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The European Rim Countries – Challenges and Opportunities for EU Competitiveness*

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I. Introduction

Reflecting the diversity of countries in its neighbourhood, the European Union (EU) has established different cooperation processes, institutional arrangements and forums for its discussions with these countries. 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 its neighbouring countries also reflect the importance of those countries for the competitiveness of the EU and its Member States. The form of cooperation is affected by the size and structure of the economy of the particular country, its geographical location, geopolitical situation and its level of economic development, by bilateral trade and investment flows, its labour market situation and the migration flows between the country concerned and the EU. This study analyses these differences, the impacts of each form of cooperation, and the implications for the competitiveness of these countries and of the EU.

Given the special connotation of the term 'European Neighbourhood' in the EU, this study instead uses the term 'European Rim' (or just 'Rim') for the countries covered.[1] Following a mapping of the economic situation and the competitiveness of the Rim countries, the study proceeds to a brief analysis of the following aspects of the Rim's competitiveness:

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1 The term 'European Rim' is borrowed from ERPIC (The European Rim Policy and Investment Council – see www.erpic.eu). However, the country coverage in the definition of the 'Rim' used here is different. The European Rim countries covered by this study are: Norway, Switzerland, Liechtenstein (EEA/EFTA or the Northern Rim); Russia (strategic partner) together with Ukraine, Belarus, Moldova, Armenia, Azerbaijan and Georgia (Eastern Partnership countries) form the Eastern Rim; Albania, Bosnia-Herzegovina, Kosovo (under UN Security Council Resolution 1244) and Serbia (Western Balkan countries); Syria, Jordan, the Palestinian Authority, Lebanon, Israel (Middle East) and Egypt, Libya, Tunisia, Algeria, Morocco (North Africa) together form the Middle East and North African (MENA) countries or the Southern Rim.

- The economic impacts of existing agreements between EU Member States and Rim countries, including in terms of FDI and trade flows. 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 Rim countries.

II. Mapping the economic situation and competitiveness

The countries that belong to the 'European Rim' (as defined in this study) differ vastly. In economic terms, most of them are small (except Egypt, Russia and Ukraine) and have less-developed, emerging economies (the exceptions being members of the European Free Trade Association (EFTA) or the European Economic Area (EEA) – Norway, Switzerland and Liechtenstein, which are among the most affluent countries in the world – and Israel, whose GDP per capita at purchasing power parity (PPP) is close to the EU average – see Annex Table 1). On the other hand, a number of Eastern Rim countries (e.g. Armenia, Georgia, Moldova), as well as several Middle East and North African (MENA) countries (e.g. Morocco, Jordan and Syria), are fairly poor, with estimated GDP per capita at PPP amounting to less than 20% of the EU average. However, in terms of population, the total of the Rim countries is close to that of the EU (87% of the EU: 435 million and 501 million inhabitants, respectively), while in terms of total GDP at exchange rates, the overall Rim economy is rather small (23% of the EU: EUR 2,790 billion and 12,260 billion, respectively – all figures are estimates for the 2010, see Annex Table 1). Even at PPPs, the estimated aggregate GDP of the Rim countries represents just about a third of the EU's – still a huge market, especially when its considerable growth potential is taken into account.[2]

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):

[2] The latest forecasts of GDP growth rates for the majority of Rim countries are 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 not Southeast European countries or Norway, Switzerland and Liechtenstein) was published recently (November 2011) in European Economy (2011). As far as Norway is concerned, a comprehensive review of that country's economic links with the EU ('a review of the European Economic Area agreements') was published in January 2012 (Outside and Inside, 2012).

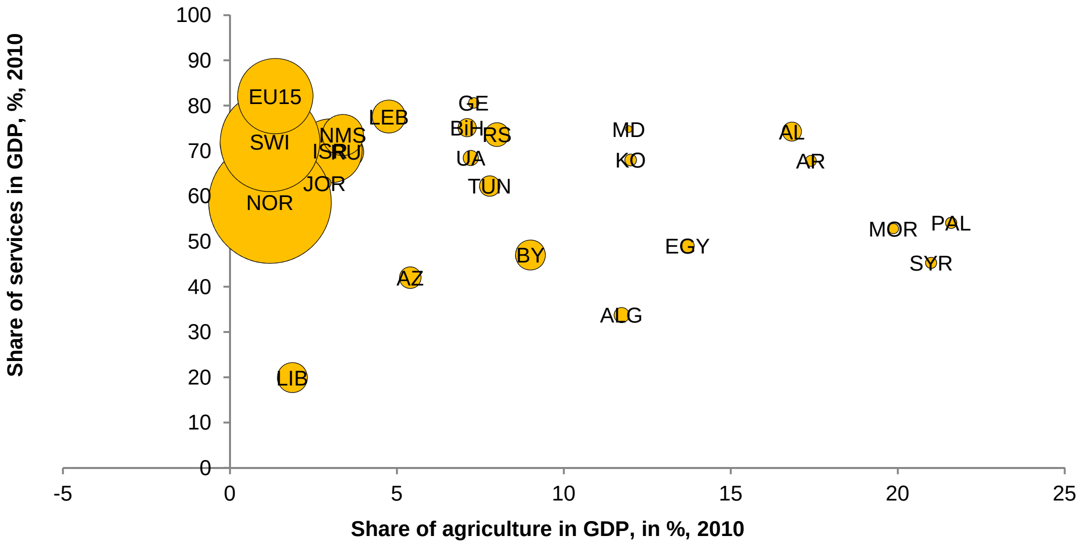
- Switzerland, Liechtenstein and Norway (EEA or EFTA countries; ‘Northern’ and ‘Advanced’) are among the most affluent and developed countries in the world. They are highly competitive democratic societies that share with the EU ‘everything but institutions’, since they have opted out of the EU membership in referendums (Norway twice, the last time in 1994) and are therefore not EU members by choice.
- The Eastern Rim countries are all former Soviet republics and share the corresponding post-communist legacy. More than 20 years after gaining independence, most of them are still politically unstable and suffer from large democratic deficits (to varying degrees). 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 a well-qualified labour force. Most Eastern Rim countries 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. The negotiation of DCFTAs (AAs) has either started (Georgia, Moldova) or is de facto completed but not implemented due to political considerations (Ukraine). Relations with Belarus are frozen. There is a common widely understood language (Russian), which is an important asset for entrepreneurship and a factor facilitating regional integration. On the other hand, numerous ‘frozen conflicts’ (Armenia–Azerbaijan, Georgia–Russia, Moldova–Transdniestria) represent a serious bottleneck.
- The Western Balkan countries are mostly former Yugoslav republics, 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. Despite persisting tensions, the post-Yugoslav legacy has a positive aspect of no (or few) language barriers (except in Albania).
- The Southern Rim countries (MENA 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 FTAs/AAs with the EU). The start of DCFTA negotiations with Egypt, Tunisia, Morocco and Jordan was approved by the Council in December 2011. The 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). The 'South' is more difficult than other parts of the Rim in terms of ease of doing business and is thus not competitive (except Israel). The Southern Rim is economically fragmented, but the common cultural (Islam) and linguistic (Arabic) links represent an asset which 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).

Figure 1

GDP structure and development levels of Rim countries, 2010

(bubbles are proportional to GDP per capita at PPP)



Source: Annex Table 1 (see also for country codes).

The wide diversity in economic characteristics notwithstanding, one should add that the European Rim is dominated by three large countries: Russia and Ukraine on the Eastern 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. 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, Algeria and Libya.[3] On the other hand, the majority of Rim countries have a relatively large agricultural sector. However, neither a large services sector nor, for that matter, a small agricultural sector indicates unequivocally a country's level of development or (industrial) competitiveness. On the contrary: a number of Rim countries (Albania, Armenia, Georgia, Bosnia-Herzegovina, Moldova, Morocco, Syria, etc.) report a very high share of services,

3 The share of industry in Norway is also fairly high – more than 40% of GDP. By way of comparison, on average in the EU industry accounts for less than 17% of GDP; and in the new EU Member States (NMS) it accounts for 23% of GDP.

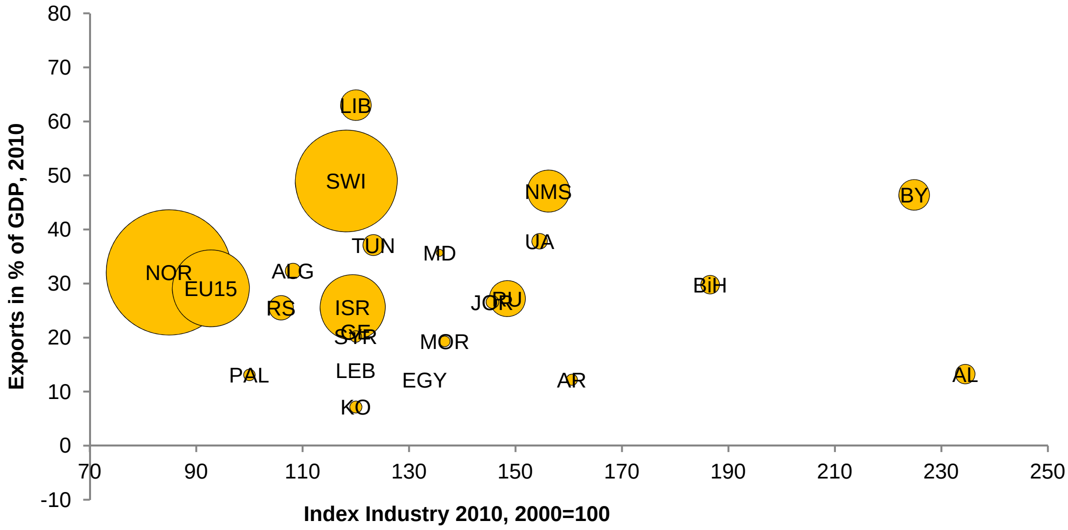
yet still they are rather underdeveloped (in terms of GDP per capita at PPP – Figure 1, Annex Table 1).

The majority of Rim countries are not very open economies either (in terms of the share of goods exports in their GDP) and, from that point of view, are not very competitive. Several Rim countries specialize in services exports, and their share of services exports in GDP are bigger than the EU's. The Rim's services exports represent a mix of transport, tourism and financial services. Financial services are important in Lebanon and Switzerland, while 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). In any case, more rapid GDP or industrial growth on the Rim has not necessarily been associated with high export openness: in a number of Rim countries, relatively rapid GDP or industry growth in the last decade (2000–10) occurred without particularly high export openness (Figure 2). In contrast to most NMS and other emerging markets, any economic catching-up the Rim countries have experienced has been a result not of export-led growth but of expanding domestic demand, frequently financed from transfers (Armenia, Georgia, Kosovo).

Figure 2

Industrial growth, export openness and development levels in the Rim countries

(bubbles are proportional to GDP per capita at PPP, EUR), 2010



Source: Annex Table 1 (see also for country codes).

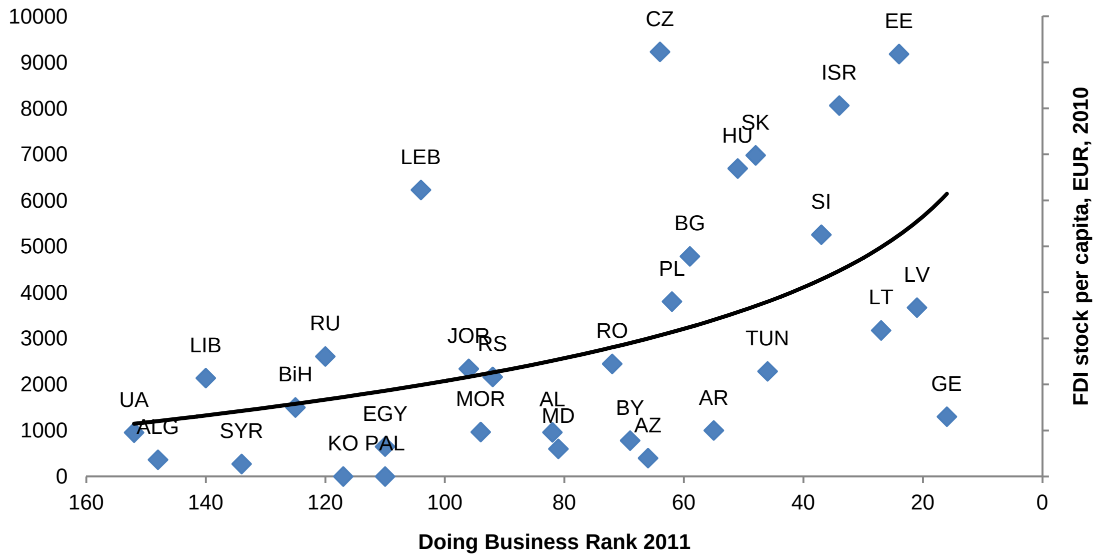
A common feature of the Rim countries is a fairly high external imbalance: energy exporters (Azerbaijan, Russia, Algeria, Libya and Norway) record huge trade and current account surpluses (close to 30% of GDP in the case of Azerbaijan), whereas the majority of resource-poor Rim countries report high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

Authority). The recent experience of Southeast Europe (including Greece, Portugal and Spain) illustrates that countries which fail to build up a viable export sector are particularly vulnerable to the kind of effects felt during the recent crisis and have to adjust their economic policies accordingly (Gligorov et al., 2012).

Turning to trade with the EU, the fact of the matter 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. But the EU is a trading giant and there is a huge asymmetry in the EU–Rim trade importance: for the majority of Rim countries, the EU represents by far their most important export and import partner. This is true especially of the Eastern part of the Rim (with the possible exception of Georgia), as well as of Jordan and the Palestinian Authority in the Southern Mediterranean. Distinct EU–Rim geographical trading patterns exist at the sub-regional level as well (see Section III below).

Figure 3

FDI stock per capita and ease of doing business



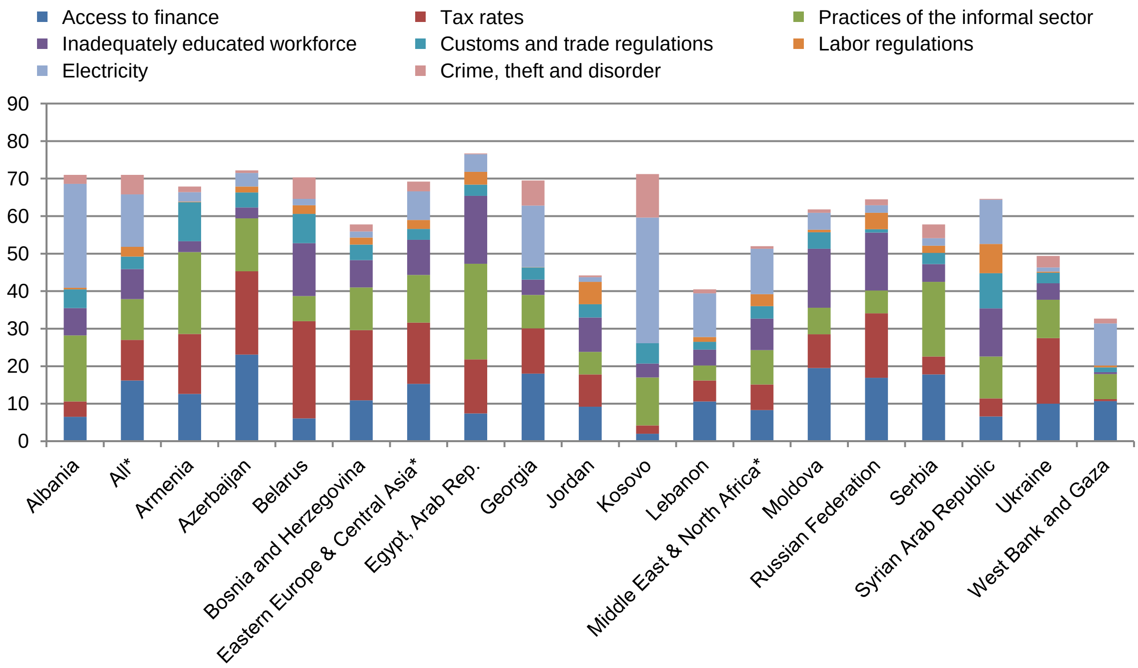
Source: Annex Table 1 (see also for country codes); World Bank, UNIDO.

The above trade asymmetry has important consequences for the Rim's competitiveness, too: any EU policy or measure that affects trade relations with the Rim countries (e.g. a free trade agreement – FTA) has a disproportionately large impact on the latter countries. This holds true for individual EU Member States, too, which may have a greater than average intensity of trading links with a particular Rim country (e.g. Poland–Ukraine, France–Egypt, Spain–Morocco, etc.) or in a particular sector (with the possible exception of energy).

Likewise, from the EU's point of view, the assessment of Rim countries' competitiveness depends, *inter alia*, on the investment climate and other conditions for doing business. Again, the Rim countries differ widely in these respects. According to the latest World Bank 'Doing Business' ranking, the majority of Rim countries do not score particularly well (in most cases they score worse than EU countries).[4] Not surprisingly, a better ranking in 'Doing Business' indicators is associated with higher FDI stock (even after excluding Norway and Switzerland, which are outliers with respect to both indicators – see Figure 3 and Annex Table 1). In general, Eastern European and Central Asian countries not only rank better than MENA in terms of FDI stocks, but have also recently been doing better in the 'Doing Business' rankings. Compared to the 84% of Eastern European and Central Asian countries that implemented at least one reform in 2009/10 to make it easier to do business, only 50% of countries in the Arab world undertook such a reform. Morocco, Moldova and Armenia are among the countries to have improved ease of doing business the 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).

Figure 4

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



Note: '*' indicates group average.

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

[4] 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).

Apart from overall rankings, the World Bank's Enterprise Surveys provide a large number of additional detailed results that are relevant for an assessment of business environment and competitiveness – particularly of SMEs.[5] These indicators evaluate several areas that are relevant for entrepreneurship and the competitiveness of firms (such as regulations and taxes, access to finance, corruption, crime, infrastructure, various characteristics of firms and labour, innovation and technology, etc.).[6] In each country covered by the survey, several hundred firms – usually domestically owned SMEs operating in the non-agricultural, formal, private economy – are polled. Figure 4 lists the eight biggest obstacles to ease of doing business in the Rim (out of fifteen obstacles surveyed), as identified by respondents (usually the owners or managers of SMEs) in the individual Rim countries. These eight obstacles account for 60–70% of all obstacles surveyed in most Rim countries covered (except for Jordan, Lebanon, Ukraine, the West Bank and Gaza).

The financial intermediation is generally underdeveloped on the Rim – as evidenced, for example, by the relatively low percentage of firms that operate with a bank loan or a credit line. Lending practices thus pose a serious obstacle – a fact that is particularly relevant for the development of SMEs (see also Alvarez de la Campa, 2011). The practices of the informal sector (corruption and crime) are frequently mentioned as important obstacles, especially in the Eastern part of the Rim. A large proportion of firms in the MENA region are also faced with corrupt practices, be it to obtain an import licence, a construction permit or a mains electricity connection, or a government contract. 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 most domestically owned and domestically operating SMEs that are covered by the sample do not export and do not require such a certificate), a relatively high proportion of firms use internet (slightly more in the Eastern part of the Rim than in the MENA region). By contrast, only a small percentage of firms use technology licensed from abroad. Again, there are relatively more such firms on the Eastern Rim than in the MENA region, indicating a relative backwardness and lower competitiveness of firms in the latter region.

Labour regulations are not perceived as a major constraint by the majority of firms, especially in the more 'liberal' Eastern part of the Rim (in contrast to the 'more regulated' pre-revolutionary Egypt and Syria). An inadequately educated workforce is seen as 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 perceived to be much less of a constraint: the firms in those countries also employ fewer unskilled workers and – something that is very important for competitiveness – a higher proportion of Eastern Rim firms offer their workers formal training (e.g. 46% of firms in Armenia, 61% in Belarus, about 50% in Bosnia-Herzegovina, Moldova, Russia and Ukraine). The fairly high

[5] SMEs employ 25% of the labour force in the Southern Mediterranean (European Parliament, 2012).

[6] See www.enterprisesurveys.org for definitions of indicators and other details.

level of qualification 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 a decline in the quality of education since the fall of the Soviet Union (OECD, 2011).

III. Trade relations between the EU and the European Rim

The countries that belong to the European Rim are mainly small economies and, with the exception of the advanced North (as well as Russia and Israel), 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. The typical country of the Western Balkans, the Eastern Rim and the Mediterranean Middle East has an even smaller share of global imports (0.1% or less; notable exceptions are Ukraine and Israel). A glance at the European Rim at the (sub-)regional level – dividing it into the advanced North, the potential EU candidate countries in the Western Balkans, the Eastern Partnership countries, the Mediterranean Middle East (except Israel), North Africa and Russia – shows that apart from Russia and the North the three country groupings account for only 0.2% to 0.5% of global exports (2010, WTO figures). The largest importers within the European Rim are the advanced North and Russia, with approximately 1.7% of global imports apiece.

Despite considerable liberalization efforts on the Eastern and Southern Rim none of the Rim countries has implemented an extensive and successful export-led growth strategy that would diversify and upgrade their export base and deeply integrate their economies into global trade networks. As a result, the Rim countries have not experienced a strong increase in their market shares of global exports. One major reason for such mediocre development is that most Rim countries have a relatively small share of manufactured goods in their exports (Figure 5). In terms of broad economic sectors, manufacturing exports are most underdeveloped in North Africa and Russia (just 18% of total exports), followed by the Mediterranean Middle East (21%). The opposite is true of Switzerland whose export structure is highly geared towards manufactured goods (63% of total exports in 2010). North Africa, Azerbaijan and Russia depend mainly on commodity exports. 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. The bulk of the revenues from services exports come in the ‘traditional’ services sectors, i.e. travel (tourism) and, to a lesser extent, transport services. This pattern – a more than proportionate share of services in overall exports – is also observable in several other European Rim countries outside MENA: Albania, Armenia, Georgia, Lebanon, Egypt, Morocco and Tunisia. 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-poor countries of the European Rim – which should be more inclined to develop manufacturing capacities because they cannot rely on rents from natural resources – have not managed to diversify their exports and move into manufacturing (see Masood, 2010; Eurochambres, 2011, López-Cálix et al., 2010).

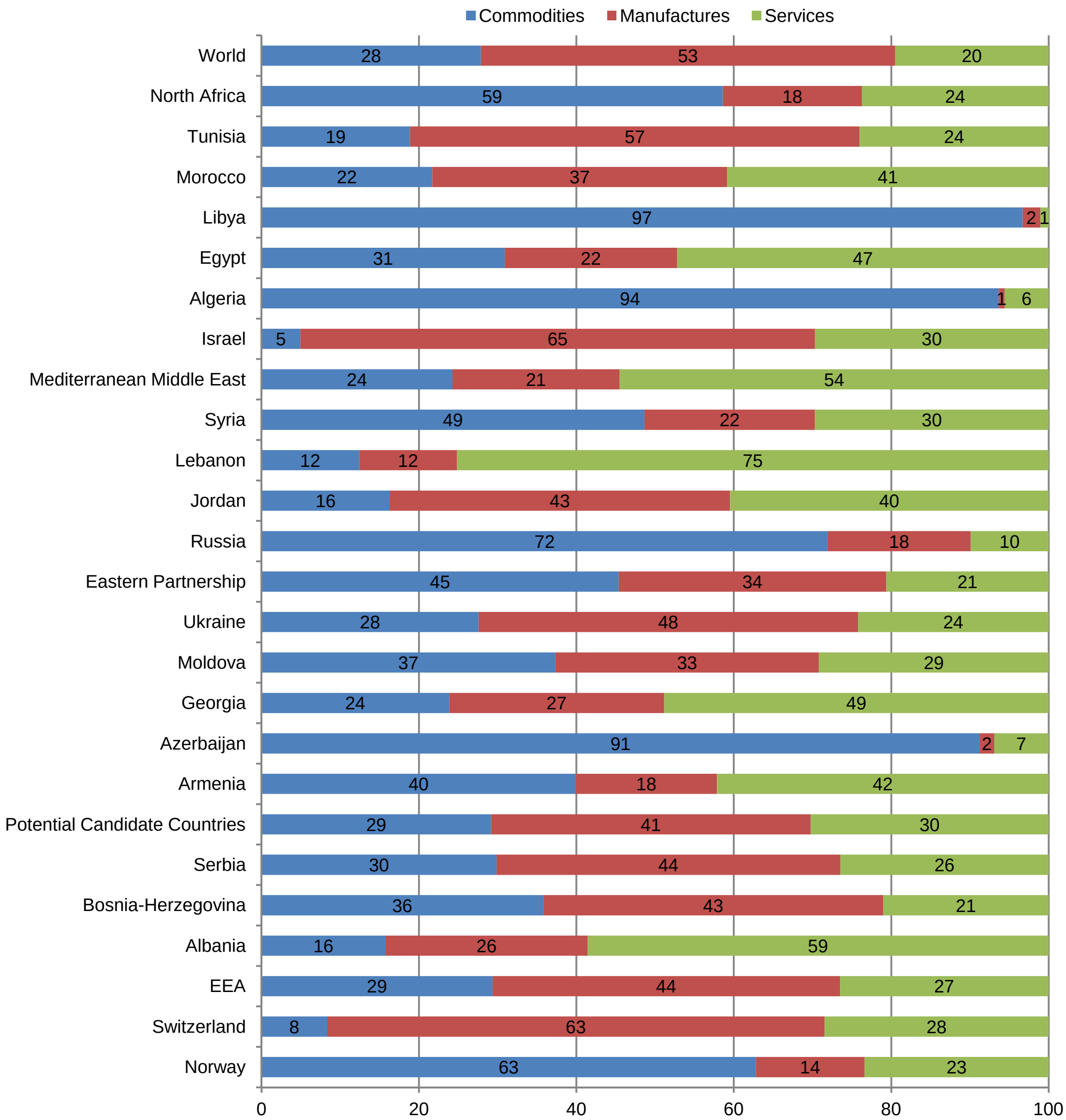
The lack of manufacturing export capacity is also revealed by the low value of manufacturing exports per capita (intensity of manufacturing exports) and by low ratios of manufacturing exports to GDP. The lack of an export manufacturing base is an essential feature that has to be taken into account when analysing the competitiveness of the European Rim countries. Therefore, most European Rim countries, particularly the North African and the Eastern Rim countries, are forced to compete mainly on price in areas with static comparative advantages from natural resource endowments. Hence, their competitiveness in international markets is currently based on the abundance of resources. Accordingly, the North African (apart from Tunisia) and Eastern Rim countries are characterized as countries that are still in the transition from 'factor-driven' to 'efficiency-driven' economies. By contrast, in developed economies (such as the EU, but also the EEA countries and Israel) innovation and resulting technological leadership in products and services are key factors for success in international markets – factors that presently are of no (or only very limited) relevance for most European Rim countries.

The EU is the major trading partner for all countries of the European Rim, but in most cases the reverse relationship does not hold. A more detailed overview of the bilateral trade relations between the EU and the European Rim countries is presented in Annex Tables 2a (EU exports) and 2b (EU imports). Taken as a whole, the European Rim countries account for approximately 27% of the EU's extra-EU merchandise exports and for 29% of extra-EU merchandise imports. On the export side, the most important trading partners are the EEA countries (11%), Russia (6%) and North Africa (5%). Turning to EU imports, the same ranking of partner regions 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.

Annex Tables 2a and 2b also show bilateral trade relations between sub-regions of the EU and each of the regions in the European Rim. The first point to be mentioned here is that the European Rim is not necessarily a focus area for the core EU (Austria, Germany and the Benelux). 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. By contrast, parts of the European Rim are important export destinations for the Southern EU countries and also for the Eastern EU. The Southern EU accounts for 62% of total EU exports to North Africa. The two most obvious reasons for this pattern are, of course, geographical proximity and the colonial heritage. Another clearly discernible pattern is the Eastern EU's export orientation towards the Eastern Rim countries – a legacy of the previous economic relations between the members of COMECON. Last but not least, the share of Eastern EU exports in total EU exports to the Western Balkans is even higher (40%), which is again explained by geographical proximity and the previous close trade relations within the former Yugoslavia.

Figure 5

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



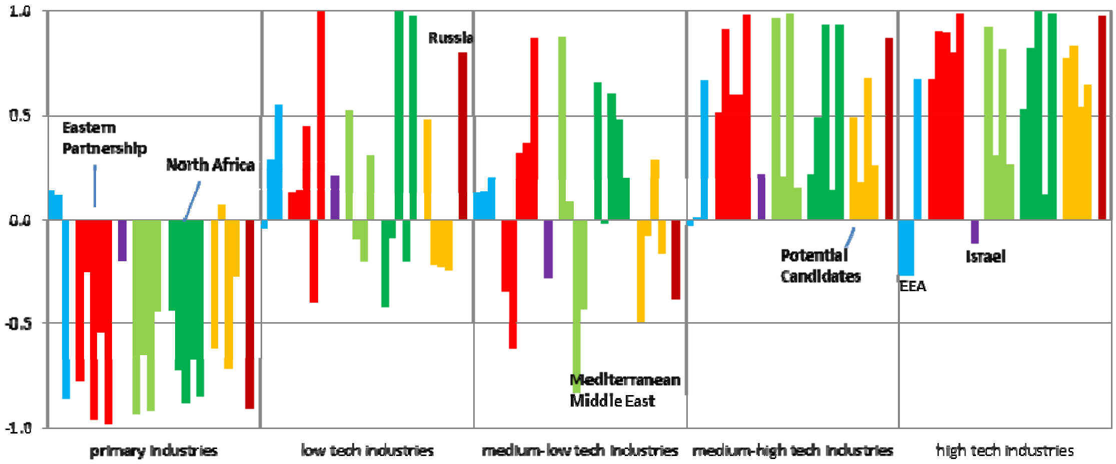
Note: Commodity exports are calculated as merchandise exports less manufacturing exports. Data for Liechtenstein, Kosovo and the Palestinian Authority are not available. For Syria and Libya, data refer to 2009 and therefore the regional average for the Mediterranean Middle East and North Africa also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

Source: WTO database; wiiw calculations.

Developing export capacities in the textile, leather and food industries is typical of how 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 increasing opportunities for multinational firms to move parts of their production processes abroad, it is possible that countries that attract the foreign direct investment implied by such offshoring activities could 'jump' straight into more technology-intensive industries. This has happened, for example, in the Central and Eastern European EU Member States that have been integrated into the European automotive industry networks, as well as in China, Malaysia and Thailand (which became 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 Western Balkan countries, and, arguably, Tunisia and Morocco on the Southern Rim.

Figure 6

Revealed comparative advantages (RCAs) in EU trade with the European Rim, industries classified by technology content, 2010



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

Source: Eurostat Comext; wiiw calculations.

While imports from the Rim countries are characterized by some extreme concentrations (mainly on primary commodities), the EU's exports to the European Rim 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. Taking the revealed comparative advantages (RCAs) of the EU's trade as a proxy for sectoral competitiveness, the EU has a pronounced comparative disadvantage in primary industries, including agriculture, fishing, mining and quarrying (Figure 6). By contrast, the EU has a strong revealed comparative advantage in high-technology and medium-technology industries such as chemicals (except pharmaceuticals), the machinery and the automotive industries. 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 and Egypt) have substantial textile industries. In the medium-technology industries, the metals and mineral industries explain the positive RCAs of Armenia and Ukraine. In the case of Russia and Belarus, it is mainly the petroleum-refining industry that explains the EU's revealed comparative disadvantage. Vis-à-vis EEA countries, the EU is almost in the opposite position – at least in trade with Switzerland and Liechtenstein (and Israel) – since it has a positive RCA in low- and medium-low-tech industries, but a comparative disadvantage in high-tech industries.

Box 1

Measuring the effects of EU trade liberalization

Almost all the countries of the European Rim have some sort of free trade agreement (FTA) with the EU or else there are EU autonomous trade measures (ATMs) or an EU generalized system of preferences (GSP) in place.[7] Hence, by 2010 the average EU tariff rate vis-à-vis the European Rim was only 0.4%. By contrast, EU exporters face an average weighted tariff rate of 5% in the Rim countries, with peaks of up to 19%. As a core component of the EU's 2020 strategy, EU trade policy pursues 'deep and comprehensive FTAs' (DCFTAs) within the framework of the Eastern Partnership and the Euro-Mediterranean Partnership. The aim is to bring all its 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).

This Box evaluates the effects of further trade liberalization between the EU and the European Rim according to three scenarios: 1) unilateral EU trade liberalization; 2) bilateral trade liberalization; and 3) customs union, where trade between the EU and the European Rim countries faces no tariff barriers and where the European Rim countries adopt the EU tariff rates against the rest of the world and give up their tariff protection against the EU. The model applied is the global simulation model (GSIM) for analysis of global, regional and unilateral trade policy changes proposed by Francois and Hall (2003). The solution of the model is reduced to those global prices that clear global markets. One of the assumptions of the model is national product differentiation; the elasticities of demand and import supply are held constant. This approach is used since a full-fledged general equilibrium model is not applicable, because many European Rim countries lack the necessary input-output tables. However, even the partial equilibrium approach provides useful insights, because it allows for a quick and transparent analysis of a wide range of trade policy issues with a minimum of data and computational requirements. The results can be interpreted rather as short-run effects (compared to general equilibrium long-run effects) and need to be treated with caution.

Overall, EU losses from trade liberalization with the European Rim – in whatever way performed (the unilateral, bilateral or customs union scenario) – would be negligible, and would be 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. Also, tariff losses could be compensated for by a considerable increase in EU gross output of 0.8% under the bilateral and the customs union scenarios. The gain from unilateral EU trade liberalization for the European Rim countries would be almost non-existent, as current EU protection in terms of tariffs is already negligible. Bilateral tariff cuts would mainly harm the European Rim countries, as tariff revenue losses would be quite considerable and the falling prices would cause certain output losses. Most European Rim countries would be net losers. This all changes in the case of customs union, as consumers on the European Rim could gain considerably from larger price drops.

7 Countries in the Eastern part of the Rim are in the process of negotiating FTAs (DCFTAs) – except Russia.

The main conclusion from the econometric analysis of the effects of trade agreements is that the EU trades more with larger economies from the Rim. Relaxing statistical significance levels, it is interesting to note that EU exports to the European Rim are quite sensitive to FTAs, while changes in tariff rates have no measurable impact. In the case of EU imports from the European Rim, it is precisely the other way around. EU tariff reductions in recent years have increased imports from the 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 to conclude FTAs with the remaining Rim countries, as FTAs seem to be correlated with more exports but not necessarily with more imports.

IV. Growth and productivity effects of foreign direct investment

Foreign direct investment (FDI) explains the intensity of firm-level integration between countries. This section looks at the changing role of the EU-based internationally operating companies (including SMEs) on the European Rim. 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 multinational corporations (MNCs) in capturing foreign markets. 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). Overall, outsourcing activity has declined during the recent crisis, and near-shoring may be preferred to far-shoring in the future. This opens up an opportunity for the Rim countries to benefit from offshoring from Europe. The size of FDI flows between the EU and the European Rim is analysed, with the aim of determining 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.[8]

The FDI activities of the EU have intensified with the countries outside the EU in recent years. FDI inflows from the Rim have fluctuated strongly around the ten-year average of EUR 16.9 billion (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); this was followed by almost no inflow in the subsequent year. In 2010, Rim countries contributed 15% (EUR 14.5 billion). The last three years point to lower than average inflows from the Rim,

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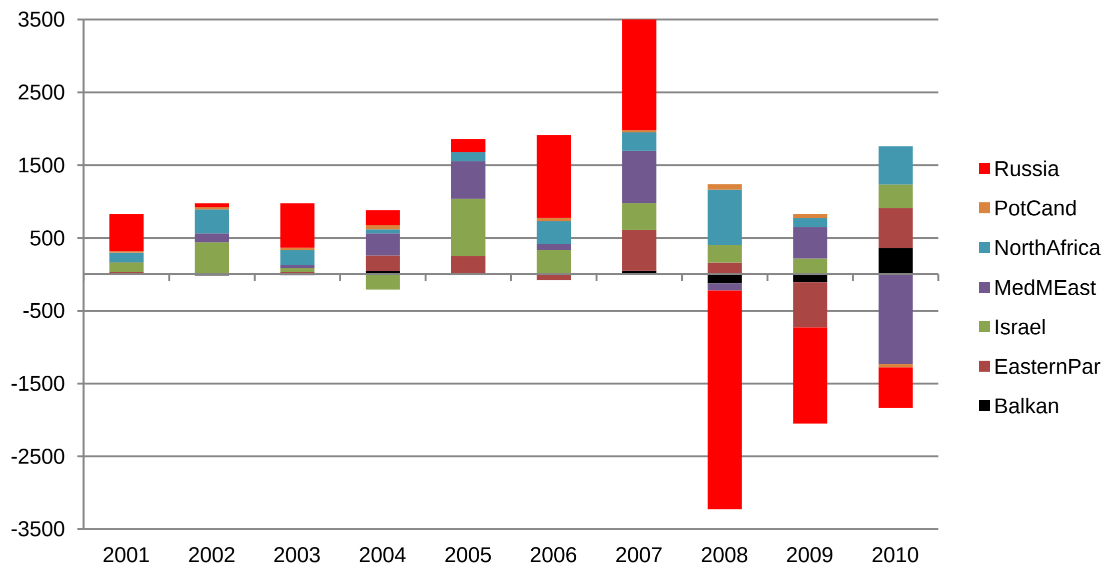
[8] This section relies on two main data sources. The first is the Eurostat Foreign Direct Investment Database, which provides consistent data on aggregate and bilateral FDI flows and stocks based on balance of payments national statistics. The second major data source is the FDI Intelligence database of the Financial Times Ltd (http://www.fdimarkets.com), which allows a most up-to-date analysis of greenfield FDI projects.

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 the Rim in the extra-EU outflows reached 42% (EUR 84.6 billion) in 2009 and 28% (EUR 55.2 billion) in 2010, far 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 if the EU has increased its share of the Rim's inward FDI.[9] Non-EFTA Rim countries are negligible investors in the EU, but they have received significant FDI flows from the EU (Figure 7a). 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 (Figure 7b).

As for EU members' inward FDI from the non-EFTA European Rim countries, the main investor is Russia. Russian firms invested the major part of non-EFTA FDI in the peak years of 2006 and 2007 (Figure 7a). It was also responsible for the massive capital withdrawals afterwards. In terms of EU outward FDI, Russia was the prime destination until 2008, with half or more of non-EFTA flows (Figure 7b). With 83% of total FDI stock in 2010, EU companies account for an overwhelming share of total FDI stock in Russia.[10]

Figure 7a

FDI inflows to EU members from Rim countries (except EFTA), EUR million

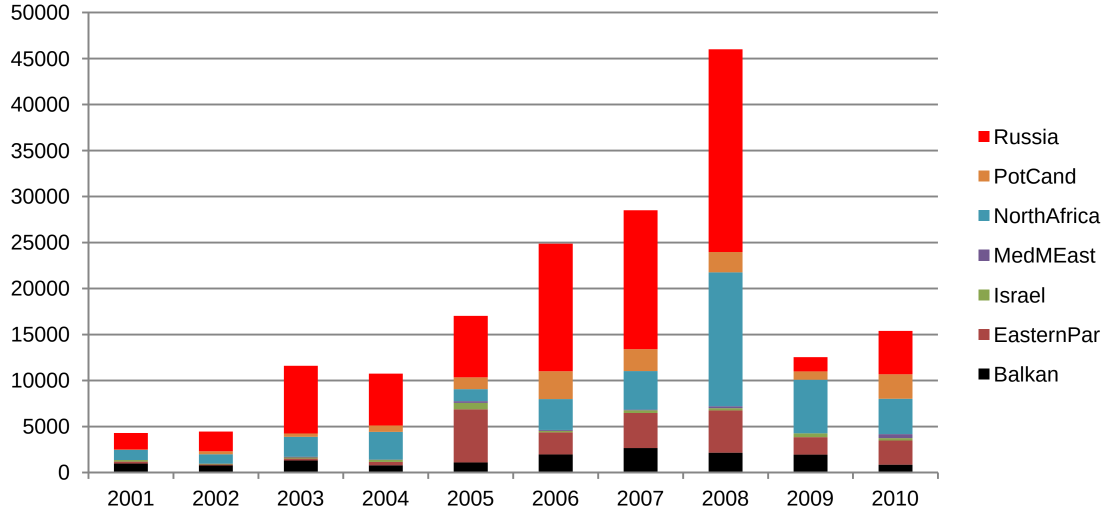


[9] Most of the European Rim-related extra-EU FDI flows are to and from the EEA/EFTA countries, in which Switzerland has an outstanding position. Almost all the inflows from the Rim to the EU also originate in the EEA/EFTA; inflows from the rest of the Rim were of a small positive sum in 2001–07, followed by years of divestment.

[10] 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).

Figure 7b

FDI outflows from EU member countries to Rim (except EFTA), EUR million



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).

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 in FDI annually from the EU over the past ten years. The other major recipient of EU FDI is Morocco, again with about EUR 1 billion annually throughout most of the 2000s. We know from host-country statistics that FDI in Algeria, Egypt and Libya went primarily into the petroleum industry. 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) in the Southern Rim region, followed by the Gulf countries. Europe's strong role can be attributed to geographical proximity and historical ties. France has retained strong positions in its former colonies of Morocco and Tunisia, while British and US firms have a leading position in Egypt.

Significant liberalization measures for the entry of FDI since the mid-2000s have boosted FDI, especially during 2006–08. Investment boom was followed by a setback – first the global crisis and then, in 2011, the events of the Arab Spring. Economic reforms sought to reinforce the attractiveness of countries to FDI. These included a wave of privatization in the telecoms and banking sectors, peaking in 2005–06. In addition, the inflow of petrodollars from the Gulf States led to a strong boom in the real estate sector. For example, increasing amounts of FDI in the Egyptian energy and services sectors followed a change of policy in 2006, when the country became more FDI friendly and also privatized some state-owned assets, allowing access to foreign investors. Similar policy changes took place in Tunisia, giving a boost to FDI in 2006. But even in these countries, several business sectors remain largely off limits to foreign investors, most widely the media, air transportation and natural resources. The Investing across Borders database of the World Bank places Tunisia in first place for openness to foreign investment in 2010; it is followed by Morocco and Egypt.[11]

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 undertaken by EU-based MNCs peaks in 2008, with lower levels in the three years before and since. 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. The main EU investor in the Rim is Germany (with a fifth of the projects), followed by France and the UK. The biggest interest of European MNCs over the past 11 years has been in Russia (40% of all EU projects and 50% of pledged investment - see Annex Table 3). Ukraine attracted 10% of the projects and 5% of the investment capital – relatively little, given the size of the country. In contrast to the Eastern Rim, the Western Balkan countries (especially Serbia) have a remarkably high number of projects relative to their size. Among the Southern Rim countries, Morocco and Tunisia also have fairly large numbers of projects in diverse industries, confirming that these are countries with a relatively liberal attitude to FDI. 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 Morocco, France and Spain are the important investors; while France is by far the most frequent investor in Tunisia. Egypt is a special case, as it combines a late opening of a large market with an important oil sector. The big oil producers of the European neighbourhood – Azerbaijan, Algeria and Libya – attracted a small number 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 FDI projects from historical, geographical and ideological allies – the Arab countries from the Gulf States and the CIS countries from Russia.

It is primarily the cumbersome local business environment on the Rim that limits FDI inflows (Section II). But the reforms undertaken in the mid-2000s have improved the conditions of doing business in several countries and have contributed to an upswing in FDI. Especially Morocco, Tunisia and Serbia, 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 by SMEs. European policies fostering trade and FDI and supporting the liberalization process have been beneficial both for the Rim countries and for European MNCs (including SMEs). Supporting open and fair competition and breaking local (often state-supported) monopolies could increase opportunities for further FDI and SME development on the Rim.

[11] The Arab revolutions of 2011 interrupted the period of rapid economic growth and had negative economic impacts on both trade and FDI.

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

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 was set out as a goal. 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). EU–Southern Mediterranean relations are currently organized mainly through the bilateral Euro-Mediterranean association agreements (apart from Syria and Libya). The latest chapter in the Euro-Med cooperation was begun on 14 December 2011, when a fresh round of trade negotiations got under way with Egypt, Jordan, Morocco and Tunisia. The aim is to establish deep and comprehensive free trade areas (DCFTAs) which will go beyond just removing tariffs and will cover all regulatory issues relevant to trade, such as investment protection and public procurement.[12] The EU will also support capacity building, and intends to pay particular attention to measures that can enhance regional economic integration, in particular the process launched within the framework of the Agadir Agreement – a free trade agreement between Egypt, Jordan, Morocco and Tunisia.

Some observers question whether the current association agreements (AAs) foster economic growth (Eurochambres, 2011; Kuiper, 2006). The main line of their argumentation is that trade agreements with many and substantial exemptions provide for few dynamic gains. Export benefits cannot be realized, as the AAs usually exclude agricultural and textile products, both of which are of vital importance for the Southern Rim countries. Besides, there are numerous impediments to competitiveness, such as trade border and technical barriers, public procurement, intellectual property rights, etc. (see also Section II above).

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 move towards the establishment of a full-fledged Euro-Med free trade area. However, regional economic integration between Southern Mediterranean countries is still limited: intra-regional trade is a small fraction (6% of exports, 5% of imports) of the Southern Rim countries' total trade (Annex Table 2).[13] Currently, the Southern Rim is one of the least business-friendly regions in the world. That also means that SMEs face extraordinary challenges both in establishing

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[12] 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.

[13] Trade data for the year 2008. Exports to the EU are ten times and imports from the EU eight times more relevant than intra-Southern Rim trade flows. Results of various gravity model calculations suggest that intra-Southern Rim trade is below its potential (Péridy, 2005).

a new business and in maintaining or extending an existing one. However, SMEs are of 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 European Investment Bank (EIB) and the European Bank for Reconstruction and Development (EBRD) will enhance their activities on the Southern Rim.

V.2 The EU and the Eastern Rim: hesitant integration and rivalry with Russia

The main institutional arrangements underlying relations between the EU and Eastern Rim countries (except Belarus),[14] are bilateral partnership and cooperation agreements (PCAs). In the sphere of the economy, PCAs aim 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.[15] They only offer the 'most favoured nation' (MFN) treatment of Eastern Rim countries' exports to the EU, which is meanwhile also provided by the various countries' World Trade Organization (WTO) membership (except Azerbaijan and – for the time being – Russia).[16] This makes PCAs essentially obsolete, at least when it comes to provisions affecting trade. The EU effective import tariffs on imports from the Eastern Rim countries are generally very low (see Section III above). Conversely, the Eastern Rim countries' level of protection against imports from the EU is considerably higher.[17]

All Eastern Rim countries except Russia are also covered by the EU Eastern Partnership (EaP) initiative, which 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' of Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine with the EU. Cooperation within the framework of EaP has concentrated on 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: on integrated border management, support for SMEs, energy efficiency, civil protection, and the environment

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[14] Although negotiations on a PCA 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 conclusions of the Foreign Affairs Council.

[15] The prospects of free trade with the EU are explicitly stated in the respective PCAs, provided the country in question has joined the WTO and 'made sufficient progress towards common values and principles'.

[16] 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.

[17] Except for Georgia, which is the most open country for imports, since it has radically liberalized its foreign trade regime as part of a broader economic reform package implemented following the 'rose revolution' of 2004.

(European Commission, 2010d). From the outset, Russia has not been covered by EaP,18 while the implementation of EaP in Belarus has stalled for political reasons.

The current EU strategy towards EaP countries is to negotiate DCFTAs, which are seen as a 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 in the pipeline). The DCFTAs aim to liberalize trade in goods and services, but also to ensure 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 sanitary rules, animal welfare, and intellectual property rights. The idea is to create, through the adoption of these reforms, a favourable business climate that can accelerate the inflow of FDI into the country, particularly from the EU (De Gucht, 2011).

The impact of 'deep' free trade with the EU should be much greater, and more positive, for the EaP countries than that of 'simple' free trade (which may even turn out to be negative – see Section III). This is due to the potential benefits of structural reforms in the EaP countries that are stipulated by the 'deep and comprehensive' free trade with the EU. Francois and Manchin (2009) found that a simple FTA with the EU would lead to a decline in the Commonwealth of Independent States' (CIS) GDP of between 0.1% and 0.4%, depending on whether trade in agricultural and food products is liberalized or not. In contrast, a DCFTA with the EU would boost the CIS's GDP by 1.2%.[19] 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 Ukraine, whose GDP should be boosted in the long run by 5.8%, followed by Armenia (3.1%), Azerbaijan (1.8%) and Georgia (1.7%). These overall gains will, however, 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 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 might be expected in the case of a simple FTA with the EU (Movchan and Giucci, 2011). Finally, the experience of Turkey, whose entry into a 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).

[18] 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, for example, Wallace (2009). Instead, Russia seeks a 'special' strategic partnership with the EU as a follow-up to the expired PCA.

[19] For Ukraine, Francois and Manchin (2009) found a negative effect even under a 'deep' free trade scenario.

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 the prospect of more formal membership. In other words, DCFTA – as with WTO membership – may be only a weak institutional anchor that is not sufficient to underpin the necessary reforms (see Havrylyshyn, 2008). Against this background, Emerson (2011) 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.[20]

Another problem area is that the already negotiated DCFTA with Ukraine only partly incorporates agricultural and food products. This is also likely to be the situation with DCFTAs with other EaP countries. As with the MENA region, leaving agriculture outside 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. At the same time, a failure of DCFTAs would have negative consequence for both sides. The EaP countries may find themselves stuck in the current low-competitiveness and instability trap. The recent experience of the new EU Member States suggests that the massive inflows of FDI from the 'core' EU, which boosted their competitiveness, economic restructuring and quality upgrading, were largely 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) and hamper the development of SMEs.

The EU perceives the regional integration 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 on the Eastern Rim involving Russia (and there is hardly any integration on the Eastern Rim without Russia, given the latter's economic size). This contrasts with 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.

20 However, the experience of MENA suggests that this approach has not been particularly successful either.

Box 2

Russia and the EU as 'strategic partners'

Russia is by far the biggest economy on the Eastern Rim; it is also the EU's second-largest export destination and the third-largest source of imports, in particular of energy (see Section III). However, the EU's integration with Russia is not very advanced: Russia is not covered by the Eastern Partnership initiative, partly because it sees itself as 'special' – see, for example, Havlik (2010). The EU–Russia PCA, which has been in force since 1997, is still the main document underlying bilateral relations. Within the framework of the PCA, 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 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.

Negotiations of a new contractual document underlying EU–Russia relations 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 in August 2008. The EU eastern enlargement of 2004/2007 brought additional complexity to EU–Russia relations. Under circumstances of EU disunity, it was often easier for Russia to cooperate with individual European countries (especially Germany and Italy) rather than with the EU Commission in Brussels. Russia's forthcoming WTO accession potentially opens a door to free trade negotiations with the EU – a possibility explicitly envisaged by the current PCA. However, given the 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 rapid.

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 term (10–15 years) by contributing to diversification and modernization of the Russian economy. However, Russia is reluctant – to a much greater extent than the EaP countries – to unilaterally adopt the EU standards required for this.[21] Instead, Russia advocates a 'symmetrical' approach in its relations with the EU, implying that the two sides should have equal rights and obligations. This 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 of '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.

[21] 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 – see Matta (2009).

Box 3

Regional integration in the post-Soviet space: implications for the EU

Unlike the situation with MENA, the Eastern Rim countries are relatively well integrated. 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). All Eastern Rim countries, except Georgia,[22] 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, for example, anti-dumping duties and quotas. The most advanced integration bloc 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 monetary union. On a wider scale, Belarus, Russia and Kazakhstan initiated a customs union (CU) in 2009. The participating countries have eliminated all remaining non-tariff barriers in mutual trade, have unified their trade regimes vis-à-vis third countries, and have 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 for the free movement of goods, services and capital, but also of labour (which is not covered by DCFTAs) and, gradually, to widen the post-Soviet space to create a EuroAsian Economic Union. Among the EaP countries, the Belarus–Russia–Kazakhstan CU project is potentially relevant for Ukraine. This has on several occasions caused the EU to voice some concern. 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. However, Ukraine has been insisting on the '3+1' formula of cooperation, rather than on full-fledged CU membership.[23] Under these circumstances, Ukraine's full 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 above all Russia – advance their own integration with the EU at least to the stage of a free trade area. As is argued in Box 2, the prospects for the latter are currently bleak. However, EU–Russia integration is a potentially preferred option for the future; when accompanied by a parallel integration of the EaP countries, this would lay the foundations for a pan-European economic space.[24]

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22 Georgia left the CIS after the Russian-Georgian war over Abkhazia and South Ossetia in August 2008.

23 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.

24 This option was recommended, for example, in Havlik (2010) and Glinkina and Kulikova (2007).

VI. Labour markets and migration on the European Rim

The impact of increased labour migration from neighbourhood countries is of particular interest to EU policymakers. The MENA region is recognized as a region of emigration, with the total number of first-generation emigrants somewhere between 10 million and 13 million (World Bank, 2011j). The increasing differences in economy, demography, politics and security matters, together with its geographical proximity, make the EU the main destination for migrants from the MENA region. Immigrants from the MENA countries represent 20% of the 30 million immigrants in the EU, and they make up 6% of the population of the EU. Following the Arab Spring, the flow of migrants from the region is expected to rise. Moreover, the MENA region is a transit route for migrants from other, more distant regions. Consequently, the EU's migration policy towards this region can be expected to evolve significantly.

The promotion of mobility of citizens from the EaP countries represents one of the EU's main commitments in the Prague Declaration of the Eastern Partnership Summit of May 2009. As a contribution to a more ambitious partnership with its Eastern neighbours, this commitment builds on 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 countries, some of which are candidates or potential candidates for EU membership and most of which have recently benefited from visa liberalization (except Kosovo), are experiencing a new migration development, since their citizens have started to travel to the EU without a visa.

The development of migration management systems has been uneven across these regions, not least due to differences in available resources and in the general development of the quality of public policy institutions. The links between migration and employment or education policies remain vague in all countries of the region (ETF, 2011); but these links are certainly relevant for those 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 to gain employment and is a reaction on the part of the population to social and economic crisis and internal conflict. The following sections examine the key labour market issues in the European Rim and provide an overview of the main characteristics of migration and remittances over the past decade.

VI.1 Labour markets in European Rim countries

VI.1.1 Eastern Partnership countries and Russia

The population structure in the Eastern Rim countries 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 and Russia. Ageing of the population in these economies will pose a serious risk to the welfare system. With the exception of Russia, the economic activity rates are below the EU average of 71%. A salient feature of the labour market in the Eastern Rim countries is the high activity rate of females; in most cases it is comparable to the EU level (and is distinctly higher than on the Southern Rim).

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. Agriculture in Moldova, Azerbaijan and Armenia can barely be considered to be an economic sector (in the sense used in developed economies), as 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' (ETF, 2011). 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 employment in the service sector has been rising steadily in Moldova, Ukraine and Russia. In the latter two countries the service sector accounts for about 60% of total employment. The fragility of the labour markets is highlighted by the high proportion of self-employment – 64% in Georgia, 58% in Azerbaijan, 39% in Armenia and about 30% in Moldova. Unemployment has been relatively low in most Eastern Rim countries. However, given the high proportion of self-employment (subsistence agriculture) in these countries, unemployment is probably much higher (European Economy, 2011).

VI.1.2 Southern Rim

A feature of the MENA countries is the high share of young people in their populations: almost a third of the population is younger than 14. This is double the rate of the EU countries. As a consequence, the working-age population in the MENA region will continue to grow in the coming decades. The large inflow of new labour market entrants, combined with lower rates of workers retiring and new job creation, has and will put enormous pressure on Southern Rim 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%.

Activity rates are very low in the MENA region and have grown only modestly (if at all). This is mainly due to low female activity rates, ranging from 14% in Syria to 32% in Libya. Israel is the only country in the region where female labour force participation (61%) is comparable to EU levels. Employment patterns by broad economic sector differ substantially across the region, but agriculture is still an important employer almost everywhere. Industrial employment is highest in Tunisia (35%) and Syria (32%), while Israel, Jordan and Morocco show the lowest shares (around 20% each). A breakdown of service sector employment shows that administration (government services sector) 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 services sector, trade, tourism and communications are the major employers (World Bank, 2011d). Together with construction and, in some cases, agriculture, these sectors have also been the major drivers of employment creation in the past couple of years. The public sector – including government agencies, military and state-owned enterprises – is the preferred source of employment for graduate (female) workers in the MENA countries and accounts for up to 35% of total employment. Employment in the public sector offers higher wages, employment protection, shorter working hours and other social benefits. In the past, the rise of public sector employment has been driven by governments' 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 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 guarantees; despite the reforms, however, the public sector wage bill still accounts for 8–10% of GDP in most countries (European Economy, 2011).

In 2010, the unemployment rate in the MENA countries reached about 10%. However, unemployment among people with a university (and secondary) education is considerably higher than among people with low (or no) education. This represents a particular challenge, though the number of university graduates is still very low in the MENA region. Youth unemployment is considered to be a major challenge: youth unemployment is highest in the Palestinian Authority (39%) and in Tunisia (31%) and is between 14% and 18% in Israel, Lebanon and Morocco. In the remaining countries, youth unemployment stands at about 20%. The 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 (European Economy, 2011). The crisis has affected mainly export-oriented firms in certain Southern Rim countries (Egypt, Libya, Syria and Tunisia), as well as migrant workers. On top of the huge pressure of young cohorts entering the labour market, the various 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 - see Galal and Reiffers, 2011).

VI.1.3 Western Balkan countries

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 population in the age group up to 14 years. The entire region also has low activity rates, with extremely low levels in Kosovo (below 50%) and in Bosnia-Herzegovina; in Albania and Serbia the figure is about 60%. Female participation in the labour force is particularly low in Kosovo and Bosnia-Herzegovina among certain ethnic groups. The region exhibits a high share of agricultural employment (Albania is the extreme case, where 44% of the total workforce is employed in agriculture; in this respect it is similar to Georgia and Morocco). Employment in industry is highest in Bosnia-Herzegovina (31%) and is about 25% in Serbia and Kosovo. The service sector is less developed in the Western Balkan countries: it accounts for about half of total employment in Serbia and Bosnia-Herzegovina, and for only 37% in Albania. Kosovo is a special case, where recent statistics report that the service sector accounts for 70% of total (under)employment. In Serbia, nearly 30% of those employed had a vulnerable job in 2009 (either self-employed or unpaid family workers).

Unemployment in the Western Balkan countries is very high – the highest of the European Rim countries. Apart from the extreme of Kosovo, where the unemployment rate stands at 45%, unemployment is highest in Bosnia-Herzegovina. Albania is the only country where unemployment has remained flat in the past couple of years, presumably thanks to outward migration. Unemployment has a disproportionate impact on young people. As in some European Rim countries in the East, there is a sizeable and persistent regional imbalance in unemployment, which suggests that there are major barriers to regional labour mobility. In many cases young people lack the skills and professional experience for employment, so their option is 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. It can be assumed, however, that the high figures for long-term unemployment are distorted due to the large flows between the formal and the informal sector.

VI.1.4 EFTA countries: Norway, Switzerland and Liechtenstein

All three EFTA countries under consideration – Norway, Switzerland and Liechtenstein – have experienced population growth over the past decade. Their labour markets are characterized by low unemployment and high activity and employment rates, the latter reaching over 75% throughout the region. In all three countries, unemployment is very low compared with the EU – another feature of the Rim's diversity.

VI.2 Migration in the European Rim

Although the upcoming demographic challenges for European labour markets have been broadly recognized, the recent financial and economic crisis has reduced the momentum of labour migration policy, both within and outside the EU. In the longer-term perspective, however, the Europe 2020 strategy recognizes the need for a comprehensive labour migration policy and for better integration of migrants, in order to meet the Union's goals for smart, sustainable and inclusive growth. The turmoil of the Arab Spring generated a new wave of mass migration, particularly from Tunisia, where illegal attempts to reach Italy increased significantly in late 2010 and early 2011 (FRONTEX, 2011). The sizeable movement of irregular migrants induced both governments to sign bilateral agreements with potential migration countries, with the goal of halting the irregular crossing of coastal borders. Moreover, climate change and environmental disasters have generated another flow of migrants from outside the Rim – people who have to migrate because of unsustainable conditions at home. But this section focuses only on migration patterns of the Rim countries.

VI.2.1 EaP countries and Russia

The latest data available for the stock of migrants from the EaP region show that in 2010 the number of migrants reached almost 11 million – a figure only slightly below the total stock of migrants from Russia. Among the EaP countries, the largest contributor to this stock is Ukraine (more than 6 million). Of the other countries, Azerbaijan and Georgia have a stock of migrants above 1 million; Armenia and Moldova do not reach that level. The preferred destinations for Eastern Rim migrants are Russia and the EaP region itself, which hosts more than half of the migrants from EaP countries. Migrants from Eastern Rim countries make up 12% of the migrant stock in the EU (in absolute numbers, the EU hosts around 1.4 million migrants from the EaP region and 1.1 million from Russia). The EaP country with the largest share of immigrants in the EU is Moldova (with more than 24%). The EU countries that host the largest number of Eastern Rim migrants are Germany, Poland, Spain, Greece, Italy, Estonia and Latvia.

VI.2.2 Southern Rim countries

Southern Rim countries have a very dynamic population and large migrant stocks; furthermore, several of them serve not only as sending and receiving countries, but also as transit countries. Figure 8 shows that before the Arab Spring, the stock of migrants was above 12 million – the highest of the Rim regions. The countries with the largest stock of migrants are Egypt and Morocco. Other countries, such as Algeria and Israel, have a stock of migrants above 1 million, while the rest of the countries are below this level. The EU is the main destination region, hosting more than 40% of migrants from the Southern Rim, particularly Morocco, Algeria and Tunisia. In addition, almost a third of migrants from Lebanon and Libya have moved to the EU, while only 7% or less of migrants from Egypt, Israel and Jordan find their way to the EU. The main destination countries for Morocco's migrants are France, Italy, Belgium, Germany and the Netherlands, while more than 80% of Algerian and Tunisian migrants are in France. The flow of migrants from the Southern Rim countries to the EU was showing an increasing trend, reaching a peak of 180,000 in 2008. However, as with the inflow of migrants from the Eastern Rim, the flow from the Southern Rim countries has declined significantly in the wake of the recent financial crisis.

VI.2.3 Western Balkan countries

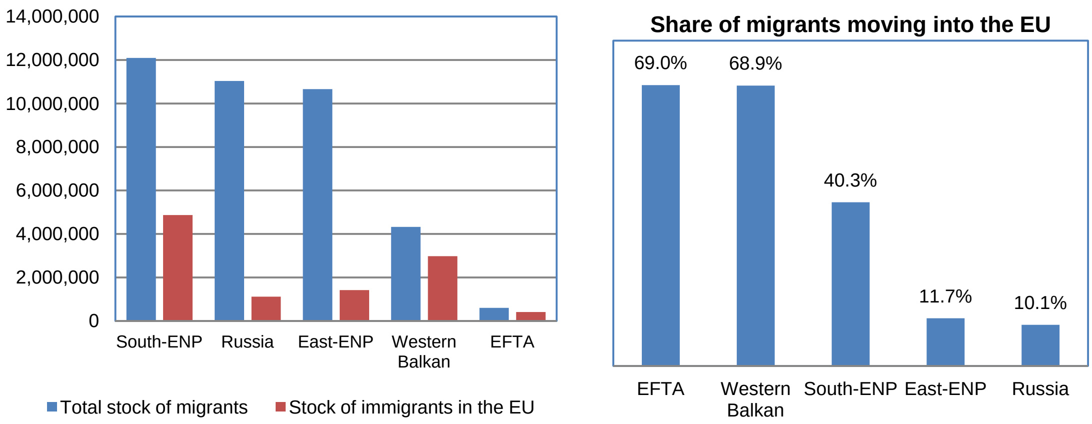
The Balkans have a rich experience of migration, as most Balkan countries share common borders and cultural ties with the old and new EU Member States. The total stock of migrants from the Western Balkans is around 4.5 million; the main sending countries are Bosnia-Herzegovina and Albania, each with a stock of emigrants above 1.4 million. However, while 85% of Albanian migrants have migrated to the EU, only half of migrants from Bosnia-Herzegovina have chosen EU as their destination. The 2011 visa liberalization contributed to an intensification of circular migration and to a reduction in illegal migration to the EU. There have been fewer cases of Albanian migrants illegally crossing the EU border and overstaying the visas in an EU country (FRONTEX, 2011). However, there has been an increase in the number of applications for international protection (asylum) submitted in the EU, particularly from migrants from Serbia and Macedonia. The difficult economic situation in Greece has obliged many Albanians to return home, many for good, but some also just temporarily.

Overall, the migration records of Rim countries confirm that migration is a crucial factor affecting the growth and development of all the countries in the region. The large outflows of population result in significant changes in the socio-economic composition and demographic trends in both the sending and the receiving countries. Emigration from the Southern Rim countries to the EU is one of the main features. Flows have intensified and continue to increase significantly, especially towards Southern EU countries. Moreover, emigration from Algeria, Libya, Morocco and Tunisia tends to be mainly towards the EU and is considered to be more permanent (Fargues, 2008). For Eastern Rim countries, even though they already have large stocks of migrants in the EU, the EU is not the main destination region (Figure 8).

The international economic and financial crisis has hit migrant workers hard, especially those who used to work 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 requisite standard. The predicted return migration, particularly of those migrants who had irregularly employment or who have been long-term unemployed, has not been very considerable, in spite of voluntary return programmes offered by various EU countries. 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 put the non-migrants at home under pressure. 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 economy, would shrink, thus resulting in a further deterioration in the situation in the country of origin.

Figure 8

Overview of migrants from the European Rim, 2010



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

VI.3 Trends in remittances

VI.3.1 EaP countries and Russia

Migration and remittances have both shown an increasing trend over the last 20 years, generating significant welfare gains either for the home country of migrants or for the migrants themselves. Whereas 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 12.322 billion. Moldova has the highest share of remittances in its GDP (23%), and remittances are among the main contributors to developments on the labour market (Figure 9).

VI.3.2 Southern Rim countries

The overall amount of remittances in 2011 was around USD 33 billion – three times higher than in 2001. The main receiving countries were Lebanon, Egypt and Morocco. In particular, Morocco has the highest level of remittances as a share of GDP (20%). There are serious risks of a downward trend because of persistent unemployment in Europe and precarious employment prospects for existing migrants, as well as rigid immigration policies (Mohapatra et al., 2011a, b). In Libya, Tunisia and Egypt, a massive number of migrants returned home or were deported back to their country of origin during the Arab Spring. Such developments might negatively affect the future flow of remittances to the country of origin.

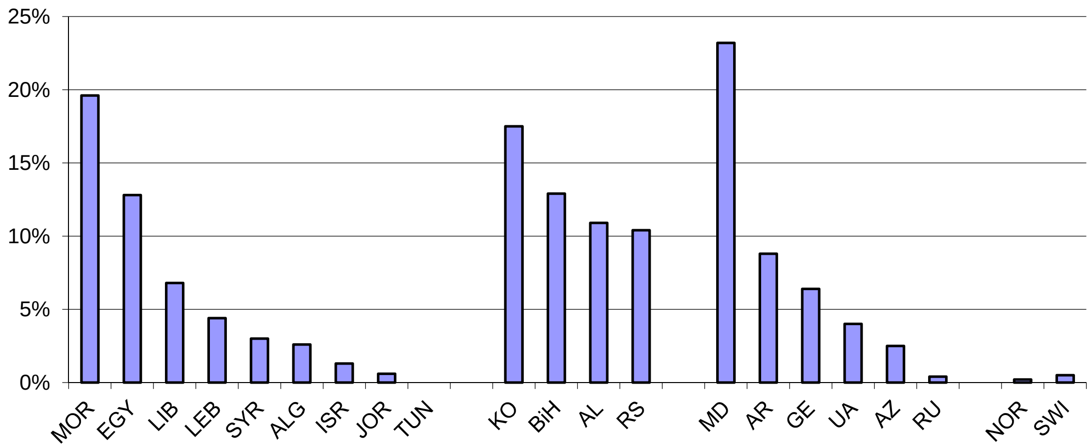
VI.3.3 Western Balkan countries

Remittances strongly affect the economic development of the Western Balkan region, in particular Kosovo, Bosnia-Herzegovina and Albania, where the share of remittances in

GDP is, respectively, 18%, 13% and 11%. In 2011, the flow of remittances to the Western Balkan countries reached nearly USD 10 billion – three times more than in 2002. As with other regions, most of the Western Balkan countries recorded a decline in the flow of remittances during 2008–09, but in 2011 there was again an increase of 6% compared to 2010. The difficult economic situation in the EU (particularly Greece, Spain and Italy) raises a concern that there will be less demand for migrant workers, which might trigger a massive return migration and depress flows of remittances accordingly. The forecast for Albania is that remittances will continue to fall if migrants continue to return from Italy and Greece.

Figure 9

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



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

VI.4 Labour migration and EU competitiveness

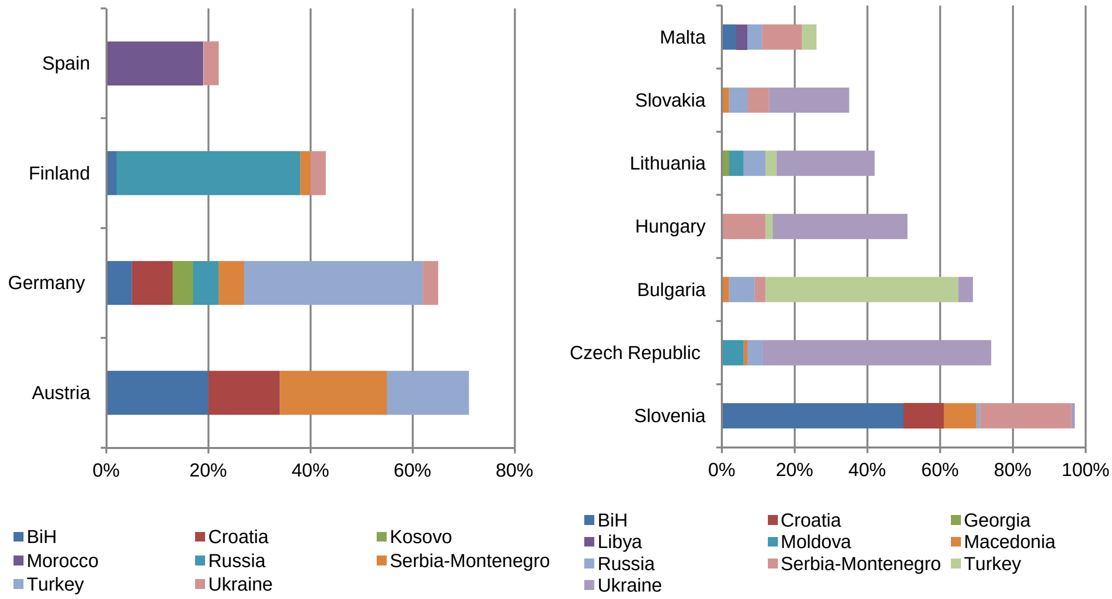
One of the objectives of the EU is the reinforcement of competitiveness on the international arena. In view of recent developments, in particular a shrinking population and labour force, the potential labour market shortages put the economic competitiveness of the EU at risk. In this context, labour 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.[25] The recent economic crisis has forced the EU Member States to introduce severe austerity 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 insufficient number of skilled native workers with the appropriate level of qualifications and skills. Migration within

[25] Fargues (2008, 2011) argues that between 2005 and 2030, the working population of the EU is set to decline by 24 million; this can be contrasted with an increase in the MENA region of 156 million.

the EU, particularly migration from the new EU Member States towards the EU-15, has generated labour market shortages in several new EU Member States as well.

Figure 10

Migrant workers from the Rim in selected EU countries, 2009 (% of total)



Source: Own elaboration using EMN (2011) data.

In contrast, demographic trends indicate that the Southern Rim countries will experience a significant increase in the working-age population that will exceed the demand on the domestic labour market. It is highly probable that a considerable number of young, and particularly well-educated, people will not find a place on the domestic labour market and will be forced to migrate. Several EU Member States have adopted national strategies that aim to mitigate the demand for labour through the migration of third-country nationals, and in particular migrant workers from Rim countries.[26] The available data about the presence of third-country workers in the EU demonstrate that Rim countries account for a large share of migrants and 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 (Figure 10).

26 For instance, Mobility Partnerships signed with Moldova, Georgia and Armenia aim to manage the migration flows and to combat illegal migration. 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. Through an EU Mobility Partnership, Lithuania has entered into an agreement with Moldova and Georgia, and another agreement has been signed with Ukraine and Russia. The Czech Republic has also signed a number of agreements with Ukraine, with the purpose of targeting potential immigrants.

VII. Conclusions

Countries belonging to the European Rim 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 EU institutional relations with individual Rim countries and for Rim countries themselves – including their competitiveness.[27]

More specifically, regarding EU–Rim institutional relations, the key question is whether the current EU approach – which aims basically at the conclusion of bilateral DCFTAs 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.[28] Most of the reviewed literature suggests that it is not. Apart from 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 detrimental.

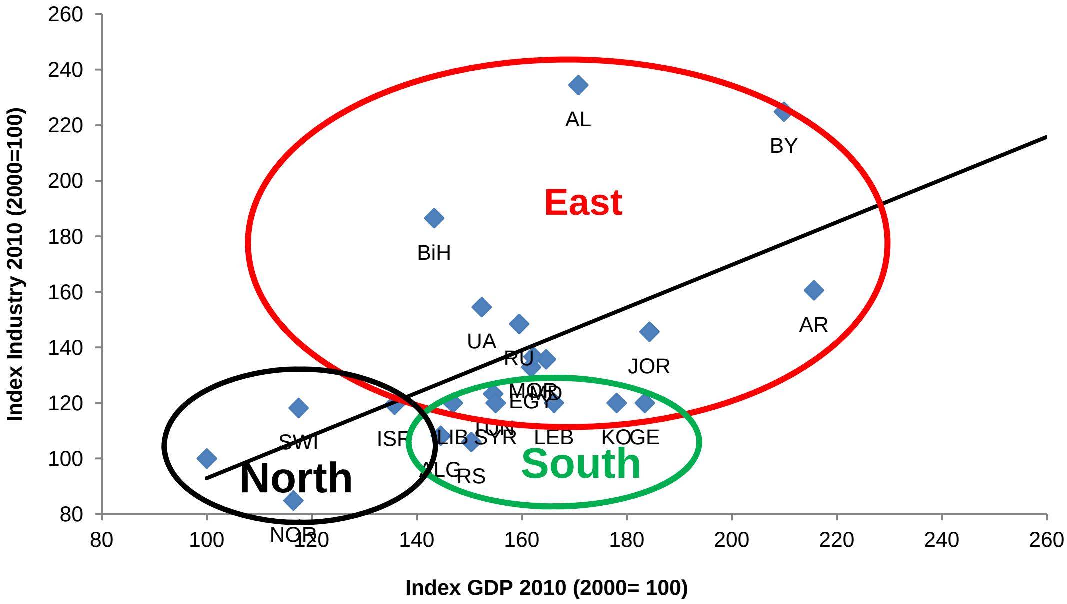
Regarding the economic development model, except for in the 'North' and Israel, the economic growth of Rim countries and their progress in catching up (if any) have been the result not of increased exports, but in most cases (apart from energy exporters and tourist destinations) have originated with the expansion of domestic demand; and this has frequently been financed from transfers (aid and remittances to resource-poor countries). As is shown in Figure 11, the growth of industry in the majority of Rim countries, in particular in the Southern cluster, is lagging behind the growth of GDP. The recent experience of Southeast Europe shows that the pre-crisis neglect in building up a viable trade sector and sufficiently competitive export capacities has aggravated the crisis. Policies leading to expansion of the export sector will have to take priority, and the use of different policy instruments (labour market, investment promotion and institutional development) will have to be strengthened (Gligorov et al., 2012).

[27] 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).

[28] For a recent critical appraisal see Schumacher (2012).

Figure 11

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



Source: Annex Table 1 (see also for country codes).

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 that adversely affects particularly SMEs. 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, the use of foreign technology, labour market regulations and workers' skills).

The Rim countries are relatively minor trading partners for the EU and do not pose any serious challenge to EU competitiveness. However, the trade asymmetry – the EU being usually the main trading partner of the Rim countries – is challenging, not least for the formulation of EU policies, since any bilateral deal has much greater consequences for the Rim than for the EU. Trade asymmetry and the underutilization of the trade potential provided by the geographical proximity of the Rim should be overcome. In particular, the proximity of the huge EU market can be regarded as the Rim's locational competitive advantage – thus far largely unexploited. Each of the sub-regions within the European Rim is a focus area in terms of trade flows for at least one sub-region of the EU. 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.

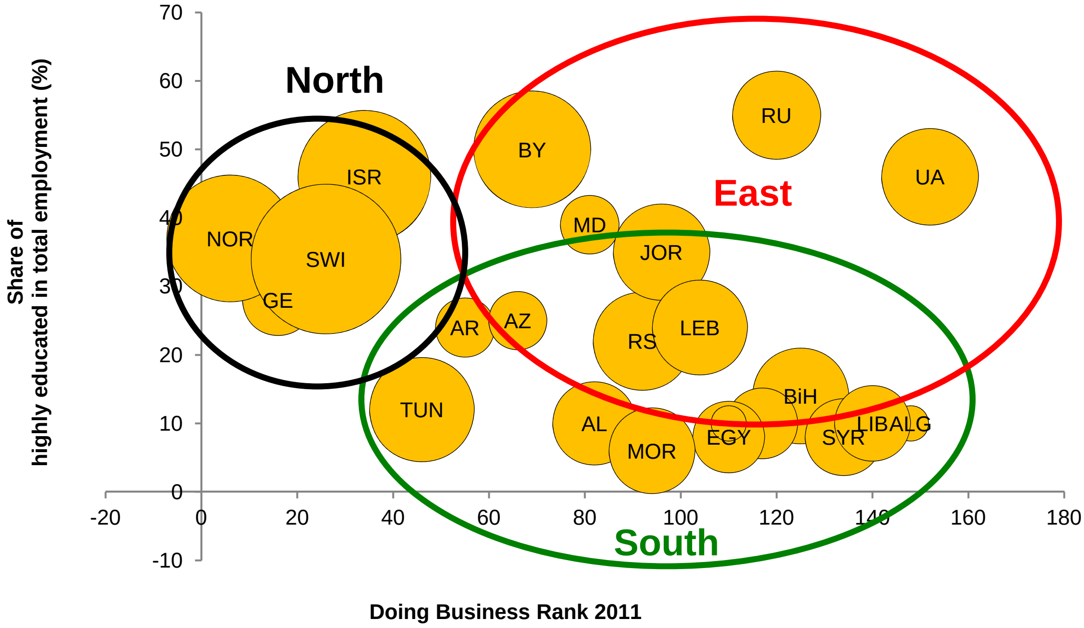
Limited diversification of the Rim's exports (except for in the advanced North) is one of the greatest stumbling-blocks to the region's competitiveness. Attempts to improve the international competitiveness of the Rim countries – such as product and labour market reforms, but also liberalization efforts 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 external 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 from the trade simulation exercise, which predicts significant short-term output losses in the European Rim countries in the bilateral liberalization scenario.

European FDI plays a primary role in the European Rim region. FDI by European companies, including SMEs, can exploit locational benefits, though the poor business environment in the Rim limits FDI inflows. Improved conditions for doing business benefit local SMEs and EU investors alike. SMEs have benefited especially in countries like Serbia, Morocco and Tunisia – countries that have attracted fairly large numbers of greenfield FDI projects in diverse industries. Further policy reforms should take place in order to open the remaining restricted sectors in the Rim countries. Open and fair competition, breaking local (often state-supported) monopolies, could increase opportunities for further FDI flows and the development of SMEs.

A major 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 persisting frozen or open conflicts are obviously not helpful either). Numerous trade barriers exist in both the Eastern and Southern parts of the Rim. In the Southern part of the Rim, the limited intra-regional integration is viewed as the key obstacle to FDI, trade diversification and growth. In the Eastern part of the Rim, attempts at a revival of Russian-led regional integration (the Russia–Belarus–Kazakhstan customs union) have not been encouraged by the EU. 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 (Baldwin, 1994). However, without the proper 'membership anchor', such arrangements are probably not sufficient to foster reforms, regional integration and a sustainable development on the Rim. Therefore, a more ambitious design of EU trade agreements with the neighbourhood countries was advocated (Dreyer, 2012).

Figure 12

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



Source: Annex Table 1.

Demography and labour market developments are among the crucial areas affecting competitiveness, yet are frequently neglected in this context. The European Rim is characterized by large informal sectors, labour market segmentation, high unemployment and large-scale migration. 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, and thus large cohorts are entering the labour market every year. All other countries are facing ageing (and often shrinking) populations; this exerts serious pressure on the welfare systems and potentially impedes competitiveness (as in the EU).
- Activity rates are below 50% in all Southern Rim countries – except Israel – and in Kosovo. Labour force participation in the Eastern Rim countries is similar to that in new EU Member States, and can even exceed the EU average.
- The employment gap between males and females is substantial in some Western Balkan countries and in the MENA region. On the other hand, female labour force participation in the Eastern Rim countries is traditionally high and is comparable to that found in the EU.
- Eastern Rim countries (with the exception of Russia and Ukraine) show a high share of persons in vulnerable employment. On the Southern Rim, 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, with more highly educated workers on the North and Eastern Rim than in the South.

Matching the potential bottlenecks in EU labour demand with the excess labour supply in the Southern Rim countries could sustain the international economic competitiveness of the EU. The promotion of circular migration and different programmes that induce temporary migration is a challenging option for satisfying labour shortages in the EU which should not be neglected.

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Glossary

AA	Association Agreements
ATM	Autonomous Trade Measures
CIS	Commonwealth of Independent States
COMECON	Council for Mutual Economic Assistance
CU	Customs Union
DCFTA	Deep and Comprehensive free Trade Agreement
EaP	Eastern Partnership
EEA	European Economic Area
EFTA	European free Trade Association
FDI	Foreign Direct Investment
GSIM	Global Simulation Model
MENA	Middle East and North Africa
NMS	New EU Member States
PCA	Partnership and Cooperation Agreement
RCA	Revealed Comparative Advantage
SME	Small and Medium Sized Enterprises
WTO	World Trade Organization

ANNEX TABLE 1

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

Country codes	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 [1]	EU-15	EU-27 [2]
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* [3]	*44.6* [3]	*44.1* [3]
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* [3]	*51.2* [3]	*50.6* [3]
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* [3]	*-6.6* [3]	*-6.6* [3]
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* [3]	*82.9* [3]	*80.2* [3]
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* [4]	*3217* [4]	*2776* [4]
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* [4]	*115.9* [4]	*100* [4]
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* [5]	*29.1* [5]	*30.4* [5]
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* [5]	*29.5* [5]	*30.9* [5]
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* [5]	*9.8* [5]	*9.7* [5]
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* [5]	*8.5* [5]	*8.4* [5]
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* [5]	*0.1* [5]	*-0.17* [5]
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*

ANNEX TABLE 1 (contd.) Country codes	ALG Algeria	EGY Egypt	MOR Morocco	TUN Tunisia	ISR Israel	JOR Jordan	LEB Lebanon	PAL Palestinian Authority	SYR Syria	LIB Libya	NOR Norway	SWI Switzer-land	Year 2009 Liechten-stein	NMS-10 [1]	EU-15	EU-27 [2]
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* [3]	*44.6* [3]	*44.1* [3]
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* [3]	*51.2* [3]	*50.6* [3]
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* [3]	*-6.6* [3]	*-6.6* [3]
Public debt, nat. def., in % of GDP														*47.1* [3]	*82.9* [3]	*80.2* [3]
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* [4]	*3217* [4]	*2776* [4]
Average gross monthly wages, EU-27=100	.	.	.	.	.	.	.	.	.	.	209.6	182.1	150.6	*32.3* [4]	*115.9* [4]	*100* [4]
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* [5]	*29.1* [5]	*30.4* [5]
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* [5]	*29.5* [5]	*30.9* [5]
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* [5]	*9.8* [5]	*9.7* [5]
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* [5]	*8.5* [5]	*8.4* [5]
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* [5]	*0.1* [5]	*-0.17* [5]
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.

Annex Table 2a

EU merchandise exports to the European Rim countries, 2010

Exporter	destination region:	European Economic Area		Potential Candidate Countries		Eastern Partnership Countries		Russia		North Africa		Mediterranean Middle East		Israel		extra-EU 27	
EU27	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	
Core EU	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	
Northern EU	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	
Western EU	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	
Southern EU	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	
Eastern EU	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	

Annex Table 2b

EU merchandise imports from the European Rim countries, 2010

Importer	source region:	European Economic Area		Potential Candidate Countries		Eastern Partnership Countries		Russia		North Africa		Mediterranean Middle East		Israel		extra-EU 27	
EU27	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	
Core EU	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	
Northern EU	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	
Western EU	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	
Southern EU	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	
Eastern EU	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	

Source: Eurostat Comext, wiiw calculations.

Annex Table 3

Number of greenfield investment projects and pledged FDI from the EU to European Rim countries, 2003-2011

Destination Country	Number of EU projects	Pledged investment USD million	EU projects, % of total in the country	EU pledged capital, % of total in the country
Russia	2450	102557.4	61	47
Ukraine	583	11235.6	62	52
Serbia	468	10060.9	87	62
Morocco	368	6807.4	68	27
Tunisia	225	4613.8	71	11
Egypt	187	7445.7	33	10
Bosnia-Herzegovina	157	5431.4	72	78
Algeria	151	12392.8	46	29
Georgia	96	783.4	45	20
Belarus	93	3645.2	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
Total	5264	201333.0		

Remark: pledged FDI excluding estimated values.

Source: FDI Intelligence from Financial Times Ltd.