The Hub and Spoke Approach of EU Trade Policy

Since the failure of the World Trade Organisation in Seattle to launch a new round of free trade talks last December, Europe's trade negotiators have been busy. Not so much with working to restore confidence in the multilateral trading regime, but with more pressing concerns, such as ensuring a trouble-free start of the bilateral free trade agreement (FTA) with South Africa, which took effect from January 1st, and negotiating another one with Mexico, which came into force on July 1st.

The EU is rather keen on such preferential pacts. In addition to the FTAs with South Africa and Mexico, it is currently negotiating one with Chile and the four MERCOSUR countries (Argentina, Brazil, Paraguay and Uruguay). And it will soon ratify the already signed new bilateral agreements with 71 poor African, Caribbean and Pacific (ACP) countries, too. Taking into account the some 100 other poor countries covered by the Generalised System of Preferences, the EU's web of preferential pacts already covers most of the world. In fact, there are only six countries-Australia, Canada, Japan, New Zealand, Taiwan and the United States - with which it trades on a "most-favoured nation" (that is normal) basis. Those six are actually among the least favoured: only states which are internationally isolated, such as Iraq and North Korea, get worse trade terms.

The EU's affection for bilateral trade deals is partly a result of politics. For the executive institution of the EU, the European Commission, they can be used as a substitute for an EU foreign policy, which is still the domain of EU national governments. Furthermore, bilateral deals may increase EU member states' influence abroad. The Europe and Euro-Med agreements, for example, helped to anchor Eastern Europe and North Africa in the EU's sphere of influence. They may also help to keep neighbour governments stable and potential migrants at home.

But as a driving force for preferential pacts economics is a bigger incentive. As a consequence of its web of agreements, the EU can act as an export and investment hub with preferential access to markets in spokes all over the world. That ensures an open door for European exporters in expanding foreign markets. They will have a competitive advantage not only over exporters from other industrialised countries, which are still less involved in preferential trade agreements, but also over firms from spoke countries, since, for example, South Africa and Mexico do not have privileged access to each other's markets.

And what about the potential benefits for the spoke countries? There might be political benefits in concluding FTAs with the EU: the East Europeans can surely expect a deepening of integration and will sooner or later achieve full EU membership; South Africa has intended to accelerate its political and economic integration in the world economy after the apartheid regime vanished; and Latin America would like to reduce the United States' sphere of influence in the Americas. Also, a deal with the EU may help lock in economic reforms, which is particularly important for transition and emerging market economies. But this argument has to be considered within a broader perspective, since international capital markets surely can do more harm or good to keep, for instance, Mexico on a track of economic liberalisation, than the EU ever will. And in particular cases, the EU has actually set back economic reform. For example, it insisted that the East Europeans raise their import tariffs for certain products to the rest of the world in order to increase the market share of EU firms.

From an economic perspective, FTAs can be welfare improving or welfare deteriorating. As we know from the theory of economic integration, the formation of an FTA not only increases trade between member countries as consumers substitute beneficiary imports for domestically produced goods, called trade creation, but imports from non-preferred countries will also decline, since they will be replaced by beneficiary imports as well. The latter effect, called trade diversion, will reduce welfare as a more efficient source of imports will be displaced by a higher cost producer. Moreover, apart from additional effects like scale economies or changes in the terms of trade, the trade effects of each FTA have to be considered in order to assess the overall impact.

Indeed, poor countries could lose economically due to their deals with the EU. Take first the South African agreement. The FTA ensures that South African firms can now sell their goods more easily and cheaply in the EU. But South African farmers, who are highly competitive, cannot, since "sensitive" agricultural products, such as cereals, are excluded. This can possibly lead to the production of goods that the EU allows in more freely. This result, however, does not make sense with respect to the principle of comparative advantage.

The Mexican agreement, as a second example, proved to be less complicated in negotiations since EU-Mexican agricultural trade was less "sensitive" from the perspective of European farmers. Mexico hopes that the FTA will reduce its dependence on trade with the United States. Due to the North American Free Trade Agreement (NAFTA) between Mexico, Canada and the United States and a booming US economy, the share of Mexico's trade with its northern neighbour has climbed to more than 80 per cent. First estimates confirm that trade creation by that agreement will outpace trade diversion by a considerable amount and help Mexican exporters to increase their market share in Europe. The EU, however, is likely to gain much more than their free trade partner, seeing that EU tariff rates are much lower than Mexico's.

But the real hope of the Mexican Government is that the deal will place the country in a privileged position internationally by making the country a point of entry to the world's two main trading blocs. This is supposed to enhance Mexico's appeal as a target for foreign investment. Whether the deal is likely to attract much foreign investment, however, seems to be ambiguous. Of course, Mexico's new privileged position might help but other important factors determine the amount of foreign direct investment as well. Complicated "rules of origin", which define how much local content is required before a good is considered Mexican and thus eligible for preferential access to the EU or NAFTA, entangle investors in red tape and will deter many from setting up shop in Mexico. Also, considerable corruption, crime, and inflexible labour markets do not make Mexico a heaven for foreign direct investment. It is therefore less clear whether the optimistic hopes of the Mexican Government will come true.

The biggest losers from all trjese FTAs are the countries that are excluded. Yet the agreements create their own logic, whereby those who are discriminated against seek their own preferential deal. The European Union was well aware of this. It was eager for the deal with Mexico because its exports to that country have slumped since Mexico entered NAFTA in 1994. Now officials of the European Commission are convinced that their talks with Chile and MERCOSUR put the EU in "pole position" in the competition for market shares in South America, ahead of the United States, whose efforts to establish a free trade area of the Americas are stalled at the moment.

And what comes next from the perspective of EU trade policy? Since EU trade negotiators will soon run out of meaningful FTA partners, assuming that current negotiations are brought to a satisfactory conclusion, they will have to rethink their strategy. As free trade agreements are discriminatory by definition, it would be wise to turn around to ensure that trade liberalisation at the World Trade Organisation no longer remains deadlocked. Multilateral trade liberalisation would both strengthen confidence in the trading system and reduce the temptations for preferential agreements.

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