	0		779	0	0	35,107	6,433	196,013
<b>Turkey</b>	40,914	25,122	55,372	42,577	3,849,992	111	2,393	2,198	91,590		21,833	8,443	0	107,284	13,958	4,261,786
<b>Total</b>	220,900	126,144	55,372	42,577	6,828,165	111	2,627	7,348	91,596	13,723	41,955	8,443	41,923	426,547	675,416	8,582,845
	Australia	Canada	EaP	EaP_o	EU	India	Japan	Latin America	Other	Other North	Other South	Jordan	Turkey	United States	Western Balkans	Total
<b>Albania</b>	0.24%	0.83%	0.00%	0.00%	85.72%	0.00%	0.00%	0.03%	0.00%		0.81%	0.00%	0.26%	5.77%	6.34%	100.00%
<b>Bosnia and Herzegovina</b>	2.76%	2.29%	0.00%	0.00%	49.66%	0.00%	0.00%	0.09%	0.00%		0.06%	0.00%	0.18%	8.32%	36.69%	100.00%
<b>Croatia</b>	10.16%	6.08%	0.00%	0.00%	74.09%	0.00%	0.01%	0.37%	0.00%	1.83%	0.23%	0.00%	0.03%	6.19%	1.30%	100.00%
<b>Kosovo</b>	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%		0.00%	0.00%	0.00%	100.00%	0.00%	100.00%
<b>Macedonia, FYR</b>	13.60%	2.25%	0.00%	0.00%	70.37%	0.00%	0.01%	0.14%	0.00%		1.17%	0.00%	8.02%	1.79%	4.21%	100.00%
<b>Montenegro</b>	0.00%	0.00%	0.00%	0.00%	98.48%	0.00%	2.81%	0.00%	0.00%		0.00%	0.00%	0.00%	0.00%	0.00%	100.00%
<b>Serbia</b>	0.00%	0.00%	0.00%	0.00%	78.40%	0.00%	0.01%	0.00%	0.00%		0.40%	0.00%	0.00%	17.91%	3.28%	100.00%
<b>Turkey</b>	0.96%	0.59%	1.30%	1.00%	90.38%	0.00%	0.06%	0.05%	2.15%		0.51%	0.20%	0.00%	2.52%	0.33%	100.05%

Source: Own elaboration using World Bank (2011j).

Table 4

## Inflow of migrants from Rim countries and Russia to the EU-27

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
<b>Eastern Rim</b>										
Armenia	1417	1944	3544	4031	4113	4483	4279	3338	1593	1393
Azerbaijan	279	408	3224	3171	1819	2169	1560	1443	506	587
Georgia	1001	1751	6178	6116	6546	8279	6367	5648	3087	5695
Moldova	1402	5177	21921	17999	15281	15849	22180	29305	21293	28453
Russia	51453	55398	56894	58380	49323	45602	44238	43306	23170	21374
Ukraine	37249	52167	96338	86883	70457	76383	85097	82169	49113	44776
<b>Total</b>	<b>92801</b>	<b>116845</b>	<b>188099</b>	<b>176580</b>	<b>147539</b>	<b>152765</b>	<b>163721</b>	<b>165209</b>	<b>98762</b>	<b>102278</b>
<b>EFTA</b>										
Liechtenstein	27	26	61	68	69	60	47	74	17	22
Norway	8982	10562	11009	9128	9067	7498	7651	6702	5299	5286
Switzerland	5360	6888	6314	7471	8441	7053	7438	6845	2274	1832
	14369	17476	17384	16667	17577	14611	15136	13621	7590	7140
<b>Southern Rim</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Algeria	8620	8571	12129	11555	9656	10135	11761	11381	7888	6957
Egypt	4185	6968	10256	16717	9970	13449	10217	9382	9647	10437
Israel	3703	4174	3793	4739	3262	3465	3231	3129	1412	778
Jordan	1902	1339	1887	1720	2304	1356	1300	1377	641	633
Lebanon	3584	4988	4229	3700	3388	4037	3846	3674	1117	996
Libya	1034	640	1306	3391	1135	1267	1231	1085	477	453
Morocco	51404	68853	110550	116975	115686	106882	121921	136769	97121	74599
Palestinian Authority	29	69	99	100	118	158	142	69	182	164
Syria	4673	4870	4697	4579	3798	5090	3949	3746	1713	2233
Tunisia	3210	8473	11236	9998	8158	7644	8161	9895	6528	6665
	82344	108945	160182	173474	157475	153483	165759	180507	126726	103915
<b>Candidate and potential candidates</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
Albania	2310	27600	51865	46040	32464	62625	126029	38214	28345	23268
BiH	22936	21173	20231	20189	19457	21142	24943	25844	15692	6314
Croatia	22164	19800	19768	16834	15020	14365	14337	14488	3021	2259
Macedonia	8207	10837	13955	12108	11160	12215	12214	13575	8935	5243
Montenegro	0	0	0	0	0	253	935	766	376	356
Serbia	0	0	0	1	0	10569	30826	29626	11625	8534
	55617	79410	105819	95172	78101	121169	209284	122513	67994	45974

Table 4 contd.

<b>Absolute numbers</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
<b>Southern Rim</b>	82344	108945	160182	173474	157475	153483	165759	180507	126726	103915
<b>Eastern Rim</b>	92801	116845	188099	176580	147539	152765	163721	165209	98762	102278
<b>Candidate and potential candidates</b>	55617	79410	105819	95172	78101	121169	209284	122513	67994	45974
<b>EFTA</b>	14369	17476	17384	16667	17577	14611	15136	13621	7590	7140
<b>Total EU Neighbourhood</b>	245131	322676	471484	461893	400692	442028	553900	481850	301072	259307
<b>in %</b>										
<b>Southern Rim</b>	33.6%	33.8%	34.0%	37.6%	39.3%	34.7%	29.9%	37.5%	42.1%	40.1%
<b>Eastern Rim</b>	37.9%	36.2%	39.9%	38.2%	36.8%	34.6%	29.6%	34.3%	32.8%	39.4%
<b>Candidate and potential candidates</b>	22.7%	24.6%	22.4%	20.6%	19.5%	27.4%	37.8%	25.4%	22.6%	17.7%
<b>EFTA</b>	5.9%	5.4%	3.7%	3.6%	4.4%	3.3%	2.7%	2.8%	2.5%	2.8%
<b>Total inflow of immigrants in EU-27</b>	2,571,566	2,670,424	3,311,577	3,406,043	3,269,173	3,384,999	3,877,815	3,749,940	2,504,377	2,717,583
<b>Southern Rim</b>	3.20%	4.08%	4.84%	5.09%	4.82%	4.53%	4.27%	4.81%	5.06%	3.82%
<b>Eastern Rim</b>	3.61%	4.38%	5.68%	5.18%	4.51%	4.51%	4.22%	4.41%	3.94%	3.76%
<b>Candidate and potential candidates</b>	2.16%	2.97%	3.20%	2.79%	2.39%	3.58%	5.40%	3.27%	2.72%	1.69%
<b>EFTA</b>	0.56%	0.65%	0.52%	0.49%	0.54%	0.43%	0.39%	0.36%	0.30%	0.26%
<b>Total EU Neighbourhood</b>	9.53%	12.08%	14.24%	13.56%	12.26%	13.06%	14.28%	12.85%	12.02%	9.54%

Source: Own elaboration using Eurostat data (online data code: migr\_imm1ctz), Extracted on 10.04.12, last update 28.03.12.

Table 5

**Migrant remittance inflows (USD million) of EaP countries and Russia**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011e	Remittances as a share of GDP, 2010 (%)
<b>Georgia</b>	284	373	361	274	181	230	236	303	346	485	695	732	714	806	904	6.4%
<b>Armenia</b>	136	92	95	87	94	131	168	435	498	658	846	1,062	769	996	1,147	8.8%
<b>Moldova</b>	114	124	112	179	243	324	487	705	920	1,182	1,498	1,897	1,211	1,370	1,526	23.2%
<b>Ukraine</b>	12	12	18	33	141	209	330	411	595	829	4,503	5,769	5,073	5,607	6,494	4%
<b>Azerbaijan</b>	5	6	54	57	104	182	171	228	693	813	1,287	1,554	1,274	1,432	1,823	2.5%
<b>Year</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011e</b>	
<b>Russian Federation</b>	2,267	1,925	1,290	1,275	1,403	1,359	1,453	2,495	3,012	3,344	4,713	6,033	5,359	5,264	5,615	0.4%

*Source:* Own elaboration using World Bank estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2011.

Table 6

**Migrant remittance inflows (USD million) of Southern Rim countries**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
<b>Lebanon</b>	..	..	..	..	..	..	..	..	..	..	..	
<b>Libya</b>	..	..	..	..	..	..	..	..	..	..	9	
<b>Egypt, Arab Rep.</b>	4,284	4,054	6,104	5,664	3,672	3,226	3,107	3,697	3,370	3,235	2,852	
<b>Morocco</b>	2,006	1,990	2,170	1,959	1,827	1,970	2,165	1,893	2,011	1,938	2,161	
<b>Israel</b>	812	877	1,160	1,263	1,602	701	639	665	446	486	400	
<b>Tunisia</b>	551	525	531	446	629	680	736	685	718	761	796	
<b>Jordan</b>	499	448	844	1,040	1,094	1,441	1,702	1,819	1,624	1,752	1,845	
<b>Syrian Arab Republic</b>	385	350	550	352	535	339	313	238	220	198	180	
<b>Algeria</b>	352	1,290	1,390	1,140	1,395	1,120	880	1,060	1,060	790	790	
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011e	Remittances as a share of GDP, 2010 (%)
<b>Lebanon</b>	..	2,544	4,743	5,591	4,924	5,202	5,769	7,181	7,558	7,558	7,558	19.60%
<b>Libya</b>	10	7	8	10	15	16	16	16	16	17	19	0.00%
<b>Egypt, Arab Rep.</b>	2,911	2,893	2,961	3,341	5,017	5,330	7,656	8,694	7,150	7,725	8,047	3.00%
<b>Morocco</b>	3,261	2,877	3,614	4,221	4,590	5,451	6,730	6,895	6,270	6,423	7,081	6.80%
<b>Israel</b>	499	409	423	714	850	944	1,042	1,422	1,267	1,411	1,475	0.60%
<b>Tunisia</b>	927	1,070	1,250	1,431	1,393	1,510	1,716	1,977	1,964	1,970	1,867	4.40%
<b>Jordan</b>	2,011	2,143	2,201	2,330	2,500	2,883	3,434	3,794	3,597	3,641	3,554	12.80%
<b>Syrian Arab Republic</b>	170	135	889	855	823	795	1,150	1,400	1,550	1,646	1,574	2.60%
<b>Algeria</b>	670	1,070	1,750	2,460	2,060	1,610	2,120	2,202	2,059	2,044	1,942	1.30%

Source: Own elaboration using World Bank estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2011.

Table 7

**Migrant remittance inflows (USD million) of Western Balkan countries**

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011e	Remittances as a share of GDP, 2010 (%)
<b>Albania</b>	734	889	1,161	1,290	1,359	1,468	1,495	1,317	1,156	1,221	10.9%
<b>Bosnia and Herzegovina</b>	1,526	1,749	2,072	2,043	2,157	2,700	2,735	2,133	1,905	2,009	12.9%
<b>Croatia</b>	439	517	665	711	859	1,194	1,361	1,337	1,315	1,262	2.2%
<b>Kosovo</b>			624	705	774	922	1,046	973	932	932	17.5%
<b>Macedonia, FYR</b>	106	174	213	227	267	345	407	381	388	435	3.9%
<b>Montenegro</b>	..	..	..	..	..	196	298	302	301	334	7.5%
<b>Serbia</b>	..	..	..	..	..	3,064	2,710	3,936	3,351	3,719	10.4%

Source: Own elaboration using World Bank estimates based on the International Monetary Fund's Balance of Payments Statistics Yearbook 2011.

Table 8

**Migrant remittance inflows (USD million) of Luxembourg, Norway and Switzerland**

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	
<b>Luxembourg</b>	..	..	..	..	..	730	711	649	657	652	579	
<b>Norway</b>	158	174	190	166	170	239	309	289	301	288	270	
<b>Switzerland</b>	924	987	1,045	1,052	1,212	1,473	1,390	1,208	1,227	1,222	1,119	
	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011e	Remittances as a share of GDP, 2010 (%)
<b>Luxembourg</b>	576	810	1,022	1,130	1,268	1,361	1,452	1,621	1,585	1,586	1,716	3.0%
<b>Norway</b>	279	333	392	465	505	529	617	685	631	680	743	0.2%
<b>Switzerland</b>	1,301	1,372	1,706	1,889	1,828	1,903	2,088	2,544	2,524	2,619	2,784	0.5%

Source: Own elaboration using World Bank (2011j).



## VII. Conclusions

Countries belonging to the European Rim as defined in the present study are extremely diverse. Their diversity is multidimensional (geographical, socio-economic, political, cultural, religious, etc.) and the individual dimensions all have important implications for EU policies towards the region(s), for the EU's institutional relations with individual Rim countries and for Rim countries themselves – including their competitiveness.<sup>49</sup> On a more aggregate level and for the sake of simplicity, the Rim region can be divided into at least four sub-regions, each with specific general characteristics along the above dimensions (there is considerable diversity within each of the sub-regions as well):

- Switzerland, Liechtenstein and Norway (EEA or EFTA countries; 'Northern' and 'Advanced') are among the most affluent and developed countries in the world. They are, *ceteris paribus*, economically highly competitive democratic societies that share with the EU 'everything but institutions', since have they opted out of EU membership in referendums (Norway twice, the last time in 1994) and are therefore not EU members by choice.
- Eastern Rim countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova, Ukraine and Russia) are all former Soviet republics that share the corresponding post-communist legacy. More than 20 years after gaining independence, most of them are still politically unstable and suffer from (in varying degree) large democratic deficits. The majority of them are low- to medium-income-level economies with still distorted economic structures inherited from the past. For countries on a comparative income level they are highly industrialized and have a fairly highly educated population and well-qualified labour force. Most Eastern Partnership countries, as well as Russia, also have a close cultural affinity to Europe (values). However, Russia (as the EU's strategic partner) competes with the EU for influence in the post-Soviet space and beyond (in Ukraine, Belarus and Moldova, in particular) and does not – in contrast to most Eastern Partnership countries – aspire to EU membership (which the others are realistically unlikely to attain in the foreseeable future anyway). Parts of the Eastern Rim are potentially competitive, in particular in selected high-tech niches (space and military technology-related industries; metals, chemicals and food industries, and tourism, for example) and many of them are important for the EU's energy supplies and transit. Negotiations of DCFTAs (AAs) have either started (Armenia) or are de facto completed but not implemented due to political considerations (Ukraine). Relations with Belarus are frozen on account of political considerations. There is a common widely understood language (Russian), which is an important asset for entrepreneurship and a factor that facilitates regional integration (which has been pursued with more vigour recently). On the other hand, numerous 'frozen conflicts' (Armenia–Azerbaijan, Georgia–Russia, Moldova–Transnistria) represent a serious bottleneck.

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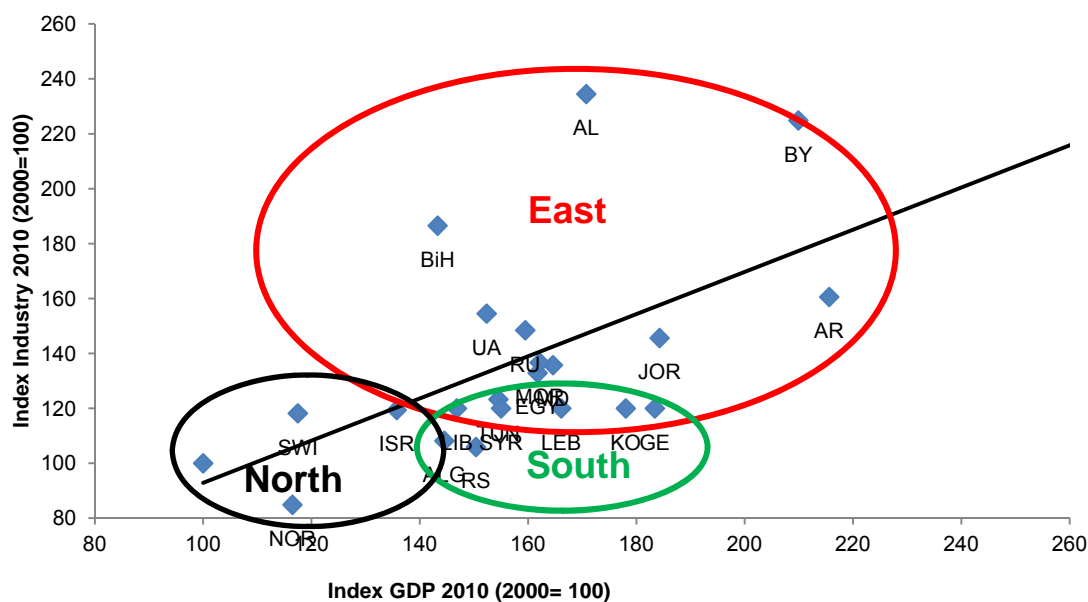
<sup>49</sup> EU relations with individual Rim countries range from nearly 'friction-free' (almost membership) with countries such as Norway and Switzerland, to frozen with EU-imposed sanctions (Belarus and Syria) or even not full recognition by all EU Member States (Kosovo).

- The Western Balkan countries in this study represent mostly former Yugoslav republics (Bosnia-Herzegovina, Kosovo and Serbia) plus Albania. Economically, they are, in many respects, similar to Eastern Partnership countries, though most Western Balkan countries are already potential candidates for EU membership (Serbia obtained candidate status in February 2012) and are thus institutionally 'closer' to the EU. The region is fragmented and plagued by serious labour market problems (extremely high unemployment, migration). In terms of competitiveness, the Western Balkans are in many respects less advanced than the Eastern Rim countries. Despite persistent tensions (especially between Serbia and Kosovo, but in Bosnia-Herzegovina as well), the post-Yugoslav legacy has a positive aspect of no (or few) language barriers (except Albania).
- The Southern Rim countries (MENA: Algeria, Libya, Egypt, Morocco, Tunisia, Jordan, Lebanon, Palestinian Authority and Syria) plus Israel (the latter being a special case, which in many respects belongs rather to the advanced 'North' yet in many other factors is positioned somewhere between the first two Rim sub-regions) are mostly less-developed traditional societies without any prospect of EU membership (but most already have FTA/AA agreements with the EU and experience of IMF/World Bank reform programmes). The start of DCFTA negotiations with Egypt, Tunisia, Morocco and Jordan was approved by the Council in December 2011. The MENA region is now in the process of transition and, as such, is highly unstable and prone to violent conflicts (Libya, Syria, Palestinian Authority, Lebanon and Israel). This new problem adds to the lasting conflict between Israel and its Arab neighbours. The 'South' is more difficult than other parts of the Rim in terms of ease for doing business, and is thus not competitive (except for Israel). Like other parts of the Rim, the South is economically fragmented, but the common cultural (Islam) and linguistic (Arabic) links are assets that could foster integration and competitiveness. Owing to demographic characteristics, the majority of MENA countries face serious labour market challenges (though official unemployment is lower than in the Western Balkans). Meanwhile the EU is coping with migration problems from the region, just as with migration from other parts of the Rim.

More specifically, regarding EU–Rim institutional relations, the key question is whether the current EU approach towards the Rim – aimed basically at the conclusion of bilateral deep and comprehensive free trade agreements or association agreements, and mobility partnerships with all countries in the Rim that are able and willing – is optimal and adequate (or even appropriate) for such a diverse group of countries and societies. As the reviewed literature shows, in the opinion of many experts from within and outside the EU it is not. Besides policies aimed at bilateral trade liberalization and measures to support the investment climate in the countries concerned, the EU should also promote regional integration and intra-regional cooperation. These initiatives would be helpful especially in the Eastern and Southern parts of the Rim, where regional fragmentation is particularly strong.

Figure VII.1

### Competitiveness of the Rim: Growth of industry and GDP, 2000–10



Source: Table II.1.

Regarding the economic development model, except for in the ‘Northern’ part (Switzerland, Norway and Israel), the economic growth of Rim countries and their progress in catching up (if any) have been the result not of increased exports, but in most cases (apart from energy exporters and tourist destinations) have originated with the expansion of domestic demand; and this has frequently been financed from transfers (aid and remittances in resource-poor countries). As is shown in Figure VII.1, the growth of industry in the majority of Rim countries, and in particular in the Southern cluster, has lagged behind the growth of GDP in the past decade. This indicates that industrial development has not been the driving force for economic growth in the region. By contrast, in most Eastern Rim countries, as well as in a few isolated industry branches (metals) in Bosnia-Herzegovina and Albania (though not in Kosovo or Serbia), industrial growth has outpaced that of GDP. The recent experience of Southeast Europe shows that the pre-crisis neglect of building up a viable trade sector and sufficiently competitive export capacities has aggravated the crisis. Policies leading to the expansion of the export sector will have to gain priority, and the use of different policy instruments (labour market, investment promotion and institutional development) will have to be strengthened (Gligorov et al., 2012).

The Rim’s competitiveness is generally low (except for the above-mentioned exceptions in the advanced North), and this is reflected *inter alia* in the low intensity of manufacturing exports and low FDI inflows. The manifold reasons for this situation are related to the economic backwardness in general, low employment skills and also the poor business climate affecting in particular SMEs – as shown in the assessment of the World Bank’s Ease of

Doing Business indicators. There is a correlation between Rim countries' export openness (a proxy for competitiveness) and their ranking in investment climate surveys. The Eastern part of the Rim has been doing somewhat better in this respect than both the Western Balkans and the MENA region in a number of business-relevant areas (such as access to finance, use of foreign technology, labour market regulations and workers' skills). This assessment is valid and relevant also for local SMEs and for the Rim's competitiveness in general.

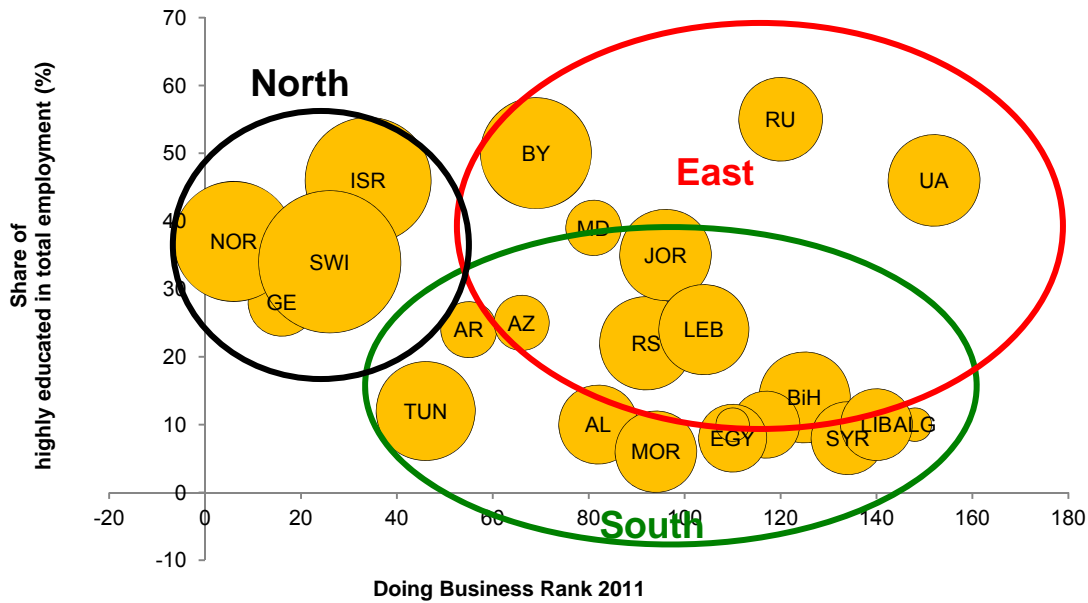
The Rim countries are relatively minor trading partners of the EU (apart from Russia, Norway and Switzerland) and do not pose any serious challenges to EU competitiveness. However, the trade asymmetry – the EU being usually the main trading partner for the Rim countries – is challenging, not least for the formulation of EU policies towards the region, since any bilateral deal has much greater consequences for the Rim than for the EU. Trade asymmetry and underutilization of the huge trade potential provided by the geographical proximity of the Rim and its historical and cultural ties to the EU need to be overcome. In particular for the European Rim countries, the proximity of the huge EU market can be regarded as a locational competitive advantage which so far has been largely unexploited. As for the asymmetry, the European Rim countries absorb 27% of the EU's extra-EU exports and are the origin of 29% of EU imports (but about two-thirds of both bilateral exports and imports are due to trade with the EEA countries and Russia). The remaining regions in the European Rim are not pivotal for the EU, given their limited market size and/or their lack of competitiveness. However, each of the regions within the European Rim is a focus area in terms of trade flows for at least one sub-region of the EU. For example, the Southern EU has strong trade links with North Africa and the Mediterranean Middle East, and the Eastern EU with the Eastern Partnership countries, Russia and the potential candidate countries of the Western Balkans. The varying regional specialization (and interests) of individual EU countries represents another challenge for the formulation of uniform and effective EU policy(ies) towards the Rim.

Limited trade diversification in EU–Rim trade (especially of the Rim's exports; apart from Switzerland and Israel) is one of the greatest obstacles to the region's competitiveness. Any market-based measures to improve the efficiency and international competitiveness of the Rim countries – such as product and labour market reforms, but also liberalization efforts and improvements in the business climate in general – may not have the desired positive effects. This is because these economies still generally lack both the industrial capacity and the necessary structural flexibility to respond successfully to competitive pressures. These drawbacks result in high adjustment costs and low gains from liberalization in terms of an increased emergence of new firms and new export products. This interpretation of the competitive situation of the majority of the European Rim countries (again except for the North) corresponds to the results of the trade simulation exercise above,

which predicts significant output losses in the European Rim countries in the bilateral liberalization scenario.<sup>50</sup>

Figure VII.2

**Competitiveness of the Rim: Ease of doing business, employment skills and manufacturing exports per capita (logarithm; proportional to bubbles)**



Source: Table II.1.

European FDI plays a primary role in the European Rim region. The region is an important supplier of energy and it is a large and potentially expanding market. FDI by European companies, including SMEs, can exploit these locational benefits, though the local business environment in Rim countries limits FDI inflows. The reforms undertaken in several MENA countries in the mid-2000s have contributed to an upswing in FDI and improved competitiveness. Domestic reforms, liberalization and market access can improve the conditions for trade and FDI and may result in an economic diversification. Improved conditions for doing business benefit local SMEs and EU investors alike. Countries with less liberalized FDI regimes receive not only less FDI altogether, but less from the EU, too. European policies supporting the liberalization processes have been beneficial both for the Rim countries and for European MNCs (including SMEs) which could expand their activities in the region. Among them SMEs have also benefited especially in countries like Serbia, Morocco and Tunisia, which have attracted fairly large numbers of greenfield FDI projects in diverse industries. European MNCs report the highest share in precisely those countries, with more than 70% of recorded greenfield projects. Further policy reforms

<sup>50</sup> However, it is fair to say that different model simulations lead to different – sometimes totally contradictory – results. Model simulation conducted for this study suggests that net welfare effects from bilateral trade liberalization are mostly negative, and the existence of a particular FTA does not have any measurable impact on Rim country's exports (Section III.4).

should take place in order to open still restricted sectors in most of the European Rim countries. Also an open and fair competition, breaking local (often state-supported) monopolies, could increase opportunities for further FDI flows.

Another impediment to the Rim's competitiveness is the regional fragmentation. Even within the four sub-regions, there are many barriers to trade and business in general (the above-mentioned frozen or open conflicts are obviously not helpful either). Numerous trade barriers exist in both the Eastern and Southern parts of the Rim (despite the latter's already existing bilateral free trade agreements with the EU). In the Eastern part of the Rim, attempts at a revival of Russian-led regional integration (customs union between Russia, Belarus and Kazakhstan, attempts to establish a Eurasian Economic Community comprising other former Soviet republics, in particular Ukraine) have not been encouraged by the EU. In the Southern part of the Rim, the limited intra-regional integration is viewed as the key obstacle to FDI, trade diversification and growth. The continuing bilateral 'hub-and-spoke trade arrangements' between the EU and the Rim resemble the pre-accession arrangements which the EU concluded with accession countries from Central and Eastern Europe during the 1990s. However, without the proper 'membership anchor', such arrangements are probably not sufficient to foster reforms, regional integration and a sustainable development in the Rim.<sup>51</sup>

Demography and labour market developments are one of the crucial areas affecting competitiveness – and are frequently neglected in this context. The European Rim is characterized by (partly) large informal sectors, labour market segmentation and large-scale migration, all of which make labour market analysis difficult (data are frequently missing). Bearing these caveats in mind, a number of differences and common features can be identified:

- The MENA countries, Armenia, Azerbaijan, Albania and Kosovo all have a high share of young people in their populations; thus large cohorts are entering the labour market every year. All other countries face ageing (and often shrinking) populations, which exert serious pressure on the welfare systems and potentially impede competitiveness.
- Activity rates are below 50% in all Southern Rim countries (except Israel) and in Kosovo. On the other hand, labour force participation in the Eastern Rim countries is similar to that in new EU Member States, and in Russia even exceeds the EU average.
- The employment gap between males and females is substantial in some Western Balkan countries and in the MENA region; especially the latter countries are characterized by exceptionally low participation by women. On the other hand, female labour force participation in the Eastern Rim countries is traditionally high and is comparable to participation in the EU.

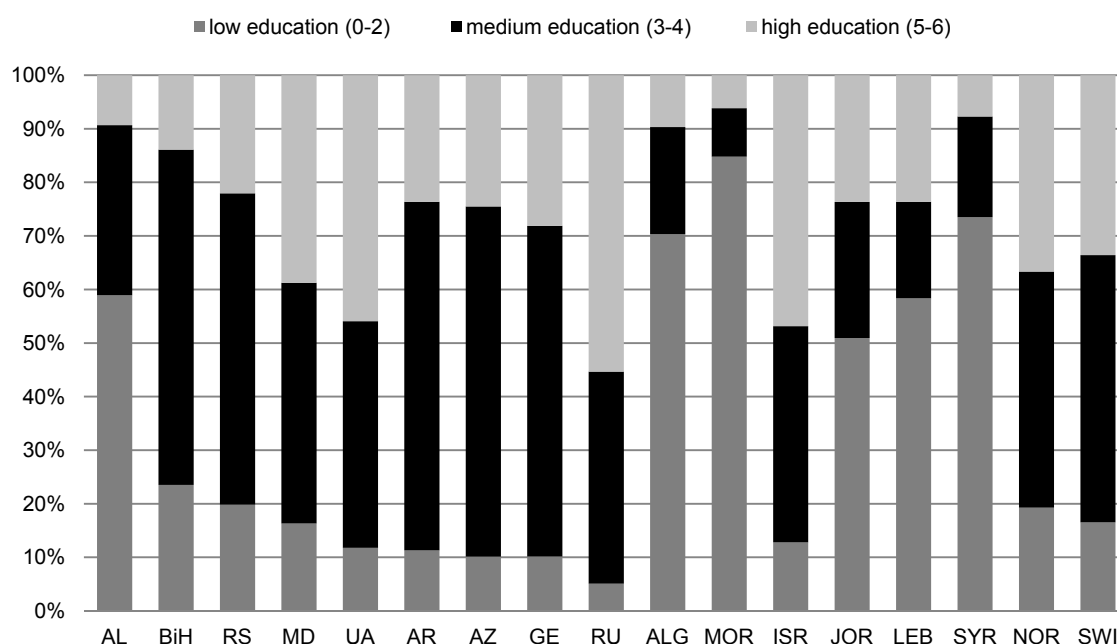
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<sup>51</sup> Similar shortcomings of the hub-and-spoke approach were identified nearly two decades ago with respect to Central and Eastern Europe (Baldwin, 1994). Dreyer (2012) advocates new comprehensive trade liberalization steps.

- Agriculture is still the major source of employment in a number of countries, particularly Georgia (more than 50%), Armenia, Azerbaijan, Albania, Morocco and Egypt (about 30–40%). Only in Israel, Jordan, Russia and Kosovo does it account for a very small share (below 10%). The service sector is most developed in Israel, Lebanon and Jordan, employing almost 80% of the workforce, and in Russia, Ukraine and the Palestinian Authority (60%).

Figure VII.3

**Competitiveness of the Rim: Employment by educational attainment, in % of the total (2010 or the latest available)**



Source: Laborsta (ILO), Eurostat and national statistics.

- In terms of employment status, most Eastern Rim countries (with the exception of Russia and Ukraine) show a high share of persons employed in vulnerable employment (self-employed and unpaid family workers), particularly in Georgia (close to two-thirds) and Azerbaijan. In the Southern Rim countries, Morocco stands out: about half of the workforce has a vulnerable job. There is also an important North–East–South divide in the educational attainment (and qualification) structure of employment in the Rim, with more highly educated people in the North and East than in the South (Figure VII.3).
- Western Balkan countries have been suffering from extremely high and persistent unemployment for years (20–45%), while the incidence of unemployment has been comparatively low in the Eastern Rim countries (except Georgia and Armenia). Unemployment in the Southern Rim countries reaches its highest levels in the Palestinian Authority, Jordan and Tunisia, while it stands at about 10% in the remaining countries of the region.

- Young people are particularly vulnerable in all groups of Rim countries, but especially in the Western Balkans – in particular in Kosovo, Bosnia-Herzegovina and Serbia. In the Southern Rim region, Tunisia and the Palestinian Authority have the highest levels of youth unemployment, at 30% and 45%, respectively – above all among young females.
- Long-term unemployment has become a persistent and salient feature of the Western Balkan labour markets, and is much more severe than in other transition countries considered. Those affected run the risk of skills degradation and permanent exclusion from the labour market.
- The incidence of unemployment by educational attainment differs significantly across the regions; the most striking feature is the high unemployment among graduates in most Southern Rim countries, while in other regions the low skilled are most affected by unemployment.

The economic crisis has affected the labour markets of the individual regions to varying extents. The Western Balkan countries were hit hardest, and the Southern Rim much less. The existence of diverse skills mismatches will require region/country-specific labour market policies. Last but not least, European Rim countries are an important source of migration to the EU (nearly 3 million migrants from the Eastern Rim, 3 million from the Western Balkans and 5 million from MENA countries); this has a number of important consequences for competitiveness (remittances, brain drain, wage pressure, etc.).



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