



POLICY NOTE OF THE WORKING PAPER 2/11

Integrating the Neighbors: A dynamic panel analysis of EU-ENP trade relations

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OBJECTIVE OF RESEARCH IN RESPECT TO POLICY

In a world where trade expansion is very often unbalanced, differences in development levels, technological competences, scale effects in production and market size play an important role in explaining trade patterns and the allocation of costs and benefits of greater interaction. In addition, as most gravity models would confirm, geography, in a sense of proximity and adjacency, is also an important driver of trade relations. *Ceteris paribus*, cross-border and regional trade is more likely to involve partners of similar levels of development and be a more balanced and symmetric type of interaction. In that perspective, it is a necessary ingredient of a trade mix that tends to be dominated by North-South and West-East relations. It has been suggested that excessive irregularity in the geographical direction of trade may have been a barrier to growth for Transition economies. This discussion reveals that there may be a need for a more balanced approach where trade integration among distant and unequal partners is complemented by regional trade, involving partners with similar levels of development and trade among neighbors.

The research questions we pose in this paper are related to the openness and integration experience of the ENP countries¹, laying in the external EU periphery and targeted by the Commission's policy to become a "ring of friends" for the EU. With the exception of Israel, these countries have relatively low, by EU standards, levels of development; they are undertaking serious socioeconomic transformations and are in a process of opening their economies to the international markets. In this context, it is an interesting exercise to investigate the impact of openness to international trade and the impact of trade integration with the EU to the growth performance of these economies.

¹ Armenia, Azerbaijan, Belarus, Georgia, Moldova, and Ukraine in the East; Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria and Tunisia in the South.

SCIENTIFIC / RESEARCH METHODS

The effect of trade openness/integration on ENP economic growth is empirically assessed with the use of recently developed panel cointegration techniques, test for causality between trade and economic growth and estimating the long-run equilibrium relationship between real GDP and a set of trade indicators.

In order to assess the effect of trade openness/integration on ENP economic growth we will employ recently developed panel cointegration techniques, and testing the causality between real GDP and a set of trade indicators. Very broadly speaking, the empirical investigation for causality between two variables in a panel context is usually conducted in three steps. First, the order of integration in the two time series variables is tested. Second, after having established the order of integration in the series, panel cointegration tests are used to examine the long-run relationships between the variables in question. If integration of order one is found, the next step is to use cointegration analysis to investigate the existence of a long-run relationship between the set of integrated variables in question. The final step is to employ dynamic panel causality tests in order to evaluate the short-run and long-run direction of causality between the variables examined.

Following the above established procedures, we examine the ENP trade growth nexus in four stages rather than three. First, we test for the order of integration in the GDP and trade openness proxies. Next, we employ panel cointegration tests to examine the long-run relationships among the variables. We then, apply dynamic panel causality tests to evaluate the short-run cointegration and the direction of causality among variables; and finally, we estimate a Panel VAR (PVAR) model for the ENP area in order to assess the qualitative and quantitative impact of trade liberalization on growth.

POLICY VALUE-ADDED

The results of the analysis indicate that exports and imports to/from the EU contribute to growth, providing some support in favor of mainstream theories of trade and development. However, when the analysis is expanded to include indicators of trade openness and trade integration and the panel of data is divided to estimate the effects of trade with different EU economic sub-groups, these results become conditional and a new set of robust findings arises, with serious implications for theory and policy.

In terms of *trade openness*, the analysis has shown that trade expansion with the EU contributes to ENP growth mainly when it concerns trade with the middle and low income EU members, that is, the Southern and the Central-Eastern EU members. In their case, the expansion of trade as a share of GDP is beneficial for ENP growth. On the contrary, when the expansion of trade as a share of GDP is related to the high income EU members, the impact on growth is negative. The analysis also shows that with existing productive capacities and structures, ENP GDP growth stimulates the expansion of trade relations as a share of GDP only with the middle and low level of income EU member states.

When the analysis uses *trade integration* indicators, the results are similar. They show that deeper trade integration with the advanced EU countries may have a negative impact on ENP countries GDP growth. At the same time, deeper trade integration with

the middle and lower income EU member states appears to have a positive and statistically significant impact on real GDP of the ENP countries. The results also indicate that, under existing production capabilities, economic growth in ENP countries favours weaker trade integration with the advanced EU countries and deeper trade integration with the middle and especially the lower income EU countries.

The dynamic causality tests that follow, broadly speaking, verify these results, as they find *limits* to the benefits of trade expansion. At the current levels of EU-ENP trade relations, the relative expansion of trade (as a share of GDP) with the less advanced EU countries seems to contribute to ENP long-term growth, while the expansion with the advanced ones it does not.

Similar findings are reported when we use a panel VAR methodology, which shows that the *relative* expansion of trade with the EU has an overall negative impact on ENP growth when it concerns advanced EU countries and an overall positive impact when it concerns the low income EU countries.

These results cast some doubt on the mainstream win-win models of trade and development and provide support to alternative theories relating trade outcomes on structural and development gaps, initial conditions, market size, scale effects and geographical coordinates.

The findings of this paper have two important messages for the theory of international trade. First, they indicate that trade among 'unequal partners' can be beneficial for the growth of developing or emerging economies only when it takes place within some *limits* that should not be exceeded. The ENP trade with the advanced EU economies should be an important part of their total trade, but it should not dominate their overall trade relations. This trade is typically unbalanced and asymmetric and locks-in their exports in sectoral specializations that do not allow for a diversification of their productive base that would be necessary for long-term growth.

Second, they indicate that the geographical allocation of trade relations affects in an important way the growth potential of the developing or emerging economies in the external European periphery. A more balanced allocation of trade; improving the participation of EU countries that are in many ways *closer* to ENP countries is found to have a positive and systematic impact on long-term ENP growth. It appears that finding trade partners with a geographical, but also economic and cultural *proximity* is a necessary ingredient for a successful integration experience for ENP countries. The development of trade among *neighbours* (which is the dominant pattern among the advanced EU countries) along the EU-ENP frontiers appears to be critical in order to balance the (otherwise necessary within reasonable limits) core-periphery trade.

The results of this analysis challenge the mainstream understanding of the external EU trade relations, where the same model of liberalization, openness and integration that has been used for the successive rounds of EU integration is now used for the development of trade relations with the ENP. The idea that international trade is always beneficial for all parts involved, no matter who the trade partners are, what mix of products are traded and if trade is balanced or not, needs to be reexamined. Consequently, the idea that the EU can integrate to its core productive system successive homocentric rounds of geographically more and more dispersed and economically less and less developed areas without altering the basic model of integration and without incurring any costs for anyone, needs to be re-examined also.

This model has produced prosperity in the EU for more than three decades. However, it has also produced an unequal allocation of costs and benefits of trade and serious discrepancies in trade balances and trade structures that are to some extent responsible for the current economic crisis.

The results of the analysis indicate that at current levels of EU-ENP trade relations, the development priorities of ENP countries are better served by expanding trade relations with the middle-low EU member states, faster than trade relations with the advanced ones. Therefore, the current mix of trade relations needs to be re-examined in order to secure that trade with the EU contributes to ENP growth as much as possible. This may be an urgent assignment in the face of the evidence that the EU-ENP trade is declining over time, as new competitors, especially in Asia, arise.

The EU policy towards ENP needs to obtain a deeper level of understanding of the interactions between trade relations and development prospects in both sides of the external borders. Moving one step away from the current policy doctrine, one may ask what type of trade arrangements may be able to improve the productive base and the growth prospects of the external and the internal EU periphery. A geographically more balanced EU-ENP integration may also lead to a more balanced development within the EU. Helping the EU South and the EU East (that is the internal EU periphery) to establish deeper and broader economic relations with the ENP South and the ENP East (that is the external EU periphery) is a feasible way to support growth in the (hit by the crisis) internal European periphery and promote EU cohesion.

Clearly, the EU policy makers would have a real difficulty to translate these findings into policy action. However, the bilateral character of EU trade agreements with each ENP country suggests that this may not be an 'impossible' task. Once policy makers understand that from the perspective of each country trade mix matters and not all forms of trade are mutually beneficial, there are some degrees of freedom for policy action. One line of policy action may suggest that (the celebrated) horizontal or 'one-size-fits-all' trade policies need to be carefully scrutinized when applied to a diverse, heterogeneous or unequal group of trade partners. This policy, however, has a limited room for success, if not combined with proactive industrial and development policies.

The EU has an expertise in development policies and has also gained some experience (and drawn some lessons) from the early stages of restructuring in transition countries. What is really needed is the will to allocate sufficient and largely unconditional resources for their implementation. These policies will help to develop cross-border multiplier effects that will be mutually beneficial for both sides of the external borders of the EU, promoting at the same time a balanced EU-ENP integration and a balanced intra-EU development.