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Chinese Foreign Investment: A Dangerous Obsession or a New Normal?

How the EU Has Been Shaping the World Trade Order

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The Vienna Institute for International Economic Studies
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RICHARD GRIEVESON
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PETER HAVLIK
ROMAN STÖLLINGER

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Save the date!
wiiw Spring Seminar
will take place on
Thursday, 4 April 2019

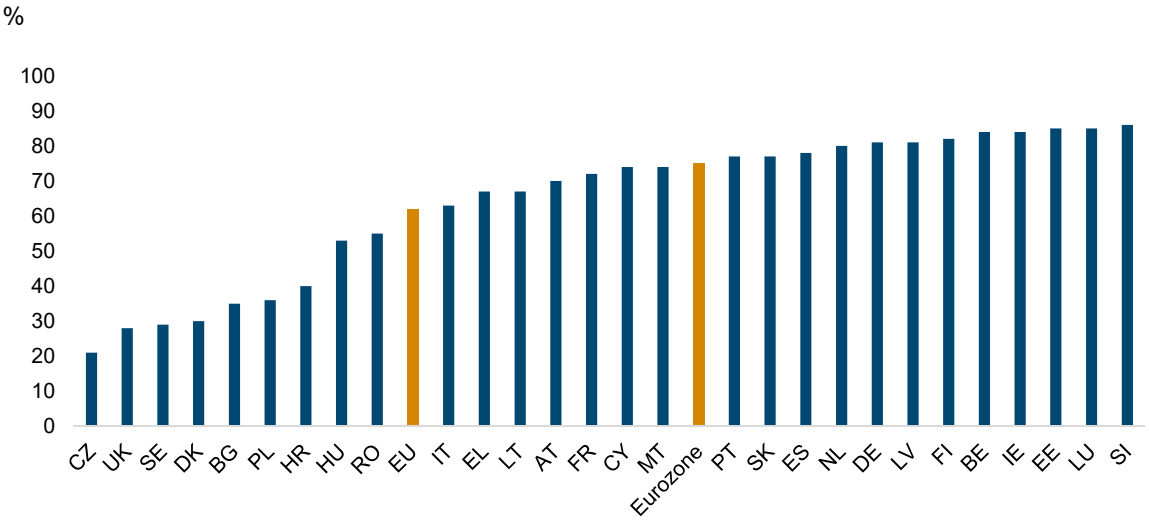
Chart of the month: The euro turns 20

BY RICHARD GRIEVESON

In January 2019, the euro celebrated its 20th birthday. The celebrations were muted, however, with the single currency having only recently emerged from a bruising series of crises which prompted serious questions about its very survival. A stand-off between Italy and the European Commission in 2018, and evidence of a sharp slowdown in the eurozone economy in the second half of last year, were significant reminders of the chance that a crisis could return.

Nevertheless, the euro has so far survived. On the occasion of its 20th birthday, debates continued to rage about its successes or achievements. At one end of the spectrum, Jean-Claude Juncker, President of the European Commission, proclaimed that 'the euro has become a symbol of unity, sovereignty and stability'. On the other side of the debate, Ashoka Mody, the IMF's representative in Ireland during the troika bailout, published a book in 2018 entitled *EuroTragedy*, in which he said that 'the euro delivered no economic benefits … the idea that the euro would be an external anchor, a disciplining device, proved utterly misguided … the promised benefits in terms of more trade within the eurozone did not materialize either'.

Support for a European economic and monetary union with one single currency, the euro



Source: Eurobarometer.

The reality is probably somewhere in between. It is true to say that the euro has often been a source of instability rather than stability since the crisis. Yet many of the criticisms of it, including by Mr Mody, go too far. The euro is blamed for many things that it is not responsible for. The supposed panacea of external devaluation outside the euro, for example, is regularly overstated, including by Mr Mody. In the days of complex cross-border supply chains, the impact of currency revaluation is much diminished. Any

competitiveness gains achieved by devaluation can quickly be eaten up by higher inflation. And for relatively closed economies such as those of Italy or Greece, benefits from an external devaluation can only ever be quite limited.

Looking at the prospects for the euro's next 20 years, one of the most important things to acknowledge is that it remains fundamentally popular. In all eurozone countries, support for the single currency is well over 50% (the lowest is Italy, with 63%). For the eurozone as a whole, the support level is 75%. According to the Eurobarometer survey, going back to 2004, the euro has never been as popular among citizens of eurozone countries as it is now. It should be noted though that among non-members in CESEE, only Hungary and Romania show support of over 50%, with only 21% of Czechs wanting to join the euro.

Opinion Corner*: Chinese foreign investment: A dangerous obsession or a new normal?

ANSWERED BY PETER HAVLIK

The Chinese economy is poised to overtake the United States before the end of the next decade; in terms of purchasing power parities, it is already now 20% bigger according to the World Bank. The unprecedented four-decade-long catching-up process by China and its geopolitical and geoeconomic consequences caught most observers in the West unprepared. In this context, the latest issue of the influential US journal *Foreign Affairs*[1] is dedicated to the implicit question 'Who Will Run the World?'. While a Chinese-led world order would be an 'illiberal one', a 'new democratic rules-based' order is less likely than a world with 'little order' according to the opinion expressed by Richard Haass (p. 30). In other words, 'China is trying to displace, rather than replace' the United States (ibid., p. 31).

China's rising foreign investment abroad is a relatively new phenomenon. According to UNCTAD, Chinese outward FDI was meagre (less than USD 20 billion per year on average) ten years ago, but jumped ten times (to nearly USD 200 billion) in 2016. By end-2017, Chinese outward FDI stocks reached USD 1,500 billion, almost matching the cumulated inward FDI (for comparison, in 1995 the inward FDI stocks in China – USD 100 billion – had been more than five times bigger than Chinese outward FDI). The Chinese use of projecting economic power has become obvious at the latest with the 'One Belt, One Road' (OBOR) initiative, or 'Belt and Road Initiative' (BRI) launched in 2013. This huge, long-term and wide-ranging infrastructure investment project of at least USD 1,000 billion is spreading Chinese influence beyond Eurasia to Africa and Europe by offering credits and other assistance without any 'usual Western strings' such as transparency or the respect for human rights attached. In other fields, China is also moving up the manufacturing value chain: in science, in space exploration (landing on the dark side of the moon), cloning human DNA etc., with perhaps more significant global consequences.

The rise of China's economic power has provoked contradictory reactions in the United States: President Trump's decision to leave the Trans-Pacific Partnership (TPP) trade agreement negotiated by the Obama administration (which excluded China anyway), launching the trade war by imposing prohibitively high tariffs on selected imports from China and, more recently, imposing restrictions on Chinese investments, bans and warnings on Chinese digital equipment purchases and technology transfer (even issuing an arrest order on Huawei Chief Financial Manager Meng Wanzhou in Canada), accusing China of intellectual property theft and spying, etc.

The European Union joined the US blame and shame campaign against China in December 2018,[2] with Germany (where Huawei European headquarters is located), France and the United Kingdom raising

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* Disclaimer: The views expressed in the Opinion Corner section of the Monthly Report are exclusively those of the authors and do not necessarily represent the official view of wiiw.

1 Haass, R. (2019), 'How a world order ends', *Foreign Affairs*, January/February, and other contributions in the same issue: https://www.foreignaffairs.com/articles/2018-12-11/how-world-order-ends

2 https://www.euractiv.com/section/eu-china/news/commission-says-europe-should-be-worried-about-huawei/

concerns about Chinese advanced digital technology, in particular bidding for advanced 5G telecom licences. According to Bloomberg, Chinese wireless technology is winning in Europe, the Middle East and Africa, with Huawei reaching a 40% market share in 2018, followed by Ericsson with 36%.[3] In the Czech Republic, for example, local cybersecurity experts even call for a boycott of Chinese electronic equipment on the absurd pretext that 'all Chinese producers are state-controlled'.[4] The Czech National Cyber and Security Information Agency issued a similar warning against using Huawei and ZTE telecom equipment by government agencies, leading to an (un)diplomatic spat between Czech Prime Minister Andrej Babiš and Chinese Ambassador Zhang Jianmin in Prague at the end of December 2018. In what seems to be a concerted anti-Chinese effort, the Polish police detained the local Huawei representative on spying allegations in January 2019.

Ironically, the above Czech-Chinese dispute adds more fuel to the EU-China rivalry and is of particular importance given the '16+1 Framework and Economic Relations between China and the Central and Eastern European Countries'. '16+1' represents the so far most important Chinese investment initiative in Europe, established already in 2012 and actively promoted by Prague and Czech President Miloš Zeman in particular.[5] Despite this, Chinese investments in Central and Eastern Europe are still rather low: the Chinese FDI stock in CESEE has so far reached only 0.2% of the total, according to wiiw's estimate.[6]

Similarly to the '16+1' initiative, the EU's reaction to China's BRI has so far been delayed and rather hesitant: only in September 2018, the European Commission adopted an 'EU Strategy on Connecting Europe and Asia' that offers a different approach from that taken by Beijing with its flagship Belt and Road Initiative.[7] The EU approach is founded on sustainable, comprehensive and international rules-based connectivity. However, compared to the Chinese BRI, the proposed EU Connectivity Strategy not only lacks sufficient resources, but is probably also excessively restrictive owing to insisting on the above-mentioned 'strings' and thus less attractive to participating countries – despite numerous recent criticisms of Chinese BRI-related activities in Africa and Asia that lead to a 'debt trap'.[8]

Summarising, one can conclude that the Chinese investments abroad are poised to grow in the future – in line with the rising strength of the Chinese economy – of course unless there is a major disruption in trade flows and a resulting global crisis. At the same time, the above reactions by both the US and the EU to China's rising power and its display in the economic arena indicate the Western discomfort with the emerging new global order. (In contrast, Russia is changing the pivot from Europe to China as one of the consequences of its conflict with the West.) Western efforts to restrict Chinese investments seem to be either a poorly disguised attempt at containing the rise of China or part of an emerging paradigm shift towards protectionism by the West itself – as globalisation no longer serves Western interests. Paraphrasing the famous paper on competitiveness written by Nobel laureate Paul Krugman,[9] these efforts are not only wrong, but could represent a 'dangerous obsession' as well.

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3 https://www.bloomberg.com/news/articles/2018-12-06/europe-was-growing-wary-of-huawei-even-before-cfo-s-arrest
4 https://tech.ihned.cz/c1-66394440-telefon-od-huawei-bych-si-nekoupil-firma-je-udem-cinskeho-statu-tvrdi-expert
5 http://critcom.councilforeuropeanstudies.org/161-framework-and-economic-relations-between-china-and-ceec/
6 https://wiiw.ac.at/economic-policy-implications-of-the-belt-and-road-initiative-for-cesee-and-austria-p-4549.html
7 https://eeas.europa.eu/delegations/cambodia/50752/european-way-connectivity-%E2%80%93-new-strategy-how-better-connect-europe-and-asia_en
8 https://www.thenational.ae/business/economy/china-s-xi-assures-african-leaders-belt-and-road-is-no-debt-trap-1.766361
9 Krugman, P. (1994), 'Competitiveness: a dangerous obsession', *Foreign Affairs*, Vol. 73, No. 2, https://cs.uwaterloo.ca/~alopez-o/politics/dangcompet.html

How the EU has been shaping the world trade order

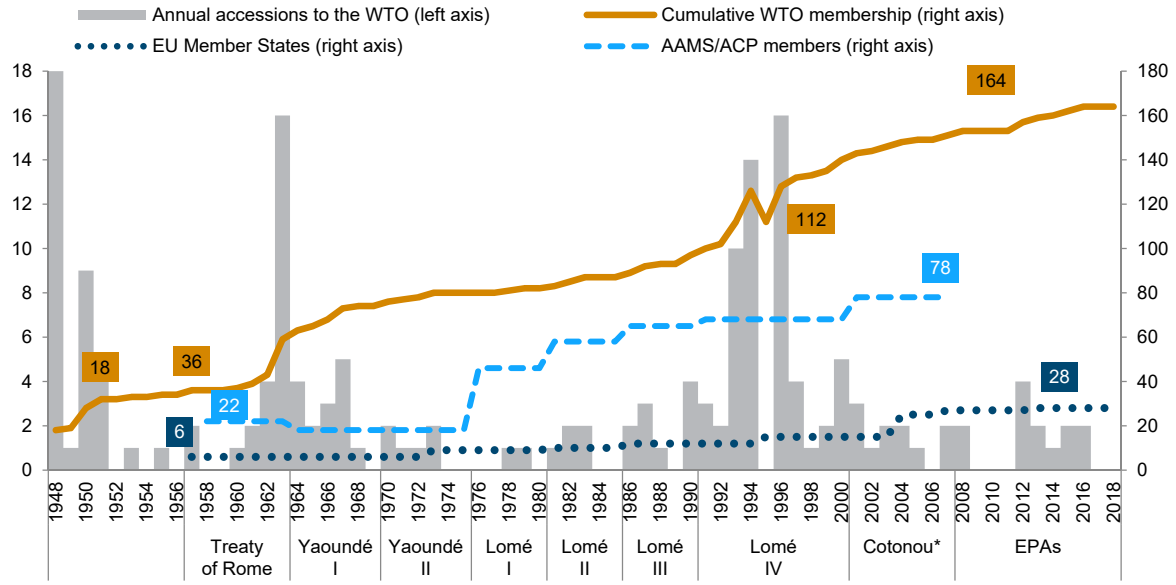
BY JULIA GRÜBLER

The world trading system based on rules laid out by the World Trade Organisation (WTO) is under acute threat by the United States blocking the reappointment of appeals judges and the standstill in the Doha Round negotiations. Reasons include the increasing number, heterogeneity and economic power of developing countries engaging in international trade and in multilateral trade negotiations. This article reviews the EU's trade relations with developing countries from the early steps until today.

THE EVOLUTION OF WTO MEMBERSHIPS OVER TIME

Though heterogeneity can be enriching in many aspects of private life as well as business operations, it generally has the drawback of slowing down decision-making processes. The EU[1] grew from six members in 1957 to 28 today. During the same time, the number of members of the General Agreement on Tariffs and Trade (GATT) , which became the World Trade Organisation (WTO) today, expanded from 36 to 164 members with a growing share of developing and emerging economies.

Figure 1 / Development of memberships to the EU, to the WTO and the AAMS/ACP group



Notes: * Only trade preferences under the Cotonou Agreement expired in 2007; AAMS/ACP = Associated African and Malagasy States/African, Caribbean and Pacific States; EPA = Economic Partnership Agreement.
Source: Author's visualisation.

[1] For simplicity, the European Community (since 1958), the European Communities (since 1967) and the European Union (since 1993) are referred to as EU.

Figure 1 is a timeline showing the growing number of members of the European Union and the GATT/WTO. In addition, it depicts the evolution of the number of African, Caribbean and Pacific (ACP) states with which the EU maintained a special trade relationship due to its colonial past, as well as the EU conventions and treaties regulating trade with ACP states from the Treaty of Rome to recently negotiated Economic Partnership Agreements (EPAs).

In the following pages, the characteristics of the EU trade relationship with developing economies and the EU's involvement in shaping the world trading order are discussed decade by decade.

THE 1950S: FIRST STEPS TOWARDS THE EU SHAPED BY FRANCE'S ASSOCIATIONISM

France's practices towards its *Etats et Territoires associés* and *Départements et Territoires d'outre-mer* were adopted by the European Union (Grilli, 1993). Part IV (Art. 131 to 136) of the Treaty of Rome[2] regulated the relationship between former and extant colonies, establishing a free trade area between the then six EU Member States[3] and 22 countries and territories, with the right for the latter to levy customs duties to protect infant industries and generate revenue in line with the needs of their development.

THE 1960S: DECOLONISATION RESULTING IN NEW COUNTRIES AND NEW FREE TRADE AGREEMENTS

At the time the Treaty of Rome was signed, there were only four independent states in Sub-Saharan Africa: Ethiopia, Ghana (Gold Coast), Liberia and Sudan. However, between 1958 and 1968 33 new states emerged, of which many were former colonies of EU Member States, dependent on the export of primary commodities and wishing to maintain preferential market access.

The EU reacted with the Yaoundé Convention (1971-1981), which marked the change from unilateral associationism towards developing countries to negotiated trade agreements. As the group of 18 independent Associated African and Malagasy States[4] (AAMS) opted out of trading freely among themselves, the free trade area established by the Treaty of Rome was split up into 18 separate free trade agreements (FTAs).

While the provisions in the Treaty of Rome and later the bilateral trade agreements economically supported associated countries and territories, the EU Common Agricultural Policy (CAP) has proven to be a protectionist tool hampering developing countries' exports. The CAP had already been discussed in the Treaty of Rome, but eventually became operational in 1962. Starting with olive oil in 1966, it quickly covered essentially all agricultural products of importance to the EU.

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2 EU founding treaties: https://eur-lex.europa.eu/collection/eu-law/treaties/treaties-founding.html

3 Belgium, France, Italy, Luxembourg, the Netherlands and Germany.

4 Burundi, Cameroon, Central African Republic, Chad, Congo Brazzaville (Republic of the Congo), Congo Leopoldville (Democratic Republic of the Congo), Dahomey (Benin), Gabon, Ivory Coast, Madagascar, Mali, Mauritania, Niger, Rwanda, Senegal, Somalia, Togo and Upper Volta (Burkina Faso).

These are two major aspects of EU policy giving relatively more favourable trade preferences to raw materials exporting associated states in comparison to food producing Latin American or Asian states.

THE 1970S: EXTENSION OF THE POST-COLONIAL NETWORK WITH THE ACCESSION OF THE UK TO THE EU

The growing discrepancy in trade preferences granted by industrialised economies to developing countries led the United Nations Conference on Trade and Development (UNCTAD) to call for a Generalised System of Preferences (GSP) in 1968. The first GSP scheme of the EU applied from 1971 to 1981 (UNCTAD, 2008) and was restricted to a range of manufactured goods, exempting agricultural goods regulated under the CAP as well as textiles and clothing regulated by the Multifibre Arrangement[5].

The year 1973 marked a drastic change in the EU's relations with developing countries – both in terms of depth of relations and geographical scope. The first oil crisis bluntly demonstrated the EU's dependence on imported energy from OPEC[6] countries. It shifted the EU's focus towards oil-exporting African states and accelerated progress in the establishment of a Mediterranean Policy.

In the same year, the EU was enlarged by three new members: Denmark, Ireland and most notably the United Kingdom (UK). With the UK joining the EU, the number of associated states to negotiate with rose to 46. These formed the group of the African, Caribbean and Pacific (ACP) alliance, which helped to incorporate favourable instruments for developing countries – such as the System for the Stabilisation of Export Earnings (STABEX) – in the Lomé Convention in 1975.

However, with nine out of then 48 least developed countries (LDC) listed by the United Nations (UN) not being covered by the Lomé Convention, it failed to reach out to the poorest regions in the world (Holland, 2002).

THE 1980S: REVIVAL OF THE RELATIONSHIP WITH LATIN AMERICA AFTER THE EU ACCESSION OF PORTUGAL AND SPAIN

The 'Lost Decade' of development was characterised by a commodity price collapse, followed by severe debt crises in developing countries and the emergence of Structural Adjustment Policies imposed by the Bretton Woods Institutions aiming at improving economic performance through assistance conditional on policy reform (Hulme, 2009). In retrospect, we know that the new paradigm did not deliver the desired economic growth and prosperity.

Due to the limited bargaining power of ACP countries, the Lomé II (1980-1985) and Lomé III (1985-1990) Conventions negotiated with the EU were not characterised by strong pro-development policies

[5] Regulations on trade in textiles and clothing aimed at allowing industrialised economies to adjust to a surge of imports from developing countries, particularly in Asia. Short-term arrangement regarding international trade in cotton textiles (1961), long-term arrangement regarding international trade in cotton textiles (1962, 1970), arrangement regarding international trade in textiles (1973), Multifiber Arrangement (1974-2004).

[6] Organisation of Petroleum Exporting Countries: Iraq, Iran, Kuwait, Saudi Arabia, Venezuela (1965), Qatar (1961), Indonesia (1962-2008), Libya (1962), United Arab Emirates (1967), Algeria (1969), Nigeria (1971), Ecuador (1973-1992, 2007), Gabon (1975-1995, 2016), Angola (2007), Equatorial Guinea (2017), Republic of the Congo (2018).

either. They were even criticised for focusing more on ensuring (mineral) supplies to the EU rather than on increasing welfare in developing regions.

More significant for Latin America was the accession of Spain and Portugal to the EU in 1986, resulting in sharply increasing trade and aid flows (Nello, 2009).

THE 1990S: NEW WAYS OF THINKING ABOUT DEVELOPMENT AND A SIMULTANEOUS SHIFT OF FOCUS TO THE EUROPEAN NEIGHBOURHOOD

In 1947, only 23 countries participated in multilateral negotiations to reduce tariffs. In contrast, the 8th and last successful negotiation round – the Uruguay Round or Development Round – lasted from 1986 to 1994, with 123 countries' interests being represented. Negotiations reached far beyond tariffs to non-tariff measures, trade in services, protection of intellectual property, dispute settlement as well as sensitive products such as textiles and agricultural goods (WTO, 2018). The Uruguay Round found itself several times close to breaking down on the question of agriculture but ultimately succeeded and resulted in the establishment of the WTO.

Trade liberalisation in the agricultural sector can to a great extent be attributed to the efforts of the Cairns group (founded in 1986), which accounted for more than a third of the world's agricultural exports and consequently mobilised against farming support in the US and the EU (Meunier and Nicolaïdis, 2011).

The EU's second GSP scheme should have applied from 1981 to 1991, but pending the outcome of the Uruguay Round, it was adapted multiple times and lasted until 1994. Crucial for the successful completion of the Uruguay Round was the EU's MacSharry reform of 1992, adapting the EU's CAP. The traditional CAP regulated minimum import prices, thereby leading to constantly varying tariffs and price uncertainty for foreign producers. This price floor was transformed to regular tariffs. In addition, payments for farmers were no longer bound to the level of production but to land, with the aim of reducing the EU's production surplus – well known as cereal, butter and beef mountains, which had previously been dumped on world markets with the help of export subsidies.[7]

The new GSP scheme additionally dropped quotas and tariff ceilings. It also introduced country-sector graduation, i.e. if the share of imports of a certain product from a beneficiary economy in total GSP imports of this product exceeded 25%, this beneficiary country lost its corresponding preferences (UNCTAD, 2008). Consequently, big emerging economies such as Brazil, China, India or Indonesia often opted out of the scheme (Gillson and Grimm, 2004).

The development-promoting initiatives during the Uruguay Round constitute only one part of a global break with traditional ways of thinking about development. The 1990s were characterised by a reactivation of UN summits and conferences, the first Human Development Report of the United Nations Development Programme was published (UNDP, 1990) and the UN, the International Monetary Fund (IMF), the World Bank and the OECD cooperated in formulating the Millennium Development Goals (MDGs).

[7] Agriculture also featured in the Lomé IV Convention (1990-2000) – emphasising food security and environmental sustainability.

The collapse of the Soviet Union, the instability in the Mediterranean region, the first Gulf War (1990-1991) and the start of the Yugoslav wars (1991), however, shifted the EU's attention to its immediate neighbourhood, in particular to transition economies of Central, East and Southeast Europe (CESEE). The drastic expansion of FTAs in the 1990s is often ascribed solely to the neoliberal agenda of the Bretton Woods Institutions. However, many agreements emerged 'naturally' as the EU tried to quickly regulate its economic relations with newly formed economies in the CESEE region.

THE 2000S: FROM MILLENNIUM TO SUSTAINABLE DEVELOPMENT GOALS

The EU's regional focus on the Eastern Neighbourhood culminated in the two enlargements by ten new members in 2004 and another two new members in 2007. Trade relations with non-European developing and emerging economies were either governed by the Cotonou Convention, the new GSP scheme or bilateral trade agreements.

As did the Lomé Conventions, the non-reciprocal provisions within the Cotonou framework violated WTO rules. The EU received a final five-year waiver to negotiate reciprocal Economic Partnership Agreements (EPAs) by 31 December 2007, meaning that ACP countries' unilaterally granted trade preferences expired. However, by 2008 only 15 Caribbean states (CARIFORUM) concluded an EPA with the EU.

Although the conclusion of EPAs would not exclude economies from preferences under the GSP scheme, the latter might reduce incentives to even negotiate reciprocal FTAs. This seems to be particularly true for the 'Everything but Arms' initiative, which was launched in the run-up to the Doha Round in 2001 and allows least developed countries as identified by the UN to export everything but arms and ammunition duty-free and quota-free to the EU common market.

In addition to the general GSP provisions and the 'Everything but Arms' initiative, the EU introduced the GSP Plus scheme, aiming at giving incentives for the protection of labour rights and the environment as well as for combating drug production and trafficking.

Furthermore, the CAP saw another reform. As 7% of the biggest farms accounted for 50% of the agricultural land while 50% of the smallest farms made up 7% of agricultural land within the EU, the Single Farm Payments (SFP) were introduced to further decouple payments for farmers from the level of production (EC, 1994). The increase in CAP spending (excluding spending on rural development) was also restricted to 1% per year in nominal terms from 2007 to 2013 (Nello, 2009).

While the CAP reform of 1992 helped to conclude the Uruguay Round successfully, the Fischler reform of 2003 could not convince negotiators of the Doha Development Round, which started in 2001. The Cancun meeting in 2003 failed upon disagreement over trade in cotton (Meunier and Nicolaïdis, 2011). The Doha Round was for the first time suspended in 2006 over US farm subsidies, EU market access for agricultural products and market access to big emerging economies. Negotiations resumed in 2007 but collapsed again in 2008.

TODAY: THE DWINDLING OF THE WORLD TRADING SYSTEM AND THE RE-EMERGENCE OF TRADE WARS

The standstill in multilateral negotiations accelerates the conclusion of bilateral, plurilateral and megaregional trade deals. By autumn 2018, 290 regional trade agreements were in place and notified to the WTO. In its 'Europe 2020' strategy, the European Commission highlights the importance of FTAs, which is also evident from the increasing number of ongoing FTA negotiations. As of today, there are more than 30 EU-FTAs in force with countries or regions outside of Europe. The most recent report on the implementation of EU trade agreements covers 35 of the economically most significant EU trade agreements with 62 trading partners, accounting for EUR 1,179 billion of trade in 2017 (EC, 2018).

Until recently, the United States was at the core of multilateral trade agreement negotiations. This has changed since 2017 with the new US administration under President Trump, which pulled out of the Trans-Pacific Partnership (TPP) and the negotiations on the Transatlantic Trade and Investment Partnership (TTIP) with the EU. It also boycotts the reappointment of appeals judges of the WTO. Recent attempts of the EU and other WTO members[8] (EC, 2018b) to rescue the appellate body by proposing a reform of the WTO have so far not been fruitful[9]. In combination with the harmful trade war between the US and China and the looming trade conflict between the US and the EU, the weakening of the multilateral trading system is bad news for the EU's small open economies and potentially devastating for its developing trading partners.

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[8] Australia, Canada, China, Iceland, India, Korea, Mexico, New Zealand, Norway, Singapore and Switzerland.

[9] See e.g. Reuters (12 December 2018): 'U.S. not swayed by WTO reform proposals', https://www.reuters.com/article/us-usa-trade-wto/u-s-not-swayed-by-wto-reform-proposals-idUSKBN1OB1XG

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Wanted: EU free trade agreements that fit the optimal degree of trade integration

BY ROMAN STÖLLINGER

Free trade is generally seen as an instrument to foster efficiency and growth and few would doubt that the European economic integration was and is a big success story. Therefore, the EU started negotiating numerous free trade agreements with extra-European partners, particularly in Asia, once it was clear that no further progress in the WTO arena would be achieved any time soon. Until recently, little attention was paid to the fact that the liberalisation drive would also entail 'pains from trade' which tend to grow with the heterogeneity of the involved partners. This article therefore argues in favour of 'an optimal degree' of trade liberalisation.

THE 'DIVINITY OF TRADE'

'Free trade is God's diplomacy', wrote the British statesman Richard Cobden in the middle of the 19th century. The belief that free trade is the ultimate tool to foster peace and prosperity implied in this statement seems to be very much alive in EU economic policy. This does not come as a surprise given the history of the EU which started mainly as an economic community with the Common Market (and later the Single Market) as one of the main building blocks.[1] No one would doubt that the European integration process was – and to some extent still is – a great success story.

Despite this[2], it is still legitimate to ask whether more trade is always better so that any dismantling of trade barriers is to be embraced – and this all the more as the EU's response to the deadlock in the multilateral trade negotiations at the World Trade Organisation (WTO) has been to intensify its bilateral trade negotiations. At the latest since 2006[3], the EU has spurred its free trade agreements (FTAs) negotiation ambitions, especially with overseas partners in Asia as evidenced by the recently concluded FTAs with South Korea, Singapore and Japan. Partly, this FTA zeal by the European Commission is also motivated by the desire to benefit from the rapid economic growth in Asia. The EU's FTA activity is, however, not limited to Asia. There is also a (provisionally) implemented FTA with Canada and there are ongoing negotiations with Australia and New Zealand as well as a number of other countries. On the other hand, in 2016 the negotiations on the Transatlantic Trade and Investment Partnership (TTIP)

1 The original intention of the founding fathers of the European integration project such as Robert Schuman was to secure peace between European countries by integrating their economies. However, in addition to the economic integration there were early plans to establish a political union too. The creation of the *European Political Community*, however, failed in 1954 after having been voted down by the French parliament.

2 Critics would argue that even the EU-internal integration process has not been fully successful. Despite the progress in terms of convergence, the core–periphery constellation within the EU is still fully in place and has potentially even been strengthened through the emergence of international production networks and the associated deep trade integration.

3 2006 may be relevant for the shift in trade policy as the move towards more bilateral efforts is enshrined in the EU's Global Europe Strategy of that year. Moreover, it was clear by that time that the progress brought about by the WTO Doha Round, if concluded at all, would be very limited.

between the EU and the US, so far the most ambitious and also largest of the new 'deep and comprehensive' FTAs of the EU, were put on ice. Due to the dynamic developments over the past one and a half decades, 40% of the extra-EU exports[4] go to countries with which the EU has an FTA in place. Another 40% go to countries with which an FTA is under negotiation, although this includes the US where no progress should be expected any time soon (Grübler and Stöllinger, 2018).

FREE TRADE, YES – BUT WITHIN BOUNDS

The fundamental motive for negotiating FTAs is the conviction that trade liberalisation promotes economic growth. There are numerous beneficial effects that can arise from intensified international trade. Free trade is expected to lead to efficiency gains (through specialisation and exploitation of economies of scale) and possibly greater product diversity and lower prices for consumers. This being the case, it seems obvious that the ultimate objective ought to be maximum trade liberalisation. By implication, FTAs should be as comprehensive as possible, which means slashing tariffs on all goods and services and eliminating all types of non-tariff barriers.

This logic, however, is based on the assumption that there are only gains from trade and no costs or 'pains from trade' whatsoever. Most economists meanwhile acknowledge (though much more rarely emphasise in their analysis) that FTAs entail structural adjustment costs, especially for import-competing industries and small, less productive firms and their workers. This applies to 'traditional' FTAs, which are primarily aimed at eliminating trade barriers 'at the border' (such as tariffs and import quotas), but especially to deep and comprehensive FTAs, very much *en vogue* and also currently sought after by the EU. Although industries rarely vanish altogether after trade liberalisation, they typically contract, forcing some firms out of the market. In fact, it is this kind of reallocations of resources – to more productive firms – that accounts for the efficiency gains (also called 'creative destruction'). While these efficiency gains will temporarily feed into economic growth, they also impose adjustment pressures on affected enterprises and workers. It is also worth mentioning that these adjustment costs are not necessarily temporary. According to the theory of the 'second best', in the case of existing market distortions (e.g. limited mobility on the labour market), measures that eliminate further market distortions (e.g. a tariff reduction) do not necessarily lead to an increase in welfare (Lipsey and Lancaster, 1956).

How high the adjustment costs are depends, among other things, on the design of related policies, such as education and active labour market policies (IMF/World Bank/WTO, 2017; European Commission, 2015; European Commission, 2017a). A concrete example would be the Trade Adjustment Assistance (TAA) Programme in the United States, which provides for compensation payments for employees who have lost their jobs as a result of internationalisation.

In any case, it is necessary that the costs arising from trade liberalisation are equally taken into account when assessing the effects of FTAs and trade liberalisation measures more generally. International organisations, including the Bretton Woods institutions (e.g. IMF/World Bank/WTO, 2017), and the EU seem to be aware of this today. For example, in its reflection paper on globalisation, the European Commission states that while 'the European economy, businesses and citizens continue to benefit

[4] In 2017 extra-EU exports accounted for about 35% of total exports by EU Member States which shows the significance of intra-EU trade.

immensely from globalisation, these benefits are not automatic nor are they evenly distributed among European regions and citizens' (European Commission, 2017a, p. 21).

NON-TARIFF MEASURES ARE INHERENTLY DIFFERENT FROM TARIFFS

Additional complications arise with deep and comprehensive FTAs, in particular through the harmonisation of standards and regulations, or even more so in the case of mutual recognition of standards. Sanitary and phytosanitary provisions as well as technical standards, all of which belong to the broad category of non-tariff measures (NTMs), are essential components of the modern EU FTAs. The dismantling, harmonisation and simplification of these regulations and standards often have a trade-promoting effect. Given that tariff rates between the EU and third countries are in many instances already very low, it is the elimination of NTMs that has the greatest potential for fostering additional trade.[5] It should be remembered, though, that harmonising standards and regulations, on the one hand, and eliminating tariffs, on the other, may have very different implications.

The expected effects of bilateral tariff reductions are relatively simple. If, for example, Japan lowers its tariffs on EU goods, these will become relatively cheaper. EU producers benefit from additional exports and Japanese consumers from lower prices (and vice versa).

The matter is much more complicated in the case of regulation. If, for example, product standards are simplified, trade costs decline so that imports and exports increase. However, product standards are not only – and typically not even primarily – trade barriers. Rather, they are also – and presumably even primarily – an instrument to protect against substances, products and technologies that are deemed to be harmful to human health or the environment. In case of an FTA-induced harmonisation of regulations, at least one of the involved partners is bound to adapt its existing regulations. This entails both opportunities and risks.

Positive effects can be expected, for example, if contracting parties commit themselves to international standards. For example, in the case of the Economic Partnership Agreement (EPA) between the EU and Japan, the international textile labelling system was agreed upon. This not only reduces information costs and administrative effort, but also avoids extra costs for different labels.

However, there may also be undesirable side effects arising from the harmonisation of NTMs. One example is the rising cost of information for consumers. Coming back to the issue of labelling, consider the labelling requirements for allergens in foodstuffs. In the United States eight products or product groups have to be labelled as allergens, whereas in the EU there are 14. Japan, on the other hand, has seven food allergens requiring labelling and 20 others for which labelling is recommended. Which of these provisions is more advantageous? Obviously, this depends primarily on the preferences of citizens (in addition to scientific evidence on the health effects of the food in question). This is just one example to illustrate that differences in the preferences of the citizens make far-reaching harmonisation of regulations problematic.

[5] The studies on the implications of the EU-Japan FTA by Felbermayr et al. (2017) and Grübler et al. (2018) both come to the conclusion that a pure tariff reduction agreement could even result in negative welfare effects for Japan, while scenarios that include harmonisation of NTMs result in positive effects for both the EU and Japan.

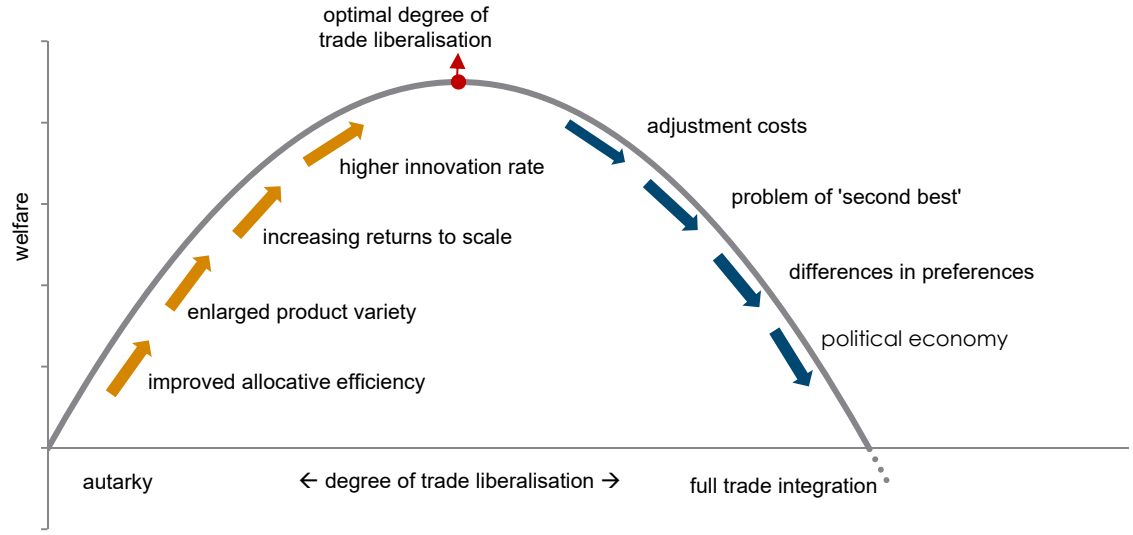
WHO HAS A SAY IN DRAFTING THE RULES?

A final point touches upon a political economy aspect in the trade negotiation process, which is the involvement of relevant stakeholders. There is an actual or perceived imbalance in the consideration of the interests of different parties in EU FTAs. In this context, non-governmental organisations (NGOs) often suspect that trade negotiators (such as the European Commission) mainly represent the interests of industry or multinational corporations. For instance, in the case of TTIP (which is currently on ice), 528 of the 597 documented meetings between the European Commission and lobbyists that took place in the period from January 2012 to February 2014 were with company representatives.[6] On the other hand, trade unions and NGOs were given 53 opportunities to voice their interests in direct consultations with the Commission. Even though these figures do not provide hard evidence that the interests of industry generally prevail in FTA negotiations, they still point to the possibility of a political economy problem.

THE OPTIMAL DEGREE OF TRADE LIBERALISATION

The above considerations seriously question the view that all FTAs should strive for the utmost trade liberalisation achievable. Rather, the idea of maximum trade liberalisation should be replaced by the concept of an optimal degree of trade liberalisation. This concept is shown schematically in Figure 1.

Figure 1 / Concept of the optimal degree of trade integration



Source: Own representation.

The degree of trade liberalisation between the partners involved is depicted on the horizontal axis, starting from complete isolation, i.e. an autarky situation, up to complete economic integration (which means the elimination of trade barriers but also the harmonisation of legislation). Figure 1 is intended to illustrate that opening to trade, by way of efficiency gains, the exploitation of economies of scale and increasing product diversity, is usually improving welfare (shown on the vertical axis). However, this logic applies only up to the point of the optimal degree of trade liberalisation. Beyond this point, the gains from

[6] See: 'TTIP deal: Business lobbyists dominate talks at expense of trade unions and NGOs', *The Independent*, 27 August 2015.

trade are increasingly dominated by the negative effects, such as structural adjustment costs and second-best problems. In the case of deep trade integration the harmonisation of regulations and standards and the issue of differences in preferences also pop up.

Note that even beyond the optimal degree of trade liberalisation, welfare will be typically higher than in autarky. While a lower welfare level than that in autarky is theoretically possible, it is rather unlikely due to the high positive effects in the initial phase of trade liberalisation. This is all the more true in a European context.

Hence, the concept of the optimal degree of trade liberalisation is fully compatible with a situation where an FTA increases welfare, even when the agreement goes beyond the optimal degree. However, it also means that, if better and more modestly designed, the welfare gains associated with the FTA would have been even greater. It should have become clear by now that this concept does not argue for a protectionist stance on trade, rather it aims at a rebalancing of the gains and pains from trade.In some sense, the idea of the optimal degree of trade liberalisation is related to Dani Rodrik's 'trilemma' of globalisation (Rodrik, 2000), according to which it is not possible to simultaneously achieve the three goals of a fully integrated global economy, the maintenance of the nation-state and democracy. Instead, only two of these goals can be achieved at any time. For example, an integrated world economy requires the dismantling of all trade barriers and the harmonisation of all relevant regulations. In addition, compliance with these rules must be monitored, and non-compliance sanctioned, by global institutions. These institutions may well be democratic, but ultimately they render the nation-state superfluous. Assuming that differences in preferences across countries remain, this consideration suggests that the world has moved beyond the optimal degree of trade liberalisation shown in Figure 1.

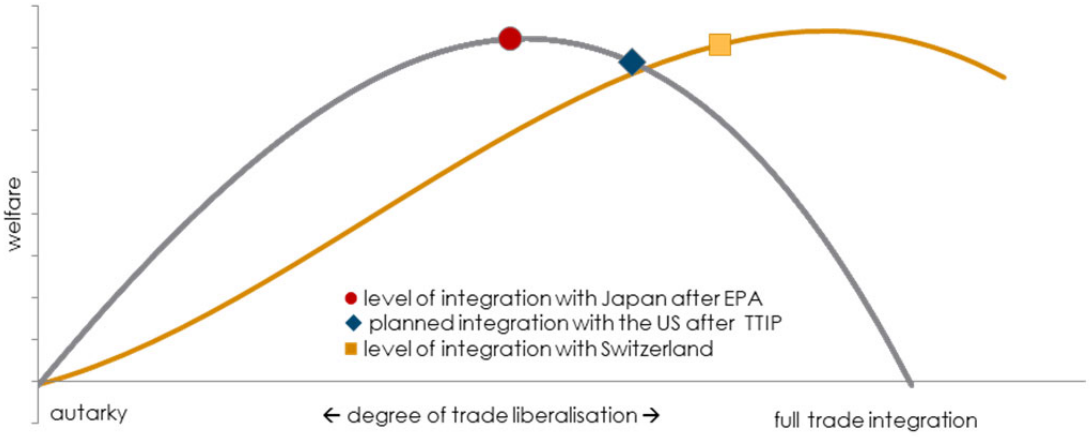
ONE SIZE DOES NOT FIT ALL: WELFARE EFFECTS FROM TRADE DIFFER ACROSS TRADING PARTNERS

Importantly, the optimal degree of trade liberalisation varies from partner to partner. Therefore, the content and scope of EU FTAs should vary depending on the partner, if the objective is to maximise the increases in welfare. For example, due to the geographical proximity (fewer distortions due to differences in taxation of different modes of transport) and cultural proximity (fewer differences in preferences) between the EU and Switzerland, it can be assumed that the optimal degree of integration between them is rather close to full economic integration. Presumably, the optimal point for EU-Switzerland trade integration lies beyond the optimal degree of integration for EU-US trade relations.

This is illustrated in Figure 2, where the optimal degree of integration in EU trade relations with Switzerland is located further to the right than is the case with the US. Figure 2 also suggests that the (now stalled) TTIP agreement between the EU and the US probably went too far in its liberalisation efforts. This assessment is based on *(i)* the far-reaching harmonisation of regulations based on the principle of mutual recognition of national standards (propagated mainly by the USA); *(ii)* comprehensive liberalisation of investments and services sector across almost all (including future!) economic sectors through the establishment of negative lists, and *(iii)* the complex of investor protection (including Investor-State Dispute Settlement Mechanism, ISDS).

The location of the EU-Japan EPA, which is modelled on the EU-South Korea FTA rather than TTIP or CETA (EU agreement with Canada), is also illustrated in Figure 2. Hence, the most contentious issues related to TTIP and CETA have been removed from the EPA with Japan. This is particularly true for large parts of the investment rules. The modified investor protection rules, which are now organised as an Investment Court System (ICS), are not part of the EU-Japan EPA that is scheduled to enter into force in February 2019.[7] The greatest advantages of the ICS over its predecessor are the clear commitment to states' right to regulate and improved transparency (Chowdhry et al., 2018; European Commission, 2017b). Thus, it is probably fair to say that the EU-Japan EPA was drafted in a way that brings the two economies (close) to the optimal degree of trade liberalisation.

Figure 2 / The optimal degree of trade integration between the EU and selected trading partners



Source: Own representation.

CONCLUDING REMARKS

The EU's determined move towards deeper trade integration via comprehensive FTAs results, on the one hand, in additional gains from free trade. On the other hand, it entails the danger of overloading FTAs with too many issues. For agreements with geographically and culturally (and therefore regulatory) distant countries in particular, it would therefore be advisable to return to the very core of trade agreements, i.e. the elimination of customs duties and other trade barriers. This does not mean that all 'WTO Plus' issues should be left out of FTAs. However, with regard to the dismantling of NTMs, it should be borne in mind that these are not merely trade barriers but have a high protective and informational value for consumers, workers and the environment. This makes NTMs very distinct from tariffs.

In this respect, the EU Commission seems to have learned from the experience of the most controversial FTA projects to date – TTIP and CETA. It has removed some particularly controversial liberalisation measures from its FTA blueprint. It is therefore a very reassuring sign that the FTAs currently negotiated with Australia and New Zealand as well as the (already signed) agreement with Japan resemble much more the EU-South Korea FTA than TTIP or CETA. Hence, if – as this article has argued – maximum liberalisation does not necessarily correspond to the optimal degree of trade

[7] Negotiations on the details of the investment protection rules will continue between the EU and Japan separately.

liberalisation, it is quite plausible that the current FTAs have again moved closer to an optimal degree of liberalisation for European citizens.

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Conventional signs and abbreviations used

%	per cent
ER	exchange rate
GDP	Gross Domestic Product
HICP	Harmonized Index of Consumer Prices (for new EU Member States)
LFS	Labour Force Survey
NPISHs	Non-profit institutions serving households
p.a.	per annum
PPI	Producer Price Index
reg.	registered

The following national currencies are used:

ALL	Albanian lek	HUF	Hungarian forint	RSD	Serbian dinar
BAM	Bosnian convertible mark	KZT	Kazakh tenge	RUB	Russian rouble
BGN	Bulgarian lev	MKD	Macedonian denar	TRY	Turkish lira
CZK	Czech koruna	PLN	Polish zloty	UAH	Ukrainian hryvnia
HRK	Croatian kuna	RON	Romanian leu		

EUR euro – national currency for Montenegro and for the euro-area countries Estonia (from January 2011, euro-fixed before), Latvia (from January 2014, euro-fixed before), Lithuania (from January 2015, euro-fixed before), Slovakia (from January 2009, euro-fixed before) and Slovenia (from January 2007, euro-fixed before).

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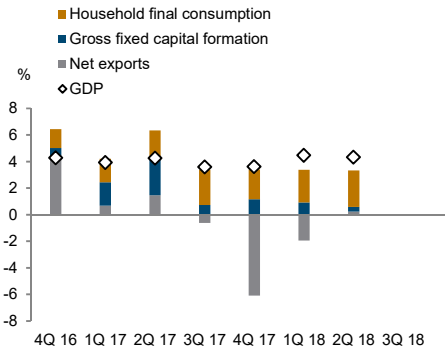
Albania

Real GDP growth and contributions
year-on-year



Real sector development
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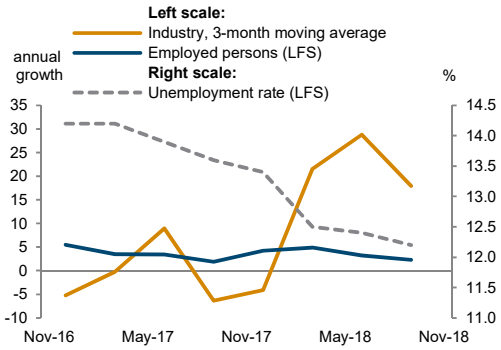
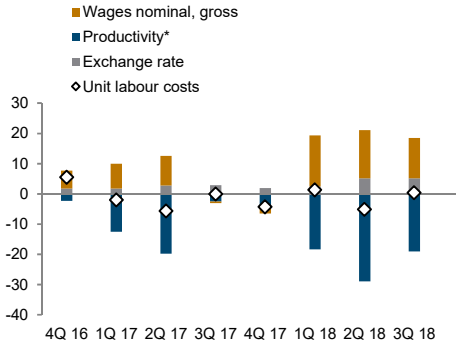


Unit labour costs in industry
annual growth rate in %



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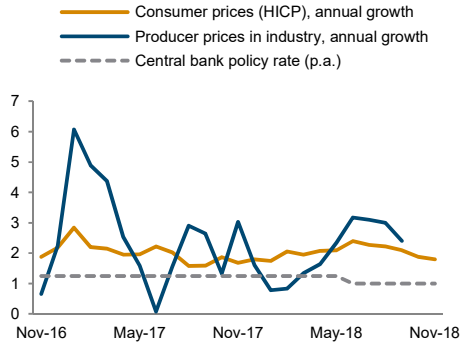

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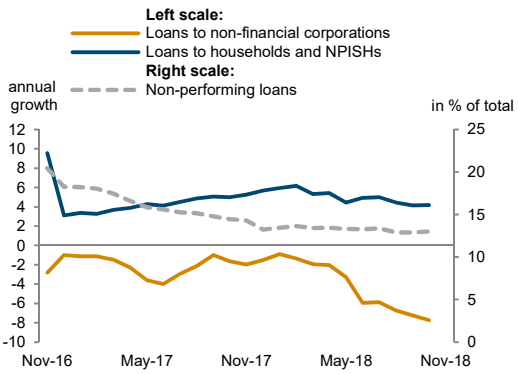

External sector development
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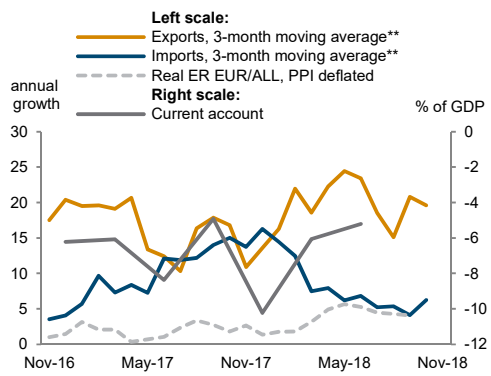

*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.
**EUR based.

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Bosnia and Herzegovina

Real GDP growth and contributions
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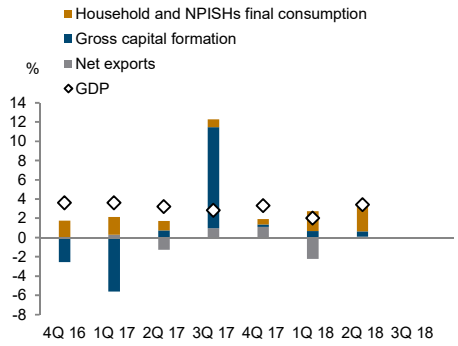

Real sector development
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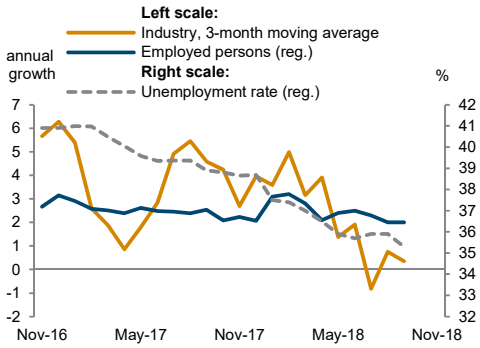
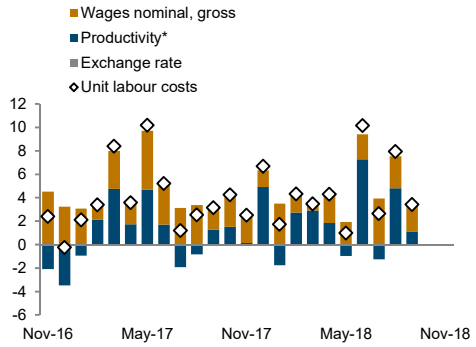
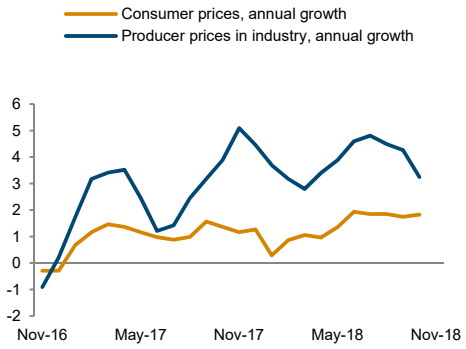


Unit labour costs in industry
annual growth rate in %



Inflation
in %



Financial indicators
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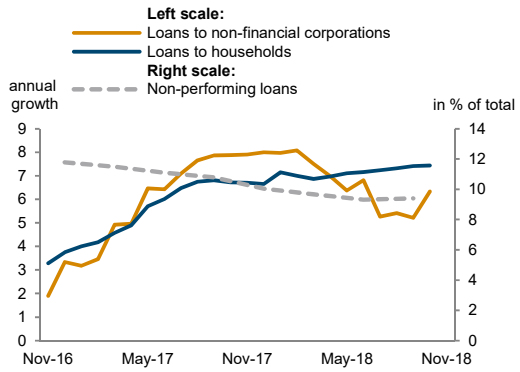
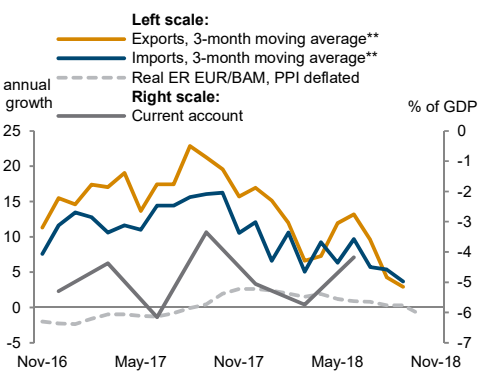


External sector development
in %



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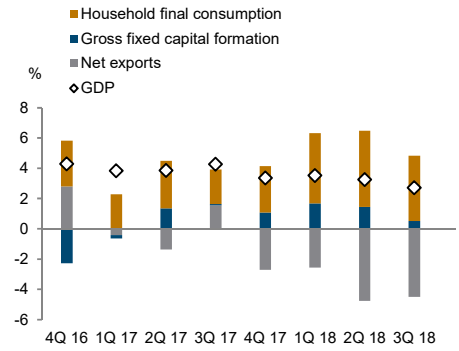
Bulgaria

Real GDP growth and contributions
year-on-year



Real sector development
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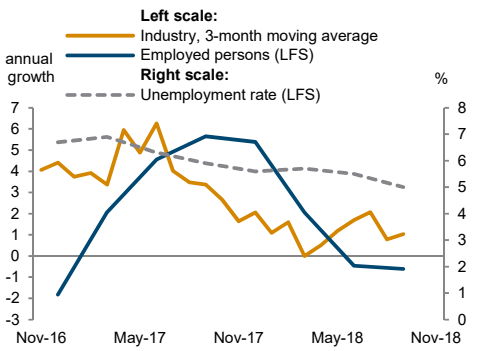
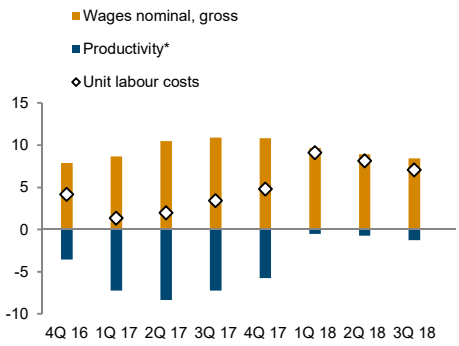


Unit labour costs in industry
annual growth rate in %



Inflation and policy rate
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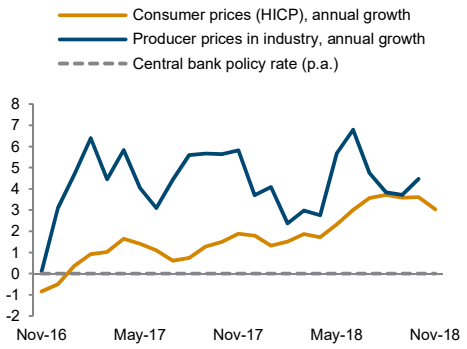

Financial indicators
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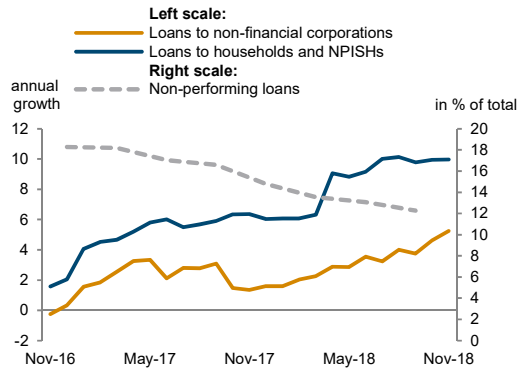

External sector development
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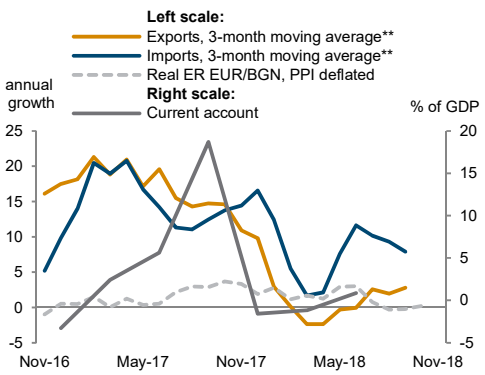

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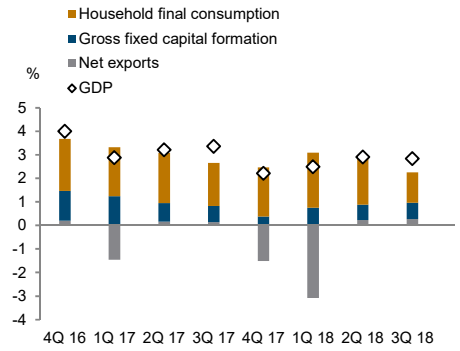
Croatia

Real GDP growth and contributions
year-on-year



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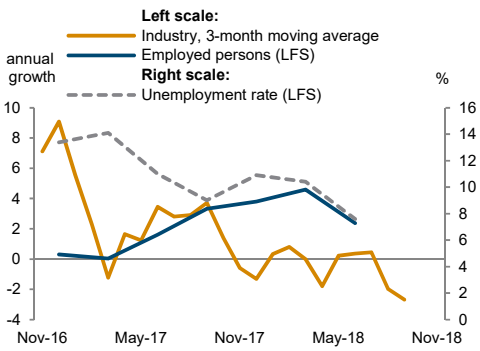

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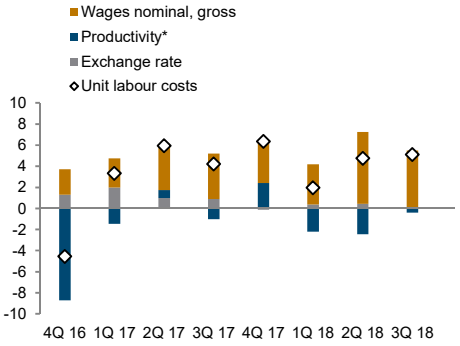
annual growth rate in %



Inflation and policy rate
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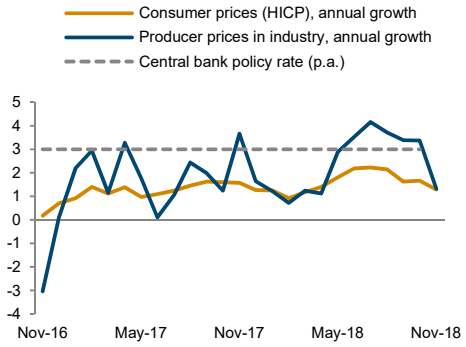
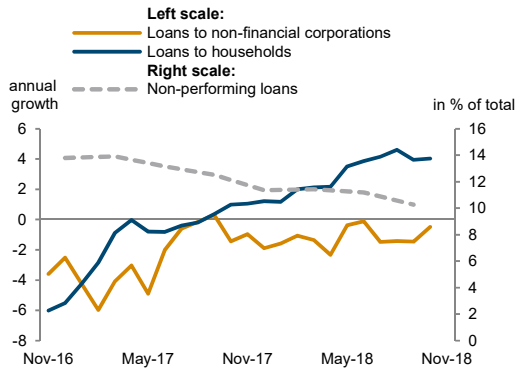
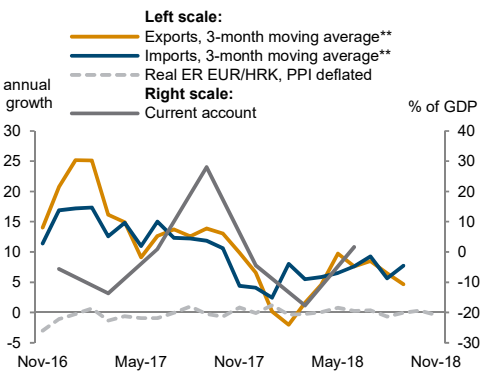


Financial indicators
in %



External sector development
in %



*Positive values of the productivity component on the graph reflect decline in productivity and vice versa.
**EUR based.

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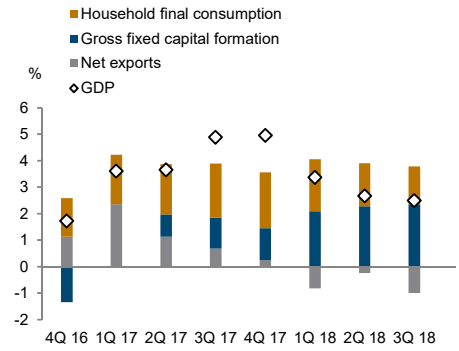
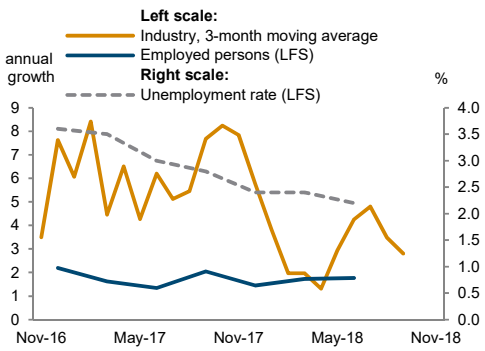
Czech Republic

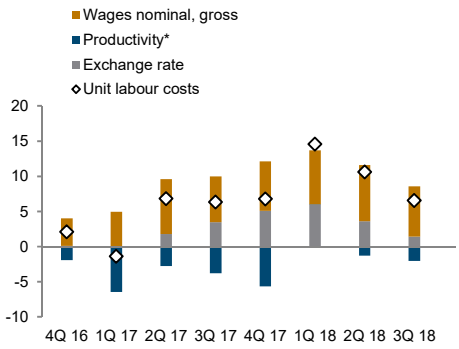
Real GDP growth and contributions
year-on-year



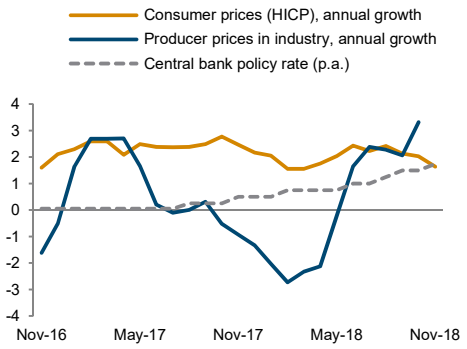
Real sector development
in %



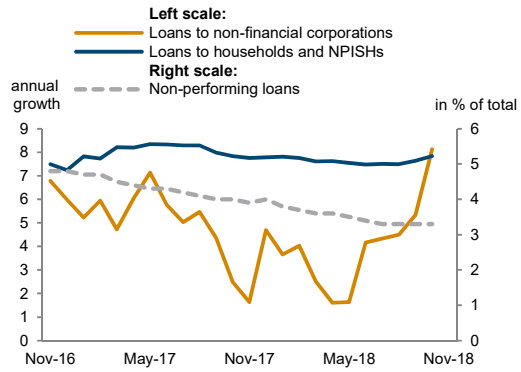
Unit labour costs in industry
annual growth rate in %



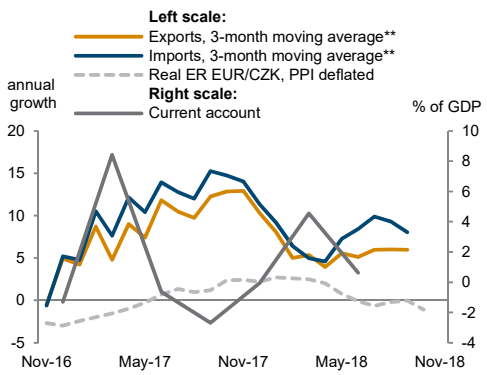
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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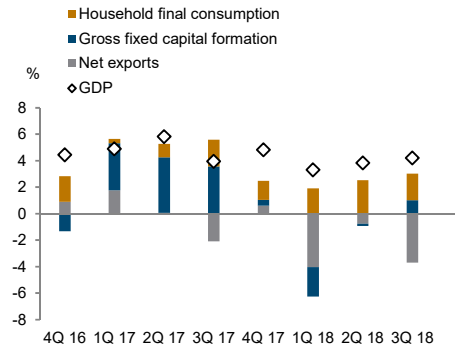
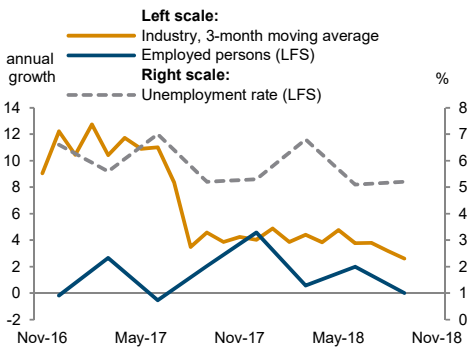
Estonia

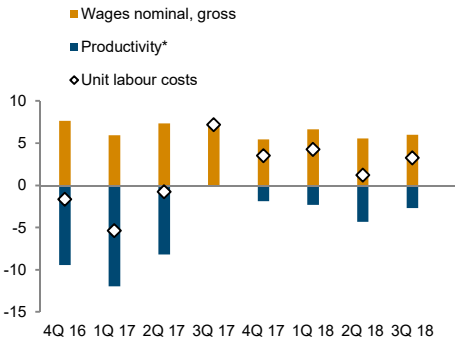
Real GDP growth and contributions
year-on-year



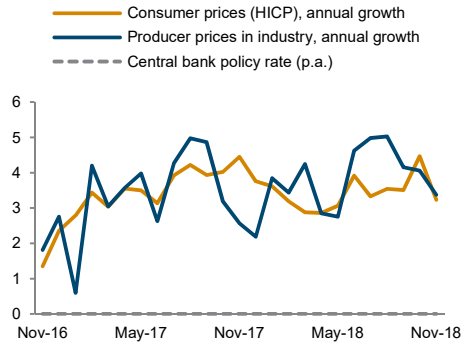
Real sector development
in %



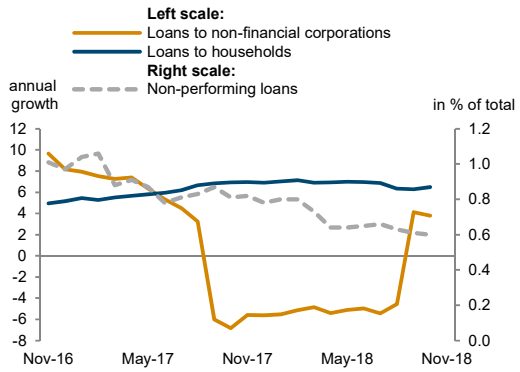
Unit labour costs in industry
annual growth rate in %



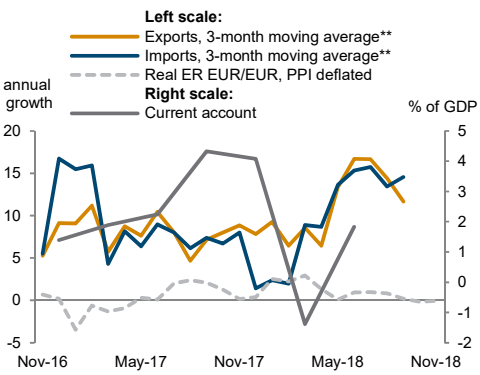
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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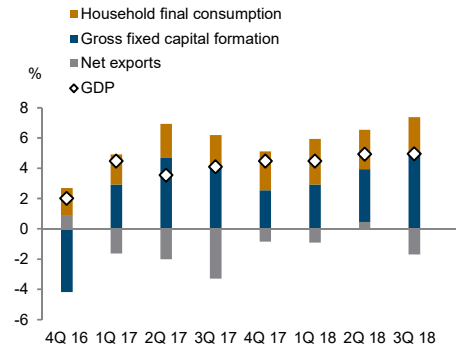
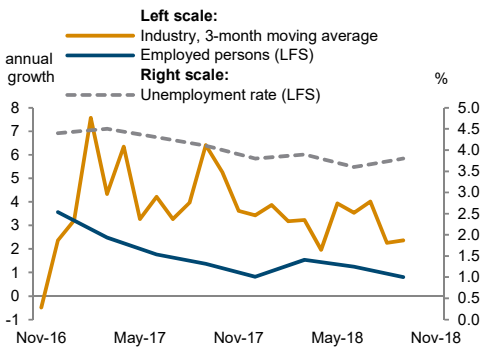
Hungary

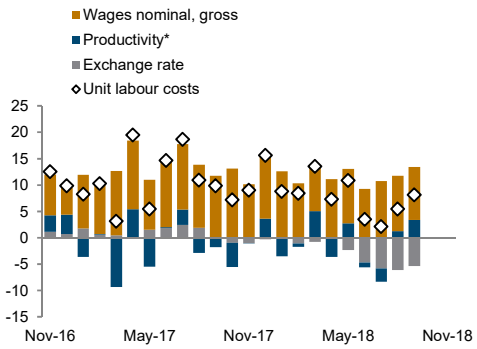
Real GDP growth and contributions
year-on-year



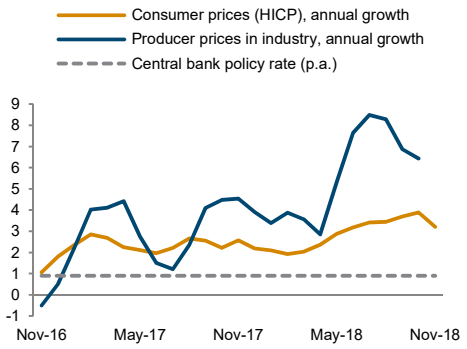
Real sector development
in %



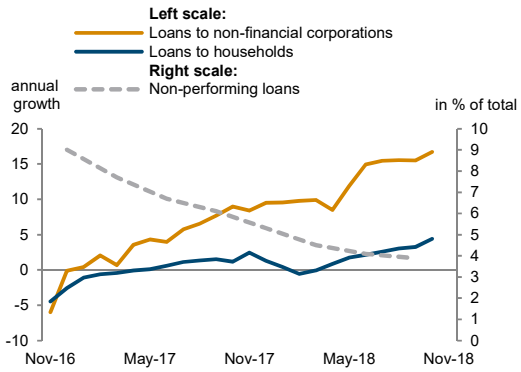
Unit labour costs in industry
annual growth rate in %



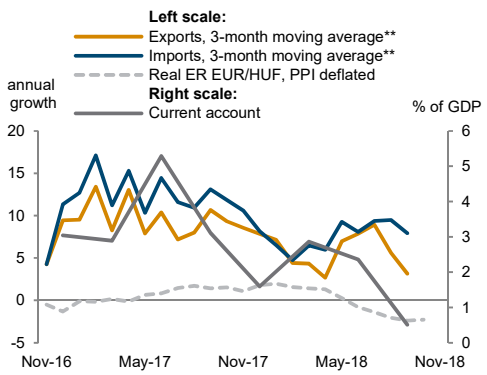
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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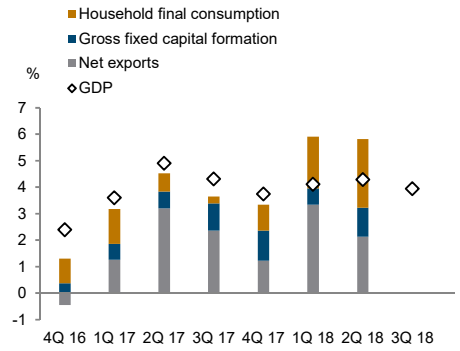
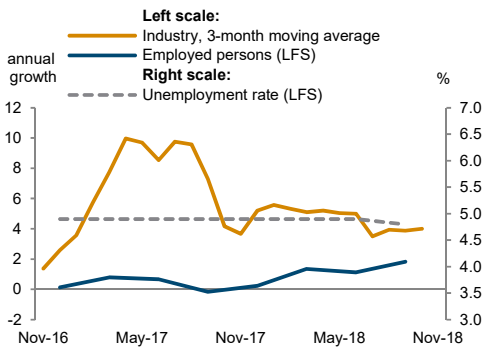
Kazakhstan

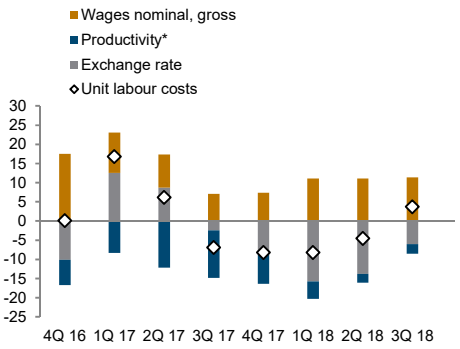
Real GDP growth and contributions
year-on-year



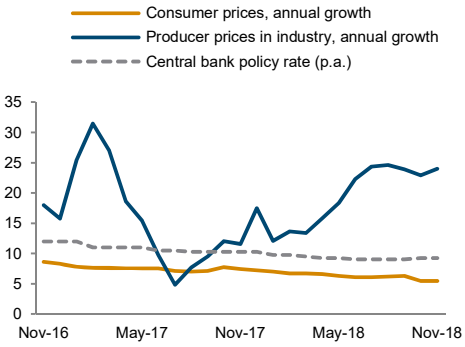
Real sector development
in %



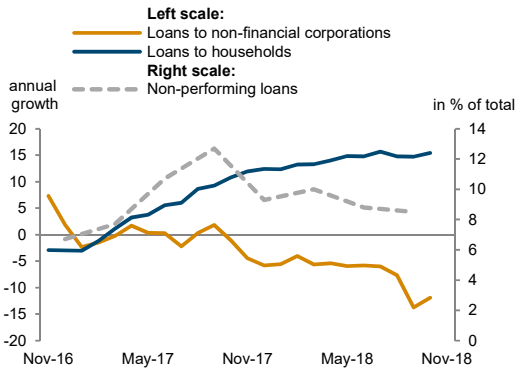
Unit labour costs in industry
annual growth rate in %



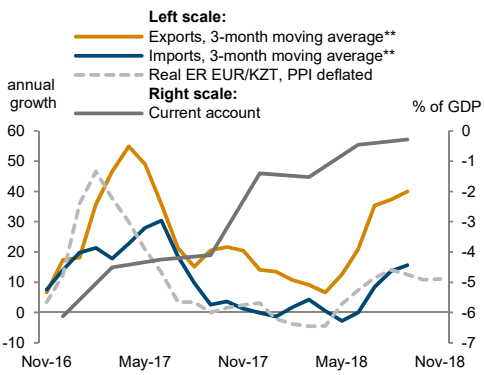
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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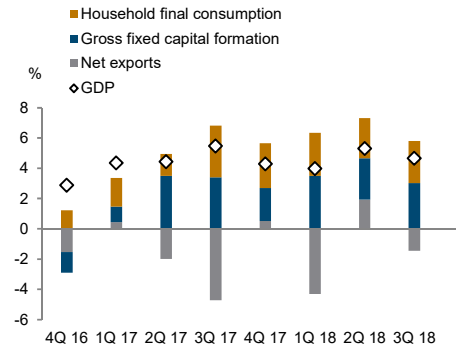
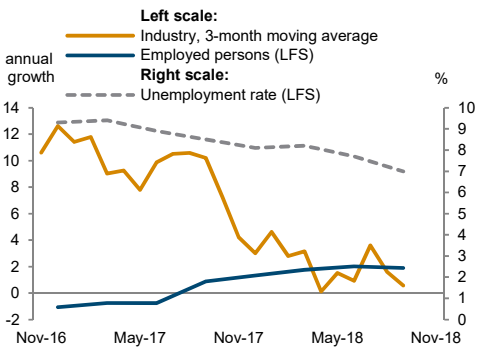
Latvia

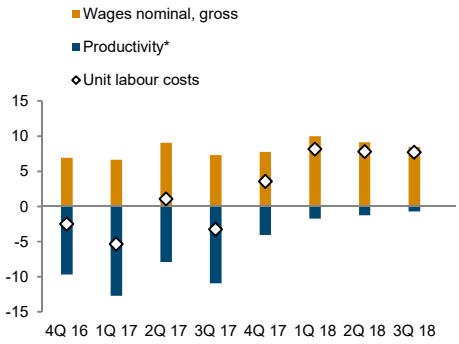
Real GDP growth and contributions
year-on-year



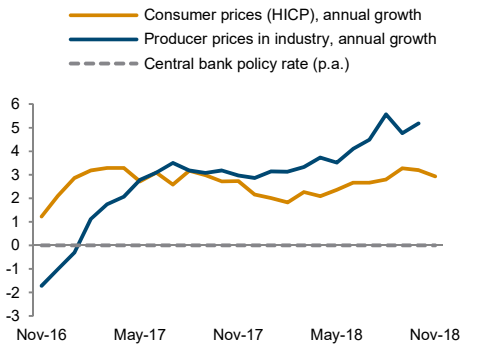
Real sector development
in %



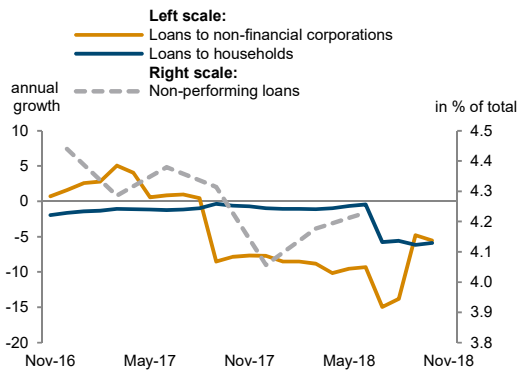
Unit labour costs in industry
annual growth rate in %



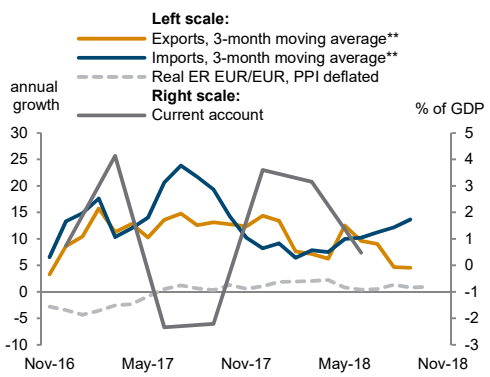
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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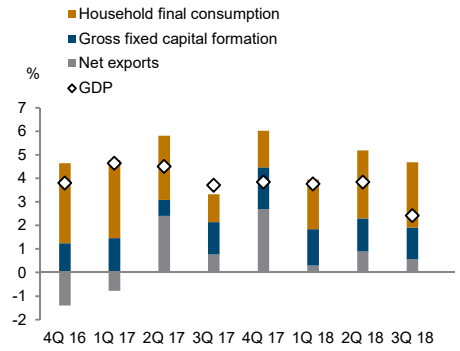
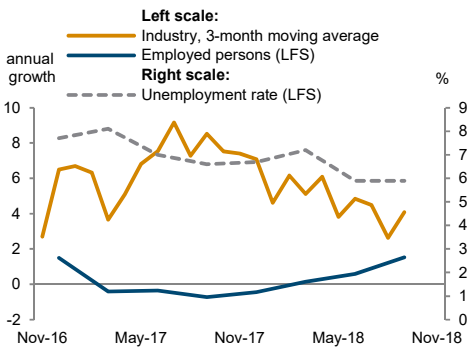
Lithuania

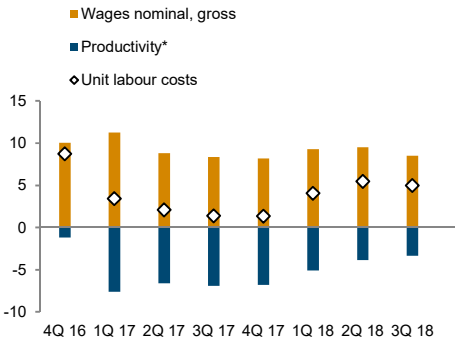
Real GDP growth and contributions
year-on-year



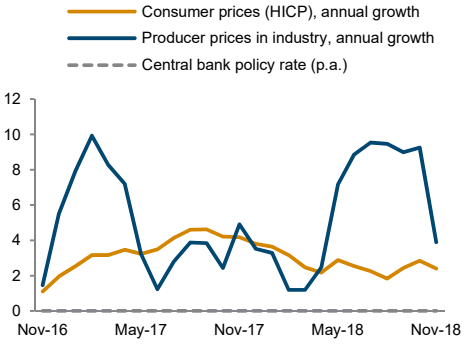
Real sector development
in %



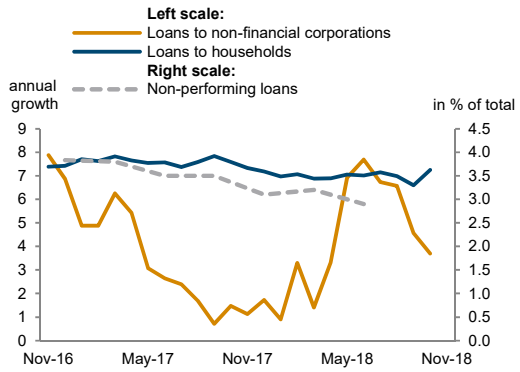
Unit labour costs in industry
annual growth rate in %



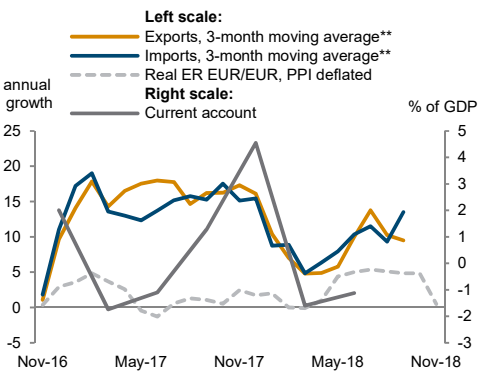
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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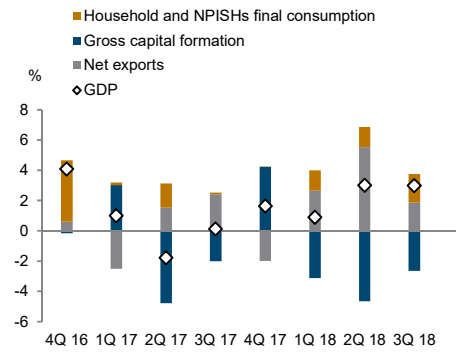
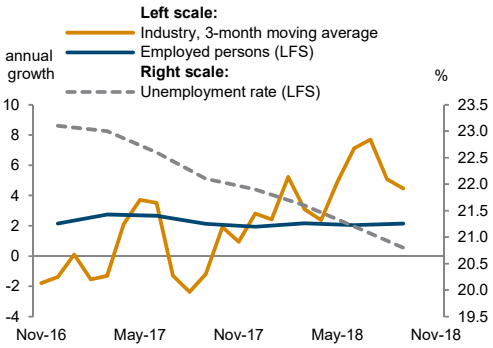
Macedonia

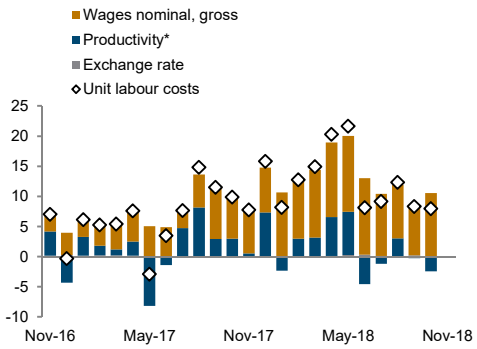
Real GDP growth and contributions
year-on-year



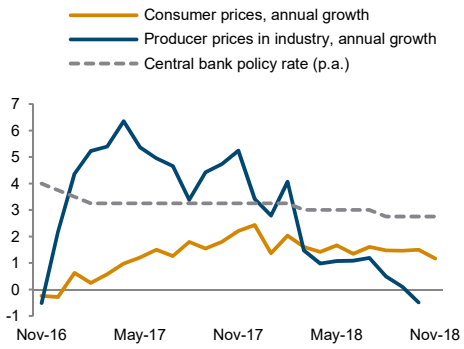
Real sector development
in %



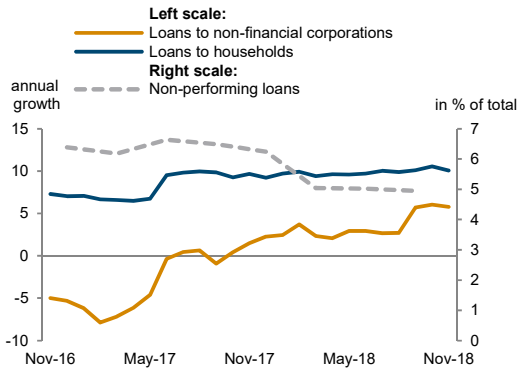
Unit labour costs in industry
annual growth rate in %



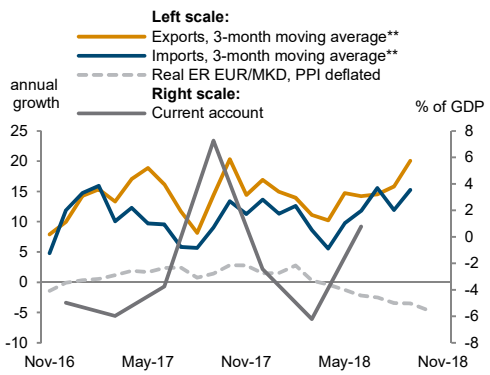
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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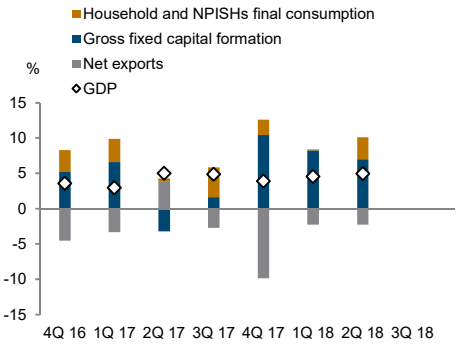
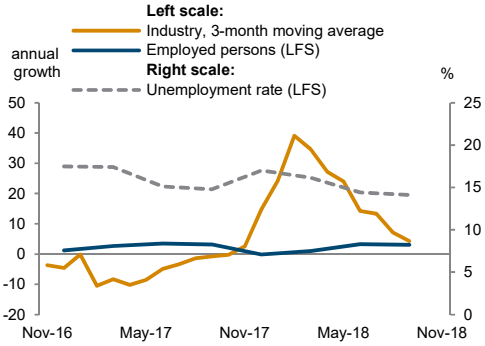
Montenegro

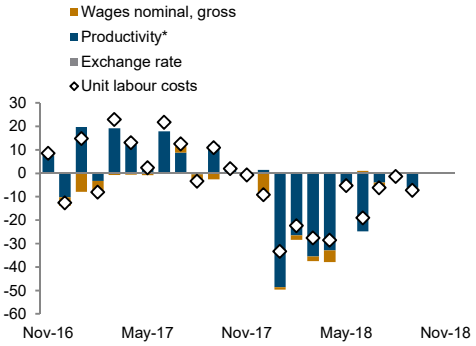
Real GDP growth and contributions
year-on-year



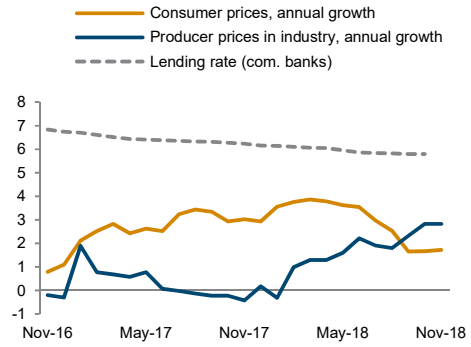
Real sector development
in %



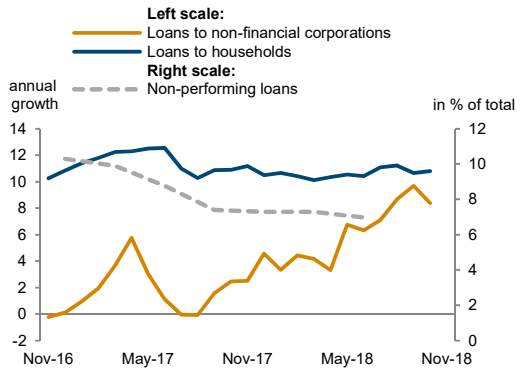
Unit labour costs in industry
annual growth rate in %



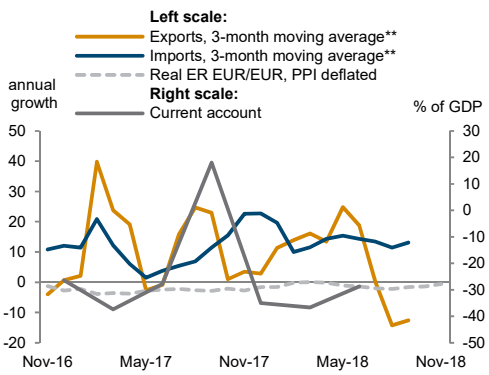
Inflation and lending rate
in %



Financial indicators
in %



External sector development
in %



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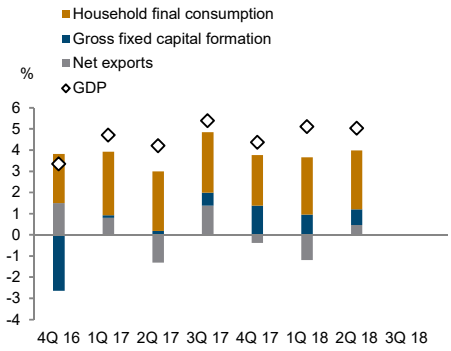
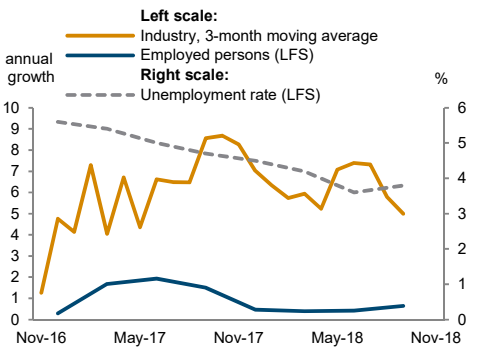
Poland

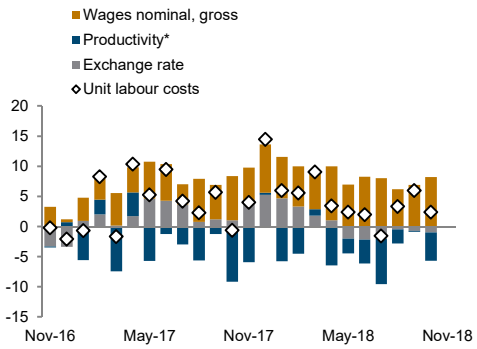
Real GDP growth and contributions
year-on-year



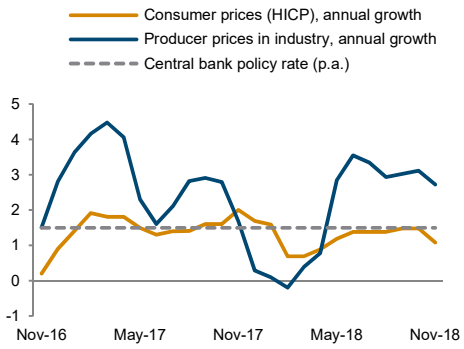
Real sector development
in %



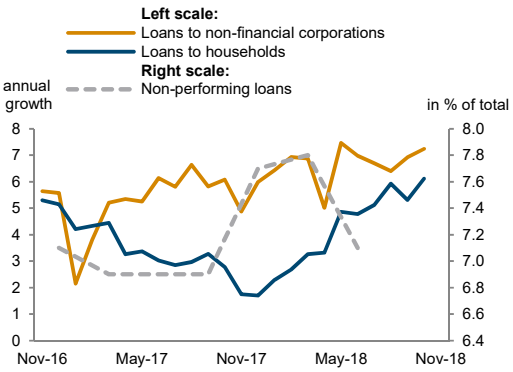
Unit labour costs in industry
annual growth rate in %



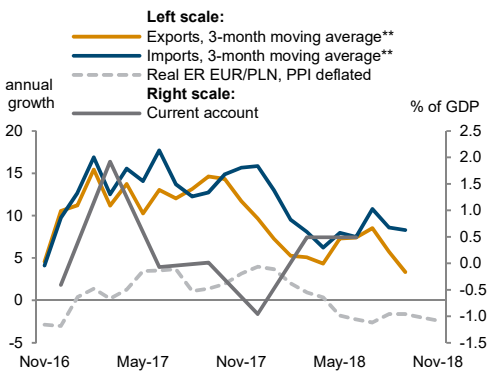
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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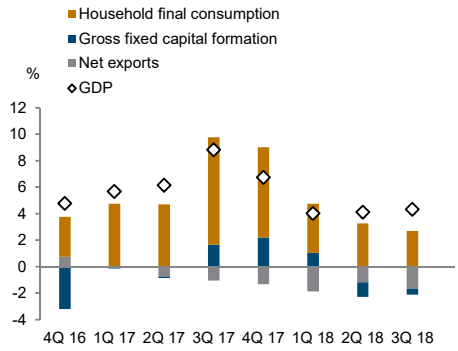
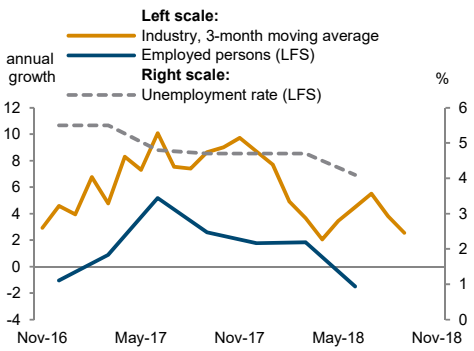
Romania

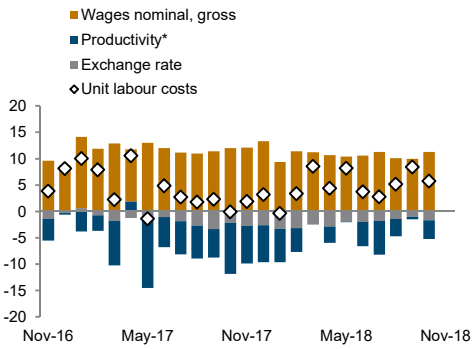
Real GDP growth and contributions
year-on-year



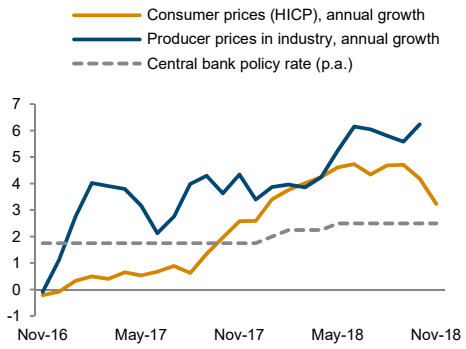
Real sector development
in %



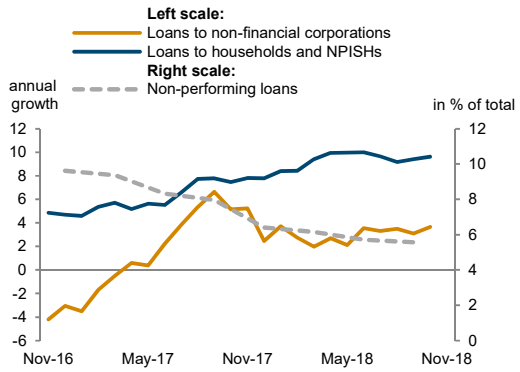
Unit labour costs in industry
annual growth rate in %



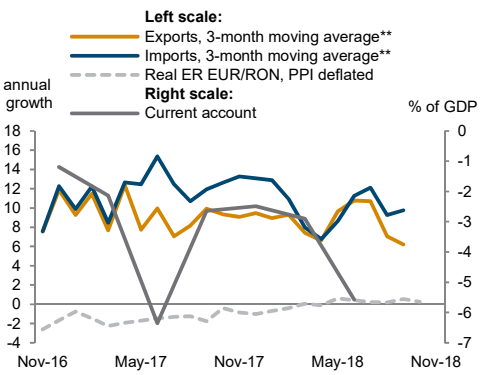
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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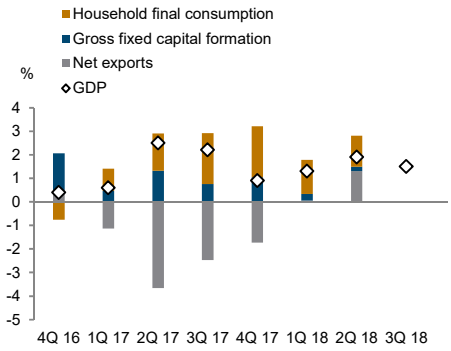
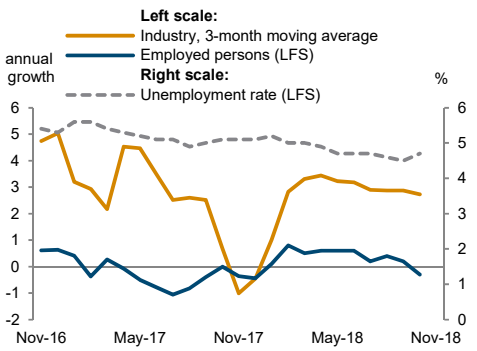
Russia

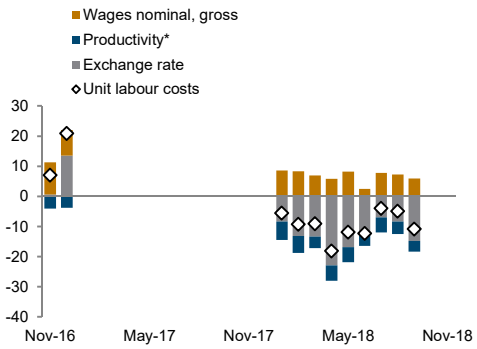
Real GDP growth and contributions
year-on-year



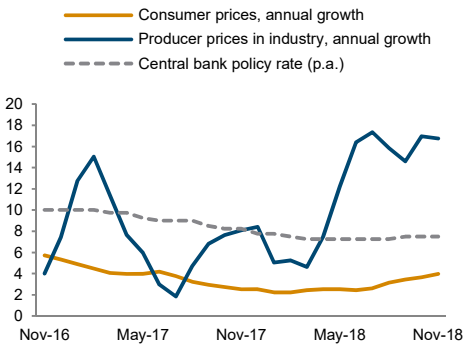
Real sector development
in %



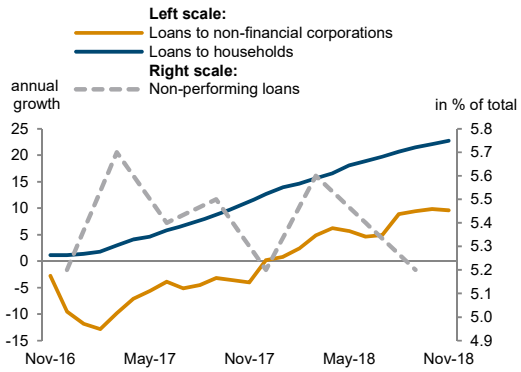
Unit labour costs in industry
annual growth rate in %



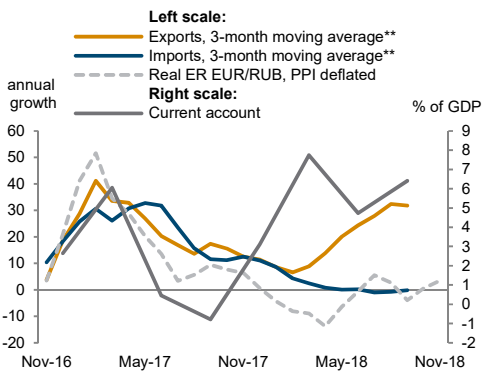
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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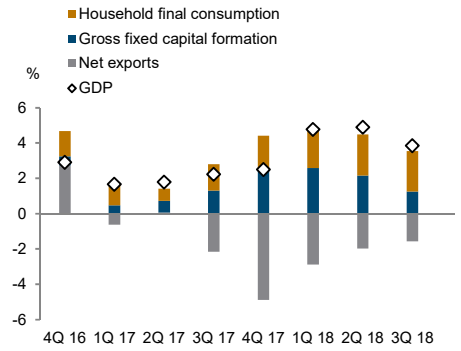
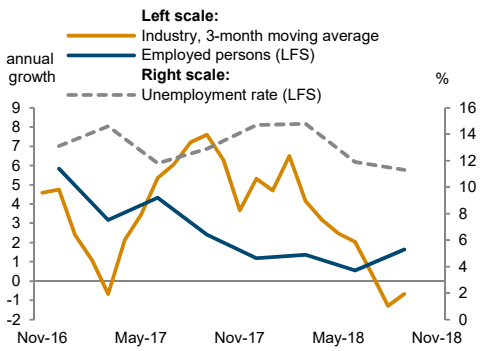
Serbia

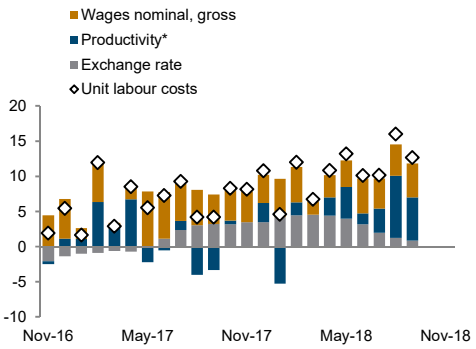
Real GDP growth and contributions
year-on-year



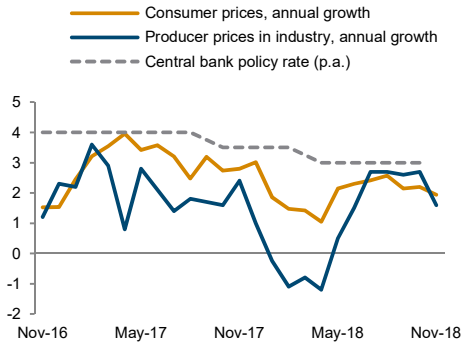
Real sector development
in %



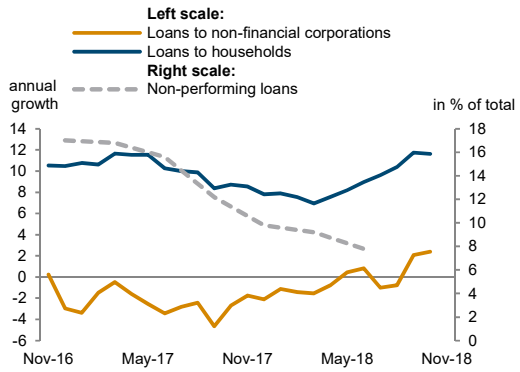
Unit labour costs in industry
annual growth rate in %



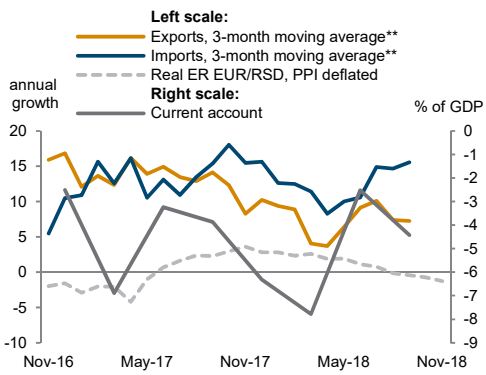
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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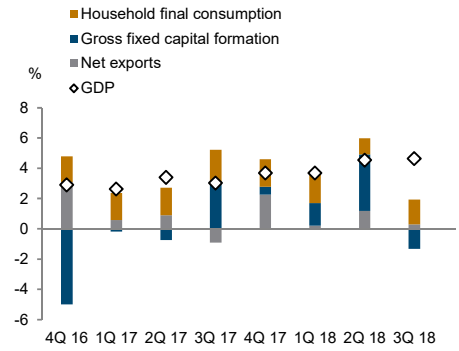
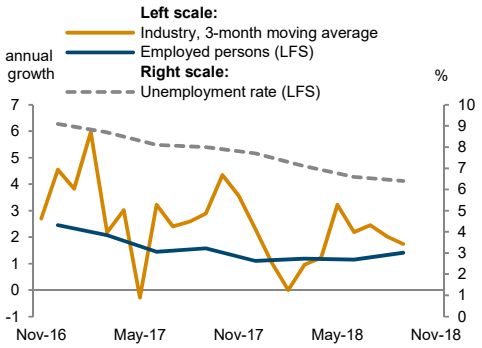
Slovakia

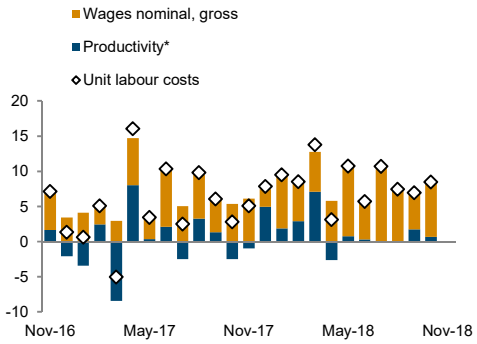
Real GDP growth and contributions
year-on-year



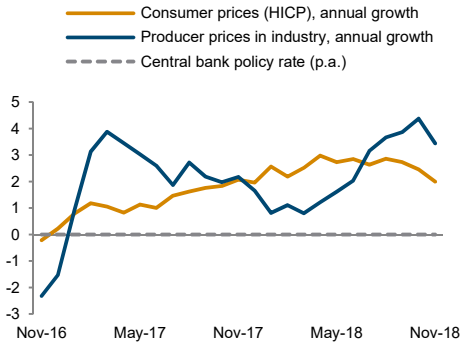
Real sector development
in %



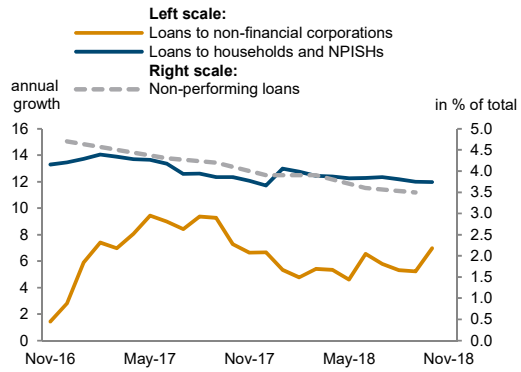
Unit labour costs in industry
annual growth rate in %



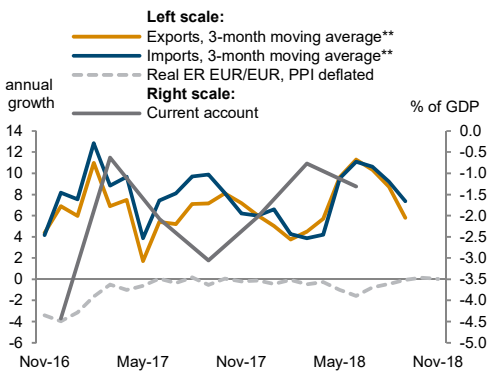
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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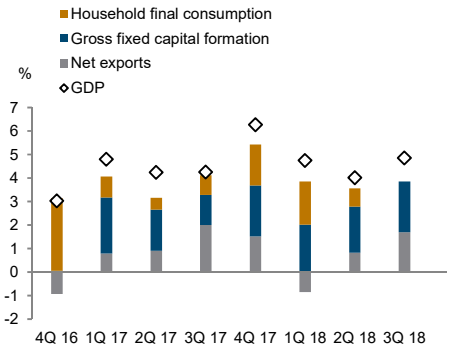
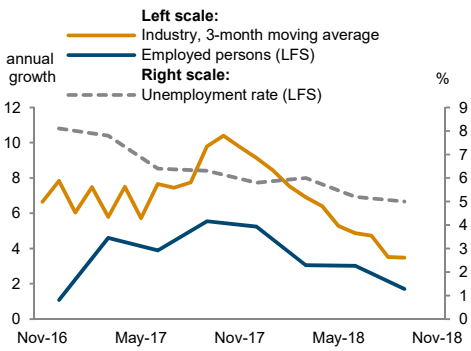
Slovenia

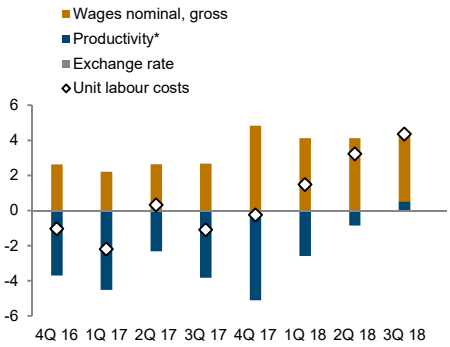
Real GDP growth and contributions
year-on-year



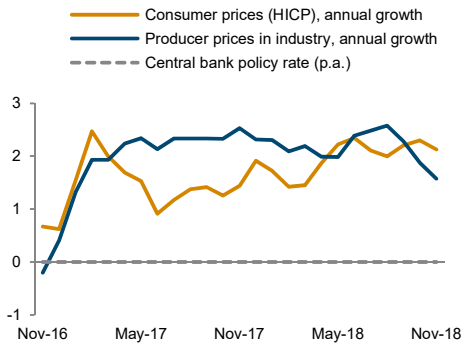
Real sector development
in %



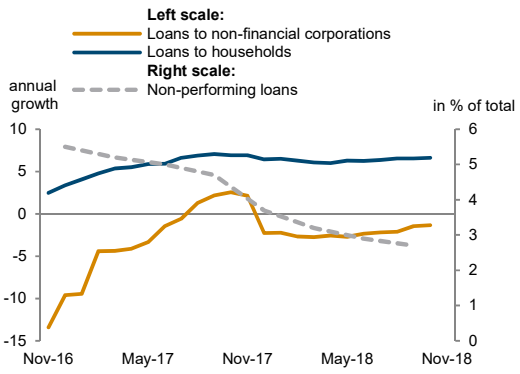
Unit labour costs in industry
annual growth rate in %



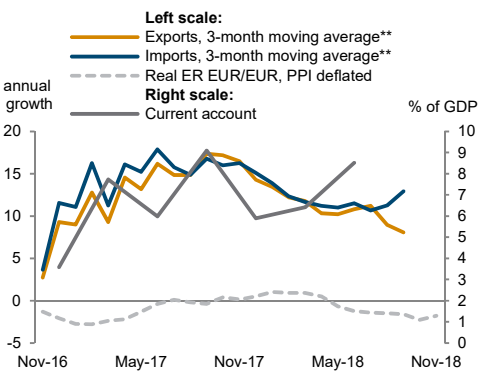
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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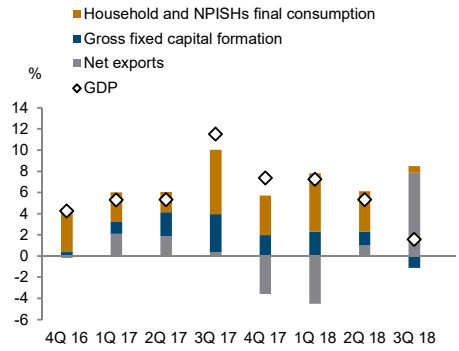
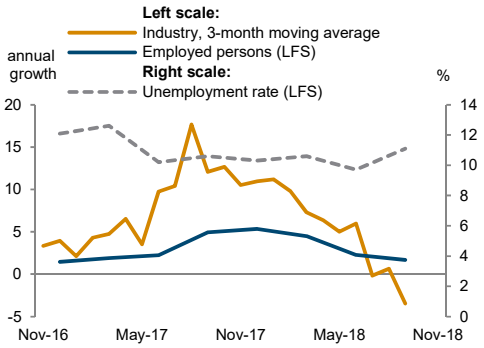
Turkey

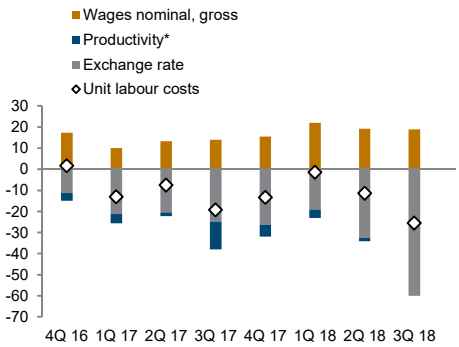
Real GDP growth and contributions
year-on-year



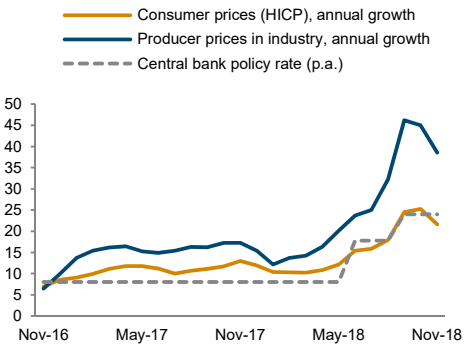
Real sector development
in %



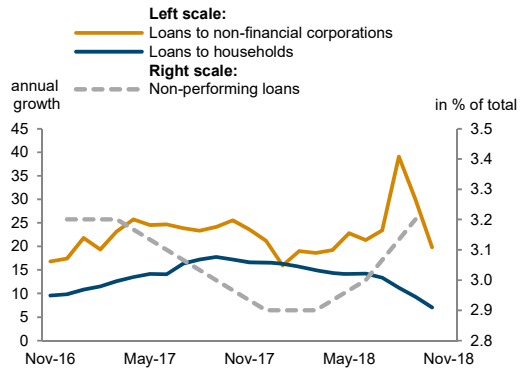
Unit labour costs in industry
annual growth rate in %



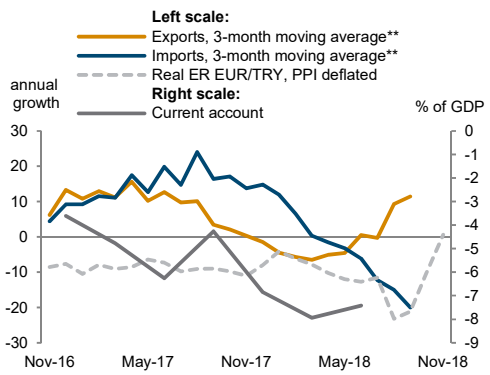
Inflation and policy rate
in %



Financial indicators
in %



External sector development
in %



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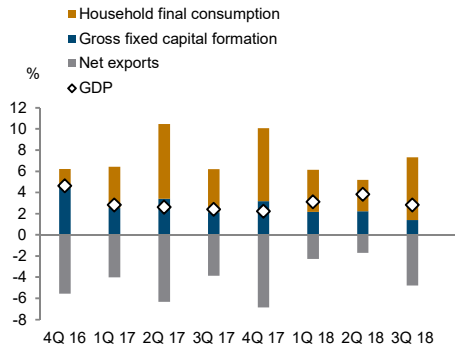
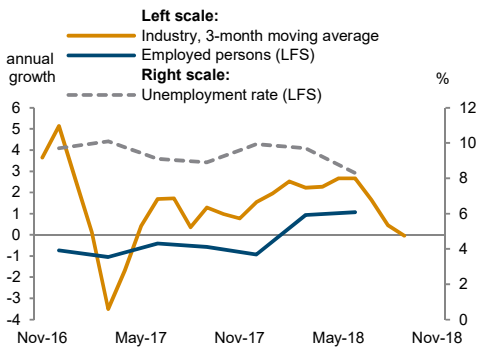
Ukraine

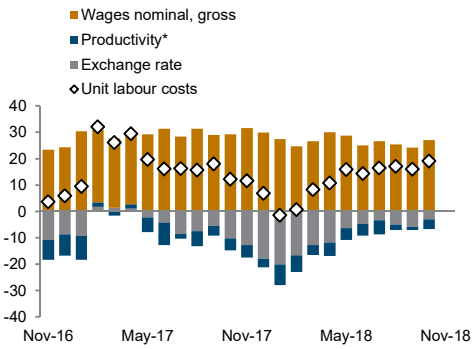
Real GDP growth and contributions
year-on-year



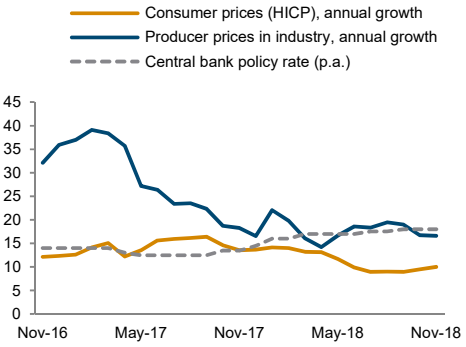
Real sector development
in %



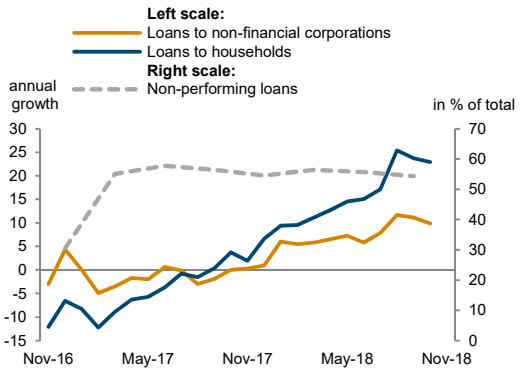
Unit labour costs in industry
annual growth rate in %



Inflation and policy rate
in %



Financial indicators
in %



External sector development
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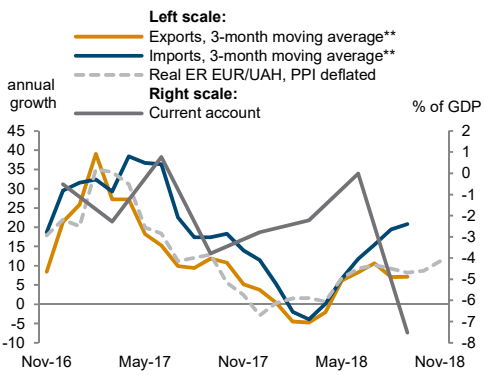

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multi-country articles and statistical overviews

Economics editors: Vasily Astrov, Richard Grieveson

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