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**THE POLITICAL ECONOMY OF EC  
REGIONALISM**

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**INTERNATIONAL TRADE**



**Centre for Economic Policy Research**

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## ABSTRACT

### The Political Economy of EC Regionalism\*

Many observers have noted a recent proliferation of regional trade agreements primarily centred in or on Europe. The paper analyses the causes and consequences of EC regionalism. It begins by examining the development and importance of the phenomenon. It finds that although the EC maintains preferential trade arrangements with virtually all countries, preferential trade accounts for no more than 25% of total EC trade. The paper investigates the causes of EC regionalism, focusing on the determinants of both the demand by third countries and the supply by the EC. Lastly, it examines future options.

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## NON-TECHNICAL SUMMARY

Several reports and studies have noted a recent proliferation of regional trade agreements (RTAs). Regional integration has been primarily centred in or on Europe. Of the 109 agreements notified to GATT between 1948 and 1994, the European Community (EC) and the European Free Trade Association (EFTA) were parties in 76 instances. The recent acceleration in the number of agreements (33 notified between 1990 and 1994) is almost entirely due to changes in the countries of Central and Eastern Europe, which account for three-quarters of such RTAs, most of them concluded with the EC or with EFTA members.

From its inception, the EC has operated a complex, three-tier system of trade relations with third countries. The first tier includes countries enjoying preferential access to the EC market. The second contains countries treated on a purely most-favoured-nation (MFN) basis. The last tier consists of countries granted access to the EC market on a less-than-MFN basis.

In 1996, the hierarchy of EC trade relations was as follows. The preferential tier still comprised of three layers. The first, containing potential EC members (and Israel), was sub-divided into three trade regimes: single market (members of the EEA), customs union (Turkey) and free trade areas (Cyprus, Israel, Malta and Switzerland) and the ten Central and East European countries with Europe or Association Agreements). The second layer contained non-reciprocal preferences granted contractually by the EC to Mediterranean and African Caribbean Pacific (ACP) countries. The third layer consisted of non-reciprocal preferences granted autonomously by the EC to Generalized System of Preferences (GSP) beneficiaries, including the ex-Soviet members of the Commonwealth of Independent States. The MFN tier consisted of only six countries, namely Australia, Canada, Japan, New Zealand, Taiwan and the United States. The less-than-MFN tier contained only one country, North Korea.

At first sight, therefore, it would seem that MFN trade might constitute only a small proportion of EC imports. A quick-and-dirty approximation, based on the EC import share of the six countries treated on a purely MFN basis, would suggest a proportion of roughly one-third. In reality, the share of EC imports enjoying preferential treatment is less than 30%, implying that over 70% of imports enter the EC market on an MFN basis. Two factors account for this surprising result: non-dutiable imports and administrative rules.

The EC is currently engaged, or envisions the possibility of engaging, in negotiations aimed at establishing (reciprocal) free trade areas with many countries or country groupings. Whereas the recent wave of EC regionalism involved exclusively European nations – all potential EC members – the on-going or future wave concerns either non-European countries not eligible for EC membership or European countries which are unlikely to join the EC in the foreseeable future.

Clearly, the distinction between potential and non-potential EC members provides an important clue for understanding the pattern of EC regionalism. But there are also political economy factors that seem to be common to many instances of EC regionalism, regardless of the foregoing distinction. These factors refer to both the demand for EC regionalism addressed by third countries and the supply of RTAs provided by the EC.

Leaving aside purely political elements, two factors played a crucial role in the demands addressed to the EC, during the late-1980s and early-1990s, by EFTA members and by the Central and East European countries (CEECs): 'domino effects' and time inconsistency of reforms. These factors also play a role in some of the on-going or future projects of free trade areas with the EC.

Trade policy has always been the principal instrument of foreign policy for the EC, particularly in the form of trade preferences. The geographical scope of preferential arrangements has widened with each successive enlargement of the EC. In addition to such political elements, two factors tend to motivate the interest of the EC in supplying RTAs: discriminatory market access and regional stability.

As long as reciprocal RTAs were limited to potential member countries, EC regionalism was an integral part of a deep process of European integration involving both economic and political objectives and instruments. The extension of RTAs to non-candidate countries represents a radical departure for the EC. By doing so, it joins the United States in promoting 'hegemon-centred' trade agreements, i.e. free trade areas centred on a major trading power. It is doubtful whether this new development in EC regionalism reflects a grand design. Instead, probably like in the United States, it is a sign of short-term economic, political and bureaucratic considerations.

Today, EC regionalism stands at a cross roads with three possible options. One extreme is to continue along the regional path, all the way down to the demise of the multilateral trading system. The other extreme consists of promoting multilateral free trade. An intermediate option is to combine

elements of the two extreme solutions, seeking a harmonious coexistence between regionalism and multilateralism.

Option two is the most desirable. Option three might be a reasonable second-best, provided it involves a substantial strengthening of GATT Article XXIV aimed at minimizing the discriminatory aspect of RTAs. But above all, the EC needs to reflect on these options and formulate a long-term vision.

## 1. Introduction

Several reports and studies have noted a recent proliferation of regional trade agreements (RTAs). Of the 109 agreements notified to the General Agreement on Tariffs and Trade (GATT) between 1948 and 1994, 33 were notified since 1990. As a result, when the World Trade Organisation was established in January 1995, all but three of its original 120 members were parties to at least one of the 62 regional agreements still in force, and some were parties to many (the exceptions were Hong Kong, Japan and Korea).<sup>1</sup>

Regional integration has been primarily centred in or on Europe. Of the 109 agreements notified to GATT, the European Community (EC) and the European Free Trade Association (EFTA) were parties in 76 instances. The acceleration in the number of agreements notified since 1990 is almost entirely due to changes in the countries of Central and Eastern Europe, which account for three-quarters of such RTAs, most of them concluded with the EC or with EFTA members. But important developments have also occurred outside Europe, especially in the Americas, with the implementation of the Southern Common Market (MERCOSUR) and the North American Free Trade Agreement (NAFTA).

This evolution has been accompanied by a rapidly growing literature on regionalism which addresses the causes and consequences of regionalism. Whereas economists tend to agree that instances of deep integration, like the EC and its successive enlargements, have been welfare-enhancing, the jury is still out on whether the same can be said for cases of shallow integration like free-trade areas (FTAs). At the same time, economists disagree in their assessment of whether regionalism threatens multilateral trade liberalisation.<sup>2</sup>

This paper focuses on the causes and consequences of EC regionalism. Section 2 examines the development and importance of EC regionalism. Section 3 looks at the

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<sup>1</sup> See WTO (1995) and Sampson (1996).

<sup>2</sup> See, for instance, Bhagwati and Panagaryia (1996) and Winters (1996).

causes of EC regionalism. The last section argues that EC regionalism has reached a cross-roads.

## **2. Development and importance of EC regionalism**

From its inception, the EC has operated a complex, three-tier system of trade relations with third countries. The first tier includes countries enjoying preferential access to the EC market. The second contains countries treated on a purely most-favoured-nation (MFN) basis. The last tier consists of countries granted access to the EC market on a less-than-MFN basis.

By the early 1970s, most EC trading partners belonged to the first tier, which was itself divided into three layers. The first layer contained European countries, potentially future EC members, namely members of EFTA, Cyprus, Malta and Turkey. Countries in this layer formed (reciprocal) free-trade areas (FTAs) with the EC. The second layer included Mediterranean countries as well as African, Caribbean and Pacific (ACP) countries granted non-reciprocal contractual preferences by the EC. The trade arrangements in layers one and two are all regional trade agreements (RTAs) notified to GATT under Article XXIV. The third layer consisted of developing countries (i.e. all those not belonging to the Mediterranean or ACP groupings) enjoying non-reciprocal autonomous preferences by the EC under its Generalised System of Preferences (GSP); the GSP does not belong to the category of RTAs, but is covered by GATT under the 1979 Enabling Clause. The second (MFN) tier comprised only a handful of non-European industrialised countries. The lowest tier contained non-market economies, namely the Soviet Union and its Socialist partners within the COMECON.

### *2.1. Recent past development*

The early 1990s witnessed important upheavals in the hierarchy of EC trade relations due to two factors. The first, the end of the Cold War and the break-up of the Soviet Union, emptied the lowest tier of most of its members, who shifted to the preferential



tier. The second factor, the transformation of the EC into a Single European Market, led to the creation of the European Economic Area (EEA) and the last EC enlargement.

**(insert Table 1)**

In 1996, the hierarchy of EC trade relations was as follows (see Table 1). The preferential tier still comprised of three layers. The first, containing potential EC members (and Israel), was now sub-divided into three trade regimes: single market (members of the EEA), customs union (Turkey) and free-trade areas (Switzerland, Israel, Cyprus, Malta and the ten central and eastern European countries with Europe or Association agreements). The second layer contained non-reciprocal preferences granted contractually by the EC to Mediterranean and ACP countries. The third layer consisted of non-reciprocal preferences granted autonomously by the EC to GSP beneficiaries, including the ex-Soviet members of the Commonwealth of Independent States. The MFN tier consisted of only six countries, namely Australia, Canada, Japan, New Zealand, Taiwan and the United States. The less-than-MFN tier contained only one country, North Korea.<sup>3</sup>

## *2.2. Importance*

The previous discussion clearly indicates that the EC grants preferential market access to the overwhelming majority of its trading partners. At first sight, therefore, it would seem that MFN trade might constitute only a small proportion of EC imports. A quick-and-dirty approximation, based on the EC import share of the six countries treated on a purely MFN basis, would suggest a proportion of roughly one-third. Indeed, the last line of Table 2 indicates that, in 1996, EC imports originated in about equal proportions from RTA, GSP and MFN partners.<sup>4</sup> Imports from partners involved in regional trade agreements with the EC accounted for 31.5 percent of total EC imports: 24.4 percent from countries with reciprocal RTAs and 7.1 percent from countries with

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<sup>3</sup> With the exception of Slovenia, members of the ex-Yugoslavia are omitted from the present discussion.

<sup>4</sup> Total EC imports exclude trade with members of the ex-Yugoslavia other than Slovenia.

non-reciprocal RTAs. Imports from GSP beneficiaries accounted for 34 percent. Finally, imports from MFN partners represented 34.5 percent of total EC imports.

**(insert Table 2)**

In reality, the share of EC imports enjoying preferential treatment is less than 30 percent, implying that over 70 percent of imports enter the EC market on a MFN basis. Two factors account for this surprising result: non-dutiable imports and administrative rules.

The last column of Table 2 shows that, in 1996, 30.1 percent of the value of EC imports was accounted for by products with zero MFN rates. This figure was computed by summing up imports for all 8-digit lines of the 1996 Combined Nomenclature with zero tariff rates.<sup>5</sup> Table 2 also indicates that the proportion of non-dutiable imports varied substantially across country groupings. To a large extent, the variation across country groupings is accounted for by differences in their reliance on primary or simply transformed exports, which tend to carry zero MFN rates in the EC.

All EC preferential trade arrangements are subject to three types of administrative regulation which limit their actual preferential treatment. Firstly, no single EC trade arrangement grants preferential treatment to all products. In particular, many agricultural products covered by the Common Agricultural Policy (CAP) tend to be either excluded or subject to strict import quotas. Secondly, all preferential arrangements contain rules of origin setting forth the requirements for products to be considered as "originating products" for the application of preferences. Products imported from preferential partners are denied preferential treatment at their entry into the EC if they do not qualify as originating products, or if traders fail to submit appropriate origin certificates.<sup>6</sup> Finally, most EC preferential arrangements contain

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<sup>5</sup> The 1996 Combined Nomenclature contains 10,846 8-digit lines, of which 1,419 have a zero tariff rate.

<sup>6</sup> In some instances, traders may simply not request that their products be considered as "originating products", for example if these products are subject to very low MFN rates in the EC.

tariff-quotas for certain products, specifying limits beyond which imports from a given partner are subject to MFN duties.

Unfortunately, there is no precise information on the impact of these administrative rules on the functioning of EC RTAs.<sup>7</sup> By contrast, information is available for imports under the EC GSP scheme. The latter indicates that if the value of EC dutiable imports from all GSP beneficiaries amounted to 100 in 1994,<sup>8</sup> the value meeting the product-coverage rule was 79, and the value actually receiving GSP treatment was only 38; the difference between 79 and 38 was due to the combined effect of origin rules and tariff-quotas, which cannot be disentangled.<sup>9</sup>

The third line of Table 2 gives an estimate of the share of EC imports receiving preferential treatment. This estimate is based on the following assumptions: all dutiable imports from trading partners covered by a (reciprocal or non-reciprocal) RTA enjoy preferential treatment; 38 percent of dutiable imports from GSP partners receive such treatment; and none of the dutiable imports from MFN partners secures any preference at all. Clearly, the estimate of 29.6 percent of EC imports receiving preferential treatment is an upper bound, since an unknown proportion of dutiable imports from RTA partners is actually subject to MFN duties. By implication, the proportion of EC imports subject to MFN treatment is, currently, above 70 percent.<sup>10</sup>

As far as exports are concerned, the EC enjoys preferential market access only in the nearly 20 countries with whom it has concluded reciprocal RTAs. The memorandum item in Table 2 indicates that, in 1996, 28 percent of EC exports were shipped to these countries. If account is taken of non-dutiable items and of various administrative rules governing preferential imports in partner countries, it is probably reasonable to

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<sup>7</sup> In principle, one could estimate the impact of the first administrative rule, the product-coverage rule, based on the text of the respective RTAs. Conversely, it is impossible to obtain information on the impact of the other two administrative rules. It would be inappropriate to assume that the impact of these rules on imports from RTA partners is the same as on imports from GSP beneficiaries; the reason is that, in the EC, GSP rules are stricter than rules applying to contractual preferential agreements.

<sup>8</sup> This is the most recent year for which information is available.

<sup>9</sup> For a discussion of the restricted character of the EC GSP origin rules, see Vermulst (1994).

<sup>10</sup> A similar estimate was obtained by Duynhouwer (1993).

estimate that the proportion of EC exports subject to MFN treatment is, currently, around 75-80 percent.

Consequently, despite an extensive and growing network of preferential trade arrangements, it appears that the EC still conducts the vast majority of its total (exports plus imports) trade on a MFN basis. No more than 25 percent of total EC trade flows currently enjoy preferential, non-MFN treatment. Assuming no further extension of EC regionalism, this figure is bound to decline in coming years with the implementation of Uruguay Round and Singapore Conference commitments, which will substantially increase the number of products with bound duty-free tariff rates.

### *2.3. On-going and potential future development*

The EC is currently engaged, or envisions the possibility of engaging, in negotiations aimed at establishing (reciprocal) free-trade areas with many countries or country groupings.

Matters are already quite advanced with the Mediterranean countries. Negotiations have already been concluded with Morocco, Tunisia and the Palestinian Authority, are on-going with Egypt, Jordan and Lebanon, and are expected with Algeria and Syria in due time.

The Lomé Convention with the ACP countries is due to expire in February 2000. One of the options currently contemplated for the future EC-ACP trade relationship is reciprocal preferences, in the form of bilateral or region-to-region FTAs, a solution strongly advocated by Collier et al. (1997) for reasons discussed in the next section.

Negotiations are also proceeding with certain GSP beneficiary countries: South Africa, Mexico, and members of the Gulf Cooperation Council (Bahrein, Kuwait, Oman, Saudi Arabia and United Arab Emirates). It is also envisioned to launch negotiations with members of the MERCOSUR (Argentina, Brazil, Paraguay and Uruguay), and other Latin American countries. Further down the road, FTAs could be negotiated

with some members of the Community of Independent States, including Russia and Ukraine.

Finally, some have even floated the idea of concluding FTAs with traditionally MFN partners like Canada and the United States. For the moment, however, the notion of a Trans-Atlantic Free Trade Area (TAFTA) has been superseded by the vaguer concept of Trans-Atlantic Market-Place.

### **3. Determinants of EC Regionalism**

The recent wave of EC regionalism involved exclusively European nations, all potential EC members. By contrast, the on-going or future wave concerns either non-European countries not eligible for EC membership or CIS members which are unlikely to join the EC in the foreseeable future.

Clearly, the distinction between potential and non-potential EC members provides an important clue for understanding the pattern of EC regionalism. But there are also political economy factors that seem to be common to many instances of EC regionalism, regardless of the foregoing distinction. These factors refer to both the demand for EC regionalism addressed by third countries and the supply of RTAs provided by the EC.

#### *3.1. The demand for RTAs by EC partners*

Leaving aside purely political elements, two factors played a crucial role in the demands addressed to the EC, during the late 1980s and early 1990s, by EFTA members and by the Central and Eastern European countries (CEECs): “domino effects” and time inconsistency of reforms.

In 1973, upon the accession of the United Kingdom to the EC, the EC and the remaining EFTA members established a free-trade area.<sup>11</sup> The new equilibrium generated by the EC-EFTA trading arrangement was perturbed in the mid-1980s, when EC members decided to deepen their own integration by embarking on the Single Market programme. As pointed out by Krugman (1988), the EC's move threatened the competitiveness of EFTA members, requiring them to participate in the Single Market programme. According to Baldwin (1995), this threat triggered a "domino effect" in Europe, leading to requests for EC membership by Austria in 1989, by Sweden in 1991 and by Finland, Norway and Switzerland in 1992. In 1994, Austria, Sweden, Finland and Norway (together with Iceland and Liechtenstein) established the EEA, a single-market-type arrangement, with the EC; one year later, the first three countries became EC members.

Sapir (1997) examines the hypothesis of domino effects in Western Europe by using an annually estimated gravity equation for the period 1960-92. The equation includes dummy variables to capture the impact of EC integration on the intensity of trade flows within the EFTA and EC-EFTA free-trade areas. The results indicate that the application for EC membership by several EFTA members at the end of the 1980s coincided with a deterioration in their competitive position. Intra-EFTA trade held its own vis-à-vis intra-EC up to 1985, with a coefficient of the EFTA dummy equal, on average, to 0.24 (but not significant at 5%) during the period 1960-75, and to -0.06 during the period 1976-85. Thereafter, intra-EFTA trade became, *ceteris paribus*, less intensive than intra-EC trade (significantly so from 1989), the coefficient of the EFTA dummy dropping to -0.48 (significant at 5%) during the period 1989-92.<sup>12</sup> Similarly, a break in the pattern of EC-EFTA trade occurred during the period 1989-92, when the coefficient of the relevant dummy fell to an average of -0.35 (significant at 5%), compared with -0.29 (but not significant at 5%) during the period 1973-85.

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<sup>11</sup> More precisely, a series of seven bilateral FTAs were established between individual EFTA members and the EC.

<sup>12</sup> A coefficient of -0.48 for the EFTA dummy means that the intensity of intra-EFTA trade is only  $\exp(-0.48) = 60\%$  the intensity of intra-EC trade.

Domino effects also played an important role in the decision of the Central and Eastern European countries to request FTAs with the EC and EFTA members. As Baldwin (1997) notes, since nearly all (industrial) trade in Western Europe was duty free and Western Europe was paramount for the CEECs, these FTAs were essential for levelling the playing field for CEEC exporters.

There is a second factor underlying the desire of the CEECs to participate in RTAs with the EC. As noted, *inter alia*, by Fernandez (1997), Europe Agreements offer a credible commitment device for implementing otherwise time-inconsistent economic reforms (concerning trade and domestic policy) and political reforms (aimed at devising stable institutions guaranteeing democracy).<sup>13</sup>

In the aftermath of their political transformation in 1989, the CEECs implemented major trade liberalisation programmes. The experience of other reforming countries suggested, however, that trade liberalisation was going to be difficult to sustain over a long period, unless governments succeeded in establishing credible commitment mechanisms. Sapir (1994) shows that, in addition to GATT obligations, Europe Agreements were successful in tying the hands of governments in favour of liberal trade policies at a crucial time, when the 'honeymoon of trade liberalisation' was coming to an end in many CEECs due to the resurgence of pressure groups. The paper argues that the main additional constraint imposed by Europe Agreements, over and above GATT obligations, lies in the process of consultation with trade partners. The GATT was notorious for its lack of enforcement discipline. Although the WTO has partly remedied the situation, the fact remains that bilateral monitoring by the EC, the main trading partner of the CEECs, is probably more effective than multilateral control.

Fernandez (1997) rightly insists that the scope of the Europe Agreements extends far beyond free trade. The Agreements contain major provisions imposing the

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<sup>13</sup> The idea of a RTA between a richer and a poorer trading partner with the explicit (but not necessarily sole) purpose of helping to implement economic and political reforms in the poorer partner probably goes back to the accession of Greece to the EC in 1981. The accession of Portugal and Spain in 1986 also fits the model. Similarly, the drive of Mexico in favour of NAFTA was partly related to its desire to lock in economic reforms.

approximation of EC law, thereby effectively binding the domestic economic policies of the CEECs in areas such as competition and investment policy.

The domino and time-inconsistency factors also play a role in some of the on-going or future projects of free-trade areas with the EC.

Until the early 1990s, the Mediterranean countries enjoyed unrivalled access to the EC market due to the combination of geographical proximity and preferential tariff treatment. The situation was challenged by the reunification of Europe and the implementation of Europe Agreements with the CEECs. This threat to the relative competitive position of Mediterranean countries in the EC market (by far their largest outlet), triggered their demand for Euro-Mediterranean Agreements comparable to Europe Agreements. However, in contrast with the CEECs, it is probably fair to say that these new agreements do not buttress significant liberalisation and policy reform, which remain to be achieved in most Mediterranean countries.

Neither the domino nor the time-inconsistency factor is a major factor in the case of the ACP countries. Contrary to the Mediterranean countries which export manufactured products in direct competition with the CEECs, the ACP countries largely specialise in primary products, many of which are imported free of duty in the EC. Few of these countries, therefore, feel threatened by the extension of EC regionalism. At the same time, very few are engaged in economic and/or political reforms which could benefit from the support of regional agreements with the EC as advocated by Collier et al. (1997).

### *3.2. The supply of RTAs by the EC*

Trade policy has always been the principal instrument of foreign policy for the EC, particularly in the form of trade preferences. The geographical scope of preferential arrangements has widened with each successive enlargement of the EC. Originally, trade preferences were granted solely to former French and Belgian colonies. They were then extended to many former British and Portuguese colonies. At present, with



the geo-political interests of EC member states stretching in all directions, new FTAs are implemented or envisioned with other parts of the world: Germany, Austria and the Nordic members were keen to have closer ties with the CEECs; the Mediterranean member states patronise FTAs with Southern Mediterranean countries; the United Kingdom and the Netherlands favour the project of a FTA with South Africa; and Portugal and Spain strongly support closer trade relations with Latin America. It has also been claimed that the tendency to set up FTAs in all directions might be reinforced by the fact that the portfolio for foreign economic relations is divided among four EC commissioners, each responsible for a group of countries.

In addition to political and bureaucratic elements, two factors tend to motivate the interest of the EC towards RTAs: discriminatory market access and regional stability.

By definition, free-trade areas between the EC and foreign partners improve the access of EC firms in partner markets, compared to third-country suppliers. Clearly, certain EC interest groups favour such preferential access to foreign markets because of the competitive advantage it provides in these particular markets. Those interest groups which favour discriminatory trade arrangements are further encouraged by the hub-and-spoke nature of EC regionalism. In the present configuration, the EC constitutes the hub in an expanding network of bilateral FTAs, which gives it two important advantages over the spoke countries. First, the EC enjoys preferential access in the markets of each of the spoke countries compared to all other spokes. Second, locations in the EC, with its duty-free access to all spokes, command an advantage in attracting investment over any other location in the network. The disadvantages incurred by the spoke countries are further compounded by the rules of origin which accompany the various FTAs in the network.

The other factor motivating the interest of the EC in supplying RTAs is regional stability. Clearly, the EC has much to gain, economically and politically, from improved economic conditions of its Eastern and Southern neighbours. This explains the conclusion of Europe Agreements with ten CEECs and the on-going negotiation of Euro-Mediterranean Agreements, both containing substantial financial protocols.

In the past, when the United States opposed the expansion of preferential trade arrangements because of their discriminatory nature, the EC was only able to conclude (reciprocal) FTAs with countries deemed as potential EC members. For instance, the original plan for a reciprocal FTA between the EC and the ACP countries was abandoned at the insistence of the United States, and converted into a non-reciprocal preferential arrangement. Today, with its participation in NAFTA and its plan for a Free Trade Association of the Americas (FTAA), the United States is actively engaged in regional trade agreements. It might not, therefore, object to the transformation of non-reciprocal arrangements with the Mediterranean countries into full-fledged FTAs. On the other hand, the United States would probably not remain passive if the EC concluded a free-trade area agreement with South Africa, a large and fast-growing market: it would either oppose it at the WTO, or seek to conclude a similar agreement.

At the same time, current developments in the Americas have prompted the EC to envisage negotiating free trade arrangements with parties to existing or planned FTAs (NAFTA, MERCOSUR AND FTAA), so as to reduce or eliminate their potential negative effects for EC exporters.

#### **4. EC regionalism at the cross-roads**

The present decade is witnessing a significant extension of reciprocal RTAs between the EC and third countries. Agreements have already been implemented with eleven and concluded with three others; and negotiations are on-going or planned with another dozen or so countries. In the past, reciprocal EC RTAs covered exclusively potential EC members (with the exception of Israel). By contrast, the new trade agreements concern both future EC members (Turkey and the CEECs) and non-candidate countries previously enjoying non-reciprocal preferences in the EC market (Mediterranean, ACP or GSP-beneficiary countries).

The extension of EC regionalism and the conclusion of reciprocal RTAs with non-EC candidates raises two separate questions. The first concerns the relatively narrow issue

of GATT/WTO compatibility of individual agreements. The second deals with the broader issue of proliferation of RTAs and its impact on the world trading system.

Since 1992, the EC has notified 15 or so new RTAs to the GATT and the WTO. In each case, a working party has been established to verify the conformity of the agreement with GATT/WTO obligations, but so far no report has been adopted by the GATT or the WTO.<sup>14</sup> This situation partly arises from the long-standing lack of agreement between countries on the interpretation of GATT Article XXIV relative to customs unions and free-trade areas for trade in goods.<sup>15</sup>

A Committee on Regional Trade Agreements was established in the WTO in February 1996 to remedy the situation, but little progress has been achieved as yet. Meanwhile, some degree of uncertainty exists as to the conformity of recent EC RTAs. Uncertainty also applies to RTAs previously accepted by the GATT as a result of the Uruguay Round Understanding on Article XXIV which states that the dispute settlement procedure of the WTO “may be invoked with respect to any matters arising from the application of Article XXIV.”<sup>16</sup>

As long as reciprocal RTAs were limited to potential member countries, EC regionalism was an integral part of a deep process of European integration involving both economic and political objectives and instruments. The extension of RTAs to non-candidate countries represents a radical departure for the EC. By doing so, it joins the United States in promoting “hegemon-centred” trade agreements, i.e. free-trade areas centred on a major trading power.<sup>17</sup> It is doubtful whether this new development in EC

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<sup>14</sup> Other regional trade agreements in the same situation include NAFTA and MERCOSUR.

<sup>15</sup> See Sampson (1996). The RTAs recently notified by the EC also cover trade in services, which requires additional conformity to Article V of the General Agreement on Trade in Services (GATS) relative to customs unions and free-trade areas.

<sup>16</sup> Preferential treatment granted and notified under Article XXIV has been subject to only three dispute settlement proceedings under GATT rules, all involving the EC as the respondent (once concerning citrus products from certain Mediterranean countries, and twice about bananas from ACP countries). In each case, the EC blocked the adoption of the panel report by the GATT Council. The banana case has been reintroduced under the enhanced dispute settlement rules of the WTO, which do not permit the blocking of panel reports. In May 1997, the Panel ruled against the EC, a decision which it appealed the next month.

<sup>17</sup> This concept is used by Bhagwati and Panagariya (1996).

regionalism reflects a grand design. Instead, probably like in the United States, it is a sign of short-term economic, political and bureaucratic considerations.

Today, EC regionalism stands at a cross-roads with three possible options. One extreme is to continue along the regional path, all the way down to the demise of the multilateral trading system. The other extreme consists of promoting multilateral free trade. An intermediate option is to combine elements of the two extreme solutions, seeking an harmonious coexistence between regionalism and multilateralism.

The first option would see the construction of a EC-centred free-trade area eventually including the EC, the remaining nations of Europe, the Mediterranean countries and some other African countries (for short, EMA). In total, this vast FTA may include 20-25 countries in addition to the 25-30 members of the EC. Such a FTA would raise internal and external problems.

The internal problem concerns the organisation of a FTA between a major trading power and a large number of small partners. Three issues stand out: hub-and-spoke, origin rules and dispute settlement.

Solving the hub-and-spoke problem would require that each pair of countries in EMA (outside EC members) creates a small FTA or that groups of countries establish regional FTAs linked to each other by larger FTAs. The Central European Free Trade Agreement (CEFTA) is a (small) step in this direction.

Even with a complete network of FTAs, the hub-and-spoke problem would remain partly unsolved due to the presence of origin rules. The solution would be to harmonise all the different origin rules prevailing inside EMA, as envisaged between the EC/CEEC/EFTA countries.

Contrary to NAFTA, which contains dispute settlement rules broadly similar to GATT/WTO procedures, most EC-centred RTAs foresee a negotiated rather than a judiciary solution to trade disputes. In principle, the EC and its RTA partners are

allowed to engage a GATT/WTO procedure in case of dispute, but it has never happened in practice.<sup>18</sup> Some may argue that negotiated solutions are unfair as they give undue weight to the partner with the largest domestic market.

The external problem lies in the fact that the creation of EMA would almost certainly precipitate the formation of the proposed FTAA and transform Asia-Pacific Economic Cooperation (APEC) into a free-trade area. In addition, the inclusion of Russia in EMA is bound to lead to strong political reactions from Washington, which could endanger the North-Atlantic Treaty Organisation (NATO).

In order to avoid the potential negative consequences of FTAA and the demise of NATO, the EC would be obliged to reinforce its ties with the United States by setting up TAFTA. However, because the United States has a clear interest in remaining both an Atlantic and a Pacific power, it could not enter into TAFTA without at the same time be part of an Asia-Pacific FTA. The latter would be a clear threat to the economic interests of the EC, unless it succeeded in forming its own free-trade area with Asia. By then, in any event, the WTO-based multilateral trading system would have become devoid of content for all intent and purposes.

A possible solution to these problems would be to set up EMA as a customs union rather than a free-trade area. A customs union would entirely eliminate the hub-and-spoke and origin-rule problems. At the same time, because it would force all its members to adopt the low EC (industrial) tariff schedule, a customs union would considerably reduce the potential threat of EMA to foreign partners.

The second option for the EC would be to back up the idea of establishing a deadline of 2010 for a global free trade pact, as first suggested by WTO director-general Ruggiero in 1996. This option has the great advantage of solving all the problems of the first option. In particular, it removes the danger of competing trade blocs.

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<sup>18</sup> As of 21 July 1997, there had been 96 dispute settlement cases under WTO procedures, of which 32 involved the EC as either complainant or respondent. Not a single case involved one of its nearly 100 RTA partners as complainant or respondent. By contrast, of the 48 cases involving the United States, one related to Canada (as respondent) and one to Mexico (as complainant), its only two RTA partners besides Israel.

The last option is a middle ground between the two extreme options. It would see a continuation in the process of regionalism (with new reciprocal RTAs centred on the EC and the United States) and of multilateralism (with a further lowering or elimination of tariffs). At the same time, this option would entail an improvement in the existing WTO rules, including Article XXIV, so as to lessen the internal and external problems raised in the context of the first option.

Option two is the most desirable. Option three might be a reasonable second-best, provided it involves a substantial strengthening of Article XXIV aimed at minimising the discriminatory aspect of RTAs. But, above all, the EC needs to reflect on these options and formulate a long-term vision.

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**Table 1: The Hierarchy of EC Trade Regime, 1996**

Type of trade regime	Name of Agreement	Countries involved
<u>Single market</u>	European Economic Area (EEA)	Iceland, Liechtenstein, Norway
<u>Customs union</u>		Turkey
<u>Free-trade areas</u>		Switzerland, Israel, Cyprus, Malta
	Europe Agreements	Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia
<u>Non-reciprocal contractual preferences</u>		Algeria, Egypt, Jordan, Morocco, Lebanon, Syria, Tunisia
	Lomé Convention	African, Caribbean and Pacific (ACP) countries (excl. South Africa)
<u>Non-reciprocal autonomous preferences</u>	Generalised System of Preferences (GSP)	Other developing countries (incl. South Africa), members of the Commonwealth of Independent States (CIS), Albania
<u>Purely most-favoured-nation (MFN) treatment</u>		Australia, Canada, Japan, New Zealand, Taiwan, United States
<u>Less-than-MFN treatment</u>		North Korea



Table 2: EC Imports, by tariff and partner category, 1996 (percent of value of total imports)

PRODUCT CATEGORY	TRADE PARTNERS, BY TYPE OF TRADE REGIME										
	Reciprocal RTAs					Non-reciprocal RTAs			GSP	MFN Partners	TOTAL
	EEA	Turkey	CH, Is, Cy, Ma	Europe Agreement	Total	Mediterranean	ACP	Total			
MFN free	3.0	0.2	2.2	1.0	6.4	1.6	2.2	3.8	12.3	7.6	30.1
MFN dutiable (preferential)	2.6	1.6	6.5	7.3	18.0	1.6	1.7	3.3	21.8	26.9	69.9
	(2.6)	(1.6)	(6.5)	(7.3)	(18.0)	(1.6)	(1.7)	(3.3)	(8.3)	(0.0)	(29.6)
<b>TOTAL</b>	<b>5.6</b>	<b>1.8</b>	<b>8.7</b>	<b>8.3</b>	<b>24.4</b>	<b>3.2</b>	<b>3.9</b>	<b>7.1</b>	<b>34.0</b>	<b>34.5</b>	<b>100.0</b>
<b>Memorandum: EC exports</b>	<b>3.5</b>	<b>3.0</b>	<b>10.9</b>	<b>10.6</b>	<b>28.0</b>	<b>4.0</b>	<b>3.1</b>	<b>7.1</b>	<b>34.1</b>	<b>30.7</b>	<b>100.0</b>

Source: own computation based on COMEXT.