



EUROPEAN POLICY BRIEF



SEARCH
SHARING KNOWLEDGE ASSETS:
INTERREGIONALLY COHESIVE
NEIGHBORHOODS

Sharing Knowledge Assets: InteRregionally Cohesive Neighborhoods (SEARCH) Project

Ongoing project (01/08/2011-31/07/2014)

Trade flows and localization choices: Policy implications of the patterns of economic interaction between the European Union and its neighboring countries

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INTRODUCTION

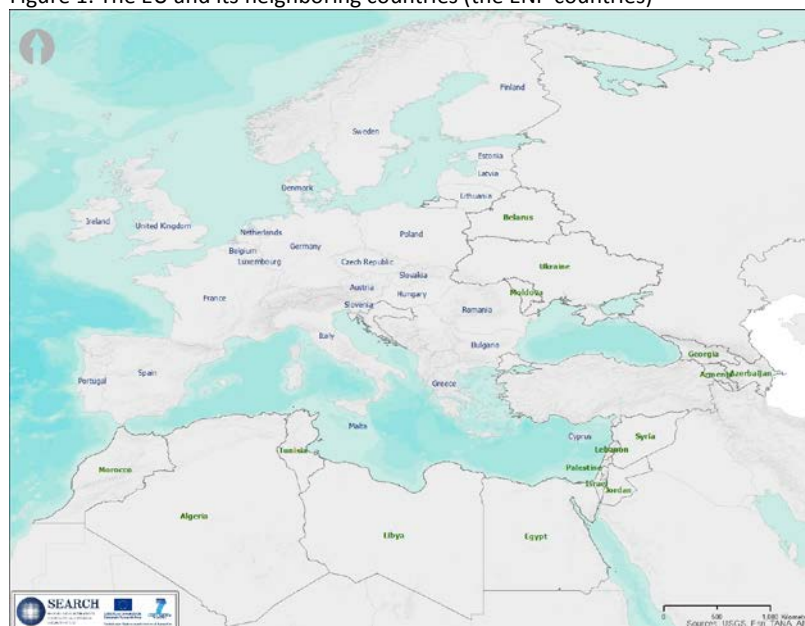
Setting the scene

The European Neighborhood Policy (ENP), launched in 2004, is a unified European Union (EU) policy framework towards the EU neighboring countries. The objective of the ENP is to strengthen the prosperity, stability and security of the EU, creating a “ring of friends” around the EU political borders. The ENP framework applies to the following countries (the “ENP countries”; see Figure 1): Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine (“ENP East”) and Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestine, Syria and Tunisia (“ENP South”). The ENP is synergic to other EU initiatives in this area such as the Eastern Partnership (launched in Prague, in 2009), the Euro-Mediterranean Partnership or Union for the Mediterranean (re-launched in Paris, in 2008), and the Black Sea Synergy (launched in Kiev, in 2008).

Even though the ENP is a distinct and separate process from the EU enlargement, the ENP countries operate under conditions of “neighborhood Europeanization” with an apparent mismatch (i.e. the so-called “capabilities-expectations” gap) between ENP requirements/demands for participating countries (i.e. demands that do not differ much from those of “accession Europeanization”), on the one hand, and potential ENP gains/rewards (i.e. the possibility of EU membership has been ruled out for the majority of ENP countries), on the other. Given this fundamental political mismatch – and the generalised skepticism about the possibility to transfer EU values and rules to the neighboring countries – deep(er) economic integration between the EU and the ENP countries is considered as a crucial condition for the success of the entire ENP process. As a consequence, the

analysis of the process of economic integration between the ENP countries and the European Union is highly relevant not only to the understanding of the economic linkages and development prospects of both areas but also to the evolution of their political relations.

Figure 1: The EU and its neighboring countries (the ENP countries)



Source: Own elaboration

Objective of the research

The EU-funded SEARCH (Sharing Knowledge Assets: InteRregionally Cohesive NeigHborhoods) Project focuses attention on the ENP countries, which so far have been neglected, even though they are of central interest in the economic literature on cohesion, in the analysis of the impact of the ENP. The main objective of SEARCH Project is to strengthen the integration process between the EU and the ENP countries, improving fundamentally the understanding of institutional framework conditions of the ENP countries and their economic interactions with the EU, in terms of people, capital, trade, knowledge and innovation, in order to improve future definition and implementation of the ENP.

The second Working Package (WP2) of SEARCH Project, in particular, titled “Trade Flows and Localization Choices”, has the general objective to advance and consolidate theoretical and empirical scientific knowledge on the patterns of economic interaction between the EU and the ENP countries, to project future trends and to identify the effects of deeper economic integration to the growth, competitiveness and cohesion prospects of both areas. The specific objectives of WP2 of SEARCH Project are: (a) the analysis of the trade patterns between the EU and its neighboring countries and their possible effects on growth, structural change and cohesion in both areas; (b) the analysis of the locational choices of EU mobile investment, the direction and drivers of capital mobility and its effects on the EU neighboring countries; (c) the assessment of the efforts made by domestic and foreign firms to invest in technological and organizational capacities with a special focus on the impact of localized institutional environments; (d) the analysis of the spatial intra-country effects of stronger trade and investment flows in both the EU and its neighboring countries; and (e) the discussion of the policy options at the EU level that take into consideration the effects of integration and attempt to increase and spread its benefits on both sides of the external EU borders.

WP2 of SEARCH Project provides innovative, clear-cut, empirical evidence in response to the following research questions: (a) how are trade patterns and capital mobility between the EU and the ENP countries evolving in response to ENP? (b) what is the impact of trade flows and capital mobility between the EU and the ENP countries on growth, structural change and cohesion? and (c) what are the policy implications of the evolution of trade flows and capital mobility

“Departure” for the present Policy Brief

between the EU and the ENP countries?

The present Policy Brief draws on Deliverable 2.1 of SEARCH Project. Deliverable 2.1 is an interim Working Paper on patterns of economic interaction between the EU and the ENP countries, submitted to the European Commission. In particular, Deliverable 2.1 includes the following Working Papers: (a) WP2/01: EU trade policies towards neighboring countries (author: Panagiotis Liargovas); (b) WP2/02: Is the EU the best trade partner for its neighbors? (author: Anna Maria Pinna); (c) WP2/03: The geography of trade relations between the EU and the ENP countries: Empirical analysis and implications for theory and policy-making (authors: Panagiotis Artelaris, Dimitris Kallioras, George Petrakos and Maria Tsiapa); (d) WP2/04: Relatedness and diversification in EU and ENP countries (authors: Ron Boschma and Gianluca Capone); and (e) WP2/05: Location choices of multinational companies in transition economies: A literature review (authors: Daria Zvirgzde, Daniel Schiller and Javier Revilla Diez). Together the aforementioned Working Papers synthesize the work done on patterns of economic interaction between the EU and the ENP countries, providing the backdrop against which further research can be conducted.

Each Working Paper has a Policy Notes addendum i.e. a 2-3 pages text consisting of 3 parts: (a) objectives of research in reference to policy; (b) scientific/research methods; and (c) policy value-added. Each Policy Notes text has contributed to the preparation of the present Policy Brief text, which incorporates the policy implications of the research findings, easing, thus, the (effective) communication with the policy-makers.

Scientific approach

The empirical analysis covers the period from 1995 to 2010, in order to gauge the latest shift operated in the economic structures of the EU and the ENP countries, and refers up to 4-digit sectoral level.

The papers dealing with the analysis of trade patterns in the EU and the ENP countries provide a theoretical discussion and detailed empirical findings. The empirical findings concern the evolution of trade patterns over time, by sector, origin and destination, as well as the degree of relatedness between export products and the evolution the export mix of the EU and the ENP countries over time. The theoretical discussion summarizes the EU trade policies towards the ENP countries, putting a special emphasis on the restrictions arising from other EU sectoral policies like the Common Agricultural Policy (CAP).

The papers dealing with the analysis of capital mobility among the EU and the ENP countries undertake a theoretical discussion and provide preliminary empirical findings on the locational choices of EU FDI in the ENP countries. Special emphasis is given on the examination of the role of offshoring (or firms' localization in general) in the dynamic evolution of prosperity gaps between more and less industrialized countries in order to assess the risk of the emergence of new economic “divides” between the EU and its neighbors.

Structure of the present Policy Brief

The current part of the present Policy Brief is introductory. The next part presents the main evidence of the analysis conducted up to now, providing valuable insight into conceptual and empirical issues of high relevance to the current debate on the process of EU integration (and its future). The third part discusses the policy implications of the analysis conducted up to now. The fourth part summarises the research parameters and the last part provides the identity of SEARCH project. Overall, the present Policy Brief synthesizes the work done, up to now, on patterns of economic interaction between the EU and the ENP countries, providing the backdrop against which the success of the ENP undertaking can be evaluated.

In general, the research progresses smoothly and in line with the structure of Annex I to the Grant Agreement.

EVIDENCE AND ANALYSIS

Policy context

The ENP is a bilateral policy, between the EU and each ENP country. In particular, following the suspension of the Doha Development Round of the World Trade Organization (WTO), the European Commission started to pursue Free Trade Agreements (FTAs) (i.e. reduction of tariffs on trade and reduction of restrictions on investment), with targeted economies, in order to protect its markets and to enhance its competitiveness. For the EU, FTAs represent a subway to implement Deep and Comprehensive Free Trade Agreements (DCFTAs) with its neighboring countries. DCFTAs go beyond tariff reductions to cover, more extensively, regulatory issues such as investment protection, public procurement and competition policy, representing the EU's support for the process of democratic and economic reform. The policies related to the internal market are the reference for the common trade policy of the EU member-states towards third countries. Thus, the common external trade EU policy has a strong impact on the EU's external economic links since its reach is not limited to cross-border trade flows. In particular, the Treaty of Lisbon, forced in December 2009, makes, *inter alia*, EU trade policy an integral part of the EU's "unified external action". Accordingly, all EU policies with a bearing on relations to third countries (except for the Common Foreign and Security Policy (CFSP)) should be guided by a common set of principles and objectives such as the consolidation and support of democracy and the preservation of peace.

As regards the ENP, in particular, the main reason for the EU to follow the road of bilateralism is its objective to deepen the substance of trade agreements, enhancing more comprehensive trade relations with its neighbors, and, thus, bringing its neighbors gradually closer to the Single Market. Thus, the DCFTAs between the EU and the ENP countries involve tailor-made agreements and conditions, in contrast to the rigid Copenhagen criteria that characterized the EU (eastwards) enlargement policy. In other words, DCFTAs are a "carrot and stick" tactic that considers mandatory *acquis communautaire* compliance related to political requirements as a precondition for trade negotiations (and agreements).

The ambiguous impact of economic integration

It is widely accepted that the European perspective acts as a very strong stimulus for, and facilitator of, economic, political and institutional development by providing not only the incentives and but also the (financial) resources to promote economic restructuring and institutional capacity-building. It is, thus, no surprise that especially for countries that are in dire need for economic restructuring, sociopolitical transformation and development, the process of European integration, in all of its facets (i.e. economic integration, political approximation and policy harmonization), has largely gone unquestioned.

However, together with the aforementioned benefits, which are too strong to be overlooked, the process of European (economic) integration is giving rise to additional processes whose nature and overall impacts remain more ambiguous. Economic integration reduces the role of national borders as barriers to factor mobility, which is, further, reinforced (self-sustained process) by the reduction of trade costs. "Closed" borders distort market size, whereas the removal of economic barriers generates (releases) a number of spatial dynamics linked to better access to foreign markets and import competition. Therefore, even if there is almost unanimous consensus in the economic literature that (market-based) economic integration is a positive-sum game, an on-going debate is currently taking place concerning the distribution of its overall welfare gains. Such a debate finds fertile ground since the size, the composition and the direction of trade and capital flows determine, to a large extent, the prospects (and the limitations) for economic development. In other words, in the economic space emerging in the EU (and its neighborhood), the space of flows (i.e. integration) affects, to a great extent, the space of places (i.e. development).

The EU-ENP bilateral trade relationship

The examination of the bilateral trade relationship between the EU and the ENP countries reveals that, during the period 1995-2010, that the patterns of interaction between the EU and the ENP countries have changed. Under the framework of the ENP, the ENP countries are deepening their trade relations with

the EU in order to open up extra agricultural trade, to liberalize trade in services and investment, to negotiate agreements on accreditation and acceptance of industrial products, to create deep and comprehensive free trade areas. However, and despite all the efforts, it seems that the ENP countries do not play a key role in European trade. Moreover, despite the increasing trends recorded in the trade activity between the EU and the ENP countries, it seems that the EU has to face important competitors in the world arena. BRIC countries, the USA and the Rest of the World group are gaining shares in the ENP trade, undermining the EU importance (see Tables 1 and 2).

Table 1: Major EU27 export partners

	2011		2006	
	rank	millions of €	rank	millions of €
USA	1	260,553	1	269,147
China	2	136,222	4	63,795
Switzerland	3	121,671	2	87,792
Russia	4	108,434	3	72,340
Turkey	5	72,671	5	50,039
Japan	6	48,968	6	44,772
Norway	7	46,529	7	38,498
India	8	40,425	10	24,394
Brazil	9	35,729	18	17,739
U.A.Emirates	10	32,615	9	25,269
Ukraine	19	21,196	17	18,268
Algeria	21	17,205	26	9,968
Israel	22	16,836	20	13,972
Morocco	24	15,168	24	10,473
Egypt	25	13,944	28	9,081
Tunisia	31	10,931	30	8,719
Belarus	33	8,486	35	5,793
Lebanon	38	7,218	40	4,393
Jordan	43	5,267	47	3,198
Syria	55	3,258	55	2,677
Azerbaijan	60	2,862	58	1,955
Libya	65	2,066	44	3,676
Moldova	67	1,858	75	1,183
Georgia	72	1,588	83	926
Armenia	107	641	106	478

Source: Pinna (2013)

Table 2: Major EU27 import partners

	2011		2006	
	rank	millions of €	rank	millions of €
China	1	292,130	1	194,945
Russia	2	198,343	3	140,920
USA	3	184,246	2	175,590
Norway	4	93,450	4	79,168
Switzerland	5	91,205	6	71,676
Japan	6	67,452	5	77,506
Turkey	7	47,593	7	41,720
India	8	39,315	15	22,615
Brazil	9	37,776	10	27,235
South Korea	10	36,101	8	40,817
Algeria	12	27,678	13	24,156
Ukraine	24	14,987	30	9,874
Azerbaijan	25	14,842	40	5,448
Israel	29	12,645	29	9,992
Libya	33	10,437	12	26,068
Tunisia	35	9,874	32	7,628
Egypt	36	9,511	31	7,654
Morocco	39	8,689	34	7,218
Belarus	51	4,220	44	4,462
Syria	57	3,071	48	3,480
Moldova	81	842	89	514
Georgia	88	614	93	471
Lebanon	100	411	119	225
Armenia	109	319	105	339
Jordan	111	313	117	233

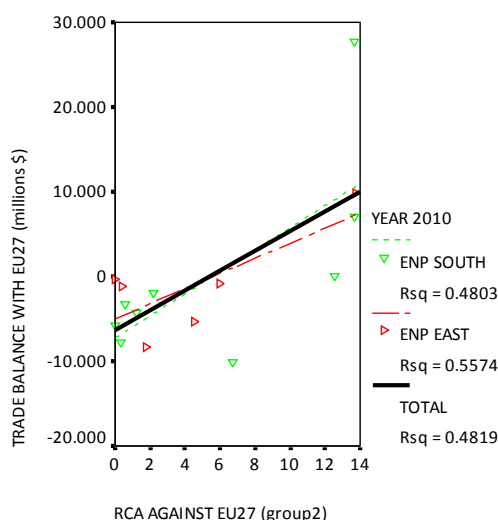
Source: Pinna (2013)

The geography of the EU-ENP trade flows

The study of the size, the composition and the direction of trade flows between the EU and the ENP countries indicates that the EU-ENP trade relation is uneven, unbalanced and asymmetric. This is so as the ENP countries are locked-in an inter-industry type of trade integration with their more advanced EU counterparts. This

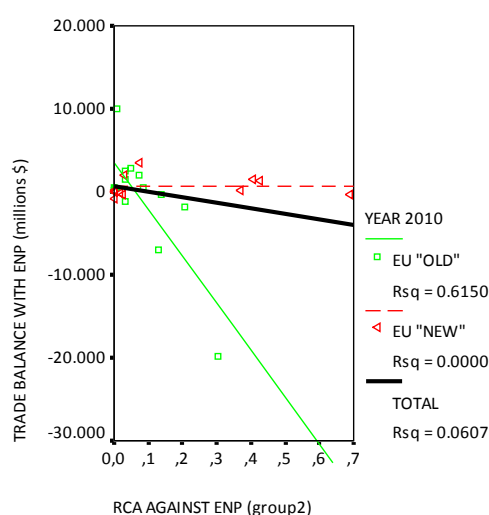
type of trade relation, an outcome of the inability of the ENP countries to compete in markets for capital-intensive and/or knowledge-intensive activities, even though it provides an alternative (and perhaps the only feasible) route for the exploitation of the locally available skills, is not in a position to guarantee (generate) prospects for long-term income convergence. Especially for the ENP countries that do not exhibit comparative advantage in the sector of fuel primary commodities, this type of trade relations provides strong implications (given the recent experience of the Southern EU member-states) that trade deficits may be, quickly, “converted” into fiscal deficits (see Figures 2 and 3). The EU-ENP trading area, clearly, reminds of a “hub-and-spoke” system. In contrast to the theoretical positions of the neoclassical school of thought, the well-established “core-periphery” EU spatial pattern of development tends to be “reproduced” in the wider EU area.

Figure 2: Collation of trade balance with the EU (millions USA \$; current prices) and revealed comparative advantage against the EU (year 2010; fuel primary commodities)



Source: Artelaris et al. (2013)

Figure 3: Collation of trade balance with the ENP (millions USA \$; current prices) and revealed comparative advantage against the ENP (year 2010; fuel primary commodities)



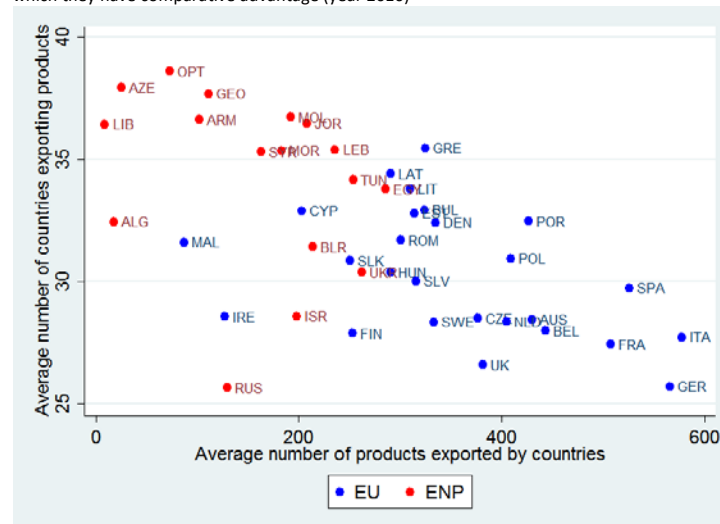
Source: Artelaris et al. (2013)

The degree of relatedness between exports products

The analysis of the degree of relatedness between exports products, conducted on the basis of co-occurrence analysis, investigates the process of diversification of the EU and the ENP countries. The results of the research show that in both EU and ENP countries the evolution of the export mix is strongly path-dependent:

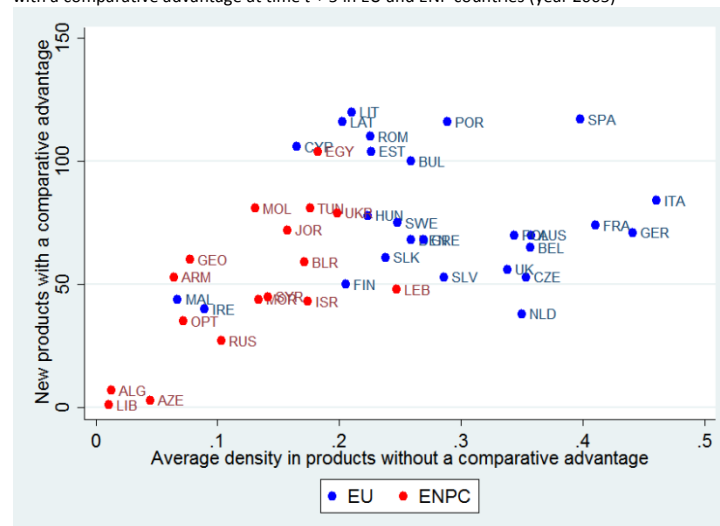
countries tend to keep a comparative advantage in products that are strongly related to their current productive structure, and they also diversify in nearby products. However, this effect is much stronger for the ENP countries, signalling their lower capabilities to diversify in products that are not very near to their productive structure (see Figure 4). Moreover, the results of the research show that the future exports structure of countries is affected by imports: both EU and ENP countries keep a comparative advantage in products that are strongly related to their imports, but only EU countries show, also, evidence of learning to diversify in new products from related import sectors (see Figure 5).

Figure 4: Relation between the level of diversification of countries and the level of complexity of the products in which they have comparative advantage (year 2010)



Source: Boschma and Capone (2013)

Figure 5: The relationship between density in products without a comparative advantage at time t and new products with a comparative advantage at time $t + 5$ in EU and ENP countries (year 2005)



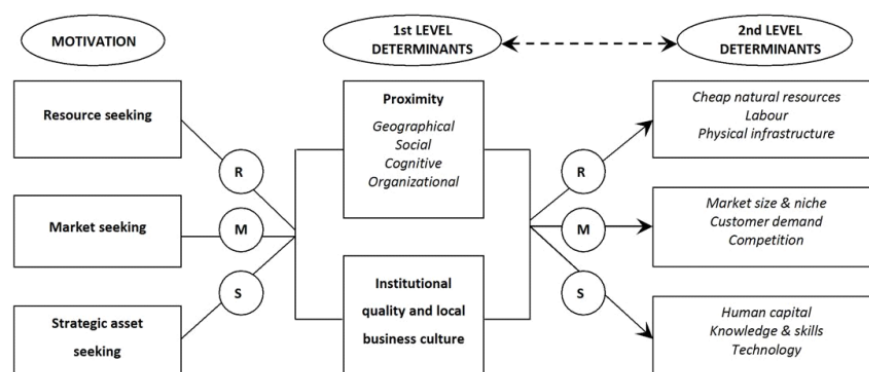
Source: Boschma and Capone (2013)

The conceptual framework for the location choices of FDI

The literature review of location choices of FDI attempts to provide the framework for the corresponding empirical analysis (see Figure 6). Putting an emphasis on transition economies, the review shows that a firm decides to internationalize in order to enforce the development of its competitive advantages. A range of traditional economic factors impact the firm's decision on a specific location for its investment, such as availability of resources, market demand, strategic assets, possibility to efficiently optimize the division of labor. Which factors do impact the location choice decision depends on the motivation of internationalisation, namely market seeking, resource seeking, efficiency seeking or strategic asset seeking. Moreover, it is highly acknowledged that agglomeration economies and

proximity definitely impact the decision of a firm locate within specific environment, so that to get easily embedded into the latter. Except for the traditional economic factors impacting the firm's decision to go abroad targeting a certain location, institutional quality and the local business culture play a very important role, especially in the transition economies.

Figure 6: Location choices of multinational companies: Conceptual framework



Source: Zvirgzde et al. (2013)

POLICY RECOMMENDATIONS

Offering policy recommendations is a very delicate exercise

Since research is still in progress, offering policy recommendations is a very delicate exercise. Deliverable 2.1 of the SEARCH Project is an interim report and the available results (and the overall analyses) are still preliminary. However, some important implications for policy-making can be derived from the findings of the analysis conducted up to now.

The “carrot and stick” tactic has not “produced” the anticipated results

The EU is the most important trade partner for the majority of the ENP countries. However, it loses its shares over time. This indicates the slow progress of the DCFTAs (mainly because the “capabilities-expectations” gap remains, and assuming, of course, that DCFTAs affect trade patterns) as well as the restrictions arising from the EU sectoral policies (and the CAP, in particular). The political instability in the ENP South and the slow reforms in the ENP East indicate that the “carrot and stick” tactic has not (at least, not so far) “produced” the anticipated results. Thus, the EU should examine the possibility that mandatory *acquis communautaire* compliance related to political requirements should not be a precondition for trade negotiations (and agreements), but for further financial and technical support. This means that a possible ENP review should consider a further (even unilateral) liberalization of trade and a stronger financial support mechanism as a reward for reforms.

The EU “core-periphery” pattern of development is expanding towards the EU neighborhood

The inter-industry type of (trade) integration between the EU and the ENP countries, an outcome of the inability of the ENP countries to compete in markets for capital-intensive and/or knowledge-intensive activities, even though it provides an alternative (and perhaps the only feasible) route for the exploitation of the locally available skills, is not in a position to guarantee (generate) prospects for long-term income convergence. Especially for the ENP countries that do not exhibit comparative advantage in the sector of fuel primary commodities, this type of trade relations provides strong implications (given the recent experience of the Southern EU member-states) that trade deficits may be, quickly, “converted” into fiscal deficits. The EU-ENP trading area, clearly, reminds of a “hub-and-spoke” system, indicating that the EU “core-periphery” pattern of development is expanding towards the EU neighborhood. Definitely, it is not reassuring the fact that the ENP countries tend to keep a comparative advantage

in products that are strongly related to their current productive structure, being unable to implement export-led growth strategies.

RESEARCH PARAMETERS

Introductory statement

The present Policy Brief text incorporates the policy implications of the research findings on patterns of economic interaction (i.e. trade flows and localization choices) between the EU and the ENP countries, conducted up to now. The present Policy Brief draws on Deliverable 2.1 of SEARCH Project and offers policy implications in order to ease the (effective) communication with the policy-makers.

Objectives of the research

The main objectives of the research, conducted up to now, on patterns of economic interaction between the EU and the ENP countries were to: (a) improve our understanding of trade patterns between the EU and the ENP countries and their effects on growth, structural change and cohesion in both areas; (b) improve our understanding of the locational choices of EU mobile investment, the direction and drivers of capital mobility and its effects on the ENP countries; and (c) detect the policy implications towards the strengthening of economic integration and the spreading of its benefits on both sides of the external EU borders.

Methodology

The research provides a theoretical discussion and an empirical analysis of economic interaction patterns between the EU and the ENP countries, combining a set of qualitative and quantitative research methodologies: (a) review of the EU trade policies towards the ENP countries, including restrictions arising from other EU sectoral policies (like the CAP); (b) review of the scientific, theoretical and empirical, literature on patterns of economic interaction (i.e. trade flows and localization choices), with a special focus on the EU-ENP area; (c) statistical and graphical analysis of trade data and estimation of a series of trade indicators; (d) analysis of the degree of relatedness between export products, based on co-occurrence analysis, and investigation of the process of diversification, using the proximity approach; (e) introduction of a set of hypotheses for testing empirically the location choices of multinational companies in transition countries (specifically, in Ukraine).

Qualitative material has been drawn from EU policy documents and the respective scientific literature. Quantitative, secondary, data were derived from BACI and COMTRADE databases. Moreover, qualitative and quantitative, primary, data are going to be derived from a series of enterprise surveys, which either are in progress or they have, already, been carried out.

The aforementioned list of methodologies is going to be enriched in the next phase of the research.

PROJECT IDENTITY

Project name

Sharing Knowledge Assets: InteRregionally Cohesive NeighBorhoods (SEARCH)

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Website

www.ub.edu/searchproject

Further Reading

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