

# **The future of EU trade policy**

A Vox EU debate moderated by Richard Baldwin  
(Graduate Institute, Geneva; Vox EU Editor-in-Chief;  
Policy Director, CEPR)

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## Introduction

The aim of this Vox EU debate was to stimulate an online discussion among leading trade economists on the subject of renewing EU trade policy. The debate was initiated by the European Commission as part of a broad public consultation before the adoption of a new EU trade policy in autumn 2010.

The discussion was launched by a lead commentary from Lucian Cernat, Chief Economist in DG Trade. His article, *Shaping the future of EU trade policy: How to maximise the gains from trade in a globalised world?*, highlights some critical areas for further reflection regarding future EU trade policy and its relationship to the EU2020 strategy.

The online debate, initially open throughout the month of September 2010 and extended because of demand to 15 October, was moderated by Richard Baldwin, Professor of International Economics at the Graduate Institute and Policy Director of CEPR.

It is estimated that over 2,500 people visited the debate, with 13 contributions received during the period. Comments were received from six countries across three continents. The following report contains the principal contributions and comments.

## Section One: Lead Commentaries

### 1.1 A transformation economy: shaping the future of EU trade policy

#### David O'Sullivan (Director General for Trade, European Commission)

*In a recent Vox Talks interview, David O'Sullivan, Director General for Trade at the European Commission, joined our EU trade policy debate. He talked to CEPR's Viv Davies about, amongst other things, the EU's responsibility within the world trading system, trade governance and the WTO, the role of reciprocity, the BRICs, and the importance of successfully concluding the DDA negotiations; he also comments on the issue of 'multilateralising regionalism.'*

#### Transcript

**Viv Davies:** Hello and welcome to Vox Talks. I'm Viv Davies from the Centre for Economic Policy Research. It's the 15th of September 2010 and I am speaking to David O'Sullivan, Director General for Trade at the European Commission. The Commission has recently launched a public consultation process designed to help shape the future direction of Europe Union trade policy. As part of the consultation process, VoxEU is currently hosting an online debate to gather the views and reactions of leading economists.

I began the interview by asking Mr. O'Sullivan what he considered to be the fundamental issues and key challenges in terms of defining and developing a European Union trade policy.

**David O'Sullivan:** Well, I think from the perspective of the European Commission and in particular Commissioner De Gucht, who wants to bring forward a communication on this subject, we are anxious to take stock of the situation after a few years on from the "Global Europe" paper, which Commissioner Mandelson issued in 2006.

But, since then, a lot has happened. Firstly, we have made a lot of progress on doing the things which we set out to do on the Global Europe communication, but more importantly the global scene has changed. We have had the dramatic events following the collapse of Lehman Brothers; we've had the financial crisis – which in turn generated an economic crisis and a recession, and an unprecedented fall in trading patterns, which we are now witnessing a small recovery and some improvement. But obviously, this all needs to be taken into account in looking forward and seeing where our policies go from here.

So, we are first and foremost looking at the lessons learned from the Global Europe experience: what has succeeded; what are the areas where we still need more work; how to leverage trade as an instrument of recovery, and as a means of putting the global economy back on the road to recovery; how to continue to project publicly the benefits of trade and globalisation, because recent events have given rise to some criticism and some suggestions that perhaps trade or globalisation might even have contributed to the difficulties, whereas we would

strongly maintain that trade and globalisation are very much part of the solution and not part of the problem.

And of course all of this as part of the institutional framework in which trade policy is now defined, in particular the enhanced role for the European Parliament, which is foreseen under the Lisbon Treaty; but also the institutional changes of the creation of a High Representative and Vice President, Catherine Ashton; a new diplomatic service, the European External Action Service; and a clear desire as witnessed by tomorrow's European Council for our member states to project more clearly a European position on issues of global importance.

**Viv Davies:** The European Union is collectively one of the world's largest traders. What do you consider to be the key responsibilities that should go with such a dominant position within the world trading system and to what extent do you think that future EU trade strategy should reflect those responsibilities?

**David O'Sullivan:** We are not only one of the world's largest traders, we are the largest trader. We are the largest economy in the world by the way, and we are the largest importer, and the largest exporter; we are the largest recipient of foreign direct investment, and we are the largest owners of foreign direct investment in countries outside Europe.

So Europe, if you like, to a certain extent, almost invented globalisation. I mean we are at the centre of this process of global supply chains and of the evolving nature of global markets. So, we not only have a responsibility but we have a self-interest in ensuring that this system works and that this system works effectively and fairly.

And of course that starts first and foremost with our very strong support for the multilateral system and the WTO. We have been and continue to be very strong advocates of a successful outcome for the DDA. I know that this can sound like a broken record because we have had so many missed opportunities, but we continue to believe that bringing this round to a successful conclusion is intrinsically important because the round has economic value, but just as importantly, systemically it is necessary to reinforce the relevance of the WTO as a global governance organisation in the 21st century.

So, we will continue to push for this and indeed push for the WTO to be recognised as a truly global organisation, which of course it is in terms of its membership, but I think it is probably true to say that a number of the developing countries who have joined perhaps more recently still don't feel in some way that it is "their" organisation. They feel they have entered a club set up and dominated by the major powers, the traditional major western powers. And I think the DDA with its development emphasis provides the unique opportunity to set the WTO firmly as not only the primary vehicle for multilateral trading, but also one which is able to take on board the diversity and the differences between the richest countries in the world such as the European Union or the United States or Japan, the emerging economies such as Brazil, China, India, and of course the poorest, even the Least Developed Countries.

So, support for the WTO is absolutely vital, similarly support for the work of the G20, which of course has emerged again reflecting the changes of recent years, and the fact that you can no longer deal with global governance issues without talking to and involving China, Brazil, India, Russia and so forth.

And of course finally in our bilateral dealings, we have to set very high standards for bilateral free trade agreements. We only, therefore, should subscribe to highly ambitious agreements which will not be “Doha instead”, but will be “Doha plus”, in other words they will go beyond what is possible in the WTO. And I would point for example to our recent agreement with South Korea as an example of an extremely ambitious and high quality free trade agreement. And those are the kinds of agreements we will continue to push in our other negotiations.

Of course we also need to show generosity in dealing with the developing world and in particular, for example, in relation to the African, Caribbean and Pacific countries where we are negotiating new trade arrangements to replace the previous autonomous regime. It is clear that there we fully accept that we are dealing with poor countries from whom we cannot expect the same level of ambition or the same degree of reciprocity.

So, I would say full support for the multilateral system, a high ambition in any bilateral trade agreements we enter into, particularly with countries of a similar level of development, and generosity and development awareness in our dealings with the less well-off countries of the world.

**Viv Davies:** The EU has been criticised by some commentators in the past for not giving enough attention to the importance of reciprocity in its trade deals and what it will be prepared to give up in return for concessions by others, both in the context of Doha round and regional trade agreements. Is the criticism justified and to what extent do you think that the EU's future trade strategy should take into account the issue of reciprocity?

**David O'Sullivan:** I think in the abstract we can all agree that as a general concept reciprocity is what we want in the trading world, because we want a level playing field and it is in everyone's benefit to open their markets. Of course a strict interpretation of reciprocity defining it sector by sector or trying to define it country by country without differentiating between the level of development or the specific situation of the trading partner you are dealing with, would ultimately be counterproductive.

But I think that we have pursued an approach of fair trade deals, but whether it is in the WTO I think the package which was on the table in July 2008 was a fair deal in the sense that of course the developed countries were giving slightly more and getting slightly less, but we always intended that the DDA would be unbalanced in favour of the developing countries.

In our free trade agreements once again I think here we have to differentiate between dealing with countries of comparable economic development such as, for example, South Korea or Canada, with whom we are engaged in negotiations where I think it is only fair to drive a hard bargain and to expect a comparable

degree of liberalisation on both sides, even if there maybe some exceptions and some different sensitivities between ourselves and our partners.

But, broadly speaking, it is important to insist on a high degree of ambition versus situations where you are dealing with a partner who is not at the same level of development. I have already cited the example of the ACP and the Economic Partnership Agreements, which are clearly lopsided in favor of the ACP countries for development reasons, and even taking into account countries such as India, for example, which though it is a powerful emerging country, it remains a developing country with legitimate development concerns which we will have to take into account in our negotiations.

So, I think reciprocity is an important concept. We have to demonstrate to our citizens that we are defending their interests and that we are not just naively opening our markets without obtaining benefits in return. But, I do think you need a sophisticated understanding of how to apply reciprocity on a day-to-day basis in our dealings with trading partners who are very often in very different economic situations.

**Viv Davies:** What do you consider to be the main benefits for European countries and their citizens within the context of a common EU trade policy?

**David O'Sullivan:** Well, I think firstly and foremost, it gives us greater weight in negotiations. By creating a Single Market, we have created the largest economy in the world. We have gained huge benefits for our member states through the integration of our markets here in Europe, and of course what we offer to any trading partner is access to one of the richest and largest markets in the world with 500 million consumers.

And the fact that in this area uniquely Europe speaks with one voice with the Commission acting as the negotiator on behalf of the 27 member states, clearly means that we are able to have an important role in shaping trade policy. This is true in Geneva where the EU sits at the table with the United States, with China, with India, Brazil as an equal in shaping the agenda in a way that not even the largest of our member states could hope to do if they were acting individually.

More generally, of course, having created the Single Market which is a huge benefit for our citizens, being able then to connect that Single Market with global trading opportunities brings huge benefits for our citizens. First of all, it brings higher economic growth because as we know trade expands welfare and we estimate that if we were to complete all the ongoing trade negotiations in which we are currently engaged, we could increase growth in Europe by as much as half a percentage point. Now, that may not sound like a huge amount but when you are talking about that making the difference between two or two and a half, or between two and a half and three, that adds up to quite a lot of economic value.

Secondly, there are benefits for both consumers and producers in having access to goods at cheaper prices. To consumers it is self evident, it keeps inflation down, it makes better quality products available at lower prices, but also to

producers because Europe has become a transformation economy. We live by trade. Two-thirds of our imports are actually used as inputs to the production process which are then very often re-exported. So it is absolutely indispensable to our industries that if they are to remain globally competitive, they have access to the highest quality inputs at the lowest possible prices.

And finally, in terms of employment, trade makes a huge contribution to job creation in Europe. We create many, many more jobs through trade than are lost through some outsourcing. We estimate that at the moment that about seven percent of EU employment depends directly or indirectly on exports and this is a very significant number of jobs.

**Viv Davies:** What factors do you think are responsible for so many emerging markets being reluctant to take on binding obligations beyond tariff reductions and other long established border barriers?

**David O'Sullivan:** Well, I think there are two factors. One is what I referred to earlier when I talked about the sense of ownership in the WTO. We have to accept that the post-war era and the history of colonialism and the history of the emergence of these countries has left some scars in terms of their sense of the fairness of the system and of the extent to which their views are genuinely taken into account in the shaping of the rules.

That's why it is terribly important that we make a success of the Doha Development Agenda so that we can really demonstrate that we are capable of producing a multilateral system in which all countries can feel their interests are heard and protected.

In this context, it is natural that many of these countries want to retain a high degree of policy space, particularly in areas where they feel they are not yet competitive and where they believe that continuing to have barriers or continuing to have a degree of control over the issue might enable them to build up a capacity which would otherwise not be possible if they liberalise too quickly.

Now, I think we have to have some sympathy for this because we in Europe did not discover the benefits of free trade overnight. We went through periods of protecting our markets and then progressively opening up. So there is some legitimacy in this point.

On the other hand, I think we have to try and persuade these countries of the fact that to recreate the path of development that, for example, Europe took over several hundred years is not necessarily their way forward. They need to leapfrog this and move into the 21st century very quickly. And in this regard, sectors such as services or investment are not optional extras but will in fact be the way of the future. It may be nice to say, well, let's keep some state monopolies because this creates policy space, but if a developing country does not develop very quickly in the 21st century an effective and competitive telecommunication system or an effective and competitive financial system, then that country will very quickly hit a wall in terms of its development capacity.



And so I think that is why we need to explain why it is important also to move forward in these new areas. And I know that there is controversy in dealing with some of these issues because they are seen to be particularly sensitive, but I think the intellectual case and the analytical/economic case for persuading countries that they need to look at having, for example, clear rules in place for the protection of investment so as to become attractive places for investment ... that competition rules are not necessarily a hindrance but actually a help in the development of the economic attractiveness of their countries, that regional integration is a very important way forward whether that is in Africa or in Asia or in Latin America.

I think these are ideas, the benefit of which we have to continue to explain, but I do understand why there is reluctance and I do understand that this is a debate that will have to continue and we will have to continue to make the case, that the benefits of trade increasingly in the 21st century will not just flow from reducing tariffs, but also from addressing beyond the border issues, non-tariff barriers, technical barriers to trade, issues like government procurement, like investment, like services, like competition rules. We will have to find ways also of addressing these multilaterally and in bilateral agreements if we are to continue the process of globalisation in supply chains and economic activity which we have seen flourish in recent years.

**Viv Davies:** You referred earlier to the BRICs – Brazil, Russia, India, China. In terms of helping shape future EU trade policy, what do you consider to have been the main lessons learned by the European Commission from its dealings in recent years with the BRICs?

**David O'Sullivan:** Well, I think first and foremost that while the term captures a concept which is important, namely that they are a group of emerging developing countries who by their size and by their economic potential are destined to play an important role in shaping the 21st century, they are all very different and they all present different challenges for Europe in terms of engaging with them.

China clearly is dominating much discussion these days, not least because of the sheer size of the country, but also because of its fantastic economic performance in the last 10 or 15 years, and the fact that it has had a pretty good recession and that it has come through the recent economic crisis rather better than many places in the developed world.

We have a very active dialogue with China, notably through the high level economic and trade dialogue and we will continue to discuss with China how to take forward our relationship. We are now China's largest export market, so we are very important destination for Chinese exports.

We understand that China wants to develop its own economy, that it still has many, many millions of people, hundreds of millions of people living in poverty, that it has huge challenges of ensuring a more prosperous future for 1.5 billion people. But, we also think that the way to do that is for China to continue on the path of opening its market and engaging actively with the global community and

resisting any temptation towards a more narrow nationalist national economic approach.

In the case of Russia, of course, the key issue is to secure the accession of Russia into the WTO. Russia remains the last major economy to be outside the system. There are encouraging signs recently and we will work extremely hard on that in order to bring that to fruition.

In the case of Brazil, our economic relations of course pass through Mercosur which is a regional integration project of which we are hugely supportive. We have re-launched our negotiations for a free trade agreement with Mercosur and that could be a deal which would bring benefits both to the countries of Mercosur and to the EU, and we would hope that we could conclude those negotiations next year.

India, of course, is a major priority and we are engaged in a free trade agreement negotiation, and again while this is challenging, because it is the first time that we have entered into a negotiation of a free trade agreement with a country, which is on the one hand one of the major powerful emerging new economies clearly with a very bright future, but which on the other hand still has many of the characteristics of a developing country and has many development challenges to face.

And we would have to get the balance right between the right level of ambition of the agreement and taking into account the legitimate development concerns that India put forward in these negotiations. But, I am very confident that we are moving forward very constructively and I would hope that this agreement could also come to a successful outcome in the first half of next year.

**Viv Davies:** You touched on the issue and importance of governance and the role of the WTO. In his response to Lucian Cernat's opening commentary in the current Vox debate, Richard Baldwin has suggested that a key goal of an EU trade policy should be to address what he considers to be a fundamental gap between what he calls "21st century trade" and "20th century governance". He suggests that bilateral and regional trade deals have been designed to try to fill that gap, but that these are not enough and that more should be done in terms of "multilateralising regionalism". Would you agree with that and if so how, and to what extent, do you think such a consideration could feature in shaping the design of EU trade strategy in the future?

**David O'Sullivan:** Well, I do agree that there is always a risk that trade negotiations are dealing with yesterday's agenda, because the world of business and the world of commerce moves much more quickly than the world of administration. But, on the other hand, I think there are certainly very significant governance issues for the world trading system, and in particular for the WTO, which will need to be addressed in the 21st century. And these are not necessarily figuring prominently in the DDA negotiations.

On the other hand, I am convinced that it will be extremely difficult to get the developing countries to engage in a debate on how we design a new agenda for

the 21st century until we have closed the chapter of the 20th century which is the DDA negotiations. So, this is yet another reason why I think it is terribly important to try to move forward and close the DDA negotiations as quickly as possible so that we can indeed then calmly sit down and talk about, well, what are the key issues that need to be addressed in the WTO in the 21st century.

And taking into account the fact that the DDA, if successful, will, to a large extent, have dealt with classic tariff issues and there will be not a lot left to dismantle in a further round, whereas there will be many, many other sensitive issues which would need to be addressed, in particular what I have mentioned already, which is technical barriers to trade, regulatory issues, sanitary and phytosanitary issues and going on then to the even more difficult material of investment or competition or government procurement.

So, I fully sympathise with anyone who says that we need to get quickly to a discussion of a 21st century trade agenda, but I am absolutely convinced that we will not have momentum to do that unless we successfully close the DDA.

Now, on the question of the role of regional and bilateral, I think we have to accept that even if we have a very successful conclusion of the DDA, the fact is there are things that can be done in the multilateral system that cannot be done bilaterally. And the most obvious example there is the case of disciplining for example agricultural subsidies and trying to have greater liberalisation of agricultural trade including disciplining of subsidies. This is classically something that we can only do at the multilateral level. It is very difficult to address that bilaterally.

On the other hand, there are things that if you want to take forward at the present time, it is very difficult to do it multilaterally. Trade and services is one example where the multilateral negotiations and services are mainly about binding what is already liberalised, whereas if you want to go beyond that, very often you have to get into a bilateral discussion, and in fact multilateral negotiations on services are really just an accumulation of a series of bilateral discussions.

The same is true, for example, in areas of government procurement where there is only a relatively limited commitment on the government procurement agreement in the WTO and where some countries, such as China, for example, are still not a part of the GPA, and where other countries are sometimes are reluctant to take multilateral commitments but more willing to do that in a bilateral context.

The question of intellectual property rights and their protection, again often difficult to address multilaterally but more easy to progress bilaterally. And I could say the same thing for competition rules, for example, or investment which is clearly a very important area. By the way, the Lisbon Treaty has now conferred on the European Union exclusive competence for investment matters and we will be able to have much more ambitious investment chapters in our bilateral agreements in the future.

So, I think, if we want to see progress in these areas, I think inevitably they will have to be through bilateral agreements and/or regional agreements. But, I absolutely agree with Mr. Baldwin that our objective should be, over time, to multilateralise this process and that these bilateral deals – that is why I said that we would see them as “Doha plus”, not “Doha instead”. And we would hope that in due course it would be possible to bring this kind of liberalisation into the multilateral framework, and that is probably one of the challenges of the 21st century. But, I think the key to doing that is firstly to ensure that the bilateral agreements are genuinely additional to WTO commitments, i.e., that they go further, but more importantly to closing the current round of DDA negotiations so that we then can cautiously and prudently begin to think about what the next wave of multilateral liberalisation would look like, and I agree hopefully it would cover a number of those issues which are currently not in the DDA agenda.

**Viv Davies:** David O’Sullivan, thanks very much indeed for taking the time to talk to us today. I look forward with interest to reading the debate on Vox as it continues through the month.

*David O’Sullivan is currently the European Commission’s Director General for Trade. His services support the EU’s Trade Commissioner in negotiating bilateral and multilateral trade agreements, ensuring that foreign markets are open for EU businesses and that the international rules agreed are actually applied, so that trade policy contributes to the Commission’s headline goals of prosperity, solidarity and security both in the EU and around the world. The post of Director General for Trade has brought David back to the Department in which he started his Commission career, first in Brussels and then in the Commission’s Tokyo office.*

*David O’Sullivan was Secretary General of the European Commission from June 2000 to November 2005, Head of Cabinet of Commission President Romano Prodi and Director General for Education and Training. He also has extensive experience in EU social and employment policy. He has a background in economics, graduating from Trinity College, Dublin and having completed post graduate studies at the College of Europe, Bruges. He holds an Honorary Doctorate from the Dublin Institute of Technology. He is also a Member of the Consultative Board of the Institute for International Integration Studies at Trinity College, Dublin.*

*In December 2010, David O’Sullivan will take up the position of Chief Operating Officer in the new European External Action Service.*

## 1.2 Shaping the future of EU trade policy: How to maximise the gains from trade in a globalised world?

### Lucian Cernat (European Commission)

*This autumn, the European Commission will set out the future direction for the EU's trade policy. In this column its Chief Trade Economist calls on Vox contributors to engage in the debate about what that direction should be.*

When the new European Commission took office in early 2010, President Barroso set out its new policy platform – “Europe 2020”. The Commission is now filling in the details through concrete programmes in several policy areas. This includes trade, where it will set out the future direction for trade policy late this autumn. In preparation for this it has been engaged in exchanges with relevant stakeholders and launched a public consultation process.

This column launches an online discussion of EU trade policy; my aim in this column is to stimulate debate and raise some initial questions. I hope that in engaging Vox readers, the resulting online discussion can provide fresh ideas and recommendations that can help us achieve our EU 2020 objectives. This column first presents the elements of the still-forming policy and its justifications in a way intended to stimulate this debate. Many questions are left open; I look forward to seeing the responses from the Vox community.

### The EU 2020 strategy and the triple benefit from trade

Europe, like many other developed regions and countries, is trying to find the best policy mix to promote sustained economic recovery. According to the IMF, GDP growth in Europe is expected to remain modest at around 1%. However, world growth is projected at around 4.5 % in 2010 and 2011, and around 7% in emerging and developing economies (IMF 2010). With subdued domestic demand in the EU, trade is going to become an important driver of growth.

The Commission's “Europe 2020” strategy targeted, inter alia,

- **smart and green growth** (in particular in terms of limiting greenhouse emission and encouraging renewable energies and energy efficiency),
- **job creation** (employment rate should increase from the current 69% to at least 75% by 2020),
- **boosting innovation and the digital economy** (investing 3% of GDP in R&D),
- **higher education, training and lifelong learning**, and
- **poverty reduction** in Europe (lifting over 20 million people out of poverty)<sup>1</sup>.

A range of EU and national policies and instruments should contribute directly or indirectly to these targets and objectives. An ambitious trade strategy, that could

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<sup>1</sup> The threshold used to define relative poverty is 60% of the median disposable income in each EU Member State.

build on growth in the rest of the world to boost growth at home is a key component in getting this mix right.

International trade has been a major driving force behind the integration of fragmented national markets for decades. The pace of this process has been extraordinary. According to the WTO, the value of world merchandise trade grew 73% in the last decade. Exports per capita have increased tenfold since 1950s. The trade-output ratio increased fourfold during the last ten years. This trend continues despite the negative shock of the 2008-2009 global crisis.

Promoting trade liberalisation brings a **triple benefit** that can underpin progress in the EU:

- **Economic growth:** Trade liberalisation creates additional opportunities for innovation and stronger economic growth (see Bloom et al. 2009)<sup>2</sup>. For instance, finalising the Doha Development Agenda and all the ongoing Free Trade Agreement negotiations would add in the range of 0.5 percentage points to the EU GDP. Making further progress on our relations with strategic partners, in particular an enhanced transatlantic partnership with the US would double this growth effect. This effect is quite significant in its own right. But this contribution of trade policy to the EU 2020 objectives is even more important, if recovery in Europe remains subdued over the next years.
- **Consumer benefits:** Apart from access to cheaper products, an important but often neglected source of consumer welfare stems from access to a wider range and variety of products and services. For example, a recent study estimates the consumer gain to American consumers of global variety growth during 1972-2001 to be about \$2.6% of GDP (see Langenfeld and Nieberding 2005, Broda and Weinstein 2006, and Mahler and Seitz 2010). Translating these "variety gains" in EU context would indicate that the average European consumer benefits in the range of €600 per year.
- **Labour effects:** Although trade opening is often perceived as a threat to jobs in Europe, the truth is that trade leads to a significant net job creation effect in Europe. In 2000 alone, around 14 million jobs (around 7.2% of EU employment) were dependent on the EU's ability to export to the rest of the world. This includes the jobs of those working directly for the production of the exported goods and services as well as those employed in downstream sectors producing inputs that are embodied in sales to foreign markets. If we imagine a world in which the EU closed its borders and stopped trading with the rest of the world, this would be equivalent to a reduction by 18% in EU employment, or a reduction in real wages by 7% on average<sup>3</sup>.

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<sup>2</sup> Using a panel of over 200,000 European firms through 2007, they demonstrated that import competition led to both within-firm technology upgrading and between-firm reallocation of employment towards more technologically advanced firms or subsidiaries. These effects account for about 15-20% of technology upgrading between 2000-2007.

<sup>3</sup> Calculations were performed with the use of the latest version available of the GTAP model and database. It was assumed that the EU stopped trading with its external partners (but continued

## **Global Europe: Assessing the current EU trade strategy and beyond**

The EU's Global Europe trade policy adopted in 2006 launched a series of new bilateral free trade agreement negotiations with fast-growing emerging market economies in Asia.

Global Europe, while maintaining the completion of the Doha trade round as a first priority, marked the end of a de facto moratorium on launching new *competitiveness-driven trade agreements*<sup>4</sup>, while reaffirming the EU's commitment to the multilateral system and the Doha Round. As a result, a series of more economically-oriented negotiations were launched with Korea, India and ASEAN in 2007 and Canada in 2009. Negotiations with Mercosur were re-launched in 2010. Priority was also given to other important economic partners (e.g. the Gulf Cooperation Council) with whom the Commission has been negotiating trade agreements. Global Europe is still unfolding but the first success of this strategy is the EU-Korea agreement, which is in the process of approval and ratification by both parties.

This brief presentation of goals and existing initiatives raises many questions.

### **What else should be envisaged in the future EU trade strategy?**

- Given the existing Global Europe initiatives and the available trade tools, how should Europe maximise the impact of the “triple benefits” and contribute to the overall ‘Europe 2020’ goals?
- What should be the new and most important priorities – at the multilateral level, in bilateral negotiations, and unilaterally?

### **The limits of “tariff-driven” trade policymaking and the critical importance of services and non-tariff barriers**

Before searching for new initiatives, it has to be acknowledged that major progresses in “traditional” trade policy were achieved over the last few decades.

- Today, from the point of view of tariffs, the EU is an open market, arguably the most open G20 economy.
- The common external trade weighted tariff for industrial products stands at 1.6%;
- When bilateral free trade agreements, autonomous preferential tariffs and duty free products are taken into account the trade-weighted tariff on industrial goods is 0.3%. On agriculture the average protection is higher, not only in the EU but also in the most parts of the world.

However, when it comes to trade in services, FDI, government procurement, and non-tariff barriers affecting both goods and services, it is worth remembering that we are still quite far from the borderless world predicted by Kenichi Ohmae in

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intra-EU exchange) and capital flows were restricted. In the second simulation, real wages in the EU were kept fixed, which allowed the European labour to adjust.

<sup>4</sup> The main criteria used to prioritise such trade agreements were the size of the market, its growth potential, level of trade barriers applied by EU trading partners.

1989 (Ohmae 1989). Typically estimates of ad valorem equivalents for such barriers places them in double digit figures.

It is clear that the most important contribution to the EU 2020 objectives would stem from non-tariff issues, notably in behind-the-border trade initiatives, such as regulatory issues, non-tariff barriers, intellectual property rights, government procurement, trade and environment, to name but a few.

- How exactly can we make greater inroads in addressing these beyond-tariff issues both in a multilateral and bilateral context, and in particular vis-à-vis strategic trading partners for the EU like the US, Japan, China, Russia, and other emerging economies?

### **The interplay between progress in the Single Market and trade negotiations**

One possibility to advance the depth of services and non-tariff barrier liberalisation is to pursue the reforms and initiatives aimed at completing the Single Market. The benefits are potentially twofold. First, well functioning and well-connected EU markets where competition and consumer access stimulate growth and innovation would, in itself, serve the Europe 2020 goals. For instance, the full implementation of the Services Directive could increase trade in commercial services by 45% and foreign direct investment by 25%, bringing an increase of between 0.5% and 1.5% increase in GDP.

Second, lowering of intra-EU costs of doing business through a Single Market for services will also lead to more gains from trade with the rest of the world as well. Offering market access as part of trade negotiations to an integrated Single Market for services would create stronger incentives for third countries to reciprocate and offer more ambitious commitments in services. The Lisbon Treaty also confers new responsibilities to EU trade negotiators in the area of foreign direct investment, granting new possibilities to deepen the integration process between the EU and third countries.

Beyond these general considerations, some open questions still remain:

- Is there any scope for an initiative in this area and if so what are the best ways to further facilitate services trade and investment? The same goes for overcoming regulatory differences that may have the effect of barriers to trade, in particular with the largest trading partners.
- Is there a need for a difference in approach vis-à-vis developed and emerging economies?
- Multilateral and bilateral negotiations have only partially succeeded in opening trade in services so far. Given the inherent difficulties in making further progress in these areas, what specific trade initiatives would generate greater trade opportunities, commensurate with the untapped economic potential in the services sectors?



## **Enforcing global trade rules**

Striving to promote existing or new trade agreements and rules would be meaningless if commitments would not be properly enforced. But many partner countries still give unfair advantages to domestic firms, for example in procurement markets or by restricting exports of raw materials and energy. The EU has therefore been a longstanding supporter of a strong multilateral system that can enforce effectively trade rules for the benefit of all WTO Members. In addition, the EU has developed a comprehensive Market Access Strategy aiming to identify trade barriers before they appear and tackle existing obstacles to trade. The EU 2020 strategy puts renewed emphasis on such efforts and calls for an annual trade and investment barriers report identifying ways to improve market access and regulatory environment for EU companies.

- Apart from these important mechanisms, are there any other initiatives the EU could best engage with major trading partners who maintain an asymmetric level of openness and resort to protectionist measures?

## **“Smart” and green growth: Challenges for the future**

The EU 2020 strategy singled out very clearly the importance of “smart” and green growth for a sustained economic recovery in Europe. Ideas and innovations are embodied in a wide array of EU products that are traded daily on a global scale. The EU has clearly recognised the need for an effective protection of intellectual property rights worldwide. As a result, an “Enhanced IPR Protection and Enforcement Strategy” in third countries is due to be launched in 2011. Beyond promoting a stronger enforcement strategy, two important questions stand out:

- What else can EU trade policy do to further improve the protection of IPR in key markets, such as China and other emerging markets?
- What trade policy instruments can be mobilised to reinforce the “smart” dimension of the Europe 2020 strategy and facilitate trade in high-tech goods and services?

When it comes to trade and “green growth”, the role that trade policy could play is clearly of increased importance to many stakeholders, particularly in the absence of a global agreement on greenhouse gases. We should be careful however to avoid “green protectionism”. Instead, one step in the right direction is the proposal to further liberalise environmental goods and services. Beyond this initiative, “greening” the world economy and putting it on a more sustainable footing, in particular, will require considerable more work to properly address possible negative environmental and social effects. So, how can trade policy best support green and inclusive growth around the globe?

## **Looking into the future**

When looking into the future of EU trade policy one could address many other “new” cross-cutting areas where the linkages between trade and broader policy objectives are becoming more complex. Trade and development, trade and

labour, and many other “trade ands” are usually brought to the fore when designing new trade initiatives. But the aim of this short paper was not to be exhaustive. Instead, it tries to highlight some critical areas for further reflection regarding the future EU trade policy and the EU2020 strategy.

This column has touched on a wide range of topics and questions, but there is certainly a need to think even more broadly and to tackle Europe’s fundamental challenges on trade with an open mind and the help of Vox contributors.

In writing this column, I hope that engaging in an online discussion forum with a specialised audience of trade economists will further enrich the pool of possible recommendations to be considered, in particular new ideas and policy recommendations on how to sharpen the existing trade tools and make them better equipped to contribute to the EU 2020 objectives.

*The opinions expressed are personal to the author and do not necessarily reflect the views of the European Commission.*

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### 1.3 A future agenda for EU trade policy as if the real world really mattered

**Simon J Evenett (University of St. Gallen and CEPR)**

*EU trade policy has accomplished little of substance during the past decade. This column, a contribution to the ongoing VoxEU debate on The Future of EU Trade Policy, identifies five reality checks that should be taken on board as the European Commission and the Member States reformulate their approach to commercial relations.*

The 27 member states of the European Union pool their sovereignty on commercial policy matters, with the European Commission negotiating on their behalf. This institutional arrangement – representing over 10 trillion US dollars of spending power per annum and several trillion dollars of overseas investments – should confer upon EU negotiators substantial clout. Yet, the EU has closed few trade deals over the past 10 years. This clout could not bring the Doha Round to conclusion. Nor have many regional trade agreement (RTA) negotiations been completed. Moreover, the benefits from the few accords that have been signed have fallen far short of initial expectations. No doubt the European Commission has blocked proposals counter to the EU's interests, but is the future of EU commercial policymaking to be entirely reactive?

The purpose of this column is to question several of the tenets of current EU trade policy. The discussion is organised around five reality checks precisely because of the Alice-in-Wonderland character of much current EU trade policy. One consequence of over-selling the effects of enforceable trade agreements is that many parties want to influence EU trade policy. This has resulted in an unwieldy negotiating agenda, poor prioritisation, and diffusion of negotiating capital. More importantly, in a business where finding the basis of a deal with trading partners is central, the EU's priorities are increasingly out of line with the aspirations of the EU's trading partners, especially the larger emerging markets. Too many angels are trying to dance on the head of the pin that is EU trade policy.

#### **Reality Check 1: With respect to the WTO "do no harm."**

We all love the WTO but we all know it is in serious trouble. Despite their public statements, Heads of Government are simply not prepared to make the trade-offs necessary to complete an economically meaningful Doha Round. No doubt a mouse could be produced if matters get so bad that we need a Doha Round deal to "save the system." But, by 2008, it became clear that everyone had learned that there was no basis for a deal.

Thomas Schelling, the Nobel Prize-winning strategist, provides the best way of thinking about the Doha Round stalemate. Schelling showed that if one negotiator was given by its government a very restrictive negotiating mandate then, under some circumstances, other negotiating parties keen to conclude a deal would do so on the former's terms. But Schelling also pointed out that if

many governments tied the hands of their negotiators then stalemate was possible.

The contemporary relevance of Schelling's insight can be found in the manner in which the European Council, the U.S. Congress, the Prime Minister and President of China, and the political forces in India have repeatedly shackled their respective trade negotiators on agricultural trade matters. Worse, the same "leaders" then issued disingenuous G20 Declarations calling on their negotiators to complete the Doha Round negotiations. This cynical device is at the heart of the Doha Round impasse and certain EU member states bear their share of the blame. Without a substantial offer to reform agricultural support policies, it is difficult to see what the EU can do to revive the WTO's negotiating function (and indeed whether such an offer would be enough).

The failure to conclude the Doha Round isn't the only drain on the credibility of the WTO and the rules-based trading system. Poor choices of dispute settlement cases are too. It appears that some are so besotted with the "power" of multilateral trade rules that they actually believe that governments will be cowed sufficiently by losing WTO disputes that they will bring themselves back into compliance with those rules. The threat of sanctions may affect the incentives to come back into compliance, but that is no guarantee that compliance will occur. In some disputes the commercial interests at stake are so big that compliance is unlikely and the magnitude of sanctions so large that their imposition would significantly disrupt the trade.

The foolishness of bringing the EU-US disputes over subsidies to wide-bodied aircraft to the WTO has been compounded by a recent case to bring a case against China on export taxes for a provision which it alone is legally bound to in its accession protocol. The latter dispute is likely to backfire, allowing the Chinese to highlight the inequities of the WTO accession process and the asymmetries in WTO rules. Moreover, a "victory" here for the plaintiffs will be pyrrhic--for it will only encourage Beijing to retaliate against the commercial interests of the plaintiffs, taking advantage of the fact that WTO accords do not cover every way to harm foreign commercial interests. Of course, the rules don't allow for the loser in a case to retaliate but expecting every government to have respect for the rules is the kind of naivety that a EU trade policy grounded in realism would avoid.

As a vehicle for advancing Europe's commercial interests in the larger emerging markets, the above considerations imply that limits of what the WTO dispute settlement system can deliver have been reached. Bringing highly controversial cases will invite retaliation against EU commercial interests from vengeful losers and will only discredit the DSU system in the eyes of developing country WTO members. Case selection should be handled very careful: "do no harm" being the operative principle. Find some other way to induce foreign governments to change their behaviour.

So what should the stance of the EU towards the WTO be? Of course, the EU is not going to disavow the multilateral trading system. Diplomatic niceties probably dictate that the EU state that the WTO and finishing the Doha Round are a

"priority." Realistically, though, EU expectations for what the WTO can deliver should be lowered significantly. Some will reject this assessment, arguing that it demonstrates the need for a WTO reform agenda. Perhaps the niceties require EU support for a WTO reform agenda but proponents should think hard about what the Doha Round negotiations and the reaction to the global economic crisis really reveal about certain governments' willingness to be further bound in legally binding accords and whether those accords can be effectively enforced through WTO dispute settlement. The success of any WTO reform agenda ultimately turns on the latter two considerations.

### **Reality Check 2: RTAs and EPAs are a sideshow.**

In its *Global Europe* Communication in 2006 the European Commission committed itself to negotiating a new tranche of RTAs and to completing the EPAs. Far less here has been accomplished than was anticipated at the time. The biggest deal, the RTA with Korea, was supposed to go well beyond the terms of the US-Korea RTA, an objective that no one mentions any more. Meanwhile, the RTA negotiations with India, Mercosur, and the GCC countries proceed slowly. The EPA process remains a public relations embarrassment, made worse by less than judicious interventions from certain EU member states.

EU RTA policy runs into two constraints. First, EU negotiating objectives are far too diffuse, ranging from traditional tariff considerations to new behind-the-border rules to "sustainable development" and a plethora of other non-economic goals. The latter are often wrapped up in patronising language about promoting European values. Second, some of the RTA partners are large enough that they too have demands, demands which the EU probably cannot deliver. (Indian demands for visas being a case in point.) Both factors have eroded, if not eliminated, the basis of the deal in many negotiations. In fact, the EU negotiating package seems best suited for other industrialised countries that have either defensive agricultural interests (Korea) or are willing to forgo their offensive agricultural interests (Canada). The problem is that there aren't many such countries left for the EU to negotiate RTAs with! As far as the large emerging markets are concerned, little should be expected.

Overall, unless there is a substantial streamlining of EU negotiating demands and occasionally a willingness to make serious concessions to negotiating partners, the EU's RTA and EPA negotiations will remain a sideshow. These negotiations may afford opportunities for experimentation but there aren't enough deals in the works to dramatically scale up any innovative provisions.

### **Reality Check 3: Follow the money.**

Whatever "grand bargain" the EU has offered trading partners in recent years, there haven't been many takers. The EU would be better advised to go back to the drawing board and identify those matters for which there are substantial supportive constituencies at home as well as in negotiating partners. Such an approach would likely streamline EU trade negotiating priorities as well as focus more attention on whether the really is a sufficient basis for a deal, however codified.

Recent developments in the world economy suggest that this approach might be not only timely but also likely to garner the support of leading lights in the corporate sector. First, a growing number of multinationals are headquartered in emerging markets<sup>1</sup> and run into the same regulatory obstacles and malfeasance abroad as Western multinationals. The recent global economic crisis has exposed much murky protectionism against foreign commercial interests. Second, participation in international supply chains requires substantial cooperation between collaborating firms, who are likely to see commercial obstacles in the same light. A trade policy agenda based on extending national treatment principles further into domestic regulations, greater transparency, stronger consultation mechanisms, requirements on scientific and evidence-based decision making by regulators, rights of review for the regulated, and encouragement to adopt common standards or at least, mutual recognition of standards would benefit this growing and substantial corporate constituency.

However, there should be no illusions about how far reaching this agenda could be. The European Commission and its Member States would have to be prepared, in some instances, to alter their domestic regulatory structures. Something-for-nothing won't work as a negotiating tactic here; the list of failed transatlantic initiatives over the past decade indicates precisely what happens when each negotiating party won't contemplate reforming its own regulatory institutions. Undoubtedly the EU would face demands for visas (so that foreign companies can better operate their supply chains in Europe), changes to competition law enforcement (especially as it relates to mergers) etc. Of course, European negotiators would be entitled to advance searching demands of their own. Still, the point remains, the EU will have to determine internally how far it is prepared to go down each of these paths.

That many of the areas of greatest interest to internationally-active business are seen as sensitive in policymaking terms suggests that initiatives here will almost certainly start off as cooperative, non-binding accords. (Given the failings of the multilateral trading system and the limited scope for negotiating RTAs mentioned earlier, binding enforceable approaches offer little realistic prospect of success, at least in the short run.) These accords could be sectoral in nature or could be bundled together in a "Business Compact" or some such package. There is no reason why such accords must initially be brought within the ambit of the WTO, even though this is a desirable long term goal.

#### **Reality Check 4: Develop a cooperative relationship with China.**

While "Follow the money" ought to raise the profile giving to tackling murky protectionism, it will also help identify the trading partners where the gains from doing so are greatest. The substantial EU corporate investments in China are a case in point. In recent months, complaints from European business associations, and from the few business persons willing to stick their head above the parapet, about Chinese domestic policies have intensified. The sheer size of

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<sup>1</sup> The 2010 version of the World Investment Report notes that there are over 20,000 transnational corporations headquartered outside of industrialised countries, approximately 28 percent of the world total. See [http://www.unctad.org/en/docs/wir2010ch1\\_en.pdf](http://www.unctad.org/en/docs/wir2010ch1_en.pdf)

the Chinese economy, plus its expected growth path, mark it out for particular attention in the years ahead.

How the European Commission best represents EU corporate interests should reflect the lessons of the past. The limits of WTO dispute settlement have already been mentioned. The incomplete nature of the WTO's rules in many areas of government policy are open invitation to Beijing to retaliate against any punitive European measures. Sticks, it seems, won't work. Carrots might. The language of partnerships is easy to use but, ultimately, there may be no alternative.

For example, establishing parallel review processes for industrial policies in the EU and in China, whereby the costs and benefits of existing measures are enumerated and lost distortive alternatives identified in a technocratic process, might be more effective in changing minds than sabre-rattling. Establishing common norms for regulatory policies that embody non-discrimination principles is another alternative, backed up with monitoring, reporting, and rights of review for aggrieved parties. A growing set of collaborative projects of commercial interest should be devised and added to over time, serving as constant reminder of the benefits of sustaining cooperation over discrimination. There will undoubtedly be bumps in the road, better that than risking one's credibility with empty threats about sanctions.

### **Reality Check 5: Can EU trade policy afford another decade of failure?**

The preceding reality checks imply that the priority given to the different challenges facing EU policymakers needs to evolve. These challenges will require a change in emphasis as far as fora, subject matter, and instruments are concerned. A major shift in mindset is probably needed--the current approach is a recipe for continued stalemate and limited benefits for the European Union.

Twenty-first century trade policymaking needs to rediscover its roots, namely, seeking pragmatic solutions to first-order commercial problems. Developments in international corporate strategy and the murky protectionism revealed during the recent global economic downturn point to a national treatment-based and transparency agenda that could be of interest to the EU, the United States, Japan, and the large emerging markets.

Pursuing this agenda will require a new consensus among Member States concerning the negotiating room for manoeuvre for the European Commission, and therefore acceptance that key regulatory policies may have to change in response to trading partners' demands. Talk of propagating European regulatory models abroad should be replaced with a willingness to create a level playing field for twenty-first century business. This will mean taking on vested interests, often the regulators themselves.

Finally, failure to update EU trade policy risks much more than losing commercial opportunities. Should internal division lead to further stalemate and few additional commercial benefits, then surely some medium and larger pro-trade Member States will begin to question the basis of another deal; namely, what are they getting in return for pooling their sovereignty on commercial policy matters?



These Member States are entitled to ask what alternatives are available to them if current arrangements do not deliver. Much more is at stake than most European policymakers probably realise.

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## 1.4 Remake trade through a US/EU trade partnership

**Susan Ariel Aaronson (George Washington University)**

*In response to Dr. Cernat's call for feedback on the EU's trade policy, this column calls on Europeans and Americans to rethink their trade policies. It argues both can meet 21st century needs only by collaborating, mostly at the WTO. Trade policy challenges are also an opportunity to make the system more coherent and meet the goals of expanding trade, enhancing human welfare and increasing employment.*

Americans may be from Venus, and Europeans from Mars; we clearly have different views about the role of government in the domestic and global economy. But Americans and Europeans have long collaborated to expand trade, enhance human welfare, and encourage employment. The US and European post-war planners wrote these objectives into the preambles of the ITO and the GATT, and they were repeated<sup>1</sup> in the WTO.

But clearly the WTO system (and related policies and institutions) do not always work for all of the world's people. The World Bank reports<sup>5</sup> that more than 1 billion people go to bed hungry each night; and many lack access to opportunities, education and even the bare necessities to sustain life. Meanwhile, since the global financial crisis of 2007, a growing number of Americans and Europeans have reduced economic opportunities. Some 10% of Americans are officially unemployed; 1 in 7 Americans live in poverty, and the US cannot meet its bills without overseas borrowing. In Europe, although the rate varies widely among the EU 27, unemployment is also around 10%, and some 17% of the population is at risk of poverty (Eurostat)<sup>2</sup>. While trade liberalisation is not to blame for these circumstances, these conditions make Americans and Europeans less positive<sup>3</sup> towards trade liberalisation and the WTO.

In 2008, in recognition that the system was not working in support of trade, development, and employment, EU officials called for a broad rethink of the global architecture that would "meet the needs of the 21st century." The leaders of the G20 agreed during their 2008 meeting in Pittsburgh, although they said nothing about revamping the WTO. They agreed "to refrain from raising barriers or imposing new barriers to investment or to trade in goods and services, imposing new export restrictions or implementing World Trade Organisation inconsistent measures to stimulate exports and commit to rectify such measures as they arise." And they vowed<sup>6</sup> to weigh international spillovers of their domestic policy actions, such as financial stimuli".

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<sup>1</sup> [http://www.wto.org/english/res\\_e/booksp\\_e/analytic\\_index\\_e/wto\\_agree\\_01\\_e.htm](http://www.wto.org/english/res_e/booksp_e/analytic_index_e/wto_agree_01_e.htm)

<sup>2</sup> <http://go.worldbank.org/TUSFFS25C0>

<sup>3</sup>

<http://www.worldpublicopinion.org/pipa/articles/btglobalizationtradera/349.php?nid=&id=&pnt=349&lb=b>  
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Some two years later, policymakers still espouse collaboration and coherence, but do little to make it a reality. In fact, rather than coordinating policy, many countries are acting unilaterally, trying to boost exports by pushing down their currencies, and using domestic stimuli to maintain jobs. Thus, in response to Dr. Cernat's call for feedback to the EU's trade policy, this American calls on Europeans and Americans to rethink their trade policies. Together the US and EU have enormous political, moral, and economic clout. As partners, we might steer the world back towards a coherent approach to multilateral trade liberalisation that addresses development and employment.

Ironically, both the US and Europe bear responsibility for moving the world away from multilateral trade liberalisation. During the Bush Administration, the US reoriented trade liberalisation efforts towards only those nations willing to make governance agreements addressing not just trade, but investment, intellectual property rights, labour rights and environmental policies. America's actions inspired many other nations to focus their efforts on negotiating preferential trade agreements. Our failure to work collaboratively has international repercussions. As economist Fred Bergsten (2002) noted, "The EU is the source of the world's greatest trade discrimination—which will increase sharply as its membership expands—and the hub of the most extensive set of preferential deals with non-members. Europe badly needs the outside pressure of global commitments to implement essential internal reforms, especially in agriculture. That outside pressure comes primarily from the Americans." But Americans have been focused on currency and trade issues with China and when we focused on negotiations, policymakers put their efforts towards preferential trade agreements, rather than the WTO.

Instead, the EU and the US should take the following three steps:

- **Move the trade liberalisation process away from preferential trade agreements and towards the WTO.**

The focus on preferential trade agreements has had several unanticipated side effects. Instead of stimulating a renewed commitment and deeper concessions at the multilateral level, countries began to focus less on the WTO as a platform, and more on using the leverage of their own markets to attract free trade agreement partners. But this approach no longer makes sense. Although the US and EU have large markets, we now compete with China, India, and Brazil for markets and trade agreement partners. Moreover, the cumulative effect of these agreements has undermined both the effectiveness of the WTO and its fundamental principle of most favoured nation (nondiscrimination among nations). The focus on preferential trade agreements has not helped expand trade for all countries; many smaller (or poorer markets) have not been invited to negotiate these preferential agreements. The citizens in such nations are thereby less able to reap access to global markets compared to their counterparts in larger or richer nations. Meanwhile, these preferential trade agreements are probably not good for business. Traders have less security of market access. Every one of these free trade agreements has preferential rules of origin, and their complexity and diversity may distort sourcing decisions. Finally, these bilateral regional agreements often contain tighter standards for intellectual

property and transparency, and broader standards for issues not covered in the WTO such as labour, the environment, democratic decision-making, and investment. As a result, the world now has a mish-mash of global trade governance, where some nations adopt higher standards on some of these issues some of the time. It would be better for the US and the EU to work together at the WTO to make a broader approach to trade liberalisation a goal of the WTO. But in order to expand the scope of the WTO, policymakers must first meet their promise of fully integrating developing countries into the WTO.

- **Work globally and at the WTO to coordinate trade and development policies.**

After the 2001 terrorist attacks, the US and the EU argued that the world must work to make trade and development policies more coherent. Then US Trade Representative Zoellick and EU Trade Commissioner Lamy (2010) wrote an op-ed arguing that "Trade policy must...make a material difference to the poorest of the world's populations." They stressed that the World Bank must do a better job "building developing country capacity" to implement trade rules, which often require these countries to make expensive and difficult governance choices. They warned that if industrialised countries didn't provide greater market access for developing country goods and services, "we shut their doors on their future," hinting it was our future as well. But the two did not offer significant enough incentives to get big developing countries to play ball. The US, EU and other industrialised countries didn't deliver on their promise to make the Doha Round focus on development. The EU and the US can rescue the round by rethinking it as a two tiered negotiation. The first tier would truly focus on the needs of developing countries—rethinking how to facilitate negotiations that provide market access for all, as well as a new approach to capacity building focused on empowering small farmers and business owners in the developing world. As an incentive, the US and the EU could jointly announce that while they could not alter agricultural or health and safety standards, they would reduce all tariffs for developing country commodities provided that all developing countries agree to wider market access commitments. They could also agree to a new common approach to trade preferences, based on the EU's incentive based General Scheme of Preferences (GSP)+. This program provides incentives (lower tariffs) to developing countries which implement international conventions on human rights, labour rights, good governance, and sustainable development. Instead of providing such benefits nationally, the major sources of GSP (the US, EU, Canada, Australia, Japan, New Zealand, Norway and Switzerland) should develop a uniform WTO based approach. After so doing, the EU and the US might find more support for a more ambitious round.

- **Finally, the US and the EU should work to make trade and employment policies more coherent.**

In 2009, the ILO (2010) reported that some 212 million of the world's able bodied workers were unemployed. Such high unemployment threatens political stability and thus, policymakers in almost in every country have made job creation and job maintenance their top priority. They recognise that investors will go where the skills, infrastructure, and incentives are most attractive and most effective.

Although job creation is not a zero sum game, where the jobs gained in one nation are lost in another, how a nation creates or preserves jobs can have implications for the terms of trade in another. Although jobs lost to trade and technology changes are normal, policymakers must find ways to ensure that job creation strategies in one country doesn't beggar jobs in another—such strategies must not be trade distorting. China provides a prominent example of why we need to address this question internationally and cooperatively.

Since the downturn, many countries including China have developed policies to maintain jobs and attract investment. China is not only the most populous country and the second largest trading nation. China has more than 750 million workers, some 26% of the world's total. Each year the work force increases by some 10 million workers. However, many observers, including the Nobel Prize winning economist Paul Krugman argue that Chinese policies to maintain employment are trade distorting. Although wages in many areas and sectors in China have been rising, they stress that China manipulates its currency, provides generous albeit GATT illegal subsidies, and ignores its own labour laws to maintain low-wage export oriented production. Moreover, because China is an opaque authoritarian regime with a huge and growing market, some fear that China cannot be reined in by the WTO.

The US and the EU should use this situation to build a global discussion about the relationship between trade and employment policies. The WTO is the right place to have this discussion, because as noted above, it is based on the idea that nations have a responsibility to collaborate in the fields of trade and investment to create employment at both the national and international levels. Since 2008, the WTO has worked with the ILO on trade and employment issues. The G20 asked the WTO to monitor the trade distortions of domestic stimuli as part of its trade policy review process; the EU and the US should partner to encourage the WTO to examine how employment policy choices may affect trade. In so doing, they may again bolster the WTO (Aaronson forthcoming).

In sum, Americans and Europeans can make the system we designed meet our 21st century needs only if we collaborate. The challenges we face today are also an opportunity to make the system more coherent and finally meet the goals of expanding trade, enhancing human welfare and increasing employment.

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## Section Two: Other Commentaries

### 2.1 EU trade policy and the future of global trade governance

**Richard Baldwin (Graduate Institute, Geneva)**

As the Vox column & Lead Commentary by Lucian Cernat shows, the EU is in a reflective mood when it comes to the Union's future trade policy. I will soon post a longer column elaborating my points, but here I wanted to weigh in with a slightly different approach to think about future EU trade policy than the one taken by my friend Lucian.

- The EU's trade strategy is focused on how it can serve the EU's goals and boost its economy. Fair enough; that's what Commission officials are paid to do.
- But I wonder if it wouldn't be useful to take a broader view of the role of EU trade policy in governance of the global trade system.
- I believe that the world trade system and world trade governance are out of balance, and my main comment is that I believe the EU should think a bit harder about this and how its trade policy might make things better, or, if designed wrongly, might make things worse.

Here is my reasoning:

#### **21st century trade but 20th century trade governance**

Let me start with a sequence of assertions about the world (I'm currently working on documenting these better in a couple of projects, and in fact there is already a lot of work showing various aspects of it, but for the moment I'll stick with assertion of stylised facts).

1. A good deal of the world's trade – and in particular its most dynamic element in the past 20 years – is a much more complex phenomenon than trade was in the 1980s and earlier. Moreover there has been a significant acceleration of this 21st century trade since the early to mid 1990s.
- The key is 'production unbundling' or what I like to call the 'second unbundling' (the 1st is the geographical separation of factories from consumers, the 2nd is the geographical separation of the factories themselves as various stages of production are offshored); see Baldwin (2006, 2009) for more detailed discussion of this.
  - Spatially separating manufacturing stages goes against the forces that had led firms to spatially concentrate the stages in a single factory or within a single city (think of Detroit, Nagoya or Stuttgart).
    - There are many names for these, but I think "coordination costs" sums them up well.
    - It is the same sort of forces that lead to the spatial concentration of academics in a university department or Commission officials in a single building.

- For reasons that are easy to list but hard to document, it is just easier, faster, surer, and cheaper to undertake complex activities that involve many people when those people are physically close to each other.
  - ICT developments made it feasible to separate some stages of production and once it became feasible, comparative advantage made it inevitable. Internationalisation of the supply chain, i.e. production unbundling, was the result.
  - However the need to coordinate was not eliminated; all that happened was the nature of the coordination changed to facilitate off-shoring.
  - The result is that production facilities located in different nations must interact in ways that were not common before offshoring. This involves sharing intellectual property, training workers, managers & technicians. It involves investment and long-term relationships. It involves more time-sensitive shipping.
  - In short, international commerce is much more than putting goods made in a factory in one nation on a boat to sell to customers in another nation. There is much more back and forth that requires excellent communication services, short-term (but guaranteed) movement of managers and technicians, overnight delivery services, exchange of tacit and explicit know-how, etc.
  - The empirical footprints left by this sort of trade between the nations engaged in it include: a great deal of imports and exports of parts and components; a great deal of business travel; a great deal of telecommunications; a great deal of services trade (especially so-called infrastructure services, or pro-export services like trade finance, insurance, overnight mail, air cargo, port services, etc.); a great deal of intellectual property trade (much of it of the tacit type that is embedded in long-term business relationship if not actual ownership); and a great deal of FDI and other forms of corporate ties (indeed practical people working in this field often use ‘trade’ and ‘investment’ in the same breath when discussing this sort of international commerce).
2. This more complex international commerce requires a different type of governance. Things such as intellectual property right assurances, rights of establishment, assurances to investors on several aspects, assurances that short-term visas will be issued promptly, assurances that world-class infrastructure services will be available continuously and at reasonable prices, etc.
  3. The national laws of rich nations are typically sufficient to give corporations the confidence to engage in this sort of commerce, but in emerging economies, the corporations often seek or demand some sort of formal international governance.
    - In East Asia, such assurances were often provided in discussions between corporations from rich nations and the governments of the host nations – what used to be called the ‘Asian approach’ to trade



and investment. The increased pace of product cycles and the growing complexity of the necessary assurances needed to underpin multi-nation supply chains tended to make this deal-making approach less feasible.

4. The WTO – whose structure was last revised based on an agenda set in 1986 when the Uruguay Round was launched – does not provide such disciplines to the necessary extent.
5. There is, in short, a governance gap between the sort of rules and disciplines necessary to foster 21st century trade (production unbundling and all it entails) and the 20th century world trade governance we have at the WTO.
6. Rich nations and emerging nations have found it mutually beneficial to fill this gap by signing ‘deep’ free trade agreements. There are three sets of these in existence – those signed the US (NAFTA-type agreements), those signed by Japan (EPA-like agreements), and those signed by the EU.
  - Some emerging economies have filled some of the gap by engaging in unilateral reforms that are often called ‘pro-business’ or ‘pro-market’ reforms. These are efforts to move themselves into a situation where corporations feel more comfortable relying on local laws even without formal ‘deep’ trade agreements. One step in this direction is WTO membership, which is one reason joining the WTO is popular even in an era of bilateralism; here China and Russia come to mind.
7. This, in short, is my picture of the imbalance between 21st century trade and 20th century trade governance; RTAs are filling the gap, but the power asymmetries involved hark back to 19th century trade governance structures.
8. This picture is not a disaster. The complex commerce I described is growing rapidly and seems robust. For example, it seems to have survived the “Great Trade Collapse” with hardly a shudder.
  - But is this the optimal path for global trade governance?
    - Is it enough to rely on bilateral agreements between middle sized emerging economies and industrial and technological mammoths like the US, EU and Japan?
  - Where do the big emerging economies fit in?
    - Will China, India and Brazil develop their own parallel set of disciplines?
    - Will they simply be forced to copy one or the other templates established by the North-South RTAs?
9. Absent some pretty determined efforts by the largest trading nations, the gap between trade and trade governance will continue to be filled by bilateralism. WTO centricity will continue to erode (Baldwin 2008). While I

don't think "the end is nigh", continued erosion of the WTO's central role in global trade governance is not a comfortable trend. At some point, nations may start to feel good about ignoring WTO disciplines since everyone else is doing so, particularly when their most important trade and investment relations are underpinned by bilateral or regional deals. This would not be a good outcome for the EU or any other nation.

10. This is the sort of thing I believe the EU needs to think more about in crafting its trade strategy for the coming decade.

11. Here are a few ideas: Why not try to see how far the deeper disciplines diverge already? Is it true that US, EU and Japanese deeper agreements are inconsistent? Could they be merged or at least be made to be more compatible with each other using things like 'codes of conduct' or discussing various deeper disciplines in a multilateral or plurilateral setting?

12. A reasonably good analogy here is what happened with investment assurances. The failure of the Multilateral Investment Agreement (which wasn't negotiated in a multilateral way!) meant that a serious gap emerged between the need for assurances to investors and the ability of world trade governance to provide it. Bilateralism filled the gap and what we have is an ad hoc 'system' of thousands of Bilateral Investment Treaties and an ad hoc 'court', the International Centre for Settlement of Investment Disputes.

- Few think that this is the optimal way to handle the problem, but with over 2500 BITs already signed, it is pretty hard to think of a way to improve the situation.

13. To put it differently, I believe that multilateralising regionalism should be one of the goals of the EU's trade policy. There are many ways to get started. A number are discussed in Baldwin and Low (2009).

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## **2.2 The importance of fixed export costs**

### **Roger Smeets (CPB Netherlands Bureau for Economic Policy Analysis)**

In a recent Vox column, Lucian Cernat – Chief Trade Economist of the European Commission – called on his colleagues to contribute to a public debate on the direction of the EU’s future trade policy (Cernat, 2010). One of the questions he addresses concerns policy’s ability to address “beyond-tariff” trade barriers. Because traditional trade policies have already achieved major progress in the past decades, the relative importance of these non-tariff barriers has increased substantially. As these barriers are intimately related to a country’s institutions, not only does lowering them require a long-term perspective, they might also pose limits to what trade policies can ultimately achieve.

### **Fixed export costs**

The heterogeneous firms literature in international trade research has made clear that non-tariff or institutional barriers are a crucial impediment for firms to export their goods abroad. In particular, they may function as a fixed export costs that firms have to overcome before they are able to serve foreign markets (Melitz, 2003; Chaney, 2008). As a result, only the world’s best, biggest and brightest firms are capable of doing so (Bernard et al., 2007). For example, in a recent study of 15,000 firms in 7 European countries, Barba Navaretti et al. (2010) estimate that big firms (>249 employees) are between 20-40 %-points more likely to engage in exports than small firms (10-19 employees). Furthermore, their subsequent export shares are also substantially higher.

By implication, many countries still face a lot of unexploited trade potential in the form of firms that are willing yet unable to venture abroad. Reducing these fixed export costs provides rich but complex opportunities for policy to facilitate firms in establishing new export relationships. These go beyond traditional trade policies like reducing tariffs and quotas, which are more suitable to deepen already existing trade relationships.

Researchers have tried to verify the existence and quantify the magnitude of fixed export costs (e.g. Das et al., 2007). Although insightful from an academic perspective, these results are of little use to policy makers because it is unclear what they actually entail. In a recent study, we have made a first attempt to open the black box and explicitly capture some aspects of fixed export costs (Smeets et al., 2010).

### **Institutions matter**

There is a consensus that poor institutional quality and national cultural differences form important impediments to economic exchange in general (e.g. Guiso et al., 2009) and international trade in particular (e.g. De Groot et al., 2004). The reason is that poor institutional quality increases uncertainty about the circumstances in which potential exporters will have to operate, e.g. due to the risk of expropriation of (intellectual) property. That is, poor institutional quality

tends to increase transaction costs. More specifically, in light of the new firm-level trade literature, we might expect it to increase fixed export costs as well.

To explore this possibility, we estimate a standard gravity model to explain both country-specific export decisions and (subsequent) export volume decisions, for a sample of 1,200 large firms in the Netherlands during the years 2006-2007. In order to capture (pieces of) fixed export costs, we employ measures on inter alia the quality of governance and regulation (Kaufmann et al., 2009), the extent of national corruption (Heritage, 2010), and cultural distance (KOF, 2009).

Our findings confirm that the “usual suspects” in the gravity literature – market size, geographic distance, and tariffs – all affect exports in the expected way, but that their effect is much more pronounced in explaining export volume decisions rather than the export decisions themselves.

What about fixed export costs? The defining characteristic of a fixed export cost is that it affects a firm’s initial decision to export to a particular market, but not the subsequent export volume decision. Our results indicate that the four proxies mentioned above indeed qualify as important and robust aspects of fixed export costs. In order to quantify these effects, we engage in a simple thought experiment. We ask ourselves by how much the export probability of the average firm would increase, were the country that has the lowest score on each of these measures to leap forward to the level of the best performing country.

Our results indicate the following: first, if Syria (minimum) were to increase its governance quality to the level of Norway (maximum), Dutch exporters would be 4.6 %-points more likely to export to Syria. Second, if Iran were to increase the quality of its regulations to the level of Denmark, the export probability would increase by 9.7 %-points. Third, the likelihood of Dutch firms exporting to Bangladesh would increase by 8 %-points if this country could lower its level of corruption to that in Finland. Finally, if Bangladesh could close the cultural gap with respect to the Netherlands completely, this would raise the export probability by 10 %-points.

When assessing the importance of these effects, it should be noted that the average export probability in our sample of firms is +/- 21 %-points. Hence, the estimated impacts are substantial, as they imply that firms in the Netherlands could increase their average export probability by 25% to 50% following these institutional changes.<sup>1</sup>

### **Policy implications**

A number of policy lessons can be drawn. First, “promoting exports” by itself is an ambivalent policy goal. In order to determine what type of trade policy is most

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<sup>1</sup> Of course, these results should be interpreted with due caution. For example, the estimated effects are extreme, in that they require full-fledged institutional reform to rain down as “manna from heaven”. Cost considerations of such reform are left out of the picture. Moreover, these effects are not likely to be partial. That is, a decrease in corruption is likely to be accompanied both by increased quality of governance as well as regulation. Indeed, the correlations between these measures are high. Hence, the estimated impacts cannot simply be added up to arrive at a total effect of full institutional reform.

appropriate, it should be made more explicit. Is the goal to turn non-exporters into exporters, or to increase the export volumes of existing exporters? And in the latter case, should this be achieved by establishing new export relationships, or by deepening existing ones? Traditional trade policies are more effective to deepen existing relationships, yet less suitable to establish new ones. In order to achieve this, creating a (more) level playing field by reducing fixed export costs is more appropriate.

What can policy do to this effect? Our results suggest that it is important to realise that setting up new export relationships is not just a matter of establishing business networks, erecting the necessary infrastructures for doing business internationally, and providing firms with information about export destinations. A second lesson is that pressing for institutional and regulatory reforms abroad are just as or perhaps even more important, possibly through bilateral or multilateral negotiations. In general, policy should aim to reduce the risk of doing business in countries that now provide opportunities that are simply too uncertain for potential exporters.

A third, and perhaps somewhat less optimistic, implication of our study might be to also point out the limits of what (trade) policy can achieve. For example, even though cultural differences might be an important impediment to the formation of trade relationships, they are not likely to completely disappear. And, quite likely, nor should we want them to. In this light, it remains important to stress that (trade) policy should try to correct the market only where it fails. To the extent that fixed export costs benefit domestic firms at the expense of foreign exporters, they seem an important subject for the EU's future trade policy.

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## 2.3 Focus, agriculture, and multilateralism: three aspects the EU should concentrate on

**Martin Gassebner (ETH Zürich)**

In the ongoing VoxEU debate on the future of EU trade policy a couple of very important points have been raised. Some aspects have not come up yet or have not been addressed sufficiently. This commentary argues in favour of three aspects which should get on the agenda.

In his lead commentary, Lucian Cernat mentioned that the EU could put an emphasis on “trade ands” in the new trade agenda. One particular example used is trade and labour issues, which could be addressed in new trade initiatives. This is exactly the wrong route! According to Horn et al. (2009) the EU already outscores the U.S. 4:1 in trade agreements containing issues lying outside the current WTO mandate (such as environmental and labour issues). We know that this is clearly a second-best solution. If there are labour issues that the EU wishes to negotiate with its partner countries (e.g., child labour or labour standards) this should be done outside of preferential/free trade agreements. It might be a core EU interest to negotiate multinational environmental and labour agreements. These should not be placed inside trade deals, however. Solving one distortion while creating another is not the way to go. Of course we also know why this happens: political feasibility and/or the influence of lobby groups for “green protectionism.” However, when setting a new agenda one should not already start with a second-best solution. When negotiating such agreements of course a trade deal might be the bargaining chip to get partner countries to sign, but the trade and environmental/labour agreements should be separate agreements that are also enforced separately.

This brings me to a second point: the potential bargaining chips in trade policy for the EU. As mentioned by Simon Evenett in his commentary, a proposal from the EU to negotiate a reform of its agriculture support policies might be one of the big bargaining chips the EU holds. Indeed, I think this is one of the things the EU should address in the new trade agenda. Agricultural trade policy is of course always a sensitive issue, but it could also be an engine of growth for several developing countries. Not only does the EU spend 42.5% of its budget (i.e., 60 billion Euro) on “Preservation and management of natural resources” in the year 2010<sup>1</sup>, Aksoy and Ng show in their VoxEU column<sup>2</sup> that “many developing countries can compete in the [agricultural] product categories historically dominated by industrial countries.” Hence, agricultural free trade has the potential to be a successful development device. However, trade protection by the EU remains strong despite recent success (OECD, 2007). It might even be a framing issue in many instances, as protection has come down in recent years. Nonetheless, many developing countries at least have a sentiment that the EU denies access to the agricultural market.

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<sup>1</sup> [http://ec.europa.eu/budget/prior\\_future/fin\\_framework\\_en.htm](http://ec.europa.eu/budget/prior_future/fin_framework_en.htm)

<sup>2</sup> <http://voxeu.org/index.php?q=node/5358>

Can this bargaining chip be used to go back and maybe complete the abandoned Doha round? Simon Evenett proposed it might. Choosing a multilateral way is very important, however. As Richard Baldwin touched upon in his comment, assurance to investors lead to the signing of 2,500 bilateral investment treaties (BITs). How does that connect to trade policy? There is evidence for a positive effect of increased imports in foreign intermediate inputs (which might stem from vertical foreign direct investment or international outsourcing). For instance, Moser et al. (2009) show that German offshoring establishments enjoy higher employment growth than non-offshoring establishments, since the positive productivity effect dominates the negative downsizing effect of offshoring on employment. Furthermore, Moser et al. (2009) document that offshoring renders these establishments more competitive, leading to higher exports. Moreover, it is documented that investors want to have stable rules, as certainty and stability are at least as important as the rules themselves (Gassebner and Méon, 2010). Stability of rules can be ensured much more effectively in a multilateral setting than in bilateral settings. Therefore, one core aspect of the EU's new trade agenda should be a focus on multilateral rather than bilateral negotiations.

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## 2.4 Overreach at the WTO

### Claude Barfield (American Enterprise Institute)

This contribution was triggered by Simon Evenett's biting essay on proposals for a new European Union trade agenda: specifically, in response to Evenett's argument that "as a vehicle for advancing Europe's commercial interests...limits of what the WTO dispute settlement system can deliver have been reached." Further, he charges that: "It appears that some are so besotted with the 'power' of multilateral trade rules that they actually believe that governments will be cowed sufficiently by losing WTO disputes that they will bring themselves back into compliance with those rules...In some disputes the commercial interests at stake are so big that compliance is unlikely and the magnitude of sanctions so large that their imposition would significantly disrupt the trade." In going forward with a WTO reform agenda, he posits that the EU—and other WTO member states—should be chastened by the lessons from the Doha Round failure and from the reactions to the global economic crisis, lessons that cast great doubt on "certain governments willingness to be further bound in legally binding accords and whether those accords can be effectively enforced through WTO dispute settlement."

These indictments are all well taken, but then Simon Evenett suggests that the major problem is "case selection": I will argue below that the problem is more fundamental to the legal system. As long as WTO member states are promised legal victories—one party is right and the other is wrong—then there will be an ineluctable movement toward seeking absolute vindication even (or especially) where WTO rules are murky or contradictory.

Evenett later in the essay moves to solid ground when he sets forth a potential trade policy agenda that reflects the new realities of the global economy, particularly the emergence of global supply chains that require cooperation among collaborating firms. This would include, among other things: national treatment or mutual recognition for regulatory systems; science-based regulatory decision making; greater due process, including rights of review; and stronger consultation mechanisms.

Crucially, however, he admits that at least at the outset, this new agenda will have to consist of "cooperative non-binding accords: binding enforceable approaches offer little realistic prospect of success, at least in the short run."

I think Evenett is on to something important concerning a viable future for the world trading system. Further, I would argue that the logic of his statement, in the context of the assignment to plot a course for future EU trade policy, provides the opportunity for a revival of Europe's older, more pragmatic view of the role of GATT in disputes among major trading nations. Until the sweeping changes in dispute settlement instituted during the Uruguay Round, which moved the system far down the road to excessive legalism, two distinct theories of dispute settlement had existed in an uneasy combination. On one side were the "pragmatists," who argued for a "diplomatic" approach that stressed conciliation and problem-solving over legal precision: by and large European trade officials

espoused this view. As a Swiss GATT Director stated in the late 1980s: “GATT cannot be a world trade court. Conciliation is our priority; it is not our job to determine who is right and wrong.”

On the other side were—and are—the “legalists,” led by the Americans, who held that legally binding rules would produce more certainty, predictability and fairness for all GATT/WTO members. At the end of the Uruguay Round, cowed by the threat that the US would act unilaterally absent legally binding judgments, Europe caved and a new more judicialised system was established: the most far-reaching change was the introduction of “automaticity,” whereby decisions by WTO panels or the Appellate Body stand unless there is a consensus (virtual unanimity) among WTO members against the decision.

Ironically, the new legalism that promised greater certainty came into being just as GATT/WTO rules vastly extended the reach of the trade regime. New rules for health and safety; regulation of services such as telecommunications, banks, insurance, securities; intellectual property; and the environment, plunged the multinational trading system into complex issues that went deep into the social and economic structures of member states. As Sylvia Ostry, a trade scholar and former Canadian trade negotiator, stated: “The degree of obtrusiveness into domestic sovereignty bears little resemblance to the shallow integration of the GATT with its focus on border issues...The WTO has shifted from the GATT model of negative regulation—what governments must not do—to positive regulation, or what governments must do.”

Over the past decade it has become clear that deep-seated societal views in different countries and regions do not lend themselves to rapid evolution or submission to a legal demand from a WTO panel—thus, Evenett’s examples regarding large aircraft subsidies or Chinese export taxes—to which could be added GMOs, climate change, and pressure to challenge social justice issues. (Before he became WTO Director General, Pascal Lamy had argued for special provisions, and exemptions, for a collection of national “collective preferences,” that coincide with the deep-seated social mores described above).

But where pragmatism and diplomacy will be needed in the future, the current legalistic WTO system precludes and forestalls such flexibility. Early on, J. H. H. Weiler, a strong advocate for the new judicial system, nevertheless candidly admitted that it was at odds with diplomatic accommodation. Though the law is supposed to be objective and dispassionate, he stated, when two parties believe that the law is on their side and litigate, then it “becomes a profession of passion, of rhetoric, of a desire to win...all inimical to compromise. And he noted: “‘We can win in court’ becomes in the hands of all too many lawyers an almost automatic trigger to ‘we should bring the case.’”

On mediation and conciliation—formally a part of the DSU process—Alan Wolff, a prominent U.S. trade lawyer, has stated: “(it) has disappeared as a meaningful step in the process. To consult openly is to risk your country’s case as an advocate, as any admission is going to be used against you. Only consult seriously if you wish to confess judgment and make amends: that is the lesson of the DSU.”

Change, even from Europe, will be difficult: the legal system has spawned a new set of powerful interests on the continent itself. Emulating the highly litigious U.S. society, new generations of EU trade lawyers now have a stake (earnings not least) in the system.

But whatever the obstacles, Simon Evenett's points and themes are highly relevant to the process of plotting a future course for EU trade policy.

In that light, attention should be paid to proposals to rein in, or at least deflect a backlash against, the current WTO dispute system. This essay is not the place to set forth such reforms in detail. But several suggestions are worth exploring as the process unfolds. First, where the texts are unclear or contradictory, panels and the AB should be allowed or even instructed to adopt the non liquet doctrine—or in effect, “it is not clear.” Invoking this doctrine would allow the judicial panels to throw the issue back to the WTO General Council or to trade round negotiations. Critics of non liquet have argued that it is prohibited because international law is necessarily “complete”—or that it is the duty of judges to step in and fill gaps. However, proponents of ‘completing’ the law and ‘gap-filling’ in the contentious areas described by Evenett reflect a dangerous technocratic myopia that will increasingly bring into question the legitimacy of the DSU process.

Alternately, the WTO could adopt a variation of the so-called “political issue” doctrine developed by the U.S. Supreme Court. The doctrine is meant to provide a means for the judiciary to avoid decisions that have deeply divisive political ramifications and thus, in the opinion of the court, should be settled through more traditional democratic processes, involving both the legislature and the executive. For the WTO, this would again drive the responsibility back to the negotiations table or to the General Council.

Much of this may seem beyond the possible—given the almost decade-long failure of substantive negotiations in the Doha Round. But whatever the outcome of Doha, a deep rethinking of the premises and operations of the global trading system is now inevitable. In that circumstance, all portions of the Uruguay Round bargain and structure should be on the table—including dispute settlement.

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## 2.5 Pre-Accession Turkish Trade Policy Issues

### Sübidey Togan (Bilkent University, Ankara) The EU-Turkey Customs Union Decision

The EU–Turkey Customs Union Decision (CUD) of 1995 and, more recently, the Accession Partnership, have been major instruments of integration into the EU and global markets, offering powerful tools to reform the Turkish economy. The former has credibly locked Turkey into a liberal foreign trade regime for industrial goods and holds a promise of Turkey’s participation in the EU internal market for industrial products. The latter extends liberal commitments of reforms to services and agriculture. In contrast to the CUD imposing legally binding commitments on Turkey, the Accession Partnership merely provides a venue for cooperation and assisting Turkey to adopt the *acquis communautaire*. The extent of its use hinges upon the political will of both sides.

14 years have passed since the formation of the EU-Turkey customs union, and almost five years since the start of EU membership talks with Turkey. In the meantime Turkey has fulfilled almost all of the requirements of CUD, and is in the process of aligning its legislation in services and agriculture to that of the *acquis*. The task is rather challenging, and probably one of the most challenging parts is related to the elimination of technical barriers to trade (TBTs). One of the requirements of the CUD is that within five years Turkey incorporates into its internal legal order the Community instruments relating to the removal of technical barriers to trade, and effective co-operation is to be achieved in the fields of standardisation, metrology and calibration, quality, accreditation, testing and certification.

#### Technical Barriers to Trade

In the case of industrial products, Turkey harmonised its technical legislation with that of the EU, established sound conformity assessment structure, and took major steps regarding the establishment of market surveillance structure. But, as emphasised by Togan (2010), TBTs between Turkey and the EU could still not be eliminated fully as of 2010.

The reasons for the non-elimination of TBTs between Turkey and the EU are various. First, the framework law and associated legislation, which is the basis for the work of harmonising the EU’s technical regulations, was put into effect only in January 2002, seven years after the formation of the customs union. Thereafter, the adaptation process accelerated for both the new and classical approach regulations, and a large number of related regulations were adopted by Turkey. This time, however, Turkey faced another difficulty. There was no mechanism between Turkey and the EU similar to the one provided by the “EFTA Surveillance Body”, which evaluates the regulations prepared by the EFTA countries and ascertains the acceptability of these regulations by the EU. Since the EU-Turkey Association Council did not establish a similar body, the regulations prepared by Turkey were not evaluated by such a body and there was no mechanism to approve these regulations. Second, the number of personnel in the responsible ministries and governmental bodies who were fluent

in English and trained in matters related to TBTs was insufficient. Finally, financial resources were limited for the harmonisation of technical legislation. On the other hand, the establishment of the quality infrastructure was also a lengthy and complex process, as Turkey, until the formation of the customs union with the EU, had neither such an infrastructure nor the required technical knowledge. Establishing public awareness of the problem, acquiring the necessary knowledge and establishing the infrastructure took quite some time. Finally, the development of a market surveillance structure, as in the EU, became even more challenging than establishing the quality infrastructure. Again, the reasons are various. A successful consumer product safety related market surveillance system requires independence, visibility, a uniform surveillance policy, a uniform enforcement policy, the integration of market surveillance and import controls, more acting power for inspectors, and sufficient technical infrastructure. Unfortunately, the Turkish system as of 2010 does not meet these conditions, and the continuation of these problems has adversely affected the elimination of TBTs in trade with the EU.

In the case of agricultural commodities, elimination of TBTs proved to be even more challenging than in the case of industrial products.

### **Fruit and vegetables – a Turkish success story**

In the agricultural sector a Turkish success story is the case of fruit and vegetables. Here, the Ministry of Agriculture and Rural Affairs (MARA) together with the Undersecretariat for Foreign Trade (UFT), are responsible for checks for conformity to marketing standards. At export stage, the inspectors for Standardisation for Foreign Trade perform the inspection of the fruit and vegetables within the scope of the standards specified by the Turkish Standards Institute (TSE) prior to export. The inspections are performed according to the TSE standards, which are parallel to UNECE standards. These standards are largely harmonised with the EU regulations, and checking is carried out in laboratories which are fully equipped. Checking operations of exports are carried out according to the OECD Scheme. The Control Certificate delivered after the inspection is compatible with the Control Certificate determined by the OECD Committee for Food, Agriculture and Fishery, and the Scheme for Implementation of International Standards on Fruits and Vegetables. The exporters obtain an Inspection Certificate from the Group of Inspectors for Standardisation for Foreign Trade. These inspection units issue a "Control Certificate" only for agricultural products to be exported within the scope of the standards, which are mandatory in exports. A control certificate is issued by UFT for the goods that are inspected, indicating that the good is in conformity with the relevant standard. The Commission with Regulation No 1790/2006 has approved, in accordance with Article 7 of Regulation No 1148/2001, the checks on conformity to the marketing standards applicable to fruits and vegetables carried out by Turkey prior to import into the Community. As a result of these achievements, during 2009 Turkey was able to export \$2.4 billion worth of fruit and vegetables to the EU.

Europe's consumers want food that is safe, and they are not interested in any way in compromising over food safety rules. Thus, Turkish farm and food

producers who intend to export to the EU, or who are actually exporting to the EU, must respect the same safety principles as apply in the EU. This is not an easy task for the Turkish farm and food producers, and the task is a costly one. But, since this approach is the only way to liberalise trade in agricultural goods between Turkey and the EU, and to have market access for Turkish agricultural goods to the very large EU market, it seems that Turkey has to replicate the success story of the fruit and vegetables case in other subsectors of the industrial and agricultural sectors following similar approaches.

### **What the European Commission could do**

The elimination of TBTs in the cases of industrial and agricultural products is a daunting task. Here the European Commission could assist the developing countries by providing guidelines derived from the experience of Turkey regarding the elimination of TBTs in its trade with the EU. In addition the Commission could prepare short papers indicating the EU requirements for the elimination of TBTs for individual sub-sectors in agricultural and industrial sectors as prepared by e.g de-Froidmont (2007) for the fruits and vegetables sector. The information should be accessible easily through the Commission's website.

### **References**

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## **2.6 EU Trade Policy: a modest step towards non discriminatory deep integration**

**Peter Holmes (Sussex University)**

*This commentary was co-authored by Peter Holmes and Jim Rollo of Sussex University.*

### **Our focus**

Standoffs in domestic and international political economy make this a particularly difficult time to point to clear directions of travel for EU trade policy. We try to identify one specific way forward that could bring market opening through the bilateral route that does not undercut further the multilateral system, namely focussing on non-tariff measures in the form of conformity assessment issues – boring but vital. The EU-Korea deal shows that this is possible, and there is evidence that a similar package with the US could deliver very large gains.

### **Politics, protectionism and 'play stoppers'**

At home, even before the financial crisis the appetite for liberalisation and market extension through enlargement had lost its lustre for elites as well as voters. The anti-globalisation movement and the rise of populist political causes are symptoms of that. More generally, the aftermath of the financial crisis increased scepticism about the efficacy of markets, while increasing government intervention gave more credence to the role of the state as an effective actor in markets. At a key sectoral level, the 5th enlargement brought a swathe of countries that benefited from the Common Agricultural Policy into the EU. More recently food security concerns as well as 'good old protectionism' after enlargement intensified the pressures against agricultural liberalisation. This left the EU internally divided on the correct path for reform of agricultural policy. As a result the policy has been subject to autonomous reforms that have been presented to trading partners in the WTO on a 'take it or leave it' basis.

In the WTO there are no more playmakers – as the US was during the cold war or the EU and US combined were in the Uruguay Round. There are only 'play stoppers'. The developing countries (many of whom - see India - are enthusiastically liberalising unilaterally) are unwilling to bind further opening of their markets for goods or services, not least because developed countries remain protectionist on agriculture and have little market access left to offer on NAMA and have little appetite to open up on mode 4 services. There is not enough for either side in the reciprocal bargain currently on offer. In any case the DSU is proving a useful lever to open markets – eg, on sugar or anti dumping, but one can wonder whether that tool will remain effective if the WTO loses its ability to deliver additional MFN liberalisation on a significant scale.



## Where next for EU policy?

Against that background EU Policy has taken on a more explicitly bilateral and market opening cast under the rubric of Global Europe<sup>1</sup> but this strategy is far from successful. There is still no apparent progress on EU-GCC or EU-Mercosur – which are negotiations that began in the 1990s. EU approaches to ASEAN have morphed from a proposed region-to-region agreement to possible bilaterals with selected individual members of ASEAN. EU-India is hanging fire notably on the “Trade and...” commitments that now form a standard element in EU bilaterals. Only EU-Korea is anything like a success. Even with the ACP countries, where the EU’s leverage is greatest, the EPAs hardly represent a vision of successful negotiations. Overall, Lucian Cernat’s column seemed to us to signal a possible rowing back from bilateralism, even despite enthusiasm among some member states for transatlantic economic integration and the potential for EU-Japan after EU-Korea.

If neither multilateral nor bilateral liberalisation strategies are working well, where next? We could as others have done make some far-reaching suggestions about what the EU should do to help revive Doha. A substantially better EU offer on agricultural market access seems to us the minimum that Europe must deliver to have any chance of encouraging developing countries and even the US to the table. But we see little chance of that in current circumstances.

Is there anything in the bilateral agenda that offers a model for market opening which is not damaging to the multilateral system?

### Non-tariff measures

It has long been held that agreement on regulatory and non-tariff measures is likely to be easier among a small rather than a large group and therefore the bilateral or regional route to deep integration is more likely to be fruitful. In truth there is as yet limited evidence, other than the EU itself, for this proposition except for the willingness of prospective members of the EU to align their norms with those of the EU prior to accession. To this we can add that the EU’s immediate neighbours, such as Switzerland, have little choice but to adopt EU standards if they are to sell into their biggest market.

However regulatory alignment in FTAs as such has been very limited. Even in the pre-accession period for the new MS of the EU it was the accession negotiations not the Europe Agreements that drove the process. The EU Turkey Customs Union agreement is proving to have lots of holes. Lucian’s own earlier work at UNCTAD on the significance of competition provisions in bilaterals sums it up nicely. “Eager to ink but ready to act?”<sup>2</sup> Among EPA partners only CARIFORUM has so far accepted any non-trade provisions: these were ones that the CNRM negotiators hoped would help underpin their own single market, an incentive absent in other cases.

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<sup>1</sup> See EU Commission, (2006), *Global Europe: Competing in the World*, COM (2006)567, Brussels and Rollo, Jim (2006), *Global Europe: old Mercantilist Wine in New Bottles?*, *Aussenwirtschaft* 61, 403-414

<sup>2</sup> Cernat, L. 2005. “Eager to ink, but ready to act?” In Brusick, P.; Alvarez, A.M.; Cernat, L., ed., *Competition Provisions in Regional Trade Agreements: How to Assure Development Gains*. UNCTAD.

General studies of non trade provisions<sup>3</sup> suggest that across-the-board EU trade agreements have included provisions on regulatory issues that were either too vague to be enforceable or explicitly non-binding. This leads one to be cautious about scope for deep integration.

But it can be argued that these agreements all reflect an older generation of negotiations. The recent EU-Korea agreement offers interesting possibilities.

### **Trade in goods and standards**

With regard to trade in goods, the key element that is usually missing from trade agreements is Mutual Recognition of testing and certification. Emphasis on standards harmonisation is potentially misleading. Even if a country adopts EU standards and makes them mandatory, the EU is not obliged to accept imports without further administrative procedures because the EU does not necessarily accept that conformity assessment systems in the partner country are good enough to ensure that EU standards really are met. This is a very delicate issue. For many years within the EU, the car industry was able to ensure continuing segmentation of even the EU market by persuading governments not to accept "Type approval certificates" issued by other member states, even when the standards had been unified. In 1997 the EU and the US signed an agreement on Mutual Recognition of Conformity Assessment – a framework agreement that required detailed sector-specific agreements, which remain limited in scope. The EU Turkey Customs Union agreement provided for early adoption of EU standards by Turkey but it was not till 2006 that steps were taken to recognise Turkish conformity assessment labs. EU Chile provides pathways for establishing procedures to agree equivalence in SPS rules but substance had to wait. EU Korea takes a major step forward however. In cars and electronics both partners agree to recognise each other's conformity assessment procedures. EU electronics and cars do not need additional inspection in Korea. The USTR in its comments on the agreement observe that this goes further than KORUS.<sup>4</sup>

The sectoral coverage here is still not 100%. But it represents a major breakthrough. Moreover the discriminatory element is small. In electronics the FTA commits both sides to basing regulations on international standards, though in cars EU standards are privileged.

The potential benefits are very significant. A study of the impact of regulatory barriers between the EU and the US estimated that the removal of all potentially actionable barriers between the EU and the US would lead to a rise in EU GDP of 0.7%,<sup>5</sup> a significantly greater amount than from the removal of tariffs and a non

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<sup>3</sup> Sapir, André and Horn, Henrik and Mavroidis, Petros C. (2009) *Beyond the WTO? An anatomy of EU and US preferential trade agreements*; Bourgeois, J, Kamala Dawar, and Simon Evenett (2007) "A Comparative Analysis of Selected Provisions in Free Trade Agreements." August 2007. Report prepared for DG Trade, Brussels; Peter Holmes "Deep Integration in EU FTAs".

<sup>4</sup> <http://www.ustr.gov/about-us/press-office/press-releases/2009/october/ustr-releases-preliminary-analysis-korea-eu-free-t>

<sup>5</sup> See Lucian Cernat and Bertin Martens "Untapping the EU-US trade potential: Taking the Transatlantic Economic Council forward" 7 May 2010 and ECORYS Nederland BV (2009). "Non-Tariff Measures in EU-US Trade and Investment – An Economic Analysis," Study for European Commission, Directorate-General for Trade".

trivial fraction of the estimates made for the impact of the creation of the original common market!

### **Looking forward**

The EU-Korea agreement provides for mutual recognition not just of standards but also of conformity testing and certification. This might prove useful more widely, and could be offered conditionally *erga omnes* to any country that met the technical requirements. This is a potential template that could be used with the US, Japan and potentially even China. Crucially however, such agreements can only work when there is a degree of trust in the regulatory arrangements. Extension to developing economies would require investment at the level of the firm as well as in regulatory institutions, but could be a priority for EU 'aid for trade' spending.

But this does not require the negotiation of a full FTA. Clearly more trade-offs are possible when other forms of market access can be mutually offered, and inclusion of NTBs in an FTA can make the package more attractive, but such regulatory agreements can be stand-alone.

The essential conclusion of our argument is that there are market access gains potentially available, on a bilateral and regional basis, that primarily involve the mutual recognition of testing and certification. This issue is politically and technically hard to address and has mostly been sidestepped in FTAs, but EU-Korea shows it can be done, albeit within limits, in an FTA. But it can also be done in other ways. The gains are potentially large and seem genuinely likely to provide stepping stones to non-discriminatory trade expansion.

*Authors' note: We are extremely grateful to Michael Gasiorek and Kamala Dawar for comments and advice.*

## 2.7 Border Carbon Adjustments: A leadership Role for the EU

James Rollo (Sussex University)

### Our focus

Border Carbon Adjustments (BCA) are a real and significant threat to the world trading system. The EU Commission has been quite vocal in its rejection of them yet within and outside Europe they are still on the agenda of many, including environmentalists, industries likely to attract high carbon charges and governments. We think there is a small but palpable chance that the EU could stray onto protectionist territory both within the single market (and hence) towards the rest of the world. There is also, we argue (based on our soon to be published research<sup>1</sup>) a more positive scenario where the EU could take a leadership role based on mutual recognition of testing and certification of carbon standards at origin and on conditional MFN which could offer a way towards a world without BCAs.

### Green growth and Border Carbon Adjustments

Lucien Cernat makes the excellent point that in pursuit of green growth the EU must avoid protectionism and, indeed, actively liberalise trade in environmental goods and services. But we fear that the threat of green protectionism is greater than he implies and is already provoking pre-emptive reactions from India and China<sup>2</sup>. Protectionist “Border Carbon Adjustments” could also set back attempts to ensure that green growth strategies are based on the most competitive technologies.

Border adjustments serve two distinct purposes, which are sometimes confused. BCAs are designed to create incentives to reduce global warming, but they are also designed to provide protection for our polluting industries. This is seen at its most blatant in the current schemes under which carbon emission permits are given free to heavily polluting industries. They can end up making more money on re-sale of the permits than the cost of reducing emissions. The fundamental goal of international public policy has to be to provide incentives to reduce domestic emissions by all players, not to mitigate “competitiveness” concerns, which most studies suggest are quite small.<sup>3</sup> Implementing BCAs risks the danger of “murky protectionism” that would either involve impossibly complex administrative demands or result in arbitrary charges.

Moreover, the appearance of national carbon taxes among EU members raises the potential for border carbon adjustments within the EU, let alone between the EU and the rest of the world. Lucian draws attention to the need to link internal

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<sup>1</sup> Peter Holmes, Tom Reilly and Jim Rollo “Border Carbon Adjustments and the Potential for Protectionism” forthcoming in *Climate Policy*. An earlier version of the paper can be seen at <http://www.sussex.ac.uk/economics/research/workingpapers>

<sup>2</sup> See “Reject protectionism in climate talks: Jairam Ramesh” *The Hindu*, Oct 11, 2010 <http://www.hindu.com/2010/10/11/stories/2010101155330700.htm>

<sup>3</sup> Julia Reinaud, *Trade, Competitiveness and Carbon Leakage: Challenges and Opportunities*, [http://www.chathamhouse.org.uk/files/13251\\_0109reinaud.pdf](http://www.chathamhouse.org.uk/files/13251_0109reinaud.pdf)

and external regulatory reform, but in this case the link may go the wrong way. The single market is not the responsibility of DG Trade but it cannot ignore the possibility no matter how remote such border taxes are within the EU. Despite its collectively agreed targets for GHG reduction at European and national level and a history of mutual recognition of standards, the mere possibility of internal EU trade barriers based on different national carbon tax regimes suggests that it will require more than good intentions to prevent the appearance of BCA at global level. It is obvious, but rarely noted, that whenever countries impose carbon taxes based on consumption within their borders rather than production, this involves every commodity being subject to two border adjustments, applying taxes (border adjustments) on imports and assessing exports for entitlement to rebates on taxes they may already have paid. As with VAT, this logic would apply within the single market as well as outside it if there is inadequate coordination and a failure to agree taxes solely based on the origin of pollution. This would apply even where emissions charges were similar. It is more complex than adjusting for VAT because the border adjustments do not depend on the value of the commodity but rather on the nature of the processes used in all stages of production of the commodity. There have already been rumblings inside the EU about the fact that with carbon tax, rebates are de facto subsidies to those who get them.<sup>4</sup>

And there is indeed mounting pressure for BCAs on imports from countries judged not to have equivalent levels of emissions controls or charges, not least in the aftermath of the failed Copenhagen summit in January 2010. The issue of mutual confidence in regulatory processes is central to any solution to this.

### **A global agreement is required**

We have argued in a forthcoming paper that the degree of disruptiveness of BCA and the potential for abuse is enormous and we should seek international agreement to prevent them. How do we evaluate the duty on a product made up of a mix of metals made in different plants? Is aluminium made with hydro power alone treated the same as that from plants connected to a power grid and hence electricity generated with high marginal carbon intensity? In the absence of a global agreement on targets for, and monitoring of, GHG emissions, the threat of such measures (and equally of retaliation by targeted countries) to the world trading system requires active policy. We note also that the effect of BCA would be particularly pernicious when value chains result in goods produced in many different locations, the inputs to which cannot be directly observed by customs officials at the final destination. This has the potential to tie trade up in administrative protectionism to rival and even surpass that of Rules of Origin in preferential agreements. To satisfy ROO rules merely requires limited information about the last stages of production. For BCAs to reflect the actual carbon they would have to be based on data that would be very hard for firms to supply, including on production methods used by their suppliers' suppliers. On the other hand, if this is to be avoided, importing country customs officials could use arbitrary or average coefficients that provided no environmental incentives at the margin at all. The least trade disruptive system would be for importers to apply

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<sup>4</sup> This was the basis of the French Supreme Court's rejection of Sarkozy's Carbon Tax

carbon coefficients based on their own production coefficients<sup>5</sup>, but this would make no environmental sense at all. We risk the noodle bowl turning into a Gordian knot, which could be cut only in arbitrary places!

### **What the EU should do**

We recommend therefore an origin based system of testing and certification. The geographical concentration of such chains in East and South East Asia suggests to us that countries with close trading ties need to be able to establish confidence in one another's emissions regimes. The EU has experience in this already and if it can nip the issue in the bud within its own borders it may have lessons for those trying to set up such intra-regional systems. At same time, the existing EU GHG bubble offers the potential to initiate mutual recognition of testing and certification schemes with both individual countries, the US in particular, as well as regional groupings, not necessarily already in RTA. These could be founded on a conditional MFN basis so that any country or grouping that met the technical criteria would be able to join. This could be a situation where initially preferential regulatory arrangements – mutual recognition – could offer incentives that in the longer run could strengthen global rules rather than weaken them.

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<sup>5</sup> A.Mattoo, A. Subramanian, D. van der Mensbrugghe and J. He (2009). "Reconciling Climate Change and Trade Policy."World Bank Policy Research Working Paper no. WPS 5123.