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Session III: Globalization, economic interdependence and new trade agreements

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Globalization, economic interdependence and new agreements: trade policy in the era of mega-regionals

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1. Introduction

For decades, regional integration was a concept that was primarily discussed as an economic policy instrument for developing countries. In the first wave of regional integration in the 1960s, there was great enthusiasm regarding the potential of regional integration. By enhancing the size of the internal market, developing countries could reach economies of scale and improve their economic prospects. Today, however, the picture has changed dramatically. Regional integration is no longer a concept that is primarily applied by small and medium-sized economies. Since about ten years, the United States and the European Union have increasingly been placing their bets on preferential trade agreements. The most obvious consequence is a structural weakening of the World Trade Organization and the undermining the existing multilateral order. For large emerging markets, the BRICS, this is a new challenge. How should these countries respond to the new policies of the USA and the EU? Should they try to revive the multilateral system or will they have to develop their own trade policy strategies outside the WTO as well?

2. Regional integration: the key elements of a political and economic concept

Integration and co-operation are frequently used synonymously, but in fact there is a need to differentiate. Co-operation is aiming at limited goals, in trade or infrastructure development for instance. By contrast, (regional) integration aims at a higher level of collaboration and will eventually result in a new, unified political and economic entity.

The typology by the Hungarian economist Bela Balassa from 1961 demonstrates the gradual deepening of collaboration and the eventual creation of a new state in stage 5, the political union. Balassa suggested that regional integration should be organized in five steps:

1. Free Trade Area
2. Customs Union
3. Common Market
4. Economic and Monetary Union

5. Political Union (Balassa 1961 and 1987)

In today's world of mushrooming free trade agreements, we can distinguish between (regional) co-operation and integration quite easily. If participating countries show no explicit interest in moving beyond a free trade area, this constitutes co-operation. If a group of countries aims at the creation of a customs union or higher forms of collaboration, this constitutes regional integration.

The distinction is useful for a number of reasons. First, the level of harmonization of economic policies in a free trade agreement is quite low. Tariffs are eliminated, but the participating economies retain their own, individual trade policy vis-à-vis the rest of the world. Norms and standards are usually not harmonized. A country can enter as many free trade agreements as it considers useful and appropriate.

By contrast, once a country enters a customs union, it loses the ability to have an independent trade policy. Since the creation of the European customs union amongst the original six members of the European Economic Community in 1968, trade policy has been formulated jointly in Brussels, not in Paris or The Hague. A customs union usually marks the beginning of an integration process, rather than (limited) economic co-operation.

Historically, the first region that successfully implemented regional integration was what in 1871 became the German Empire. From 1834, the German Customs Union (Zollverein) was implemented and gradually enlarged. Balassa's typology was clearly inspired by the experience of Germany. Led by Prussia, the largest economy, the small and medium-sized economies were dismantling the economic boundaries between them and within 40 years the regional integration process was successfully concluded. The participating states ceased to exist. A new state emerged as the successor.

The creation of the German Customs Union was the first example of a group of sovereign countries that permitted the creation of supranational economic regulation without – initially – political union. Countries participating in the German Customs Union continued to be sovereign until German unification took place. But even after 1871, Luxembourg continued to be part of the customs union until 1919, but not of the German Empire.

In fact, the Zollverein not only stands out as the first example of regional integration by economic, rather than military, means, but also because of its early success in organizing economic relations with non-participating economies. In 1865, the Zollverein created a free trade agreement with Sweden-Norway, linking the customs union with foreign markets.

It should be noted that in the current discussion about the external economic relations of Ukraine, a fundamental misunderstanding emerged. Ukraine can ***either*** have a free trade agreement with the EU ***or*** join the customs union between Russia, Belarus and Kazakhstan. If Ukraine wanted to join the customs union, that would prevent the establishment of an FTA between Ukraine and the EU because of the joint external tariff that defines a customs union. The only solution would be to create a free trade agreement between the EU and the customs union led by Russia. The policies of the European Union towards Ukraine were either somewhat naïve – assuming that eventual EU membership of Ukraine would have been as technical as, say, Norwegian membership – or deliberately fuelling conflict.

3. The politics of regional integration

The debate on Ukraine underlines that regional co-operation and integration can have a strong political dimension. In Europe, this is of course not a new development. The EU has been using accession as an instrument of foreign policy for many years. The enlargement of the EU has of course always had a political dimension, most obvious when the formerly socialist countries of Eastern Europe joined in 2004. But the EU has also used trade policy vis-à-vis other countries as an instrument of foreign policy. In fact, since the EU still does not have a joint foreign policy, trade policy may have served in lieu of a European foreign policy.

The political use of regional integration is of course not a European domain. In recent years, China has been using trade policy to advance political goals. This was most noticeable when China and the Association of Southeast Asian Nations (ASEAN) agreed upon the creation of a free trade agreement in 2002. It is noteworthy that ASEAN had been established as anti-communist, i.e. Anti-Chinese, bulwark in 1967. The ASEAN-China Free Trade Area came into effect on 1st January 2010 and it constitutes the world's largest FTA by population. In the contrast to the 1960s and 1970s, when Southeast Asian countries were afraid of an increasing economic and political Chinese influence, today these states have opened up for business with China. The fear of revolution and weapons has been replaced by a desire for trade with Beijing.

The BRICS-countries – all of them influential powers in their region – are inclined to use regional integration to promote political goals. South Africa has been ahead of its peers for more than a century: The Southern African Customs Union is the oldest existing customs union between sovereign states. It exists since 1910 and comprises Botswana, Namibia, Lesotho, Swaziland and South Africa. Neither China nor India are currently participating in a customs union, but instead have pushed free trade agreements. Russia has established a customs union, as mentioned above, with Kazakhstan and Belarus in 2010. The eventual goal of this project is the creation of a Eurasian Union – somewhat similar to the European Union. Many former member countries of the old USSR have been invited to join, and in 2013 Vietnam expressed interest in creating an FTA with the customs union.[1] Western critics have been arguing that the Eurasian Union represents an attempt to recreate the USSR. Whilst it is evident that there is very limited interest in re-establishing a communist bloc, there clearly is a battle for influence. Moscow is trying to enlarge its influence, whilst the USA – with its two mega-projects – is attempting to establish an even larger sphere of influence. Regional co-operation and integration have been re-politicized.

Brazil and its neighbors Argentina, Paraguay and Uruguay have been working on the establishment of the Mercosur since 1991, but the results have been mixed. The Treaty of Asuncion, signed in March 1991, aimed at the creation of a customs union, but that goal has not yet been achieved. However, the Mercosur does have the potential to become a Latin American common market. The main political obstacle is the unresolved rivalry between Mercosur's two largest members.

Of course, from an economic perspective this is absurd. The dismantling of obstacles to trade is welfare enhancing, and there is little need for political considerations. But policy makers apparently prefer to implement preferential trade agreements – rather than advancing the multilateral system. But what can explain this seemingly irrational trade policy?

From a realist perspective, the main reason for the inability to advance the multilateral system is the emergence of a multi-polar world. In the bi-polar world between 1945 and 1991, the two hegemonic powers established economic regulation in their spheres of influence. The USA established and backed the General Agreement on Tariffs and Trade, the GATT. The USSR set up the Council for Mutual Economic Assistance, the COMECON. Since the short "unipolar moment" (Charles Krauthammer) ended and has since been replaced by a multipolar world, there are increasing difficulties in maintaining the multilateral trade regime. Geopolitics and the competition for power and influence have returned.

Optimists could argue that the WTO is back on stage – after the successful conclusion of the conference in Bali in December 2013. The unwillingness of the member countries' to advance the multilateral trading system may have ended with Bali, and the WTO could regain the strength it had in the first decade of its existence after its establishment in 1995. But that position appears to be too buoyant. In Bali, low hanging fruit was harvested. None of the difficult issues were put on the table

[1] The Saigon Times, 13 September 2013, available at http://english.thesaigontimes.vn/Home/business/vietnam-economy/25534/

(Dieter 2014). Trade facilitation – the most important component of the Bali agreement – is useful, but on balance the Bali deal is probably not much more than “a tropical fling”, the label provided by the Financial Times. The key reason for this skeptical view is that important countries, in particular the USA, are no longer placing their bets on the WTO. The USA is creating a post-WTO world.

4. TTIP, TPP and the mushrooming of free trade agreements

For many observers in Europe such a critical assessment is surprising. Few trade projects have been welcomed more enthusiastically than the Transatlantic Trade and Investment Partnership (TTIP) between the European Union and the United States. But the initiative is set to send us down the wrong track. For Europeans, that project does not make much sense, neither economically nor geopolitically. The economic gains would be minimal and the political damage would be enormous.

However, it is not the first time that a transatlantic free trade area has been discussed. The idea was debated intensively during the 1990s, although no formal negotiations were opened (Siebert et al. 1996). The two most important reasons for the skepticism at the time were the successful establishment of the World Trade Organization (WTO) and the trust bestowed on concepts of “global governance,” which then seemed modern and promising.

Roughly 20 years later, the excitement over the WTO has evaporated. As the negotiations of the Doha round trudge along slowly, governments around the world are pursuing the new approach of creating free trade areas, which is labeled as trade pragmatism, rather than trying to reach at multilateral regulations. The EU and the US, but also China and smaller economies have altered their trade policies over the last few years. Globally, preferential discriminating trade areas are on the rise. Every single WTO member, Mongolia excluded, is party to at least one free trade area or customs union. According to WTO data, in January 2014 there were 377 preferential treaties in force and about 200 more were still being negotiated.[2]

There are numerous reasons for this expansion. The most important factor is probably the failure of the Doha round; few observers still reckon that those negotiations can still be brought to a successful conclusion. It was a mistake to label the Doha negotiations as the “development round”; in consequence, traditional supporters of a multilateral trade order – industry associations like the Federation of German Industry (BDI) – lost interest in the further development of the WTO.

[2] See the WTO database, available at http://www.wto.org/english/tratop_e/region_e/region_e.htm.

Also, the changed global economic climate has greatly contributed to the dimmed interest in the WTO. 2001 not only marked the start of the Doha round, but also the accession of China to the WTO. The rocket-like take-off of the Chinese economy has since continued, which is now met with growing concern. People in OECD countries are asking themselves whether they can still compete globally with China and other emerging countries. For the moment, this does not apply to Germany, but certainly to a number of EU member states and definitely to the United States.

There is another central problem of preferential trade treaties: Many of those do not contribute to a further liberalization of trade, but rather are meant to function as protection from all-too-powerful competition. That thinking plays a central role in the approach taken by US President Barack Obama's administration; the focus is not so much on free, but rather on fair trade.[3] In other words, the aim is to exclude allegedly unfair competitors – from an American perspective, this is mainly China. Therefore, the TTIP and TPP projects at one level are defensive in nature – attempts to create a trade regime without China.

Thus, the US, but also the EU are not only fundamentally weakening the WTO, but they also are betraying their own principles. The multilateral trade regime established after World War Two was specifically designed to overcome the discriminatory trade agreements of the interwar period, which greatly contributed to the rise in tensions during the 1930s.

With this historical lesson in mind, there is no convincing reason to jettison the multilateral trade order. Emerging economies still conduct the bulk of their trade with the EU and the US and prefer to use the mechanisms of the WTO. A counter-proposal on their part for an alternative to the existing trade regime is currently not perceptible. The EU and the US cannot influence the further rise of China and other countries, but they can make sure that international trade relations will continue to be shaped by the order established by the US and its allies in the 1940s (Ikenberry 2008).

5. The politics of self-interest

The current multilateral trade order is deemed to protect the interests of all states – including those less powerful – in the complexity of the 21st century world. However, the EU in particular, which has repeatedly stressed the importance of multilateral rules for emerging countries, has weakened the trade order with its foreign trade policy.

3 President Obama's „State of the Union"-address, 12 February, 2012. Obama speaks of "free and fair trade".

The EU would, by agreeing a preferential treaty with the US, end up being used by Washington for US geopolitical goals. Presently, the US not only pursues a transatlantic, but also a Trans-Pacific project: The Trans-Pacific Partnership (TPP) Agreement, to which twelve countries are currently party to, including the economic heavyweight Japan. With the exception of South Korea and China, the largest economies of the Pacific are participating in the project. South Korea already has an FTA with the USA and thus can be considered a special case. Of course, China is not invited to join. Should the US succeed in both concluding a Trans-Atlantic and a Trans-Pacific agreement, the result would be a new bipolar world order. The US would then no longer be dependent on the WTO and could push ahead in its trade confrontation with China, as has been demanded by various American politicians over the last few years.

The European accomplices – first and foremost Germany – have, of course, no lasting gain to expect from such a fragmentation of world trade. German, and other European, companies prove their competitiveness on world markets every single day. Europe in particular should support a multilateral order not only rhetorically, but strengthen it actively. In other words: Europe, especially, should not erect any parallel structures that weaken the WTO.

Alas, such insights are rare in Brussels these days. The last EU Trade Commissioner who knew about the fragility of the multilateral order, and imposed a moratorium on EU preferential trade agreements in 1999, was Pascal Lamy, the former WTO chief. After the Briton Peter Mandelson took over as EU trade commissioner in 2004, the EU set out on the wrong track and concluded more and more preferential treaties. But what sort of arrangement is really about to be negotiated between the EU and the US? What are the advantages and disadvantages of the TTIP?

6. Construction flaws of small and large FTAs

Political implication aside, the economic arguments are not convincing either. Rather, the claims made by advocates of TTIP and other large integration projects are quite astounding. The supporters usually advance three reasons why TTIP and TPP would be desirable: first, because the competitive advantage of the industrialized nations is being eroded by emerging nations such as China and India; second, because multilateral trade negotiations have come to a standstill; and third, because the crash of 2008 has proven the need for reforms.

Undeniably, the Doha round has come to a halt, but the other arguments do not hold water. Even if one accepts the dwindling competitiveness of the EU and the US vis-à-vis the emerging countries – highly debatable looking at a number of European companies – a discriminatory trade agreement would be the wrong answer; rather, wide-ranging structural reforms would be the remedy for lost competitiveness. A treaty that disadvantages third parties does not strengthen the competitiveness of companies. Of course, the danger is that reforms will be delayed because a single transatlantic market would convey a deceptive sense of security; the exclusion of strong competition has rarely led to strong economies.

In addition, a free trade area has a number of construction flaws, which the most capable negotiators will not be able to resolve.

The most important shortcoming is that the origins of duty-free traded products need to be documented. Free trade areas do not function without so-called rules of origin. What does this mean exactly? Within free trade areas, only products from participating countries can be traded duty-free, but not those from third countries. Therefore, the origin of a given product needs to be documented carefully (which means higher costs), by certificates of origin. The more complex a product is, the more expensive is the drawing-up of its certificate. It gets really complicated, however, if inputs from third countries are to be accounted for. Furthermore, within the almost 400 free trade areas in existence today, the procedures to determine the origin of a product vary widely. The most complex is the most common one: measuring the percentages of value added.

This means that for small and middle-size companies, preferential agreements are of limited benefit. For developing countries, such complex rules are high hurdles, too. The abolition of tariffs is bought with the obligation to document the origins of products. This considerably reduces the value of the agreement for many players. With tariffs in the lower one-digit region, companies are right to question whether it would be easier and cheaper for them to waive the preferential treatment and pay the tariff. This has the additional advantage of greater clarity. After paying an import fee, no further costs are to be reckoned with. As tariffs are negligible in transatlantic trade these days, it is highly likely that many companies will opt for paying tariffs and against the drawing up certificates of origin. Estimates suggest that the provision of a certificate of origin is costing companies about 5 percent of the value of the product (Dieter 2004). On average, current tariffs are at 3.5 per cent for the EU, and at 2.5 per cent for the US.

The United States has carefully acted to safeguard American interests within every free trade area it is party to. The rules of origin have contributed to this: the regulations cover 200 pages in the NAFTA document. The origins of raw materials that are or are not allowed are listed within the document in great detail. The so-called “fiber-forward” rule says that cotton needs to have been produced in the NAFTA area to be traded without tariffs. This rule was pushed through by the US to protect the American cotton producers. It is likely that similar rules would be incorporated in the TTIP. The victims would be African cotton producers who could no longer be allowed to supply cotton for Spanish or Italian fashion products to be exported to the US.

Other regulations currently in place in the US would need to be reviewed, too. For instance, there is the rather bizarre "Jones Act," officially known as Section 27 of the Merchant Maritime Act of 1920, which stipulates that all goods transported by water between American ports be carried in US-flagged ships, constructed in the United States, owned by American citizens, and crewed by US citizens. The EU representation in Washington has railed against this for decades without success.

Over the past few years, there have been a number of contentious issues between the US and the EU. Most pertinent are real or alleged cases of government subsidies for the aerospace manufacturers Airbus and Boeing. Those have not been resolved, even with the WTO acting as mediator. It is rather implausible to expect a solution without the WTO being involved.

With the creation of a transatlantic free trade agreement, the historic success of multilateral trade would be abandoned carelessly. In bilateral or other preferential trade agreements, neither the inclusion of developing countries nor the very successful WTO dispute settlement mechanism stemming from a transparent and coherent rulebook could be preserved. TTIP and TPP will degrade the WTO to irrelevance – and neither would enhance the competitiveness of participating economies.

7. Conclusion

The question of course is how the BRICS-countries should respond to the processes outlined above. There are two potential avenues. The first option is to form an alliance against the destruction of the multilateral trading system. The BRICS-countries, together with African, Asian and Latin American developing economies, could form a group that aims at revitalizing the WTO. Global economic governance, in particular the multilateral regulation of trade, would be the platform for that group. However, the likeliness of such a concerted action is limited indeed. The BRICS-countries are most probably not sufficiently unified in their foreign (economic) policy to push such a campaign. Even if they were, their ability to force the USA (and the EU) to return to Geneva might not be sufficient.

The second option is certainly less optimistic, but probably more realistic. In a multi-polar world characterized by the limited willingness for co-operation, the

BRICS-countries perhaps have no other option and have to push their own political projects. A race for alliances is the inevitable result. Of course, some of this is already happening. Russia does not want Ukraine to become associated with the European Union. China is ensnaring its neighbors and is eager to form a Chinese-led Asian bloc. Brazil and South Africa are both seeing themselves as legitimate leading regional powers. Only India, lacking neighbors that are willing to co-operate with Delhi, is an exception in this game.

The trade policy instrument that fits these ambitions best is the creation of a regional customs union. Brazil, Russia and South Africa are following that approach, although these three cases are of course diverging greatly. Regional free trade agreements, by contrast, do not have the same political binding power, as discussed above.

Trade policy has been massively re-politicized in recent years. For trade economists, this is a regrettable development. The first-best solution – the multilateral regulation of trade – is replaced by second-best approaches. For political scientists, the main concern is that the political lessons of the 1930s have been forgotten. Discrimination in trade is back – and this may result in greater conflict and less co-operation in international relations. Geopolitics has replaced the post-1945 liberal consensus in trade policy.

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