Trade policy Briefing

The SAIIA Trade Policy Briefing Series is intended to elicit debate on critical issues relating to South Africa's overall trade strategy. The broad focus of the series is on the political economy of the international trading system and South Africa's strategic responses to it. This covers the full spectrum of our trade strategy, from the multilateral trading system, to strategic regional and bilateral partnerships, and particular issues within the trade agenda.

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More than Just Numbers: The Implications of EU Enlargement from 15–25 for South Africa's Trade Strategy

by Peter Draper and Greg Mills

Summary of Recommendations

This briefing is intended to offer insight into the strategic implications of EU enlargement for South Africa's trade strategy. Eight recommendations are made:

1. In the WTO agriculture negotiations, maintain ambitions on domestic support proposals whilst increasing ambition in tariff liberalisation proposals.
2. In the WTO industrial tariff negotiations retain tariff liberalisation ambition.
3. Conduct an assessment of the impact of EU expansion on the US market and of a possible Democrat administration on US trade policies.
4. Conduct a thorough strategic assessment of African Union integration initiatives in light of EU expansion.
5. Separately conduct an analysis of the EPA negotiations in our region and their implications for emerging regional configurations.
6. Pursue a more liberal approach to our region, particularly in the spheres of rules and origin and trade facilitation.
7. Consolidate quantitative analysis of the economic impact of enlargement on SA trade with the accession countries and supplement this by tapping SA business community thinking on this issue. Use the results of these analyses to target trade missions to the accession countries.
8. Study the institutional management of the EU's enlargement process in order to yield lessons for managing potential SACU expansion.

Analytical Perspectives on Englargement

Enlargement will fundamentally effect the EU's internal dynamics. These are dealt with in greater detail elsewhere[1], and so will not receive attention here. Rather, this briefing focuses on the dynamics most likely to impact on EU trade strategy particularly in the sphere of agricultural policy; and how the broader political dynamics pertaining to enlargement will affect South Africa's trade strategy.

This is of particular relevance as the new Commission takes up office. Commissioner Barroso, the former Portuguese Prime Minister, has made appointments that have been widely interpreted as pushing the EU in a more liberal direction. This is scarcely surprising given Portugal's strong association with the "Lisbon process", an ambitious plan to make Europe the most competitive economic space globally by 2010. But powerful countervailing pressures in the EU will temper liberalising ambitions.

These tendencies are briefly analysed below, specifically through the prisms of: budgetary policy; agricultural policy;

legal implications of enlargement for the EU's trading partners; and possible trajectories for a further widening of the EU space. Based on the parameters developed in this discussion implications for South Africa's trade strategy are proffered.

Economic Policy and Budgets: Deeper and Deeper?

The continued existence of welfare state systems in most western European countries gives rise to a general reluctance to liberalise, in trade and other spheres of economic policy. Yet enlargement brings a group of aggressive liberalisers, in Central and Eastern Europe (CEE), together with the likes of Britain and Ireland to form a stronger group of liberalisation advocates.

When viewed in combination with a massive build- up of long- term budgetary pressures in Western Europe owing to aging populations, it is apparent that enlargement has upped the ante for budgetary reforms, within states and at the EU level. In the long- run this should promote liberalising reforms in the taxation- subsidisation- resource transfer nexus.

However, the Common Agricultural Policy (CAP) budget has been fixed until 2013. Therefore, in the medium- term countervailing pressure to this budget reform trajectory will come from the accession countries' desire to retain and increase resource transfers from the EU to promote their own development, notably through regional aid. They will also most likely resist further cuts in agricultural support (discussed below). The big budget contributors, on the other hand, will use this desire as a source of leverage to promote their own agendas elsewhere (for some this means resisting further CAP reform). It is difficult to predict how these dynamics will play out[2], nonetheless they form a critical backdrop to understanding agricultural policy dynamics.

Agricultural Policy

The trajectory of EU agricultural policy is of most interest in EU trade strategy. Traditional EU alliances, particularly on agriculture, are relatively well- known: a northern "liberal" group consisting of the UK, Scandinavian and Baltic countries, and the Netherlands, has traditionally favoured more liberal agricultural policies. France and Mediterranean countries have traditionally been supportive of more protection whilst Germany has vacillated between the two.

The key question is what approach CEE agricultural producers will take to reforming the CAP, and potential (re)alignments arising from this. Several developments are relevant:

a. Overall, tariff levels in the accession countries have halved. Thus despite a generally aggressive liberalisation stance pressures from this quarter for further liberalisation are likely to be muted.
b. Notwithstanding (a), accession countries have apparently had to raise their average agricultural tariff levels. This has caused prices of some agricultural products to rise, which could render them sympathetic to more ambitious tariff liberalisation formulas in the Doha round.
c. However, a new constituency of protected farmers will militate against this. That constituency now has partial and increasing access to CAP subsidies, most likely rendering them resistant to reductions in such support. Furthermore, whilst these subsidies are being decoupled from production, the process of "box shifting" (moving subsidies from the "trade- distorting" category to "non-trade distorting" categories) will render reductions in overall support beyond 2013 unlikely.
d. Furthermore, accession countries will have to make substantial investments in infrastructure and SPS systems to meet EU standards, and similar investments are required to upgrade their industrial sectors. Until those investments have materialised, and whilst their standards remain below EU requirements, their access to the common market will be curtailed.
e. Therefore their appetite for regional aid will remain high, rendering them vulnerable to budgetary pressures from the net budget contributors. The latter include France and Germany, who on balance do not want to see reductions in overall CAP levels.
f. Meanwhile their access to the Russian market, via Soviet- era preferences, has also been curtailed as they have taken on the EU's trade arrangements. Poland in particular has apparently lost substantial market access there.
g. And the CEE countries' accession to the EU's various preference schemes and free trade agreements will open their own markets to developing countries, currently largely on a non- reciprocal basis. This will increase their resistance to further trade liberalisation, particularly if developing countries are perceived to be withholding reciprocal access to their markets.

On balance it is our view that the accession countries, at least the key agricultural producers, have a stake in continuing the status quo in agricultural policy for the foreseeable future. This may militate against more generous preferential or multilateral concessions being offered by the EU in domestic support (subsidisation) although there may be some (temporary) support for tariff liberalisation.

Compensation

Articles XXIV(5) and (6) of the GATT require customs unions to compensate trading partners when incorporation of new members renders other trading partners worse off, on balance, than they were prior to such expansion. Most economic analyses of this issue, and the EU's internal assessment, indicate that compensation is not necessary for any trading partners, and that in fact most will benefit owing to the lower overall tariff levels in accession countries. Therefore it is unlikely to be an issue for South Africa.

New Members Still? Wider and Wider?

Further afield, whilst Central and Eastern Europe is being digested, with more candidates in the wings potentially being incorporated through the EU's "Neighborhood Policy" (Ukraine? Turkey? The Balkans?), the Commission is laying plans to more tightly integrate North Africa and the Muslim east into its expanding economic space. This has been given impetus from 9/11 and the deteriorating security situation in Iraq. The North African strategy is now known as the "everything but institutions" initiative, positing the development of a relationship with North Africa built on *"four freedoms": trade, capital flows,* and movements of people and services; but short of institutional membership. This process will more firmly divorce North Africa from sub- Saharan Africa, with attendant implications for the African Union (AU) and continental integration processes, and further distract EU attention from South Africa's regional and continental concerns.

In this light the future of the ACP grouping is uncertain. By 2008 it will most likely have lost its cohesion, and probably its raison d'etre. There is a view that this may reflect a deliberate EU strategy to achieve this outcome, thus shedding the EU of an historical burden at a time when it is fundamentally re-inventing itself. Regardless of whether this is true the EU will consolidate these (re)emerging relationships through the Economic Partnership Agreement (EPA) negotiations, promoting its standards and more tightly integrating its former colonies into its expanding economic space. This process will decouple regional formations within the broader ACP to focus closely on themselves and their immediate group's direct relations with the EU.

Therefore ACP unity in WTO negotiations is likely to diminish as reciprocal market access negotiations get underway. Furthermore, the EPAs could ultimately come to replace preferential access into the EU market. This could remove a key "drag" on the multilateral trading system -- notably in terms of developing country fears over loss of preferences.

Finally, Turkish attempts to accede to the EU may have been given a boost by the failure of the Annan- instigated referendum on Cyprus reunification. Failing a resumption of talks over the island's future, given the resounding Greek Cypriot 'no' and Turkish Cypriot 'yes' vote, Greek Cyprus may well join the EU as a distinct entity with international recognition also being conferred on the Turkish north. Whatever the outcome, this will likely prove a further distraction away from Africa.

Development Aid

Based on the EU's ever wider expansion, and its internal budgetary and political battles, it is inevitable that changes are on the cards for EU development aid policies. In the long- term, as the EU's link with the ACP diminishes in favour of its expanding frontier, it is likely that resources will be re- directed to new and associated members. This will be offset by pressure (to the extent such pressures move the EU) to buy ACP acquiescence in the EPA process through increased development aid flows.

Therefore reorganisation of DG Development should be closely monitored for its potential impact on the ACP group in particular.

Implications for South Africa's Trade Strategy

Based on the preceding analysis the following implications for South Africa's trade strategy are evident:

a. The WTO

i) **Agricultural trade policy** is the principle concern. Our analysis suggests that enlargement is likely to expand support for retaining the CAP, especially the domestic support component, in the medium-term. This suggests that agricultural liberalization proposals emanating from the G20 and Cairns group will have to be less ambitious on domestic support. However, a constituency for more ambitious tariff liberalisation may develop in the EU in the short- term, but unless substantial cuts are quickly achieved this constituency is likely to dissipate. In light of the current lack of ambition in Geneva concerning agricultural tariff liberalisation (the average cut formula currently on the table will not yield substantial reductions in EU tariffs), this is a narrow window that should be vigorously pursued.

Recommendation: Maintain ambition in domestic support proposals whilst increasing ambition in tariff liberalisation proposals.

ii) The fortunes of the **ACP/G90 grouping** will have a bearing on the Doha round. Our analysis suggests that owing to EU enlargement this group is likely to become less cohesive over time. In the short term this may generate a backlash and backsliding, but in the medium- term as the full implications of the EPA negotiations become apparent this reaction will subside and a more realistic approach should prevail. Therefore it would make sense to hold the line on ambitious tariff liberalisation proposals for industrial and agricultural goods, particularly as this will ultimately benefit all participants.

Recommendation: Retain industrial tariff liberalisation ambition whilst explaining these longer- term considerations to ACP partners to allay political fallout.

b. The expansion of EU membership is not likely to alter (but may well exacerbate) **trade tensions with the US**, particularly around monopolies and issues of product subsidisation. Related to this, any shift in US attitudes regarding trade liberalisation must be closely monitored, especially given the prospects for a (more protectionist) Democrat Kerry administration. Notwithstanding this, EU membership expansion may, however, lead to a more aggressive US approach in securing external trade preferences in Latin America (through the FTAA), Asia (bilaterally), and with select African countries. This has implications for the SACU- US FTA negotiations currently underway; notably that US commercial objectives may be increasingly aggressively pursued. To the extent this is true it may afford SACU increased leverage in those negotiations by widening the scope of possible trade- offs.

Recommendation: Closely monitor the US- EU relationship and conduct an assessment of EU membership expansion on the US market and of a possible Democrat administration on US trade policies.

c. The trajectory of **AU and continental integration processes** is generally poorly understood, and it is not clear how useful those efforts are to South Africa. Nonetheless, it is clear that EPA negotiations will have consequences for processes of regional integration, especially in our region. This has clear, potentially negative, implications for South Africa, which is trying to build a viable South African- centric regional integration project.

Recommendation: Conduct a thorough strategic assessment of AU integration initiatives in light of EU expansion. Separately conduct an analysis of the EPA negotiations in our region and their implications for emerging regional configurations.

d. Concerning our direct relationship with the EU, a thorough assessment of trade losses versus gains for South Africa is required. Static quantitative analysis indicates that, based on our low levels of trade with the accession countries, **compensation** is not an issue. It also indicates that minor gains from trade can be expected. It does not take into account any bilateral deals we may have with accession countries, although as far as can be ascertained there are none. However this static analysis needs to be complemented by inputs sourced from the business community before we can obtain a full picture. These inputs should explicitly consider the dynamic gains likely to flow from anticipated inflows of FDI into the accession countries. It is likely that their rates of economic growth will substantially exceed the EU average, making them potentially lucrative markets for the expansion of South African exports (admittedly off a low base).

Recommendation: Consolidate quantitative analysis and tap SA business community thinking on this issue. The results should be used to target trade missions into CEE countries with a view to possibly using them as "stepping stones" into the broader EU market.

e. As the EU refocuses its attention domestic policy consequences will ensue in South Africa. In particular, the attraction of accession country markets as investment destinations for OECD multinational corporations will increase. Add the attractions of the Chinese, Indian, and Brazilian markets to this equation and it is likely that FDI will continue to elude our region. This should spur regional policy makers to make the region much more attractive for South African FDI. South African policy makers, on the other hand, will have to pull out all the stops to promote domestic investment. On the trade front this has at least two implications:

i) A more liberal approach to our trading partners in the region is imperative. As they find themselves increasingly shut out of EU markets and cut off from flows of FDI, their dependence on South Africa's economy is likely to grow.

Recommendation: Pursue a more liberal approach to the region, particularly in the sphere of rules of origin and trade facilitation.

ii) Expansion of the customs union will become imperative: to secure markets in the face of increasing competition from US and EU producers in particular; and to harmonise policy regimes where appropriate in order to promote smooth location of industrial activity. However, this requires consolidation of the existing SACU arrangements and careful consideration of the procedures governing expansion. Here we could learn much from the EU's management of its enlargement process.

Recommendation: Study the institutional management of the EU's enlargement process in tandem with analysing the possibilities for SACU expansion.

Endnotes:

1 See Jones E, "The European Union After Enlargement", <u>SAIIA Trade Policy Briefing</u> No. 6, October 2004.

2 See Jones, <u>Ibid.</u> for a more thorough treatment of these issues.

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