



## PRESS RELEASE OF THE DELIVERABLE 2.3

### Trade flows and localization choices: Policy aspects of the research findings

#### OBJECTIVE

The ENP, despite its foreign-policy origins, has become one of the main EU economic-policy instruments and has accelerated and intensified economic flows and interactions between the EU and the ENP countries as well as between the corresponding businesses. Yet, despite the increased interaction – if not integration – between the two regional blocks, there are concerns about the progress of the DCFTAs and, consequently, about the success of the overall ENP undertaking. The political upheaval in the ENP South and the slow reforms in the ENP East “legitimize” such concerns. Given that, up to now, the ENP has not produced the anticipated results, a discussion about a possible reinvigoration of the current ENP perspective is ante portas. Such a discussion (if and when, eventually, it is made) should take into a consideration a couple of extremely important remarks. The first remark is that the pattern of integration between the EU and the ENP countries is uneven, unbalanced and asymmetric. This, inter-industry, type of integration is not in a position to narrow the welfare gap between the EU and the ENP countries. The second remark is that the interaction between the EU and ENP countries generates spatial side-effects (imbalances), favoring, mostly, the capital and the most dynamic regions in the ENP countries. Should they take these remarks into consideration, the ENP may pave the ground for deeper and more sustainable integration between the EU and its neighbors. To do so, the EU policy towards the ENP countries needs to obtain a deeper level of understanding of the interactions between the international and the regional dynamics in the latter. This is, definitely, not an easy task. Challenging mainstream policy perspective, the research team, after setting a number of (uncomfortable) policy dilemmas, offers a set of delicate policy recommendations to this direction.

#### MAIN RESULTS

Overall, policy-makers might examine the possibility that mandatory *acquis communautaire* compliance related to political requirements should not be a precondition for trade negotiations and (agreements) but for further financial and technical support. This means that a possible ENP review should consider a further (even unilateral) liberalization of trade and a stronger financial support mechanism as a reward for reforms. If the EU is only interested for partnership (not membership) with its trade partners in the East and the South, it is not totally understandable why it imposes conditionalities related to regulatory issues such as investment protection, public procurement and competition policy. Considering that the ENP area is sensitive in economic (i.e. low welfare level) and in demographic (i.e. high presence of rural population) terms, the current perspective of the ENP faces the danger for the ENP countries to “export” people instead of (agricultural) products to the EU market.

Eventually, this may push the (non-fuel producing) ENP countries to gravitate towards different trade poles (i.e. BRICs) that offer less uneven, less unbalanced and less asymmetric trade relations.

Even under the current ENP perspective, however, policy-makers might consider the ENP countries' trade flows as a whole: sectors opening to international imports should also be opened very soon to opportunities in exports, so to have the possibility to grow and support the diversification process of the ENP countries. Currently, the EU imposes relatively high (simple) average tariffs to trade with the ENP countries, especially on agricultural goods, making it difficult to achieve conditions of trade creation. The reluctance on behalf of the EU to remove its (agricultural) tariff (and, also, non-tariff) barriers to trade activity with the ENP countries leads to deadlock as it raises major hurdles for the ENP countries to export, to the EU market, the products on which they, mainly, specialize. At the same time, aim at improving and speeding up the diversification process in the ENP countries, policy-makers might consider that this could be obtained mostly by favouring the development of nearby sectors. Directly favouring the creation of very distant industries might result in severe failures, since the lack of necessary supporting infrastructure and institutions may doom these initiatives before positive diffusion effects may occur.

For the time being, under the existing production possibilities, and within the current ENP perspective, it turns out 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. This means that 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. Such trade is, typically, uneven, unbalanced and asymmetric and does not allow for the diversification of the productive bases of the less developed countries, which is necessary for long-term growth. Furthermore, as 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, improving the participation of the EU countries that are, in many ways, closer to the ENP countries is beneficial for the long-term growth of the latter. 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 the ENP countries. Policy-makers might aim at developing, along the EU-ENP frontiers, trade among neighbors (which is dominant among the advanced EU countries) in order to balance the (otherwise necessary, within reasonable limits) "core-periphery" EU-ENP trade activity. 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. The EU policy towards ENP countries needs to obtain a deeper level of understanding of the interactions between trade relations and development prospects in both sides of the external borders. 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. This may be an urgent assignment in the face of the evidence that the EU-ENP trade is declining over time, in relative terms, as new competitors (i.e. BRICs), arise.

In any case, the ENP undertaking has a limited room for success if not combined with proactive industrial and development policies. The EU has an expertise in such policies, gaining, also, some experience (and drawn some lessons) from the early stages of restructuring in transition countries (i.e. the new EU countries). Policy-makers need to find the will to allocate sufficient and, largely unconditional, resources for the implementation of such policies in the ENP countries. 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. These policies, however, given that the ENP area is still fragmented, with weak demand-supply chain links, need to assume active and coordinated plans not only at the

national but also at the macro-regional level. This means that policy-makers might adopt a new perspective, taking into consideration the specificities of the ENP countries, their initial constraints and the ensuing competitive pressures that EU association brings. This is a salient issue as, despite their current fragmentation, (many of) the ENP countries have many common historical, political and cultural elements, and, most importantly, common future trajectories.

Besides the aforementioned common characteristics, the ENP countries have, unfortunately, another common element: with the possible exception of Israel, the ENP countries exhibit major differences, comparing to the EU countries, with respect to institutions. Institutions refer to how societies are organized at all levels, including laws, customs, habits and traditions, and how this has an impact on the incentives, frameworks, ideas and behaviours of individuals and social entities. There is, actually, a strong consensus on the role that institutions play in determining innovation and competitiveness of countries. Some institutions directly favour or hinder the emergence of innovations; moreover, they interact at different levels, generating complex structures such as national, regional or sectoral systems of innovation. Thus, policy-makers might consider taking actions aim at improving the quality of institutions in the ENP countries. This is the main reason why policy-makers need to consider the establishment of a strong – and disconnected from trade agreements – financial support mechanism as a reward for reforms.

Improving economic institutions, is very likely to be evaluated as a positive signal by foreign investors. This is even more relevant in the case of developing and transition economies, where economic institutions are frequently poor, whilst MNCs are increasingly interested in expanding into the new markets that they represent. Although some MNCs appear to be attracted by less good economic institutions, it is not suggested that replicating flawed institutional environment is an adequate policy option. In fact, weak institutions imply distortions in the system of incentives within an economy that are not counterbalanced by more FDIs. Furthermore, FDIs attracted by institutional weakness are more likely to benefit local elites than the aggregate recipient economy. In contrast, improving economic institutions is relevant not only to attract global capital but also to stimulate the domestic capacity (i.e. local firms, new innovators) of the local economies.

Doing so, policy-makers might consider taking actions in order to encourage investing firms to serve the local market rather than use the regional economic systems as solemnly resource bases. This could be possibly achieved by the targeted development of local infrastructures, especially in areas where the tendency of incoming investors is to re-import manufactured goods abroad. Targeted development of local infrastructures refers to the support of local SMEs in building customer-supplier networks and clusters of sector-specific firms by the national (and regional) governments as well as by public institutional centers. Moreover, policy-makers might consider taking actions in order to support domestic firms so that the technological gap between foreign-owned and domestic firms decreases. In particular, there is a need to provide financial incentives especially to domestic new private firms, which will enable them to innovate and become competitive enough towards their foreign counterparts. Providing sufficient financial support for innovation activities, will allow domestic firms to invest more in research and development (R&D) activities. In order to increase the absorptive capacity of domestic firms, policy-makers might, also, consider introducing more research-based education programs at the universities so that local human capital is skilled enough to enable innovations. Moreover, policy-makers might take actions to create high quality labor conditions for local personnel so that employees get motivated to work in tech-related industries as highly competitive and prestigious work environments.

Closing the discussion about the policy aspects of the research findings, it should not be forgotten that interaction, with respect to trade and capital flows, generates spatial side-effects. Economic growth, achieved through interaction, is a spatially selective process, favoring, mostly, the capital and the most dynamic regions in the ENP countries, in particular. It turns out, that despite the wide-held belief, economic growth is not the main medicine for the reduction of regional imbalances. This hands-free and

policy-free understanding of the spatial economy, irrespective of the level of development, the macro-geographical coordinates and the response plan of the country under consideration is not supported by the evidence. In contrast, the evidence that regional disparities in the ENP countries have a pro-cyclical character and that economic growth always generates new imbalances, while long-term development favours cumulative processes, set a new framework for the discussion of regional policy in countries of low- and middle-level of development. Through its policy of approximation and conditionality, the EU has affected in fundamental ways the market orientation and external political and economic relations of the countries in its neighborhood. This influence, and the very gravitational pull of the EU economy (even during the time of the Eurozone crisis), makes the countries in the external EU periphery unable to choose or control the pace at, and areas in, which processes of integration and market openness take place. In this sense, policy-makers might realize that the EU shares a responsibility, together with the countries concerned, to address any adverse consequences and any imbalances generated by these processes of approximation and openness.

Policy-makers might take action in support of public policy in the confrontation of regional inequalities and imbalances in the ENP countries. Given that in most ENP countries the public sector is limited in size, compared to the EU standards, the active involvement of the State in pursuing a more balanced economy should be a main policy priority. With the exception of Israel, however, the ENP countries' national or regional administrations do not appear to have the required experience in setting-up and implementing an effective regional policy. Policy-makers might take actions to upgrade the technical and the financial support on behalf of the EU, transmitting the EU's know-how and, also, sufficient funding for the design and implementation of regional development programs that will (at least partially) ameliorate the impact of internationalization on the spatial balances of the ENP countries. Policy-makers might need to obtain a deeper level of understanding of the interactions between the international and the regional dynamics in the ENP countries. A further upsetting of spatial balances in the ENP countries may be the ground for either political unrest or a population exodus from poor rural areas, where currently reside over 100 million people. A migration leak (or tide) to the relatively more advanced urban centers or the core EU countries is more likely to fuel further internal and external imbalances, than operate as a safety valve to the pressures exerted.