

THE NEW CONCEPT OF NEIGHBOURHOOD OF THE EU

Towards a Pan-European Economic Space

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The new European Neighbourhood Policy (ENP)

May 12, 2004, The European Commission proposed concrete steps to ensure that the historic enlargement which took place on 1 May “*does not create new dividing lines between the EU and its neighbours*”. Having defined the guiding principles of the European Neighbourhood Policy last year, the Commission has now adopted a “Strategy Paper” proposing how the benefits of enlargement, i.e. “*peace, stability and prosperity*”, can be extended to the neighbours of the enlarged Union¹.

“This enlargement has brought us much closer to our neighbours in Eastern Europe and the Mediterranean region” Günter Verheugen, Commissioner for Enlargement and European Neighbourhood Policy, said. *“Today we are proposing to reinforce our ties with these partner countries through an array of new forms of cooperation and assistance. We want to give them a real stake in the enlarged EU so that they too can develop and prosper. A ring of well-governed countries around the EU, offering new perspectives for democracy and economic growth, is in the interests of Europe as a whole.”*

In a very important document of March 11, 2003 the EU defined the new orientations of its relations with the “*Wider Europe Neighbourhood*”.² In addition to EU enlargement in preparation, the EU had to show its willingness to open broad and generous co-operation with its neighbours, which are not concerned by this process. It was time to show that the EU has something important to propose to its close partners and that enlargement is not the unique tool. This represented a major change in EU policy and a move by the Commission away from the *enlargement paradigm*. This was not a brutal change, because the process started at least as early as 1999, but it is clear that the approach of 2004 made creation of a new paradigm into an urgent priority. The ENP means the building of a belt of democracy and prosperity around Europe, which will ensure shared stability and security. It is interesting to note the prevalence of geographic proximity as a criterion for definition of strategic partnerships, which reflects the importance of the integration process in the EU’s international relations. What is Wider Europe Neighbourhood? The content will of course be more precisely defined, but the guidelines are already quite clear. The EU will strive to disseminate its values and prosperity within this “*ring of friends*”. Free movement of goods, services and capital should be ensured and the economic dimension is very close to what was proposed for the Common European Economic Space with Russia. There is one important difference: the free movement of persons, that was included as a target in several CEES documents, does not seem so clearly on the agenda of the ENP, or its scope is moving toward distant future.

In October 2003, the European Council welcomed this initiative and urged the Commission and the Council to take it forward. Since then, the Commission has also held exploratory talks with partners in Eastern Europe and the Southern Mediterranean³ which have Partnership and Cooperation Agreements or Association Agreements in force. These talks have confirmed their interest in European Neighbourhood Policy (ENP) and heard their views on the priorities to be addressed in possible ENP Action Plans. Reports on the current situation in these countries and their cooperation with the EU are attached to the Communication.

¹ http://europa.eu.int/comm/world/enp/index_en.htm

² “Wider Europe— Neighbourhood: A New Framework for Relations with our Eastern and Southern Neighbours”, COMMUNICATION FROM THE COMMISSION TO THE COUNCIL AND THE EUROPEAN PARLIAMENT, 26 p. http://europa.eu.int/comm/external_relations/we/doc/com03_104_en.pdf

³ Israel, Jordan, Moldova, Morocco, Palestinian Authority, Tunisia and Ukraine.

The intention is progressively to extend the process to other countries which have themselves ratified Association Agreements, that is in the first instance, Egypt and Lebanon.

The objective of the European Neighbourhood Policy (ENP) is to share the benefits of the EU's 2004 enlargement with neighbouring countries – i.e. stability, security and well-being - in a way that is distinct from EU membership. ENP will also help address one of the strategic objectives the European Union set in the European Security Strategy in December 2003, that of building security in our neighbourhood. The ENP is addressed to the EU's neighbours and, in particular, those that have drawn closer to the EU as a result of enlargement. In Europe, this applies to Russia, Ukraine, Belarus and Moldova. The EU and Russia have decided to develop their strategic partnership further through the creation of 'four common spaces' (for external security, Justice and Home Affairs, the economy and science and culture), as defined at the 2003 St Petersburg Summit. In the Mediterranean region, the ENP applies to all the non-EU participants in the Euro-Mediterranean Partnership (also called the Barcelona process)⁴ with the exception of Turkey, which is pursuing its relations with the EU in a pre-accession framework. The Commission also recommends the inclusion of Armenia, Azerbaijan and Georgia within the scope of ENP. The European Security Strategy, adopted by the European Council in December 2003, clearly identifies the South Caucasus as one of the regions in which the EU should take a "*stronger and more active interest*". The EU Parliament november 2003 supported the inclusion of Southern Caucasus countries, as well as of Lybia and Mautitania, which belong to the emergin Arab Maghreb Union.

The Commission today proposes a **method** to meet the goals of the European Neighbourhood Policy. This method consists in defining, together with partner countries, a set of priorities in **jointly agreed Action Plans** with a view to bringing these countries as close as possible to the European Union. The Action Plans are based on a commitment to shared values, that is respect for human rights, including minority rights, the rule of law, good governance, the promotion of good neighbourly relations, and the principles of market economy and sustainable development as well as to certain key foreign policy goals. The pace at which the EU develops links with each partner will reflect the extent to which these common values are effectively shared. The Action Plans will contain a number of priorities intended to strengthen commitment to these values. The Action Plans will also cover a number of other key areas, as political dialogue, economic and social development policy, offering neighbouring countries the prospect of a stake in the EU internal market based on legislative and regulatory approximation, trade (ENP foresees a greater market opening in accordance with the principles of the WTO and convergence with EU standards), Justice and Home Affairs.

The Action Plans will be differentiated, i.e. tailor-made to reflect the existing state of relations with each country, its needs and capacities as well as common interests. They will be put forward by the Commission and approved by the respective Cooperation or Association Councils. The Action Plans will define the way ahead over the next three to five years. The next step could consist in offering a new privileged partnership in the form of **European Neighbourhood Agreements**, to replace the present generation of bilateral agreements, when Action Plan priorities are met. The priorities set in the Action Plans will be a reference for the financial support provided by the EU to the countries concerned. Assistance from existing sources –mainly the INTERREG, TACIS and MEDA programmes – for an amount close to € 1 billion, which is not so much. This will be complemented in the future by anew financial

⁴ Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Syria, Tunisia, as well as the Palestinian Authority

instrument from 2007, the **European Neighbourhood Instrument**, which will focus on cross-border cooperation along the external border of the enlarged EU.

The European Neighbourhood Policy also strongly encourages **regional and subregional cooperation**. The importance of this issue is increasing compared to the WEN document of 2003. By further developing various forms of cross-border cooperation, the EU and its partners can work together to ensure that regions benefit from the EU's enlargement. In the South, the ENP will also encourage the participants to reap the full benefits of the Euro-Mediterranean Partnership, notably through the promotion of infrastructure, interconnections and networks, in particular energy, and to develop new forms of cooperation with their neighbours.

What is the meaning of the Neighbourhood concept ?

The idea of "neighbourhood" appeared in the international law in the XIXth century as a special object different from the rules of cooperation relationships between two States. It is the law ruling the relationships between two States *that have as a direct source the fact that the territories of these States are contiguous*⁵. One State may take care of the interests of a neighbouring State because some events happening on its own territory may bring damages to the neighbouring State. It is the fact that the two States have to manage their common good : the border.

Pr Andrassy underlined two contradictory considerations in the law of neighbourhood:

- On the one side, the need for security of each State should make the border a safe and well-managed wall.
- On the other side the needs and the interdependencies of the economies lead to the progressive alleviation of the artificial obstacles created by the existence of this border.

The unity of neighbouring territories creates a community of interests shared by two neighbouring States.

The concept of Neighbourhood appeared in the March 2003 document of the Commission, considering the new situation created by the enlargement of 2004. This concept underlines the common interests of the EU and its bordering partners: Western CIS and Mediterranean countries. This will lead to the renewal of the cooperation of the EU with these countries and will open a new chapter of EU external policy. The draft of the EU Constitution⁶ includes this neighbourhood concept in the title VIII of its first part, showing the importance of this issue and the need for another tool than enlargement.

Since the late 80's, the situation in Balkan region showed the risk that represent for the EU the development of conflicts on its periphery. The 2004 EU enlargement is unprecedented and means a huge extension of its Eastern, and Southern borders. It provides the opportunity for the EU to strengthen the links set-up with all these future neighbouring States. However there exists still a need for consistency and efficiency of the external activities of the EU. The external policies are numerous and various, they affect the community pillar (for ex the common trade policy, the cooperation for development, humanitarian aid, the visas and

⁵ Andrassy J., *Les relations internationales de voisinage*, Recueil des cours de l'Académie de droit international de la Haye, éd. Sijthoff, Leyde, tome 79-II, 1951, pp. 77-181

⁶ Projet de Traité établissant une Constitution pour l'Europe, JOCE n° C 169 du 18 juillet 2003.

immigration policy), as well as the two intergovernmental pillars (ESCP⁷ and JIA)⁸. The building of the ENP belongs to the rationalisation of its external action. With Russia and Western CIS countries the EU established bilateral Partnership and Cooperation Agreements (PCA) since mid 90's, with the Tacis economic tool. Southern Mediterranean States started in the 70's to pass bilateral agreements with the EEC, replaced since the 1995 Barcelona Conference by the Euro-Mediterranean Partnership. It aims at building an Euro-Mediterranean shared prosperity zone, and the development of a free-trade area thanks to bilateral association agreements. This partnership paves the way for an original global and multilateral approach with a regional dimension. These States benefit from the Meda economic tool.

One should notice that in the ENP documents there is no definition of the neighbourhood concept, but the presentation of its principles and objectives. The notion of proximity included in the ENP goes beyond the standard international law approach : safe border management and alleviation of the obstacles connected with borders. The principles, objectives and prospects reflect an ambitious policy which tends to develop the Union, building a "ring of friends" from Russia to Morocco.

In the March 2003 document, the Commission insisted on two major objectives of the neighbourhood policy.

1 – It aims at building with its neighbours a common space of prosperity, stability and security. This includes four priorities :

- to promote sustainable economic and social development in border areas;
- to approach jointly environmental and organised crime issues;
- efficient and safe border management;
- to promote "inter-communities" local actions.

2 – The provision of concrete advantages and preferential relationships by the Union depends on the realisation of effective political and economic reforms. The efficiency of these reforms will be measured by reference criteria jointly set-up with each neighbouring State. This conditionality of the aid was already present in the agreements already passed with neighbours, but within the ENP it will be renewed and made more precise in order to increase the credibility of EU action. The EU will provide to the neighbours sharing the values of its foundation, the "full benefit" of its inside market, ie the four fundamental freedoms : the free circulation of persons, of goods, of services and of capitals. In this respect, the Commission relies on the approach developed with the European Economic Space, and more precisely the Common European Economic Space with Russia.

The two basic principles of the ENP are the principle of "joint ownership" : the EU and the neighbouring State recognise their interest to manage jointly their common border and the principle of differentiation: the EU will take into consideration the economic, political and social peculiarities of each neighbour.

The originality of the ENP is that beyond a standard bilateral cooperation, it will help building a regional cooperation for a pan-European and Mediterranean space relying on common values.

⁷ Common external policy, Common Security policy and Common Defence policy.

⁸ Judiciary cooperation in penal issues.

Why an European Neighbourhood Policy ?

May 1st, 2004 eight Eastern transition countries joined the EU. This process is usually presented as the next major step in so-called EU enlargement. However, "EU enlargement" is a convenience term, which is in many ways inadequate and politically not very correct. It would be better to speak of the next step in "European reunification". The two processes are different and completion of the reunification of Europe after World War 2 cannot be confused with EU enlargement. The latter is a smaller process and countries like Russia or Ukraine, for example, are not expected to be integrated in the EU in the near future. That means that EU enlargement leaves major European countries beyond its scope. It is also important to note that the term "EU enlargement" reflects West European ethno-centrism. The population of Poland or Estonia may have a quite different understanding of their future entry into the EU.

On the eve of this major step towards European reunification, the situation of Eastern transition countries is highly contrasted. "Accession countries" have seen strong economic growth and structural change in the last 10 years. They are even expected to bring the EU some growth impulses: the EU forecasts average growth for the period 2002-2004 in EU-15 at 1.6%, whereas estimates for the 10 accession countries in the same period are 3.2% growth. The prospect of EU membership speeded-up structural change and capital inflows, and provided a stability premium for these countries. By contrast, the economic, political and social situation in CIS countries remains disappointing and rather insecure. The starting position in these countries was worse and their structural changes in the late 1990 were very rapid, but their transition indicators are still far behind those of Central, East European and Baltic countries (CEB) (see appendix). A slight catching-up process was observed in 2000-2002, but it is already disappearing in 2003. Moreover, although it is possible to detect a kind of nominal convergence consistent with the Baumol-Lucas-Barro paradigm, according to which less developed countries grow faster,⁹ this convergence disappears when measured as a percentage of 1990 GDP. That means that the transformational crisis of the 1990s increased the gap between CEB and CIS countries. The picture is the same if one considers FDI: FDI flows to CEB countries in 2002 were four times higher than flows to CIS countries (calculation in terms of dollars per capita would give an even worse picture). And FDI dynamics are quite depressing: since 1997 FDI to CEB countries multiplied threefold whereas flows to CIS countries stagnated.

The overall picture is thus as follows:

- *The transition process has increased the gap between two parts of Eastern Europe;*
- *The process of accession by CEB countries to the EU has strengthened this trend;*
- *Earlier experience of EU enlargement suggests high probability that EU membership of CEB countries will strengthen this trend even further.*

The direct trade effects of EU enlargement for EU-CIS economic relations are not necessarily negative. If we take the example of Russia, some Russian experts and officials fear a further deterioration of trade with the CEECs after the latter's accession to the EU. However, the trade figures suggest that there is not much scope for a further decline of trade. In fact, as the CEECs adopt the EU's lower external import tariffs (4.4% instead of their present 6.5% on average) after accession, the effect on trade with Russia should on balance be rather

⁹ W.J. Baumol (1986) "Productivity Growth, Convergence, and Welfare : What the Long-Run Data Show", American Economic Review, 76, 5, p1072-1085; R.E. Lucas (1988) "On the Mechanics of Economic Development", Journal of Monetary Economics, Vol. 22, p139-199; R.J. Barro, X.X. Sala-I-Martin (1991) "Convergence across States and Regions", Brookings Papers on Economic Activity, 1, p107-158.

*positive*¹⁰. This effect will be particularly pronounced in the case of Poland, where the average tariff will fall by 9.5 percentage points (p.p.). In Hungary, the average tariff will fall by 5.1 p.p., in Slovakia and the Czech Republic by 0.6 p.p. The Russian concern that new non-tariff barriers may emerge is not fully substantiated either, and an agreement on extending the EU import quota for Russian steel has reportedly already been reached. Also, accession to the EU is expected to lead to a higher market growth in the CEECs. In several other important respects, EU policies towards Russia have also been more favourable than those currently applied by several CEECs. At the same time, some Russian *fears* regarding adverse consequences of enlargement are definitely real. First, the CEECs have introduced the Schengen visa regime on their (future EU) borders for Russian citizens, even before accession. Second, Russian energy exports to the EU may suffer in the medium and long run due to the EU strategy of diversification of energy supplies. The strategy stipulates that not more than 30% of the EU's energy needs may come from one source, whereas most CEECs are heavily dependent on imports of Russian fuels. Finally, according to Astrov and Havlik, the future new members will affect EU voting procedures, and there is at least a possibility that they may twist EU policies towards Russia – and that not necessarily in a direction favourable for Russia.

The concept of ENP offers a way of filling this structural gap, encouraging mutual prosperity, stability and security by removing economic barriers between EU25 and CIS countries. This would offer the EU better access to markets, which, along with China, are the most dynamic in the world, at a time when the developed world is trying to escape or prevent recession. It would also reinforce stability and security, which are increasingly recognised world-wide as highly desirable public goods.

The need for a new EU Eastern policy

At the "Sommet de l'Arche", held in Paris in 1989, the G24 mandated the EU to organise and coordinate support for reconstruction and development of post-communist countries, However, the EU has gradually shifted towards a different approach. The technical assistance activities developed through PHARE and Tacis programmes, which were very appropriate and highly focused on specific needs, have become less and less important compared with another policy, which has absorbed most of the EU's efforts and resources: the policy of EU enlargement. This is what we call the *enlargement paradigm*, i.e. prioritising the enlargement process as the way to support economic restructuring and political democratisation in the East.¹¹ It is true that this implicit policy shift was also a response to strong demand from several East European states, and the enlargement paradigm was very broadly shared in central Europe. But EU policy was never decided by third parties.

The enlargement paradigm was very strong during the period before Romano Prodi and well reflected by the words: "*Relevant EU Eastern policies should distinguish and not divide, instead of dividing without distinction*".¹² The analysis done before Romano Prodi's appointment was the following.

¹⁰ V. Astrov, P. Havlik: European Union, Russia and Ukraine : Creating New Neighbourhoods, WIIW Research Reports 305, April 2004.

¹¹ Ivan Samson (1999) "The Eastern policies of Europe and the two worlds of transition"; 2nd EACES workshop "European enlargement to the East, but at what speed ?" Paris, March 22-23..

¹² Samson (1999) op. cit. p. 10.

*"EU enlargement is the keystone of EU Eastern policies. Not because joining the EU is the final destiny of each transition country, but, on the contrary, because it plays the role of a prize for certain winners. However the development-enhancing effect of a selective and competitive approach is blurred by the lack of clear criteria for accession. No such approach can succeed unless it is transparent and sends consistent signals. As a matter of fact the latter are missing.(...) As a consequence of that, the positive effect of a sequenced enlargement tends to be reversed. Following the difficulties of reforming the EU and the cost of the first wave of accession, there is a risk that enlargement will end with this first wave, leaving many other countries and public opinions very frustrated. (...) A major result of aid to transition countries, mainly provided by the EU and EU countries, and of EU Eastern policies has been to increase former divisions and produce new divisions between these countries. That means that such policies do not bring any answer to the problems of the future of most transition countries and may even make solution of these problems more difficult."*¹³

This policy started to change after the appointment of Romano Prodi, when the EU opened the door to 10 candidate countries instead of 5 (the 8 accession countries plus Bulgaria and Romania). However, the enlargement paradigm remained dominant, so that instead of disseminating prosperity (such dissemination did not go beyond countries of the first circle) the EU acted mainly as a magnet with divisive effects. The new enlargement policy has been beneficial for the accession countries, but, by definition, left other transition countries without any strong message.

Related problems attach to aid to the east and the bilateral approach towards economic co-operation. Analysis of government assistance, extended by western countries (mainly the EU countries) to transition countries, reveals a clear case of the *paradox of aid*,¹⁴ which is that aid tends to be based on the quality of the recipient rather than the recipient's needs. Measured per capita, we observed that aid to the developed countries of central Europe and to the Baltic States was twice as generous as that to CIS countries. This suggests that donor countries followed the same signals as private capital flows. There are several reasons for this paradox, one being dissemination ability (the usual ceiling for absorption capacity of aid is 4% of GDP) and another being the fact that aid to transition countries benefited Western companies.

It is important to distinguish four types of aid:

- 1 – Emergency and humanitarian aid, which should go to the poorest;
- 2 – Development aid, which aims to compensate weakness of the state in providing conditions for investment (education, material infrastructure, energy, with particular attention to nuclear plants);
- 3 – Specific aid for transition, which offers know-how transfers in public and private management and construction of market institutions;
- 4 – Bilateral and multilateral loans to states to support budget and monetary policies.

The second and third types of aid mainly represent financing of projects and technical cooperation. The latter, which is 1/8 of total public aid, is best suited to emerging countries where the educated and skilled workforce shows spectacular learning abilities. PHARE and Tacis programmes are typical of multilateral technical assistance. Between 1991 and 2001, PHARE delivered three times more resources than Tacis, and the gap is widening (in 2001, it is close to four times). PHARE and Tacis aid is modest in quantity and is likely to bring perceptible and durable effects: we are far from the limits of capacity absorption for such aid. The fact that technical cooperation per capita is higher for CEB countries shows that the

¹³ Samson (1999) op. cit.

¹⁴ Ivan Samson - "Il est indispensable de repenser l'aide aux pays en transition" Le Monde 8.11. 1999.

enlargement paradigm is alive and well and that EU support policies are not succeeding in reducing the structural gap between CEB and CIS countries. On the contrary, they are helping to make the gap wider.

Partnership and Cooperation Agreements were set-up by the EU with most of the CIS countries. Such agreements came into force on December 1, 1997 for Russia, March 1, 1998 for Ukraine and July 1, 1999 for the other CIS countries (the exceptions are Belarus and Turkmenistan, with whom the PCAs have been signed but are not yet in force, and Mongolia, with whom there is only a Trade and Cooperation Agreement, signed in 1993). PCAs offer the prospect of closer cooperation with the EU for non-candidate countries and aim at preventing possible crowding-out effects after EU enlargement to the CEB countries. The PCAs also mention the possibility of establishing free trade zones in the future and ensure the freedom of transit of goods destined for third countries. Any subsidies distorting free and fair competition between domestic and imported goods are unwelcome, except in the production of unprocessed agricultural and mineral products. Generally, the PCAs also forbid the application of quantitative restrictions in mutual trade, although they give the EU a right to impose import quotas for textiles and steel products. While the textiles quotas have been abolished in the meantime, the one for steel is still in place¹⁵.

The philosophy of these agreements is to create the conditions for a free-trade area, with the further prospect of developing free movement of services and capital. The sides grant each other most-favoured-nation status in trade and the absence of discriminations concerning goods, labour conditions and the establishment of companies. In addition, PCAs include several dispositions for law approximation that are very broad, but not very binding. The basis of these agreements is bilateralism, which means that the EU negotiates and passes the agreements country by country. This approach seems well-founded: the bilateral approach has proved to be much more efficient than the multilateral approach, for liberalisation of services as well as for regulatory convergence, as it is the case with the WTO. However the bilateralism in economic cooperation is structurally associated with negative side-effects and crowding-out effects: for example when the EU opens its borders to Russian steel, steel exports from Ukraine and Kazakhstan to the EU suffer from this measure. As it was the case with the enlargement paradigm, the bilateral approach of EU economic cooperation is associated with divisive effects, suggesting that revision of EU policy is called for.

The lessons of research on the Common European Economic Space

The RECEP White Book shows that the CEES can be an important lever of sustainable growth for Russia, and that it represents something much more sophisticated than a traditional free-trade area, a customs union or recognition of the EU 'acquis communautaire'¹⁶. The CEES is both a final aim and an economic mechanism. The final aims of this space are: to implement the four fundamental freedoms for goods, services, capital and persons; to achieve an intensive exchange of know-how and capital through FDI; and to support strong modernisation policies. The importance and the specificity of Russia make any reference to past experiences inadequate and successful creation of the CEES could contribute to the economic and social development of all Europeans.

¹⁵ Astrov and Havlik, 2004, op. Cit.

¹⁶ Ivan Samson, Xavier Greffe (2002) "Common Economic Space: Prospects for Russia-EU relations", RECEP White Book Moscow., 160 p.

Achievement of this long-term objective requires implementation of the CEES as an economic mechanism for changing the path of growth and the path of reforms in Russia. The Common European Economic Space (CEES) between Russia and the European Union has first to be considered as a *co-development path* that will define, step by step, its actual content. As a co-development path the CEES offers a way for Russia to find a *virtuous growth cycle* that could become sustainable. It is dependent on adequate positive interactions between development of trade liberalisation (the small scale of the Russian domestic market makes the EU market vital for modernisation of the Russian economy), investment and know-how flows, and institutional adjustments. Lack of parallelism between these three essential pillars would induce inefficient reorganisation and could even generate tensions. The economic mechanism of the CEES could organise the whole opening process of the Russian economy, starting with WTO accession. In its movement towards WTO accession, Russia has made the important choice of "large openness" as opposed to "small openness". The nature of Russia's negotiations on bound tariff rates, which will be progressively reduced, suggests that Russia will benefit from a 6-8 year "window" in order to implement needed adjustments. This is not a long time. EU support is essential for Russian accession to the WTO, and active partnership within the CEES for modernisation of Russia's production is a condition for making this accession a success.

This co-development path is of *mutual interest* because creating a Common European Economic Space is a win-win project for the two main forces on the European continent: the Russian Federation and the European Union. For Russia it offers a way to diversify an economic system based mainly on the exploitation of natural resources and permanently exposed to Dutch disease, and to organise a diversified competitive economy based on relevant investments. For the Economic Union, Russia is a major foreign trade partner in absolute terms and presents opportunities for capitalisation of EU strengths through increased complementarities. The chief aim could be best defined as sustainable growth for all the inhabitants of Europe. Russia and the EU may have very different levels of development but, between them, they also have all the ingredients of success at a time when globalisation and knowledge are the main levers of development. Both parties will gain increased prosperity, stability and security from creation of the CEES.

The challenge of the CEES goes beyond creation of a free-trade area and focuses on transformation of the development model of the Russian economy. Despite good performance by the Russian economy after 1998 rouble devaluation and the rise of world energy prices, Russia faces difficulties in transforming its economic surplus into a basis for sustainable development.

Russia's macroeconomic health since 1999 is reliant on exports: the increase in the trade surplus since 1998 has been 2-2.5 times greater than increase in GDP, which has grown by over 20% in the last three years. The trade surplus exceeds \$60 bn, and the net balance is \$40 bn. Thanks to this situation, the budget surplus is close to 5% of GDP and debt has been reduced by \$2.7 bn. However, since two thirds of Russian exports are primary goods, Russia's growth is dependent on evolution of world market prices. Lack of significant increase in imports of machinery and equipment also gives cause for concern. The overall investment rate relative to GDP remains low, at around 15-16% over the last five years, which is far below the rates that are needed for economic take-off in emerging economies (between 25% and 35% in a medium-term perspective), and is even below investment rates in developed EU countries. The hypothesis of export-led growth is not convincing, and there is nothing to indicate that such growth, which has benefited from the devaluation of 1998, is sustainable. This is also

indicated by the balance of public finances, which remains highly volatile. We are still far from a Russian economic boom based on multi-sectoral productivity increases and strong investment activity. It is thus fair to say that Russia remains mainly a rent economy and a victim of Dutch disease.

The situation is thus more fragile than superficial reading of the macroeconomic indicators may suggest, and two issues have to be considered in order to clarify the challenges for the Russian economy. First, can Russia rely only on primary goods or should it look harder at the new situation created by the knowledge economy and flexible specialisation in industry? And second, can foreign direct investment (FDI) help to bring sustainable growth by boosting current low investment rates? It seems that both the EU and Russia would benefit from integrating within a new type of economic space where a productive partnership could mobilise their respective resources for their common interest. The challenge here is not only trade but also capital and know-how flows. Moreover, dynamic strategies underlying implementation of the CEES must consider new features of the world economic environment. Growth relies on new productive paradigms, such as the knowledge economy and environmental values. Orientation towards the knowledge economy is very consistent with Russia's human capital endowment. This means that themes such as intellectual property rights, environment-friendly production or SME development have to be at the top of the agenda.

Econometric simulation shows that the best formula for CEES is free-trade measures completed by strong modernisation policies thanks to intensive FDI and know-how flows. The economic efficiency for Russia of such a CEES concept is manifest, since it will lead to the highest GDP increase, strong expansion of imports and exports, a higher share of manufactured goods in exports, and improved welfare in Russia. This conclusion is of highest importance: although the calculations should be done for the other neighbours, we can assume it as valid as an hypothesis. That means that CEES policies could provide a good approximation of the economic content of the ENP for Western CIS and mediterranean countries. In no case, the building of free-trade zones can be considered as sufficient. One should mention that this free-trade issue, that was included in the PCA agreement, disappeared in the EC Strategy Paper 2002-2006 for the Russian Federation. The efficiency of free-trade measures is possible when accompanied by FDI and know-how flows, as well as with regulatory convergence. The question to raise is whether the small budget allotted to ENP will be sufficient to bring the expected economic impulses through which the EU will disseminate its prosperity. Although the bulk of capital flows to neighbouring economies should be private, the amounts of public aid may be too short.

The European Neighbourhood Policy: a model of regionalism ?

After its enlargement to 10 countries in Central and Eastern Europe, the EU has to show that it has a concept for helping the other transition countries in the CIS as well as mediterranean countries to resolve their problems. Reduction of the development gap between accession countries and neighbouring countries is a critical issue, and the initial task is to prevent further widening of this gap.

Research conducted on the Common Economic Space with Russia provided highly valuable conclusions. Such a Pan-European Economic Space should be built on the basis of tailored and complex agreements with regions consisting of groups of countries. The approach of

negotiating PEES with several countries having common features, even if not strongly or formally integrated, has several advantages. It represents a half-way house between bilateralism and multilateralism that one could call *regiolateralism* (the EU term is “regional cooperation”). The justification for promoting forms of *regiolateralism* in relations between the EU and CIS countries are as follows.

- *Regiolateralism* echoes the Marshall Plan spirit, where US aid was conditioned by mutual trade development between the countries of Western Europe;
- It prevents mechanical crowding-out effects connected to bilateral FTA, without entering the overall approach of multilateralism, which is not the optimal framework for liberalisation in services and for regulatory convergence;
- The political message of opening from the EU is much stronger because instead of making a single state "negotiate" with 25 EU states, it shows respect by the EU for regional peculiarities and regional integration measures.

Regional cooperation is not new for the EU, which already has experience of the ACP (Africa, Caribbean, Pacific) agreements: the so-called Lome conventions, successively organising preferential trade with 71 developing countries. In 1989 the EU and the six-state Gulf Cooperation Council signed a cooperation agreement, in 1993 the EU-Central America Framework Cooperation Agreement was begun, followed by the EU-Mercosur Interregional Framework and Cooperation Agreement in 1996 and an agreement with the Andean Community in June 1999. Summits with the five Western Balkan countries are organising the process of further integration of these five states with the EU, and there is also a Euromediterranean partnership with 12 States from this region. This list is not complete and is merely intended to show examples of successful regional cooperation by the EU with very different regions and in very different forms.

Surprisingly, such regional co-operation never took place with transition countries, probably because of the enlargement paradigm, which gave priority to bilateralism. The fact that the EU is preparing deeper integration with transition countries, including forms of legal approximation on the basis of the EU *acquis communautaire*, is not a sufficient explanation. Deeper integration is also being developed with the Mercosur countries, where the aim is to move towards association agreements, and an economic partnership agreement is being prepared with ACP, not to mention the Western Balkans, which are sooner or later expected to become EU members.

Regiolateralism would be the most adequate form for the EU to negotiate building of the Pan-European Economic Space, since:

- It is perfectly suited for negotiations that combine trade and regulatory issues;
- It will show readiness of the EU to take certain existing integration processes between CIS countries into account.
- It will help to keep a special position for Russia. The CEES, which is currently being discussed, relies on the idea of a strategic partnership between the two parties. The building of PEES should not give the impression of diluting the CEES process (which is more advanced) and the special position of Russia.

The PEES model, based on CEES, could be extended to several CIS sub-regions as Western CIS, Caucasus and even Central Asia, as well as for EU cooperation with the Mediterranean region or Middle East.

Building PEES means a radical change in the world economy as well as formation of a large economic belt around the enlarged and unified EU25. Understanding of PEES as a space with free circulation of persons and goods is a very exciting prospect, representing an unprecedented level of European unification. But is this realistic? Is it really thinkable in a near future? Our answer is yes for two reasons. The first is the asymmetry of economic relations between the EU and its eastern neighbours (Russia, Western CIS, Caucasus, Central Asia), which paradoxically pleads for further economic integration and will facilitate it. Russia, the EU's biggest partner in the region, was the fifth largest source of EU imports and sixth largest destination for EU exports in 2001, but represented only 1.5% and 1.1% of its imports and exports respectively. On the other hand, EU15 represented 29.5% of CIS exports and 35.2% of CIS imports in 2001 (see appendix). For Russia the figures are respectively 33.3% and 45.1%, for Ukraine 19% and 27.2%, for Belarus 8% and 15% and for Kazakhstan 30.2% and 21.9%. If we consider EU25, the overall share of the EU in CIS trade will be increased by 3%. The CIS is already more integrated with the EU than with itself as regards trade. Removing economic barriers will have thus small economic impact on the EU (CIS GDP is only equal to that of Spain) but will have major impact on CIS countries. Therefore potential negative impact on EU companies due to trade liberalisation is not a serious factor and should not be a serious obstacle to building of PEES, which presents huge opportunities.

Success of PEES also requires attention to remarks made by Russia in discussions concerning CEES.¹⁷ Beside the usual – and sometimes not unjustified – request for additional liberalisation by the EU side, the Russians support the idea of an "open" scenario, i.e. that the CEES should not rely on preferential forms of cooperation regarding third countries, which could become obstacles to overall trade development, but that it should rely on integration forms transferable to third countries. In other words, Russia will avoid becoming "captured" in a CEES with the EU that will constrain its trade with third parties. Although this request is largely symbolic, because the CEES is oriented towards increasing the competitiveness of Russian companies and not towards giving trade preferences, the Russian fear of a lock-in with the EU should be considered.

Another argument already heard against ENP is the following: "Well, with ENP, what you offer is a trick to avoid letting us into the EU!" This remark is typical of the enlargement paradigm, which has gained acceptance beyond the EU. It relies on the idea that there is no salvation outside EU membership, forgetting one very important fact: that the accession process is associated with extremely high constraints and costs. The cost for sharing the decision process of the EU and benefiting from its (decreasing) structural and agricultural policies is the loss of a part of national sovereignty and of autonomy in economic policy. Precise calculation of the costs for accession countries is of course a difficult exercise. But there are some partial estimates. For example: *"realising massive infrastructure development projects and environmental investments (motor way construction, impacts of the EU directive for heavy weight vehicles, directives on waste handling and public utilisation densities) is almost beyond rationality. These investment needs are estimated to around 25-30% of the GDP of candidate countries in the next 5 to 10 years"*.¹⁸ The cost to Poland of introducing the

¹⁷ Vladimir Mau, Vadim Novikov (2002) "Economic relations between Russia and the EU: the Space of Choice or the Choice of Space?" (in Russian), *Voprosy Ekonomiki* n°6.

¹⁸ Béla Galgóczi (2003) "Social and economic cost of EU enlargement – from the point of view of the new member states", prepared for the UN-ECE conference: "TRADE, BUSINESS AND INVESTMENT IN A WIDER EUROPE" Palais des Nations, Geneva, 7 April 2003, p. 12.

320 EU environment directives could represent 4-8% of current GDP for the next 20 years¹⁹ and the cost to Poland of complying with EU directives on standards and safety rules in transportation would be somewhat less.²⁰ In 1997, the Commission estimated the cost for the 10 CEE candidate countries of integrating the whole *acquis communautaire* in national legislations at \$120 bn.²¹ There are even voices expressing the idea that the EU regulatory system may draw the new EU accession countries into "a poverty trap".²² Without going to such extreme views, the point is thus to find forms of economic integration with the EU for third countries that maximise the benefits and minimise the costs. This is what the ENP and PEES may offer.

The second reason why PEES is realistic is that with the ENP, the EU officially stated commitment to such a target. This new paradigm extends the first approach proposed for the CEES and that the building of a Pan European Economic Space is quite compatible with the ENP. They rely on the same vision, and the PEES is ideally suited to found the economic dimension of the *"ring of friends"* proposed by the EU. The only discrepancy is that the ENP suggests a bilateral approach, country by country, which is less than optimal for the reasons set out above. *Regiolateralism* would appear friendlier in this respect.

However, as explained above, the latest EPN documents from May 12, 2004 express a shift towards regional cooperation. This was also supported by EU Parliament report expressing that the ENP should become a trouble for the Arab Maghred Union building. Moreover when Prodi visited Morocco, he expressed a strong wish that regional integration in Southern Mediterranean, creating broader economic spaces, will make them more attractive for EU investors. The EU Parliament Report expressed also the wish that EPN takes into consideration the decision, September 2003, of Russia, Ukraine, Belarus and Kazakhstan to build a Common Economic Space. *The main challenge for the EU policy-makers in the present circumstances would be to foster balanced economic integration with countries involved in regional integration in CIS and Mediterranean, thus avoiding a costly disruption of trade links between these- countries. Such an approach will be indispensable for preventing the emergence of new dividing lines in Europe and promoting new Neighbourhood relations.*

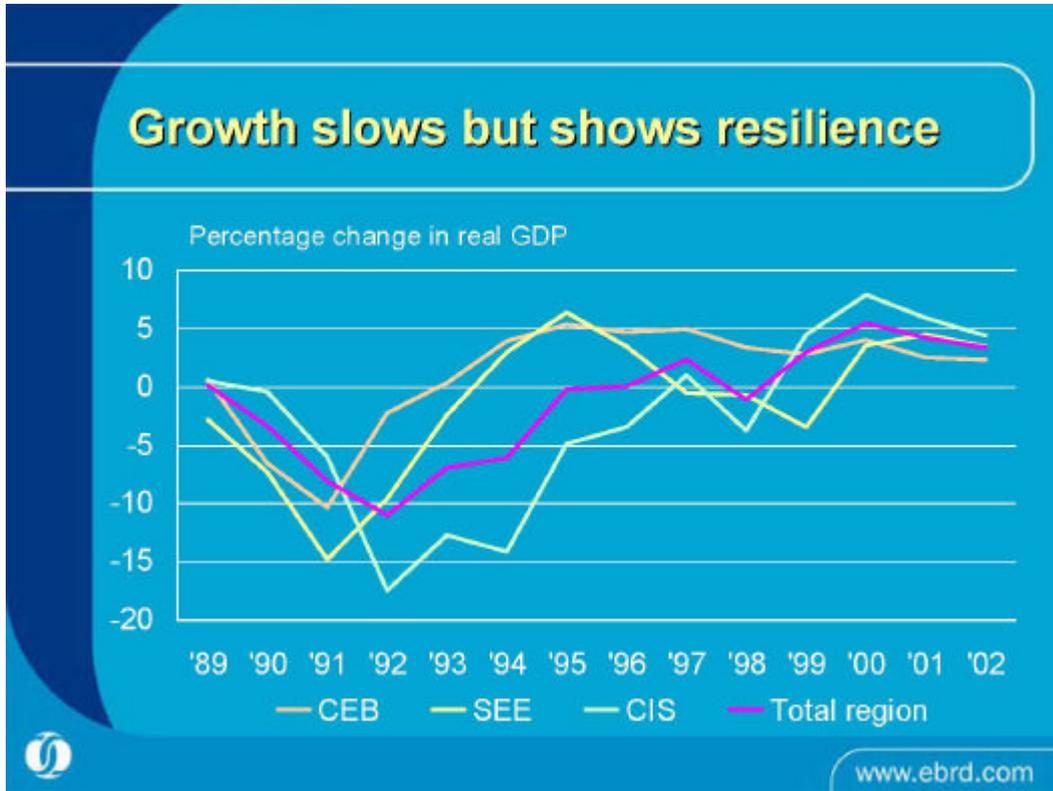
¹⁹ Alan Mayhew "Financial and Budgetary Implications of the Accession of Central and East European Countries to the European Union" Working Paper 33, Brighton: Sussex European Institute, cited in Patrick A. Messerlin, *Measuring the Costs of Protection in Europe*, Washington, DC: Institute for International Economics.

²⁰ Alan Mayhew and W. Orłowski "The Impact of EU Accession on Enterprise Adaptation and Institutional Development in the EU-Associated Countries in Central and Eastern Europe" London: European Bank for Reconstruction and Development, 1998, cited in Messerlin, *op. cit.*

²¹ http://www.eu2001.se/static/fr/eu_info/utvidgning_effekter.asp

²² Anders Aslund (2003) "East-Central Europe & the CIS: Economic divergence?" Meeting of the UNDP/RBEC Advisory Board, Moscow, May.

APPENDIX



... as FDI reaches record levels



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The outlook for the region

- Growth set to rise in 2003 in CEB / SEE but to slow further in CIS

Region	Growth		Inflation - annual average	
	2002	2003	2002	2003
Region	3.4	3.9	8.3	6.9
CEB	2.2	3.7	3.2	3.7
SEE	3.6	4.1	10.4	6.5
CIS	4.4	4.0	11.0	9.5



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EU trade with neighbours and China 2001 (bn\$)

	Exp Tot	Share	Rank	Imp Tot	Share	Rank
Total	2291	1		2334	1	
CEEC	105	0.046		94	0.040	
CIS	33	0.014		43	0.018	
Russia	24.4	0.011	6	34.3	0.015	5
China	26.5	0.012	5	67.3	0.029	2
Turkey	17.7	0.008	12	18	0.008	11
UAE	12.1	0.005	19			
S Arabia	11.5	0.005	20	11.36	0.005	16
Tunisia	7.1	0.003	27			
Algeria	6.7	0.003	29	10.5	0.004	20

Source: WTO

CIS Trade with main partners 2001 (bn \$)

	Exp Tot	Share	Imp Tot	Share
CIS Total	146,3	100	94,1	100
CIS	30,9	0,211	34,8	0,370
CEEC	16,7	0,114	5	0,053
EU	43,1	0,295	33,1	0,352
USA	8,3	0,057	3,8	0,040
China	9,6	0,066	3,5	0,037
Russia tot	103,1	100	53,9	100
CIS	15,3	0,148	13,2	0,245
CEEC	13,6	0,132	2,3	0,043
EU	34,3	0,333	24,3	0,451
USA	6,7	0,065	2,7	0,050
China	8	0,078	2,7	0,050
Ukraine tot	16,3	100	15,8	100
CIS	4,7	0,288	9	0,570
CEEC	1,8	0,110	1,7	0,108
EU	3,1	0,190	4,3	0,272
USA	0,8	0,049	0,2	0,013
China	0,6	0,037	0,2	0,013
Kazakhstan	8,6	100	6,4	100
CIS	2,6	0,302	3,3	0,516
CEEC	0,4	0,047	0,2	0,031
EU	2,6	0,302	1,4	0,219
USA	0,4	0,047	0,2	0,031
China	1	0,116	0,3	0,047
Belarus	7,5	100	8	100
CIS	4,5	0,600	5,9	0,738
CEEC	0,4	0,053	0,4	0,050
EU	0,6	0,080	1,2	0,150
USA	0,1	0,013	0,03	0,004
China	0,03	0,004	0,01	0,001

Source: WTO

Statistiques de base PECO-MED

	PIB/hab (USD PPP) 2000	Taux de croissance (% annuel moy.)			Inflation (% annuel moy.)			Solde budgétaire (% PIB)		Chômage % p.a. 2001	IDE Stock 2002
		1995-1998	1998-2001	% 2002	1995-1998	1998-2000	% 2001	1995	2001		
Algérie	5 308	3,0%	2,6%	n.a.	16,1%	2,6%	4,2%	-1,4%	-1,6%	27,3%	5 702
Egypte	3 635	5,4%	4,9%	3,0%	7,9%	3,6%	2,2%	0,9%	-4,7%	9,0%	20 746
Israël	20 131	3,3%	2,9%	-1,2%	8,9%	4,2%	1,1%	-5,0%	-3,1%	9,3%	24 762
Jordanie	3 966	2,7%	3,7%	5,1%	4,1%	1,9%	1,8%	0,3%	-3,0%	14,9%	2 414
Liban	4 308	3,3%	0,5%	n.a.	7,7%	0,6%	-4,9%	-18,6%	-16,9%	n.a.	1 622
Maroc	3 546	5,4%	2,7%	4,5%	3,2%	1,8%	6,0%	-4,4%	-6,7%	12,5%	9 994
Syrie	3 556	5,8%	-0,7%	n.a.	4,3%	0,1%	4,0%	-1,8%	-4,5%	10,3%	2 129
Tunisie	6 363	5,8%	5,2%	3,8%	4,2%	2,9%	1,9%	-3,2%	-2,7%	15,0%	14 061
Turquie	6 974	6,0%	-1,8%	3,9%	84,7%	68,2%	60,4%	-4,1%	-10,0%	10,4%	18 558
PM	4 308	4,4%	3,8%	3,8%	7,7%	2,6%	2,2%	-1,8%	-3,1%	12,5%	99 988
Chypre	14 290	5,2%	4,7%	2,2%	2,8%	2,6%	4,1%	-0,3%	-3,0%	3,6%	4 827
Estonie	20 824	6,1%	3,8%	4,3%	13,8%	4,3%	5,7%	2,0%	0,2%	9,1%	4 226
Hongrie	10 066	3,6%	4,4%	3,4%	18,6%	9,7%	9,1%	-6,8%	-4,1%	5,6%	24 416
Lettonie	12 416	5,6%	5,8%	5,0%	10,1%	2,5%	2,5%	n.a.	-1,6%	12,8%	2 723
Lituanie	7 045	5,7%	1,9%	5,0%	12,5%	1,0%	1,2%	-1,1%	-1,9%	13,1%	3 961
Malte	9 910	4,1%	3,1%	2,8%	3,0%	2,5%	2,9%	-10,7%	-6,8%	7,4%	2 891
Pologne	17 273	5,9%	3,0%	0,8%	15,5%	7,6%	5,5%	-4,3%	-3,1%	19,9%	45 150
Rép. tchèque	9 051	8,0%	2,3%	2,2%	9,3%	3,6%	4,7%	-2,6%	-5,5%	7,3%	38 450
Slovaquie	11 243	5,1%	2,3%	3,9%	6,2%	10,0%	7,3%	-5,5%	-5,6%	18,6%	10 225
Slovenie	17 367	4,0%	4,3%	2,6%	9,1%	9,0%	9,4%	n.a.	-2,5%	6,0%	5 074
PCI*	11 830	4,4%	3,2%	2,0%	9,1%	4,6%	5,1%	-3,5%	-3,1%	8,3%	141 964

Source : FMI, CNUCED

	Pop. Nombre 2002	Croissance annuelle (%)		Moins de 15 ans (% Total)	Plus de 65 ans (% Total)	Illettrisme (% Pop) 2002	Esp. de vie Années 2002	Routes pavées (% total) 1998	Superficie km ² 2002
		1975-2000	2000-2015						
ALG	31,320,430	2,5	1,5	34,8	4,1	31	71	69	2,381,740
EGY		2,2	1,5	35,4	4,1				
ISR	6,494,220					5	79	100	21,06
JOR	5,171,340	3,7	2,5	40	2,8	9	72	..	89,21
LIB	4,441,240	0,9	1,3	31,1	6,1	13	71	..	10,4
MAR	29,640,540	2,2	1,5	34,7	4,1	49	68	52	446,55
SYR	17,004,680	3,1	2,4	40,8	3,1	24	70	..	185,18
TUN	9,788,290	2	1,2	29,7	5,9	27	73	64	163,61
TUR	69,626,000	2	1,1	30	5,8	14	70	28	774,82
PM		1,8	1,3	32,6	3,7				
UE15		0,4	0,1	17,4	15,7				
BU	7,868,000	-0,4	-0,1	18,3	13,3	1	72	92	110,91
CY	764,970					3	78	57	9,25
CZ	10,209,830	0,1	-0,2	16,4	13,8	..	75	100	78,87
EST	1,358,000	-0,1	-1,1	17,7	14,4	0	71	22	45,1
HU	10,166,000	-0,2	-0,5	16,9	14,6	1	72	43	93,03
LET	2,335,000	-0,1	-0,6	17,4	14,8	0	70	39	64,6
LIT	3,476,000	0,5	-0,3	19,5	13,4	0	73	91	65,2
MAL	397,000					7	78	95	320
POL	38,626,192	0,5	-0,1	18,2	12,1	0	74	66	323,25
ROU	22,354,650	0,2	-3	33,9	3,4	2	70	53	238,39
SLK	5,408,760	0,5		19,5	11,4	..	73	87	49,01
SLV	1,991,960	0,5	-0,2	13,9	13,9	0	76	100	20,25
PCI*		0,15	-0,61	19,27	13,55				

Source : Banque Mondiale

Echanges des PECO et des PM, totaux et avec l'UE

M USD	Exports 2001		Exports 1993		Imports 2001		Imports 1993		Poids de l'UE (% X+M)	
	Monde	UE 15	Monde	UE 15	Monde	UE 15	Monde	UE 15	2001	1993
Algérie	20 119	13 064	10 803	7 680	10 673	6 807	7 454	4 950	65	69
Egypte	6 049	2 729	4 763	2 677	17 463	6 020	12 297	5 579	37	48
Israël	28 923	8 178	14 706	4 653	30 410	13 926	18 833	10 119	37	44
Maroc	8 850	5 935	5 319	3 736	11 158	7 076	7 393	4 813	65	67
Tunisie	7 172	5 818	3 740	2 924	9 372	7 400	5 663	4 427	80	78
Turquie	30 636	16 315	15 008	7 361	38 963	18 530	28 686	14 528	50	50
PM 6	101 748	52 038	54 338	29 033	118 039	59 759	80 326	44 416	51	55
Bulgarie	5 788	3 027	3 332	1 163	7 352	3 568	4 499	1 770	50	37
Estonie	4 384	2 920	761	424	4 959	2 690	1 049	668	60	60
Hongrie	29 866	20 651	8 771	5 516	30 740	20 324	12 463	7 596	68	62
Lettonie	3 050	1 901	1 427	879	4 252	2 162	1 181	483	56	52
Lituanie	4 299	2 323	1 910	828	6 392	3 013	2 018	620	50	37
Pologne	33 725	23 150	13 793	9 495	47 686	31 706	19 337	12 946	67	68
République tchèque	31 460	21 436	12 129	6 344	35 561	24 087	13 918	8 329	68	56
Roumanie	12 109	8 217	4 769	2 012	14 937	9 320	6 057	2 918	65	46
Slovaquie	12 255	7 189	4 827	1 589	13 731	6 998	5 925	1 862	55	32
Slovénie	8 889	5 575	5 596	3 597	10 238	7 553	6 066	4 291	69	69
PECO10	145 826	96 389	57 314	31 847	175 849	111 421	72 512	41 483	65	56

Source : Chelem-CEPII (2003)

Exportations de services (M USD)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
EGY	7 716	7 895	8 070	8 590	9 271	9 379	8 141	9 494	9 803	9 042
Transport	2 882	2 869	3 165	3 202	2 689	2 524	2 494	2 658	2 645	2 738
Tourisme	2 165	1 927	2 006	2 684	3 204	3 727	2 565	3 903	4 345	3 800
Autres	2 669	3 099	2 899	2 704	3 378	3 128	3 082	2 933	2 813	2 504
JORD	1 449	1 574	1 562	1 709	1 846	1 737	1 825	1 702	1 637	1 482
Transport	334	368	353	419	377	390	310	298	298	257
Tourisme	463	563	582	660	744	774	853	796	723	700
Autres	652	643	627	630	726	572	662	608	616	525
MAR	2 125	2 050	2 014	2 173	2 744	2 471	2 826	3 115	3 034	4 029
Transport	315	357	342	410	416	440	446	478	485	660
Tourisme	1 371	1 234	1 231	1 296	1 675	1 446	1 744	1 949	2 039	2 583
Autres	439	459	441	467	653	585	636	688	510	786
SYR	1 281	1 595	1 863	1 899	1 792	1 582	1 666	1 651	1 700	nd
Transport	260	271	342	237	245	214	257	240	246	nd
Tourisme	600	1 011	1 149	1 258	1 165	1 013	1 017	1 031	1 082	nd
Autres	421	313	372	404	382	355	392	380	372	nd
TUN	1 973	2 040	2 267	2 509	2 632	2 614	2 757	2 921	2 767	2 912
Transport	491	521	577	598	642	644	635	599	595	638
Tourisme	1 174	1 225	1 417	1 530	1 588	1 543	1 657	1 827	1 682	1 751
Autres	308	294	273	381	402	427	465	495	490	523

Source : FMI