Trade, Globalisation and the Lisbon Agenda

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Europe is today the biggest trading bloc in the world. Even if you exempt export and import between members of the EU, the volume of European trade is considerably bigger than US or China trade. The expansion of membership in the European Union – from 15 to 27 countries within just a few years – and, more importantly, the growing reliance on trade (measured as trade-to-GDP ratios) have boosted trade and lifted Europe to the top position.

But this leadership will not continue by default. The structure of the world economy is changing rapidly. In this era of explorers and innovators rankings will change constantly – and in some cases abruptly. European leaders know the importance of upgrading competitiveness, but essentially fail to understand the texture of the emerging world-economy order and its implications for European policy. This article broadly sketches the main features of the new world economy, discusses European problems to adjust to globalisation, and analyses why the Lisbon Agenda has failed to increase competitiveness.

The new world economy

The last decades have witnessed a significant change of world trade patterns. World trade has grown at an unprecedented pace – on average 20 per cent faster than the world output growth over the last 50 years. The rapid increase of trade has facilitated a more interdependent structure of the world economy. The idea of national self sufficiency is today a redundant concept; something for the history books rather than policy programmes. All but a few rough states are entirely dependent on cross-border exchange.

Falling barriers to trade is a key factor behind this development. When the GATT, the predecessor to the WTO, started in 1947 the average tariff on merchandise trade was 40 percent. Today it is 1,4 percent. On many goods, particularly in the IT and telecom sectors, trade is duty free.

Europe has been a vehicle of the progressive reduction of barriers to trade in the post-war era. Together with the United States, the EU assumed for a long time the leadership of the world trading order and steered it in the direction of freer trade. The successive reforms of internal trade policy in the EU provided substantial momentum to multilateral trade reforms. The formation of the Customs Union after the Rome Treaty led to an overall reduction of tariffs in Europe, particularly in France and Italy.

Equally important, the common commercial policy pushed other countries in Europe to undertake trade reforms (EFTA emerged as a response to the Rome Treaty trade reforms) and facilitated two key GATT rounds of multilateral liberalisation – the Dillon Round and (in particular) the Kennedy Round, both negotiated in the 1960s. The internal

reforms of trade policy in Europe became a stepping stone for multilateral leadership – Europe prepared itself for more extensive liberalisation on the international scene – but also gave an extra incentive to other countries, notably the United States, to negotiate multilateral reductions to get better access to the European markets. The Customs Union reduced trade barriers between its members and gave participating countries preferential access to each others markets. To avoid such disadvantages in access to the big European markets, the U.S. had an incentive to push general reductions of tariffs in the world.

A similar template for multilateral trade liberalisation – first internally, then externally – was also used in the early 1990s during the Uruguay Round. The Single Market of Europe, and the equivalent process of building a Free Trade Area in North America, gave the impetus needed to conclude the most ambitious round ever in the history of GATT.

But trade policy is no longer shaped along the Transatlantic axis. 150 countries are today part of the negotiations. More importantly, almost as many countries are today of relevance to other countries as export destinations and origin of import. The rapid increase in trade volumes in the last decade involves all continents; in fact, trade has grown faster than output on all continents in the last decade. Asia is leading this trend, but Africa too has witnessed strong trade growth.

Asia's economic growth model is based on substantial trade-to-GDP ratios – on average in the spectrum of 130-150 percent in Southeast region of Asia. Japan and the next generation of Asian Tigers for long dominated Asian economic activity. But other countries have picked up fast – in particular China. Chinese trade has grown by 15-20 percent annually in the new Millennium and China is already more globally integrated than Japan. China recently replaced Japan as the world's third largest trading nation. This unprecedented *geographical equalisation* of trade looks set to continue in the near future.

Regionalisation of trade policy has been particularly strong in the last 15 years. The number of primarily bilateral agreements has exploded. The EU has recently embarked on a new programme for Free Trade Agreements (FTA) with no less than 24 countries. Only in Southeast Asia there are 60 new FTAs in the pipeline.

This regionalisation is also mirrored in actual trade patterns. In some parts of the world it has led to a primarily regional structure of trade along the "hub-and-spoke" model. In other parts the regionalisation is more conducive to international trading patterns and accommodates the trend of *fragmentised trade* – the emerging pattern of "trade in tasks" rather than trade in finished goods. Such trading structures are more in accordance with many companies' strategies to globalise the supply chains. The trade policy of Asia is more conducive to a supply-chain orientation of trade than EU trade policy. Asian trade is more centred on big-volume, low-margin production and is sensitive to all forms of trade regulations. Furthermore, the strict rules-of-origin regulations applied by the EU in its bilateral agreements prevent many companies from trading at lower tariffs because these regulations do not fit modern supply chains.

The fragmentisation of trade has been pushed by a rapid increase in Foreign Direct Investments (FDI). In fact, the world economy today is not primarily function of trade; it is rather "investment first, trade second". This *functional sophistication* of the world economy has added a new flavour to economic integration. The sheer volume of FDI increase is impressive. FDI has grown much faster than trade through the last two decades. The world stock of FDI equals today roughly 8 trillion US dollars compared to less than 1,5 trillion in 1990. Cross-border investments are still subject to extensive regulations, but they have been substantially liberalised and facilitated the trade-in-tasks structure of world trade.

Nor is the world economy any longer a function of merchandise trade. Goods still accounts for 70 percent of all trade, but services are increasing its share of trade and will in near future represent an equal share of world trade. This will correct the *imbalance of globalisation*, its heavy reliance on trade in goods. Services trade will be pushed primarily by increasing movement of production factors – capital (investments) and labour (migration). The *increasing tradability of many services* also leads to a rapid increase in the volume of services trade.

The European economy

What do these changes in the texture of the world economy hold for Europe? How does Europe fit in this broad sketch of globalisation? Europe has been a great beneficiary of global economic integration. European welfare has increased substantially because of globalisation. But Europe's position in the global economy is not without problems.

Firstly, globalisation has sharpened the need for structural change, but the European economy has not changed sufficiently. Europe still insists on a general economic philosophy based on manufacture as the hub of the economy. The manufacturing sector still represents a significant share of the European economy and a sizeable part of the recent surge in economic growth in some leading member states in Euroland is effectively driven by productivity increases in traditional manufacturing. A surprisingly high share of European export growth is accounted for by the industrial sector. But Europe's future position in the world economy is not to be found in this sector. The comparative advantages of many emerging economies are too big for Europe to stay competitive in industrial production.

The heavy reliance on manufactures adversely affects trade policy. Europe is today the top user of so called trade defence instruments – in particular anti-dumping duties. These are primarily applied against exports from emerging economies, but have generally little to do with dumping or unfair competition. They are rather used as a relief from international competition. It should not come as a surprise that the least competitive EU members – notably Greece and Italy – are the strongest proponents for an extensive use of trade defence protectionism.

Secondly, Europe is investing too little in research and development and, equally important, earns too small yields to the economy from investments generally. In

comparison to other developed regions in the world, a larger share of the investments intends to replace labour with capital (technology). The generally high employment costs in Europe incentivise such substitution and this pattern is most frequent in the non-tradable sectors – sectors that are not integrated in the world economy.

Europe has another problem related to return on investments – the return on human capital investments (in particular higher education). The reservation wage in many European countries is high and has underpinned a transfer from labour to education for many young people. But a high share of young Europeans with a university degree is unemployed or cannot find a job that matches their educational qualifications. As a consequence, the entry standards to the labour market have increased. A job that fifteen years ago required only secondary education is today employed by university graduates. In most European countries, newly employed bank cashiers have a three-to-four yeas business and economics education. The output rate from such an investment in higher education is too low.

Thirdly, the structure of the European economy does not facilitate an easy climb in the value-added chain of international trade. It is rather warranted to speak of a value-added chain logic of protectionism in Europe.

The move from an industry-based economy to a service-based economy is slow but nonetheless present in Europe. As the relative share of services in total production increases, the *de facto* level of trade protection follows suit and leads to an overall increased protectionism. Why? In the first place, services are generally much more protected than industrial production. The post-war development of falling barriers to trade has produced an overall globally-integrated industrial sector in Europe. But this development essentially confined itself to merchandise trade. Services are still highly protected. In the second place, many services sectors are not tradable sectors. Almost 60 percent of services production in Europe is non-tradable. This is partly due to the nature of many services – not all services can be traded. But the chief explanation to why many services have not been subject to trade is to be found in the organisation of production and of markets. In short, the production and market structure for many services are not conducive to trade.

This is particularly true for many services in the higher end of the value-added chain – education and health care, for instance. It also produces an unhealthy structure of the economy from the vantage point of international trade – and opinions over trade. Jobs in the trade-oriented industrial sectors are reduced while the number of staff in the non-traded services sectors increase. When key sectors of the economy are locked in an artificially non-traded structure, it also adversely affects economic growth. Let's illustrate with two examples.

The Knowledge Commission in India recently reported that the country needs 1 500 new universities in the next decades. India alone will have a giant growth in the market for higher education. But few European universities are interested to take a share of that

growing market. In fact, the policy for university and higher education in most European countries disincentivise such a global market outlook.

The market for health care in China is projected to rise with a few trillion US dollars to 2020. But we don't find any European hospitals strategically positioning themselves to take part of that growing market. In fact, most European countries reject the notion of trade in health care.

In other words, key service sectors in Europe are not organised to benefit from rapid growth in emerging markets. This puts these sectors, and countries, on the defensive and constrains the EU position in international trade policy. Europe is not a leader for reduced barriers to trade in services. For several key sectors, Europe refutes to commit to any form of liberalisation of service trade. In the current negotiations over services in the Doha Round, Europe has made the fewest offers of all countries in sectors such as education and health care. Interestingly, it is not the traditionally protectionist wing of Europe that suppresses efforts to liberalise. It is rather countries that are usually free-trade minded. Sweden is the country among the EU-15 group that made fewest commitments to services-trade liberalisation in the Uruguay Round and has offered least liberalisation of the same trade in the current round.

The Lisbon Agenda

The Lisbon Agenda started as an ambitious and comprehensive reform programme for increased European competitiveness. Many properties of this agenda rest on a correct analysis of European concerns and benefits economic growth. But in terms of achieved reforms in member states, the agenda has been a failure. The headline ambition with this reform programme – to make Europe the most competitive economy by 2010 – was unrealistic already at the outset of the Lisbon Agenda. Many of the sub-targets of the agenda, also the less controversial reform proposals in areas such as financial services and intellectual property rights, have stumbled on political resistance. The Commission has tried to be pro-active and launch new initiatives to get member countries to push reform efforts, but to little success. This also demonstrates a central problem of the Lisbon Agenda: it is clearly a Commission project, but reform delivery has almost entirely been assigned to member states. The EU lacks jurisdictional competence to act in many of the Lisbon Agenda policy areas and effectively no part of the agenda is based on the single area in which the EU actually can push reforms with substantial impact on competitiveness: external trade liberalisation.

Yet the most troublesome aspects of the Lisbon Agenda is not its political structure, it is rather the content. To put it shortly: Lisbon Agenda reforms come 15 years too late and do not add much to Europe's adjustment to a new structure of the world economy. The sector liberalisations that form the core part of the agenda are necessary, but the return to these reforms is much lesser today than one or two decades ago. Markets, competitors, and the economic structure have changed to such a degree that these reforms alone will not produce the same benefits as before to producers.

For example, telecom liberalisation in Italy will have positive effects for consumers, but hardly for Italian telecom producers that will not be competitive on a market in which other actors have adjusted to competition for the last 15 years. Similar conclusions apply to other policy areas as well: investments in information technology, or innovation-policy reforms, are still necessary, but they do not provide a competitive advantage. Fifteen years ago, the Lisbon agenda would have been an offensive reform programme; today it is rather a defensive effort to balance competitive disadvantages.

From the vantage point of adjusting to the new structure of the world economy, there are two key areas missing in the Lisbon agenda.

Firstly, the agenda does not at all address supply-chain concerns. There have been efforts to add an "external dimension" to the Lisbon Agenda by connecting it to ambitious strategies for the Doha Round of trade liberalisation. This did not materialise. Europe is committed to multilateral trade liberalisation, but it does not show in the actual policies and the proposals tabled in the negotiations. The chief priority for the EU still is to hedge European farmers from real liberalisation and market openings. The current impasse of the Doha Round implies not only stalled efforts to liberalise tariffs on a multilateral basis, and by such a move get access to emerging markets and surpass the complex problems around rules-of-origin regulations in bilateral agreements. It actually gives a push to entrenched bilateralism and regionalism. The new EU policy for bilateral agreements will add more complexities for companies with sophisticated supply chains.

Secondly, the Lisbon Agenda is devoid of reforms of key service sectors in order to subject them to trade. This translates into missed opportunities to benefit from rapid growth of the services sectors in emerging markets. Sectors that could provide economic growth and jobs in Europe have been entirely neglected in the Lisbon Agenda.

A failing Lisbon Agenda would not have been a problem if countries had pushed these reforms on their own. But they have not. Most European countries suffer from reform inertia. In the short run this inertia hampers economic growth. In the long run it fosters a growing opposition to globalisation and outward-looking economic policies.

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