Defensiveness and Fragmentation in Trade Policy

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1. Introduction

European trade policy finds itself in an unenviable position; it is stuck in an agenda that does not yield desired results. Its core trade agenda for the past ten years has been strikingly unsuccessful. With the exception of the EU's eastward enlargement in 2004, the record of achieved trade agreements or trade reforms is thin and covers mostly countries of little commercial significance. Nor does it seem likely that its current agenda, which was set out in 2006 and travels under the name of *Global Europe*, [1] will change this record significantly.

More importantly, protectionism is on the rise. The global economic downturn has spawned protectionist sentiments in general, and specific policies to prop up ailing industries and firms. That applies to Europe and its trading partners. It puts EU trade policy on the defensive, imposing greater constraints on the EU's ability to open up third-country markets through trade negotiations. It also causes problems at home; the economic recession can give cover for protectionist measures that have been brewing in the EU in recent years. Calls for action are mostly directed against China. They are meant to correct a ballooning EU-China trade deficit. They are also meant to prevent relocation of production away from Europe as a result of measures to reduce carbon emissions in Europe. As the world's number one destination for outsourced manufacturing production, China is the main target for such concerns.

This chapter is a stock-take of EU trade policy and its likely direction in the short-to-medium term. It points to two serious challenges: emerging protectionist threats; and the fragmentation, or disintegration, of EU trade policy.

2. Europe's trade agenda: from multilateral to bilateral

For most of the post-war era, European trade policy has followed three tracks: multilateral, preferential and unilateral. Europe has always been a key actor in the multilateral trading system, and in the last few decades multilateral trade agreements have formed the backbone of EU trade-policy ambitions.

Its preferential trade policy was long directed towards neighbours outside the Common Market (especially countries in the European Free Trade Area), and the former colonies of

[1] European Commission (2006).

Britain and France. Important changes have emerged, with Europe seeking stronger trade ties with other regions. Some have been close to home (as with the free trade agreements signed with Central and Eastern European countries in the 1990s); others have been farther away.

There have also been important unilateral trade reforms; reforms opening up the European market outside the realm of typical trade negotiations. The bulk of these reforms have been essentially “domestic”, intended to reduce intra-European barriers to trade. The Single-Market reforms in the early 1990s did away with many non-tariff intra-regional barriers, which also improved market access for non-European firms.

In 2006 the EU launched a new trade strategy centered on bilateral trade negotiations with emerging markets in Asia. This grand strategy has not been particularly successful.[2] Key elements of it were ill-advised, and the lack of progress was predictable from the start. *Global Europe* has not had any visible effect on the Doha Round. Other countries do not appear to have changed their positions because Europe launched bilateral negotiations with a selected number of countries. It seems more correct to say that the new bilateral strategy entrenched positions within Europe; some EU member-states seeking to protect their agricultural sectors portrayed the new FTAs as an alternative to the Doha Round. Bilateral agreements with emerging Asia, some argued, would gain new market access without having to concede EU reductions in agricultural tariffs and subsidies. But such talk was on the fringe. Europe’s Doha Round positions, like those of other countries, were largely unmoved by this bilateral strategy.

More visible, however, has been the failure to achieve results on the bilateral front, with the exception of South Korea. The new agenda attempted to revitalize Europe’s negotiations with the Latin American Mercosur group and the Gulf Cooperation Council (GCC). These negotiations were literally and figuratively a legacy from the last century. They had been on the books for a decade or more, and obstacles to finishing them were well known. To no one’s surprise, these negotiations have not made real progress since 2006.

Global Europe also singled out ASEAN (Association of Southeast Asian Nations), India and South Korea for new preferential trade agreements. This was new for EU trade policy: emerging Asia was to become front and centre in Europe’s new bilateral drive. A new trade deal with South Korea was considered a necessity as the United States was finishing its negotiations with South Korea for an FTA. A region-to-region negotiation with ASEAN was considered a way for Europe to help Southeast Asia form its own common market. It also justified a new trade deal with countries that had been knocking individually on the EU’s door for some time, but that as individual countries were not significant enough from a commercial viewpoint. Lastly, a deal with India, with its large and rapidly growing market, was seen as a way to integrate more closely with a developing country whose export strategy rested more on services than manufactures.

Negotiations started in 2007, but it is only the negotiation with South Korea that has made any progress. The EU and South Korea have agreed terms for an FTA, but ratification in the EU depends on overcoming opposition from German car producers. The negotiations with

[2] Sally (2007) and Abbott (2008).

India stalled soon after they were launched. Substantive negotiations with ASEAN have not started at all. Current efforts are directed at finding a subset of ASEAN countries willing and capable of negotiating a trade agreement with the EU. This may take the form of FTA negotiations with individual ASEAN countries – which would be commercially much less advantageous than a serious FTA with ASEAN collectively.

The new trade strategy also involves negotiations with China and Russia. These are not negotiations about classic FTAs; nor are they presented as such in Global Europe. Rather they take the form of Partnership and Cooperation Agreements (PCAs). Current trade-cooperation agreements with China and Russia are weak and do not cover many of the commercial aspects included in stronger bilateral trade agreements. But as FTAs with these big markets have been ruled out (because Russia is not yet a member of the WTO; and China is too competitive and its policies considered too opaque for an FTA), the PCAs are considered an alternative way of dealing with bilateral trade tensions and negotiating better market access. Hence EU trade-policy ambitions in these PCA negotiations are substantial.

With China, Europe has also set up a High Level Economic and Trade Dialogue Mechanism (hereafter the High Level Dialogue), intended to be a forum for discussions and negotiations about commercial policy.[3] This is modeled on the US-China Strategic Economic Dialogue, the framework used by Hank Paulson, the former US Treasury secretary, to get better market access in China while at the same time containing US protectionist initiatives directed at China.

PCA negotiations with China are intended to upgrade a commercial agreement dating back to 1985. They have been launched but have not really started. Nor do they seem likely to start in the near future. Political sensitivities are high, and have intensified lately. The High Level Dialogue was launched at an EU-China summit in Beijing in April 2008, but in contrast to the Sino-US dialogue, the High Level Dialogue has hardly produced anything at all.

PCA negotiations with Russia were launched in the summer 2008. But less than a month after the launch, Russia invaded Georgia. Europe's response was to put these negotiations in the freezer. They were relaunched again in November the same year, but expectations for these talks are not high. The trade component in these talks will get ever more complicated after Prime Minister Putin announced the withdrawal of Russia's application to join the WTO in favour of a customs union with Belarus and Kazakhstan (though President Medvedev has sent contradictory signals that Russia's solo WTO application still stands). Russian membership in the WTO has been a prerequisite for the EU to move towards a Free Trade Agreement with Russia. Hence the uncertainty hovering over Russia's WTO application will prevent substantial trade negotiations between the two parties.

What has actually been achieved in the past decade? The EU has had one major – though indirect – trade-policy success: the transformation of a patchwork of first bilateral trade agreements, and then Europe Agreements, into the full accession of twelve new members into the EU in 2004 and 2007. This is a historic achievement: it enlarges the EU's internal market; and it incorporates the new member-states into the Common Commercial Policy. That said, the trade-policy aspects of the accession negotiations (concerning trade with non-

[3] Dreyer & Erixon (2008); Erixon, Messerlin & Sally (2008); Messerlin and Wang (2008).

EU countries) were a minor component of overall negotiations. And so far the new members have made little difference to overall EU trade policy.

That aside, several Stabilisation and Association Agreements with neighbours have been agreed (such as those with Albania, Croatia, Macedonia, Montenegro and Bosnia-Herzegovina). Economic Partnership Agreements with ACP countries have been signed (as interim or final agreements) to allow for continued preferential openness to the EU market after the WTO waiver for Europe's preexisting Lome and Cotonou agreements with ACP countries expired. Of greater commercial relevance have been the FTAs with Chile, Mexico and South Africa. But these agreements were signed very early in the new millennium and were a vestige of the trade agenda in the 1990s.

3. EU trade policy: emerging protectionist threats

Despite this thin record of trade liberalisation in the new millennium, Europe's trade has increased considerably. Exports as well imports, intra- as well as extra-EU trade, have grown at very high rates. European multinational firms have continued to drive much of this trade, and associated flows of foreign direct investment, as they have extended their supply chains to benefit from lower production costs in other countries. European consumers have benefited from falling costs for many consumer goods and greater product variety. Technological developments and falling transaction costs have been the chief determinants of this trade and FDI growth. Previous rounds of policy liberalisation have also contributed.

The absence of new liberalisation will slow down future growth in trade and FDI. Nor should all past liberalisation be considered safe from reversals. Trends in EU trade and regulatory policy rather suggest increasing protectionism. What are the main emerging protectionist threats?

Stalled economic liberalisation

Economic crises in the 1980s and the early 1990s triggered market-based reforms around the world. Macroeconomic stabilisation, often followed by other macroeconomic reforms such as central bank independence and inflation targeting, combined with microeconomic liberalisation, such as market deregulation and privatization of state-owned companies, to stimulate greater competition. This trend has clearly slowed down in the new millennium. Reforms have not been repealed, but the few efforts to advance further economic liberalisation have not been successful.

This slowdown has affected EU trade policy. The latter is often a reflection of domestic economic policy; and lately there has been little impetus for external reforms from domestic reforms. In contrast, in the early 1990s, the Uruguay Round of trade negotiations enjoyed the tailwind of Single-Market reforms in the EU and an overall policy climate of deregulation and greater competition. The overall policy climate in the new millennium has been less clement to market forces. It has stymied initiatives in the EU to liberalise trade and increase competition. The most prominent example is the failed attempt to create a single market for services. A second version was approved by EU member states and the European Parliament, but it is a damp squib. Many sectors are carved out, and EU member-states can continue do discriminate against suppliers from other member-states on the grounds of regulatory differences.

The non-tradability of many services in Europe is itself a problem. It raises the cost of services. Relative prices are biased to favour consumption of goods rather than services. It also has a discernable effect on trade negotiations. Europe is not as offensive as it should be when it comes to liberalising services trade in third-country markets. Many service providers feel threatened by foreign competition, including service providers in other parts of the EU. There is widespread concern that free trade in services would damage jobs and welfare in Europe. The closer one gets to services provided by the welfare state, the greater the sensitivities and defensiveness – also directed at other EU member-states. Healthcare, potentially a prominent export sector for Europe, is closed to trade and operates in an autarkic milieu. Not even a patients' rights proposal from the European Commission --little more than a codification of rulings by the European Court of Justice -- can get the approval of the member states as it comes too close to opening national healthcare sectors to intra-EU trade and intra-EU competition. Such defensiveness cramps the EU's ability in trade negotiations to open foreign markets for European services providers. The lack of overall market dynamism in the European services sector also prevents the EU from trading off its agricultural protectionism for access to other countries' service sectors.

Standards protectionism

The EU has been a standard-bearer for labour and environmental standards in trade agreements. It tried to make them an explicit part of the Doha Round, but developing countries resisted on the grounds that they would be an open invitation to backdoor protectionism. The EU's bilateral trade agreements typically have provisions on labour and environmental standards, but they take the form of commitments to general principles and adherence to relevant international conventions. They are relatively weak and difficult to enforce. Again, resistance from trading partners probably explains why such standards have not become stronger than they are.

This is about to change: the EU is at risk of engaging in "standards protectionism" on an unprecedented scale. It is the policy for reducing carbon emissions that pushes it in this direction.

The EU has set targets to lower its carbon emissions. These targets are more ambitious than they are elsewhere. To that end, the EU has set up an emission trading scheme (ETS), which limits the amount of carbon which can be emitted and enables parties to trade in emission allowances. There are several problems with this "cap-and-trade" approach to carbon reduction. For starters, a simple carbon tax would be more efficient, transparent and fair than the quota-based, administratively complex ETS. But the main problem is that deep cuts in carbon emissions will increase European production costs relative to production costs in other countries that do not undertake similar carbon-reduction efforts. European-based companies might actually relocate to the latter, and replace production in Europe with exports to Europe from new host countries. This is known as "carbon leakage".

There is little evidence that current carbon-reduction measures have lowered the competitiveness of EU firms or provoked companies to move out of Europe. But as emissions limits are progressively lowered, the pressures will rise. Furthermore, the EU's two main trading partners, the United States and China, have not signed on to carbon reductions in a global agreement. The United States appears likely to take part in a post-Kyoto agreement; and a climate-change bill laying the ground for a US equivalent of the EU ETS is likely to be agreed by the US Congress in late 2009 or 2010. China might also be coaxed into signing an international agreement on carbon emissions. The problem for the EU is twofold. First the United States is unlikely to agree to such big reductions as the EU plans to undertake. And second, China is unlikely to reduce its emissions at all. If it does sign an international agreement, it is unlikely to agree to anything more than limits to a projected increase in carbon emissions.

Hence it is not surprising that trade sanctions have entered the EU global warming debate – as a means of plugging potential carbon leakage, mitigating the damage to the competitiveness of European firms, and encouraging other countries to reduce their carbon emissions. Specifically, this would entail the threat or imposition of tariffs on imports from countries that have not committed themselves to carbon reduction. Proposals have already appeared, but they have been postponed to the next round of negotiations for an international agreement on carbon reduction.

Carbon tariffs would be a serious blow to European trade, producers and consumers. They would also poison the trading system: a new set of trade restrictions would invite protectionist retaliation by other countries and on other grounds; it would probably unleash unprecedented legal conflict in the WTO; and put an already enfeebled WTO under much greater strain. However, carbon tariffs might be an appealing option for many protectionist-leaning EU member-states and intra-EU special interests who feel threatened, especially by competition from China.

Protectionism against China

There is a strong backlash in Europe against China's phenomenal rise in world trade. EU-China trade has exploded in the last decade, and China today ranks as Europe's second largest trading partner. Total trade between the EU and China has almost tripled in the last five years. Europe's bilateral trade deficit with China has ballooned, amounting to nearly EUR 200 billion in 2007.[4]

Yet Europe has benefited much from trade with China; and the notion that a *bilateral* deficit represents a problem which must be corrected is simply bad economics. In contrast to the United States, the EU's overall current account is in balance and has remained stable (plus or minus 1 per cent of GDP) for the last decade. If a bilateral deficit really constituted a problem, Bulgaria, France, Romania, the UK and several other trade-deficit countries in the EU, should rather be worried about their deficits with other European countries --which dwarf their trade deficits with China.

[4] Freytag (2008); Erixon, Messerlin & Sally (2008).

But there is more to this story than meets the eye. The EU's trade deficit with China largely mirrors replacement of other countries' exports to the EU. In other words, China's increasing exports to the EU have been accompanied by falling exports to the EU from other emerging markets. For example, in machinery and transport equipment, which features prominently in EU-China trade, China's surplus with the EU has increased by EUR 50 billion since 2000. But the EU's import of goods in the same category from other emerging markets has *decreased* by nearly as much in the same period. Similar patterns exist in other traded goods sectors, with China replacing other trading partners.

In the last decade, China has established itself as the final-assembly hub for Asia's trade with Europe. Supply chains in multinational firms have been "fragmented" to take advantage of labour-cost and skills advantages in various countries. China is abundant in cheap labour, and its comparative advantage lies in labour-intensive exports, particularly in manufacturing. Hence multinational firms have located labour-intensive production in China, mainly assembly operations for final goods exports to Europe and the United States, while locating other, medium and high-value parts of their supply chains in other east-Asian countries. The latter export parts and components to China for assembly and re-export. Hence a large part of China's exports is based on imports. "Processing" or "fragmentation" trade --the refinement of an imported good before it is re-exported -- has been central to China's export-development model, and is estimated to account for between one-half and two-thirds of China's total exports.

4. The fragmentation of EU trade policy

The EU faces the fragmentation of its trade-policy making process. This is happening more in the EU than in other jurisdictions. In the EU, as elsewhere in the OECD, the core ambition of post-war trade policy – to eliminate tariffs and other border barriers – has largely been achieved. But the next frontier in trade policy – the reduction of non-border barriers embedded in domestic regulation – trespasses on other policy areas, such as the regulation of services sectors, health- and-safety standards, food-safety standards, intellectual property protection and government procurement. These are inherently "domestic". Hence trade policy's ever-expanding range enmeshes it in lots of domestic policy thickets. Yet there is an additional aspect of this development in the EU, given its peculiar hybrid of supranationalism and intergovernmentalism. Trade policy is one of the EU's few "hard" policy areas in that policy making is centralised in Brussels. From the Brussels vantage point, trade policy is also foreign policy and development policy. This makes it a tempting tool of action for other EU policy areas that might not be directly "trade-related", but in which direct EU competence is weak.

Another source of fragmentation is the limits to EU supranational jurisdictional competence in new areas of trade policy. The EU's competence has been extended to cover some aspects of services and intellectual property rights. But these new competencies are limited, and they do not mandate the Commission to negotiate ambitious new trade agreements in these areas. Furthermore,, there is no unified EU-wide regulation in both policy areas: the EU does not have a Single Market for services or a Community-wide patent system. This is a clear constraint on the EU's negotiating power vis-à-vis third countries.

Investment policy is another area with limited EU jurisdiction (apart from "post-establishment" matters, which are subject to Single-Market rules). The Commission has secured a mandate to negotiate some investment issues related to the General Agreement on Trade in Services (GATS) in the WTO. But this is a narrow mandate; it does not cover many investment issues that are front and centre in today's world of global economic policy. In fact, in these areas EU member-states compete with each other to secure advantageous access to third countries. The energy sector is similarly problematic: the absence of a Single Market for energy cramps the EU's ability to negotiate commercial agreements with third countries.

Such policy fragmentation constrains the EU's current agenda for trade negotiations. The lack of a unified policy for services and investment has decreased the chances to negotiate a substantial trade agreement with India, whose core ambition is to get better access for Indian investors and service suppliers to the EU. Investment and services are core concerns European multinational firms have with access to the Chinese market. Core problems in EU-Russia relations – investment protection and the energy sector – cannot be adequately dealt with by the EU as it has no mandate for protection of European investments abroad and no common energy policy.

Conventional wisdom holds that these deficiencies will be overcome as soon as the Lisbon Treaty is adopted. That is not true. There is a possibility that Brussels will be given some extra competence in investment policy. However, it should be prepared for a situation where individual member-states will fight to retain competence on investment policy. Ultimately, this will have to be settled by the European Court of Justice (assuming no changes to the current treaty text). Even if the ECJ rules in favour of an expansion of jurisdictional competence, it will cover only a small part of relevant investment issues.

5. Conclusion: more difficult times ahead

EU trade policy is sailing into turbulent waters. Its trade-policy strategy in the recent past has been unsuccessful. Prevailing political winds will make it even more difficult in the near-to-medium term future to conclude substantial trade deals. It is difficult to see what factors can lead to a quick and successful conclusion of the Doha Round. The EU's bilateral trade strategy will also likely remain stuck for a while. An FTA with South Korea might be signed in 2009-10, but that is the only one of the many bilateral EU trade negotiations that is within reach of a deal.

The agenda for autonomous reforms, already weak in recent years, appears completely stalled in the wake of economic recession. Rather EU member-states have responded to recession with Keynesian-style demand expansion, no supply-side reforms and extra microeconomic intervention – not least through bank bailouts and industrial subsidies. This is likely to strengthen protectionist thinking and spill over into protectionist measures. A 1930-style scenario of depression accompanied by spiraling protectionism appears unlikely; but Europe and other part of the world are facing a replay of 1970-style recession, accompanied by greater *ad hoc* government intervention and creeping protectionism.[5]

[5] Erixon & Sally (2009).

Finally, the fragmentation of EU trade policy, particularly on non-border regulatory issues, weakens the EU's ability both to contain emerging protectionist forces at home and negotiate market access abroad.

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