The Future of World Trade:

EU Priorities for the Global Trading System after the Crisis

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CREDITS

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Executive Summary

The world is recovering from the biggest deglobalisation since the Great Depression. But this is happening in the context of an anaemic West and a faster-rising East. The global economic crisis has accelerated the shift of economic power to emerging markets, particularly in Asia.

Nevertheless, the EU remains the world's leading trading entity, at the heart of globalisation. European producers and consumers have benefited hugely from the long pre-crisis globalisation boom. This did not happen automatically: in the EU, as elsewhere, it was powered by a combination of technological innovation and the liberalisation of internal and external markets. Now the danger is that the EU, consumed with fighting internal problems, will retreat into defensiveness and passivity; it might allow protectionism to creep ahead and fail to lead to keep markets open abroad. That would be disastrous. It would damage the competitiveness of European firms and the welfare of European consumers, it would entrench anaemic economic performance and it would exacerbate intra-EU political and social conflicts. It would take the EU back to the Eurosclerosis of the 1970s. Externally, the EU would be diminished and marginalised, squeezed between the US—still the fulcrum of international relations—and rising emerging powers.

Hence the EU must rise to the post-crisis challenge, not duck it. The domestic house must be put in order. Fiscal and monetary policies need to be cleaned up. At least as important, new structural reforms are needed to defend and advance the single market. The EU also needs to be more proactive in external trade policy, co-leading to contain

emerging protectionism, induce further trade liberalisation worldwide and put the world economy back on the track of 'reglobalisation'.

The single market is the bedrock of EU trade policy. When the single market is healthy and integrating, the EU looks outwards and helps to secure open markets abroad. When the single market is undermined by internal protectionism, the EU becomes more defensive abroad. The first priority must be to defend the single market from 'crisis interventions' that threaten existing gains. The second priority must be to tackle 'unfinished business' on the single market. These two priorities frame our policy objectives for the single market:

- stronger state-aids disciplines;
- avoiding intrusive over-regulation of financial markets;
- containing costly, heavy-handed 'green interventions' (quite different from market-conforming policies to promote energy efficiency and 'green growth');
- energy and services liberalisation;
- further Common Agricultural Policy (CAP) reform;
- transparency mechanisms to scrutinise policies that affect the single market and the EU's international trade.

Turning to external trade policy, we propose the following policy objectives for the EU's multilateral and bilateral agendas. The EU should consider the following on the WTO:

- Lead an initiative to finish the Doha Round as soon as possible, though the result is likely to be modest. The priority must be to despatch the Doha Round so that the WTO can move on to pressing twenty-first century business.

- Undertake a strategic examination of post-Doha priorities. The benchmark should be commercial relevance, with the twin objectives of containing emerging protectionism and providing stronger multilateral rules for twenty-first century trade.
- Place commercial priorities for European producers and consumers at the heart of a post-Doha agenda. The WTO will have to address new issues such as investment, competition and energy, as well as strengthening existing rules on subsidies, public procurement and other issues.
- Emphasise decision-making flexibility. The WTO needs to move to workable plurilateral coalitions—'variable geometry', in other words.

The other plank of external trade policy is the bilateral agenda. Here the EU needs to be more strategic and ambitious, using its existing international bargaining power more forcefully and effectively. It should:

- Avoid a permissive, indiscriminate approach to FTAs: eschew deals with commercially insignificant countries, and less-than-comprehensive deals with commercially significant partners.
- Insist on comprehensive, 'deep-integration' FTAs—going well beyond rather weak WTO benchmarks—that seriously liberalise trade and induce structural reforms in the EU and its partners.
- Focus on top trading partners: examine options for FTAs with the US and Japan, and look to strengthen the bilateral framework for trade cooperation with China.

We conclude on a note of political advocacy. European elites, especially in policy and business, do not talk enough, publicly and explicitly, about the benefits of open markets and the hard policy choices required. This applies to the single market and globalisation generally. That leaves the field open to those who peddle 'globalisation angst' and who provide excuses for protectionism at home and abroad. A few prominent Europeans from past generations have done the opposite, making the public case for open markets at home and abroad. Statesmen such as Ludwig Erhard and business leaders such as Wisse Dekker come to mind. Today, the fortunes of the single market and international trade do not depend merely on technocratic fixes by privileged insiders in Brussels and national capitals; the prevailing climate of ideas and opinions is at least as important. Europe's leaders must make the case for open markets, publicly and explicitly. Europe's future depends on them.

Introduction

World trade is recovering from its steepest fall since the 1930s—part of the biggest 'deglobalisation' the world has seen since the Great Depression. The good news is that rampaging 1930s-style protectionism has not returned; indeed, new crisis-related protectionism has been remarkably restrained. But that leaves a lot of bad news. Nowhere are alarm signals stronger than in Europe.

The global economic crisis has ushered in a dramatically different political and economic context compared with benign pre-crisis conditions. The West's recovery remains anaemic. But non-Western emerging markets are roaring ahead. Europe has had a particularly bad year—though with pockets of faster recovery, notably Germany and Sweden. Symptoms of *malaise* abound: sovereign debt crises, still malfunctioning banking systems, industrial strife, sclerotic labour markets, bloated welfare states, intergovernmental squabbling and weak EU institutions. What a contrast with dynamic, forward-looking, super-confident Asia.

Trade protectionism might be restrained, but it has resurfaced nonetheless, creeping out of the thicket of domestic 'crisis interventions' and the seeming return to 'big government'. Trade liberalisation had already stalled around the world before the crisis; the latter, predictably, increased all-round defensiveness.

Commendably, the EU has not retreated into a protectionist fortress; it remains largely open to external trade and foreign investment. But it lacks a forward agenda for trade liberalisation, both at home and abroad. Political leadership and strategic priorities for world trade have long been absent—not just in the

EU. But this lacuna is most striking in the EU, for it is the world's leading trading and investing entity. The EU is at the epicentre of globalisation, but it does not lead on globalisation—far from it. In the next decade, the real danger is that the EU, blighted by macroeconomic crises, sclerotic economic performance and internal divisions, will withdraw into its shell, allow protectionism against outsiders to creep ahead, and fail to lead to secure open markets abroad. That would be disastrous. The EU's internal economic health—the life-blood of its political and social health—depends more than ever on the health of the global economy.

Hence the EU must raise its game, internally and externally. It must put its fiscal and monetary houses in order, and revive structural reforms to defend and advance the single market. But it also needs a much more active trade policy as part of an overall growth strategy. The EU must co-lead to contain emerging protectionism and revive trade liberalisation around the world. These two legs of an EU growth strategy—single market reforms and external liberalisation—are joined at the hip and must move in lockstep. It is inconceivable that one is possible without the other. This is our central message.

Part One of our paper sets the context and outlook for world trade. It begins with the huge benefits the EU has gained from open markets in the long pre-crisis globalisation boom. It goes on to examine the effects of the crisis and the medium-term outlook (2010–15), first for the world trading system, then for the EU specifically. Part Two focuses on policy recommendations. It begins with EU priorities for the single market—the foundation of sensible trade policy. Then it proceeds to the two external tracks of trade policy: the WTO and bilateral relations, including free trade agreements. We round up with a call for more transparency, advocacy and up-front political leadership for an outward-looking, liberal trade policy in the EU.

Part One: Context and Outlook

1. World Trade Before the Crisis: the Benefits of Open Markets for the EU and the World

The pre-crisis global economy enjoyed golden conditions. The quarter-century up to the crisis saw the fastest increase in economic growth, globalisation and prosperity in history. International trade increased sevenfold between 1980 and 2008, outpacing the increase in world GDP in the same period. World foreign direct investment (FDI) increased thirtyfold.

The global economy had its 'Goldilocks' moment in the half-decade from 2002. Growth, trade and FDI soared to ever-greater heights. Financial globalisation soared even higher. Comparative advantage worked in textbook fashion. Labour-abundant Asia rose, powered by the opening and global integration of China and, to a lesser extent, India. China became deeply enmeshed in East-Asian manufacturing supply chains, serving as the final-assembly hub for exports of finished goods to the West. Resource-abundant Latin America, Africa and the Middle East did well in a China-led commodity super-cycle. And the capital- and technology-abundant West also prospered.

Today's global production is a combination of horizontal and vertical integration. *Horizontal integration* expands the geographical scope of markets; it brings international

commerce to new countries and regions. *Vertical integration* fragments supply chains and creates new international production networks. Different parts of the value chain are 'outsourced' or 'offshored' to many production sites in many countries, all brought together through trade in parts and components, and advanced logistics. Vertically integrated production and associated trade have exploded in the past two decades, especially in information-and-communications-technology (ICT) products. This has knitted countries and markets together—and spurred competition—as never before. It has brought globalisation deep into domestic economies and domestic policies, blurring the separation between 'external' and 'internal' commerce and public policy.

Modern globalisation has two engines: technology and policy liberalisation. Technological innovation has slashed the transaction costs of trade by shrinking physical distance; the information technology (IT) revolution—a combination of the Internet and mobile phones—has obliterated it altogether. Advanced IT has created new global manufacturing supply chains as well as new, highly tradable services sectors. Dramatically lower transport and communications costs have allowed multinational firms to arbitrage unit production costs between several locations, and thereby improve the supply, quality and flexibility of production and distribution.

But technological innovation has not occurred in a vacuum; it has been enabled by internal and external policy liberalisation. *Internal liberalisation* has reduced or eliminated regulations in product, capital and labour markets, thereby liberating the 'animal spirits' of competition and entrepreneurship. This was the essence of the Reagan, Thatcher and European single market revolutions in the 1980s and early 1990s. *External liberalisation* has lowered

barriers to cross-border trade and investment. Developing countries liberalised massively and integrated into the global economy in the 1980s and 1990s, with ex-Soviet economies following from the early 1990s. According to Jeffrey Sachs and Andrew Warner, around a quarter of the world's population lived in open economies in 1980.[1] Today, adding China and India, that figure is closer to 90%.

Finally, there was a favourable geopolitical environment. America became the sole superpower in the 1990s, replacing Cold War bipolarity. And global economic institutions, especially the IMF, World Bank and WTO, were at the height of their powers.

Europe is at the heart of modern globalisation and has benefited hugely from it. European businesses have become globally oriented and competitive by taking advantage of policy liberalisation and technological innovation. This has not only created new markets, customers and suppliers; it has also been a boon to European consumers. By offshoring lower-value activities to cheaper locations, European firms have been able to focus on higher-value activities, with better-paid, higher-skilled jobs, in Europe itself. And they have driven down (or limited the increase of) prices for an ever-wider range of consumer products. This is especially true for manufactured goods, where markets have been opened up most. But it applies much less to agriculture and services, still hobbled by government restrictions in Europe and elsewhere.

European real incomes have risen significantly as a result: without cross-border trade, investment and specialisation, productivity and living standards would not have risen as much as they have done, and European growth would have lagged even further behind other regions.

These trends are reflected in the results of a recent Eurobarometer survey on international trade. A large majority of Europeans (60% of respondents) say they buy goods and services made outside the EU in a regular week. Forty-four per cent of respondents say they personally benefit from international trade. Sixty-five per cent believe that the EU as a whole benefits from international trade. Cheaper products and wider choice are recognised as international trade's major benefits.[2]

But this leaves a European paradox. Globalisation has delivered unambiguous benefits for European producers and consumers. It has given Europeans unprecedented opportunities and life choices. Yet Europe is the cradle of 'globalisation angst'. In the *Eurobarometer* poll mentioned above, 39% of respondents say they do not personally benefit from international trade. All sorts of social ills, including unemployment, are blamed on globalisation. And negative views of globalisation seem to be concentrated in France and the southern European countries—much less so in northern Europe, with eastern Europe in between.[3]

It is true that globalisation has made life more difficult for unskilled workers in the West as developing countries have exploited their advantage in low labour costs. But other factors—notably technological change—have had the same effect; and globalisation, along with other forces of material progress, has created new skilled and better-paid jobs in abundance. The fact that the EU's Globalisation Fund has hardly been used shows that globalisation has not been responsible for mass redundancies. Contrary to folk myth, globalisation does not 'steal jobs'.

Still, folk myths abound, as do quack remedies. There is the widespread belief that firms, workers and consumers need ‘protection’ from global competition. That ignores historical facts and modern reality, not least a twenty-first century world of fragmented trade and global supply chains. For most goods and services produced and consumed in Europe today, ‘nationality’ is almost irrelevant. Firms’ supply chains have become so sophisticated that they involve many far-flung countries and several hundred suppliers (Box 1).

The lesson from this modern globalisation story should be crystal clear: maintaining or increasing trade barriers would damage the competitiveness of European firms and the welfare of European consumers.

Box 1: Fragmented Trade and Global Supply Chains

To take the most familiar example: An iPod is 'made in China' inasmuch as its final assembly takes place in China, whence it is exported around the world. But the 451 components that go into making the iPod are imported from many countries. Only a small fraction of the consumer price of the iPod can be attributed to Chinese value-added.

Even in the late 1980s, a telephone in Europe was made from start to finish in one factory. A modern mobile phone, in contrast, emerges from a highly fragmented supply chain. Nokia is estimated to handle more than 100 billion components every year. In 2006, its plants produced about 900,000 mobile phones and handled about 275 million components every day. A low estimate is that half the components used to make a mobile phone have crossed a national border.

Or take an example outside ICT. The Swedish chainsaw producer Husqvarna sources its components from 250 suppliers in 30 countries. One hundred and fifty different components go into making one chainsaw. It is estimated that, in aggregate, these components cross borders 80 times before final assembly.

And take Nike, the world's most celebrated shoe brand. Nike owes much of its success to advanced use of global supply chains. It has outsourced all its shoe production to hundreds of suppliers around the world. This has enabled it to focus on high-value activities—developing performance technology and materials, product design and marketing. All leading European shoe producers have gone down the same track. By outsourcing low-cost production and climbing the

value chain in Europe, they have increased aggregate value-added in Europe. When the EU slaps anti-dumping duties on imported shoes from China and Vietnam, made for European brands, it protects a small knot of uncompetitive firms in Europe. But it strikes three blows: one hurts foreign suppliers and their workforces; another hurts European consumers through higher prices; and the third—more injurious than the other two—hurts high value-adding production by European producers in Europe.

Source: 'A modern trade policy for the European Union: A report to the new European Commission and Parliament from the EU Trade Policy Study Group', European Centre for International Political Economy, Brussels, January 2010, 6–8; available at http://www.ecipe.org/tpsg/A%20Modern%20Trade%20Policy%20for%20The%20European%20Union.pdf.

2. The Crisis and Beyond: World Trade Outlook 2010-15

2.1 The Crisis, Deglobalisation, Recovery and the Shift to the East

The world suffered a sharp contraction in growth in 2008/9. This was reinforced by an even sharper 'deglobalisation': world trade contracted by over 10% in 2009, mirroring a collapse in global industrial production, and global FDI contracted by about one-third. Contractions in growth, industrial production and trade bottomed out in mid-2009, followed by recovery. But the latter remains anaemic in the West, though with a few notable exceptions such as Germany, Sweden and Canada.

The picture looks very different in emerging markets, particularly in Asia. Unlike the West, Asia did not suffer a financial crisis; its banks and balance sheets (household, corporate, government and external) were reasonably solid. Rather it suffered a trade or deglobalisation crisis as the financial crisis, originating in the West, spread to the rest of the global economy. But Asia rebounded quickly, much more so than the West. China led the Asian bounce-back, helping to lift other East Asian countries out of the crisis, and India recovered fast as well. China and India are expected to grow at more than 10% and just under 10% respectively, and developing Asia at over 9%, in 2010. Advanced economies are projected to grow at only 2.7%.

Trade volumes for emerging and developing economies suffered a smaller contraction than for advanced economies in 2009, and are enjoying a faster recovery; they are expected to increase by over 13% in 2010, compared with an estimated 10–11% increase for advanced economies (Table 1). Foreign direct investment contracted sharply in 2009, with a modest recovery in 2010. FDI inflows to developing countries decreased by 24% in 2009, compared with a 44% cent decrease in developed countries (Figure 1). FDI flows to China and India remained buoyant in 2009, generally with a small decline on record inflows in 2008, though other emerging markets saw bigger contractions. Also, FDI inflows and outflows for emerging markets look set to increase in 2010.

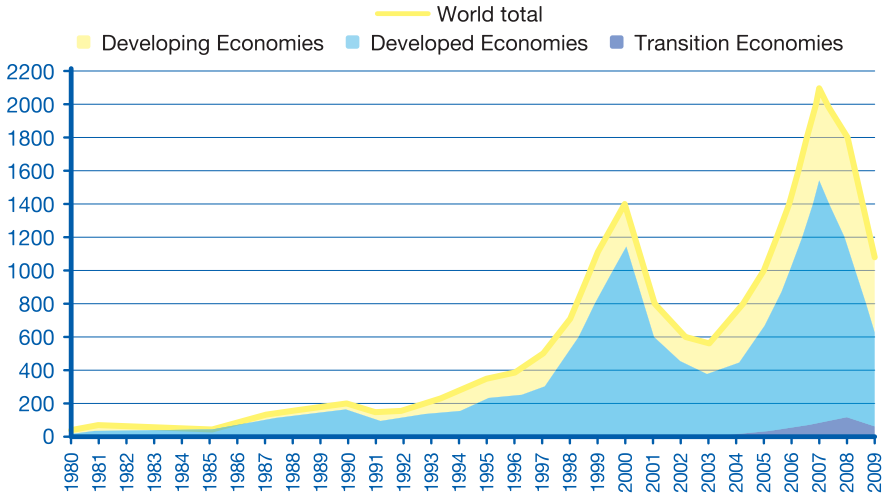
Thus the crisis seems to have accelerated the shift of economic gravity to the East. It has given rise to sunny Asian optimism, which contrasts sharply with Western gloom.

Table 1: Growth in World Trade Volume of Goods and Services

	2008		2009		2010		2011	
	Import	Export	Import	Export	Import	Export	Import	Export
Advanced Economies	0.4	1.9	-12.7	-12.4	10.1	11.0	5.2	6.0
Emerging/ Developing Economies	9.0	4.6	-8.2	-7.8	14.3	11.9	9.9	9.1

Source: IMF World Economic Outlook, october 2010.

Figure 1: FDI Inflows, Global and by Groups of Economies, 1980–2009 (USD BN)



Source: UNCTAD World Investment Report 2010

2.2 The Economic and Trade Policy Outlook

The crisis has triggered a big shift in ideas and policies against free markets and in favour of government interventionism. Pro-market reforms had slowed down around the world before the crisis broke, and there was rising scepticism of the liberalisation and globalisation policies associated with the Washington Consensus. But the crisis marked the close of a 30-year chapter of freer markets and more limits on government intervention. A new chapter of bigger government has opened. The election of President Barack Obama and the Democrats' clean sweep in the US congressional elections in 2008 accelerated the shift to big government.

So far, government interventions have been more evident in domestic economic policy than in trade policy. Domestic 'crisis interventions' are bunched in two key areas: huge bailouts and associated subsidies, especially but not confined to financial services; and fiscal stimulus packages, usually combined with loose and unorthodox monetary policies. The former is concentrated in the West; the latter spread across the OECD and developing countries.

It is estimated that total economic stimulus and financial-sector support amounts to about USD 12 trillion in the United States and USD 18 trillion in the EU. Financial bailouts in high-income countries cost 28% of GDP in 2008—and close to 75% in the United Kingdom—akin to public financing of a large-scale war. In China, government stimulus (direct spending plus state-directed bank lending) was equivalent to about 45% of GDP in 2009. However, given solid public finances, this takes the fiscal deficit to a modest 3% of GDP, and public debt to about 20% of GDP. Most high income countries are not as fortunate. In the OECD, the average fiscal deficit is estimated to have risen to 9% of GDP in 2009 (even higher in the United States and the UK). US and EU public debt is projected to rise to about 70% and 120% of GDP respectively over the next decade.[4]

In the West, oceans of public debt portend higher taxes and real interest rates, in addition to inflationary threats (given governments' temptation to inflate their way out of debt repayments). Inflation has not yet broken loose, but it is still a spectre on the horizon. The *microeconomics* and *politics* of financial bailouts and profligate macroeconomic policies are equally vexing. Intrusive financial regulation and bigger public expenditure portend arbitrary interventions by politicians and bureaucrats, wasteful pork barrel spending, indiscriminate subsidies, long-term entitlements and rent seeking. This will

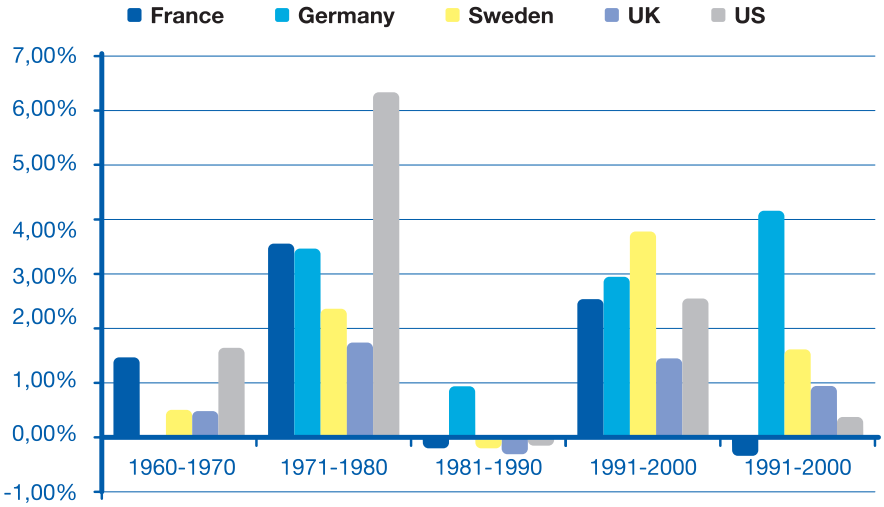
stifle private sector incentives to save, invest and innovate. It will restrict competition and raise costs for businesses and consumers. The EU hopes that global coordination through the G20—on an 'exit strategy' from macroeconomic stimulus and harmonised rules on financial regulation—will contain macro and microeconomic threats. Whether such coordination will occur and be effective is another matter.

These, then, could be the medium-term consequences of short-term crisis interventions and the return to big government. And they could spill over into trade protectionism. How real is this prospect? Here historical parallels are in order. It is fashionable to make comparisons between the recent crisis and that of the 1930s. But it is highly misleading on trade. In the 1930s, tit-for-tat trade protection rapidly followed the Wall Street Crash, and the world splintered into warring trade blocs. That has *not* happened today, and it is unlikely to happen any time soon.

Rather the appropriate comparison is with the 1970s. Then, a series of shocks (notably the collapse of the Bretton Woods system and oil price hikes) ended a long boom and triggered more government intervention. New labour-market and capital-market regulations were introduced. Subsidies were sprayed at vulnerable sectors. There were fiscal stimulus packages. Governments slapped on price and wage controls to combat inflation. These measures exacerbated initial crises and prolonged stagnation. They also spawned protectionism. Industry after industry, coddled by government support at home, demanded protection from foreign competition. The result was the 'new protectionism' and 'managed trade' of the 1970s and 1980s. Trade-restricting measures—Voluntary Export Restraints (VERs), Orderly Market Arrangements (OMAs) and other mostly non-tariff barriers—had a

contracting effect on global trade in the 1980s. The trade-to-GDP ratio shrank in major Western economies and contributed to overall slow GDP growth (Figure 2). It was the 'lost decade' for trade in much of the West.

Figure 2: Annual Average Growth of Trade as Part of GDP



Source: World Trade Organisation, International Trade Statistics, database

New protectionism was *creeping* protectionism. Unlike 1930s' protectionism, it was not an upfront declaration of a trade war with tariff hikes, blanket quotas and draconian foreign exchange controls. Rather it was more subtle, deploying non-tariff regulatory barriers such as subsidies, public procurement restrictions, VERs, OMAs and onerous standards requirements. It did not spiral out of control; rather it unfolded slowly and insidiously, and lasted more than a decade and a half. It created overcapacity in several industrial sectors (cars, steel and airlines, for example), and delayed global recovery and globalisation. That, not a melodramatic 1930s scenario, is the danger facing us today.

2.3 Emerging Protectionism

The good news is that the world has not hurtled into tit-for-tat protectionism. That is a big and very welcome surprise, given the scale of growth contraction and deglobalisation in 2008/9. New protectionist measures have appeared—what the WTO refers to as 'policy slippage'—but they are remarkably mild. They affect just over 1% of world trade in goods (1.2% of world imports at the latest count), and protectionism in trade in services has not increased noticeably. One caveat: The WTO focuses on established and commonly understood trade instruments covered by WTO disciplines, especially import and export tariffs, quotas and licences, and trade remedies. It notes a range of non-border measures such as government-procurement restrictions, technical standards and potentially trade-distorting subsidies. But it does not take a stand on financial bailouts, saying that their discriminatory impact on international trade is still unclear.[5]

Global Trade Alert (GTA) paints a more alarming picture. It counts nearly 650 trade-discriminatory measures from November 2008 to June 2010. G20 governments are responsible for just over 60% of these measures. GTA estimates that 22 far-reaching protectionist measures alone affected over 10% of world imports in 2008. Unlike the WTO, GTA includes financial bailouts. By November 2009, it estimated that one-third of new protectionist measures were bailouts to financial service, automobile and other sectors. Trade remedies accounted for one-fifth and tariffs 14% of new protectionist measures. China remains the biggest target, followed by the EU 27 and the United States (Table 2). Russia is probably the worst single offender, with a significant increase in protection since the crisis started. The EU 27, though, tops the list in terms of the number of new protectionist measures imposed (Table 3).[6]

Table 2: Countries Targeted by Crisis-Era Trade-Restrictive Measures

Target	Number of discriminatory measures imposed on target		Number of pending measures which, if implemented, would harm target too	
	November 2010	Increase since June 2010	November 2010	Increase since June 2010
China	337	55	129	4
EU27	322	56	88	8
USA	260	47	51	5
Germany	240	36	63	7
France	221	33	50	4
UK	214	33	48	4
Italy	211	36	53	3
Japan	192	24	50	4
Netherlands	191	21	45	3
Belgium	189	19	46	3

Source: Global Trade Alert (2010): The 8th GTA Trade Report, CEPR, London, http://www.globaltradealert.org/sites/default/files/GTA8_0.pdf

Table 3: Crisis-Era Trade-Restrictive Measures by Country

Rank	Ranked by number of measures	Ranked by the number of tariff lines affected by measures	Ranked by the number of sectors affected by measures	Ranked by the number of trading partners affected by measures
1	EU27 (166)	Viet Nam (926)	Algeria (67)	Argentina (174)
2	Russia (85)	Venezuela (785)	EU27 (57)	EU27 (168)
3	Argentina (52)	Kazakhstan (723)	Nigeria (45)	China (160)
4	India (47)	Nigeria (599)	Venezuela (38)	Indonesia (151)
5	Germany (35)	Algeria (476)	Viet Nam (38)	Algeria (476)
6	Brazil (32)	EU27 (467)	Germany (36)	India (145)
7	UK (31)	Russia (426)	Kazakhstan (36)	Russia (143)
8	Spain (25)	Argentina (396)	Russia (36)	Finland (132)
9	Indonesia (24)	India (365)	India (32)	Germany (132)
10	Italy (24)	Indonesia (347)	Ethiopia (32)	South Africa(132)

Source: Global Trade Alert (2010): The 8th GTA Trade Report, CEPR, London, http://www.globaltradealert.org/sites/default/files/GTA8_0.pdf

Summing up, the good news on remarkably mild 'traditional' protectionism (mainly border barriers) is balanced by worrying signs of non-traditional, non-border protectionism.

'Financial mercantilism' is at the top of the latter list. One aspect of it is home government pressure, whether formal or through nods and winks, on bailed-out and other banks to 'lend local', i.e. to lend at home at the expense of foreign lending (e.g. through foreign subsidiaries). There is also pressure from home governments and regulators to concentrate more financial trading activities at home, with accompanying restrictions on cross-border trade. Finally, regulatory proposals in the United States, EU and elsewhere may end up with a *cordon sanitaire* around mammoth banks deemed 'too big to fail', with alarming implications for global competition as well as moral hazard.

Financial mercantilism is clearly a work in progress; it is too early to judge its protectionist impact. But it has potential to escalate and cause great harm. It threatens to renationalise and fragment global finance, which would damage market globalisation generally, and with it the welfare of rich and poor countries.

There are several other non-traditional protectionist instruments deployed in the wake of the crisis. Discriminatory industrial subsidies have gone overwhelmingly to the automobile industry in the US and EU. In China, they have been sprayed more liberally at state-owned enterprises (SOEs) in several capital-intensive sectors. The US and China have imposed public procurement or 'buy national' restrictions as part of their fiscal-stimulus packages. There are more restrictions on migrant labour in both developed and developing countries. Restrictions on FDI—'investment nationalism'—have not generally increased. But 'standards protectionism' has been on the rise. Anecdotal reporting points to more restrictive application of technical and food safety standards on imports since the crisis started.

The climate change agenda could be the Trojan horse of new standards protectionism. The EU emissions trading scheme and other measures, in the EU, US and elsewhere in the developed world, will impose substantial compliance costs on energy-intensive sectors at home. This generates pressure to impose similar costs on cheaper, carbon-intensive production elsewhere not subject to carbon-reduction policies. Hence the spectre of trade sanctions on 'free riders'—China in particular. Retaliatory threats revolve around 'border tax adjustments', i.e. tariffs on carbon-intensive imports. But climate change protectionism could include 'green subsidies' that discriminate in favour of domestic renewable energy providers, and all sorts of discriminatory standards.

The credit for restraining traditional protectionism must go in the first instance to *markets* and *globalisation*. Global market integration has imposed *spontaneous* disciplines on governments and businesses. They realise that upfront protectionism raises business costs, invites retaliation, excludes them from the benefits of globalisation, and damages wealth and welfare at home. That applies particularly to global supply chains. Take manufacturing supply chains with production centred in East Asia. They suffered disproportionately from trade contraction in the first six months of the crisis. But protectionism did not increase in these sectors. And supply chains remained intact, ready for the upturn that followed.

WTO disciplines, especially on tariffs, have reinforced spontaneous market disciplines. But it is doubtful that assorted summitry in the G20 and elsewhere has helped much: G20 pledges not to increase protectionism have been violated 'every other day' by its members.[7] More worrisome is the non-traditional regulatory protectionism in the pipeline, especially

on subsidies and standards, on which WTO disciplines are weak to non-existent. These measures are not covered by the Doha agenda. They are more opaque than border-based protection. Governments and organised interests may well resort to them more frequently, not least to evade existing WTO disciplines. The danger is that, if not contained, they will spread gradually to cover bigger swathes of international trade. That is the 1970s scenario we worry about.

2.4 Global Economic Scenarios, 2010-15

Overall, we think there are three basic scenarios for the global economy in the next half-decade: *reglobalisation, deglobalisation and anaemic recovery* (Box 2).

Reglobalisation, akin to conditions in the 1990s up to 2007, sees a return to global growth above the long-term trend. Growth relies less on credit and consumption expansion in the United States. Globalisation is a key engine of growth. Trade and FDI return to pre-crisis growth patterns. Globalisation expands horizontally (geographically) and vertically (through product supply chains). All countries except some LDCs integrate more deeply into the global economy. Emerging markets gain most; the shift to the East accelerates. But OECD countries also prosper.

This scenario presupposes a new wave of internal and external policy liberalisation, and technological innovation.

The Doha Round is concluded quickly, and the WTO moves on to an ambitious post-Doha agenda of liberalisation and rule-strengthening. FTAs are simplified and consolidated to make them more compatible with multilateralism. Above all, there is renewed unilateral liberalisation (outside trade negotiations) and domestic structural reforms. The OECD embarks on pro-market structural reforms, especially in services. And emerging markets, led by China, launch new trade and FDI liberalisation, as well as 'second-generation', behind-the-border structural reforms.

At the other end of the spectrum, *deglobalisation*, akin to conditions in the 1930s, sees continued global economic stagnation in a noxious climate of internal and external policy *deliberalisation*. Economic contraction is cyclical, driven by falling demand, but also structural, driven by escalating protectionism and deteriorating international trade and investment. Massive, across-the-board government interventions in capital, labour and product markets restrict competition overall. Global supply chains unravel. Global finance fragments along national lines. Domestic and international political tensions and conflict escalate.

In this nightmare scenario, the WTO stalls on all fronts and is marginalised. The Doha Round lies dead and buried, and there is no progress on a post-Doha agenda. FTAs proliferate, and become more inward-looking and trade-restrictive. Conflicts between FTA hubs escalate. Last, unilateral measures start out as creeping protectionism but degenerate into full-blown protectionism. This involves a combination of traditional border barriers and new non-tariff and regulatory barriers.

Our in-between scenario, *Anaemic Recovery*, is akin to conditions in the 1970s and early 1980s. It sees neither a

return to pre-crisis growth nor continued contraction; rather continued turbulence over the next decade. This is reinforced by domestic interventions creeping over the border into protectionism. Industrial-policy and trade-union activism return to the OECD; and industrial-policy activism increases in the BRICs. Trade and FDI are volatile and do not return to pre-crisis growth levels. Global supply chains remain intact but are under stress and do not expand the way they did before the crisis. Global finance frays as a result of national reregulation of financial markets and the imposition of selective capital controls. Emerging markets perform less badly than the West; the gap between the West and the East widens.

In this scenario, the WTO continues to drift as it did in the previous decade. The Doha Round might be concluded but lacks credibility. No progress is made on a post-Doha agenda. FTAs proliferate, with a mix of market-opening and market-restricting tendencies, but with the net effect of putting greater stress on multilateralism. Last, unilateral measures lean more in the direction of domestic distortions and creeping protectionism than liberalisation and pro-market structural reforms. Governments intervene more in domestic labour, product and capital markets. Much of this spills over into creeping protectionism, based more on non-tariff and regulatory barriers than traditional border barriers.

Frankly, in 2010, we think this third scenario, with its precedent in the conditions of the 1970s and early 1980s, more plausible than the other two. But that does not make it acceptable, least of all for the EU, which would be among the biggest losers. The EU's challenge is to make policy choices that move it away from *anaemic recovery*—and certainly as far as possible from *deglobalisation*—and towards *reglobalisation*.

Box 2: Scenarios for the Global Economy 2010–15

	Reglobalisation	Deglobalisation	Anaemic Recovery
World Order and Policy Climate	Multilateralism (strong WTO); open regionalism; unilateral liberalisation and structural reforms	Power fragmentation; nationalism; closed regionalism; strong deliberalisation	Weak multilateralism; more domestic more bilateralism /regionalism; market distortions; creeping protectionism
Ideological Paradigms	Free market economics; renewed compact for free trade	Dirigiste economics; economic nationalism	Keynesianism and the mixed economy; 'managed trade'
Features of Globalisation/ Deglobalisation	Higher-value specialisation in OECD; commodity boom; rapid industrial expansion in Asia; cross-border fragmentation of services; migration	Global economic disintegration; regionalisation and relocalisation	Asian industrialisation; volatile
Sources of Globalisation/ Deglobalisation	Horizontal integration; vertical integration; FDI	Demand contraction; supply-side restrictions; escalating protectionism	Business cycle volatility; extra horizontal integration;
Horizontal Integration	Strong	Negative	Weak
Vertical Integration	Strong	Negative	Weak

3. Beyond the Crisis: EU Trade Outlook 2010-15

The EU has behaved better than most in terms of headline protectionist measures. It has not increased tariffs, nor, unlike the Americans and Chinese, resorted to discriminatory public procurement measures. And there has been no significant increase in anti-dumping actions and other 'trade remedies'.

But worrying signs persist. They concern crisis-related regulatory measures that could easily spill over into protectionism. The relaxation of EU state-aid rules during the crisis opened the door to discriminatory subsidisation, especially to the financial sector. The EU already has the most stringent food safety and technical standards in the world. These could become more restrictive, especially on environmental and climate change regulations. 'Green protectionism' is more of a threat in the EU than anywhere else in the world. One or two Member States have already called for 'border tax adjustments' (i.e. tariffs) on imports from countries that do not put in place sufficiently high carbon emission standards; and 'green subsidies' and 'green standards' already discriminate in favour of domestic renewable energy providers. For example, the EU has a technical regulation in its Renewable Energy Directive that insists on a 35% saving on greenhouse gas emissions from biofuels entering the EU market. Effectively, that discriminates in favour of EU producers of rapeseed oil at the expense of cheaper East-Asian competition.[8]

EU defensiveness is the main danger. Generally, when the single market is opening up and integrating, EU trade policy

is more outward-looking and proactive. That was the case in the 1990s. When the single market is under stress from internal protectionism, EU trade policy turns to navel gazing and gives way to protectionism against outsiders. That happened in the 1970s and 1980s. And that is what we risk repeating today.

Perhaps the biggest casualty of the crisis was the abandonment of the Lisbon Agenda of market reforms to boost EU competitiveness. Now the EU has a '2020 strategy'. It is working on a new Internal Market strategy and will announce a review of external trade policy. But in our view, EU 2020 is not ambitious enough, vague in parts and with hints of soft industrial-policy activism (e.g. centralised targets for R&D spending). There should be more hard market liberalisation and concrete structural reforms. Externally, trade policy is defensive. Trade negotiations are not advancing or stuck. That is the case with the WTO's Doha Round, Economic Partnership Agreements with African, Caribbean and Pacific countries, and bilateral negotiations with several countries in Asia, the Middle East and Latin America. Trade relations with China are also adrift and replete with tensions. The exceptions to this rule are the recently ratified FTA with South Korea, and ongoing negotiations with Canada, Singapore and India. However, the lengthy debate on the duty-drawback clause in the EU–Korea FTA shows that EU negotiators have to take into account the interests of all important sectors at the very beginning, and cannot rely solely on Member States' readiness to accept roughly balanced packages.

Will the Lisbon Treaty make a difference to EU trade policy outcomes? It is of course far too early to say. The EU now has unified trade policy competence on services, investment

and intellectual property rights. That should give the EU more bargaining power with third countries. But, with 'co-decision', the European Parliament now has more power in EU trade policy. We hope that this will not allow single-issue and market-sceptical lobbies to tilt policy outcomes in a more protectionist direction.

Finally, how does the EU fit into the three global economy scenarios we described earlier? If the EU gets stuck in defensive mode on both the single market and trade policy, it will also be stuck in *anaemic recovery*, with a slight risk of falling into *deglobalisation*. But if it wants to shift to *reglobalisation*, it will need to be proactive on two fronts: new structural reforms to liberalise the single market; and a more vigorous, open market trade policy. The two are linked; they are two sides of the same pro-growth coin. To these policy priorities we now turn.

Part Two: Policy Recommendations

1. Putting the Domestic House in Order: Defending and Advancing the Single Market

Mercantilist myths pervade trade policy. One is that trade policy is all about exports, not imports; another is that it is all about trade negotiations, the arena for haggling over export concessions. Export market access is important. So are trade negotiations. But they are not the be-all and end-all of international trade. Opening one's market to *imports* is at least as important as exporting; import liberalisation boosts competition, increases efficiency *and* drives export competitiveness. Moreover, import liberalisation does not have to be haggled over exclusively in trade negotiations; at least some of it can be done unilaterally (or autonomously). This is what Britain did in the second half of the nineteenth century. Ludwig Erhard, the architect of the German *Wirtschaftswunder*, did the same after 1948. The bulk of trade liberalisation in developing countries and ex-command economies has been done unilaterally. This is also true of China's and India's massive, historic opening to the world economy.

The EU is, in one sense, different. The single market is a product of *negotiated* liberalisation. But the further, *non-negotiated* opening of Europe to the outside world is a major indirect effect of the single market. This is *de facto* unilateral liberalisation, in addition to what the EU has procured or

conceded in trade negotiations. It has boosted competition in Europe and the export competitiveness of European firms. It is very much part of Europe's modern globalisation, as we described earlier.

Ultimately, a combination of negotiated and non-negotiated liberalisation has been mutually reinforcing and served Europe very well. Global integration has strengthened the single market; and a wider and deeper single market has strengthened the EU's bargaining power in trade negotiations, putting it in a better position to open other markets to European exports and investment. This is why we place so much importance on a flourishing single market, open to the world, as the foundation of EU trade policy.

As the Monti Report highlights, the single market is under stress. Political and social support for it is not as strong as it should be. There is 'integration fatigue' and 'market fatigue'. Complacency set in while the EU concerned itself with other business (monetary union, enlargement and institutional reforms). The crisis made matters worse.[9] Divisions within the EU sharpened as national crisis responses trumped coordinated EU responses. Bigger national government interventions threatened to spill over into intra-EU protectionism, especially with the relaxation of state-aids disciplines. And the lack of a credible structural reform agenda is perhaps the biggest casualty of the crisis.

It is testament to the strength of European integration that the single market has not unravelled under these pressures; it remains intact. But it is still under great stress. That will remain the case as long as EU members are burdened with parlous public finances, sovereign-debt crisis, euro instability and the lack of pro-market, pro-growth reforms. It will be

worse if the EU succumbs to another bout of Eurosclerosis, not to mention global marginalisation, squeezed between the USA and rising emerging powers. Finally, there is much 'unfinished business': the single market remains far from complete.

Allowing the single market to deteriorate will not only damage internal economic performance directly; it will also make the EU more defensive in its external trade relations and succumb to the 'creeping protectionism' we described earlier. Hence it is categorically imperative to *defend* the single market from pressures to reverse existing gains, and *advance* it in the direction of further liberalisation governed by common rules. That will directly benefit the EU internally; but it will also be the bedrock of a more effective trade policy. Internal market regulatory reforms on subsidies, services, energy and intellectual property rights (to name an abbreviated wish list) will strengthen the EU's capacity and bargaining power to negotiate on the same issues in bilateral and multilateral forums. Put another way, an unreformed, weaker single market will undermine the EU's bargaining power abroad. Structural reforms for a stronger, more competitive single market will enable the EU to be more *strategic* and *offensive* in external negotiations; it will strengthen EU trade policy.

1.1 What should be the EU's Priorities for the Single Market?

First comes defence. 'Crisis subsidies' should be dismantled as soon as possible; and there should be stronger disciplines on state aids in the future. Also, the backlash against global finance may result in over-intrusive, discriminatory financial market regulation at national and Brussels levels. The temptation is to micro-regulate—which must be resisted. The fragmentation of European and global finance would damage wider European competitiveness and welfare. The EU needs integrated and globally competitive financial markets for the benefit of the wider European economy, not just to serve the narrow interests of the City of London. And on no account should efficient financial markets be sacrificed to appease leftist anti-capitalist forces in Europe.

Next comes advance—the single market's 'unfinished business'. Here we echo many recommendations in the Monti Report. The EU needs to liberalise its markets in services and energy to reinforce its single market in goods. The Services Directive should be implemented fully. National barriers in financial services (e.g. retail banking), telecommunications services and health care provision should be reduced and eliminated. The EU should move towards a 'digital single market' by eliminating barriers to online commerce. On energy, the EU needs more investment in cross-border grids and transmission capacity; and it needs to be less exposed to erratic Russian gas supplies and predatory pipeline politics. That demands liberalisation of highly fragmented markets in gas and electricity.

There are other single market priorities. The EU patent system needs strengthening, for patents are central to the competitiveness of core sectors such as automobiles, pharmaceuticals, chemicals, telecommunications and green technologies. There is the hard nut of the Common Agricultural Policy. It remains costly, accounting for about 40% of the EU budget. And it weakens the EU in trade negotiations: EU agricultural protectionism is the main excuse for others not to open their markets to European industrial and services exports. Hence the CAP needs serious reform, starting with the next budget framework from 2013.

Finally, *transparency* and the single market are of a piece. The EU should establish an independent mechanism to monitor and assess the costs and benefits of national and EU measures that affect the single market and the EU's international trade. Such a 'transparency board' should begin with 'crisis interventions' and proceed to 'unfinished business'.

2. External Trade Policy and the WTO: the Doha Round and the Post-Doha Agenda

After almost a decade of running around in circles, the Doha Round remains stuck. As a result, the WTO suffers from a slow-burning credibility crisis. Much has changed in the transition from the GATT to the WTO; but the bald reality is that WTO members have been woefully inadequate in adapting to new twenty-first century realities.

The old GATT delivered results with a relatively slim agenda, club-like decision-making dominated by a handful of developed countries (especially the US and EU), and the glue of Cold War alliance politics. The WTO goes wider (with broader sectoral coverage) and deeper (into domestic regulation), with what has proved a large and unwieldy agenda. The GATT's 'reciprocity model' seemed to work with the exchange of concessions on relatively simple tariffs and other border barriers. It has been painfully difficult to make it work on the plethora of much more complex regulatory issues on the WTO's agenda. The large increase in membership, with the attendant desire to widen the decision-making circle, strains the workability of the system. Decision-making is less technocratic and more politicised; the WTO is in the media spotlight and subject to public pressure from governments, NGOs and other quarters. Decision-making stalemate, North vs. South polemics and other forms of political posturing make the WTO look more like dysfunctional UN organisations. The USA and EU no longer predominate; emerging markets—China, India, Brazil and others besides—have come to the fore. And last, the unifying glue of the Cold War has dissolved.

These structural features have played into Doha Round stalemate. Worse, the Round has become riddled with so many compromises that it has reduced possible deals to very low common denominators. Market-access ambition has had to be diluted; and outline deals on rules have added to discriminatory treatment, with so many exceptions and loopholes to satisfy an array of blocking minorities. This threatens to undermine the WTO's *raison d'être*: non-discrimination. Hence, as a *negotiating* mechanism, the WTO has malfunctioned since the late 1990s. On the other hand, it has worked reasonably well in two other key areas, dispute settlement and accessions (notably China).

Multilateral trade rules are vital for the stability and progress of international trade. This was appreciated by previous generations of leaders in the West; and that is why they invested political capital in the GATT. But this is much less the case with the WTO. As Peter Sutherland remarks:

> My point is this…: that in the seemingly limitless, and futile, pursuit of headlines about trade agreements that 'create domestic jobs' too many political leaders of our time have lost sight of the much larger stakes that are in play as they use, abuse and ignore the multilateral trading system. If you reduce the WTO to a simple mercantilist calculation, engaging minimum levels of political discomfort, you get what we have right now: negotiating stalemate. Nothing moves. Deals do not get done… Indeed, I would have to conclude… that the WTO has become a position-taking institution, rather than a deal-making institution.[10]

The EU is the leading trading bloc in the world; its fortunes are intimately bound to those of the WTO and its rules. Hence the EU cannot allow the WTO to drift as it has done in the past decade; it has a strong self-interest to co-lead in the WTO. It must prioritise two objectives, and invest political capital accordingly. The first objective must be to finish the Doha Round as soon as possible; the other to move on to a post-Doha agenda that addresses twenty-first century trade realities.

All major and many minor players share blame in blocking progress in the Doha Round. But, in recent years, the EU has not been a blocking party; rather the US, India and China have blocked overall deals. That was true in July 2008, the last time the Doha Round seemed close to conclusion. This

puts the EU in a better position than others to take initiatives, use its good offices to goad others to make further concessions and bridge remaining gaps.

The EU and other majors (especially the US, China, India and Brazil) should aim for a modest Doha package—'Doha-lite' as it were—that can be concluded expeditiously. High ambition is politically undeliverable. Low ambition means a Doha package that would make little difference to existing international trade and hardly strengthen multilateral rules. Besides, what is on the negotiating table does not address the creeping regulatory protectionism that the recent crisis may have accelerated. Hence even a 'successful' Doha Round would be a damp squib in comparison with its predecessor, the Uruguay Round. But that is the price of despatching the Doha Round so that it does not continue to block WTO business and further undermine its rules. The WTO desperately needs to deal with today's and tomorrow's trade realities; the Doha Round keeps it stuck with the trade agenda of the 1990s.

An outline package could look as follows. Industrial-goods (NAMA) and agricultural negotiations could be concluded on the basis of the 2008 draft texts. Even better, these mind-bogglingly complicated texts could be simplified, with lower market-access ambition but with fewer exceptions and loopholes.[11] Minimalist deals could be done on services and 'rules' issues (such as anti-dumping) that would hardly change the status quo. Extra concessions could be given to low-income and least-developed countries (LDCs) on cotton and Aid for Trade; and to LDCs on duty-free and quota-free access to developed country markets. Modest gains would come from cutting developed country peak tariffs and agricultural subsidies, stronger, comprehensive developing

country tariff bindings (i.e. without excluding whole sectors), and a soft agreement on trade facilitation. Getting to this point depends on key developing countries like India making concessions—not just on concessions from developed countries. Most important, a finished Doha Round, however modest, would boost confidence: it would show the WTO was back in business.

In parallel, the EU should start thinking seriously about its medium-term post-Doha priorities—looking ahead to what WTO rules are needed 5 to 10 years from now. That requires a proper strategic review and one or two guiding principles.

Our first guiding principle for a post-Doha agenda is *commercial relevance*. This must of course include what is commercially relevant for the EU. Make no mistake: the EU should use its considerable bargaining power to get its commercial priorities into the core of a post-Doha agenda.

Sadly, the Doha Round has drifted ever farther from commercial relevance, and too many debates surrounding the WTO are too abstract, or too mired in minutiae about institutions and decision-making processes, to connect with the real world outside Geneva. Rather the focus should be on priority negotiating issues—not institutions and decision-making processes—that would deliver the greatest commercial gains for WTO members. For the EU, these issues should be linked to the single market reform agenda we outlined earlier.

Our second guiding principle is to have *stronger multilateral rules against creeping protectionism*. This would be the EU's, and others', anti-protectionist insurance policy for future times of economic recession and crisis.

A post-Doha agenda could comprise the following: improvements on whatever Doha package is negotiated; and a 'twenty-first century agenda' of new issues. The former could focus on lower tariff bindings and subsidy caps, stronger trade-facilitation disciplines, and the extension of duty-free and quota-free access by emerging markets (including Brazil, China and India) to imports from LDCs. The forward agenda of new issues could comprise some or all of the following: export restrictions; non-tariff barriers on goods trade; energy; a stronger Government Procurement Agreement (GPA); a stronger Information Technology Agreement (an 'ITA II' that would widen coverage to all ICT products and tackle NTBs); plurilateral sectoral negotiations in services to strengthen GATS commitments; plurilateral negotiations on investment and competition rules; plurilateral negotiations on trade and climate change (to reduce subsidies on carbon-intensive products, liberalise trade in clean energy products, and prevent carbon tariffs and other trade-restricting measures); and a cross-cutting programme to strengthen transparency and due process in the implementation of WTO rules (on subsidies, RTAs, trade remedies, dispute settlement and the Trade Policy Review Mechanism). Given the EU's already strong internal disciplines on subsidies and public procurement, for example, it has every interest to negotiate stronger multilateral disciplines in these areas.

The EU and others will need to do business differently in order to tackle a post-Doha agenda. That demands more flexible decision-making. This should not be a pretext to dream up grand institutional designs, a time-wasting distraction. Rather it is a matter of persuading WTO members to negotiate in more flexible formations—'willing coalitions', or 'variable geometry' in EU parlance—to liberalise trade and

strengthen rules. Plurilateral, club-like negotiations will be needed on many new issues; 'purist' multilateralism will not work. Groups of like-minded members constituting a 'critical mass' of international trade in a particular area could negotiate among themselves, providing concessions were extended to the rest of the membership through unconditional MFN (along the lines of the ITA and GATS telecoms agreement). Plurilateral negotiations with conditional MFN (i.e. not extending concessions to non-signatories), modelled on the GPA, could work on some issues. Those WTO members wary of stronger commitments would be free to stay out of these negotiations, or opt in at a later stage if they felt willing and able.

3. External Trade Policy and the Bilateral Agenda: strengthening Core Trade Relationships

Bilateral and regional trade agreements have proliferated around the world, especially in the past decade. At the latest count, 474 regional trade agreements (the sum of free trade agreements, or FTAs; customs unions, such as the EU; and other, more limited, preferential agreements have been notified to the WTO, with 283 agreements in force. East and South Asia—now the prime target for EU FTAs—have seen an explosion of FTA activity: 88 FTAs are in effect, up from 25

in 2000. Overall, 221 FTAs are proposed, under negotiation or concluded in the region.

Frenetic FTA activity is understandable, given WTO stalemate. Strong, 'WTO-plus' FTAs can make sense in certain circumstances. But FTAs and other discriminatory trade agreements can distort and divert trade and investment, raise business costs through complicated rules of origin and other restrictions, distract attention from the WTO, and generally favour powerful players at the expense of the weak. The 'spaghetti bowl' of RTAs can indeed undermine non-discriminatory multilateral rules. Moreover, the vast majority of FTAs are weak, partial, and do not liberalise much trade or improve upon WTO rules. At best they eliminate most tariffs, but hardly tackle non-tariff and regulatory barriers in goods, services, investment and public procurement. This pattern of 'trade-lite' FTAs is evident throughout the developing world, including east and south Asia.

The EU now has an active bilateral trade agenda. The foundations were laid by the Commission's *Global Europe* paper in late 2006. *Global Europe's* objectives are reasonably clear: the EU targets key emerging markets, and aims for comprehensive, commercially significant FTAs. But the reality does not quite match the rhetoric. So far, the EU has targeted small and medium-sized economies, not its top trading partners. Of the existing batch of FTA negotiating partners, South Korea, India, Mercosur, the GCC, ASEAN and Canada are most important commercially. But none of them are among the EU's top five trading partners, and only a couple figure among the EU's top 10 trading partners (Table 4). Conspicuously, the EU's two leading trading partners in Asia, China and Japan, were not targeted for FTAs. Nor was its leading trade partner, the US.

Table 4: 2007 EU 27 trade partners in goods and services (excluding intra-EU trade)
(Billions dollars and percentage)

Export			Imports		
Destination	**Value**	**Share**	**Origin**	**Value**	**Share**
World (excl EU)	2061.9	100.0	World (excl EU)	2218.5	100.0
Economy			**Economy**		
1. United States	541.0	26.2	**1. United States**	416.1	18.8
2. Switzerland	210.7	10.2	**2. China**	334.1	15.1
3. Russian Federation	146.7	7.1	**3. Russian Federation**	212,9	9.6
4. China	121.1	5.9	**4. Switzerland**	163.8	7.4
5. Norway	85.3	4.1	**5. Japan**	125.1	5.6
6. Japan	84.8	4.1	**6. Norway**	121.1	5.5
7. Turkey	80.9	3.9	**7. Turkey**	80.2	3.6
8. Canada	77.7	3.8	**8. Korea, Republic of**	60.5	2.7
9. India	52.5	2.5	**9. Canada**	56.5	2.5
10. Australia	45.7	2.2	**10. Brazil**	48.6	2.2

Source: World Trade Organization, International Trade Statistics 2008 and 2009

The EU's FTA strategy has had mixed results. Negotiations with Mercosur and the GCC have long been stuck. Deals have been struck with relatively minor countries in Latin America. The EU's major success is the relatively strong FTA with South Korea. However, this was criticised for being too generous to Korea on 'duty drawbacks' and neglecting the interests of the European car industry in particular. Predictably, India has proved much more defensive than South Korea; and the EU has been unable to negotiate with ASEAN collectively. Hence its decision to negotiate FTAs with ASEAN countries individually, starting with Singapore and moving on to Vietnam and Malaysia.

We strongly believe that the EU needs an active bilateral trade agenda as a *complement* to, not a substitute for, active single market and multilateral agendas. Catch-up is one motive for EU FTAs; otherwise European firms would be at a disadvantage in key markets compared with non-European competitors who have preferential access through FTAs. But

we also think that the EU needs to be more *strategic* and *ambitious* on the bilateral track. It should use its bargaining power more forcefully and effectively to open priority markets abroad. In particular, it should target three of its top trading partners, the US, China and Japan, for FTAs (or 'economic cooperation agreements'—or whatever they are to be called) or much stronger bilateral frameworks for trade cooperation. What follows are our criteria for the EU's bilateral trade agenda:

First, high ambition means going for wide and deep FTAs: comprehensive tariff elimination with short transition periods; elimination of NTBs in key industrial sectors; deep commitments in services and investment; WTO-plus rules in government procurement, subsidies, intellectual property rights and other trade procedures; and not too restrictive rules of origin. Commitments should be an incentive to further liberalisation and structural reform at both ends—for the EU's FTA partners, and for the EU itself.

Note that the 'deep-integration' FTAs we have in mind go well beyond 'shallow-integration' FTAs that merely conform to GATT Article XXIV and Article V GATS. The former stipulates coverage of 'substantially all trade' in goods. But this is interpreted to mean tariff elimination on at least 90% of goods trade; disciplines do not extend to reduction or elimination of NTBs and regulatory barriers. Also, Article V GATS refers to 'substantial sectoral coverage' of services, but it does not indicate the extent of services liberalisation. Hence, in our view, EU FTAs should be GATT and GATS 'plus-plus-plus'.

Second, a strategic approach to FTAs requires caution and selectivity—the opposite of launching initiatives

indiscriminately. Some willing countries may be commercially insignificant for the EU; they are not worth the effort. Others may balk at 'deep-integration' FTAs with serious commitments on non-border barriers; they are not worth the effort either. Finally, the EU should not sign less than comprehensive FTAs with negotiating partners such as India, Malaysia and Vietnam: no deals are better than bad deals.

Third, the US, China and Japan should be targeted for major new initiatives. All three are commercially very significant; closer trade relations with each would yield large gains.

Start with the US. We think the time may be ripe for a new transatlantic FTA initiative, perhaps starting with the US, and maybe later expanding it to include Canada and further develop the existing EU–Mexico FTA. True, the EU and the US have been here before: the idea was floated in the 1990s, only to be dismissed by both sides. There is a Transatlantic Economic Council, charged with reducing regulatory barriers in selected sectors, but, in the absence of any binding agreement, it has made little progress.

Still, given huge potential gains with what remains by far the EU's biggest trade and investment partner, the EU should conduct a detailed examination of EU–US options for a partnership agreement to liberalise trade and investment, with up-front tariff elimination and binding targets for progress in tackling regulatory barriers. Tariff elimination, save for some agricultural items, should not be difficult, given already very low average tariffs. This would deliver significant benefits for both sides as the volume of trade is so large, and with minimal 'trade diversion' from third countries. Much, much bigger gains would come from liberalisation in services and

investment. But this is precisely where negotiations would be most difficult, given regulatory differences not just between the EU and US but also within the EU (among member-states) and US (among states of the Union).[12]

The EU should also consider an FTA with Japan, its second-biggest Asian trading partner. This could be labelled a 'comprehensive economic partnership agreement' (Japan's term for its FTAs) or an 'economic integration agreement'. The Japanese would be primarily interested in tariff elimination in industrial goods. The EU's primary interest would be in eliminating Japanese NTBs in goods, and deeper access to Japanese markets in services, investment and public procurement.

That leaves China, the EU's biggest trading partner in Asia and second-biggest trading partner in the world. A free-trade and economic-cooperation agreement with China is not in the cards: China would balk at WTO-plus commitments in services, investment, subsidies and other regulatory areas; the EU would have difficulty in eliminating peak tariffs and restricting regulatory discretion in standards and trade remedies. But both sides could significantly strengthen their existing framework for bilateral cooperation. That is imperative to contain trade tensions and conflict, and deepen engagement, in what is now one of the three most important trading relationships in the world (alongside US–EU and US–China trade relations). The spectre of 'currency wars' with China only strengthens the argument for closer bilateral cooperation.

The EU and China need to find ways to make their High Level Trade and Economic Dialogue (HLD) credible, rather than leaving it as an open-ended talking shop neither side—least of all the Chinese—take seriously. The HLD should

target only priority issues, and aim to achieve the credibility and effectiveness of the US–China Strategic and Economic Dialogue, which the Chinese take far more seriously. The EU needs to contain internal 'China bashing' on the bilateral trade deficit and the Yuan exchange rate. These are not the problems they are made out to be, and they distract EU attention from more serious 'market-access' issues in China. The EU should prioritise the latter, notably Chinese regulatory barriers in investment, services, intellectual property, subsidies and public procurement. In these areas, the EU needs to be more selective and targeted, focusing on a few priorities rather than presenting a Christmas-tree wish list the Chinese can easily dismiss. And it should be possible to fashion a series of *quid pro quos*, for example EU concessions on 'market economy status' for China, limits on anti-dumping actions and openness to Chinese sovereign wealth funds, in return for Chinese concessions on better implementation of WTO commitments and more openness in services and investment. Finally, the EU should try to keep 'sustainability' or 'trade-and' issues (e.g. labour and environmental standards, climate change, human rights and democracy) on separate tracks rather than bundling them with commercial issues.

Fourth, FTAs should be compatible with 'open regionalism'. They should be open to third countries to join, providing they sign on to and implement already agreed commitments. Rules of origin should be as simple, harmonised and least restrictive as possible.

Fifth, Russia is also a leading trade partner, but it cannot be a candidate for an FTA. It is not yet a member of the WTO; and in any case it is not minded to make the sort of market reforms that would be consonant with a serious FTA. Hence

bilateral cooperation with Russia will have to proceed outside an FTA framework.

Sixth, the EU's 'trade-and-development' agenda mainly concerns the African, Caribbean and Pacific (ACP) countries. Its chief tools are trade preferences (the Generalised System of Preferences [GSP], GSP-plus, and the Everything But Arms [EBA] initiative for LDCs) and trade-related aid. Both have a long history but a record of mixed results and failure. The target countries are not commercially significant for the EU, though the EU is very significant for them. The EU's approach to the ACP and other LDCs should be different from its policies towards commercially significant emerging markets. Trade and development goals should be modest and focused. Aid and preferences should be targeted overwhelmingly at LDCs rather than at a diverse array of LDCs, low-income and middle-income countries. GSPs should be simple, stable and predictable. The EU should limit the linkage of non-trade conditions to trade agreements. Its Economic Partnership Agreements (EPAs) with ACP countries should focus on border barriers and not impose WTO-plus provisions on the Singapore and other regulatory issues. And the EU should drop unrealistic ambitions to foster EU-style regional integration through EPAs.

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