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Trade Policy in the EU's Neighbourhood

Ways Forward for the Deep and Comprehensive Free Trade Agreements

Iana DREYER

Foreword by Eneko Landaburu

Studies & Research
90

Study & 90 Research

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Iana DREYER

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This Study is written in her personal capacity.

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Foreword

An ambitious and responsible European Union wishing to carry weight in our multipolar world needs to build an environment of security, stability and prosperity with its neighbours to the south and to the east.

Yet a great deal remains to be done both in order to achieve it and in the field of economic relations. The merit of Iana Dreyer's work lies in its assessment of the situation today and in its presentation of prospects for the future.

It is a hard fact that most of our neighbours rely on the EU both as their primary export market and as their primary source of imports. Thus it is crucial for the EU to develop increasingly close ties with each one of its neighbouring countries through a new model of Association Agreement known as a "deep and comprehensive free trade agreement" (DCFTA). As its name indicates, this kind of accord runs "deeper" than a mere agreement on the abolition of duty, its aim being to chip away at every possible barrier standing in the way of free trade by harmonising laws, regulations and standards in each country with those of the European Union. This approach adopted by the European Commission is a welcome and healthy move which should bind our various neighbouring countries more tightly to our internal market.

The author makes three concrete proposals which I feel deserve reflection and debate. I do not subscribe totally to the ideas she puts forward, in particular when she calls into question certain political conditionalities, shows hesitation in acknowledging the virtues of regulatory convergence, or overestimates the benefits of customs union. Be that as it may, the merit of this work lies in its sparking a debate outside expert circles on issues which have an unquestionable political impact on the future of the European Union.

The credibility of the EU's external and neighbourhood policies depends on major progress being made in the spheres which Iana Dreyer addresses, but also on measures capable of facilitating individual mobility and on cooperation aid equal to its political aspirations. This is the price to pay if we want the European Union to be an influential regional power and to carve out a better place for itself in a globalised economy.

Eneko Landaburu,
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Executive Summary

This study assesses the trade policy of the European Union (EU) in its neighbourhood. It formulates **proposals for the negotiation of "Deep and Comprehensive Free Trade Agreements" (DCFTAs)** that the EU is currently engaged in, or offering to, Ukraine, Moldova, Georgia, Armenia, Jordan, Egypt, Tunisia and Morocco, as part of the European Neighbourhood Policy (ENP). DCFTAs belong to a wider package of EU policies towards its neighbours brought forward as a response to the democratisation processes witnessed in Eastern Europe and the Caucasus in 2003-2005, and in the Middle East in 2011.

The study **draws lessons from past EU policies aiming at economic integration in its vicinity.** It **takes stock of the trade policy arrangements currently in place** with all its neighbours, from the wealthiest to the poorest. It also **sets the proposed DCFTAs against broader recent trade policy trends in the EU. In particular it uses as a benchmark the bilateral free trade agreements (FTAs)** the EU has signed in recent years with emerging markets outside its neighbourhood.

The fundamental issue at stake in the current DCFTA negotiations is **how far the EU should push the EU *acquis communautaire*** in particular in the field of technical and sanitary standards. The countries under discussion are not expected to join the EU or the Single Market with its four freedoms – free movement of goods, services, capital and people – anytime soon. This is a very different setting from the trade arrangements that have been developed in the EU's neighbourhood in the past, for which EU enlargement played a significant role. Despite this reality, the EU continues to push for regulatory alignment. Yet this is problematic. The EU is dealing with **economies that are much poorer than the EU's poorest member states**. For them, integrating EU standards into their legislation, and in particular putting them into practice, will be costly and will probably fail.

Another important issue is the **need to foster investment in the economies targeted by the DCFTAs**. Both for the purposes of these economies, and for the sake of its own growth, the EU will need to focus on convincing these countries to open up their economies to EU investments in manufacturing and services, not least in infrastructure-related and business services. This is not an easy task. In order to achieve this, the EU needs to design DCFTAs that are ambitious, while offering trade concessions in return that respond sufficiently to the expectations of EU neighbours for access to the EU's market. These expectations revolve around agriculture, and activities in manufacturing and services that require low-to-medium-skilled labour.

The **DCFTAs should also be considered a means to foster industrial renewal in the EU and in the partner economies**. However, in a world of global industrial supply chains, the **EU's rules of origin (ROOs)** in its current FTAs in the neighbourhood (PanEuro) are inadequate to foster the kind of regional trade in parts and components that would be required to build sophisticated cross-border production chains that are part of today's competitive industries.

Three proposals are formulated:

- The first is to **design an ambitious FTA** building on the most advanced FTAs the EU has recently signed outside the region. This means a bolder DCFTA that offers swift 100% duty free trade, with longer phase-in periods for agriculture. It focuses on liberalising and protecting investments in manufacturing and services, and limits the EU's regulatory agenda to essential areas such as public procurement.

- The second is a formula to **help directly exporting firms based in DCFTA economies to comply with EU standards** by giving them direct access to EU based standardisation bodies.
- The third proposal is to **shift from an FTA model to a customs union**. In the EU's neighbourhood, it is a better formula to both achieve the goals of regional economic integration and reduce the distortions coming from rules of origin in FTAs.

Table of Contents

List of tables

List of figures

List of boxes

Introduction

This study assesses the trade policy of the European Union (EU) in its neighbourhood[1] and formulates proposals for the negotiation of "Deep and Comprehensive Free Trade Agreements" (DCFTAs) that the EU is currently engaged in, or offering to, Ukraine, Moldova, Georgia, Armenia, Jordan, Egypt, Tunisia and Morocco, as part of the European Neighbourhood Policy (ENP).

The study draws lessons from past EU policies aiming at economic integration with its neighbours. It takes stock of the trade policy arrangements currently in place with its neighbours, from the wealthiest to the poorest. It also sets the proposed DCFTAs against broader trade policy trends in the EU. In particular it uses as a benchmark the bilateral free trade agreements (FTAs) the EU has signed in recent years with emerging markets outside its neighbourhood.

The fundamental issue at stake is how far the EU should go in demanding that its DCFTA partners align their regulations with those of the EU in return for greater access to the EU market for their exports and services. In other words, how far should the EU

1. The views expressed in this study are not necessarily those of *Notre Europe*.

push the EU *acquis communautaire* in economic policy-making, in particular in the field of technical and sanitary standards? This question is vital because the neighbouring economies under discussion are not expected to join the EU or the Single Market with its four freedoms – free movement of goods, services, capital and labour (i.e. people) – anytime soon. This is a very different situation from the trade arrangements that have previously been developed in the EU's neighbourhood, for which EU enlargement played a significant role. Despite this political reality, the EU continues to push for regulatory alignment.

Yet in the current context, freeing up trade for DCFTA partners under the condition that they adopt EU laws is problematic. The EU is dealing with economies that are much poorer than the EU's poorest member states. For these countries, integrating EU standards into their legislation, and in particular implementing them, will be costly and will probably fail. But these countries need greater access to the EU's markets. Are there other ways to simultaneously free up trade and investment and facilitate the adoption of EU standards by partner countries?

Another important issue is the need to foster investment in the economies targeted by the DCFTAs. Both for the purposes of these economies, and for the sake of its own economic and industrial growth, the EU will need to focus on convincing these countries to open up their economies to EU investments in manufacturing and services, not least in infrastructure-related and business services. This is not an easy task. In order to achieve this, the EU will need to design FTAs that help achieve these goals while offering trade concessions in return that respond to some of the key expectations of EU neighbours for their access to the EU's market.

This study is structured as follows. Part 1 analyses EU trade arrangements within its neighbourhood and draws lessons for today's trade initiatives in the context of the EU's Neighbourhood Policy and the DCFTAs. Part 2 assesses the DCFTAs by discussing the case for economic integration between the EU and these partners and discusses whether the negotiating objectives and methods that the EU proposes are appropriate for responding to the identified economic needs. It also tries to assess how far the EU can draw lessons for the DCFTAs from the FTAs that it has with partners outside the neighbourhood. Part 3 formulates proposals that could help design a DCFTA strategy that responds to the economic needs of both EU and its negotiating partners.

1. EU's Trade Arrangements in Its Neighbourhood Today

1.1. Four Types of Neighbours

With 500 million inhabitants and high average per capita incomes, the EU is the world's biggest economic and trading entity. It is also a major export powerhouse. Although in recent years its overall goods trade balance has been slightly negative, standing at 159 billion EUR in 2010, this can largely be attributed to energy imports. The EU has a trade surplus in high value-added industrial products such as machinery and transport equipment (126 million EUR in 2010). Even more importantly, the EU is a services exporter, with a services trade surplus standing at 85.5 billion EUR in 2010. It is the world's largest investor, with a positive balance of 1,188 billion EUR in foreign direct investment (FDI) stocks abroad in 2010[2].

The EU is currently surrounded by four major types of economies: wealthy advanced economies, dynamic upper middle income economies, economies dependent on hydrocarbon exports, and a handful of lower middle income economies.

2. Figures provided by the European Commission, on the website of the External Trade Directorate General.

The EU enjoys a net positive trade balance with almost all of its trade partners and is particularly competitive in its exports of high value-added manufactures. The EU is also a major investor in its neighbourhood and is, in many countries, the main source of FDI (*see Annexes 2 to 4*). However, the EU is not uniformly a net exporter of services to all of its neighbours, notably in the Mediterranean, where it has a negative services trade balance with Turkey and Morocco. It is the latter's role as tourism destination for Europeans that explains this negative balance. However, it also reflects the fact that high-value added services that the EU could export there are very probably well under their potential.

Table 1 – European Union - Some Economic Indicators

Country	**Population** *(million, 2010)*	**Per capita income** *(current USD, 2011)*	**Average annual GDP growth rate** *(per cent, 2000-2010)*
France	62.8	44,401	1.4
Germany	82.3	44,556	1.2
Italy	60.5	37,046	0.6
United Kingdom	62.0	39,604	1.7
EU 27	500.1	35,743	1.7
Euro zone	330.3	40,232	1.4
Source	*UN*	*IMF*	*IMF*

1.1.1. Wealthy Advanced Economies

The wealthiest major economies around the EU are Iceland, Norway, Switzerland and Liechtenstein. They are wealthier than the EU average and the biggest Euro zone economies. Norway, with its 96,591 USD GDP per capita in 2011 tops the league in income, surpassing all EU member states. It is followed by Switzerland with 84,983 USD GDP per capita. Israel (32,298 USD per capita) is also a high income country. These economies have enjoyed slightly higher growth rates than the four major economies of the EU (*see Table 1 above and Table 2 below*).

Table 2 – Wealthy Neighbours - Some Economic Indicators

Country	GDP per capita (current USD, 2011)	Average annual GDP growth rate (per cent, 2000-2010)	Unemployment rate (per cent, 2009)	Unemployment (young men 15-24) (per cent, 2008)	Population working in agriculture (per cent of total working population, latest available data)
Iceland	43,226	2.5	7.2	8.8	5.9
Liechtenstein	n/a*	n/a	n/a	n/a	n/a
Norway	96,591	1.7	3.2	8.2	2.8
Switzerland	84,983	1.9	4.1	6.7	3.9
Israel	32,298	3.7	7.6	11.9	n/a
Source	*IMF*	*IMF, own calculations*	*World Bank*	*World Bank*	*World Bank*

* *n/a: not applicable.*

Among this group of countries the EU's deepest economic ties are with Switzerland. Switzerland is a major destination of EU manufacturing exports. The EU has a services trade surplus of 16 billion EUR with Switzerland, as well as an accumulated outward stock of FDI of more than EUR 500 billion. Switzerland accounts thus for just below a third of the EU's outward FDI stocks.

What kind of trading partners are these economies? The cursory trade policy profile shown in Table 3 below reveals that the trade policy pattern of these economies is relatively similar to the one of the EU: low tariffs for manufactured goods, relatively open services sectors, and high levels of protection for agriculture.

Advanced diversified economies that engage in mutual trade liberalisation tend to have similar, converging, commercial interests: to export sophisticated manufactured goods and services, and to invest in each other's economies to reach local consumers. Hence they quite readily and easily agree to open their markets to each other. This is the case between the EU and this group of wealthy neighbours.

Table 3 – Trade Policy Profile - Non Preferential (MFN) - Wealthy Neighbours

Country	Average applied MFN tariff (per cent, 2010)		Total number of services sectors with GATS commitments in WTO*
	Agriculture	Manufacturing	
EU 27	13.5	4	115
Iceland	28.6	2.3	113
Israel	16.5	5	58
Norway	43.2	0.5	111
Switzerland & Liechtenstein	36.9	1.9	115
Source	*WTO*	*WTO*	*WTO*

** Note: For Iceland and Norway, EU Single Market rules apply. For Switzerland, preferential services arrangements apply.*

1.1.2. Dynamic Upper Middle Income Economies

The majority of countries surrounding the EU are upper middle income[3] economies which had dynamic economic growth rates in the first decade of this millennium (*see Table 4*). Ukraine and Turkey are particularly noteworthy.

Ukraine, with 45 million inhabitants, has seen strong growth and dynamism in its economy in the new millennium, at least before the 2008 crisis. In addition, Ukraine has a strong industrial base inherited from Soviet times.

Turkey, with 73 million inhabitants, is a major market in the EU's neighbourhood. Its 2011 per capita income was more than 10,500 USD, significantly more than that of Romania (8,666 USD) and Bulgaria (7,243 USD), both EU members states.

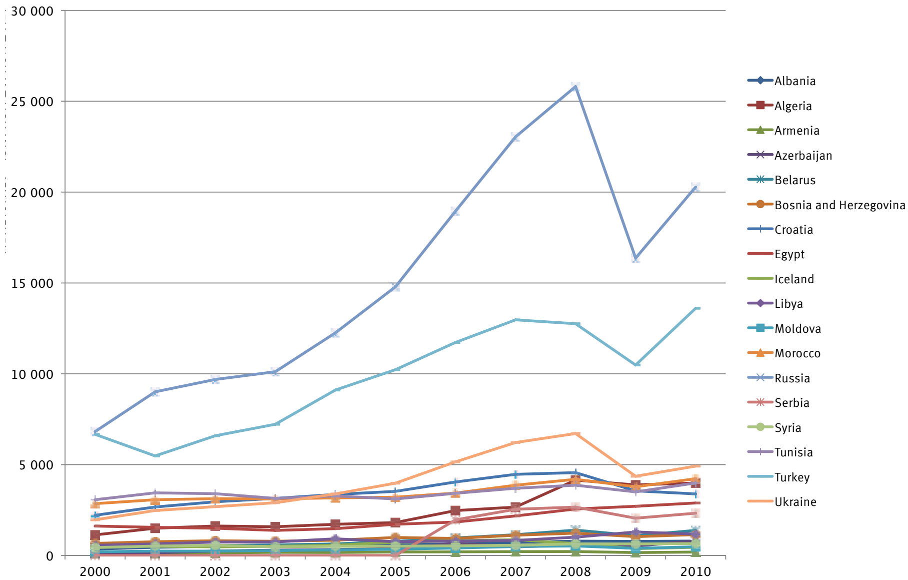
After Russia, Turkey and Ukraine have been, in recent years, the EU's most dynamic destinations for manufacturing exports in the low-to-middle-income neighbourhood as shown in Figure 1 below.

3. The term "middle income" economy used in this study refers specifically to countries included in the World Bank classification of countries with a per capita income (Gross National Income - GNI) between 1,006 and 12,275 current USD. Another subdivision is between lower middle income economies (between 1,006 and 3,975 current USD per capita) and upper middle income (between 3,976 and 12,275 USD per capita).

Table 4 – Dynamic Upper Middle Income Economies - Some Economic Indicators

Country	GDP per capita *(current USD, 2011)*	Average annual GDP growth *(per cent, 2000-2010)*	Unemployment rate *(per cent, 2009)*	Unemployment rate (young men 15-24) *(per cent, 2009)*	Population working in agriculture *(per cent of total working population, latest available data)*
Belarus	6,118	7.3	n/a	n/a	n/a
Ukraine	3,575	4.7	8.8	n/a	16.7
Turkey	10,576	4.2	14	25.4	26.2
Croatia	14,529	2.9	9.1	18.5	12.8
Bosnia-Herzegovina	4,715	3.8	23.9 *(2008)*	44.7 *(2008)*	n/a
Serbia	6,267	3.8	16.6	31 *(2008)*	20.8
Macedonia	5,012	n/a	32.2	52.8	18.2
Montenegro	6,668	3.6	n/a	n/a	n/a
Albania	4,131	5.7	12.7 *(2008)*	n/a	58
Lebanon	10,474	4.9	n/a	n/a	n/a
Jordan	4,542	6.1	12.9	22.6	3
Tunisia	4,593	4.4	14.2 *(2008)*	n/a	26.4
Source	*IMF*	*IMF, own calculations*	*World Bank*	*World Bank*	*World Bank*

Figure 1 – Extra- EU 27 Exports of SITC 6 "Other manufactured goods" to Selected Neighbours (*2000-2010, in million €*)

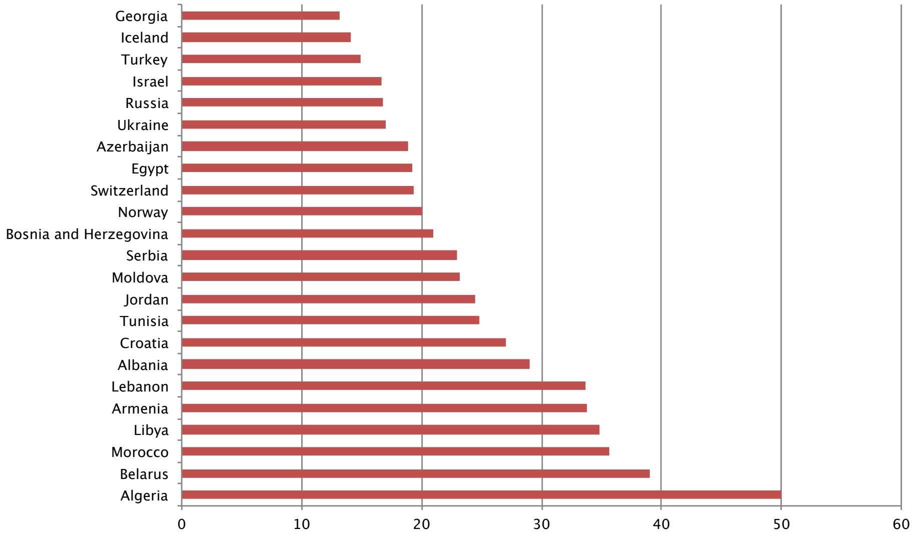


Source: Eurostat.

Despite their recent solid growth performance, a majority of the dynamic upper middle income economies in the neighbourhood are likely to see lower growth in the coming years. Many of them have low levels of investment *(see Figure 2)*. This retards their capital accumulation, hence their convergence with advanced economies.

Figure 2 below shows that investment to GDP ratios in these economies are particularly low, with some below 20% of GDP including Ukraine at 17.1 percent and Turkey's at 14.9. It is interesting to compare these figures to those of East Asian economies such as Korea, Taiwan, China, Thailand, Malaysia and others, which have seen their living standards improve significantly in recent decades. Over several decades, these countries have generally had investment rates above 30% of their GDP. The strong performance of these East Asian economies can also be linked to their export-led growth strategies, which has involved active policies to attract FDI.

Figure 2 – Investment Rates in the EU's Neighbourhood (*2009, in % of GDP*)



Source: International Monetary Fund, World Economic Outlook Database, September 2011.

These countries are faced with a substantial backlog in infrastructure requirements, ranging from utilities to transport. The World Economic Forum's Global Competitiveness Report[4] ranks countries in terms of their quality of infrastructure with global rankings of 51st for Turkey, 59th for Jordan, 69th for Morocco, and 71st for Ukraine. There is thus substantial room for development in this field in which European firms and capital could play a role.

The trade policy profile (*see Table 5*) reveals that these economies tend to shield their manufacturing sectors with relatively high average manufactured goods import tariffs. Only Turkey, which is member of a customs union with the EU and Ukraine, which very recently joined the World Trade Organization, apply low average tariffs.

Similarly to the EU, these economies also tend to apply high tariffs in agriculture. Their services sectors are generally much less open than the EU's. In order for these economies to attract more investment, especially in infrastructure related services, their services sectors should be liberalised.

4. World Economic Forum, The Global Competitiveness Report 2011-2012.

Table 5 – Trade Policy Profile - Non Preferential (MFN) - Dynamic Upper Middle Income Economies

Country	Average applied tariff (per cent, 2010)		Total number of services sectors with GATS commitments in WTO
	Agriculture	*Manufacturing*	
EU 27	13.5	4*	115
Albania	7.9	4.5	108
Belarus	12.2	10.4	n/a
Bosnia-Herzegovina	10.8	5.9	n/a
Croatia	10.7	4	126
FYRM	13.4	6.4	n/a
Jordan	18.6	9	110
Lebanon	n/a	n/a	n/a
Serbia	14.2	6.3	n/a
Tunisia	40.9	18.6	20
Turkey	42.9	4.8	77
Ukraine	9.7	3.8	137
Source	*WTO*	*WTO*	*WTO*

** Note: in most bilateral arrangements the EU applies zero tariffs.*

1.1.3. Hydrocarbon Exporters

The third set of EU partner economies in the neighbourhood are hydrocarbon producers and exporters[5]. Except for Russia, at 79.5 percent, more than 90 percent of the exports to the EU from each of these countries are hydrocarbons (*see Annex 4*). They are ranked as EU trading partner: Russia, Algeria, Libya, Azerbaijan and Syria. Russia, Algeria and Libya together account for about half of the EU's gas imports and almost half of the EU's oil imports. Note that 42% of the EU's final energy consumption is made of petroleum products[6].

Hydrocarbon exporters tend to have relatively high per capita income levels but these are the result of the hydrocarbon rent rather than of proper economic development. Algeria, for example, still employs more than one fifth of its population

5. The author does not include Norway in this category. Norway's exports of hydrocarbons were 63% of its total exports to the EU in 2010, and Norway is the EU's second largest provider of oil and gas, but Norway still differs from the countries included in this classification. The latter export almost exclusively oil and gas to the EU, contrary to Norway which has a more diversified trade relationship with the EU.
6. See Factsheets provided by the EU Commission on the Europe's energy portal.

in agriculture, and in Azerbaijan the proportion is nearly twice as high. Azerbaijan also has a very high rate of unemployment, particularly among youth (*see Table 6 below*).

Table 6 – Hydrocarbon Exporters - Some Economic Indicators

Country	GDP per capita (current USD, 2011)	Average annual GDP growth (per cent, 2000-2010)	Unemployment rate (per cent, 2009)	Unemployment (young men 15-24) (per cent, 2008)	Population working in agriculture (per cent of total working population, latest available data)
Russia	13,236	5.3	8.2	17.7	9
Azerbaijan	7,510	13.9	6.1 *(2008)*	18.7	38.7
Syria	3,050	4.3	n/a	n/a	n/a
Libya	10,873 *(2010)*	4	n/a	n/a	n/a
Algeria	4,366	3.6	11.3 *(2008)*	n/a	20.7
Source	*IMF*	*IMF, own calculations*	*World Bank*	*World Bank*	*World Bank*

Box 1
Top 5 Sources of EU Gas Imports
NB - Gas accounts for 23.9 per cent of EU energy consumption

Russia: 40.8 %
Norway: 26.7%
Algeria: 6.9 %
Nigeria: 5.1%
Libya: 3.2%

Box 2
Top 5 Sources of EU Oil Imports
NB - Oil accounts for 36.4 per cent of EU energy consumption

Russia: 34.0%
Norway: 15.5%
Libya: 10.2 %
Saudi Arabia: 7.2%
Other Middle East: 6.3%

Source: EU Commission, 2010 Energy Transport Figures.

In the last ten years, trade between the EU and these economies has risen substantially. As hydrocarbon exporters like Russia and Algeria have seen their incomes rise, EU manufacturing exports to those countries have risen substantially (*see Figure 1*). Russia has become the biggest export destination in the neighbourhood.

The trade relationship between the EU and the hydrocarbon exporters can be summarised as follows: exports of oil and gas to the EU, and imports primarily of manufactured goods, plus some services and agricultural products, from the EU. This is the typical pattern of trade between commodity exporters and advanced industrialised nations (*see Annex 4*).

The political economy of trade relationships between the EU and these partners is shaped by strong dependence on hydrocarbon exports. This raises the question of security of supplies as highlighted by the gas supply disruptions of 2006 and 2009 by the Russian export monopoly Gazprom and the supply disruptions and oil price hikes in the aftermath of the 2011 descent of Libya into civil war.

This dependency also poses significant political and trade policy problems. None of these countries are members of the World Trade Organization (WTO). Russia was offered membership accession in late 2011 but, at the time of writing, still requires its parliament to ratify the accession treaty (*more below*). Consequently, the EU's trade relationships are outside the reach of the least-common-denominator international trade rules embodied by this multilateral institution. The WTO provides rules that guarantee non-discrimination, national treatment, and a predictable framework for tariff and other trade policies[7].

In addition, the trade policies of these countries are relatively protectionist. They tend to have a high rate of average import tariffs on manufactured goods (*see Table 7*) and high levels of protectionism in the services sector.

7. With Russia, in particular, EU trade relationships have involved major problems. The EU exports significant amounts of industrial and agricultural goods to Russia. More than 44 per cent of the EU's exports to Russia are machinery and transport equipment, while 18.3 per cent are chemical products (including medicines) and more than 10 per cent are agricultural products. EU exports have been subjected in the last decade to import bans and sharp tariff rises that would have been outlawed by the WTO; in the summer of 2011, after the E.coli crisis, the entire EU's agricultural exports were blocked for several weeks – an utterly disproportionate response. In the autumn of 2008, car import tariffs were raised from 25 to 30 per cent.

The business climate in the economies of these countries tends to be less attractive than in other economies at similar level of per capita income. All these countries suffer disproportionately from corruption. Russia ranks 154th in Transparency International's 2010 Corruption Perceptions Index (CPI)[8], Algeria 105th, Syria 127th Azerbaijan 134th and Libya 146th. This compares poorly with, for example, the CPI rankings for EU candidate countries Turkey (56th) and Croatia (62nd). This corruption issue discourages foreign investment that could help these economies diversify.

European investors interested in these economies are mostly major energy firms. However, in particular in the case of Russia, investors in services and manufacturing would be very interested in serving the relatively attractive domestic Russian market. For this they would require a safe and predictable trade and investment policy framework in line with international standards.

Table 7 – Trade Policy Profile - Non Preferential (MFN) - Hydrocarbon Exporters

Country	Average applied tariff (per cent, 2010)		Total number of services sectors with GATS commitments in WTO
	Agriculture	*Manufacturing*	
EU 27	13.5	4	115
Algeria	23.3	17.8	n/a
Azerbaijan	13.5	8.2	n/a
Libya	n/a	n/a	n/a
Russia	13.2	10.1	n/a
Syria	n/a	n/a	n/a
Source	*WTO*	*WTO*	*WTO*

1.1.4. The EU's Poorest Neighbours

Moldova, Georgia, Armenia, Egypt and Morocco, are the EU's five poorest neighbours (*see Table 8*). They have income levels less than half that of the EU's poorest member state, Bulgaria[9].

8. Transparency International's 2010 Corruption Perceptions Index evaluates 178 economies.
9. Bulgaria has a 2011 per capita income of 7,243 current USD, according to the latest IMF World Economic Outlook (WEO) statistics.

These economies have labour forces strongly concentrated in uncompetitive agricultural sectors. Moldova, Georgia and Armenia are very small countries with limited commercial potential for the EU.

Egypt is a big economy of 81 million inhabitants with one third of its working population employed in agriculture. Due to its geographic proximity to the EU market and its labour abundance, Egypt has a substantial potential for developing light manufacturing industries such as textiles or electrical equipment, and being part of international production supply chains to serve the EU market. Egypt requires a lot of investment into its economy and into its infrastructure (it ranks 75th in the quality of its infrastructure in the last Global Competitiveness Report[10]) where EU investors could play a role.

Morocco has an economic and trade policy profile that can partly be likened to Egypt's. However, lower external tariffs in the WTO (*see Table 9*), deeper-ranging domestic economic reforms, buttressed by an FTA with the United States that came into force in 2006, makes it a country that appears to have a significant growth potential in the coming years.

Table 8 – The EU's Poorest Neighbours - Some Economic Indicators

Country	GDP per capita, rounded *(current USD, 2011)*	Average annual GDP growth *(per cent, 2000-2010)*	Unemployment rate *(per cent, 2009)*	Unemployment rate (young men 15-24) *(per cent, 2009)*	Population working in agriculture *(per cent of total working population, latest available data)*
Moldova	2,022	4.9	6.4	15.8	32.8
Georgia	3,098	5.9	16.5 (*2008*)	32.4	53.4
Armenia	3,048	8.1	28.6 (*2008*)	n/a	46.2
Egypt	2,922	5.0	9.4	n/a	31.2
Morocco	3,162	4.7	10	22.8	40.9
Source	*IMF WEO*	*IMF WEO*	*World Bank*	*World Bank*	*World Bank*

The trade relationships between the EU and Armenia, Georgia and Moldova are minuscule. Their exports to the EU are dominated by agricultural products. The EU exports both industrial goods and agricultural products to these markets.

10. World Economic Forum, The Global Competitiveness Report 2011-2012.

According to figures provided by the EU Commission, Egypt absorbs 1.1 percent of the EU's exports, which is more than most "Euromed" neighbours but less than Ukraine. The EU has a services trade deficit with Egypt, a major exporter of tourism services. While the primary EU exports to Egypt are machinery and transport equipment, Egypt primarily sells hydrocarbons in return (47.9 percent of exports to the EU). Trade levels are below potential. With Morocco, the EU has a services trade deficit as well, presumably due to the country's role as tourist destination and to imports of services that are below potential.

Armenia, Georgia and Moldova, given their size, will never be major commercial targets for EU exporters and investors. However, these economies would gain *substantially* by having better access to EU markets for goods, services, capital and labour. These three economies have trade policy regimes that are significantly more open than the EU: they apply low tariffs and have a services trade regime that is at least as open as the EU's (*see Table 9 below*). Georgia is fully open to FDI and recognises the technical standards of the EU and of other trading partners[11]. The EU offers these countries trade preferences under the Generalised System of Preferences (GSP). With Egypt the situation is different as Egypt practices high levels of trade protectionism, particularly in agriculture (*see Table 9*).

Table 9 – Trade Policy Profile - Non Preferential (MFN) - The EU's Poorest Neighbours

Country	Average applied tariff (*per cent, 2010*)		Total number of services sectors with GATS commitments in WTO
	Agriculture	*Manufacturing*	
EU 27	13.5	4	115
Armenia	6.8	2.2	106
Georgia	7.7	0.3	125
Moldova	10.7	3.7	n/a
Egypt	70.7	9.2	44
Morocco	42.1	14.4	45
Source	*WTO*	*WTO*	*WTO*

11. Messerlin P. *et al.*, "An Appraisal of the EU's Trade Policy Towards its Eastern Neighbours: The Case of Georgia", Joint GEM-SciencesPo/CEPS Policy Study, March 2011.

1.2. The Depth of Economic Integration Agreements in the EU Neighbourhood

The trade agreements currently in force between the EU and its neighbours are "deeper" in the scope of commerce covered and in their legal "bite", the wealthier the partner economy is. Four types of arrangements appear to have crystallised between the EU and its partners over the last decades:

1. Participation in the Single Market including labour mobility, but exclusion from the Common Agricultural Policy (CAP);
2. A customs union;
3. "Shallow" bilateral free trade agreements (FTAs);
4. No formalised bilateral agreements.

These four types of arrangements partly overlap with the four categories of trading partners described in Section 1.1. above.

1.2.1. Participation in the Single Market Excluding the Common Agricultural Policy: the EEA

A first set of EU partners enjoys the four freedoms of the European Union: the free movement of goods, of services, of capital and of persons. This arrangement applies to the economies in the European Economic Area (EEA): Iceland (so far), Norway and Liechtenstein.

These partners are obliged to apply EU rules and the *acquis communautaire* built up since 1957 but are not part of EU political institutions and decision-making. They have thus lost significant policy autonomy. However they keep their sovereignty in trade policy, as they are not part of the EU customs union.

These three economies are also not part of the Common Agricultural Policy and their agricultural goods exports are subject to the EU's rather high levels of import protection through tariffs and quotas. This latter arrangement is by mutual consent: Norway and Switzerland (*see Table 3*) are even more protectionist in agricultural matters than the EU.

A variant on the arrangement with Iceland, Norway and Liechtenstein is the one with Switzerland with whom a set of bilateral agreements has been in place since 1999 under the heading "Bilateral I". These agreements involve:

- Free movement of manufactured goods – duty-free and with mutual recognition of conformance assessment of technical standards;
- Free movement of services;
- A liberal regime for labour mobility.

The latter includes a liberal regime for temporary movement of workers for service provision (by internationals standards), also called "Mode 4" in trade policy jargon. Indeed Article 5 of the Agreement between the European Community and its Member States (...) and the Swiss Confederation (...) on the free movement of persons states the following: *"Without prejudice to other specific agreements between the Contracting Parties specifically concerning the provision of services (...), persons providing services, including companies in accordance with the provisions of Annex I, shall have the right to provide a service in the territory of the other Contracting Party for a period not exceeding 90 days' of actual work in a calendar year."*[12]

By mutual consent, agricultural goods are not included in the EU-Swiss bilateral arrangements.

1.2.2. Customs Union Excluding Agriculture and Movement of Labour: Turkey

The second arrangement is the customs union, involving a joint trade policy, which is in place only with Turkey[13]. Since 1996 there has been duty-free trade between both parties and Turkey applies the same external tariffs as the EU. In practice, Turkey delegates its external trade policy to Brussels. The trade arrangements with Turkey cover technical standards, intellectual property and other trade-related rules.

12. Agreement between the European Community and its Member States, of the one part, and the Swiss Confederation, of the other, on the free movement of persons - Final Act - Joint Declarations - Information relating to the entry into force of the seven Agreements with the Swiss Confederation in the sectors free movement of persons, air and land transport, public procurement, scientific and technological cooperation, mutual recognition in relation to conformity assessment, and trade in agricultural products.
13. When one discounts San Marino and Andorra, minuscule countries in the heart of Europe, which are part of the EU's customs union.

In the field of technical standards, Turkey is required by the Customs Union Agreement "*to incorporate into its internal legal order the Community instruments relating to the removal of technical barriers to trade.*"[14]

The agreement adds: "*When Turkey has put into force the provisions of the Community instrument or instruments necessary for the elimination of technical barriers to trade in a particular product, trade in that product between the Parties shall take place in accordance with the conditions laid down by those instruments.*"

Agricultural goods are largely left out of the customs union. This has long been a source of Turkish dissatisfaction with the EU, along with services and the temporary movement of labour, which are of interest to Turkey. Turkey is rather reticent to open up in services or public procurement markets, in which EU firms have a particular interest.

1.2.3. "Shallow" Free Trade Agreements: Euromed

The weakest trade policy agreements which are currently in force in the neighbourhood are the free trade agreements with the Middle Eastern and Northern African economies that emerged from the 1990s Barcelona Process, called the "Euromed" Association Agreements. These agreements can be considered "WTO Minus" in the sense that they do not significantly liberalise trade beyond the benchmark set by the WTO's body of rules and treaties on goods trade, services trade, trade-related intellectual property rights, government procurement, investment, technical standards, sanitary standards, and antidumping rules, to name the most important[15].

Euromed agreements focus almost exclusively on tariff reductions. They provide for a slow transition towards duty-free trade in manufactured goods. The EU allows its partners long transition periods to apply duty-free treatment to its manufactured exports.

14. Decision No 1/95 of the EC-Turkey Association Council of 22 December 1995 on implementing the final phase of the Customs Union.
15. The GATT and GATS demand that FTAs "cover substantially all trade". Because FTAs create significant trade distortions, economists and policy makers tend to consider that FTAs are beneficial when they are comprehensive and tackle barriers to trade behind the border. In formal terms, agreements should thus be "WTO-Plus", i.e. they liberalise a member state's trade more than its current commitments in the WTO, not only on tariffs, but also in services and in a range of trade-related rules ranging from the handling of public procurement to the administration of technical and sanitary standards to the regulation of foreign investment.

Agriculture is not liberalised in any meaningful way, in either direction. In recent years, the EU has granted relatively preferential access to some of its partners in the Southern Mediterranean. This has mainly consisted in a reduction – but not elimination – of tariffs in some fruit and vegetables, as well as an expansion – but not elimination – of quotas. Recently, in an upgrade of Egypt's agreement with the EU, the EU agreed to eliminate all tariffs and quotas, *except* in products that make up a typical Mediterranean dish: tomatoes, garlic, cucumbers, courgettes, grapes and strawberries. Rice, sugar and sugar products confectionary, any food preparations of flour, groats, meal, and starch also remain excluded. All these products have a modest reduction of tariffs and quotas in favour of Egypt.

Trade rule language relating to technical barriers to trade, sanitary regulations, intellectual property, and public procurement of investment in current agreements, when it exists, is not legally binding. On services, future negotiations on liberalisation are called for but have never seen progress. More generally, a "free trade area" planned for 2010 has failed to materialise.

One major explanation for the shape of these agreements and of the failure of negotiations undertaken in recent years, such as after the launch of the Union for the Mediterranean, has to do with political economy problems. Trade agreements that are "WTO Plus" would require significant adjustments for most of the partner countries, particularly in services and manufacturing. Most of the regimes in place in the 1990s were not willing to risk this. On the other hand, liberalising trade in agriculture and other sensitive areas for the EU (including temporary movement of services workers or on labour-intensive manufactures) risks running against strong domestic resistance, notably from member states with a more conservative attitude towards the Common Agricultural Policy and economies on the Mediterranean rim struggling with industrial competitiveness. There has so far been no higher domestic political or geopolitical imperative on either side to justify overcoming domestic resistance to liberalisation and hence to reach an agreement.

1.2.4. No Formal Arrangement: Hydrocarbon Exporters and Most Poorest Neighbours

With countries that are highly dependent on hydrocarbon exports, no trade arrangements are in place. Most are not even members of the WTO. Russia, once its WTO accession ratified, will face major challenges in implementing its commitments[16]. There is no prospect for any form of free trade arrangement with Russia in the coming years.

The EU offers unilateral trade preferences to its poorest neighbours, Armenia, Georgia and Moldova, under the GSP scheme. The EU has, however, just launched free trade negotiations with all three of these states[17].

Table 10 – Overview of Existing Trade Relationships Between the EU and its Neighbours

Type of bilateral trade agreement	Entry into force	Member or target countries	Key characteristics
European Economic Area/ European Free Trade Area – EEA/EFTA	1994 for EEA. Switzerland has "Bilateral I" series of treaties since 1999.	Iceland, Norway, Liechtenstein, Switzerland.	• EEA: full participation in EU Single Market (four freedoms). No agricultural goods trade liberalisation. • Switzerland: also agreement on processed agricultural goods with EU. • Partners maintain external trade policy autonomy.
Common Economic Space	Projected, stalled.	Russia.	• Unclear. Close to full economic integration with free movement of goods, services and capital and easy movement of labour.
"Euromed" Association Agreements, stemming from the Barcelona Process in the 1990s	Late 1990s or early years of 2000 decades.	Jordan, Lebanon, Israel, Egypt, Tunisia, Algeria, Morocco.	• Focus on tariffs in goods – progressive elimination of tariffs. Trade rules: Intellectual Property clauses. • No meaningful liberalisation in agriculture. No liberalisation of services, no liberalisation of investment, no clauses on government procurement. • No meaningful clauses on Technical standards (TBT) or sanitary and phytosanitary standards (SPS). • Partners maintain their domestic economic policy and trade policy autonomy.

16. Freedman, J., "Russian Industries May Rile WTO by Undermining Trade Pledges", Bloomberg, 11 November 2011.
17. European Commission, "Commissioner De Gucht visits Moldova and Georgia to open trade negotiations", *Press release*, 24 February 2012 and European Commission, "EU launches free trade negotiations with Armenia", *Press Release*, 20 February 2012.

Accession countries	Croatia to join EU in 2013, and Iceland expected to join. Accession negotiations with Turkey stalled.	Croatia, Iceland, Turkey; With Turkey, customs union in force which excludes agriculture.	• Projected: Full participation in EU Single Market (four freedoms) and inclusion into the CAP and fisheries policy.
Association and Stabilisation Agreements in Balkans	2007-2010.	Bosnia-Herzegovina, Serbia, Albania, Montenegro; No agreement with Macedonia.	• Various levels of trade integration. • Preferential tariff regime, no meaningful agricultural market liberalisation, no meaningful liberalisation of services markets both ways.
DCFTA (Deep and Comprehensive Free Trade Agreements)	Projected.	Formally concluded but not signed nor disclosed with Ukraine in late 2011; negotiations launched with Georgia, Armenia and Moldova; proposed by EU to Euromed countries in late 2011.	Proposed: • Duty free quota free trade in manufactured goods. • Almost duty free quota free trade in agricultural goods. • Advanced rules to open services markets and investment regimes, as well as government procurement. • Partners have to apply EU laws related to Single Market, not least technical standards and sanitary standards. This is not only for their exports to the EU, but their entire domestic market needs to comply with these rules. • No meaningful liberalisation of Mode 4, i.e. temporary movement of labour in sight. "Mobility partnerships" supposed to deal with labour migration.
Others	No agreement related to trade liberalisation in last two decades.	Azerbaijan, Syria, Libya.	• n/a

Source: Iana Dreyer.

1.3. The Primacy of Politics over Commerce – The Legacy of Enlargement

Trade agreements ultimately serve and are shaped by political and geopolitical goals. In the EU neighbourhood, political, more than commercial, considerations are paramount in shaping these relationships and blocking or unblocking commercial negotiations. Trade arrangements are not only the most comprehensive with the wealthiest economies; they are also the most comprehensive with the economies which the EU has been most eager to invite to become EU members. One could say that it is not deep trade per se that the EU has been seeking in its (European) neighbourhood; it has rather been seeking its own expansion, in the form of the export of the EU *acquis communautaire*, with access to its Single Market as the key attraction point for its partners.

The EU has been very successful so far, as its successive phases of enlargement demonstrate. Yet, one can interpret the refusal to join the EU by Norway and Switzerland, via referendums held in the 1990s, as the rejection of the EU by economies that are wealthier than the EU average. They fear losing sovereignty and becoming a net contributor to the EU's budget.

The choice made by the Western European member states of expanding the EU to integrate Southern Europe in the 1980s, and then Central and Eastern Europe in 1990s-2000s, has been a means to reward and entrench democratisation on the European continent.

The latter process was a response by EU leaders to the fall of the Iron Curtain and understood as the best means to stabilise the European continent. As an expert on the matter put it: "*The Union tried to assert political and economic control over the unstable and impoverished eastern part of the continent. This enlargement was thus about filling in an unprecedented power vacuum in the northern, eastern and southern parts of the continent. It was about conquering, reforming, and regulating*[18] *new emerging markets. In essence it was about securing peace and prosperity in the future Europe through the skilful use of EU membership conditionality*"[19].

18. Author's highlights.
19. Zielonka, J., *Europe as Empire. The Nature of the enlarged European Union*, Oxford University Press, 2006, p. 45.

Trade policy has been a central tool in the enlargement process before the 2004 accessions. Yet in the context of the Europe Agreements which framed the accession process for the Central and Eastern European (CEE) candidate countries, trade negotiations with the candidate countries were very difficult[20]. The prospect of increasing exports to the EU has been a key incentive and deliberate policy to have candidate countries open up, reform their economies and adopt the *acquis communautaire*.

However, opening up its agricultural, metals and textiles markets – then the bulk of CEE export interests – to these new partners has not been an easy task internally. It has been the subject of great acrimony. Enlargement generally went against what scholars have termed the "conservative bias" of individual EU policy areas in the Commission or in member states affected by trade liberalisation, and their related vested interests (agriculture, industry/antidumping). Only the sense of a higher political imperative seems to have allowed the process to overcome domestic resistance. Europe's top leadership in the 1990s appears to have "*demonstrated a considerable shared sense of purpose*". The EU was "*collectively (...) much more receptive to the demands of the CEECs"*[21] than it is to today's candidates such as Turkey and to other neighbours[22]. It appears that a combination of joint German, British and Commission leadership and activism has been able to move trade discussions, and thus the wider enlargement process, forward[23]. Regardless of this leadership, the new candidate countries in the East have been long frustrated in their push to enjoy full mobility despite the fact that labour mobility is one of the EU's four freedoms. Romania and Bulgaria are still waiting for it.

Disenchantment set in, however, after 2004 when ten new Central and Eastern European member states joined the EU. Günter Verheugen, Enlargement Commissioner, stated in May 2004, "*the enlargement process is finished for the time being.*"[24] Formally, this statement was not true. Romania and Bulgaria were admitted as new members by 2007 and offering EU accession as a prospect is currently a major policy instrument in the EU's dealings towards the Balkans. In late 2011 Croatia was given the green light to become the EU's 28th member in 2013.

20. Wallace, H. *et al., Policy Making in the European Union*, Fifth Edition, Oxford University Press, 2010, Chapter 16, pp. 401-428.
21. Wallace H. et al., *Ibid.*, p. 405.
22. *Ibid.*
23. *Ibid.*, p. 409
24. *Ibid.*, p. 424.

The impetus to enlarge, however, has faded. Accession negotiations were launched with Turkey in 2005 but have stalled. Some EU member states wish to see enlargement to selected European neighbours, and there are expectations in partner countries that the EU shall offer membership, such as to Ukraine, but big EU member states are much more reluctant.

The policy the EU has offered since 2004 to neighbours to its East, in the Caucasus and around the Mediterranean has been the European Neighbourhood Policy (ENP).

The trade policy component of this set of policies is the *Deep and Comprehensive* Free Trade Agreement (DCFTA).

The EU's DCFTAs are part of a wider package of EU policies towards its neighbours adopted as a response, within the ENP framework, to the democratisation processes witnessed in Eastern Europe and the Caucasus in 2003-2005, and in the Middle East in 2011. This involves aid, technical assistance on democratic governance, regulatory cooperation, and arrangements for mobility (circular migration, visa facilitation) and border management[25].

In late 2008, when the EU launched the Eastern Partnership (EaP), the EU offered to open negotiations towards a DCFTA with Ukraine, Moldova and the Caucasus economies. The EU has also pledged to offer this DCFTA to four Mediterranean states in the aftermath of the 2011 "Arab Spring": Egypt, Jordan, Morocco and Tunisia[26]. With Ukraine, negotiations were formally concluded in late 2011. But the agreement is not signed and the text is not publicly available at the time of writing this study. With Georgia, Moldova and Armenia, negotiations were launched in early 2012.

The EU's overall goal in the region can be summarized as follows: "*The European Union has a vital interest in seeing stability, better governance and economic development at its (...) borders*". [27] And: "*to build and consolidate healthy democracies, pursue sustainable economic growth and manage cross-border links.*"[28]

25. See European Commission, website of the European Neighbourhood Policy.
26. See European External Action Service (EEAS) and European Commission, "A New Response to a Changing Neighbourhood. A Review of the Neighbourhood Policy", 25 May 2011.
27. European Commission, Communication from the Commission to the European Parliament and the Council, *Eastern Partnership*, COM 2008 823 final, 3 December 2008.
28. EEAS and European Commission, *Ibid*.

Trade policy is a tool used by the EU to foster the economic development it pursues in the region.

Yet DCFTAs are offered in a political context that is very contentious and shaped by expectations on both sides that are inherited from the EU's past enlargement policies.

The central question today is one of overall purpose for the ENP and by extension of its DCFTAS. Is the EU aiming to integrate these economies into its Single Market, if not in the form of full EU membership, so at least under a scheme that is similar to the one offered to EEA economies, as it has done in the past with neighbours? In other words, is it willing to offer free movement of goods, services, capital and labour under the same set of common rules and regulations? If so, what is the timeframe? What are the pre-conditions for this to happen?

The EU will probably not answer these questions anytime soon. What is more, recent developments indicate that the EU is increasingly unwilling to integrate new members into its Single Market.

Despite this context there remain strong expectations on both sides as regards these DCFTAs:

- The EU would like to continue to export its *EU acquis* in the EU neighbourhood as in the past;
- The EU's partners expect to obtain significant preferential treatment from the EU that allows them to export more and its labour force to move more, notably in comparison with other trading partners of the EU in the emerging and developing world.

Yet, for the EU to continue to export its rules "wholesale" without guarantees to its partners that they will be integrated into the Single Market will be economically costly, politically contentious and probably materially impossible. This matter will be discussed in the next section.

1.4. Concluding Remarks

Three main lessons for the analysis of current and future DCFTA negotiations, to be discussed in the next chapter, can be drawn from the economic integration processes of the EU and its neighbours:

1. The EU, in negotiating agreements on economic matters, has the propensity to "regulate" its neighbours, i.e. to require them to adopt the EU acquis communautaire.
2. The EU has a legacy of "conservatism" in opening its markets in agriculture, some sensitive industrial sectors, and the movement of workers.
3. Opening up these sectors is a major incentive for the EU's partners to agree on the regulatory and other changes the EU demands of them. Yet only strong political imperatives and leadership from key institutions and big member states allow the EU to overcome domestic resistance to opening up.

Similarly to previous enlargements and Single Market expansions (comparable to those witnessed with EEA countries), the EU today has maintained its impetus to export its *acquis*. However, contrary to previous episodes, the current context does not guarantee that the EU will be in a position to overcome the "conservative bias" of sectors more reluctant to open up. These sectors are agriculture, remaining parts of industry, and low-skilled labour.

2. Do DCFTAs Respond to the Trade Policy Needs of the EU and its Partners?

The commercial and economic objectives of the DCFTAs that the EU proposes to ENP countries are summarized in the Communication published jointly by the EU Commission and the new European External Action Service in May 2011[29]. According to this communication, DCFTAs aim to: "*cover substantially all trade (…) and aim at the highest possible degree of liberalisation (with the asymmetry in the pace of liberalisation appropriate to the partners' economies). They will contain legally binding commitments on regulatory approximation in trade-related areas and will thus contribute to the modernisation of the economies of the partner countries (…). They will create real perspectives for enhanced movement of goods (this could include Agreements on Conformity Assessment and Acceptance of Industrial Products and the recognition of equivalence achieved by partners related to sanitary and phytosanitary standards for agricultural and food products)*".[30]

From this summary two key, intertwined, objectives appear:

- to liberalise markets;
- to export the EU *acquis*, as expressed in the term "regulatory approximation".

29. *Ibid.*
30. *Ibid.*

This section will show that in today's context liberalisation and regulatory approximation can in some economically significant cases, be contradictory. However, before coming to this issue, this section will discuss the economic case for the proposed DCFTAs, question whether the proposed instruments respond to the identified economic needs, and explore, thanks to a benchmark with other FTAs the EU has recently signed, whether there are alternative means of satisfying them.

2.1. The Case for Deeper Economic Integration Between the EU and its DCFTA Partners

2.1.1. The Economic Case for DCFTAs

Comparative advantages

Trade policy is – or at least should be – a means for a government to increase the efficiency of an economy by allowing it to realise its comparative advantages. The EU's DCFTA partners are, as we have seen, dynamic upper middle income economies and lower middle income economies. Their comparative advantages in international trade tend to lie in low to middle skilled labour-intensive activities in agriculture, manufacturing and services. The EU's comparative advantages can summarily be described as residing in capital and human-capital intensive activities, especially in the manufacturing sector and in the services sector, notably infrastructure-related services and knowledge-intensive services such as business services. As the previous section has shown, the current trade arrangements with these economies could be improved to allow both sides to take best advantage of their complementarities. For the EU's partners, deeply entrenched obstacles to the access to EU markets persist in agriculture, to a lesser extent in manufacturing, and especially in labour mobility, not least the temporary movement of services providers for activities requiring low or middle levels of activities (Mode 4). For the EU, its export performance in services could be improved significantly, notably in North Africa, where the EU has a services export deficit.

Investment

In terms of goods exports, the EU already offers preferential terms to these partners' exports (except Ukraine). Indeed, they enjoy duty-free exports to the EU in the context of the GSP regime and the Euromed agreements. DCFTAs will not be of much gain for them in terms of tariff reductions. The main reason emerging markets sign FTAs with advanced trading partners is not to make trade preferences permanent, but to attract investment.

Indeed, FTAs are a good means to stabilise the policy and the regulatory framework, raising the confidence of both foreign and domestic investors. Eliminating import tariffs, opening up services sectors (most services trade occurs through FDI), and becoming embedded in a legal framework that renders the business environment more predictable is considered a good method to attract investment. As we have seen in the previous chapter, investment is strongly needed in the EU's neighbourhood.

Industrial renewal for the EU and its partners

Industrial production in many fields, not least in textiles, electrical equipment and electronics, and machinery and automobiles, is now a global cross-border process. This explains a rising share of component trade in recent decades as a share of global trade (*see Table 11 below*). Component trade is hard to capture statistically, but it is estimated at between 56% and 73% of world trade[31].

Different economies participate in the production process depending on their respective capital and labour cost structures and specific expertise, i.e. on the different level of value-added they are able to provide. Production processes involving abundant labour for mass production (such as textiles and other light manufactures) tend to be located in poorer, labour abundant countries, while production processes with high value-added such as research and development, marketing, or logistics, tend to be located in advanced economies with comparatively scarce unskilled labour. There are shades of grey in terms of cost and skill structures in between these two extremes. Hence, a product may be produced in a great number of different countries with different cost levels until it is finally assembled, either in a major centre like China or in the final location of consumption in the West. What is more, global supply chains and FDI go hand in hand.

31. Miroudot, S., R. Lanz and A. Ragoussis, "Trade in Intermediate Goods and Services", *OECD Trade Policy Working Papers*, No. 93, OECD Publishing, 2009.

There is a tremendous opportunity for the poorer economies on the periphery of the EU to participate in global and regional industrial supply chains. Indeed, they have a major advantage: they are close to a major final consumption market and industrial powerhouse, the EU. The EU's Eastern and Mediterranean neighbours could participate in global production networks and become part of the industrial and even services supply chains (such as back office services) now involving the advanced Western economies, the increasingly wealthy Central and Eastern European member states and Turkey.

Table 11 – Growing Shares of Parts and Components (P&C) Trade in Overall Industrial Product Trade, and Contribution of P&C Trade to Overall Manufacturing Trade Growth

Product category	1992/93, per cent of P&C trade as part of total trade	2005/06, per cent of P&C trade as part of total trade	Contribution of P&C to manufacturing trade growth (*per cent*)
Machinery and transport equipment (of which:) (SITC 7)	**36.5**	**40.7**	42.7
Power generating machines (SITC 71)	66.7	67.3	**67.5**
Specialised industrial machine (SITC 72)	25	27.3	29
Metal working machine (SITC 73)	26.3	27.4	28.1
General industrial machinery (SITC 74)	17.1	18.1	18.6
ICT products (SITC 75, 76, 772, 776)	**50.5**	**55.5**	57.1
Office machines and automatic data processing machines (SITC 75)	***31.9***	***38.4***	*41.5*
Telecommunication and sound recording equipment (SITC 76)	*29.3*	*27.3*	*26.7*
Semiconductors and semiconductor devices (SITC 772+776)	*94.8*	*94.7*	***94.7***
Electrical machinery (SITC 77-772-776)	*15.6*	*11.7*	*10.4*
Road vehicles (SITC 78)	26.1	27.7	28.6
Other transport equipment (SITC 79)	30.1	29.3	28.6
Miscellaneous manufacturing (SITC 8)	*4.6*	*5.9*	*6.7*
TOTAL MANUFACTURING TRADE	18.9	22.3	**24**

Source: Athukorala, P., "East Asia in World Trade, The Decoupling Fallacy, Crisis and Policy Challenges", *FIW Working Paper No. 52*, ***2010.***

With the rise of China as the world's manufacturing power house in the last decade, thanks to its abundant pool of low-cost labour, it has been difficult for other developing economies, not least those on the EU's periphery, to compete for global market shares in the export of manufactures involving abundant labour. China's labour costs are rising, however, and certain production processes are now being relocated and could be moved closer to the big EU market[32].

Allowing this relocation to happen is, in a time when the EU is seeking ways to raise growth rates and many member states struggle with industrial competitiveness, an opportunity for industrial renewal. It is useful to be reminded that a similar process has occurred within the EU. Industries from Western Europe, not least Germany, whose industrial renewal and performance have impressed its European partners, have massively off-shored industrial processes to the new EU member states in the last ten to twenty years. Germany has become a major final assembly hub for the high value-added manufacturing products it conceives and exports. It produces them in a sophisticated chain across the new EU member states involving massive trade of intermediary inputs. Recent measures of intermediary input trade between the EU 10 and the EU 15 show that countries like the Czech Republic, Slovakia, Hungary and Estonia had export growth rates of more than 10% per year between 1996 and 2004, and trade in intermediate goods, and in parts and accessories of capital goods, have constituted the bulk of this growth. The share of imported intermediary products in German and French exports is close to 30%, up from below 20% in the mid 1990s, and most of these imports originate in Europe. This reorganisation of industry in the EU has significantly benefited the new EU member states and has contributed to rising incomes there. Contrary to a widely-held view, this trade has benefited employment, notably in Germany. In France, there is evidence that firms engaging in processing trade have been net employment creators in contrast to firms that have not[33].

Table 12 below shows that there is scope for the EU to increase the share of component trade in comparison to other regions in the world, such as Japan, ASEAN or NAFTA, where regional supply chains play an important role in the industrial production process.

32. Jacob, R., "China wage rises bring shift in production", *Financial Times*, 6 September 2011.
33. Kramarz F., "Employment and Trade in France: A Firm-Level View (1995-2004)", *OECD Working Papers*, No. 124, OECD Publishing, 2011.

Table 12 – Share of Parts and Components in Manufacturing Trade (SITC categories 5-8)

	1992/93 (per cent)	2005/06 (per cent)
ASEAN 10	28	40.9
China	9.1	24.7
Japan	22	27.8
India	8.8	10.5
EU 15	16.9	17.9
NAFTA	28.9	27.2
Developed Countries	19.2	19.7
Developing Economies	18.3	26.1

Source: Athukorala, P., "East Asia in World Trade, The Decoupling Fallacy, Crisis and Policy Challenges**",** *FIW Working Paper No. 52*, **2010.**

2.1.2. What Needs to be Achieved in the DCFTAs

In the EU's neighbourhood, realising comparative advantage, fostering investment, and favouring regional production chains will require a comprehensive view of trade policy that involves tariffs, services and investment regulations, rules of origin, technical regulations, and the movement of personnel. The most important conditions for success are the following:

- Foreign direct investment in manufacturing and in key services sectors must be liberalised and the investment climate sufficiently predictable for investors, both local and foreign;
- Tariffs must be eliminated on both sides. Countries wishing to export must agree to import first to source cheaper inputs and to test their competitiveness on global markets;
- Rules of origin (ROOs) of the free trade zone must be liberal and user-friendly so that the production chains operate smoothly and more actors are allowed to be involved (*see Box 3*);
- Non-tariff barriers to imports such as overly trade-restrictive accreditation procedures for technical standards should be kept to a minimum.

Box 3
Rules of Origin in an FTA and a Customs Union

When parties sign a free trade agreement (FTA), they have higher external tariffs towards third parties. They want to make sure that third countries do not abuse their FTA partner economy's duty-free status by exporting through there, and avoiding the higher tariffs imposed to the rest of the world. Hence FTA partners establish rules that determine under what conditions a product can enter duty free into their economy. Given that many products require imported inputs, rules on the extent of local production required for a product to qualify to enter duty free into the partner economy are negotiated: these are called rules of origin (ROOs). In a world of fragmented production chains, the design of these rules can lead to more or less trade restrictiveness. Local content requirements that are set too high might offset the liberalisation effect sought by the elimination of tariffs. The real liberalisation effect of an FTA is not so much to be sought in the extent of elimination of import duties, but sought in the details of the ROOs.

In a customs union, the parties do not require ROOs, because they apply the same tariffs to the rest of the world.

The EU's trade policy situation with the neighbourhood is not satisfactory on these four fronts. The issues at stake are discussed as follows.

Foreign Direct Investment (FDI) in Services and Manufacturing

The EU has major advantages in FDI for manufacturing and in services but in the current trade policy setting the EU does not benefit from sufficient liberalisation commitments and legal guarantees in terms of investor protection. The 1990s "Euromed" agreements that regulate trade between the EU and its four DCFTA targets in the Mediterranean region do not cover investment liberalisation in services or in manufacturing (such as elimination of joint venture requirements or performance requirements), let alone investor protection (*more below*).

A good complement to liberalising investment (called "establishment" in trade policy jargon) in services of interest to the EU, where government contracts play a big role, would be for the EU to achieve commitments on more open and transparent government procurement markets. The EU's DCFTA partners are not parties to the WTO's Government Procurement Agreement and current agreements do not cover these matters. Emerging market governments have shown great reluctance to address this issue.

Import Tariffs

In terms of tariffs, the EU offers Euromed countries and the Caucasus economies a preferential duty-free tariff treatment in manufacturing. While Ukraine offers reasonably low tariffs, and Georgia and Armenia very low tariffs, the EU could certainly obtain more reciprocity from its Euromed partners in terms of tariffs on manufactured goods.

In the Euromed agreements, the EU's partners were granted very long transition periods of up to 15 years to eliminate tariffs in manufacturing sectors in which they would have great comparative advantages such as electronics or textiles. In the current framework, a full-fledged duty free regime in goods with Egypt would only be operational by 2019. However, this is not the case of Tunisia, which has eliminated import tariffs for the EU unilaterally in 2008. Partly as a result of this unilateral liberalisation, textiles now constitute a quarter of Tunisia's exports to the EU (*see Annex 3*).

Rules of Origin (ROOs)

In order to facilitate the development of regional industrial supply chains, the EU's current ROO system would need to be rethought. It is too restrictive on imports of goods to the EU and among its neighbours. In its FTAs, as a general rule, the EU requires countries to produce 50-70% of a product locally for it to apply for duty free status. Only the US applies similarly strict ROOs, while Asian FTAs, such as with ASEAN or Singapore, facilitate regional supply chains with simpler and more general ROOs[34]. Furthermore, rules are different for different goods, which makes administration of rules of origin very cumbersome[35]. The EU's PanEuro system of ROOs that allows accumulation across EFTA and Euromed countries is criticised by experts for being too cumbersome for businesses, and for having failed to facilitate regional integration[36].

Technical and Sanitary Standards

While EU exporters are often faced with barriers to their manufacturing exports that have to do with standards regulations and their administration, the EU itself does

34. See also relevant sections in Dreyer I. *et al.*, "Beyond Geopolitics, the case for an FTA between the EU and Taiwan", *ECIPE Occasional Paper No. 03/2010*. Note, however, that even in Asia, in 80-90 per cent of cases, business do not actually use the preferences offered by FTAs, notably because of cumbersome rules of origin. See Landingin, R., "Jayant Menon: Proliferation of deals is 'costly and confusing'", *Financial Times*, 9 November 2011.
35. Heydon, K. and Woolcock, S., *The Rise of Bilateralism. Comparing American, European and Asian Approaches to Preferential Trade Agreements*, United Nations University Press, 2009, p. 38.
36. World Bank, *Trade Integration in the Middle East and North Africa*, 2010.

not make it easy for its partners to access its market. It is not the nature of the EU's technical or sanitary standards that is in question but the cost of their administration, the transparency of the decision-making process in standard setting and administration, and the legal uncertainty surrounding the implementation of new regulations. The accreditation procedures surrounding, for example, the 2006 REACH regulation regarding chemical substances have been a contentious issue for the EU's partners for years[37]. If the EU wishes to create a much more integrated market for goods with its ENP neighbours, it will have to make efforts to facilitate trade.

Sanitary standards are a key issue in agricultural trade. The EU has a philosophical approach to sanitary and phytosanitary standards (SPS) that differs from most of its trading partners in the world. It abides by the "precautionary principle" which, in trade policy, allows it to take preventive import measures on health, safety and environmental grounds even if the harm of their consumption is not necessarily supported by science. Many partners consider this policy to lead to protectionist abuses, or at least to high legal uncertainty surrounding the accreditation of their exports to the EU. This is tempered by the fact that the EU has signed the WTO's SPS Agreement which stipulates that import bans of agricultural products in grounds of health and environmental hazard need to be based on scientific evidence.

2.2. Can the Proposed DCFTAs Deliver Deeper Economic Integration?

Can the DCFTAs proposed by the EU, considering what we know about their contents, respond to these challenges?

2.2.1. Foreign Direct Investment (FDI)

Investment has been slowly sneaking into EU negotiations with external partners. When the EU gained powers in the 1990s to negotiate liberalisation of services, "establishment" was also included. This is why the EU has been able to table offers and ask its partners to liberalise certain services in the WTO or its FTAs. Since December 2009, the Lisbon Treaty has given the EU's Trade Policy exclusive competence in the field of FDI.

37. "European Union", *in* Office of the United States Trade Representative (USTR), *2011 Report on Technical Barriers to Trade*, pp. 69-75.

For its DCFTAs, the EU has stated in its May 2011 Communication that it is currently exploring the opportunity to offer an "*enhanced investment protection scheme*"[38]. However, the EU is not yet able to provide for an EU-wide investor-to-state protection scheme to guarantee the protection of investment of all EU member states and the protection of foreign investments on EU territory. The latter are in the hands of individual member states' bilateral investment treaties (BITs), of which about 1,200 are in force. The EU is still struggling to bring these under its own responsibility in a drawn-out legal battle to "grandfather" these BITs. What is more, there are legal and political obstacles to develop an own "EU-BIT", or a special chapter dedicated to investor-to-state protection[39].

2.2.2. Tariffs

Tariffs are likely to be eliminated relatively easily in manufacturing by both sides, although the EU's partners might ask for longer transition periods than the EU. Agricultural quotas and tariffs are less likely to be eliminated on the same scale as in manufacturing. Protectionist pressures to keep barriers high on competitive partner country agricultural exports of cereals such as wheat and other "Mediterranean" produce are strong and are likely to complicate trade negotiations.

2.2.3. Rules of Origin (ROOs)

The current system of ROOs regulating the EU's trade relationships with the EEA/EFTA and its Euromed partners is likely to continue to apply with the DCFTAs if they come into force.

In its May 2011 Communication, the EU announced it would seek to simplify the PanEuro system. Details are not known and the final shape of such a scheme is hard to predict given that intense back-door lobbying and conflicts of interests among the EU administration itself can significantly water down initial ambitions. Indeed, the precedent set by the reform of the ROOs of the GSP regime – which came into force in early 2011[40] – highlights the need for low expectations in this regard. This

38. See EEAS and European Commission, *Op. cit*.
39. Dreyer, I., "Heading Towards a Battle of the BITs", in *FDI Magazine*, April/May 2010.
40. Commission Regulation (EU) No 1063/2010 of 18 November 2010 (...) laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 establishing the Community Customs Code.

regime is now unquestionably more liberal for least developed economies (LDCs) than before. Administration of ROOs is expected to be simplified starting in 2017 through a system of pre-registration of firms who would then only need to self-declare the origin of their products. However, ROOs for key manufactures such as textiles, where these countries that benefit from GSP status are competitive, remain more restrictive than for other products (47.5% foreign content allowed against 70% for LDCs as a general rule).

2.2.4. Standards and Regulatory Approximation

The EU has the clear and stated objective to demand from its partners that they apply EU standards in their domestic economies. It will condition market access to the EU on them doing so. According to the words of Karel de Gucht, current Trade Commissioner leading the DCFTA negotiations with Ukraine, "*Ukrainian manufacturers will meet EU norms and standards simply by respecting Ukraine's own rules and regulations*"[41]. This approach presents major problems.

Regulatory approximation is also economically questionable when applied to countries with much lower income levels and with which trade relations are not very dense. Regulatory approximation is the same as what economists call "harmonisation" of standards (although in this case harmonisation goes only one way with the partner required to adopt EU standards and not the other way round). Harmonisation, however, is a double-edged sword.

Research has shown that harmonising domestic technical standards among economies can be trade-creating, hence welfare enhancing. But this is only so when both economies are already sufficiently integrated with each other, i.e. they trade at a very significant level. When one country aligns its standards with another, then trade with third parties is significantly reduced, leading potentially to a rise in domestic prices and economic loss[42]. The EU accounts only for 31 percent of Ukraine' external trade (imports and exports), and for 31.7 percent of Georgia's external

41. De Gucht K., European Commissioner for Trade, "EU-Ukraine trade negotiations: a pathway to prosperity", INTA Committee Workshop, Brussels, 20 October 2011.
42. Chen, M.X. and A. Mattoo, "Regionalism in standards: good or bad for trade?", *Canadian Journal of Economics*, Vol 41(3), 2008, pp. 839-863.

trade[43]. Imposing EU technical and sanitary standards on the entire economies of these countries would lead to massive trade diversion, with a significant reduction of their trade with the rest of the world. Nothing guarantees that trade with the EU will increase symmetrically.

What is more, this trade could well involve higher prices. Hence these country's agricultural sectors and industrial enterprises would be choked off. Recent estimates show that the adoption by Georgia of the EU's entire SPS rules book to apply to its entire economy (which is what the EU is seeking) would lead to a 90 percent hike in food prices[44]. Given that Georgia is one of the EU's poorest neighbours, this is dangerous.

A better approach would be to find means to increase bilateral trade first, and seek legal approximation at a later stage.

2.2.5. What is the Justification for Regulatory Approximation Today?

The EU's insistence on regulatory approximation in its DCFTAs needs to be questioned in a context of fading prospects for EU trade partners to join the Single Market or use the model of EEA economies like Norway. A reflection of these developments is the EU's officially stated ambitions.

The 2008 Commission Communication on the Eastern Partnership Agreements (part of the ENP policy) stated: "*As a further step, the EU and its partners may reflect on a broader regional trade approach establishing a Neighbourhood Economic Community, taking inspiration from the European Economic Area where appropriate. Such a Community would in the longer term offer full access to the single market.*"[45]

This vision, stated in vague terms, is no longer referred to in the EU's 2011 review of the ENP[46].

43. European Commission, DG Trade, Statistics Of The Bilateral Relations (*statistics last viewed 30 Mars 2012*).
44. Messerlin P. *et al.*, "An Appraisal of the EU's Trade Policy Towards its Eastern Neighbours: The Case of Georgia", Joint GEM-SciencesPo/CEPS Policy Study, March 2011.
45. European Commission, Communication from the Commission to the European Parliament and the Council, *Eastern Partnership*, COM 2008 823 final, 3 December 2008.
46. See EEAS and European Commission, *Op. Cit.*

Contrary to past enlargement processes, the EU is not offering, in return for regulatory approximation, the prospect of enjoying the four freedoms of the Single Market, which such legal approximation would justify. The EU is imposing many adjustment costs to its partners, putting them into its "regulatory straitjacket", as it has done with candidate countries in the past, without offering full commercial benefits in return, let alone the prospect of being able to shape EU decisions as a future member. The political balance that a bilateral trade agreement requires has not been adapted to a new political reality. In the case of DCFTA negotiations with Ukraine, the EU is not even willing to open up its market to key competitive Ukrainian exports such as wheat in return for its efforts to adopt the EU *acquis*[47].

The EU's DCFTA partners and targets are countries with relatively weak administrative capacities, financial means and human resources. Their priorities currently lie in strengthening their judiciaries and the general effectiveness of the state, not in administering expensive food and other standards. Administrating EU-style standards will be costly and complex. What is more, it will probably fail. It is likely to drive parts of the economy into informality and black markets[48]. Non application of EU standards could lead the EU to justify the introduction of import restrictions, which could lead to commercial friction with exporters which do comply with EU standards, and hence to political acrimony.

2.3. Deep Integration Without Regulatory Alignment? Lessons from Recent EU FTAs with Emerging Markets Outside the Neighbourhood

The economies that the EU is targeting in its DCFTAs are emerging markets, some of them with major commercial potential, not least its North African partners. In the last decade, the EU has engaged in bilateral FTAs with other countries with equivalent economic profiles, similar economic needs and similar export interests to those of the EU neighbours targeted by DCFTAs. The content of EU FTAs in recent

47. Indeed the EU is reported to exclude wheat from its free trade commitments in the negotiations for a DCFTA with Ukraine. The EU has only agreed to a modest import quota. See Konończuk, W. and Matuszak, S.,"The negotiations on the EU-Ukraine Association Agreement and Russia", *Eastweek*, Center for Eastern Studies (OSW), 13 April 2011.
48. See Messerlin, P., "The EC Neighbourhood Policy: An Economic Review", *The Journal of International Trade and Diplomacy* 2 (2), Winter 2008, pp. 27-54. and Messerlin P. *et al., Op. Cit.*

years has taken directions that will be of interest to the EU and its DCFTA partners. In these FTAs, some answers to the economic needs and trade policy instruments identified in section 2.1. could be found.

2.3.1. General Trends in Recent EU FTAs

Since the 1990s, the EU's bilateral FTAs outside the neighbourhood have become much more commercially ambitious than the Euromed agreements that DCFTAs are expected to partly replace.

This is notably the case with the FTAs it has signed with dynamic emerging markets such as Chile with whom a FTA has been in force since 2003. Since 2008, the EU-CARIFORUM, EU South Korea FTA (*see Box 3 below for highlights*), and EU-Central America agreements are the new benchmark for EU bilateral FTAs. All these deals reveal interesting trends that will be of interest to the EU's DFTA partners:

- The EU has become more ambitious in its demands on its partners in the field of services and investment liberalisation. Business services, telecommunications services, and environmental services, among others, are competitive EU sectors where the EU has demanded and obtained significant market openings.
- The EU is ready to adopt almost 100% tariff elimination in goods and even in its agricultural products, except in the most sensitive areas (sugar, bananas, some fruit and vegetables and cereals).
- The EU has greater ambitions in the field of dispute settlement for trade disputes. This renders its trade agreements more legally binding. A quasi-judicial panel dispute settlement system has seen light for the first time with the EU South Korea FTA.
- With the EU South Korea agreement, the EU has become slightly more liberal than before in ROOs. It has reduced the general qualifying requirement to 45 percent of the ex-works price of the product as maximum non-local content, down from 50% (*see Box 4*).

2.3.2. The EU's Regulatory Agenda in Recent FTAs

In its international trade policies, the EU pursues a rules agenda. This is partly the rules agenda that it has tried to advance in WTO negotiations in the early years of the Doha round and nicknamed the “Singapore Issues”, i.e. investment regulations, competition policy, and transparency government procurement. Furthermore, the EU pursues a specific intellectual property agenda (Geographical Indicators). It has been able to have its partners sign up to binding commitments to change their legislation to fit these regulatory demands. The EU also pursues an agenda to have its own standards, or international standards, recognised by its partners through mutual recognition, elimination of double testing, or harmonisation of very targeted standards. Success in the field of standards however has been very limited in practice and confined to specific sectors and products. This regulatory agenda is derived from the EU’s *acquis communautaire*, but is by far less ambitious, comprehensive and intrusive than the EU’s traditional approach in its neighbourhood.

Now to some concrete recent developments in all those fields.

In the field of investments, in the Economic Partnership Agreement with the Caribbean (CARIFORUM), which was signed in late 2008, the EU secured free investment in most non-services sectors – with a few exceptions. In the field of services the agreement prohibits numerical quotas, monopolies, exclusive rights or economics needs tests, output limitations, limitations on foreign capital participation, restrictions on branching, and forced joint-ventures.

In the field of competition policy, the EU demands from its partners that they abide by basic principles of EU competition law. In government procurement, the EU has been able to make developing countries which are not signatories of the WTO’s Government Procurement Agreement (GPA) sign up to transparency rules and abide by international best practice (CARIFORUM) and even national treatment (EU Central America).

The EU has been rather successful in having its partners apply its rules on Geographical Indicators (*see Box 4, for example*).

Finally, the EU conditions the signing of an FTA on the partner country abiding by democratic principles, international labour (ILO conventions) and environmental standards (Kyoto Protocol in EU Korea FTA).

Box 4
Highlights of the EU-South Korea Agreement

Tariffs: EU eliminates almost all tariffs on entry into force of the agreement. South Korea benefits from more exemptions in agriculture. Tariffs will be eliminated in all manufactured goods, with phase-in periods of up to five years in some sensitive manufacturing goods for Korea.

Services: Establishment in telecommunications and financial services on both sides is generally free. There is progress on establishment in business services and maritime services on both sides. South Korea opens its retail and environmental (sewage; industrial waste) sector to establishment; financial information and satellite broadcasting services are opened to cross-border provision.

Investment: Establishment in both services (in principle) and manufacturing (except nuclear production) liberalised. As a general rule, the agreement prohibits numerical quotas, monopolies, exclusive rights or economics needs tests, output limitations, limitations on foreign capital participation, restrictions on branching, and forced joint ventures.

Intellectual property rights: Copyright protection extended to 70 years. Geographical Indicators. The EU's list of protected goods extended to 60 products beyond wine and spirits and to more than 50 Korean agricultural goods.

Rules of origin: The general qualifying requirement is 45 percent of the ex-works price of the product as maximum non-local content (i.e. 55 per cent local content). The EU's ROOS here are more liberal than before, but not as liberal as other Asian ROOs. For some electronic products, even 50 percent local content is deemed sufficient.

Non-tariff barriers (NTBs) & technical standards. For the first time in EU FTA history, sector-specific disciplines on NTBs in goods are adopted. In electronics: elimination of duplicative testing for health and safety standards, alignment of both sides' standards to international standards. In automobiles: standards harmonisation based on international UNECE criteria. Automotive standards are subject to the FTA's dispute settlement mechanism and have a sector-specific accelerated procedure. Pharmaceuticals and medical devices: focus on procedures to make the process on listing for reimbursement more transparent. In chemicals: language on transparency and a Working Group on Chemicals.

Dispute settlement: US-style panel arbitration system for goods trade and most other regulatory disciplines, and which also covers financial services and automotive standards. Other services, anti-dumping and safeguards, non-tariff measures and SPS issues are excluded.

Source: Dreyer I. *et al.*, "Beyond Geopolitics, the case for an FTA between the EU and Taiwan", *ECIPE Occasional Paper No. 03/2010*.

2.3.3. The Political Balance in the EU's Recent FTAs

Bilateral trade agreements not only reflect economic considerations and commercial interests. They are also the result of a negotiation that results in a "political" balance between both partners that allows both to sign up to a deal.

The FTAs that have come to fruition so far for the EU are with small and less prosperous economies which depend strongly on access to the EU's big market to secure their exports and development. This creates an asymmetry in negotiations in favour of the EU, which is able to shape the content of its agreements largely in its favour.[49] Nonetheless, the EU does engage in reciprocity in the negotiation process in order to satisfy its development policy goals, to satisfy WTO obligations, to raise domestic economic efficiency and not least to "smoothen" the negotiation process with its partners.

It appears that in recent bargaining processes, the EU has prioritised market access in manufactured goods, services and, to a certain extent, in investment and its trade rules agenda. This is in the EU's interests and helps it play out its comparative advantage internationally. In return it has accepted the need to be more flexible in areas in which it has traditionally been reluctant to open its markets or respond to demands from its trading partners, not least in the field of agriculture. One can note a substantial liberalisation of its tariff regime in agriculture, where the CAP makes it more reluctant to reduce border trade barriers. These agricultural concessions, however, have been made with partners that do not export significant amounts of agricultural goods to the EU, or only do so in the winter season (Chile, South Africa). The most sensitive products remain protected.

In the case of the CARIFORUM agreement, the EU has even – if modestly – made concessions in the Mode 4, an area in which it is traditionally very conservative. It extends the possibility for Contract Services Suppliers and Independent Professionals in certain sectors to offer their services in the EU on a temporary basis. This mostly involves highly skilled professionals but also, for the first time, lower skilled professionals such as nurses, midwives, or chefs de cuisine[50].

49. This is not only true of the EU, but also of the world's biggest trading entities and not least to be found in US FTAs. A recent study has highlighted how the services chapters of FTAs are shaped by the preferences of the stronger partner. See Van Grasstek, C., "The Political Economy of Services in Regional Trade Agreements", *OECD Trade Policy Working Papers*, No. 112, OECD Publishing, 2011.
50. Sauvé P. and Ward N., "The EC-Cariforum Economic Partnership Agreement: Assessing the Outcome on Services and Investment", *ECIPE Paper*, January 2009.

It has also shown flexibility and a certain degree of proportionality in the field of rules. In the Chile agreement, for instance, the EU has signed up to transparency disciplines in the administration of sanitary standards that respond to the demands of a competitive agricultural exporter (*see Table 13*).

Table 13 - SPS Provisions in Existing EU FTAs

WTO consistent rules	Euro-Med	TDCA	EU-Mexico	EU-Chile	EU-South Korea
Reaffirmation of WTO SPS obligations	Yes	Yes	Yes	Yes	Yes
General cooperation in SPS	Yes	Yes	Yes	Yes	Yes
Harmonisation of SPS standards as an objective	Yes	Yes	Yes	Yes	-
Cooperation towards development of international standards	-	-	-	-	Yes
General exception possible similar to GATT Art. XX	Yes	Yes	Yes	Yes	-
Provision for specific technical assistance in the SPS field	-	-	-	Yes	-
Procedural WTO-plus measures					
Establishment of a joint committee on SPS	-	-	Yes	Yes	Yes
Detailed rules for determining equivalence	-	-	-	Yes	-
Guidelines for conducting verifications, checking imports and certification of testing	-	-	-	Yes	-
Schedules for reporting and consultation	-	-	-	Yes	-
Specific rules on import administration	-	-	-	Yes	-
Requirement to exchange information	-	-	-	Yes	-
Provisional approval of certain establishments	-	-	-	Yes	-

Source: based on Heydon, K. and Woolcock, S., *The Rise of Bilateralism. Comparing American, European and Asian Approaches to Preferential Trade Agreements,* United Nations University Press, 2009.

2.3.4. Precedent Set by US FTAs

A final element to take into account is that the ambitious FTAs the EU has signed in recent years are generally agreements that follow agreements that EU partners countries had already signed with the United States. The EU tries thus not to be excluded from these markets.

For example, the EU-South Korea deal was negotiated after the US-South Korea Agreement (though the US took longer to ratify it). Since the signing of NAFTA in the early 1990s, US bilateral trade agreements are reputed to be more ambitious in commercial terms than the EU's. For example, they open up services sectors more comprehensively than do EU FTAs. They also have more legal "bite", not least thanks to the investor-to-state dispute settlement provisions of US FTAs[51].

There is one advantage for the EU in following the US: stepping into a market that has already agreed to open up to the US makes it easier for the EU to negotiate and advance its own interests during bilateral DCFTA negotiations, as the partner already has experience of trade negotiations and opening up to a major advanced economy. In the context of the current EU DCFTA negotiations, Morocco and Jordan already have had FTAs in force with the US since 2006 and 2010, respectively.

2.4. Concluding Remarks

There is a strong economic case in favour of ambitious free trade agreements in the EU neighbourhood. The EU's proposed DCFTAs with its partners to its East and with four Mediterranean countries (Egypt, Jordan, Morocco and Tunisia), all dynamic emerging markets, are a welcome step in this regard.

Both sides would gain substantially by allowing EU investors and services providers to upgrade the partner's economies, and by allowing these partners to export under better conditions their manufactured and agricultural products to the EU. Greater labour mobility would also be welcome, particularly the allowance of temporary movement of workers (in the field of services, FTAs deal with the issue under the heading Mode 4).

The EU's recent FTAs with other emerging markets in recent years show that the EU is slowly moving in a direction that prioritises its economic interests in high value-added industrial and services sectors as well as some of the key economic policy making rules it considers essential to enable its exporters and investors to operate

51. Horn, H. *et al.*, "*Beyond the WTO? An anatomy of the EU and US preferential trade agreements*", *Bruegel Blueprint Series*, Volume VII, 9 February 2009.

abroad. Although timidly, the EU is also discussing opening up its markets to areas of lower value-added (agriculture and, very marginally, low-skilled labour) that it has heretofore shielded from international competition in the WTO and in earlier FTAs such as Euromed agreements.

The content of these agreements, however, which are still in the process of being designed and negotiated, appear to be excessively influenced by past EU enlargement episodes: they focus too strongly on the partner country's regulatory approximation, i.e. the exporting of the EU *acquis*. This chapter has shown that in the absence of clear prospects for these partner countries to become part of the EU Single Market, implementing this approach would do more economic harm than good. It would probably fail, while preparing the ground for possible new trade frictions in future.

3. Three Proposals for the EU's DCFTA Strategy in its Neighbourhood

This section formulates policy proposals based on the analysis of the previous chapters for DCFTA negotiations. They attempt to take into account the political reality of the EU's increasing unwillingness to absorb new parties into its Single Market – at least when they are poorer than the EU average or the EU's poorest neighbours, which is the case of DCFTA partners.

While DCFTAs are part of a wider package to promote democratisation in the region these proposals start from the premise that the goals of FTAs should, above all, be economic and conceived as a means to provide a framework for greater trade integration.

The author considers the first proposal economically essential and feasible in the current context because it builds on existing precedents in EU trade policy. The second proposal deals with the regulation, administration and accreditation of standards and proposes an alternative approach to the usual EU approach to dealing with standard recognition. The third and final proposal is an optional and complementary proposal regarding the possibility of a customs union to foster regional supply chains more effectively than FTAs would do.

3.1. First Stick to the Basics: Significantly Free up Trade and Investment

As a general principle, given the current economic crisis, both the EU and their neighbourhood trade partners need a boost to their economic growth and to their industrial sectors. The purpose of the DCFTAs should therefore be to serve as an instrument that helps to unblock economic forces that spur growth. Significantly freer movement of goods, services and factors (capital and labour) are a key to this, as this leads to better allocation of economic resources and efficiency gains. In order to achieve these purposes, the EU should build on the precedents set by the EU's latest FTAs with emerging market partners, while taking into account that the EU's partners in the neighbourhood will expect somewhat better market access conditions than these emerging markets do.

The ingredients involved in developing the DCFTAs should, at minimum, include the following:

- **100% duty free trade in manufactured goods and agricultural products**. Transition periods to zero duties in sensitive manufactures should be kept short (two-three years), while non-sensitive manufacturing tariffs should immediately go down to zero. For sensitive agricultural products, notably wheat and typical Mediterranean fruit and vegetables, the EU could propose a phased elimination of tariffs and quotas over a transition period that can allow domestic producers in the EU to adjust (5-10 years). The EU could also demand progressive liberalisation of the partners' agricultural tariffs, with appropriate transition periods (say, 10 years). Except in the case of Ukraine[52], antidumping issues do not appear to have been a major issue between the EU and the DCFTA partners. If the EU ambitions strong commitments from its partners in services and FDI, it could consider offering a commitment not to start antidumping actions in future.
- **Opening up the EU's partner economies to foreign investment, notably in key services sectors** such as infrastructure-related and business services including transport, telecommunications, environment/energy, banking and insurance, accounting and law.

52. See EU antidumping statistics (*statistics last viewed on 30.03.2012*).

- **Subjecting foreign investment to predictable rules and principles of openness**. The EU-CARIFORUM FTA's Establishment chapter (see Section 2.3.2.) could be seen as a model.
- **Bolder Mode 4 approach**. Build on the EU-CARIFORUM agreement to offer a more liberal regime for the temporary movement of workers in the field of services, in both higher and lower end of the skills spectrum, ranging from engineers to construction and healthcare workers.
- **Liberalising and simplifying the PanEuro system**: reduce local content requirements for manufactures, apply the same content rules to all products and reduce paperwork as much as possible.

The EU will want to have its partners adopt key trade-related regulations that are of interest to EU exporters and investors, and that at the same time are beneficial to the partner economies. These rules cover the following fields:

- **Government procurement procedures**: more transparency, national treatment, and possibly signing up to the WTO's GPA;
- **Competition rules**: restrictive trade practices, prohibition of cartels, and transparency in subsidies.

Although the economic benefits of Geographical Indicators (GIs) in agricultural trade are questionable, nothing stops the EU from having its partners sign up to respecting its list of GIs.

However, given that the EU is not offering a clear prospect to its DCFTA partners that they will be part of the Single Market, the EU should not go much beyond these rules, and should abandon pretences to "regulate" its neighbours and to foster "regulatory approximation".

3.2. Preferential Treatment in Receiving Help on Accreditation of Technical and Sanitary Standards

A proposal to achieve the triple objective of encouraging the adoption of EU sanitary and technical standards by its partners, fostering more trade and facilitating exports, and offering a preferential treatment to neighbours is presented below.

Individual firms based in the partner country, whether connected with inward FDI or not, that wish to export to the EU market should be allowed to use the facilities of designated EU-based certification agencies to obtain accreditation to sell their products on EU markets. Contrary to what the EU currently imposes on its prospective DCFTA partners, the latter should not be forced to open up new agencies to certify products for export to the EU. This would reduce costs of government and administration in poor countries with endemic problems of scarce human capital and maladministration[53]. This would also avoid the problem of having to negotiate a necessarily complicated Agreement on Conformity Assessment and Acceptance (ACAA) of industrial products as the EU is currently proposing to DCFTA candidates. Such an ACAA can be negotiated at a later stage.

The costs of EU-based certification should be borne by the EU itself: certification bodies should invoice the relevant EU authority, which in turn should budget this appropriately. The firms should have the right to contest the decisions taken by the certification bodies in the European Court of Justice. When the partner country is close to reaching an agreed per capita income threshold, these countries should be obliged to set up appropriate certification bodies at home with EU financial assistance.

This approach could be limited to countries with per capita income levels that are lower than the EU's poorest member state. For the moment all the EU's DCFTA partners fall into this category.

EU partners should be obliged to apply the full EU *acquis communautaire* at home in terms of sanitary standards only when the time has come to establish a common economic area with the full application of the four freedoms. Such discussions should start only when it is clear that the partner country trades significantly more with the EU than with the rest of the world and when its per capital income levels are clearly approaching the EU population-weighted average.

In coming DCFTAs the partner economies should of course be required to automatically recognise EU standards for their imports.

53. See Messerlin P. *et al.*, *Op. Cit.*

3.3. A Customs Union to Better Foster Regional Industrial Supply Chains

The previous sections have discussed the problems posed by rules of origin in FTAs and the failure of the existing PanEuro system to foster the emergence of supply chains that make industry competitive today and allow emerging markets to integrate into the global economy. This is because free and non-discriminatory trade is what fosters these supply chains. Rules of origin (ROOs) are restrictions on trade, even if the design of FTAs requires their existence. They are cumbersome in their administration and are not flexible enough to respond to rapid industry developments. This explains why even the comparatively liberal Asian FTA ROOs are underutilised by business[54]. The EU's PanEuro system is complex and rather restrictive with up to 60% local content requirements, and is hence reported to be ineffective in fostering enough regional trade.

The reason East Asia and ASEAN have developed their industrial supply chains on a large scale lies in their choice in the 1980s and 1990s to adopt low or zero tariffs towards the rest of the world in the industries of their choice, without discriminating in favour of specific trade partners (i.e. on an "MFN" basis). This approach dispenses with ROO certification requirements. The international trade agreement that has most contributed to the development of global supply chains, and to the impressive related levels of components trade in ASEAN (*see Table 12*), is probably the WTO's 1997 Information Technology Agreement. This multilateral agreement, signed by the most important WTO members, the EU, the US and East and South East Asian economies, foresees a regime of zero tariffs for any import of electronic devices and their components. In addition, ASEAN economies have also made the choice of opening up unilaterally to foreign investors which has favoured the spread of cross-border production networks.

In the EU's neighbourhood, the only way to both achieve the goals of greater regional integration and reducing the distortions coming from ROOs is the customs union. The current production chains within the EU spanning Western and Central and Eastern Europe itself are favoured by the EU customs union. In the EU neigh-

54. Landingin, R., "Jayant Menon: Proliferation of deals is 'costly and confusing'", *Financial Times*, 9 November 2011.

bourhood, the only commercially significant customs union is with Turkey[55]. An improved model could be proposed to the DCFTA partners[56].

There are limits to this approach: these countries, like Turkey, would be obliged to delegate their trade policies to Brussels. This can be a problem of national sovereignty and may not be economically optimal in all cases because some countries like Georgia and to a lesser extent Ukraine would need to raise tariffs. Turkey would also claim a right to agree to this extension. Unfortunately, history shows that successful customs unions are the exception rather than the rule. Only the EU appears to be, today, a complete and fully functioning customs union. The one between the EU and Turkey works well but does not cover all trade.

55. If one discounts the one with San Marino and Andorra.
56. Such a proposal was tabled by Ülgen for the Mediterranean economies. It can also be offered to Ukraine. See Ülgen, S., "A faster, Better Route to Economic Integration Across the Mediterranean", *International Economic Bulletin*, Carnegie Endowment for International Peace, 13 October 2011.

Concluding Remarks

The proposed DCFTAs that the EU is offering to its partners in its neighbourhood are strongly influenced by past enlargement experiences. The EU is making legal approximation with the EU a condition for better market access to the EU. This was past practice with EU neighbours, which were destined to join the Single Market and enjoy its four freedoms, generally as new EU member states. However, contrary to past episodes, the EU is not giving a clear prospect to these economies that they will ultimately join the Single Market and benefit from these freedoms.

The EU is also dealing with some economies that are significantly poorer than the EU's poorest member states. For these states, the EU is seeking to impose significant adjustment costs and higher prices on these economies, without obvious benefit for them or for EU exporters or investors.

In the DCFTAs that the EU proposes, it should instead suffice to ask their trade partners to comply with EU standards to be able to sell in the EU markets and ask these partners to allow the EU to export its products according to its own standards. The EU can directly help exporters from these economies comply with EU standards.

Changing the entire domestic law of DCFTA partners to fit the EU's rule book is not necessary and is politically and economically unhelpful. Some partners are not only very poor but also very small, and hence not of major commercial interest to EU business. It is thus perplexing to see the EU spending bureaucratic energy and putting its political capital at risk in its neighbourhood by imposing a costly rule book with its DCFTA efforts with Georgia, Armenia or Moldova. Georgia and Armenia are already open for business as has been highlighted in the first section of this study.

The EU should focus its efforts on economies that need trade liberalising reforms and a better environment for investors. In the context of its DCFTAs, Egypt is the greatest priority, though the EU cannot expect an economy like Egypt's to readily and easily adopt EU-style legislation. The EU should rather attempt to offer an attractive FTA, similar to those it has been signing with other emerging markets in recent years, with significant market openings in goods and services on both sides. A DCFTA between the EU and Tunisia, Morocco and Jordan is a good means to lock in their recent domestic economic reforms, as long as they are not overburdened by regulatory approximation with the EU.

More generally, the EU should consider favouring the development of regional industrial production networks. The rules of origin of FTAs are not a good instrument for this, so offering a customs union to willing neighbours could be a more effective option.

A final point is on political conditionality. While it is understandable that the EU conditions the signing of a DCFTA on the partner country signing up to democratic principles, the EU should deal with the DCFTA as a comprehensive economic and commercial package and not subject individual items of the DCFTA to a conditionality that is not related to trade and investment.

Annex 1 – The EU's Neighbourhood - A Demographic Overview

Wealthy Advanced Economies in the EU's Neighbourhood

These countries have small populations with demographic profiles typical of advanced wealthy economies. Life expectancy is high. Populations are ageing and fertility rates are low. Population growth is slow.

Wealthy Advanced Economies - A Demographic Overview

Country	Population, (*million, 2010)*	Fertility, average number of children per woman *(1990-1995)*	Fertility average number of children per woman *(2005-2010)*	Life expectancy at birth *(2011)*
Iceland	0.3	2.19	2.1	81.8
Liechtenstein	0.03	n/a	n/a	79.4
Norway	4.9	1.89	1.92	80.7
Switzerland	7.7	3.02	2.3	82.2
Croatia	4.4	1.52	1.42	76.6
Israel	7.4	2.93	2.91	80.4
Source	*UN*	*UN*	*UN*	*UNDP*

Dynamic Upper Middle Income Economies

These include the countries of the former Soviet Union, former Yugoslavia, Turkey and the countries on the Mediterranean. These are rather small economies. Morocco, with 32 million inhabitants is an exception in a list of countries counting from half a million (Montenegro) to just above ten million inhabitants (Tunisia). Demographically, there has been a clear convergence in the neighbourhood to Western fertility rates. In the former Soviet Union, fertility rates are very far below the population replacement rate.

Dynamic Upper Middle Income Economies - A Demographic Overview

Country	Population, *(million, 2010)*	Fertility, average number of children per woman *(1990-1995)*	Fertility average number of children per woman *(2005-2010)*	Life expectancy at birth *(2011)*
Belarus	10	1.68	1.39	70.3
Ukraine	46	1.64	1.39	68.5
Turkey	73	2.9	2.15	74
Bosnia-Herzegovina	4	1.53	1.18	75.7
Serbia	10	1.96	1.62	74.5
Macedonia	n/a	2.06	1.46	n/a
Montenegro	0.6	1.81	1.69	74.6
Albania	3.2	2.78	1.6	76.9
Lebanon	4.2	3	1.86	72.6
Jordan	6.2	5.14	3.87	73.4
Tunisia	10.5	3.13	2.04	74.5
Source	*UN*	*UN*	*UN*	*UNDP*

Hydrocarbon Exporters

Russia has the largest population in the neighbourhood. As in the rest of the former Soviet Union, fertility rates are very far below the population replacement rate, and even below Western European averages. Russia's population is declining. In the Middle East and North Africa, a demographic transition is occurring. Over the last twenty years, fertility rates have dropped significantly. In 1990-1995, women in this region averaged more than four children but by 2005-2010 this figure has been brought down to less than three in Libya and Algeria and only slightly more than three in Syria is converging with all others too.

Hydrocarbon Exporters - A Demographic Overview

Country	Population, (million, 2010)	Fertility, average number of children per woman (1990-1995)	Fertility average number of children per woman, (2005-2010)	Life expectancy at birth (2011)
Russia	143	1.55	1.44	68.8
Azerbaijan	9	2.9	2.16	70.7
Syria	20	4.83	3.1	75.9
Libya	6.4	4.1	2.72	74.8
Algeria	35.5	4.13	2.38	73.8
Source	*UN*	*UN*	*UN*	*UNDP*

The EU's Poorest Neighbours

Moldova, Georgia and Armenia are small economies while Egypt is the second biggest EU neighbour after Russia. Morocco lies in between in terms of size.

The EU's Poorest Neighbours - A Demographic Overview

Country	Population, (million, 2010)	Fertility, average number of children per woman (1990-1995)	Fertility average number of children per woman (2005-2010)	Life expectancy at birth (2011)
Moldova	4	2.11	1.5	69.3
Georgia	4.4	2.05	1.58	73.7
Armenia	3	2.38	1.74	74.2
Egypt	81	3.9	2.85	73.2
Morocco	32	3.66	2.38	72.2
Source	*UN*	*UN*	*UN*	*UNDP*

Annex 2 – The EU's Trade with its Wealthiest Neighbours

Country	Share of EU external trade (2010, per cent)	Share of EU in partner total trade (2010, per cent)	Goods trade balance of EU with partner (2010, per cent)	Services trade balance of EU with partner (2009 or 2008, billion €)	Outward FDI of EU in partner economy (2010, billion €)	Inward FDI of partner economy in EU (2010, billion €)	Top 3 EU exports to partner (2010, 2-digit SITC category & per cent)	Top 3 partner exports to EU (2010, 2-digit SITC category & per cent)
Iceland	0.2	66	positive	-0.5	1.4	6.0	2400 - Machinery and transport equipment: 27,0% 1200 - Fuels and mining products: 20,6% 1100 - Agricultural products: 13,0%	1200 - Fuels and mining products: 51,6% 2100 - Iron and steel: 4,0% 1100 - Agricultural products: 36,2%
Liechtenstein	0.1	n/a	even	0.1	2.0	5.2	2400 - Machinery and transport equipment: 37,7% Other manufactures: 14,8% 2300 - Other semi-manufactures: 21,7%	2400 - Machinery and transport equipment: 35,9% 2200 - Chemicals: 7,4% 2300 - Other semi-manufactures: 27,4%
Norway	4.2	74.8	negative	7.2	70.4	64.5	2400 - Machinery and transport equipment: 41,8% 2300 - Other semi-: 10,4% 2700 - Other manufactures: 12,3%	1200 - Fuels and mining products: 63,1% 2400 - Machinery and transport equipment: 5,3% 1100 - Agricultural products: 6,0%
Switzerland	6.6	68	positive	15.9	562.8	365.4	2400 - Machinery and transport equipment: 27,1% 2200 - Chemicals: 19,9% 2700 - Other manufactures: 14,6%	2200 - Chemicals: 35,1% 2400 - Machinery and transport equipment: 9,9% 2700 - Other manufactures: 15,6%
Israel	0.9	30.6	positive	0.8	5.3	22.3	2400 - Machinery and transport equipment: 38,0% 2300 - Other semi-manufactures: 19,0% 2200 - Chemicals: 18,2%	2200 - Chemicals: 27,9% 2300 - Other semi-manufactures: 16,1% 2400 - Machinery and transport equipment: 22,3%

Source: European Commission, DG Trade.

Annex 3 – The EU's Trade with the Dynamic Upper Middle Income Economies in its Neighbourhood

Country	Rank as trading partner of the EU (2010, rank)	Share of EU in partner total trade (2010, per cent)	Goods trade balance of EU with partner (2010)	Services trade balance of EU with partner (billion EUR, 2010)	Outward FDI stocks of EU in partner economy (2010, billion €)	Inward FDI stocks of partner economy in EU (2010, billion €)	Top 3 EU exports to partner (2010, per cent)	Top 3 partner exports to EU (2010, per cent)
Ukraine	23	31.4	positive	N/A	18.0	2.9	2400 - Machinery and transport equipment: 33,9% 2300 - Other semi-manufactures: 11,8% 2200 - Chemicals: 19,9%	2100 - Iron and steel: 28,2% 1100 - Agricultural products: 16,4% 1200 - Fuels and mining products: 27,4%
Balkan countries								
Bosnia-Herzegovina	53	69.3	positive	N/A	N/A	N/A	2400 - Machinery and transport equipment: 26,3% 2300 - Other semi-manufactures: 14,1% 2200 - Chemicals: 15,5%	2700 - Other manufactures: 28,5% 1200 - Fuels and mining products: 18,7% 2400 - Machinery and transport equipment: 17,6%
Croatia	0.5	61.1	positive	-3.0	20.0	1.0	2400 - Machinery and transport equipment: 28,6% 2200- Chemicals: 16,6% 1100 - Agricultural products: 11,8%	2400 - Machinery and transport equipment: 27,0% 1200 - Fuels and mining products: 16,7% 1100 - Agricultural products: 13,7%

Serbia	39	66	positive	n/a	14.4	0.4	2400 - Machinery and transport equipment: 30,0% 2200 - Chemicals: 18,3% 1200 - Fuels and mining products: 15,6%	1100 - Agricultural products: 17,9% 2400 - Machinery and transport equipment: 17,4% 1200 - Fuels and mining products: 17,2%
Macedonia	58	62.2	positive	n/a	1.9	1.0	2400 - Machinery and transport equipment: 21,3% 2200 - Chemicals: 16,8% 1200 - Fuels and mining products: 16,2%	2600 - Clothing: 25,6% 2100 - Iron and steel: 24,3% 1200 - Fuels and mining products: 12,9%
Montenegro	113	74.3	positive	n/a	0.8	0	2400 - Machinery and transport equipment: 32,3% 1100 - Agricultural products: 20,0% 2300 - Other semi-manufactures: 12,1%	1200 - Fuels and mining products: 80,3% 2400 - Machinery and transport equipment: 6,9% 1100 - Agricultural products: 4,2%
Albania	67	74.2	positive	n/a	1.9	0.2	2400 - Machinery and transport equipment: 23,0% 2300 - Other semi-manufactures: 16,5% 1100 - Agricultural products: 16,1%	1200 - Fuels and mining products: 28,7% 2700 - Other manufactures: 23,8% 2600 - Clothing: 22,8%
Mediterranean countries								
Turkey	7	42	positive	-5.8	65.5	8.2	2400 - Machinery and transport equipment: 45,1% 1200 - Fuels and mining products: 10,4% 2200 - Chemicals: 17,6%	2400 - Machinery and transport equipment: 38,0% 1100 - Agricultural products: 8.6% 2600 - Clothing: 18,7%
Lebanon	55	31	positive	n/a	n/a	n/a	2400 - Machinery and transport equipment: 26,8% 1200 - Fuels and mining products: 18,9% 1100 - Agricultural products: 15,2%	2300 - Other semi-manufactures: 26,6% 1100 - Agricultural products: 17,1% 1200 - Fuels and mining products: 14,7%

Jordan	65	16	positive	n/a	n/a	n/a	2400 - Machinery and transport equipment: 38,5% 2200 - Chemicals: 19,3% 1100 - Agricultural products: 16,5%	1200 - Fuels and mining products: 25,3% 2200 - Chemicals: 24,9% 2400 - Machinery and transport equipment: 15,3%
Tunisia	31	70.1	positive	n/a	n/a	n/a	2400 - Machinery and transport equipment: 36,6% 1200 - Fuels and mining products: 13,1% 2500 - Textiles: 11,7%	2400 - Machinery and transport equipment: 31,7% 2600 - Clothing: 24,5% 1200 - Fuels and mining products: 17,7%
Morocco	29	57.9	positive	-1.4	15.2	0.6	2400 - Machinery and transport equipment: 36,6% 1200 - Fuels and mining products: 12,4% 2200 - Chemicals: 10,6%	2600 - Clothing: 27,3% 1100 - Agricultural products: 25,8% 2400 - Machinery and transport equipment: 19,9%

Source: European Commission, DG Trade.

Annex 4 – The EU's Trade with Hydrocarbon Exporters in its Neighbourhood

Country	Rank as trading partner of the EU	Share of EU in partner total trade *(2010, per cent)*	Outward FDI stocks of EU in partner economy *(2010, billion EUR)*	Inward FDI stocks of partner economy in EU *(2010, billion EUR)*	Goods trade balance of EU with partner *(2011, billion EUR)*	Services trade balance of EU with partner *(2010, billion EUR)*	1st EU export *(2010)*	1st partner export *(2010)*
Russia	3	46.8	120.0	42.0	-89.9	9.1	2400 - Machinery and transport equipment: 44,7%	1200 - Fuels and mining products: 79,5%
Algeria	18	49.4	N/A	N/A	-10.5	N/A	2400 - Machinery and transport equipment: 40,3%	1200 - Fuels and mining products: 97,1%
Libya	19	65.5	N/A	N/A	-8.4	N/A	2400 - Machinery and transport equipment: 29.5%	1200 - Fuels and mining products: 98,5%
Azerbaijan	38	46.9	N/A	N/A	-12.0	N/A	2400 - Machinery and transport equipment: 47,1%	1200 - Fuels and mining products: 99,3%
Syria	50	22.5	N/A	N/A	-0.1	N/A	2400 - Machinery and transport equipment: 34,6%	1200 - Fuels and mining products: 92,1%

Source: European Commission, DG Trade.

Glossary of acronyms used

ACAA: Agreement on Conformity Assessment and Acceptance

ASEAN: Association of Southeast Asian Nations

BIT: Bilateral Investment Treaties

CAP: Common Agriculture Policy

CEE/CEEC: Central and Eastern Europe/Central and Eastern European Countries

DCFTA: Deep and Comprehensive Free Trade Agreements

EaP: Eastern Partnership

EEA: European Economic Area

EFTA: European Free Trade Association

ENP: European Neighbourhood Policy

FDI: Foreign Direct Investment

FTA: Free Trade Agreements

GATS: General Agreement on Trade in Services

GATT: General Agreement on Tariffs and Trade

GDP: Gross Domestic Product

GI: Geographical Indicators

GNI: Gross National Income

GSP: Generalised System of Preference

ILO: International Labour Organization

LDC: Least Developed Economies

MFN: Most Favoured Nation

NAFTA: North American Free Trade Agreement

NTB: Non-Tariff Barriers

ROO: Rules Of Origin

SITC: Standard International Trade Classification

SPS: Sanitary and Phytosanitary

TBT: Technical Barriers to Trade

UNECE: United Nations Economic Commission for Europe

WTO: World Trade Organization

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Europe and World Governance

Trade Policy in the EU's Neighbourhood

Ways forward for the Deep and Comprehensive Free Trade Agreements

This study assesses the trade policy of the European Union (EU) in its neighbourhood and formulates proposals for the "Deep and Comprehensive Free Trade Agreements" (DCFTAs) that the EU is currently offering to Ukraine, Moldova, Georgia, Armenia, Jordan, Egypt, Tunisia and Morocco, as part of the European Neighbourhood Policy and in response to the democratisation processes in the region.

The study puts DCFTAs in context by taking stock of the trade policy arrangements currently in place with all its neighbours. It also benchmarks the DCFTA projects against the Free Trade Agreements (FTAs) the EU has signed in recent years with emerging markets outside its neighbourhood. The fundamental issue at stake is how far the EU should push the EU *acquis communautaire* in particular in the field of technical and sanitary standards. Another important issue is the need to foster investment in the partner economies. Also DCFTAs should be considered a means to foster industrial renewal on both sides.

The proposals revolve around an ambitious mutual trade and investment liberalisation agenda, an alternative solution to regulatory alignment in standards, and a customs union to both achieve the goals of regional economic integration and reduce the distortions coming from rules of origin in FTAs.

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