Summary

Already the Treaty of Rome called for internal and external liberalisation

Forty years ago, external protection was high in most countries and Europe was comprised of many "trade fortresses". The founders of the Community shared a coherent economic policy view, with the Treaty of Rome calling for an internal market with no obstacles to trade and strong competition, as well as for multilateral liberalisation. This publication retraces the external liberalisation efforts, discusses the current trade regime in international comparison, and sets out the Community's future trade agenda. A key aim of the study will be to clarify and, where feasible, to quantify the economic effects of the European Union's (EU) trade policies.

Decision-making on foreign trade policy is largely centralised at the EU level

Partly by necessity, partly by design, the EU's trade policy has been "walking on two legs" since its early days: multilateral liberalisation and regional integration. The long-standing pursuit of deeper integration and enlargement, and the involvement in regional preferential agreements makes the EU's experience unique. Another unique feature is the institutional set-up. While largely prepared by the Commission, major decisions are taken by the Council (for trade in goods and part of services). Some competencies are shared between the Union and the Member States. However, the negotiation and decision making process is not different between the areas of mixed or exclusive competence. Centralisation of most decisions on foreign trade policy at the EU level is necessary to ensure the functioning of the internal market. Centralisation should, in principle, strengthen the EU's position in international trade matters. Whether a strong negotiating position is a good thing for its trading partners depends on the position the negotiating "club" is taking, for instance, whether it pursues an inward or outward looking agenda. In addition to the size of the club, its "quality" matters: if club members push different views, slow decision making or paralysis could be the consequence.

Internal integration has probably not hampered multilateral liberalisation

Since its creation, the European Union has actively participated in multilateral liberalisation efforts. Whether the creation and expansion of the European Union has speeded up or slowed down such efforts is impossible to tell. Many commentators argue that the creation of the European Economic Community (EEC) led directly to the Dillon and Kennedy Rounds, as other countries were concerned by the trade diversion consequences. On the other hand, the Community successfully resisted for decades the inclusion of agriculture in trade liberalisation negotiations. Also other countries have at times resisted liberalisation efforts and deep integration in Europe shows that a vast regional integration scheme does not necessarily undermine the multilateral trading system.

The coincidence of multilateral and bilateral liberalisation makes the assessment of economic effects difficult

While it is clear that trade barriers have come down considerably across a wide range of sectors, it is very difficult to compare trade regimes across countries and assess their economic effects. This is so, because the distance of a country's trade regime from an "ideal" world of free trade cannot be measured in the absence of comprehensive empirical measures of effective protection. In addition, while a feature of multilateralism is the absence of discrimination among trading partners, another one is how close a country's trade regime comes to approximate free trade. If a country opened markets to just one small country that would seem to decrease multilateralism, but opening trade to all countries but a small one would seem to increase it. Given the large number of bilateral trade agreements, the latter aspect is of considerable importance for the European Union.

Tariffs have come down, but EU consumers could still benefit a lot from further liberalisation of trade in agricultural and textile products

Taking the modest route of comparing trade policy indicators nevertheless provides plenty of insights. In particular, most-favoured-nation tariffs on most goods have fallen considerably, to levels which probably are more a nuisance than a barrier to trade. However, tariffs on textiles and apparel still remain rather high – a feature also found elsewhere in the OECD – and the high level of agricultural protection has not declined, despite efforts to reform the Common Agricultural Policy (CAP). Contrary to developments in the Union, agricultural protection has shown a trend decline in many other OECD countries, even though in most countries protection has drifted up again in recent years, in line with developments in the Union. The tariffication process of agricultural and food products agreed upon in the Uruguay Round raised measures of average tariff rates, and high rates of tariffs across a wide range of products probably imply that agricultural imports will be only little affected even after the phasing in of the Uruguay Agreement on Agriculture. However, market access has improved to some extent due to minimum access requirements and a sizeable reduction in export subsidies has been phased in. While the Agenda 2000 reform in anticipation of the widening of the Union will deepen and extend the 1992 CAP reform, it is uncertain whether it will be sufficient to resolve the problem of exportable surpluses for some commodities. Consumers in the Union could benefit considerably from a further substantial liberalisation of trade in agricultural and textile products.

The Union is a frequent user of non-tariff barriers and of the WTO dispute settlement mechanism

Non-tariff border measures have traditionally been more prevalent in the Union and the United States than in Japan or Canada. The textile sector remains the most protected by non-tariff barriers, while tariffication implied a sharp fall in the pervasiveness of such barriers for agricultural products and in the processed food sector. Concerning anti-dumping and other price control measures, the Union is a major user, second only to the United States. In contrast, Japan has hardly used such measures at all. The European Union changed anti-dumping legislation in 1994, while revising other provisions such as those on circumvention. The new regulation provides for fairer price comparisons, stricter injury requirements and for a broader role of the "Community interest test" but, even after these changes, proving the existence of unfair trade practices has remained highly contentious. The European Union, with the United States, is a frequent user of the World Trade Organisation (WTO) dispute settlement mechanism. While many disputes could be settled without creating frictions, some have led to serious tensions, most prominent being the banana case, EU imports of hormone-treated beef and of genetically-modified food.

The liberalisation of services is still in its infancy, but gains could be substantial

Multilateral liberalisation of services is still in its infancy, but got a strong boost from the General Agreement on Trade in Services. Assessing the openness of service sectors across countries is very murky and only very crude indicators are available. Despite the long history of sheltering certain service sectors, such as airlines, telecommunications and certain professions, internal liberalisation due to the single market initiative has also improved external access. Liberalisation efforts in Europe continue, to varying degrees across sectors, and could lay the ground for a liberal EU position in the next multilateral services round. Gains from multilateral liberalisation of services trade could dwarf that of further liberalisation of goods industries. The European Union has also launched an e-commerce strategy to catch up with the United States in this area.

Trade liberalisation has boosted growth…

Growth and labour market effects of trade liberalisation are close to the heart of current policy debates. While it was accepted wisdom earlier on that a strong correlation exists between trade and growth, more recent research suggests that the apparent direct link could be spurious. However, trade could still affect growth indirectly through positive effects on capital formation in a broad sense. This study indeed finds a sizeable growth effect for a trade openness indicator and a smaller additional effect coming from rising intra-industry trade, probably reflecting trade-induced scale economies and better specialisation due to the greater variety of available inputs. Moreover, it also found that it is openness in general, rather than regional trade integration that has favoured growth in Europe.

… but labour market rigidities may have forestalled even larger gains

A fast-growing body of research has focused on the wage and employment effects of rising competition from low wage countries. While some studies found little effect, in line with research concerning the United States, others tell a more cautionary tale: the effect would largely depend on labour market institutions. Indeed, slow restructuring in some European countries could lower the benefits induced by trade liberalisation, with gains from freer trade being largely used to compensate those who have lost their job. On the other hand, the labour market effects may not be unfavourable over the medium term, as a lowering in rents could lead to weaker insider power and make labour markets more flexible. Given the different labour market institutions within Europe, the trade and employment story is probably country-specific.

External and internal liberalisation have gone hand in hand

Internal integration in the European Union has progressed in waves and the integrated trading area has expanded from the original six to the current fifteen countries. The single market programme was the latest initiative to remove the remaining obstacles to trade. Overall, access of third countries has improved over a wide range of sectors and products. National quotas have been removed and only a few have been replaced at the Union level, barriers to establishment have been lowered and most services are undergoing major liberalisation. Overall, the parallel, interactive nature of external liberalisation and internal integration has to be emphasised. However, there are still areas, which continue to be strongly sheltered at the national level, largely because policy changes occurred only recently. This is the case, for example, for public procurement and professional services. In other areas, policy changes at the EU level have been timid or non-existent so far. Examples are liberalisation efforts concerning postal services or railways, even though some Member countries have made considerable progress in raising competitive pressures in these sectors. Also the internal market is not entirely in place, with company law being an important area still to be dealt with. Overall, both potential external and internal competitors suffer to the same extent from these shortcomings. There is, however, one exception: the public procurement directives contain a small Union preference.

The number of regional trade agreements has proliferated

Following a period of relative quiescence, the number of regional trade agreements has risen considerably in the past decade (27 countries were covered in 1970, but close to 100 currently), with another 40 countries receiving unilateral concessions under the Generalised System of Preferences (GSP). They provide for different levels of trade liberalisation, from deep integration in Europe over bilateral preferential agreements down to non-reciprocal agreements with many African, Caribbean and Pacific countries. Apart from reaping the gains from freer trade, political concerns have also provided a strong impetus to the proliferation of trade agreements. Indeed, especially in Europe and the surrounding area, trade agreements are part of a broader political agenda, which aims at creating a large, prosperous, stable and democratic area. Co-operation is not limited to trade, but also includes a considerable amount of funds flowing from the European Union to its partner countries.

Trade diversion due to regional trade agreements has probably become minor

Countries outside the EU's regional agreements have often voiced concerns about the possibility that trade diversion could outweigh trade creation – an inherent possible problem in any free-trade area arrangement. While the General Agreement on Tariffs and Trade (GATT) provides guidance – agreements must free "substantially all trade" and external trade barriers ought not be raised – it has always been difficult to reach agreement on the conformity with GATT requirements, or on the compensation for changes in bound tariffs. On the other hand, none of the agreements has been disapproved explicitly. Assessing the economic effects empirically is also a difficult issue, as the counterfactual state of the world without regional agreements is not known. An assessment based on manufacturing sector import penetration ratios suggests that, since 1970, internal import penetration rose about as fast as external import penetration, while the share of domestic production in apparent consumption fell. Double trade creation (internal and external) does not, however, permeate all sectors and regions. Notable exceptions are the food, drink and tobacco industries and non-ferrous metals, while external import penetration rose considerably in the textile, footwear and leather sectors, despite heavy protection. Overall, any bias against extra-EU imports was probably minor. Also, other trade indicators do not suggest that the Union is an outlier (its share of trade in GDP is somewhat higher than that of the United States or Japan, for instance) and it is also difficult to find evidence of diversion of foreign direct investment. This is to be expected, because external protection in the manufacturing industries was already low in the early seventies and the internal market for goods fairly well integrated. Academic work suggests that some trade diversion may have occurred between the creation of the EEC and the late 1960s, a time when the difference between external and internal protection was still considerably higher.

Recent regional trade agreements take other countries' concerns better into account

Except for the well-documented case of the agricultural area, trade diversion should currently be of little concern for the Union's trading partners because a low level of overall protection has been achieved. But there is some risk of trade diversion as a result of the agreements between the European Union and the eastern European and Mediterranean countries. Some of them still have very high levels of protection and rules of origin have intensified potential diversion risks. However, for those countries, which will join the Union, tariffs are set to decline considerably. It should also be recognised in this context that the European Union has made a considerable effort over the years to better reflect concerns of third parties: recent agreements provide for reciprocal industrial free trade over shorter transition periods; agriculture is included, even though the ambition to liberalise remains weak; many agreements also cover services; and the European Union encourages countries both to join the World Trade Organisation and to liberalise trade unilaterally. Finally, rules of origin have changed recently to a European-wide cumulation system, which implies that imported inputs can now be sourced in 28 European countries to produce an originating product.

The future agenda is multilateral and regional, and also focuses on trade-related issues

Given the impetus to form free trade agreements also in America and Asia, the issue of trade creation versus trade diversion is relevant not just with regard to the EU initiatives. More broadly, there is concern that the trading world will fragment into a tripolar constellation. Recent research shows that this could theoretically be a global welfare-minimising solution and that the impetus for the trading blocs to pursue multilateral liberalisation could vanish. While the theoretical arguments are well taken, the medium-term trade agenda of the Union shows that there is currently little risk that it will start looking inwards or pursue aggressive unilateralism. Indeed, the EU's trade policy is now "walking on three legs": it intends to pursue multilateral liberalisation actively; to deepen integration with the eastern European and Mediterranean countries; and to strengthen co-operation on trade-related issues with major trading partners.

Co-operation on trade-related issues with other countries has been stepped up

While the World Trade Organisation received a mandate to work on new trade issues, the European Union is pressing ahead with bilateral agreements, as multilateral progress will probably be slow. The European Union is very well placed to show the way forward, because it itself has had to grapple with cross-border policy spillover issues over the last 40 years in implementing the internal market. In the competition policy field, countries who want to join the Union will have to implement competition laws modelled on EU rules. With other countries, such as the United States, co-operation has advanced, and is largely based on the exchange of information. While many cases have been handled on a mutually satisfactory basis, recent experience shows that not all trade frictions can be avoided. The current agreement with the United States is a timid start as compared with the Commission's broader long-term views on global competition policies as it promotes a multilateral agreement on minimum competition standards, enforcement mechanisms and mutual assistance. The European Union has, for instance, recommended the creation of a framework in which the members of the World Trade Organisation would enforce their own competition rules based on commonly adopted principles. In a similar vein, the European Union is pursuing the elimination of technical barriers to trade, an area in which it has gained considerable experience through the single market. The Union has struck several agreements on conformity assessment, covering key industrial sectors. These agreements allow trading costs to be reduced, but may raise access problems for those outside the agreement. A key issue in this context is confidence in each partner's certification procedures.

The future enlargement implies a considerable reform effort by applicant countries and by the Union itself

The central and eastern European countries (CEECs) regard membership of the European Union as vital and accession negotiations have begun with ten CEECs. Negotiations have also started with Cyprus and Malta, and Turkey has been added to the list of accession candidates. Important groundwork has been laid with the Europe Agreements, with Interim Agreements phasing in bilateral free trade areas for non-agricultural products over a ten-year period and providing also for some liberalisation of agricultural trade. The Agreements contain many additional provisions, which aim at the approximation of economic rules in these countries to those of the European Union. Current levels of protection for industrial goods in some CEECs are considerably above EU levels, while agricultural protection is much lower. Accession of these countries poses a major challenge to the European Union: there are large differences between applicant countries and the European Union; these countries would all be net recipients of EU funds; and the Amsterdam Summit made no progress in reforming the EU's institutions. Commission scenarios suggest that the current budgetary ceiling may not have to be lifted. They are based on the working assumption that new members will start to join in 2002, and contain a reform of the CAP. Moreover, the 2000 intergovernmental conference will again consider the implications of enlargement for the EU's institutions. The European Union has also struck free trade agreements with Mediterranean countries, which provide for free trade in industrial goods, but are less ambitious otherwise than the agreements with the eastern European countries. On the other hand, the Customs Union Agreement between the European Union and Turkey entered into force in 1996 and fairly ambitious free trade agreements with Mexico and South Africa were signed recently.

Trade across the Atlantic could still benefit from deeper integration

The New Transatlantic Agenda includes many initiatives to eliminate trade barriers that hinder trade across the Atlantic. It does accelerate trade liberalisation beyond that which can be achieved at the multilateral level, for instance via a Mutual Recognition Agreement and co-operation in customs and competition matters. However, it does not provide for the creation of a free trade area, even though the Commission recently launched an initiative to broaden the trade agenda significantly.

The European Union is pushing for a rapid preparation of another trade liberalisation round

Concerning the multilateral agenda, the European Union played a major role in the recently negotiated agreements on information technology, basic telecommunications and financial services liberalisation. However, it is not in favour of a sectoral liberalisation approach but prefers a global approach, which should make it easier for all participants in trade negotiations to share in the mutual benefits from comprehensive and broad liberalisation. After the failure to launch a new round of trade liberalisation in Seattle, the European Union is pushing for the rapid preparation of another round. The European Union also supports an early start to negotiations in the WTO on multilateral rules for international investment and competition policy which have become increasingly important in underpinning effective market access in an increasingly integrated world.

Environmental and labour issues have come to the fore

On environmental issues, the European Union had ambitious goals for the work of the WTO's Committee on Trade and Environment, but its wide-ranging agenda ran into considerable opposition by other countries. However, the European Union is still convinced that trade and the environment are central aspects of the wider goal of sustainable development on a global basis. Concerning labour standards, on the other hand, the European Union agrees that comparative advantage, particularly of low-wage countries, should not be put into question, but that core labour standards should be promoted. The European Union actually does this by its GSP grading system. Clearly, connecting trade, environment and labour issues moves the agenda considerably beyond the already complex economics of trade liberalisation.

Overall, the Union's track record is encouraging

Overall, the Union's track record in the international trade and investment area is encouraging, but the Union itself could, for instance, still gain considerably from freeing up trade in agriculture and textiles. Globalisation also implies that cross-jurisdictional spillovers will become more serious. The World Trade Organisation is tackling many trade-related issues for which the Union has found practical solutions and the EU's experience shows that deep integration is possible. However, building a global club, whose governance structure is accepted by all participants, will probably be a long process as economic structures, laws and institutions are diverse and free-riding a temptation. "Walking on more than one leg" might also be fruitful in these areas for finding mutually acceptable solutions and for providing domino effects to free up trade elsewhere.