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**ABOUT**

Thomas Grennes and Andris Strazds offer perspectives from the U.S. and Europe on current economic issues.

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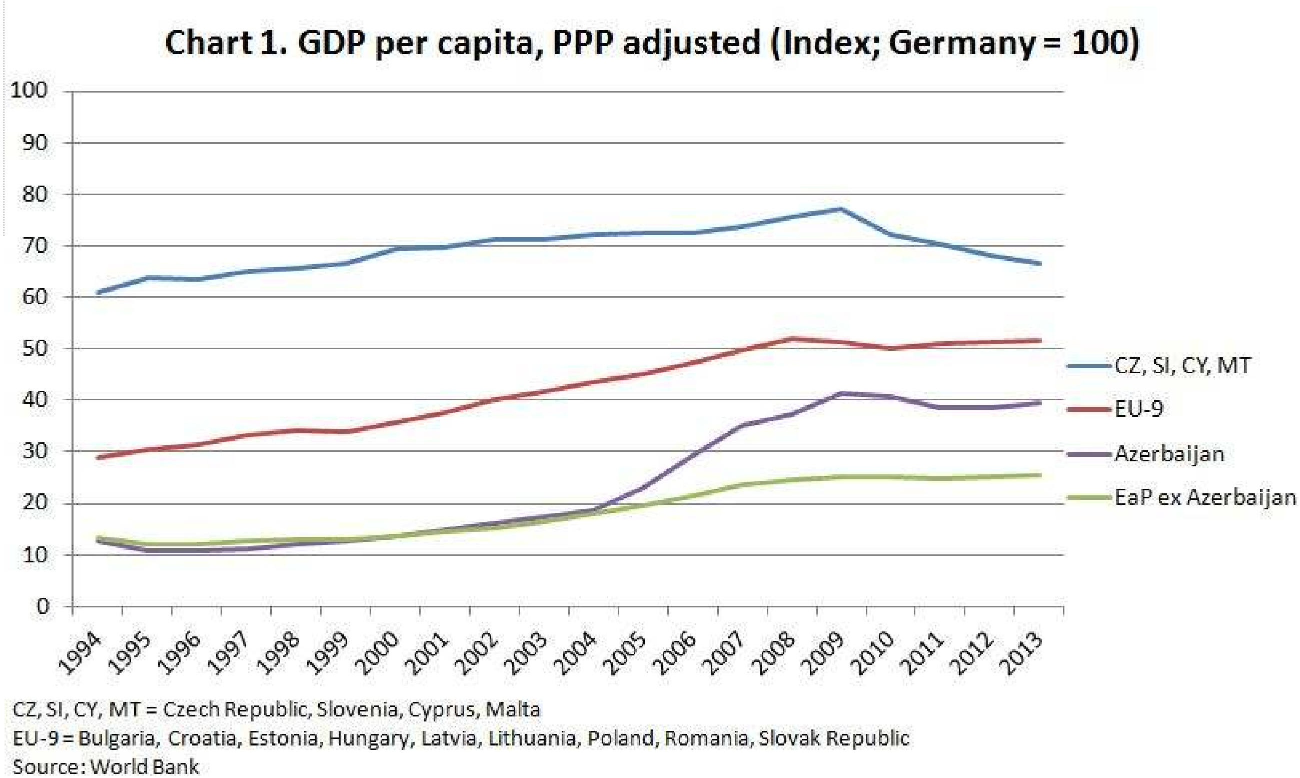
# Do Free Trade Agreements with the EU Promise Higher Incomes for the Eastern Partnership Countries?

Authors: Andris Strazds (/blog/author/astrazds) & Thomas Grennes (/blog/author/tgrennes) · October 2nd, 2014 · Comments (1) (http://www.economonitor.com/thoughtsacrossatlantic/2014/10/02/do-free-trade-agreements-with-the-eu-promise-higher-incomes-for-the-eastern-partnership-countries/#idc-container)

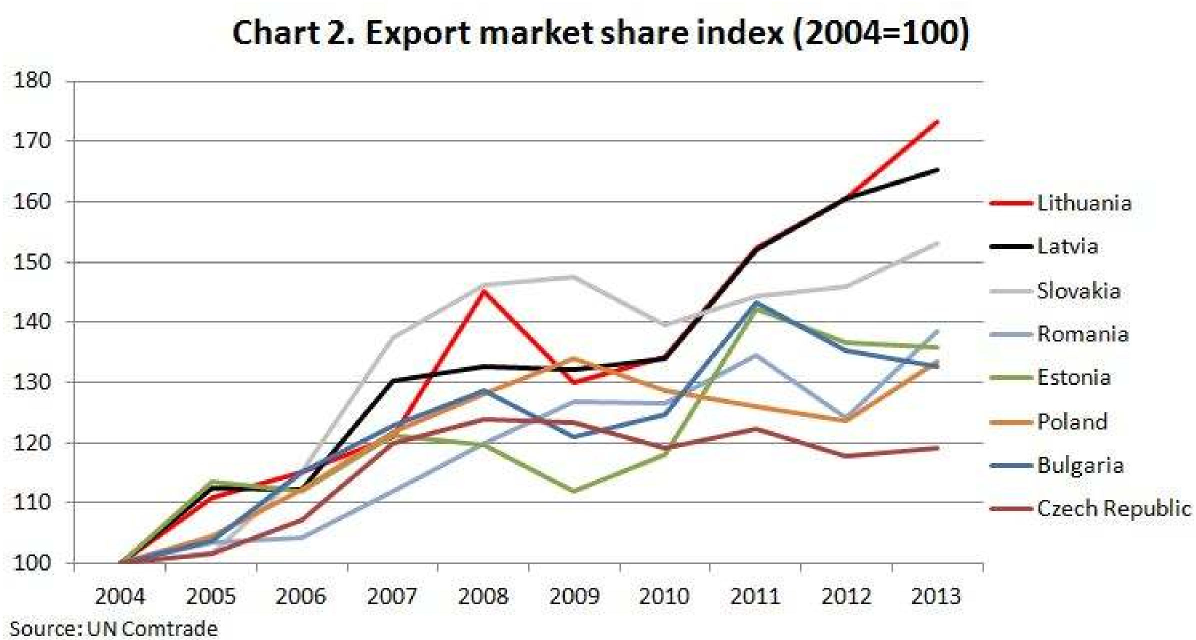
A year ago (http://www.economonitor.com/thoughtsacrossatlantic/2013/09/13/to-eu-or-not-to-eu/ (http://www.economonitor.com/thoughtsacrossatlantic/2013/09/13/to-eu-or-not-to-eu/)) we analysed the real convergence during last two decades in both the 13 member states that joined the EU on or after 2004 and the EU Eastern Partnership countries (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine). The new EU members that were relatively poor a generation ago showed more significant improvement in their relative income level with wealthy countries such as Germany contrasted to the Eastern Partnership (EaP) countries in some of which one could indeed speak of a lost generation in terms of economic development (see Chart 1 below for a summary). Azerbaijan was a notable exception to the rule due to its oil boom.



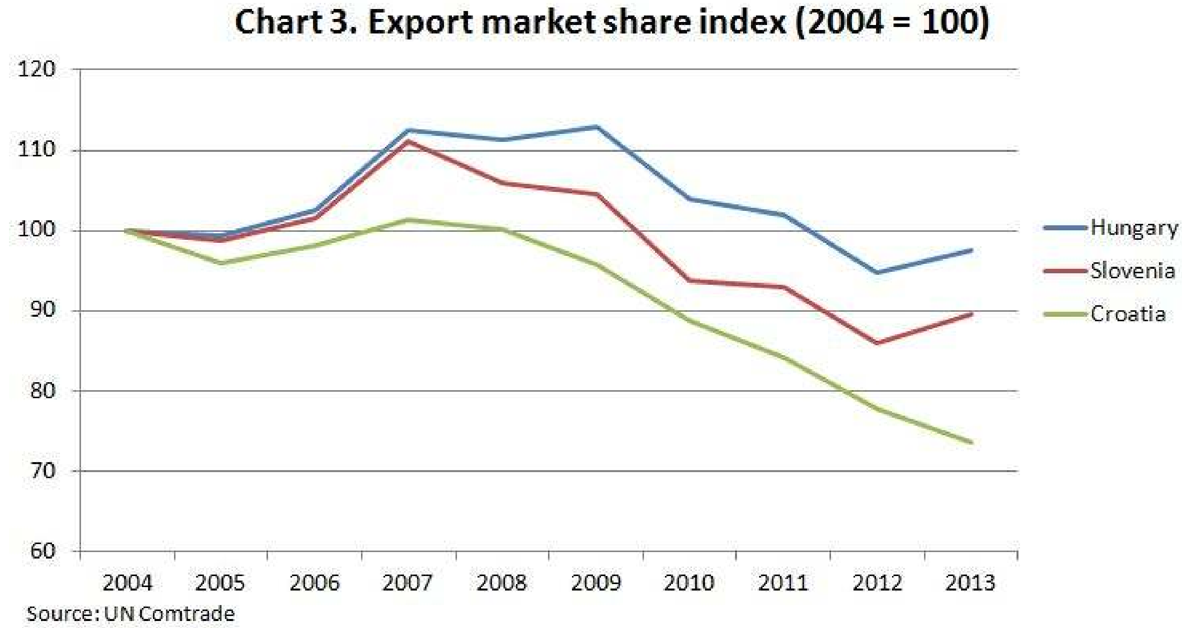
(http://www.economonitor.com/thoughtsacrossatlantic/files/2014/10/Chart1.jpg)

In this post, we look more closely at the role that trade expansion, in particular, goods export growth has played in economic development of these countries. Since trade agreements explicitly discriminate against non-members, they can either add or subtract from a country's economic growth.  We analyse the period from 2004 to 2013 as ten of the 13 EU member states in our analysis joined the European Union in 2004 (Romania and Bulgaria followed in 2007 and Croatia in 2013). The EaP countries, in contrast, were not part of a genuine free trade area until very recently when some of them joined the CISFTA (Commonwealth of Independent States Free Trade Agreement) in 2012 and 2013, although FTAs with Russia and among themselves were common since the 1990s.

We first look at the global merchandise export market shares of all 17 countries (Cyprus and Malta are excluded because of both of their small size and their economies predominantly being based on services exports). The 11 remaining EU member states in our analysis can broadly be divided into two groups. Eight of them have significantly increased their global goods export market shares since 2004 (see Chart 2) while the other three (Hungary, Slovenia and Croatia) have recently seen their global goods market export share deteriorate and fall to below its level in 2004 (see Chart 3).

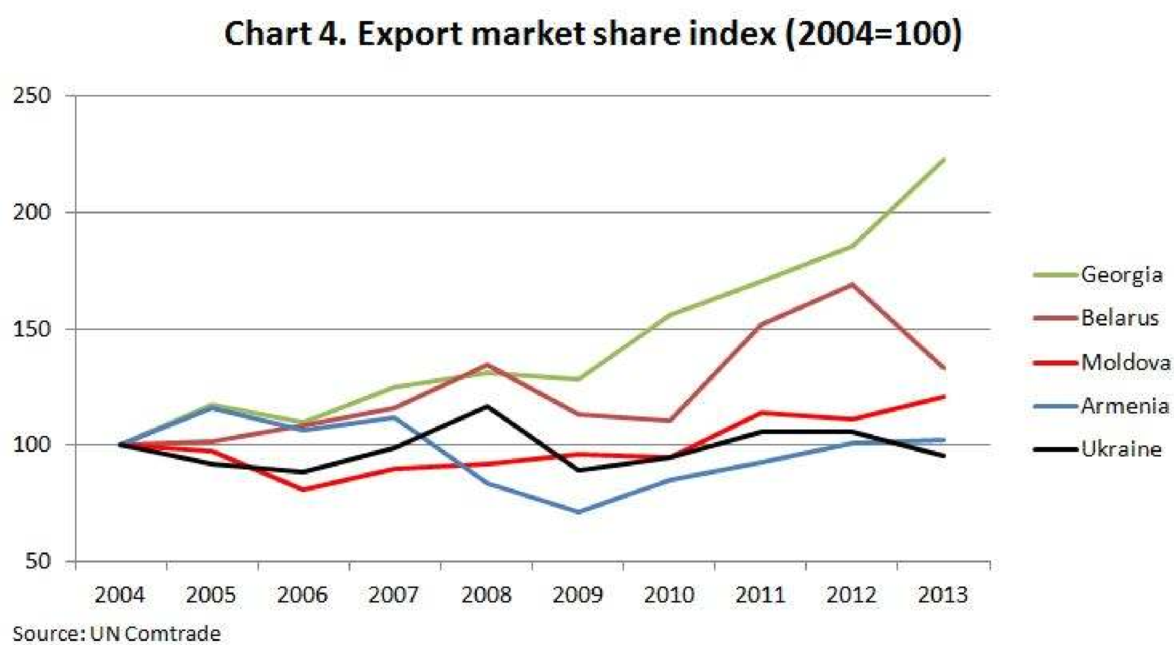



(http://www.economonitor.com/thoughtsacrossatlantic/files/2014/10/Chart2.jpg)




(http://www.economonitor.com/thoughtsacrossatlantic/files/2014/10/Chart3.jpg)

The development of the global goods export market shares for the EaP countries has been even more diverse than that of the 10 EU member states in our analysis. Two of them (Armenia and Ukraine) have barely seen the global export market share improve during last decade. Two others (Moldova and Belarus) have recorded moderate export market share growth. Georgia has more than doubled its export market share with the most significant market share growth happening after it exited the CIS following the war with Russia in 2008 (although it kept the FTA with Russia). Finally, Azerbaijan, due to its oil boom, has seen its export market share during last decade explode to the extent that it has to be depicted on a separate chart (see Chart 5 below) for scaling reasons.

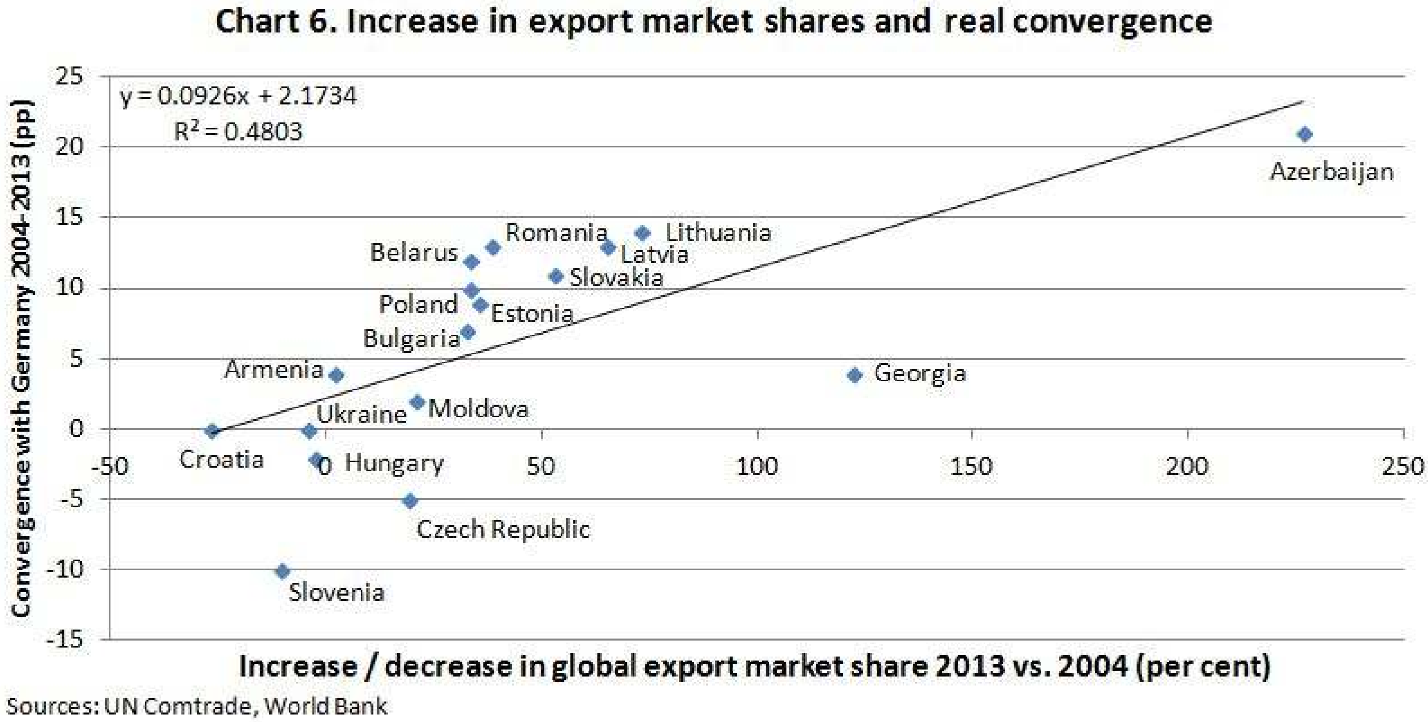



(http://www.economonitor.com/thoughtsacrossatlantic/files/2014/10/Chart4.jpg)


(http://www.economonitor.com/thoughtsacrossatlantic/files/2014/10/Chart5.jpg)

We can make several observations from the above charts. Although most new EU member states have achieved significant export market share growth since 2004, membership in the EU is not a guarantee of export market share growth, as the experience of Hungary and Slovenia shows. Clearly factors other than membership in a free trade area also influence export performance. At the same time, as the experience of Georgia, Belarus and to a lesser extent Moldova confirms, trade creation is possible also without being part of a multilateral free trade area. Finally, the poor export performance of Armenia and Ukraine during last decade just reconfirms the obvious – a country can fail to achieve any significant trade creation.

Now, we look at the increase in relative income vis-a-vis Germany (in percentage points) in all of the 17 countries during last decade and plot it against the percentage change in their global goods export market shares during the same period (see below). For example, Poland has increased its global export market share by 33% (from 0.82% to 1.1%) and has recorded an improvement in Purchasing Power Parity adjusted GDP per capita compared to Germany by 10 percentage points (from 44% to 54%) during the respective period. As expected, there is a significant positive correlation between global goods export market share growth and real convergence with an R squared value of 0.48 (we don't enter into a discussion of „correlation vs. causality" here as the positive link between export growth and economic growth has broadly been empirically demonstrated).




(http://www.economonitor.com/thoughtsacrossatlantic/files/2014/10/Chart6.jpg)

We can make several observations from the above chart. It shows that while export market share growth alone is not sufficient to ensure (further) real convergence (as the cases of Georgia and Czech Republic show), it is a necessary condition for real convergence. In other words, there is no country in the upper left hand side of the scatter plot that would have achieved significant real convergence without export market share growth. At the same time declining global export market shares appear almost to be a guarantee of real divergence rather than convergence.

Conclusion

All the countries included in this sample of Central and Eastern European countries participated in some free trade agreement during last decade while 10 countries were members in the EU, which is more than just a free trade area. Some countries experienced an increase in income relative to Germany, but others did not or even fell behind. Relatively poor European countries that joined the EU have achieved more significant real convergence with Germany than countries that remained outside the EU or relatively rich countries that joined the EU. A key determinant of whether a country's income level converged or diverged from that of Germany was the development of its export market share. An increase in export market share was necessary for convergence with Germany, although it was not sufficient.

This result is consistent with the idea that certain kinds of trade agreements contribute more to economic growth than others. Specifically, trade agreements that substitute trade with members for trade with non-members can be harmful if non-members were initially lower cost sources. At the same time the lower cost countries can benefit from trade creation as a result of joining a free trade area with higher income (and higher cost) countries. In general, countries whose free trade agreements resulted in more trade with the world as a whole experienced faster growth of real income. Thus, the medium term development prospects for those Eastern Partnership countries that have chosen to conclude free trade agreements with the EU look promising, but only if they manage to turn the opportunities provided by the free trade agreements into actual export market share growth.

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