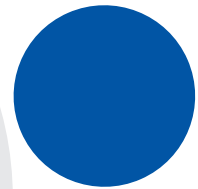


Eastern Partnership Review

Medium-term trade flows between EU27 and EaP6: what trends are visible?



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Contents

Regional trade trends EU-EaP in 2006-2011	5
Country-by-country trends	11
Armenia.	11
Azerbaijan	12
Belarus.	13
Georgia.	14
Moldova.	15
Ukraine.	16
Conclusions	17
Bibliography	18

This paper analyses trade flows between the European Union and its Eastern Partners within the six-year period 2006-2011. It uniformly uses the IMF Direction of Trade statistics 2006-2010, as presented in the database of DG TRADE,¹ while preliminary country trade data for 2011 are addressed to define the overall trends in that year. The use of uniform statistical data is an essential prerequisite to attain coherency of results and circumvent contradictions in mirror statistics, which in specific cases can become substantial in scope.

The main objective of the paper is to see if any distinct trends can be identified to characterise trade developments between the EU and EaP regions in an environment, where the parties seek, as a rule, deep and comprehensive free trade agreements (DCFTA). To reach this objective, the paper rests on a two-fold approach. Firstly, it examines consolidated data for the region's trade with the EU, in what concerns trade dynamics and comparisons of EaP6 trade with the EU27 and with the world. Secondly, it sheds light at EaP trade with the EU country by country in a broader trade policy context, including, where appropriate, the state of DCFTA negotiations.

Academic publications on the EU trade seldom focus on countries of Eastern Partnership as a distinct, homogeneous trading partner. Pastore et al (2009) reveal, on the basis of a gravity analysis, the existence of sizeable and largely unexploited trade potential with the EU both Southern and Eastern neighbours, where the ratio of potential to actual trade with the former is larger, more dispersed and stable than with the latter. Wijkman (2011) discusses DCFTAs as a trade policy solution in the context of a deeper economic integration of the EaP6 with the European Union. A number of papers look at export diversification problem in specific East European economies with regard to expanding their trade links with the EU beyond the traditional trading schemes (see Vincentz, 2008 and 2010, Shepotylo, 2009a and 2009b). DG ECFIN regularly monitors trade developments and external competitiveness of the EaP6 in its annual occasional papers about EU neighbours' economic development, however, none of those papers have focused on trade since the launch of the Eastern Partnership in 2009.

The scarcity of academic attention to EaP6 as a composite EU trade partner might be attributable to the fact that DCFTA feasibility studies commissioned by the EU for the EaP economies (see e.g. Maliszewska et al, 2008) commonly reveal negligible expected welfare effects of a simple trade liberalisation with the EU and a too distant way the countries have to go to arrive at benefits of a deep and comprehensive free trade arrangement. Of significance might be as well the geographic distinction between the immediate neighbours with land frontier to the EU and the three South Caucasus states, which makes itself visible, as shown below, in the development and composition of trade with EU. Finally, differences in resource endowment between the EaP countries and their respectively different importance to the EU underscore bilateral trade issues rather than any regional approach, all the more so as non-EaP countries Russia and Kazakhstan retain their positions as imperative trade partners to the EU's East.

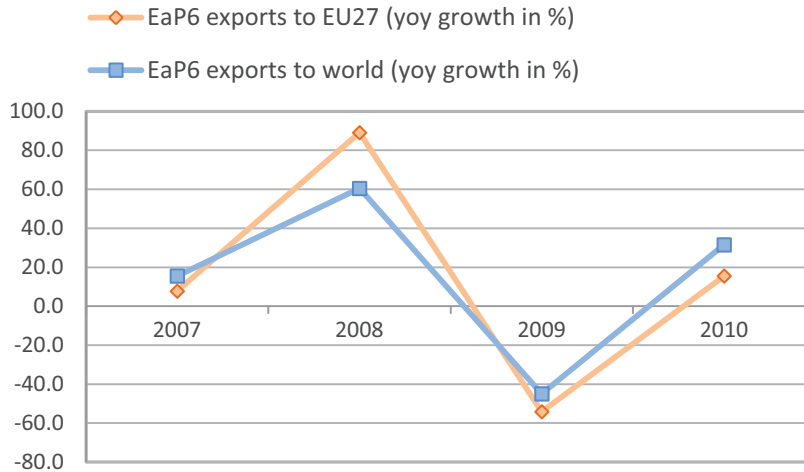
¹ See <http://ec.europa.eu/trade/creating-opportunities/bilateral-relations/statistics/> (accessed 19.12.2011). Unless otherwise stated, data for all diagrams and numbers used in the text originate from this source.

Regional trade trends EU-EaP in 2006-2011

EaP countries' trade in general stood under the influence of the world economic crisis, as shown by a drastic decrease of both imports and exports in 2009. The contraction came after several years

of steady growth of trade volumes observed in the whole EU neighbourhood since 2004, i.e. over the medium-term period preceding the crisis.

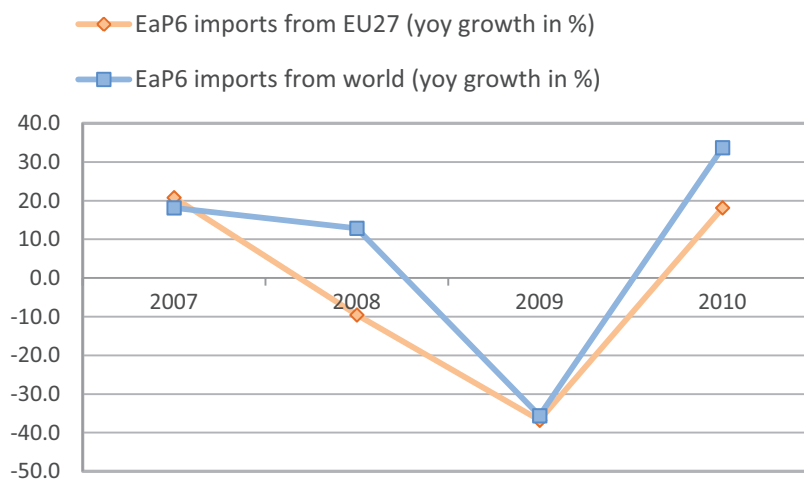
Diagram 1a. EaP6 exports to the world and EU27: year-on-year growth rates



The subsequent recovery has been impressive, with trade volumes matching or even exceeding the pre-crisis level in some EaP countries (Armenia, Georgia) already in 2010. Available preliminary

data from national statistics show an uninterrupted strong year-on-year growth of trade volumes (by around one third and higher) in all EU Eastern neighbours also in 2011.

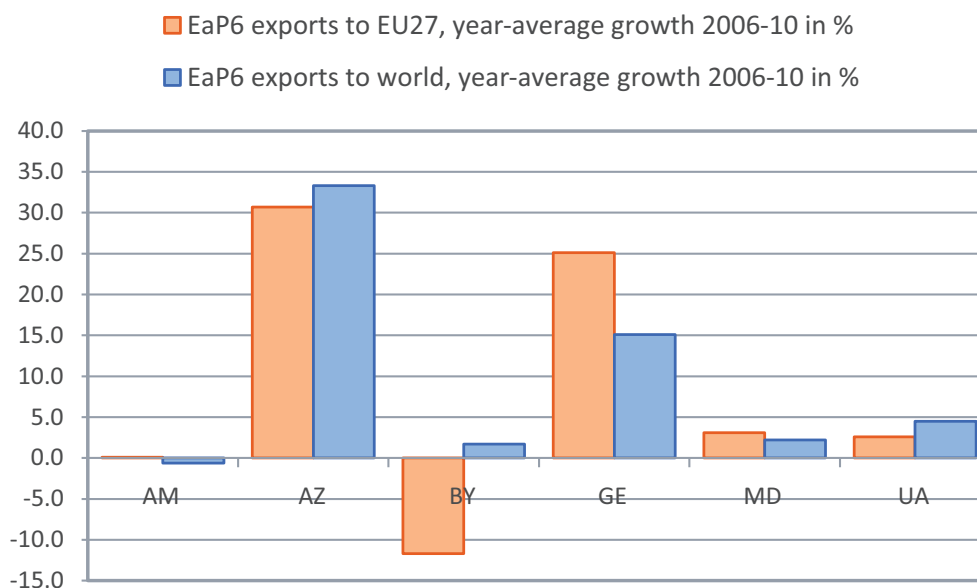
Diagram 1b. EaP6 imports from the world and EU27: year-on-year growth rates



In the years of recovery, exports benefitted from growing demand in main trading partners, however mostly outside EU27, explaining the fact that EaP6 global exports outpaced those to the EU. The same

can be said about the revival in imports, which has been, as a rule, stronger than in exports. In 2011, however, exports were growing faster than imports in Armenia, Georgia and Moldova.

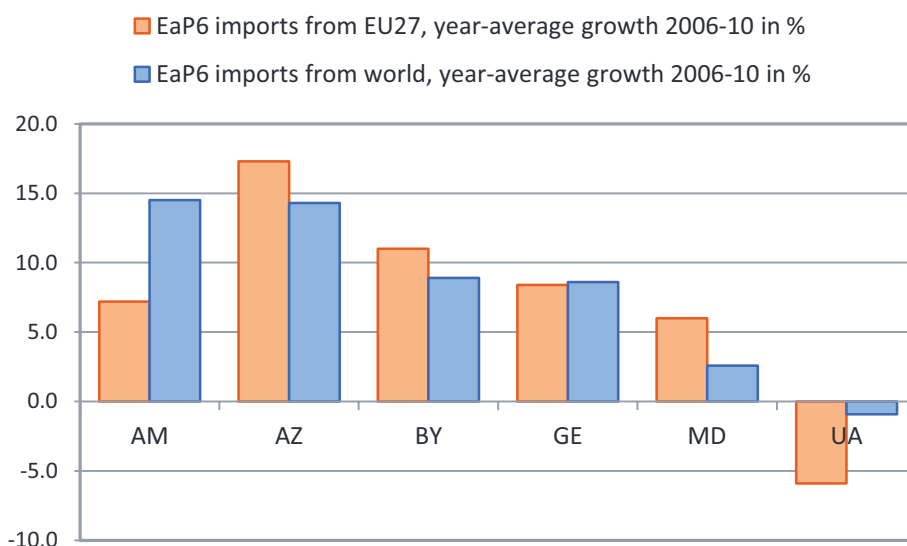
Diagram 2a. Eastern Partnership economies' exports to EU and the world in 2006-10



Imports from the EU started to decrease already in 2008, owing to a sharp drop of private capital inflows to the most countries of the Eastern Neighbourhood (DG ECFIN, 2011) and the resulting contraction of paying capacity. The decrease in

imports from the world lingered by roughly one year, which may be explained by the predominance of pre-paid arrangements in the intra-CIS trade, notably for energy imports from Russia.

Diagram 2b. Eastern Partnership economies' imports from EU and the world in 2006-10



The recovery of trade volumes in 2010-11 might disguise the general underperformance in terms of trade of goods in some of the EaP economies. The IMF surveyed a decrease of goods' exports to GDP in 2003-07 in Belarus, Moldova and Ukraine (DG ECFIN, 2011). The same trend was observed

in Armenia (2006-09) and Georgia (2005-09). As a result, these economies experience a relative loss of external market share and competitiveness in the tradable sector (manufactures) against the background of GDP growth being driven mostly by construction, financial intermediation and real estate.

Diagram 3. EU27 shares in EaP6 total exports and imports, in percent

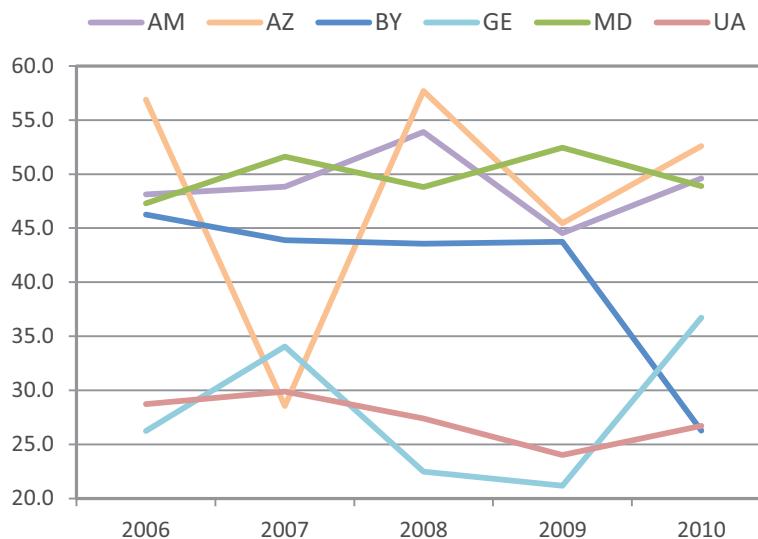


Both IMF (2011) and EBRD (2010) highlight the need to reorient resources to the tradable sector in order to achieve sustainable growth. The post-crisis recovery, after the external imbalances of the boom years have been corrected, offers a good opportunity to turn to a new growth pattern with more reliance on external demand. Supporting demand-oriented export activity would have a significant positive effect on research and development as well as on product innovation. The downward trend of goods' exports to GDP reversed in 2010 in Armenia, Georgia and Ukraine, but it needs to be supported by the respective measures in industrial and regulatory policy.

EU remains an important trade partner for its Eastern neighbours

The share of the EU in EaP6 cumulative exports and imports has somewhat decreased within the observation period (Diagram 3), from around 37 percent in 2006 to 32-33 percent in 2010. Nevertheless, the EU remained the leading trade partner for Armenia, Moldova and (in what concerns imports) Georgia, while the other three countries stayed stronger oriented toward CIS and Russia. The different country-by-country trends are shown on the Diagrams 4a and 4b and discussed in more detail in the next section.

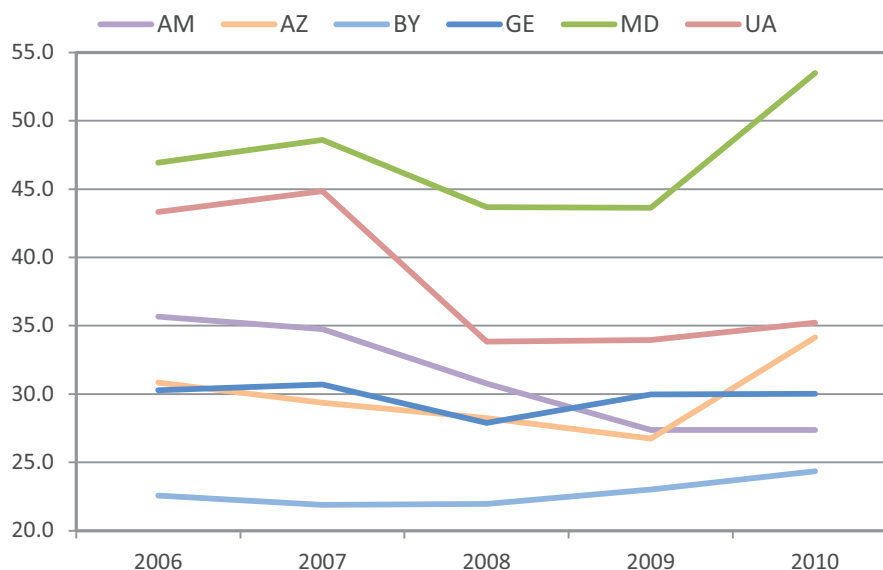
Diagram 4a. EU27 share of exports (in percent of total exports), by country



A common feature for all EaP countries except Azerbaijan and, since 2010, Belarus is the negative trade balance with the EU. Azerbaijan's energy exports to the EU have been quite uneven throughout 2006-10, but the country would nevertheless keep (except in 2007) a trade surplus with EU 27, as an important energy supplier. Trade data on Belarus show a drastic reduction of exports of fuels and mining products to EU in 2010, which turned medium-term trade surplus to a deficit. This development is most probably explained by statistical (capturing transit from Russia) rather than economic reasons: EU energy imports from Russia were likewise on a downward trend in the same time period. Belarus also exported less manufactures to EU in 2010, although the economy has been already recovering from the previous-year drastic output decline. Because in 2011, according to the national data (Belstat, 2011), the country's exports were growing faster than imports, a reduction of trade deficit with the EU is likely.

Other EaP economies stayed firmly on a position of net importers vis-à-vis the EU. The main item of their import spending was machinery and transport equipment: the share of this commodity group in total imports from EU fluctuated between 30 percent in Georgia and 50 percent in Belarus in 2010. Although many governments understand the need to support the development of domestic innovative industries by means of a targeted industrial policy, the overwhelming lack of clear concepts and realistic programmes hampers the transition from resource-driven to efficiency- and innovation-driven development patterns. The process is additionally slowed down by the dominance of corruption in decision-making and typical weaknesses in medium- to long-term strategy planning. This means that the EaP region will, generally, remain importer and consumer of high-technology products and services from the EU (as well as from other developed countries) in the longer run.

Diagram 4b. EU27 share of imports (in percent of total imports), by country



Medium-term trade balance in favour of the EU rests on a commodity composition, where the EU delivers mainly machinery and equipment in exchange for metals, ores, other minerals and fuels, in some cases agricultural and food products and clothing. Other commodity items, with few exceptions, play a negligible role. It should be also noted that, as a whole, the importance of EaP economies as EU trade partners has been (and remains) much

lower than vice versa: their share in EU imports fluctuated in 2010 between 0.8 percent (Ukraine) and 0.02 percent (Armenia).

Against this background, nevertheless, the EU is preparing or negotiating DCFTAs with its Eastern Partners, to underpin the process of political association with economic integration based on regularly convergence and removal of tariffs and technical barriers (European Commission, 2010). It can

be argued about desirable and/or realistic returns of reforms presupposed by DCFTA for the EaP countries' statehood building and sustainable development (see Wijkman, 2011, De Gucht, 2011), but the rationale for the EU to go for such arrangements is quite lucid: by forcing – softly or not – trade partners to assume EU trade-related regulatory framework, the Union aims at reducing technical costs of trade and thus ensure competitiveness gains in the long-term perspective. EaP economies are by far not an exception in this approach, which the EU pursues far beyond its neighbourhood, in its global trade and development strategies.

2011 saw progress by some of the EaP economies towards Deep and Comprehensive Free Trade Agreements with the EU. The table below summarises the current DCFTA status.

Future DCFTAs with EaP countries have a strong political connotation, going far beyond technical trade policy issues. The EU has linked trade agreements firmly with the forthcoming agreements on political association. In case of Armenia, Georgia and Moldova, DCFTAs are to become integral parts of the Association Agreements (AA), in case of Ukraine, the pioneer of DCFTA negotiations, it is “embedded” into AA. Failure to show credible progress on either of the agreements can stall the overall political process, as demonstrated by the refusal of the EU to sign the ready agreements with

Ukraine for impudent reverse from the principle of rule of law by the authorities of that country.

Linking free trade agreements with political developments in EaP countries is logical, given their looked-for depth and comprehensiveness. Indeed, application of regulatory rules common in the EU by the new trade partners is only possible if the necessary legal framework is adopted, institutions put in place and practices established. That would enable EU companies, especially small and medium-sized, to operate smoothly in a business environment they are accustomed to in their home countries. It is however exactly the adherence to EU regulatory principles that causes serious concern in view of the endemic corruption, widespread legal uncertainty, low accountability and efficiency of the most EaP public administrations (Sekarev et al, 2011). The short DCFTA preparations and negotiations history has shown particular severity of these problems in such areas as quality infrastructure, public procurement, protection of intellectual property rights, producers' liability etc. If business environment becomes risky owing to, for instance, selective and biased judiciary, observance of fundamental rights and freedoms get equally uncertain. The deadlock in the association and DCFTA process with Ukraine demonstrates this clearly.

Status of DCFTA with EU Eastern Partners as per 01.01.2012

Country	Status	Remarks
Armenia	in preparation	Progress has been made in meeting key priorities from the EU fact-finding mission report of 2009; a joint declaration by the Armenian government and European Commission of April 2011 stresses “the importance of taking further steps” by Armenia towards meeting the conditions to launch DCFTA negotiations
Azerbaijan	none	WTO accession is a prerequisite for starting DCFTA process
Belarus	none	The EU has frozen moves towards closer economic partnership with Belarus until its government is able to show a greater commitment to democracy and political and civil rights
Georgia	launched 12.12.2011	Technical talks are set to begin in January, official negotiations scheduled for the first quarter of 2012. DCFTA is to become integral part of the association agreement with the EU
Moldova	launched 12.12.2011	Technical talks are set to begin in January, official negotiations scheduled for the first quarter of 2012. DCFTA is to become integral part of the association agreement with the EU
Ukraine	completed, the last (18th) round of negotiations took place on 19-23.9.2011	According to De Gucht (2011), EU and Ukraine “reached an agreement on all elements of a trade deal”, while “some technical details” remain to be fine-tuned; an Association Agreement with DCFTA embedded was not signed on the EU-Ukraine Summit in December 2012 owing to political tensions

Sources: DG TRADE, De Gucht (2011), EaP Community daily news www.easternpartnership.org, Armenia Ministry of Foreign Affairs http://www.mfa.am/u_files/file/docs/declaration_eng.pdf

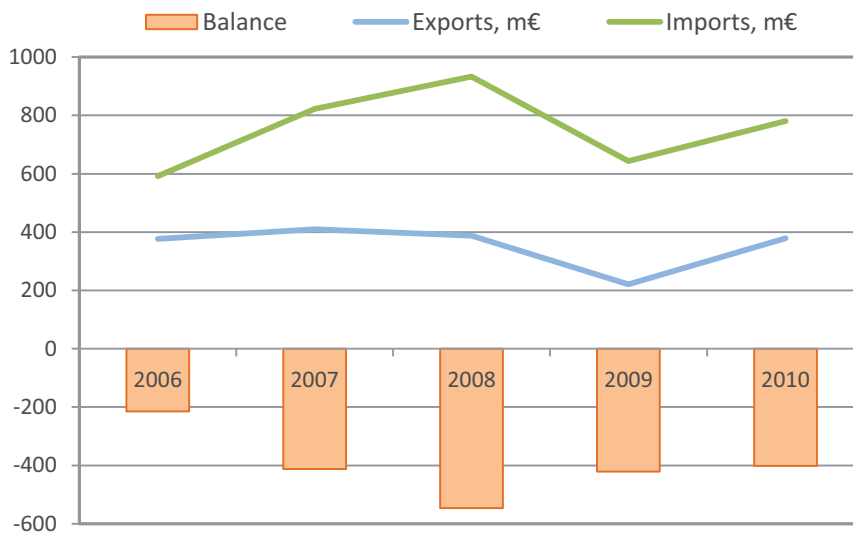
Country-by-country trends

Armenia

Armenia's exports to EU have been growing until 2007 to reach roughly US\$400-m level, but almost halved in the crisis year 2009. Imports kept rising until 2008, to the effect of wider trade deficit.

The subsequent recovery has been buoyant, with exports regaining pre-crisis level within one year. As mentioned above, the strong growing trend kept on in 2011.

Diagram 5. Armenia's trade with the EU27, m€



The main commodity items that Armenia imports from the EU are machinery and transport equipment (33.7 percent of total imports from the EU in 2010), food (12.4 percent), and chemical products (11.8 percent). The country's exports to EU are shaped mainly by ores, minerals and non-ferrous metals with a cumulative share of 33.9 percent as well as iron and steel (35.4 percent). Traditionally, Armenia imports pearls and other precious stones from the EU for inward processing (16.7 percent of total imports from the EU), which are then sold back (17.3 percent of exports to EU) with quite modest value added. Efforts are being made to diversify the trade structure by exploring new export products and services (crayfish, IT services), but the volumes of these new exports are still negligible.

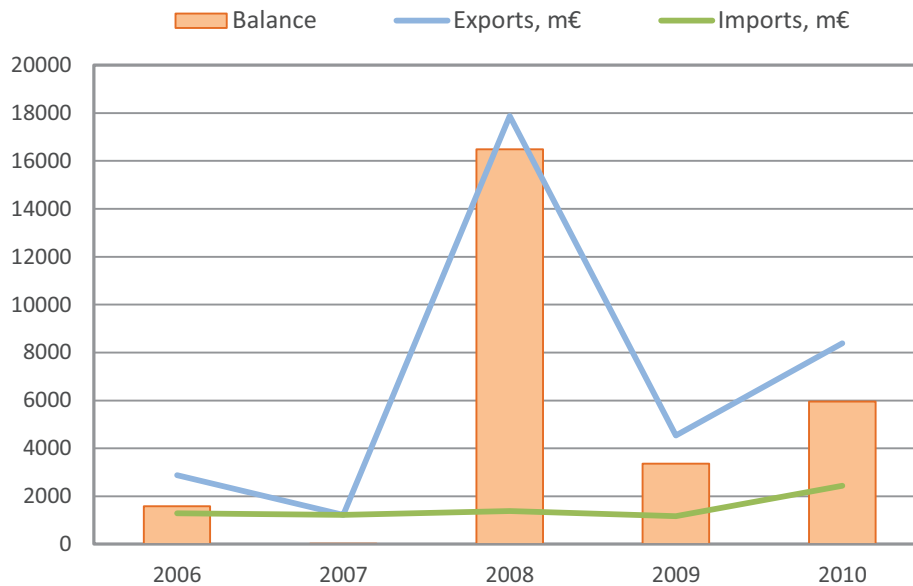
Armenia has lost one and a half decade by repeated failures in reforming trade-related sectors quality infrastructure, food safety and IPR protection, where vested interests and corruption have been dominating. Since 2009, as the EU made these reforms conditional for upgrading the relations with Armenia to political association and free trade, the government has shown more resoluteness in its approach. Although the resistance remains strong, pursuing trade-related reforms to reach the point of readiness to embark on DCFTA negotiations is nothing unrealistic within one or maximum two years, provided no new slippages occur.

Azerbaijan

Oil exports are not simply dominant, they compose practically the sole item of Azerbaijani exports to the EU: in 2010 fuels and mining products made up 99.3 percent of total, of which petroleum and petroleum products were 97.7 percent. This puts

Azerbaijan in a very specific – compared to other EaP countries – situation as the EU trade partner. The country imports from the EU chiefly machinery and transport equipment (47.1 percent), various manufactures (20.9 percent) and food (7.8 percent).

Diagram 6. Azerbaijan's trade with the EU27, m€



EU has invested much effort to engage Azerbaijan as the important energy supplier in the different energy-related programmes and projects. An EU-Azerbaijan Memorandum of Understanding on Energy Policy of 2006 foresees gradual harmonization of the energy legislation with the view of convergence of electricity and gas markets. It also aims at securing the transportation of the Caspian oil and gas resources towards Europe, where the Baku initiative of 2004 creates the needed international framework.

Azerbaijan started negotiating an Association Agreement with the EU in July 2010. In contrast to Ukraine, Armenia, Georgia and Moldova, the

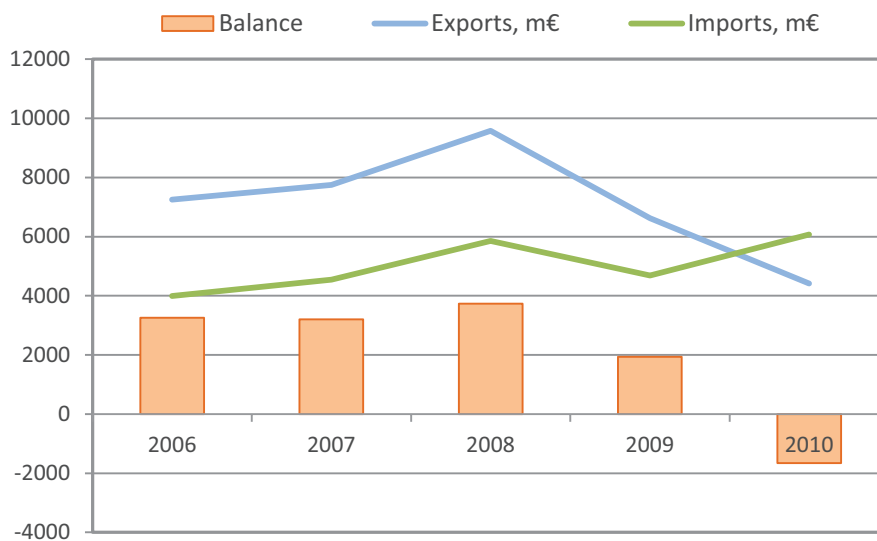
agreement with Azerbaijan will not contain a free trade arrangement so far, but only mention an objective of negotiating a deep and comprehensive FTA in the future. The formal obstacle is the country's non-membership in WTO, with which negotiations have been in process since 1997. On the other hand, the European choice is much less pronounced in Azerbaijan than in the neighbouring Georgia or Moldova. Analysts see the country's links with the EU rather as part of a "balanced" foreign policy of Azerbaijan (FES, 2010, p.46), which logically relegate the country ambitions toward the EU.

Belarus

Long-standing political tension between the EU and Belarus would not influence bilateral trade in any negative way. Both exports and imports were on rise before the 2008-09 crisis, with a steady trade surplus for Belarus. As mentioned, a statistical drop in exports of fuels and mining products to the EU after 2008 turned the trade balance to a defi-

cit. After Russia, the EU is Belarus' 2nd main trade partner with almost 33 percent share in the overall trade. Exports to the EU are nevertheless dominated by fuels (32 percent of total exports to the EU in 2010), followed by chemicals (15 percent), base metals (13.7 percent) and agricultural products (11.6 percent).

Diagram 7. Belarus' trade with the EU27, m€



Since 1993, Belarus has been standing under a tight bilateral trade regime with the EU with regard to textiles, with the textile agreement (renewed on numerous occasions) setting quotas on Belarus' exports to the EU. In 2009 the quotas were abolished, and the country's textile exports to EU increased from €74.5m in 2008 to €90.1m in 2010. Further expansion of Belarusian textiles to the EU seems unlikely, at least in the short to medium run owing to the reported output constraints in the sector.

The main items of the EU exports to Belarus are machinery (33.1 percent of total EU exports to Belarus in 2010), transport equipment (17.1 percent) and chemicals (17.9). For obvious reasons, DCFTA is not on bilateral agenda.

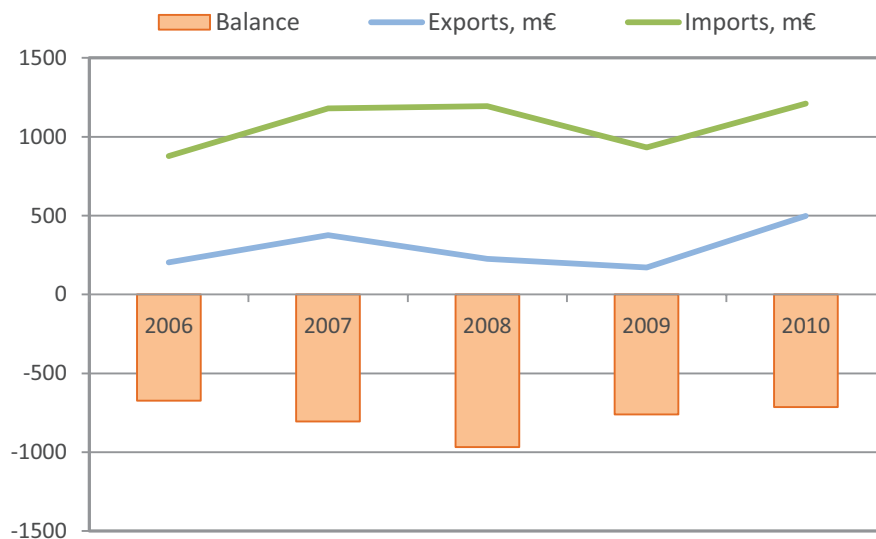
Georgia

Weak manufacturing sector and non-diversified exports characterise Georgia's trade position vis-à-vis the EU as well as other trade partners. Vincentz (2008) registered a substantial discrepancy between the EU and Georgian data on the country's exports to EU27: Georgian data covered less than a half of what was reported by Eurostat in 2006 and 2007. This can be traced to just one product, medium oils, which Georgian Customs captures as exports at the moment of filling tankers at Georgian Black Sea port of Poti. Because Georgia is certainly not an oil producer, these exports do not possess the country origin. More recent observations confirm that this practice continues and the data problem becomes even more significant.

With this irregularity removed from the Georgian export data, the country's trade deficit with the

EU becomes the largest among the small EaP economies: it can be sustained only by capital inflows, which indeed has been the case in the recent years. Problematic remains however the commodity composition of exports, where there are only few processed items. Ferroalloys, ferrous waste and scrap as well as food products (mainly nuts) build the core of Georgian supplies to the EU. With the Russian market lost in political tensions and the war of 2008, the country maintains strong trade ties with its neighbours in South Caucasus and the rest of EaP: together with Ukraine, Armenia and Azerbaijan accounted for 41 percent of Georgian exports and 31 percent of imports in 2010. For the EU, Georgia is an important transit country for oil and gas supplies, which is why a regulatory harmonisation in the energy sector is pursued.

Diagram 8. Georgia's trade with the EU27, m€



The announcement of the DCFTA negotiations with Georgia for 2012 is an important impetus for EU-driven reforms in the country. Since the Rose revolution of 2003, the government has shown strong commitment to supporting business through vehement deregulation, which in several areas went too far in view of regulatory convergence agreed in the various policy documents with the EU. The catalogue of priority measures formulated by the European Commission in 2009 for the country to

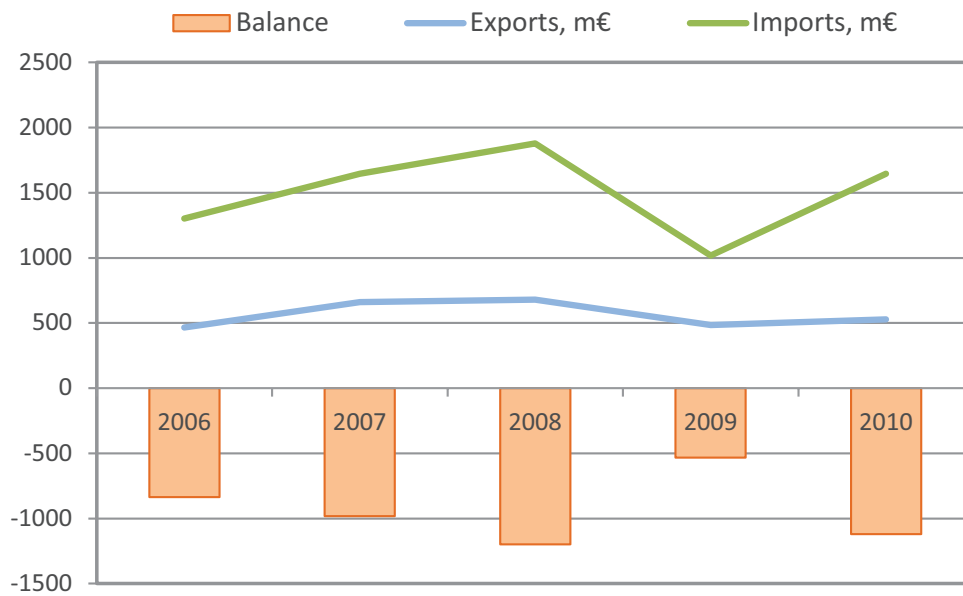
get ready for negotiations was respectively longer than in the neighbouring Armenia, covering in addition to TBT, food safety and IPR protection also competition policy. The Commission reported progress on these areas in its annual ENP country report of May 2011. The environment for negotiations became more favourable after Georgia had lifted its reservations for WTO accession of Russia, which the EU has been long advocating in Tbilisi.

Moldova

The cumulative EU share in Moldovan trade (around 50 percent of total turnover in 2010) is the highest among EaP6. Similarly to Georgia, its exports to EU are non-diversified. Only few products – food items, clothing and personal and household goods – accounted together for around

65 percent of total supplies to EU in 2010. The narrow export base allowed the country to only marginally increase its exports to EU in 2010, whilst the imports from the EU posted quick post-crisis recovery.

Diagram 9. Moldova’s trade with the EU27, m€



Since 2008, Moldova enjoys autonomous trade preferences beyond GSP+ preferences of the EU, which are granted in the EaP region to Armenia and Georgia. The autonomous trade preferences give unlimited and duty free access to the EU market for all products originating in Moldova, except for certain agricultural products (DG TRADE, 2011). Trade privileges for Moldova have, however not brought about any significant exports diver-

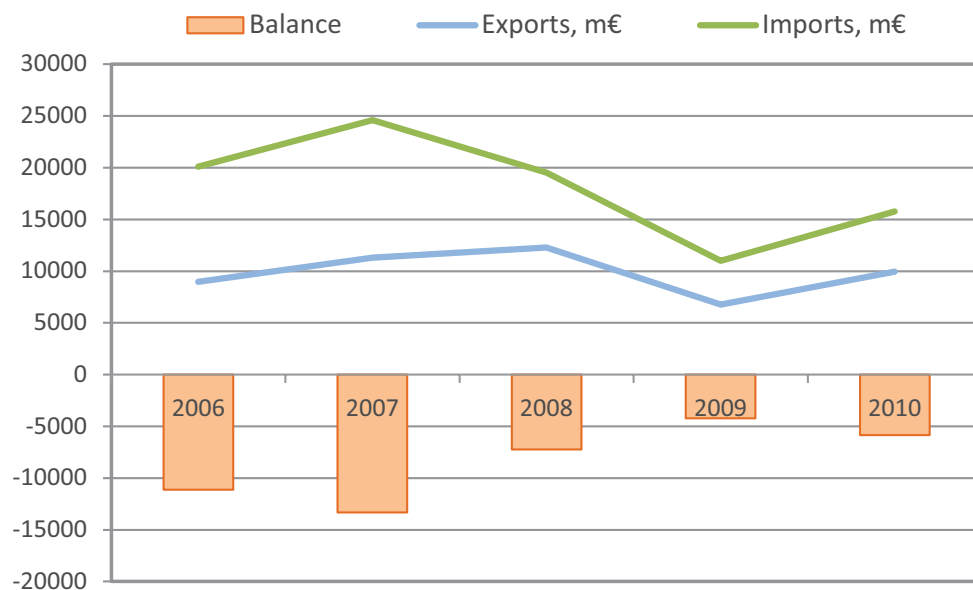
sification so far. The Regulation on autonomous trade preference for Moldova was amended in 2011 to increase tariff rate quotas from wine (from 2011), wheat, barley and maize (as from 2013), and to extend the validity until December 2015. The returns of these measures on Moldovan exports and, overall, economic growth are still outstanding. New opportunities are seen in the DCFTA, where negotiations are due to start in 2012.

Ukraine

Ukraine was the first EaP country to technically conclude DCFTA negotiation with the EU in 2011. As mentioned, owing to political reasons, the process on the Association Agreement and DCFTA has been suspended until the domestic situation in the country with regard to the rule of law improves. In the course of negotiations, which took altogether 18 rounds over 4 years, progress – albeit at different pace and with several reversals – was achieved in all trade-related reform areas. Like in no other EaP country, the EU applied a specific set of tools (such as an Association Agenda, joint committee of high-level officials, a “matrix” of reform priorities) to guide and monitor the respective domestic developments.

Completion of negotiations should not disguise risks to sustaining the reform achievements in an environment of legal uncertainty, non-transparency of tax and customs regulations and endemic corruption. An example of such risks are the amendments to the government procurement law of 2010, which withdrew a big number of state and municipal enterprises from the scope of the application of the public procurement legislation and extended the rights of companies to resort to price quotations rather than competitive tendering (Sekarev et al, 2011). These novelties may expand non-competitive and non-transparent public procurement practice in Ukraine.

Diagram 10. Ukraine's trade with the EU27, m€



Ukraine managed to contract its trade deficit with the EU by steadily reducing imports in 2007-09. In the two subsequent years, however, imports recovery has seen livelier than that of exports. Iron and steel, fuels, agricultural products and some electrical machinery are the main commodity groups in the country's exports to EU. Imports from the EU are dominated by machinery and transport equipment and chemicals.

The EU remains Ukraine's important trade partner, accounting for about one third of the country's external trade. It has always laid value on a closer economic integration that, in the overall context of a political association, can become the key factor

of economic growth for Ukraine. Since 1993, the EU has been granting Ukraine GSP regime, and in 2010, the GSP utilisation rate reached a rather good level of 72.2 percent of eligible products. With €2.15b of GSP preferential imports to the EU, Ukraine ranks 12th among the most effective users of the system. Preferential imports include machinery and mechanical appliances, plants, oils, base metals, chemicals and textiles (DG TRADE, 2011). At the same time, Russia seems to be regaining its position as the leading trade partner of Ukraine: its share in the country's external trade was on rise in 2010 and 2011.

Conclusions

In the medium-term retrospective 2006-10, trade statistics did not reveal any stronger trade integration between the EU27 and EaP7. With the moderately declining cumulative share of the EU in EaP6 exports and imports in that period the suggestion is rather the contrary. The EU has taken various trade policy measures (free trade negotiations, extension of autonomous trade preferences to Moldova, inclusion of Georgia into GSP+ in 2009) to stir up commercial links with its Eastern Partners, but the results are still outstanding.

It should be noted that the five-year time period might be too short to anticipate some fundamental changes in trade pattern of countries that formerly belonged to centrally planned economic system. On the one hand, reforms in economy and society in the new independent states did not extend to all spheres, and have been typically controversial in building up accountable public administration and pursuing efficient reform policies. On the other hand, the EU addressed this region as a focused area of interest only with its enlargement eastwards in 2004 and has since then intensified its interventions in the most of EaP countries. The results of these policies will have to be seen in the longer run.

It is quite likely that the existing trade pattern between the EU27 and EaP6 will stay on without significant changes in a longer-term perspective. This expectation concerns the trade balance in favour of the EU (except with Azerbaijan) and the commodity composition, where the EaP economies mostly supply resources and semi-manufactured items in exchange for machinery and equipment. Even under future DCFTAs significant changes in the present commodity structure seem unlikely, unless technological cooperation, inward processing and intra-industry trade progresses to potentially competitive sectors in the Eastern Partners. While a DCFTA creates important prerequisites for such integration by converging regulatory frameworks, much will depend on how consistent the EaP countries implement these frameworks in practice. Until present, this implementation has been a big challenge.

The question open for further research would be indeed to identify the magnitude of trade and economic integration between the EU and EaP countries, for example by means of a gravity analysis. Empirical evidence, however, already now supports the idea that the EU should remain assertive in promoting closer trade integration in the context of a political association, so as to anchor sustainable development and economic growth of its Eastern neighbours.

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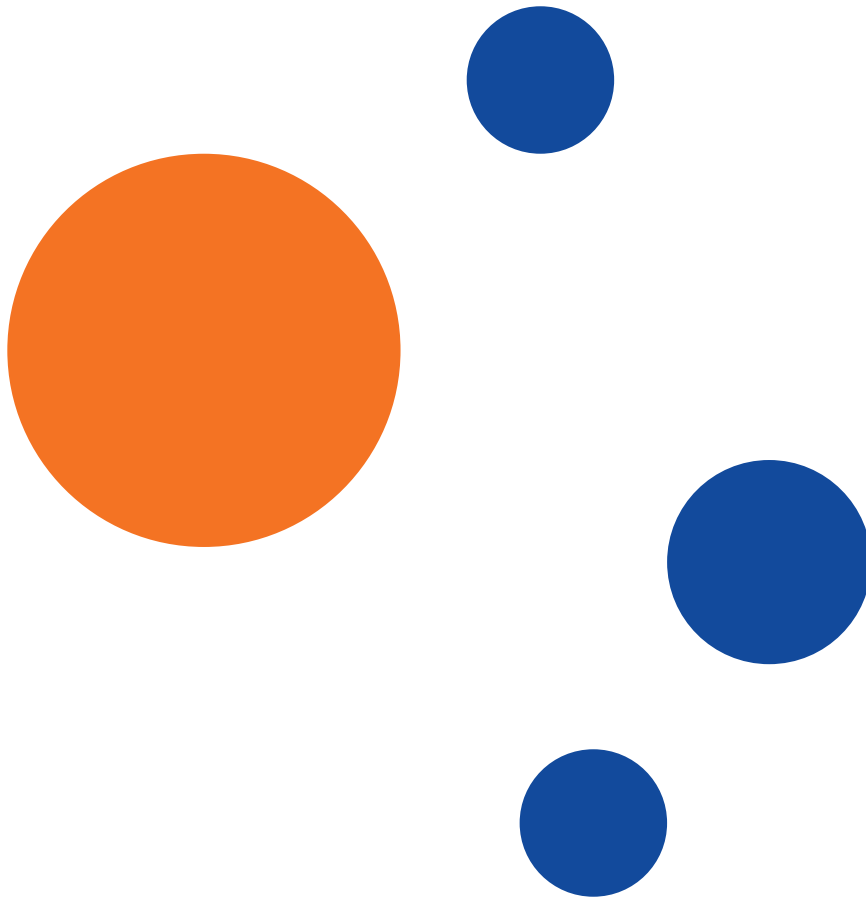


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