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The European Union's Trade Policies and their Economic Effects

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THE EUROPEAN UNION'S TRADE POLICIES AND THEIR ECONOMIC EFFECTS: ECONOMICS DEPARTMENT WORKING PAPERS NO. 194

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ABSTRACT/RÉSUMÉ

This paper retraces the Communities external liberalisation efforts, and discusses, where relevant, the repercussions of internal liberalisation on foreign competitors. The aim of the paper is to clarify, and when feasible, to quantify the economic effects of the EU's trade policies. To this end, it provides an overview of past liberalisation efforts, reviews trade indicators in international comparison and lays out the future trade agenda of the Community. The empirical evidence provided in the paper points to little evidence for trade diversion due to integration in Europe, while trade is likely to have boosted area-wide income significantly. It is openness in general, rather than regional integration, that has favoured growth in Europe.

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Cet article retrace les efforts de libéralisation extérieure de la Communauté et discute des effets du marché unique sur les compétiteurs étrangers. L'objectif de cet article est de clarifier et, si possible, de quantifier les effets économiques de la politique commerciale commune de l'UE. A cette fin, ce document présente un survol des efforts de libéralisation passés. Il procède ensuite à une comparaison internationale des indicateurs de commerce et décrit le futur agenda de la Communauté. Les résultats empiriques obtenus dans cet article indiquent que l'intégration européenne n'aurait entraîné que peu d'effet de diversion des échanges tandis que l'ouverture commerciale semble avoir relevé de façon importante le niveau du revenu de la région dans son ensemble. C'est l'ouverture extérieure plus généralement davantage que l'intégration régionale qui a favorisé la croissance en Europe.

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THE EU'S TRADE POLICIES AND THEIR ECONOMIC EFFECTS

Peter Hoeller, Nathalie Girouard and Alessandra Colecchia[1]

INTRODUCTION

1. Over its four decades of existence, the European Union (EU) has gradually become a global economic heavyweight and economic policies, whether internal or external, have become of great importance to the Union's trading partners. This paper reviews the EU's trade policies and analyses their economic effects.

2. The Treaty of Rome foresaw a common commercial policy as a complement to the goal of realising the internal market. Centralisation of this policy function is necessary to ensure a level internal playing field, but the Treaty also enshrined multilateral trade liberalisation as a goal in itself to be pursued by the Community. Four decades ago, external protection was high in most European countries. Since the Treaty of Rome, internal liberalisation has made much progress which also improved market access by third countries across a wide range of sectors and products. At the same time the Community actively participated in multilateral liberalisation efforts and barriers to trade have come down considerably. The Union's experience is not only unique in its aim at deep integration in the Community, but also in its long-standing pursuit of regionalism. Chapter I provides a short overview of the evolution of the EU's trade regime and draws on the empirical literature to highlight the economic effects.

3. The EU's barriers to trade have come down considerably for most industrial goods, protection has remained high in the agricultural sector and multilateral liberalisation of services is still in its infancy. While these features are easy to track, it is difficult to compare trade regimes across countries as no comprehensive trade policy indicators exist. Chapter II takes the modest route of comparing the available trade policy indicators, which, nevertheless, provide plenty of insights. The focus here is on trade in goods, as service liberalisation as well as many other trade-related issues have only recently been taken up

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at the multilateral level. Foreign direct investment is only covered to the extent that it touches on trade issues.

4. Chapter III reviews the economic effects of trade liberalisation, largely from a macroeconomic perspective. Growth and labour market effects of trade liberalisation are important in the current policy debate. While the many links between trade and welfare are well understood, the empirical literature still has not come to strong conclusions, whether the effects of trade on growth are sizeable or rather small. Concerning labour market effects, a fast growing body of research has focused on the wage and employment effects of trade integration, especially increased competition from low wage countries. Given the diversity of labour market institutions within Europe, this issue is even more difficult to tackle empirically. Finally, for countries which are not party to a regional agreement with the EU, trade diversion due to regional integration is of major concern. This paper reviews the empirical literature on these topics and uses a wide range of trade indicators and regression analysis to shed light on these questions.

5. In the future, the EU intends to go ahead with deepening economic integration with the eastern European and Mediterranean countries and several countries are currently gearing up to join the Union. The Union is also pursuing bilateral agreements on trade-related issues, such as competition policy and the elimination of technical barriers to trade. Finally, the EU intends to actively pursue multilateral liberalisation. The EU's future trade agenda is reviewed in Chapter IV. A summary pulls together the major insights.

I. PROGRESS TOWARDS FREER TRADE: AN OVERVIEW

6. Since its creation the EU has pursued trade liberalisation, by reducing trade barriers internally, by widening the Community, by striking regional trade agreements, and by participating actively in multilateral trade liberalisation efforts.

Internal integration improves access of third countries

7. The single market, largely accomplished in 1993, stands out as the deepest regional integration scheme world-wide. A first major step towards liberalisation was achieved with the Customs Union formed in 1968. However, non-tariff trade barriers remained and the impetus towards effective implementation of the four freedoms (free movement of goods, services, capital and people) lost momentum. With growth slowing in the mid-1970s, recourse to non-tariff trade barriers and subsidies to protect non-viable industries multiplied. Restrictions concerning services, which should have been progressively abolished, were either only partially eliminated or completely excluded from the liberalisation process.

8. During the early 1980s, the case for the growth-enhancing effects of liberalisation became widely accepted and the Single Act, containing some 300 proposals for implementing the internal market was ratified in January 1987.[2] The single market goes considerably beyond a customs union as it provides for the abolition of non-tariff barriers and for free factor movement. It is also more ambitious than free trade agreements such as the North American Free Trade Agreement (NAFTA), which abolishes tariffs and quotas among member countries, allowing each country to protect itself against non-Member countries on an individual basis. Another distinguishing feature of the EU scheme is that it provides for EU-wide legislation across a specific range of competencies. Legislation is interpreted and applied by a Court of Justice. Finally, better EU-wide co-ordination of policies was achieved by the signing of the Maastricht Treaty in 1992 and the Amsterdam Treaty in 1997, the former aiming largely at establishing an Economic and Monetary Union (EMU) and the latter at achieving stronger political integration in a number of areas. Table 1 highlights the major differences between the NAFTA and the EU.

9. At the same time the Union has widened beyond the six founding members, with the accessions of the United Kingdom, Denmark and Ireland in 1973, Greece in 1981, Portugal and Spain in 1986 and of Austria, Finland and Sweden in 1995. The Treaty of Rome allows other European nations to join if the existing members unanimously agree and the new members undertake the full duties of membership, which implies enacting the "acquis communautaire". Today, the European Union is the largest integrated economic area in terms of population in the OECD. GDP is close to that of the United States, and nearly

2. The single market programme was flanked by a strengthening in EU-wide competition policies, by a stepping up of inter-regional transfers and by providing for a few EU-wide competencies in the social area.

Table 1. **The EU and NAFTA trade frameworks: an overview**

	EU	NAFTA
Goods	Since 1992, intra-area trade is free of tariffs and QRs.	Five to ten-year phase-out of all tariffs (fifteen years in sensitive sectors). Liberalisation of NTBs. Elimination of tariffs and quotas on textiles, apparel and cars. Free trade in agricultural products within fifteen years.
Investment	All restrictions have been lifted from the movement of portfolio capital among members. Provisions have been made for firms' freedom of establishment.	National treatment of investors. Mexican export performance, local content, and foreign exchange requirements are being phased out. Reduction of taxes on dividends, interest and royalties. Some restrictions remain in Mexico's basic energy and railroad industries, Canada's cultural industries and US airline and radio industries.
Services	Trade barriers have been removed with the exception of energy, telecommunications and transportation which have undergone liberalisation to varying degrees. Exceptions are also made for leasing services, legal services, accountancy and postal services.	Substantially opens up financial services in Mexico to US and Canada by 2000 (includes phased reduction of tariffs and NTBs in banking, insurance and brokerage sectors). Nearly full liberalisation of telecommunication and land transportation services. Establishment of negative list of exceptions.
Labour	Labour movement is almost completely liberalised. Some barriers still exist in the form of professional and vocational qualifications and limited portability of fringe benefits, pensions, and so on.	Includes provisions for entry of business and professional personnel. Intra-company transferees are allowed to enter member countries. 5 500 additional Mexican professionals are allowed to enter the US annually (above global immigration limits).
Antidumping provisions (versus competition policy)	Antidumping measures were eliminated within the area but common anti-dumping policy exists. Establishment of strong competition policy and enforcement mechanisms covering trade among members.	Continued application of anti-dumping laws but Mexican procedures have been brought closer to those of the US and Canada.

Table 1. **The EU and NAFTA trade frameworks: an overview** (cont.)

	EU	**NAFTA**
Subsidies	European competition policies have reduced state aid but level of subsidisation is still high. Community-wide subsidy for agricultural products persists (CAP).	No progress made in eliminating subsidies.
Regulations and standards	Mutual recognition of each country’s regulations and standards (includes firms’ rights of establishment and certification of professionals) unless minimum community-wide standards have been set (in health, safety, environment). Customs formalities abolished. Some differences in technical standards and indirect taxation persist. Working on harmonisation of technical product standards.	No common set of rules or institutional harmonisation. Enforcement of domestic laws is subject to international scrutiny.
Government procurement	Public procurement of goods and services has been made subject to rules providing for transparency and free market access. Some monitoring problems exist.	Liberalisation of procurement by major government agencies in all three countries.
Dispute settlement	Disputes are handled by the Court of Justice.	Disputes handled by Free Trade Commission (augments dispute settlement provisions of CUSFTA).
Supranational institutions	Commission (administrative and technical body); Council of Ministers (main decision making body); Court of Justice (enforcement of common body of law); and the Assembly (parliament). Each of these organisations has power that is comparable to institutions in federal states.	Free Trade Commission (supervises implementation of agreement, resolves disputes); Commission for Environmental Cooperation (commits members to improve and enforce domestic environmental protection laws); Commission for Labor Cooperation (forum for consultation on domestic Labor standards). In addition, eight committees and six working groups on various trade issues.

Source: Adapted from Lawrence (1996).

Table 2. **Economic indicators: an international comparison**

	North America[1]	Japan	EU12
Population			
1996, thousands	295 521	125 864	351 134
GDP			
1996, billion US$			
1991 PPP rates	7 327	2 546	5 990
Exchange rates	8 238	4 595	8 005
Real GDP			
Average growth 1991-96, per cent	2.4	1.5	2.3
Trade in total goods[2]			
Per cent of GDP, average 1991-95			
Trade share	6.6	7.5	9.2
Trade balance	-2.3	2.6	-0.5
International direct investment flows[2]			
Average 1991-94, billion US$			
Inflows	32.6	3.9	24.5
Outflows	52.3	38.2	41.0

1. Canada and the United States.
2. Excluding intra-zone trade.
Source: OECD Secretariat.

three times larger than that of Japan (Table 2) and its economic weight is likely to grow further with the accession of several eastern European countries and Cyprus. In addition, the EU has become the world's largest trading area, even when excluding intra-EU trade; and foreign direct investment inflows and outflows are only higher in North America.

10. The implementation of the internal market programme also changed the conditions under which third countries gain access to the Union's markets. Before its implementation, there existed a large number of formal and informal national trade restrictions (Stevens and Young, 1996). Major impediments to access included: national quantitative restrictions,[3] technical barriers to trade, barriers to establishment and the provision of services, restrictions due to company law, taxation and intellectual and industrial property rights, barriers due to restrictive public procurement regimes, and access restrictions in heavily regulated industries. While in some of these areas barriers have come down considerably or been eliminated entirely, others continue to hamper trade internally and externally.

11. Table 3 provides a qualitative overview of the earlier restrictions *vis-à-vis* non-Member countries and the direction of change in the implementation of such restrictions. The entries in the table suggest that access has improved considerably. For instance, internal border controls have been suppressed for EU as well as for non-EU firms and much fewer quantitative import restrictions exist now. Other changes, such as the removal of barriers concerning services, were a mixture of harmonization and liberalisation, from which non-EU suppliers have benefited to varying degrees.

3. These restrictions were based on Article 115 (providing a safety valve for national governments to protect industries facing economic difficulties) and given practical effect through national control of internal frontiers.

Table 3. **The effect of internal market changes on third parties**

Pre-IMP barrier	External effect	Nature of change	Potential external effect of change
QRs in Member States	Discrimination between internal and external	Removal of QRs	Better access for externals
		Substitution of EC QRs	Complex change
	Discrimination among third parties	Removal of QRs	Better access for some; more competition for others
		Substitution of EC QRs	Complex change
Physical barriers between Member States (*e.g.* controls on borders)	No differential effects *vis-à-vis* domestic suppliers	Removal of barriers	Increased ease of supply
Technical barriers (*e.g.* regulations and standards)	No differential effects	Mutual recognition	Access to new markets, more competition in old markets
		Harmonisation	Complex change
	Discrimination among third parties (*e.g.* MRAs)	Mutual recognition	Access to new markets, more competition in old markets
		Harmonisation	Complex change
Barriers to provision of services, right of establishment and free movement of capital (*e.g.* financial services, transport)	No differential effect	Primarily liberalisation	Greater ease of establishment
Barriers in the business environment (*e.g.* intellectual and industrial property, company law, taxation and media)	No differential effect	Primarily approximation	Simpler operating conditions
Public procurement	No differential effect	Some liberalisation	Mix of opening plus continued discrimination
Barriers in regulated industries (*e.g.* energy and telecommunications)	No differential effect	Primarily liberalisation	Improved access

Source: Stevens and Young (1996).

12. It is impossible to evaluate in full the scale, incidence and effects of previously existing restrictions. However, data on quantitative restrictions, public procurement and changes in regulated industries, such as energy and telecommunications contain useful information.[4] While data on the actual use of quantitative import restrictions and informal arrangements restricting imports are not complete, the applications by Member States to implement national level import restrictions (under Article 115) provide a helpful barometer of the changes in trade regimes at the national level. Restrictions rose sharply in the early 1970s (about 50 applications per year) to a peak of more than 350 applications in the early 1980s and subsided afterwards with a steep decline in the early 1990s. While applications in the early 1990s were very few, in 1992 some 6 421 national quantitative restrictions existed concerning products imported from non-state trading countries.[5] Countries concerned were mainly Asian and three-quarters of the products belonged to the textile and clothing sectors. In addition, 4 800 quantitative restrictions covered products from state trading countries, the principal target being China.[6] Finally, bilateral industry-to-industry and other import-limiting arrangements existed. While national quantitative restrictions under Article 115 have been removed,[7] some have been replaced by Community-wide restrictions. The latter mainly concern textile and clothing products and imports from China. In the case of replacement of national by EU-wide quotas, third party effects depend on the extent to which countries were favoured or hurt by the old regime. Beyond national Article 115 restrictions, a few bilateral export monitoring and restraint arrangements have continued and such cases also exist at the EU-level, the most prominent being the 1991 “consensus” on cars with Japan.

13. Another area where at least some quantification is possible is public procurement. Traditionally, public procurement markets were among the most sheltered, and according to the Cecchini Report, they were characterised in 1987 by nationalistic purchasing, lack of transparency, wide price differences for similar products and negligible cross-border trade. The original Works and Supplies Directives of 1971 and 1977 and the 1979 Tokyo Round Government Procurement Agreement had done little to change the situation. The internal market programme introduced new legislation on regulating works, supply and services contracts of public bodies and a separate Directive on purchases by utilities, whether publicly owned or not.[8] By opening the tendering to non-national companies the Directives gave new opportunities for firms from third countries, even though non-EU firms face some discrimination in the utilities sector, if no bilateral agreement exists. While the public procurement market is fairly large (close to 12 per cent of GDP), import penetration in the EU on average is low at an estimated 2 to 3 per cent of total direct public sector purchases in 1994, with third country purchases at only 0.5 per cent (Eurostrategy, 1996). Data reported to the WTO Secretariat’s Government Procurement Committee (Hoekman, 1996*a*) indicate that the share of procurement outside the EU in 1990-92 was on average 3 per cent in France, 1 per cent in Germany and 2 per cent in Italy and the United Kingdom. Shares were much larger for some of the smaller countries, with some 15 per cent for the Netherlands and Ireland. For the EU countries as a whole, the share was 5 per cent, as compared with 10 per cent for the United States and 15 per cent for

4. Stevens and Young (1996) also provide an overview concerning changes for the other areas.

5. This number excludes quantitative restrictions covered by the derogations granted to Spain and Portugal upon their accession. The total number is 7 269 (Stevens and Young, 1996).

6. In 1988, roughly half of all textile and clothing imports into the EU faced quantitative limitations, one-quarter was subject to the so-called ‘basket exit mechanism’ but not restricted and about one quarter was not covered by any form of arrangement.

7. It is still legally possible to impose quantitative restrictions only in parts of the EU but enforcement would be nearly impossible and no such measures were taken since 1993.

8. In addition to the internal market legislation public procurement was liberalised in recent years by the European Economic Area Agreement, the revised (WTO) Agreement on Government Procurement, bilateral agreements and Association Agreements with the central and eastern European countries.

Japan. While openness in this respect has remained stable in Japan since 1983-85, it shrank in the United States but increased for the European Union.

14. While the single market has led to deep integration over a wide range of sectors and also benefited non-EU member countries, recent Commission studies (EC, 1996*a*) point to the need to be vigilant against backsliding and to pursue integration further, for instance, in public procurement, company law and taxation. The United States Trade Representative annual review of EU obstacles to trade also points to areas in need of improvement.[9]

An expanding network of regional trade arrangements

15. While there were many proposals and attempts to form free trade agreements or customs unions during the 1960s, regional integration schemes played little role up to the end of the decade, except for the European Community, EFTA and the now defunct Council of Mutual Economic Assistance.[10] However, regional integration schemes have started to flourish again outside Europe since the early 1980s. They include, for instance, the Australia-New Zealand (1983) and Canada-United States (1989) free trade agreements. In recent years, the number of free trade agreements and customs unions has risen considerably, the European Union and other European countries alone striking more than two-thirds of the 40 agreements between 1990 and 1994 (Figure 1). In December 1997, the EU and Mexico signed a wide-ranging agreement, which provides *inter alia* for the establishment of a free trade area. Currently, virtually all WTO member countries are party to at least one preferential trade agreement -- Japan, Korea, Hong Kong and Mongolia being exceptions. The Community has been a pioneer in entering preferential trading relations. Today, virtually all countries in the world are covered by reciprocal or non-reciprocal contractual concessions with the EU, except the United States, Canada, Japan, Australia and New Zealand. Most of the rise in regional agreements is accounted for by free trade areas, while the Union itself started as a customs union and moved further on to an economic union, which provides for much deeper integration. Countries acceding to the Union have to sign up to the obligations of being a member to the economic union.

16. With the accession of the United Kingdom, Denmark and Ireland in 1973 a Community-wide policy with respect to the remaining EFTA countries was elaborated and individual free trade agreements for industrial products were signed with the remaining EFTA countries. The outcome of these agreements was the establishment in 1973 of the largest free trade area in the world. Free trade agreements also preceded accession to the EU for Greece and Spain (Table 4). Co-operation with the remaining EFTA countries deepened further in the early 1990s, with the establishment of the "European Economic Area" (EEA), which provided for the implementation of most single market legislation and led to the accessions of Austria, Sweden and Finland in 1995. The EEA applies currently to Norway and Iceland. Finally, a customs union between the EU and Turkey recently came into force.

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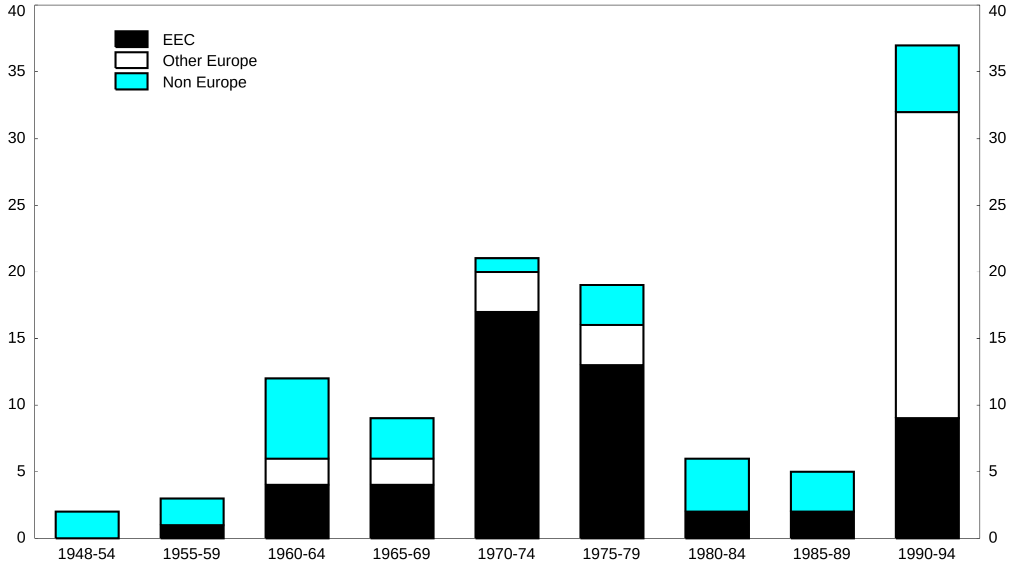
9. Similar exercises by the EU concerning the United States ("United States Barriers to Trade and Investment") shows that the same is also true elsewhere.

10. WTO (1995) provides an overview of the development of regional agreements in a global context.

Figure 1. REGIONAL INTEGRATION AGREEMENTS NOTIFIED TO THE GATT AND WTO
Number of agreements 1948-94 (1)



1. A notification may include one or more related agreements involving the same group of countries. For example, the treaties establishing the European Economic Community and European Atomic Energy Community, signed in 1957, are counted as a single notification. Figures include agreements which are not currently in force.
Source: WTO (1995).

17. Trade preferences have also played an important role in shaping the trade relations of the former colonies of Member States. With the Yaoundé Convention of 1963 the EEC countries "inherited" the trade preferences provided by France and Belgium to their former colonies.[11] It linked the EEC with 18 African States and Madagascar in a series of bilateral free trade agreements. The same question arose again with the accession of the United Kingdom, and the Community established trade relations with the Commonwealth countries. The ACP-EEC Lomé Convention (1975) grouped together the African, Caribbean and Pacific countries of the Commonwealth and the Yaoundé countries. At present 70 ACP countries are covered by the Fourth Lomé Convention. The Lomé Conventions eliminated duties and other restrictions on most products, except for agricultural products falling under the Common Agricultural Policy and a range of textile and clothing products. The Lomé Convention will expire in the year 2000 (see below). Like the other GATT members the EU extends non-reciprocal trade preferences under the Generalised System of Preferences (GSP) to a large number of developing countries outside the Lomé Convention.[12]

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11. The convention provided for a considerable amount of aid in cash, duty-free access of industrial products and preferential treatment for competing (non-tropical) farm products. In return, the Associated States granted preferential treatment to imports from the common market.

12. The new European GSP scheme, which entered into force in 1995, comprises a general scheme and a special incentive scheme. The general scheme is based on a "tariff modulation mechanism", by which different preferential rates are applied to products according to their level of "sensitivity", and a "graduation mechanism" by which indexes of development and specialisation are used to determine whether GSP preferences apply to a specific country-product combination. Under the special incentive scheme, instead, supplementary preferential margins can be granted to countries that implement advanced social and environmental policies.

Table 4. **The network of regional agreements**
1995

EUROPEAN UNION

Reciprocal

Austria	France	Italy	Spain
Belgium	Germany	Luxembourg	Sweden
Denmark	Greece	Netherlands	United Kingdom
Finland	Ireland	Portugal	

EU Free Trade Agreements with

Estonia	Israel	Liechtensein	Norway
Iceland	Latvia	Lithuania	Switzerland

EU Association Agreements with

Bulgaria	Czech Republic	Poland	Slovak Republic
Cyprus	Hungary	Romania	Turkey

Non-reciprocal

EEC-Association of certain non-European countries and territories (EEC-PTOM II)

EEC Co-operation Agreements with

Algeria	Jordan	Morocco	Tunisia
Egypt	Lebanon	Syria	

ACP-EEC Fourth Lomé Convention

EFTA AND OTHER EUROPEAN COUNTRIES

European Free Trade Association (EFTA)

Iceland	Liechtenstein	Norway	Switzerland

EFTA Free Trade Agreements with

Bulgaria	Hungary	Poland	Slovak Republic
Czech Republic	Israel	Romania	Turkey

Norway Free Trade Agreements with

Estonia	Latvia	Lithuania

Switzerland Free Trade Agreements with

Estonia	Latvia	Lithuania

Czech Republic and Slovak Republic Customs Union

Central European Free Trade Area

Czech Republic	Hungary	Poland	Slovak Republic

Czech Republic and Slovenia Free Trade Agreement

Slovak Republic and Slovenia Free Trade Agreement

Table 4. **The network of regional agreements** *(cont.)*
1995

NORTH AMERICA

Canada-United States Free Trade Agreement (CUFTA)
North American Free Trade Agreement (NAFTA)

LATIN AMERICA AND THE CARIBBEAN

Caribbean Community and Common Market (CARICOM)
Central American Common Market (CACM)
Latin American Integration Association (LAIA)
Andean Pact
Southern Common Market (MERCOSUR)

MIDDLE EAST

Economic Co-operation Organisation (ECO)
Gulf Co-operation Council (GCC)

ASIA

Reciprocal

Australia-New-Zealand Closer Economic Relations Trade Agreement (CER)
Bangkok Agreement
Common Effective Preferential Scheme for the ASEAN Free Trade Area
Lao People's Democratic Republic and Thailand Trade Agreement

Non-reciprocal

Australia-Papua New Guinea Agreement
South Pacific Regional Trade Co-operation Agreement (SPARTECA)

OTHER

Israel-United States Free Trade Agreement

Source: WTO (1995).

18. When the EC formulated its policy towards the ACP countries, it also developed a "Mediterranean policy", covering trade relations with Turkey, the former Yugoslavia, the Maghreb (Algeria, Tunisia and Morocco), the Mashreq countries (Egypt, Jordan, Lebanon, Syria) and Israel. These agreements differed in the treatment of products imported from the EC and in the speed of elimination of trade barriers. Recently, a new initiative concerning the Mediterranean countries outside the EU was taken to speed up co-operation (see below).

19. Trade relations within Europe changed profoundly with the transition of the former centrally planned economies to market economies. The starting point of deepening trade relations were the "Europe Agreements" with the Czech and Slovak Republic, Hungary and Poland in 1991 and with Bulgaria and Romania in 1993. These treaties recognise the aspirations of these countries to future EU membership and provide for the establishment of free trade agreements in the interim, with certain "sensitive" sectors being covered in protocols. The agreements also include provisions on rules of origin, competition policy, etc. In 1994, the EU signed free trade agreements with the Baltic states, while co-operation with the other former Soviet states is still in its infancy.

20. The result of the post-war process of regional integration is the creation of different levels of trade liberalisation. The deepest level of integration applies to the EU itself, but most of this extends to the other West European countries through the EEA. A second circle is formed of the central and eastern European countries, as well as those Mediterranean countries with whom reciprocal trade agreements have been concluded. Some of these agreements are a first step towards future accession. A third circle is formed by the non-reciprocal agreements with the North African and ACP countries.

21. Reaping the gains from freer trade was clearly not the sole impetus -- and often not the major reason -- motivating negotiations of trade agreements and thus distinguishes the EU's pursuit of regional agreements from those elsewhere. Historically, in the early EFTA agreements and first generation agreements with the Mediterranean countries, preferential agreements for trade liberalisation provided an economic dimension to wider agreements with neighbouring countries; and the Lomé Conventions are seen to provide an economic underpinning to support economic, social and political reforms in these countries. Similarly, preferential agreements with the central and eastern European countries are seen as the first step towards Community membership. The set of overall objectives pursued goes significantly beyond the provision of a close and stable economic relationship and often covers also technical and administrative assistance. Frequently, considerable amounts of financial assistance flow from the EU to the partner countries (EC, 1996*a*). Clearly, being surrounded by peaceful and prosperous regions is very important for the well-being of the Community itself.

22. EU agreements and unilateral concessions now cover virtually all countries in the world except the non-European OECD countries, and the number of such agreements has risen considerably since the early days of the Community. For instance, regional trade arrangements covered only 27 countries in 1970 but now cover close to 100, with another 40 countries receiving unilateral concessions under the Generalised System of Preferences. This could suggest that virtually all trade is on a preferential basis. However, the geographic coverage exaggerates the importance of regional agreements for trade as the share of extra-EU imports from countries receiving Most Favoured Nation (MFN) treatment was close to a third in 1995, largely reflecting the high degree of trade integration among the EU and the non-European OECD countries and the size of these markets. The Community import share originating both from countries covered by reciprocal trade agreements and by unilateral concessions was also close to a third. In addition, the overall share of imports entering on a non-discriminatory basis is larger than a third due to the fact that more than 30 per cent of EU imports enter duty free, in which case trade preferences do not represent a benefit for the preferred country.

23. While geographic and trade coverage can be measured, it is not possible to measure the degree of trade liberalisation among members of the regional trade arrangements as no comprehensive measures of national trade barriers exist. While the OECD, for instance, produces data on overall support levels for agriculture or tariff and non-tariff barriers for trade in goods, these data do not allow the measurement of the margins of preference of regional trade arrangements. It is clear, on the other hand, that the sectoral coverage of the agreements has increased; margins of preference have fallen with multilateral liberalisation; non-tariff barriers have also been reduced; and agreements leading up to EU membership, such as the EEA and Europe Agreements, provide for deep integration.

Multilateral liberalisation has kept momentum

24. Regional trade integration has gone hand in hand with significant multilateral trade liberalisation under the auspices of the GATT and the WTO. Multilateral trade policy is, in principle, a competence of the Community and guided by the Treaties. They provide for a complex interplay between the Council, the Commission and the Parliament, while in a number of areas trade competencies are shared between the Community and the Member countries. The institutional framework is outlined in Box 1.

25. Progress towards liberalising trade in a world-wide context has shown unsteady yet distinct momentum over the last decades. At the time of its creation, EEC average tariff rates for manufactured goods differed sharply, ranging from 6.4 per cent for Germany to 18.7 per cent for Italy in 1958 (Table 5). Rates fell somewhat after the Dillon Round in 1961 and more so for the countries with high tariff rates. With the introduction of the common external tariff the average tariff rate was 10.4 per cent in 1968, implying sharp falls in tariff protection for Italy and France, a considerable increase for Germany and to a lesser extent, increases for the Benelux countries. After the five-year phasing in of the 1968 Kennedy Round, the average tariff fell to 6.6 per cent. Overall, tariff protection declined considerably between 1958 and the early 1970s. Over the same period, tariff protection was relatively low in Denmark and Sweden, but fairly high in the United Kingdom, Austria, Finland and Norway.[13]

26. Contrary to developments in manufacturing, the introduction of the Common Agricultural Policy (CAP) during the 1960s[14] led to rising protection in the agricultural sector. Calculations by Thorbecke and Pagoulatos (1975) show that *ad-valorem* tariff equivalents of pre-CAP import restrictions were for most agricultural products far higher than tariff rates for manufactured products and that they increased

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13. The tariff rates in Table 5 are estimates. While they probably give a good indication about trends, levels are subject to considerable uncertainty. Estimates by Curtis and Vastine (1971) for post-Kennedy Roundtariff rates for industrial products give the following results:

All items	Dutiable items only	
United States	5.6	8.7
EC	4.0	8.3
Japan	6.5	10.7
United Kingdom	8.0	10.9
Sweden	5.0	7.9
Denmark3.8	7.9	
Norway	4.1	10.2
Finland	6.8	11.2

Cline *et al.* (1978) estimate 1973 average tariff rates on all industrial imports of 4.2, 7.1 and 6.3 per cent for the EEC, the United States and Japan, respectively and of 9.0, 8.9 and 11.2 per cent respectively on dutiable imports.

14. While the principle of a Common Agricultural Policy was established with the Treaty of Rome, common policies were only introduced between 1962 and 1965 for the different agricultural products and common prices only between 1967 and 1968. Thorbecke and Pagoulatos (1975) provide an overview of the early development of the CAP.

Box 1. The institutional framework

Trade policy in the EU is by-and-large correctly perceived to be essentially a competence of the Community. But matters are never quite so simple, and a number of considerations need to be taken into account in assessing the functioning of the institutional framework. Policy making in the EU is characterised by mutual dependence, complementary functions and overlapping competencies between different bodies. The Single European Act and the Maastricht Treaty, by establishing co-operation and co-decision procedures, have transformed the legislative process from a Council-dominated process to a complex interplay between Council, Parliament and Commission. These procedures give the Commission a significant agenda-setting capacity and make it a sort of broker between the two institutions.[15] Overall, the Commission is a crucial actor in the policy initiation phase; it has substantial executive autonomy in the areas of agriculture, trade and competition and contributes to decision-making in other areas by influence rather than sanction. Also the Court of Justice, which ensures the interpretation and the application of the treaties, is playing an increasingly important role in this mutually dependent decision-making process.

Community law is anchored in the Treaties and includes a common commercial policy[16] whose purpose is the following:

By establishing a customs union between themselves Member States aim to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers. The common commercial policy shall take into account the favourable effect which the abolition of customs duties between Member States may have on the increase in the competitive strength of undertakings in those States (Treaty of Rome, 1957).

The sections of the EC Treaty concerning the common commercial policy underwent only minor modifications under the Maastricht Treaty. The Treaty provisions concerning trade policies (Articles 110-116) are reproduced in Annex 1. In addition, the Council can also take trade policy measures, if this is needed to attain the overall objectives of the Community and the Treaty does not provide explicitly for the necessary powers (Article 235).

Qualified majority voting in the Council has now been extended to most of the policy areas covered by the original Treaty of Rome, including agriculture, competition policy, transport, and policy areas concerned with the implementation of the single market.[17] Decision-making concerning trade in goods is also governed by qualified majority voting except for initiatives under Article 235. This has contributed to a more rapid and effective decision-making process in this field. In addition, consultations with the Parliament are usually not obligatory, even though a regular information process has in recent years been initiated by the Commission. A Council decision is required for the Commission to enter into negotiations with third countries, usually on the basis of a negotiating directive. A Committee consisting of national high-level trade officials -- the so-called Article 113 Committee -- co-ordinates the negotiations and gives advice to the Commission as negotiator. It aims at insuring that agreements with third countries will not run into strong opposition by Member States and will be approved by the Council upon completion of the negotiations.

The common commercial policy falls under the exclusive competence of the Community and covers trade in goods, including agriculture, nuclear products as covered by Euratom, as well as coal and steel products as covered by the European Coal and Steel Community. Competencies in other trade areas are split between the Community and Member States, but 1971 and

15. Under the co-operation procedure, the Commission can set the agenda and may decide to take up or drop amendments from either the Council or the Parliament. According to the co-decision procedure, under which the Parliament has a veto power, if the Parliament or Council reject each other's position, a conciliation Committee is established. Such a Committee consists of representatives from both institutions, with the Commission acting as a broker. A compromise needs the approval of an absolute majority in the Parliament and of a qualified majority in the Council. If there is no agreement the initiative returns to the Council, which can make it a take it or leave it offer, which the Parliament can reject by absolute majority (Marks, Hooghe and Blank, 1996).

16. Presa (1993) provides a concise overview of the common commercial policy and related legislation; and the WTO Trade Policy Reviews provide follow-ups on institutional changes.

17. There are some important exceptions which include the EU budget, taxation, capital flows, self-employed and professions, free movement of persons, and rights of employed persons (Marks, Hooghe and Blank, 1996).

1976 Court of Justice rulings made it clear that the Community has external competence also in the fields in which it has internal competence,[18] because bilateral international treaties could lead to an uneven internal playing field.

Nonetheless, the Community's exclusive competence in the field of commercial policy has continued to arouse controversy. Even on the occasion of the Uruguay Round there was disagreement between the Commission on one hand, and the Council, the Member States and the European Parliament on the other hand, who should sign the agreement (Emiliou, 1996) as the Member States took the view that the Final Act and the WTO Agreement covered matters of national competence. Hence, the WTO Agreement was signed by representatives of both the EU Council and of the Member States on behalf of their respective governments.

A major issue was that, in contrast to trade in goods, the Community never had a clear mandate to negotiate and implement trade policies in the services sector. Therefore the Court of Justice was asked to provide a ruling on the matter. The 1994 Court ruling concluded that the Community had exclusive jurisdiction to conclude the Multilateral Agreement on Trade in Goods and that also trade in services could not in principle be excluded from the Community's competence.[19] As concerns the General Agreement on Trade in Services (GATS), the Court ruled that it should fall under the scope of the EU's external competence under Article 113. That implies, however, that areas already covered by other policies set out in the EC Treaty, such as those concerning most modes of services supply[20] and transport policy, as well as other issues covered by GATS but not dealt with by Treaty provisions at all, remain within the competence of Member States. As concerns the Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS), only border measures fall under the competence of the Community. After the ratification of the 1997 Amsterdam Treaty, the Article 113 powers will be extended to negotiations and agreements on services and intellectual property rights. However, unanimity will be required in the Council's voting.

The decision-making power was delegated from the Council to the Commission in some areas, for instance, in anti-dumping cases and safeguard actions. Nevertheless, the rules often provide for the possibility of further review by the Council, which can confirm, reject, or modify the Commission's decision. A few other trade-related areas fall under partial competence of the Community, especially to ensure that uniform conditions prevail in the internal market. That is the case of competition policy (including subsidies), public procurement and export promotion.

While decision-making on issues related to trade in goods is less cumbersome than in many other areas of Community policy, policy decisions are still the outcome of intensive bargaining and negotiation processes. Concerning the Commission's work, difficulties and divided situations may appear at different levels of the decision process. For instance, there can be disagreement within the Commission on the analysis of facts and the appropriate measures to be taken. Another layer of complexity is due to the need to reach a compromise among 15 Member States, the bargaining behaviour of which is dictated by domestic preferences and general trade philosophy that still diverges considerably across countries.[21]

Concerning trade in services and other trade-related issues, decision-making is even more complex due to the restrictive interpretation of Article 113 by the Court of Justice. This is of particular concern, given the number of new trade issues emerging on the agenda of the WTO. The current set-up could make future negotiations cumbersome, as the outcome of negotiations is usually presented as a "single undertaking". This implies that, if part of the negotiated agenda is not under the sole competence of the Council, unanimity is required for the entire agenda, even though part of the overall "undertaking" could concern goods.

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18. Competence is only established insofar as a common internal policy is effectively in place.

19. Bourgeois (1994) provides a legal interpretation of the Court ruling and an overview of its implications for international negotiations.

20. That is, in the case of commercial presence, consumption abroad and presence of persons.

21. Negotiation outcomes are often achieved through "side-payments" (*i.e.* compensation to a bargaining party that loses from a particular collective policy measure in order to gain political support from it); "log rolling" (*i.e.* a "vote trading" by which an actor votes for an issue that does not serve her/his interest in exchange for a positive vote on another issue); and "package deals" (*i.e.* issue-linkage, by which decisions are taken over different issue areas simultaneously to achieve support by all actors involved).

considerably until the end of the 1960s. In the United Kingdom, Ireland and Denmark levels of agricultural protection, while also sizeable, were significantly lower. In addition, the 1962 Long-Term Arrangement Regarding Trade in Cotton Textiles (the forerunner to the Multifiber Agreement) led to a highly protectionist system of trade in textiles, which was little changed by the Kennedy Round.

27. Progress towards multilateral liberalisation was slow during the early 1970s and the significant resurgence of protectionist pressures, especially via non-tariff measures, showed the necessity to enlarge the mandate of the GATT or to make existing rules operational. Negotiations of the Tokyo Round started in 1973. It was far more ambitious in its scope, coverage and complexity than the earlier Rounds, which had mainly focused on tariff reductions. Negotiations focused on many new areas, for instance, the elimination of quantitative restrictions and technical barriers to trade, subsidies and countervailing duties; government procurement and agricultural liberalisation also received strong attention. [22]

28. The Tokyo Round led to a reduction in the external EC tariff levels by some 3 percentage points to reach 6 per cent and rate dispersion was reduced considerably. While the agreement focused on greater clarity, precision and enlarged coverage of provisions concerning subsidies, countervailing duties or public procurement rules, these had only minor overall effects. For instance, while subsidies in the EU have come down since the mid-1980s, they still remain high in international comparison (Figure 2) and trade in publicly procured goods has only started to rise in recent years from very low levels. In addition, little progress was made on agricultural trade, and levels of protection, as measured by Producer Subsidy Equivalents, remained very high (Figure 3). Indeed, among the large agricultural producers high levels of protection persisted only in Japan and the EU, while they declined considerably in the United States since the mid-1980s and later on in Canada; and protection was always low in Australia. Finally, the Round made no headway in reining in the use of non-tariff measures, such as anti-dumping actions (Figure 4), voluntary export restraint and orderly marketing arrangements.

Table 5. **Multilateral tariff reductions**

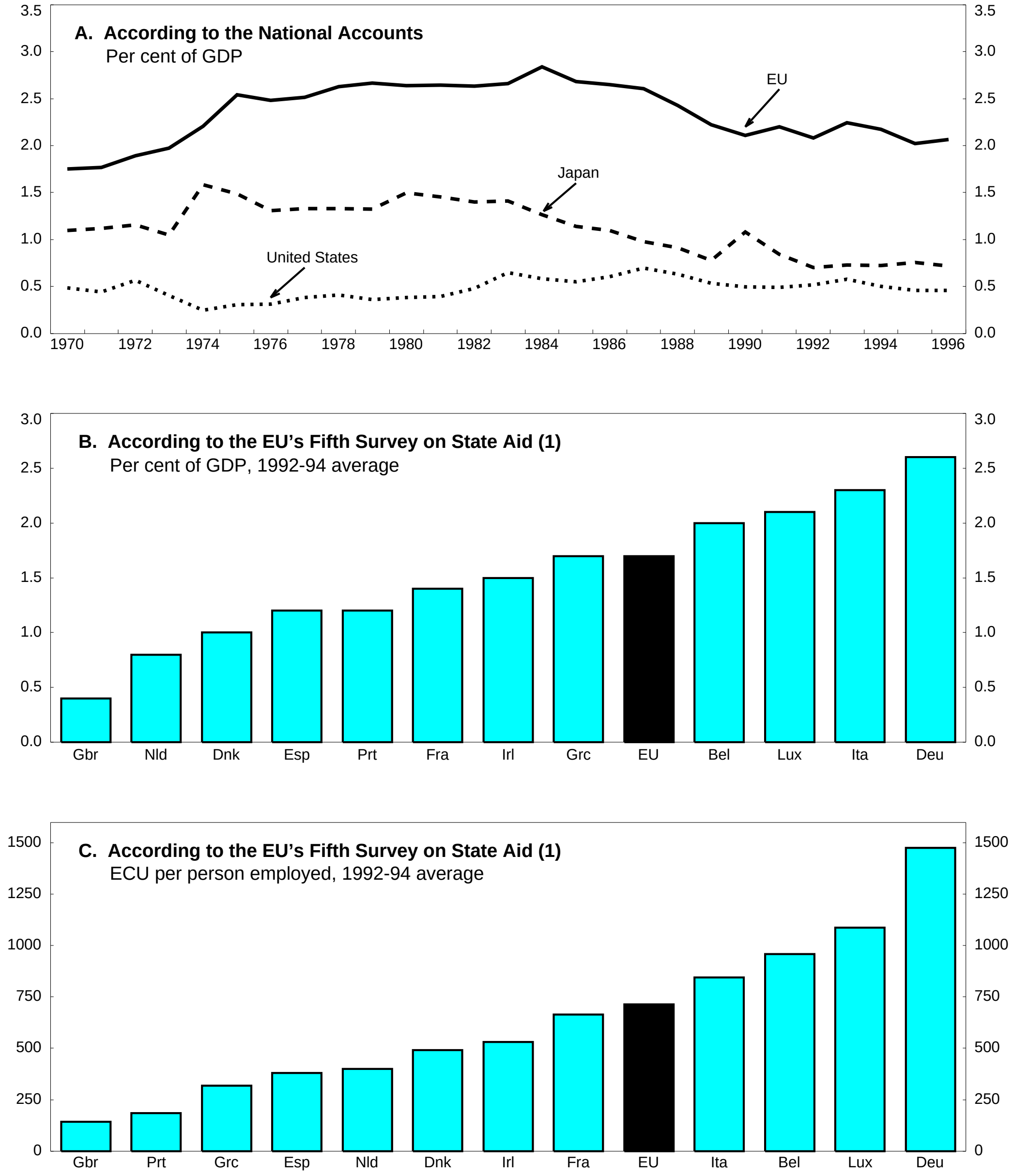
Simple average MFN tariff rates, industrial products

	1958	After Dillon Round	1968 External tariff	After Kennedy Round
Belgium	9.7	8.7		
France	17.0	15.3		
Germany	6.4	5.8	10.4	6.6
Italy	18.7	16.8		
Netherlands	9.7	8.7		
United Kingdom	16.5	14.9	14.9	9.2
Denmark	5.6	5.2	5.2	3.2
Austria	14.9	11.4	11.4	8.2
Sweden	6.5	6.3	6.3	4.2
Norway	10.3	10.3	10.3	6.4

Source: Resnick and Truman (1975).

22. The original GATT agreements, drafted during the 1940s, were intended to cover also agricultural products. As it worked out, however, agriculture had been largely excluded from the broad sweep of liberalisation. While agriculture also was prominent in the discussions of the Kennedy Round, results were minimal.

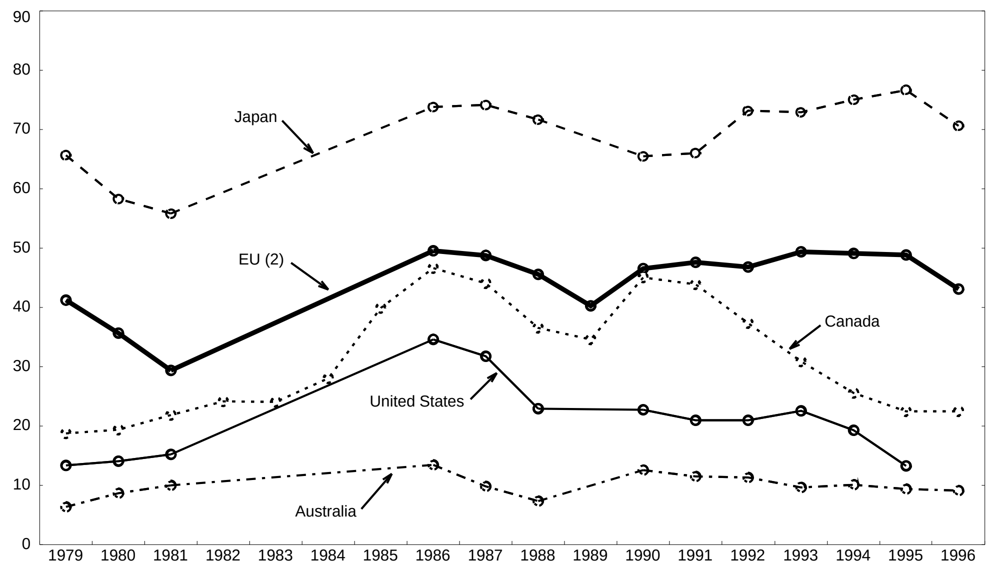
Figure 2. SUBSIDISATION



1. Including direct grants, tax reductions, equity participations and aid elements contained in soft loans, tax deferrals and State guarantees but excluding EU subsidies.

Source: OECD, National Accounts and European Commission (1997), Fifth Survey on State Aid in the European Union in the Manufacturing and Certain Other Sectors.

Figure 3. PROTECTION OF THE AGRICULTURAL SECTOR
Producer subsidy equivalents, per cent (1)

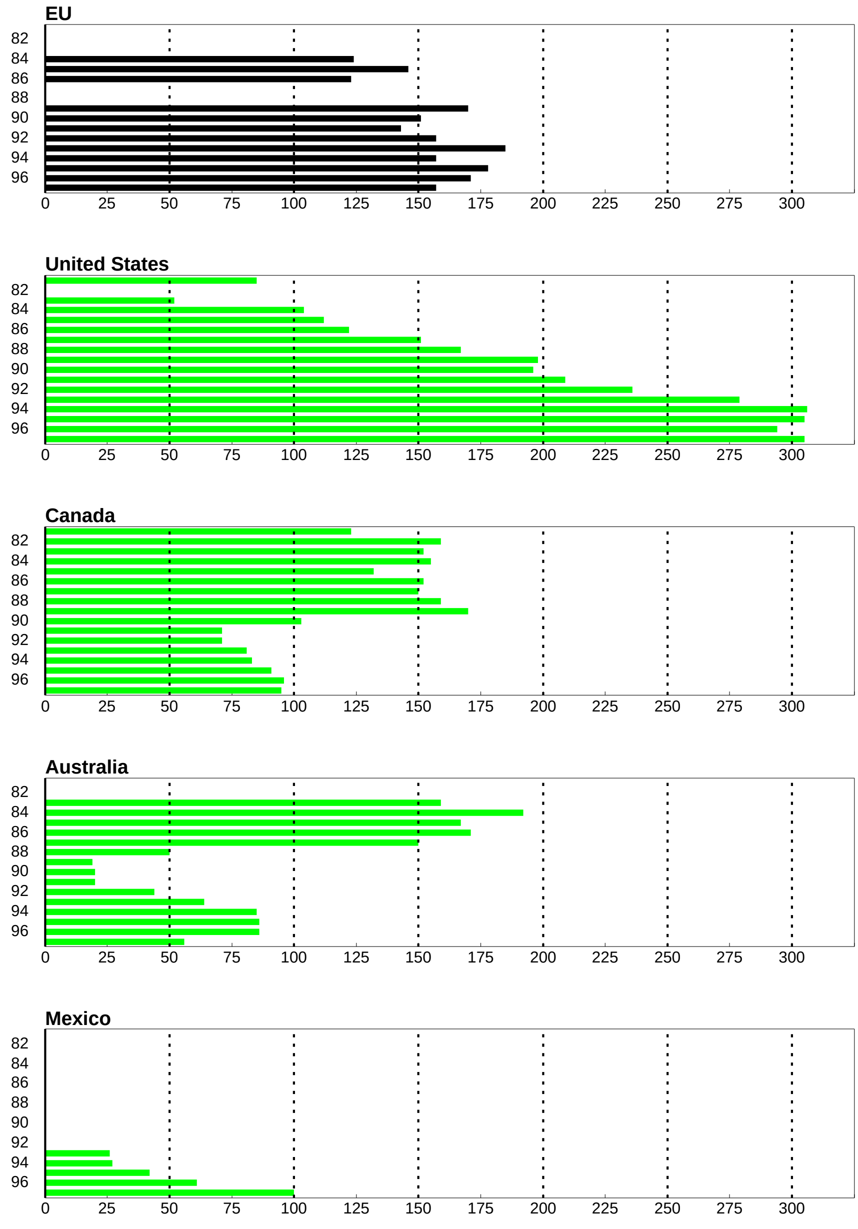


1. The total value of transfers as a percentage of the total value of production (valued at domestic prices), including transfers such as consumer subsidies. The last two years of data are estimates or provisional data.
2. EU = EU9 for 1979-81, EU12 for 1986-94 and EU15 from 1995 onwards. EU includes ex-GDR from 1990.
Source: OECD(1996a) and Secretariat estimates.

29. The goals set for the Uruguay Round were even more ambitious than those for the Tokyo Round. Apart from cutting tariffs further, efforts were made to broaden the world trading system to include services and intellectual property rights, and to achieve a full return of agriculture, textiles and clothing to the system. As a result of the Round, most industrial tariffs will fall below 5 per cent in the developed countries, while the Agreement on Textiles and Clothing requires a gradual phase out of MFA quota restrictions over a 10 year transition period. Concerning agriculture, the Round provided for the conversion of non-tariff barriers to tariffs, the reduction of tariffs and export subsidies, and disciplines on domestic support. Where market access was largely absent, countries have to provide for a minimum 3 per cent import share of domestic output at the outset, rising to 5 per cent over the implementation period of six years, at “low or minimal” tariff rates. Also “grey area” measures, such as voluntary export restraints and orderly marketing arrangements, have been prohibited.

30. New issues covered in this Round concerned intellectual property rights, trade-related investment measures, and trade in services. Concerning the latter, the General Agreement on Trade in Services provides a framework for liberalising services across borders (services supplied from one country to another), consumption abroad, commercial presence and the temporary presence of persons to deliver services. As for goods, a cornerstone of the agreement is the unconditional MFN principle, even though exemptions from this principle have been granted for specific periods, which cannot be extended.

Figure 4. NUMBER OF OUTSTANDING ANTI-DUMPING ACTIONS
1981-97 (1)



1. At 30th June.
Source: WTO and GATT.

31. Foreign direct investment has become an important market access strategy due to the continued growth of foreign trade, liberalisation of national markets and the rapid integration of financial markets. The rise in foreign direct investment has been impressive since the early 1980s, the European Union being the second largest host and source area of foreign direct investment globally after North America. Yet, trade-related investment measures were only included explicitly at the Uruguay Round. However, given the rising importance of foreign direct investment and multinational enterprises, bilateral treaties have proliferated as well as regional and other multilateral agreements. Concerning the latter, the most active fora have been the OECD and the World Bank (Witherell, 1996).

32. Furthermore, the Uruguay Round managed to strengthen multilateral disciplines by clarifying concepts and agreeing on new understandings of safeguards, anti-dumping, subsidies, countervailing duties, etc. and by strengthening the dispute settlement system significantly. Finally, a main feature of the Round was the creation of the World Trade Organization, where membership is conditional on countries having schedules of concessions and commitments on market access in agricultural, industrial and service sectors. Membership also implies acceptance of the GATT's "acquis" until 1994 and the Uruguay Round agreements.

33. Contrary to earlier agreements, the economic effects of the Uruguay Round have been well researched. A summary of this research is provided in Box 2.

Box 2. Quantitative assessments of the Uruguay Round

There is a sizeable empirical literature assessing the Uruguay Round Agreements. These quantitative studies, based on computable general equilibrium (CGE) models, generally conclude that countries that liberalise the most tend to gain the most. CGE studies generally cover tariff cuts, the phase out of MFA and other industrial quantitative restrictions, and liberalisation in agriculture. What is generally taken as constant or ignored in the modelling, however, is the use of contingent protection as well as the impact of liberalisation in the service sector.

All these models emphasise the impact of trade liberalisation on resource allocation, directly through efficiency gains, while some others provide for an indirect link through income-induced changes in capital accumulation rates. The main differences in the models' structure can be pinned down to: *(i)* the level of sectoral and regional aggregation, *(ii)* different assumptions on market structure, and *(iii)* the inclusion or disregard of accumulation effects.

Francois, McDonald and Nordström (1996), after having controlled for differences in the liberalisation coverage, differences in models' structure and in the base year used, present comparable estimates from the available post Uruguay Round CGE literature. They find that the regional and sectoral model structure largely determines the relative size of the impact. Models especially designed to study liberalisation in agriculture (*e.g.* the RUNS model of the OECD and the World Bank), and giving less emphasis to the formalization of the manufacturing sector, will attribute higher gains to agricultural liberalisation. Models incorporating scale economies and imperfect competition deliver stronger gains from liberalisation; and, similarly, the estimation of dynamic gains from capital-induced accumulation effects adds to static efficiency gains. Products' specification also influences the results. Models with products originating from different countries that are assumed to be imperfect substitutes within the same product category (the so-called Armington assumption) deliver smaller liberalisation effects than models where products are assumed to be homogenous or differentiated at the firm level.

Overall these studies find that the world as a whole gains from the Uruguay Round (the OECD's estimate pointing to a gain of about 1 per cent of GDP). The gains are concentrated in developed countries, especially the EU, Japan and the United States. The intuition is that these countries liberalised areas that were very costly in terms of foregone welfare to themselves, most notably by reducing agricultural and MFA protection. However, the gains from reducing agricultural protection are probably considerably overestimated, as most modellers assumed an average reduction in protection of 36 per cent, which is far from being the case for products that were tariffied. On the other hand, the disregard of service sector liberalisation biases most model results downwards. A notable exception is the study by Brown *et al.* (1995) where gains from services' trade liberalisation are estimated to outweigh those coming from further liberalisation of trade in goods.

II. THE CURRENT TRADE REGIME IN INTERNATIONAL COMPARISON

34. Comparisons of trade regimes are difficult as no comprehensive measures of trade policies exist, which could be used to simulate a country's distance from an "ideal" world of free trade. In the following, the effects of the Uruguay Round on the EU's current trade regime are outlined and trade policy indicators compared to those of the other "Quad" countries. Recent developments concerning the EU's regional agreements are covered in the section on the EU's future trade agenda as they are currently being shaped or reshaped.

Tariff barriers are losing in importance

35. As a result of the Uruguay Round, tariffs are increasingly losing importance as trade policy instruments. In addition to an overall increase in bindings, which reduces the use of tariffs as a discriminatory policy instrument, enhanced market access will be ensured by an overall reduction of tariffs of almost 40 per cent. In the EU, the simple average tariff on manufacturing products will be reduced to 3.7 per cent by the year 2000. In non-food manufactured products, where all tariffs are *ad-valorem* tariffs, tariff peaks will all be lower than 20 per cent by the year 2001.[23] Moreover, the share of duty-free imports in developed countries will more than double after the implementation of the cuts, rising from 20 per cent to 44 per cent of imports.

36. While this section focuses on the multilateral trading system, it should be remembered that a distinguishing feature of the EU's trade policy is the extent of preferential agreements. However, while the vast majority of the EU's trading partners qualify for preferential treatment, in terms of value, more than 60 per cent of imports to the Community are not affected by preferential treatment (see above). Also, both the lowering of tariff levels and the increase in the duty-free treatment will lead to a reduction in the importance of preferential trade.

37. Despite average rate reductions and the phasing-out of duties in several sectors, tariffs still remain high for certain manufacturing products,[24] and, following "tariffication",[25] high tariffs and tariff peaks have replaced non-tariff barriers in agriculture. OECD (1997*a*) shows that the average tariff reduction rule for agricultural products has been widely used to concentrate tariff reductions in less sensitive product categories, where tariffs were generally already low, and to minimise reductions in

23. Tariff peaks will be lower than 15 per cent by the end of the implementation period, except for trucks and a few footwear items.

24. For instance in textile and clothing, leather, rubber, footwear and travel goods, fish and fish products and transport equipment.

25. By the Uruguay Round Agreement on Agriculture, Members are committed to convert all non-tariff barriers into tariff equivalents (*tariffication*), followed by reductions on a simple average basis. In nearly all instances, the new tariffs consist of specific duties, for which the *ad-valorem* equivalent cannot be easily calculated. Overall the tariffication requirement resulted in high levels of initial tariffs, due to both the high level of protection in the base period and to the level of prices used to calculate tariff equivalents.

sensitive, high tariff, product categories. In the case of the EU, tariffication resulted in prohibitively high tariffs on dairy products, sugar and fruits and vegetables.

38. On the basis of duty-free tariff lines and of average applied MFN rates, both the use of tariffs[26] and the level of protection seem to be greater in the EU than in the United States and Japan. Specifically, the import-weighted average tariff rate was 6.6 per cent in the EU in 1996, as compared with 3.7 per cent in the United States and 3.5 per cent in Japan[27] (Table 6). The use of MFN rates as indicators of overall protection can be misleading in the presence of preferential agreements. In Table 6, MFN applied rates are used instead of collected tariff rates (*i.e.* inclusive of preferential rates). The relevance of the applied MFN tariff rate as an indicator of distortions will depend on the size and elasticity of supply from the countries which benefit from preferential rates. If supply is relatively limited and inelastic, the applied MFN rate might be the relevant marginal rate. In the opposite case the relevant tariff will be lower than the applied MFN tariff depending on the size of imports entitled to preferential treatment (OECD, 1997*b*). Concerning duty free items, it should be noticed that the number of duty free lines reported here applies only to products covered by MFN treatment and not to those covered by preferential treatment. The importance of duty-free treatment in EU and United States could thus be underestimated with respect to that in Japan.

39. The noticeable increase in the EU simple average applied tariff (from 7.6 per cent in 1993 to 9.5 per cent in 1996) reflects the impact of the "tariffication" process in the agricultural sector, which outweighed reductions elsewhere.[28] The EU's relatively high protection levels in the agricultural sector clearly affects comparisons of these indicators. Looking at the production-weighted average tariff rate, for which a disaggregation by sector is available, the average level of protection in the EU has, in fact, declined from 8.4 per cent in 1993 to 7.7 per cent in 1996 (Table 7). Increases in sectoral rates are in those areas hit by tariffication, *i.e.* agriculture and processed food, while tariffs on textile and apparel products have remained relatively high in all Quad countries, with EU tariffs being the lowest in 1996. On the other hand, tariffs in the other manufacturing sectors have become low in all Quad countries, with tariffs being lowest in Japan, followed by the EU and the United States, and highest in Canada. The pattern of sectoral protection is similar across the Quad countries.

40. The use of specific tariffs has increased due to the process of tariffication. In that respect, the United States was ranking first in 1996, with such tariffs amounting to 17.7 per cent of all tariffs, as compared with 12.1 per cent for the EU, and 10.6 per cent for Japan. Overall, the "tariffication" process leads to an increase in the "quantified" average tariff level, to higher levels of distortion in the tariff structure and to an observed reduction in tariff "escalation".

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26. In the EU less than 12 per cent of tariff lines were duty free in 1996, as compared with about 18 per cent and 40 per cent respectively in the US and Japan.

27. While 1996 *ad-valorem* equivalents (AVEs) for specific and compound duties were available for the EU and Canada, estimates from AVEs of base rates and bound rates are used for the other countries (OECD, 1997*b*).

28. The increase could also be partly explained by the different availability of estimates of *ad-valorem* equivalents (AVEs) for specific duties in the two years. While the availability of estimates of AVEs for the United States and Japan has decreased from almost 100 per cent in 1988 and 1993 to 60-70 per cent in 1996, the availability of AVEs for the EU has increased from less than 30 per cent in 1988 and 1993 to more than 80 per cent in 1996.

Table 6. **Structure of applied MFN tariffs in the "Quad"**[1]
Per cent

		United States			European Union[2]		
		1989	1993	1996	1988	1993	1996
1.	Bound tariff lines	98.1	98.1	100.0	91.8	92.7	100.0
2.	Duty-free tariff lines	17.4	14.4	17.8	10.5	10.9	11.4
3.	Specific and compound tariffs/all tariffs	17.6	17.0	17.7	10.6	11.1	12.1
4.	Tariff quotas/all tariffs	0.1	0.2	2.3	1.0	2.4	2.3
5.	Tariffs with no ad valorem equivalent	1.3	1.6	5.7	8.4	8.1	2.0
6.	Simple average bound tariff rate[3]	6.3	6.5	3.9	7.5	7.6	7.2
7.	Simple average applied tariff rate	6.2	6.4	6.2	7.4	7.6	9.5
8.	Import-weighted average tariff rate[4]	4.0	4.0	3.7	6.0	6.2	6.6
9.	Production weighted average tariff rate[5]	4.4	4.7	5.2	8.2	8.4	7.7
10.	Domestic tariff "spikes"[6]	4.5	4.0	3.8	2.2	2.3	4.8
11.	Overall standard deviation (SD)	7.7	8.6	14.2	6.1	6.1	20.7
		Japan			**Canada**		
		1988	1993	1996	1988	1993	1996
1.	Bound tariff lines	89.8	90.5	98.8	98.4	98.6	99.6
2.	Duty-free tariff lines	21.9	35.4	34.8	25.7	26.3	31.6
3.	Specific and compound tariffs/all tariffs	7.4	8.8	10.6	8.6	6.2	9.1
4.	Tariff quotas/all tariffs	1.0	1.2	2.2	0.0	0.0	1.5
5.	Tariffs with no ad valorem equivalent	1.0	0.4	4.0	0.5	0.1	2.5
6.	Simple average bound tariff rate[3]	8.2	8.5	4.7	9.3	9.3	5.1
7.	Simple average applied tariff rate	6.9	7.0	6.7	9.1	8.8	9.2
8.	Import-weighted average tariff rate[4]	3.8	3.6	3.5	6.9	6.7	5.7
9.	Production weighted average tariff rate[5]	4.2	3.6	3.4	8.7	8.4	12.1
10.	Domestic tariff "spikes"[6]	5.3	5.7	6.8	0.5	0.3	1.4
11.	Overall standard deviation (SD)	8.9	12.7	11.8	8.8	8.4	27.5

1. Indicators 7 to 12 include ad-valorem equivalents (AVEs) for specific and compound duties when available. For 1996, ad-valorem equivalents were made available only for Canada and the EU. For other countries, AVEs are estimated using AVEs of base rates and UR bound rates when available, and interpolating for 1996 rates under the assumption of equal installment in reduction rates from the base to the bound rate. Different durations for reduction for each product have been taken into consideration.
2. Indicators encompass sliding charges.
3. UR bound rates aligned to 1996 tariff schedules are available only for the EU. For all other countries, bound rates were provided based on the base year (1988/89) tariff nomenclatures. With the exception of the EU, the average for 1996 is therefore based on those nomenclatures.
4. Constant OECD import weights.
5. For the EU, German weights are used.
6. Domestic tariff "spikes" are defined as those exceeding three times the overall simple average MFN rate.

Source: OECD (1997a).

Table 7. **Production-weighted average applied MFN tariff rates in the "Quad"**[1]

Per cent

ISIC		United States			European Union		
		1989	1993	1996	1988	1993	1996
1	Agriculture, forestry, fishing	3.8	4.1	7.9	6.4	6.1	10.7
2	Mining and quarrying	0.2	0.2	0.2	0.5	0.3	0.6
21	Coal mining	0.0	0.0	0.0	0.4	0.0	0.0
22	Crude petroleum	0.1	0.1	0.1	..	..	0.9
23	Metal ore mining	1.2	1.2	1.1	..	..	0.0
29	Other mining	1.1	1.1	0.9	1.0	1.0	0.7
3	Manufacturing	4.7	5.0	5.4	8.4	8.6	7.7
31	Food, beverages and tobacco	7.6	8.2	15.9	27.4	27.1	32.5
32	Textiles and apparel	11.6	11.8	11.3	10.0	9.9	9.8
33	Wood and wood products	4.1	4.2	3.5	5.2	5.4	3.4
34	Paper and paper products	2.0	2.0	1.8	7.1	7.2	4.7
35	Chemicals, petroleum products	5.7	5.8	4.4	6.4	6.5	5.3
36	Non-metallic mineral products	4.9	5.0	4.5	5.5	5.4	3.9
37	Basic metal industries	4.1	4.3	3.7	5.1	5.1	3.6
38	Fabricated metal products	3.5	3.9	3.2	6.0	6.3	4.3
39	Other manufacturing	6.0	5.9	4.8	5.6	5.5	4.2
Total all products		**4.4**	**4.7**	**5.2**	**8.2**	**8.4**	**7.7**
		Japan			Canada		
		1988	1993	1996	1988	1993	1996
1	Agriculture, forestry, fishing	5.1	5.1	5.0	4.1	4.0	5.5
2	Mining and quarrying	0.5	0.3	0.3	3.4	3.4	1.9
21	Coal mining	..	..	..	0.0	0.0	0.0
22	Crude petroleum	..	..	..	5.8	5.8	3.8
23	Metal ore mining	..	..	..	0.0	0.0	0.0
29	Other mining	..	..	..	3.2	3.2	0.8
3	Manufacturing	4.1	3.5	3.3	10.0	9.7	14.4
31	Food, beverages and tobacco	15.6	17.5	18.9	16.8	15.6	57.4
32	Textiles and apparel	10.4	11.7	10.1	20.2	19.6	17.8
33	Wood and wood products	5.0	3.7	3.6	9.0	8.9	6.7
34	Paper and paper products	2.0	1.6	1.2	6.3	6.4	3.8
35	Chemicals, petroleum products	4.6	4.3	3.2	9.6	9.4	6.3
36	Non-metallic mineral products	2.9	1.7	1.5	6.9	6.7	4.3
37	Basic metal industries	4.1	3.7	3.0	6.9	6.8	4.1
38	Fabricated metal products	1.7	0.3	0.3	7.3	7.2	5.0
39	Other manufacturing	3.8	2.9	2.5	10.9	10.1	6.8
Total all products		**4.2**	**3.6**	**3.4**	**8.7**	**8.4**	**12.1**

1. Based on each country’s own value-added.

Source: OECD Secretariat.

41. While the United States and Japan presented lower levels of overall tariff protection, their tariff structures were more distorting than that of the EU in 1993. In 1996, tariff dispersion,[29] as measured by the overall standard deviation, increased in most countries due to tariffication of agricultural imports. This trend was more accentuated in the EU which, in 1996, presented a more distorted tariff schedule than that of the United States or Japan. The standard deviation reached 20.7 per cent in the EU as compared to 14.2 per cent in the United States and 11.8 per cent in Japan.[30] This is in line with the increase in tariff spikes[31] in the EU from 2.3 to 4.8 per cent. Abstracting from "tariffication", the tariff schedule in all countries has become less distorting, as high tariffs were cut more than lower ones.

42. Tariff "escalation" has been another traditional feature displayed by the Communities' tariff schedule. Tariff "escalation" takes place when the level of effective protection increases as goods undergo further processing. Tariff escalation in developed countries is of great concern to developing countries, as higher rates of effective protection of processed goods in developed countries, could hurt their potential to develop processing industries. The figures in Table 8 give a broad indication of the direction of change in tariff escalation. One should be cautious in drawing conclusions from these figures since the concept of tariff escalation refers to precisely defined manufacturing processes involving particular products and not to whole economic sectors. Moreover, these figures are based on MFN tariff averages and do not reflect preferential treatment. Since concessions under preferential agreements tend to focus on raw material inputs rather than on processed products, they may reinforce escalation effects. Changes in the tariff wedge, *i.e.* the absolute difference between the tariff at the higher and lower stages of processing, can predict the direction of changes in effective rates of protection.[32] Tariffication seems to have reduced tariff escalation across countries. Based on simple applied MFN averages, the wedge between raw materials and finished manufactured goods in developed countries declined after the Uruguay Round, especially in the EU and US. The EU and Canada, though, exhibit increased wedges between semi-finished and finished manufactured goods, suggesting that reductions in tariff escalations for these countries only apply because of the tariffication requirement; and OECD (1995 and 1997*a*) find that tariff escalation still prevails in a number of agricultural product chains, such as coffee, cocoa and nuts, while they have been reduced in other cases. Overall these crude tariff indicators, especially in the case of the EU, have to be interpreted with caution. Nevertheless, they seem to indicate that the EU tariff schedule in the post Uruguay Round continues to exhibit peaks and tariff escalation (after having taken into account the tariffication requirement) and even show an increased level of distortion.

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29. The dead-weight losses associated with a country's tariff structure depends not only on the average tariff rates and elasticities of demand and supply, but also on the variance in tariff rates across products.

30. The increase in the standard deviation can also be partly driven by the increase in the level of average protection, *i.e.* the mean of the sample over which the coefficient is calculated. In terms of welfare both the dispersion and the mean of the tariff structure are important. The relevant tariff in the case of the EU is lower than the MFN applied rate due to the preferential agreements and this should be taken into account.

31. Tariff rates in excess of a given domestic reference level.

32. Declines in the tariff wedge as a result of trade liberalisation may lead to a decline in the effective rate of protection of the more processed product. This will depend on the elasticities of demand and supply, *i.e.* the net impact of tariff reductions on domestic demand and supply of final goods.

Table 8. **Tariff escalation[1] in the "Quad"**
Per cent

	United States			European Union		
	1989	1993	1996	1988	1993	1996
Raw materials	3.2	3.3	6.2	6.0	6.0	10.9
Agriculture, forestry, fishing	3.8	4.1	8.3	8.5	8.3	11.9
Mining and quarrying	1.0	1.0	0.8	0.8	0.8	0.4
Manufacturing	2.3	2.3	3.2	5.2	5.4	11.7
Semi-finished	7.0	7.0	5.7	7.3	7.3	6.7
Finished	6.3	6.6	6.4	7.8	8.1	10.8
Total all products[2]	6.2	6.4	6.2	7.5	7.6	8.4
	Japan			**Canada**		
	1988	1993	1996	1988	1993	1996
Raw materials	3.8	3.8	3.9	3.4	3.3	6.8
Agriculture, forestry, fishing	5.1	5.1	5.0	3.6	3.5	5.6
Mining and quarrying	0.5	0.3	0.3	2.7	2.8	0.8
Manufacturing	3.4	3.4	3.5	2.5	2.4	5.7
Semi-finished	6.6	6.8	6.3	9.9	9.4	6.2
Finished	7.8	7.8	7.6	9.8	9.6	12.8
Total all products[2]	6.9	7.0	. .	9.1	8.9	. .

1. Based on simple applied MFN tariff averages.
2. The total for all products can differ from indicator 7 of table 6 (simple average applied tariff rate) for two reasons: i) they also include ad-valorem equivalents (AVEs) for tariff quotas and variable charges; ii) there may be some missing values in the ISIC classification reporting. In the case of Europe, the fact that the production structure of Germany is used here constitutes a third potential source of difference.

Source: OECD Secretariat.

Greater transparency of non-tariff barriers

43. Non-tariff border measures (NTBs) have traditionally been more prevalent in the EU and US than in Japan and Canada. Outside the “Quad” non-tariff barriers are used to a lesser extent or even hardly used as in the case of New Zealand, Iceland and Turkey. Frequency and import coverage ratios[33] show a generalised decline in the pervasiveness of NTBs except for those countries that have recently accessed the EU. In the Community the textile sector remains the most protected by NTBs, while the pervasiveness of NTBs declined sharply in the processed food sector, reflecting tariffication.

44. One of the objectives of the Uruguay Round has been to ensure greater transparency and stricter discipline in the use of non-tariff barriers. A major achievement was the multilateral status given to the

33. The import coverage ratio has the important drawback that those products facing very restrictive NTB’s enter the calculation with a low weight.

agreements on non-tariff measures,[34] ensuring a global coverage of the rules. To reduce uncertainty in the conduct of trade, including in the case of measures adopted by governments to counteract the effect of “unfair” trade practices, agreements on Subsidies and Countervailing Measures and on Anti-dumping were also concluded. Another major achievement of the Uruguay Round has been to prohibit the use of Voluntary Export Restraints and comparable inter-industry arrangements.[35] A full assessment of all these agreements[36] and the implications for EU legislation and trade practice is not within the scope of this work. In the following, the focus is on trends in the use of different non-tariff barriers and on anti-dumping actions which are, in principle, instruments of trade defence.

Quantitative restrictions

45. While their importance had diminished considerably since the late 1980s, export restraints remained the predominant form of quantitative restrictions in 1996 in both the EU and the United States (Table 9). Frequency ratios in both countries stood at around 11 per cent, while, in Japan, non-automatic licensing remained the most important form of quantitative restriction. Apart from the remaining restrictions on agriculture and textiles and clothing, Community-wide quantitative restrictions remain only on a few categories of products from China and on imports of steel products from Russia, Ukraine, and Kazakstan, with which bilateral agreements were made.

Price control measures

46. With the progressive phasing out of VERs under WTO rules and the high degree of substitutability between Anti-Dumping or Countervailing Measures (AD/CVM) and VERs, the use of AD/CVM could become more frequent in the future. In addition, the process of tariffication of variable levies and quantitative restrictions applicable to agricultural products could increase resort to AD/CVM in this area. While the importance of AD/CVM and Voluntary Export Price Restraints (VEPRs) increased in the US where such measures replaced the use of VERs, especially in the case of steel, the relative importance of these measures declined in the EU. For the latter, both frequency and import coverage ratios of AD/CVM and VEPRs fell in the period from 1988 to 1996, from 2.6 to 0.9 per cent, and from 2.2 to 0.2 per cent, respectively. In the United States, though the frequency ratio fell over the same period, the import coverage ratio increased from 3.4 per cent in 1988 to 5 per cent in 1996. On the other hand, Japan hardly used AD/CVM or VEPRs between 1988 and 1996.

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34. The agreements reached in the Uruguay Round concern sanitary and phytosanitary measures, technical barriers to trade, anti-dumping, custom valuation, pre-shipment inspection, rules of origin, import licensing procedures, subsidies and countervailing measures and safeguards.

35. Existing grey area measures must be phased out within four years, or by December 1999 for the EU-Japan VER on automobiles.

36. See for example Schott (1994) for a comprehensive assessment of the Uruguay Round agreements.

Table 9. **Pervasiveness of different types of NTBs in the "Quad"**[1]
Per cent

	Frequency ratio (F)[2]			Import coverage ratio (IC)[3]		
	1988	1993	1996	1988	1993	1996
United States						
All Non-Tariff Barriers (NTBs)	25.5	22.9	16.8	16.7	17.0	7.7
Core NTBs	25.5	22.9	16.7	16.6	17.0	7.7
Quantitative Restrictions (QRs)	20.4	18.1	10.9	13.7	10.2	2.7
Export restraints	19.5	13.1	10.8	12.9	10.1	2.7
Non-automatic licensing	0.0	0.0	0.0	0.0	0.0	0.0
Other QRs	6.6	5.6	0.6	1.1	0.2	0.0
Price Control Measures (PCMs)	17.8	10.8	7.6	3.6	7.3	5.2
Variable charge	0.1	0.0	0.1	0.1	0.0	0.1
AD/CVs and VEPRs[4]	17.8	10.8	7.6	3.4	7.3	5.0
Other PCMs	0.0	0.0	0.1	0.0	0.0	0.1
European Union						
All NTBs	26.6	23.7	19.1	13.2	11.1	6.7
Core NTBs	25.2	21.8	15.1	10.9	9.0	4.2
Quantitative Restrictions	19.5	17.2	13.1	7.8	7.1	3.8
Export restraints	15.5	13.9	11.4	6.2	5.6	3.0
Non-automatic licensing	4.4	3.5	1.5	2.2	1.7	0.8
Other QRs	0.2	0.2	0.2	0.1	0.0	0.0
Price Control Measures	12.4	8.4	3.2	6.0	3.5	0.5
Variable charge	6.3	5.4	1.4	1.8	1.5	0.1
AD/CVs and VEPRs[4]	2.6	1.9	0.9	2.2	1.3	0.2
Other PCMs	4.3	1.1	1.0	2.1	0.6	0.3
Japan						
All NTBs	13.1	12.2	10.7	8.6	8.1	7.4
Core NTBs	12.5	11.3	10.0	7.4	3.8	2.6
Quantitative Restrictions	11.7	10.5	9.2	6.6	3.0	1.8
Export restraints	0.3	0.1	0.0	0.2	0.0	0.0
Non-automatic licensing	8.9	8.9	8.6	1.3	1.3	1.3
Other QRs	2.8	1.6	0.6	5.4	1.7	0.6
Price Control Measures	0.8	0.9	0.7	0.7	0.8	0.8
Variable charge	0.8	0.9	0.6	0.7	0.8	0.7
AD/CVs and VEPRs	0.0	0.0	0.0	0.0	0.0	0.0
Other PCMs	0.0	0.0	0.0	0.0	0.0	0.0

Table 9. **Pervasiveness of different types of NTBs in the "Quad"**[1] *(cont.)*
Per cent

	Frequency ratio (F)[2]			Import coverage ratio (IC)[3]		
	1988	1993	1996	1988	1993	1996
Canada						
All NTBs	11.1	11.0	10.4	5.7	4.5	4.0
Core NTBs	8.9	8.2	7.2	4.1	2.5	1.9
Quantitative Restrictions	6.6	6.8	5.9	3.0	1.7	1.2
Export restraints	4.8	5.8	5.9	1.2	1.4	1.2
Non-automatic licensing	2.6	0.2	0.0	0.7	0.0	0.0
Other QRs	0.8	0.8	0.0	1.1	0.3	0.0
Price Control Measures	2.4	1.4	1.3	1.1	0.8	0.7
Variable charge	0.0	0.0	0.0	0.0	0.0	0.0
AD/CVs and VEPRs	2.4	1.4	1.3	1.1	0.8	0.7
Other PCMs	0.0	0.0	0.0	0.0	0.0	0.0

1. Indicators for 1996 are calculated after revising the 1993 Non Tariff Measures database by eliminating quantitative restrictions on "tariffied" products and updating the price control measures.
2. The frequency ratio (F) indicates the proportion (or percentage) of national tariff lines that are affected by a particular NTB or by a specified group of NTBs, irrespective of whether the products affected are actually imported.
3. The import coverage ratio (IC) indicates the share (or percentage) of a country's own imports that is subject to a particular NTB or any one of a specified group of NTBs.
4. Anti-dumping (AD) / Countervailing Measures (CVs) and Voluntary Export Price Restraints (VEPRs).

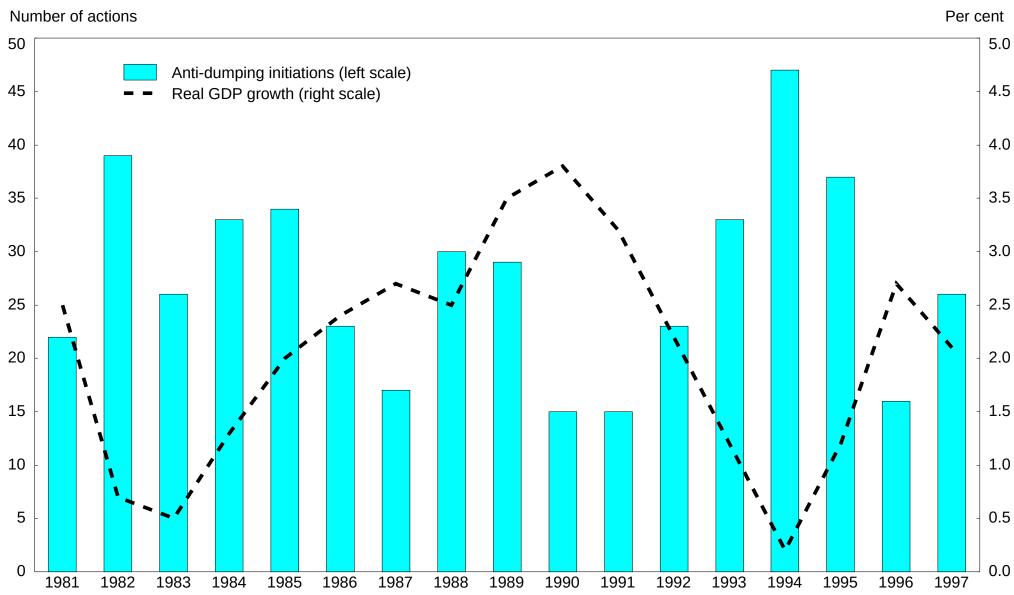
Source: OECD Secretariat.

The new anti-dumping regulation

47. The EU has been a frequent user of anti-dumping measures under the GATT, and has used anti-dumping actions a lot more than either safeguards or countervailing duties.[37] However, while the number of outstanding anti-dumping actions has risen markedly in the US since the early 1980s, it has remained relatively stable in the EU (Figure 4). In mid-1997, some 150 measures were in force, which is considerably below the number of measures taken by the United States. The number of anti-dumping cases initiated by the EU has shown a noticeable degree of counter-cyclical behaviour since the early 1980s (Figure 5). Resort to anti-dumping actions by the United States also appears to have been increasingly related to macroeconomic conditions. The correlation with macroeconomic developments is less tight, but still exists, for Canada and Australia.

37. Since the conclusion of the Tokyo Round in 1979, the EC has undertaken some 550 anti-dumping investigations and less than twenty safeguard investigations (Bronckers, 1995). Explanations for the large difference in the use of the two instruments range from the fact that anti-dumping measures can be requested directly by the industry, and that they can be adopted more easily than safeguards given the broader definition of dumping.

Figure 5. EU ANTI-DUMPING INITIATIONS AND REAL GDP GROWTH (1)
1981-97, mid-year



1. Anti-dumping initiations over 12 months to mid-year and one-year advanced real GDP growth.
Source: OECD Secretariat.

48. In order to implement the 1994 Anti-Dumping Agreement of the GATT the EC Council adopted a new anti-dumping Regulation.[38] The Regulation entails some major changes with respect to the previous legislation in terms of fairer price comparisons to determine the dumping margin, stricter injury requirements, anti-circumvention measures[39] and a broader role for the "Community interest test". Existence of injury does not give automatic entitlement to anti-dumping relief in the EC. The Community will take anti-dumping measures only if these are considered to be in the Community interest. This degree of non-automaticity in the attribution of anti-dumping relief has traditionally distinguished EU from US anti-dumping law (Bronckers, 1995). Another issue not regulated under the WTO agreement but addressed by the EU legislation is that of actions against absorption of duties.[40] While EC rules are broadly in line with the WTO Agreement, significant differences remain in the areas of absorption of duties, circumvention of imposed measures, "Community interest" and *de minimis* import levels.[41]

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38. See Council Regulation 3283/94, as amended by Council Regulation 384/96.

39. Circumvention is defined as a change in trade patterns due to a practice, process or work for which there is insufficient due cause or economic justification, other than the imposition of the duty.

40. EU producers can complain that an anti-dumping measure has brought no or "insufficient" changes in resale or subsequent selling prices in the EU and ask for an examination of the price effect. The Council may, by simple majority, amend the measure in force should the examination confirm "increased dumping" (WTO, 1995). Currently two absorption reviews are ongoing. One, initiated in 1996, concerns imports of television camera systems from Japan. The other, initiated in 1997, concerns imports of microwave ovens from South Korea.

41. In line with the WTO Agreement, EU legislation incorporates a *de minimis* clause defining "negligible imports" to be excluded from an initiation. Countries representing a market share of less than 1 per cent of Community consumption

49. Concerning the calculation of the dumping margin, the earlier EC legislation displayed two major biases when making comparisons between export prices and "normal values" (Bronckers, 1995). Firstly, price comparisons could be made at different levels of trade. For instance, "normal values" established at the level of sales to independent retailers could be compared with export prices established at the level of sales of independent distributors. Under the new regulation, the exporter can claim an adjustment whenever the different levels of trade are shown to affect price comparability. The second bias originated from comparisons of weighted averages of the normal values prevailing during the period of investigation versus individual export transactions in the same period. This practice could give disproportionate weight to dumped exports. Under the new legislation comparisons are normally made between weighted averages.

50. Compared to WTO rules and US anti-dumping law, the injury requirement under EC law allows anti-dumping measures to be softened. Members may, under WTO rules, continue to impose anti-dumping duties corresponding to the entire amount of the dumping margin even if a smaller amount is sufficient to remove the threat of injury to a domestic industry. The Community is alone among major trading partners in having introduced a "lesser duty" rule, under which the level of the measure applied is the minimum necessary to remove the injury. From 1988 to 1992, the average measure imposed was thus only half of the average dumping margin which was 40 per cent.[42]

51. While in the WTO forum no international consensus could finally be reached on anti-circumvention measures, the new EC anti-dumping law continues to envisage applying such rules, a version of which had already been in force prior to the Uruguay Round negotiations. If circumvention of an existing measure is established, the new Regulation permits anti-dumping duties to be extended to imports of like products and parts thereof under certain conditions.[43]

52. Under the "Community interest" test, the overall interests of the Community are taken into account in deciding whether or not to apply anti-dumping measures, whereas there is no compulsory uniformity when applying a "public interest" test as set in the WTO Agreement. Despite the existence of a "Community interest" clause, several authors have pointed out[44] that in a majority of cases the Commission seems to have equated the producers' interest with that of the Community. In early 1997, an upgrading process was initiated following growing criticism among market participants that EU anti-dumping procedures are rigid and one-sided. This new approach is based on a more rigorous economic analysis of products and markets and a consultation of more interested parties, including importers, retailers, and users, while anti-dumping investigations have thus far relied primarily on information from the European producers which initiated complaints.

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of a product are excluded, unless the collective share of such countries amounts to 3 per cent or more as compared with WTO limits of 3 and 7 per cent share of total imports respectively. It should be noticed that the Community legislation uses a consumption benchmark to set the *de minimis* import levels rather than the volume of imports as specified in the WTO agreement.

42. Commission's 11th Report on the Community's Anti-dumping and Anti-subsidy Activities (1993).

43. These conditions stipulate that the parts imported from the targeted country amount to at least 60 per cent of the total value of the parts incorporated in the final product, and that the value added to the imported parts during assembly within the EU does not exceed 25 per cent of the manufacturing cost.

44. See Messerlin (1991) or Vermulst (1987).

Rules of origin

53. While regional cumulation of origin already existed for EFTA/EU trade and trade between the Czech Republic, Hungary, Poland and the EU recent changes have harmonised rules of origin among European countries. They have created a preferential territory for origin between the EEA (including the EU), EFTA and CEEC countries, covering 28 countries. The reform consists in an alignment of the rules of origin in the different trade agreements and the linkage of all countries through diagonal cumulation. In contrast to bilateral cumulation, diagonal cumulation implies that producers can use imports from any country in the zone to produce an originating product. For instance, a producer in Hungary is now able to use Norwegian inputs to produce for export to a Community country. Efforts are currently underway to extend the new system to the countries covered by the Euro-Mediterranean agreements.

54. The changes are likely to further promote outward processing and assembly operations within this larger area and is another step in fostering integration within the European continent. The new system is probably most beneficial for the CEEC countries as it coincides with the abolition of EU duties on textiles and clothing and the dismantling of quantitative restrictions.

Agricultural protection remains high

55. Agriculture has traditionally been the most protected sector in the Community, even though the EU is a major player in the world market (*e.g.* it accounts for 50 per cent of world dairy production). The 1992 reform of the Common Agricultural Policy (CAP) centred on reducing price support for cereals, oilseeds and protein crops, and beef, leading to a significant fall in the level of price support for grain by about one-third. In order to compensate for diminishing market price support, direct income compensation payments and set-aside measures were introduced. In conjunction with strong world market prices, the reform led to an almost complete elimination of grain export subsidies in 1995, but the threshold price has been kept roughly at 1992 levels, and access conditions for third country suppliers have thus not improved.

56. The Uruguay Round Agreement on Agriculture has brought a number of changes to EC trade policy in this area. Under the Agreement, all border measures have to be converted to tariffs, while any further use of non-tariff measures is prohibited. Tariffs will be brought down by an unweighted average of 36 per cent, with a minimum reduction per tariff line of 15 per cent by the end of the implementation period (1 July 2000). Export subsidies and subsidised volumes, will have to be cut by 2001 by 36 and 21 per cent, respectively.

57. The tariffication of border measures together with the progressive binding of all tariffs will enhance transparency and predictability of the trading system. However, even though committed tariff reductions under the WTO Agreement might appear ambitious, different studies have shown (OECD, 1995 and Hathaway and Ingco, 1995) that the final level of tariffs is likely to be so high that the overall impact on trade will be limited. This is largely due to the choice of the reference period (in 1986-88 many agricultural world market prices were particularly low) and uneven tariff cuts across categories of products. Moreover, the Uruguay Round Agreement contains provisions which allow for the imposition of additional tariffs should import prices decline or imports exceed base-year levels during the implementation period. In total, the most significant move towards trade liberalisation should stem from the new disciplines with respect to export subsidies and subsidised volumes under the Agreement, especially when one considers that the EU is the largest user of export subsidies among trading partners as well as the introduction of minimum access commitments.

58. During the period from 1986 to 1988, export subsidies accounted for around 44 per cent of the average annual level of agricultural support in the EU, as compared with only 8.2 per cent in the US, and 1.5 per cent in Japan. While overall export subsidies for all commodities decreased from ECU 8 billion in 1994 to ECU 7.6 billion in 1995 -- against a background of rising world prices -- important export subsidies remain in the sectors that have been less affected by the CAP reform. In particular, export subsidies are estimated to have amounted to ECU 1.4 billion for beef and to ECU 2.2 billion for dairy products in 1995 (OECD, 1996).

59. Implementation of the single market required substantial changes in the banana market since bananas were not subject to the CAP, nor to the common commercial policy. The Community's problem was to create a uniform system while keeping Member States' -- notably France, Italy and the United Kingdom -- special practices with respect to their favoured suppliers (the ACP countries). There was also a legal problem arising from mutually incompatible obligations from the Community's preferential (the Lomé Convention), general (the GATT) arrangements and the internal market rules. A two-tier import regime was finally adopted by the EU, by which ACP suppliers no longer had an absolute advantage on some Member States' markets but still had a substantial tariff advantage on the Community's market over Latin American suppliers.[45] Moreover a system of import licenses was created and a 30 per cent quota was reserved for ACP suppliers. The new regime affected substantially the balance of interests and was opposed internally by Germany, and externally by Latin American exporters, which were backed by the United States. Most features of the EU's banana regime were recently found inconsistent with its WTO obligations, in particular the EU's complex licensing system for the distribution and ripening of bananas which discriminated against US and Latin American companies. The WTO, however, upheld the EU's right to grant preferential tariff treatment to ACP countries, for which the EU has a WTO waiver.

60. The agricultural policy agenda is moving forward both in the EU and in the world community. New multilateral trade negotiations will take place in 1999 as a follow-up to the Uruguay Round and will aim at cuts in border protection and reductions in export subsidies. The Commission recently proposed new objectives to continue the CAP reform in the following areas (EC, 1997): *(i)* increase in internal and external competitiveness; *(ii)* food safety and quality; *(iii)* fair standard of living and income stability in agriculture; *(iv)* integration of environmental goals in the CAP; *(v)* promotion of sustainable agriculture; *(vi)* creation of alternative job and income opportunities for farmers and their families; *(vii)* simplification of Union legislation. Areas of new reforms could be in the crop sector, in order to restrain future cereal surpluses; in the beef sector, to develop new export outlets without subsidies; in the dairy sector, including a cautious approach of gradual price reductions accompanied by an extension in the quota regime up to 2006; and in the rural policy area, where targeted agro-environmental measures together with an overall reorganisation of the existing rural policy instruments will be reinforced and encouraged to support sustainable development. In addition, a big challenge will come from eastward enlargement, which could lead to an expansion of the agricultural area by half and a doubling of the agricultural labour force (see Chapter IV).

45. ACP bananas continued to enter the community duty-free but dollar fruit was to be subject to a two-tier tariff. A tariff of 100 ECU per tonne was set on the first two million tonnes of imports from Latin America; for imports above this threshold, the duty increased to 850 ECU per tonne. In 1992, this corresponded to a lower 24 per cent *ad-valorem* tariff and to a higher 206 per cent tariff above the quota threshold.

Services are undergoing a major liberalisation

61. Liberalisation in the EU services sectors is less advanced than in manufacturing. Core services' markets, such as telecommunications, air transport, and to a lesser extent financial services, have long been shielded from both internal and external competition. These sectors have recently undergone major liberalisation both inside the Community, with the Single Market Program in Services (SMPS), and outside, with the General Agreement on Trade in Services (GATS). The liberalisation approaches of the SMPS and the GATS differ significantly. The Treaty of Rome basically imposes the same rules for trade in goods and trade in services, and the SMPS requires liberalisation of cross-border and establishment-based trade in services within the framework of mutual recognition and minimal harmonization. In contrast, the GATS defines four modes of supply (cross-border supply, consumption abroad, foreign commercial presence, movement of persons) and leaves open the possibility of liberalising only certain modes, thereby limiting the extent of liberalisation. Table 10 presents EU internal and external policies in the core service sectors.

Table 10. **EU policies in core service sectors**

Sector	Internal market integration	Common external policy	Trade policy orientation[1]	Multilateral commitments
Financial services	Yes, but not yet fully achieved in all areas and by all Member States	Yes (authorisation and supervision of branches remain under national law)	Free access - reciprocity provisions (88/357, 89/646, 92/22)	GATS[2]
Telecom services	Yes, with differences due to monopolies in basic telecommunica-tions	Yes, though access conditions may vary because of national monopolies and tariffication practices	Free access in liberalised areas (90/387, 92/44) - reciprocity rules under consideration	GATS (value-added and other advanced services);[2] not for basic phone and fax services. Basic telecom-munications agreement
Air transport services	Yes, for EU nationals	Rudimentary. Bilateral aviation agreements at national level	Non-discrimination (slot allocation and aviation-related services) - reciprocity provisions (2299/89, 95/93)	GATS (auxiliary services);[2] traffic rights not covered by GATS
Maritime transport	Yes, for EU nationals; temporary exemptions for island cabotage; several Member States tend to confine flag rights to their nationals	Yes, but some Member States maintain cargo-shipping arrangements with third countries	Free access, no cabotage rights - anti-dumping, countervailing and other trade remedy instruments (4057/86, 4058/86)	Not yet
Audio-visual services	Yes, for "European works"	Yes, with significant differences in Member States' interpretation and application of EU law	Preferences for European productions - non-mandatory quotas (89/552)	No, MFN exemptions for "European works"

1. Principal Community legislation (Council Regulations or Directives) is indicated in parentheses.
2. Subject to limitations on market access and national treatment.

Source: WTO and OECD Secretariat.

Table 11. **Sectoral coverage of specific commitments under the GATS**
Per cent

	EU	Canada	Japan	US
Number of commitments	392	352	408	384
Market access commitments[1]				
"No restrictions" unweighted count	169	186	230	244
"No restrictions" / count	52.8	43.1	56.4	63.5
Average sectoral coverage	44.4	43.3	50.4	50.6
Average sectoral coverage weighted by world GDP share	12.8	0.9	8.0	13
"Tariff equivalents" for 1-digit ISIC sectors				
Construction	10	6	5	5
Wholesale and retail distribution	10	9	4.6	4.6
Transport, storage and communications	182	117.7	142	111.4
Business and financial services	27.2	25.9	28.9	21.7
Social and personal services	23.6	40.2	32.3	31.7

1. The "no restrictions" indicator, *i.e.* the share of "no restriction" commitments in Members total commitments, is conceptually similar to NTB frequency ratios. The "no restrictions/count" indicator, *i.e.* the share of "no restriction" commitments relative to the maximum number of commitments possible, is similar to an NTB coverage ratio. The higher these numbers the more liberal is the country in its commitments. The "average coverage" of the schedule is instead a weighted mean of all the entries in the commitments, where the weights reflect a subjective appreciation of the extent of liberalisation implied by the commitment. The higher the number, the greater the implied extent of openness-cum-binding.

Source: Hoekman (1995).

62. Indicators of the extent of protection in the services sectors are difficult to obtain. The construction of frequency and coverage indicators has been constrained by the lack of suitably comprehensive inventories of trade impediments. However, some efforts have been carried out recently, based on the inventory of barriers provided by the GATS schedule of commitments. Several market access barriers are not captured in the schedules. Examples include labour legislation, tax regimes, restrictions on land ownership or use, licensing and related fees, existence and reach of competition policies, regulation of monopolies, etc. Moreover, the existence of bilateral sectoral agreements should be taken into consideration in assessing the overall degree of a country's openness. The following indicators are, therefore, fairly crude -- even more so than the NTB indicators for trade in goods.

63. Hoekman (1995) used frequency and coverage ratios to give an indication of the degree of liberalisation implicit in the GATS.[46] In Table 11, Hoekman's calculations on coverage of specific commitments for market access are presented.[47] The EU schedule seems to imply a lower degree of

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46. He calculates a "Revealed Relative Restrictiveness" Index. The underlying assumption is that the more liberal a country, the less constrained its government can be expected to be in binding the *status quo* in the GATS. Hence the higher the coverage ratio of its schedule, the more liberal the country is relative to other countries.

47. At the core of the GATS are specific commitments. Each Member first negotiates which service sectors will be subject to the GATS market access and national treatment disciplines. It then negotiates what measures will be kept in place for that sector that violates market access and/or national treatment. Such limitations have to be specified by mode of supply. As there are four modes of supply, there are therefore eight opportunities for GATS Members to avoid full application of market access/national treatment. In addition to specific commitments, countries make "horizontal" commitments, *i.e.* they provide a list of laws and policies that restrict the use of a mode of supply by foreign suppliers, independent of the sector involved. Horizontal commitments often involve restrictions on the movement of persons (Hoekman, 1995).

liberalisation as compared to the United States and Japan. Hoekman also calculated some very crude indicators of "tariff equivalents" by sector.[48] The sectoral figures show how cautiously these indicators have to be interpreted. The low "tariff equivalent" for the distribution sector in Japan shows that market access barriers and entry regulations, such as vertical restraints, are not captured by the GATS schedules. Moreover, these figures are calculated solely on the basis of EU-wide commitments, while individual EU Member States may have attached additional restrictions to the schedule. The USITC (1995) has compared the EU-wide commitments with the ones made individually by EU Member States. The results show a higher degree of "revealed relative restrictiveness" for the latter.

64. The Community has recently undertaken a series of sectoral studies to evaluate the impact of the single market on some core services. In the case of the air transport sector, the absence of a common policy has long delayed liberalisation and the third "liberalisation package" was only approved in mid-1992.[49] The EU study finds the results of the single market air transport liberalisation somehow disappointing, although the coincident timing of the liberalisation effort with economic conditions has to be taken into account. Based on surveys and interviews, the most important remaining barrier is access to airport slots, which inhibits competition on existing routes as well as the development of new ones. Slot allocation is currently a core issue in deciding on the compatibility of the British Airways-American Airlines alliance with EU competition rules. The second most important problem is considered to be state aid. Overall, monopoly-operated routes still account for 64 per cent of all intra-Community routes. Concerning openness to foreign competition, barriers at the EU-level are to some extent offset by more liberal provisions in bilateral air services agreements with individual Member States. The United States has signed or is currently negotiating open skies agreements with many European States. The Commission, though, has recently received a mandate by the Council for a two-stage direct negotiation with the United States. The first stage envisages an agreement on a common regulatory framework for EU and US air carriers. A second stage, though only under explicit instructions of the Council, would involve negotiations on market access.

65. Telecommunication services have undergone significant liberalisation both at the EU-level, with the EU harmonization starting in 1987, and at the multilateral level, with the GATS agreement covering advanced telecommunications services and the recent WTO Agreement on Basic Telecommunications (WTO/GBT, 15 February 1997). A problem is the different degree to which individual Member States have implemented the single market legislation. Also under the WTO/GBT agreement, EU Member States have made a variety of individual commitments.

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48. Commitments can be broken down into three broad categories: "None", implying no restrictions are applied on either market access or national treatment for a given mode of supply/sector; "Unbound", meaning no commitment is made for a given mode of supply/sector; and "Other", which, in practice, implies that bound restrictions are listed for a mode of supply/sector. The weights used to calculate coverage ratios are obtained as follows: a value of "1" is allocated to all instances where "None" is found; a zero in all instances of "Unbound"; and 0.5 if specific bound restrictions are listed. The resulting ratios range from 0 (no restrictions) to 1 (no access).

    To estimate a country specific "tariff equivalent", each average coverage ratio is multiplied by a benchmark "guesstimate" of what the tariff equivalent of the most protectionist nation might be. The "tariff equivalent" list for the most restrictive" country is completely arbitrary. A value of 200 was chosen for sectors where access tends to be prohibited by most countries, and which do not appear in most schedules (maritime cabotage, air transport except for ground services, postal services, voice telecommunications, and life insurance). The rest varies between 20 and 50 per cent.

49. They abolished national exclusivity rights and granted full cabotage rights. The single market in air transport services was completed with the full implementation of the liberalisation packages in April 1997.

66. After the completion of the single market in the air transport sector, the multilateral achievements in the basic telecommunications sector, and the Europe Agreements with the Central European countries which cover also liberalisation in trade in services, in December 1997 the EU signed the WTO agreement on financial services.[50] A new push towards liberalising services will come with the new multilateral services round which should start in the year 2000.

Cross-border competition issues receive more attention

67. Trade liberalisation and the parallel globalisation of businesses have led to changes in the nature and workings of the trading system. There has been a significant increase in commercial practices with an international dimension such as mergers, strategic alliances and joint ventures. These can lead to an increase in anti-competitive practices across borders: cartels, abuse of dominant position, etc. The adoption of an international framework of competition rules would strengthen the multilateral trading system and promote more equal conditions of competition and market access. Even though the GATT has started to tackle these issues, progress in ensuring a global competitive playing field has been slow.

68. Nevertheless, some agreements contain competition-related rules. For example, the Agreement on Trade-related aspects of intellectual property rights contains provisions on the control of anti-competitive practices or conditions in contractual licenses, relating to the transfer of technology or of other proprietary information. It also recognises the right of countries to regulate such practices through their domestic laws, and it provides for consultations and exchange of information between governments where there is reason to believe that licensing practices or conditions constitute an abuse and have an adverse effect on competition in the relevant market. The GATS contains provisions on consultation and exchange of information, similar to those in the TRIPs Agreements, and requires countries to ensure that monopoly services providers do not abuse their position in activities outside the scope of their monopoly privilege. A number of sector-specific trade agreements also include competition provisions. The scope of these provisions remains far too limited to provide for the effective control of anti-competitive practices at the international level.

69. Some countries have negotiated bilateral agreements on co-operation between their competition authorities. Such agreements have been negotiated in the Union both at the Community and the national level. At the Community level, for example, a co-operation agreement has been concluded with the US. While the substance of these treaties has evolved, their scope remains also limited, as shown by recent competition policy-related trade conflict between the EU and US. The EU's approach towards a further international strengthening of competition policy is described in Chapter IV.

Harmonization of standards: a response to increasing technical barriers to trade

70. Technical barriers to trade (TBTs), *i.e.* trade barriers related to product standards and conformity, while falling in the EU due to the single market, have probably risen in relative importance at the global level in tandem with the liberalisation of border measures, demanding greater attention and action than in the past.[51]

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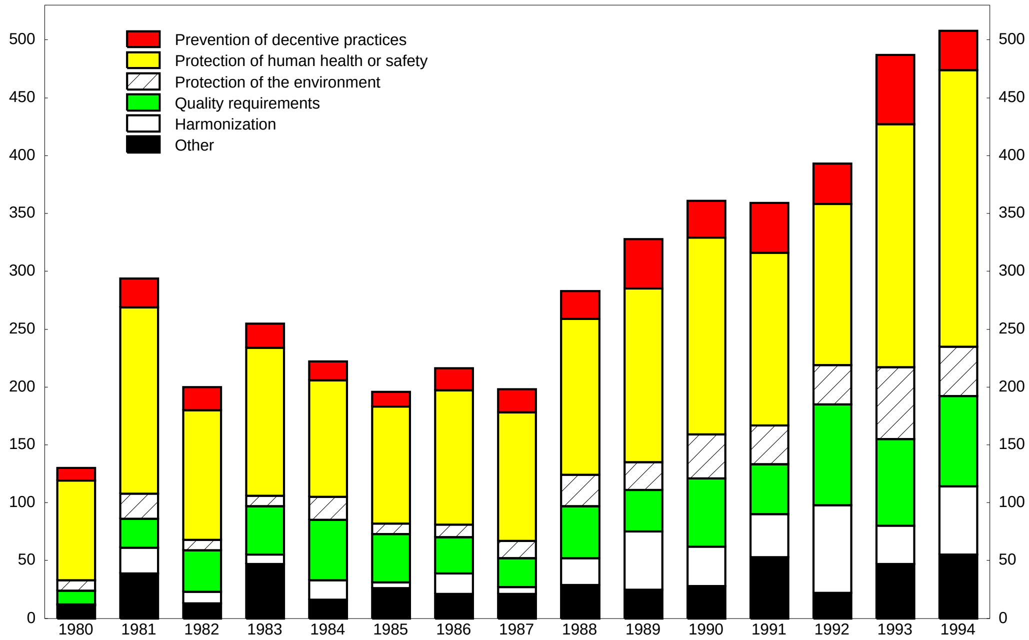
50. 56 offers were made by 70 countries (counting the EU as 15) representing over 95 per cent of the trade in banking, insurance, securities and financial information.

51. TBTs can take the form of technical regulations imposed by national governments, mainly for health, safety and environmental protection for the consumers; and non-regulatory barriers imposed by groups, trade associations,

Figure 6. NOTIFICATIONS UNDER THE GATT TOKYO ROUND TBT AGREEMENT
Number of notifications of draft technical regulations, 1980-94



Source: WTO Secretariat.

71. With the Uruguay Round a new agreement on Technical Barriers to Trade was concluded, which was followed by a continuing rise in the number of notifications of mandatory standards[52] (Figure 6) and by an expanded coverage of conformity assessment procedures. Other major changes were the integration of the agreement into the overall WTO dispute settlement procedure, and the bringing in of standardizing bodies, including private institutions, through the Code of Good Practice. Although not legally binding, the code assures greater visibility and transparency of non-regulatory barriers. Overall the new multilateral rules have strengthened the surveillance mechanism for standard-related measures, and have encouraged the use of internationally harmonized standards.

72. EU-wide co-ordination of national regulations was of particular importance to achieve the single market. The Community approach to removing barriers in the form of technical regulations rests on theprinciple of harmonization of national rules. Mutual recognition agreements (MRAs) were developed to allow competent third country assessment bodies to take part in the EU's conformity assessment activities. MRAs are agreements on the mutual recognition of conformity assessment procedures for

institutions, etc. Such barriers require either the application of technical specifications or standards to products, or the testing and certification of products or suppliers. TBTs impose additional costs on importers that are not faced by domestic suppliers. The magnitude of these costs may vary and can make imported products not competitive or unacceptable in the target market. Delays are often caused by conformity testing which can create an effective barrier to entry.

52. The figures concern only notifications of the introduction or modification of mandatory standards which may cause an impact on international trade, hence they do not reflect the total amount of existing standards.

regulated products. The main features of the Community approach, together with some elements of the US federal system and the NAFTA, are presented in Box 3.

Box 3. Different approaches to the removal of technical barriers to trade

The EU Approach

The Community approach to removing barriers related to technical regulations rests on the principle of full harmonization of national legislation, where uniform standards are set for all Member countries. There have been distinct approaches to harmonization. The "old approach" incorporates all the technical details of the mandatory requirements in a directive. Under the "new approach" (introduced with the internal market), essential policy requirements for particular products are set out, while the development of detailed technical standards conforming to the requirements has been entrusted to standardizing bodies.[53] Moreover, in 1989, the Community put in place the "global approach to testing and certification" which sets principles for conformity assessment. The global approach is based on international practice (ICO/IEC) and on mutually acceptable auditing procedures.[54] Goods manufactured pursuant to the requirements of the global approach are permitted to display a generic mark of conformity -- the "CE" mark. All goods displaying that mark are entitled to circulate freely within Europe and are exempted from further conformity assessment by an importing nation.

The US Federal System

The US Constitution imposes a number of explicit restrictions on State commercial policies, such as the imposition of export or import duties without the consent of Congress (Sykes, 1995). The Congress is also empowered to regulate commerce with foreign nations and among States. State policies that are in contradiction with federal regulatory policy may be "pre-empted" by the Federal regime. The Congress has eliminated TBTs in many areas, *e.g.* drugs, television broadcast standards, design of tanker vessels, etc. Yet many technical barriers remain outside the scope of federal legislation, *e.g.* in the case of building codes, health regulations, pollution control regulations, etc. The absence of clear constitutional limitations on state powers in the regulatory arena has hampered the development of a coherent doctrine.

The NAFTA

The NAFTA agreement on technical barriers is broadly similar to the GATT/WTO provisions. Also NAFTA contains separate agreements on Sanitary and Phytosanitary Measures (SMP) and technical barriers, and applies the GATT principles. NAFTA goes somewhat beyond the GATT/WTO system, as parties are committed to harmonize their standards to the greatest extent possible, provided that this does not reduce "the level of safety or protection of human, animal or plant life or health, the environment or consumers" [NAFTA, TB Accord, Article 906(2)].

73. A recent study by Atkins (1996) assesses the incidence of TBTs for manufacturing and extractive industries sectors (3-digit NACE) through case studies and interviews. It shows that 79 per cent of intra-EU trade in non-agricultural products is potentially affected by regulatory barrier and, within this, 55 per cent of trade is also subject to non-regulatory barriers (Table 12). Case studies on the effectiveness of different approaches to removal of restrictions indicate that the mutual recognition principle seems to work only in the presence of Mutual Recognition Arrangements (MRAs), or where mutually recognised standards have been developed.[55] Case studies of products under the New Approach Directives (see

53. The European Standardization bodies (CEN, CENELEC and ETSI) have the mandate to elaborate harmonized standards. These harmonized standards are not mandatory and are not necessarily based on international standards drawn up by ISO or IEC.

54. An interesting feature of the system concerns the procedure for opting out of a harmonization or mutual recognition initiative. A nation seeking to do so must justify and present an explanation whether or not another party has complained. The procedural structure of escape clauses are analogous to the provisions in GATT that apply when a signatory deviates from international standards or enacts, in the absence of international standards, new standards that may significantly affect trade. They go beyond GATT obligations, however, by requiring a statement of justification. For a detailed discussion, see Sykes (1995).

55. Under a MRA, each party is given the authority to test and certify products against the regulatory requirement of the other party, in its own territory and prior to export. MRAs do not require prior harmonization of each party's requirements, so that each country's "technical culture" is preserved (Clarke, 1996).

Box 3) show that this approach works well and has removed barriers, both regulatory and non-regulatory. Nevertheless, the study also reports some areas of concern related to the New Approach Directives. Complaints are mainly related to firms' difficulties to adapt, and lack of consistent enforcement and of information.

74. As traditional means of protection are used to a lesser extent, it is important to understand whether policies like standard setting procedures can be and are used to protect home firms or markets.[56] If standards are adopted with no strategic purposes, regional and bilateral initiatives may, in the long run, facilitate negotiations over multilateral standards. In this context, the EU offers one model and has made it an important element of its market access strategy. Chapter V, on the future agenda, discusses recent EU initiatives.

The EU's market access strategy

75. In the mid-1990s, the EU added flanking policies to the existing trade policy. The market access strategy provides for mechanisms and instruments to act more forcefully against trade barriers elsewhere. At the multilateral level, the EU aims at strict compliance by its trading partners with WTO rules, at reductions of barriers to EU exports in the context of accessions of third countries to the WTO, and at shaping its strategy for the next round of multilateral negotiations, especially in the fields of agriculture and services.

Table 12. **Application of different approaches to removing technical barriers to trade**[1]

	Percentage share of intra-EU trade	Percentage share of EU manufacturing value added
Sectors with regulatory barriers		
Relying on mutual recognition of regulations	28	21
Harmonized by new approach	17	22
With detailed harmonization (old approach)	33	33
Total	**79**	**75**
of which:		
Sectors also possessing non-regulatory barriers	55	44
Sectors with MRAs	10	7
Non-regulated sectors		
With non-regulatory barriers	2	1
With no apparent barriers	19	24
Total all products	**100**	**100**

1. A regulated sector is defined as a sector where a significant range of products are covered by technical regulations in at least one Member State, and which potentially creates barriers to trade.

Source: Atkins (1996).

56. The literature on the impact of standardization on international trade is still very incomplete; see Matutes and Regibeau (1996) for a review. Another line of research which is relevant to market access issues is the one on the use of standardization policies for entry deterrence.

76. Where this appears to be the most fruitful avenue to reduce barriers, the Union pursues bilateral negotiations. Mutual recognition agreements are, for instance, one way to reduce regulatory obstacles to trade. More broadly, the Community will continue to pursue agreements for improved market access or free trade agreements. A database has been created to compile information on existing obstacles to trade from various sources. Over 700 obstacles have so far been identified. In addition, the Commission issued a Trade Barriers Regulation, which allows firms to file complaints about trade barriers with the Commission. Where the Commission decides to open an investigation, it first tries to resolve the issue in an amicable way. Failing this, the complaint is brought before the WTO dispute settlement procedure. Until early 1997, two proceedings under the Trade Barriers Regulation were underway, but no measures were in force. Several complaints are currently under examination. Market access is not only a concern for the EU, but also for other countries. Box 4 provides some examples of recent trade frictions.

Box 4. The Community's involvement in trade frictions and conflicts

US-EU co-operation is developing through bilateral initiatives, such as the New Transatlantic Agenda, but major frictions still arise at the bilateral and multilateral level. While a few of these frictions receive large media coverage, most issues have been resolved bilaterally or multilaterally, without receiving attention. The United States and the EU have, for instance, been by far the biggest users and beneficiaries of the WTO dispute settlement system. The US has brought 35 cases (a third of the total) and defended 20, while the EU has brought 21 cases, while it defended 14. Sir Leon Brittan, the EU's trade Commissioner, recently stressed that Europe and the United States have enjoyed an unprecedented period of trade peace ever since the WTO came into force.

There remain still some issues which have led to major trade frictions with other countries. A long-standing cause for friction is the EU's Common Agricultural Policy, a recent dispute focusing on the European attitude towards environmental and human health protection. Disagreement on whether bio-engineered foodstuffs should be banned concerns millions of dollars of trade. Even though the EU ban on the use of growth-promoting hormones in meat production is motivated by public health concerns, it has raised issues of backdoor agricultural protectionism. The ban has recently been condemned by WTO rulings because the EU failed to satisfy the new standard for trade restrictions based on health as formulated in the Safety and Phytosanitary Agreement.[57] In the multilateral context major frictions between the United States and the EU have been related to the sanctions by the United States against Cuba and Iran/Lybia. These frictions have been interpreted in the United States as EU moves to bring to the WTO dispute settlement cases which are more political in nature than commercial.[58]

While many cases could be settled without creating any frictions, two competition policy cases led to considerable friction recently. These concerned the Boeing/McDonnell-Douglas merger and the proposed alliance between British Airways and American Airlines. While the former could be resolved in the meantime, a solution is outstanding for the latter.

Implementation of the single market legislation had implications for external trade. This is the case, for instance, of the EU-wide harmonization of standards. The introduction of the EU-wide ecolabeling programme led to complaints by foreign firms whose production processes differ from those used in European companies, while having comparable environmental impact.[59] The external implications of internal EU policies are also highlighted by the so called "banana problem" (see above).

57. The WTO decision is based on the fact that the international scientific community has found no evidence of human health risk arising from the use of the five most common hormones.

58. See for example the opinion of Deputy US Trade Representative Jeffrey Lang (USTR document: iwp972465, 24 July 1997).

59. On 23 March 1992, the EU Council approved an EU-wide ecolabeling programme which permits a manufacturer to obtain an ecolabel for a product when its production and life-cycle meet general and specific criteria established for that particular product.

III. ECONOMIC EFFECTS OF TRADE LIBERALISATION

77. Economic integration has significant implications for the allocation of resources, patterns of specialisation and location of economic activities and, through all these channels, it affects growth. In this chapter, the focus is on the extent to which the process of internal and external integration can be associated with changes in trade patterns and how this may have affected overall economic performance.

Eyeballing trade indicators

78. Regional integration in Europe has had a strong impact on trade flows. The extent of regionalisation is commonly measured by the share of intra-area trade in total trade. Between the late 1950s and the mid-1990s, the share of regional exports and imports in the respective EU12 totals rose considerably, from about 40 per cent to close to 60 per cent currently. Imports from the EFTA6 countries remained rather stable over this period, but those from other regions fell significantly. Trade shares with other industrial countries (excluding the EFTA countries) declined up to the mid-1970s and have since remained roughly unchanged, even though trade with eastern European countries was very dynamic in recent years (Table 13). Quite apart from the effects due to the reclassification of trade from inter to intra-area trade, accessions boosted intra-area trade over the medium term: for Greece, Portugal and Spain intra-area trade rose by more than 20 percentage points after accession, with similar developments after earlier accessions. Data spanning over a long period suggest that integration proceeded faster in recent years than over the 1970-85 period, but more slowly than in the early integration phase.[60]

79. While the EU is the largest trading bloc, its trade openness, once intra-area trade is subtracted, is not very different from that of the United States or Japan. Trade openness, as measured by the average shares of extra-EU nominal goods exports and imports in GDP, rose from 8 per cent in the early 1960s to about 10 per cent in 1995 (Figure 7). Currently, the NAFTA area and Japan show somewhat lower trade shares in GDP, with the former increasing its share over the period. Since the mid-1980s, the EU and Japanese trade shares have shown a decline. This is largely due to relative price changes of energy and raw materials. Including services, for which Eurostat estimates are available since 1985, raises openness to 12½ per cent, with transport and tourist exports and imports accounting for more than two-thirds of service trade flows. An indicator of exposure to foreign competition is provided by a measure which weights together export orientation and import penetration (Table A1). The exposure to foreign competition for the manufacturing sector was always higher in the EU as compared to North America, even though North American trade exposure is catching up slowly to the European level. Japan continues to have a much lower exposure and, contrary to the EU and the United States, its exposure has hardly changed since the early 1980s.

60. The trade indicators discussed in this paper are documented in Annex 2 for the EU, a North American aggregate (United States and Canada) and Japan.

Table 13. **The regional structure of EU[1] trade**

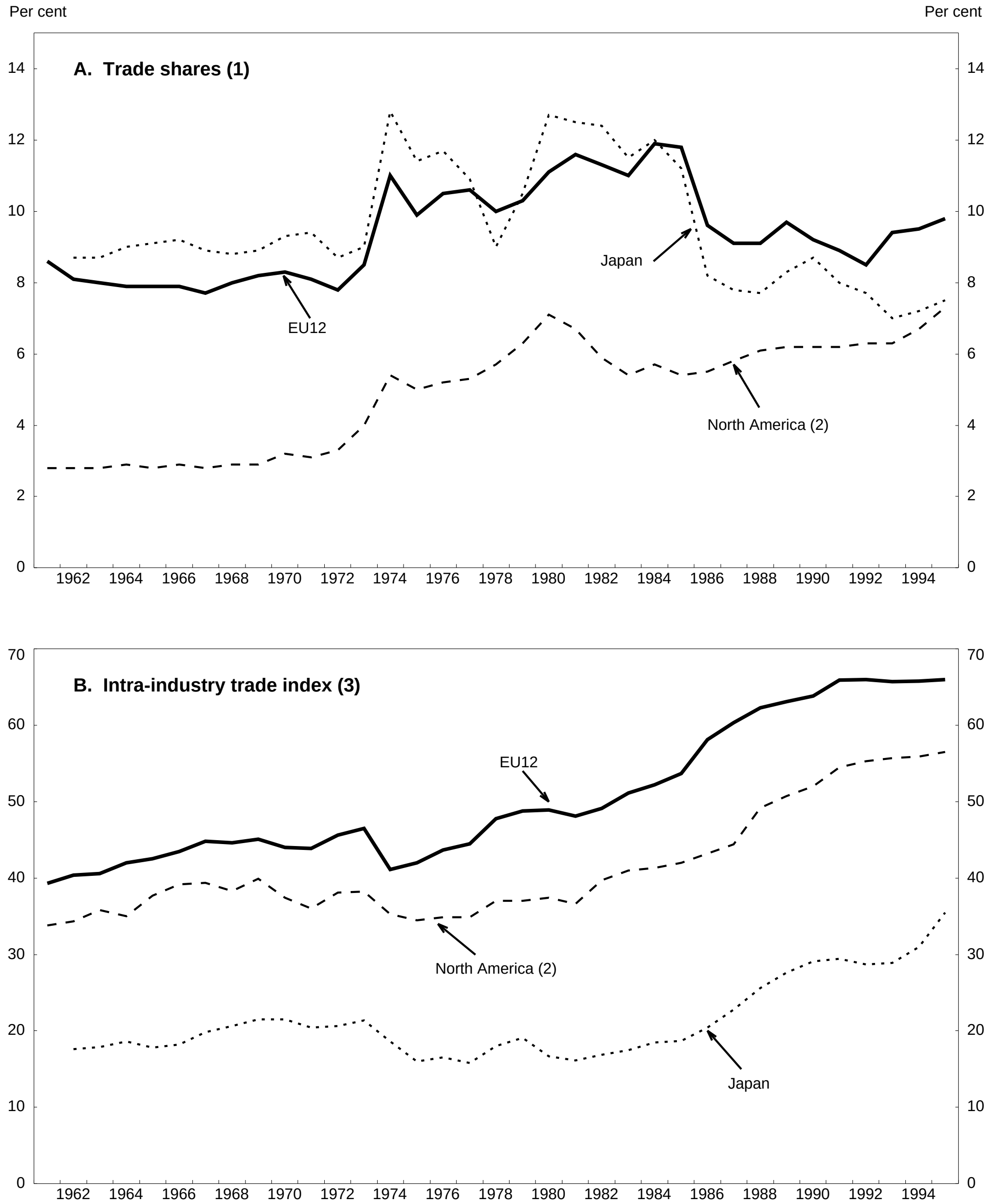
Per cent of total

	1961	1965	1970	1975	1980	1985	1990	1995
	Exports							
Western Europe								
EU12	43.3	49.9	53.5	52.7	55.6	54.8	60.1	56.9
EFTA6	13.2	13.0	11.7	10.5	10.9	10.0	10.1	9.3
Total	56.5	62.9	65.2	63.2	66.5	64.8	70.3	66.1
Eastern and southern neighbours								
Eastern and central Europe[2]	3.9	3.3	4.5	5.9	4.1	3.4	2.9	4.6
Mediterranean partners	5.5	3.7	3.2	4.6	3.9	4.0	3.0	3.3
ACP[3]	4.6	4.2	3.5	3.5	3.4	2.3	1.6	1.1
Total	14.0	11.3	11.1	14.0	11.5	9.7	7.6	9.1
Rest of the world								
Developing countries	16.3	12.7	10.9	13.5	13.7	11.7	11.3	14.6
Industrial countries	13.3	13.2	12.8	9.2	8.4	13.8	10.8	10.2
Total	29.5	25.9	23.7	22.7	22.0	25.5	22.1	24.8
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
	Imports							
Western Europe								
EU12	40.2	45.1	50.4	50.5	49.2	52.7	57.1	55.9
EFTA6	9.5	9.0	8.6	7.5	8.0	9.0	9.3	9.1
Total	49.7	54.1	59.0	58.0	57.2	61.7	66.4	65.0
Eastern and southern neighbours								
Eastern and central Europe[2]	3.6	3.7	3.4	3.6	3.8	4.0	3.2	4.6
Mediterranean partners	3.7	2.9	2.2	2.3	2.6	3.3	2.4	2.4
ACP[3]	5.2	5.0	4.3	3.6	3.7	3.5	1.9	1.4
Total	12.5	11.6	9.9	9.5	10.1	10.9	7.5	8.4
Rest of the world								
Developing countries	18.7	16.1	14.7	19.2	19.7	13.7	12.9	13.6
Industrial countries	19.1	18.2	16.5	13.3	13.0	13.7	13.2	13.1
Total	37.8	34.3	31.2	32.5	32.7	27.5	26.1	26.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

1. EU12.
2. Central and Eastern European countries (CEEC), Community of Independant States (CIS), Czech Republic, Bosnia and Herzegovina, Croatia, former Yugoslav Republic of Macedonia, former USSR and former Yugoslavia.
3. African, Carribean and Pacific countries which have signed the Lomé convention.

Source: OECD, Foreign Trade Statistics database, November 1997.

Figure 7. TRADE OPENNESS AND SPECIALISATION
Excluding intra-zone trade



1. Average of goods export and import shares in GDP, current prices, per cent.
2. Canada and the United States.
3. For total goods. The index varies between 0 and 100. The index is high if a country's disaggregated exports and imports roughly balance.

Source: OECD Secretariat.

80. Both the EU and North American manufacturing export market shares (excluding intra-zone trade) experienced a considerable decline between the early 1960s and early 1970s, largely reflecting very fast growth in a number of countries elsewhere (Table A2). Market shares have shown little trend in the ensuing period, but large fluctuations due to exchange rate changes. The Japanese market share has risen considerably between the early 1960s and early 1980s and remained fairly stable since then, again with large fluctuation due to changes in competitiveness. The EU's overall stability of export market shares over the last two decades masks considerable changes by industry.

81. Depending on the type of trade, there can be a considerable difference in terms of relocation and adjustment costs following integration. Trade in different products (inter-industry) brings efficiency gains, but within individual industries can lead to higher production in one country and plant closures in another. On the other hand, trade in similar products will in most cases have lower adjustment costs and the geographical distribution is likely to change less drastically. Measured by the Grubel-Lloyd index, extra-EU trade integration has led to a considerable expansion of intra-industry trade, with intra-industry trade within the EU being only somewhat higher than for external trade (Figure 7 and Table A3). Trade specialisation in North America has also risen considerably and developments there are very similar to those of the EU. On the other hand, intra-industry trade has always been much lower in Japan, with a much higher dispersion of export/import ratios.

82. Structural changes are also depicted by indicators of export specialisation (revealed comparative advantage). They show that the EU's high technology exports are below the OECD average, with little change over time, while North America largely kept its edge (Table A4). At the same time, Europe's specialisation in labour intensive, low-skilled and low-wage industries tended to rise, while showing a considerable trend decline in North America and even sharper changes in Japan. Overall, structural changes as depicted by these indicators were more significant in Japan than in the EU, with North America in between.

83. European integration was accompanied by a substantial rise in foreign direct investment flows, even though flows were considerably smaller than in North America until the mid-1980s. With the single market project the EU's FDI flows surged ahead and inflows and outflows surpassed North American flows by the early 1990s (Figure 8). However, much of these flows took place within Europe itself and excluding intra-European flows, Europe's position as a host is well behind that of both North America and Asia. Furthermore, outflows are concentrated in the Union, European companies investing about twice as much within the European Union as they do outside (OECD, 1997*e*). The sectoral composition of the EU's FDI flows is close to that of the United States and Japan. There is an increasing concentration of FDI in the service sectors, especially in finance, banking, insurance, telecommunications and business services.

84. Despite the rapid pace of regional integration, the EU's overall trade developments with the rest of the world in terms of openness are close to those in North America, while Japan is lagging, with external trade having a relatively small weight in all three areas. In addition, developments of import penetration ratios (discussed below) suggest that the propensity to trade with other regions has also been rising, which implies that multilateral integration has continued alongside regional integration.[61] On the other hand, it appears that the Japanese economy has undergone more structural adjustment than North America, with the EU countries lagging behind in this respect.

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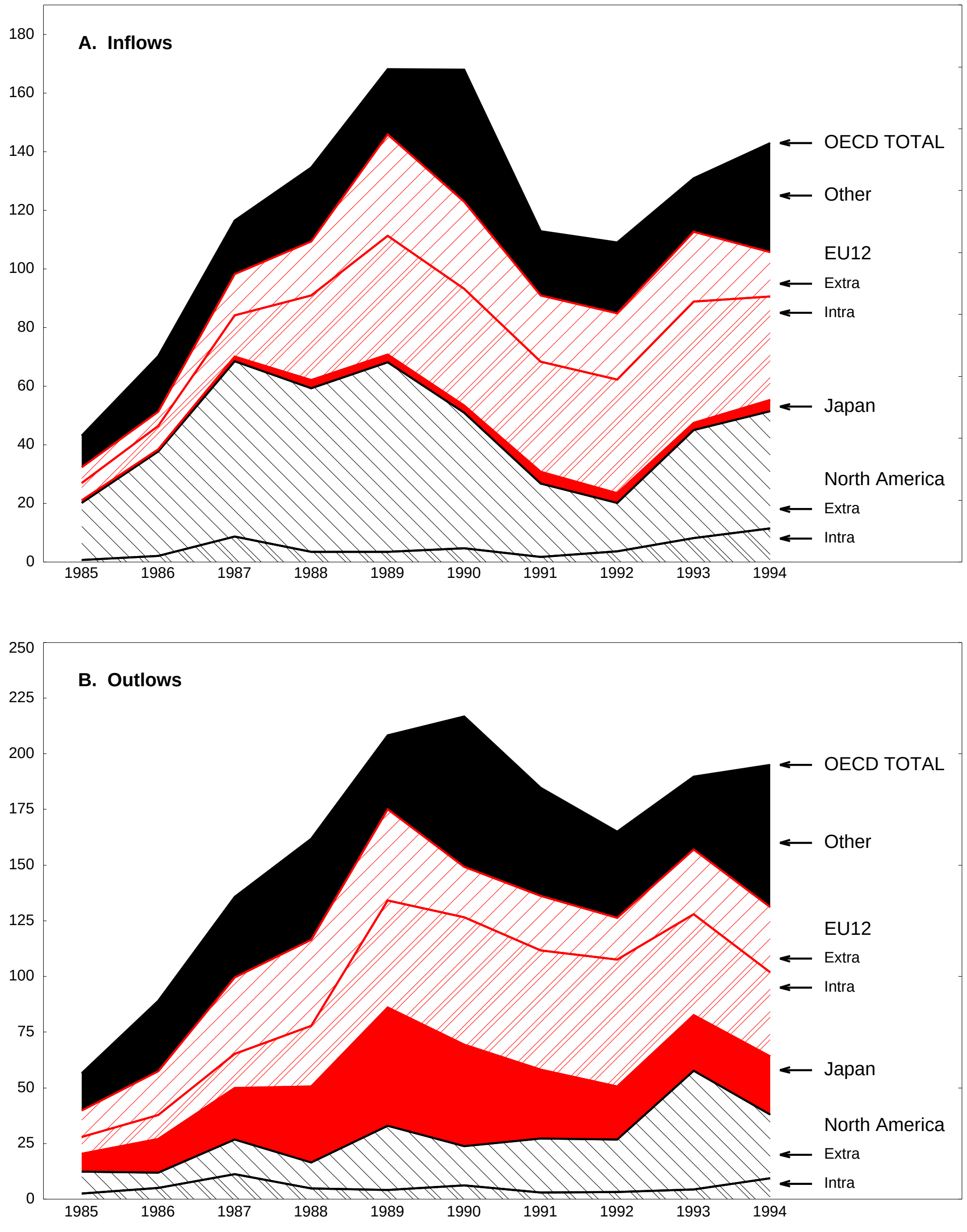
61. Anderson and Norheim (1993) analyse trade integration globally since the 1830s. They find that the propensity to trade extra-regionally increased throughout the hundred years to 1928, that it fell in the 1930s and then increased for virtually all regions (though least so for Europe) since then. The slower increase for Europe is largely explained by the switch from colonial trade of Britain and France towards intra-European trade.

Figure 8. INTERNATIONAL DIRECT INVESTMENT FLOWS
Billion US$



Source: OECD (1996), International Direct Investment Statistics Yearbook, 1996.

Trade creation and trade diversion

85. Regional trade agreements which discriminate in favour of member countries can lead to trade creation or to trade diversion of particular products. Trade creation refers to the substitution of a high cost supplier for a lower cost source of supply inside the integrated area. Trade diversion occurs if a higher cost source of supply from a partner country is substituted for a lower cost supply from third countries. Trade creation deepens the reliance on comparative advantage, while trade diversion does the opposite (WTO, 1995). The size of the diversion effects depends on the relative price changes following regional integration and the substitution elasticities between preferred and non-preferred imports. However, apart from the static relative price effects, regional integration is likely to raise growth performance and should also benefit third countries. In addition, regional integration in Europe has gone hand in hand with multilateral liberalisation, which has reduced margins of preference embedded in trade agreements.

86. Changes in demand shares have been used for a long time to examine the effects of integration [Jaquemin and Sapir (1988) and Neven and Roeller (1991)]. These shares can be split into domestic production (net of exports), intra-EU imports and extra-EU imports. A decrease in domestic production is indicative of trade creation, which may be due to an increase in intra-EU or extra-EU imports. On the other hand, a rising share of domestic production is characteristic of trade diversion, which may be either internal or external. Table 14 shows the evolution of consumption shares and internal and external import ratios for the manufacturing sector since 1970.[62] The latter are split into EFTA, non-European OECD and rest of the world import ratios. Overall, there was a continuing decline in the share of domestic production in apparent consumption, accompanied by an overall rise in intra as well as in external import ratios, with about as much internal as external trade creation. Internal imports expanded about as fast as imports from the EFTA countries, while trade creation was relatively lower for the non-European OECD countries and relatively faster for the rest of the world. As a comparison, in North America (the United States and Canada), internal trade advanced at about the same pace as in the EU, but external trade advanced much faster for the rest of the world and the non-European OECD countries, while imports from EU countries were lagging behind.

87. Intra-EU and external trade creation does not, however, permeate all sectors and regions. This is, for instance, the case for the food, drink and tobacco category, where internal import penetration rose considerably, while falling somewhat for the non-European OECD countries, declining considerably for the rest of the world and rising somewhat for the EFTA countries. The same occurred also in North America, even though to a lesser degree (Table A5). On the other hand, external import penetration rose significantly in the textile, footwear and leather sector, despite the high level of protection. Another sector where internal import penetration rose considerably, while external imports declined in relative terms, is non-ferrous metals. At this sectoral detail, in no EU industry did overall external import penetration rise faster than internal import penetration, while this was the case in North America in all industries. This largely reflects the fact that internal trade creation was much stronger in the EU, while the rise in external trade creation was only somewhat faster in North America, with the latter region catching up to the external import penetration ratio observed in the EU. Overall, extra-regional trade expanded rapidly, but to a lesser extent than intra-regional trade, and any bias against extra-EU imports due to regional integration was probably minor. This was to be expected since external protection in manufactured goods

62. Analysis of the trade effects of the customs union between the original six members of the EEC (Balassa, 1975*a*) indicated that trade creation outweighed trade diversion for manufactured products until the early seventies, while the opposite was true for agricultural products, with the balance between the two being difficult to establish.

was already fairly low in the early seventies and internal liberalisation of the manufacturing sector had already gone a long way.

Table 14. **Import penetration ratios**

Average ratio of EU12 imports to total domestic demand for main industry groups

Industry	Period	Internal EU12	External			Total World
			Other main OECD partners[1]	Rest of OECD (24)	Rest of world	
Total manufacturing	1970-72	10.5	2.6	1.8	2.6	17.5
	1980-82	14.7	3.5	2.3	3.7	24.1
	1993-95	19.8	4.7	3.4	6.1	33.9
Food, drink and tobacco	1970-72	5.9	2.0	0.5	4.4	12.7
	1980-82	8.9	1.6	0.6	3.1	14.2
	1993-95	13.6	1.1	0.8	3.3	18.9
Textiles, footwear and leather	1970-72	11.0	0.9	1.2	3.9	17.0
	1980-82	16.4	1.5	2.0	8.8	28.8
	1993-95	21.7	1.4	3.8	20.3	47.2
Wood, cork and furniture	1970-72	4.6	1.4	4.2	3.4	13.5
	1980-82	7.2	1.7	4.2	4.4	17.5
	1993-95	8.8	1.6	4.7	6.3	21.4
Paper and printing	1970-72	5.1	2.7	6.1	0.4	14.3
	1980-82	7.7	2.9	6.0	0.8	17.5
	1993-95	10.1	2.3	6.4	1.4	20.2
Chemicals	1970-72	12.9	2.6	1.4	1.5	18.3
	1980-82	17.5	2.7	1.9	5.0	27.2
	1993-95	22.9	3.5	3.3	4.5	34.3
Stone, clay and glass	1970-72	6.2	0.5	0.6	0.3	7.7
	1980-82	8.1	0.7	0.7	0.7	10.2
	1993-95	10.2	0.8	1.1	1.9	14.0
Basic metals	1970-72	10.7	2.9	2.0	4.5	20.0
	1980-82	15.8	2.6	3.2	4.6	26.2
	1993-95	19.7	1.8	4.7	6.6	32.8
Ferrous metals	1970-72	10.2	1.4	1.4	1.1	14.2
	1980-82	15.1	0.9	2.5	1.8	20.3
	1993-95	20.8	0.6	4.5	3.8	29.7
Non-ferrous metals	1970-72	11.8	6.9	3.4	13.4	35.6
	1980-82	17.2	6.1	4.4	10.4	38.1
	1993-95	17.9	3.7	5.2	11.2	38.0
Fabricated metal products	1970-72	14.4	3.9	2.0	0.6	21.0
and machinery	1980-82	18.1	6.4	2.5	1.8	28.8
	1993-95	24.5	9.1	3.7	5.7	42.9
Fabricated metal products	1970-72	8.1	1.1	1.1	0.3	10.6
	1980-82	11.1	1.6	1.7	0.8	15.2
	1993-95	12.9	1.6	2.5	2.7	19.7
Instruments	1970-72	23.1	12.3	6.5	1.2	43.0
	1980-82	29.6	22.1	7.8	4.6	64.1
	1993-95	37.0	26.9	11.1	9.8	84.8

1. Australia, Canada, Ireland, Japan, New Zealand and United States.

Source: OECD Secretariat.

88. Gravity models, which model trade as a function of geographic distance, income and population have also been used to assess the trade creating and diverting effects of regional trade agreements, typically by adding dummy variables for membership in such agreements. In a recent study, Bayoumi and Eichengreen (1995)[63] find that some trade diversion occurred between the initial period of the EEC and the late 1960s, but not thereafter. Later on, accessions by the United Kingdom, Ireland, Denmark and Greece led to some trade diversion, but no evidence of trade diversion was found after Spain and Portugal joined.

89. What could be more worrying in this context are trade developments between eastern European countries and the European Union in recent years. The lifting of the iron curtain and liberalisation in these countries led to a strong reorientation in trade flows. The share of trade among the eastern European countries collapsed until 1994 and recovered afterwards, while that with the EU soared, both for exports and for imports (Figure 9). These two changes were accompanied by an equally important collapse in trade with MFN countries. While a sharp fall in trade with the former Soviet Union countries was to be expected, trade developments with the largest and/or most dynamic economies in the world (United States, Japan and Pacific Asia) were subdued. With the economic recovery of the eastern European countries, fairly rapid output growth could have ensured that trade with the rest of the world would also grow substantially, despite the preferential agreement with the EU. In the absence of data on apparent consumption, trade intensity and propensity indices can shed light on this question. The trade intensity index measures whether a country's trade with a certain region is higher or lower than its importance in world trade, while the propensity to export index measures to what extent there is still a rise in their propensity to export extra-regionally. Based on the developments of these two measures, Messerlin (1996) concludes that there is a risk that trade diversion has occurred. It should be stressed, on the other hand, that these trade developments could also partly reflect geographic proximity, with trade further away developing more slowly, and that is not easy to determine comparative advantage for countries undergoing swift transition.

Investment and trade liberalisation

90. Numerous links exist between trade and FDI, even though FDI is by and large not "trade by other means". The links between trade and FDI are reviewed in Box 5. Empirical work on the effects of European integration on FDI has mainly dealt with the impact on inter-regional FDI.[64] Earlier research points to increased inward FDI flows from the United States following the formation of the European Community, while studies at later stages in the European integration find more mixed results. Studies of the impact on intra-regional FDI are rarer and constrained by data shortages. Again the results are mixed and depend on the period considered. Some studies focus on changes in the number of foreign subsidiaries of EU firms established in other EU countries in the pre-1985 period and point to some "investment diversion". On the other hand, a study by Agarwal *et al.* (1995) shows that in the post-1985 period there is no evidence that the growth of extra-EU FDI into the EU in the sectors where intra-EU trade has expanded has been at the expense of extra-EU FDI into other developed countries.[65] Studies of outcomes for individual countries within the region have been given less attention. The results are mixed, with Ireland, Spain and Portugal benefiting from large intra and inter-regional flows, while no investment effects were found for Greece.

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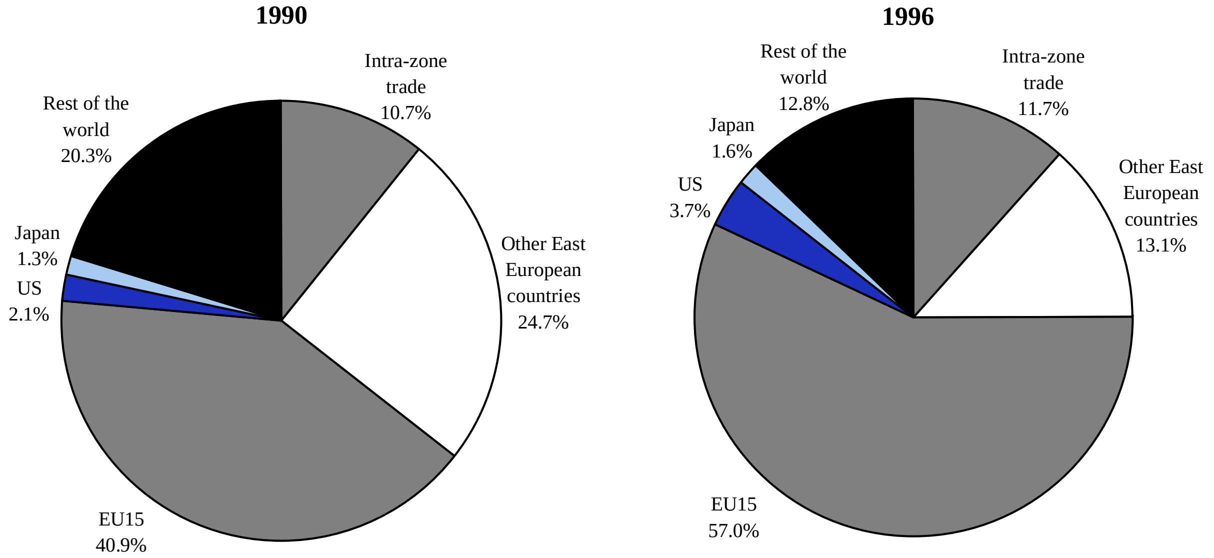
63. Bayoumi and Eichengreen also review earlier studies using gravity models.

64. For a review see Blomström and Kokko (1997).

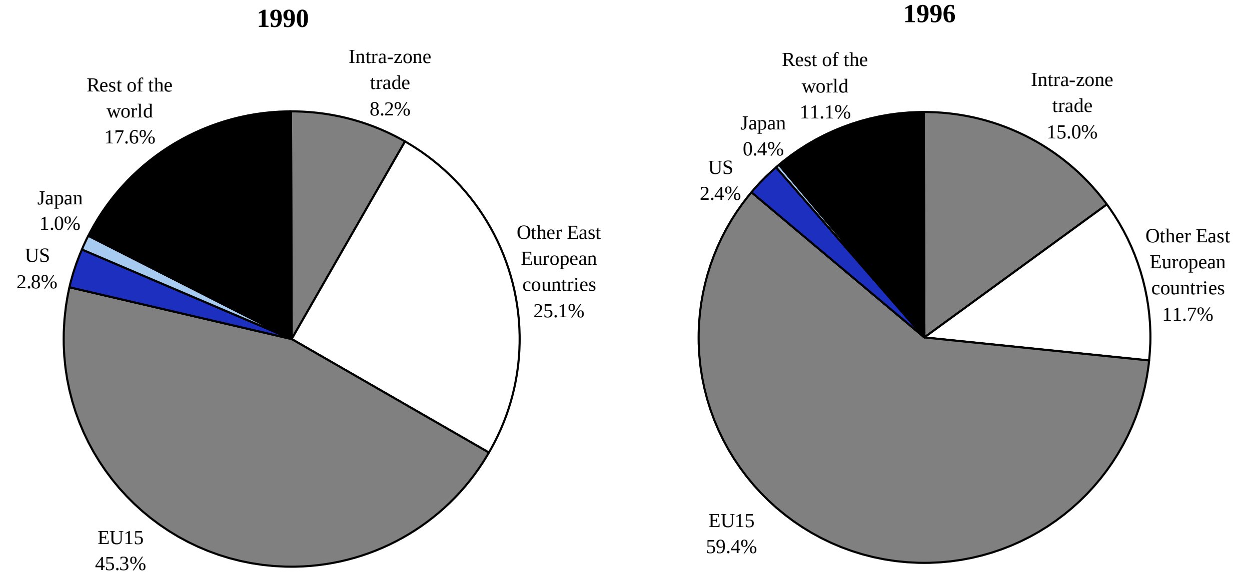
65. Except for some service sectors where barriers to trade and investment before the single market programme were particularly high (*e.g.* in finance, insurance and telecommunication) (Dunning, 1997).

Figure 9. **TRADE OF EASTERN EUROPE** [1]

A. Source of imports



B. Destination of exports



1. Czech and Slovak Republics (Czechoslovakia for 1990), Hungary, Poland and Romania.

Source: IMF, Direction of Trade Statistics, November 1997.

Box 5. Trade and foreign investment

FDI is in many cases a complement to trade, including, for instance, local offices or distribution channels. Traditional FDI theory also motivates the decision of a firm to engage in FDI abroad on the basis of some cost advantage that the multinational enterprise (MNE) might have in the foreign market. Cost advantages can be due to ownership specific advantages, internalisation advantages and locational advantages.[66] Regional integration affects locational advantages directly and ownership advantages indirectly, the latter by strengthening the competitiveness of firms. Recent models of multinationals and two-way investment between countries have emphasised the role of the interaction between economies of scale and trade costs on MNEs' activity. The higher firm-level fixed and trade costs relative to plant-level economies of scale, the higher will be the level of FDI. According to these models, increased convergence in size and endowments led by integration intensifies MNEs' activity, especially in those sectors with high firm-level fixed costs. On the other hand, the lowering of trade costs will tend to increase trade relative to FDI, especially in those sectors characterised by large, unexploited economies of scale.[67] Hence, the net effect of regional integration on intra-regional FDI flows is ambiguous and will vary according to sectors.

To the extent that regional trade agreements also entail capital flow liberalisation, intra-regional FDI will be encouraged. This takes place with the direct elimination of restrictions on inward FDI, the introduction of national treatment provisions, the elimination of trade-related investment measures and the establishment of a common strong framework of investor property rights. On the other hand, inter-regional FDI flows would be expected to increase if the overall level of average protection increases after integration, or if the act of integration raises fears about future levels of protection (*e.g.* in the debate on "Fortress Europe"). Moreover, a large "internal" market, by fostering demand (a larger number of consumers) and supply linkages (lower average costs), reinforces the locational advantage of the integrated area.[68] In addition, inward FDI might rise due to strategic considerations. To the extent that regional trade integration may cause trade diversion, outside firms losing export shares to region-based suppliers might respond with investment creation.

Dynamic growth effects of economic integration could raise the overall impact of regional integration on FDI flows. On the one hand, capital-induced growth effects are reinforced by capital inflows and spillovers, while, on the other hand, growth in the region makes it an even more attractive location, thereby stimulating both intra-regional FDI flows as well as inward flows from the rest of the world.

91. Gravity models have also been used to assess the impact of European integration on bilateral FDI flows. CEPS (1996) models the geographical distribution of outward FDI and exports for France, Germany, Japan, Sweden, the United Kingdom and the United States. The importance of the EU destination market for the European countries in the sample is considerable. FDI outflows from France to the EU appear to be six times higher than would be expected on the basis of income, population and distance alone. The effect is eight times higher for the United Kingdom and two times for Germany. Dividing the sample into pre and post-single market periods, results indicate that during the single market programme, in the year of its peak effect, FDI to the EU increased by 100 per cent for France, 80 per cent for Germany, and 200 per cent for the United Kingdom.

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66. Ownership advantages are linked to the product or process characteristics or to intangible reasons such as brand name and quality. Internalisation advantages are driven by the exploitation of intangible assets such as knowledge of local markets, consumer preferences and business practices. Locational advantages relate to trade barriers, cheap factors of production and ease of access to consumers.

67. This is an effect equivalent to the one taking place in the presence of tariff-jumping FDI as referred to in traditional FDI theory. Intra-regional investment flows motivated by tariff-jumping are expected to contract since the liberalised trade within the region makes them relatively less attractive than direct trade.

68. As suggested by the new economic geography literature, the relocation of economic activities following integration will depend on the net effect of centripetal and centrifugal forces. To the extent that a pattern of a centre (where production activities are located) and a periphery emerges, differences in locational advantages might be reinforced by inward FDI flows in those areas. In this case, some member countries could experience investment diversion.

92. In conclusion, the impact of trade integration on FDI is multidimensional, and from the empirical evidence only a few patterns emerge clearly. Even if trade and FDI can be alternative ways of supplying a foreign market, the empirical evidence points to a relation of complementarity rather than substitutability between the two; FDI has increased strongly, but this is due to the market size and growth effects of integration rather than to fears of a “Fortress Europe”; and there is no strong evidence that the increased intra-EU FDI has diverted investment flows away from one or more destinations outside the regional integration agreement. Finally, FDI is largely not “trade by other means” or a redistribution of production from one location to another. Most direct investment involves mergers and acquisitions in Europe and elsewhere. While market access is always part of the motive of mergers and acquisitions, it is also an industrial strategy to increase the size of a firm. In this way, cross-border acquisitions have more in common with domestic mergers and acquisitions than they do with traditional FDI. This raises many issues which go considerably beyond the trade-related issues raised above. Differences in capital market structures are still large across Europe as are corporate governance rules and their institutional setting. While on the agenda, a common European-wide framework concerning company law has yet to be established. Also privatisation of state-owned enterprises is far from complete in many EU countries. The influence of these factors is likely to be as important or even more important than trade liberalisation in shaping FDI flows.

Trade and growth

93. The surging exchange of goods, services, capital and ideas has fostered strong interdependence among countries and trade is likely to be an important determinant of long-term growth performance. While international trade liberalisation progressed little over the last decade, though it received a boost recently with the conclusion of the Uruguay Round, interest in the nexus between trade and growth has been renewed by regional integration schemes, such as the EC's internal market programme or the North American Free Trade Agreement. Research on potential gains from such regional integration schemes has shown that they should be considerable. On the other hand, while the large amount of empirical work on trade and growth has found so far only a few robust trade effects, recent work seems to be going in a promising direction. A review of this empirical research is provided in Box 6.

94. While the early analysis of economic integration focused on the gains from increased specialisation according to comparative advantage and lower trading costs,[69] recent advances in trade and growth theory have stressed the importance of imperfect competition, economies of scale, product diversity and dissemination of technical progress. In the presence of economies of scale, an increase in market size will allow production at lower average costs. The Commission's assessment of achieving the single market in the late 1980s, for instance, concluded that about a third of industry could benefit from scale economies, yielding aggregate savings of 2 per cent of GDP (EC, 1988). Large gains from scale economies were also thought to boost growth in Canada after conclusion of the US-Canada Free Trade Agreement. Trading costs will be lowered further in the EU with the introduction of a single currency.

95. Removing trade barriers is also likely to induce increased competition, causing prices to converge towards levels more consistent with economic and technical efficiency. Before the Single Market Program many service industries in the EU, as well as most public procurement markets, were shielded from foreign competition. Evidence of a lack of deep integration in the EU is given by the large dispersion of prices across EU member countries which persisted until the early 1990s.

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69. Empirical estimates of European integration in the 1960s using this approach showed that gains due to tariff reductions might have been very small (Balassa, 1975*a*). Indeed, given the large share of two-way trade and similarity in factor endowments only small gains from exploiting comparative advantage could be expected.

Box 6. Trade and growth: is there a link?

Trade liberalisation can affect growth if it alters the return to capital accumulation. In a neo-classical growth framework this leads to medium-term investment and growth effects. Trade liberalisation will induce a more efficient allocation of resources and this in turn will have a one-shot positive impact on the level of per capita income, thereby stimulating saving and investment. In a framework with endogenous capital accumulation economic integration may have, instead, long-run growth effects. Any policy which affects the costs and benefits of capital formation can have a long lasting impact and, if the term capital is used in its broader definition, economic integration can affect growth rates through three different channels: physical capital formation (integration-induced investment-led growth), human capital formation (integration-induced skills-led growth) and knowledge capital formation (integration-induced technology-led growth).

While it is only recently that tools have been developed to evaluate the link between long-run growth and trade, empirical work on the effect of trade liberalisation on economic growth has a long tradition. The large number of case studies reviewed by Edwards (1989) document the experience of many countries which have undergone trade liberalisation efforts, and provide a fairly impressive amount of qualitative evidence pointing to a positive relation between trade liberalisation and growth.

The vast quantitative empirical literature of the 1970s mostly uses cross-country regressions to look at the link between openness and growth. This literature has failed to provide a convincing theoretical framework to address the question and it mainly relies on simple correlations between exports and GDP growth, or on correlations between a set of proxies for openness or trade policy indicators and long run growth. Studies looking at correlations between export shares or export growth and GDP growth (surveyed by Edwards, 1993) usually find a strong link between openness and growth. However, the lack of a theoretical framework, and issues of causality and of spurious correlation, have undermined the credibility of the results of this work. Another line of research has linked measures of trade policy with growth and has generally been carried out in the context of the so called regressions *à la Barro*. This framework allows the estimation of the cross-country speed of convergence of per-capita income levels. After having controlled for country differences in initial conditions, such as the level of human capital, other variables are added to see if they affect long run growth. Levine and Renelt (1991) thoroughly examined the methodological, conceptual and statistical problems flawing cross-country regressions, which should be viewed as suggestive of empirical regularities and not as describing behavioural relationships. The same authors (1992) criticise the *ad hoc* framework used in these cross-country regressions and show the lack of robustness of most of the correlations found in this literature. They find that openness proxies (export, import and total trade to GDP shares), as well as some trade policy indicators, are robustly correlated with the investment share, but do not have an independent relation with GDP growth. They suggest that if a robust link between trade and growth exists, this is based on the correlation between openness and physical capital accumulation as proxied by investment shares.

The new trade and endogenous growth literature has led to empirical research being focused on the channels through which trade liberalisation and economic integration might have an impact on growth. Empirical studies have basically been carried out within the framework of growth accounting equations (Baldwin and Seghezza, 1996*a*) and have relied on either cross-section or time series data, and a few recent attempts combine the two dimensions. If the impact of trade and trade policy on growth is indirect, the proper way to assess it would be to estimate a full system of simultaneous equations in which trade affects the accumulation of the broadly defined capital. A complete full equation system has never been estimated but Baldwin and Seghezza (1996*b*) use three stages least squares regressions to endogenize physical capital and control for technological progress. This and other studies (*e.g.* Lee, 1993 and 1994) conclude that, using cross-country data, one can find positive evidence of integration-induced investment-led growth but not an independent effect of trade barriers on technological progress.

Time series and pooled regressions have been estimated both in growth rates and in levels using co-integration techniques. This work tests directly for the link between trade and growth through the technology channel, and points to some direct positive impact of openness on innovation. Coe and Moghadam (1993) conclude that trade and capital broadly defined account for almost all the growth in the French economy in the last two decades; and Coe and Helpman (1995) find that international knowledge spillovers, defined as trade weighted averages of foreign R&D capital stock, affect growth in a panel of developed countries. Although the use of co-integration techniques in these studies allows a direct test for a long-run relation between trade and growth, one needs to be very cautious in interpreting this kind of evidence. On the one hand the mismeasurement of the explanatory variables, especially the R&D stock, can be correlated with the proxies used for openness, thereby generating spurious correlations; on the other hand, co-integration techniques applied to pooled regressions are not yet well developed. Recent work by Edwards (1997) seems to be more promising. The author, using a panel of 93 countries, finds a correlation between eight alternative openness indexes and TFP growth which appears to be robust to differences in samples and estimation techniques.

The empirical literature on trade and growth suggests that, while the intuition of a positive link between trade and growth is justified, this link is indirect. It is crucial to assess through which channels trade operates to be able to infer policy conclusions. For the moment empirical work points to a robust relation between openness and physical capital accumulation. Work on the impact of openness on total factor productivity growth, has shown that, even if positive, such an impact seems to be relatively less important than other factors, such as human capital formation and catching-up.

96. Larger markets are also likely to induce increased variety and specialisation in producing inputs (Romer, 1987). Apart from the welfare effects stemming from the availability of new product varieties, the new trade and growth literature predicts a link between the nature of trade and growth. A rise in intra-industry trade in intermediate inputs raises efficiency in production. If this increased specialisation takes place in the research sector, this will boost innovation activity. Backus, Kehoe and Kehoe (1992) show a positive correlation between productivity growth and intra-industry trade over a cross-country sample after having controlled for scale effects. This channel could be of particular relevance for Europe where intra-industry trade, especially at the intra-European level, is high. In addition, trade may help in the process of technological dissemination and raise incentives for industrial research.

97. There is a general belief that European integration has promoted growth. Evidence in terms of productivity and investment trends, as well as empirical studies of growth and convergence in the European Community, point in this direction.[70] A few studies have tried to test the growth effects of European integration. In Coe and Moghadam (1993) the trade proxy is intra-European trade as a share of European GDP. This variable is thought to capture the beneficial effects from enhanced competition and economies of scale.[71] Baldwin and Seghezza (1996*a*) test for a differential impact of knowledge spillovers on the growth of countries belonging to the European regional area. Building on the analysis of Coe and Helpman (1995), they add a multiplicative European dummy to the stock of foreign R&D. Their results do not allow a formal assessment of the impact of European integration and their positive point estimates of the European dummies might capture many effects other than European integration. Italianer (1994) adds to physical capital and labour accumulation a proxy for trade integration and a general openness variable. The author finds a strong and positive impact of both the openness and integration proxies.[72] The results, though, could reflect the correlation of the openness variables with both human capital and technological progress, and thus not play an independent role.

98. In the exercise detailed in Annex II, further evidence on the link between trade indicators and overall growth in the context of an aggregate production function approach is provided. A cross-country panel of 11 EU countries is used in estimating a production function in growth rates over the period 1970-95. Following Italianer (1994), a proxy for openness (O, defined as the share of total trade in GDP) and a proxy for European integration (I, defined as the share of area trade in total trade, corrected for successive enlargements) is added to the regression. In addition, an intra-industry trade index (S) is included in the production function estimate. Hence, an attempt is made to control some of the channels through which trade could have an indirect impact on growth (physical capital formation, investment in

70. See the European Commission’s extensive work on this.

71. Coe and Moghadam’s results point to fairly strong gains from integration, the integration variable contributing ¾ per cent annually to growth between 1971 and 1991 and still ¼ per cent annually between 1987 and 1991.

72. According to Italianer's (1994) estimates, intra-EC integration has contributed nearly 0.3 percentage points to output growth per year over the whole sample period 1961-92. The impact of openness over the same period would instead be an average of 0.2 percentage points per year. Estimations for the different sub-periods show a very strong EC6 integration effect compared to openness for the period 1961-73. For the period 1974-86, EC6 integration has had a negative impact on growth and no impact if EC12 integration is considered. In 1987-92, intra-EC6 integration did not contribute to growth while intra-EC12 has by 0.4 per cent per year.

research and development, country-specific differences in technical progress) and test whether additional gains to the 11 European countries could stem from increased trade on a multilateral or on a regional basis.

99. The estimates show that the openness variable has a significant and positive coefficient which is robust to changes in sample period and estimation methods. The intra-industry trade index is also positive over the whole period but the coefficient decreases dramatically when the integration variable is introduced. This is understandable, given that intra-Community trade is to a large extent intra-industry trade. On the other hand, the integration variable is positive but never significant. Hence, there is no evidence on pooled data of an additional independent impact of regional trade integration apart from that stemming generally from exploitation of scale economies. By breaking down the sample period it appears that scale economies have played a role only in the 1970s, while investment in R&D starts playing a role only later (see equations 1 and 2 in Table 15).

100. In conclusion, there is evidence that openness in general, rather than regional trade integration, has favoured aggregate growth in Europe. A 1 per cent change in the openness variable would imply on average, across time and across countries, a 0.09 per cent increase in GDP growth, compared to a 0.44 and 0.42 per cent elasticity estimates of employment and the physical capital stock respectively. The openness coefficient tends to vary across countries, being higher for the EU6 and Portugal. The magnitude of the estimated coefficients have to be taken cautiously, given the great heterogeneity across countries and the heroic assumption of a common European production function. Finally, given that the R&D variable only becomes significant in the 1983-95 sample, greater attention should now be given to the R&D growth channel and to the role that trade might play in the diffusion of technology.

Table 15. **Trade and growth in a panel of 11 European countries**[1]

Fixed effects estimator with different time slopes for the R and S variables

$$\Delta 1nY=\alpha_0+\alpha_1\Delta 1nE+\alpha_2\Delta 1nK+\alpha_3\Delta O+\alpha_4\Delta S+\alpha_5\Delta I+\alpha_6\Delta lnR$$

	α_1	α_2	α_3	α_4	α_5	α_6	Rbar**2	DoF
(1)	0.38 (6.45)	0.42 (4.96)	0.09 (3.48)	0.13 (2.05)	0.02 (1.38)	0.01 (1.12)	0.35	230
				1970-82		**1970-82**		
(2)[2]	0.38 (6.41)	0.43 (5.09)	0.09 (3.61)	0.22 (2.92)	0.02 (1.58)	0.00 (0.00)	0.36	228
				1983-95		**1983-95**		
				0.00 (0.00)		0.05 (2.15)		

1. **Variables**: Y = real GDP; E = total employment; K = private sector capital stock; R = private sector expenditure in research and development; O = share of total trade (imports + exports) in GDP; S = intra industry trade index; I = share of area trade in total trade which takes into account successive enlargements.
   Sample: Yearly data (1970-95) for eleven EU countries (Luxembourg excluded). T-statistics in parenthesis.
2. In equation (2), the coefficients of the specialisation index and of the R&D variable vary between the two sub-periods, while the other coefficients are estimated over the whole sample period.

Source: OECD Secretariat.

Trade and employment

101. Increasing wage inequalities in the United States and rising unemployment of unskilled labour in Europe have generated a lively debate on the impact of trade with low wage countries. These labour market trends could also be due to the adoption of new technologies (*e.g.* information technologies) which can be skill-biased. The relative contribution of these different explanations is a question of empirical assessment.

102. Theory suggests strong trade and wage linkages, which can occur through different channels: changes in relative output prices affecting relative factor prices (relative wage of skilled and unskilled labour) as generally analysed in the Heckscher-Ohlin-Samuelson framework;[73] "outsourcing"[74] and "delocalisation" of production to low wage countries via foreign direct investment, which could reduce demand for skilled labour; and increased international competition which could lead to investment in skilled-labour-intensive technologies. On the other hand, traditional theory implies a small impact, if any, of trade on the overall level of employment, by assuming away labour market rigidities and unsound policy responses to labour market problems.

103. Results in the empirical literature suggest, firstly, that the impact of trade on the labour market is very difficult to assess and, secondly, that trade has played only a small role in labour market outcomes, such as changes in relative employment and wages of unskilled labour in OECD countries (OECD, 1997*d*). Due to data availability most studies concern the United States. Most studies concerning Europe do not find a significant impact of trade with low wage countries on the labour market (Cortes and Jean, 1995). On the contrary, trade and international competition among OECD countries seem to have played some role. Freeman and Revenga (1995) find for the OECD countries some moderate effects of import competition on employment and wages. As expected, they find that in Europe employment is more sensitive to imports than wages, while the opposite is true in the United States. Moreover they find evidence that the impact on employment of intra-OECD trade is more important than the impact of non-OECD trade. On the other hand, Neven and Wyplosz (1996), use import prices instead of trade flows as an indicator of international competitive pressure and they find that European industries are affected by competition with developing and developed countries to the same extent. Restructuring at the industry level, though, involves substantial defensive innovation accompanied by skills upgrading in the workforce, rather than reflecting the patterns of adjustment predicted by the Hecksher-Ohlin model. The authors find different results across the four European countries in the sample and suggest that the reason probably reflects differences in labour market legislation and functioning.

104. Another line of research is the literature on the impact of European integration on the economy, which takes into account employment effects. This has generally been assessed using both macro models and computable general equilibrium (CGE) models. The efficiency gains due to market integration are typically modelled via its impact on demand elasticities perceived by producers.[75] A reduction in firms' mark-ups is likely to have a positive impact on employment. Static models, such as in Mercenier (1995),

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73. The Stolper-Samuelson theorem underlines the linkage between relative output prices and relative wages. Trade liberalisation between skilled-labour-abundant OECD countries and unskilled-labour-abundant countries will lead to a decline in the relative price of unskilled-labour-intensive products imported from low-wage countries. This in turn will lead to a more than proportionate cut in the relative wage of unskilled labour.

74. Geographically segmented production process which allows the import of labour-intensive inputs from low-wage countries.

75. Integration, by preventing price segmentation raises perceived demand elasticities and leads to a reduction in the producer's average mark-up. This induces market exit of non-profitable firms, while the remaining producers can fully exploit economies of scale.

find that although welfare effects are unambiguously positive for Europe the gains are quite modest. Taking into account growth effects can increase the size of the impact. The EC (1996*b*), for instance, estimated that the Single Market Programme generated 300 000 jobs by 1994.

105. Most of these studies, with few exceptions, limit their analysis to the unrealistic full-employment/flexible-wage case. EC (1996*b*) estimates, using a model which allows for unemployment, show a three-fold rise in the size of employment gains. In that exercise wages are set in a bargaining framework and trade unions are able to extract some monopoly rent from firms. A decrease in mark-ups has a negative effect on wage claims and it strengthens the employment effect. Mercenier (1995) introduces some short-run rigidities in his model and, contrary to the results obtained with the full-employment case, finds that welfare gains more than doubled in Europe, with five-fold increases in some cases. The author assumes that wages are tied to the consumer price index. Lower mark-ups, when translated into lower prices and wages, increase external competitiveness and boost output and employment. Instead of assuming costless entry and exit of firms, Burniaux and Waelbroeck (1997) take into account a potential side effect of the Single Market Program, that is the possibility that European labour markets have in fact failed to reallocate efficiently the factors released by the firms which close down. They suggest that large adjustment costs may arise if some of the workers belonging to firms closing down decide to retire definitively; and this is most likely in Europe where firms are more reluctant to hire older workers and generous retirement schemes may encourage workers to withdraw from the workforce. In their model the efficiency gains stemming from European integration are partially offset by the wastage of labour as older workers retire from the labour market.

IV. THE FUTURE AGENDA

106. The European Union has lived long enough and is big enough to have had a sizeable impact on the multilateral trading system. However, it is difficult to draw general lessons because of the difficulty of sorting out what is generic and what is specific to the EU's trade history. Nonetheless, one lesson can be drawn: deep integration in Europe shows that a vast regional integration scheme does not necessarily undermine the multilateral system, and many observers have pointed out that the creation of the EU and its enlargement provided an impetus to start multilateral negotiations. In addition, multilateral negotiations have benefited from the EU's internal integration experience as this often gave confidence that practical ways exist to tackle new trade issues.

107. Concerning the future, it is conceivable that the reduction of the number of independent middle-sized and small countries, which have the strongest interest in maintaining an open world trading system, could sow the seeds for more protectionist policies. The same could happen if the EU's success with deepening and widening led to the creation of trading blocs elsewhere, to the extent that these were inward looking. While an empirical assessment of such tendencies is impossible, recent theoretical advances point to a variety of possible outcomes (Box 7). However, the trade agenda of the Community for the coming years can shed some light on these questions.

108. Priorities in the Community's future trade agenda are:

- to actively pursue multilateral liberalisation;
- to deepen integration with the eastern European and Mediterranean countries; and
- to strengthen co-operation on trade-related issues with major trading partners.

Co-operation on trade-related issues

Trade and competition

109. Since the foundation of the Community, a strong common competition policy was seen as important to ensure free and undistorted competition, as anti-competitive behaviour and subsidies can distort trade in the same way as border measures do. Outside the EU, too, co-operation on competition policy matters has increasingly been seen as necessary to prevent anti-competitive practices which could hurt EU companies. Therefore, the EU has established competition policy co-operation agreements with a number of major trading partners.

Box 7. Welfare and the number of trading blocs

Since the mid-1980s, a fast growing body of economic research has accompanied the revival of regionalism. One of the key questions analysed is how world welfare is affected by the number of trading blocs. The traditional view held that world welfare decreases with the number of trade blocs, because in a world where every country forms its own bloc, welfare is minimised as every country levies tariffs on all foreign goods and services. On the other hand, world welfare increases as trade barriers are removed among the members of ever larger trading blocs, and finally, global free trade reigns.

While there is agreement that a world without trade barriers would maximise world welfare, the move towards large regional trading blocs may not procure a monotonic rise in welfare. Indeed, basic trading-bloc models (Krugman, 1991 and Frankel *et al.,* 1996) have shown that world welfare is U-shaped in the number of trading blocs and that the number of trading blocs that minimise welfare is small -- as few as two or three. A world with only a few large trading blocs is harmful for two reasons: each of the large blocs will be tempted to use its monopoly power by raising tariffs to a greater extent than a smaller bloc would and the elimination of tariffs within blocs introduces more distortions than it eliminates. In view of current developments in the formation of regional trading blocs in Europe, America and Asia these results are not encouraging.

An important extension to this model is the explicit modelling of transport costs. If blocs were formed on a continental basis and intercontinental transport cost were prohibitive, then consolidation into continental blocs becomes the best outcome, because there is no intercontinental trade to be diverted. Krugman dubbed such regional blocs as "natural", because if blocs are formed by countries with low trading costs regionalism is a beneficial policy also in terms of world welfare. Trading costs are obviously not prohibitive, so that there will be a mapping between such costs and intra-bloc preference margins which will generate positive returns for regionalism (preferences are low as compared to transport cost) or negative returns (preferences are high as compared to transport cost).

Even more difficult to tackle are questions about the dynamics of regional trade agreements and their interaction with multilateralism (Bhagwati and Panagariya, 1996 and Winters, 1996): will they be "stumbling blocks" or "building blocks" towards world-wide trade liberalisation? Regional agreements have attracted many new members and defections are rare. Overall, these agreements appear to create a "domino" effect, as outsiders lose competitiveness and exporters will lobby for entry. New memberships could raise the cost of non-membership and pull in countries at the next margin. This process would end up in global free trade and the path towards it could be accelerated further, if regional agreements provide an incentive to outsiders to conclude multilateral trade negotiations. While regional integration schemes have attracted new members, regionalism has also provided an incentive to form new regional integration schemes, partly in order to create greater bargaining power. This can lead to multilateral free trade through continued expansion and coalescence of the regional agreements. But it may also lead to a fragmentation of the world economy as regional liberalisation could reduce the incentive to liberalise with the non-Member world. Inward-looking trading blocs or aggressive unilateralism could be the consequence. It should be stressed, that these recent modelling efforts do rely on many assumptions, some of which have little resemblance with reality. It is, for instance, often assumed that countries behave as "optimal tariff setters".

110. The Commission's White paper on the future integration of eastern European countries into the Community underlined the importance of a viable competition policy for economies in transition. These countries are currently in the process of developing competition laws modelled on EU rules, with technical assistance from the Commission. However, competition rules are still judged to be in need of improvement in several countries.[76] Similar rules are included in the agreements with the Mediterranean countries, even though accession for these countries is not on the table, except for Cyprus.

111. The EU bilateral Agreement with the United States is another example of competition policy co-operation, although co-operation is still in its infancy. The main purpose of this agreement is to promote co-ordination in the application of competition laws.[77] The biannual high-level meeting between

76. Under the EEA, a model of co-operation was established involving a full exchange of information between the (EFTA) Surveillance Authority (ESA) and the Commission. An independent EFTA Court in Geneva controls ESA decisions.

77. It contains a "positive comity" clause which gives to either party the right to request the other to act on the basis of its own powers, and to investigate activities which adversely affect important interests of the first party. The notified party

the Commission and the US anti-trust authorities discussed recently the effectiveness of current bilateral co-operation and a number of areas were identified for further study. The Commission also began discussions with Canada on a bilateral co-operation agreement. Japan and the EU have contacts via the Japanese Fair Trade Commission (JFTC), where the Commission put forward a request for a broader and more rigorous application of Japanese competition rules. The recent controversial merger between Boeing and McDonnell Douglas and controversy surrounding the proposed co-operation between British Airways and American Airlines underline the need for close co-operation in this area in order to avoid trade frictions and to provide for a fair assessment of cross-border spillovers of domestic and international mergers. On the other hand, it also shows that there is still a long way to go to create workable institutions to handle such cases.

112. In July 1995, the Commission published a report by a group of experts (the "van Miert Report"), which draws up proposals for strengthening international co-operation between the EU and its trading partners in the field of competition policy in the years ahead.[78] It considered that a strengthened framework for co-operation between competition authorities and for an exchange of information is essential for achieving effective enforcement of competition rules. It also suggested that the international community needs to be equipped with the power to ensure that the authorities of the country in which offending firms are located act to eliminate the anticompetitive practice. A combination of several steps are recommended in order to limit anticompetitive practices which have international effects. A first step would be to encourage countries or regional groupings of countries to ensure that they have in place an adequate set of competition rules comprising agreed minimum standards, *per se* prohibitions and a rules of reason approach, and that these are effectively enforced. A second step would be a strengthening of existing bilateral comity-based agreements. A final step would be the negotiation of a plurilateral agreement including most of the elements already incorporated into the bilateral agreements, comprising a set of minimum competition rules and a binding positive comity instrument. An international body would oversee the agreement and its further development, establish a register of anti-competitive practices and provide a dispute settlement structure. This framework would include, in the first instance, a group of core countries only, although it should expand its coverage progressively in terms of its geographic scope, substantive coverage and surveillance.

113. In June 1996, the Commission published a Communication on Developing an International Framework for Competition Rules. The WTO is identified as the most suitable body to deal with multilateral competition rules. The report recommended the creation of a framework in which the WTO countries could eventually adopt and enforce their own competition rules along commonly adopted principles. At the WTO ministerial meeting in Singapore in December 1996, the EU recommended the establishment of a study group, under the auspices of the WTO, to examine how competition policy can be better linked to global trade rules.

Standardization and certification

114. The Community's trade objectives regarding standards and conformity assessment are to eliminate or reduce TBTs in third countries; and encourage those countries to adopt standards based on, or compatible with, international and EU practices.[79] The strategy pursued is four-fold and relies

is free to decide whether to undertake enforcement activities, but if it does so, it is obliged to advise the first Party of the outcome.

78. Hoekman (1996*b*) reviews additional proposals and the relevance for WTO negotiations.

79. "Community external trade policy in the field of standards and conformity assessment". Communication of the Commission: COM(96)564 final, 13.11.96.

simultaneously on: the WTO multilateral framework complemented with bilateral initiatives; the negotiation of mutual recognition agreements (MRAs); technical assistance programmes to developing countries to promote the adoption of international or European standards; and regulatory co-operation, whether multilateral, plurilateral, or bilateral, on some key industrial sectors such as vehicles, pharmaceuticals, medical equipment, foodstuffs and chemicals.

115. European initiatives concerning MRAs are based on three main conditions: the competence of the third country technical bodies, limitation of recognition to the activity of the bodies designated, and achieving a balanced situation with regard to the advantages derived by both parties for the products concerned (WTO, 1995). Hence MRAs do not presuppose harmonization of each party's substantive requirements or recognition of their equivalence (as with the EU's internal market). They require, though, full confidence in each side's certification process. In the case of the EEA, the EC-Turkey customs union, and arrangements with central European countries, mutual recognition will be based on common regulations, because the ultimate goal is full integration. In most other cases, however, MRAs will operate where the parties' underlying rules remain different.

116. The Community has established MRAs on conformity assessment with Australia, New Zealand and Switzerland. The EU-New Zealand MRA covers telecommunication terminal equipment, low voltage equipment, electromagnetic compatibility, machinery, pressure equipment, medical devices and medical products and the EU-Australia MRA motor vehicles in addition. Current negotiations between the EU and Japan cover pharmaceuticals, medical devices, telecommunications equipment and electrical equipment. Standardization plays an increasingly significant role in the relationship between the United States and Europe. The US Department of Commerce estimates that EU legislation covering regulated products will affect 50 per cent of US exports to Europe.[80] Discussions between the United States and the EU concerning MRAs in the areas of certification and testing procedures have been ongoing since October 1992 and the text of the new MRA was submitted for approval and implementation in June 1997. The final package includes information and telecommunication equipment, pharmaceuticals, medical devices, electrical safety, electromagnetic compatibility, and recreational craft.

Trade and investment

117. Capital movements liberalisation was an objective of the Union from the outset and largely achieved with the 1988 Directive on capital movements. By the early 1990s, capital controls had been removed in all EU countries. A few remaining restrictions concern FDI in certain sectors (typically transport and communications), acquisition of real estate by foreigners for non-business purposes and admission of certain securities issued by non-EU residents. The restrictions are motivated by industrial policy, sovereignty and prudential concerns. The Maastricht Treaty went a step further, by prohibiting restrictions on capital movements and on payments also between Member States and third countries. However, restrictions on direct investment, on the provision of financial services or on the admission of securities to capital markets existing at the end of 1993 could be maintained.

118. The European Commission and its Member States are actively participating in the negotiations of the Multilateral Investment Agreement (MAI) which were launched in 1995 at the OECD. The purpose of the negotiations is the establishment of a broad multilateral framework for international investment providing for the liberalisation of investment regimes, strong investor protection and effective dispute settlement procedures. The MAI is to be a free-standing international treaty open to OECD as well as non-OECD countries. Most elements of the treaty are now in place, but certain topics remain sensitive

80. Annual Report of the President of the United States on the Trade Agreements Program (1996).

issues. These concern, for instance, measures taken by sub-national levels of government, extra-territoriality, the scope of exceptions (*e.g.* with respect to culture, subsidies...), and labour and environment. OECD Ministers have called for conclusion of the negotiations in time for the Ministerial meeting in Spring 1998.

Deepening regional integration

Regional agreements and the GATT's Article XXIV

119. Since the start of European integration and more recently again in the WTO, countries outside EU preferential agreements asked legitimately whether their interests would be hurt by the rising number of regional agreements. Such concerns do obviously not only apply to EU arrangements but are an inherent possible problem in any free trade agreement. GATT rules on customs unions and free trade areas do attempt to ensure that third country interests are respected and that they are compatible with a rules based and progressively more open world trading system. Article XXIV of the GATT, for instance, states that agreements must free "substantially all trade" and that trade barriers with respect to third countries must not be higher on the whole than prior to the agreement.

120. However, the interpretation of the GATT provisions has always been difficult. The GATT contracting parties could never reach an agreement on whether the original EC Treaty is consistent with Article XXIV. The disagreement has continued since then, in relation with the EU regional agreements as well as other preferential agreements.[81] On the other hand, despite problems of compatibility with GATT rules, preferential treatment has only seldom been the subject of dispute settlement proceedings.[82] The WTO is currently considering whether reforms in this area are necessary. In this context, several developments concerning EU agreements should be noted:

- recent agreements provide for reciprocal industrial free trade areas over short transition periods; agricultural trade is also covered, even though liberalisation is still much less ambitious[83] than for industrial goods; and many agreements also provide for liberalisation of trade in services;

- the EU encourages countries which are party to a preferential EU agreement to join the WTO, to liberalise trade unilaterally and to form free trade agreements among themselves; and

- in 1995, the Council established that the Commission has to produce studies on the conformity with WTO provisions and the impact on common policies of each new preferential agreement proposal.

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81. Of the 69 WTO working parties considering regional agreements only six were able to reach agreement on the compatibility with Article XXIV.

82. They were three in total and all concerned the EU.

83. Free trade would conflict with the Common Agricultural Policy where it provides for limits on production, high levels of external protection and high support prices (see above).

Table 16. **Europe Agreements**

Country	WTO member	Agreement signed[1]	In force	Interim agreement on trade with EU
Hungary	Yes	EA 16/12/91, CEFTA	1/2/94	3/4/92
Poland	Yes	EA 16/12/91, CEFTA	1/2/94	3/4/92
Czech Republic	Yes	EA 4/10/93, CEFTA	1/2/95	1/4/92
Slovak Republic	Yes	EA 4/10/93, CEFTA	1/2/95	1/4/92
Bulgaria	Yes	EA 8/3/93	1/2/95	23/12/94
Romania	Yes	EA 1/2/93	1/2/95	23/12/94
Estonia	Accession requested	EA 12/6/95	Pending ratification	NA
Latvia	Accession requested	EA 12/6/95	Pending ratification	NA
Lithuania	Accession requested	EA 12/6/95	Pending ratification[2]	NA
Slovenia	Yes	EA 10/6/95	Pending ratification	NA

1. EA: Europe Agreements
   CEFTA: Central European Free Trade Agreement.
2. Ratified 20/6/96 by Lithuanian Parliament.

Source: European Commission and WTO.

121. The risk of trade diversion is, nevertheless, real in the context of the Eastern European and Mediterranean Agreements. This is also true for free trade agreements elsewhere. Indeed, the EU itself is pushing for reform of WTO procedures in order to increase the legal certainty for its own preferential agreements and in order not to suffer from trade distortions from preferential agreements being struck elsewhere. EC (1996*c*), for instance, points to trade diversion in the context of NAFTA, the free trade area being formed by countries where one or more of the partners has comparatively high duties on imports from the EU, but zero duties exist on trade within the free trade area. Yeats (1997) came recently to a similar conclusion for the Latin American MERCOSUR agreement.

Relations with central and eastern European countries

122. An increasing number of countries in this region has identified membership of the EU as vital for the achievement of economic growth and political and social development. The EU has received applications for membership from seven Central and Eastern European countries (CEECs) and three Baltic States, and it was recently agreed that negotiations will get under way with Hungary, Poland, the Czech Republic, Slovenia, and Estonia.

Table 17. **Eastern European and Baltic MFN tariffs**
1996, per cent

	MFN tariff, unweighted averages				Output-weighted tariff averages[2]
	All goods	Processed food sectors	Manufacturing[1]	Sensitive sectors	
Founding members of CEFTA					
Czech Republic	8.0	19.0	5.9	7.2	..
Hungary	10.0	10.4	10.1	10.9	10.2
Poland	10.3	18.3	8.4	9.0	21.2
Slovakia	10.0	22.3	7.6	9.6	10.3
Founding members of BFTA					
Estonia	..	..	..	..	..
Latvia	9.9	14.6	9.4	8.4	10.6
Lithuania	4.5	14.1	2.6	5.5	8.0
Other EEBCs					
Romania	10.3	15.6	9.1	10.1	11.6
Slovenia	29.0	28.9	24.8	24.7	..
Other countries					
EU	7.2	16.0	6.6	8.1	..

1. Only non-sensitive sectors.
2. Output-weighted tariffs, for 3-digit ISIC industrial sectors.

Source : Messerlin (1996).

123. The first step towards future EU enlargement involved the negotiation of Europe Agreements (EAs). They form the institutional framework for trade integration between the CEECs and the EU and govern economic aid and political co-operation between the EU and the applicant countries. EAs have been concluded between the EU and Poland, Hungary, the Czech Republic, Slovak Republic, Romania, Bulgaria, Lithuania, Latvia and Estonia. Slovenia became the tenth country to sign in June 1996. The EAs are fully implemented only after ratification by the national parliaments and the European parliament. The trade provisions of the EAs, called the Interim Agreements[84] (IA), have however been implemented in each of the CEECs (Table 16).

124. The main objectives of these agreements are the creation of bilateral free trade areas for non-agricultural products within a period of 10 years, close compatibility of economic laws and practice, and the development of a framework for political dialogue and economic co-operation. The EAs include specific provisions for adjusting state monopolies to EU competition rules; for adopting EU legislation on free movement of capital; for liberalising services; and for ensuring compliance with international agreements such as the WTO and conventions on intellectual property and the right of establishment.

84. As the EAs required the time-consuming process of ratification by all EU parliaments and the parliament of the respective CEEC, IAs have been concluded as an intermediate solution in each of the CEECs providing a legal framework for trade co-operation.

125. The basic liberalisation principles embodied in the EAs are preferential treatment, asymmetric reductions in tariffs and the respect of rules of origin. The EU committed itself to eliminate all quotas and levies on industrial goods imported from the CEECs with the exception of steel and textiles as soon as the IAs were in force (in 1992 for the Czech Republic, Hungary and Poland). The period of liberalisation for signatory CEECs however, is longer, with customs duties on imports from the EU to be progressively reduced to zero by the end of 1997 and duties on the most sensitive products[85] to be abolished by the year 2002. Trade liberalisation concerned only products originating either in the EU or in CEEC's until 1997, since when a European-wide diagonal rule of origin system was introduced (see above).

126. Table 17 gives an overview of CEECs MFN tariffs in comparison with the EU average. In 1996, the CEECs were still considerably more protectionist than the EU. As noted above, the difference between the MFN and preferential tariffs of the members of a preferential trade agreement can have important implications for trade. Messerlin (1996) has calculated differences between the highest MFN tariffs of the CEECs and the EU for each ISIC three-digit sector and found that the highest tariffs in these countries are often 20 percentage points higher than the corresponding EU tariffs. On the other hand, agricultural protection is considerably higher in the EU than in the CEECs, and the EAs do not provide for liberalisation in this area. The OECD's (1997*e*) calculations of Producer Subsidy Equivalents show that in 1996, the average value of market support measures was 43 per cent for the EU as a whole. This contrasts with much lower levels of protection of 10 per cent in the Czech Republic, 28 per cent in Poland and 11 per cent in Hungary.

127. The EAs still provide the EU with important tools to protect its market against CEEC imports. The EU as well as CEECs are authorised to take appropriate measures against dumping.[86] The EU is also authorised to take appropriate safeguard actions.[87] Some critics claim that this system is in fact equivalent to voluntary export restraints, as exporting countries ensure that implicit quotas are not exceeded. Table 18 lists the number of anti-dumping cases initiated and completed in the United States and the EU against the CEECs in the period from 1991 to 1995. There is some sign of an increase in the number of cases initiated and measures taken by the United States against the NIS and by the EU against the EA countries during this period. Amongst the EA countries, Poland has been the most exposed to anti-dumping proceedings in the period (16 cases in total) followed by Hungary and Bulgaria (5 cases each). The sectoral breakdown of the data suggests that the proceedings have mainly affected chemicals (in particular chemical fertilisers) and metals (iron and steel).

128. Some of the current trade issues are likely to disappear as soon as accession negotiations are completed. The Commission has recently submitted its opinions on the individual applications and has provided a communication on the future financial framework to cope with enlargement (EC, 1997). The major challenges facing the Community are the large differences between applicant countries and the EU, as well as the fact that all of them will be net recipients of Community funds. In addition, recent institutional reforms of the EU (such as the re-weighting of the votes in the Council, and the reduction of the number of Commissioners), which were seen as necessary for enlargement, did not live up to expectations.

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85. EU sensitive product imports from CEECs are agriculture, textiles and apparel, chemicals, iron and steel.

86. Before measures are taken, the Association Council must be supplied with all relevant information with a view to seeking a solution acceptable to the two parties (Article 33 of the EA). If the Council takes no decision within 30 days, the measure can be taken. Except for this mechanism, no framework for the settlement of disputes is specified in the EAs.

87. The main reasons are serious injury to domestic producers of like or directly competitive products, serious disturbances in any sector of the economy, or circumstances which could bring about serious difficulties in the economy of a region.

Table 18. **Anti-dumping actions against the EA and NIS countries**

	1991	1992	1993	1994	1995
A. European Union					
Against the Europe Agreement countries[1]					
Initiations	2	2	2	5	1
Provisional measures	0	1	3	3	2
Duties Imposed	0	0	3	0	3
Price Undertaking	1	0	3	0	1
Total	3	3	11	8	7
Against the NIS					
Initiations	0	1	8	7	5
Provisional measures	0	2	0	4	2
Duties Imposed	0	0	3	4	5
Price Undertaking	0	0	0	0	0
Total	0	3	11	15	12
B. United States					
Against the Europe Agreement countries[1]					
Initiations	3	1	2	0	1
Provisional measures	0	1	3	0	0
Duties Imposed	1	0	0	1	0
Price Undertaking	0	0	0	0	0
Total	4	2	5	1	1
Against the NIS					
Initiations	0	8	0	4	1
Provisional measures	0	5	3	1	4
Duties Imposed	0	0	2	1	4
Price Undertaking	0	0	0	0	1
Total	0	13	5	6	10

1. From 1 July to end June one year later.
2. For the purpose of this table European Agreement countries include: Bulgaria, Czech Republic, Hungary, Poland, the Baltic States, Slovenia and Yugoslavia (before 1992).

Source: WTO, Report of the Committee on Antidumping practices, various issues (1991-95).

129. Applicant countries were screened by the Commission on the basis of political criteria (democratic rules, rule of law, etc.), economic criteria (functioning of the market economy) and their ability to take on the obligations of membership, including adherence to the aims of political, economic and monetary union. Based on an extensive analysis, the Commission concluded that the Council should open accession negotiations with the Czech Republic, Estonia, Hungary, Poland and Slovenia. However, it also stressed that these countries will need to make significant progress in many areas in order to make accession feasible.

130. The Commission also produced studies which provide the necessary elements for the pre-accession strategy. In this context, of considerable importance are the financial implications of the enlargement on the Community budget. Overall, the Commission suggests that the current budgetary ceiling may not have to be lifted (Table 19). Concerning the Structural Funds, this would imply a freeze of nominal expenditure for the EU15 at ECU 210 billion, a reduction in the number of Objectives from seven to three (two regional and one human resource-related), a streamlining of the number of programmes, and a strict application of thresholds. This would imply that the percentage of the population affected would be reduced from 51 per cent to between 35 and 40 per cent. On the other hand, the Cohesion Fund will be maintained in its present form for those countries which take part in the third phase of EMU. While new Member countries will also benefit from the Structural Funds, the Commission suggests to cap payments at 4 per cent of GDP, and that spending should already be phased in over the pre-accession period.

131. Concerning agriculture, the 1995 Agricultural Strategy Paper highlighted the need for further reforms of the CAP, by continuing the reform process started in 1992. While the eastward enlargement could potentially add 100 million consumers, it would also expand the agricultural area and labour force significantly. Clearly, applying the current CAP regime to these countries would create serious budgetary difficulties, but also change the income distribution in these countries considerably. Greater market orientation is, therefore, necessary in order to facilitate the integration of new Member States, and also to help prepare the Union for the next WTO Round. According to the Commission, new reforms should deepen and broaden the 1992 reform, by a further shift from price support to direct payments, and by developing a coherent rural policy, with Agenda 2000 providing an overview of proposed reforms by sector. Overall, it is expected that rising food prices in Eastern European countries and reforms of the CAP should lead to a considerable reduction in the current price gaps by the time of accession.

Relations with the Confederation of Independent States

132. The EU has signed Partnership and Co-operation Agreements (PCA) with Russia, Ukraine, Belarus, Azerbaijan, Armenia, Georgia, Kazakstan, the Kyrgyz Republic, Uzbekistan and Moldova[88] (Table 20). They replace the Trade and Co-operation Agreement of 1989 between the EC and the Soviet Union and cover in particular the following areas: political dialogue; trade in goods (on the basis of MFN treatment); provisions affecting business and investment; cross-border supply of services; payment and capital; intellectual, industrial and commercial property protection; and economic co-operation in many

88. In early 1997, the Council of Ministers gave the Commission a mandate to start negotiations with Turkmenistan to conclude a PCA. A PCA between the EU and the Former Yugoslav Republic of Macedonia was initialled in June 1996 and the Commission proposed its conclusion in November 1996.

Table 19. **The EU's new financial framework**
ECU billion, 1997 prices

	1999	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
A. Appropriations								
Agriculture	43.3	44.1	45.0	46.1	47.0	48.0	49.0	50.0
Structural operations	36.1	35.2	36.0	38.8	39.8	40.7	41.7	42.8
Internal policies	6.1	6.1	6.4	7.3	7.5	7.7	7.9	8.1
External action	6.6	6.6	6.8	7.0	7.1	7.3	7.5	7.6
Administration	4.5	4.5	4.6	5.1	5.2	5.3	5.4	5.5
Reserves	1.2	1.0	1.0	0.8	0.5	0.5	0.5	0.5
Total	**97.8**	**97.5**	**99.8**	**105.1**	**107.1**	**109.5**	**112.0**	**114.5**
Memorandum item:								
Own resource ceiling (as a per cent of GNP)	1.27	1.27	1.27	1.27	1.27	1.27	1.27	1.27
B. Commitments for new members								
1. Pre-accession aid and expenditure								
Agriculture		0.5	0.5	0.5	0.5	0.5	0.5	0.5
Structural operations		1.0	1.0	1.0	1.0	1.0	1.0	1.0
Other	1.3	1.5	1.5	1.5	1.5	1.5	1.5	1.5
Total	**1.3**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**
2. Amounts for new Member States								
Agriculture				1.5	1.9	2.4	2.9	3.3
Structural operations				3.6	5.6	7.6	9.6	11.6
Internal policies				0.7	0.7	0.8	0.8	0.8
Total				**5.8**	**8.2**	**10.8**	**13.3**	**15.7**

Source: EC (1997), "Communication for a Stronger and Wider Union", DOC/97/6, Agenda 2000, Vol. I, 15 July 1997, Strasbourg.

Table 20. **Partnership and Co-operation Agreements (PCA)**

Country	Customs tariffs and other duties and changes on imports	WTO member	Agreement signed	Interim agreement on trade in force
Russia		Accession requested	Pending ratification 23/6/94	1/2/96
Ukraine	Maximum import tariff lowered to 30%. Few quantitative restrictions primarily for health and safety reasons. Export quotas and licences for export subject to VERs.	Accession requested	Pending ratification 9/11/95	1/2/96
Belarus	Surrender requirements for exporters	Accession requested	Pending ratification 1/12/94	Signed ony[1]
Azerbaijan	NA	Accession requested	Pending ratification 22/4/96	Signed only
Armenia	NA	Accession requested	Pending ratification 22/4/96	Signed only
Georgia	NA	Accession requested	Pending ratification 22/4/96	Signed only
Kazakstan	NA	Accession requested	Pending ratification	1/2/96
Kyrgyz Republic	NA	Accession requested	Pending ratification	Signed only
Uzbekistan	NA	Accession requested	Pending ratification	Signed only
Moldova	Maximum import tariff lowered to 20% by 30/11/95, with a few exceptions	Accession requested		1/2/96
Turkmenistan	NA	No	Negotiations started on 1/5/97	
Former Yugoslav Republic of Macedonia	NA	Accession requested		

1. Due to be ratified by the European Parliament in December 1997.

Source: European Commission.

areas. These agreements will be valid for ten years, once they have been finally ratified. Interim Agreements have been signed and entered into force in order to provisionally apply the trade and trade-related provisions of the PCAs with Russia, Ukraine, Belarus and Moldova.

133. The existing bilateral textile agreements concluded in 1993 have almost all been renewed until 31 December 1998. The only exception is the textile agreement with Russia, which expired at the end of 1996 and for which new negotiations are ongoing. Only the agreements with Russia, Belarus and Ukraine provide for quantitative restrictions. Concerning steel, agreements have been signed between the EU and Russia and Ukraine providing for self-limitation of exports for a restricted number of steel products during 1995 and 1996. Negotiations are ongoing to renew the agreements for a period of five years. Negotiations to conclude agreements on nuclear products are ongoing with Ukraine, Kazakstan, Uzbekistan and the Kyrgyz Republic.

Euro-Mediterranean Agreements

134. Traditionally, the EU has sought to strengthen its relations with its southern Mediterranean neighbours through a series of bilateral agreements. The Euro-Mediterranean Partnership represents a new direction by adding a multilateral forum for developing closer political and economic links in the area. The EU trading partners represented more than half of the Mediterranean market in the mid-1990s. By contrast, the Mediterranean zone accounts for a small share of EU trade, roughly 7 per cent. An analysis by product shows that trade relations have been characterised by an important deficit in the energy sector, that was more than offset by surpluses on manufactured products, in particular transport equipment and machinery (Figure 10). In 1995, the trade balance surplus of the EU with the Mediterranean countries reached ECU 14 billion.

135. The Euro-Mediterranean partnership was formally established at a conference in Barcelona in November 1995. At this meeting, representatives of the EU Member States and the governments of Algeria, Cyprus, Egypt, Israel, Lebanon, Malta,[89] Morocco, Syria, Tunisia, Turkey and the Palestinian Territories unanimously adopted the Barcelona Declaration. The declaration has three principal dimensions: a political and security partnership, an economic and financial partnership, and partnership in social, cultural and human affairs. The second section of the declaration supports the creation of a free trade area by 2010 through the completion of the Euro-Mediterranean Association agreements (EMAs).[90] At the bilateral level, the EU has signed EMAs with Tunisia, Israel and Morocco. Similar agreements are still being negotiated with Egypt, Jordan, Lebanon and the Palestinian Authority. As with some of the eastern European countries, accession negotiations will soon start with Cyprus and a customs union has come into force between the EU and Turkey.

136. The main features of the EMAs are the following (Table 21):

- progressive elimination of all tariffs on industrial goods over 12 years. However, most manufactured exports from these countries already receive preferential customs treatment both by virtue of the GSP and of the existing bilateral agreements, whereas the current heavy protection against manufactured imports from the EU will have to be dismantled;

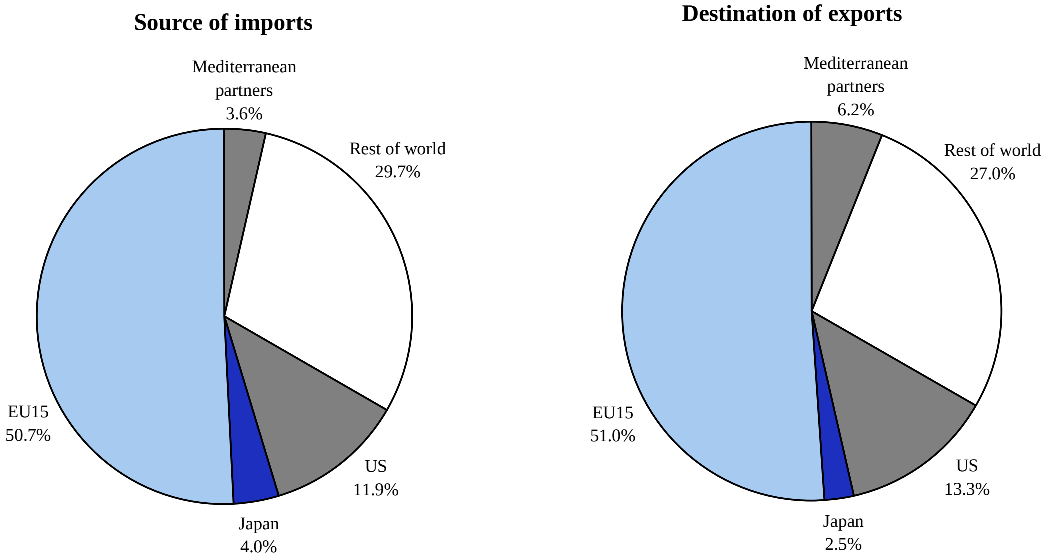
89. Since then, Malta has withdrawn its application to join the EU. The structured dialogue for accession to the EU has therefore been suspended.

90. These new agreements are intended to replace the Co-operation Agreements currently in force between the European Union and its Mediterranean partners dating from the 1970s.

Figure 10. **TRADE OF THE MEDITERRANEAN PARTNERS** [1]

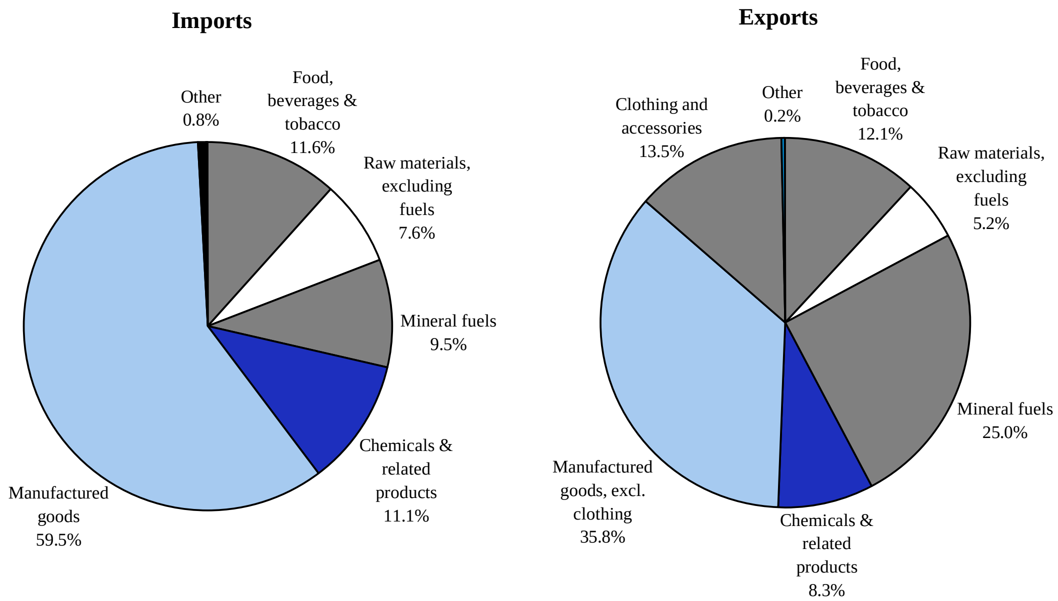
A. Direction

1990-96 average



B. Composition

Total trade, 1990-94 average



1. Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon (panel A only), Morocco, Syrian Arab Republic, Tunisia and Turkey.

Source: IMF, Direction of Trade Statistics, November 1997; United Nations (1997), *International Trade Statistics Yearbook,* Volume I, 1995 and OECD estimates.

Table 21. **The Euro-Mediterranean Association agreements**

	Customs tariffs on imports (%)	Other duties and charges on imports	Quantitative restrictions	Other observations
Euro-Mediterranean Agreements				
Tunisia	0-63	2% import customer fee + countervailing import duty	Agricultural products, 20% of domestic production	WTO member, EMA[1] pending ratification (signed 17/7/95)
Israel	0-100	Variable levies on some agricultural products + 2% port fee + 1.5% other tariff	Agricultural products for health and sanitary reasons	WTO member, EMA pending ratification (signed 20/11/95)
Morocco	0-45	15 % fiscal levy + parafiscal 0.25%	Agricultural products, 8% of industrial products	WTO member, EMA pending ratification (signed 15/11/95)
Egypt	5-70	2-5% import surcharges	Poultry, textiles and garments	WTO member, EMA being negotiated
Jordan	0-50	0.1% import license fee + 10% exchange permit fee for imports	On specific commodities	EMA being negotiated
Lebanon	0-50	None	On specific commodities from certain origins	EMA being negotiated
Syria	0-200	2% import license fee + other specific import fees + 6-35% import surcharge	Numerous	Mediterranean agreements of the old generation[2]
Algeria	3-50	0-6%, few products for religious reasons	Agricultural, chemical and pharmaceutical products	Mediterranean agreements of the old generation[2]
Relations with neighbouring countries				
Turkey	5-9	22-35%	None	WTO member, a customs union entered into force on 1/1/96[3]
Cyprus				Negotiations for Cyprus' Accession to EU should begin 6 months after the conclusion of the Intergovernmental Conference

1. EMA - Euro-Mediterranean Association Agreement.
2. Co-operation agreement including preferential non-reciprocal access to the EC market
3. On 1 January 1996, Turkey adopted the EU Common Customs Regime (including the EU's common external tariff).

Source: IMF-GATT 1994 or 1995, World Bank and European Commission.

- gradual and limited trade liberalisation for agricultural products with substantive discussions only by the year 2000. Mediterranean countries' agricultural exports to the EU will not receive more favourable treatment in the short run, with some exceptions where additional preferences are envisaged;

- concerning services, EMAs simply refer to the obligations of each party under the GATS. Mediterranean countries made very limited commitments under the GATS, subjecting some 6 per cent of their service sectors to national treatment and market access principles, as compared with 26 per cent for the EU;[91]

- measures to liberalise the right of establishment do not go beyond WTO commitments except for Lebanon;

- the EMAs envisage the adoption and application of the basic EU competition rules, a progressive elimination of non-tariff barriers, and harmonization of safeguard and anti-dumping provisions within five years.[92] During the transition period WTO rules with respect to countervailing duties and anti-dumping legislation will remain applicable. State aid for disadvantaged regions would have to be compatible with EU competition rules. EMAs generally refer to commitments of the Agreement on Trade Related Aspects of Intellectual Property rights (TRIPs). For non-WTO members, the legal framework would have to comply with WTO requirements both in terms of scope and enforcement with a transition period envisaged. Even though in principle Mediterranean countries already have duty-free access to EU markets for manufactured goods, in practice rules of origin may be such as to require the use of EU inputs in order to benefit from duty-free treatment.[93]

137. Furthermore, the absence of binding commitments in the areas of FDI and supply of services, the exclusion of government procurement and the maintenance of anti-dumping and broadly worded safeguard provisions imply that the EMAs do not go significantly beyond existing multilateral (WTO) disciplines.

138. The Commission considers that a substantial increase in financial support for the Mediterranean countries is necessary to achieve the objectives of its Mediterranean policy. Financial support should aim at helping the process of economic modernisation and restructuring of those countries prepared to open their markets in the context of new EMAs and support structural adjustment in countries less advanced in this process with a view to preparing them for entering into free trade with the Union. The Community's financial support will also focus on the strengthening of north-south economic and financial co-operation, and among southern and eastern Mediterranean countries themselves. For the 1995-99 period, ECU 4.9 billion are being allocated in grants from the Community budget, plus loans from the European investment bank. By comparison, for the CEECs, an envelope of ECU 6.7 billion has been approved by the European Council.

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91. The share of the service sector where commitments were made -- even if not guaranteeing national treatment and market access -- also differed substantially. The EU scheduled 57 per cent of its services; the Middle East and North African members of the WTO only 16 per cent.

92. Implementing rules are to be adopted by the Association Council.

93. Local content requirements are often 60 per cent, *i.e.* to benefit from duty-free access to the EU, 60 per cent of the value added must originate in either the EU or in the partner country.

139. Several studies have analysed the welfare implications of the trade agreements for a number of Mediterranean countries that have already concluded agreements. Rutherford, Rutström and Tarr (1995) estimate that Morocco and Tunisia would experience welfare gains equivalent to around 1½ per cent and 4½ of GDP per year, respectively. The benefits would rise further in the event of MFN liberalisation on a multilateral basis to 2½ per cent of GDP a year for Morocco and 5¼ per cent of GDP a year for Tunisia. On the other hand, in the case of Tunisia, Brown *et al.* (1997) suggest that overall welfare could actually be lowered, due to the sizeable fall in tariff revenues.

140. The reliance on customs tariffs for government revenue is non negligible. The high level of tariffs raises several issues. There is again a risk of trade diversion. In addition, the higher the share of tariffs in total government revenues, the more difficult it may be to mobilise the alternative resources needed to allow a reduction in MFN tariffs on top of the implementation of the EMA. Moreover, manufactured goods with relatively high tariffs constitute a large share of imports from the EU, so that the loss in customs revenues would be comparatively larger. CEPII estimates point to fiscal losses of 1.4 per cent of GDP for Egypt, 1.5 per cent for Algeria, 2.9 per cent for Morocco and 6.0 per cent for Tunisia.

141. Revenue losses could also depend on the phasing of the liberalisation measures and the products affected. The strategy of starting with products that have the lowest tariffs is designed to reduce the fiscal adjustment costs. However, this strategy may entail sizeable welfare losses because the sectors receiving the highest protection at the outset would receive even higher protection in relative terms. Hoekman and Djankov (1995) argue that multilateral liberalisation could prove more difficult due to the revenue losses entailed by liberalisation *vis-à-vis* the EU and the pressures by domestic and EU firms to maintain sheltered home markets, pressures that could be heightened by erroneous sequencing. In addition, the Uruguay Round Agreement on Agriculture will have important repercussions on agricultural trade of the Mediterranean countries with the EU. Many Mediterranean countries depend heavily on food imports, the prices of which are expected to increase following the full implementation of the Uruguay round. While higher prices will hurt consumers, farmers who could not compete with subsidised exports from OECD countries should benefit.

Towards a new Lomé Convention

142. The mid-term review of the Lomé-IV Convention included the extension of preferences to almost all products from the ACP countries, the acceleration of the liberalisation schedule and an increase in tariff quotas. As the Uruguay Round is resulting in lower MFN tariffs, concerns about the erosion of preferential margins were addressed by reducing preferential rates. Also the financial protocol to the Convention was renewed and financial aid to these countries stepped up to ECU 14.6 billion for the period 1995-2000. South Africa became a member of the Convention in April 1997, but does not benefit from all provisions.[94]

143. The current Convention will expire in the year 2000 and negotiations for a successor Convention will begin in Autumn 1998. A recent “Green Paper” by the Commission points out that economic and institutional constraints have led to disappointing economic performance in several ACP countries, despite the EU’s trade preferences and financial support. The Green Paper sets out several options to better integrate these countries in global markets: the maintenance of the current comprehensive agreement with few adaptations; a general agreement complemented by bilateral agreements; the replacement of the

94. The EU and South Africa are currently negotiating a free trade agreement, a major sticking point being the EU’s agricultural offer, which would exclude about 40 per cent of South African agricultural products from the agreement.

convention by a series of regional agreements; and a specific agreement with the least developed countries of the zone, which could be combined with elements of the other options.

Relations with North America

144. The New Transatlantic Agenda (NTA) signed in 1995 in Madrid by the United States and the EU commits the two partners to co-operate in a large number of political and economic areas. In the trade field the United States and the EU agreed to work together to strengthen the multilateral trading system and to support the WTO. The main objective of the NTA is the establishment of a "New Transatlantic Market Place" designed to eliminate trade barriers that hinder the flows of goods, services and capital across the Atlantic. Initiatives which are being pursued in the framework of the Transatlantic Marketplace include: the negotiations of a customs co-operation and mutual assistance agreement covering simplification of customs procedures, data and personnel exchanges and increased investigative co-operation. This agreement was signed in 1996; the negotiation of a Mutual Recognition Agreement (MRA) on standards certification covering various sectors (telecommunications equipment, pharmaceuticals, medical devices, recreational craft); the negotiation of a new agreement in the area of competition law enforcement which is intended to improve co-operation by complementing the 1991 Agreement between the United States and the EU regarding the application of their competition laws, without replacing existing law, which does differ considerably; and regulatory co-operation seeking to make regulators more aware of the trade and investment consequences of their decisions and to discourage the development of divergent regulations that could otherwise become the source of future trade disputes.

145. Co-operation is also multilateral. This was, for instance, the case in the negotiation of the Information and Technology Agreement (ITA), which committed the two parties to attempt to conclude an ITA that will eliminate tariffs in the IT sector by the year 2000. A provisional agreement between the Transatlantic partners and other WTO Members was reached at the WTO Singapore Ministerial meeting in December 1996 and finalised in the spring of 1997.

146. A major test for the NTA came in March 1996 with the adoption of the Helms-Burton Act[95] in the United States. The EU is firmly opposed to the use of extraterritorial legislation by the US government and has challenged the Act before the WTO. The EU has also adopted legislation making it illegal for European companies or individuals to comply with the Helms-Burton Act. A Regulation and a joint action were formally adopted in November 1996, giving the EU a legal framework to defend interests which may be threatened by the act.

147. Concerning trade in goods and services, liberalisation between the United States and the European Union will continue on an MFN basis and the NTA does not provide for the creation of a free trade area. Close co-operation in a large number of areas, which are not yet well-defined under WTO rules, could help reduce trade frictions, and joint initiatives could boost liberalisation in the multilateral context. Recently the Commission launched another initiative to broaden the trade agenda, by proposing to eliminate all industrial tariffs by 2010 as long as a critical mass of other trading partners also agree to do so; to create a free trade area in services; and to further liberalise investment, public procurement and intellectual property.

95. This act allows US citizens to sue in US courts any foreign company or individual deemed to have benefited from investments in property confiscated by the Cuban government following the Cuban revolution in 1959. Title IV of the Act also imposes visa restrictions on individuals with links to companies suspected of investing in such property.

148. Efforts towards deeper integration in North America extend beyond the United States. In December 1997, Mexico and the European Union signed the Economic Partnership, Political Co-ordination and Co-operation Agreement. The agreement covers economic and commercial co-operation and political concertation. Concerning trade, the objective is to establish a free trade area, by gradually eliminating barriers to trade in goods and services, increasing investment opportunities, providing adequate protection for intellectual property rights, and establish disciplines in areas such as government procurement and dispute settlement, among others. In March 1998, the Commission adopted, for submission to the Council, guidelines for the negotiations on trade with Mexico. Trade negotiations will start in the second half of 1998.

The multilateral agenda

149. The EU played a key role in the recent negotiations on basic telecommunications and on information technology. The WTO Declaration on Trade in Information Technology Products (ITA), for instance, provides for the elimination of customs duties and charges on information technology products by the year 2000, on an MFN basis. The agreement will cover well over 90 per cent of trade in such products. As the EU is the second largest importer of information technology products in the world, the agreement represents a significant market access improvement for foreign suppliers. Strong EU support was also key in achieving an interim agreement on financial services in 1995 and in ensuring the successful conclusion of a final agreement in December 1997 .

150. It is obviously impossible to say much currently about the future negotiation stance of the EU sector by sector and on trade-related issues. However, the EU has reiterated on several occasions that a key part of its approach to external trade policies remains its commitment to further multilateral liberalisation under the umbrella of the WTO. It is committed to the framework for further liberalisation, which was already established when the WTO was set up and supports the additional decisions taken at the WTO Ministerial Conference in Singapore. The latter include the establishment of WTO work programmes on aspects of investment, competition and government procurement policies. The EU's vision concerning competition policy in a global setting has been laid out above. Concerning investment, the EU considers the OECD negotiations on investment liberalisation and the protection of investment only as a first step towards broader work in this area, which should be undertaken by the WTO's Group on investment. The EU sees public procurement as another important area for further liberalisation and is committed to improve the WTO's Government Procurement Agreement by extending its membership and coverage.

151. While the EU has strongly supported recent sectoral negotiations on telecommunications and information technology, as well as the current work on financial services, it sees limits to the progress which can be achieved on an *ad hoc* or sectoral basis and does not want to have the debate on trade questions conducted in a fragmented manner and on a sectoral basis. It prefers package deals, allowing for comprehensive and broad liberalisation. This would enable participants in trade negotiations to take a broad view of their economic and other interests, provide for room to exploit the trade-offs inherent in such negotiations, and make it easier to explain the overall benefits of trade liberalisation to political constituencies.

152. Following up on the initiatives agreed upon in Singapore in 1996, the Community has put forward options to improve market access for the least developed countries (LDCs). In the short term, the Community has levelled EU preferences granted to the LDCs to match the best available under the GSP and the Lomé Convention (except for certain sensitive products). In addition, it will simplify the rules of origin and extend the possibilities of accumulation for LDCs. Further revisions will depend on the

development of market access arrangements with the ACP countries after the present convention expires in 2000 (see above). In the long term, the EU supports the creation of a multilateral scheme of preferential market access in the context of the new round of world trade negotiations.

153. The social and environmental dimension of increased international trade has led to a heated debate in recent years, including the question whether trade policies should be used to pursue changes in standards in other countries. There is a clear case for regional or international co-operation concerning cross-border environmental spillovers and there is actually a large number of agreements, for instance, on the abatement of chemicals which lead to acid rain or reductions in CFCs. Co-operation has been achieved without recourse to trade sanctions. On the other hand, it is difficult to come up with a strong economic case for changing standards in other countries, where it comes to local pollution or social and human rights issues (Krugman, 1997). What matters for the gains from trade is that relative prices differ, be it for differences in resources, technologies, tastes, labour or environmental standards; and countries do have different ideas about what a reasonable standard is. In line with these arguments, the Community considers that differences in labour standards should not be used to justify protectionist measures and that comparative advantage of low-wage countries should not be put into question. On the other hand, it intends to promote core labour standards, such as the prohibition of slavery or the suppression of the exploitation of child labour and to find ways in multilateral fora, such as the WTO and the ILO, to do so. In addition, the GSP arrangements allow for the withdrawal of preferences to countries which countenance slavery and forced labour and since 1998 additional preferences have been granted to countries which respect the ILO conventions on the freedom of association, the right to collective bargaining and the Convention on child labour.

SUMMARY

154. Forty years ago, external protection was high in most countries and Europe was comprised of many “trade fortresses”. The founders of the Community shared a coherent economic policy view, with the Treaty of Rome calling for an internal market with no obstacles to trade and strong competition, as well as for multilateral liberalisation. This paper has retraced the external liberalisation efforts, discussed the current trade regime in international comparison, and set out the Community’s future trade agenda. A key aim of the paper was to clarify and, where feasible, to quantify the economic effects of the EU’s trade policies.

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

The EU’s trade regime and overall economic performance

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

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

would seem to increase it. Given the large number of bilateral trade agreements, the latter aspect is of considerable importance for the EU.

158. Taking the modest route of comparing trade policy indicators nevertheless provides plenty of insights. In particular, most-favoured-nation tariffs on most goods have fallen considerably to levels which probably are more a nuisance than a barrier to trade. However, tariffs on textiles and apparel still remain rather high -- a feature also found elsewhere in the OECD -- and the high level of agricultural protection has not declined much, despite efforts to reform the Common Agricultural Policy. Contrary to developments in the Union, agricultural protection has declined in many other OECD countries. The tariffication process of agricultural and food products agreed upon in the Uruguay Round raised measures of average tariff rates, and high rates of tariffs across a wide range of products probably imply that agricultural imports will be only little affected even after the phasing in of the Uruguay Agreement on Agriculture. However, market access has improved to some extent due to minimum access requirements and a sizeable reduction in export subsidies will be phased in. Consumers in the Union could benefit considerably from substantial liberalisation of trade in agricultural and textile products.

159. Non-tariff border measures have traditionally been more prevalent in the Union and the United States than in Japan or Canada. The textile sector remains the most protected by non-tariff barriers, while tariffication implied a sharp fall in the pervasiveness of such barriers for agricultural products and in the processed food sector. Concerning anti-dumping and other price control measures, the Union is a major user, second only to the United States. In contrast, Japan has hardly used such measures at all. The EU recently changed anti-dumping legislation, while revising other provisions such as those on circumvention. The new regulation provides for fairer price comparisons, stricter injury requirements and for a broader role of the “Community interest test” but, even after these changes, proving the existence of unfair trade practices will probably remain highly contentious.

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

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

162. A fast-growing body of research has focused on the wage and employment effects of rising competition from low wage countries. While some studies found little effect, in line with research concerning the United States, others tell a more cautionary tale: the effect would largely depend on labour market institutions. Indeed, slow restructuring in some European countries could lead to sizeable macroeconomic effects, with gains from freer trade being largely used to redistribute between those who still have a job to those who have lost theirs. On the other hand, the labour market effects may not be

unfavourable over the medium term, as a lowering in rents could lead to weaker insider power and make labour markets more flexible. Given the different labour market institutions within Europe, the trade and employment story is probably country-specific.

Regionalism: has trade creation outweighed diversion?

163. Internal integration in the EU has progressed in waves and the integrated trading area has expanded from the original six to the current fifteen countries. The single market programme was the latest initiative to remove the remaining obstacles to trade. Overall, access of third countries has improved over a wide range of sectors and products. National quotas have been removed and only a few been replaced at the Union level, barriers to establishment have been lowered and most services are undergoing major liberalisation. Overall, the parallel, interactive nature of external liberalisation and internal integration has to be emphasised. However, there are still areas which continue to be strongly sheltered at the national level, largely because policy changes occurred only recently. This is the case, for example, for public procurement and professional services. In other areas, policy changes at the EU level have been timid or non-existent so far. Examples are liberalisation efforts concerning postal services, energy or railways, even though some Member countries have made considerable progress in raising competitive pressures in these sectors. Also the internal market is not entirely in place, with company law being an important area still to be dealt with. Overall, both potential external and internal competitors suffer to the same extent from these shortcomings. There are, however, exceptions: the banking, insurance and investment services directives include a reciprocity clause, which has never been invoked, and the public procurement directives contain a small Union preference.

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

165. Countries outside the EU’s regional agreements have often voiced concerns about the possibility that trade diversion could outweigh trade creation -- an inherent possible problem in any free-trade area arrangement. While the GATT provides guidance -- agreements must free “substantially all trade” and external trade barriers ought not be raised -- it has always been difficult to reach agreement on the conformity with GATT requirements, or on the compensation for changes in bound tariffs. On the other hand, none of the agreements has been disapproved explicitly. Assessing the economic effects empirically is also a difficult issue, as the counterfactual state of the world without regional agreements is not known. An assessment based on manufacturing sector import penetration ratios suggests that, since 1970, internal import penetration rose somewhat faster than external import penetration, while the share of domestic production in apparent consumption fell. Double trade creation (internal and external) does not, however, permeate all sectors and regions. Notable exceptions are the food, drink and tobacco industries and non-ferrous metals, while external import penetration rose considerably in the textile, footwear and leather sectors, despite heavy protection. Overall, any bias against extra-EU imports was probably minor. Also, other trade indicators do not suggest that the Union is an outlier (its share of trade in GDP is higher than that of the United States or Japan, for instance) and it is also difficult to find evidence of diversion of

foreign direct investment. This is to be expected, because external protection in the manufacturing industries was already low in the early seventies and the internal market for goods fairly well integrated. Academic work suggests that some trade diversion may have occurred between the creation of the EEC and the late 1960s, a time when the difference between external and internal protection was still considerably higher.

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

The future agenda is multilateral and regional, and tackles trade-related issues

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

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

169. Internal capital market liberalisation was an objective of the Union from the outset. The Maastricht Treaty enshrines the freedom of capital movements, including between Member States and third countries, as one of the fundamental economic freedoms. The EU is currently actively participating in the negotiations of a Multilateral Agreement on Investment, which will establish rules for investment protection and liberalisation within the OECD area and be open to non-member countries.

170. The central and eastern European countries (CEECs) regard membership of the EU as vital. Seven CEECs and three Baltic States have applied for membership, and the Commission suggested recently that negotiations should begin with Hungary, Poland, the Czech Republic, Slovenia and Estonia. Negotiations will also start with Cyprus. Important groundwork has been laid with the Europe Agreements, with Interim Agreements phasing in bilateral free trade areas for non-agricultural products over a ten-year period and providing also for some liberalisation of agricultural trade. The Agreements contain many additional provisions which aim at the approximation of economic rules in these countries to those of the EU. Current levels of protection for industrial goods in the CEECs are considerably above EU levels, while agricultural protection is much lower. Accession of these countries poses a major challenge to the EU: there are large differences between applicant countries and the EU; these countries would all be net recipients of EU funds; and the Amsterdam Summit made no progress in reforming the EU's institutions. Commission scenarios suggest that the current budgetary ceiling may not have to be lifted, if spending by the Structural Funds is frozen in nominal terms and payments to these countries are capped at 4 per cent of GDP; and if the Common Agricultural Policy undergoes major reform. The EU has also struck free trade agreements with Mediterranean countries, which provide for free trade in industrial goods, but are less ambitious otherwise than the agreements with the Eastern European countries. On the other hand, the Customs Union Agreement between the EU and Turkey entered into force in 1996.

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

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

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

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

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GLOSSARY OF TERMS

Anti-dumping measures - Measures that can be adopted after an investigation by the investigating authority of the importing country when dumping and material injury resulting therefrom has occurred. Dumping takes place when a product is exported at less than its normal value, *i.e.* the comparable price, in the ordinary course of trade, for the like product when consumed in the exporting country. Anti-dumping measures may take the form of anti-dumping duties or of price undertakings. Anti-dumping duties are generally enterprise-specific duties levied on certain goods to offset the dumping margin. Anti-dumping price undertakings may be offered to exporters to avoid the imposition of anti-dumping duties.

Binding - Commitment under GATT or GATS to keep the market open or (in the case of GATS) to provide national treatment, specifying maximum level of trade barriers. It requires negotiations and possibly compensation if a trade barrier is to be raised beyond the bound ceiling.

Countervailing measures - Measures that can be taken whenever an investigation, by the investigating authority of the importing country, has led to the determination that the imported goods are benefiting from subsidies, and that they result in an injury. Countervailing measures may take the form of countervailing duties or of undertakings by the exporting firms or by the authorities of the subsidising country.

Export restraints arrangement - Agreements by which an exporter agrees to limit exports in order to avoid imposition of mandatory restrictions by the importing country. The arrangement may be concluded either at the industry or government level. These arrangements are known as voluntary export restraints arrangements (VERs) and in the latter case as orderly marketing arrangements, etc. In addition to bilateral agreements there is also the **Multilateral Multifibre Arrangement** (MFA) which regulates trade in textile products. The MFA provides the framework and rules for negotiating bilateral restraint agreements. An MFA quota agreement establishes an export quota with a growth rate.

GATS - General Agreement on Trade and Services.

Most Favoured Nation (MFN) **-** Treatment: principle of non discrimination embodied in Article I of the General Agreement on Tariffs and Trade (GATT), whereby any concession or privilege granted by one contracting party to GATT to a product of another contracting party will be unconditionally granted to the like product of all other contracting parties. In practice, the MFN treatment is no longer limited to GATT contracting parties but applicable to other trading partners.

National Treatment - Principle of non discrimination between a country’s own nationals and foreigners, embodied in Article 17 of the GATS.

Non-automatic licensing - The practice to require, as a prior condition to import, an import licence which is not granted automatically. The licence may either be issued on a discretionary basis or may depend on specific criteria.

Preferential duties under trade agreements - Duties applicable under multilateral or bilateral trade agreements or duties extended without reciprocity by one group of countries to another group of countries (*e.g.* the Generalized System of Preferences, GSP). These duties may be applied with no limitation of quantity or may be linked to preferential tariff quotas.

Variable charges - Charges that bring the market prices of imported agricultural and food products close to those of corresponding domestic products, in advance, for a given period of time, and for a pre-established price. These prices are known as reference prices, threshold or trigger prices. Primary commodities may be charged per total weight, while charges on processed foodstuff can be levied in proportion to the primary products contents in the final product. In the case of the European Union, the charges applied to primary products as such are called variable levies and those as part of a processed product, variable components.

Voluntary export price restraint - A restraint arrangement in which the exporter agrees to keep the price of his goods above a certain level.

GLOSSARY OF ACRONYMS

ACP	African, Caribbean and Pacific
AD	Anti-dumping
AVE	*Ad-valorem* equivalent
CAP	Common Agricultural Policy
CEFTA	Central European Free Trade Agreement
CEECs	Central and East European Countries
CGE	Computable general equilibrium
CIS	Commonwealth of Independent States
CVM	Countervailing measures
EA	Europe Agreement
EC	European Commission or European Community
EEA	European Economic Area
EEC	European Economic Community
ECU	European currency unit
EFTA	European Free Trade Association
EMAs	Euro-Mediterranean Association Agreements
EU	European Union
FDI	Foreign direct investment
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product

GPA	Government Procurement Agreement
GSP	Generalized system of preferences
IA	Interim Agreements
ISIC	International Standard Industrial Classification
ITA	Information and Technology Agreement
IMF	International Monetary Fund
MAI	Multilateral Investment Agreement
Mercosur	Common Market of the Southern Cone
MFA	Multifiber Arrangement
MFN	Most favoured nation
MRA	Mutual Recognition Arrangement
MRP	Mutual Recognition Principle
MNEs	Multinational enterprises
NACE	Statistical Classification of Economic Activities in the European Community
NAFTA	North American Free Trade Agreement
NIEs	Newly Industrialising Economies
NIS	Newly Independent States
NTA	New Transatlantic Agenda
NTB	Non-tariff barrier
OECD	Organization for Economic Co-operation and Development
PCA	Partnership and Co-operation Agreement
QUAD	GATT/WTO group of four: Canada, European Union, Japan and United States
SMP	Single Market Program
SMPS	Single Market Program in Services
TBT	Technical barrier to trade
TECA	Trade and Economic Cooperation Agreement
TPR	Trade Policy Review
TRIPs	Trade related aspects of intellectual property rights
UNCTAD	United Nation Conference on Trade and Development
URAA	Uruguay Round Agreement on Agriculture
USITC	United States International Trade Commission
VEPR	Voluntary export price restraint
VER	Voluntary export restraint

WTO	World Trade Organization
WTO/GBT	WTO Agreement on Basic Telecommunications

ANNEX I

COMMERCIAL POLICY AND PROVISIONS[96]

Article 110

By establishing a customs union between themselves Member States aim to contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers.

The common commercial policy shall take into account the favourable effect which the abolition of customs duties between Member States may have on the increase in the competitive strength of undertakings in those States.

Article 111

Article 111 has been repealed.[97]

Article 112

1. Without prejudice to obligations undertaken by them within the framework of other international organisations, Member States shall, before the end of the transitional period, progressively harmonise the systems whereby they grant aid for exports to third countries, to the extent necessary to ensure that competition between undertakings of the Community is not distorted.

On a proposal from the Commission, the Council, shall, acting unanimously until the end of the second stage and by a qualified majority thereafter, issue any directives needed for this purpose.

2. The preceding provisions shall not apply to such drawback of customs duties or charges having equivalent effect nor to such repayment of indirect taxation including turnover taxes, excise duties and other indirect taxes as is allowed when goods are exported from a Member State to a third county, in so far as such drawback or repayment does not exceed the amount imposed, directly or indirectly, on the products exported.

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96. Treaty Establishing The European Economic Community, Rome, 25 March 1957.

97. Council of the European Communities, Commission of the European Communities (1992), *Treaty on European Union,* Luxembourg.

Article 113

In 1992, Article 113 has been replaced by the following: [97]

1. The common commercial policy shall be based on uniform principles, particularly in regard to changes in tariff rates, the conclusion of tariff and trade agreements, the achievement of uniformity in measures of liberalization, export policy and measures to protect trade such as those to be taken in the event of dumping or subsidies.

2. The Commission shall submit proposals to the Council for implementing the common commercial policy.

3. Where agreements with one or more States or international organizations need to be negotiated, the Commission shall make recommendations to the Council, which shall authorize the Commission to open the necessary negotiations.

The Commission shall conduct these negotiations in consultation with a special committee appointed by the Council to assist the Commission in this task and within the framework of such directives as the Council may issue to it.

The relevant provisions of Article 228 shall apply.

4. In exercising the powers conferred upon it by this Article, the Council shall act by a qualified majority.

New Article 113(5) of the TEC (not yet ratified)

5. The Council, acting unanimously on a proposal from the Commission and after consulting the European Parliament, may extend the application of paragraphs 1 to 4 to international negotiations and agreements on services and intellectual property insofar as they are not covered by these paragraphs.

Article 114

Article 114 has been repealed. [97]

Article 115

In 1992, Article 115 has been replaced by the following: [97]

In order to ensure that the execution of measures of commercial policy taken in accordance with this Treaty by any Member State is not obstructed by deflection of trade, or where differences between such measures lead to economic difficulties in one or more Member States, the Commission shall recommend the methods for the requisite cooperation between Member States. Failing this, the Commission may authorize Member States to take the necessary protective measures, the conditions and details of which it shall determine.

In case of urgency, Member States shall request authorization to take the necessary measures themselves from the Commission, which shall take a decision as soon as possible; the Member States concerned shall then notify the measures to the other Member States. The Commission may decide at any time that the Member States concerned shall amend or abolish the measures in question.

In the selection of such measures, priority shall be given to those which cause the least disturbance to the functioning of the common market.

Article 116

Article 116 has been repealed. [97]

Article 235

If action by the Community should prove necessary to attain, in the course of the operation of the common market, one of the objectives of the Community and this Treaty has not provided the necessary powers, the Council shall, acting unanimously on a proposal from the Commission and after consulting the Assembly, take the appropriate measures.

ANNEX II

TRADE AND GROWTH IN THE EU

In the following exercise, further evidence on the link between trade indicators and overall growth in the context of an aggregate production function approach is provided. A cross-country panel of 11 European countries is used to estimate a production function in annual growth rates over the period 1970-95. The basic equation relates annual growth rates of GDP to growth rates in employment, capital stock and expenditure on research and development (R&D). An intra-industry trade index (**S**) is included in the production function estimates.[98] Following Italianer (1994) we also add to the regression a proxy for openness (**O**, defined as the share of total trade in GDP) and a proxy for European integration (**I**, defined as the share of area trade in total trade, by taking into account successive enlargements).[99] The introduction of these two trade indexes leads to an implicit test of whether regional trade has a stronger impact on productivity growth than trade in general. The exercise differs from that carried out by Italianer in at least three respects.

Firstly, growth in R&D expenditure is used here as a proxy for investment in human capital. Over the sample considered, the use of secondary enrolment rates or other education proxies do not seem to be appropriate to explain differences in productivity across European countries. Data on private R&D expenditure, on the contrary, mainly reflect expenditure on wages of researchers and scientists, and can be considered to be a proxy for investment in innovation activity.

Secondly, the analysis of the panel data reveals the presence of individual, time and joint effects. We test for the appropriate specification to be used in the estimation, which in all the three cases appears to be that of a fixed effects model rather than a random component model. The Fixed Effects (equation 16), the Feasible General Least Square estimators (equation 17) and the Hausman specification test are reported here for the case of individual effects. By allowing for country-specific intercepts, one can control for cross-country differences in total factor productivity growth or the residual of the estimated function. This specification implies a direct test of the impact of trade on total factor productivity, after having controlled for the impact of investment in human capital devoted to innovation, and for exogenous cross-country differences in technological progress.

Thirdly, the Grubel and Lloyd intra-industry trade index is introduced in the specification, in order to capture the productivity gains stemming from economies of scale and increased specialisation in

98. The intra-industry trade index is defined as the change in the unadjusted Grubel-Lloyd index for all goods. This index calculates the part of balanced trade (overlap between imports and exports) in all trade in a given industry j; *i.e.* $S = 1 - \frac{\left|X_j - M_j\right|}{(X_j - M_j)}$, where X and M denote exports and imports.

99. The variable is constructed as the share of intra-EC6 trade over world trade from 1970 to 1972, while intra-EC9/10 trade is considered from 1973 to 1985, intra-EC12 from 1986 to 1994 and intra-EC15 for 1995.

production.[100] Obviously this index captures both intra-industry trade in intermediate inputs, from which positive externalities should be generated, and intra-industry trade in final consumption goods, which mainly produce welfare gains. Fontagné, Freudenberg and Ünal-Kezenci (1996) estimate that the share of intra-industry trade consisting of intermediate inputs, carried out by the Community, is 36 per cent, while it is 38 per cent in the US and 21 per cent in Japan. Moreover, 43 per cent of that share takes place within the Community. The variable could therefore also capture the positive externalities associated with integration.

The estimated base equations (3-6) are reported in Table A6.

The analysis of variance on the residuals of the base equation points to the existence of individual time and joint effects and varying variances across sections.

To control for the individual effects one should chose between fixed or random estimators. Given that the panel is composed of countries it is more likely that the best model is the dummy variable one. In this case, the inference is conditional on the individuals or cross-sectional units. Moreover if a correlation between the immemorable individual characteristics and the regressors exists, the random effects estimator will be biased, while the fixed effect estimator will be not. If one interprets the individual effects as cross country differences in the production function (a sort of TFP difference), then one might expect this correlation to exist.

Even if the fixed effect estimator is expected to be the best linear estimator, the Hausman specification test is calculated. Such a test is based on whether or not the difference between the estimators is significant. The within (fixed effects) estimator (equation 3) and the generalised least square (random effects) estimator (equation 17) are computed. If the null hypothesis is true, then, asymptotically, the two estimators differ only through sampling error Rejection of the null hypothesis suggests that the error components model is not appropriate. The Hausman specification test gives a Chi-Squared (5) = 60.026 with Significance Level 0.000. Under the null hypothesis of no correlation between the regressors and the effects, the significance level below 0.5 or 0.1 indicates rejection of the null. It is better to use the fixed effects model.

Finally, to allow for individual heteroscedasticity of the disturbances, the variance in each cross-section is determined empirically and the fixed effect model is estimated by Weighted Least Squares (equation 18).

In conclusion, an attempt is made to control for the channels through which trade could have an indirect impact on growth (physical capital formation, investment in R&D, country-specific differences in technical progress) and test whether, apart from the positive externalities generated by trade, additional gains to the 11 European countries could stem from increased trade on a multilateral or on a regional basis. The regressions show that the openness variable (O) has a significant and positive coefficient which is robust to changes in sample and estimation methods. The intra-industry trade index (S) is also positive over the whole sample period (equation 18). The coefficient, though, decreases dramatically when the integration variable is introduced (equation 6). This is understandable, given that (I) is in part a proxy for intra-industry trade inside the Community. On the other hand, the integration variable is positive

100. There is vast literature on the methodological problems associated with the measurement of intra-industry trade and the debate on the Grubel and Lloyd type of indicators (see for example Fontagné and Freudenberg, 1997). Vona (1991), on the other hand, argues that regardless of its shortcoming, the unadjusted Grubel and Lloyd index is to be preferred in the empirical analysis of intra-industry trade.

but never significant. Hence, there is no evidence on pooled data of an additional independent impact of regional trade integration.

Changing the sample period reveals that these correlations are very sensitive (compare equations 7-10 and 11-15 in Table A6). In general the break is between the seventies-mid-eighties and the nineties. The sample is broken up into two subperiods: 1970-82 and 1983-95, in order to have an approximately equal number of observations. In the fixed effect specification the coefficients of the intra-industry index and of R&D are left to vary across the two sample periods (see equation 2 in Table 15). While up to early eighties scale economies seem to have played an important role (the coefficient reaches 0.22), this effect disappears in the second period. On the other hand, the coefficient on R&D expenditure only becomes significant in the latter period. If R&D shows to have an increasingly important role in a cross-country aggregate production function, a further step could be the introduction of a proxy for trade as a vehicle of technology diffusion (like in Coe and Helpman 1995).

Annex Tables

Table A1. **Exposure to foreign competition**

Excluding intra-zone trade

Industry	Period	EU6	EU12	North America[1]	Japan
Total manufacturing	1970-72	17.4	15.5	8.8	12.8
	1980-82	27.0	20.9	14.5	17.5
	1993-95	36.0	27.4	22.6	18.3
Food, drink and tobacco	1970-72	9.8	10.2	7.6	8.3
	1980-82	14.2	10.6	8.7	8.3
	1993-95	17.5	11.4	9.8	8.9
Textiles, footwear and leather	1970-72	13.9	13.1	8.6	16.7
	1980-82	27.7	21.1	17.8	18.3
	1993-95	49.1	38.4	34.5	24.1
Wood, cork and furniture	1970-72	9.1	11.0	3.8	5.0
	1980-82	15.8	14.3	6.9	7.3
	1993-95	20.7	17.8	9.4	13.5
Paper and printing	1970-72	12.2	12.4	3.6	3.5
	1980-82	15.7	13.8	5.0	4.2
	1993-95	20.2	15.6	6.4	3.4
Chemicals	1970-72	18.5	15.4	8.5	14.1
	1980-82	29.1	21.0	11.8	15.5
	1993-95	35.0	25.3	18.3	18.5
Stone, clay and glass	1970-72	6.8	5.6	3.8	4.4
	1980-82	11.3	8.8	6.8	6.2
	1993-95	15.4	11.0	12.0	7.0
Basic metals	1970-72	20.1	16.6	9.5	10.8
	1980-82	28.8	22.4	15.1	14.1
	1993-95	29.7	23.9	15.8	11.0
Ferrous metals	1970-72	14.7	11.5	8.6	9.7
	1980-82	24.8	18.5	13.3	13.1
	1993-95	27.4	21.0	13.7	8.8
Non-ferrous metals	1970-72	35.7	30.1	11.0	15.7
	1980-82	36.8	30.1	17.7	16.4
	1993-95	33.5	28.7	18.4	18.2
Fabricated metal products and machinery	1970-72	23.9	20.2	10.8	16.9
	1980-82	33.7	27.5	20.6	27.1
	1993-95	45.2	36.2	32.0	25.7
Fabricated metal products	1970-72	12.0	9.9	3.7	10.0
	1980-82	20.2	15.9	7.9	16.6
	1993-95	21.9	16.9	11.4	8.6
Instruments	1970-72	47.6	38.8	7.8	31.4
	1980-82	61.2	56.1	14.3	55.5
	1993-95	76.0	69.0	26.5	70.8

1. Canada and the United States.

Source: OECD Secretariat.

Table A2. **Export market shares**
Excluding EU12 intra-zone trade

Industry	Period	EU12	North America[1]	Japan
Total manufacturing	1961-63[2]	43.3	38.1	8.5
	1970-72	37.1	32.2	14.6
	1980-82	36.6	29.8	18.5
	1993-95	33.8	30.3	21.1
Food, drink and tobacco	1961-63[2]	36.8	44.6	5.0
	1970-72	34.3	33.3	4.4
	1980-82	42.6	31.5	2.8
	1993-95	41.2	35.4	1.9
Textiles, footwear and leather	1961-63[2]	48.9	25.6	21.2
	1970-72	45.8	14.9	22.1
	1980-82	42.9	20.2	15.1
	1993-95	51.1	19.6	7.9
Wood, cork and furniture	1961-63[2]	17.5	47.4	8.6
	1970-72	15.9	42.2	6.0
	1980-82	23.2	39.3	1.6
	1993-95	22.7	48.3	1.3
Paper and printing	1961-63[2]	14.8	54.3	1.9
	1970-72	14.7	45.2	3.1
	1980-82	16.2	44.0	3.6
	1993-95	21.0	42.6	3.6
Chemicals	1961-63[2]	48.5	38.3	5.3
	1970-72	46.7	27.9	11.7
	1980-82	45.1	30.6	10.4
	1993-95	40.7	29.4	13.9
Stone, clay and glass	1961-63[2]	55.7	22.7	15.6
	1970-72	49.9	19.8	16.6
	1980-82	52.4	17.0	16.6
	1993-95	48.1	19.6	17.6
Basic metals	1961-63[2]	45.4	31.9	11.8
	1970-72	34.4	24.1	23.4
	1980-82	34.9	18.3	27.6
	1993-95	31.7	22.1	20.4
Ferrous metals	1961-63[2]	56.0	18.3	17.5
	1970-72	39.3	14.0	32.8
	1980-82	38.8	10.5	37.4
	1993-95	36.6	12.4	27.7
Non-ferrous metals	1961-63[2]	27.5	54.8	2.0
	1970-72	24.6	44.0	4.8
	1980-82	26.8	33.9	7.5
	1993-95	24.2	36.8	9.1
Fabricated metal products and machinery	1961-63[2]	46.1	38.4	7.1
	1970-72	36.5	36.0	15.9
	1980-82	33.7	31.6	24.1
	1993-95	30.2	31.0	28.2
Fabricated metal products	1961-63[2]	52.9	26.9	10.8
	1970-72	45.3	21.8	17.8
	1980-82	45.2	21.5	18.5
	1993-95	40.7	25.1	15.5
Instruments	1961-63[2]	33.0	32.7	9.3
	1970-72	30.9	30.6	17.0
	1980-82	27.3	29.6	25.9
	1993-95	27.1	27.9	27.6

1. Canada and the United States.
2. 1962-64 for Japan.
Source: OECD Secretariat.

Table A3. **Intra-industry trade index**

Excluding intra-zone trade

	1961-63	1970-72	1980-82	1993-95
Total manufacturing				
EU6	58.7	58.9	70.8	81.6
EU12	53.1	59.3	69.4	81.4
North America[1]	59.5	65.8	69.6	72.3
Japan	51.2 [2]	39.8	31.0	40.9
Total goods				
EU6	44.6	45.3	50.4	68.1
EU12	40.1	44.5	48.7	65.8
North America[1]	34.6	37.2	37.9	56.1
Japan	18.0 [2]	20.8	16.6	31.8

1. Canada and the United States.
2. 1962-64.

Source: OECD Secretariat.

Table A4. **Revealed comparative advantage**
Excluding intra-zone trade

Industry classification	Period	EU6	EU12	North America[1]	Japan
Technology level					
High	1961-63[2]	96.4	98.7	139.1	101.4
	1970-72	98.6	98.1	166.9	125.4
	1980-82	85.0	91.6	156.4	138.2
	1993-95	84.5	94.0	150.7	144.4
Medium	1961-63[2]	109.0	109.0	110.8	63.0
	1970-72	114.6	111.9	94.8	85.0
	1980-82	108.1	105.2	96.1	106.1
	1993-95	109.1	101.6	82.6	111.4
Low	1961-63[2]	96.6	94.1	78.1	136.3
	1970-72	89.2	92.0	75.4	108.0
	1980-82	98.4	99.3	76.1	76.0
	1993-95	99.4	100.8	82.0	47.3
Orientation					
Resource-intensive	1961-63[2]	76.3	77.0	106.5	50.7
	1970-72	75.1	80.4	112.0	31.4
	1980-82	90.8	92.4	93.5	22.7
	1993-95	87.3	89.8	102.2	22.9
Labour-intensive	1961-63[2]	108.8	108.1	81.7	212.1
	1970-72	101.8	114.4	59.5	123.6
	1980-82	112.7	115.8	70.6	80.0
	1993-95	130.9	130.8	67.0	49.6
Specialised-supplier	1961-63[2]	105.0	108.9	111.1	76.4
	1970-72	123.8	119.6	113.8	109.7
	1980-82	107.1	111.6	118.5	137.2
	1993-95	102.9	106.8	116.3	155.8
Scale-intensive	1961-63[2]	121.3	115.7	76.4	113.1
	1970-72	107.9	101.2	65.6	137.3
	1980-82	103.0	95.5	72.8	139.5
	1993-95	99.0	87.9	69.6	115.1
Science-based	1961-63[2]	79.2	78.6	176.3	52.0
	1970-72	87.0	89.7	228.1	68.3
	1980-82	79.3	91.6	205.7	76.8
	1993-95	84.8	100.9	174.7	104.5

1. Canada and the United States.
2. For Japan 1962-64.
Source: OECD Secretariat.

Table A4. **Revealed comparative advantage** *(cont.)*

Excluding intra-zone trade

Industry classification	Period	EU6	EU12	North America[1]	Japan
Wage level					
High	1961-63[2]	118.6	113.2	119.2	39.9
	1970-72	112.3	105.5	118.3	72.2
	1980-82	104.6	98.2	111.3	89.2
	1993-95	97.4	94.0	106.0	104.0
Medium	1961-63[2]	103.9	102.2	88.5	114.0
	1970-72	107.0	103.7	89.6	134.5
	1980-82	100.8	104.5	94.8	134.3
	1993-95	98.1	101.7	99.5	127.6
Low	1961-63[2]	85.8	89.5	99.2	132.9
	1970-72	82.7	94.1	92.4	83.9
	1980-82	93.1	97.0	92.2	63.4
	1993-95	105.4	103.7	93.1	54.3
Skill level					
Skilled	1961-63[2]	93.3	89.9	118.4	71.1
	1970-72	93.7	94.0	133.7	79.1
	1980-82	94.6	96.1	126.3	72.5
	1993-95	91.0	96.0	131.2	87.0
Unskilled	1961-63[2]	107.2	109.0	83.2	121.6
	1970-72	107.3	105.8	72.2	118.4
	1980-82	103.4	102.2	77.1	127.2
	1993-95	105.9	99.6	70.9	115.5

1. Canada and the United States.
2. For Japan 1962-64.

Source: OECD Secretariat.

Table A5. **Import penetration in North America**[1]

Average ratio of imports to total domestic demand for main industry groups

Industry	Period	Internal	External				Total
		North America[1]	EU12	Australia, Japan and New Zealand	Rest of OECD (24)	Rest of world	World
Total manufacturing	1970-72	2.8	1.7	1.2	0.2	1.4	7.4
	1980-82	3.4	2.0	2.1	0.3	2.9	10.8
	1993-95	5.4	3.1	3.5	0.5	6.9	19.4
Food, drink and tobacco	1970-72	0.7	1.1	0.8	0.2	2.7	5.5
	1980-82	0.9	1.3	0.8	0.2	2.1	5.2
	1993-95	1.6	1.4	0.5	0.2	2.0	5.8
Textiles, footwear and leather	1970-72	0.7	2.4	1.3	0.2	2.8	7.3
	1980-82	0.9	2.1	0.8	0.1	9.8	13.7
	1993-95	1.7	3.0	0.4	0.5	24.9	30.5
Wood, cork and furniture	1970-72	3.4	0.3	0.4	0.1	1.3	5.6
	1980-82	4.0	0.5	0.1	0.1	2.3	7.1
	1993-95	6.3	0.8	0.2	0.1	4.0	11.4
Paper and printing	1970-72	3.3	0.3	0.1	0.1	0.1	3.9
	1980-82	3.8	0.4	0.1	0.1	0.2	4.6
	1993-95	4.1	0.7	0.1	0.3	0.6	5.8
Chemicals	1970-72	1.5	1.4	0.6	0.2	2.0	5.7
	1980-82	2.0	1.5	0.5	0.2	3.5	7.7
	1993-95	4.0	3.3	1.5	0.5	4.5	13.9
Stone, clay and glass	1970-72	1.1	1.4	0.8	0.1	0.3	3.8
	1980-82	1.5	2.1	1.1	0.1	1.0	5.9
	1993-95	3.1	3.6	1.2	0.4	3.7	11.9
Basic metals	1970-72	2.5	2.3	2.0	0.4	1.4	8.5
	1980-82	3.1	3.1	3.6	0.5	3.4	13.6
	1993-95	5.6	3.2	1.8	0.7	5.3	16.7
Ferrous metals	1970-72	1.3	2.9	2.9	0.2	0.6	7.8
	1980-82	1.9	3.9	4.4	0.4	1.9	12.5
	1993-95	3.6	4.1	1.9	0.8	4.5	14.8
Non-ferrous metals	1970-72	4.5	1.2	0.5	0.6	2.9	9.8
	1980-82	4.9	1.9	2.3	0.6	5.7	15.3
	1993-95	8.2	2.1	1.6	0.7	6.5	19.1
Fabricated metal products and machinery	1970-72	4.9	2.2	1.8	0.3	0.4	9.6
	1980-82	5.9	2.8	4.3	0.5	2.1	15.6
	1993-95	8.1	4.0	7.2	0.7	8.2	28.2
Fabricated metal products	1970-72	1.2	0.8	1.0	0.1	0.2	3.3
	1980-82	1.7	1.2	1.3	0.2	1.2	5.7
	1993-95	3.3	1.8	1.4	0.4	3.7	10.6
Instruments	1970-72	1.7	1.2	1.2	0.7	0.1	4.9
	1980-82	2.0	1.5	3.0	0.5	1.4	8.5
	1993-95	3.1	3.5	5.8	1.1	4.8	18.3

1. Canada and the United States.

Source: OECD Secretariat.

Table A6. **Estimation by OLS**[1]

$$\Delta 1nY=\alpha_0+\alpha_1\Delta 1nE+\alpha_2\Delta 1nK+\alpha_3\Delta O+\alpha_4\Delta S+\alpha_5\Delta I+\alpha_6\Delta lnR$$

	α_0	α_1	α_2	α_3	α_4	α_5	α_6	Rbar**2	DoF	DW
1970-95										
(3)	0.01	0.37	0.43					0.31	259	1.90
	(0.98)	(6.40)	(6.28)							
(4)	0.01	0.38	0.42	0.07				0.33	258	1.88
	(0.97)	(6.59)	(6.25)	(2.82)						
(5)	0.003	0.36	0.43	0.08	0.14			0.34	255	1.89
	(0.58)	(6.26)	(6.32)	(3.14)	(2.29)					
(6)	0.002	0.359	0.440	0.081	0.001	0.018		0.34	254	1.91
	(0.41)	(6.15)	(6.47)	(3.20)	(2.01)	(1.45)				
1970-82										
(7)	-0.02	0.32	0.76					0.27	119	2.13
	(1.85)	(2.04)	(5.67)							
(8)	-0.02	0.27	0.75	0.08				0.29	118	2.10
	(1.95)	(1.72)	(5.71)	(1.98)						
(9)	-0.02	0.24	0.72	0.09	0.18			0.30	117	2.13
	(1.90)	(1.56)	(5.47)	(2.25)	(2.03)					
(10)	-0.02	0.22	0.72	0.09	0.17	0.02		0.30	116	2.13
	(1.89)	(1.43)	(5.47)	(2.23)	(1.91)	(1.10)				
1983-95										
(11)	0.03	0.52	-0.15					0.44	127	1.73
	(4.21)	(7.87)	(0.93)							
(12)	0.02	0.48					0.05	0.52	123	1.76
	(5.20)	(10.19)					(2.67)			
(13)	0.02	0.49		0.07			0.05	0.54	122	1.75
	(5.02)	(10.60)		(2.57)			(2.93)			
(14)	0.02	0.50		0.07	0.00		0.05	0.54	116	1.73
	(4.76)	(10.11)		(2.48)	(0.00)		(2.69)			
(15)	0.02	0.50		0.07	0.00	0.01	0.05	0.54	115	1.77
	(4.70)	(10.15)		(2.60)	(0.00)	(1.05)	(2.60)			

1. **Variables**: Y = real GDP; E = total employment; K = private sector capital stock; R = private sector expenditure in research and development; O = share of total trade (imports + exports) in GDP; S = intra industry trade index; I = share of area trade in total trade which takes into account successive enlargements.
Sample: Yearly data (1970-95) for eleven EU countries (Luxembourg excluded). T-statistics in parenthesis. Country dummies are included.

Source: OECD Secretariat

Table A7. **Estimation of individual effects**[1]

$\Delta 1nY=\alpha_0+\alpha_1\Delta 1nE+\alpha_2\Delta 1nK+\alpha_3\Delta O+\alpha_4\Delta S+\alpha_5\Delta I$

		α_0	α_1	α_2	α_3	α_4	α_5	Rbar**2	DoF
(16)	Fixed Effects Estimator		0.36 (6.18)	0.44 (6.46)	0.081 (3.19)	0.001 (2.00)	0.018 (1.45)	0.33	254
(17)	Feasible General Least Square Estimator	0.010 (4.18)	0.38 (6.61)	0.350 (6.10)	0.090 (3.50)	0.001 (2.02)	0.16 (1.26)	0.32	264
(18)	Fixed Effects Estimator, Estimation by Weighted Least Squares		0.44 (8.59)	0.42 (6.32)	0.093 (4.27)	0.002 (3.15)	0.0007 (0.70)	0.44	265

1. **Variables**: Y = real GDP; E = total employment; K = private sector capital stock; R = private sector expenditure in research and development; O = share of total trade (imports + exports) in GDP; S = intra industry trade index; I = share of area trade in total trade which takes into account successive enlargements.
Sample: Yearly data (1970-95) for eleven EU countries (Luxembourg excluded). T-statistics in parenthesis.

Source: OECD Secretariat.

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