

LOOKING EAST: THE EUROPEAN UNION'S NEW FTA NEGOTIATIONS IN ASIA¹

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Summary

- The EU's new FTA policy, centred on negotiations with three Asian partners, is supposed to deliver strong, WTO-plus FTAs. This is unlikely. The EU's self-declared commercial criteria are open to question. The EU is not as ambitious on market access and rules as the USA. It is excessively zealous to export the "EU regulatory model", especially on non-trade issues. And its two major Asian trading partners, China and Japan, are not on its FTA wish-list.
- In Asia, the emerging FTA patchwork leaves much to be desired. Some FTAs are preferential-tariff agreements on a limited range of goods. Even the better ones are trade-light and barely WTO-plus: they cover tariff elimination on most goods trade, but do not seriously tackle non-tariff and regulatory barriers. They are unlikely to contribute to regional and global economic integration, but will cause extra complications through a noodle-bowl profusion of complicated and discriminatory deals.
- The EU's best prospect is a relatively strong, WTO-plus FTA with Korea, building on the recently concluded US-Korea FTA. But it will probably leave significant gaps, notably in agriculture and some services sectors.
- The EU has little hope of concluding a serious FTA with ASEAN collectively (or even with ASEAN minus Cambodia, Laos and Myanmar). With the exception of Singapore, ASEAN countries' bilateral and collective FTAs are trade-light. Intra-ASEAN divisions preclude advancing beyond low common-denominator positions; and ASEAN lacks a common negotiating machinery. Instead of an EU-

ASEAN FTA, the EU should focus on stronger EU-ASEAN trade-related regulatory-cooperation, and a strong, WTO-plus FTA with Singapore. Strong bilateral FTAs with other ASEAN countries are unlikely.

- The EU has as little hope of concluding a strong FTA with India. The latter's existing FTAs are weak and commercially nonsensical. India is still defensive and inflexible in the WTO; and unilateral reforms have stalled. The EU should focus rather on stronger bilateral regulatory cooperation, and consider a deep-integration FTA later if Indian political conditions change and there is a renewed wave of unilateral liberalisation.
- The EU needs a much stronger framework for trade-related regulatory cooperation with China. An EU-China FTA is neither desirable nor feasible. The EU could draw lessons from the new US-China Strategic Economic Dialogue. The focus should be on tackling concrete issues where there is trade tension and conflict. These issues should not be linked to the EU's non-trade objectives. At the same time, a coalition within the EU needs to be assembled to accord China market-economy status. All these measures would help to contain protectionism, strengthen bilateral relations, encourage the Beijing leadership to go forward with WTO-plus reforms to open up the Chinese economy, and reinforce China's engagement as a responsible stakeholder in the multilateral system.

Introduction

In late 2006, Peter Mandelson, the EU trade commissioner, announced a new EU policy on free trade agreements (FTAs). This is contained in the European Commission's *Global Europe* Communication.² The core of this new chapter in EU trade policy is planned FTAs with three Asian partners, India, ASEAN and South Korea. The Commission secured a mandate for new negotiations from the EU Council in April 2007. Negotiations have already started.

The EU has thus joined the bandwagon of FTAs in Asia. It is not of course new to FTAs. Indeed, the EU has more preferential trade agreements (PTAs) on the books than any other leading power. But it did put new FTAs in deep-freeze from the late 1990s, giving priority instead to the WTO and the Doha round. Others, meanwhile, launched themselves into FTAs. Before the EU's change of heart, it was the only leading power not to be engaged in FTAs in Asia.

What do the new EU-Asia FTA negotiations mean – for the EU, for its Asian partners, and for the international trading system? I address this question in four parts. The first section summarises the state of EU-Asia trade relations. The next section puts the new negotiations in the context of overall EU FTA policy, and makes some comparisons with the US approach to FTAs. The third section summarises the *ex ante* state-of-play of FTAs in Asia, i.e. FTAs negotiated or underway in the region not involving the EU. The fourth and central section assesses prospects for EU negotiations with India, ASEAN and Korea. It also assesses the institutional framework for EU-China trade relations.

EU-Asia trade relations: facts and figures

The EU, to an even greater extent than the USA, dwarfs its Asian trading partners in terms of GDP, GDP per capita, trade in goods and services, and inflows of foreign direct investment (FDI). Japan, Hong Kong and Singapore are close to or above EU levels of per-capita GDP, but are some way behind on other headline economic indicators (Table 1).

TABLE 1 ABOUT HERE

The EU is the world's largest trading entity, accounting for 19 per cent of total world trade (excluding intra-EU trade). It is followed by the USA. China, ASEAN and Japan each account for 7-9 per cent of world trade. Korea and India are farther behind, with just above 3 per-cent and under 2 per-cent shares respectively (Table 2). Rankings and shares of world trade in merchandise goods are similar – though note that China accounts for 10 per cent of goods exports, while India's share is stuck at just above 1 per cent (Table 3). The EU has an even bigger share of world trade in commercial services, accounting for over 25 per cent per cent of the total. China has a much lower share, Japan, ASEAN and Korea moderately lower shares, but India a bigger share, of world services trade than they have in goods trade (Table 4).

TABLES 2,3,4 ABOUT HERE

The EU's lead in FDI is even greater than it is in world trade. It accounts for almost 50 per cent of outward FDI and over 40 per cent of inward FDI. Japan, Korea, China, India and ASEAN all have very low global shares of accumulated FDI in comparison (Table 5). Note, however, that China accounts for nearly 9 per cent of recent FDI inflows (Table 6).

TABLES 5,6, ABOUT HERE

Now turn to EU bilateral trade-and-investment relations with third countries. The USA is by far its leading trading partner. China is its second largest trading partner, followed some distance behind by Japan and ASEAN, and even farther behind by Korea and India (Table 7). In 2005, China accounted for almost 14 per cent of EU goods imports (Table 8). Indeed, by 2006 it had displaced the USA as the EU's biggest trading partner in goods. The EU in turn is China's biggest trading partner, ahead of the USA and Japan. EU-China trade has been increasing by over 20 per cent per annum in recent years.

Japan and ASEAN have similar shares of EU trade in goods (Table 8). The EU is ASEAN's third biggest trading partner. Korea and India are farther behind in their shares of EU goods trade (Table 8). The EU is Korea's second largest export market. It is India's premier trading partner; and EU-India trade has been growing at 14 per cent per annum since 2002.

EU services trade with Asian countries is very low compared with goods trade, and minuscule compared with EU-USA services trade (Table 9).

TABLES 7,8,9 ABOUT HERE

The USA is by far the EU's biggest investment partner. EU FDI to the USA and FDI into the EU from the USA dwarf other bilateral EU FDI stocks and flows. Outward and inward FDI with Japan follows far behind. Accumulated EU FDI to ASEAN countries is not far behind EU FDI stock in Japan – though the bulk of it goes to Singapore. Farther behind are China and Korea, with India even farther behind. Note, however, that EU FDI flows to Japan, China, ASEAN, Korea and India have been increasing in recent years (Table 10). The EU is the biggest source of FDI for Korea and India, though behind the USA and Japan as an FDI source for ASEAN and China.

TABLE 10 ABOUT HERE

Finally, to give a first impression of comparative trade barriers, take a look at average tariffs for the EU, USA and Asian countries. The EU, USA, China, Taiwan and Japan have bound all (or almost all) tariffs in their WTO tariff schedules. Korea and Indonesia have bound over 90 per cent of their tariffs. Other Asian countries have lower levels of tariff bindings, with big differences across the continent. The EU, USA and Japan have low bound and applied overall average tariffs. The same applies to their average tariffs on manufactures. Hong Kong and Singapore are exceptional: they are free ports with zero applied tariffs. Some ASEAN countries – Malaysia, Indonesia and the Philippines – have average applied tariffs under 10 per cent, though bound at noticeably higher levels in the WTO. China’s applied tariff average is about 10 per cent; Korea’s, Thailand’s and Vietnam’s a little higher; and India’s much higher. India and Thailand have noticeably higher bound than applied rates. China and Vietnam, on the other hand, have lower bound rates very close to their applied rates – a product of their recent accessions to the WTO (Table 11). (Table 12, compiled from World Bank rather than WTO figures, and including figures for 2005, shows India with an overall average tariff that has come down to 16 per cent. It also shows lower tariff averages for Korea and Thailand.)

Most countries have higher average tariffs for agriculture than for manufactures. Note Korea’s and India’s very high rates. China, Thailand and Vietnam have average agricultural tariffs around the 15 per-cent mark. Other ASEAN countries have rates around or below 10 per cent (very low in the case of Malaysia) (Table 11).

TABLES 11 AND 12 ABOUT HERE

EU-Asia FTAs in EU trade-policy context

In *Global Europe*, the Commission stresses commercial criteria for its new FTAs. These are all about “stronger engagement with major emerging economies and regions; and a sharper focus on barriers to trade behind the border.” FTAs should strengthen EU competitiveness. The commitment to the WTO and a successful Doha round is restated,

but renewed priority is given to bilateral and region-to-region negotiations to achieve market-access objectives.

This is in line with official statements of EU trade policy going back to the 1990s, but it represents a shift from EU trade-policy priorities when Pascal Lamy was the trade commissioner. Before *Global Europe*, the EU focused on the WTO at the expense of new FTAs. Rhetorically, Mr. Lamy embedded market-access objectives in a broader EU approach to “regulating globalisation”, with its emphasis on equity, public legitimacy and other goals.³ It does not take rocket science to understand the EU’s change of heart: the Doha round has gone nowhere; other leading players have left the EU behind in the scramble for FTAs; and the EU’s “footprint” in Asia is seen to be less visible compared with the USA and others.

In terms of content, *Global Europe*’s stated aim is to have strong, comprehensive, “WTO-plus” FTAs. Tariffs and quantitative restrictions should be eliminated. Presumably, this should apply to at least 90-95 per cent of tariff lines and trade volumes in order to comply safely with the “substantially-all-trade” criterion in Article XXIV GATT. There should be “far-reaching” liberalisation of services and investment. Services provisions should presumably be compatible with the “substantial-sectoral-coverage” criterion in Article V GATS. A model EU investment agreement, developed in coordination with EU member-states, is envisaged. There should be provisions going beyond WTO disciplines on competition, government procurement, intellectual property rights (IPR) and trade facilitation. There should also be provisions on labour and environmental standards. Rules of origin (ROO) should be simplified. More generally, there should be strong regulatory disciplines and regulatory cooperation, especially to tackle non-tariff barriers. This should involve improved transparency obligations, mutual recognition agreements, conformity with international standards, regulatory dialogues and technical assistance.

With the economic criteria of “market potential (economic size and growth) and the level of protection against EU export interests (tariffs and non-tariff barriers)” in mind, the EU

has selected India, ASEAN and Korea as partners for new FTAs. FTA negotiations with Mercosur and the Gulf Cooperation Council (GCC) are ongoing. There are existing FTA or PTA initiatives involving Central-American and Andean countries. Russia is of “direct interest”, but not yet a priority for an FTA. Nor is China, which “meets many of these criteria, but requires special attention because of the opportunities and risks it presents.” Transatlantic economic cooperation (i.e. with the USA) also gets a mention, but there are no plans for an FTA. Finally, *Global Europe* announces a review of EU trade defence instruments (anti-dumping duties, safeguards and countervailing duties). But the EU also wants “to make sure that others apply high standards in their use of trade defence instruments and international rules are fully respected.”

Judging by its rhetoric, the EU seems to be serious about serious, commercially-relevant FTAs. The latter would differ from several other EU PTAs, e.g. with Middle-Eastern and North-African countries, and with African, Caribbean and Pacific (ACP) countries. EuroMed agreements, and envisaged Economic Partnership Agreements (EPAs) with the ACP (to replace existing preferential schemes), are not strongly WTO plus and rather one-sided: EU concessions dwarf concessions by its partners. In contrast, the EU-Asian FTAs are intended to go wider and deeper, and contain more *reciprocal*, i.e. roughly equivalent, concessions. These are closer in spirit to more commercially-motivated FTAs with Mexico, Chile and Mercosur.⁴

Just how serious is the EU about FTAs that are commercially meaningful and make economic sense? The benchmarks for such FTAs would be the following: comprehensive coverage of trade in goods, with zero tariffs and quotas on at least 95 per cent of trade volumes (and without wholesale exemptions for “sensitive” agricultural products); strong coverage of services and investment, underpinned by solid disciplines on domestic regulation; reasonably strong coverage of competition rules, government procurement and trade facilitation; improved transparency obligations and better regulatory cooperation, especially on non-tariff barriers; avoidance of specific WTO-plus obligations on labour and environmental standards (which could harm developing-country trade prospects); and a serious effort to simplify ROO requirements. WTO-plus

obligations on IPR could also be more of a burden than a benefit to low-income, less-advanced developing countries. It would be better to stick to the implementation of the WTO's TRIPS obligations and adoption of associated international standards.

Going beyond the rhetoric in *Global Europe*, there are several features of EU existing trade policy, and of EU regulation generally, that raise doubts about the EU's willingness and ability to conclude economically sensible FTAs.

First, the EU seeks increasingly to export its regulatory practices; and FTAs are a tempting vehicle. International organisations and multilateral, regional and bilateral agreements are all used to promote the adoption of EU standards on product safety, the environment, corporate governance and a host of other issues.⁵

The EU always links its “non-trade” goals to its trade agreements, preferably by having non-trade provisions in such agreements. *Global Europe*, under the heading of “social justice”, seeks to “promote our values, including social and environmental standards and cultural diversity around the world.” Hence the commitment to include core labour and environmental standards in FTAs. The EU is also increasingly interested in linking trade policy to climate change. New FTAs will likely contain trade-and-sustainable-development chapters, which could house climate-change provisions in the future. Fairly general, declaratory language on climate change, democracy, human rights and other EU pet issues could well be inserted into FTAs and linked to other non-trade bilateral agreements. These could conceivably limit negotiating partners' freedom of action down the line by tying them to EU-specific standards.

The EU's approach to the regulation of risk in international trade is another issue that could be exported via FTAs. The USA and the WTO itself have a science-based approach to risk assessment of product standards in international trade (covered by the WTO's SPS and TBT agreements). The EU has a broader approach that takes non-scientific considerations into account, particularly in its interpretation of the “precautionary principle”, which can be used to restrict trade on public health-and-safety grounds. This

allows for wider regulatory discretion than in science-based risk assessments and can be more exposed to protectionist abuse – or so its detractors argue. Given the EU's failure to get the WTO to adopt its version of precaution, it is all too tempting to use FTAs as the preferred alternative for regulatory export.⁶

Promotion of regional integration elsewhere – obviously using the EU as the model – is another vehicle for regulatory export. Hence the EU's preference for region-to-region negotiations wherever possible, e.g. with the ACP countries, Mercosur, Central America, the Andean Community, the GCC and now ASEAN.⁷

Second, while the EU is more serious about commercially-relevant FTAs than most other players, it is not as serious as the USA. US FTAs are tougher on market access and related rules in several ways. Transition periods tend to be short. The USA insists on negative listing of scheduled sectors in services and investment, as well as investor-state dispute settlement. It also insists on strong disciplines on domestic regulatory discretion, e.g. in administering licenses, granting subsidies and using performance requirements. There are also relatively strong, WTO-plus provisions on competition, government procurement and trade facilitation in US FTAs. The EU, in contrast, uses GATS-type positive listing for services and investment; it does not use investor-state dispute settlement; it has weaker constraints on domestic regulatory discretion; and it has fairly general, non-binding, barely WTO-plus provisions on competition, government procurement and trade facilitation.⁸ This could allow the EU and its negotiating partners, in a spirit of mutual defensiveness, to carve out sensitive services sectors (such as health care, education, the utilities and audiovisual services) and get away with weakish regulatory disciplines in other areas.

The USA also goes further than the EU on IPR, with strong TRIPS-plus provisions in its FTAs, and insists on restrictions on short-term capital controls. The EU approach to IPR, as well as to labour and environmental standards in its FTAs, is to have general language to secure acceptance of international standards, rather than specific WTO-plus obligations.⁹ Geographical indicators (GIs) is the one exceptional area of IPR where the

EU will likely try to secure TRIPS-plus obligations. Both the EU and USA concede very little on the movement of temporary workers (covered by GATS Mode Four), except for limited provisions on business personnel. Neither allows FTAs to impose disciplines on anti-dumping procedures or agricultural subsidies. Neither has been successful in concluding mutual recognition agreements in FTAs. And both have added considerably to the “spaghetti-bowl” complexity of ROOs.

To sum up what Asian partners can expect from the EU, using US FTAs for comparison: Tariffs and quotas will be eliminated on 90 per cent or more of goods trade, but that will still allow for carve-outs for swathes of agricultural trade. Market access and rule-discipline in services, investment, government procurement, competition and trade facilitation will not be as strong as in US FTAs.¹⁰ The EU approach to IPR will sit more comfortably than the US approach with developing-country partners. The EU is likely to concede very little on Mode Four, and is unlikely to relax its tough SPS and TBT measures for FTA partners. There will be little or nothing on anti-dumping and agricultural subsidies. Finally, negotiating partners should be alert to EU strategems to sneak in non-trade provisions on climate change, human rights and other issues into FTAs. That is the EU Trojan Horse to watch out for.

Third, sceptical economists raise other objections. Why has the EU decided to negotiate FTAs with India, ASEAN and Korea but not with Japan and China? The latter two comprise 55 per cent of the EU’s potential Asian market. An FTA with Korea could be considered a stepping-stone to one with Japan. But excluding China from the FTA calculus is even less convincing, and diminishes the EU’s “economic criteria” for new FTAs. Fear of Chinese competition is clearly the main reason why China is not on the list.¹¹

Then there are the dangers of efficiency losses from trade diversion, i.e. sourcing imports from high-cost countries in a preferential agreement and not from low-cost countries outside the agreement. This could be a problem when FTA partners have relatively high MFN tariffs and high regulatory barriers in goods, services and investment. As Patrick

Messerlin argues in his ECIPE Policy Essay, this applies to some of the EU's preferred Asian partners – India and some ASEAN countries – while others not selected, such as Japan, USA, Canada and Australia, have low MFN tariffs and low regulatory barriers.

Professor Messerlin also considers wider systemic effects. The EU's Asian FTAs, he thinks, can only add to the existing spaghetti bowl of market preferences and ROO complications – an unholy mess of arbitrary, tailor-made regulations for politically-influential companies, moving ever farther away from the simplicity, transparency and predictability of non-discriminatory multilateral rules. Companies increasingly depend on governments to do sweet deals for them rather than relying on a simple level playing field. This makes business more costly and uncertain. Competition and efficiency are the losers.¹²

Finally, the EU policy elite's mercantilist outlook leads it to believe that the lack of EU competitiveness in Asian markets can be fixed by opening them through FTAs. That would of course benefit some EU firms in some sectors. But that is not the same thing as EU competitiveness. EU firms' market share in expanding Asian markets has not fallen due to lack of market access. On the contrary, non-discriminatory unilateral liberalisation in Asia has expanded market access for EU and other firms. Rather the competitiveness of EU firms has more to do with EU internal-market conditions. Policies to improve competition and efficiency in the Internal Market are far more likely than FTA quick fixes to boost the competitiveness of EU firms in Asia. EU non-discriminatory unilateral liberalisation and improved offers in the Doha round would be the external complement to competition-friendly internal-market reforms.¹³ But that is not how mercantilist politicians, bureaucrats and CEOs see the world.

To sum up: The EU is more serious about commercially-relevant FTAs than most other players – Brazil, India, South Africa, ASEAN, Japan and China, for example. But its “economic criteria” for new FTAs are compromised by non-trade goals and onerous regulations the EU tries to export via FTAs; a weaker stance on market access and related rules compared with the USA; the absence of Japan and China from its FTA wish-list;

potential trade-diversion and spaghetti-bowl effects; and a general mercantilist outlook that neglects unilateral liberalisation and internal-market reforms. The last two features are of course not confined to the EU.

FTAs in Asia¹⁴

Having put the EU's new FTA policy in a bigger EU context, now turn to the state-of-play of FTAs in Asia. Is the PTA spaghetti bowl in danger of being replicated in Asia? Or are the new Asian FTAs more serious? Do they hold out the prospect of strengthening regional and global integration? This section first looks at the FTA activity of the major Asian players: China, the ASEAN countries, India, Japan and Korea. It follows up with some observations on regional economic integration initiatives.

Unlike other regions, East Asia used to rely on non-discriminatory unilateral and multilateral liberalisation rather than discriminatory FTAs. Now it is playing catch-up, with FTA initiatives spreading like wildfire in the past six years. The major Asian powers – China, India and Japan – are involved, as are Korea, Australia, New Zealand, Hong Kong, the Southeast-Asian countries, as well as other South-Asian countries. There are about 20 FTAs in force and 60 more in the pipeline in China, India and Southeast Asia. The USA is involved with individual countries in East Asia, as are some Latin American countries (notably Mexico, Chile and more recently Brazil). South Africa is considering initiatives in the region.

China is the driving force for FTAs in Asia. It is considering or negotiating FTAs left, right and centre – in East and South Asia, the Middle East, Latin America, Africa, and with Australia and New Zealand. By 2006, it had 9 FTAs on the books and was considering negotiations with up to 30 other countries.

The China-ASEAN set of negotiations, more than any other FTA initiative, is the one to watch in the region. The aim is to have an FTA in place by 2010. It would be the largest FTA ever negotiated, covering 11 diverse economies with a population of 1.7 billion and a GDP of US\$2 trillion. There has been reasonable progress in eliminating tariffs on trade in goods. Duties on 95 per cent of tariff lines will disappear by 2010; many remaining tariffs will go by 2012; and other tariffs will be reduced or be capped thereafter. However, little progress to date has been made on non-tariff barriers in goods, services (where a relatively weak agreement has been reached), investment and other issues. China also has relatively strong, WTO-plus FTAs with Hong Kong and Macau (both admittedly special cases); a comprehensive FTA on goods with Chile; and is negotiating FTAs with Australia, New Zealand and Singapore. It is also negotiating or thinking of negotiating rather weak FTAs elsewhere in the developing world, e.g. with Pakistan, MERCOSUR, the South African Customs Union (SACU) and perhaps India. These are shallow -- mostly preferential tariff reductions on a limited range of products.

China's approach to FTAs is pragmatic and eclectic, ranging from strong (Hong Kong and Macau) to middling-to-weak (probably ASEAN) to very weak (probably India, SACU and other countries in Africa, the Middle East and elsewhere). Even the China-ASEAN FTA is unlikely to create much extra trade and investment if it does not go substantially beyond tariff elimination in goods. Trading interests are placed in the context of foreign-policy "soft power", i.e. diplomacy and relationship building. Though China is a little more serious about FTAs than most other regional players, its FTAs are driven more by "high politics" (competition with Japan to establish leadership credentials in East Asia; securing privileged influence in other regions) than economic strategy. The danger is that this will deliver weak, partial FTAs that create little trade but a lot more political and economic complications. And that would send powerful signals to other countries to do the same.

Turning to *Southeast Asia*, Singapore blazed the FTA trail, with Thailand next to follow, and now Malaysia, Indonesia, the Philippines and Vietnam trying to catch up. Singapore

has agreements in force with Australia, New Zealand, Japan, USA, Korea, India and a host of other minor trading partners; and several others proposed or under negotiation in Africa, the Middle East, South Asia and the Americas. Thailand has agreements in force with Australia, New Zealand, Bahrain, Japan, China and India. It was in negotiations with the USA and others, before the Thai political crisis and the subsequent military coup put all negotiations on hold. Malaysia has an agreement with Japan, and is negotiating with the USA, Australia, New Zealand, India, Pakistan, Korea and Chile. The Philippines has a new FTA with Japan; Indonesia is negotiating with Japan; and both are looking to start negotiations with others. Vietnam has a bilateral trade agreement with the USA, is negotiating with Japan and considering other negotiations. In addition, ASEAN collectively has negotiations with China, India, Japan, Australia-New Zealand CER and Korea.

Of the ASEAN countries, only Singapore has reasonably strong FTAs, and an especially strong FTA with the USA with comprehensive coverage and strong rules for goods, services, investment and other issues. But Singapore, with its free-port economy, centralised city-state politics, efficient administration and world-class regulatory standards, is a misleading indicator for the region. Thus far most signs point to other ASEAN countries becoming entangled in a web of weak and partial FTAs. Many product areas, especially in agriculture, are likely to be excluded from goods liberalisation. Regulatory barriers are unlikely to be tackled with disciplines that go much deeper than existing WTO commitments. Services commitments are unlikely to advance much beyond the WTO's GATS agreement, let alone deliver meaningful net liberalisation or regulatory cooperation (e.g. on mutual recognition of standards and professional qualifications). Provisions on investment and the temporary movement of workers are also likely to be weak, with perhaps even weaker commitments on government procurement, competition rules and customs administration.

More important than all the above considerations, it is already apparent that agreements in force and those being negotiated are creating a "noodle bowl" of complex and

restrictive rules of origin. A dog's breakfast of differing general and product-specific ROO criteria is emerging. These differ between bilateral FTAs. Collective ASEAN FTAs with third countries will compound the problem, if (as is quite likely) they end up with yet another layer of differing ROO criteria. If this is indeed what emerges, administrative and other compliance costs could be too onerous for most exporters in the region. Many will find it cheaper to pay the MFN-tariff duty.

India is also newly active with FTAs, in its South-Asian backyard and in other developing-country regions. In South Asia it has several bilateral FTAs. Hitherto loose regional cooperation is supposed to be transformed into the South Asian FTA (SAFTA) by 2010, leading to a customs union by 2015 and economic union (whatever that means) by 2020. This looks unachievable in practice. For starters, SAFTA excludes Indo-Pakistani trade. Planned negotiations are only on goods; they do not cover services, investment and other non-border market-access issues. There are bound to be plenty of exemptions, given similar trade structures with competing products (especially in agriculture). Finally, severe political problems in the region (the Indo-Pakistani conflict over Kashmir, and the fact that India is completely surrounded by weak, failing or failed states) will make progress very difficult.

India's approach to FTAs outside South Asia is mostly about foreign policy and is "trade light", with little economic sense or strategy. An FTA with ASEAN is planned for completion by 2011; and bilateral FTAs are also in place with Thailand and Singapore. ASEAN-India and India-Thailand negotiations have been bedevilled by India's insistence on exempting swathes of products and on very restrictive rules of origin for products covered. In addition, India is part of the BIMSTEC group (the other members being Bangladesh, Sri Lanka, Nepal, Bhutan, Thailand and Myanmar) that plans an FTA by 2017. It has mini-FTAs – basically limited tariff-concession schemes – in force or planned with several countries and regions, e.g. Chile, SACU, MERCOSUR, IBSA (India-Brazil-South Africa). FTA negotiations have started with Russia, Japan and South Korea.

Japan was the last major trading nation to hold out against discriminatory trade agreements, preferring the non-discriminatory WTO track instead. This has changed decisively in the past six years.

Japan's biggest FTA initiative is the Japan-ASEAN Economic Partnership Agreement, which is supposed to be completed by 2012. It is comprehensive on paper, covering goods, services, investment, trade facilitation and several areas for economic cooperation. However, progress has been slow – much slower than in the China-ASEAN FTA. This is due to Japanese reluctance to reduce and then phase out agricultural tariffs, and to its insistence on restrictive and often product-specific rules of origin, especially for agricultural products (though for some manufacturing products as well). Another complicating factor is that Japan has given greater priority to bilateral FTA negotiations with individual ASEAN countries. Such bilateralism, especially with its noodle-bowl profusion of rules of origin, is going to make it very hard to achieve a clean, comprehensive Japan-ASEAN FTA. The latter risks ending up as a loose umbrella for a series of bilateral FTAs.

Japan has several other FTA initiatives in train. It calls its FTAs “economic partnership agreements” (EPAs) – to indicate that they go beyond traditional FTAs in goods and have comprehensive coverage of trade and investment-related issues in goods and services. That is misleading: EPAs are euphemisms for weak and partial FTAs. In essence, Japan seems to be reacting to China's FTA advance, but without a real strategy.

South Korea is also in the thick of FTA activity. Like Japan, it is defensive on agriculture. Unlike Japan, it seems to be more serious on other negotiating issues. It has made more progress than Japan in FTA negotiations with ASEAN. Korean and US negotiators concluded an FTA in April 2007 – the strongest FTA to date in Asia, and the US's first in the region. The FTA has not yet been ratified (at the time of writing).

In addition to bilateral FTAs, Asia – East Asia in particular – is awash in regional economic integration initiatives. How serious are they?

APEC's membership is diverse and unwieldy; its agenda has become impossibly broad and unfocused; its vaunted Open (i.e. non-discriminatory) Regionalism is dead in the water; and these days it is driven by shallow conferencitis and summitry. An APEC FTA initiative (FTAAP – Free Trade Area of the Asia Pacific) was launched at the APEC Hanoi Summit in 2006. It will go nowhere: political and economic divisions in such a large, heterogeneous grouping are manifold and intractable.

In Southeast Asia, the *ASEAN Free Trade Area* (AFTA) has an accelerated timetable for intra-ASEAN tariff elimination, but seen little progress on “AFTA-plus” items such as services, investment, non-tariff barriers, and mutual recognition and harmonisation of standards. An ASEAN Economic Community, a single market for goods, services, capital and the movement of skilled labour, is supposed to be achieved by 2015. So far, however, ASEAN Vision Statements and other blueprints have largely failed to remove barriers to commerce in Southeast Asia. They seem rather distant from commercial ground realities.

Lastly, there is much talk in the region of folding bilateral and ASEAN FTAs into larger, integrated FTAs that would cover East Asia, and perhaps include South Asia too. An *ASEAN Plus Three* (APT) FTA (the “three” being Japan, South Korea and China) has been touted, as has an East-Asian FTA that might include Australia and New Zealand. There is talk of a pan-Asian FTA that would include India or SAFTA. Visions of an East Asian Economic Community and even an Asian Economic Community have appeared on the horizon.

So far this talk is loose and empty – nothing more. Regional players are speeding ahead with quick and dirty bilateral FTAs, while little progress is being made with the larger ASEAN FTAs (beyond tariff elimination in goods trade). The emerging pattern is of a patchwork of bilateral “hub-and-spoke” FTAs, in a noodle bowl of trade-restricting rules of origin. This threatens to slow down and distort the advance of regional and global

production networks. In particular, it could undermine the dense networks of East-Asian production-sharing and trade in manufacturing parts and components (“fragmentation-based trade”, or what Richard Baldwin calls “Factory Asia”), which are in turn linked to final export markets in Europe and North America.¹⁵ Moreover, such FTA activity distracts attention from further unilateral liberalisation and domestic reforms. That will probably hinder, not help, the cause of regional economic integration.

More generally, bitter nationalist rivalries (especially in northeast Asia and between India and Pakistan), and vast inter-country differences in economic structure, development, policies and institutions, will continue to stymie Asian regional-integration efforts for a long time to come. This applies to East Asia; it applies even more to South Asia.

EU-Asia FTAs

Having covered EU-Asia trade relations, and then the record of EU and Asian FTAs, this section turns to the three new bilateral negotiations: EU-Korea, EU-ASEAN and EU-India. But first it takes a look at the EU’s most important bilateral relationship in Asia, i.e. with China.

EU-China trade relations: the institutional framework

China is now the EU’s largest trading partner in Asia and its second largest trading partner in the world. European multinational enterprises have big investments in China, much of it linked to trade: their China operations import machinery and other inputs from Europe and elsewhere, and export final goods back to Europe and the wider world. The EU Commission goes so far as to say that “China is the single most important challenge for EU trade policy.”¹⁶ Yet the EU is avoiding an FTA with China, while it prioritises negotiations with less important Asian trading partners.

As things stand, a serious EU-China FTA is not achievable for either side. China is unlikely to get what it wants from the EU through an FTA: recognition of market-

economy status; stronger disciplines on EU anti-dumping and safeguard measures; removal of peak tariffs on garments, leather goods and other manufactured exports; reduction of EU agricultural subsidies and tariffs to open markets for its expanding agricultural exports; and less trade-restrictive EU SPS and TBT measures. All these measures restrict China's labour-intensive goods exports. FTA negotiations would put extra pressure on the EU to reduce or remove many of these barriers, which would expose inefficient EU producers to even greater Chinese competition. That is why the EU does not want an FTA with China.

What would EU exporters and investors gain from an FTA with China? China has already made very strong WTO commitments on tariffs and non-tariff barriers to goods trade, and on services liberalisation. But that still leaves significant gaps. A comprehensive, WTO-plus EU-China FTA would take over 90 per cent of Chinese tariffs down to zero (from a nominal MFN average of 9 per cent); deliver GATS-plus commitments on services liberalisation; remove foreign-ownership restrictions and secure better legal protection for EU investors; impose greater disciplines and transparency on all manner of domestic regulation (e.g. on administering subsidies, licenses, safety standards, IPR and customs procedures); gain WTO-plus commitments on government procurement, competition rules and trade facilitation; and extract commitments on core labour and environmental standards. But, since the EU is unlikely to concede anything major to China, it is unlikely to get the above concessions from China. Furthermore, Chinese liberalising reforms do not have the strong tailwind they had in the run-up to WTO accession: the politics of further liberalisation in China is proving more difficult.

Given these realities, now is not the time to launch an EU-China FTA initiative. But now *is* the time to strengthen and strongly institutionalise bilateral trade cooperation. Present and envisaged arrangements are too soft. They should be hardened – without jumping onto the FTA bandwagon.

Hitherto, the legal basis for bilateral relations has been the Trade and Cooperation Agreement of 1985. Since then there have been 7 formal agreements and 22 sectoral and

regulatory dialogues on a wide range of issues. The EU and China agreed to a “strategic partnership” in 2003. In 2007, both sides agreed to start negotiations on a new Partnership and Cooperation Agreement (PCA), which would update and expand bilateral cooperation since 1985. The EU intends the PCA to cover political and economic issues, including its non-trade objectives on democracy, human rights, the rule of law, sustainable development, climate change, and labour and environmental standards. Its trade-and-investment priorities for the PCA include: better enforcement of IPR; mutual recognition of geographical indicators; WTO-plus commitments on access for EU investors; and stronger regulatory cooperation on health-and-safety standards. The EU also envisages some institutional changes, such as an annual heads-of-government summit, stronger exchanges and dialogues at ministerial, senior-official and technical levels, and an independent EU-China Forum for non-governmental representatives.¹⁷

This is welcome, but it is not enough: bilateral cooperation will remain too “soft”. Granted, EU-China relations do not yet suffer from the shrill, China-bashing protectionist rhetoric found in the USA. But there is in-built EU protectionism directed at China, which reinforces protectionism and foot-dragging on reforms in China. To contain protectionism and incrementally open markets on both sides, the institutional framework for bilateral cooperation must be bolstered. It must go beyond low-key, low-level, inconclusive regulatory dialogues and set-piece, photo-op annual summitry. What should be done?

- The EU has to overcome internal divisions and zero-sum competition in its relations with China. The Big Three – Germany, the UK and France – prioritise their bilateral relations with China with competing and conflicting agendas, and often at the expense of the EU-China relationship.¹⁸ It is natural for EU member-states and China to nurture country-to-country relationships through contacts at the level of national capitals. But EU member-states – the Big Three in particular – must pull together and give more priority to collective EU-China trade relations. After all, trade policy is the one area of EU external policy that is highly

- centralised; and headline trade-policy issues concerning China can only be dealt with at the EU level.
- The EU should refrain from linking trade to its all-embracing non-trade goals, such as democracy, human rights, the environment, cultural diversity and sustainable development (which, like social justice, apple pie and mother's milk, encompasses just about everything). These issues should be discussed on separate tracks. Linking them to bilateral trade issues makes the EU look politically correct and preachy, constantly pandering to its anti-market NGO and other constituencies. It also gets Chinese backs up. Far better to deal with outstanding trade tensions and conflict in a contained, businesslike, problem-solving setting.
 - Regular high-level contacts need to be strengthened significantly and better focused. The EU needs its equivalent of the US-China Strategic Economic Dialogue, launched on the initiative of US treasury secretary Hank Paulson in 2006. This involves intensive bilateral exchanges, focused on the most contentious trade issues. It draws in government agencies across the economic-policy spectrum, and culminates in twice-yearly ministerial-level meetings, led by Secretary Paulson and Vice Premier Wu Yi. This will be more difficult to organise at the EU end, given that member-states, and especially the Big Three, will have to be involved. Nevertheless, it is something Commissioner Mandelson should propose and initiate.
 - The EU should give China market-economy status (MES) as soon as possible. Its argument – namely, that China does not yet meet four out of five set criteria – is specious. China is more marketised than Russia and most other developing countries, as shown by the rapid global integration of its economy and the strength of its WTO commitments. Yet the EU recognises Russia but not China as a market economy. Giving China MES is only right and proper. It would impose more limits on arbitrary EU protectionist measures, especially the use of anti-dumping procedures that are not even constrained by weak GATT Article VI disciplines. And it would, at a stroke, improve bilateral relations considerably. Sadly, the EU presently lacks the internal consensus to go down this route. It is incumbent on a range of actors – producers and retailers who import from China,

market-friendly governments in the EU Council, freer-trade elements in the Commission and the European Parliament, and think tanks such as ECIPE – to make a powerful case and assemble the votes within the EU to get the policy changed.

These are all measures that would not only help to contain protectionism, but also reinforce China's engagement as a "responsible stakeholder" in the WTO and other international institutions – a stated EU goal. They would create extra political space for the Beijing leadership to better implement China's WTO obligations (e.g. on IPR, subsidies and services), and to go forward with unilateral, WTO-plus structural reforms to further open up the economy. Parallel moves by the USA are at least as important. Hence both the USA and the EU have a vital role to play in smoothening China's integration into the global economy.

The EU-Korea FTA

The EU trades at lower levels with Korea than it does with China, Japan and ASEAN. This is also true of EU FDI to and from Korea. An EU-commissioned study on the potential impact of an EU-Korea FTA comes up with the following numbers. An FTA that liberalises all trade in goods and services would deliver a real-income gain of 4.3 billion euros for the EU and 10 billion euros for Korea (equivalent to an increase of 0.05 per cent of EU GDP and 2.3 per cent of Korean GDP). A much more limited FTA (a 40 per-cent reduction in agricultural tariffs and a 25 per-cent reduction in barriers to services trade) would deliver an EU gain of 1.2 billion euros and a Korean gain of 2.5 billion euros (0.01 per cent of EU GDP and 0.58 per cent of Korean GDP). An in-between scenario (with a 50 per-cent reduction in barriers to services trade) would result in an EU gain of 2.2 billion euros and a Korean gain of 4.3 billion euros (0.03 per cent of EU GDP and 1 per cent of Korean GDP).¹⁹

Hence a full FTA would deliver appreciable gains for Korea, but the net effect on the EU would be rather modest. A limited FTA would drastically reduce Korean gains and have

an even more modest effect on the EU. Significant liberalisation of services is crucial in order to deliver meaningful gains. The model used takes account of Korean FTAs with the US, ASEAN and others.

Note that this computable-general-equilibrium (CGE) model, while providing useful ballpark guesstimates of trade-policy changes, suffers from serious limitations. It covers short-term (static) effects driven by changes in terms of trade, but neglects longer-term dynamic effects from FDI and technology transfer, for example. That is one reason why predicted gains seem relatively small. At the same time, the model underestimates the extent of trade protection. It does not incorporate rules of origin, nor does it seriously cover a range of non-tariff and regulatory barriers. Such limitations also apply to the CGE models used to predict outcomes for the EU-ASEAN and EU-India FTAs.

Korea is by far the EU's best FTA prospect in Asia – for two reasons. First, Korea, next to Singapore, is the most credible FTA player in Asia. It has very high levels of agricultural protection and correspondingly defensive negotiating positions. But it has been more serious and forthcoming than Japan, China, ASEAN countries and India on non-agricultural issues in FTA negotiations. That is why Korea successfully concluded FTA negotiations with the toughest *demandeur* around, the USA, while US FTA negotiations with Thailand and Malaysia got stuck.

Second, the US-Korea FTA sets the floor for EU-Korea negotiations: the EU can and does expect at least parity with Korean concessions made to the USA. It remains to be seen (at the time of writing) whether the US-Korea FTA will be ratified by one or both countries.²⁰ But the chances of successfully concluding EU-Korea negotiations in reasonably quick time are good. Both sides aim to complete negotiations by early 2008. The result might be a relatively strong, WTO-plus FTA, though with significant gaps.

During the second round of negotiations, the EU offered to abolish all its tariff duties on bilateral goods trade – its most ambitious market-access offer in an FTA to date. High ambition includes no exemptions or extra-long transition periods for agriculture. That is a

major departure for the EU. In return the EU wants 100 per-cent removal of Korean tariffs, major services liberalisation, the removal of restrictions on EU investors, and a strong focus on tackling non-tariff and domestic regulatory barriers.²¹ The EU seeks strong regulatory cooperation and improved transparency on SPS and TBT measures, conformity assessment and adoption of international standards. It wants market-access commitments in government procurement that would build on the WTO's Government Procurement Agreement (GPA); commitments on enforcement of competition rules, including disciplines on state aid; trade-facilitation commitments; commitments on core labour and environmental standards; and a dispute-settlement mechanism.

It is probable that an EU-Korea FTA will leave significant gaps. Both sides might well agree to zero duties on all trade in manufactures, but it remains unlikely that they will agree to something similar for agriculture. In that case, many "sensitive" products will be exempted totally or included with extra-long transition periods and tariff-rate quotas.²² There will be a special safeguards mechanism for agriculture. It remains to be seen what devils will lie in the detail of agreed ROOs. Mutual defensiveness and GATS-style positive listing might result in several services sectors being exempted from liberalisation or covered by weak disciplines. The EU in any case wants to exempt audiovisual, air and maritime cabotage services. Both sides may agree to soft, barely WTO-plus disciplines on government procurement and competition rules. Finally, the depth and bite of the FTA depends crucially on strong disciplines on domestic regulatory barriers.

The EU-ASEAN FTA

EU-ASEAN trade is lower than EU bilateral trade with China and Japan, but it is higher than EU bilateral trade with Korea and India. EU FDI stock in ASEAN is higher than it is elsewhere in Asia except Japan. EU-ASEAN trade is overwhelmingly with Singapore, Malaysia and Thailand. EU FDI goes mostly to these three countries, and the bulk of it to Singapore.

Relatively big numbers for EU trade and FDI with ASEAN should not be taken at face value: ASEAN is neither a country nor an integrated economic region. ASEAN countries vary widely in historical legacies, political systems, levels of economic development and institutional capacity. Singapore has high Western-style per-capita income; Malaysia is one of the wealthiest developing countries; Thailand is in the middle-income developing-country bracket; the Philippines and Indonesia have much lower, and Vietnam even lower, real incomes; and Cambodia, Laos and Myanmar are least-developed countries. Tiny Brunei is rich solely due to oil revenues. Trade barriers between ASEAN countries, especially non-tariff and regulatory measures, are quite high. Regional economic integration exists more in ASEAN blueprints and “visions” than it does on the ground – a world away from the EU.

An EU-commissioned study on the potential impact of an EU-ASEAN FTA comes up with the following numbers. An ambitious FTA (with zero tariffs on all goods trade and a 50 per-cent reduction in barriers to services trade) would increase EU GDP by 0.1 per cent and ASEAN GDP by 2.2 per cent. A less ambitious FTA (with carve-outs for sensitive agricultural products) would hardly change these figures. A third scenario (taking into account other existing FTAs) would increase the ASEAN gain to 2.6 per cent of GDP. A much more modest FTA (limited to goods liberalisation) would increase EU GDP by 0.03 per cent and ASEAN GDP by 0.5 per cent.²³

Hence a substantial FTA would deliver appreciable gains for ASEAN but have a modest effect on the EU. Seventy per cent of the gains would accrue from services liberalisation. Limited services liberalisation would drastically reduce ASEAN gains, and reduce EU gains to virtually nil. These forecasts are similar to those for the EU-Korea FTA. The CGE model used covers non-tariff and regulatory measures only superficially, and is silent on rules of origin.

A survey of Swedish firms operating in Singapore, conducted by the Swedish embassy in Singapore, fills in the picture with some qualitative detail. For the firms surveyed, non-tariff measures (product classification and standards, regulation of services, investment

restrictions, government procurement, customs procedures, bureaucratic red tape, visa and other labour-market restrictions, lack of transparency and corruption) far outweigh tariffs as impediments to doing business. Singapore is exceptional in having very low non-tariff and regulatory barriers, in addition to its zero-tariff regime. In addition to tariffs, other ASEAN countries have much higher non-tariff and regulatory barriers, which also vary considerably between countries.²⁴

The EU and ASEAN have a Cooperation Agreement that dates back to 1980. Since 2004, they have the Trans Regional EU-ASEAN Trade Initiative (TREATI), which is now the framework for region-to-region regulatory cooperation on trade, investment and trade-facilitation issues. The EU is also negotiating Partnership and Cooperation Agreements, covering a host of political and economic issues, with Singapore and Thailand, and will start PCA negotiations with Malaysia, Indonesia, the Philippines and Brunei. There are plans for a PCA with Vietnam as well. More broadly, the Asia-Europe Meeting (ASEM) is an annual summit involving the EU Commission, the EU member-states and the ten ASEAN members. It has an “economic pillar” for meetings of economic and finance ministers and senior officials, as well as an Asia-Europe Business Forum. The EU has also expressed its wish to accede to the ASEAN Treaty of Amity and Cooperation.²⁵

The EU Commission’s mandate is to negotiate a collective FTA with the ASEAN members with which it has started or plans to start PCA negotiations. This leaves out Cambodia, Laos and Myanmar. The EU gives Cambodia and Laos duty-free access to its market already as part of its Everything But Arms package for LDCs. It will not include Myanmar on principle, given its human-rights record and the existence of EU sanctions on Myanmar. Some ASEAN leaders, on the other hand, insist that the FTA must include all ASEAN members, in line with other ASEAN FTAs with third countries. These issues remain to be resolved. But compromise is likely: these should not be big negotiating road-blocks.

As for negotiating content: The EU wants a ten-year transition period for tariff elimination and commitments in services and investment, perhaps with longer transition

periods for some sensitive agricultural products. It is willing to give Special and Differential Treatment (SDT) to less-developed ASEAN countries in the form of longer transition periods. Interestingly, this differs from the EU's approach to the negotiations with Korea and India, for whom no SDT is envisaged. The EU's draft mandate for the ASEAN FTA negotiations contains softer language on government procurement and competition rules than in the draft mandate for the negotiations with Korea. With ASEAN, the EU wants compatibility with the WTO's GPA and regulatory cooperation on competition issues; there is no mention of GPA-plus market-access commitments, nor of binding commitments on competition enforcement. Finally, the EU aims to complete negotiations by mid 2009.

The bottom line is that an EU-ASEAN FTA only makes economic sense if it goes deep into non-tariff and regulatory barriers in ASEAN countries other than Singapore. This is highly unlikely.

First, the record of existing ASEAN FTAs – AFTA, FTAs between individual ASEAN countries and third countries, collective ASEAN FTAs with third countries – shows that they hardly go beyond tariff elimination on 90 per cent or more of goods trade. Singapore's FTAs are exceptional. The USA is the only player that has attempted strong FTAs with ASEAN countries. It succeeded with Singapore, but has failed so far with Thailand and Malaysia, and considers Indonesia and the Philippines unlikely prospects. That is also why a US-ASEAN FTA is not on the cards.

Second, given intra-ASEAN differences and the lack of an adequate common negotiating machinery, the EU will find it exceedingly difficult to negotiate with ASEAN collectively. ASEAN is big on summits, other meetings, Visions, Charters and sundry blueprints. Much of this is hot air. When it comes to concrete measures, ASEAN decision making is very unwieldy and dilatory, and eventually-agreed positions tend to be low common denominators. The easy way out for the EU and its ASEAN counterparts is to negotiate a relatively trade-light FTA that does not seriously tackle non-tariff and

regulatory barriers – akin to other ASEAN FTAs. That would be politically symbolic but commercially nonsensical.

If this is indeed what transpires with ASEAN, the EU should change strategy, and the sooner the better. What should it do?

- The EU should give up on negotiating with ASEAN collectively (meaning ASEAN-10 or ASEAN-minus-3). Rather it should aim for a stronger TREATI framework for regulatory cooperation with ASEAN. This should be complemented with stronger trade-and-investment regulatory cooperation with individual ASEAN countries, perhaps within a PCA framework. This approach would be similar to the US approach to ASEAN: it has a Trade and Investment Facilitation Agreement (TIFA) rather than an FTA with ASEAN, in addition to TIFAs with individual ASEAN countries.

Such EU-ASEAN trade cooperation would mirror the EU-China approach proposed earlier in this paper – but with an exception. An EU-China framework on a par with the US-China Strategic Economic Dialogue is much needed. But it would not make sense for EU-ASEAN: ASEAN is too diverse and unwieldy for it to work. It would quickly degenerate into vague general statements, photo opportunities, golf excursions and karaoke sessions. That is already covered by ASEM, APEC and other forums.

- The EU should go full speed ahead with an FTA with Singapore. This could be done in quick time and be relatively strong and clean. It would be at least as wide and deep as the US-Singapore FTA. Ideally, it would remedy some of the latter's faults, notably on complicated, product-specific rules of origin.
- The EU should *not* go full speed ahead with bilateral FTAs with other ASEAN countries. Serious FTAs with them are presently not deliverable. Malaysia and Thailand are the strongest candidates after Singapore. But Malaysia's vested interests are intimately bound up with its *Bumiputra* policies (that discriminate in

favour of the Malay majority). This precludes sufficient opening of services markets and government procurement. Thailand has gone backwards after the military coup in 2006: economic-nationalist rhetoric has increased; anti-market NGOs are more influential; protectionist interests are more powerful; government is more incompetent; and economic illiteracy is all-pervasive. Indonesia, the Philippines and other ASEAN countries present even greater obstacles.²⁶

Stronger regulatory cooperation with ASEAN and an EU-Singapore FTA would of course deliver paltry welfare gains compared with a serious EU-ASEAN FTA. But the latter is politically not feasible; and the former economically more sensible than a dirty EU-ASEAN FTA.

The EU-India FTA

India is the smallest of the EU's Asian trading partners considered here. It also receives less EU FDI than the others. But the relationship looks very different from the Indian end: the EU is India's biggest trading partner and biggest source of FDI.

An EU-commissioned quantitative analysis of the potential impact of an EU-India FTA considers two scenarios. Both assume tariff elimination on 95 per cent of goods trade. In the first scenario, services protection is cut by 10 per cent; in the second by 25 per cent. In both scenarios EU gains are very modest, amounting to 0.025 per cent of GDP (an increase in exports of US\$ 17-18 billion) by 2020. Indian gains are bigger, but still fairly modest: a 0.5 per-cent increase in GDP (an increase in exports of US\$ 9 billion) by 2020. Indian gains are sensitive to the sectors covered, and particularly dependent on sufficient services liberalisation. The authors stress that these predictions are conservative; they do not model productivity gains and GATS Mode Three (FDI through local establishment) liberalisation. The study does not seriously model non-tariff barriers and says nothing about rules of origin.²⁷

A far more revealing EU-commissioned qualitative analysis, conducted by the Centre for the Analysis of Regional Integration at Sussex (CARIS) and CUTS International, gets to the nub of the issue.²⁸ A “shallow” FTA, i.e. one with tariff liberalisation but little else, would result in limited welfare gains and risk strong trade diversion. That is because India has relatively high tariffs and the EU low tariffs, with little overlap in their production structures. Diversion away from efficient third-country suppliers could happen in services trade and FDI in addition to goods trade.

The study goes on to argue that only a “deep-integration” FTA would be worthwhile. That requires serious tackling of India’s non-tariff and regulatory barriers. These are on a much bigger scale than the EU’s non-tariff and regulatory barriers. Such an FTA could induce significant productivity gains driven by technological change, economies of scale and other dynamic effects. Growth in FDI is very much related to productivity gains. An FTA would need careful identification of non-tariff barriers; convergence of standards (with Indian adoption and enforcement of a range of internationally-recognised standards); mutual recognition of conformity tests and certification of products; substantial liberalisation of FDI through raising investment caps in some sectors and opening hitherto closed sectors (such as legal and other professional services); improved access for EU services suppliers through other modes of supply, including liberalisation of business-visa regimes; mutual recognition of qualifications; more transparency in information and procedures on trade-related regulations at central and state levels; lowering obstacles to trade facilitation, especially in customs procedures; better access to government procurement; and improved enforcement of competition rules and IPR. The report emphasises that many of these measures have to be tackled at central *and* state levels.

The EU-India FTA negotiations follow the formal upgrading of bilateral relations in recent years. A broad EU-India Cooperation Agreement has been in force since 1994. A “strategic partnership” was announced in 2004. For the FTA, both sides aim to eliminate duties on 90 per cent of tariff lines and trade volumes within seven years of an agreement being signed. They hope to eliminate “non-justified non-tariff obstacles

to trade”; ensure substantial sectoral coverage of services, aiming for *net* liberalisation (based on applied measures rather than much weaker GATS commitments); have mutual recognition of qualifications and more transparency in services regulation; improve market access and transparency, and provide for national treatment, in investment regulations; cover trade facilitation and government procurement; have stronger regulatory cooperation on competition policy, TBT and SPS measures; agree stronger protection of GIs; and include binding dispute settlement.²⁹ Both sides aim to complete negotiations by 2009.

The EU Commission’s mandate for negotiations with India contains softer language on government procurement and competition policy than it has for negotiations with Korea. But it implies higher ambition than for negotiations with ASEAN. There is no mention of SDT for India, whereas there is for the less-developed ASEAN members. This is strange, since India’s per-capita income is much lower than the ASEAN average. It seems both sides are happy to leave most agricultural trade out of liberalisation commitments, while still covering 90 per cent or more of total trade. Both sides profess high ambition for liberalisation of trade in industrial goods, and even higher ambition for services liberalisation.

The CARIS/CUTS study has the right diagnosis and prescription – and (without saying so) points to the near impossibility of a serious FTA with India. India has the worst FTA record of all the major Asian players: its FTAs are appalling. Many are gimmicky, commercially nonsensical preferential-tariff agreements on a limited range of goods. Even in the relatively more serious FTA with ASEAN, India insists on carving out much of agricultural trade as well as a range of industrial products, all hedged about with very restrictive rules of origin. India is not serious about WTO-plus liberalisation of assorted regulatory barriers in services, investment, government procurement and other issues in its FTAs. Moreover, dirty, trade-light FTAs fit the broader pattern of Indian trade policy. The Government of India remains inflexible and defensive in the WTO. It is one of the major obstacles to the conclusion of the Doha round. More importantly, unilateral trade-and-investment liberalisation, and

market reforms more generally, have stalled since the present Congress-led government took power in 2004.

In this context, it would be naïve to expect the Government of India to sign, let alone implement, the kind of deep-integration FTA described in the CARIS/CUTS study. If the Indian government cannot pursue even a small fraction of these measures unilaterally, it is out of the question to impose them “from above” through an FTA – and least of all in India’s boisterous culture of democratic politics. Furthermore, the CARIS/CUTS study, with its vast wish-list of reforms, implies a wholesale overhaul of Indian regulation. That includes deep reforms in the states. Such a programme not only presupposes renewed reform momentum in Delhi (which is nowhere to be seen), it also presupposes concerted action by the states. That is not realistic. The states have entrenched political autonomy, with constitutional guarantees; they cannot be commanded to act by the central government.

Ultimately, this kind of reform agenda can only be pursued unilaterally through a combination of initiatives at central and state levels. Inevitably, it will be long drawn out and patchy. A deep-integration FTA might be a useful lock-in mechanism if and after renewed unilateral reforms materialise. But it defies belief that such an FTA can trigger such reforms and overcome huge domestic political obstacles.

The EU is on a hiding to nothing if it believes it can get a deep-integration FTA from India. It was a mistake to launch FTA negotiations, just as it was a mistake to launch FTA negotiations with ASEAN collectively. So what should be done?

- If negotiations do not soon show signs of sufficient progress on non-tariff and regulatory barriers, the EU should put them in deep freeze. It could consider restarting FTA negotiations if political conditions change in Delhi and there is a new wave of market reforms, including unilateral trade-and-investment liberalisation. That is highly unlikely in the short term.

- The EU should focus instead on much stronger trade-related regulatory cooperation, along the lines advocated here for EU-China and EU-ASEAN. This could be enshrined in a new bilateral agreement, but not in an FTA framework. And it should encompass regulatory cooperation with the Indian states on trade and FDI-related issues. Finally, the EU could envisage a Strategic Economic Dialogue with India along the lines of what it should have with China. It is far more urgent to set up an EU-China mechanism, given the EU's much stronger commercial ties – and correspondingly greater trade tensions – with China. But thinking of a parallel EU-India mechanism for the medium-term would be wise.

Conclusion

The EU says its new FTAs with Asian countries will be governed by commercial criteria, and that it is aiming for strong, comprehensive, WTO-plus FTAs. But, for the most part, this is unlikely to materialise. The EU is not as ambitious on market access and rules as the USA in FTA negotiations. It has entrenched protectionist interests in agriculture as well as in some industrial-goods and services sectors. Its commercial criteria are severely compromised by its zeal to export the “EU regulatory model”. This includes a range of non-trade objectives it sneaks into bilateral and regional trade agreements. Its two major Asian trading partners, China and Japan, are not on its FTA wish-list.

Over in Asia, the emerging patchwork of FTAs leaves much to be desired. Some FTAs are preferential-tariff agreements on a limited range of goods. Even the better ones are trade-light and barely WTO-plus: they cover tariff elimination on most goods trade, but do not seriously tackle non-tariff and regulatory barriers. They are unlikely to contribute to regional and global economic integration, but will cause extra complications through a noodle-bowl profusion of complicated and discriminatory deals. This is undermining comparatively simple, transparent, predictable and non-discriminatory multilateral trade rules. The new EU-Asia FTAs risk making the problem worse. Finally, the mercantilist outlook of all major FTA players, including the EU and its Asian partners, leads them to

neglect unilateral liberalisation and domestic structural reforms. The latter are far more important to building up firm-level competitiveness than crowbaring open export markets through FTA negotiations.

As for the new FTA negotiations: The EU's best prospect is a relatively strong, WTO-plus FTA with Korea, building on the recently concluded US-Korea FTA. But it will probably leave significant gaps, notably in agriculture and some services sectors. The EU has little hope of concluding a serious FTA with ASEAN collectively (or even with ASEAN minus Cambodia, Laos and Myanmar). Rather it should focus on stronger EU-ASEAN trade-related regulatory-cooperation, and a strong, WTO-plus FTA with Singapore. Strong FTAs with other ASEAN countries are unlikely. The EU has as little hope of concluding a strong FTA with India. It should focus rather on stronger bilateral regulatory cooperation, and consider a deep-integration FTA later if Indian political conditions change and there is a renewed wave of unilateral liberalisation.

Last – and far from least – the EU needs a much stronger framework for trade-related regulatory cooperation with China. It could draw lessons from the new US-China Strategic Economic Dialogue. The focus should be on tackling concrete issues where there is trade tension and conflict. These issues should not be linked to the EU's non-trade objectives. At the same time, a coalition within the EU needs to be assembled to accord China market-economy status. All these measures would help to contain protectionism, strengthen bilateral relations, encourage the Beijing leadership to go forward with WTO-plus reforms to open up the Chinese economy, and reinforce China's engagement as a responsible stakeholder in the multilateral system.

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Endnotes

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2. European Commission (2006d).
3. Evenett (2006), pp. 382-385.
4. Woolcock (2007), pp. 3-4.
5. Financial Times (2007).
6. Woolcock, *op cit.*, p. 6.
7. Woolcock, *op cit.*, p. 4.
8. Woolcock, *op cit.*, pp. 8-9.
9. On IPR, see Perez Pugatch (2007).
10. The EU-Korea FTA will be exceptional as the EU is likely to get at least parity with provisions in the US-Korea FTA. The USA, however, does not have FTAs with India and ASEAN.
11. Evenett, *op cit.*, p. 386.
12. Messerlin (2007), pp. 5-8.
13. Rollo (2006), pp. 408-409.
14. This section draws on Sally (2006). Also see Antkiewicz and Whalley (2005) pp. 1540, 1554-1555; Baldwin (2006b); Baldwin (2006a); Soesastro (2006).
15. Also see Athukorala (2006), pp. 1-27.
16. European Commission (2006f).
17. European Commission (2006c). Also see the Commission's accompanying Working Document, COM(2006) 632 final.
18. Barysch, Grant and Leonard (2005), pp. 10-20.
19. European Commission (2007d).

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20. On the US-Korea FTA, see Schott (2007).
 21. European Commission (2007b).
 22. The US-Korea FTA exempts rice, at Korea's behest. It also has partial tariff reductions, long transition periods (from 10 to 20 years) and tariff-rate quotas for many other agricultural products. See Schott, *op cit.*.
 23. European Commission (2006b).
 24. Lindberg (2007).
 25. European Commission (2004).
 26. On the state of trade policies in individual ASEAN countries, see Sally and Sen eds. (2005) and Sally (2007).
 27. European Commission (2007a).
 28. European Commission (2007c).
 29. European Commission (2006e).