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Economic Integration and Vulnerability in the EU Neighbourhood

Dimitris Kallioras and Anna Maria Pinna

In 2004, the EU launched the European Neighbourhood Policy (ENP), a unified policy framework towards its neighbours in the external EU periphery, aiming at strengthening prosperity, stability and security around its geopolitical borders. However, in-depth empirical analysis provides clear-cut evidence that, while the size and composition of trade flows between the EU and the ENCs may be growing, they are not favourable for the ENCs from the perspective of export diversification, in terms of either products or number of destinations. This condition increases their exposure to volatility in international markets. These results provide valuable insight into economic integration theory and for policymaking.

Keywords: EU, ENP, integration, trade, diversification, vulnerability

The paradigm of the European Communities indicates that the process of integration, although it does not stem solely from economic incentives, is achieved, first and foremost, in the economic field, through economic integration.[1] Economic integration is a process which involves the amalgamation of separate economies into larger free trade regions.[2] Indeed, international trade is usually the first type of linkage between independent economic units, and one of the most expedient (economic) factors in pushing economies toward integration.[3] Economic integration reduces the role of national borders as barriers to factor mobility and is, further, reinforced (a self-sustained process) by the reduction of trade costs. 'Closed' borders distort market size,[4] whereas the removal of economic barriers generates a number of spatial dynamics linked to better access to foreign markets and import competition.[5]

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[1]Shams, *Why do Countries Form Regions?*

[2]El-Agraa, "European Union – Economics and Policies".

[3]Paas and Tafenau, "Regional Interaction and International Trade Clusters".

[4]Niebuhr and Stiller, *Integration Effects in Border Regions.*

[5]Brülhart *et al.*, "Enlargement and the EU Periphery".

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Currently, the EU consists of 28 member states, having managed – after the end of the Cold War and the fall of the Iron Curtain – to almost match its politico-economic with its geographical boundaries. The recent (2004, 2007 and 2013) EU enlargements, in particular, brought the EU adjacent to a set of countries in the east with historically less intensive economic relations. Formerly part of the Soviet Union, these countries are characterised by lower development levels and significant institutional and structural differences. At the same time, on the southern and eastern shores of the Mediterranean Sea, the EU is ringed by countries that are linked to individual EU countries through their colonial past. Both bordering areas, to the east and to the south, have been gaining significance as they include emerging economies, energy suppliers or, simply, a large neighbouring market that is crucial for the EU economy.[6]

Therefore, in 2004 the EU launched the European Neighbourhood Policy (ENP), a unified policy framework towards neighbouring countries (ENCs) lying in the EU's periphery.[7] The ENP is aimed at strengthening prosperity, stability and security around the EU's borders. Currently, the ENP framework applies to Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine (Eastern ENCs) and to Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Occupied Palestinian Territory (Palestine), Syria and Tunisia (Southern ENCs).

Focusing on the economic aspect of the ENP and considering that international trade activity is the primary proxy for economic integration, discussing the level and quality of economic integration may be taken as an assessment of the level and type of broader relations between the EU and its neighbours, adding to the understanding of their political relations. Should they develop in a symmetrical way, trade activity could pave the way for more intense (economic) integration between the EU and the ENCs.[8] In-depth empirical analysis can provide responses as to the level and type of trade integration going on between the EU and the ENCs. In turn, these responses can offer valuable insight into economic integration theory (that is, identification of the theoretical schools that tend to be confirmed) and for policymaking.

The article uses trade data derived from the UN COMTRADE Database,[9] which cover the period 2000-10 and refer to the national-sectoral level (as per the 2-digit Standard International Trade Classification, SITC). The timespan considered makes it possible to study trade dynamics during the implementation of the ENP. Even more than the global economic crisis, events at the national level and internal conflicts following 2010 strongly influenced trade data dynamics, pushing them beyond the scope of this analysis. The sectors considered belong to the

[6]Petrakos *et al.*, "Regional Inequalities in ENP Countries".
[7]EC, *Wider Europe – Neighbourhood.*
[8]*Ibid.*
[9]See http://comtrade.un.org/db/.

primary and secondary sector of production and form six groups of activities, according to the intensity of the production factors used. Specifically, as classified by the Harmonized System (HS),[10] these groups are: HS1 (non-fuel primary commodities), HS2 (fuel primary commodities), HS3 (labour-intensive and resource-based commodities), HS4 (low skill, low technology, low capital and low scale-intensive commodities), HS5 (medium skill, medium technology, medium capital and medium scale-intensive commodities), and HS6 (high skill, high technology, high capital and high scale-intensive commodities).

The article proceeds as follows: The next section surveys the literature on the level and type of trade activity in conditions of economic integration. The third section provides an overview of the ENP framework. The fourth illustrates the empirical analysis carried out on the level and type of trade flows between the EU and the ENCs, within the ENP framework. The last section offers the conclusions.

Trade activity under economic integration: a review of the literature

Neighbouring countries provide the easiest market access for the majority of tradable goods as trade costs are, *ceteris paribus*, lower over small distances.[11] Furthermore, when one country is much richer than the other, proximity trade is mutually beneficial as the richer country usually offers a wide variety of goods of superior quality, while the poorer country usually offers lower prices and attractive production locations.[12] Free trade agreements (FTAs) are largely based on this argument. Doing away with national borders is meant to create larger economic spaces for exploiting economies of scale, thereby reducing production costs. This means that the level of trade activity among the counterparts involved in an FTA is expected to intensify over time.[13] Yet, the effect of international trade – and the formation of FTAs in particular – on the type of trade activity between the counterparts involved is an open issue.

In accordance with the concept of absolute advantage,[14] comparative advantage[15] refers to the ability of one country to produce a particular product at a lower opportunity cost than another country. In order to gain from international trade, countries are expected to export products for which their relative prices in an autarchy (that is no trade) situation are lower than other countries. Building on the concept of comparative advantage, the Heckscher-Ohlin-Samuelson[16] (H-O-S)

[10]See http://unctad.org/en/Docs/tdr1996_en.pdf.
[11]Leamer and Levinsohn, *International Trade Theory.*
[12]Venables and Limão, "Geographical Disadvantage".
[13]Burke, "The Effects of Economic Integration".
[14]Smith, *The Wealth of Nations.*
[15]Ricardo, *Principles of Political Economy and Taxation.*
[16]Heckscher, "The Effect of Foreign Trade"; Ohlin, "Interregional and International Trade"; Samuelson, "International Trade and Equalization".

model predicts the patterns of trade based on the factor endowments of trading countries: countries will export products that use their abundant and cheap factor(s) of production in order to gain from international trade. Overall, traditional theories indicate that gains from international trade should be greatest between countries with the greatest differences either in terms of opportunity costs or in terms of factor endowments. Hence, countries are expected to export products distinctly different from the ones they import. Therefore, traditional trade theory suggests that developing countries (such as the vast majority of the ENCs) are likely to gain more from forming an FTA with high-income countries (such as the vast majority of the EU countries) than with other developing countries.[17] This way, countries may reap the so-called static effects of international trade.[18]

In addition to the static effects generated for members of an FTA, international trade can generate positive externalities and spillover effects by transmitting and disseminating technological progress, knowledge and ideas (so-called dynamic effects).[19] Yet, this may not be the case when trading counterparts exhibit considerable differences in terms of endowments and level of technology, in that lagging economies may find it difficult to grasp the dynamic effects.[20] Therefore, the positive impact of international trade is expected to be conditioned by the level of development. In other words, international trade might push some countries, especially within an FTA framework, to specialise in products with low added value.[21] Even though it provides an alternative (and perhaps the only feasible) route for the exploitation of locally available skills, it is doubtful whether such a structural differentiation can produce long-term income convergence.

In an imperfectly competitive economic environment (where firms reduce their costs by increasing the scale of production), comparative advantage is said to be created rather than naturally given, favouring intra-industry trade activity (that is more trade occurs within sectors than between sectors).[22] This fact stresses that specialisation is an essential parameter of international trade activity. In an open economy, specialisation is related to the export base of an economy.[23] International trade allows for greater specialisation – since domestic demand for some products can be satisfied, at least partially, by imports – allowing inherent and acquired comparative advantages to be exploited more intensively.[24] When two countries are similar, intra-industry trade is the natural outcome of expanding the scale of

[17]Venables, "Winners and Losers".
[18]Balassa, *The Theory of Economic Integration.*
[19]*Ibid*; Rivera-Batiz and Romer, "Economic Integration and Endogenous Growth".
[20]Deveraux and Lapham, "The Stability of Economic Integration".
[21]Paci and Usai, "Technological Enclaves and Industrial Districts".
[22]Poon and Pandit, "Geographic Structure of Cross-national Trade Flows".
[23]Tiebout, "Exports and Regional Economic Growth".
[24]Weinhold and Rauch, "Openness, Specialization and Productivity Growth".

production. When two countries are different in their income and production structures, intra-industry trade can be favoured by capital flows or the activity of multinationals, which seek to reduce their production costs in the lower income (labour abundant) country. In lower income countries, the activity of firms from high-income countries can provide a technology link for the dynamic gains of trade to accrue. If this is missing, less advanced (and, usually, peripheral) countries, when trading with more advanced partners, tend to become locked into specialisation in labour- or resource-intensive economic activities, given their inability to compete (successfully) with their more advanced counterparts in the markets for capital-intensive and knowledge-intensive economic activities.[25] Less advanced economies, with weaker productive bases, a high share of sensitive, labour- and/or resource-intensive sectors and unfavourable geographic coordinates struggle during integration to redeploy their resources effectively in order to gain from the opening of markets.[26]

The ENP framework: an overview

The ENP is an EU external relations and trade policy tool offering the ENCs conditional, preferential politico-economic relations – but not full membership.[27] In contrast to the (rigid) Copenhagen criteria[28] that characterised the EU (eastward) enlargement policy, the ENP framework involves bilateral, tailor-made, agreements between the EU and each of the ENCs. In particular, within the ENP framework, the EU negotiates a bilateral 'association agenda' with each of the ENCs, setting out a roadmap for jointly-agreed priorities in terms of political, economic and institutional reforms.[29] Subject to progress (compliance) with respect to the jointly-agreed priorities, the EU and each of the ENCs may sign an Association Agreement. Even though it is a distinct and separate process from EU enlargement,[30] the ENP is modelled upon the EU enlargement policy. As a result, the partnerships established under the ENP framework entail an almost continuous deepening of relations with the EU, with deep and extensive forms of economic association.[31]

The general principles and objectives (such as the consolidation of democracy, promotion of human rights, preservation of peace, eradication of poverty and enhancement of market economy) enshrined in the EU Treaties are the cornerstones of the ENP undertaking. In exchange for the approximation of EU

[25]Brülhart and Elliott, "Adjustment to European Single Market".
[26]Camagni, "Development Scenarios".
[27]Tocci, "Does the ENP Respond to Challenges?".
[28]Preston, *Enlargement and Integration in the EU*.
[29]Cadier, *Neighborhood Policy a Substitute for Enlargement?*
[30]Emerson, *Strategy or Placebo?*
[31]Monastiriotis *et al.*, *Regional Impact of EU Association Agreements.*

standards and values, the EU offers ENCs a triad of incentives: the provision of financial support; the removal of tariff and non-tariff barriers to trade; and visa liberalisation. With respect to the removal of tariff and non-tariff barriers, the EU started to pursue FTAs bilaterally with targeted economies in order to protect its markets and enhance its competitiveness. In this sense, FTAs represent the first step in the implementation of Deep and Comprehensive Free Trade Agreements (DCFTAs) with the ENCs thus bringing the ENCs closer to the Single Market.[32] Yet, to date (2015), only Ukraine has signed a DCFTA with the EU.

Indeed, DCFTAs envisage not only the mutual lifting of trade barriers but also harmonisation of economic laws and regulations (related to investment protection, public procurement and competition policy) with the *acquis communautaire* conditions of "neighbourhood Europeanisation".[33] This means that, even though the "membership anchor" is missing,[34] the ENCs may perceive the ENP framework as a first step in a long road that will end up with full EU membership. Such an expectation is partly justified by the historical record of EU enlargement, which has managed to integrate countries with different development levels and institutional endowments.[35] Therefore, assessment of the level and type of economic integration between the EU and the ENCs is highly relevant not only to the understanding of the economic linkages and development prospects of both areas, but also to the evolution of their political relations.

The level and type of trade activity between the EU and ENCs: an empirical analysis

Quantifying the amount and type of trade

EU-ENC trade activity grew significantly in the period 2000-10 (Table 1), even though a decrease was recorded in 2008-09, just after the eruption of the economic crisis. In 2000, the top-5 ENCs with the highest export shares (percentages of country exports to the EU in relation to the corresponding ENCs' total exports) were in the south (Libya, Algeria, Israel, Morocco and Tunisia). The situation changed, to some extent, in 2010: Libya, Algeria and Israel retained the top 3 positions, however Ukraine and Azerbaijan managed to enter the top 5, displacing Morocco and Tunisia. Over time, the top 5 ENCs exhibiting the highest corresponding increases were in the east (Azerbaijan, Ukraine, Georgia, Moldova and Belarus). Taking a look at the imports to the ENCs from the EU, the situation was analogous. In 2000, the top 5 ENCs with the highest import shares belonged to the ENCs South (Libya, Egypt, Morocco, Tunisia and Algeria).

[32]Dreyer, *Trade Policy in EU's Neighbourhood.*
[33]Koopmann and Wilhelm, "EU Trade Policy".
[34]Havlik *et al.*, *European Neighborhood – Challenges and Opportunities.*
[35]Petrakos *et al.*, "Regional Inequalities in ENP Countries".

Table 1. Volume of ENCs exports and imports to and from the EU (millions USD; current prices).

	2000	2005	2010	2000	2005	2010
	Exports			Imports		
Algeria	11,554	20,211	27,341	5,655	12,969	20,423
Armenia	120	656	340	246	534	730
Azerbaijan	912	3,114	12,920	302	1,852	3,102
Belarus	1,069	4,242	3,452	1,291	3,994	8,830
Egypt	3,206	6,431	9,256	7,486	10,435	19,371
Georgia	216	345	733	336	834	1,525
Israel	9,465	12,095	14,618	14,416	16,575	18,968
Jordan	172	485	316	1,519	2,896	3,655
Lebanon	237	268	433	2,730	3,920	6,228
Libya	12,029	23,580	36,360	2,341	4,445	8,763
Moldova	237	533	770	507	1,338	2,020
Morocco	5,552	n/a	10,050	7,138	n/a	17,833
Palestine	n/a	n/a	n/a	n/a	n/a	n/a
Syria	3,282	3,741	4,733	1,745	3,498	4,813
Tunisia	5,098	8,459	12,574	6,724	9,843	14,603
Ukraine	3,854	10,481	14,417	4,143	16,338	22,786

Sources: COMTRADE database, http://comtrade.un.org/db/. Authors' elaboration.

In 2010, the top position was no longer held by a country from the south but by Ukraine. Over time, the top 5 ENCs exhibiting the highest corresponding increases belonged, again, to the ENCs East: Azerbaijan, Belarus, Ukraine, Georgia and Moldova. Overall, the vast majority of trade activity referred to the ENCs South; yet the share of the ENCs East increased. These facts beg the question whether these increases in trade activity were related to the formation of FTAs, given that the EU still does not have action plans with some important trade partners such as Libya, Belarus and Algeria.

Comparing exports to imports, it turns out that the vast majority of the ENCs have a negative trade balance with their EU counterparts (Table 2). The Index of Trade Balance[36] (the difference, in value terms, between the exports and the imports of a country under consideration concerning trade activity with a specific partner country or the world, in general) reveals that in the year 2000 only Libya, Algeria, Syria and Azerbaijan had a positive trade balance. In 2010, this was true for only Libya, Azerbaijan and Algeria, meaning that the ENCs with a positive trade balance had decreased in number. Over time, Libya together with Azerbaijan, Algeria and Israel were the countries that exhibited an improvement in their trade balance figures, even though Israel continued to have a negative trade balance, complementary to its surplus with the US.

[36]Sullivan and Sheffrin, *Economics: Principles in Action.*

Table 2. Index of Trade Balance / Index of Trade Asymmetry / Index of Intra Industry Trade.

	2000	2005	2010	2000	2005	2010	2000	2005	2010
	Index of Trade Balance*			Index of Trade Asymmetry**			Index of Intra Industry Trade***		
Algeria	5,899	7,242	6,918	0.011	0.031	0.110	0.037	0.069	0.051
Armenia	−126	122	−390	0.801	0.252	0.146	0.459	0.244	0.202
Azerbaijan	610	1,262	9,818	−0.002	−0.011	−0.004	0.038	0.047	0.016
Belarus	−222	248	−5,378	0.236	0.049	0.075	0.345	0.229	0.227
Egypt	−4,280	−4,004	−10,115	0.109	0.130	0.178	0.201	0.260	0.248
Georgia	−120	−489	−792	0.750	0.551	0.595	0.350	0.273	0.348
Israel	−4,951	−4,480	−4,350	0.885	0.915	0.748	0.664	0.668	0.625
Jordan	−1,347	−2,411	−3,339	0.362	0.285	0.403	0.169	0.179	0.117
Lebanon	−2,493	−3,652	−5,795	0.106	0.316	0.142	0.115	0.117	0.117
Libya	9,688	19,135	27,597	0.412	0.560	0.619	0.053	0.066	0.087
Moldova	−270	−805	−1,250	0.035	0.166	0.207	0.237	0.295	0.287
Morocco	−1,586	n/a	−7,783	0.323	n/a	0.273	0.307	n/a	0.287
Palestine	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
Syria	1,537	243	−80	0.180	0.531	0.657	0.067	0.195	0.234
Tunisia	−1,626	−1,384	−2,029	0.371	0.547	0.718	0.409	0.493	0.505
Ukraine	−289	−5,857	−8,369	0.179	0.094	0.236	0.339	0.267	0.330

*Positive (negative) values of the Index of Trade Balance indicate trade surplus (deficit). Values are expressed in millions USD.
**The Index of Trade Asymmetry takes values in the interval [-1, 1], from perfect negative symmetry to perfect positive symmetry; values close to 0 indicate asymmetry.
***The Index of Intra-Industry Trade takes values in the interval [0, 1], from no intra-industry trade (perfect inter-industry trade) to perfect intra-industry trade (no inter-industry trade).
Sources: COMTRADE database, http://comtrade.un.org/db/. Authors' elaboration.

Throughout the period, asymmetry characterised trade activity between the EU and the ENCs (Table 2). The Index of Trade Asymmetry[37] (the correlation of the export and the import shares of a country under consideration concerning trade activity with a partner country or the world, in general), indicates that the sectoral composition of ENCs' exports to the EU did not correspond to the sectoral composition of ENCs' imports from the EU. In particular, in 2010, only Israel, Tunisia, Syria, Libya and Georgia experienced (positively) symmetrical trade activity with respect to the EU. In addition the Index of Intra-Industry Trade[38] (the matching of the value of the exports of a specific sector to the value of the imports of the same specific sector, for a country under consideration with respect to a partner country or the world, in general), indicates that the trade activity between the ENCs (with the notable exceptions of Israel and Tunisia) and the EU was of the inter-industry type. This is the clearest measure of the distance between the production structure of the EU's and the ENCs' economies.

The Index of Revealed Comparative Advantage (results are available upon request) confirms the picture of asymmetry that characterises trade activity between the EU and the ENCs. In 2010, Algeria, Azerbaijan, Belarus, Egypt, Georgia, Libya and Syria all exhibited their highest revealed comparative advantage with respect to the EU in the primary fuel commodities sector (HS2).

Measuring trade diversification

Measuring the level of diversification in ENC trade structures provides information on the quality of trade exchanges. Export diversification is variously defined as the change in the composition of a country's existing export product mix or export destination,[39] or as the spread of production over many sectors.[40] Poor countries have, on average, undiversified exports. As they grow, they diversify and then re-concentrate at higher income levels. Although the direction of causation between income and diversification is unclear, depending on the stage of development, there are various stylized facts which indicate that a higher concentration level is not necessarily associated with greater prospects of prosperity.[41] By looking at the Aggregated Specialisation Index[42] (a way of capturing a measure of sectorial concentration/diversification) (Table 3), it is evident that the vast majority of the ENCs exhibited higher levels of concentration in their exports to the EU market (higher than exports to alternative destinations) in 2010 than in 2000.

[37]Jackson and Petrakos, "Industrial Performance under Transition".
[38]Grubel and Lloyd, "Empirical Measurement of Intra-industry Trade".
[39]Ali *et al.*, *Is Export Diversification the Best Way?*
[40]Berthelemy and Chauvin, *Structural Changes in Asia*.
[41]WTO, "Trade and Development: recent trends and the role of the WTO", https://www.wto.org/ENGLISH/res_e/publications_e/wtr14_e.htm.
[42]Nakamura and Paul, *Measuring Agglomeration*.

Table 3. Sectorial diversification (Aggregated Specialisation Index)* in the World, EU and BRICS markets.

	Exports			Imports		
	2000			2000		
	World market	EU market	BRICS market	World market	EU market	BRICS market
Algeria	0.47	0.57	0.26	0.07	0.07	0.08
Armenia	0.19	0.28	0.77	0.17	0.12	0.24
Azerbaijan	0.19	0.21	0.84	0.14	0.13	0.25
Belarus	0.13	0.13	0.12	0.05	0.05	0.12
Egypt	0.14	0.18	0.35	0.06	0.07	0.06
Georgia	0.34	0.14	0.19	0.17	0.17	0.26
Israel	0.10	0.06	0.09	0.06	0.06	0.08
Jordan	0.13	0.12	0.47	0.04	0.06	0.08
Lebanon	0.06	0.05	0.15	0.03	0.04	0.08
Libya	0.63	0.68	0.72	0.06	0.07	0.22
Moldova	0.13	0.16	0.23	0.05	0.05	0.17
Morocco	0.11	0.14	0.67	0.04	0.06	0.08
Syria	0.42	0.55	0.57	0.07	0.09	0.07
Tunisia	0.18	0.24	0.90	0.05	0.07	0.07
Ukraine	0.10	0.07	0.49	0.04	0.04	0.09
	2010			2010		
	World market	EU market	BRICS market	World market	EU market	BRICS market
Algeria	0.56	0.65	0.46	0.07	0.07	0.08
Armenia	0.12	0.22	0.21	0.03	0.06	0.06
Azerbaijan	0.80	0.95	0.35	0.05	0.09	0.05
Belarus	0.11	0.40	0.09	0.10	0.10	0.23
Egypt	0.07	0.12	0.17	0.05	0.07	0.05
Georgia	0.08	0.14	0.12	0.05	0.09	0.06
Israel	0.09	0.06	0.12	0.04	0.06	0.05
Jordan	0.08	0.11	0.54	0.04	0.08	0.05
Lebanon	0.07	0.17	0.83	0.05	0.07	0.04
Libya	0.79	0.82	0.97	0.06	0.09	0.05
Moldova	0.07	0.09	0.09	0.04	0.05	0.09
Morocco	0.09	0.11	0.33	0.04	0.05	0.06
Syria	0.27	0.76	0.15	0.05	0.08	0.05
Tunisia	0.09	0.12	0.36	0.05	0.06	0.08
Ukraine	0.08	0.08	0.07	0.06	0.05	0.17

*The Aggregated Specialisation Index takes values in the interval [0, 1], from zero exports specialisation (perfect exports diversification) to perfect exports specialisation (zero exports diversification).

Sources: COMTRADE database, http://comtrade.un.org/db//. Authors' elaboration.

Table 4. Best sector in the ENCs' best export destination, years 1995 and 2010.

	World market					
	1995			2010		
	Best destination	Best sector in the best destination	Best sector share	Best destination	Best sector in the best destination	Best sector share
Algeria	Italy	Crude petroleum and natural gas production	75%	USA & P.Rico	Crude petroleum and natural gas production	74%
Armenia	Belgium & Luxem.	Other Manufacturing industries	79%	Russia	Beverage industries	55%
Azerbaijan	Turkey	Manufacture of textiles	27%	Italy	Crude petroleum and natural gas production	99%
Belarus	Germany	Manufacture of industrial chemicals	29%	Russia	Food manufacturing	26%
Egypt	Italy	Crude petroleum and natural gas production	51%	Italy	Crude petroleum and natural gas production	34%
Georgia	Turkey	Iron and steel basic industries	82%	Turkey	Iron and steel basic industries	50%
Israel	USA & P.Rico	Other Manufacturing industries	41%	USA & P.Rico	Other Manufacturing industries	37%
Jordan	Iraq	Food manufacturing	72%	Iraq	Food manufacturing	17%
Lebanon	Saudi Arabia	Agriculture and livestock production	34%	Switzerland & Lic.	Non-ferrous metal basic industries	74%
Libya	Italy	Crude petroleum and natural gas production	81%	Italy	Crude petroleum and natural gas production	87%
Moldova	Russia	Beverage industries	40%	Russia	Agriculture and livestock production	24%
Morocco	France	Manufacture of apparel, except footwear	39%	France	Manufacture of electrical machinery appar.	25%
Syria	Germany	Crude petroleum and natural gas production	87%	Germany	Crude petroleum and natural gas production	91%

(*Continued*)

Table 4. (*Continued*).

	World market					
	1995			2010		
	Best destination	Best sector in the best destination	Best sector share	Best destination	Best sector in the best destination	Best sector share
Tunisia	France	Manufacture of apparel, except footwear	55%	France	Manufacture of electrical machinery appar.	38%
Ukraine	Turkey	Iron and steel basic industries	38%	Russia	Manufacture of transport equipment	21%
	EU market					
	1995			2010		
	Best destination	Best sector in the best destination	Best sector share	Best destination	Best sector in the best destination	Best sector share
Algeria	Italy	Crude petroleum and natural gas production	75%	Italy	Crude petroleum and natural gas production	91%
Armenia	Belgium & Luxem.	Other manufacturing industries	79%	Bulgaria	Metal ore mining	100%
Azerbaijan	Italy	Agriculture and livestock production	57%	Italy	Crude petroleum and natural gas production	99%
Belarus	Germany	Manufacture of industrial chemicals	29%	Netherlands	Petroleum refineries	98%
Egypt	Italy	Crude petroleum and natural gas production	51%	Italy	Crude petroleum and natural gas production	34%
Georgia	Italy	Iron and steel basic industries	59%	Bulgaria	Metal ore mining	92%
Israel	UK	Other mining	15%	Belgium & Luxem.	Other mining	40%
Jordan	Italy	Other mining	29%	Italy	Non-ferrous metal basic industries	50%
Lebanon	France	Manufacture of wearing apparel, except footwear	31%	France	Manufacture of machinery except electrical	84%

(*Continued*)

Table 4. (*Continued*).

	EU market					
	1995			2010		
	Best destination	Best sector in the best destination	Best sector share	Best destination	Best sector in the best destination	Best sector share
Libya	Italy	Crude petroleum and natural gas production	81%	Italy	Crude petroleum and natural gas production	87%
Moldova	Romania	Food manufacturing	53%	Romania	Manufacture of electrical machinery appar.	34%
Morocco	France	Man. of wear. apparel, except footwear	39%	France	Manufacture of electrical machinery appar.	25%
Syria	Germany	Crude petroleum and natural gas production	87%	Germany	Crude petroleum and natural gas production	91%
Tunisia	France	Manufacture of apparel, except footwear	55%	France	Manufacture of electrical machinery appar.	38%
Ukraine	Italy	Iron and steel basic industries	34%	Italy	Iron and steel basic industries	61%

Sources: COMTRADE database, http://comtrade.un.org/db/. Authors' elaboration.

When discussing diversification, the number and the weight of first export destinations also plays a crucial role. The idea is simple: if a country's flows are concentrated in a few destinations and, on top of this, only some sectors are considered, the vulnerability of the whole trading system increases. Analysis of the best export and import partners for each ENC (Table 4), reveals that a good number of ENCs, especially the Southern ones (Algeria, Egypt, Libya and Syria), mainly export primary fuel commodities to their main destination. The respective shares are around 80 percent. The eastern ENCs mainly export machinery or agricultural products. Middle Eastern ENCs and Israel have no predominant sector; it depends on the destination. In general, at world level, even when the first destination does not have a big share, in seven out of fifteen ENCs, the first exporting sector accounts for more than 50 percent of the country's total exports. When concentrating on the EU market, in eight out of 15 ENCs, the best exporting industry accounts for more than 80 percent of total exports. When such a sectorial concentration is recorded in the destination that receives the most exports, the presence of export differentiation to other destinations is of less importance.

Reliance on the export of raw materials, in particular, may create detrimental conditions for the exporting countries. This is so for three main reasons: deteriorating terms of trade, excess volatility and low productivity growth.[43] Things work well when prices are high but there is always the risk of a sudden reduction in price. Furthermore, specialisation in raw materials drives out resources from manufacturing activities which are characterised by higher gains in productivity. Therefore, export dependence on a few products (especially those whose price has increased considerably since 2000) can be successful under strict and tight conditions which include farsighted fiscal and monetary policies in order to avoid a quick depletion of trade revenues. Of course, even when such conditions are in place, reliance on the export of raw materials may increase natural resource exporters' vulnerability to boom-bust cycles.

This discussion becomes even more complicated when ownership contracts are taken into consideration. Energy production is dominated and controlled globally by non-competitive market forces. Concentration in these sectors can be favoured by foreign interests, which enter the domestic market with their capital and technological ownership, creating conditions for revenue concentration and broad inequalities in the distribution of the gains from trade.[44] Thus, the lack of diversification when looking both at the production side and destination countries mix, and at the trade imbalances, is alarming as concerns the success of the (trade component of the) ENP undertaking.

Conclusions

By means of an in-depth empirical analysis, this article provides data regarding the level and type of economic integration taking place between the EU and the ENCs within the ENP framework. It is evident that the gradual dismantling of economic borders as part of the ENP has allowed for the expansion of trade activity between the EU and the ENCs. This means that economic integration between the EU and the ENCs has been increasing over time. Yet, the ENCs are engaged in an asymmetrical, inter-industry type of trade activity with their more advanced EU counterparts, and face serious difficulties in restructuring and diversifying their production bases: for many of them the main one. This is the main factor behind the negative trade balances that the vast majority of ENCs have with respect to their EU counterparts. Thus, the trade component of the ENP does not seem to provide a solid stimulus for the process of neighbourhood Europeanisation.

Another problem is the ENCs' strong dependence on primary and energy resources. There are various political-economy mechanisms by which natural

[43]Cadot *et al.*, "Trade Diversification, Income and Growth".
[44]Tornell and Lane, *Are Windfalls a Curse?*

resources interact with institutional deficiencies to hamper growth:[45] in the absence of well-defined property rights, natural resources introduce a common pool problem and elicit rapacious rent-seeking, detrimental for growth. Resource abundance is also known to erode the critical ability of politicians to avoid myopic choices that tend to keep bad policies in place.[46]

Overall, the findings of this article provide valuable insight into economic integration theory and are important for policymaking. The well-established EU 'core-periphery' spatial pattern seems to be reproduced in the wider EU area, thus throwing into question traditional theories of international trade that indicate that gains from international trade should be greatest among countries with the greatest differences either in terms of opportunity costs or factor endowments. While on the increase, the inter-industry type of trade activity between the EU and the ENCs cannot generate a sustainable economic integration path, even though it provides an alternative for the exploitation of locally available skills.

Translating the findings of the analysis into policy action, the EU should consider how best to calibrate its conditions and trade concessions more finely to meet the highly specific domestic and trade circumstances of the ENCs (by and large, its least able bilateral partners). In particular, EU trade policies, incentives and supporting programs should encourage ENC trade activity with the structurally proximate, low- and medium-income, EU countries, as well as provide technical support to improve diversification in the ENCs' productive bases. By doing so, the EU could maximise the potential of trade as a reform incentive, a cornerstone of the ENP framework.

The process of building up governance structures designed to separate the management of resource wealth from short-term political pressures is also a fundamental step in promoting positive trade effects for the economies of the countries lying on the outskirts of Europe. In the long run, policymakers need to take actions aimed at further improving the quality of institutions in the ENCs in order to establish controls on the risk of rent-seeking behaviour by domestic governments, as well as by domestic and foreign investors, especially in conjunction with ill-defined property rights, imperfect markets and lax legal structures.

The slow reforms and the upheaval and tensions in the vast majority of the ENCs may have their roots in the difficulty of the ENCs to adapt their productive systems to the pressures of internationalisation and to deliver tangible welfare services to large and increasingly mobile populations. Definitely, the trade incentives that are in place (the removal of tariff and non-tariff barriers) are not sufficient. Even though ENCs may see the ENP's trade component as a commitment to lock in to economic reforms, in their long road toward EU

[45]Arezki and Van der Ploeg, *Can Curse be Turned into Blessing?*
[46]Gylfason, *Development and Growth.*

accession, the absence of a real membership anchor might induce them to perceive the asymmetric type of economic integration with the EU negatively (even if the aspiration of full membership remains). Thus, the outlook for the viability of the ENP undertaking is uncertain, especially considering that there are countries (such as the BRICS) that can offer the ENCs less asymmetrical – and more importantly, conditionality-free – conditions for economic integration.

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