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**Article (Accepted version)
(Refereed)**

Original citation:

Crescenzi, Riccardo and Petrakos, George (2016) The European Union and its neighboring countries: the economic geography of trade, FDI and development. *Environment and Planning C: Government and Policy*, 34 (4). pp. 581-591. ISSN 0263-774X
DOI: [10.1177/0263774X16642640](https://doi.org/10.1177/0263774X16642640)

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This version available at: <http://eprints.lse.ac.uk/66988/>

Available in LSE Research Online: June 2016

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The European Union and its Neighboring Countries: The economic geography of Trade, FDI and Development

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Abstract

This Editorial looks at the process of political and economic integration between the European Union and the European Neighborhood Policy (ENP) countries with a special focus on the processes linked to trade flows, FDI and their spatial impacts. This Editorial highlights the key 'unanswered' questions in the existing literature and explores outstanding conceptual and empirical challenges, discussing how the various papers included in the Theme Issue can provide systematic coherent answers to a number of these research questions. The Editorial includes a synopsis of the key findings of the papers and highlights their connections and linkages. It concludes with open questions for further research and a potential agenda for future conceptual and empirical analyses in this area.

The European Neighborhood Policy: background, existing literature and relevant gaps

The European Neighborhood Policy (ENP), launched in 2004, is a unified European Union (EU) policy framework towards the EU neighboring countries (see Wesselink and Boschma, 2012 for an overview). The objective of the ENP is to strengthen the prosperity, stability and security of the EU, creating a ‘ring of friends’ around the EU political borders. As Štefan Füle - former EU Commissioner for Enlargement and ENP - stated “our Neighborhood Policy provides us with a coherent approach that ensures that the whole of the EU is committed to deeper relations with all our neighbors [...]” (Füle, 2013).

The ENP framework applies to the following countries ('ENP countries'): Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine ('ENP East') and Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia ('ENP South'). The ENP is synergic to other EU initiatives in this area such as the Eastern Partnership (launched in Prague, in 2009), the Euro-Mediterranean Partnership or Union for the Mediterranean¹ (re-launched in Paris, in 2008), and the Black Sea Synergy (launched in Kiev, in 2008). Even though the ENP is a distinct and separate process from the EU enlargement, ENP countries operate under conditions of 'neighborhood Europeanization'² with an apparent mismatch (i.e. the so-called ‘capabilities-expectations’ gap;³) between ENP requirements/demands for participating countries (i.e. demands that do not differ much from those of ‘accession Europeanization’⁴) and potential ENP gains/rewards (i.e. the possibility of EU membership has been ruled out for the majority of ENP countries) (Lavenex, 2004; Lang, 2007; Mahncke and Gstöhl, 2008). Romano Prodi, former EU Commission President, highlighted that “we have to be prepared to offer [the ENP countries] more than partnership and less than membership, without precluding the latter” (Prodi, 2002, p.4). Given this fundamental political mismatch – and the generalised skepticism about the possibility to transfer EU values and rules to the neighboring countries – deep(er) economic integration between the EU and the ENP countries is considered as a crucial condition for the success of the entire ENP process (Dreyer, 2012). As a consequence, the analysis of the process of economic integration between ENP countries and the European Union 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.

Even if the proper ‘membership anchor’ is missing (Havlik et al., 2012a and 2012b), the progressive compliance with the *acquis communautaire* is a necessary condition for the ENP countries to increase their presence in the EU common market.

In this sense the ENP is simultaneously stimulating economic, political and institutional development by providing not only political incentives but also financial resources. Deeper association with the EU brings a number of political and economic benefits at the domestic level, strengthening domestic policies and facilitating political reforms that

¹ Formerly known as the Barcelona Process (launched in Barcelona, in 1995).

² See Axt et al., 2007 and Schimmelfennig, 2012 for a discussion of the “Europeanization” debate.

³ See Monastiriotis and Borrell, 2012.

⁴ See Hughes et al., 2004 and Schimmelfennig and Sedelmeier, 2005 for a discussion about the “Europeanization” of the new EU member-states.

consolidate the process of political transition, democratization and, in some cases, conflict resolution and normalization of external relations (Monastiriotes et al., 2010).

However, together with the aforementioned benefits, the process of European (economic) integration is giving rise to additional processes whose nature and overall impacts remain more ambiguous. Economic integration reduces the role of national borders as barriers to factor mobility which is further reinforced by reductions in trade costs. 'Closed' borders distort market size effects (Niebuhr and Stiller, 2002), whereas the removal of economic barriers generates a number of spatial dynamics linked to better access to foreign markets and import competition (Brühlhart et al., 2004). Therefore, even if there is almost unanimous consensus in the economic literature that (market-based) economic integration is a positive-sum game, an on-going debate is currently taking place concerning the distribution of its overall welfare gains (Crescenzi and Rodriguez-Pose, 2001; Petrakos et al., 2011). Such a debate finds fertile ground since the size, the composition and the direction of trade and capital flows determine, to a large extent, the prospects (and the limitations) for economic development. In other words, in the economic space emerging in the EU and its neighborhood, the space of flows (i.e. integration) affects, to a great extent, the space of places (i.e. economic development) (Petrakos, 2012).

The evolving economic linkages between the EU and its neighboring countries

The general objective of this Theme Issue is to advance and consolidate theoretical and empirical knowledge on the patterns of economic interaction between the EU and its neighboring countries, to project future trends and identify the effects of deeper economic integration on the growth, competitiveness and cohesion prospects of the two areas.

When looking at the existing literature a number of key issues in the current co-evolution of the EU and ENP economies remain un-explored. In particular relevant gaps in the literature remain in the analysis of:

- (a) trade patterns between the EU and its neighboring countries and their possible effects on growth, structural change and cohesion in both areas;
- (b) the location choices of EU foreign investment, the direction and drivers of capital mobility and its effects in the EU neighboring countries;
- (c) the efforts of domestic and foreign firms to invest in technological and organizational capacities, contributing to the co-evolution of local institutional environments;
- (d) the spatial sub-national effects of stronger trade and investment flows in both the EU and its neighboring countries.

Further investigation of these questions is necessary in order to inform the discussion of the policy options at the EU level and maximize the potential benefits from the process of integration on both sides of the EU external borders.

Changing trade patterns and their spatial impacts

The most recent Enlargement brought the EU borders to a set of countries in the East characterized by a more limited history of previous economic relations with the EU. These countries are characterized by lower development levels and significant institutional and structural internal differences. However, this group of countries has gained increasing importance to the EU as it includes large emerging economies, strategic energy suppliers as well as a large market with over 250 million inhabitants.

This new scenario, as well as the experience of previous rounds of expansion of EU trade relations in the South and the East, raises a number of relevant questions about the economic relations of the EU with its neighboring areas and the prospects and effects of deeper economic integration. Will trade relations with the ENP Countries be as strong as in previous rounds of trade expansion? Do trade patterns lead to a sustainable relationship that will offer the justification for further integration in the future? How does trade affect the economic structure in the EU and ENP countries? Are there geographical limits or barriers to the expansion of the European market? Is the EU a gravitation center exercising a force of attraction to all peripheral economies that surround it? Is this force of attraction declining with distance? Are there any other competing poles of attraction for neighboring countries?

The expansion of trade relations between heterogeneous economic groups has always been followed by a debate concerning the distribution of the overall welfare gains. Although there is a strong consensus that the market-based process of economic integration is a positive-sum game increasing aggregate efficiency (Heckscher 1919/1991; Ohlin 1933; Samuelson 1949; Solow 1956), the allocation of overall welfare gains is highly debated (Amin et al. 1992; Gianneti 2002; Guerrieri and Rossi 2002; Melachroinos 2002; Petrakos et al. 2005). Imperfectly competitive markets are deemed to result in an uneven distribution of the benefits of economic integration, increasing spatial imbalances (Lyons et al. 2001; Martin and Ottaviano 2001; Brühlhart and Elliott 2004). In this context, relatively more advanced economies are expected to benefit more, either due to their ability to generate new knowledge (Romer 1986, Lucas, 1988) or, simply, due to favorable initial conditions (Krugman 1980), while initially disadvantaged economies are likely to benefit less, or even fall further behind. International trade might also push some economies to specialize in low value-added sectors, with an overall detrimental impact on long-term economic growth (Young 1991, Rivera-Batiz and Xie 1993). This might be the case when trade partners are asymmetric, exhibiting considerable differences in terms of endowments and level of technology (Grossman and Helpman 1991, Devereaux and Lapham 1994).

Therefore, peripheral and less advanced economies may develop inter-industry types of trade relations (Kallioras and Petrakos 2010, Petrakos et al. 2012). This type of trade relations - typically leading to specialization in labor-intensive or resource-intensive activities - is the outcome of the inability of peripheral and less advanced economies to compete (successfully) with their more advanced counterparts in the markets for capital-intensive and knowledge-intensive economic activities (Brühlhart and Elliott 1998). Even if this model of specialization can make it possible to exploit locally available skills, it is doubtful whether such a structural differentiation can produce long-term income convergence.

Trading different types of commodities is not neutral with reference to the capability of an economy to promote (sustainable) growth (Kallioras and Pinna 2013). International trade allows for greater specialization - since

domestic demand for some commodities can be served by imports - allowing inherent and acquired comparative advantages to be exploited more intensively (Weinhold and Rauch 1999). However, the positive impact of specialization may be weaker in economies that are not specialized in sectors associated with increasing returns to scale (Paci and Usai 2000).

The evidence related to EU-ENP Countries trade activity is still limited. It shows that trade has grown significantly over the past decade and the EU has become the most significant ENP Countries trade partner (Kallioras and Pinna, 2015; 2016). The major trade partners for the ENP Countries are advanced EU 'core' countries, while trade within the internal and external EU periphery remains limited (Petrakos et al, 2013).

The EU-ENP trade seems to develop in an unbalanced way: EU imports from the ENP countries are limited, all ENP Countries experience trade deficits with the EU and trade flows have mainly an inter-industry orientation (Petrakos et al, 2013). The ability of the ENP countries to export is greater in less advanced EU countries, where competition by domestic producers is lower, market entry requirements and standards are not excessively high and consumer tastes are similar. However, deeper integration with the EU is likely to be more beneficial for the growth prospects of the ENP Countries when it is based on geographically more balanced trade relations with both the EU core and periphery (Anagnostou et al, 2016).

The drivers of the establishment of trade linkages between the EU and the ENP countries are explored by Pinna (2016). This paper examines empirically the characteristics of European firms which have one of the ENP countries as their main export destination. Considering the increasing functional integration between European firms and the ENP economies, it is crucial for EU policy makers to understand what firm level characteristics explain their internationalization strategies. By analyzing a large sample of manufacturing companies in seven EU countries (Austria, France, Germany, Hungary, Italy, Spain and the UK), Pinna (2016) investigates the drivers of the decision to export and, for exporting firms, the factors that lead to the selection of the first export destination. This approach makes it possible to study what factors – if any – might favor the orientation of EU trade towards the ENP countries. The results suggest that, once EU firms target economies outside the borders of the Common Market, geographical proximity to the ENP countries plays a limited role in attracting EU firms' exports. Therefore, ENP countries do not benefit from any specific advantage as export destination: on the contrary for these countries the negative impact of geographical distance on the intensity of trade flows is magnified. Even if some ENP countries are large markets in terms of population other factors seem to work as barriers, discouraging EU exports. In order to foster the process of integration more attention should be devoted to the reduction in transport costs between the EU and ENP countries (e.g. by means of investment in infrastructure in the ENP as well as by addressing the numerous bottlenecks on both sides of the EU border). Of crucial importance is also the reinforcement of trade networks in order to compensate for the increasing 'cost' of distance when trading with this particular set of partners. These aspects have often been under-estimated in the design and implementation of the ENP policy and the results of Pinna (2016) call for their re-consideration together with more 'horizontal' policies favoring competitiveness, innovation and expansion of EU firms that would also favor EU-ENP trade integration.

The nature and composition of the trade linkages between the EU and ENP countries are investigated in Boschma and Capone (2016), looking at the process of industrial diversification both in the European Union and in the ENP countries. The productive structure of each country is the result of a path-dependent process driven by the relatedness between products in terms of the resources that are needed for their development and production: knowledge, skills, organizational arrangements and institutions. Countries can diversify their economic structures and, as a result, their export mix by leveraging these internal resources as well as their linkages with other countries (such as those facilitated by the ENP framework). Internal capabilities interact with external linkages, shaping the evolutionary trajectories of different countries and, ultimately, shaping their developmental patterns. The linkages between the EU and the ENP countries offer an ideal laboratory for the analysis of this process: EU countries benefit from more general and stratified capabilities and their increasing linkages with the less advanced ENP economies have the potential to play a key role in the diversification and development of the European Neighborhood. The econometric analysis of trade data sheds light on the strong path-dependency that characterizes the process of diversification of the ENP economies. Comparative advantages tend to remain persistent over time and diversification happens in the domain of related products. Path-dependency is significantly stronger in the ENP countries than in the EU. The inclusion of new products in their export mix is restricted by their more limited resource and capabilities. In their turn, imports have also a limited impact on the diversification of the ENP economies. Overall, the results suggest that the ENP countries have to rely much more on the relatedness between products and the specific resources and capabilities necessary for their production. This has significant implications for both trade policies and economic development actions. It might be difficult for policy makers to support the rapid diversification of the ENP economies but – in line with Pinna (2016) – the quality of the institutions supporting the capability of domestic firms to diversify and innovate remains of paramount importance. The establishment of an appropriate set of incentives and opportunities for local firms seems to be the necessary pre-condition to break established path-dependency and make structural change possible in the ENP.

Capital mobility in the EU and the ENP countries

The study of the process of integration between the EU and the ENP countries cannot be limited to trade flows. Over the past decade Foreign Direct Investments (FDI) have been playing an increasingly relevant role for the process of functional integration of the world economy (UNCTAD, 2015). A growing body of literature has emphasized their role as engines of the process of globalisation, highlighting their impact on the economic development and innovation potential of recipient countries and regions (McCann & Mudambi, 2005; Beugelsdijk & Mudambi, 2013; Crescenzi et al. 2014 and 2016). In this perspective FDI can be considered as key components of the process of economic integration between the European Union and the ENP countries. EU FDI not only provide essential physical capital for the development of ENP countries but also develop strategic ‘pipelines’ for the diffusion of knowledge and innovative processes and products (Ascani et al. 2016a). Consequently, FDI are central to the process of integration and development of the NRs not only for their contribution to local physical capital formation but also for their two-way relationship with local intangible assets. The accumulation of intangible assets is simultaneously an important driver and a by-product of the operations of Multinational Enterprises (MNEs) in the

host economies. When making their investment decisions, MNEs take increasingly into account local intangible assets endowment. Conversely, foreign investment – by channelling new knowledge and innovation into the local socio-economic tissue - exerts a significant influence on local intangible assets (Crescenzi et al. 2014). An in-depth understanding of this two-way nexus (and its cumulative nature) is of crucial importance in order to capture opportunities and challenges generated by the process of economic integration between the ENP countries and the EU. What are the key drivers of FDI strategies in the ENP countries? What is the role of institutions in attracting these investments? What is the impact of FDI on domestic firms in the ENP countries? How can the European Neighbourhood Policy impact on these dynamics to promote economic cohesion in the area (i.e. break the vicious circle that prevents the benefits of integration from spreading towards the most deprived areas)?

These relevant questions related to the process of regional integration have remained relatively under-explored in the existing literature on the process of European Integration and its impact on neighbouring countries. However, by innovatively cross-fertilising different streams of literature in Economic Geography, International Business Studies as well as Political Economy it is possible to shed new light on all these aspects.

The papers dealing with the analysis of capital mobility among the EU and the ENP countries undertake a theoretical discussion and provide empirical findings on the locational choices of EU FDI in the ENP countries as well as on their impacts on the evolution of domestic firms. Zvirgzde, Schiller, and Revilla-Diez (2016) explicitly look into institutional factors and how they are valued by foreign investors in the ENP. Foreign investors rely on transparent and reliable institutions in order to organize their operations in the host economies. Institutional conditions in the host economies shape investment motives, entry modes, typologies of de-localised activities as well as the development of linkages with the host economies. However, these conditions are highly diversified within countries: some regions can offer better and more receptive institutional environments than others. Zvirgzde et al. (2016) explore this heterogeneity from the viewpoint of foreign investors in Ukraine. They analyze the material collected by means of a large number of interviews to MNEs operating in different regions of the country in order to uncover their perception of the local institutional environment and investigate how this shapes the nature of their operations in the host region. Their results confirm the importance of low production costs and market potential as key drivers of foreign activities in all Ukrainian regions. In the area close to the EU border in the western part of the country, more sophisticated local assets (including human capital and clustering of foreign investors) are also important to MNEs. Institutional quality is generally perceived as highly problematic in Ukraine (as in large part of the ENP countries). However, the capital city (Kyiv) benefits from a more accomplished process of institutional transition from the Soviet legacy even if local embeddedness remains limited. This heterogeneity suggests that institutional change is not only needed – as extensively discussed by the literature on the impact of trade flows (see Pinna 2016 and Boschma and Capone 2016 in this Theme Issue) - but also possible. Horizontal actions addressing macro-level institutional factors should be coupled by place-specific remedies in order to tackle localized institutional failures and promote a balanced pattern of institutional development and consolidation.

The location strategies of MNEs are further investigated in Ascani, Crescenzi and Iammarino (2016b) by looking at FDI from Italy (one of the 'old' EU-15 member states with significant strategic interests in the ENP countries due to its geo-political position in Europe) into all ENP countries. The paper explores the factors underlying the location strategies adopted by Italian MNEs when targeting ENP economies: market size, availability of key inputs to the production process, natural resources as well as institutional and geographical proximity. The paper compares the relative importance of these factors (and their interactions) by combining quantitative and qualitative methods. As highlighted by Zvirgzde et al. 2016 for the case of Ukraine, market seeking motivations remain prevalent among foreign investors in the ENP coupled by the interest in low wages and natural resources. ENP countries where the general business environment is more supportive and the rule of law is better enforced get a 'premium' in terms of their attractiveness to foreign investors. However, MNEs show significant heterogeneity in their preferences depending on their sector of activity and on the nature of the delocalized business functions. Highly diversified are also the patterns that lead to the development of institutional proximity between MNEs and their host ENP economies. In some cases MNEs rely on inter-governmental networks and bilateral international agreements in order to support their entry into local markets, in other cases institutional assimilation is based on special arrangements (e.g. local training initiatives) and employment of local workforce ('local content'). These mechanisms can foster institutional change and reforms in the ENP countries, supporting new patterns of institutional and economic co-evolution in the host locations. As a consequence, openness to FDI can offer relevant opportunities to the ENP economies that national and regional government should be encouraged to nurture. In this context the EU can play a relevant role in terms of technical assistance and capacity building, ensuring mutual benefits for both the investors and the host economies.

Having explored the drivers of FDI location choices in the ENP countries, the assessment of the impact of these investments in the destination economies remains key to the analysis of the process of integration with the EU. Monastiriotis and Borrell (2016) address this question by looking at the productivity spillovers from foreign investment into domestic firms in a set of transition economies comprising Central and Eastern European Countries (CEE), the Balkans (SEE) and the ENP countries. In particular, Monastiriotis and Borrell (2016) explore the role of institutional proximity in shaping the impact of FDI. Their micro-level analysis shows that the concentration of European-owned firms leads to greater productivity spillovers when compared to FDI from other origins. Non-EU FDI cannot benefit from the same degree for institutional proximity with the host economies that instead characterizes European investments. The process of EU association creates an environment of deepening economic relations and institutional convergence that facilitate the embeddedness of European investments. However, the positive impact of EU investments is stronger in the Balkans – where association with the EU is more advanced – than in the ENP countries. In addition the positive impact of EU FDI is largely concentrated in the most advanced 'core' regions of the host countries, with potentially adverse effects on regional imbalances. Overall, the evidence produced by Monastiriotis and Borrell (2016) confirms that increased institutional proximity can enhance the benefits from foreign investment in the ENP but also sheds light on the importance of dedicated regional development policies as part of the broader set of EU policy tools in the area. Closer economic integration with the

EU might deliver spatially asymmetric benefits unless appropriate policies are put in place in order to foster absorptive capacity in peripheral areas and promote regional development.

The Spatial implications of ENP integration

The expansion of trade and capital flows on both sides of the external EU borders has significant spatial implications in terms of economic development and inequalities. The regional structure of the ENP countries and the evolution and typologies of inequalities, as well as of the major drivers of regional performance are affected by increased trade and capital flows. Petrakos, Tsiapa and Kallioras (2016) look into the nature and drivers of regional disparities in a number of ENP countries. Their results - based on an innovative database with statistical information at the sub-national level for the ENP countries - suggest that over the 2000s regional inequalities have increased significantly in most ENP countries. Many ENP economies are characterised by marked core-periphery patterns with metropolitan regions dominating the national economy and less developed regions struggling to catch-up. Spatial imbalances show a pro-cyclical behaviour, increasing in periods of expansion and decreasing in periods of slow growth or recession. Less developed regions in the ENP show a reduced growth potential and face significant pressures in their productive base arising from integration and competition from the more advanced European partners. These results challenge the conventional wisdom that has informed and shaped part of the EU policies for the ENP countries. Trade and capital mobility are not per se capable of generating economic opportunities for all economic agents. Centrifugal and centripetal forces are constantly at work, shaping the distribution of the benefits arising from the process of integration. In the ENP countries – given their level of socio-economic and institutional development – centripetal forces are likely to prevail in the medium-run, making spatial imbalances a top-priority of development policies. A new generation of European policies for the EU Neighborhood should carefully take these aspects into account.

Key policy message

The papers collected in this Theme Issue cover a wide range of aspects of the process of economic integration between the EU and the ENP countries. The papers look at the nature, composition and evolution of trade and investment flows and at their impacts on the ENP economies at the national and regional level. The papers have relevant policy implications for European, national and regional policies in the ENP. Five key overall policy messages emerge from this Theme Issue:

- a) Economic development policies cannot be disjoined from institutional reforms and institution-building actions at all levels. The ENP framework has reinforced and facilitated trade and investment. However for these factors to work in favour of economic development, quality of governance and institutions need to be reinforced. Supportive institutions are needed to sustain the process of structural change and sectoral diversification with implications for the upgrading of the ENP export. Institutional quality is also of paramount importance for the upgrade of foreign activities along the value chain as well as for the diffusion of positive spillovers into the local economy;
- b) Economic policies cannot be limited to reinforcing trade and investment. Two key internal components of the ENP economies need to be reinforced: human capital and domestic firms technological upgrading. Development policies should be targeted to both the reinforcement of human capital accumulation as well as to its qualitative

upgrading. Professional training and intermediate skills should be prioritized together with a wider participation into tertiary education.

c) Regional disparities in the ENP countries are significantly more marked than in Central Eastern European Countries. In addition, the process of integration is likely to further increase the concentration of economic activity in core areas. Therefore, integrated and comprehensive regional policies should be put in place in the ENP countries. A lot can be learnt from the EU experience in this regard and EU institutions can provide invaluable help and technical assistance in this area.

d) Effective and well-designed policies rely on detailed and accurate data on the target economies and actors. Data availability in many ENP countries is still very limited for many economic indicators. Sub-national level data are even more limited. A coordinated action between the EU, national governments and statistical offices as well as international organizations active in the area will need to address this fundamental gap together with specialized research teams.

e) This Theme Issue also sheds light on the importance of a coherent and long-term research agenda focused on the ENP economies and the challenges of the process of economic integration with the EU in order to inform fact-based policy-making. Future research in this field is needed in order to guide and evaluate all policy efforts discussed above.

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