The New EU Frontier: Perspectives on Enhanced Economic Integration

Editors: Małgorzata Jakubiak, Wojciech Paczyński

Authors: Małgorzata Jakubiak
Anna Kolesnichenko
Wojciech Paczyński
John Roberts
Sinan Ülgen

Warsaw 2007
The views and opinions expressed here reflect the authors' point of view and not necessarily those of the CASE.

This publication is an abridged version of the report that has been prepared for the Ministry of Economic Affairs of the Netherlands (Ministerie van Economische Zaken) under contract no. EP/EIS 5048195 "The Countries Bordering the EU and Enhanced Economic Integration" by CASE – Center for Social and Economic Development and Istanbul Economics. The views presented here are only those of the editors of the report and authors of specific sections and should not be attributed to Ministerie van Economische Zaken, CASE, Istanbul Economics or other institutions the authors may be affiliated to.

Keywords: ENP, economic integration, EU Neighbourhood

© CASE – Center for Social and Economic Research, Warsaw 2007

EAN 9788371784286

Publisher:
CASE – Center for Social and Economic Research
12 Sienkiewicza, 00-010 Warsaw, Poland
tel.: (48 22) 622 66 27, 828 61 33, fax: (48 22) 828 60 69
e-mail: case@case.com.pl
http://www.case.com.pl/
Table of Contents

Executive Summary ................................................................. 9

1. Introduction .............................................................. 19

2. Review of existing forms of economic integration ......................... 24
   2.1. Multilateral trade liberalisation: WTO .................................. 24
   2.2. Enhanced trade preferences ............................................... 25
       2.2.1. Generalised System of Preferences .................................. 26
       2.2.2. Autonomous Trade Preferences (ATP) .............................. 27
   2.3. Free Trade Agreements (FTA) .......................................... 28
   2.4. Customs Union .......................................................... 29
   2.5. Participation in the internal market ................................... 30
       2.5.1. Internal goods market ............................................... 30
       2.5.2. Complete internal market .......................................... 31
   2.6. Participation in European networks ................................... 32

3. Time dependencies between various forms of economic integration .... 33
   3.1. Sequencing of stages of integration .................................... 34
   3.2. Coordination of integration in different sectors ....................... 35
   3.3. Time frame .............................................................. 35
   3.4. Country cases .......................................................... 35
       3.4.1. Russia .............................................................. 35
       3.4.2. Ukraine ........................................................... 39
       3.4.3. Euro-Mediterranean partnership .................................... 41
       3.4.4. Algeria ............................................................ 42
       3.4.5. Egypt .............................................................. 44
       3.4.6. Morocco ............................................................ 45

4. Institutional basis for integration .......................................... 48
   4.1. Institutional requirements for alternative models of economic integration .... 49
       4.1.1. WTO membership .................................................. 50
4.1.2. Free trade area .................................................. 51
4.1.3. Customs union ................................................. 54
4.1.4. Partial Internal Market integration ......................... 54
4.1.5. Full Internal Market participation: the EEA option. ....... 57
4.2. Prospects for regulatory convergence in service sectors .......... 58
  4.2.1. Financial services ........................................... 58
  4.2.2. Energy ..................................................... 60
  4.2.3. Transport .................................................. 61
  4.2.4. Telecommunication ......................................... 62
4.3. Deeper integration options between ENP countries and the EU ........ 63
  4.3.1. Strengthened bilateralism .................................. 63
  4.3.2. "EEA Light" ................................................ 64
4.4. Conclusions ....................................................... 65

5. Effects of economic integration ........................................ 67
  5.1. Trade in goods – assessment of selected integration modes ........ 67
    5.1.1. The importance of coverage of trade agreements .......... 67
    5.1.2. WTO accession, FTA formation, domestic liberalisation
           – empirical results ........................................... 68
    5.1.3. Reduction of import duties – fiscal impact on ENP countries .. 73
    5.1.4. Potential imports from ENP countries ....................... 73
  5.2. Trade in services ................................................ 75
    5.2.1. Full liberalisation of trade in services: freedom of movement
           and establishment ............................................. 75
    5.2.2. Effects of liberalisation are likely to be positive for both parties .. 75
    5.2.3. But: liberalisation of trade in services is difficult to achieve even
           within the EU15 ................................................. 76
    5.2.4. What liberalisation of trade in services means in case
           of ENP countries ............................................... 77
    5.2.5. Outlook for 2006-2010: relaxation of barriers to trade in selected
           service sectors .................................................. 78
  5.3. Migration ........................................................ 85
    5.3.1. Recent migration flows .................................... 86
    5.3.2. Future migration flows ..................................... 88
    5.3.3. What matters for gains and losses from migration? ............. 89

6. EU Energy Cooperation with Russia, Algeria and Ukraine ............. 91
  6.1. EU concerns ..................................................... 92
  6.2. The Importance of Russia, Ukraine and Algeria in European markets .. 96
    6.2.1. Russia ..................................................... 96
The Authors

Małgorzata Jakubiak graduated from the University of Sussex (UK; 1997) and the Department of Economics at the University of Warsaw (1998). Her main areas of interest include foreign trade and macroeconomics. She has published texts on trade flows and exchange rates in emerging or transition economies, EU integration with its neighbours and CIS economies. During 2000-2001 she was working at the CASE mission in Ukraine as resident consultant. She has collaborated with the CASE Foundation since 1997.

Anna Kolesnichenko has been working at CASE Ukraine since 2001. Currently she specializes in political economy of European integration, EU-Ukraine relations and energy security and efficiency. She has also worked with the NATO Parliamentary Assembly, the Centre for Strategic and International Studies (CSIS) in the USA, the United Nations Development Program (UNDP) in Ukraine and the Harvard Institute for International Development (HIID) in Ukraine. Anna holds an MA in European Studies from SAIS, Johns Hopkins University; and an MA in Economics from the EERC programme at the Kyiv-Mohyla Academy. She has also qualified as a Specialist in Environmental Management from the Donetsk State Academy of Management.

Wojciech Paczyński has been an economist at CASE since 2000. His research interests include applied macroeconomics, international economics, international relations, game theory and economics of education. He has managed several research and analytical projects in Europe and Central Asia and has published on EU integration, EU relations with neighbouring countries, monetary policy, and currency crises. He worked for the OECD, World Bank, OSCE, University of Dortmund and the Polish Ministry of Economy. He holds MA in International Economics from University of Sussex, MA in Economics from Warsaw University and MSc in Mathematics from Warsaw University.

John Roberts is the Energy Security Specialist with Platts, the world's largest independent source of energy information. He has worked as a consultant for the European Union, the World Bank and the Kazakh government and particularly focuses on the triangular relationship between the EU, Russia and the Caspian. His recent specialist papers include 'Mitigating Geopolitical Risks: Eurasian Energy Security in the Wake of the Russia - Ukraine Imbroglio' (February 2006); and 'The Turkish Gate: Energy Transit and Security Issues' (October 2004). His publications include 'Caspian Pipelines' (Royal Institute of International Affairs, London 1996) and

Sinan Ülgen graduated in 1987 from the University of Virginia with a double major in computer sciences and economics. He undertook graduate studies at the College of Europe in Bruges, Belgium where he received, in 1990, a masters degree in European economic integration. He then joined the Turkish Foreign Service as a career diplomat and worked for two years at the Ministry of Foreign Affairs in Ankara at the United Nations desk. In 1992, he was posted to the Turkish Permanent Delegation to the European Union in Brussels where he took part in the Turkey-EU negotiations on the completion of the customs union. He is currently the managing partner of Istanbul Economics, a consultancy focusing on business strategies for EU accession. He is also the author of numerous publications. His research and opinion pieces have been published by the Center for European Policy Studies (CEPS), Center for European Reform (CER), the World Economic Forum as well as newspapers such as Le Figaro, the Financial Times and the International Herald Tribune.
# List of abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>AA</td>
<td>Association Agreement</td>
</tr>
<tr>
<td>ACAA</td>
<td>Agreement on Conformity Assessment and Acceptance of Industrial products</td>
</tr>
<tr>
<td>ASA</td>
<td>air service agreement</td>
</tr>
<tr>
<td>ATP</td>
<td>Autonomous Trade Preference</td>
</tr>
<tr>
<td>bcm</td>
<td>billion cubic meters</td>
</tr>
<tr>
<td>BoP</td>
<td>balance of payments</td>
</tr>
<tr>
<td>CAP</td>
<td>Common Agricultural Policy</td>
</tr>
<tr>
<td>CEES</td>
<td>Common European Economic Space (between EU and Russia)</td>
</tr>
<tr>
<td>CES</td>
<td>Common Economic Space (between EU and Russia)</td>
</tr>
<tr>
<td>CGE</td>
<td>computable general equilibrium</td>
</tr>
<tr>
<td>EC</td>
<td>European Community</td>
</tr>
<tr>
<td>ECJ</td>
<td>European Court of Justice</td>
</tr>
<tr>
<td>ECT</td>
<td>Energy Charter Treaty</td>
</tr>
<tr>
<td>EEA</td>
<td>European Economic Area</td>
</tr>
<tr>
<td>EEC</td>
<td>European Economic Community</td>
</tr>
<tr>
<td>EFTA</td>
<td>European Free Trade Area</td>
</tr>
<tr>
<td>EMFTA</td>
<td>Euro-Mediterranean Free Trade Area</td>
</tr>
<tr>
<td>ENP</td>
<td>European Neighbourhood Policy</td>
</tr>
<tr>
<td>ENPI</td>
<td>European Neighbourhood and Partnership Instrument</td>
</tr>
<tr>
<td>EuroMed</td>
<td>Euro-Mediterranean</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FAO</td>
<td>Food and Agriculture Organisation</td>
</tr>
<tr>
<td>FCT</td>
<td>Financial Charter Treaty</td>
</tr>
<tr>
<td>FDI</td>
<td>foreign direct investment</td>
</tr>
<tr>
<td>FSU</td>
<td>Former Soviet Union</td>
</tr>
<tr>
<td>FTA</td>
<td>Free Trade Agreement</td>
</tr>
<tr>
<td>GATS</td>
<td>General Agreement on Trade in Services</td>
</tr>
<tr>
<td>GATT</td>
<td>General Agreement on Tariffs and Trade</td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
</tr>
<tr>
<td>GSP</td>
<td>Generalised System of Preferences</td>
</tr>
<tr>
<td>IEA</td>
<td>International Energy Agency</td>
</tr>
<tr>
<td>INOGATE</td>
<td>Interstate Oil and Gas Transport to Europe programme</td>
</tr>
<tr>
<td>IPR</td>
<td>Intellectual Property Rights</td>
</tr>
<tr>
<td>ISO</td>
<td>International Organization for Standardization</td>
</tr>
<tr>
<td>LNG</td>
<td>liquefied natural gas</td>
</tr>
<tr>
<td>mb/d</td>
<td>million barrels per day</td>
</tr>
<tr>
<td>MENA</td>
<td>Middle East and North Africa</td>
</tr>
<tr>
<td>MEDA</td>
<td>EU financial instrument for the Euro-Mediterranean Partnership</td>
</tr>
<tr>
<td>MFN</td>
<td>most-favoured-nation</td>
</tr>
<tr>
<td>MTOE</td>
<td>million tonnes of oil equivalent</td>
</tr>
<tr>
<td>NAFTA</td>
<td>North American Free Trade Agreement</td>
</tr>
<tr>
<td>NIP</td>
<td>National Indicative Programme</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
</tr>
<tr>
<td>PCA</td>
<td>Partnership and Cooperation Agreement</td>
</tr>
<tr>
<td>RTA</td>
<td>regional trade agreement</td>
</tr>
<tr>
<td>TPES</td>
<td>Total Primary Energy Supply</td>
</tr>
<tr>
<td>TRACECA</td>
<td>Transport Corridor Europe Caucasus Asia</td>
</tr>
<tr>
<td>TRIPS</td>
<td>Trade-Related Aspects of Intellectual Property Rights</td>
</tr>
<tr>
<td>UNCTAD</td>
<td>United Nations Conference on Trade and Development</td>
</tr>
<tr>
<td>WAPS</td>
<td>World Alternative Policy Scenario</td>
</tr>
<tr>
<td>WHO</td>
<td>World Health Organisation</td>
</tr>
<tr>
<td>WTO</td>
<td>World Trade Organisation</td>
</tr>
</tbody>
</table>
Executive Summary

Introduction (chapter 1)

The central objective of this report (completed in March 2006) is to identify the best forms of enhanced economic integration that could be pursued over the next 5-10 years between the EU and Ukraine, Russia, Egypt, Morocco and Algeria, from the EU perspective.

All of these countries except Russia are partners in the European Neighbourhood Policy, which is a new framework for the EU’s relations with its neighbour countries. Russia is not formally part of the ENP, but the four common policy spaces agreed at the summit in May 2005 amount to a more selective Russian derivative of the ENP, with the notable exclusion of democracy and human rights. Russia is also to be included in the operating area of the European Neighbourhood Policy Instrument (ENPI, the ENP’s budget).

The five countries covered in this report are of medium to large size in terms of population, but small in economic terms, relative to the EU. They have different histories of co-operation with the EU, but all have been recipients of substantial EU financial assistance.

Review of existing forms of economic integration (chapter 2)

Membership in the WTO is a precondition for further trade liberalisation and economic integration between the ENP partners and the EU. After becoming WTO members, the neighbouring states and the EU should aim at the establishment of free trade areas and closer co-operation in selected sectors. This is the most realistic short to medium term goal for deepening integration.

More ambitious plans, such as participation in certain aspects of the internal market, are possible forms of enhanced economic integration between the EU and its Neighbours, albeit on a fairly long time-scale. However, the process of meeting the conditions for achieving such objectives may already be important and bring visible gains both to the ENP countries and the EU.
**Time dependencies between various forms of economic integration**

*(chapter 3)*

The countries covered in this report have achieved different degrees of integration with the EU: some of them (Algeria, Russia and Ukraine) are not yet WTO members, while others advanced as far as concluding FTA agreements with the EU and are now working on their implementation (Egypt and Morocco). Different starting points suggest that integration will be multi-speed. At the same time, coordination of integration in different sectors is necessary to achieve full benefits.

Completion of FTAs with Algeria, Egypt and Morocco appears feasible between 2013 and 2018. In the meantime, some liberalisation of service sectors is expected. Algeria is expected to enter the WTO soon – possibly by 2007.

Russia and Ukraine may possibly enter the WTO in 2007, which opens the door for further economic integration with the EU. Soon after this, it is expected that the EU will begin talks on formation of an FTA with Ukraine. Expiration of PCAs with Russia and Ukraine opens options for concluding new agreements that take into account the lessons that have been learned from the functioning of PCAs over the last decade.

**Institutional basis for integration (chapter 4)**

The institutional requirements for closer cooperation between the EU and ENP countries are dependent on the exact form and scope of economic integration to be pursued. As regards the EU-ENP framework, priority should be given to partial Internal Market integration, where market integration in goods and services would constitute the two main pillars.

Free Trade Agreements will likely offer the most realistic framework for deepening trade and market integration in the short to medium term.

Fostering market integration in services necessitates taking into consideration the required degree of regulatory convergence for enhancing cross-border trade and investments as well as the domestic regulatory capabilities of ENP countries. An obligation to adopt EU policies in all fields as a prerequisite for integration of the services market should be avoided and more flexibility should be sought. Such an approach is already embedded in the ENP logic and efforts should be sustained to actively pursue this strategy.

In several policy areas economic integration can advance without full regulatory convergence. Examples include financial services, telecommunication and sea transport. In these areas domestic reforms to enhance the contestability of markets
are more important. In other areas, such as air transport or electricity markets, the gradual adoption of the EU *acquis* can be contemplated. Additionally, creative institutional measures to enhance labour mobility without harming the labour markets in the EU and neighbouring countries should also be sought.

The incorporation of incentive mechanisms within the ENPI could be a good way of enhancing implementation of the ENP and could increase the chances of the ENP meeting its objectives. The “bonus” allocation of aid would go to those countries that perform best according to economic and political criteria, evaluated by progress in committing to and implementing action plans. Such a mechanism is hoped to foster competition in the field of domestic reforms among the ENP partners, similarly to the case of the current new EU member states during their EU accession process.

In the medium to long term perspective two institutional options appear most promising. One could be dubbed “strengthened bilateralism” and would focus on significant widening of the coverage of FTAs, particularly to services and agricultural goods. In view of the importance of FTAs’ coverage, as discussed in the following chapter, this option is particularly worth promoting. The approach will be necessarily multi-speed, depending on the progress in domestic reforms.

Another option would be to form a new regional institution providing an underpinning for EU-ENP market integration. This could be modelled on the EEA, though institutional capacity constraints on the side of Neighbouring countries imply much less regulatory harmonisation than in the current EEA. This solution is likely to be feasible only in the longer term and, depending on political and economic dynamics in the ENP countries, may eventually cover only some of them. Among other roles, such an “EEA-light” could be a powerful incentive mechanism and anchor for consolidation of domestic reforms in ENP countries.

**Effects of economic integration (chapter 5)**

**Trade in goods**

The coverage and specific features of agreements such as FTAs are extremely important for their impact on partners – they can be decisive for whether any particular FTA brings benefits to ENP countries or is in fact harmful. The existing EU FTAs usually fall short of truly liberalising trade, but cover many aspects beyond tariff barriers. The first feature is unfortunate. Protection of agriculture and service markets significantly limits the economic relevance of FTAs for partner countries and under some circumstances could even make the agreements harmful. The second feature has a large, yet somewhat unexplored potential to promote gains for both sides – for instance by stimulating reform efforts and promoting competition in domestic markets.
WTO accession by countries that are not yet members will enable further steps in trade liberalisation. Its crucial importance – for Algeria, Russia and Ukraine and the EU – rests in the fact that it will ensure more stable and predictable regimes for FDI (also in the services sector).

Elimination of barriers to trade in industrial goods would open new markets for EU manufacturers and at the same time expose them to new competition. Existing studies suggest that, overall, the direct effects of these processes on the EU would be positive, albeit very small. In the longer term, the initially small positive effects would be enhanced by better direct investment opportunities in the European Neighbourhood. This could be particularly important in the case of Russia, given the size of its internal market. For this reason, the trade- and investment-related provision of FTAs (and earlier also WTO accession) are important from the EU perspective.

Current levels of tariffs and other trade protection measures towards various partners (EU, regional partners and third countries) are an important factor in terms of the likely impact on ENP countries of creating FTAs with the EU. From today’s perspective the implementation of the partial EU-Morocco FTA is expected to bring the highest gains among all the scheduled EU FTAs. In the case of Egypt, reduction of trade barriers towards third countries is important in order to avoid trade diversion after formation of the FTA. Full trade liberalisation (FTA covering all goods) would result in a significant boost to trade between the EU and ENP countries, particularly Ukraine, Algeria and Egypt. These gains are not necessarily conditional on adoption of the EU acquis.

One issue that stands out when one looks further into the future is liberalisation of agricultural trade. The effects of substantial progress in this sphere could be quite pronounced – both in the EU (where the CAP would need major reform) and in particular for ENP countries. Existing estimates suggest that for ENP countries the impact of agricultural trade liberalisation could be comparable to liberalisation of trade in services.

**Trade in services**

Liberalisation of trade in services means fewer restrictions on the movement of people and capital as well as freedom of establishment. Although supposed to bring beneficial effects to both sides, it is likely to be resisted by interest groups and has already proved to be difficult to achieve even among highly developed and otherwise integrated economies.

The current patterns of trade in services between the EU and ENP partner countries are typical for trade with less-developed regions. The EU is a net buyer of services for which market access in the ENP economies is restricted (such as transport), it absorbs skilled professionals from Neighbouring states and it sells more high-tech and capital intensive services.
In the case of the neighbouring countries considered here, easing EU-ENP barriers in trade in services would mean:

• adherence to GATS commitments (where appropriate),
• approximation of relevant rules to the EU acquis in some sectors where this is considered advantageous and feasible,
• an increase in the effectiveness of market regulators,
• equalisation of the rights of foreign and domestic firms, and
• simplified establishment of firms in relevant sectors.

Mutual commitments have been made in action plans or relevant documents regarding the development of the service sector in ENP economies. Besides, some of the ENP countries have already embarked on domestic reforms to increase efficiency and competition. All these actions will most likely affect EU-ENP country trade in services, although the impact will vary by country and by service market. The expected developments in selected service sectors in the analysed countries are discussed in section 5.2.5 of this report.

**Migration**

There is little direct linkage between the selected forms of economic integration between EU and ENP countries and any likely ensuing migration flows. In the baseline scenario migration from ENP countries to the EU is expected to continue at levels observed in recent years, but the outlook might change – in some cases radically – depending on political, social and economic developments in the ENP countries and the migration policies of the EU. Better prospects for social and economic development in the EU Neighbourhood are likely to translate into migration flows that are most beneficial for both the sending and receiving countries (legal, often temporary migration helping to balance labour markets, for example), whereas social tension, conflict and economic problems in ENP countries would be expected to result in migration flows that could be difficult for the EU to handle. This is an additional argument for EU actors to carefully analyse the long-term impact of integration processes on the ENP partner countries rather than taking a short-sighted perspective.

The economic and social consequences of migration are crucially dependent on the policies of both home and host countries but have little to do with the intensity of economic integration between the EU and ENP. One exception relates to financial integration, which might lower the costs and thus stimulate remittances, therefore supporting the development of ENP countries and encouraging temporary rather than permanent immigration to the EU.
EU Energy Cooperation with Russia, Algeria and Ukraine (chapter 6)

From the EU perspective, overall trade volumes with ENP countries are relatively small. However, the countries covered in this report are important EU trade partners in energy commodities. Russia and Algeria account for some 70% of the EU’s gas imports, for instance. Russia is also a source of some 30% of the EU’s oil imports. Current forecasts suggest that the EU will be becoming increasingly dependant on imported oil and gas over the next decades and thus the importance of the analysed countries in energy security will increase.

The three countries play very different roles in terms of the EU’s energy security. Russia is clearly by far the most important player. The EU is looking to secure extensive supplies of gas in addition to its current Russian gas imports – these could come either from higher Russian exports (i.e. increased domestic production and/or energy savings leading to lower domestic consumption) or from Central Asia, which is currently linked to European markets only via Russian gas pipelines. On the Russian and Algerian sides sales of energy resources to Europe constitute a major share of overall export revenues.

Russia and Algeria will have to secure considerable investment flows if they are to continue both to modernise and expand their hydrocarbon production. These will require a predictable and favourable investment climate. EU oil and gas companies could be well placed to play an important role in the future development of the energy commodities sector in Russia and Algeria, but the scope for their actions will be determined by the policy framework in place in these countries. The situation in Russia is a source of concern in this respect as oil and gas sector-related policies often appear to be motivated by political considerations and result from the actions of domestic pressure groups rather than being based on rational economic considerations. In this respect the situation in Algeria is somewhat better and there is more optimism as to the country’s ability to secure the investment necessary to enhance production and export capacity. However, in Algeria much will still depend on domestic political and economic developments.

From the energy security perspective the situation in the gas sector is more problematic given the limited control over demand growth in the EU, the key role of pipeline infrastructure and thus limited options for diversification of sources, and the lower transparency of gas deals relative to oil deals. In the case of Russia, the monopolistic position of Gazprom and in particular its full control of gas pipelines and thus also of production potential in Central Asia, puts European consumers in a disadvantaged position.

An energy dialogue with Russia requires a unified position to strengthen the EU’s bargaining power and ensure its interests. Relations with all Neighbour countries
should be centred on market access issues (FDI, EU participation in the sector, reform and the opening of the gas sector) but also on energy efficiency.

**Future EU financial assistance (chapter 7 and 8.2)**

This section seeks to draw some broad lessons for the way in which the European Neighbourhood and Partnership Instrument (ENPI) should be applied in the ENP countries starting from 2007. The issue is important as the budget for the ENP will be nearly double the previous level, amounting to close to 15 billion EUR in 2007-2013. The general and rather obvious observation is that the ENPI should build upon experience gathered during the operation of previous EU financial assistance operations targeted at the countries concerned here.

With regard to bilateral relations between EU and ENP countries greater reliance on incentive schemes, where additional financial assistance could be linked to progress in the domestic liberalisation of financial services and telecommunication, would support EU interests. Such actions could boost services trade and create investment opportunities for EU companies.

Greater synergy in financial flows to the neighbouring countries is needed between the ENPI, European Investment Bank, EBRD and World Bank. Both technical assistance funds and development loans should be more closely related to the priorities and commitments expressed in Action Plans.

**Conclusions and recommendations (chapter 8)**

Recommendations are divided into two categories. Firstly, we suggest areas that could be prioritised in the existing or future action plans. Secondly, we highlight areas where good business opportunities are likely to open up for EU partners.

However, before moving to the specific prospects arising out of integration in various segments of the EU and ENP markets the following statement has to be made. The EU’s generic priority interest is that Neighbouring countries (and the five important countries covered in this report in particular) build as hospitable business and political environments as possible, by European standards. This means that the EU should give a high priority to its political and economic investment in the Neighbourhood Policy concept. The EU has the unique advantages of an attractive normative reputation with its Neighbours – from multiple angles, such as honest business methods, technical modernity, political ideals for Europe etc. This makes it plausible for the EU to work hard at leveraging its technical and normative standards.
into these Neighbouring states, which if done successfully would effectively extend the EU’s sphere of economic influence and privileged market area.

**Priority areas for EU politics – lessons for the Action Plans**

With Russia not formally a part of the ENP, on the one hand it would appear that there is more room for manoeuvre in terms of possible policy options, but on the other hand the lack of a familiar framework may make working out integration policies more difficult. The experience of the previous strategic documents and their implementation suggests that grand words and ideas should not be overused, while co-operation should concentrate on practical issues that are relevant for both sides, such as energy issues, Russia’s WTO accession or negotiations on EU-Russia FTA.

WTO accession should remain a short-term priority of the EU in Ukraine, as it would help to some extent to push liberalisation, deregulation and more equal treatment of economic agents. It seems, however, that what remains to be done lies largely on the Ukrainian side, as the bilateral negotiations with the EU are already completed. After WTO accession, an EU-Ukraine FTA should be forwarded. The existence of such an FTA is expected to enhance trade and FDI in less protected sectors. Importantly, it would also lay the ground for deeper integration in the sphere of agricultural trade and investment in agribusiness (where Ukraine may possess a comparative advantage) and for locking-in reforms.

The prioritisation of the EU-Morocco Action Plan should focus on closer trade integration with the EU, and on measures that would support the implementation of an EU-Morocco FTA in manufacturing (expected to be formed in 2013), as it is a precondition for deeper integration in other spheres. In general, any points of the Action Plan that address either the development of the business climate in Morocco or the development of the SME sector or promotion of education are also worth pursuing, as they will tend to limit illegal migration and support the overall development of the country. Support for social development is also important given the role of Morocco in immigration to the EU.

During the implementation phase of the EU-Egypt FTA that started in 2004 monitoring of the timing of tariff dismantling and the implementation of supporting measures should be centre stage. As the consumer goods sector in Egypt will remain protected for a considerable amount of time, the focus on implementing other trade liberalisation and reform measures is also of particular importance. Given the domestic political situation in Egypt, gradually falling public support to the presidential “dynasty”, and hence uncertainty about the future commitment to further reforms and the promotion of openness, transparency etc., a political dialogue with the EU should support economic integration.
Relations with Algeria will most likely be dominated by energy issues supplemented by support for the general development of the country. Of the three Mediterranean ENP states considered here Algeria’s relations with the EU within the ENP framework are at the least advanced stage. The challenge for the EU remains helping to improve the political climate without jeopardising economic recovery.

**Business opportunities for EU**

Gradual lowering of bilateral barriers to trade will most likely lead to increased exchange of manufacturing products in the short to medium run. This will most likely result in the following consequences for the EU business sector. Firstly, the ENP markets for EU products will become more accessible which should result in growing demand for the EU produce in the neighbouring markets. Secondly, the abundance of cheaper suppliers from the ENP countries may motivate subcontracting lower-end products, thus enhancing efficiency and productivity of the EU manufacturing. It is also possible that some EU manufacturers feel worse off, as a result of increased competition. Although it seems that these eventual loses have been already experienced after the recent EU enlargements and competitive pressure from the side of Asian producers, Chinese and Indian in particular. Overall, these effects will neither be immediate, nor felt significantly across the EU markets.

Apart from this, business opportunities for EU enterprises arising from market integration between the EU and ENP countries will depend on the timing and specific solutions within agreed forms of market integration.

The energy sector is one where there has already been substantial involvement of EU companies and where a positive political scenario would create more lucrative options. The scope of new opportunities will be primarily determined by liberalisation of energy FDI rules and practice and overall improvement of the investment climate in Russia, progress of reforms in the energy sector in Ukraine and security developments in Algeria. Thus, the link to chosen forms of economic integration is indirect, but at the same time there are obvious lessons as to what elements of co-operation agreements the EU could try to promote to improve business opportunities in the energy sector. In Russia (and other countries), opportunities should arise for provision of services and equipment for both upstream and infrastructure projects.

Another important sector with large potential for business co-operation, foreign trade and investment is agriculture and food processing. For instance, demand for modern food processing equipment is expected to remain strong in all the analysed countries. In other spheres, the nature of emerging opportunities will be determined by the specific solutions leading to partial liberalisation of trade in agricultural goods.
There are very interesting potential opportunities that may open in the services sector. In financial intermediation, these will largely depend on development of prudential and other regulations at the national level. Effective domestic prudential regulation is a pre-requisite for cross-border integration. In view of the above, the most appropriate method for the integration of financial services is the path of domestic reform.

In the transport sector, opportunities will gradually expand in the ENP countries in air transportation, together with liberalisation of services, adoption of European and international standards and commitments, and opening possibilities for new connections. Morocco and Ukraine are expected to be the most promising markets in this sphere. With respect to cooperation with Russia, royalties for flying over Siberia are expected to be gradually eliminated and disappear by 2013.

There are plans for investment in road transportation, developing national road networks as part of Pan-European transport corridors and improvement of road safety etc., which will represent challenges to logistics companies. Morocco and Ukraine are currently perceived as frontrunners also in this sphere. As far as the development of water transport infrastructure is concerned the best opportunities will most likely open up in Morocco, Russia and Ukraine.
I. Introduction

- The central objective of this report is to try to identify the best forms of enhanced economic integration between the EU and Ukraine, the Russian Federation, Egypt, Morocco and Algeria, from the EU perspective.
- European Neighbourhood Policy is a new framework for the EU’s relations with its neighbouring countries.
- The five countries covered in this report are medium to large in terms of population, but small in economic terms, relative to the EU.
- These countries have different histories of co-operation with the EU, but all have been recipients of EU financial assistance.

This report looks at economic integration and its prospects between the European Union (EU) and five of its neighbour countries: Ukraine, Russia, Egypt, Morocco and Algeria. Of these, all countries but Russia are formally part of the EU’s recent European Neighbourhood Policy (ENP) initiative. Russia is not formally part of the ENP. However, the four common policy spaces agreed at the summit in May 2005 amount to a more selective Russian derivative of the ENP, with the notable exclusion of democracy and human rights. Russia is also to be included in the operating area of the European Neighbourhood and Partnership Instrument (ENPI, the ENP’s budget). These factors, plus its economic importance for the EU and similarities to other EU neighbour states explain Russia’s inclusion in this report. For simplicity, all five countries are referred to as “the ENP countries” in this report.

The central objective of this report is to identify the best forms of enhanced economic integration between the EU and ENP countries, from the perspective of the EU. Analysis related to this question takes into account the current levels of economic development of the ENP countries and the current character and intensity of integration and institutional capacities on both sides. The report also acknowledges

1 The authors are grateful for comments and suggestions received from Marek Dabrowski, Michael Emerson, Peter Holmes, Lucio Vinhas de Souza and the Ministerie van Economische Zaken team. Opinions expressed in the report should not be attributed to any of these persons and institutions they are affiliated with. Sole responsibility for the content of this report rests with the editors and authors of respective sections. This work was completed in March 2006. The selection of the five countries from EU Neighbourhood to be covered in the report was driven by contract requirements only.
limitations in policy-making originating in the fact that some elements of economic integration have already been defined.

The framework for new relations with Eastern Europe and Mediterranean was set in 2003, in the Communication on “Wider Europe”. Later, in 2004, the European Commission adopted a Strategy Paper proposing how the benefits of enlargement could be extended to the EU25’s neighbours. The aim of the new European Neighbourhood Policy has been to encourage stability, security and prosperity in a way that is distinct from membership. At the same time, the ENP should prevent the emergence of new dividing lines, offer the chance to participate in various EU activities and support security in the European neighbourhood.

The Strategy Paper has been further elaborated on and tailor-made to specific countries’ needs in individual Action Plans. The aim of the Action Plans is to indicate crucial reforms agreed upon by the partner country and the EU and in this way to improve implementation of the Partnerships and Cooperation Agreements (PCAs – for the countries in Eastern Europe) and Association Agreements (AA – for the Mediterranean countries) in order to bring these countries closer to the EU. A limited number of priorities are defined in action plans that should be realised in the medium term (3 to 5 years). These priorities are in fact in a very large number of fundamental areas: political dialogue and reform; trade and measures to prepare partners for potential participation in the internal market of the EU; judicial and domestic affairs; energy, transport, information society, environment, research and innovation, social policy and interpersonal contacts. The ENP envisages that after the Action Plans’ priorities are met the EU will offer a new framework for enhanced cooperation to its partners in the form of European Neighbourhood Agreements, which will replace the existing AAs and PCAs. It is a matter for speculation at this stage how such agreements might compare with what some EU member states are advocating under the name of privileged partnership (e.g. ersatz membership for Turkey).

The strategic line for the ENP has already been set out in a number of Commission Announcements (Communication on Wider Europe, 2003, and Strategy Paper, 2004). The first wave of Action Plans has been drawn up and approved by the European Council (for Israel, Jordan, The Palestinian Authority, Tunisia, Moldova, Morocco and Ukraine). In 2005, based on the Country Reports for Egypt, Lebanon, Armenia, Azerbaijan and Georgia, work started on Action Plans for these countries. Thus, among the five countries concerned, only Ukraine and Morocco have signed Action Plans with the EU to date (Spring 2006).

This report deals mainly with the third of the ENP’s aims, namely underpinning prosperity beyond the EU’s borders. With this in mind the report concentrates on economic issues, with priority given to trade relations, and increased financial and technical support from the EU. The focus is on the likely development of economic
relations between the EU and the five ENP countries over the next five to ten years and the economic effects of this closer cooperation.

The five countries in focus are medium to large sized states in terms of population (from around 140 million in the case of Russia to just over 20 million in the case of Morocco). However, in economic terms their size relative to the EU is small – in 2004, Dutch GDP at current prices was almost equal to Russia’s, while the four other countries’ combined GDPs accounted for around 45% of Dutch GDP².

Thus, economic relations are asymmetric, with rather marginal importance of the four countries for the EU and much greater interest from the countries in question in maintaining good economic relations with the EU. Russia – which ranked fourth in the list of major EU external trade partners in 2004, mainly on the back of oil and gas trade – is the only exception. Algeria, Ukraine, Morocco and Egypt ranked 19th, 26th, 28th and 32nd, respectively.

The countries covered in this report are, however, important EU trade partners in energy commodities. Russia and Algeria account for some 70% of the EU’s gas imports, for instance. Russia is also a source of some 30% of the EU’s oil imports. Thus, the energy dimension of economic relations is quite important and therefore a separate section of this report has been devoted to its discussion (section 5.3).

Since 1997 EU-Russia relations have been governed by the Partnership and Cooperation Agreement (PCA) that will be in place until 2007 (and beyond in the absence of any decision to the contrary). Under the terms of the PCA Russia has been granted MFN treatment, GSP has been applied to a number of products lowering the MFN tariff rates further, and in 2002 the country was granted “market economy status”, which increases chances for Russian exporters to defend their interests in the context of anti-dumping measures. Currently, EU-Russia relations are grouped into four common spaces: economic (with reference to energy and the environment), freedom, security and justice, external security, research and education. The roadmaps for these spaces were signed in May 2005. The EU is by far Russia’s most important trade partner, accounting for over 40% of both exports and imports. Russian exports to the EU are dominated by mineral fuels, while machinery and various manufacturing goods are the mains imports from the EU. Companies from EU countries are the major foreign investors in Russia. The EU strongly supports Russia’s efforts to join the WTO, and the EU and Russia agreed bilaterally on the terms for Russia’s accession to the WTO at the EU-Russia Summit in 2004. With regard to technical assistance, under the TACIS programme alone over 2.6 billion EUR

² When purchasing power parity (PPP) is used for calculating the GDP of respective countries the size of the 5 countries covered in the report increases significantly relative to the EU. By this measure the Russian economy was roughly 3 times larger than the Dutch economy by 2003, while Ukraine and Egypt were close to 60% of the size of the Dutch economy.
has been allocated to Russia since 1991 to promote the transition to a market
economy and reinforce democracy and the rule of law.

The PCA governing relations between Ukraine and the EU entered into force in
1998. With the most recent enlargement of the EU the country – similarly to Russia –
became an immediate EU neighbour (with 30% of exports going to the EU and around
50% of non-oil imports originating in the EU), and especially after the political
changes of late 2004 has been pressing for deeper integration. The feasibility of
introducing a free trade area between the EU and Ukraine is currently being
investigated, and the final shape of a future agreement is not yet known. In the
meantime, it is envisaged that Ukraine will join the WTO, although this appears
unlikely before 2007. Ukraine became a partner in the new European Neighbourhood
Policy in 2004, and the Action Plan covering mutual commitments in the sphere of
politics, economic integration (including gradual approximation of legislation, norms
and standards with those of the EU) and justice and home affairs was agreed in
February 2005. The EU is the largest foreign donor in Ukraine at present and the
majority of aid is transferred under the TACIS programme (over 1 billion EUR from

The Association Agreement (AA) signed between the EU and Egypt in 2001 (the
continuation of previous Cooperation Agreements) has since then governed the
political, security, economic, social and cultural relations between the two parties.
The Agreement entered into force in 2004 and, based on respect for democratic
principles, provides a framework for political dialogue and liberalisation of trade in
goods, services and capital, including the completion of the FTA by 2015-2018. The
country report on Egypt, preparing the ground for the Action Plan, was released in
March 2005. It is envisaged that the Action Plan for Egypt will focus on two broad
areas: 1) democracy and the rule of law, administration of justice and human rights
and certain objectives in the area of foreign and security policy and 2) actions which
will bring the EU and Egypt closer in a number of priority fields such as economic
and social development policy (including sustainable development), trade and an
internal market (including sectors such as energy, transport, environment, maritime
affairs and fisheries, information society, research and innovation, justice and home
affairs and people-to-people contacts). The EU accounts for over 40% of Egyptian
exports (mineral fuels and various manufacturing goods) and nearly 40% of total
imports (machinery and chemicals). Egypt has been one of the main beneficiaries of
EU assistance among its Mediterranean partners. In 2000-2004 over 361 million EUR
was transferred under MEDA. The European Investment Bank committed nearly 0.8
billion EUR in loans in 2002-2004, with a special focus on private sector support.

EU-Morocco relations are governed by the AA that was signed in 2000, and
similarly as in the case of Egypt, was a continuation of previous bilateral
agreements. The AA provides for the gradual establishment of free trade in industrial products, for which the EU has already granted free access, whereas Morocco committed itself to a gradual removal of tariffs by 2013. However, one fifth of Moroccan exports to the EU consist of agricultural products, and the next round of lowering EU import restrictions for these goods is scheduled for 2007. Membership in the WTO since 1995 has facilitated Morocco’s further economic integration with the EU. The Action Plan for Morocco released in late 2004 has among its priorities legislative reforms and adherence to human rights, political dialogue on fighting terrorism, negotiations on liberalising trade in services, improving the investment climate, reduction of poverty and enhancing employment, support for education, dialogue on readmission and visa facilitation, improvement of infrastructure, including energy infrastructure. Given its geographical location and historical links, the EU is by far Morocco’s most important external trade partner, with a 70% share in Moroccan exports (mainly labour intensive commodities) and a 65% share in imports (machinery). France and Spain are its most important trading partners. Morocco is the leading beneficiary of Community assistance in the region. Since 1995 1.1 billion EUR has been committed.

The Association Agreement between the EU and Algeria was signed in April 2002, but ratified only in March 2005. Correspondingly, ENP initiatives on Algeria were somewhat delayed. These delays reflect basic political situation in Algeria, where the regime is hyper-sensitive to suggestions of conditionality. The EU is the major trade partner of Algeria - it accounts for 54% of Algeria’s exports and 55% of its imports. EU-Algeria cooperation aims to promote more balanced structure of the Algerian economy and trade. Yet, energy is likely to be a predominant area of cooperation given EU’s energy needs and Algeria’s resource endowments. The Association Agreement with Algeria envisages establishment of a free trade area over a transitional period of twelve years maximum starting from the date of the entry into force of the Agreement, i.e. the EU-Algeria FTA is expected to come into force by 2017.

The report is structured as follows. The next chapter reviews existing forms of economic integration, focusing on those that have either been used in EU relations with other countries or that could potentially provide blueprints for future relations. Chapter three highlights the time dimension of the economic integration processes. Chapter four discusses institutional issues that have turned out to be very important for the functioning of various forms of economic integration. The next chapter is devoted to analysis of selected effects of integration. It covers the effects of increased trade in goods and services and migration issues. Chapter six is devoted to energy issues in view of their importance in some of the ENP countries. The subsequent part focuses on future EU financial assistance. The concluding chapter contains recommendations that could be useful in shaping EU policies in the framework of the ENP.
2. Review of existing forms of economic integration

- Membership in the WTO is a precondition for further trade liberalisation and economic integration.
- Establishment of free trade areas and closer co-operation in selected sectors emerges as the most realistic short to medium term goal for deepening integration.
- More ambitious goals, such as participation in certain aspects of the internal market are possible forms of enhanced economic integration between the EU and its neighbours, albeit on a fairly long time-scale. However, the process of meeting the conditions for achieving such objectives may already be important and bring visible gains to the ENP countries and the EU alike.

This section explores the options that could be considered as possible forms of enhanced economic integration between the EU and its neighbours. The discussion starts with the forms of integration that are already being implemented and then turns to proposals of possible further integration that are outlined in the EU documents on the ENP, and potential further steps that go beyond the currently discussed framework. The theoretically possible forms of integration are illustrated by brief descriptions of examples of EU relations with some of its partner countries. The selection of the models is primarily motivated by their feasibility as potential solutions for the ENP countries in the perspective of 5-10 years.

2.1. Multilateral trade liberalisation: WTO

Membership in the WTO has become a stepping-stone of trade liberalisation around the globe. Relations among WTO members are governed by the General Agreement on Tariffs and Trade (GATT). The most-favoured-nation (MFN) clause is one of the basic principles of GATT. MFN treatment is the principle of not discriminating
between one’s trading partners. This means that an advantage granted through
negotiation to one country must be extended to all WTO members. Since 2000, WTO
members started to liberalise trade in services in the frames of General Agreement on
Trade in Services (GATS). According to the agreement, member countries, inter alia,
should give MFN treatment to service providers from other countries, provide
information on relevant regulations, recognise qualifications obtained in other
countries and not restrict international transfers (all with a range of exceptions).

The EU bases its trade relations with neighbours on the WTO norms and
encourages them to join the organisation. Among countries covered in this report,
only Egypt and Morocco are WTO members. Russia and Ukraine have been
negotiating the accession for many years but their entry appears unlikely before 2007-
2008. Algerian officials also express optimism about the WTO accession date.

WTO entry is important in thinking about the future prospects for any closer
forms of integration. This is because the WTO membership establishes a set of rules
universally accepted by all parties, thus making negotiation of more ambitious
arrangements easier. Institutional capacity required to successfully enter the WTO
and function within it is not overly high, nevertheless some countries were faced with
problems in this sphere. Prolonged negotiations of the accession of Russia and
Ukraine are in part due to the opposition from pressure groups within the countries
defending their (perceived) interests.

2.2. Enhanced trade preferences

Partly irrespective of the WTO membership, systems of unilateral or bilateral
preferences in economic relations are possible and such schemes have been used by
the EU in relations with less developed countries. At present, cooperation between
the EU and its neighbours is governed by partnership and cooperation agreements
(PCA) in case of Ukraine and Russia and association agreements (AA) in case of
Algeria, Egypt and Morocco. These agreements cover a broad range of policy areas
such as political dialogue, respect for human rights and democracy, trade
liberalisation and economic cooperation, a range of provisions on intellectual
property, services, public procurement, competition rules, state aid and
monopolies. The economic and trade provisions of the PCAs and AAs are based on
the most favoured nation (MFN) treatment. In addition, many of the neighbouring
countries, including all 5 countries covered in this report, enjoy Generalised System
of Preferences (GSP) treatment for a range of products.

---

3 There are important exceptions to the rule, such as regional free trade agreements.
2.2.1. Generalised System of Preferences

Generalised System of Preferences is a scheme according to which developed countries grant preferential tariffs to imports from developing countries. The EU’s GSP regime grants imports from GSP beneficiary countries either duty-free access or tariff reductions below MFN levels for many product categories with the exception of sensitive ones. One caveat is that these are often the products that have large share in exports of many developing countries, including the five countries studied in this report. Moreover, some products are excluded from GSP or are subject to safeguard measures.

The GSP follows ten-year cycles and is implemented through Council regulations. The last cycle ended in 2005 and a new GSP scheme was adopted on 27 June 2005\(^4\). According to the regulation, all countries studied in this report can enjoy GSP treatment, with some exceptions in case of Russia and Algeria (Table 2.1).

### Table 2.1. Exceptions from GSP: Russia and Algeria

<table>
<thead>
<tr>
<th>Excluded articles</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Algeria</strong></td>
</tr>
<tr>
<td>S-V Mineral products</td>
</tr>
<tr>
<td><strong>Russia</strong></td>
</tr>
<tr>
<td>S-VI Products of the chemical or allied industries.</td>
</tr>
<tr>
<td>S-X Pulp of wood or of other fibrous cellulose material; recovered (waste and scrap) paper or paperboard; paper and paperboard and articles thereof.</td>
</tr>
<tr>
<td>S-XV Base metals and articles of base metal.</td>
</tr>
</tbody>
</table>


### Table 2.2. EU’s GSP sensitive products

<table>
<thead>
<tr>
<th>Agricultural products</th>
<th>Footwear</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inorganic and organic chemicals (some products)</td>
<td>Ceramic and glass products</td>
</tr>
<tr>
<td>Plastics (some products)</td>
<td>Non-ferrous metals (exception: nickel)</td>
</tr>
<tr>
<td>Leather products (some products)</td>
<td>Base metals products</td>
</tr>
<tr>
<td>Wood (some products)</td>
<td>Machinery and vehicles (some)</td>
</tr>
<tr>
<td>Textiles (silk, wool, cotton and products thereof)</td>
<td>Optical, medical instruments; clocks</td>
</tr>
</tbody>
</table>


The regulation also defines a list of sensitive products, which broadly consists of agricultural products and textiles (Table 2.2). For sensitive products MFN tariffs are reduced only by 3.5 percentage points, while for non-sensitive products – by 30%.

In addition, the EU applies antidumping and safeguard measures to some products. For example, as a part of antidumping procedures it introduced higher tariffs for Ukraine’s and Russia’s steel and chemical products.

In sum, options for preferential EU imports of agricultural, textile, steel and chemical products are substantially limited due to different exceptions to the GSP

---

regime. As a result, the actual relevance of GSP for ENP countries might be limited and there is some evidence that this was the case for the CIS countries, including Russia and Ukraine (Aslund and Warner, 2003). A quick look at trade statistics of the ENP countries studied in this report supports this claim. For example, agricultural exports are important for Egypt, Morocco and Ukraine (they account for 14.3%, 19.1% and 12% of their total exports – Table 2.3). Apparel is the major item in Morocco’s exports; metals accounts for some 34% of Ukraine’s total exports.

The above analysis suggests that there is room for further trade liberalisation within the existing arrangements. This point deserves attention as lifting of remaining restriction on the side of the EU can be the simplest route to follow without a need for any new institutional arrangements. The ENP does envisage further trade liberalisation and enhanced trade preferences between the EU and its neighbours. The strategy paper on the ENP suggests that the most immediate goal of the ENP is to achieve full benefits of the existing partnership and association agreements (Strategy Paper, 2004, p.15). This implies, in particular, concluding free trade agreements (FTAs). Less ambitious option for further trade liberalisation would be adopting other forms of trade preferences, for instance similar to the Autonomous Trade Preference regime (ATP).

### 2.2.2. Autonomous Trade Preferences (ATP)

The EU has the Autonomous Trade Preference Scheme with countries of South East Europe. This regime gives the exports from beneficiary countries non-reciprocal, customs-free access to the EU market, under the condition that these products conform to EU standards and requirements. Such an arrangement could be potentially considered for other neighbours, in particular, as a transitory solution.

---

**Table 2.3. Composition of merchandise exports to the world, 2004, %**

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
<th>Russia</th>
<th>Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Agricultural products</td>
<td>0.2</td>
<td>14.3</td>
<td>19.1</td>
<td>7.5</td>
<td>12.0</td>
</tr>
<tr>
<td>1.1. Food</td>
<td>0.2</td>
<td>9.8</td>
<td>17.7</td>
<td>3.9</td>
<td>10.4</td>
</tr>
<tr>
<td>2. Fuels and mining products</td>
<td>97.9</td>
<td>50.8</td>
<td>12.7</td>
<td>59.9</td>
<td>17.3</td>
</tr>
<tr>
<td>2.1. Fuels</td>
<td>97.5</td>
<td>47.7</td>
<td>4.5</td>
<td>49.1</td>
<td>10.4</td>
</tr>
<tr>
<td>3. Manufactures</td>
<td>1.2</td>
<td>27.0</td>
<td>68.4</td>
<td>27.5</td>
<td>69.4</td>
</tr>
<tr>
<td>3.1. Iron and steel</td>
<td>0.3</td>
<td>8.3</td>
<td>1.0</td>
<td>9.4</td>
<td>34.3</td>
</tr>
<tr>
<td>3.2. Chemicals</td>
<td>0.6</td>
<td>5.3</td>
<td>13.3</td>
<td>6.2</td>
<td>8.4</td>
</tr>
<tr>
<td>3.3. Machinery and transport equipment</td>
<td>0.1</td>
<td>0.8</td>
<td>14.5</td>
<td>6.2</td>
<td>13.6</td>
</tr>
<tr>
<td>3.4. Textiles</td>
<td>0.0</td>
<td>3.9</td>
<td>1.5</td>
<td>0.4</td>
<td>0.7</td>
</tr>
<tr>
<td>3.5. Clothing</td>
<td>0.0</td>
<td>3.7</td>
<td>31.0</td>
<td>0.3</td>
<td>2.1</td>
</tr>
<tr>
<td>Other</td>
<td>0.7</td>
<td>8.0</td>
<td>0.0</td>
<td>5.1</td>
<td>1.3</td>
</tr>
<tr>
<td>Memorandum:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total merchandise exports, USD mln</td>
<td>32298</td>
<td>7682</td>
<td>9739</td>
<td>183452</td>
<td>32672</td>
</tr>
</tbody>
</table>

Source: WTO country time series from www.wto.org
before a comprehensive free trade regime is created. This could be the case of Russia and Ukraine, for example, which do not yet have free trade arrangements with the EU. (The Commission proposed this now to another ENP state, Moldova.) The relevance of ATP-like solution for Russia and Ukraine will perhaps depend on the perceived prospects of FTA. In case of Mediterranean countries, this solution is irrelevant, as they are working on implementation of FTAs.

2.3. Free Trade Agreements (FTA)

A free trade agreement in its full form stipulates liberalisation of trade in goods and services on a reciprocal basis, namely removing tariffs and import quotas for goods and nationality and market access restrictions for services. At the same time, FTA members set their own tariffs on imports from other countries. FTA represents an exception to the basic rules of the GATT and the GATS as it deviates from the MFN principle. Yet, GATT allows formation of an FTA subject to certain conditions, in particular, if it involves elimination of all barriers on almost all bilateral trade between the members, has a “substantial sectoral coverage” in services and eliminates discrimination against service suppliers of other countries in the group.

The Barcelona Declaration of 1995 provides for establishment of a Euro-Mediterranean Free Trade Area (EMFTA) by the target date of 2010. Association Agreements that the EU has concluded with Mediterranean partners are to serve as means towards attainment of this goal. The AAs stipulate for free trade in manufactured goods and progressive liberalisation of trade in agricultural products. In return, Mediterranean countries are removing barriers to EU imports, usually over a transition period. PCA with Ukraine also envisages establishment of an FTA, however, no target date is defined for this.

The FTAs that have actually been implemented by the EU and other countries are in practice often rather far from achieving liberalisation of trade in goods in the majority of sectors that matter for the partners, with agriculture being a prominent example, not to mention successful liberalisation of services. Table 2.4 makes it clear that these two sectors are important for ENP economies.

Table 2.4. Composition of GDP, %, 2003

<table>
<thead>
<tr>
<th></th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
<th>Russia</th>
<th>Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture</td>
<td>10.2</td>
<td>16.1</td>
<td>16.8</td>
<td>5.2</td>
<td>14.1</td>
</tr>
<tr>
<td>Industry</td>
<td>55.1</td>
<td>34</td>
<td>29.6</td>
<td>34.2</td>
<td>40.3</td>
</tr>
<tr>
<td>Services</td>
<td>34.7</td>
<td>49.8</td>
<td>53.6</td>
<td>60.7</td>
<td>45.6</td>
</tr>
</tbody>
</table>

Source: http://www.europa.eu.int/comm/trade/issues/bilateral/datapdf.htm
The benefits of removing barriers to trade in these sectors are generally found to be substantial – often outweighing by a large margin liberalisation of trade in industrial goods (see discussion in chapter 5). The difficulty with these sectors is that the historical experience clearly suggests that plans to remove trade barriers will likely be met with strong opposition from interest groups both in the EU and ENP countries. Also, institutional requirements for liberalisation in these sectors are somewhat higher, in particular for the services sector (see chapter 4 for discussion).

Overall, FTAs appear to offer a realistic option for further (near to medium term) economic integration between EU and its neighbours. The specific nature of these arrangements will matter substantially.

2.4. Customs Union

Another possible arrangement that could be considered for ENP countries (though certainly not in a perspective of 5 years or so) is a customs union with the EU. A customs union, according to its textbook definition, implies full trade liberalisation among a group of countries accompanied by an application of a single external tariff. The customs union is one of the key components of the EU itself.

In 1995, the EU concluded a customs union with Turkey, which made Turkey the only country that has a customs union with the EU without being an EU member. According to the agreement, the two parties gradually eliminated tariff and non-tariff barriers to each other’s industrial goods (but not agricultural ones) and Turkey adopted Community’s Common Customs Tariff for imports from the third countries. In addition, the agreement includes adoption of a wide range of legislation on trade and standards, participation in several conventions on intellectual, industrial and commercial property rights, as well as harmonisation according to the technical standards of the EU. The customs union with Turkey can be seen as a relevant example, given the similarities in the level of economic development to the ENP countries. The
full-fledged union would set rather high institutional requirement on all parties of an agreement (as common external trade policy needs to be decided either collectively or asymmetrically, with the EU as the major party effectively deciding unilaterally). The experience of Turkey suggests that the EU will be very reluctant to enter further commitments of this type complicating its trade policies. Custom union with Turkey has in practice turned out to be a very uneven arrangement with a clear leader (EU) followed by a much smaller partner. Certainly, such a scheme does not automatically imply negative consequences for partner countries, yet an uneven nature of ensuing relations needs to be understood by all parties prior to their decisions on opting for such a form of integration. Chapter 4 discusses the institutional dimension of the Turkish case in more detail and draws more conclusions for the appropriateness of customs union as a mechanism of future integration between EU and ENP region.

A serious economic disadvantage of the customs union option can arise between (say) states A and B, when state B wishes to enjoy free trade with other major trade partners, which do not have free trade with state A. In this case the constraint of the common external tariff could be significantly trade diverting. This is not just a theoretical case, since it would arise in the case of a customs union between the EU and Ukraine in the event that Russia and the EU do not make also a free trade agreement. For similar reasons Ukraine has refused to enter into a customs union with Russia.

2.5. Participation in the internal market

The EU made quite an ambitious, yet still only vaguely defined offer in the formulation of the ENP – a prospect for the neighbours’ “stake in the EU’s Internal Market” (Communication on Wider Europe, 2003, p. 4). This implies that ENP countries would be able to become a part of the “four freedoms” - free movement of goods, services, labour and capital. The institutional, economic and other requirements for full participation in the internal market are very high and the prospects of the five countries joining the market are distant. However, partial access could be considered as it can motivate reform effort in several fields that are crucial for social and economic development of ENP countries and business options for EU partners. Precisely for this reason we include discussion of this option in the report.

2.5.1. Internal goods market

To participate in the Internal Market for goods, neighbour countries would have to adopt the *acquis* in relevant areas, use European and international standards and
apply the principle of mutual recognition in non-harmonised sectors. The latter requires substantial amount of confidence on the side of all the parties – something that will take time to develop.

Even though the prospect of participation in the Internal Market may be remote, it may make sense for the neighbour countries to adopt the Internal Market legislation in some areas. This will facilitate access of their products to the EU market and vice versa, because non-alignment with EU regulations often serves as a non-tariff barrier. Mediterranean countries are already advancing with harmonization of some priority areas in legislation and regulatory framework based on the Palermo Conference (2003); legislative harmonization is under way in Ukraine as well. Where neighbours are not going to adopt the *acquis*, it may make sense to converge on some main principles – this will reduce uncertainty and transaction costs. Participation in a common regulatory policies may also promote cooperation among neighbours themselves. In particular, it can complement such regional trade liberalisation initiatives as Agadir Agreement in the Mediterranean.

### 2.5.2. Complete internal market

Neighbours’ participation in the complete Internal Market (i.e. in free movement of services, labour and capital in addition to that of goods) is also a possibility, although even more remote than participation in the Internal Commodity Market.

Free movement of labour can potentially bring big efficiency gains and also serve as a good “carrot” for the ENP, but it is a sensitive issue, socially and politically. The

---

**Box 2.2. Example of participation in the Internal Market: EEA**

European Economic Area (EEA) is an example of how participation in the Internal Market can be arranged. The idea of shaping EU’s relations with its neighbours along the EEA lines has been discussed at the Convention on the Future of Europe in 2002-2003, and also as a part of the development of the EU Constitution (Vahl, 2005). The Commission Communication on Wider Europe of March 2003 also mentions EEA as a model for relations with neighbours, saying that the long-term goal of the Wider Europe initiative is to move towards an arrangement resembling EEA (Communication on Wider Europe, 2003).

The EEA was formed by the EU, Norway, Iceland and Lichtenstein and assures four freedoms of movements of: manufacturing goods (agricultural trade is excluded), services, capital and persons. Norway, Iceland and Lichtenstein have rights to participate during the formulation of European Community legislation, but not the right to a voice in decision-making, which is reserved exclusively for Member States. Because the countries are very closely linked to the EU, some of their national legislation is taken over by the EC rules (connected with trade and movement of people and companies, also about company law) and their laws, especially those regarding economic activity are harmonised with these of the EU.
ENP’s offer on movement of labour is quite cautious. So, the EC Communication speaks about “perspectives for lawful migration and movement of persons” (Communication on Wider Europe, 2003, p. 11). Chapter 5 of the study discusses the likely consequences of services liberalisation and migration in more detail.

2.6. Participation in European networks

Yet another model of economic integration of neighbours is participation in European networks. The basic distinction of this option is institutional inclusion of the ENP countries. The ENP offers neighbours a possibility of participation in transport, energy, telecommunications networks and the European Research Area. In particular, in the energy sector, the EU Strategy Paper on ENP envisages consideration of possibilities for partners to participate in the Intelligent Energy Programme and for their gradual involvement in EU’s regulatory practices and bodies such as the European Gas and Electricity Regulatory fora (Strategy Paper, 2004, p.17). In transport, the paper suggests further developing pan-European initiatives such as the Pan-European Transport Network Concept, Pan-European Transport Conferences, Euro-Mediterranean transport network, etc. Analogous proposals are put forward for environment protection, communication and research areas.

In chapter 4 of the report we analyze in detail the existing framework and opportunities for neighbour’s participation in the European energy network.
3. Time dependencies between various forms of economic integration

- Countries covered in this report have achieved different degrees of integration with the EU: some of them (Algeria, Russia and Ukraine) are not yet WTO members, others advanced as far as concluding FTA agreements with the EU and now work on their implementation. Different starting points suggest that integration will be multi-speed.
- Coordination of integration in different sectors is necessary to achieve full benefits.
- Completion of FTAs with Algeria, Egypt and Morocco appears feasible between 2013 and 2018. In the meantime, some liberalisation of service sectors is expected.
- Russia and Ukraine will most likely enter the WTO in 2007, which opens door for further economic integration with the EU. Soon after this, it is expected that the EU will begin talks on formation of an FTA with Ukraine.

The countries covered in this report have achieved quite different degrees of integration with the EU: while some of them (Algeria, Russia and Ukraine) are not yet WTO members, others advanced as far as concluding FTA agreements with the EU and now work on their implementation. Such a difference in starting positions means that integration between the EU and its neighbours will necessarily be multi-speed. Different structures of the economies and different levels of institutional development in these countries also justify differentiated approach.

In this chapter we look at the issues of sequencing and coordination of different forms and spheres of integration. Then we review each country’s case to see what kind of integration is the most feasible in the short to medium term. The summary of timing of different integration initiatives is provided in table 3.1. As EU’s cooperation with Algeria, Egypt and Morocco is shaped to a large extent by a common framework of Euro-Mediterranean partnership, we discuss EU’s policies towards these countries in the context of this partnership, and then focus on specific country cases.
3.1. Sequencing of stages of integration

According to a classic theory of economic integration, the usual sequencing is from free trade area to customs union and then to a common market (Balassa, 1961). However, this conventional view might need a correction when applied to the wider European area. The thrust of the ENP is in the direction of free trade and internal market integration, which for transition/developing counties offers potential advantages for improving domestic economic governance through anchorage on EU standards and regulatory rules. On the other hand, the feasibility and positive implications of a customs union is questionable.

Regarding sequencing of different components of trade liberalisation, it is acknowledged that removal of quantitative restrictions should be conducted at the early stages, followed by reduction or elimination of tariffs. Relative to reforms in other sectors, trade liberalisation should follow after a broad macroeconomic stabilisation and before capital account liberalisation (Nsouli et al., 2002).

There is some discussion going on about sequencing of trade and monetary integration, notably, with respect to East Asia (Pomfret, 2004; ADB, 2005). We will not analyse this issue, as monetary integration between the EU and neighbours is quite a far-fetched option.

What is relevant in case of the countries concerned is sequencing of the WTO membership and regional integration. The major argument for conducting multilateral liberalisation first is that regionalism can inhibit multilateral liberalisation due to lobby of inefficient firms against subsequent removal of the preferential rates (Krishna, 1998). In the case of CIS countries, one study assesses welfare benefits of different sequencing to conclude that precedence of the WTO membership over regional customs union brings superior results (Tumbarello, 2005). It should be noted, however, that these studies focus on regional trade agreements (RTAs) among developing countries, which have high tariffs and conduct regional integration instead of multilateral liberalisation.

Proponents of regionalism suggest that because trade (in industrial products) is already quite free in the major trading economies, few regional liberalisation initiatives are capable of creating important anti-liberalisation forces (Baldwin, 2004). This seems to be the case in economic relations of the EU with its neighbours, as they are based on simultaneous multilateral and regional liberalisation, with WTO conditions being embedded in bilateral agreements. In sum, there are reasons to believe that WTO membership should go before other liberalisation initiatives, and this is exactly what the EU requires in the frames of the ENP.5

5 On the other hand the EU was ready to follow regional trade integration route in the case of the Baltic states and ex-Yugoslavia countries before or in parallel to their WTO accession.
3.2. Coordination of integration in different sectors

There are many reasons to believe that liberalisation of trade in commodities should be accompanied by liberalisation in services and investment. For example, to realize gains from trade liberalisation in the manufacturing sector it is necessary to also liberalise and harmonise such services as transportation and communication. Improved market access is likely to attract export-oriented FDI in the neighbouring countries, prompting for integration in the area of investment. This means that to achieve full benefits from integration, it is necessary to coordinate liberalisation in several sectors.

Another argument for coordinated or simultaneous integration is that “package deals” are easier to reach because they generate losers and winners on both sides, as opposed to sectoral agreements that are likely to generate losers on one side and winners on the other, making it difficult to make a deal. Package deals are at the heart of EU decision making, which only strengthens the case for the use of similar techniques in relations with neighbours.

3.3. Time frame

It has been a general tendency for economic integration initiatives to fall behind the established time frame. This is the case, for example, with implementation of the FTA in the Mediterranean: the Barcelona Declaration envisaged establishment of the FTA by 2010; yet, due to delays with conclusion and ratification of Association Agreements, the FTA is unlikely to be achieved by 2010. Similarly, dates of EU accession of eight Central European new member states have been delayed (relative to earlier plans), reflecting that more time than initially planned was needed for both sides to be ready for subsequent steps. Yet from another perspective, these countries needed only 15 years to move from economic and political isolation to EU membership. In subsequent sections we try to figure out realistic time frame of integration initiatives, taking into account the EU experience with economic integration.

3.4. Country cases

3.4.1. Russia

Russia occupies a special place in relation to the ENP: it does not participate in it as a target of the policy; rather, it seeks a partnership with the EU on more equal terms.
3.4.1.1. Legal framework

The PCA forms the current basis for EU-Russia relations. By 2007, either some new agreement will need to be signed or the PCA will be automatically extended. The agreement establishes a partnership between the EU and Russia, which is to serve as a venue of political dialogue between the parties and to facilitate political and economic reform in Russia and intensification of economic cooperation between the parties. According to the PCA, the parties apply MFN treatment to each other’s products and eliminate quantitative restrictions (PCA Russia, 1997, Articles 10 and 15). The agreement, however, does not apply to trade in textiles, coal and metal products, which is governed by separate agreements. With regard to the establishment of companies, the PCA requires treatment no less favourable than that granted to any third country, and home treatment to subsidiaries (PCA Russia, 1997, Article 28). PCA also provides for establishment of the institutions to govern the relations, such as biannual summits at the country head level, a Cooperation Council at ministerial level and a Parliamentary Cooperation Committee.

3.4.1.2. Trade pattern

The EU is now by far Russia’s main trading partner: in 2004, it accounted for 40% of Russia’s exports and 45% of its imports. Russia’s exports to the EU are dominated by energy commodities (60%), while its imports from the EU mainly consist of machinery, transport equipment and chemicals. Such an unbalanced trade pattern illustrates the EU’s dependence on Russian energy supplies, on the one hand, and the need for raising competitiveness of Russian industry and improving its access to the EU market, on the other. EU Strategy paper on Russia declares trade promotion and the removal of access restrictions as the key elements of the EU-Russia cooperation (Strategy Paper Russia, 2001, Art. 4.2). To this end, the Strategy envisions the launch of two initiatives - a Common European Economic Space (discussed below) and Energy Dialogue (discussed in chapters 4 and 6).

3.4.1.3. Integration and liberalisation initiatives

WTO membership

Russia’s WTO membership is the most realistic step to happen in the nearest future. In May 2004, Russia and the EU signed a bilateral agreement on Russia’s accession to the WTO (in a package with Russia’s signing the Kyoto protocol). Optimistically, membership could be agreed in 2007, but some delay seems more realistic. As of January 2006, Russia still had to conclude bilateral negotiations with the United States, Australia, Switzerland and Columbia. Negotiations with the US

---

6 See also trade statistics in Tables 3.1A and 3.2A in the Statistical Appendix.
proved to be the most contentious over US demand for Russia’s opening its banking sector and observing intellectual property rights.

Russia’s WTO membership is important from the point of view of the European investors, as it is hoped to encourage market reform in Russia, enhance equal treatment of foreign and domestic investors and reduce uncertainty, which will lead to improvement of the investment climate.

**Regional and bilateral trade liberalisation**

The PCA envisages creating the necessary conditions for future establishment of a free trade area between the EU and Russia that would cover trade in goods, as well as conditions for bringing about freedom of establishment of companies, of cross-border trade in services and of capital movements (PCA Russia, 1997, Article 1). A number of studies have been conducted on the assessment of the impact of the FTA (some of which are discussed in section 5.1), yet the idea has not resulted in any practical steps so far. According to some Russian analysts and officials advance of free trade between the EU and Russia was hindered by fears in the EU of competition from Russian companies (Mau et al., 2004, p. 59; Gref Interview, 2005).

**Integrated market**

The idea of integration of Russian and European markets was first declared in the EU Common Strategy for Russia that was adopted in 1999. It envisaged creation of an FTA, to be followed by common European economic space that is to be gradually implemented through convergence of legislation and standards. At the EU-Russia Summit in May 2001 the parties agreed to study a possibility of creating a Common European Economic Space (CEES) and created a joint group tasked with investigating such a possibility.

This initial proposal was quite vague and resembled the EEA arrangement in that it suggested adopting the EU’s acquis, what became an object of criticism of some Russian observers. The idea was later transformed into Common Economic Space (CES) as one of four common spaces (the other three are a common space of freedom, security and justice; a space of co-operation in the field of external security; and a space of research and education, and culture). The Moscow Summit in May 2005 adopted a package of Road Maps that outline the actions necessary to make the common spaces a reality, and the most recent summit in London in October 2005 focused on the implementation of the Road Maps.

It is important to note that in the process of elaboration, the idea of a common economic space got substantially transformed. Symbolically, it lost the word “European” in its title. Its substance has also transformed: it does not speak of Russia’s
adopting EU’s *acquis*, but rather about “dialogue” and “approximation”. The Road Map on CES does not speak about Russia’s access to EU common market, but about creation of an “integrated market”. The document, however, does not give any precise picture of what such a market may mean in practice. What the Road Map speaks about is efforts in standardization, with a possibility of participation of the Russian bodies in the European standardization, accreditation and metrology organizations (Road Map on CES, 2005, p. 2). Another major feature of the CES proposal is its emphasis on creation of common networks in several areas: telecommunications, transport, energy, space and environment. The focus on networks may reflect Russia’s interest in institutional participation in policies, which is more feasible in case of Pan-European networks than in the case of the EU internal market.

Overall, the new initiative represents a not wholly successful attempt at clarifying what the Common Economic Space could look like, yet further elaboration of the concept is needed. At this stage it is unclear how an “integrated market” will look like. However observers of the Russian policy making scene are beginning to notice that Russia is in practice going more in the direction of adopting EU standards and regulatory norms than their political leaders are willing to state in official communiqués. At the same time, integration in pan-European networks seems to be a promising concept, in particular in relation to the energy sector.

**Energy sector cooperation**

Russia-EU relations on energy are developing within the frames of the Energy Dialogue that was launched in October 2000. The main idea of this partnership is to enhance the energy security of the European continent by binding Russia and the EU into a closer relationship. We address this issue in chapter 6.

**Conclusions**

The most feasible option for Russia to follow during the next 5-10 years is to work towards a partial but hopefully more comprehensive free trade area with the EU (after accession to WTO), supplemented by harmonization of legislation and regulations in some areas of the internal market, as well as participation in a range of European networks and programs. Chapter 5 discusses the risks of partial trade integration, which can be relevant. In terms of the time frame, WTO membership is still possible in 2007. It is difficult to devise any projections for timing of the FTA and integrated market. Theoretically, FTA negotiations could start immediately after the WTO membership; yet, there are no plans so far to proceed with the FTA. The idea of an integrated market has yet to be elaborated conceptually before any projections about timing of its implementation could be made.
3.4.2. Ukraine

3.4.2.1. Legal Framework

EU-Ukraine relations are governed by the Partnership and Cooperation Agreement, which entered into force in 1998 and expires in 2008, but can continue in the absence of new decisions. The economic provisions of PCA stipulate reciprocal MFN treatment for goods. There are also specific agreements in particular policy areas such as trade, science and technology, and nuclear energy. Conclusion of agreement on steel and textile allowed to gradually liberalise trade in these sectors.

Ukraine became a partner in the European Neighbourhood Policy in 2004, and an Action Plan covering mutual commitments in the sphere of politics, economic integration (including gradual approximation of legislation, norms and standards with those of the EU) and justice and home affairs was agreed in February 2005.

In 2006-2007, after the review of the first year of implementation of the Action Plan, the parties are expected to start negotiations on the new framework agreement that will replace the current PCA. According to Ukrainian side, this should be an Association Agreement. The EU speaks of European Neighbourhood Agreement but has not outlined a vision on its substance yet.

3.4.2.2. Trade pattern

Ukraine’s trade turnover with the EU has been rising and in 2004 EU accounted for 33% of total Ukraine’s exports and for 32% of its imports. Metals and energy accounted respectively for 32% and 25% of the Ukrainian exports to the EU, whilst machinery, transport equipment and chemical products are major EU exports to Ukraine. Ukrainian exports to the EU have been inhibited by EU’s protective measures as Ukraine happens to specialise in goods that are considered “sensitive products” by the EU: steel, chemical, textile and agricultural products.

3.4.2.3. Integration and liberalisation initiatives

Market economy status

Until December 2005, the EU treated Ukraine as a non-market economy, which made it easy to file antidumping cases against Ukrainian companies. In 2005, 10 Ukrainian chemical and steel products were subject to EU safeguard measures. Granting Ukraine market economy status in December 2005 eased access of Ukrainian companies to the EU market.

---

7 One of the latest statements on this was made by President Yushchenko in London on October 18, 2005. He said that an association agreement could be signed within three years. Source: Anton La Guardia, ‘Ukrainian leader sets sights on joining the West’, The Daily Telegraph, October 18, 2005.

8 http://www.ukraine-eu.mfa.gov.ua/eu/en/publication/content/2276.htm
WTO

Ukraine’s plans to join the WTO have been regularly delayed and it remains to be seen whether 2007 can be a realistic date. Bilateral protocols with the US and Australia have not been signed yet because of US demands on intellectual property rights and Australia’s demand on easing access to Ukraine’s sugar market. Yet, it is internal political situation that may prove the major factor behind the delay of WTO accession: during 2005, the bills needed for Ukraine to comply with WTO requirements were repeatedly blocked by the opposition.

Those close to negotiations predict that Ukraine and Russia will likely join the WTO simultaneously. Acquiring WTO membership is one of the priorities of the Action Plan.

FTA

The EU is currently investigating the feasibility of concluding a free trade agreement with Ukraine. The Action Plan suggests that negotiations on a free trade agreement can start as soon as Ukraine becomes a WTO member (Chapter 2.3.1 of the Plan). President Yushchenko declared that the agreement could be signed by 2007\(^9\). Yet, it seems more likely that the process will be delayed. However the EU-Ukraine summit of 1 December 2005 noted that the two parties were willing to move fast with FTA after WTO accession of Ukraine.

Access to EU internal market

The Action plan envisages a possibility of Ukraine’s participation in the EU internal market in selected priority industrial sectors. Inclusion of Ukraine in an Agreement on Conformity Assessment and Acceptance of Industrial products (ACAA) would be an important step to this end. In December 2005, the parties started elaborating a timetable for Ukraine’s inclusion in ACAA, which is expected to happen by 2011\(^10\).

Networks

The Action Plan envisages a possibility of Ukraine’s participation in the joint development of the Pan-European Corridors and Areas as well as in the TRACECA program. In the energy sector, the Plan suggests exploring the possibility for Ukraine’s participation in the Intelligent Energy-Europe program. Currently, Ukraine participates in INOGATE program, which aims at diversification of energy supplies to the EU away from Russia. The agenda for the nearest years is likely to be dominated by energy security issues, in particular, gas transit from Russia to the EU (Ukraine transits about 80% of Russian gas to the EU). Increasing Ukraine’s energy efficiency

---

\(^9\) Anton La Guardia, “Ukrainian leader sets sights on joining the West”, The Daily Telegraph, October 18, 2005.

and independence along with adoption of market rules in gas transit will be the key tasks in this realm (energy issues are discussed in chapter 6).

Participation in Pan-European networks will likely be the most dynamic area in EU-Ukraine cooperation in the nearest future, as interests of the parties broadly coincide and the issue of Ukraine’s institutional participation in such networks does not invoke a dispute (more on integration of the transport sector can be found in section 5.2). EU-Ukraine summit in December 2005 gave a new impetus to Ukraine’s integration in transport, energy and space networks. In particular, a memorandum on mutual understanding and cooperation in the energy sector was signed that envisages gradual integration of Ukrainian gas and electricity sector into the domestic energy market of the European Union; an Agreement on some aspects of air transport stipulates deeper cooperation in the context of forming a single air space; and an Agreement on cooperation in the Galileo satellite navigation system provides for Ukraine’s direct participation in the Galileo project, its involvement in realization of the first EU Space Program and Ukraine’s membership in the European Space Agency.

Conclusions

The short-term agenda of EU-Ukraine economic integration is going to be dominated by Ukraine’s WTO accession (possibly in 2007). This will bring important steps of liberalisation in sensitive sectors, including on the EU side, since its existing restrictive quota for imports of Ukrainian steel would be illegal between WTO partners, and so will have to be eliminated. A possible creation of a free trade area with the EU will begin soon after, but the level of ambition and timing of entry into force needs to be worked out, and the concept is currently at the stage of impact assessment studies. Ukraine’s inclusion in European energy and transport networks has already started, and in the next several years is to be filled with practical work. An important event will be renegotiation of the PCA that is to be concluded by 2008.

3.4.3. Euro-Mediterranean partnership

The Euro-Mediterranean Partnership has been the major mechanism for cooperation between the EU and Mediterranean countries. It was initiated at the Barcelona Conference on 27-28 November 1995. The Partnership is a wide framework of political, economic and social relations between Member States of the EU and Partners of the Southern Mediterranean. It embraces 25 EU Member States and 10 Mediterranean Partners: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestinian Authority, Syria, Tunisia and Turkey.
The Economic and Financial Chapter of the Barcelona Declaration envisages construction of a zone of shared prosperity through an economic and financial partnership and the establishment of a Euro-Mediterranean Free Trade Area (EMFTA) by the target date of 2010. The EMFTA foresees free trade in manufactured goods and progressive liberalisation of trade in agricultural products. EU has been concluding Association Agreements with each country which should eventually lead to implementation of the EMFTA. They are to be supplemented by free trade agreements between the Mediterranean partners. All three Northern African countries studied in the report take part in the Barcelona process and all three have concluded and ratified Association Agreements with the EU: Algeria in 2002 (ratified in 2005), Egypt in 2001 (ratified in 2004), and Morocco in 1996 (ratified in 2000). Morocco, Tunisia, Egypt and Jordan also signed a Free Trade Agreement between themselves in Agadir in February 2004.

Recently, the EU has been active in promoting trade liberalisation with Mediterranean partners. On 11 October 2005, the Council adopted Commission's proposals to extend the system of cumulation of origin to Mediterranean countries. The system will permit products processed in one or more countries to benefit from the same preferential access to the EU market as those exported directly from the country of origin. This decision aims to encourage Mediterranean countries to conclude free trade agreements with each other so as to speed up the completion of EMFTA. Furthermore, in November 2005, the Council decided to authorise the European Commission to open negotiations on the liberalisation of services and investment with the EU’s Mediterranean partners. Negotiations started in March 2006.

At the Summit in Barcelona on November 27-28, 2005, the EU presented its five-year work program which focuses on education, sustainable economic growth, human rights and democracy. The EU also raised the issues of terrorism and migrations, which are likely to dominate EuroMed partnership in the years to come (see section 5.3).

3.4.4. Algeria

3.4.4.1. Legal Framework

Cooperation between the EU and Algeria has been inhibited for years due to the protracted conflict in the country. Still, the cooperation proceeded based on the 1979 Co-operation Agreement and four Financial Protocols that supplemented the agreement, the Barcelona Declaration and the MEDA program. The Association Agreement was signed in April 2002, but ratified only in March 2005.

---

Correspondingly, ENP initiatives on Algeria were somewhat delayed, and as of the fall 2005 the EU did not have a country report on Algeria and an Action Plan as a part of the ENP. These delays reflect basic political conditions in Algeria, where the regime is hyper-sensitive to suggestions that conditionality on the part of the EU might be reminiscent of still bitter memories of French colonialism. Indeed the kind of policy conditionality which the EU applies to the Balkan states is rejected on principle by most Mediterranean Arab states.

3.4.4.2. Trade pattern
The Algerian economy is very dependent on exploitation of its oil and gas, which make up 98% of its exports, 30% of GDP, and bring 65% of the state budget’s revenues. The EU is the major trade partner of Algeria - it accounts for 54% of Algeria’s exports and 55% of its imports. EU-Algeria cooperation aims to promote more balanced structure of the Algerian economy and trade. Yet, energy is likely to be a predominant area of cooperation given EU’s energy needs and Algeria’s resource endowments. More on the cooperation in the field of energy can be found in chapter 6.

3.4.4.3. Integration and liberalisation initiatives

**WTO**
Algeria, despite applying to GATT back in 1987 is still in the process of negotiating the WTO membership. The last meeting of the working group took place on October 21, 2005. The negotiations have been proceeded rather slowly, although Algerian authorities have been consistently optimistic in expecting accession in the near future.

**Regional and bilateral trade liberalisation**
The Association Agreement with Algeria envisages establishment of a free trade area over a transitional period of twelve years maximum starting from the date of the entry into force of the Agreement, i.e. the EU-Algeria FTA is expected to come into force by 2017.

**Energy sector cooperation**
The Barcelona declaration names energy as one of the priority sectors of the Euro-Mediterranean Partnership. The EU hopes to create a stable climate for energy investment and supply security, and the Mediterranean partners see the Partnership as a privileged channel for investment and technical assistance. Algeria, together with Libya and to a lesser degree Egypt, is the main target of the policy due to its role in the hydrocarbons supply. The Association Agreement envisages creation of partnerships in oil and gas exploitation and modernisation and development of Algerian energy.
networks for their linking to EU networks (Article 61). Chapter 6 of the report addresses the issues of energy security and trade in hydrocarbons in more detail.

**Conclusions**

In the short-to medium term, Algeria’s integration agenda with the EU is likely to be dominated by the WTO accession and implementation of the free trade provisions of the Association Agreement (by 2017). The energy sector is likely to see some joint initiatives, including creation of integrated networks. Beyond this all depends on whether the Algerian political regime can evolve in directions more compatible with European values.

3.4.5. Egypt

3.4.5.1. Legal Framework

EU relations with Egypt are governed by the Euro-Mediterranean Partnership that is implemented through the EU-Egypt Association Agreement (signed in 2001 and came into force in 2004). The Agreement provides a framework for political dialogue, liberalisation of trade in goods, services and capital, including the completion of the FTA by 2015 (2018 for a very limited number of industrial goods). In March 2005, the European Commission issued a Country Report on Egypt in the framework of the ENP, and the drafting of an Action Plan started in the fall of 2005.

3.4.5.2. Trade pattern

The EU accounts for over 34% of Egyptian exports (energy, textiles, metals and agricultural products) and nearly 28% of total imports (machinery, transport equipment and chemicals; see tables 3.1A and 3.2A in the Statistical Annex).

3.4.5.3. Integration and liberalisation initiatives

**WTO**

Egypt has been a WTO member since 1995 (it joined GATT in 1970).

**Regional and bilateral trade liberalisation**

Under the EU-Egypt Association Agreement, the EU is to dismantle tariffs on industrial imports from Egypt in three years, and Egypt is to do the same in 12 years. Liberalisation of trade in agricultural products is governed by a separate agreement, according to which the EU grants a range of concessions to Egypt.
Energy sector cooperation

Due to its oil and gas resources, Egypt is one of the important partners of the EU in the area of energy sector cooperation. Thanks to sizeable discoveries of gas, Egypt is becoming an important gas producer. Egypt also lays an important role in energy transit, with Suez Canal and the Suez-Mediterranean pipeline serving as major routes for transiting Persian Gulf energy resources to the European market. Egypt participates in several new projects on gas pipelines that will help to create a Mediterranean gas ring involving Southern Mediterranean countries and the EU.

Conclusions

Egypt is likely to go along a similar path to Algeria, but faster due to a less brittle political relationship. However, Egypt is also extremely resistant to ideas of introducing more political conditionality into the relationship with the EU. The agenda for the nearest years will include elaboration of an ENP Action Plan, the gradual implementation of the FTA provisions (by 2015-2018), as well as participation in network projects, notably, on energy.

3.4.6. Morocco

3.4.6.1. Legal Framework

The EU-Morocco relations are governed by the Association Agreement that came into force in 2000. In 2004, the EU issued the ENP Action Plan for Morocco that is to serve as a policy guide for the next 3-5 years.

3.4.6.2. Trade pattern

The EU is by far the most important Moroccan external trade partner with share in Moroccan exports of 74% (mainly food and textiles) and 56% share in imports (machinery and textiles; see tables 3.1A and 3.2A in the Statistical Annex). France and Spain are the most important trading partners.

3.4.6.3. Integration and liberalisation initiatives

WTO

Morocco has been a WTO member since 1995 (it joined GATT in 1987).

Regional and bilateral trade liberalisation

The Association Agreement provides for the gradual establishment of free trade in industrial products, for which the EU has already granted free access, whereas
Morocco committed gradual removal of tariffs until 2013. In agriculture, there is to be progressive and reciprocal liberalisation. The Agreement also commits Morocco and the EU to explore ways in which to liberalise trade in services beyond WTO obligations.

The Action Plan foresees, among other things, negotiation of an agreement on liberalisation in services, development of favourable investment climate, improving management of migration flows (conclusion of readmission agreement), and integration of Morocco into Trans-European transport and energy (electricity) networks.

Migration is going to be at the forefront of the EU-Morocco relations, as substantial number of African illegal migrants use Morocco as a transit country on their way to the EU.

Integration in Pan-European networks


In the area of transport, the Plan suggests developing of regional transport systems and their integration into Trans-European Transport Network (more can be found in section 5.2).

Conclusions

Economic integration between the EU and Morocco is, together with the case of Tunisia (not studied in this report) going to be something of a pace-maker for integration processes with other Mediterranean countries. This will include gradual implementation of FTA (optimistically by 2013), and integration into Trans-European networks and a relatively constructive political dialogue over Morocco’s political liberalisation and civil society development.
Table 3.1. Realistic timing of integration initiatives

<table>
<thead>
<tr>
<th></th>
<th>Russia</th>
<th>Ukraine</th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>2006</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Start of talks on services and investment liberalisation</td>
<td>Start of talks on services and investment liberalisation</td>
<td>Start of talks on services and investment liberalisation</td>
<td></td>
</tr>
<tr>
<td><strong>2007</strong></td>
<td>WTO accession (?) PCA expires; new agreement possible</td>
<td>WTO accession (?) Start of FTA talks (optimistic)</td>
<td>WTO accession (?)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2008</strong></td>
<td>Start of talks on FTA possible</td>
<td>PCA expires, new agreement expected</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2009</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2010</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2011</strong></td>
<td></td>
<td></td>
<td>Inclusion in ACAA (optimistic)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2012</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2013</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>FTA completion</td>
</tr>
<tr>
<td><strong>2014</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td>FTA completion in majority of industrial products (optimistic)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2016</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2017</strong></td>
<td></td>
<td></td>
<td>FTA completion (optimistic)</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>2018</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>FTA completion in all industrial products</td>
</tr>
</tbody>
</table>
4. Institutional basis for integration

• The institutional requirements for closer cooperation between the EU and ENP countries are dependent on the exact form and scope of economic integration to be pursued.

• As regards the EU-ENP framework, priority should be given to partial Internal Market integration where the market integration in goods and services would constitute the two main pillars.

• Free Trade Agreements will likely offer the most realistic framework for deepening of trade and market integration. Customs union would set too high institutional requirements for the EU (effective power sharing).

• For fostering market integration in services, a methodology taking into consideration the required degree of regulatory convergence for enhancing cross border trade and investments as well as the domestic regulatory capabilities of ENP countries should be devised. A requirement to adopt EU policies in all fields as a prerequisite to services market integration should be avoided and more flexibility should be sought.

• In some policy areas, economic integration can advance without full regulatory convergence. Examples include financial services, telecommunication and sea transport. In these areas domestic reforms to enhance the contestability of markets are more important.

• In other areas such as air transport or electricity markets, the gradual adoption of the EU acquis can be contemplated.

• Creative institutional measures to enhance labour mobility without harming the labour markets in EU countries should also be sought.

• The incorporation of incentive mechanism within the ENPI should help in the implementation of ENP. Such mechanism should lead to competition in domestic reforms among the ENP partners.

• In the longer perspective establishment of a new regional instrument to provide the institutional underpinning of EU-ENP market integration should be envisaged. The EEA provides useful blueprint in this respect which, however, should be adjusted to the capacities of Neighbouring countries. Such regional institution would also fulfil the role of an anchor to accelerate and consolidate domestic reforms in ENP countries.
4.1. Institutional requirements for alternative models of economic integration

The question of institutional requirements related to alternative models of economic integration has two dimensions: external and internal. The external dimension relates to the specific institutional setup which will underpin the economic integration between the EU and ENP countries. The internal dimension relates to the domestic political, regulatory and administrative structures which will drive the internal changes for achieving economic integration. There is generally a link between the two: more ambitious external structures targeting more comprehensive forms of integration would necessitate a more developed domestic framework. For the ENP, the challenge is to find the appropriate model for the external institutions taking into account domestic institutional capacity. In the longer term, the nature of the external institutional setup will have an impact on domestic structures but it will be the present state of development of domestic structures which should determine the short and medium term objectives for economic integration. Table 4.1 provides a summary of the main aspects of the institutional setup of the agreements covered in this section.

Table 4.1. Institutional dimension of selected EU integration models

<table>
<thead>
<tr>
<th>External Dimension</th>
<th>Internal Dimension</th>
</tr>
</thead>
<tbody>
<tr>
<td>WTO</td>
<td></td>
</tr>
<tr>
<td>Political Institutions</td>
<td>Technical Committees</td>
</tr>
<tr>
<td>Ministerial Council; General Council</td>
<td>WTO Secretariat + various committees</td>
</tr>
<tr>
<td>EU FTA</td>
<td></td>
</tr>
<tr>
<td>Association Council</td>
<td>Association Committee</td>
</tr>
<tr>
<td>EU-Turkey customs union</td>
<td>Association Council</td>
</tr>
<tr>
<td>EU-Switzerland</td>
<td></td>
</tr>
<tr>
<td>Joint committees</td>
<td></td>
</tr>
<tr>
<td>EEA</td>
<td></td>
</tr>
<tr>
<td>EEA Council</td>
<td>EEA Joint Committee Sub committees</td>
</tr>
</tbody>
</table>

Source: Own elaboration.
From a different perspective, this question is also of interest as regards the development of the EU’s foreign policy. Membership policy might be reaching its limits. There is a need for an alternative policy, especially with regard to countries that do not have the vocation to become a full member, that would nonetheless tie these countries to the EU. Terms such as “virtual membership” or “privileged partnership” are used to describe this new policy. Yet a consensual and satisfactory identification of what exactly these policies should entail remains so far lacking. The review of alternative institutional setups for ENP can therefore contribute to the debate on the privileged partnership option. As such, the ENP itself could possibly provide the answer to this elusive question.

This chapter will elaborate on the nexus between the external and the domestic dimension for ENP countries. The domestic implications of the integration models set out in chapter 2 will be reviewed with a view to determine the most appropriate forms of economic integration between the EU and ENP countries.

The main challenge at this stage is the identification of realistic models of economic integration\[12\] between the EU and ENP partner countries. The following sections evaluate different external institutional setups that can be contemplated for EU-ENP economic integration. Two aspects are discussed: the requirements placed on domestic institutional and regulatory capacities and the scope of actual economic integration that could realistically be achieved.

### 4.1.1. WTO membership

The initial option for some of the ENP countries (Russia, Ukraine and Algeria) is WTO membership (see chapter 3 for details). The objective is to improve the degree of contestability in different sectors of the economy. In addition, the modernisation of the economic legislation in particular in areas such as the protection of intellectual property is also being sought. The institutional requirement of WTO membership can therefore be defined as the ability of a candidate country to implement all the specific liberalisation measures and the improvements in the economic legislation agreed in a round of bilateral negotiations.

The economic integration impact of WTO membership is, however, limited for a number of reasons. The market opening commitments undertaken by the candidate countries are limited by the fact that liberalisation measures agreed during bilateral

---

\[12\] The term “economic integration” combines in fact a number of linked and yet different concepts. Economic integration comprises trade integration to be defined as the elimination of tariff barriers and market integration which in addition requires the elimination of barriers to cross border investments and additional measures to eliminate non tariff barriers such as technical standards and policy induced obstacles. The second aspect is synonymous with “deep integration”.

---

50

CASE Reports No. 71/2007
negotiations subsequently apply on a global scale via the MFN rule. This fundamental characteristic creates a natural disincentive for ambitious market opening measures. The strategy of aspiring members is to give the minimum amount of concessions which will satisfy current members. Secondly, once WTO membership is obtained, the economic integration impact of WTO membership depends on the outcome of global rounds of trade talks. As a result, the WTO should be viewed as a strong external anchor for inducing domestic structures to carry out the initial set of market opening measures linked to the requirements of membership but a relatively weak anchor in terms of ensuring the continuation of trade and investment liberalisation.

4.1.2. Free trade area

In its simplest and textbook form, an FTA aims at the liberalisation of trade in goods by eliminating tariff barriers. In the EU practice, the term free trade area refers to agreements varying in terms of their scope and ambition as discussed in section 2.3 and in chapter 3. An important positive side of such FTAs, is that they include a number of provisions targeting market integration. Typical EU-partner country FTA\textsuperscript{13} covers, on top of trade liberalisation:

- competition provisions with limits on state aids,
- transparent and fair public procurement,
- rights of establishment beyond GATS commitments,
- liberalisation of capital flows,
- harmonisation of standards,
- dispute settlements,
- political dialogue, scientific cooperation, respect of human rights, migrations, money laundering etc. (Francois et al, 2005)

From the standpoint of domestic structures, the requirements for free trade in its simplest form (liberalisation of trade in goods) are rather low and can be summarised as the capacity to reform the domestic import regime coupled with the existence of a functional customs administration. The level of development in terms of state building and the application of the rule of law in the countries covered in this report are generally sufficient to guarantee the sound implementation of bilateral free trade agreements. However, what is strictly necessary for the implementation of a free trade agreement may not be sufficient for deriving most of the benefits from free trade. In

\textsuperscript{13} Including the ones signed with Morocco and Egypt.
Box 4.1. Deep integration: where do they stand? Competition rules, intellectual property and technical barriers to trade

All countries covered in this report have adopted competition legislation, but its application is marred by several problems and there are still major obstacles in this field for successful deepening of integration with the EU (Geradin, 2004). One problem is the lack of political independence. The competition authorities in the region are not distanced from the executive power. It makes the implementation of competition legislation difficult in practice. The second structural deficiency relates to the inability of these institutions to recruit and retain qualified people whereas the application of competition rules requires a highly educated staff with a thorough understanding of complex and intertwined disciplines such as law, economics and business practices. On the other hand, we believe that competition policy is one of the areas where full regulatory harmonisation should be avoided for the simple reason that the EU has recently adopted a new competition regime, which after 40 years of centralised implementation, allows for a significant degree of decentralisation. The new EU regime relies on the existence of a competition law culture which was nurtured by the old system. Therefore given the youth of the competition culture in ENP countries, the regulatory model more suitable for the needs of those countries is believed to be the former EU system with its mandatory notification rules for the granting of individual exemptions to agreements.

As regards the protection of intellectual property, it has to be stated that following their accession to the WTO, the ENP countries have overhauled their system of intellectual property protection. The countries in question (Morocco, Egypt) became signatories to numerous multilateral agreements on the protection of intellectual rights. Egypt for instance adopted a new Intellectual Property Protection Law in 2002 to bring its legislation in line with its obligations under TRIPS. Apart from enlarging the scope of IPR protection, the law also enhances the level of enforcement by stipulating higher fines and prison sentences for convicted violators (USTR, 2005). The government is apparently putting significant resources and effort in ensuring a more serious application and respect of the law (FEMISE, 2004). Morocco seems to be in a different situation with a commendable enforcement practice. It is contended that Morocco "presently possess a competent legislative and repressive arsenal and implementation measures that are as efficient as those of the OECD countries" (Handoussa and Reiffers, 2002). In Russia and Ukraine, the ongoing process of WTO membership also contributed to an improvement in the legislative framework of intellectual property rights but implementation remains a problem. Ukraine and Russia remain on the priority watchlist of the Office of the United States Trade Representative. In Ukraine the main problems relate to optical media piracy in addition to counterfeiting of pharmaceuticals and consumer products (USTR, 2005). In Russia, problematic areas are listed as copyright piracy (films, videos, sound recordings, books and computer software) and counterfeiting of patented and trademarked goods especially for consumer goods, distilled spirits and pharmaceuticals (USTR, 2005). The weak link in the IPR regime of all these countries appears to be the area of enforcement.

In the area of technical barriers to trade, the most visible remaining barrier relates to standards and conformity assessment. The application of mandatory standards and lack of transparency in the rules governing existing standards, technical regulations and conformity assessment procedures act as disincentives to trade. In addition, the implementation of the
The question acquires a different dimension when the FTA’s scope is enlarged, as in the case of AAs with the Mediterranean ENP countries, so as to cover market integration (or deep integration) measures. In light of the above, the situation in ENP countries is somewhat disparate. There has been very little progress in the service sectors, while the introduction of basic competition rules was achieved in all of the ENP countries. As can be seen in the Statistical Annex based on the World Bank doing business database (World Bank, 2005) compared to the world average, Morocco has a more flexible regime in areas related to the contestability of markets such as the conditions for starting a business whereas Egypt scores below global averages. In areas related to red tape in foreign trade, Algeria and Ukraine are outliers on the negative end, while Morocco perform relatively better.

The FTA approach stands as the most realistic and – at least in the short to medium term – the most suitable path to foster the economic integration between the EU and ENP countries. The current ENP strategy vis-à-vis Mediterranean ENP countries is already in tune with this objective. The conclusion of a free trade agreement with Ukraine is contemplated in the wake of this country’s accession to the WTO. The most interesting issue in this respect is the determination of the specific scope of the FTAs with ENP countries. The FTAs will and already do target the liberalisation of trade in manufacturing commodities. But what to do with regard to remaining market integration measures and other sectors such as services and agriculture? This is the question which will be reviewed in the following sections.

---

14 It should be stress that these are very basic rules. In general, large part of economies in question remain monopolised, subsidised and protected.
4.1.3. Customs union

Compared to the free trade area, the main advantage of a customs union would be the elimination of the risk of trade diversion. Adoption of common EU external tariff can lower protection for third countries. Conversely, under the FTA protection towards third countries may remain high, directing “too much” of the ENP countries’ trade to the EU, with a loss to domestic consumers. The EU as the “hub” would then be the main beneficiary to serve the “spoke” markets.

The practical obstacles regarding a customs union scenario are essentially twofold. The external institutional difficulty related to the customs union involves the establishment of the proper political institutions between the EU and the countries concerned ensuring smooth functioning of the customs union. The establishment of a common decision making or even decision shaping body to decide on the rules and regulations related to the common commercial policy would be a challenging task. As the example of the EU-Turkey customs union showed, common decision making is difficult to achieve in practice.

The internal difficulty of the customs union scenario relates to its fiscal and political impact. Since the customs union would require ENP countries to adopt the Common External Tariff, a loss of tariff revenues would ensue. In the short term, this may have a negative impact on fiscal balances. In the longer term, as the economy would adjust to the new competitive pressures the fiscal balance could nonetheless improve on account of increased productivity and economic activity. Finally, the loss of independence over trade policy may be politically difficult to accept for some of the countries and particularly for Russia.

To conclude, the custom union option for ENP countries seems to be difficult to realize in view of the significant institutional problems that it contain.

4.1.4. Partial Internal Market integration

The partial internal market integration involves measures to enhance labour mobility and liberalisation in services trade.

4.1.4.1. Labour Mobility

The integration of labour markets is a difficult aspect of the economic integration between the EU and ENP countries. In realistic terms, the issue of labour mobility comes to the fore in connection with the liberalisation of services trade. Under GATS rules\(^\text{15}\), one of the four recognised methods for the supply of services is the cross

\(^{15}\) More on GATS rules can be found in section 5.2.
border movement of service suppliers which is denoted as the “supply mode no 4”. As such, the liberalisation of trade in services should lead to some liberalisation regarding the movement of labour. In fact, this is exactly the issue that Southern Mediterranean countries are raising under the Euromed trade liberalisation agenda (Hoekman, 2005). The quid pro quo for the lifting of protection in services by Euromed countries is the easing of restrictions by the EU on the temporary movement of Euromed service suppliers. Labour mobility can easily be incorporated in the institutional models for services trade liberalisation mentioned in the previous section. Already the existing templates such as the EEA, the ECT (Energy Charter Treaty) or NAFTA incorporate provisions to that effect. EEA rules are arguably much more ambitious and aim at the integration of labour markets. ECT rules are more restrictive and focus on the temporary movement of workers. NAFTA rules also focus on the temporary movement of business people but allow for more flexible arrangement for this specific category of service suppliers. Annex 1 presents NAFTA provisions related to labour mobility in more detail.

If ENP countries are to be gradually integrated in the European Single Market, the question of the temporary movement of workers must be addressed within a more appropriate framework. There are many constraints on the movement of naturalised persons, most of which stem from the fact that there is no separation between temporary and permanent labour movement. At present, the temporary movement of labour comes under the purview of EU immigration legislation and labour market policy rather than that of international trade. It should be possible to establish a predictable, harmonised and transparent system with the overall objective of allowing the necessary mobility of service providers on a temporary basis without compromising immigration policy.

4.1.4.2. Services trade liberalisation

As regards services trade two broad options are available. The first one, which we shall denominate as the GATS option, rests on services trade liberalisation characterised by the principles of non discrimination and national treatment. This option does not require regulatory harmonisation. The second model, which we shall denominate as the EEA option, is based on regulatory harmonisation. It is essentially the EU model and necessitates the adoption and implementation of the internal market acquis. As discussed above, the EU in its external relations has actually gone both ways. With EFTA countries, the services trade liberalisation was conditioned on the adoption of the EU acquis. With Switzerland, services trade was liberalised in one area (land transport) on the basis of the mutual recognition of

---

16 Regulatory harmonisation refers to the adoption of the EU sectoral policies in the area of services by partner countries.
legislation\textsuperscript{17}, whereas in another area (civil aviation) the adoption of the EU \textit{acquis} became a requirement. Finally under the Energy Charter Treaty (ECT), a GATS-like approach was adopted.

Services industries are in general more regulated than traditional industries. Domestic regulations often act as a non tariff barrier to trade in services. The identification of the most realistic path towards services trade liberalisation in the EU-ENP setting should start with the identification of how regulatory differences will be addressed. The starting point would be to remark that different types of regulation may be appropriate for partners at different levels of economic and institutional development (Hoekman, 2005; Mueller-Jentsch, 2005). Secondly, the objective of regulatory convergence should be the removal of non tariff barriers in services trade. Thirdly, regulatory convergence should only be sought where its benefits outweigh the costs of compliance. This is all the more important where the countries concerned suffer from institutional deficiencies. Finally, regulatory convergence makes sense if the common standards are in line with international best practice. Otherwise convergence will lead to suboptimal policies. For the case of the ENP partner countries, the initial hypothesis is that harmonisation with EU rules for its own sake should be avoided (and this indeed has been recognised in the ENP construction).

\textsuperscript{17} Under mutual recognition, although there is no policy or regulatory harmonisation, the two parties agree to lift mutual barriers to services trade based on the assumption that the level of regulatory oversight practiced by each party is sufficient to protect the general interest.

\begin{table}[h]
\centering
\begin{tabular}{|c|c|}
\hline
\textbf{Box 4.2. The Energy Charter Treaty and the Energy Community Treaty} & \textbf{CASE Reports No. 71/2007} \\
\hline
The Energy Charter Treaty is a multilateral institution which rests on the principle of the adoption of a core set of rules by the parties. This set of rules comprise rules on trade, transit, investment, movement of key personnel and dispute resolution within the field of energy. Of the countries analyzed in this report, Ukraine has ratified the Treaty, Russia is a member of the Energy Charter Conference but has not yet ratified the Treaty, Algeria and Morocco have the observer status to the Energy Charter Conference, and Egypt is not involved. The ECT does not require the adoption of EU rules but nonetheless goes further than simple free trade agreements by incorporating specific elements of the four fundamental freedoms. It allows the application of WTO rules in the energy sector in some aspiring WTO members. In addition it introduces a novel dispute settlement mechanism for private-state disputes which contributes to the protection of foreign investments in the energy sector. Finally it provides for a regional forum for dialogue on energy policy.  
\textbf{The Energy Community Treaty for Southeast Europe} is a very recent regional instrument which covers the EU and nine countries or territories of South East Europe. The major difference between the Energy Charter Treaty and the Energy Community Treaty stem, in addition to the geographical coverage, from the approach to regulatory convergence. The Energy Charter Treaty does not foresee any regulatory harmonisation while the Energy Community Treaty is based on the adoption of the EU acquis in the field of energy by the partner countries. &  \\
\hline
\end{tabular}
\end{table}
As a result, the identification of the most realistic option for ENP countries will necessitate a closer examination of the following parameters for each sector:

- Is the adoption of the EU *acquis* necessary for the liberalisation of trade and investments?
- What are the main regulatory barriers to cross border trade and investment?
- What alternative measures to enhance economic integration can be available?

The suggestions concerning the usefulness of EU *acquis* and potential role of alternative solutions are given in the sections 4.2 and 4.3. Estimates of future conditions for service trade are in section 5.2.

### 4.1.5. Full Internal Market participation: the EEA option

<table>
<thead>
<tr>
<th>Table 4.2. Pros and cons of selected integration models for EU-ENP</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pros</strong></td>
</tr>
<tr>
<td><strong>WTO</strong></td>
</tr>
<tr>
<td><strong>EU FTAs</strong></td>
</tr>
<tr>
<td><strong>EU-Turkey customs union</strong></td>
</tr>
<tr>
<td><strong>EU-Switzerland</strong></td>
</tr>
<tr>
<td><strong>ECT</strong></td>
</tr>
<tr>
<td><strong>EEA</strong></td>
</tr>
</tbody>
</table>

Source: Own elaboration.
The EEA option would allow ENP countries to achieve almost full internal market integration. But the domestic requirements for adopting the EEA blueprint are very high in terms of local institutional and regulatory capacity. The history of regulatory and other reforms in the ENP countries and their level of institutional and regulatory development suggest that full participation in the Internal Market is not really realistic even in the much longer perspective.

The following table recapitulates the advantages and shortcomings of alternative models of economic integration reviewed in section 4.1.

4.2. Prospects for regulatory convergence in service sectors

Since full participation in the EU’s Single Market is precluded at this stage, the identification of the most appropriate form of partial internal market integration will necessitate a case by case analysis. The best and the most realistic model for integration will depend on the characteristic of the sector in question and the progress achieved by specific countries in terms of de-regulation and liberalisation. The rationale for choosing between full regulatory harmonisation and some regulatory convergence would be based on the assessment whether services trade in a specific sector can be liberalised without full regulatory harmonisation. To the extent that full regulatory convergence is not indispensable, alternative measures to enhance opportunities for cross border trade and investment are to be identified. This study focuses on the tradable backbone services defined as financial services, energy, transport and telecommunications.

4.2.1. Financial services

The EU acquis in this sector are amongst the most developed and the most meticulously detailed sections of the internal market acquis. They aims at the regulatory oversight of a highly competitive and highly complex sector. In addition, the EU acquis are also in the midst of change. The Financial Services Action Plan is still being implemented. Finally the acquis rest on the single passport and home country prudential control principles which necessitate a very high degree of mutual trust in partner countries’ institutions.

18 There is also substantial effort involved in harmonisation of technical standards that a country integrating with the EU is expected to undertake. Harmonisation of technical standards relates mostly to trade in goods. As the EU integration has shown, it has been gradually happening alongside liberalisation lowering tariffs for good (on basis of FTAs). As this type of regulatory convergence is relatively better covered in the literature, we restrict this section to opening up of sectors that are rather more challenging in terms of regulation.
It is worth recalling that unlike other service industries where a higher degree of regulatory convergence is essentially needed to boost cross border trade, in financial markets the onus will be on prudential regulation at the national level. An effective domestic prudential regulation is a pre-requisite for cross border integration. There will however be less need for regulatory convergence.

In view of the above, the most appropriate method for the integration of the financial services is actually the path of domestic reforms. There does not seem to be either the need or a sizeable benefit in the complete and quick adoption by the ENP countries of the relevant acquis. On the contrary, the EU legislative framework may in this instance be counter productive by straining the regulatory capacity as well as by focusing regulatory oversight out of the most important spheres.

The timing and the sequencing of the introduction of foreign competition and the strengthening of the capacity of banking supervision is, however, critical. A sound regulatory framework is indispensable before the introduction of a full fledged competition. Therefore, properly designed regulatory reform and the introduction of competition is of crucial importance here.

Possible institutional models to enhance integration

We believe for all those reasons that the EU acquis may not be the most relevant template for the ENP countries. Developing countries would need a different regulatory framework than one designed for developed countries (Hoekman, 2005; Mueller-Jenstch, 2005). A case in point is the observation that the EU acquis contain very detailed rules about securities market legislation while the need for ENP countries lie elsewhere, essentially in the development of an appropriate regulatory framework for the banking and insurance sectors which are obviously at a different level of development. Similarly the onset of Basel II is also a case in point. The risk evaluation and control approach reflected in Basel II has been tailored in accordance with the needs of highly sophisticated financial markets. In contrast, if there is to be regulatory convergence for ENP countries, the needs of those countries would better be served by an approximation of legislation where the target would be the soon to be replaced Basel I regulations.

The role of foreign direct investment in the banking sector is also of key importance as demonstrated by the experience of the new EU member states. The inflow of FDI in the banking sector and the acquisition of domestic banks by international banks would contribute to the improvement of prudential security and the introduction of modern banking practices (outlook for financial services in the ENP countries for the next few years can be found in section 5.2).
4.2.2. Energy

The energy sector in ENP countries is still largely organised according to the traditional model. Utility companies remain state owned and vertically integrated. With the exception of Egypt, independent regulatory authorities are lacking and tariff policies are determined by the executive bodies where energy price subsidies are used as an industrial policy tool. In short, the situation is comparable to the pre-liberalisation situation in EU countries. As such, the EU acquis would provide a valuable reference point for the policy reform process in the energy sector of ENP countries. However, given the difficulties in achieving regulatory convergence, the optimal path in the medium term should be that of domestic reforms.

As to the prospects of cross border integration and an eventual participation in the Internal Market, it needs to be pointed out that unlike many other services sectors, the energy sector and particularly the electricity sector require a physical infrastructure to link the trading regions. This is indispensable for cross border trade. There are several interconnection projects completed in recent years but the capacity of many interconnections is still low. Capacity expansions should therefore be planned (Mueller-Jentsch, 2005). Furthermore, the increasing need for interconnection brings to the fore the question of the technical compatibility of systems as well as regulatory convergence issues.

Possible institutional models to enhance integration

There are already two multilateral and one bilateral instrument in this area (Energy Charter Treaty, Energy Community Treaty, Energy Dialogue). The Energy Charter Treaty aims to accomplish some if not most of the above mentioned tasks. Therefore, the primary aim for the ENP countries should be to fully participate in the ECT. In the medium term, ENP countries that are members of the Energy Charter Treaty could “graduate” to the Energy Community Treaty which requires a more ambitious approach in terms of regulatory convergence. The ensuing domestic reforms would then pave the way for a smoother path towards integration with the Single Market. In the longer term, we believe that EU rules could provide a basis for the integration of energy markets. Cross border integration can provide a valuable support to domestic liberalisation as illustrated by the EU experience. Private investors are more willing to invest in larger markets especially if investor protection schemes have been made available through the regional institutional setups mentioned here. In addition, the enlargement of the potential market facilitates the implementation of measures such as the

---

19 The term plurilateral is used to describe regional institutions as opposed to the term multilateral which denotes global institutions.
introduction of competition and the unbundling of the activities. Otherwise the small market size acts in many ways as an obstacle.

The case of Russia merits a special mention in view of the importance of this country as an energy provider. Russia has so far been very reticent to get fully involved in the Energy Charter Treaty. The limitations that full membership of the Energy Charter Treaty would impose on Russian energy policy have so far been considered too high price to pay. Therefore in the short and medium term, the EU-Russia relationship on energy matters is likely to be pursued under the institutionalised Energy Dialogue between the two parties (A more detailed analysis of this situation is provided in chapter 6).

4.2.3. Transport

We believe that in the area of air transport, the adoption of the EU *acquis* for further trade integration seems to be indispensable for two reasons. Firstly, the liberalisation of air traffic requires an overhaul of the existing structure of agreements between the ENP countries and the EU. The present system is based on bilateral air service agreements (ASA) between governments. These ASAs regulate market access on cross border routes according to the Chicago Convention of 1944. The EU system calls for abolition of the ASAs for internal trade. That is how an internal market can be created. Secondly, unless this option is implemented, there is very little scope in extending free trade essentially because in an area where security concerns are of essence, regulatory harmonisation seems to be indispensable for the enjoyment of full liberties in air travel. Therefore the liberalisation of trade in air transport between the EU and the ENP countries can be based on the Swiss-EU bilateral agreement model where the trading parties take on the EU *acquis*.

It can be maintained, however, that full regulatory convergence would not be needed for sea transport. The main structural deficiencies can be remedied by domestic reforms that would concentrate on eliminating the inefficiencies in port management (more on this in section 5.2).

*Possible institutional models to enhance integration*

Given the importance of the adoption of the EU *acquis*, the EU-Swiss bilateral agreement can be suggested as a model for the ENP countries in air transport. In this respect, it is worth pointing out that the European Commission is slated to start new negotiations with Balkan countries, which are not yet candidates, for open sky agreements that require *acquis* compliance. This would imply the conclusion of a sectoral agreement covering regulatory principles as well as air
A regional multilateral option would be the establishment of a common transport area based on the adoption of EU rules for air transport and the identification of a core set of common rules for other transport services. At least one of these options is necessary for the granting of cabotage rights as well as rights to fly domestic routes to EU companies (outlook for the transport sector in the EU Neighbourhood for the next few years can be found in section 5.2).

### 4.2.4. Telecommunication

In telecommunications, full policy harmonisation is not really needed for the enhancement of cross border trade and investment. The establishment of a market friendly domestic regulatory framework aiming at the introduction and protection of full and fair competition and the presence of an independent regulator to oversee sectoral developments are arguably more important. Therefore the institutional framework for integration between the EU and ENP countries in this sector should not necessarily imply full regulatory harmonisation. Domestic reforms could nonetheless take into consideration the early experience of the EU Member States and the EU policies of the early 1990s which were designed to address the essential question of the introduction of competition in hitherto state dominated markets. It should also be pointed out that, just like in financial services, openness to FDI is the best fast track method for securing a competitive telecommunication market. One key condition is that the entry for competitors is not protected.

**Possible institutional models to enhance integration**

Unlike in other sectors, in telecommunication the GATS framework provides a suitable institutional basis for the advancement of economic integration between the EU and the Southern Mediterranean ENP countries. The reason is that there exists a separate agreement covering the telecommunication sector under the GATS which allowed for a more ambitious liberalisation outcome. This Basic Agreement on Telecommunications is moreover complemented by a “Reference Paper” which was the first instance where multilateral disciplines included explicit provisions on domestic regulatory principles. Therefore the Basic Agreement and the Reference Paper constitute a suitable and stronger policy anchoring framework when compared to other sectors covered by GATS. Therefore, the improvement of the ENP countries’ commitments such as the lifting of monopoly rights in fixed line telephony under the Basic Agreement should be sought.

---

21 It is known that Morocco has expressed interest in the “open sky” agreement.
4.3. Deeper integration options between ENP countries and the EU

4.3.1. Strengthened bilateralism

An assessment of the institutional requirements for deeper integration between ENP countries and the EU should start with an evaluation of the prevailing ENP strategy. As discussed in chapter 3 and section 4.1, the currently pursued economic integration strategy rests on the implementation of the free trade agreements with Mediterranean ENP countries and the PCAs with Russia and Ukraine. The analysis carried out in chapter 5 shows that the enlargement of the scope of the FTAs would bring about considerable benefits for ENP countries. In particular, the gradual incorporation of agriculture and the services sectors should be targeted. In addition to these measures which will focus on liberalisation of trade, accompanying measures to address impediments to market integration and to eliminate non tariff barriers to trade and cross border investments should also be considered.

The approach will necessarily be multi-speed, depending on the progress in domestic reforms. The question is whether this approach, that can be called "strengthened bilateralism", can be strong, credible and effective enough to enable implementation of necessary domestic reforms given the nexus between the external institutional setup and domestic structures. The difficulty in this regard is the political feasibility of domestic reforms; namely whether reforms can actually be implemented and consolidated under current conditions. Given the remaining challenges in ENP countries in terms of market liberalisation, as illustrated in the preceding section, the feasibility of domestic reforms remains an open issue. What transpires from the analysis of the previous section is that the majority of domestic political dynamics of these countries did not, in the past, create the right conditions for market liberalisation measures. This is where an external anchor might be needed to ensure a more consistent progress towards economic integration.

The following suggestions can be made to enhance the ability of the bilateral ENP approach to act as a more effective anchor for domestic reforms in ENP countries:

a) **Stronger conditionality.** The EU could contemplate stronger use of conditionality in carrying the ENP. This could specifically refer to financial support provided under ENPI. The disbursement of funds can be more closely linked to the achievement of ENP countries of specific milestones or benchmarks to be determined and specified in advance. The evolving nature of the action plans can be particularly helpful. Periodic reviews can provide the opportunity to assess both the implementation and the overall adequacy of the measures.

This proposal is clearly not without problems. One issue linked to the transposition of the conditionality approach to the ENP strategy is the difficulty of actually
implementing the conditionality from the donor’s (EU) side. It all looks good while there is progress on the ground but if and when reforms stall, the decision to suspend aid becomes nonetheless very controversial. Given the possibly remaining differences in national foreign policy objectives among Member States with regard to ENP countries, difficulties may arise in building a consensus among Member States for this politically sensitive decision. The second difficulty related to increased conditionality is the “image” problem that this linkage may trigger. An overt “conditionality” will, no matter how noble the goal is, come to be resented by the ENP domestic constituencies. A case in point is the image of the IMF in developing countries. This is where the political shortcoming of the bilateral approach with its lack of a common political vision or goal acquires significance. Conditionality works better, as illustrated perfectly by enlargement strategy, if there is a common political goal embraced by the domestic public opinion as well. To conclude, we believe that the incorporation of a strengthened conditionality component in the ENP could at least merit an in-depth analysis which would look at the potential gains but also take into consideration all the mentioned potential difficulties.

b) Motivating competition between ENP countries. The logic behind “conditionality” element is that best reformers among ENP countries receive additional incentives. ENPI would therefore be structured so as to have a regional component which would influence national allocations on the basis of specific benchmarks set to determine the pace and effectiveness of domestic reforms. This approach would aim to transpose the impressive results obtained in the accession process from generating competition between the candidate countries.

c) Reliance on existing institutions. The above propositions would be based on existing EU institutions, with a governance facility within the future ENPI.

4.3.2. “EEA Light“

Economic integration movements do not happen in a political vacuum. A sense of a common political vision is generally needed for more ambitious forms of economic integration. As an alternative to the “strengthened bilateralism” approach and with a view to improve the political attractiveness of the ENP, a multilateral institutional approach can be contemplated. The effectiveness of the ENP in terms of constituting a credible external anchor for domestic reforms would thus be improved, especially if “conditionality” is to acquire a more visible dimension. This instrument would supply the relevant actors with a sense of political common goals, which may be necessary to
avoid discouragement on the difficult road to closer economic integration. The lack of a
genuine political partnership could potentially lead to a loss of momentum of the whole
ENP process when the initial era of easy economic reforms in ENP countries comes to
an end and political leaders are faced with far more difficult and sensitive choices.

We believe that a combination of the institutional aspects of the EEA and of the
Energy Charter Treaty to create an “EEA Light” can be envisaged. The extension of the
scope of the EEA – coverage of services and market integration measures as well as
agricultural trade liberalisation – can be accompanied by the institutional structure of
the Energy Charter Treaty\(^\text{22}\). For sectoral policies, unlike in the EEA and in the Energy
Community Treaty, there would not be any automatic requirement for full regulatory
harmonisation. The degree of regulatory harmonisation would be decided on a case by
case basis in view of the characteristics of each sector. For instance, full regulatory
harmonisation could be targeted for air transport. On the other hand, the adoption of a
common set of rules introducing the national treatment principle for intra regional
operators, opening the market to intra regional competition, protecting cross border
investments and eliminating all discriminatory practices could provide the basis for
market integration in such areas as telecommunication and energy. These rules can be
augmented if needed by additional sectoral provisions. That would be the case for
instance for financial services where common rules for prudential supervision can also
be envisaged. The establishment of a regional political institution (an “ENP Council”) to
oversee economic integration would also alleviate concerns about policy dependence
and therefore provide a sound political basis for further economic integration.

4.4. Conclusions

To conclude, the fostering of economic integration between the EU and ENP
countries requires a more creative institutional setup. This chapter identified possible
options. The key points are threefold:

- **WTO membership.** A first step for Russia, Ukraine and Algeria.
- **Strengthened bilateralism.** The scope of the FTAs should be enlarged to include
additional trade and market integration measures. In particular, the gradual

---

\(^{22}\) The Energy Charter Treaty (ECT) is not generally seen as a success story. That is essentially due to the failure
of the ECT’s overarching political goal of tying Russia to WTO disciplines in energy. But the institutional
structure of the ECT provides an interesting blueprint for the ENP. It goes beyond WTO commitments by
introducing new disciplines such as competition rules, private-state dispute settlement for investment
disputes, increased flexibility for the movement of key personnel etc. In addition it creates a political platform
for policy dialogue. It shies away from creating a policy taker/follower framework, a characteristic of the EEA
which stipulates the adoption of the EU *acquis*. As such, the ECT model creates a politically more acceptable
framework for ENP countries. Unlike the EEA however, it has a mono-sectoral ambit.
incorporation of the services sectors and agriculture is essential. Furthermore, the institutional structure of ENPI should be reviewed with a view to strengthen the principles of conditionality and inter ENP competition.

- **“EEA Light”**. Alternatively, the creation of a new plurilateral instrument combining the coverage of the EEA (plus agriculture) and the institutional setup of the Energy Charter Treaty can be envisaged. The need for harmonisation would be lower than in the current EEA. This would help to foster the political dimension of the ENP which stands out as the main shortcoming of the bilateral approach. However, it does not seem to be a possible near-term solution.

Future deeper integration options going beyond WTO agreements are depicted on Figure 4.1 below.

### Figure 4.1 Future deeper integration options between the EU and Neighbouring countries

<table>
<thead>
<tr>
<th>Feasible</th>
<th>Long-term</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strengthened bilateralism</td>
<td>“EEA Light”</td>
</tr>
<tr>
<td>=</td>
<td>=</td>
</tr>
<tr>
<td>Stronger conditionality</td>
<td>Less regulatory harmonisation than in the EEA</td>
</tr>
<tr>
<td>↓</td>
<td>↓</td>
</tr>
<tr>
<td>Motivating competition between ENP partner states</td>
<td>Politically and economically attractive for the ENP partners</td>
</tr>
</tbody>
</table>

Source: Own elaboration.
5. Effects of economic integration

5.1. Trade in goods – assessment of selected integration modes

- The coverage and specific features of agreements such as FTAs are extremely important for their impact on partners – they can be decisive for whether any particular FTA brings benefits to ENP countries or is actually harmful.

- The existing FTAs usually fall short of truly liberalising trade but cover many aspects beyond tariff barriers. The first feature is unfortunate. Protection of agriculture and service markets significantly limits the economic relevance of FTAs for partner countries. The second feature has a large, yet somewhat unexplored, potential to promote gains to both sides – for instance by stimulating reform effort and promote competition at domestic markets.

- WTO accession by countries that are not yet members will not have substantial direct economic impact on bilateral trade. Its crucial importance – for Algeria, Russia and Ukraine and the EU rests in that it will ensure stability and predictability for FDI (also in the services sector) and will enable further steps in liberalisation of economic relations.

- Implementation of the partial EU-Morocco FTA is supposed to bring the highest gains from all the scheduled EU FTAs.

- Fully functional trade liberalisation would result in significant boost to trade between the EU and ENP countries, particularly Ukraine, Algeria and Egypt. These gains are not necessarily conditional on adoption of the EU acquis.

This section discusses evidence on the consequences of various trade integration models. The impact on both the EU and ENP countries is analysed.

5.1.1. The importance of coverage of trade agreements

While discussing the expected effects from any form of trade integration, such as an FTA one needs to take into account the difference between an ideal version of it
(full liberalisation) and the much more common versions where only some sectors (e.g. manufacturing goods) are covered. The difference between the two scenarios can be substantial, and in particular the coverage of an FTA can be decisive for it being advantageous or disadvantageous for less developed EU partners.

Generally speaking, for a country possessing comparative advantage in food and agricultural production, typical EU FTA covering trade in manufacturing goods may fall short of creating free trade. The exchange of food and agricultural products remains highly restricted, with the very complex system of concessions and tariff and non-tariff barriers in place in the EU. EU partner countries, in turn, typically also set up rather substantial protection in agriculture, often higher than that of the EU, to counteract the subsidisation of food production in the European Union. In this way, potentially most profitable exchange for both parties remains shielded from international trade. Moreover, often the exchange of labour intensive commodities is nearly through all the transitional period when the FTA is implemented (10 years or more) bounded by quotas or other restrictive measures. This is to say, that producers of labour intensive commodities from the ENP countries (in which the region also possesses comparative advantage vis-a-vis the EU) can wait as long as 10 years to get an access to the EU market. This is another potentially most beneficial area, where gains from trade for both parties are being eroded over time due to remaining restrictions.

However, an important positive side of FTAs signed by the EU, is that they typically include a number of provisions (e.g. related to capital flows, standards, political dialogue, etc.) that could lower non-tariff barriers to trade, as discussed in section 4.1.

Provided that the whole liberalisation program is attractive and strict but realistic timetable is set, such wider in scope FTAs could bring substantial gains. Namely they can support reforms in less developed EU partner countries, similarly as they did in the case of current new Eastern European member states. The last EU enlargement has shown that wholesale adoption of modern European governance rules and standards can bring gains (and costs) in excess of benefits from pure external liberalisation. For example, it can overcome such deficiencies as monopolised markets and corrupted administration found in much of the EU’s post-communist and Arab Mediterranean neighbourhood.

5.1.2. WTO accession, FTA formation, domestic liberalisation – empirical results

This section reviews some of the recent empirical literature looking at the impact of particular trade liberalisation measures involving the countries covered in this study. While such estimates are necessarily subject to wide error margins they are

23 See Table 5.2.
important to understand the magnitude of effects and to make comparisons between likely consequences of particular forms of trade integration.\(^{24}\)

The estimates gathered here were obtained as results of simulations within general computable equilibrium models (CGE). These tools allow for modelling of producers and consumers behaviour, take into account the underlying structure of production of trading partners, and allow for estimating effects on production, income, employment and trade flows in the short and longer run. The elimination of tariffs (or export taxes or non-tariff barriers) works through the change of import and export prices, and has an effect on domestic prices, which in turn impact demand and production. Here, we focus mainly on welfare effects.

**Effects for the EU**

Elimination of barriers to trade in industrial goods would open new markets for EU manufacturers and at the same time expose them to new competition. Existing studies suggest that overall direct effects of these processes on EU would be positive, albeit very small (see table 5.1).\(^{25}\) In the longer term, initially small positive effects can be enhanced by better direct investment opportunities in the European Neighbourhood. Precisely for this reason trade-related provisions of the FTAs or even obligations connected with WTO entry of Algeria, Russia and Ukraine are very important from the EU perspective. On top of this, labour costs differences between the EU and its Neighbourhood will stay large, and domestic demand in the ENP states will continue growing. These two features will improve long-term investment prospects.

**Effects for the Neighbouring countries**

The magnitude of effects for the ENP partners will be more pronounced. The entry of Russia into WTO is estimated to be domestically welfare improving on the back of lower import tariffs and also through phasing out of non-tariff barriers and easier dispute settlements.

The implementation of a the typical EU “partial” FTAs will lead to important welfare gains for countries such as Morocco that has large proportion of trade with the EU, and is expected to realise productivity gains in labour-intensive sectors such

\(^{24}\) Here, we ignore the benefits arising from deep integration.

\(^{25}\) If any shrinkage of the EU production can be expected, this will most likely occur in the labour-intensive sectors such as textile production, as predicted by the model of Augier and Gasiorek (2001). However, given the fact that they modelled simultaneously integration between the EU and the whole Mediterranean (including Turkey, Cyprus and Malta among others), and some of which already happened, it is reasonable to expect that the effect of FTAs analysed here on the EU production levels will be small (as predicted by Francois et al, 2005). Overall effect is expected to be welfare improving, due to improved consumer welfare and other industries-effect.
as textiles or chemicals very quickly, once the access to the EU market is given. Thus, even a partial EU-Morocco FTA can be significantly welfare improving.

FTA between the EU and Egypt envisages on Egyptian side faster elimination of tariffs on capital goods and intermediates, that were initially less protected anyway, and much more gradual removal of protection of domestic production of consumer goods. On the back of this provisions, Francois et al (2005) got the result that Egyptian domestic price distortions during the transitory period can lead to inadequate preparations to the competition with the EU producers once FTA is implemented (2018). As a result, partial FTA can be welfare reducing for Egypt (while negligible for the EU), and lead to manufacturing plant closures. It seems that under current provisions, only the full FTA, covering also agricultural trade, can increase domestic welfare.

Finally, the simulations of future EU-Russia (together with EU-Ukraine) FTA lead to the conclusion that welfare gains under the typical “partial” FTA are not certain, however even the partial FTA can lead to increased domestic production in Russia. Similar effect should be expected for Ukraine. However, full FTA could be more beneficial not only to Russia or Ukraine, but could be also of some importance for the EU. For Russia, removal of industrial and agricultural tariffs coupled with liberalisation of services would bring incentives to regulatory reforms, and boost agricultural and services trade.

**Longer-term concerns**

Looking more into the future, liberalisation of trade with ENP countries that are characterised by substantially lower wage costs will facilitate sectoral changes in the EU, with relative losses for labour-intensive sectors. However, this process should be treated as a natural long-term consequence of globalisation. In particular, competition from the side of Asian manufacturers seems to be of much higher importance than evolution of trade relations with ENP countries.

Another important issue is liberalisation of agricultural trade. While this issue is not covered in detail in this report, as political considerations (primarily linked to the functioning of CAP) make substantial progress in this sphere unlikely over the next few years, one should remember that the impact of measures liberalising trade in agricultural products could be quite pronounced, particularly for ENP countries. Conforti and Velazques (2003), for instance, estimate that 45% reduction of EU export subsidies would boost agricultural supply of Mediterranean countries across all categories of agricultural products. On average, Mediterranean ENP countries welfare gain from extending FTA to agricultural products could be in the range of 0.5% of GDP, a similar magnitude to services liberalisation (IARC, 2005).  

26 Yet, the same paper shows that full liberalisation, while boosting output of some agricultural products even further, can cause lower production of some others.
### Table 5.1. Welfare gains from liberalisation of trade – selection of empirical results

<table>
<thead>
<tr>
<th>Country (study)</th>
<th>Gains for the EU (% change of national income)</th>
<th>Gains for ENP countries (% change of national income)</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>WTO accession</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Russia (Rutheford et al, 2005, Jensen et al 2004)</td>
<td>n/a</td>
<td>3.3-3.4%</td>
<td>Welfare change for the EU greater if coupled with gas prices increases for Russian domestic users</td>
</tr>
<tr>
<td>Russia (Manchin, 2004)</td>
<td>Negligible welfare change and marginal decrease in production (very close to 0)</td>
<td>High welfare improvement and increased production</td>
<td></td>
</tr>
<tr>
<td>Former Soviet Union (Vinhas de Souza, 2004)</td>
<td>Welfare improving for EU15, welfare reducing for some new member states and 0% change in production</td>
<td>Marginally welfare reducing and no change in production</td>
<td></td>
</tr>
<tr>
<td>Ukraine* (Eremenko and Lisenkova, 2004)</td>
<td>n/a</td>
<td>Welfare gain of 1.1% of GDP from bringing the steel production to WTO rules – elimination of subsidies and opening for external markets</td>
<td></td>
</tr>
<tr>
<td><strong>EU-ENP Free Trade Agreements</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Algeria, Egypt, Morocco (IARC, 2005)</td>
<td>Net consumer welfare gain of 0.2% of GDP from free trade in industrial goods; Potentially important long-term gains in services (investment effects); Negative social impact from agricultural liberalisation</td>
<td>Welfare gain of 0.8% on average. Services and agricultural liberalisation could add 0.5% of GDP, each</td>
<td>The numbers are averages from a number of other studies</td>
</tr>
<tr>
<td>Egypt (Francois et al, 2005)</td>
<td>No change in welfare and production (0.1% with full FTA)</td>
<td>-1.1% (0.5% with full FTA)</td>
<td>Comparing actual FTA with full trade liberalisation</td>
</tr>
<tr>
<td>Egypt (Augier, Gasiorek, 2001)</td>
<td>welfare: 0.04% manufacturing production: -1.43%</td>
<td>welfare: 0.75% manufacturing production: -10.07%</td>
<td>Actual FTAs happening simultaneously (liberalisation of tariffs, some harmonisation, lowering domestic distortions – allowing for productivity improvement in the ENP countries)</td>
</tr>
<tr>
<td>Morocco (Augier, Gasiorek, 2001)</td>
<td>Marginal fall in welfare and marginal increase in manufacturing production (slightly welfare improving with full FTA)</td>
<td>Negligible fall in welfare and increase in production (but highly welfare improving under full FTA)</td>
<td>Typical EU FTA</td>
</tr>
<tr>
<td>Russia (Manchin, 2004)</td>
<td>Welfare improving and negligible increase in production</td>
<td>Welfare improving and 0.2% increase in production</td>
<td></td>
</tr>
<tr>
<td>Former Soviet Union (Vinhas de Souza, 2004)</td>
<td>Welfare improving and negligible increase in production</td>
<td>Welfare improving and 0.2% increase in production</td>
<td></td>
</tr>
<tr>
<td>Ukraine (Emerson et al 2006)</td>
<td>negligible</td>
<td>4.7% welfare gain through lowering of non-tariff barriers to trade</td>
<td>“deep” FTA</td>
</tr>
</tbody>
</table>

Notes: table contains references to static welfare gains

* – slightly different approach; partial equilibrium analysis

Source: Own elaboration.
**Trade openness and tariff rates**

The empirical results of CGE models should be treated with caution due to various limitations inherent to the modelling approaches and data availability. The results reported above can be supplemented with the simple, straightforward evaluation of estimated gains from regional trade integration. In general, the integration of the neighbouring countries with the EU will be productivity-increasing if:

- **tariffs in the Neighbourhood for the third parties are low, limiting the possibility of trade diversion (buying higher-cost production from the EU, instead of lower-cost production from a third party, with a loss for domestic consumers);**
- **high percentage of trade is being carried out with the EU, increasing probability of trade creation (shift from the consumption of higher-priced domestic production to cheaper imports);**
- **trade is initially a small share of national production.**

The summary data gathered in Table 5.2 confirm the results obtained in the CGE models. FTA between the EU and Morocco seems to be the most welfare improving. The EU is a “natural” trading partner for Morocco, and high Moroccan tariff protection calls for its lowering. FTAs to be concluded with Russia and Ukraine have the potential to bring important productivity gains, especially for Ukraine, given its smaller size. In case of Ukraine, there is almost no risk of trade diversion, as the country has concluded FTAs with its other important partners from the CIS block. In fact, tariffs weighted by all industrial imports in Ukraine are half the size of the MFN weighted by imports.

### Table 5.2. Trade openness and tariff rates

<table>
<thead>
<tr>
<th></th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
<th>Russia</th>
<th>Ukraine</th>
<th>EU</th>
</tr>
</thead>
<tbody>
<tr>
<td>share of trade in GDP</td>
<td>60%</td>
<td>42%</td>
<td>71%</td>
<td>59%</td>
<td>112%</td>
<td>-</td>
</tr>
<tr>
<td>share of trade with the EU25 (2004)</td>
<td>54%</td>
<td>30%</td>
<td>62%</td>
<td>42%</td>
<td>33%</td>
<td>-</td>
</tr>
<tr>
<td></td>
<td>total trade</td>
<td>18.7*</td>
<td>20*</td>
<td>33.4*</td>
<td>14.5</td>
<td>9.7</td>
</tr>
<tr>
<td></td>
<td>agricultural products</td>
<td>23*</td>
<td>66.4*</td>
<td>53.2*</td>
<td>16.0</td>
<td>37.6</td>
</tr>
<tr>
<td></td>
<td>non-agricultural goods</td>
<td>18.1*</td>
<td>12.8*</td>
<td>30.1*</td>
<td>-</td>
<td>5.9</td>
</tr>
</tbody>
</table>

| probable effects of FTA with the EU | probably positive, after tariff cuts | risk of trade diversion if third party protection stays high | probably positive | probably positive | probably positive | - |

Note: * – simple average rates

27 Weighted by imports: a) qualifying and b) non-qualifying for MFN treatment.
rates (World Bank, 2005c), signalling very low protection towards third countries (CIS). Removing the remaining restrictions on imports of final goods from the EU would stimulate stronger competition on the Ukrainian market.

Perhaps it is too early to estimate welfare gains from the EU-Algeria FTA, but given the current trade shares and high protection, it may easily be welfare improving, provided that the FTA locks in necessary reforms and that Algeria lowers its overall import protection before FTA enters into force. The risk of trade diversion exists in the case of Egypt, unless the country lowers trade barriers towards third-countries.

5.1.3. Reduction of import duties – fiscal impact on ENP countries

Reduction of import tariffs will normally lead to a decrease in government revenues, at least in the short run. The negative impact on the fiscal stance will be more important for countries where tariff revenues represent a non-trivial part of government revenues. Among analysed countries total tariff revenues amounted to around 1% in Ukraine and Russia, between 2 and 3% of GDP in Morocco and Algeria but close to 5% in Egypt. Given that integration with the EU will lower import duties only on imports from the EU and that the process normally takes several years (such as in the case of the EU-Egypt FTA) one should not expect direct fiscal effects of foregone revenue from import duties to be particularly important in the debate. Moreover, increased economic activity and tax reforms that are likely to be triggered by an EU-ENP FTA can result in higher tax collection, mitigating the effect of lower tariffs revenues.

5.1.4. Potential imports from ENP countries

In this section we provide some quantitative estimates of the potential for trade between the EU and ENP countries. These estimates are based on the gravity trade model where the potential intensity of trade is determined by the respective economic size of partners and the distance between them. In other words, the approach allows estimating the amount of bilateral trade that would happen under “normal” trading conditions, as opposed to the current situation when trade is heavily distorted by high tariffs and non-tariff barriers.

The approach presented in this part is complementary with the outcomes from computable general equilibrium models presented earlier. For example it does not

---

28 The gravity approach to foreign trade was pioneered by Jan Tinbergen, Dutch economist, winner of the first Nobel prize in economics (Tinbergen, 1962). It has since gained popularity thanks to its empirical and theoretical appeal.

29 Such as among highly developed economies.
take into account the effects on other (non-EU) trade partners of ENP countries, does not explicitly model behaviour of economic agents, and the focus is exclusively on trade flows. Still, it is interesting to compare the magnitude and direction of effects using different methodology.

Concerning ENP countries, the latest gravity analysis has been carried by Peridy (2005). He carries out a traditional gravity equation estimation based on two different scenarios. The first scenario assumes liberalisation and the adoption of the EU acquis by the ENP countries. The second scenario is limited to trade liberalisation. Export potential is defined as the difference between estimated exports and actual exports as a percentage of estimated exports. The results are summarised in Table 5.3.

Table 5.3. ENP export potential to EU15

<table>
<thead>
<tr>
<th>Country</th>
<th>Actual exports to EU 15 million USD (2003)</th>
<th>Potential gain in exports to the EU15 (%) with EU acquis</th>
<th>Potential gain in exports to the EU15 (%) without EU acquis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Russia</td>
<td>48038</td>
<td>14.2</td>
<td>4.7</td>
</tr>
<tr>
<td>Ukraine</td>
<td>3314</td>
<td>37.1</td>
<td>30.2</td>
</tr>
<tr>
<td>Algeria</td>
<td>13483</td>
<td>24.4</td>
<td>18.1</td>
</tr>
<tr>
<td>Morocco</td>
<td>6153</td>
<td>7.6</td>
<td>12.1</td>
</tr>
<tr>
<td>Egypt</td>
<td>2977</td>
<td>27.8</td>
<td>24.2</td>
</tr>
</tbody>
</table>


Among the countries covered in our study, Ukraine followed by Egypt and Algeria stand to benefit most from trade liberalisation. The results suggest that Moroccan and Russian exports to the EU are already not too far from the potential. This may be due to the fact that Morocco has benefited from preferential access to EU markets since 1960s and Russian exports are dominated by products (hydrocarbons), where the EU does not protect its market. One other significant result of this estimation is that the difference in potential trade under the two scenarios is not as large as one would tend to think. This may be due to the fact that other barriers to trade, such as distance tend to dominate the effects of legislative adaptation. This implies that even without adopting the acquis, ENP countries may capture gains from increased trade with the EU, provided they can liberalise their trade regimes. By the same token, the EU could ensure similar gains provided it eases access to its markets and motivates ENP countries to carry domestic liberalisation policies.

---

30 Tochitskaya and Vinhas de Souza (2005) come to similar results for Ukraine, which they find to "under-trade" with the EU, using the same methodological approach.
5.2. Trade in services

- **Liberalisation of trade in services** means fewer restrictions on movement of people and capital as well as freedom of establishment. Although supposed to bring beneficial effects to both sides, it is likely to be objected by interest groups and has already proved to be difficult to achieve even among highly developed and integrated economies.

- **Current pattern of trade in services** between the EU and ENP partner countries is typical for trade with less-developed regions. The EU is a net buyer of services to which market access in ENP economies is restricted, absorbs skilled professionals from neighbouring states and sells more high-tech and capital intensive services.

- **Mutual commitments** have been made in action plans or relevant documents regarding development of service sector in ENP economies. Besides, in some of the ENP countries governments have embarked on domestic reforms to increase efficiency and competition. Some other policies were announced. They will most likely affect EU-ENP countries trade in services, although the impact will vary by country and by service market.

5.2.1. Full liberalisation of trade in services: freedom of movement and establishment

Freedom of movement of services within the internal market (“some parts” of which are to be offered the ENP countries) means freedom to provide services and freedom of establishment. For the ENP countries it would mean that based on the principle of reciprocity, selling specific services would not be restricted neither in the EU nor in an ENP economy. Similarly, neither an ENP country nor the EU should restrict the establishment of a company or a subsidiary with respect to the nationality of owners or providers of services.

5.2.2. Effects of liberalisation are likely to be positive for both parties

There are numerous positive effects of liberalisation of trade in services. It is estimated that welfare gains within the EU15 from creating fully functioning internal market for services would range from additional 0.3% to 1.8% of GDP growth and up to 2.5 million new jobs, stemming mainly from higher productivity and price convergence towards the best performers (Vogt, 2005). While the effects of a partial
liberalisation of trade in services with the ENP countries, with some restrictions especially regarding employment of workers from the ENP, would be positive, they are likely to be marginal for the EU.

Given the small size of the service sectors in the ENP countries (see table 2.2 in chapter 2) and their relative technological and managerial gap vis-à-vis the EU, it is expected that welfare gains from the liberalisation of trade in services would be important for them. One OECD study underlines that welfare gains from the liberalisation of trade in services for less developed countries are likely to be positive and much higher than the effects of liberalizing trade in goods (OECD, 2005a). Additionally, liberalisation of some services trade (like transport, financial and insurance services etc.) can support FDI inflows, which are badly needed in these economies and can provide interesting business opportunities for the EU companies.

5.2.3. But: liberalisation of trade in services is difficult to achieve even within the EU15

Irrespective of estimated likely gains from free trade in services, even the EU15 has not yet managed to establish fully functioning internal services market. There are still large barriers to trade among the old EU countries, and the most important are: monopolies restricting the entry of foreign providers (as in postal services, energy utilities, distribution networks), quantitative restrictions (on number of service points per geographical area, quotas), territorial and residency restrictions, rules designed to ensure independence or autonomy, professional regulations, company tax regimes, price regulations, restrictions on opening bank accounts, accounting rules, payment and reimbursement of

Box 5.1. GATS

The GATS is the first and only set of multilateral rules and commitments within the WTO covering government measures which affect trade in services. It has two parts – the framework agreement containing the rules, and the national schedules of commitments in which each member specifies the degree of access it is prepared to guarantee for foreign service suppliers.

- The GATS covers all services except government services and air traffic rights.
- Negotiations on GATS are viewed as relatively easy, because of the significant degree of flexibility. Each member’s government determines the level of obligations a country will assume.
- Developing countries are expected to liberalise fewer sectors and types of transactions, in line with their development situation.

Source: WTO.

---

31 The perspective of full liberalization of trade in services between the EU and the ENP partners lies beyond the scope of this report (see preceding chapter for details).
VAT, etc. Transport, followed by retail trade and telecommunication are the most regulated sectors in the EU15 (Vogt, 2005).

Barriers in services trade between the old and new EU members are even greater. Therefore, the possibility of significant liberalisation of trade in services between the EU and the considered five ENP economies during the next five years are not very realistic, but limited progress in certain services is possible and should be sought. For the majority of the considered countries, the likely threshold possible to attain within the five years time are the provisions negotiated under the GATS. For Algeria, Ukraine and Russia that are not yet WTO members even binding future commitments will be an important step forward in liberalising trade in services.

5.2.4. What liberalisation of trade in services means in case of ENP countries

The concept of provision of services across national borders is very broad. The whole “services trade” groups together services that require or do not require presence abroad, and this presence may mean either presence of natural persons or commercial presence or both (see box 5.2).

Depending on the type of service, trade barriers may be of different character. For example, if commercial presence abroad is not required, and the sale of services abroad is executed by phone, internet, fax etc., the most likely obstacles to trade is services are business regulations in a provider’s country. Similarly, if the presence of natural persons is required abroad in order to provide specific type of service, the most likely barriers may arise from visa regimes and employment regulations in host countries. When commercial presence abroad is needed, then host country regulations regarding the establishment of a business and its activity will play an important role.

The current extent of trade in services between the considered economies and the EU is not significant. Taken together Algerian, Egyptian, Moroccan, Russian and Ukraine – EU service trade flows accounted for less than 5% of the overall EU-rest of the world service flows, as of 2003. The pattern of trade in services between the EU and ENP partner countries is typical

Box 5.2 Major service categories used in balance of payments statistics

1. Transportation
2. Travel
3. Communications services
4. Construction services
5. Insurance services
6. Financial services
7. Computer and information services
8. Royalties and license fees
9. Other business services
10. Personal, cultural and recreational services
11. Government services not included elsewhere (not included in the GATS coverage)

Source: WTO.
for trade with less-developed regions. The EU is a net buyer of transport services, which mainly reflects bad infrastructure in the ENP countries and restricted market access (also, in sea transport lower costs of ENP partners). As for travel, Russians and Ukrainians are net buyers, while development of tourism make North African countries net sellers. Communication services are not an important subject of EU-ENP trade, however, here the EU is a net buyer. The EU sells ICT-intensive services like financial and computer services, as well as capital intensive services such as construction both in North Africa and in Eastern Europe. The EU is also a net seller of merchanting, professional and technical services to North African countries, while at the same time imports this kind of services from Eastern Europe. This last feature probably reflects mainly outflow of high-skilled workers from Eastern Europe (for details see Table 5.2A in Statistical Annex).

In this report, we concentrate on the description of changes in the service trade that are most likely to affect relations between the EU and ENP countries over the next five years. Leaving aside freedom of movement of people and employment rights (discussed in chapter 4 and in section 5.3), it often reduces to liberalisation or approximation of regulatory norms in specific sectors. Given high regulatory burden in the five ENP countries and at the same time ineffectiveness of local administration and regulatory bodies, relative to the EU’s, easing EU-ENP barriers in trade in services will mean:

- adherence to GATS commitments (where appropriate),
- approximation of relevant rules to the EU acquis,
- increase in the effectiveness of market regulators in five ENP countries,
- equalisation of rights of foreign and domestic firms and
- simplified establishment of firms in relevant sectors.

5.2.5. Outlook for 2006-2010: relaxation of barriers to trade in selected service sectors

This part presents the outlook of changes in the service trade that are most likely to affect relations between the EU and the ENP partners within the next five years. The focus is on transport and financial intermediation sectors. As the telecommunication sector is also an important service sector, and at the same time important infrastructure indicator, we additionally include it in the analysis. The choice of the sectors was motivated by:

---

32 As not being central for his study, we left aside travel and construction services. The analysis of "other business services" category that groups together merchanting and trade-related services, professional and technical and R&D services and the like lies beyond the scope of this report.
The presentation is organised according to the main service sectors (transport, financial services, telecommunication) and by individual ENP countries. This section primarily discusses actions that are committed in the mutually agreed action plans (Morocco, Ukraine). If action plans are not ready yet, the focus is on EU commitments expressed in indicative programmes, and on initiatives announced by national governments. Conclusions on expected changes within these sectors are developed also on the basis of the current state of development of each sector and regulatory barriers.

**Transport**

**Russia**

National indicative programme for 2004-2006 specifies EU commitments and objectives within the transport sector for end-2006:

- civil aviation: improvement in air safety, Russia’s participation in European organisations like Eurocontrol or the new European Aviation Safety Agency, and industrial co-operation. It is expected that royalties for flying over Siberia will be gradually phased-out to disappear by 2013.

- maritime transport sector: improvement of maritime safety, maritime training, liberalisation of the sea-river transport services in Russia, co-operation in research and development, use of Automatic Identification System on board vessels, co-operation in the field of maritime transport security (implementation of recently agreed maritime security legislation in International Maritime Organisation (IMO) and co-operation within the G8 context). It should also be added that the conclusions agreed at the Council of Transport Ministers of December 2002 include an “agreement” which stipulates that heavy grade of oil should only be transported in double-hull tankers.

Additionally, progress in the cooperation within the spheres of: (1) transport strategies and public-private partnership (PPP), (2) transport security and (3) road and rail transport is expected over 2005-2007. In October 2005, the EC-Russia intergovernmental group on transport dialogue revealed in October 2005 that it designated working groups in these spheres.

It is expected that in the transport sector barriers in trade with Russia for the EU agents will be gradually reduced, although no sudden changes are foreseen. The
sector will most probably remain relatively protected, although safety and infrastructure will be gradually improved.

**Ukraine**

No common EU-Ukraine action funded by the EU is scheduled until 2006 in the transport sector. However, Ukraine declared in the action plan that it would work on national transport strategy, improve transport safety, cooperate closely with relevant European bodies with regard to rail trail, maritime, and inland waterways transport, and both parties will identify financing options for transport infrastructure development. Taking into account these declarations, the years to come should see lifting of barriers (restructuring of state-owned ports and integration into Pan-European aviation structure should be put on the agenda, in particular) and some improvement of infrastructure.

**Egypt**

Reforms aimed at “all modes of transport”, also directed towards harmonisation of standards as well as safety and security were indicated as necessary and EU financial support for 2005-2006 was committed for this. However, it is hard to assess at this stage what exactly will be supported and how much from the EUR25 million technical support will go to improving Egyptian transport sector.

**Morocco**

Morocco declared its readiness to work on the national transport strategy in the view to enhance EU-Moroccan transport capacities during the next 5 years in the EU-Morocco action plan. Once the priority infrastructure areas are identified, the EU offered its assistance both in identifying and granting funds. For the moment, MEDA funding is arranged for planning of the Euro-Mediterranean transport networks and for the participation in the new satellite navigation project.

With regard to the specific types of transport the EU-Morocco action plan gives priority to the following:

- granting easier access to road transport services and improving road safety and road infrastructure until 2010 (in the northern area, the EU supports road construction with EUR34 million in 2005),
- promotion of the multi-mode railway transport and improvement of railway infrastructure,
- improvement of airports infrastructure, liberalisation of airport transport (both regular and charter flights) including possibilities of new EU-Moroccan
connections, and explorations of possibilities of Morocco entering the Single European Sky,

- enhance competition in the maritime transport and among Moroccan ports by granting easier access and privatisation, introduce an independent maritime regulator, approximate maritime law to that of the EU, improve safety and reduce pollution (gradually remove single-hull oil tankers), fight with maritime terrorism. It is expected that Morocco will take part in the MEDA regional project on maritime safety.

Taking into account far-reaching provisions of Moroccan obligations to reform its transport sector, it is expected that costs of transport services will fall and entry of the EU logistics companies will be significantly facilitated. It is also expected that ENPI funds will be directed further towards the development of transport infrastructure.

Financial intermediation

Russia

The EU-Russian cooperation supported by the EU funds within the financial sector will focus on the technical advice in the following areas (NIP 2004-2006):

- consolidation of a sound and effective financial sector in Russia, combining competitive and efficient banking and investment institutions, the stock market and insurance services,
- fight against money laundering, implementation and enforcement of related international conventions to boost confidence in the Russian financial system;
- promotion of investment in small and medium enterprises, in close collaboration with relevant international financial institutions.

This is supposed to bring the following effects before 2007:

- enhanced efficiency, performance, financial transparency and credibility of a restructured financial sector;
- Reduced incidence of financial abuse and money laundering;
- further approximation and convergence of relevant EU and Russian legislative and regulatory frameworks;
- guaranteed equal terms of competition for economic operators (“level playing field”);
- increased investment flows into the economy across a wider range of productive sectors;
- further development of small and medium entrepreneurship.
However, as the recently declared strategy of the central bank states, no significant changes in the sector such as large privatisations (state still owns majority of the capital in the banking sector and non-residents own only 6% of the total banking sector capital) are expected at least until 2008.

**Ukraine**

Mutual EU-Ukraine assistance programmes supported by the EU funds until 2006 will focus on:

- improvement of operational capacities in the banking sector,
- introduction of up-to-date mechanisms and tools for banks,
- fostering the development of the regulatory framework and supervision of financial markets equivalent to that existing in the EU,
- effective implementation of independent and well-trained supervisory authorities in accordance with internationally recognised standards, especially in insurance services (NIP 2004-2006, Action Plan for Ukraine).

In addition, Ukraine declared that it would continue easing restrictions on movement on capital, especially with regard to transfer of investment money or investment income, which is also of interest for agents present in the Ukrainian financial market. Some relaxation of restrictions on capital account happened already in autumn 2005.

Additionally, more foreign banks are expected to enter before 2010, which will strengthen competition. At the moment, less than 20% of the sector is foreign-owned, and this share will surely increase very soon, judging from declared strategies of some EU international players. This all means that the banking sector in Ukraine will develop considerably over the next few years, and entry and operating conditions for the EU financial institutions will become easier.

**Egypt**

Although no common EU-Egypt actions regarding its financial sector are scheduled in the indicative programme for 2005-2006, the current government plans to deregulate and privatise banking sector. If successful, this could open door to new EU funding supporting its development. Currently, the majority of Egyptian banking sector (representing 80-90% of domestic financial market) is owned by the state, and the profitability is low. The central bank is working with banks to comply with Basle II standards by 2006.
**Morocco**

There have been two major priorities for action until 2010 related to the Moroccan financial sector, listed in the EU-Morocco action plan, namely:

- development of competent supervisory body, modelled after EU financial supervisors,
- strengthening of independence of supervising authority according to international standards.

Additionally, liberalisation of capital account was declared, especially when it comes to protection of foreign ownership, rights of closing down the business and removing restrictions on repatriation of earnings. After reaching this stage, the involvement of Moroccan side is expected in the dialogue on removing remaining restrictions on the capital account. Some of the EU funds scheduled for support of implementation of the AA with Morocco in 2005-2006 are to help in liberalisation of capital account.

**Telecommunication**

**Russia**

Common economic space provides for future cooperation in the telecommunication sector. However, full details are not yet known. Indicative programme for 2004-2006 suggests the need for cooperation on legislative and regulatory convergence in the fields of telecommunication and electronic commerce and for implementation of an appropriate investment framework that would allow for development of infrastructure in Russia. The EU secured funds for supporting policy dialogue and granting policy and legal advice in these two areas. However, given the general formulation of these objectives, and the fact that they are in the same budget category as support of energy and transport dialogue, it is hard to draw any conclusions as to whether the EU will support development of Russian telecommunication.

During the next few years, harmonisation of the telecommunication rules with those of the EU (including market access) will depend on the Russian side. It is reasonable to assume that no changes more binding than GATS commitments (that again depend on Russia and take time to be implemented) will occur in the Russian telecommunication sector, although easier access for foreign firms and less discriminatory treatment will have to be assured after Russia enters WTO.

**Ukraine**

EU-Ukraine action plan sets rather general priorities for cooperation in the field of telecommunication. It basically reduces to declarations by the Ukrainian side about
adopting regulatory legislation, establishment of an independent regulator, and ensuring fair competition. This last point is especially hard to attain as markets are monopolised and competition authority is not willing to act against big domestic players. However, the sale of the large state-owned telecom operator is scheduled to happen soon (after several delays over the last years).

Following the general nature of commitments in the action plan, no EU funds to support the liberalisation of the telecom sector in Ukraine are scheduled until 2006, and most probably none will be directed at least until 2010, unless Ukrainian government takes serious steps towards deregulation.

**Egypt**

Although no common actions backed by the EU funds are scheduled until 2006, the country is supposed to allow for more competition at the fixed and mobile telephony markets. State fixed telephony enterprise was partly privatised in end-2005 and lost its monopoly on international calls from the beginning of 2006. Granting of the third mobile operator license is expected during 2006.

**Morocco**

As listed in the EU-Morocco action plan, the following moves in the Moroccan telecommunication sector were agreed and are expected to happen until 2010:

- EU support for gradual liberalisation of fixed telephony market,
- liberalisation of market for mobile telephony (two operators at the moment),
- strengthening of the capacity of the regulatory body (ANRT) and enhancing its cooperation with agencies from other Mediterranean countries and the EU,
- improving existing networks and enhancing investment in new ones,
- encouraging internet-based communication, also in relations with the government and implementation of relevant legislation (electronic signature, protection of personal sites, name of domains etc.).

No funds for telecommunication sector reforms were provided under indicative programme for 2005-2006. Together with continued liberalisation of telephony market, the access should be easier, costs lower, and network infrastructure more developed. If Morocco adheres to the above commitments, the EU is expected to support the liberalisation of Moroccan telecommunication market starting from 2007 using ENPI funds.
5.3. Migration

- **There is little direct link between selected forms of economic integration of EU and ENP countries and ensuing migration flows.**
- **Migration from ENP countries to the EU is expected to continue at levels observed in recent years, but the outlook might change depending on political, social and economic developments in the ENP countries and migration policies of the EU.**
- **The economic and social consequences of migrations are crucially dependent on policies of home and host countries but have little to do with the intensity of economic integration between the EU and ENP partners. One exception relates to financial integration which may lower the costs of and thus stimulate remittances, therefore supporting development of ENP countries and encouraging temporary rather than permanent migrations to the EU.**

This section attempts to shed some light on the questions on the likely links between various forms of economic integration and migration flows, and the impact of migrations on both host and home countries. It should be noted that there is hardly a consensus on the factors determining migrations and their social and economic consequences. Additionally, statistical base for migration analysis is not sufficient, despite some recent progress in compiling more reliable databases (OECD, 2005b; Fargues, 2005; see also Eurostat, 2005).

While there certainly is an economic dimension to migrations, which can be important in some instances, there is little relation between economic policies affecting migrations and trade and investment policies which are the focus of this report. As discussed by Boeri and Brücker (2005) existing trade models suggest that trade integration can both stimulate and mitigate migration flows depending on additional assumptions. We emphasize the importance of the following factors:

- the policy towards legal migration, i.e. visa regimes, residence and work permits, etc.,
- the policy towards asylum seekers and illegal migrants, strictness of asylum practice, border controls, other controls aimed at detecting illegal migrants, deportation policies,
- economic developments in (potential) home and in host countries, and in particular labour market conditions.

While the above list is clearly not exhaustive it enables to highlight the likely consequences of some policy choices facing the EU. All else equal, one should expect
that more “liberal” policies towards legal migrations will result in higher inflows of migrants. Moreover, there is scope for implementing policies that will encourage inflows of people with specific characteristics, such as highly skilled specialists. Indeed, some of the OECD countries have been introducing measures making it easier for highly skilled foreigners (e.g. foreign students) to get jobs and stay in OECD countries (OECD, 2005b). The impact of tougher policies towards asylum seekers and illegal migrants is subject to more controversies, and it is not clear that they can be very effective in reducing migration inflows (Monheim, 2005 and references cited therein). All else equal, the larger gap in the attainable standard of living between home and host countries, the larger the incentives for migration. The situation of the labour market is particularly important. Better employment prospects in the host countries might induce more immigration and at the same time stronger positive effects of labour migration. On the other hand, Boeri and Brücker (2005) argue that rigid labour market in the host countries might imply negative externalities affecting native populations in the receiving countries.

5.3.1. Recent migration flows

The EU has historically been an attractive place for migrants and has attracted large migration inflows over the recent decades. Table 5.4 presents recent trends in migration inflows to selected EU countries. One immediate observation is that several EU countries experienced large volatility of inflows. While, the early 1990s were characterised by large immigration related the dissolution of the Soviet Union and war and instability in the Balkans more recent years saw particularly strong increases in immigration to South European countries. Also, these figures indicate a continued increase in immigration to the EU25, a trend which is not fully confirmed by another set of statistics compiled by the OECD (2005). OECD data indicate that after increases up till 2001 or so, 2002-2003 witnessed stabilisation of

Table 5.4. Net migrations to the EU, 1992-2003 (persons per 1000 inhabitants)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>EU-25</td>
<td>1.9</td>
<td>1.6</td>
<td>2.9</td>
<td>3.8</td>
<td>4.6</td>
</tr>
<tr>
<td>EU-15</td>
<td>2.4</td>
<td>2.0</td>
<td>3.5</td>
<td>4.5</td>
<td>5.4</td>
</tr>
<tr>
<td>Belgium</td>
<td>1.6</td>
<td>1.3</td>
<td>3.5</td>
<td>3.9</td>
<td>3.4</td>
</tr>
<tr>
<td>Germany</td>
<td>6.0</td>
<td>1.9</td>
<td>3.3</td>
<td>2.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Spain</td>
<td>1.5</td>
<td>4.6</td>
<td>10.5</td>
<td>15.8</td>
<td>17.6</td>
</tr>
<tr>
<td>France</td>
<td>0.1</td>
<td>0.2</td>
<td>1.0</td>
<td>1.1</td>
<td>0.9</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.1</td>
<td>5.7</td>
<td>10.0</td>
<td>8.3</td>
<td>7.8</td>
</tr>
<tr>
<td>Italy</td>
<td>0.5</td>
<td>1.0</td>
<td>0.8</td>
<td>6.1</td>
<td>10.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.0</td>
<td>2.5</td>
<td>3.5</td>
<td>1.7</td>
<td>0.4</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1.4</td>
<td>2.5</td>
<td>3.1</td>
<td>2.1</td>
<td>4.4</td>
</tr>
</tbody>
</table>

Note: Annual averages in the first two columns.
migration inflows to several European countries, with declining number of asylum seekers and growing relative importance of labour migration.

The distribution of total immigrants from specific ENP countries among EU member states is fairly stable, at least over shorter time horizons. This is because the costs of migrations to particular countries/regions tend to decline when larger diaspora are present in these countries/regions. For example a closer look at the foreign-born population of the Netherlands reveals that four countries are home to above 40% of the whole foreign-born population. Morocco is home to above 160,000 people or almost 10% of the total, while the share of populations born in other countries covered in this report are small. The figure for whole former Soviet Union area is just 30,800. For details see Figure 5.1. Absent of unexpected shocks to social and economic developments and migration policies, the recent patterns and intensity of migrations can be regarded as best predictors for the developments over the next decade or so.

Figure 5.1. Foreign born population in Netherlands, 2002 (thousand of people)

![Pie chart showing foreign born population in Netherlands, 2002 (thousand of people)](source: OECD (2005b)).

Migration stock data are even less reliable due to large differences in definitions. One interesting indicator can be provided by the numbers on foreign-born population. In countries such as Netherlands, Austria, Ireland, Norway or Sweden the share of foreign-born population has been around 10% in recent years with a slow tendency to rise between 1993 and 2002 (OECD, 2005b). For comparison – in the US, respective share increased from 8.2% in 1994 to 11.8% in 2002.
5.3.2. Future migration flows

Forecasting total migrations flows has been an extremely difficult task and any scenarios crucially depend on the set of underlying assumptions, both the ones influenced by policies (on the side of potential home or host countries) and exogenous factors. Also, there are in fact many different forms of migrations responding to diverse incentives: Okólski (2004) proposes identification of seven categories, including migration for settlement, labour migration, incomplete migration, and flows of asylum seekers and refugees. In the case of the ENP countries analysed in this report, domestic economic and political developments will play a crucial role in determining the willingness of their citizens to migrate to the EU. Under the plausible assumption that forced migration (e.g. due to political instability) or migrations motivated by particularly harsh economic conditions are more problematic for receiving countries, the better the domestic political and economic situation in ENP countries, the less problems and more advantages the EU can expect from migration flows. Consequently, the proper evaluation of the EU policies towards ENP countries should take into account long term development impact on the latter group of countries.

The long term migration forecasts should be treated with great caution and are best thought of as providing benchmarks for comparing migration responses to alternative scenarios. Actual point estimates are necessarily subject to wide error margins. Below we rely on the results emerging from the on-going project on the migration impact on demographic trends in Europe carried at the Central European Forum for Migration Research (Bijak et al., 2004 & 2005)\textsuperscript{33}. The advantage of this work is that it utilises the most recent available data and provides quantitative scenarios for migrations to the EU27 (current EU plus Bulgaria and Romania which are likely to join the Union in 2007) in the 20 and 50 years perspective. Main sources of external (extra-EU) migration are expected to be former Soviet Union region (with Russia and Ukraine being the most important countries due to the size of the populations, geographical proximity to the EU and already existing diasporas). Existing networks of immigrants from this region imply that eastern parts of the EU, particularly Germany and Poland are likely to remain the main target EU countries. The second source region of potentially large population inflows is Northern Africa (and Turkey). Migrants from this region are expected to be concentrated on Southern and (to a lesser extent) Western countries of the EU. China and some other Asian countries will form the third major source of EU immigrants.

Migration flows to the EU27 under various scenarios are shown in table 5.5. Base scenarios imply slight increases in annual net immigration to EU27. Share of new

\textsuperscript{33} For more information on the project and full list of publications see www.cefrm.pan.pl
migrants in the labour force is unlikely to surpass 10% by 2020 and in the base scenario it increases to around 20% by 2050.

### 5.3.3. What matters for gains and losses from migration?

One important question is whether the forms of economic integration with ENP countries are likely to significantly impact on the distribution of gains and losses from migrations for the parties involved. We argue that such impact should be expected to be negligible compared to other factors, primarily domestic policies towards migrants. Let us concentrate on four factors: social tensions in host countries related to the presence of migrants, contribution of migrants to economic growth in host countries, and in the case of the sending countries the consequences of “brain drain” on the one side and remittances on the other side.

The roots of social tensions involving migrants that have recently erupted in violent outbreaks in some EU countries (France and the Netherlands for example) appear to be related to social exclusion, and economic inequalities. International relations between countries from where the migrants come from and those where migrants currently reside are unlikely to offer solutions to these problems. However, it is worth remembering that employment can be a very important mechanism for social inclusion of immigrants. The record of some of the EU countries in this respect is not particularly encouraging. For example, despite strong increases in foreign employment during 2000-2003, in 2003 unemployment rate among non-OECD foreigners in the Netherlands stood at 14%, compared to 7% unemployment among foreigners from OECD countries and 4% unemployment rate among nationals (OECD, 2005b). The gap between unemployment of foreigners and nationals is only slightly less pronounced in countries such as Belgium, Denmark or France. While the underlying reasons for lower employment of immigrants may vary from one country

---

34 The analysis of other important factors lies beyond the scope of this report.
to another it is clear that addressing the problems related to this phenomenon could greatly enhance the gains and limit the costs of immigration to the EU. Ultimately, EU would benefit most if immigrants were able and ready to take up productive jobs and were not endangered by social exclusion.

Similarly, the migrants contribution to economic growth in host countries and the scope of potential negative externalities on domestic workers is little affected by trade relations, but can be strongly dependant on the flexibility of domestic labour and other markets in the EU countries (World Bank, 2005b; Boeri and Brüber, 2005).

One migration-related issue that has been hotly debated recently is the impact of high-skilled out-migration on their home countries – the question of “brain drain” (World Bank, 2005b; Baldwin-Edwards, 2005). The gains for receiving countries from “importing” high skills are quite obvious. However, the impact of such trends on ENP countries should be taken into account. In particular, deficit of highly skilled workers in ENP countries can slow their development and thus contribute to slowing down of the catch-up process (with all the potential negative consequences). Again, the net effect of high-skilled migration is hardly linked to general nature of economic and political relations between countries but can be influenced by some policies on the side of both receiving and sending countries. While declining entry to highly skilled migrants might not be a solution (as those willing to leave their home countries are anyway likely to find a place of work / residence elsewhere) specific policies could mitigate potential negative externalities for ENP countries. In particular, temporary and “circular” migration might be promoted with some support for highly skilled nationals of ENP countries willing to return home. Also, one potentially effective EU policy could be supporting upgrade of educational services in ENP countries. This would help in meeting rising demand for educational services as returns to education are increasing. Additionally, promotion of student mobility is certainly worth continuing.

Remittances can be a very important factor stimulating economic growth in ENP countries. It is now widely recognised that government policies can affect flows of remittances. What matters for remittances are the transaction costs (lower for legal, registered transfers), tax, custom, and exchange rate policies of the countries receiving remittances, and financial integration of the sending and receiving country (see World Bank (2005b) and references cited therein for an in-depth discussion). Financial integration between EU and ENP countries can thus play a role in encouraging remittances flows. In turn, remittances are believed to have an additional effect of providing migrants with incentives to return to their home countries. Thus, closer financial integration between EU and ENP countries might, other things equal, encourage more of temporary labour migration relative to total migrations.
6. EU Energy Cooperation with Russia, Algeria and Ukraine

- There are no detailed programmes for achieving a joint vision of energy security that would embrace Russia, Algeria, Ukraine as well as the EU. What does exist is a disparate array of programmes.

- The three countries play very different roles for the EU energy security. Russia is clearly by far the most important player. The EU is looking to secure from Russia extensive supplies of gas in addition to its current Russian gas imports. On the Russian side, sales of energy resources to Europe constitute important share of all export revenues.

- Russia and Algeria will have to secure considerable investment flows if they are to continue both to modernise and expand its hydrocarbons production.

- The energy dialogue with Russia requires a unified position of the EU to strengthen the bargaining power and to ensure EU interests. Relations with all neighbour countries should be centred on market access issues (FDI, EU participation in the sector, reform and opening of the gas sector) but also on energy efficiency.

EU energy cooperation with the two of three countries covered in this section – and indeed, with all the partner countries in the Mediterranean area and most of the Neighbourhood countries to the east – is essentially concerned with general structures of macro economic stability and economic liberalisation. The exception is Russia, where energy is quite clearly one of the core elements in a two-way dialogue. With regard to Algeria and Ukraine, however, specific programmes for either energy reform or the attainment of individual energy objectives by either the EU or the partner and neighbourhood countries are less important than overall macroeconomic reform.

Moreover, although energy is one of the most important issues confronting the EU – and although it plays a major role in all three countries under specific study in this section – there are no detailed programmes for achieving a joint vision of energy security that would embrace all three countries as well as the EU. What does exist is a disparate array of programmes, ranging from the broad based regeneration agenda of
the Euro-Mediterranean Partnership (Barcelona process) to concepts such as the Putin-Prodi initiative intended to work out a structure for EU-Russian energy cooperation.

In sum, because the three countries in this section concern the European Union in very different ways so energy issues concerning Russia, the Ukraine and Algeria are addressed by the EU in very different ways. Such differences mean that it generally makes sense to pursue this country-specific approach, so long as the EU also pursues clear overarching policies for energy security, which can then be addressed in bilateral dialogues with Russia, Ukraine and Algeria. In one specific case, the role of Ukraine as an energy transit corridor from Russia to the EU, careful consideration has to be given as to whether a trilateral approach, seemingly the obvious solution, might actually prove counter-productive from an EU perspective.

6.1. EU concerns

The overall EU concern is energy security. At its simplest, the quest for energy security is an attempt to strike a balance between the following elements: diversity of energy use and energy supply – which essentially means diversification of fuels and diversification of supply sources; security of transit mechanisms – which embraces both flexibility of systems for delivering energy to the EU and protection of supply infrastructure; and security in terms of production – embracing both the operational conditions of EU companies producing energy outside the EU and the stability of countries on which the EU relies for its fuel imports, principally those of oil and gas. And all this then has to be placed in a context of perhaps the most complex of issues – the price to be paid for energy, whether in a secure or insecure form.

The more the EU moves towards the establishment of single markets for oil, gas and electricity, the greater the EU’s own direct involvement in negotiating access terms for those seeking entry into European markets. However, the development of the energy infrastructure used to import oil, gas and electricity is essentially organised on a national basis (sometimes, with groups of EU member states). There is a major potential weakness in this: pipelines or import facilities developed on an essentially bilateral basis may squeeze out pipelines and facilities intended to serve multiple suppliers and multiple customers, which have a greater potential for lower import costs.

One of the EU’s main concerns is its increasing reliance on energy imports, which, at least until recently, had been widely expected to become dependent on imports for 81% of its gas in 2030 and for 94% of its oil (see Table 6.1).

There is a major need for the EU, both collectively and at member state level, to understand the fundamental differences between the problems the EU faces with
regard to oil and gas. At first, it would appear to be oil that is the more significant issue. The EU needs oil – or liquid fuels derived from gas and other alternatives, to fuel its transport industry (with the death of steam trains, we no longer run any routine form of transport on anything but liquid fuels).

In fact, it is gas that poses the more significant problems, especially with regard to its relations with Russia, the Ukraine and Algeria. There are several factors involved:

I. Demand Control. The EU has less of an interest in controlling gas demand than oil demand. Gas is a more environmentally friendly fuel than oil and there are good reasons why the EU and its member states should wish to continue to increase gas consumption at the expense of both coal and oil. As well as environmental reasons, these include the fact that gas is available from a greater diversity of suppliers than oil. In addition, the EU possesses a much greater ability to control demand for oil than for gas. Were the EU to adopt the International Energy Agency’s World Alternative Policy Scenario (WAPS), oil demand in 2030 would actually fall a little by comparison with today’s levels. This would free up incremental oil production for such developing economies as China and India. There is also every reason to believe that EU Commission’s Directorate-General for Energy and Transport favours adoption of the broad range of measures envisaged in WAPS; the UK Government’s current policies are already based de facto on a WAPS-based approach.

II. Import volumes. Reducing demand, switching fuels and developing alternative forms of liquid fuels can all help to mitigate the impact of increased oil imports. According to the IEA’s main reference scenario, oil imports would rise from 492 million tonnes (mt) in 2002 to 698 mt in 2030; by comparison, under the WAPS, this 206 mt increase is more than halved, amounting to just 98 mt. For gas,

| Table 6.1 Scenarios for EU Primary Energy Demand, 1971-2030 (million tonnes of oil equivalent – MTOE and billion cubic meters) |
|--------------------------------------------------|---|---|---|---|---|
| EU TPES Reference Scenario (MTOE) | 1,211 | 1,690 | 1,848 | n/a | 2,048 |
| Net oil import dependency (%) | 76 | 85 | 91 | 94 | |
| Net gas import dependency (%) | 49 | 60 | n/a | 81 | |
| Gas consumption (bcm/y) | 471 | 567 | 684 | 786 | 1.8 |
| Gas imports (bcm/y) | 233 | 342 | n/a | 639 | |
| EU TPES Alternative Scenario | 1,211 | 1,690 | n/a | 1,881 | 1,872 | 0.4 |

Note: TPES stands for Total Primary Energy Supply.

The reduction is almost certainly understated. It assumes that EU net oil production under the WAPS scenario is the same as that under the Reference Scenario; in practice, it could well be higher, thus further reducing import requirements.
however, the prospect is of gas imports rising from 233 bcm in 2002 by no less than 406 bcm to reach 639 bcm in 2030 under the Reference Scenario, whereas even the WAPS postulates an increase of 305 bcm/y to 538 bcm. This remains a massive increase and, given the classic bilateral nature of gas deals, will require persistent EU attention. The prominence of Russia and Algeria as EU suppliers ensures that particular attention will have to be paid to these two countries, and to the Ukraine as a gas transit country.

III. Supply availability. Oil remains an essentially fungible commodity. If the EU doesn’t buy it from one source, it will buy it from another. Essentially, its purchase is a matter of price and the EU can afford to purchase even expensive oil – and that is what the EU is likely to face, not because of a lack of oil in the ground but because of limits to physical production caused by investment constraints in the major producing countries. Because oil is fungible, the crucial issue in this regard is not EU relations with Russia or Algeria, but its relations with the oil producing world as a whole, and that really means the Middle East. Gas, despite advances made in the spot market by liquefied natural gas (LNG), is far less fungible than oil, although it is available from a greater variety of sources.

IV. Transparency. Oil deals have well-established commercial mechanisms. They are probably more transparent than longer-term gas deals. Gas deals generally require long-term take-or-pay agreements which often include greater or lesser degrees of government-to-government commitments. With regard to Russian gas sales to some EU purchasers, these deals have not always been fully transparent. There may be requirements for payments to be made to third parties as part of the conditions of sale, raising questions concerning corruption. The political input to contract negotiations may also pose problems. For example Russia’s Gazprom is a state-controlled entity offering contracts intended to serve state interests. Were it to operate on purely commercial lines, its terms for gas sales to the EU might be very different. Were there to be a split amongst Russian policy makers concerning the

---

36 This figure also underestimates potential import savings, since it makes no allowance for increased EU or, more to the point EU/Norwegian gas production as a result of altered economic conditions. One of the key points that needs to be borne in mind in considering EU oil and gas issues is whether Norwegian production should be considered to fall outside the EU rubric (since Norway is not an EU member state) or whether its production should be included within an EU framework, since Norway is a member of the European Economic Area (EEA). In the opinion of the authors, Norway is more inside than outside the EU umbrella and, moreover, its role as a supplier of gas to the EU – an issue with obvious consequences for both Russia and Algeria – appears under-estimated. As of late 2004, the EU was anticipating imports from the North Sea – i.e., from Norway, as totalling around 110 bcm in 2030.

37 This is almost openly admitted even by Gazprom bosses – see e.g. ‘Natürlich ist das, was wir tun, politisch’, interview with Gazprom vice-president Alexander Medvedyev, Welt am Sonntag, 22 January 2006.
issue of state control of Gazprom, as there has been in the past, EU purchasers would have to consider whether to involve themselves in an issue with potentially profound repercussions for the EU in terms of both price and conditions of supply, or whether to refrain from involvement, arguing this was a purely internal Russian matter.

V. Transit issues. Russia’s reluctance to sign the Energy Charter Treaty’s Transit Protocol, which would, *inter alia*, govern the transit across Russia of non-Russian gas, poses acute policy questions for the EU and its member states. The protocol has the potential to end Russia’s pipeline monopoly, which ensures that Russia can demand that new European customers pay as much as $250 per thousand cubic metres ($250/tcm) for its own gas, whilst importing gas from Central Asia at prices which it hopes to keep as low as around $50/tcm. This has profound implications for current and prospective gas producers in Turkmenistan, Uzbekistan and Kazakhstan. These countries have alternative options for securing access to world markets for their oil but Russia’s continued monopoly or near-monopoly over their access to world gas markets concerns the EU, since the EU’s member states are major potential purchasers of Central Asian gas, with IEA Chief economist Fatih Birol estimating the EU might seek to purchase up to 51 bcm/y of gas from this source by 2030 (See Table 5.4).

None of these points are intended to challenge or even question Russia’s reputation as a remarkably reliable supplier in terms of its deliveries to EU member states (it has, however, used supply cutoffs and the threat of supply cutoffs to put political pressure on former Soviet republics). But such issues do raise profound questions concerning both the process of negotiation and the terms negotiated for gas contracts with the EU’s biggest single gas supplier. Once Russia signs a contract with an EU customer, it delivers; it is the terms of its contracts that pose problems for the future.

To a lesser extent, some of these issues also apply to Algeria. But Algeria’s position in terms of negotiating with prospective EU customers is not as strong as Russia’s. It is more dependent on EU investment in the first place and its exports are subject to far more regional competition than Russia’s. In addition, Algeria’s trade performance
is intimately connected with the EU, since the EU takes majority of Algeria’s exports and supplies majority of its imports.

What has also changed is the sharp rise in energy prices since 2004. It is beyond the scope of this paper to provide what it is now increasingly obvious, that any deep study of EU energy security requires consideration of a wide range of scenarios spanning a wide range of alternative price, supply and demand assumptions. The drive for energy imports from Russia and Algeria (Table 5.3), and for transit security across Ukraine, should be seen against this kind of a backdrop, with its options for EU demand management to ensure an eventual decline in oil demand and limitations on the increase in gas consumption. Moreover, it would be prudent for the EU to assume that there will be severe investment constraints for major energy producers, including Russia and Algeria, and that this will ensure high energy prices (at least by comparison with pre-2004 price levels) for the foreseeable future.

6.2. The Importance of Russia, Ukraine and Algeria in European markets

The three countries play very different roles in the EU markets and in the EU energy security equation. In this regard Russia is clearly by far the most important player in terms of supply. In 2004, the EU produced 215.2 bcm of gas; and consumed some 466.9 bcm meaning that net imports, including those from Norway, amounted to 251.7 bcm. Essentially, all these imports came from just three countries: Russia, around 125 bcm (all by pipeline); Norway, around 75 bcm (all by pipeline); and Algeria, 51.6 bcm (33.8 bcm by pipeline and 18.8 bcm as LNG). The aggregated EU figures mask major differences in EU member states reliance on energy sources (and thus potentially differing priorities in energy policies). For example in 2004, imported Russian gas accounted for more than 80% of all consumed gas in the Czech Republic, Finland, Greece, Lithuania and Slovakia, while Algerian gas accounted for above 50% of consumption in Portugal and Spain. On the other hand Netherlands produces much more gas than it consumes (BP, 2005).

6.2.1. Russia

Russia is thus supplying around half of all EU gas imports – and around 30% of all EU oil imports – and Algeria just over 20% of EU gas imports38. Moreover, the EU

---

38 Oil and gas imported from Russia plays an important role in many other European countries, some of which are likely to join the EU over the next decade or so. In 2004, above 40% of Europe’s (including Turkey) imports of gas and oil came from Russia.
is looking to secure from extensive additional supplies of gas from both countries. Indeed, the International Energy Agency has estimated that the increase in Russian supplies might total as much as 79 bcm in 2030, which would account, on the IEA’s mainstream Reference Scenario, for one-quarter of the projected 315 bcm/y increase in EU gas imports by that date. While such import levels seem large, they would, in fact, actually dilute Russia’s share of the EU import market from around 50% in 2004 to around 41% in 2030.

Although this constitutes a high rate of dependency on a single supplier, Russia is also vulnerable, since its energy exports to Europe currently account for around half of total Russian export. In contrast, Russian energy imports to the EU constitute only 2.5% of overall EU imports. In terms of the relative importance of these figures, the issue is whether it is easier for the EU to diversify its sources of supply or for Russia to diversify its markets. The anticipated reduction in Russia’s share of the EU import market would seem to indicate that the EU’s position is stronger: The EU can look to alternative suppliers in an arc stretching from Central Asia through the Middle East to North Africa, and then beyond these to West Africa and the Americas. Russia’s prospective non-EU export markets lie in the Far East, notably China, although the practical feasibility of export diversification will depend on the costs related to building of the transport infrastructure. The EU has estimated Russia’s energy investment requirements between 2003 and 2030 as totalling no less than $735 bn, an average of $27.2 bn a year. Significant FDI or (partial) privatisation of state owned energy companies will be needed to ensure finance for such investments. From this perspective, the position of the EU is stronger as its affluence suggests that the price to be paid for transport infrastructure needed for import diversification would not be beyond reach.

In 2004 and 2005, Russia pumped oil at record post-Soviet rates of up to 9.5 mb/d; almost as much as Saudi Arabia. Despite recent output declines, there is little doubt that Russia will continue to produce at more than 9 mb/d for many years, with most of this being exported, so long as its oilfields will bear the strain. The extent of the country’s reserves remains a subject of some controversy, although that largely reflects revisions both to Soviet era data and methodology. Official figures show that since 1994 new discoveries have failed to offset oil production, but BP, for example, is still showing a year-on-year increase in the reserve base. What does seem clear is that new field discoveries are increasingly smaller, and a growing portion of remaining reserves falls into the ‘difficult-to-recover’ category. The bottom line, however, is that while it is useful for the EU to have a major flow of oil coming into the union from its next-door neighbour (and vice versa) it is not essential for either. Whether Russia produces as much oil as the EU might hope it will produce is an issue whose consequences are essentially felt by the world as a whole, not the EU in particular. The oil market is global, not regional.
6.2.2. Ukraine

The Ukraine’s principal role in both EU and Russian energy affairs is as a transit country, although it is also a significant importer of Russian gas in its own right. Russia routinely exports well over 100 bcm a year (more than three-quarters of all Russian gas exports) to European customers via Ukraine. The overwhelming bulk of this is bound for the EU, but such totals also include most of the 24 bcm shipped to non-EU European countries. Despite remaining spare capacity of the Ukrainian pipeline network Russia would like to develop alternative export routes that would reduce its dependence on transit through Ukraine for both financial and political reasons. November-December 2005 witnessed Russian-Ukrainian clash over gas pricing and transit which at some point resulted in Gazprom reducing its exports to several EU member states. The agreed solution is only transitory and one can expect the issue to return again. Apart from economic ones, there are substantial political interests involved in the conflict.

Ukraine counts among the most energy-wasteful economies in the world, consuming several times more energy per unit of GDP than EU countries. This deplorable state of affairs has been sustained by the cheap supplies of gas from Russia, which (partly) came to an end in early January 2006 after the well-publicised crisis negotiations. While Russia’s bargaining tactics can certainly be criticised, for Ukraine the main point now is that the country has to adjust to becoming an energy-efficient economy. This will imply serious restructuring of the steel and chemical sectors, as well as in household electricity consumption. Even with drastic restructuring Ukraine is going to have to diversify its production into more light industry and service sectors, which makes the complete opening of the economy with a free trade agreement with the EU all the more relevant.

6.2.3. Algeria

In 2004, Algeria produced 82.0 bcm of gas, of which 60.9 bcm was exported, with 51.6 bcm going to the EU (BP, 2005). The IEA (2005) considers that Algeria might well be in a position to export as much as 144 bcm in 2030. While much of this would be LNG, and therefore available for sale to markets as far afield as the United States, most would be likely to go to Europe. It is thus not unlikely that Algerian exports to the EU will double by 2030. The energy commodities dominate the Algerian economy. Hydrocarbons accounted for 36% of GDP, 98% of exports and 70% of budgetary revenues in 2003 (IMF, 2005).
6.3. EU investment concerns

6.3.1. Russia

From an EU perspective there are serious concerns regarding Russia’s required energy investment levels, even in an era of comparatively high prices. As noted above, the EU anticipates that total Russian energy investment needs over 2003-2030 could total as much as $735 billion. IEA (2003) considers that “cumulative investment needs in the Russian gas sector are projected to total just over $330 billion, or $11 billion per year, over the period 2001-2030.” Of this, the IEA adds, “one third of cumulative investment will be in projects for export to OECD countries.” The IEA report also notes that Russia’s own national energy strategy postulates an investment requirement of between $170 billion and $200 billion for the period 2003 to 2020, with specific investment levels ranging from $9.4 billion to $11.1 billion a year. The UK Government appears to have been drawing on such figures when it cited estimates that “investments of US$170 billion may be required to develop gas production in Russia alone to 2020” – in effect, around $10bn a year (HMSO, 2003). Sourcing this investment remains unclear. Economic and Trade Minister German Gref said in June 2004 that private capital would be necessary to finance oil pipelines (Oil & Gas Monitor, 2004).

But there are doubts whether investment on such a scale will be forthcoming. One prominent oilman, Ray Leonard, former vice president for exploration with Yukos and now with Hungary’s MOL, anticipates that current investment problems in oil will cause Russia to face an oil production crisis in the next four or five years. Leonard argues that Russia will need to secure considerably increased investment after 2008 to maintain output at roughly current levels. “The crisis will come at the end of the decade when lack of investment during 2005-2010 needed to maintain future levels of production by development of new areas becomes apparent – unless current policies are changed.” Leonard says (Leonard, 2005).

There are also investment questions related to gas transit routes and Russia’s policies in this respect. Transit issues have profound repercussions for the EU. Russia is becoming increasingly dependent on securing access – on monopoly terms – to Central Asian gas supplies, which it can then use to serve its own domestic, subsidised, customers, leaving Gazprom free to export Russian gas to international customers at world prices. This policy has the great advantage, for Russia, of delaying the necessity for major investments to expand Russia’s own capacity to meets its export commitments. The question then arises as to whether, instead of supporting Russian monopoly power and enabling Russia to avoid much of the necessity for reform of its bloated domestic energy sector, it would might prove more beneficial in the long run for the EU to invest directly in development of
Central Asian gas – which means developing a non-Russian route for delivery of Central Asian gas to world markets or else securing Russian acceptance of the Energy Charter Secretariat’s Transit Protocol.

The argument here is that a Russia committed to domestic energy reform, with all its energy operations essentially placed on a commercial basis, becomes a better partner for the EU than a Russia which bases much of its energy policy, and not a little of its political relations, with its neighbours on its ability to exercise monopoly powers in terms of energy purchases and transit. There are major opportunities for EU investment in Russian energy, particularly in terms of the development of Russian gas reserves in the Yamal peninsula and other Arctic regions, but pouring investment into a country which is still so wasteful of its own energy use, and which uses its powers to restrict other countries’ access to global markets, may not prove to be the best use of EU investment facilities.

6.3.2. Algeria

Similarly to Russia, Algeria will have to secure some very considerable investment flows if it is to continue both to modernise and expand its hydrocarbons production. The IEA considers Algeria will have to raise no less than $114bn between 2004 and 2030 to satisfy the investment requirements of both upstream and downstream oil and gas, along with electricity generation, transmission and distribution. In particular, the IEA considers Algeria will need to find $35bn for upstream gas development; $24bn for downstream gas development, $27 bn for upstream oil development and $10bn for refining if Algeria is to play its role in meeting global demand in accordance with the Agency’s Reference Scenario. This amounts to close to $5bn a year, far more than Algeria itself, with a GDP of around $82bn in 2004, can be expected to finance from the state budget. Even under the IEA’s Deferred Investment Scenario – under which the MENA producing countries only move slowly and in a notably delayed reactive manner to increase energy investment in general and upstream oil and gas investment in particular – Algeria would still be expected to invest some $24 bn in oil exploration and development and around $53 bn in overall gas development.

For the EU, the crucial issue remains the pursuit of macro-economic reform and, in particular, the development of an attractive investment climate for international energy companies. There are encouraging signs that, although the security situation in Algeria remains far from perfect, the economic situation is starting to change. Between January and November 2005, Algeria has received at least $5.19 bn in FDI, compared to just $301.2 million in 2004 and $916.5 million in 2003. Were FDI to continue to flow in at a similar level and on a similar basis – most to energy-related projects – Algeria would be able both to meet consumer expectations of increased oil
The turnaround in the Algerian economy, and in the management of the economy, is perhaps the main reason why the IEA, which remains sceptical of Russian ability to meet investment targets, is more hopeful with regard to Algeria. Even before parliament approved a new hydrocarbon law last summer, the IEA considered Algeria possessed “a relatively attractive investment climate”, while the law itself, which allows foreign companies to challenge state-owned Sonatrach for domestic contracts, could significantly enhance the investment climate. The IEA notes that other items in its favour include the country’s geographical proximity to Europe, Algeria’s efforts to comply with EU environmental regulations and long-standing relationships established with European buyers, are major advantages. In addition, the development of a series of pipeline and LNG connections should make for a relatively smooth expansion of export volumes to Europe. Overall, the IEA argues, “Algeria is unlikely to face major difficulties in financing the projected gas production and export capacity expansions.” In such circumstances, while the European Commission will doubtless continue to press for further macro-economic policy reform (and for fulfilment of reforms already initiated), it is for the EU’s companies to come up with the investments required to satisfy the EU’s prospective appetite for Algerian gas. The resource base, the desire for foreign investment and the market for additional production are all present; the only issue that could pose a real problem is security. But then, of course, perhaps the best way to bolster Algeria’s domestic security is to improve its economic well being.

6.4. The concerns of the ENP countries

6.4.1. Russia

Russia itself has made clear that its own energy security concerns include worries that it may be over-reliant on gas in its own domestic fuel mix (IEA, 2002). In 2003, Russia was able to produce 578.6 bcm of gas, but it actually consumed 405.8 bcm, slightly more than the EU-15. However, it should be noted that Russia is an inefficient user of energy. Its domestic energy saving potential could well total 120 bcm/y, equivalent to current Russian exports to Western Europe. Russia currently eases its own gas balance by importing gas from Turkmenistan and Uzbekistan under long-
term contracts and very low prices for domestic use. Since this gas, with only modest exceptions, can only go to Russia or reach other markets by means of transiting Russia, Russia’s Gazprom has effectively locked up most Central Asian gas export potential. The availability of this gas on terms largely dictated by Gazprom has helped to delay domestic reforms in Russia, in particular of the energy pricing system and the restructuring of Gazprom itself. Russia’s official policy, set out in the Main Provisions of the Energy Strategy to 2020, anticipates a significant switch from gas to coal between 2000 and 2020. The share of coal in the Russian energy mix would increase from 16% to 22%; gas would fall from 50 to 42-45%. Nuclear would go up from 5% to 6% while oil’s share would be almost unchanged. It is hard to see how implementation of such a strategy can be squared with Russia’s obligations under the Kyoto accord, and this, in turn, raises questions about the coherence of Russian energy policy and the current objectives of the Russian government and its state energy companies.

For Russia, the goal is to continue to be able to operate in an essentially monopolistic manner, facing relatively little competition and controlling both the flow of its own oil and gas to Europe, but also most of the prospective oil and gas exports from other FSU producers in the Caspian, notably Kazakhstan and Turkmenistan. Russia’s determination to continue operating in such a manner continues to put obstacles in the way of such key initiatives as the Energy Charter Secretariat’s Transit Protocol, which, inter alia, aims to ensure a level playing field for Caspian producers securing access to the Russian pipeline network. The importance of this is highlighted by the fact that while Turkmenistan was selling its gas to Russia for around $44/tcm in 2005 – and was seeking an increase to $60/tcm – Russia has been able to sell its gas to Turkey for around $130 - $133/tcm with some 2005 gas sales into the EU hitting $250/tcm. It is not transit costs but the Gazprom monopoly that accounts for most of the difference between the amounts Turkmenistan and Russia receive for their gas.

6.4.2. Ukraine

Very low energy efficiency and monopolisation and lack of transparency in the energy commodity markets are major issues in Ukraine. The gas pipeline infrastructure, while still underutilised, is nevertheless ageing and in need of upgrading. Ukraine’s economic concerns are strongly linked to political developments and in particular the relations with Russia on the one side and the EU on the other side. The necessary restructuring of the coal sector and energy intensive heavy industries will undoubtedly be strongly opposed by groups and regions affected by this creating internal social and political tensions.
6.4.3. Algeria

Algeria’s main concern is to improve the political climate without jeopardising the economic recovery. The EU obviously needs to offer political support for reconciliation efforts between the government and opposition, and to encourage European companies to continue their operations in, and trade with, Algeria.

6.5. The way in which the EU addresses energy issues in Russia, the Ukraine and Algeria

Russia is a power in its own right, which means a very high level essentially bilateral dialogue is maintained with Moscow, both by the EU as a body and by leading individual member countries. Since energy is an increasing EU concern, this has naturally brought energy to the forefront of the dialogue. With Algeria, although oil and gas revenues are the motors that largely drive the Algerian economy, and in particular, its government revenues and exports, energy is, in fact, subsumed into a much broader approach. By and large, it is hard to find cases of strategic thinking on energy in EU programmes concerning Algeria. That is not to say there is no such thinking, but it does not seem to manifest itself in current programmes concerning Algeria. This may well be because EU-based companies, along with those of major non-EU nations, already play a major role in Algerian energy development.

Ukraine is dealt with in a separate manner again. The EU’s prime concern, as with Algeria, is with overall political, economic and social stability. The EU wants to see a successful reform process in Ukraine that will encourage the same kind of transformation that most of the former communist states of Eastern Europe, and the Baltic countries, have undergone in the last 15 years. Energy developments play a rather different role in this process than they do in Algeria. From an EU perspective, Ukraine’s role in EU energy security is that of an absolutely vital transit country through which major oil and gas pipelines carry Russian and Caspian hydrocarbons to markets in the EU and Mediterranean.

6.6. Russia – energy policies, prospects and EU relations

It is with Russia that the EU possesses the best opportunity to develop an energy partnership based on the common pursuit of a clear programme of specific energy
projects intended to boost both Russian and EU energy security. The core concept of long-term commitments for EU investment in Russian energy in exchange for long-term Russian commitments to supply energy to the EU remains unassailable. The problem is that to make this work requires strategic thinking of the very highest calibre since, in essence, the European agents in this would largely be private companies seeking commercial deals whereas their Russian partners would either be state-owned (notably Gazprom) or potentially state influenced (notably Lukoil). In the five years since EU-Russia Energy Dialogue was initiated by Presidents Putin and Prodi, there has been no real resolution of this dichotomy. Russia’s energy industry has become less, not more, liberalised.

Operating conditions for foreign investors in energy have become less favourable. Whether BP can make a success of its TNK-BP venture, and whether Shell (and indeed non-EU companies such as Exxon-Mobil) can make a success of their development programmes in Sakhalin, is still open to question. There are enormous potential opportunities in Russia, notably above the Arctic Circle, but it will require perhaps unprecedented political input by both the EU as an organisation and the governments of its leading member states to ensure the development of a genuine energy partnership. In the absence of such a partnership this does not mean that the next five to ten years would bring an end to EU-Russian energy cooperation, but it would essentially limit that cooperation to commercial exchanges, notably EU purchases of Russian oil and gas and Russian purchases of EU technology and energy services.

What has survived so far from the original Putin-Prodi initiative is the concept of creating a Common European Economic Space, intended to boost the movement of goods and services, and also people, between the EU and Russia. The CEES was not originally intended to embrace energy, but discussions in 2003 included then possibility that it should be extended to cover energy. Were the CEES concept to be extended to cover energy, Russian energy exports would benefit from the effective transfer to another part of a tariff-free market. But the EU would want to know that Russian gas was entering its territory on both a competitive and transparent basis. And that would require a sound regulatory framework.

It will be difficult for the EU to put direct pressure on Russia to make it easier for foreign companies to operate there, particularly in the energy sector. Still, the EU leverage towards Russia rests on financial and technology that EU companies can bring to develop the oil and gas sectors in Russia and on the monopsony position in gas and the access to the EU common market that is very important for Russia.

First, the energy partnership could include agreements that cover EU upstream investments in Russia in exchange for Russian downstream investments in the EU. Second, the EU should stick to the policy of ruling out destination clauses in energy contracts. The objective should be that once Russian gas enters the EU territory, it can
be freely traded on the common market. This implies continued effort for fully
effective gas market liberalisation in the EU. This will not please Russia, since it will
reduce Gazprom’s negotiating power, but it is a core principle that needs to be
upheld. It will also show that the EU means business.

Third, the co-operation on addressing energy inefficiencies in Russia can be
attractive for both sides. Fourth, the European Commission should directly
address the question of how to make Russia itself wish to become a more
competitive supplier – i.e., one less reliant on its monopoly status either to secure
sales or to penalise neighbouring gas producers reliant on its transit system. One
way that this might be done is through encouraging a more rapid expansion of gas
imports from non-Russian suppliers – even if this means the rapid development of
fresh infrastructure to facilitate such imports. The Commission might care to
ponder the proposition that construction of a new pipeline to carry non-Russian
gas to the heart of the EU, such as the Nabucco pipeline from Turkey to Austria or
the Interconnector intended to link Turkey, Greece and Italy, need to be
considered as strategic pipelines implying EU support for these projects (even if
only political). In addition it may be useful to discus with Azerbaijan and
Turkmenistan on re-opening the earlier plan for a trans-Caspian gas pipeline.
Azerbaijan is now complaining at Russia’s energy power play, and sooner of later
Turkmenistan must appreciate how it is now being ripped off by the Kremlin and
Gazprom. The very existence of alternatives, perhaps regardless of the volumes of
gas they may bring into Europe from new suppliers, will have an impact on the
price and terms under which Russian gas is exported to the EU. Certainly, EU
could insist on a Central Asian element in its bilateral dialogue with Russia. The
problem is that the consumers who stand to gain from paying less for Russian gas
are unlikely to be the same people or groups as those who might be called upon to
finance alternative pipelines. The Commission might wish to investigate ways of
squaring this circle since it is quite feasible, particularly in an era of comparatively
high energy prices, that the cost-savings on long-term Russian gas imports might
well exceed the costs associated with constructing or expanding infrastructure to
serve non-Russian suppliers. In particular this means investing in LNG
technologies, which are becoming increasingly cost-effective, and provide a
plausible escape route from the Gazprom network monopoly.

It is in both the EU’s interest, and in the interest of various Central Asian
producers, for Russia to sign the Energy Charter Secretariat’s Transit Protocol. The
problem is convincing Russia that this would also be in Russia’s own interest, since it
would demonstrate to the world Russia’s understanding that reliance on monopoly
power is, or should be, outdated.
6.7. Ukraine – energy policies, prospects and EU relations

In the case of Ukraine, the EU could call for and support transition to less energy wasteful economic model. This implies support for the difficult yet necessary process of bringing energy prices to market levels and necessary adaptation measures on the side of industry and households. Also, demonopolisation of the energy sectors should be supported. Such objectives, while consistent with long-term development agenda of Ukraine may nevertheless be quite difficult to sell politically in view of the (transitory but substantial) social and economic costs involved in adaptation to market rules in energy.

Also, EU specific thought might be given to helping Ukraine to diversify its sources of gas imports. Construction of a spur to Ukraine from the planned Nabucco pipeline between Turkey and Austria would be an obvious medium-term option. In the short-term, directed EU investment into broad based industrial redevelopment and assistance to the Ukrainian coal industry, both to improve productivity and to reduce carbon emissions through introduction of ‘clean coal’ technology should reap both economic and political dividends.

6.8. Algeria – energy policies, prospects and EU relations

In 2005, there were major developments in both Algerian energy development and in Algeria’s relations with the EU. In April, after four years of controversy and debate – including fierce trade union opposition) – parliament adopted a new Hydrocarbons Law under which production sharing contracts will be made available through transparent bidding rounds. On 1 September 2005, Algeria’s political and association agreement with the EU came into effect. Of these two developments, the former is by far the most important, even though the latter does specify the desirability of energy sector cooperation.

The hydrocarbons law (which was only actually published in July 2005) is considered crucial to Algerian chances of securing access to international capital to pursue energy-led economic growth. In its absence, the deferred investment scenario would doubtless have become the normal and that would have had a major impact on Algerian export prospects. The law, which is aimed at overcoming two decades of ineffective resource management – encourages transparency, competitiveness and efficiency and offers higher shares to private investors in production sharing contracts (PSC). In effect, as one specialist publication has noted, it marks a shift in the role of Sonatrach, the state oil & gas monopoly, “from organiser to equal
participant in licensing rounds, and an end to the monopoly ownership and management of oil and gas pipelines”.

Although Algeria is clearly a major partner in any process intended to enhance EU energy security, the most striking aspect of current programmes under the Barcelona process is the way that they avoid specific reference to the depth of the EU-Algerian energy relationship. The programmes focus on the creation of a generally much more liberalised economy in Algeria rather than on the attainment of any specific cooperative relationship in energy. This is quite natural, since major EU companies such as BP, Total, Repsol and ENI are all substantial players in Algerian energy development and it can be argued that all three sides in this triangle – the EU, the companies and the Algerian authorities – understand both the need and benefits of continued close cooperation.

Because of its partnership with international energy companies, which means that foreign companies provide much of the investment capital for development of its oil and gas, Algeria should prove less susceptible than most OPEC producers to the prospect of deferred investment.

Greater liberalisation of the Algerian economy, coupled with the attainment of free trade between Algeria and the EU should further incorporate Algeria into what might be termed the broader European common market. But over the next five to ten years, great care will have to be exercised to ensure that other aspects of integration, notably where employment is concerned, are clearly seen to benefit ordinary Algerians. There may well be scope for an approach based on the concept that EU companies would be encouraged to take care of much of the fresh investment Algeria requires to increase its gas production and to limit the decline in its oil production, leaving the Algerian government with a relatively free hand to dispense actual revenues as it – and the Algerian people – see fit. In this regard, EU training programmes that promote understanding of how mixed economies work may prove far more important in terms of encouraging both responsible and responsive governance, and thus enhancing energy security by improving overall stability in Algeria, than any specific focus on increased access to, or direction of, Algeria’s energy resources.

6.9. Investment opportunities

One result of the Russia-Ukraine gas imbroglio at the turn of 2005/2006 is likely to be a fresh look at overall EU energy infrastructure, particularly with regard to gas supply. In terms of gas supply, there will be specific prospects for investment in developing:
• The Nabucco pipeline intended to convey gas from Turkey via Bulgaria, Romania and Hungary to an Austrian hub at Baumgarten (Turkey does not produce gas, but would be a collection point for gas coming from an arc of countries, including Azerbaijan, Iran, and Egypt, and which could, eventually, extend to Turkmenistan, Kazakhstan, Uzbekistan, Iraq and Arab Gulf state producers). The Nabucco project developers – the leading gas companies in the five states – hope to be able to start shipping gas through such a line in 2011. Strong EU support could bring this date forwards. Ukraine has expressed interest in the project, and an extension from Romania to Ukraine would ease pressures on both Ukraine and Moldova, which also suffered a cutoff of Russian supplies in the December 2005-January 2006 gas pricing dispute.

• The Turkey-Greece-Italy Interconnector. The underwater section from Greece to Italy has yet to be finalised.

• A possible gas line from Greece through the western Balkans to central Europe. This is a long shot. But such a line might be developed as part of a diversification strategy by the EU, in conjunction with the development of new delivery sources of gas to the EU market.

• New LNG terminals in the Mediterranean.

• New delivery systems: Further pipelines to expand gas deliveries from North Africa, incorporating new lines to bring West African gas to the EU via North Africa.

### 6.9.1. Specific prospects in Russia

EU energy companies would love to be able to invest in both the Russian upstream (both oil and gas) and in new pipelines to carry Russian oil and gas to market. In practice, in the absence of major Russian reforms covering foreign ownership and creation of a competitive internal market, this is not likely to happen in any general manner. There will be specific exceptions, notably for new infrastructure linking Russia with the EU – such as the North European gas pipeline through the Baltic to Germany in which BASF and E.ON each have 24.5% stakes – with Gazprom holding the remaining 51%.

General future prospects for direct investment may prove limited, unless there is a change in the Russian approach. What there will be, however, is considerable opportunity for provision of equipment and services for both upstream and infrastructure projects. Russian energy companies will be looking for high-tech skills and equipment, especially for use in arctic conditions. In this regard, the corporate structures for developing the Shtockman gas condensate field are already in place, but there should be considerable scope for EU corporate participation and contracts in the Yamal Peninsula.
6.9.2. Specific prospects in Ukraine

Ukraine’s transit pipeline system needs upgrading. Whether this will be open to EU investment will remain dependent on the Ukraine’s privatisation policy for the energy sector. The Ukraine’s opposition to genuine involvement of foreign companies may be partly due to fears of losing control on the pipeline network, the key leverage in the disputes with Russia. Such fears are unfortunate but they cannot be deemed unjustified. One of Russia’s goals in the series of disputes with Ukraine appears to be Gazprom control of Ukraine’s gas trunkline system in much the same way that it is now negotiating with Belarus for joint ownership of the Soviet-era transit pipeline system across Belarus and its outright ownership of the newer Yamal peninsula – Northern Europe gas line. As mentioned above, new infrastructure capable of delivering non-Russian gas supplies to Ukraine also constitutes a possible investment opportunity.

There are also potentially interesting opportunities related to future reform of the country’s coal industry. Introduction of clean coal technology, rationalisation of existing mining operations and, longer-term, the possible development of plants to convert coal to liquid fuels all offer considerable scope for EU investors. The Ukraine is particularly looking at ways to reduce energy usage in mining. It believes it can save up to 5 bcm of gas per year.

Exploration and production also offer interesting prospects. Shell is exploring onshore for gas, including exploration of strata below existing gas in the Dniepr-Donetsk Basin, while there is increasing interest in offshore Black Sea prospects.

One specific oil project is worth mentioning, ensuring that the newly constructed oil pipeline between the Black Sea port of Odessa and the inland refinery of Brody carries Caspian and/or Russian oil northwards to European markets rather than, as at present, carrying Russian crude southwards into the Black Sea would help the EU diversify its oil supply sources. Various ways of tying this line into existing pipeline systems within the EU have been suggested, notably extensions to Gdansk in Poland and Wilhelmshavn in Germany (although the delays in the project kick-off suggest that its economic rationale has not been perceived as guaranteed by potential investors). Both offer scope for EU investment, and while the Wilhelmshavn project would be more expensive – $2bn as against upwards of $500m for an extension to Gdansk – it also opens up the prospect of securing US as well as EU investment.

6.9.3. Specific prospects in Algeria

Algeria is open to external energy investment across the board, including competition for supply to domestic oil and gas markets. EU majors are already well-
established, as are suppliers and service companies. The issue is not one of specific new opportunities for EU companies, but the security conditions in the country.

The Algerians want to increase oil production by 43% and gas product exports by 87% over the next five years, including the expansion of LNG capacity to 60 mt/y. Although many of the projects required to achieve these targets are already tendered, other new projects or expansions of existing activities can be expected over the next several years. While the EU obviously remains a prime market, much of the expansion, particularly in LNG, will be directed at North American markets, and US investment will also be sought.

6.10. Conclusion: The balance: who is more important to whom?

The problem with the various EU programmes is that while they lay out a set of highly laudable goals that the EU and partner countries should jointly strive to attain, and promote a whole series of aims indeed to boost political, economic and social stability, they tend to shy away from detailed specific programmes for actual implementation of such goals.

For example, the Five Year Work Plan adopted by the EuroMed Partnership in Barcelona on 27 November 2005 states that the 35 member states of the Euro-Mediterranean partnership – which includes all the EU member states and, amongst a cluster of Mediterranean states, both Algeria and Egypt – will: “Implement sub-regional energy projects to promote a Euro-Mediterranean energy market, including the progressive integration of Mashrek-Maghreb electricity networks with the EU electricity network; the integration of Middle East gas networks, energy co-operation between Israel and the Palestinian Authority; and several important pipeline connections.”

The impact that the various EU programmes has had, or will have, on the key issue of energy cooperation remains hard to assess, not least because the term energy cooperation can embrace anything from technical workshops to full scale contractual supply agreements between producers and consumers. The EU programmes may be helping to create a climate within which a new generation of Russians, Ukrainians and Algerians have a better grasp of, and faith in, the principles of the free market. But while this means they should be able to ensure that in a mixed-economy world the technocrats of all three countries will have a better understanding of EU business concerns and practises, they cannot, in and of themselves, ensure that key decision-makers will make EU import requirements their main priority. As ever, that will remain a subject for essentially political argument.
Nonetheless, creation of a business friendly climate is important for several reasons, notably promotion of transparency. This is particularly important in terms of the investment requirements of energy producers and the transit tariff arrangements in transit countries. Agreement to work towards a “consolidated macro-economic stability and improved public finance management” – one of the goals of the Five Year Work Programme unveiled at the EuroMed summit in Barcelona on 27 November 2005, would contribute to the overall environment within which regional oil operate.

Economic integration, by which is meant moves towards development of a free trade area including any or all of the three countries under consideration, should clearly promote energy security in that it would strengthen conditions in all three countries for inward EU investment in general, and thus for energy sector investments in particular. But economic integration should not be divorced from social and even political integration. The more these partner countries are economically integrated into the EU, the greater the aspirations of their populations for real benefits. Economic integration has to be a two-way street; it has to be seen to be benefiting the partner countries; if not, it may provoke rather than prevent political discontent. In Algeria, with 36% of GDP deriving from oil and gas, ensuring that the EU (or anybody else) is not simply seen as a power seeking to secure control of the country’s principal source of wealth is obviously crucial. A similar concern arises with respect to Russia, although practical problems with transmitting a message on EU objectives to ordinary Russians will be substantial.

It may well prove necessary to balance EU concerns over investment – the energy security issue – with partner country concerns about access to the EU labour market – one of their biggest social security issues. This, of course, is not only relevant to EU relations with Algeria, but also to the Union’s relations with Egypt and, in a transit role, Jordan and Syria as well.
7. Future EU financial assistance

- The budget for the European Neighbourhood Policy ENP budget will be nearly doubled and will be close to 15 billion EUR in 2007-2013.
- The EU generic priority interest is that Neighbouring countries build as hospitable business and political environments as possible. Thus, any assistance supporting better investment climate and harmonisation of different areas with the EU regulations should bring positive results for EU business.

It is envisaged that future European Neighbourhood and Partnership Instrument (ENPI) will determine technical assistance in the EU priority areas for the next financial perspective of 2007-2013. This is to say, that the ENP budget will be nearly doubled and will be close to 15 billion EUR\(^\text{39}\). Also, it is foreseen that together with the higher budget, the ENPI will take over some of the priorities supported for bilateral assistance funds. Taking this into account, it is desirable to analyse what has been the EU financial assistance for analysed ENP economies to date. Based on these, EU member states can form positions on prioritisation of the new instrument.

Table 7.1 shows EU expenditures on programs in selected fields such as development of transport infrastructure, financial intermediation and telecommunication, together with energy sectors, water management and waste treatment in the EU Neighbourhood. Up to the end of 2006, nearly half of the overall EU financial assistance was directed to these sectors in the three Mediterranean countries. National Indicative Programmes predict that during 2005-2006 from 30% of the overall EU Indicative Programmes budget in Morocco to nearly 50% of the total budget in Algeria will be directed to cover these areas. In contrast, these areas have played a less important role in 2004-2006 EU assistance directed to Eastern partners (9% in Ukraine and around 20% in Russia of the NIPs total). However, the total EU support for private sector reform (covering also such spheres as local development and policy dialogue) in both Russia and Ukraine accounts for around 30% of the total EU funds. This broad support for private sector reform should have also beneficial effects for EU economic actors, although the influence will be indirect.

\(^{39}\) If one looks at the two existing instruments, TACIS and MEDA: it shall actually be a little more, as the ENPI will not cover Central Asian countries now covered by TACIS, those will be dealt now by the EDI –European Development Instrument.
The effectiveness of EU financial assistance in ENP countries lies beyond the scope of this report. This will depend on the constellation of factors, including the institutional solutions and priorities of ENP, absorption capacity of the ENP countries, etc. Even ex-post evaluation of financial assistance programs is a difficult exercise, though the lessons from past programs should certainly be studied in thinking about potential future impact. The experience of TACIS and MEDA is particularly relevant and recent evaluations can be found in ECORYS-NEI (2005) and DRN (2005).

Table 7.1. EU programmes in selected areas, committed funds, EUR million, 2004-2006

<table>
<thead>
<tr>
<th></th>
<th>Russia</th>
<th>Ukraine</th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transport</td>
<td>30*</td>
<td>20+10**</td>
<td>25**</td>
<td>34 + 15**</td>
<td></td>
</tr>
<tr>
<td>Financial intermediation</td>
<td>30</td>
<td>8</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Telecommunication</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>other sectors of interest:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>support to energy sector reform</td>
<td>30*</td>
<td>12</td>
<td>10**</td>
<td>25**</td>
<td>15**</td>
</tr>
<tr>
<td>water management</td>
<td>2</td>
<td>0</td>
<td>80</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td>waste treatment/environment</td>
<td>45***</td>
<td></td>
<td></td>
<td></td>
<td>10</td>
</tr>
<tr>
<td>Memorandum item: NIPs total</td>
<td>392</td>
<td>212</td>
<td>106</td>
<td>243</td>
<td>275</td>
</tr>
</tbody>
</table>

Notes:
* – transport, telecommunication, energy dialogue
** – technical assistance in implementing AA's provisions. Among others, in the transport and energy sector (regulatory reform)
*** – technical assistance in implementing PCA, among other in aligning environmental regulations to that of the EU

Source: National Indicative Programmes.

More generally, the EU generic priority interest is that these Neighbouring countries create as hospitable business and political environments as possible. Thus, any assistance supporting better investment climate and harmonisation of different areas with the EU regulations should bring positive results for EU business.

More detailed recommendations regarding ENPI can be found in section 8.2.
8. Conclusions and recommendations

This section draws from earlier analysis to formulate two sets of recommendations. Firstly, we suggest areas that could be prioritised in the existing or future action plans. Secondly, we highlight areas where good business opportunities are likely to open up for EU partners.

In discussing specific economic integration policies and the gains that EU countries can secure one should not lose sight of the broader picture. The difference in economic weight between the EU and ENP countries implies that direct economic gains from integration are unlikely to be comparable to what the EU can achieve by pursuing domestic policies aimed at deepening integration within the EU or in relations with major current and potential future trade partners, primarily the US, as well as China and India.

The economic importance of the countries covered in this report rests in that they are direct EU neighbours, and thus the EU will be directly affected by developments there in the next few years and decades. This is most dramatically illustrated in the case of negative scenarios, such as internal conflict. The Balkan wars of the early 1990s had a strong and lasting impact on the EU, with large migrations ensuing, crime (arms smuggling and human trafficking), etc. However, a similarly strong impact could result from the realisation of positive scenarios in this regard. Examples are provided by the history of economic transition leading to the 2004 EU accession of 8 Central and Eastern European countries, and developments in current EU accession countries, for instance.

The implication of this is that EU policies towards the ENP countries should be primarily oriented towards securing sustainable economic and social development in this region, rather than realisation of any short-term gains. It is in the EU’s interest to ensure that its direct neighbourhood gradually becomes a sphere of security and well-being, not only in economic terms but also in assuring basic freedoms to the populations. There may be some short-term trade-offs between such goals and the economic interests of EU partners (for instance linked to the allocation of EU budget resources, liberalisation of trade in “sensitive” sectors, etc.). However, in the long-run such trade-offs disappear and the EU’s long term economic objectives coincide with the development objectives of the ENP region.
8.1. Priority areas for EU politics – lessons for the Action Plans

This section reviews the elements of the European Neighbourhood Policy that have either already been agreed on or may be agreed on in the near future and makes recommendations as to the priorities that would help in pursuing economic integration between the EU and ENP countries in a manner most advantageous to both sides.

8.1.1. Russia

With Russia not formally part of the ENP, on one hand it would appear there is more room for manoeuvre in terms of possible policy options. But on the other hand the lack of a familiar framework could make working out a policy more difficult.

The first important observation is that a focus on the economic dimension of relations appears too narrow to formulate workable recommendations. The economic dimension should be better thought of as just one element of the complex relations, where general political and security issues play a major role. Recent trends in Russia’s development, particularly as concerns the growth of authoritarianism, human rights situation, freedom of the media, freedom of economic activity and Russia’s relations with its neighbour states have been a source of concern among several EU member states and EU institutions. While the situation at present may still be better than in some of the North African or Middle East countries, the direction of changes is worrying. It is a matter of debate whether advantages can be obtained by trying to link economic integration to progress in other spheres where the EU sees its interests (which are normally believed to coincide with the long-term interests of Russian society). The “values gap” between Russia's political elite and the EU is evidently wide. On the other hand the Putin regime enjoys undoubted political legitimacy at home, and most Russian people seem to largely support the idea that their country is only governable with a strong hand (still, when one looks at the other countries neighbouring the EU, Russian society appears closer to the EU in terms of values, basic social structures, etc.).

Russia’s high human, economic and military potential clearly distinguishes the country from other states participating in the ENP. Russia has already secured its special status in relations with the EU and it is unlikely that attempts to change this situation could be productive for either of the sides. The real challenge is how to fill high-level declarations with some practical content that could lead to meaningful progress in bilateral relations. The risk with the strategy that has been pursued so far is that special relations and various initiatives that have been agreed upon will retain their largely facade character, while real progress will lag behind what can be achieved by the EU’s dialogue with the ENP countries. One implication of this would be that the
relevance of EU-Russia dialogue would diminish further, while all matters would be settled via Russia’s bilateral relations with individual EU member states. This appears a suboptimal scenario as the divergent interests of EU member states might easily lead to deals that create conflicts within the EU. The recent clash between Germany and Poland and Baltic States over the Baltic gas pipeline provides a good example.

While Russia and the EU may be willing and able to fruitfully co-operate in several fields, some areas of conflict will likely arise. In this case the bargaining power of member states acting separately is much weaker than that of the EU as a whole, due to the EU’s variegated human and economic potential (Russia has a much larger population than any of the member states and its GDP (at market exchange rates) is roughly equal to that of the Netherlands). Thus, the chances for securing any of the EU’s joint objectives in its relations with Russia (e.g. related to security or human rights issues) would be slim.

In order to be effective EU policies need to address various concerns articulated by Russian society that has in recent years supported the policy line set by the current presidential administration. Although such a task is very difficult. There is a need to ensure wider availability of information about the EU, its objectives and policy towards Russia. This dimension should not be overlooked in shaping economic relations between the two sides if the EU wants to have a chance of eventually being perceived (by some of the population) as a friendly partner rather than as an antagonist trying to secure its interests in relation to energy commodities.

In thinking about the development of economic relations over the next five to ten years one should remember that political relations between Russia and the EU have actually worsened in the last few years compared to the situation in the 1990s. The divergence of views on the Yukos case, elections in Belarus, Ukraine and Azerbaijan, the situation in Chechnya, or the conflict with Ukraine over gas deliveries and the British “spy scandal” have prompted several observers to shift to a very negative assessment of President Putin’s regime. The major change in assessment may be partly due to earlier overly optimistic perceptions of Putin’s initial commitment to democratic values and the free market and overly pessimistic view of the most recent developments, but certainly the style and tone of the dialogue has changed and “the West wind in Moscow today is a lot frostier than just a few years ago” (Kuchins, 2005).

In the short-term perspective several political developments will be taking place offering opportunities for promotion of the economic aspects of EU-Russia relations, among other issues. Firstly, several new strategic policy documents will need to be worked out in the near future. With the current PCA expiring in 2007 there will be

---

40 As an example, commentator of the British *The Times* did not hesitate to note that “Russia’s idea of democracy and an independent media is very different from the West’s”; J. Page, Analysis: a shot across Western bows, *The Times*, 23 January 2006.
scope for in-depth thinking on a new agreement. Planning for the new financial co-operation/assistance instrument (ENPI) will need to be finalised in 2006 before it replaces TACIS in 2007. This will include working out a Country Strategy Paper and a National Indicative Programme. Additionally, a new political framework reshaping the Northern Dimension will be agreed in 2006. Thus, a window of opportunity will be open for substantial revival of co-operation in several fields.

The experience of the previous strategic documents and their implementation suggests that grand words and ideas should not be overused, while co-operation should concentrate on practical issues that are relevant for both sides. In the economic sphere, the dialogue will continue to be concentrated on energy issues.

WTO accession will be an important step for Russia that should bring more stability and predictability to EU-Russia economic relations. Trade dispute settlements should be easier, their impact less harming and the scope of introducing numerous unexpected trade restrictions reduced (recall the recent Russian bans on imports of selected commodities from several member states, described elsewhere in the report). To this end, the EU should continue supporting Russia in trying to ensure early membership, although the very nature of the WTO sets clear limits as to what the EU can do in this regard.

8.1.2. Ukraine

Ukraine belongs to the group of countries that are relatively advanced in their dialogue with the EU in the ENP framework. The Country Report had already been accepted in May 2004 and Action Plan was agreed at the end of 2004. The Action Plan already clearly identifies priorities for action, but its monitoring section explicitly allows for changes and evolution of priorities. The first review of the Action Plan should be undertaken not later than two years after its adoption, that is by the turn of 2006/2007.

An important factor is that Ukraine has declared its interest in eventual membership of the EU. Poland, Sweden, and the Baltic States have declared their support for this, while several other member states have raised concerns that it may not be realistic. The idea is certainly controversial, but even if eventually implemented it will not happen earlier than 15-20 years from now. Thus, we do not discuss this issue in the report.

In thinking about the EU’s strategy for strengthening economic integration with Ukraine in a manner that would be most beneficial to both sides one should take into account some of Ukraine’s characteristics. Ukraine’s foreign policy in recent years has been characterised by attempts to balance the objectives of integration with the EU (or the “West” in general) and Russia, which were perceived as opposing rather than
complementing each other (at least in the political sphere). President Yuschenko appears to be more committed to the “European” dimension of Ukrainian policy, though he also clearly understands the need for close economic and political cooperation with Russia. Ukrainian society is strongly divided on what should be the country’s optimal economic and foreign policy. The broadly defined “Eastern option” appears to have stronger support than a “Western option” and the level of basic knowledge about the EU is alarmingly low (Konieczna, 2006).

Deepening economic integration between the EU and Ukraine could be treated as a way to reduce the relevance of a strategic choice between “the East” and “the West” as mutually excluding options. If economic gains from such co-operation are visible to Ukrainian society and the political elite they could provide a strong impetus for deeper integration with Europe by overcoming negative stereotypes about the EU. At the same time, membership in the WTO and the strength of economic links with the EU could improve the negotiation climate in talks on Ukraine’s relations with Russia that in turn could help in building closer links between the two countries, to the benefit of both. Ukraine’s commitment to European economic integration could also become stronger on the back of recent Russian moves, aimed at heavily reducing subsidisation of energy resources sold to Ukraine. Higher domestic production costs can be expected to make integration with more developed EU countries more attractive.

The commitments listed in the EU-Ukraine Action Plans regarding economic issues by and large properly address major priorities for the EU, and the vast majority of them remain relevant today and worth pursuing. Nevertheless, we have identified the most important broad categories for action. Among the issues listed we see the following as offering the greatest potential for the benefit of both sides.

WTO accession should remain a short-term priority, as it may force some liberalisation, deregulation, and more equal treatment of economic agents. Although it seems that what remains to be done is largely on the Ukrainian side, as the bilateral negotiations with the EU are already completed. Still, the EU should extend its support where possible.

Then, if economic integration is to be pursued, an EU-Ukraine FTA should be forwarded. The existence of such an FTA would not only enhance trade and FDI in less protected sectors. It would also lay the groundwork for deeper integration in the sphere of agricultural trade and investment in agribusiness (where Ukraine is believed to possess a comparative advantage). Given the history of EU integration, such liberalisation is unlikely to occur before liberalising trade in manufacturing. Also, the conclusion of an FTA would lock-in reforms, such as completing legislation guaranteeing competition (especially regarding state aid, where foreign investors are disadvantaged).

Further approximation of Ukrainian standards and procedures to those of the EU would be beneficial to both the EU and Ukraine. It would help Ukrainian producers
get better access to the EU market (even if “access to the EU internal market” is not granted immediately, adoption of common standards will facilitate trade). It would also foster the realisation of gains from the future FTA. Such a process is underway in the industrial sector, but it is agriculture that has great potential.

The priorities regarding deepening and widening of financial intermediation are worth pursuing, as they not only create windows of opportunity for EU investors, but also lower various transaction and operating costs. From the points mentioned in the Action Plan the following are of particular relevance: strengthening banking and non-banking financial sector regulation and supervision, intensification of financial sector reform and taking measures aimed at increasing stock market capitalisation and turnover.

Any measures that support the improvement of the broadly understood investment climate are also worth pursuing. These include: easing restrictions on land ownership by foreign entities, facilitating rights of establishment, tax reform, implementation of the law on state aid and enhancing the independence of the competition authority and other regulators.

As our analysis suggests, incorporation of neighbours into pan-European networks does not pose major obstacles in terms of institutions (unlike participation in the internal market). Therefore, networks provide a good opportunity to offer neighbours a sense of inclusiveness. Common networks will also bring economic benefits, such as cost reduction and better security of supplies. Ukraine is a transit country, therefore by including it in its networks (and, thus, acquiring powers to influence Ukraine’s transit policies) the EU could improve security of supply of some important products (mainly energy). Ukraine would also benefit greatly, as improvement of its transit capacity and compatibility of its networks with EU standards would make feasible an improving of transit services and, thus, play a more important role and earn more from transit.

The Action Plan is very cautious with regard to facilitation of movement of people between the EU and Ukraine, although some recent developments have opened prospects for a more ambitious agenda in this field. Abolition of visa requirements for EU citizens introduced by the Ukrainian President in 2005 gave a new impetus to discussions about a reciprocal move from the EU side. In November 2005, the parties conducted the first round of negotiations on visa facilitation and discussions of the draft agreement on readmission of persons (a necessary condition for liberalisation of the visa regime), where they agreed on the need to simplify visa procedures and agreed a list of categories of persons to get visa-free entry into the EU. Given the costs of the readmission agreement some EU support for a functioning system for detention and deportation of illegal migrants might be needed. A more ambitious approach to the visa

---

regime may be beneficial to the EU mainly via the impact of foreign travel on the attitudes of ordinary Ukrainians. Konieczna (2006) provides evidence that foreign travel (proxied by possessing a passport) emerges as a strong determinant of basic knowledge about the EU and tends to be connected with higher human capital.

8.1.3. Morocco

Morocco is the second of the two analysed countries that have concluded an Action Plan with the EU (in 2004). At the same time, its trade links with the EU are the strongest among all the analysed countries.

Therefore, the prioritisation of the Action Plan should focus on closer trade integration with the EU and on measures that would support the implementation of the EU-Morocco FTA in manufacturing, as it is a precondition for deeper integration in other spheres. The implementation phase has already started and it is envisaged that FTA in industrial goods will be formed by 2013. Among the supporting measures listed in the Action Plan the following are of particular importance: implementation of Combined Nomenclature of products, modernisation and strengthening of capacity of customs, harmonisation of customs law with that of the EU, harmonisation of norms, standards and procedures wherever necessary.

Along with these, the conclusion of FTAs with other Southern Mediterranean countries will speed up the process of integration. The benefits for the ENP Mediterranean countries will materialise in the form of cumulative rules of origins, while on the EU side the treatment of the whole group of countries will be easier and integration should proceed more smoothly.

The next priority would be the creation of coherent agricultural policy in Morocco that would serve as a basis for the creation of free trade in agricultural products between the EU and Morocco, which in turn would allow for a full harvesting of the benefits of trade integration, as explained in section 5.1 of this report. The action should go in two broad directions. Firstly, the quality of agricultural products should be gradually improved, and secondly, coherent rural development policy should be pursued. This latter point, i.e. rural development policy, will also be needed in order to prevent large scale exodus to the cities and possibly excessive migration to the EU.

With potential large scale Moroccan migration in mind, the EU should give priority to support for social development (e.g. via strengthening the education system) in Morocco. As for the flow of people, information about the possibilities of legal migration as well as the consequences of illegal migration should be disseminated to the general public. The dialogue on the treatment of migrant workers should be reinforced and the Moroccan authorities should engage (possibly with the
EU’s assistance) in the prevention of illegal transit migration and cooperate with the EU on the readmission issue and on visa facilitation.

In general, any points of the Action Plan that address either the development of the business climate in Morocco or the development of the SME sector or promotion of education are also worth pursuing, as they will tend to limit illegal migration and support the overall development of the country.

8.1.4. Egypt

The recommendations for the future EU-Egypt Action Plan are based on the country report that was released in 2005.

Following the implementation phase of the EU-Egypt FTA that started in 2004, the monitoring of the timing of tariff dismantling and of the implementation of supporting measures should be the main focus. During the first three years Egypt is supposed to gradually phase out tariffs on about half of all imports from the EU. As the consumer goods sector in Egypt will remain protected for a considerable length of time, a focus on the implementation of other trade liberalisation and reform measures is also of particular importance. It should also be noted that the Egyptian economy, after being relatively open in the 1970s and 1980s, was heavily protected through the 1990s and export-orientation has received a boost only since 2001. The adherence of the Egyptian government to the objective of opening the economy should receive international support.

Among various measures supporting trade liberalisation the enactment of a new customs code (to replace the outdated 1963 one) and work on further restructuring of the customs administration appear worthy of receiving priority attention.

It is also important to carefully monitoring whether the bilateral preferences in agricultural trade between the EU and Egypt are granted as scheduled. As regards domestic policy, the EU could extend its assistance to Egypt in the sphere of coordination of foodstuff requirements, in order to simplify respective requirements so that these are coordinated by a single agency only and can indeed be met by producers.

Due to its large oil and gas resources, Egypt is an important EU partner in energy sector cooperation. Thanks to the sizeable discoveries of gas Egypt is becoming an important gas producer. Egypt also plays an important role in energy transit, with the Suez Canal and the Suez-Mediterranean pipeline serving as major transit routes for Persian energy resources. Therefore, cooperation in the field of pipeline transport should be of particular importance from the point of view of EU energy security. The regional Arab gas pipeline could at some future stage of development be connected not only to Cyprus and Turkey, but also to Greece and Central Europe. This is a rather
long-term goal, but cooperation in the planning and even early development stage with the EU would appear beneficial.

Given the domestic political situation in Egypt, gradually falling public support for the presidential “dynasty”, and hence uncertainty about future commitments to further reforms, promotion of openness, transparency, etc., political dialogue with the EU should support strengthening of Egypt’s economic ties with the EU that could benefit the general public.

8.1.5. Algeria

Relations with Algeria will most likely be dominated by energy issues and support for the general development of the country. Among the three Mediterranean ENP states considered here, Algeria’s relations with the EU within the ENP framework are at the least advanced stage. The sides concluded the AA only in 2005. The country report, which will create the basis for the Action Plan, is to be prepared some time in 2006-2007.

In the field of energy, large oil and gas extraction potential, existing demand especially from the European market, and the investment needs of the country create fields for EU-Algerian cooperation. For the EU the development of an attractive investment climate for international energy companies remains crucial. The major EU extracting companies are already well-established in Algeria, as are suppliers and service companies. The issue therefore is not one of specific new opportunities for EU companies, but the development of existing relations and the improvement of security conditions in the country.

Given the political situation in Algeria, the challenge for the EU remains helping in the improvement the political climate without jeopardising the economic recovery. Thus, any future actions that would support general economic development should support building prosperity and stability in Algeria as well as in the neighbourhood.

8.2. Approaches to ENPI

This section seeks to draw some broad lessons for the way in which the European Neighbourhood and Partnership Instrument (ENPI) can be applied in the ENP countries starting from 2007.

The general and rather obvious observation is that the ENPI should build upon experience gathered during the operations of previous EU financial assistance operations targeted at the countries concerned. In particular the experience in implementation of
TACIS and MEDA should be carefully analysed. Recent evaluation reports on these two programmes are particularly useful (ECORYS-NEI, 2005; DRN, 2005).

With regard to the EU-ENP partners bilateral relations, greater reliance on incentive schemes, where additional financial assistance could be linked to progress in domestic liberalisation of financial services and telecommunication could be beneficial for both sides including business communities. Such actions could boost services trade and create investment opportunities.

Greater synergy between ENPI, European Investment Bank, EBRD and World Bank financial flows to the neighbouring countries is needed. Both technical assistance funds and development loans should be more closely related to the priorities and commitments expressed in Action Plans. This in particular relates to financing of infrastructure development (ports, roads etc.). More “inter-programme” coherence should help in addressing at least part of the concerns related to weak effectiveness of the TACIS and MEDA programmes. At present, a widespread criticism is that the constraints on the process of contracting and financial control imposed upon the Commission by the Council and European Parliament make it extremely difficult to devise timely and user-friendly projects. As a result, the EU’s private sector may best rely on its own resources for using consultancy services.

8.3. Business opportunities for EU actors

The successful economic and social development of the ENP countries and closer economic co-operation with the EU would not only expand the zone of security and stability to Europe’s borders and beyond, improving the standard of living of local populations, but could also create business opportunities for the EU economic actors. This section outlines some such potential opportunities, although, given the geographic and sectoral scope of this report, the discussion necessarily remains rather general in nature.

Business opportunities for EU enterprises arising from market integration between the EU and ENP countries will depend on the timing and specific solutions within agreed forms of market integration. Thus, while discussing particular options we explicitly refer to market integration models.

The energy sector is one where there has already been substantial involvement of EU companies and where realisation of a positive political scenario would create more lucrative options. The scope of new opportunities will be primarily determined by liberalisation of energy FDI rules and practice and overall improvement in the investment climate in Russia, progress of reforms in the energy sector in Ukraine, and security developments in Algeria. Thus, the link to chosen forms of economic integration...
integration is indirect, but at the same time there are obvious lessons as to what elements of co-operation agreements the EU could try to promote to improve business opportunities in the energy sector.

In terms of gas supply, there will be specific prospects for investment in developing gas transport infrastructure. This mainly refers to the completion of the Nabucco pipeline (by 2011) intended to convey gas from Turkey via Bulgaria, Romania and Hungary to the Austrian hub, the Turkey-Greece-Italy Interconnector, and in the longer term a possible gas line from Greece through the western Balkans to Central Europe, new LNG terminals in the Mediterranean area and further pipelines to expand gas deliveries from North Africa.

With regard to specific prospects in Russia, direct investment opportunities may prove limited unless there is a change in Russia’s approach. It is expected that cooperation will be exceptional, as was the case with the North European gas pipeline under the Baltic Sea to Germany. In the absence of major Russian reforms covering foreign ownership and the creation of a competitive internal market, this is not likely to happen in any general manner. What there will be, however, is considerable opportunity for provision of equipment and services for both upstream and infrastructure projects. Russian energy companies will be looking for high-tech skills and equipment.

In Ukraine, reforms of the energy sector should create opportunities in particular in equipment purchases, ensuring energy effectiveness, developing Ukraine’s traditional and alternative sources of energy and modernising the pipeline system. For instance, Shell was one of the first larger oil companies to sign a contract with Naftogas of Ukraine to invest in gas exploration. While the progress of energy reforms has been problematic in the past, the very recent conflict with Russia on the price of imported gas (and resulting increase in imported gas prices) might provide a stimulus for a more coherent approach to reforming the sector.

The further development of the investment climate and overall stability in Algeria will provide a window of opportunity to broaden investment in the oil and gas sector there.

Another important sector with potentially large potential for fruitful business cooperation, foreign trade and investment is agriculture and food processing. Here, the nature of emerging opportunities will be determined by specific solutions leading to partial liberalisation of trade in agricultural goods.

In all five countries, food processing has been developing rapidly over the last few years and this trend is expected to continue. This, firstly, creates opportunities for producers of food processing equipment as new high-tech equipment purchases are a necessary element of quality improvement processes and indeed demand for such equipment appears strong, at least in Russia and Ukraine. An additional advantage comes from the fact that EU companies currently dominate this market (at least in Russia) (BISNIS, 2005).
Investments in food processing could ensure taking some of the gains from this rapid expansion. Investments oriented towards the domestic market and markets of neighbouring states may already be attractive, though given the still low purchasing power of the populations of the ENP countries only ensuring that food processed in particular ENP countries can eventually access EU markets would make investments much less risky. There is therefore an important and potentially difficult policy issue of lifting some of the EU’s import restrictions for food products from the ENP countries. This should be linked to ensuring that essential quality standards and in particular food safety standards are not compromised. This will be a challenge for Russia and Ukraine and perhaps even more so for three North African countries, where standards need to become an element of FTAs. There is therefore scope for EU support in strengthening the national quality control systems, possibly making them more coherent with EU quality regulations. Bearing the costs of introduction of standards would most usefully be shared between EU and ENP countries as the subject can be considered as being a joint responsibility of both sides. While introduction of standards and quality control systems is costly some countries may opt for this if promised reasonable access to the EU market once the system is functional and the EU’s support for systems implementation. The latter would in itself create opportunities for companies with know-how in quality control and management.

The experience of the new EU member states can be instructive in thinking about options for the food sector. The boom in food exports from new member states to more developed EU countries could on the one hand indicate the great potential of the sector (stemming from cheaper labour, favourable natural conditions, etc.). On the other hand the fact that when the moment of EU accession arrived trade patterns changed substantially, even after years of FTAs, clearly illustrates the importance of various trade barriers that countries from outside the EU face. Thus, the prospects for deeper co-operation between the EU and ENP countries and business opportunities that may emerge are determined not only by the institutional character of the co-operation option that will be chosen but also, or primarily so, by the effective level of market protection that the EU will be maintaining.

---

43 Local markets, while expanding dynamically, are still quite shallow. Most consumers in North African countries still cannot afford imported food products. For instance, recent estimates suggest that only some 10% of Moroccans buy imported food products (Agriculture and Agri-Food Canada, 2005).
44 Examples of such initiatives include the “Improvement of logistics services and marketing channels for SMEs in agriculture” project organised jointly by TACIS and the Ukrainian Ministry of Agriculture and targeted at improving food safety on Ukraine’s livestock market (http://www.agrilogistics.com.ua/?lang=eng) and another project in Ukraine: “The establishment of an Agricultural Standards Certification and Control Mechanisms in Line with WTO-SPS Requirements”, that is focused on preparation of proposals for legislative and regulatory changes in the areas of food safety and production in line with WTO-SPS requirements. One of its outcomes was a creation of the WTO-SPS Information Centre (http://www.sps-info.org.ua/en/home/).
There are very interesting potential opportunities that may open up in the services sector. Within the financial intermediation sector these will depend on the development of prudential and other regulation at the national level. An effective domestic prudential regulation is a pre-requisite for cross-border integration. In view of the above the most appropriate method for the integration of financial services is a path of domestic reforms.

Some opportunities for investment in the financial sector will open in Russia, as it is expected that the efficiency, performance, transparency and credibility of the sector will have improved by 2007. The Russian government is supposed to approximate its relevant legislation to that of the EU, and domestic demand for financial intermediation will steadily expand. The opportunities may arise in expanding existing operations or potential greenfield investment, as the Russian central bank’s strategy does not envisage any large privatisation before 2008.

The Ukrainian market, although much smaller, may offer relatively more opportunities. These will primarily stem from expected entries of some international players, increased competition, further easing of capital restrictions, increased efficiency of supervisory authorities, both in the banking and in the insurance sector.

The opportunities for financial services development in Morocco and in Egypt will be conditional on the realisation of its commitments concerning independent regulators, easing restrictions on the capital account and privatisation efforts.

Within the transport sector, the opportunities will gradually expand in the ENP countries in air transportation, together with liberalisation of services, adoption of European and international standards and commitments and opening possibilities for new connections. Morocco and Ukraine are expected to be the most promising markets in this sphere. With respect to cooperation with Russia, royalties from flying over Siberia are expected to be gradually eliminated and disappear by 2013.

There are plans for investment in road transportation, developing national road networks as part of Pan-European transport corridors, improvement of road safety etc., which will open possibilities for logistics companies. Again, here Morocco and Ukraine are currently perceived as frontrunners. However, given the high costs of road infrastructure to be borne, these will happen in a gradual way and can deliver rather longer-term gains.

Within the sphere of development of water transport infrastructure, new opportunities are likely to open up in Morocco, as can be judged from declarations of granting easier access to port services and privatisation and approximation of Moroccan regulations to EU law. Also, the opportunities are apparently arising in river transport in Russia, on the back of the need for investment in infrastructure and declarations about easier access. In the future, Ukraine might also be an interesting place in this regard.
More generally, the EU’s generic priority interest is that its neighbour countries (and the five countries covered in this report in particular) create as hospitable business and political environments as possible, by European standards. This means that the EU should give a high priority to its political and economic investment in the neighbourhood policy concept. While this might seem obvious, actually some member states have their reasons (poorly conceived in our view) to treat the ENP as a token piece of inexpensive diplomacy to placate the neighbours for not being offered a membership perspective. To counter this “placebo diplomacy” in the Council is an important task for those member states who take a more serious pro-active view. In fact the EU has unique advantages: an attractive normative reputation with its neighbours – from multiple angles – such as honest business methods, technical modernity, political ideals for Europe, etc. This makes it plausible for the EU to work hard at leveraging into these neighbouring states its technical and normative standards, which if done successfully will effectively extend the EU’s sphere of economic influence and privileged market area.
Annex 1. NAFTA and labour mobility

There are various categories of temporary entry for business persons among the NAFTA member states: business visitors, traders and investors, intra-company transferees and professionals. The basic principles for the temporary entry for businesspersons in NAFTA are transparent criteria and procedures, reciprocity and recognition of the preferential trading relationship. There are no conditions – such as labour certification tests, prior approval procedures, petition, or other procedures of similar effect – and with one broad exception related to professional services there are no numerical quota restrictions.

The definition of a ‘business visitor’ is a citizen of a party who is engaged in the trade of goods, the provision of services or the conduct of investment activities. ‘Temporary’ is defined as having no intent to establish permanent residence. NAFTA grants temporary entry visas to business visitors seeking to engage in a business activity without requiring that person to obtain an employment authorisation from the host country. Visitors must ensure that their primary source of remuneration for the proposed business activity is their home country, not the territory of the party granting temporary entry; their principal place of business and actual place of accrual of profits must, at least predominantly, remain outside such territory. Instead of defining what kind of persons or professions may move, the NAFTA agreement defines the business activities in which such persons engage. Business activities include: research and design; growth, manufacture and production; agriculture (harvester-owner supervising a harvesting crew admitted under the applicable law); marketing (market researchers and analysts conducting research); sales, distribution, after-sales services and general service including tourism. Under the category of sales, for example, Mexican sales representatives and agents are allowed to enter Canada to take orders or negotiate contracts for goods or services for the Mexican firm. They are not, however, allowed to deliver goods or provide services to the public in Canada. Relatively low-skilled workers, such as transportation operators (tour-bus operators) are allowed to move across countries to provide services under the auspices of their domestic companies.

The second NAFTA category under the temporary entry of businesspersons is for traders and investors. Traders, who carry on substantial trade in goods and services between member states are granted temporary entry. Investors are those who are seeking to establish, develop, administer or provide advice or key technical services to the operation of an investment. The investment does not have to be owned by the person who is seeking the temporary entry nor does it have to be committed, but can rather be in the process of commitment. The agreement indicates that the investment should involve a ‘substantial’ amount of capital, but without spelling out how much this would be.

Under the category of intra-company transferees, the person involved must have been employed continuously by the enterprise for one year in the previous three-year period. He/she must work in the capacity of manager or executive, or be the repository of special knowledge. As with all the other categories, there are no numerical quotas imposed on the intra-companies transferees between NAFTA members.
Under the category of professionals, NAFTA encourages the mutual recognition of accreditation, licensing and certification requirements. A person seeking to engage in a business activity at a competent level in a profession is permitted temporary entry. Unlike the other categories, however, this category allows the US to impose annual numerical limits on Mexico. Initially, the US approved up to 5,500 professional Mexicans per annum seeking temporary entry to the US; NAFTA requires that the US should, in consultation with Mexico, increase its annual quota each year. The US and Mexico agreed that the US would phase out the annual quotas if it grants a better treatment to a third party (a most-favoured nation clause) or ten years after signing the agreement, whichever is sooner. In defining ‘professionals’, most require a university degree or equivalent qualification.

Compiled from (Winters et. al, 2002)
### Table 3.1A. Geographical and commodity structure of Algerian, Egyptian, Moroccan, Russian and Ukrainian trade, 2003

<table>
<thead>
<tr>
<th></th>
<th>Russia</th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
<th>Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Exports</strong></td>
<td>By commodity</td>
<td>By commodity</td>
<td>By commodity</td>
<td>By commodity</td>
<td>By commodity</td>
</tr>
<tr>
<td>Agricultural products</td>
<td>7.5</td>
<td>0.2</td>
<td>14.3</td>
<td>19.1</td>
<td>12</td>
</tr>
<tr>
<td>Fuels and mining products</td>
<td>59.9</td>
<td>97.9</td>
<td>50.5</td>
<td>12.5</td>
<td>17.3</td>
</tr>
<tr>
<td>Manufactures</td>
<td>27.5</td>
<td>1.2</td>
<td>27</td>
<td>68.2</td>
<td>69.4</td>
</tr>
<tr>
<td><strong>Imports</strong></td>
<td>By commodity</td>
<td>By commodity</td>
<td>By commodity</td>
<td>By commodity</td>
<td>By commodity</td>
</tr>
<tr>
<td>Agricultural products</td>
<td>16.8</td>
<td>24</td>
<td>27.4</td>
<td>14.2</td>
<td>7.7</td>
</tr>
<tr>
<td>Fuels and mining products</td>
<td>5.1</td>
<td>2.2</td>
<td>12.2</td>
<td>19.3</td>
<td>38.6</td>
</tr>
<tr>
<td>Manufactures</td>
<td>77.6</td>
<td>73.8</td>
<td>51.8</td>
<td>66.4</td>
<td>52.4</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>By main destination</strong></th>
<th>Russia</th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
<th>Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. European Union (25)</td>
<td>40.3</td>
<td>54</td>
<td>34</td>
<td>73.9</td>
<td>33</td>
</tr>
<tr>
<td>2. Belarus</td>
<td>5.7</td>
<td>23.6</td>
<td>8.5</td>
<td>4.1</td>
<td>17.6</td>
</tr>
<tr>
<td>3. Ukraine</td>
<td>5</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
<td>6.9</td>
</tr>
<tr>
<td>5. Turkey</td>
<td>3.1</td>
<td>2.3</td>
<td>1.1</td>
<td>2.8</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>18</td>
<td>15.5</td>
<td>1.1</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th><strong>By main origin</strong></th>
<th>Russia</th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
<th>Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. European Union (25)</td>
<td>45</td>
<td>54.6</td>
<td>27.8</td>
<td>55.7</td>
<td>37.1</td>
</tr>
<tr>
<td>2. Ukraine</td>
<td>8.1</td>
<td>5.9</td>
<td>11.7</td>
<td>5.7</td>
<td>32.2</td>
</tr>
<tr>
<td>3. Belarus</td>
<td>7.9</td>
<td>5</td>
<td>4.9</td>
<td>5.4</td>
<td>11.1</td>
</tr>
<tr>
<td>4. China</td>
<td>6.3</td>
<td>3.6</td>
<td>4.2</td>
<td>4. United States 2.7</td>
<td></td>
</tr>
<tr>
<td>5. Japan</td>
<td>5.2</td>
<td>3.4</td>
<td>4.1</td>
<td>5. Kazakhstan 2.3</td>
<td></td>
</tr>
<tr>
<td>Other</td>
<td>1.1</td>
<td></td>
<td>14.1</td>
<td>0.3</td>
<td></td>
</tr>
</tbody>
</table>

Source: WTO trade statistics.
Table 3.2A. Composition of EU trade with 5 countries, in percent, 2004

<table>
<thead>
<tr>
<th>HS</th>
<th>Description</th>
<th>EU imports from</th>
<th></th>
<th>EU exports to</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>ALGERIA</td>
<td>EGYPT</td>
<td>MOROCCO</td>
<td>RUSSIA</td>
</tr>
<tr>
<td>I-XXI Total*</td>
<td></td>
<td>78.2</td>
<td>99.4</td>
<td>99.1</td>
<td>88.1</td>
</tr>
<tr>
<td>I-IV</td>
<td>Agricultural products</td>
<td>0.3</td>
<td>8.5</td>
<td>22.4</td>
<td>0.9</td>
</tr>
<tr>
<td>V-XXI</td>
<td>Non-agricultural products</td>
<td>77.9</td>
<td>90.9</td>
<td>76.7</td>
<td>87.2</td>
</tr>
<tr>
<td>I</td>
<td>Live animals and animal products</td>
<td>0.1</td>
<td>1.1</td>
<td>6.0</td>
<td>0.4</td>
</tr>
<tr>
<td>II</td>
<td>Vegetable products</td>
<td>0.1</td>
<td>6.6</td>
<td>10.6</td>
<td>0.3</td>
</tr>
<tr>
<td>III</td>
<td>Fats and oils</td>
<td>0.0</td>
<td>0.0</td>
<td>0.8</td>
<td>0.0</td>
</tr>
<tr>
<td>IV</td>
<td>Processed foodstuffs, beverages and tobacco</td>
<td>0.1</td>
<td>0.7</td>
<td>5.0</td>
<td>0.1</td>
</tr>
<tr>
<td>V</td>
<td>Mineral products</td>
<td>73.4</td>
<td>45.3</td>
<td>5.2</td>
<td>63.4</td>
</tr>
<tr>
<td>VI</td>
<td>Chemical products</td>
<td>1.2</td>
<td>3.9</td>
<td>5.1</td>
<td>3.8</td>
</tr>
<tr>
<td>VII</td>
<td>Plastics, rubber and related products</td>
<td>0.0</td>
<td>2.3</td>
<td>0.4</td>
<td>0.4</td>
</tr>
<tr>
<td>VIII</td>
<td>Leather, skin and related products</td>
<td>0.1</td>
<td>1.4</td>
<td>0.7</td>
<td>0.2</td>
</tr>
<tr>
<td>IX</td>
<td>Timber and timber products</td>
<td>0.1</td>
<td>0.1</td>
<td>0.9</td>
<td>2.2</td>
</tr>
<tr>
<td>X</td>
<td>Wood pulp, paper and board</td>
<td>0.0</td>
<td>0.3</td>
<td>0.5</td>
<td>0.7</td>
</tr>
<tr>
<td>XI</td>
<td>Fabrics and fabric products</td>
<td>0.0</td>
<td>15.5</td>
<td>38.9</td>
<td>0.3</td>
</tr>
<tr>
<td>XII</td>
<td>Shoes, hats, and cups</td>
<td>0.0</td>
<td>0.3</td>
<td>2.9</td>
<td>0.0</td>
</tr>
<tr>
<td>XIII</td>
<td>Glass, stone products, cement</td>
<td>0.0</td>
<td>1.4</td>
<td>0.7</td>
<td>0.1</td>
</tr>
<tr>
<td>XIV</td>
<td>Pearls, precious stones</td>
<td>0.0</td>
<td>0.3</td>
<td>0.1</td>
<td>2.7</td>
</tr>
<tr>
<td>XV</td>
<td>Non-precious metals</td>
<td>0.8</td>
<td>10.7</td>
<td>2.9</td>
<td>11.4</td>
</tr>
<tr>
<td>XVI</td>
<td>Machinery and equipment</td>
<td>0.3</td>
<td>3.9</td>
<td>15.8</td>
<td>0.8</td>
</tr>
<tr>
<td>XVII</td>
<td>Transport equipment</td>
<td>2.0</td>
<td>3.7</td>
<td>1.1</td>
<td>0.7</td>
</tr>
<tr>
<td>XVIII</td>
<td>Measure and controlling equipment</td>
<td>0.0</td>
<td>0.7</td>
<td>0.4</td>
<td>0.1</td>
</tr>
<tr>
<td>XIX</td>
<td>Arms and ammunition</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>XX</td>
<td>Various manufactures</td>
<td>0.0</td>
<td>0.7</td>
<td>0.9</td>
<td>0.2</td>
</tr>
<tr>
<td>XXI</td>
<td>Works of art</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td></td>
<td>Other</td>
<td>0.0</td>
<td>0.5</td>
<td>0.1</td>
<td>0.5</td>
</tr>
<tr>
<td></td>
<td>Memorandum:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Total, EUR mln</td>
<td>15250</td>
<td>4192</td>
<td>6549</td>
<td>80708</td>
</tr>
</tbody>
</table>

Note: * – total is less than 100% because of some unclassified transactions.
Source: Own calculations based on Eurostat data.
Table 4.1A. Selected indicators of starting a business in the ENP countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Procedures (number)</th>
<th>Time (days)</th>
<th>Cost (% of income per capita)</th>
<th>Min. capital (% of income per capita)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVERAGE (2005)</td>
<td>10.4</td>
<td>27.6</td>
<td>31.6</td>
<td>336.5</td>
</tr>
<tr>
<td>Algeria</td>
<td>14</td>
<td>26</td>
<td>25.3</td>
<td>55.1</td>
</tr>
<tr>
<td>Egypt</td>
<td>10</td>
<td>34</td>
<td>104.9</td>
<td>739.8</td>
</tr>
<tr>
<td>Morocco</td>
<td>5</td>
<td>11</td>
<td>12</td>
<td>700.3</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>8</td>
<td>33</td>
<td>5</td>
<td>4.4</td>
</tr>
<tr>
<td>Ukraine</td>
<td>15</td>
<td>34</td>
<td>10.6</td>
<td>183</td>
</tr>
</tbody>
</table>


Table 4.2A Selected indicators of starting hiring and firing workers in the ENP countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Difficulty of Hiring Index</th>
<th>Rigidity of Hours Index</th>
<th>Difficulty of Firing Index</th>
<th>Rigidity of Employment Index</th>
<th>Hiring cost (% of salary)</th>
<th>Firing costs (weeks of wages)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVERAGE (2005)</td>
<td>37.6</td>
<td>60</td>
<td>56</td>
<td>51</td>
<td>28.7</td>
<td>59.1</td>
</tr>
<tr>
<td>Algeria</td>
<td>44</td>
<td>60</td>
<td>50</td>
<td>51</td>
<td>27.5</td>
<td>16.9</td>
</tr>
<tr>
<td>Egypt</td>
<td>0</td>
<td>80</td>
<td>80</td>
<td>53</td>
<td>26</td>
<td>162.3</td>
</tr>
<tr>
<td>Morocco</td>
<td>100</td>
<td>40</td>
<td>40</td>
<td>60</td>
<td>17.7</td>
<td>83.3</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>0</td>
<td>60</td>
<td>30</td>
<td>30</td>
<td>35.8</td>
<td>16.6</td>
</tr>
<tr>
<td>Ukraine</td>
<td>44</td>
<td>60</td>
<td>80</td>
<td>61</td>
<td>36.4</td>
<td>16.6</td>
</tr>
</tbody>
</table>


Table 4.3A. Selected indicators of trading across borders in the ENP countries

<table>
<thead>
<tr>
<th>Country</th>
<th>Documents for export (number)</th>
<th>Signatures for export (number)</th>
<th>Time for export (days)</th>
<th>Documents for import (number)</th>
<th>Signatures for import (number)</th>
<th>Time for import (days)</th>
</tr>
</thead>
<tbody>
<tr>
<td>AVERAGE (2005)</td>
<td>7.4</td>
<td>9.8</td>
<td>30</td>
<td>9.2</td>
<td>11.4</td>
<td>38.8</td>
</tr>
<tr>
<td>Algeria</td>
<td>8</td>
<td>8</td>
<td>29</td>
<td>8</td>
<td>12</td>
<td>51</td>
</tr>
<tr>
<td>Egypt</td>
<td>8</td>
<td>11</td>
<td>27</td>
<td>9</td>
<td>8</td>
<td>29</td>
</tr>
<tr>
<td>Morocco</td>
<td>7</td>
<td>13</td>
<td>31</td>
<td>11</td>
<td>17</td>
<td>33</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>8</td>
<td>8</td>
<td>29</td>
<td>8</td>
<td>10</td>
<td>35</td>
</tr>
<tr>
<td>Ukraine</td>
<td>6</td>
<td>9</td>
<td>34</td>
<td>10</td>
<td>10</td>
<td>46</td>
</tr>
</tbody>
</table>

Table 5.1A. EU25 trade in services with selected countries in 2003 in millions of euro

<table>
<thead>
<tr>
<th></th>
<th>Extra EU</th>
<th>Russian Federation</th>
<th>Ukraine</th>
<th>Northern Africa</th>
<th>Egypt</th>
<th>Morocco</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>credit</td>
<td>debit</td>
<td>credit</td>
<td>debit</td>
<td>credit</td>
<td>debit</td>
</tr>
<tr>
<td>Services - total</td>
<td>330 649</td>
<td>295 030</td>
<td>6 727</td>
<td>5 152</td>
<td>6 500</td>
<td>9 632</td>
</tr>
<tr>
<td>Transportation</td>
<td>78 502</td>
<td>70 447</td>
<td>1 799</td>
<td>2 004</td>
<td>1 554</td>
<td>2 958</td>
</tr>
<tr>
<td>Sea transport</td>
<td>38 280</td>
<td>33 702</td>
<td>:</td>
<td>:</td>
<td>6 102</td>
<td>695</td>
</tr>
<tr>
<td>Air transport</td>
<td>28 260</td>
<td>24 534</td>
<td>:</td>
<td>:</td>
<td>75</td>
<td>59</td>
</tr>
<tr>
<td>Other transport</td>
<td>11 963</td>
<td>27 910</td>
<td>:</td>
<td>:</td>
<td>42</td>
<td>237</td>
</tr>
<tr>
<td>Travel</td>
<td>63 682</td>
<td>75 722</td>
<td>2 052</td>
<td>1 388</td>
<td>299</td>
<td>162</td>
</tr>
<tr>
<td>Communications services</td>
<td>5 960</td>
<td>6 870</td>
<td>:</td>
<td>:</td>
<td>15</td>
<td>21</td>
</tr>
<tr>
<td>Construction services</td>
<td>10 567</td>
<td>5 985</td>
<td>:</td>
<td>:</td>
<td>46</td>
<td>13</td>
</tr>
<tr>
<td>Insurance services</td>
<td>15 227</td>
<td>5 478</td>
<td>:</td>
<td>:</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>Financial services</td>
<td>21 482</td>
<td>10 160</td>
<td>:</td>
<td>:</td>
<td>25</td>
<td>6</td>
</tr>
<tr>
<td>Computer and information services</td>
<td>15 922</td>
<td>7 284</td>
<td>:</td>
<td>:</td>
<td>43</td>
<td>14</td>
</tr>
<tr>
<td>Royalties and license fees</td>
<td>15 094</td>
<td>24 291</td>
<td>:</td>
<td>:</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Other business services</td>
<td>88 481</td>
<td>74 145</td>
<td>:</td>
<td>:</td>
<td>83</td>
<td>132</td>
</tr>
<tr>
<td>Personal, cultural and recreational services</td>
<td>3 981</td>
<td>5 271</td>
<td>:</td>
<td>:</td>
<td>2</td>
<td>7</td>
</tr>
<tr>
<td>Government services, n.i.e.</td>
<td>9 286</td>
<td>6 444</td>
<td>:</td>
<td>:</td>
<td>17</td>
<td>18</td>
</tr>
</tbody>
</table>

Percent of Extra-EU trade

<table>
<thead>
<tr>
<th></th>
<th>Extra EU</th>
<th>Russian Federation</th>
<th>Ukraine</th>
<th>Northern Africa</th>
<th>Egypt</th>
<th>Morocco</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>..</td>
<td>..</td>
<td>2%</td>
<td>2%</td>
<td>0%</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>..</td>
<td>..</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>2%</td>
</tr>
<tr>
<td></td>
<td>..</td>
<td>..</td>
<td>0%</td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>..</td>
<td>..</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
<td>1%</td>
</tr>
</tbody>
</table>

Note: no data for Algeria available. North Africa covers data from Algeria, Egypt, Libyan (Arab Jamahiriya), Tunisia.
Source: BoP data from Eurostat.
Table 5.2A. EU15 trade in services with selected countries in 2003 in millions of euro

<table>
<thead>
<tr>
<th></th>
<th>Extra EU</th>
<th>Russian Federation</th>
<th>Ukraine</th>
<th>Northern Africa</th>
<th>Egypt</th>
<th>Morocco</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>credit</td>
<td>debit</td>
<td>credit</td>
<td>debit</td>
<td>credit</td>
<td>debit</td>
</tr>
<tr>
<td>Services - total</td>
<td>313 650</td>
<td>280 635</td>
<td>4 922</td>
<td>4 626</td>
<td>575</td>
<td>566</td>
</tr>
<tr>
<td>Transportation</td>
<td>73 228</td>
<td>67 180</td>
<td>493</td>
<td>1 425</td>
<td>689</td>
<td>2 091</td>
</tr>
<tr>
<td>Sea transport</td>
<td>36 573</td>
<td>32 699</td>
<td>220</td>
<td>929</td>
<td>268</td>
<td>1 471</td>
</tr>
<tr>
<td>Air transport</td>
<td>27 163</td>
<td>23 629</td>
<td>169</td>
<td>257</td>
<td>271</td>
<td>375</td>
</tr>
<tr>
<td>Other transport</td>
<td>9 492</td>
<td>10 851</td>
<td>104</td>
<td>240</td>
<td>149</td>
<td>243</td>
</tr>
<tr>
<td>Travel</td>
<td>57 326</td>
<td>72 058</td>
<td>1 535</td>
<td>1 249</td>
<td>185</td>
<td>154</td>
</tr>
<tr>
<td>Communications services</td>
<td>5 742</td>
<td>6 404</td>
<td>:</td>
<td>:</td>
<td>14</td>
<td>19</td>
</tr>
<tr>
<td>Construction services</td>
<td>9 971</td>
<td>5 386</td>
<td>:</td>
<td>:</td>
<td>41</td>
<td>10</td>
</tr>
<tr>
<td>Insurance services</td>
<td>15 062</td>
<td>5 283</td>
<td>:</td>
<td>:</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>Financial services</td>
<td>21 083</td>
<td>9 514</td>
<td>:</td>
<td>:</td>
<td>24</td>
<td>3</td>
</tr>
<tr>
<td>Computer and information services</td>
<td>15 610</td>
<td>6 989</td>
<td>:</td>
<td>:</td>
<td>40</td>
<td>14</td>
</tr>
<tr>
<td>Royalties and license fees</td>
<td>14 965</td>
<td>23 558</td>
<td>:</td>
<td>:</td>
<td>3</td>
<td>1</td>
</tr>
<tr>
<td>Other business services</td>
<td>85 765</td>
<td>70 738</td>
<td>:</td>
<td>:</td>
<td>64</td>
<td>106</td>
</tr>
<tr>
<td>Personal, cultural and recreational services</td>
<td>3 378</td>
<td>4 506</td>
<td>:</td>
<td>:</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Government services, n.i.e.</td>
<td>9 068</td>
<td>6 092</td>
<td>:</td>
<td>:</td>
<td>15</td>
<td>14</td>
</tr>
<tr>
<td>Percent of Extra-EU trade</td>
<td>..</td>
<td>..</td>
<td>2%</td>
<td>1%</td>
<td>0%</td>
<td>0%</td>
</tr>
</tbody>
</table>

Note: no data for Algeria available. North Africa covers data from Algeria, Egypt, Libyan (Arab Jamahiriya), Tunisia.
Source: BoP data from Eurostat.
Table 5.3A. Selected transport infrastructure indicators for 5 ENP economies, 1997-2003

<table>
<thead>
<tr>
<th></th>
<th>Roads</th>
<th>Railways</th>
<th>Ports</th>
<th>Air</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Total road network</td>
<td>Paved roads</td>
<td>Passengers carried</td>
<td>Goods hauled</td>
</tr>
<tr>
<td></td>
<td>km</td>
<td>%</td>
<td>passenger km</td>
<td>ton-km</td>
</tr>
<tr>
<td>Algeria</td>
<td>104,000</td>
<td>68.9</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Egypt, Arab Rep.</td>
<td>64,000</td>
<td>78.1</td>
<td>..</td>
<td>..</td>
</tr>
<tr>
<td>Morocco</td>
<td>57,694</td>
<td>56.4</td>
<td>3</td>
<td>2,952</td>
</tr>
<tr>
<td>Russian Federation</td>
<td>537,289</td>
<td>67.4</td>
<td>164</td>
<td>139</td>
</tr>
<tr>
<td>Ukraine</td>
<td>169,679</td>
<td>96.8</td>
<td>36,612</td>
<td>20,593</td>
</tr>
<tr>
<td>comparators:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Turkey</td>
<td>354,421</td>
<td>41.6</td>
<td>163,327</td>
<td>150,912</td>
</tr>
<tr>
<td>Poland</td>
<td>364,697</td>
<td>68.3</td>
<td>30,997</td>
<td>74,403</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>42,970</td>
<td>87.3</td>
<td>33,234</td>
<td>22,347</td>
</tr>
<tr>
<td>Europe EMU</td>
<td>99.5</td>
<td>76,186</td>
<td>32,700</td>
<td>120,432</td>
</tr>
<tr>
<td>France</td>
<td>893,100</td>
<td>100</td>
<td>..</td>
<td>245,400</td>
</tr>
<tr>
<td>Netherlands</td>
<td>116,500</td>
<td>90</td>
<td>193,900</td>
<td>32,700</td>
</tr>
</tbody>
</table>

Note: no data for Algeria available. North Africa covers data from Algeria, Egypt, Libyan (Arab Jamahiriya), Tunisia. Source: BoP data from Eurostat.
Table 5.4A. Selected telecommunication infrastructure indicators in 5 ENP economies, 2000 and 2003

<table>
<thead>
<tr>
<th></th>
<th>Algeria</th>
<th>Egypt</th>
<th>Morocco</th>
<th>Russian Federation</th>
<th>Ukraine</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Fixed lines and mobile telephones (per 1,000 people)</strong></td>
<td>60.8</td>
<td>114.8</td>
<td>107.8</td>
<td>211.7</td>
<td>131.2</td>
</tr>
<tr>
<td><strong>Internet users (per 1,000 people)</strong></td>
<td>4.9</td>
<td>..</td>
<td>7.1</td>
<td>39.3</td>
<td>7</td>
</tr>
</tbody>
</table>

Source: WB WDI database.
References

Boeri, Tito and Herbert Brücker (2005), ‘Why are Europeans so tough on migrants?’ *Economic Policy*, October, pp. 629-703.


Erzan, Refik, Umut Kizibas, and Nilufer Yildiz (2005).’Growth and immigration scenarios for Turkey and the EU’, CEPS-EFPF Turkey-EU working papers No 14.


ERT (2004), 'ERT's vision of a bigger single market. The position of the European Roundtable of Industrialists on the EU Neighbourhood Policy'. Brussels.


FEMISE (2004), Egypt country profile.


Manchin, Miriam (2004), 'The Economic Effects of a Russia-EU FTA', *Tinbergen Institute Discussion Papers* no. 04-131/2


