



# EUROPEAN POLICY BRIEF



**SEARCH**

SHARING KNOWLEDGE ASSETS:  
INTERREGIONALLY COHESIVE  
NEIGHBORHOODS

## Sharing Knowledge Assets: InteRregionally Cohesive Neighborhoods (SEARCH) Project

Ongoing project (01/08/2011-31/07/2014)

### Spatial implications of expansion of capital flows in and out of the EU borders

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## INTRODUCTION

### Setting the scene

The recent (i.e. years 2004, 2007, and 2013) EU enlargements brought the borders of the EU to a set of countries in the East with historically less intensive economic relations. These countries have been part of the (former) Soviet Union and are characterized by lower development levels and significant institutional and structural differences. At the same time, in the Southern and the Eastern rim of the Mediterranean Sea, the EU is faced with countries that are linked to individual EU countries through their colonial past. Both bordering areas, in the EU East and the EU South, have been gaining significance as they include emerging economies, energy suppliers, or, simply, a large neighboring market, which is crucial for the EU economy.

Thus, the EU launched, in 2004, the European Neighborhood Policy (ENP), a unified policy framework towards its neighboring countries (the ENP countries; see Figure 1). The objective of the ENP is to strengthen the prosperity, stability and security of the EU, creating a “ring of friends” around the EU political borders. The ENP framework applies to Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine (the ENP East countries) as well as to Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Occupied Palestinian Territory (hereinafter: Palestine), Syria and Tunisia (the ENP South countries). The ENP is synergic to other EU initiatives in this area such as the Eastern Partnership (launched in Prague, in 2009), the Euro-Mediterranean Partnership or Union for the Mediterranean (re-launched in Paris, in 2008), and the Black Sea Synergy (launched in Kiev, in 2008).

The ENP is a distinct and separate process from the EU enlargement; however, the ENP countries operate under conditions of “neighborhood Europeanization”. This indicates an apparent mismatch – the so-called “capabilities-expectations” gap – between ENP requirements/demands, on the one hand, and ENP potential gains/rewards, on the other. To put it simply, on the one hand, the EU has designed the ENP, for its neighboring countries, aiming to expand relations and strengthen prosperity, stability and security in its external borders. On the other hand, the neighboring countries understand the ENP as a first step in a long road that will end-up with full membership. Such an expectation is, partly, justified on the historical record of the EU formation, which, in a series of enlargements, has managed to expand, first southwards and then eastwards, and integrate countries with different development levels and institutional endowments.

Despite the fact that the proper “membership anchor” is missing, the progressive

compliance with the *acquis communautaire* (i.e. the corpus of EU laws and policies) is a necessary condition for the ENP countries in order to increase their “weight” on the EU market. This is so, since according to the Treaty of Lisbon, forced in 2009, EU policies with a bearing on relations to third countries (such as the ENP countries) should be guided by a common set of principles and objectives such as the consolidation and support of democracy and the preservation of peace. Thereof, the ENP offers conditional preferential economic and political relations in exchange of the recipient countries’ adherence to the ENP principles. In particular, the EU pursues the implementation of Deep and Comprehensive Free Trade Agreements (DCFTAs) with its neighboring countries. DCFTAs are the main policy thrust of the ENP, involving tailor-made agreements and conditions (in contrast to the rigid Copenhagen criteria that characterize the EU eastwards enlargement) aiming at bringing the EU neighbors gradually closer to the Single Market. Hence, in practice, the ENP countries operate, within the ENP framework, under conditions tantamount to economic integration.

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### Objective of the research

SEARCH (“Sharing Knowledge Assets: InteRregionally Cohesive NeighBORhoods”) Project, being implemented within the 7th European Community Framework Programme (FP7-SSH-2010.2.2-1(266834) European Commission), analyses the impact of the ENP on the integration of neighboring countries and the EU in the areas of trade and capital flows, mobility and human capital, technological activities and innovation diffusion, and the institutional environment. In particular, the 2nd Work Package (WP2) of SEARCH Project, titled “Trade Flows and Localization Choices” has the general objective to study, both theoretically and empirically, the patterns of economic interaction between the EU and its neighboring countries, to project future trends and identify the effects of higher levels of economic integration to the growth, competitiveness and cohesion prospects of the two areas.

The specific objectives of WP2 are: a) the analysis of the trade patterns between the EU and its neighboring countries and their possible effects on growth, structural change and cohesion in both areas; b) the analysis of the locational choices of EU mobile investment, the direction and drivers of capital mobility and its effects on the EU new member states and its neighboring countries; c) the assessment of the efforts made by domestic and foreign firms to invest in technological and organizational capacities with a special focus on the impact of localized institutional environments; d) the analysis of the spatial intra-country effects of higher levels of trade and investment interaction in both the EU and its neighboring countries; and e) the discussion of the policy options at the EU level that take into consideration the effects of integration and attempt to increase and spread its benefits on both sides of the external EU borders.

The findings of WP2 provide clear-cut answers to a series of research questions: Which is the evolution of trade patterns between EU countries and their neighboring countries? Which is the impact of trade activity between EU countries and their neighboring countries on growth, structural change and cohesion? Which is the evolution of capital mobility between EU countries and their neighboring countries? Which is the impact of capital mobility between EU countries and their neighboring countries on growth, structural change and cohesion? Which are the policy implications of the evolution of trade activity and capital mobility between EU countries and their neighboring countries?

WP2 is carried out in parallel to WP3 (“People Mobility and Human Capital”), WP4 (“Technological Activities and Innovation Diffusion in the EU and Interaction with Neighboring Countries”), and WP5 (“Institutional Environment”). Hence, a strong cooperation methodology has been established among the WP leaders, ensuring the progressive coordination and alignment of the research activities. Building on the relevant findings, this allows for cross-fertilization and strengthening of the existing interrelation among the WPs of SEARCH Project. Given that SEARCH Project places strong emphasis on the policy dimension, research results of WP2 – as well as of WP3, WP4, and WP5 – are closely monitored and assessed as they emerge from WP6 (“Policy Issues and Research Implications: Toward an integrated European Research Neighborhood Policy Posture”) in order for their relevance for the formulation of policy recommendations to be ensured.

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the part that refers to Task 2.3. Deliverable 2.2 is a complete report on patterns of economic interaction between the EU and its neighboring countries, submitted for review to the European Commission in line with the structure of Annex I to the Grant Agreement (i.e. the reference document for the work and the effort to be executed by SEARCH Consortium in carrying out SEARCH Project). Deliverable 2.2 synthesizes the work done on patterns of economic interaction between the EU and its neighboring countries, informing both the empirical direction and the theoretical underpinnings of WP2 of SEARCH Project. The general objective of Task 2.3 (spatial implications of integration and expansion of capital flows in and out of the EU borders), in particular, is to investigate the spatial implications of trade and FDI flows between the EU and the ENP countries in order to shed light on a wide set of countries that has remained, largely, unexplored (not only at the regional level but also at the national one).

According to Task 2.3, there are four (4) Working Papers analysing the spatial implications of expansion of capital flows in and out of the EU borders. These Working Papers are: a) WP2/13: Origin of FDI and domestic productivity spillovers: Does European FDI have a “productivity advantage” in the ENP countries? (authors: Vassilis Monastiriotis and Mireia Borrell); b) WP2/14: Location choices of multinational companies in Ukraine (authors: Daria Zvirgzde, Daniel Schiller and Javier Revilla Diez); c) WP2/15: Impacting innovation behavior of foreign and domestic firms: The case of Ukraine (authors: Daria Zvirgzde, Daniel Schiller and Javier Revilla Diez); and d) WP2/17: The effect of FDI on regional inequality in the ENPs: Evidence from Israel (authors: Michael Beenstock, Daniel Felsenstein and Ziv Rubin).

Each Working Paper has a Policy Notes addendum i.e. a 2-3 pages text consisting of three (3) parts: (a) objectives of research in reference to policy; (b) scientific/research methods; and (c) policy value-added. Each Policy Notes text has contributed to the preparation of the present Policy Brief text, which incorporates the policy implications of the research findings, easing, thus, the (effective) communication with the policy-makers.

### Scientific approach

Task 2.3 discusses theoretically and investigates empirically the spatial implications of the new wave of integration and expansion of trade and capital flows on both sides of the external EU borders. In particular, a number of assignments include: a) the analysis of the regional structure of EU neighbouring countries and the evolution and type of inequalities, as well as of the major drivers of regional performance during the last two decades; b) a recording of the regional policy agenda in the EU neighbouring countries, including goals, policies and available funds; c) a theoretical and empirical analysis of the spatial impact of trade expansion and factor flows expansion on the performance of economies on both sides of the external EU borders; the critical research question is whether trade and FDI flows lead to increasing polarisation and within-country regional disparities, thus creating adverse economic effects on the less advanced regions of the EU and the neighboring countries; and d) the combination of national and, possibly, regional-level data to estimate the impact of the increasing internationalization of the neighboring countries on their spatial economic structures; the underlying hypothesis is that, whereas internationalisation has beneficial effects at the national level, it leads to increased inequalities at the sub-national level and a skewed spatial distribution of economic activity and potentials.

The analysis covers the period 1987-2010. The study overcomes the limitation of data at the regional level, either through data mining (and the compilation of database) or through the conduct of indirect estimations. Data derived from UN COMTRADE and SEARCH database. SEARCH is a unique data set, compiled within the framework of SEARCH Project, which includes stylized facts (i.e. economic, demographic, structural, social) for the regions of many ENP countries.

### Structure of the present Policy Brief

The current part of the present Policy Brief is introductory. The next part presents the main evidence of the analysis, offering valuable, conceptual and empirical, insight to both theory and policy-making. The third part provides policy recommendations on the basis of the analysis conducted. The fourth part summarizes the research parameters. The last part of the present Policy Brief presents the identity of SEARCH Project.

## EVIDENCE AND ANALYSIS

### **The European perspective stimulates and facilitates development**

It is widely accepted that the European perspective acts as a very strong stimulus for – and facilitator of – economic, political and institutional development by providing not only the incentives but also the (financial) resources to promote economic restructuring and institutional capacity-building. It is, thus, no surprise that especially for countries that are in dire need for economic restructuring, socio-political transformation and development, the process of European integration, in all of its facets (i.e. economic integration, political approximation and policy harmonization), has largely gone unquestioned. Indeed, deeper association with the EU brings a number of political and economic benefits at the domestic national level, strengthening domestic policies and, thus, facilitating political reforms that consolidate the process of political transition, democratization and, in some cases, conflict resolution and normalization of external relations.

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### **The pre-accession experience of the regions of the new EU countries**

In the 1990s, the new EU countries (i.e. acceded in 2004 and 2007) have experienced the processes of transition, from central planning to a free market economy, and integration, into the European economic space. The dynamics of these interacting processes have generated unprecedented pressures and have upset the spatial structures of these countries. In particular, the new EU countries experienced a significant increase in their levels of regional inequalities during the early transition period. Capital and western border regions enjoyed a relatively better performance, especially in the Central European countries, while the corresponding performance of eastern border regions had, in general, been worse. Growth drivers tend to favour the larger, central and better structured regions of the new EU countries, hence counteracting the, overall, adverse impact of economic integration. Capital regions and western regions that border the EU-15 countries (i.e. the old EU countries) seem to be the relative winners since they have managed to combine a set of positive, structural and geographical, initial conditions with market dynamics. The majority of regions, however, have followed a rather different path. Endowed with an unfavorable set of initial conditions and being peripheral in the national and the European setting, these regions have been faced in the new economic environment with fewer opportunities and more threats. Unable to attract (or maintain) a critical scale of industrial activities, they have witnessed the collapse of large parts of their industrial bases, drastically cutting local demand and setting real restrictions to efforts and policies of indigenous growth.

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### **Spatial selectivity of regional dynamics**

Regional dynamics in the external EU periphery are characterized by spatial selectivity and an, overall, unfavorable environment for lagging-behind regions. Over the last decade, regional inequalities have increased significantly in most ENP countries to levels that are unusually high by European standards. Some countries (such as Azerbaijan and Georgia), have experienced a “core-periphery” pattern of development, with metropolitan regions dominating the national economy and lagging-behind regions being in a great difficulty to catch-up.

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### **Pro-cyclical behavior of regional disparities**

Regional disparities exhibit a pro-cyclical behavior, increasing in periods of expansion and decreasing in periods of slow growth or recession. Long-term processes embodied in the level of development tend to favor a more equal allocation of activities and resources over space. However, this balancing effect will take place after a level of development that most ENP countries will not attain in the near future.

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### **Drivers of regional growth favour the more advanced regions**

With the exception of public policy, all drivers of regional growth (i.e. growth level, per capita GDP level, integration with the EU in terms of trade and FDI) tend to favour the metropolitan and the more advanced regions. The peripheral, structurally weak and lagging-behind regions are expected to experience an inferior growth performance and a pressure in their productive bases arising from integration and competition from the more advanced EU partners.

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### **Productivity spillovers favour the capital**

Productivity spillovers accruing by the presence of FDIs, although not particularly localized,

**regions**

tend to be significantly stronger and more positive for firms located in the capital regions of the ENP countries. As FDIs tends to concentrate in, or near, capital cities, it follows that they act to amplify within-country spatial disparities. EU FDIs appear to have the strongest contribution to this adverse geographical effect, partly owing to the fact that their effect is, also, stronger at the national level.

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**The predominance of capital regions over border regions in attracting FDIs**

Market-seeking investors, most probably, invest in capital regions rather than in border regions. Large market potential, better access to resources and, overall, higher institutional quality of capital regions, usually, attract greenfield investors. In contrast, border regions, still, perform quite poor with regard to absorptive capacity parameters (i.e. R&D activities), in comparison to the capital.

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**POLICY RECOMMENDATIONS****Economic growth is not a panacea for the reduction of regional inequalities**

Policy-makers might take into consideration that economic growth, despite the wide-held belief, 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.

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**Shared responsibility for the reduction of regional inequalities**

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 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.

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**Adoption of geographically-specific policies**

Evidence suggests that the effects of FDIs, and particularly of EU FDIs, in the external EU periphery are favouring geographical differentiation and regional disparities. Therefore, policy-makers might suggest policies obtaining a much specific geographical focus and attention, developing actions and interventions that will seek to identify and correct regional imbalances.

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**Development of regions' specific assets**

Policy-makers might take actions towards the development of strategic region-specific assets. Such strategic assets are human capital, concentrated knowledge pools, highly-skilled labour and technology-oriented infrastructures. This could potentially lead to the attraction of more strategic-asset-seeking investors, which would increase the competitiveness of certain regions, on the one hand, and provide an alternative to the market-seeking motivation of the majority of MNCs, on the other, as the potential of the market is a limited asset by itself.

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**Provision of support to the enhancement of institutional quality**

There is a need to introduce equal national and regional government support in terms of overall regional institutional quality and preferential government treatment to both capital and border regions. This will lead to introduction of FDI-friendly local institutional frameworks, which will positively affect FDI inflows, since institutional quality does have an

important impact on the inward FDIs. To this end, policy-makers might consider to take actions towards the provision of region-specific FDI incentives, such as the creation of business incubators and the stimulation of inter-firm cooperation between domestic and foreign firms.

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#### Support of public policy

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.

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#### Provision of technical and financial support

With the exception of Israel, 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.

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#### Obtainment a deeper level of understanding of the interactions between the international and the regional dynamics

Policy-makers might need to obtain a deeper level of understanding of the interactions between the international and the regional dynamics in the latter. A further upsetting of spatial balances in these 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.

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## RESEARCH PARAMETERS

#### Introductory statement

The present Policy Brief draws on Deliverable 2.2 of SEARCH Project, and, in particular, on the part that refers to Task 2.3 (spatial implications of integration and expansion of capital flows in and out of the EU borders), incorporating the policy implications of the corresponding research findings. The present Policy Brief offers policy recommendations, easing the (effective) communication with the policy-makers.

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#### Objectives of the research

The specific objectives of the research are: a) the analysis of the trade patterns between the EU and its neighboring countries and their possible effects on growth, structural change and cohesion in both areas; b) the analysis of the locational choices of EU mobile investment, the direction and drivers of capital mobility and its effects on the EU new member states and its neighboring countries; c) the assessment of the efforts made by domestic and foreign firms to invest in technological and organizational capacities with a special focus on the impact of localized institutional environments; d) the analysis of the spatial intra-country effects of higher levels of trade and investment interaction in both the EU and its neighboring countries; and e) the discussion of the policy options at the EU level that take into consideration the effects of integration and attempt to increase and spread its benefits on both sides of the external EU borders.

In particular, the specific objectives of Task 2.3 (spatial implications of integration and expansion of capital flows in and out of the EU borders) are to examine: a) the regional structure of EU neighboring countries and the evolution and type of inequalities, as well as of the major drivers of regional performance; b) the regional policy agenda in the EU neighboring countries, including goals, policies and available funds; c) the spatial impact of trade expansion and factor flows expansion on the performance of economies on both sides of the external EU borders; and d) the impact of the increasing internationalization of the neighboring countries on their spatial economic structures.

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**Methodology**

Addressing the research objectives of Task 2.3, secondary and primary, regional-level, data are utilized. The study overcomes the limitation of data at the regional level, either through data mining (and the compilation of database) or through the conduct of indirect estimations. Secondary data are derived from SEARCH database as well as from national data sources. SEARCH is a unique data set, compiled within the framework of SEARCH Project, which includes stylized facts (i.e. economic, demographic, structural, social) for the regions of many ENP countries. Primary data are obtained from field research conducted within the framework of SEARCH Project. The utilization of the available data allows for the thorough study of trade and capital flows, between the EU and the ENP countries, at the regional level, by means of a wide array of (sophisticated) research methodologies: a) screening of the EU policy documents related to the ENP; b) review of the theoretical and empirical literature on the spatial impact of economic interaction; c) conduct of descriptive statistical analysis; d) compilation of production function models; e) compilation of multinomial logit regression models; f) compilation of binary logit regression models; g) estimation of inequality indicators; h) compilation of regional growth models; and i) compilation of Mincerian models. The analysis covers the period 1987-2010.

## PROJECT IDENTITY

**Project name**

Sharing Knowledge Assets: InteRregionally Cohesive NeigHborhoods (SEARCH)

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14. International Centre for Black Sea Studies – ICBSS – Athens, Greece  
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15. European Institute of the Mediterranean – IEMED – Barcelona, Spain  
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**European Commission**

Directorate-General for Research & Innovation, European Research Area  
Unit B.5 "Social Sciences & Humanities".

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**Duration**

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European Community's Seventh Framework Programme FP7-SSH-2010-2.2-1 (266834), 2011-2014. Collaborative Projects

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**Budget**

EU contribution: 2,636,942.00 €

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**Website**

[www.ub.edu/searchproject](http://www.ub.edu/searchproject)

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**Further Reading**

Monastiriots Vassilis and Borrell Mireia (2013), Origin of FDI and domestic productivity spillovers: Does European FDI have a “productivity advantage” in the ENP countries?



*SEARCH Working Paper, 2/13.*

Available:

[http://www.ub.edu/searchproject/wp-content/uploads/2013/09/SEARCH\\_Working-Paper\\_2.13.pdf](http://www.ub.edu/searchproject/wp-content/uploads/2013/09/SEARCH_Working-Paper_2.13.pdf).

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