

# **The EU Common Commercial Policy and Global/Regional Trade Regulation**

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**Summary:** this chapter covers various aspects of the Common Commercial Policy (CCP) of the EU. After describing the patterns of EU trade with the rest of the world, we describe the various instruments of the CCP and the institutional process through which EU member countries manage to reconcile their differences to reach a common position on trade. We then look at the complex system of trade preferences of the EU and examine the role of the Union within the multilateral trade system. Finally, we discuss the tensions between the global and regional dimension of EU trade policy.

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## **1. Introduction**

The European Union (EU) constitutes the largest trading bloc in the world. It is the world largest exporter and the second largest importer of goods, and it is the first trader of commercial services. Though its members represent just over 7 percent of the world's population, they account for more than a fifth of global imports and exports.

At the basis of this leading role lies the Common Commercial Policy (CCP) which, together with agricultural policy and competition policy, is the only truly centralized policy of the Union. Since the Treaty of Rome in 1957, EU member countries

accepted to speak with one voice in trade, transferring their sovereignty in this policy area to the supranational level.<sup>1</sup>

In 1968, the Customs Union entered into force among the six original EU member countries, remaining duties were eliminated among them, and a Common External Tariff (CET) was introduced to replace national tariffs vis-à-vis non-member countries. Since then, the scope of the CCP has expanded in two important dimensions: first, the members of the Customs Union have increased to 27; secondly, commercial policy has broadened to include not only border measures restricting trade in goods, but also policies affecting trade in services and a vast range of trade-related regulatory measures (e.g., intellectual property, technical standards).

In terms of the decision making process, the European Commission is responsible for the implementation of the CCP, proposing new trade initiatives to the Council, managing tariffs and other trade policy instruments, and conducting trade negotiations. Contrary to other policy areas in which member states decide by unanimity, trade policy decisions of the Council are taken by qualified majority.

Trade policy thus lies at the heart of the identity of the EU and of its presence in the world. This is also reflected in the World Trade Organisation, one of the only international organizations in which the Union is itself a member and in which EU member countries are represented by the European Commission. Reaching a “single voice” in trade policy is often a complicated process, since EU members have different trade policy interests and agreeing on a collective policy and bargaining position requires compromises among them.

This chapter covers various aspects of EU trade policy. In Section 2, we describe the patterns of EU trade with the rest of the world. Section 3 describes the instruments of the CCP and the process through which EU member countries manage to reconcile their differences to reach a common position on trade. Section 4 looks at the complex system of trade preferences of the EU, while Section 5 examines the role of the EU

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<sup>1</sup> Legally, responsibility for external trade policy remains with the European Communities. However, to simplify the exposition, throughout most of the chapter we will refer to the European Union.

within the multilateral trade system. Section 6 discusses the tensions between EU regionalism and multilateralism. Finally, Section 7 offers some concluding remarks.

## 2. The EU and world trade

The EU is the largest trading actor in the world. As it can be seen from Table 1 below, the Union is the world's leading exporter and second-leading importer of goods and is the biggest exporter and importer of commercial services. In 2006, it accounted for 16.4 percent of world exports and 18.1 percent of world imports in goods. The shares of EU external trade in total world trade are even higher for trade in services, with the EU-25 representing 27.3 percent of world exports and 24.0 percent of world imports.

**Table 1: Leading countries in world merchandise and service trade (2006)**

### Merchandise trade

	Exports		Imports	
	Value (Billion US\$)	Share of world trade	Value (Billion US\$)	Share of world trade
EU 25*	1481.7	16.4	1697	18.1
United States	1038.3	11.5	1919.4	20.5
Japan	968.9	10.7	791.5	8.5
China	649.9	7.2	579.6	6.2

### Service trade

	Exports		Imports	
	Value (Billion US\$)	Share of world trade	Value (Billion US\$)	Share of world trade
EU 25*	554.4	27.3	471.7	24.0
United States	388.8	19.1	307.8	15.7
Japan	122.5	6.0	144.0	7.3
China	91.4	4.5	100.3	5.1

Source: WTO (2007a)

\* Excludes intra-EU trade

The trade shares reported in Table 1 do not take into account intra-EU trade, which has increased over the years as a result of the fact that trade with the acceding countries has now become internal. If we include trade among the member states, in 2006 the EU was responsible for almost 40 percent of world merchandise import and exports. The importance of intra-EU trade can also be seen from Table 2, which looks at the major EU trading partners: the overwhelming majority of trade occurs between member countries; outside the EU, the main trading partners are the United States, Russia, Switzerland and China.

**Table 2: EU merchandise trade by country (2006)**

	Exports			Imports	
	Value (Billion US\$)	Share of world trade		Value (Billion US\$)	Share of world trade
EU 25*	3050.8	67.3	EU 25*	3050.8	67.3
United States	332.8	7.3	China	240.5	5.1
Switzerland	106.8	2.4	United States	220.6	4.6
Russian Federation	89.3	2.0	Russian Federation	148.7	3.1

Source: WTO (2007a)

\* Excludes intra-EU trade

In terms of trade composition, EU merchandise trade consists predominantly of trade in manufactured goods, while trade in services is mainly in travel and transportation (see Table 3). It should be pointed out that the commodity structure of EU trade varies greatly across trading partners. In particular, manufacture goods dominate EU merchandise trade with other developed countries, while primary products figure more prominently in trade patterns with developing countries.<sup>2</sup>

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<sup>2</sup> For example, if we look at the relations between the EU and North America, manufactured goods comprise 80.4 percent of EU imports and 83.8 percent of exports in 2006, while agricultural goods make only for 6 percent of imports and 5.3 percent of exports. In comparison, manufactured goods represent 24.6 percent of imports and 79.2 percent of exports to African countries, while agricultural goods comprise 12.0 percent of imports and 10.1 percent of exports.

**Table 3: Composition of EU trade as a percentage of world trade (2006)**

Merchandise trade			Trade in services		
Commodity groups	Exports	Imports	Service categories	Exports	Imports
Manufactures	83.3	60.4	Travel	63.3	15.2
Fuel and mining Products	7.0	3	Transportation	16.1	47.7
Agriculture	6.4	7.3	Other commercial services	20.6	37.1

Source: WTO (2007a)

Looking at the relations between the EU and its trading partners reveals that many neighbouring countries are largely “dependent” on the EU market. For example, in 2006 the EU accounted for a large share of trade of the Russian Federation (56.7 percent of its exports and 43.9 percent of its imports) and of Turkey (52.5 percent of its exports and 39.5 percent of its imports). In contrast, trade with these countries accounted for much smaller shares of EU trade (WTO, 2007a).<sup>3</sup>

The EU has often exploited this commercial hegemony as a diplomatic tool. Indeed, it has been argued that “trade policy has always been the principal instrument of foreign policy for the EU” (Sapir, 1998). Access to the EU market, combined with financial aid, economic cooperation and infrastructural links have been used to foster the Union’s geopolitical interests. An example is the European Neighbourhood Policy (ENP), launched by the European Commission in 2003. This offers to the EU’s immediate neighbouring countries by land or sea a privileged trade relationship in the form of association or cooperation agreements (see Section 4 below) in exchange for their commitments to some values (e.g., respect for the rule of law, good governance, respect of human rights, etc.), with the explicit goal of extending stability, security and economic development.

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<sup>3</sup> In the same year, Russia accounted only for 2 percent of EU exports and 3.1 percent of EU imports, while the shares of EU exports and imports from Turkey were 1.3 percent and 1.9 percent, respectively.

### **3. The Common Commercial Policy**

In this section, we review the main instruments of the EU Common Commercial Policy (CCP) and describe the institutional process through which member countries manage to reconcile their differences to reach a common position on trade.

The key provisions of the CCP are contained in Articles 131-4 (ex Articles 110-16) of the Treaty of Rome. The cornerstone of the CCP is Article 133, according to which the CCP establishes uniform principles between all member states governing EU trade policy including changes in tariff rates, the conclusion of tariff and trade agreements with non member countries, uniformity in trade liberalisation measures, export policy and instruments to protect trade such as anti-dumping measures and subsidies.

#### **3.1 Main instruments of the CCP**

Article 133 does not exhaustively specify the instruments of EU trade policy. Indeed, as discussed below, EU trade policies and the environment in which they are applied have substantially changed over the years. While in the 1960's and 1970's the CCP consisted mainly of the common external tariff (CET) and other border measures, it now comprises various measures which are only indirectly trade-related (e.g., domestic regulatory barriers and the protection of intellectual property rights).

When the Treaty of Rome was signed in 1957, the liberalization of merchandise trade between industrialized countries still had a long way to go and **tariffs** were the main instrument of trade protection. Since then, tariffs have been drastically reduced and their levels have been bound through successive rounds of multilateral trade negotiations.

EU tariffs combine ad valorem duties and specific duties and vary substantially across sectors and individual products. Although the average EU applied MFN tariff is relatively low (6.9 percent in 2006), a significant proportion of imports enter the EU at very high tariff rates. In particular, higher tariffs are imposed on many agricultural products and other "sensitive sectors" (e.g., food, textile and clothing, footwear,

trucks, cars), with rates ranging up to 427.9 percent on certain processed food products (WTO, 2007b).

In addition to tariffs, the EU has made wide use of various **non-tariff barriers** (NTBs). The main types of NTBs imposed by the EU in the past have been import quotas and voluntary export restraints (VERs). The 1990's have seen a clear tendency towards the decreasing use of quantitative trade measures. This is mostly due to the fact that the Uruguay Round agreements prohibited VERs and led to the tariffication of many import quotas. As a result of the Uruguay Round Agreement on Textiles and Clothing, the EU eliminated in 2005 the quotas it had imposed on imports of clothing and textiles under successive Multifibre Agreements (MFAs).

As traditional trade barriers are dismantled, other ways of restricting imports on "sensitive" sectors are often resorted to. Frequent use of **antidumping duties** is an example of such practice. Dumping is a form of price discrimination, in the sense of charging different prices in separate geographical markets. Article VI of the GATT refers to "export prices being lower than prices in the domestic market of the exporter". In the EU, antidumping duties are generally triggered by a claim from EU manufactures that an export has caused them damage. The Commission then has to establish, consulting with member countries, if dumping has occurred, if the industry concerned has been injured, and where the "Community interest" lies, based on an assessment of the costs and benefits of imposing antidumping duties. The Commission can impose preliminary duties, while the Council considers whether to impose definite duties, which can last up to five years.

Although antidumping duties were originally devised to combat unfair trade, their broad and arbitrary use has led economists to conclude that antidumping "has nothing to do with keeping trade "fair" ... It is simply another form of protection" (Blonigen and Prusa, 2003). The EU has been a heavy user of anti-dumping measures,<sup>4</sup> particularly on mineral products and chemicals, textile products and machinery equipment. Since the mid-1990's, more countries started frequently using anti-dumping measures (e.g., India, Brazil, China, and South Africa) and the EU now find

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<sup>4</sup> However, the EU has seemingly become less aggressive in its use of anti-dumping since the turn of the century: the annual average number of initiated antidumping proceeding was 31 in the period 1991-1995, 44 in the period 1995-1999, and 15 in the period 2004-2006 (WTO, 2007b).

itself increasingly on the receiving end of antidumping investigations (see Vandenbussche and Zanardi, 2008).

Trade policy instruments also include **export subsidies**, which are mostly used on agricultural products (e.g., dairy products, sugar). Although their use is on the decline, “in value, export subsidies notified by the EC represent approximately 90 percent of all the WTO Members’ notified export subsidies” (WTO, 2007b).

Protectionist measures also include **technical barriers** that products imported in the EU must comply with. This type of barriers arise whenever foreign producers may have to alter their products in order to comply with EU regulations, they are usually justified in terms of health, safety, environmental or consumer protection and can be imposed by governments or by non-governmental organizations. The use of these measures is restricted by the WTO agreement on Technical Barriers to Trade (TBT Agreement).

As mentioned in Section 1, the EU is the first exporter and importer of commercial services in the world. EU external **policy on trade in services** must comply with the WTO General Agreement on Trade in Services (GATS). This was the first multilateral agreement aimed at liberalising trade in crucial sectors such as telecommunications and financial services. The issue of service liberalisation also arises in various EU preferential trade agreements, although the coverage and the extent of liberalisation vary widely across the different agreements. Similarly to the rules governing preferential trade in goods in the GATT (see discussion in the next section), the GATS requires that overall barriers to service trade faced by non-member countries should not rise, that bilateral trade agreements must have “substantial sectoral coverage” and eliminate “substantially all discrimination”.

The protection of **intellectual property rights** has also become a trade policy issue, given the increased importance of trade in “knowledge goods” – for which most of the value of new products arises from initial efforts in research and development (e.g., pharmaceuticals or high technology products) – and “brand goods” – for which most of the value comes reputation effects. (e.g., trademarks, appellations of origin). With respect to these types of goods, trade policy consists of measures aimed at protecting



owners' property rights. The Uruguay Round negotiations led to the Agreement on Trade Related Intellectual Property Rights (TRIPs), under which signatories have to establish minimum standards of intellectual property right protection and extend the traditional GATT principles of non-discrimination to intellectual property.

### **3.2 The Common Agricultural Policy**

We conclude this section by stressing the fundamental link between the EU's commercial policy and its common agricultural policy (CAP). This has been an extremely controversial policy, which has even been referred to as "the single most idiotic system of economic mismanagement of all times" (*The Economist*, 29 September 1990). As discussed in Section 5 below, the CAP has also constituted a major obstacle in all rounds of GATT/WTO trade negotiations.

The objectives of the CAP as stated in Article 39 of the Treaty of Rome were to (i) increase agricultural productivity; (ii) ensure a fair standard of living for the agricultural community; (iii) stabilize markets; (iv) provide certainty of food supplies; and (v) ensure that those supplies reached consumers at reasonable prices. To attempt to achieve these sometimes conflicting objectives, two main mechanisms were used. First, a generous EU-wide common "target price" was set for each of the major farm products. Agricultural products entering the EU from non-member countries were subject to "variable levies" (tariffs), which prevented target prices from being undercut by cheaper imports. Second, if a commodity's market price within the Union fell to an appointed "intervention price", then national agencies would purchase all produce that could not otherwise be sold at that price, artificially removing supply and thereby preventing a further fall in price.

The establishment of the CAP helped reduce Europe's reliance on imported food. However, when prices were set above what could bear, government agencies had to take stocks off the market in order to sustain the price. The result was overproduction of butter, wine, beef and other products. Some of the product surpluses were held in storage or destroyed, others were exported at prices far below the costs of production

with the help of export subsidies. These measures had a high budgetary cost and led to an increase in agricultural prices within the EU, becoming unpopular with European taxpayers and consumers. They also distorted agricultural world markets and angered producers in developing countries, making it harder for the EU to be perceived as a leading actor in multilateral trade negotiations and to campaign for the liberalization of world trade in other goods and services.

CAP reform began in the early 1990s, with the goal of reducing support prices and compensating farmers by paying them direct aids. Several rural development measures were introduced, notably to encourage environmentally sound farming. Production limits helped reduce surpluses. The so-called “Agenda 2000” reforms reinforced the move to make farmers more reliant on the market and improved incentives to farm in an environmentally sensitive way, adding a comprehensive rural development policy encouraging many rural initiatives and helping farmers to diversify and restructure. The budget available to agricultural policy was capped to reassure taxpayers that CAP costs would not escalate, and export subsidies were reduced on various goods.

### **3.3 The institutional process**

As discussed in Chapter 6, the Commission has sole competence over the implementation of the CCP, proposing eventual new initiatives to the Council and managing trade tariffs. When the EU is engaged in trade negotiations with third countries, its members act as a “single voice”. This is reflected by the fact that the EU is a member in its own right of the World Trade Organization (WTO). Although every member state has the right to attend WTO meetings, it is only the European Commission that represents the entire EU.

In negotiating trade agreements at the bilateral, regional, or multilateral level all member states must thus coordinate in order to present a cohesive EU external policy. Under Article 133(2) the Commission has the right of initiative as far as trade negotiations are concerned, but must seek and obtain a mandate from the Council of Ministers. Commission officials must conduct international trade negotiations within the limits set by the Council’s mandate.

When the European Commission negotiates trade agreements on behalf of the member states, it acts in consultation with a special committee, “the Article 133 Committee”. This is composed of representatives from the twenty seven member states and the European Commission and its main function is to coordinate EU trade policy. The Committee meets on a weekly basis, discussing various trade policy issues affecting the EU (e.g., strategic issues linked to multilateral, regional or bilateral negotiations, difficulties encountered in particular export or import-competing sectors).

At the conclusions of the negotiations, the Council approves or rejects the negotiated trade agreement. Article 300 of the amended Treaty describes the intra-EU procedures governing ratification. With the exception of a few sensitive areas, the Council decides according to qualified majority voting (QMV). Member states are assigned different voting weights, which reflect the size of their populations, and ratification requires approval by two-thirds of the votes. However, on most occasions member countries try to reach a general consensus, without resorting to a formal vote.

Unanimity applies to agreements involving non-traditional trade sectors, in which the Community and the member states have shared competence. The Treaty of Nice, which entered into force in 2003, has broadened EU trade competences on non-traditional trade issues, enabling the EU to conclude international agreements covering trade in services and intellectual property rights by QMV and without ratification by the member states.<sup>5</sup>

The Treaty of Rome provided no role in trade policy for the then European Assembly. The European Parliament (EP) has acquired some trade policy powers under Article 310, according to which ratification of the EP by simple majority voting may be required for association agreements.

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<sup>5</sup>As a result of pressures by France, a cultural exception on goods and services was included in Article 133(5) and Article 133(6). This concerns international negotiations related to audio visual services, educational services, and social and human health services, for which unanimity is still required.

The EU policy process has also allowed lobby groups to voice their interests. In particular, the Commission has established a consultative process with various civil society organizations, including business groups, sectoral interests, and consumer groups. EU consultations with interest groups are not based on any formal rules, and have been criticised for not being transparent enough.

It is often argued that the EU is “handicapped” internationally by the complexity of its institutions and the constraints imposed on its negotiators. For example, ratification of a trade deal negotiated between the United States and the EU may only require a vote by simple majority in the U.S. Congress, but requires the approval of at least a qualified majority of the European Council. However, it could be argued that the institutional limitations faced by EU negotiators might actually help to strengthen its bargaining position and extract concessions from its trading partners. As first argued by Schelling (1956), “the power of a negotiator often rests on a manifest inability to make concessions and to meet demands.”<sup>6</sup>

#### **4. The system of EU trade preferences**

A key feature of EU commercial policy is the combination of regionalism and multilateralism: on one hand, the Union has been a strong supporter of multilateral trade rules; on the other hand, it has developed the most extensive network of preferential trade agreements (PTAs) of any GATT/WTO member.

The fundamental principle of multilateral trading rules is that of non-discrimination. The goal is to eliminate any form of preferential treatment in international trade. In particular, Article I of the WTO establishes the most-favoured-nation (MFN) principle, according to which all WTO members should receive from any given member country the same trade preferences accorded to the partner that receives the best (most-favoured) treatment. If enforced, the MFN treatment would guarantee that the tariff rate on any given product would be uniform across trading partners.

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<sup>6</sup>See Meunier (2000) for an analysis of the impact of EU institutional complexities on trade negotiations and Conconi *et al.* (2008) on trade negotiation procedures in the United States.

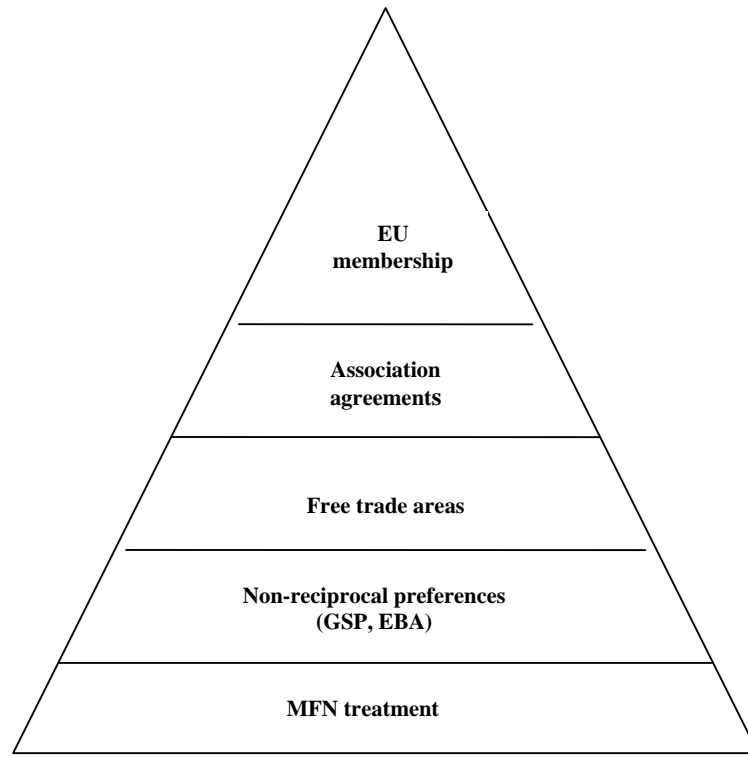
The creation and expansion of the EU, as well as the various agreements negotiated between the EU and some of its trading partners violate the MFN principle. Article XXIV of the WTO allows for an exception to the MFN rule for countries that sign regional trade agreements in the form of customs unions (CUs) or free trade area (FTAs). To be WTO compatible, regional trade agreements should fulfill two criteria: (i) they should not lead to an increase in average trade barriers against third parties; and (ii) they should lead to the elimination of tariffs and non-tariff barriers on “substantially all” trade between member countries.

WTO members are bound to notify the preferential trade agreements (PTAs) in which they participate. Nearly all of the WTO’s Members have notified participation in one or more PTAs (some Members are party to twenty or more). Notifications may also refer to the accession of new parties to an agreement that already exists, e.g., the notification of the accession of Bulgaria and Romania to the European Union Customs Union. In the period 1948-1994, the GATT received 124 notifications of PTAs (relating to trade in goods); in the period 1995-2007, over 240 additional arrangements covering trade in goods or services have been notified.

Figure 1 describes the so-called EU “pyramid of trade preferences”. The top of the pyramid captures the maximum preferential treatment that the EU can grant to another country, i.e., **membership to the Union**. Intra-member relations are characterised by the deepest integration, involving not only common commercial policy, but also common agricultural policy and competition policy, and common basic rules governing the movement of goods, services, capital and persons.

One level below, we find **association agreements**, which involve the creation of a CU or a FTA between the EU and the trading partner, as well as common rules on non-trade issues (e.g., mobility of citizens, industrial standards, financial aid and development, etc). An example of this type of preferences is the European Economic Association between the EU, Iceland, Liechtenstein and Norway.

**Figure 1: The EU pyramid of trade preferences**



One step below, we have the **free trade areas** between the EU and various trading partners, such as Mexico, Chile, South Africa and Israel. Examples also include the Economic-Partnership Agreements (EPAs) negotiated between the EU and its former colonies from African Caribbean and Pacific (ACP) regions. With respect to the relations between the EU and its former colonies, it should be stressed that the EU's system of preferences has been greatly simplified as a result of the expiration of the WTO waiver for discriminatory and non-reciprocal contractual preferences (Lomé/Cotonou agreements). This has led the EU to promote regional grouping among ACP countries, with the goal of negotiating reciprocal trade agreements with them. For example, in January 2008 a trade and aid EPA entered into force between the EU and 15 Caribbean nations.

Next we find **non-reciprocal preferences** granted by the EU to developing countries under the Generalised System of Preferences (GSP). This is legitimized under the

1979 Enabling Clause, which allows GATT/WTO members to offer lower-than-MFN tariffs to developing countries. Under its GSP scheme, the EU offers tariff-free access, without demanding reciprocity,<sup>7</sup> to some industrial and agricultural products from developing countries. GSP preferences are lost upon “graduation”, i.e., when a beneficiary country is deemed by the granting country to have attained a sufficient level of progress. For example, in 1998 the EU graduated three countries (Hong Kong, the Republic of Korea and Singapore) from its GSP scheme, and their exports now face MFN duties. Under the so-called Everything But Arms (EBA) initiative, the EU grants duty-free access in all sectors, with the exceptions of arms and munitions, to all least developed countries (LDCs)<sup>8</sup>. The EU has also established special preferential GSP schemes for countries that have programs to combat drug trafficking, to protect labour rights and the environment.<sup>9</sup>

Finally, at the bottom of the EU pyramid of trade preferences are countries that do not enjoy any trade preferences, which only export to the EU under **MFN treatment**. It should be stressed that, although there are only nine such countries (Australia, Canada, Chinese Taipei, Hong Kong, Japan, Republic of Korea, New Zealand, Singapore and the United States), the importance of trade preferences should not be exaggerated, since approximately three quarters of imports by the EU enter on non-preferential (MFN) terms (see WTO, 2007a).<sup>10</sup>

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<sup>7</sup> However, explicit or implicit elements of conditionality are often included in GSP programs (see Conconi and Perroni, 2005).

<sup>8</sup> These are designated by the United Nations and the World Bank on the basis of various criteria: national income below a certain threshold, weak human assets (based on health, nutrition and education indicators) and high economic vulnerability (based on indicators of instability of agricultural production and exports, inadequate diversification and economic smallness).

<sup>9</sup> In a case brought before the WTO, India has targeted the EU for granting preferential GSP treatment to some countries because of their efforts to combat illegal drugs. In 2004, the WTO Appellate Body ruled that developed countries are allowed to grant different GSP treatment to different developing countries, provided this is done in a non-discriminatory and transparent manner.

<sup>10</sup> The limited importance of trade preferences in terms of trade volumes is partly due to the administrative rules restricting their use. In particular, to take advantage of EU tariff preferences, an exporting country must satisfy cumbersome “rules of origin” to substantiate the claim that it indeed produced the good, rather than import it from another country excluded from the preferences.

## 5. The EU and multilateralism

### 5.1 The EU in the world trading system

In the post World War II period, the U.S. and the EU have been strong supporters of multilateral trade rules, recognizing the economic benefits of trade cooperation. Economic theory has stressed two main economic arguments for trade cooperation (see Bagwell and Staiger (2002) for a discussion). According to the so-called **terms-of-trade** argument, a country seeking to improve its terms of trade (relative price of exports in terms of imports) by unilaterally increasing its import tariffs may provoke retaliatory behavior from other trading partners, making all parties concerned worse off. According to the **commitment argument**, if governments lack credibility vis-à-vis domestic economic agents, they may wish to “tie their hands” by signing an international agreement. For example, if the decision of a government to liberalize trade in a particular sector at a certain future date is not deemed credible by the industry concerned, the latter may fail to undertake the required restructuring during the transition period. This implies that, when the due date comes, trade liberalization will not be an optimal because the sector will not be ready for international competition. An international trade agreement can be a way to solve this time-inconsistency problem.

In what follows, we briefly describe the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO), outlining the role played by the EU in shaping the evolution of the multilateral trading system,

#### The GATT

The multilateral trading system was originally set up under the GATT in the aftermath of World War II. The Bretton Woods Conference of 1944 recognized the need for an international trade institution to complement the International Monetary Fund and the World Bank. In particular, the United States – the leading political and economic power after World War II, which took over a large share of responsibility of building



a new international economic system - wanted at all costs to avoid a return to the protectionist battles of the 1930s.<sup>11</sup>

The GATT agreement was signed in Geneva in 1947 by 23 countries. Originally, the GATT was intended to serve as a temporary agreement until the ratification of the Charter of the International Trade Organization (ITO). This was signed in 1948 by 53 nations, but never entered into force, since it was not ratified by the US Congress.<sup>12</sup>

The GATT consisted mainly of the commercial policy provisions of the ITO Charter, with minor formal adjustments. The overall objective of the GATT was to reduce barriers to trade, especially tariffs, and to limit the use of certain trade barriers, such as quotas. The negotiating parties agreed that substantial tariff cuts could only be achieved if certain exceptions were included in the structure of trade rules. The GATT therefore contains several escape clauses and contingent provisions.

The system was developed through a series of trade negotiations, or rounds, held under GATT. Early negotiation rounds dealt mainly with tariff reductions, while later negotiations included other areas such as anti-dumping and non-tariff measures. Since the Treaty of Rome was signed in 1957, the process of European integration had a critical impact on GATT trade rounds. The creation of the EEC raised the question of how to manage trade relations between the members of this upcoming customs union and the other GATT members. The fear was that an unsatisfactory adjustment would undermine the multilateral trading system. This concern was one of the main driving forces behind the **Dillon Round** 1960-61, which was meant to transform the tariffs of the six EEC members into a common schedule applied by all six towards non-member countries. In accordance with Article XXIV of GATT, the new common external tariff could be no higher on average than the separate tariffs of the six countries. Whenever the EEC members wanted to deviate from this rule, they had to offer tariff

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<sup>11</sup> In the 1930's, the adoption of the infamous Smoot-Hawley Act in the United States raised import duties to record levels and was widely blamed at the time for sharply reducing trade, triggering retaliatory moves by many other countries, and exacerbating the Great Depression (see Irwin, 1998).

<sup>12</sup> A majority in the U.S. Congress opposed the ITO Charter, considering that it was overloaded with topics only indirectly related to trade (e.g., employment and antitrust). At the end of 1950, President Truman decided not to submit the ITO for congressional approval.

concessions on other items as compensation. The negotiations made satisfactory progress, except in the field of agriculture.

The **Kennedy Round** (1964-1967) was to a large extent motivated by the growth and steady integration of the European Common Market, which was perceived as a threat to U.S. trade interests.<sup>13</sup> In the field of tariff reductions on industrial goods the Kennedy Round achieved an average cut of 38 percent covering two-thirds of developed countries' tariff-bound industrial imports. Tariff reductions for textiles products, however, remained much below the average cuts for industrial products. This was the first round that went beyond tariffs (anti-dumping duties in particular) and in which the negotiating parties agreed for the first time to include agricultural products as a major negotiating topic, acknowledging that trade in agriculture was distorted by highly interventionist policies. However, the outcome on agriculture was very limited, mainly due to the fact that the EU struggled to reconcile the objectives of elaborating and putting into force its common agricultural policy (CAP) and participating in international trade negotiations on agriculture.

The enlargement of the EU to the United Kingdom, Denmark and Ireland was a major motivation for the launch of the **Tokyo Round** (1973-1979). In particular, the United States perceived the membership of the United Kingdom, which accounted for the vast majority of US investment in the EU, as a threat to its interests. Tokyo was chosen strategically as the location to initiate a new multilateral round of trade negotiations because Japan had become one of the biggest world exporters and several other Asian economies were gaining expanding shares of world trade. The main protagonists of the round were again developed countries, in particular the United States, the EU and Japan. However, since the agenda also included a variety of development issues, non member countries were invited to participate in the negotiations. Nearly thirty developing countries took up this invitation increasing the number of participants to over 100 countries. During the Tokyo Round, agriculture, once again, proved intractable: attempts to reconcile the positions of the United States and the EEC on agriculture failed during 1975 and 1976 and held up progress in

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<sup>13</sup> Although the U.S. was concerned about a European "tariff wall", it was keen to support the expansion and further integration of the EU to enhance economic and political cooperation among European countries, thus reducing the risk of war between them, and to oppose communist expansion.

almost every other area of the negotiations. In July 1977 both parties agreed to drop most substantive questions dividing them, such as market access and subsidies. This at least allowed the negotiations to go forward (UNCTAD, 1982).

### The WTO

The agenda of the **Uruguay Round** (1986-1994) was the broadest ever agreed to in multilateral negotiations: the talks extended the trading system into several new areas, notably trade in services and intellectual property, and to reform trade in the sensitive sectors of agriculture and textiles; all the original GATT articles were up for review.

The round was supposed to end in December 1990, but the U.S. and EU disagreed on how to reform agricultural trade and decided to extend the talks. Finally, In November 1992, the U.S. and EU settled most of their differences in a deal known informally as “the Blair House accord”, and on April 1994, a deal was signed by ministers from the 123 participating governments. The agreement established the World Trade Organization (WTO), which came into being upon its entry into force in January 1995, to replace the GATT system. This is widely regarded as the most profound institutional reform of the world trading system since the GATT’s establishment.

The WTO is composed of governments and political entities (such as the EU) and is a member-driven organisation with decisions mainly taken on a consensus basis. Between 1995 and 2008, the number of its members expanded from 123 to 151, the vast majority of which are developing countries. The EU is the largest and most comprehensive entity in the WTO. As mentioned above, its member states coordinate their positions in Brussels, while the European Commission alone speaks for the EU at WTO meetings in Geneva.

The top level decision-making body of the WTO is the Ministerial Conference, which meets at least once every two years. The latest conferences were in Seattle (1999), Doha (2001), Cancun (2003) and Hong Kong (2005). Below this, the General Council meets several times a year in the Geneva headquarters. Both are composed of representatives of all member states.

The **dispute settlement** mechanism, which came into being with the WTO in 1995, is one of the cornerstones of the world trading system. It gives all WTO members the confidence that the agreements negotiated will be respected. The rationale behind the Dispute Settlement Understanding (DSU) is to provide members with a clear legal framework for solving disputes which may arise in the course of implementing WTO agreements.

During the Uruguay Round, dispute settlement procedures were strengthened in an unprecedented manner, with the introduction of the quasi-automatic adoption of reports and the establishment of the Appellate Body as a standing organ for legal review. Clearly, agreed solutions between members are the most desirable way of solving disputes. However, if this is not possible, members can ask for WTO panels and appeal procedures to solve the dispute.

The Panels and the Appellate Body are limited to making recommendations; decisions based on these recommendations are taken by the Dispute Settlement Body (DSB), which consists of a session of the General Council. The DSB uses a special decision procedure known as “reverse consensus”, which makes it almost certain that the recommendations of the Panel (possibly amended by the Appellate Body) will be accepted. The process requires that the recommendations should be adopted, unless there is a consensus of the members against adoption. Once it has decided on the case, the DSB may direct the losing member to take action to bring its laws, regulations or policies into conformity with the WTO rules. If the losing party fails to do so within a “reasonable period of time”, the DSB may authorize a successful complainant to take retaliatory measures to induce action on the part of the losing party.

Since the establishment of the WTO, the EU has been involved in many disputes, being on the offensive more than on the defensive: between 1995 and 2008, it has acted as a complainant in 77 cases and as a respondent in 59 cases. Some of these cases have been widely publicized, such as the long-running disputes between the EU and the United States over the EU tariff system for banana imports or over the U.S. subsidies to Foreign Sales Corporations.

## 6. Regionalism versus multilateralism?

Since the early 1990s, the proliferation of PTAs has generated a heated debate on whether such agreements represent a threat to the multilateral trading system. In the words of Bhagwati (1991), the question is whether the PTAs are “stumbling blocs” or “building blocs” towards multilateral free trade. In what follows, we summarize the arguments of two opposite views on regionalism; in light of these arguments, we then try to evaluate the impact of EU regionalism on the multilateral trading system.

### 6.1 PTAs as “stumbling blocs”

This view highlights the discriminatory nature of PTAs and provides a pessimistic prognosis on the effects of regionalism on multilateral liberalization. Below, we outline four of the main arguments put forward by the proponents of this view.

First, PTAs may promote **trade diversion** rather than trade creation, thus reinforcing vested interests and increasing opposition to multilateral trade liberalization.<sup>14</sup> The argument is that, if there is trade diversion, a firm located in a member country, although inefficient, may be able to overcome competition from a more efficient firm located in a non-member state, because it benefits from preferential tariff rates. This inefficient firm will then lobby against future global liberalization, in order to retain its privileged access to the regional market. Consequently, trade diverting PTAs are not only welfare reducing, but might also have negative effects on further liberalization of the multilateral trading system (see Grossman and Helpman, 1995).

Second, the market power effect that accompanies the formation or enlargement of customs union can lead to **increased protection** against outside countries. The increase in trade barriers may take the form of higher tariffs or of anti-dumping duties, when tariffs are bound by WTO commitments.

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<sup>14</sup> Trade creation implies a shift from costly domestic producers to lower cost PTA partners; trade diversion refers to the fact that PTAs may shift imports from more efficient non-member countries to less efficient member countries.

Third, large countries may benefit from signing preferential agreements with small countries, in which they can use their market power to extract concessions on non-tariff issues, such as labor market or environmental standards, migration or intellectual property protection. This implies that large countries may have an incentive to **slow down multilateral liberalization**, in order to maintain their bargaining power *vis-à-vis* their partners (see Limao, 2007).

Finally, it is often argued that being engaged in regional negotiations may **crowd out resources from multilateral negotiations**, stalling the process of MFN liberalization.

## 6.2 PTAs as “building blocs”

The alternative view on the relationship between regionalism and multilateralism predicts a benign effect of PTAs. Several arguments have been put forward as to why regionalism can complement the multilateral trading system and be a driving force for multilateral trade liberalization.

One argument is that PTAs increase the pressure to act in the direction of further multilateral liberalization. The idea is that the proliferation and expansion of PTAs leads to the **erosion of existing preferences**, thus reducing the opposition to multilateral liberalization.

It is also argued that by reducing the margin of competitiveness of countries that remain outside the agreement relative to partner countries, the formation of PTAs may prompt non-member countries to **pursue more multilateral trade liberalization** to avoid the negative effects of trade diversion. Furthermore, the anticipation of a strengthening of regionalism may offer a boost to multilateralism, as it may increase the penalty associated with retaliation in case of a defection from multilateral rules (see Bagwell and Staiger, 1999).

Another argument in support of the complementarity between regionalism and multilateralism is that PTAs act as **laboratories of international cooperation**, whereby cooperation can be tested among a small number of countries before being

extended multilaterally. This can help to build up the political consensus for further liberalization, thus making multilateral liberalization politically viable.

## **6.2 The case of EU regionalism**

In line with the negative view of regionalism, some evidence suggests that the creation and expansion of the EU may pose a threat to multilateral trade liberalization. In particular, it could be argued that the process of EU integration may have stalled multilateral liberalization by absorbing resources away from multilateral negotiations. For example, during the Kennedy Round, the Chairman to the Meeting of the Trade Negotiations Committee pointed out to the EU representatives that, with respect to agriculture negotiations, “all delegations were aware that in many respects there was a real dilemma for them because they were really engaged in two operations at the same time”<sup>15</sup>, i.e., elaborate and put into force a common agricultural policy for the Community, and participate in international negotiations covering the same field.

However, other considerations suggest that EU regionalism may instead be compatible with multilateral trade liberalization. In particular, there are at least three reasons to believe that the EU system of preferences promotes more trade creation than trade diversion: firstly, as mentioned above, although very few countries conduct their trade with the EU on a purely MFN basis, approximately three quarters of imports by the EU enter on non-preferential terms; secondly, the expansion of the EU web of PTAs – from agreements with neighboring countries and former colonies to transcontinental agreements that are not driven by geographical or historical links – implies that trade diverting effects are less likely to occur; thirdly, the progressive reduction in MFN tariffs has “eroded” the preferences of beneficiary countries, reducing the risk of trade diversion.

It should also be noted that the EU has on various occasions complied with WTO restrictions aimed at reducing the discriminatory effects of its trade policies. For example, since the WTO did not allow for the continuation of the discriminatory and non-reciprocal trade provisions of the Lomé/Cotonou agreements, the EU has

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<sup>15</sup> See the summary of the Progress Report by the Chairman to the Meeting of the Trade Negotiations Committee, WTO document TN. 64/28, p.3.

replaced them with reciprocal trade agreements (see discussion in Section 3). Similarly, following the Appellate Body ruling in the above-mentioned dispute between the EU and India, the EU has made changes to its GSP program, with the objective of making it non-discriminatory and more transparent.

Concerning the risk of an increase in external tariffs as a result of EU enlargement, there is evidence that the alarming predictions about “fortress Europe” have not been realized. On the contrary, it has been argued that European integration has played a considerable role in the liberalization of European external trade policy by changing the institutional context in which trade policy is made. In particular, the implementation of the Single European Act (SEA) has undermined the effectiveness of national trade barriers: before the SEA, member states could limit imports by a variety of national regulations to protect their economies (e.g., health, safety, and technical standards); with the completion of the single market, states lost the tools they needed to maintain national non-tariff barriers against non-EU imports (see Hanson, 1998).

Finally, different “waves” of EU regionalism have triggered fears of trade diversion in the United States and other non-member countries. As discussed in the previous section, these fears have been an important driving force behind different rounds of GATT/WTO negotiations. First, the period 1958-1965 saw the formation of the EEC, together with the launch of the Dillon Round and of the Kennedy Round. Second, the period 1973-1979 saw the enlargement of the EEC and the signing of the EEC-EFTA FTAs, where almost all tariffs in Western Europe were eliminated and, on the multilateral side, the launch of the Tokyo Round. Third, the Uruguay Round was launched in 1986, the same year in which the European Single Act was signed.

## **6. Conclusions**

We conclude by discussing the challenges faced by the multilateral trading system after the creation of the WTO and the crucial role played by the EU in the



controversial Doha Development Round (DDR), which was launched in December 2001, at a WTO ministerial conference in Doha, Qatar.<sup>16</sup>

The Ministerial Declarations agreed in Doha set a detailed work program, with the goal of completing it by 2005. The main objective of the Doha Development Agenda was to put development at the heart of the world trade system, so as to help them combat poverty. Negotiations involve commitments to take measures necessary to integrate developing countries into the world trading system, notably by strengthening assistance to build capacity.

As in previous rounds, the limited scope for concessions on agriculture on the part of the EU, due to the continuing resistance of France and other member countries to the dismantling of the CAP,<sup>17</sup> has meant that EU's trading partners (especially the large developing countries) have refused to make more ambitious offers to liberalize their service sectors and tariffs on industrial products, which are of direct concern to EU's commercial interests.

EU enlargement has also the potential to crucially affect the outcome of the DDR. New member states may aggressively assert their commercial policy interests, being less supportive of new trade policy issues (e.g., strengthening of intellectual property rights (IPR) regimes abroad and opening foreign financial markets), preferring instead measures that promote more traditional trade policy objectives (e.g., better access to the product markets of middle-income developing countries and promotion of foreign direct investments). Given the use of qualified majority voting in trade policy decisions within the Council, this could lead to fundamental changes in the EU's position in multilateral negotiations.

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<sup>16</sup> The terrorist attacks in the United States on September 11 2001 were arguably an important contributing factor to the launch of the Doha Round, generating the geopolitical imperative to demonstrate that the world's governments could cooperate at a time of heightened uncertainty.

<sup>17</sup> For example, proposals in 2002 by the EU Agriculture Commissioner Fischler for a modest reform in the CAP were blocked by a bilateral agreement between French President Jacques Chirac and German Chancellor Gerhard Schröder with the objective of freezing CAP spending until 2013. In February 2008, France argued that "twenty European Union countries are opposed to compromise proposals on agriculture floated by a World Trade Organisation mediator as part of a bid to rescue global trade talks", though the EU trade Commissioner Peter Mandelson shrugged off the criticism and said he still had the backing of the bloc" (Reuters, February 18, 2008).

Looking at the history of past multilateral negotiations suggests that the initial deadline for the completion of the Doha Round by 2005 was far too optimistic. Since the creation of the GATT in 1947, the number of its member countries has increased from 23 to more than 150 and the multilateral trading system has moved from being bipolar – dominated by the United States and the EU – to being multipolar – with Brazil, India and China playing an increasingly important role in the WTO. As a result, multilateral negotiations have become more complex and have taken longer to conclude.<sup>18</sup>

Multilateral negotiations have also become more complex with respect to the number of issues covered. While in early rounds the negotiating agenda included mostly tariff reductions in product markets, over the years, it has expanded to include non-tariff barriers and new issues such as the liberalization of trade in services and the protection of intellectual property rights. The text of the Uruguay Round Agreements (26,000 pages!) reflects this increased complexity.

Since the end of the Uruguay Round, there has been an intense debate over the potential overlaps between trade and non-trade objectives, especially with respect to environmental protection and workers' rights. Should trade sanctions be used to buttress environmental policy cooperation or promote more stringent labor standards? Or should the WTO forbid the use of trade sanctions to enforce non-trade agreements? Economic analysis suggests that the answer to this question is far from being obvious: on one hand, linking different policy dimensions may allow negotiating parties to arrive at a mutually advantageous (and economically efficient) exchange of concessions across different issues; on the other hand, making trade cooperation conditional on cooperation on other policy issues such as environmental protection may hinder the viability of multilateral cooperation in both areas (see Conconi and Perroni, 2002).

The demand that trade liberalization be linked to labor and environmental standards has received some backing in developed countries. However, labour and environmental standards are unlikely to be included in the Doha Round of multilateral

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<sup>18</sup> Based on the relationship between the number of participants and the duration of the negotiations in earlier rounds, the Doha Round should end in 2010 (see Neary, 2004).

negotiations, since the vast majority of developing countries regard them with scepticism and hostility, considering them as hidden forms of protectionism.<sup>19</sup> It remains unclear whether other trade-related policy issues will be included in the Doha Development Agenda, such as competition policy issues arising in connection with cross-border mergers and acquisitions (see Chapter 3 for a discussion).

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<sup>19</sup> The official position of the WTO is to leave the responsibility for the protection of labor and environmental standards to the ILO and to international environmental agreements such as the Kyoto Protocol. In particular, during the 1996 Singapore ministerial meeting, WTO members agreed that core labor rights should be globally recognized and protected; however, its fundamental legal mandate is to regulate trade and international protection of labor rights should be primarily the task of the ILO.

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