



Fragmented Power: Europe and the Global Economy

Edited by André Sapir



Foreword

In the last twenty years, Europe has come a long way: the European Union has expanded from 12 to 27 members, created a unified internal market and introduced a single currency, the euro. This internal transformation has had profound external consequences. With now the largest unified market in the world and the second most important global currency, Europe has become a powerful global player. But the world has changed too, only more so. Market openness and technological change have spread world wide and helped China and India to become new global powers. Demographic change and poverty in other parts of the world such as Africa have brought mass international migration. And climate change has become the main symbol of the emergence of the global commons. As a result, foreign economic relations – be they in trade, development, market regulation, migration, money, climate or energy – have become central to the activities of the EU.

In a nutshell, globalisation has become the central theme of the European narrative for the 21st century. This year, on the occasion of the 50th anniversary of Europe's Treaty of Rome and the celebration of a peaceful European political order, heads of state and government proclaimed that the EU is an effective response to major global challenges which allows Europeans to 'shape the increasing interdependence of the global economy and ever-growing competition on international markets according to [their] values'. Many leaders, such as European Commission President Barroso, have declared that the new *raison d'être* of the EU is 'to use its collective weight to shape globalisation' in order 'to help Europeans prosper in a globalised world' and 'to create a new and better global order'.

This way of considering the EU is new. As recently as twenty years ago, it was

primarily envisaged as a regional integration experiment among a relatively small number of participating countries. 'Europe' was about tearing down the walls that separated member countries and prevented their economic and political integration. Accordingly, the EU's external policy was essentially a side-product of its internal dynamics. There were even fears of a 'fortress Europe' that would have liberalised internally while closing borders externally. But then came globalisation and Europeans began to realise that in a world of freer trade, global capital flows and globally integrated enterprises, they could hardly define the entity they were building by reference to the differential degree of integration within it – that is, as a single market. An EU defined in this way – by 'negative integration' in the jargon of EU scholars – was bound steadily to lose its relevance as global integration developed.

Such an inward-looking view of the EU still has supporters among those who advocate building a European shield against the winds of global change. But it is increasingly challenged by another view which sees Europe primarily as a player in a fast-changing world. According to this view, the EU should be characterised by the role it plays in shaping its environment rather than by its economic borders. Europe should not define itself by the degree to which it is closed to flows of products and capital from the rest of the world but by its stance on the global rules governing these flows, and by the role it plays in defining them. Again according to this view, Europe should not solve its identity crisis by arbitrarily deciding that enlargement has come to an end but by actively promoting development and stability in its neighbourhood. It should certainly retain economic legislation that corresponds to the preferences of its citizens and member countries but, just as importantly, it should contribute to defining global rules for integrated markets and companies. And it should first and foremost wake up to the full extent of its responsibilities as one of the few players with an ability to tackle questions related to the global commons: climate, global diseases, world poverty...

It is thus paradoxical that there has been no comprehensive study of European foreign economic policy. There is, for sure, much research on the various sectoral aspects of EU external relations. But to our knowledge, no research has attempted to provide an overall picture of Europe's interaction with its international environment, outlining priorities and discussing policy coherence. Clearly, the fragmented character of the governance of Europe's external economic policy – with responsibility shared or split between the Commission, the European Central Bank, the Council of Ministers, the Eurogroup or the member states – makes formulating a comprehensive view a tall order. By contrast, American foreign economic relations have long been the subject of numerous studies.

The purpose of the present project, launched by Bruegel in the spring of 2006 and culminating in this publication, was precisely to fill this gap. The project was divided into two parts. The first part involved systematically examining seven separate areas of European foreign policy: trade policy; development policy; external competition policy; external financial markets policy; external monetary policy; migration policy; and external energy/environmental policy.

The results of these seven investigations are reported in chapters three to nine of this volume.

The second part of the project consisted of drawing upon the individual policy studies to examine the coherence of European foreign economic policy, in particular but not exclusively in terms of European governance. The outcome of the two transversal analyses undertaken is presented in chapters one and two.

Two major themes pervade the nine chapters of the study: first, the new geography of the world outside the European Union, which dictates an overhaul of the external policy agendas and, second, the need to improve the governance framework of Europe's foreign economic policies in order to ensure their effectiveness.

Viewed from the EU standpoint, the world outside the EU can be divided into five groupings: i) the neighbours in Europe (including Russia), the Middle East and North Africa (EMENA), which together have a somewhat larger population than the EU, a much smaller GDP, and a significant part of the world's energy resources; ii) the United States, with roughly the same GDP as the EU but a smaller population; iii) the other advanced countries, which together have the same population as the US but a much smaller GDP; iv) the emerging and developing countries of Asia and Latin America, which have a population of five times, and a GDP of about the same size as, that of the EU and the US combined; and v) the non-emerging developing countries (essentially sub-Saharan Africa), with a population as large as, but a GDP of less than one third, that of the EMENA region.

This way of analysing the world reveals that Europe confronts three agendas at the global, transatlantic and regional levels.

A global agenda

The first agenda relates to increasing economic integration world wide and its management in a way conducive to growth, development and financial stability through enhancement and reform of the core set of multilateral rules and institutions. It also

relates to the provision of global public goods such as containment of climate change.

What is at stake here is adjustment and response to the emergence of new global economic powers in some parts of the world (mainly Asia) and the absence of progress elsewhere (mainly Africa) in a context of increasing awareness of risks to the global commons and tensions about access to resources world wide. The main policy instruments are trade policy, international finance and development policy, which are managed globally by three multilateral economic institutions – the World Trade Organisation, the International Monetary Fund and the World Bank – as well as environment policy, for which there is no single forum or world institution.

The EU is in all these fields an undisputed player. It is one of the few key participants in all trade discussions, the issuer of one of the two main global currencies, a major stakeholder in the international financial institutions, the number one provider of development assistance and a leader in the field of the environment. However, the effectiveness of its policy in these areas varies depending on its internal governance structure - from excellent (in trade) or acceptable (in international money and finance) to second rate (in development). In comparison to the other main player, the US, the EU sometimes exercises world leadership (in trade and the environment) and sometimes seems happy to take a secondary role. Furthermore, the EU faces the need to adjust its representation in international fora in accordance with its rapidly declining relative demographic and economic weight. The challenge here is one of effectiveness and, as developed in this book, this calls for significant reforms of internal governance and external representation.

A transatlantic agenda

The second agenda involves both bilateral EU-US relations and the stance of the two sides of the Atlantic on global issues. What is special about the EU and the US is that they jointly continue to be the 'regulators of the world'. Even though together they only account for 40 percent of world GDP (at PPP) and world trade and a little more than 10 percent of world population, they probably produce around 80 percent of the international norms and standards that regulate world markets. Although this leadership is bound to dwindle eventually as new powers emerge and become more assertive, it is likely to persist for a few decades yet, because China, India and the other emerging powers are still far from having developed at home the elaborate body of law and institutions that is essential in order to be effective regulators. In fields like competition policy, product and financial market regulation or technical standards, the US and the EU are, and will remain, ahead of the pack by virtue of

their level of development, their experience and the size of their markets. Even Japan, a country of comparable development, has not really challenged their leadership in this area.

A big question is whether the EU and the US will act separately or even as rivals on the global regulatory scene or whether they will cooperate with each other and also involve the new global powers. Voices on both sides of the Atlantic complain about the other side's suspected pretension to act as the regulator of the world. Regulatory competition is certainly healthy as it helps to sort out which rules perform best. But this should not hide the fact that the main joint challenge for the EU and the US is what role they will jointly play in setting the rules for the world economy of the 21st century, and with whom they will do so.

How well is the EU equipped for this task? Its effectiveness in external regulatory matters varies, again depending on internal regulatory organisation. It is either excellent (for instance, in competition policy) or merely satisfactory (for instance, in external financial market policy). But what has until now been in short supply is the strategic perspective, as illustrated by repeated failure to provide an overall framework for the transatlantic economic dialogue. German Chancellor Merkel's recent initiative in this field is a welcome attempt to put EU/US dialogue onto a promising track. Yet as it involves, by the nature of the exercise, a host of different issues, responsibility for which is scattered among many agencies, the challenge of implementation is a significant one.

A regional agenda

The third agenda involves the relationship between the EU and its EMENA neighbours. Of the three agendas, it is here that one would expect the EU to be most effective, since it is the undisputed regional economic power and has much to gain from peaceful development in the region. From the Maghreb to the Middle East, from the former Soviet republics to Russia itself, and in Turkey, the EU's neighbours have considerable potential. Experience in other regions of the world, especially Asia, illustrates the extent to which integration between countries of different development levels can help promote all partners' successful integration within the web of world trade and foreign direct investment. But economic failure and political instability at the border can also act as major drags on prosperity.

Paradoxically, however, it is on this front that the EU is in fact the least effective. Two reasons account for this paradox. First, the European Neighbourhood Policy, which was meant to provide a framework for countries with little or no prospect of joining

the EU, is a complete shambles: it is a plane without a pilot. Partners are drawn into procedures but are not given a credible political and economic perspective for their relations with the EU. Second, the EU has little or no common approach in two areas that are particularly important for interaction between the EU and its neighbours: migration policy, owing to proximity and income differentials, and energy policy, since the EU possesses little oil and gas and its neighbours hold between 70 and 80 percent of the world's reserves. In spite of the Commission's recent efforts and the agreement reached in March 2007 on a common energy strategy, the effectiveness of EU policy in these two areas is not what it should be, simply because a common migration policy and a common energy security policy do not exist. What is missing, therefore, is a genuine political commitment in these fields supported by effective implementation.

The three agendas above clearly suggest a need for an integrated, coherent foreign policy to confront Europe's global, transatlantic and regional challenges. Yet a common finding of the studies in this volume is that current arrangements for Europe's foreign economic policy 'are both complex and evolving, that their efficiency is questionable, and that the choice of governance models is inherited from history rather than based on efficiency criteria'. Authors make a number of suggestions for improving the situation, which all revolve around the idea of delegating more responsibility for foreign economic policies either to the European Commission alone or to the European Commission in partnership with the Council of Ministers, possibly via the new High Representative of the Union for Foreign Affairs and Security Policy envisaged in the new treaty.

As long as the EU was legitimately centred on achieving peace in Europe, or reunifying it, the design and implementation of internal integration obviously took precedence over external relations. The message from this volume is that this era has passed and that, in a fast-changing and challenging international environment, external economic relations have become too important an issue for the EU to remain a fragmented power.

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Europe and the global economy

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The European Union is the largest single economic entity in the world, with half a billion people and a gross domestic product (GDP) slightly larger than that of the United States. Its presence in the world economy is powerful: it is the largest exporter and the second largest importer (behind the US) of goods; the largest exporter and importer of services; the largest importer of energy; the largest donor of foreign aid; the second largest source of foreign direct investment (FDI) and the second largest destination of FDI (behind the US); and the second destination for foreign migrants (also behind the US).

The EU's presence in the world economy manifests itself not only through trade, capital and migratory flows but also via an intense regulatory activity. It is, if not the main, at least the second most important regulatory power in the world in just about every area, including: competition policy, where EU authorities have taken the lead in certain aspects of antitrust; environmental protection, where the EU is the main proponent of regulation against global warming; money, with the euro being the second largest international currency in the world (behind the US dollar); and financial market regulation, with European markets also ranking number two in the world (again behind the US).

The European Union is not only a global economic power, more or less on a par with the United States. It is also *the* undisputed regional economic power of a geographical area that encompasses Europe, the Middle East and North Africa (EMENA). But is it a global or even a regional economic leader, with clearly defined objectives and a coherent set of foreign economic policies to achieve them?

The question arises because, unlike other economic powers such as the US, the EU is obviously not a state or a federation, but a collection of states that share sovereignty. Yet, like a state, the EU aspires to play a leading role in foreign economic policy, an area which is a subset of foreign policy, itself a core prerogative of states.

The need and the desire of the European Union to play a bigger role on the international scene stem from dramatic changes in the international environment that have occurred in the last twenty years.

At the regional level, the collapse of the Soviet Union led to the creation of new states, some of which are now inside a vastly expanded European Union with 27 member states (EU27), while others remain outside its new eastern borders. After an initial period of high economic and political instability in some of these countries, the situation has improved, although important risks remain. A similar danger prevails in many of the EU's southern neighbours that stretch around the Mediterranean and the Gulf. Consequently, the EMENA region which is close to the EU27 can be described as potentially volatile.

At the global level, the last twenty years have witnessed three major developments which have an important bearing on Europe's international economic relations. The first is globalisation, which is characterised by the emergence of a number of developing countries with the technological capacity to supply an increasingly sophisticated range of manufactured goods and services. These emerging economies are located essentially in Asia and Latin America and include new global powers – China, India and Brazil – with huge populations and very rapid economic growth. By contrast, Africa remains by and large a continent in dire straits with few emerging economies and where conflict and poverty prevail. The second global development is the unprecedented pressure on the environment and on natural resources, which has led to major concerns about climate change and energy security. The third development is the new status of the United States as the sole superpower, combining a military might totally unrivalled since the collapse of the Soviet Union, and an economic dynamism currently superior to that of the European Union or of any other advanced economic entity.

The European Commission under President Barroso has probably devoted more attention to Europe's foreign economic policy than any previous Commission. This reflects the personality and foreign policy experience of Barroso himself and of some members of his team. But it is also a reflection of the challenges Europe faces and of the demand on the part of public opinion for a 'global Europe', capable both of helping 'Europeans prosper in a globalised world' and of creating 'a new and better global order'.

The objectives of the EU's foreign economic policy outlined by the Commission are quite clear.

On the economic front, the EU's primary goal is spelled out in the Lisbon Strategy for economic reform, which was re-launched in 2005 and now clearly focuses on growth, jobs and competitiveness in the context of globalisation. The external dimension of the renewed Lisbon Strategy has been developed in a number of recent Commission policy papers ('communications'), most notably in Trade Commissioner Peter Mandelson's 2006 Communication 'Global Europe: Competing in the World' which, although it focuses on trade policy, 'also addresses some of the links between the policies we pursue at home and abroad. As globalisation collapses distinctions between domestic and international policies, our domestic policies will often have a determining influence on our external competitiveness and vice versa. Recognising the need for an *integrated, coherent approach* to domestic and to global challenges has been a hallmark of this Commission¹. But there is more to do to reflect this in the ways we think and work' (emphasis added; footnote in the original text).

On the political front, the EU's three foreign policy objectives are: contributing to stability and governance in Europe's immediate neighbourhood; helping build an international order based on 'effective multilateralism'; and dealing with security threats.

It is against these ambitious objectives that the complex character of the governance of Europe's external economic policy – with different roles for the EU and the member states, for the European Commission and the Council of Ministers, for different policies – poses a real challenge to Europe.

This introductory chapter is divided into five parts. The first provides a map, which divides the world outside the European Union into five groupings: the neighbours in Europe, the Middle East and North Africa; the United States; the other advanced countries; the emerging and developing countries of Asia and Latin America; and finally sub-Saharan Africa and its mainly non-emerging developing countries. This division suggests that Europe confronts three agendas: a global agenda, which is the subject of the second section; a transatlantic agenda, which is examined in the third section; and a regional agenda, which is the subject of the fourth section. The chapter concludes with a finding that there is a gap between, on the one hand, the need for an integrated, coherent foreign policy that will meet Europe's global, transatlantic and regional challenges and, on the other hand, the current governance of Europe's foreign economic policy, which is complex and not very efficient. Suggestions are made to fill the gap.

Table 1.1: Europe and the world

	Population (2005) [% of world]	GDP at PPP (2005) [% of world]	GDP per head (2005) (EU27=100)	GDP growth (1998-2007) [% per annum]
EU27	7.6	20.4	100.0	2.4
(Euro area)	(4.9)	(14.8)	(112.5)	(2.1)
Neighbours*	10.9	8.5	29.1	4.2
(Russia)	(2.3)	(2.6)	(42.1)	(5.4)
United States	4.6	20.1	162.8	3.1
Other advanced	4.5	13.9	115.1	1.8
(Japan)	(2.0)	(6.4)	(119.2)	(1.3)
Emerging economies**	60.8	34.5	21.1	6.1
(China)	(20.7)	(15.4)	(27.7)	(9.1)
(India)	(17.3)	(6.0)	(12.9)	(6.6)
(Brazil)	(2.9)	(2.6)	(33.4)	(2.4)
Other developing***	11.6	2.6	8.3	4.3
World	100.0	100.0	37.2	4.1
- G7****	11.4	41.2	134.6	2.4
- BRICS*****	43.2	26.6	23.0	7.8

* Rest of Europe (including Russia and other CIS countries), Middle East and North Africa.

** Developing Asia and Latin America.

*** Sub-Saharan Africa.

**** Canada, France, Germany, Italy, Japan, United Kingdom and United States.

***** Brazil, Russia, India and China.

Source: own calculations based on IMF (2006).

A map of Europe and the world

We divide the world outside EU27 into five groupings (shown in Table 1.1): the EMENA neighbours; the United States; the other advanced economies; the emerging developing economies; and the other developing economies.

The main economic features of each grouping and the most significant economic linkages with the EU are as follows:

1. The EU's EMENA neighbours² have a somewhat larger population, but a much smaller GDP than the European Union. Their average *per capita* GDP (measured at PPP) is less than one third that of the EU. This region is heavily dependent on the

EU market, which absorbs more than 70 percent of its exports; it is also an important outlet for the EU, with more than one third of its exports being sold there. In turn, the EU relies heavily on its neighbours, who hold most of the world's oil and gas reserves³, for its energy imports. Given the wide income and demographic disparities between the two regions, there are significant flows of migrants from EMENA to the EU, and of labour remittances in the opposite direction. Moreover, the neighbouring region receives large amounts of foreign aid from Europe: about 25 percent of total aid granted by the EU and the member states (see the chapter by Arne Bigsten in this volume).

2. The United States has roughly the same GDP as the European Union, although with 200 million fewer inhabitants, which implies that *per capita* GDP is about 60 percent higher than the EU's. The bilateral transatlantic economic relationship is the largest in the world. The two entities are each other's largest single trading partner, accounting for roughly 20 percent of each other's total trade in goods, and almost 40 percent of trade in services. They are also each other's most important source and destination of foreign direct investment, accounting for more or less 50 percent of each other's total inward and outward flows – and stocks – of FDI.
3. The other advanced (non-European) countries, which include Japan, have the same population as the United States, but a much smaller GDP. Consequently, their trade and FDI relationship with the EU is also less significant, although far from negligible.
4. The emerging economies, which include China, India and Brazil⁴, constitute by far the largest of the five groupings. They account for 60 percent of world population and 35 percent of world GDP, almost as much as the EU and the US combined. But their average GDP *per capita* is only one fifth that of the EU. The main channel of interaction between these fast-growing countries and the European Union is trade. They have recently become a sizeable outlet for the EU, already absorbing more than 25 percent of its total exports. The EU is also an important market for their fast-growing exports. In addition, there are major investment flows from Europe to emerging countries, and increasingly in the opposite direction, although from a very low base. Finally, in spite of their relatively low income and their large populations, emerging economies receive only 25 percent of Europe's foreign aid, the same share as the EU's EMENA neighbours, who have a slightly higher income level and a much smaller population.
5. The last grouping is sub-Saharan Africa, which comprises mostly non-emerging

developing countries. It is, by far, the poorest of the five groups. It accounts for nearly 12 percent of world population but less than three percent of world GDP, which implies an average GDP *per capita* of less than one tenth that of the European Union. This region is heavily dependent on the EU market, which absorbs about 40 percent of its exports. By contrast, it represents a very small outlet for EU exports. The income and demographic disparities with the European Union are even greater than is the case for the EU's EMENA neighbours; yet the flows of migrants are smaller, although illegal migration is rapidly rising. On the other hand, sub-Saharan Africa attracts about twice as much foreign aid as the EMENA neighbours, for a population of roughly the same size but a GDP *per capita* more than three times smaller.

This map of the world suggests that Europe confronts three agendas: a global agenda, relating to the emergence of new global economic powers; a transatlantic agenda, involving not only bilateral EU-US relations but the relationship between the two partners *vis-à-vis* the emerging global powers; and a regional agenda, involving Europe's relations with its neighbourhood.

The global agenda

All the issues on the EU's global agenda – trade, money and finance, and development – share one common feature: the challenge arising from the shift of economic power towards emerging economies. It is increasingly evident that policies and institutions must be adapted to the new global reality, and that this requires a re-think on the part of the EU in terms of both policies and institutional design.

Nowhere has the change been more dramatic than in international trade. In 1994, at the end of the Uruguay Round and just before the creation of the World Trade Organisation (WTO), the four leading goods exporters were: the EU12, the US, Japan, and Canada. Together, these so-called Quad countries accounted for 50 percent of world trade (excluding intra-EU trade). By 2005, their share had dropped to 40 percent, and the four leading exporters were: the EU25, the US, China and Japan.

The chapter by Simon Evenett leaves no doubt that the biggest challenge to Europe's trade policy comes from the emerging countries, which are both major competitors and markets. He argues that Europe and the emerging countries share a common interest in preserving the multilateral trading system, but have different commercial interests. This leads him to recommend that Europe seek a *modus vivendi* with the new trading powers and develop a trade strategy with the ultimate goal of identifying the potential basis for future multilateral trade agreements.

How well are the global trading system and the European Union itself equipped to respond to the challenge? The short answer is: fairly well, but the problems should not be underestimated.

During the 1999 Seattle WTO Ministerial Conference, the then EU Trade Commissioner, Pascal Lamy, famously declared that the WTO was 'medieval'. He was right. The Quad, that cosy club of old powers, basically set the agenda of the World Trade Organisation, as it had done for many years with its predecessor, the General Agreement on Tariffs and Trade (GATT). But what Lamy was describing was in fact an ancient regime about to change. In 2001, China became a member of the WTO, and by the time of the 2003 Cancun WTO Ministerial Conference, it had joined forces with Brazil, India and South Africa to create a powerful coalition of twenty emerging trading countries, the G20, which together account for about the same share of world trade as the European Union or the United States. The Quad disappeared and was replaced by the G4, a new quartet of old and new powers (the EU, the US, Brazil and India) which is attempting to steer the multilateral trade negotiations.

The fact that the EU always sits at the high table of global trade negotiations reflects not only its size in world trade but also its ability to speak with one voice in trade policy. However, one clearly needs to make a distinction between institutional and political ability. Trade policy is an exclusive competence of the European Union (at least as far as goods are concerned), which is conducted by the European Commission under the supervision of the Council. Hence, the EU indeed speaks with one voice, that of the EU trade commissioner, but the accent of this single voice must reflect the many, and increasingly numerous, accents of the member states.

As the chapter by Benoît Coeuré and Jean Pisani-Ferry shows, trade is an interesting case of a policy that has been centralised since the early days of the EU, but where national public opinion and policymakers exhibit a fairly high degree of preference heterogeneity. They conclude that this is an indication that a common EU policy can be maintained in spite of diverging national preferences, provided the institutional structure allow decisions to be taken. But they also admit that European trade policy is notoriously contentious within the EU. One could add that the balance is probably shifting towards greater political difficulty in conducting common trade policy, because globalisation and the emergence of new global actors are viewed very differently across EU member countries. Eurobarometer surveys indicate that globalisation is generally viewed as an opportunity in the Nordic and Anglo-Saxon countries, as well in some of the new member states, but mainly as a threat in the other countries, a division that largely reflects differences in the

efficiency of national welfare states⁵. Hence, as long as EU member states remain split between those with efficient and inefficient social models, the EU trade commissioner will find it difficult to speak with a clear and loud voice and to put forward the kind of trade strategy advocated by Simon Evenett in his chapter.

The situation is very different in monetary and financial affairs, and in development policy. Here, the emergence of new global powers also poses a major challenge but the current governance of global institutions and the European Union is inadequate and cannot respond effectively.

The International Monetary Fund (IMF) and the World Bank, the two global institutions in charge of monetary and development affairs long seen as most effective, are struggling to adapt to the new global reality. As Ahearne *et al.* (2006) suggest, they are both in danger of losing their relevance. The IMF core business of financial assistance is threatened by Asian dissatisfaction and Latin American detachment and its attempt to resurrect itself as a venue for managing global current account imbalances, although welcome, is a gamble. The World Bank has been largely crowded out by the development of private financial markets. It remains important for the world's poorest countries through its soft-loan window, the International Development Association (IDA). Even here, however, conditional debt relief to poor, non-emerging countries is being undermined by a new wave of unconditional bilateral credits from emerging countries such as China and India.

Both institutions are also badly in need of further governance reform to enhance the voice and participation of emerging countries. The composition of the 24-person Executive Board of the IMF and the World Bank is a relic of the past. European countries have eight members on the boards of the two institutions and control 30 percent of the votes. Their overrepresentation is exactly mirrored by the underrepresentation of emerging countries. At the same time, Europe's fragmented representation causes it to punch below its weight, as Alan Ahearne and Barry Eichengreen note in their chapter on Europe's external monetary and financial relations. Consequently, in the same vein as Bini-Smaghi (2006a), they propose that Europe should unify its representation at the IMF and the World Bank so that places can be freed for underrepresented emerging countries – thereby enhancing the legitimacy of the two Bretton Woods institutions – and Europe's influence can match its economic size.

Ahearne and Eichengreen clearly recognise that the political obstacles to progress towards single European representation in the IMF and the World Bank are huge because it implies an apparent loss of sovereignty over an important area of foreign

policy. At the same time, it is clear that European countries have two clear incentives to take the plunge. First, even the largest ones recognise that they have lost their status as global powers and that the only way for them to exercise effective foreign policy is collectively. Second, making room for emerging countries is crucial for the reinforcement of multilateral institutions, a *sine qua non* for achieving the EU's stated foreign policy objective of effective multilateralism.

In view of this, Ahearne and Eichengreen suggest an incremental strategy, starting with the IMF. They argue that the rationale for consolidating EU representation at the IMF is stronger than in the World Bank for two reasons. First, preferences among European countries are relatively more homogenous, especially among the countries in the euro area, who share the same currency and the same exchange rate. Second, European countries have already made progress in coordinating their national positions in the Fund by creating a specialised sub-committee in the EU Economic and Financial Committee.

An important caveat to this is that consolidation of Europe's representation at the IMF and the World Bank would largely be ineffective as long as Europe is unable to improve its decision-making mechanism. External monetary affairs are, like trade policy, an exclusive competence of the Union, but with two important qualifications. First, the competence of the Union only applies to the monetary policy and the exchange rate of the euro area. Second, according to the EU treaty, external representation of the euro area is conducted by the Council, not by the Commission under the Council's supervision as for trade policy, with the Commission and the European Central Bank being 'fully associated' in the process. Effective representation of the euro area at the IMF would require clarification of the respective responsibilities of each of these three actors.

By contrast, development policy is a shared competence of the European Union and the member states, with two separate tracks. On the one hand, there is a common policy, which is an exclusive competence of the EU, and which is conducted by the European Commission under the supervision of the Council. On the other hand, there are 27 national policies, which are the exclusive competence of the member states, with loose EU coordination at the EU level.

Coeuré and Pisani-Ferry find that this combination of partial centralisation and loose coordination is hard to justify on economic grounds. The chapter by Arne Bigsten argues that the reasons for the persistence of this situation are two-fold: the fact that development policy belongs to the realm of foreign policy, and the dissatisfaction of many member states with the way EU development policy is run. The

counterargument to the first point – that member states should pool together all their development assistance in order to regain power in foreign policy – is probably less persuasive here than for monetary affairs, since countries with a colonial past tend to direct a disproportionate part of their bilateral aid flows to their former colonies where they continue to enjoy influence. Regarding the alleged inefficiency of EU development policy, the correct way to address the problem would seem to be to reform its substance rather than to maintain decentralised national policies.

The real question, then, is what the content of a reformed EU development policy should be, and how it should relate to other EU policies, especially trade policy.

The transatlantic agenda

The European Union and the United States are the two largest economic entities in the world. Their economic relationship, therefore, matters a great deal, not only to themselves but also to the world at large. We focus here on the transatlantic economic relationship between the EU and the US and examine, first, its purely bilateral context and, second, the global context.

The bilateral EU-US trade relationship – the largest in the world – takes place essentially within the framework of the multilateral trading system. Although there are naturally some trade frictions between the two partners, the bilateral relationship runs quite smoothly. So much so, that the chapter on EU trade policy by Simon Evenett does not devote any space to EU-US trade relations. In fact, out of 171 trade disputes brought before the WTO during the period 2000-2006, seven were complaints by the US against the EU and 13 by the EU against the US, which makes an average of only three transatlantic disputes per year. Granted, some of them (such as the Airbus/Boeing case) are fairly significant, but they are nonetheless relatively minor in the overall scheme of things.

There have long been attempts to supplement the multilateral trading framework with bilateral transatlantic agreements. The first was in the early 1960s, just after the creation of the European Economic Community, when the US administration proposed the creation of a North Atlantic Free Trade Area (NAFTA). The idea re-emerged in the early 1990s under the label Transatlantic Free Trade Area, or TAFTA, the acronym NAFTA having meanwhile been taken by the North American Free Trade Agreement. TAFTA encountered strong opposition on both sides of the Atlantic, which eventually led to the creation of the less ambitious New Transatlantic Agenda (NTA) in 1995⁵.

The NTA essentially ignores the more contentious conventional trade barriers (such as those in agriculture), focusing instead on regulatory issues, including competition policy. It involves a number of fora, including the Transatlantic Business Dialogue (TABD), which brings together American and European business leaders and high-level officials with a view to promoting transatlantic regulatory cooperation.

Besides trade and the exchange rate of the euro, competition policy is the only area where the EU has exclusive competence. As Coeuré and Pisani-Ferry observe, it is also the sole area where the Commission has been granted unconditional delegation, rather than supervised delegation as in trade or development policy. The Commission has, therefore, exceptionally extensive powers to conduct competition policy in an international setting and to conclude foreign agreements.

As discussed at great length in the chapter by Olivier Bertrand and Marc Ivaldi, the Commission enjoys far-reaching extraterritorial powers in the enforcement of EU competition rules. Unilateral exercise of such power clearly risks creating serious tensions with countries where large companies, which are the most likely target of EU antitrust action, are headquartered. The United States is obviously the prime country concerned. There have been a number of instances where the Commission has acted to block a merger between two US-based companies (ie Boeing/McDonnell Douglas, and General Electric/Honeywell) or sought to prevent the abuse of dominant power in the EU market by US-based corporations (ie Intel, Microsoft and Qualcomm), which could have resulted in serious EU-US disputes. In fact, no major clash has occurred on account of the excellent formal cooperation between the EU and US competition authorities initiated in the early 1990s.

Whether or not regulatory cooperation in the field of competition policy constitutes a good example of potential cooperation in other regulatory areas remains an open question. The main obstacle to extending the competition policy approach to other areas is generally the lack of a single regulator and hence of a single voice on the European side.

The difficulty faced by Europe in negotiating with foreign partners on certain regulatory matters is well illustrated by the situation in financial markets, one of the areas singled out in the New Transatlantic Economic Partnership. This initiative, launched by German Chancellor Merkel at the start of the German presidency of the EU in 2007, aims to reduce regulatory obstacles in key economic sectors, including industrial products, energy, intellectual property, financial markets and emerging technologies. A framework agreement intended to launch negotiations to that end was concluded at the EU-US summit in Washington on 30 April 2007.

The chapter on financial market regulation by Marco Becht and Luis Correia da Silva clearly shows that Europe's international role in this area is often severely impeded by its inability to adopt EU-wide regulation. A remarkable exception is in the field of accounting, where the EU was instrumental in promoting the creation of an international standard and in making it compulsory for all EU-listed companies. To a large extent, therefore, Europe's potential to negotiate in the regulatory area with foreign partners like the United States depends on its ability to improve its internal regulatory regime.

Will the EU and the US act separately or even as rivals on the global regulatory scene or will they cooperate with each other and with the new global powers? Regulatory competition is certainly positive as a way to identify the best rules. Nonetheless, the EU and the US cannot escape the fact that they both have a vital role to play in setting the rules for the world economy. In the 21st century, however, they can no longer act alone and will need to involve new global powers.

At the moment, the European Union and the United States are clearly the two 'regulators of the world'. Although together they only account for about 40 percent of world GDP (at PPP) and world trade, they probably produce around 80 percent of the international norms and standards that regulate global markets, including the dollar and the euro.

In recent years the EU and the US have each sought to export their regulatory rules. The commonest approach has been to include regulatory requirements in bilateral or regional free trade agreements (FTAs) that principally seek reciprocal preferential trade access. There has been a proliferation of FTAs centred on the EU and the US. Initially most of the FTAs were with countries in the relative vicinity of the EU or the US: the Americas for the United States, and EMENA or Africa for the European Union. In a second phase, the two hubs went on to sign agreements in the each other's 'backyard': for instance, the EU with Mexico and Chile, and the United States with Jordan and Morocco.

The latest, and most significant, development is the drive by the European Union and the United States to enter into FTAs with emerging Asian economies, many of which are engaged in bilateral negotiations with Asian partners, including China and Japan. The US concluded an agreement with Singapore in 2004 and with Korea in 2007. The European Union started negotiating an FTA with Korea in May 2007 and is considering a similar move with India.

Clearly, the proliferation of FTAs is a phenomenon which is by no means limited to

trade agreements that involve the European Union and the United States. There are also many FTAs among countries in Africa, Asia or Latin America. Nonetheless, the fact that the EU and the US are the two largest trading blocs in the world implies that FTAs centred on them pose a far greater systemic challenge to the WTO than any other FTA.

This competitive attitude between the EU and the US, in terms of gaining preferential market access and extending regulatory rules to emerging countries, manifests itself beyond the signature of FTAs. In competition policy, for instance, the EU maintains different forms of cooperation with various countries, including China, to which the Commission currently provides technical assistance for preparing its first comprehensive competition policy law, which the Commission hopes will be similar to EU competition policy.

In financial market regulation, the EU was the first to adopt in 2005 the International Financial Reporting Standards (IFRS) as the required accounting standard for companies listed on its territory and has been successfully pushing for their adoption by other countries. The IFRS, which aims to harmonise financial reporting in a world of cross-border trade and investment, have already been, or soon will be, adopted by over 100 countries, including Australia, Canada, China, Hong Kong and Russia. The IFRS are a rival to the Generally Accepted Accounting Principles (GAAP) used by the US and other systems of national standards in major countries, such as India and Japan, where the IFRS are currently not permitted. All these countries are, however, considering recognition of IFRS as an acceptable set of standards for at least some of the companies listed on their markets⁷. In the end, therefore, IFRS may actually emerge as the global accounting rules.

Clearly, one of the main objectives of the New Transatlantic Economic Partnership initiative is for the EU and the US to change gear and adopt a more cooperative attitude at a time when their global economic leadership is more and more called into question by the emergence of new economic powers.

This view was recently articulated by members of the Commission on Transatlantic Leadership in the Global Economy convened by the Atlantic Council of the United States who declared that⁸: 'The United States and the European Union [have not] proven adept at providing leadership in this modern economy. They have too often been divided, sometimes acting as rivals... [N]ow [they] face a serious challenge – the international economic system from which they have prospered so much now hangs in the balance. If they do nothing, the global economy may well fracture – regional arrangements will divide the world into blocs, protectionism and economic

nationalism will rise, and the governing institutions will fade into irrelevance. Only with stronger and broader leadership will the global economy continue to be open and stable in the face of the pressures of globalization and economic nationalism'.

For the members of the Transatlantic Commission referred to above, the EU and the US need to move on two separate, but complementary, fronts. First, they must help rebuild global economic governance by ensuring that all the essential economic players have a stake in the process and are effectively engaged. Second, they must promote the development of a new approach to reducing the remaining barriers to trade and investment, with the eventual goal of creating a global market. In their view, as a first step in this direction, the EU and the US should negotiate a series of agreements, including a framework regulatory accord along the lines suggested by Chancellor Angela Merkel, aimed at creating a barrier-free transatlantic market.

Although these various transatlantic initiatives are clearly and rightly couched in the language of the new global economic environment, their ultimate aim is nonetheless ambiguous. Do they constitute a last-ditch effort to maintain the superiority of the transatlantic incumbent powers against the inevitable rise of new global giants? Or do they instead amount to a genuine attempt on the part of America and Europe, who founded the global economic institutions after the Second World War, to share power with the newcomers in order to ensure that these institutions continue their mission of ensuring a world economy of peaceful interdependence?

To put it differently: will bilateral transatlantic regulatory cooperation pave the way for genuine multilateral cooperation?

In the case of competition policy the answer seems to be 'yes'. The EU and the US were instrumental in the creation, in 2001, of the International Competition Network (ICN), an informal network of antitrust agencies from about 80 developed and developing countries that addresses practical antitrust enforcement and policy issues of common concern. Its aim is to bring 'antitrust enforcement into the 21st century. By enhancing convergence and cooperation, the ICN promotes more efficient, effective antitrust enforcement world wide'. But exactly how far cooperation will go is hard to say at the moment.

What is clear is that, at least for a while longer, the EU and the US will continue to dominate the formulation of global rules. But whether they cooperate or compete, the consequences will be huge not only for them but also for the global economy. Bilateral cooperation could pave the way for a new age of global economic governance involving all major actors, old and new alike. By contrast, competition

between the EU and the US might result in fragmented rules of the global game and possibly in fights between the two protagonists over alliances with emerging powers that would be detrimental to all countries.

The regional agenda

A key challenge for the EU is to promote economic and political stability among its regional neighbours. This is in fact the EU's overriding foreign policy objective. In order to achieve this objective, the EU implements different strategies towards different groups of neighbours, which involve different policy instruments:

1. The first group comprises Turkey and the six Balkan countries⁹, and also the three EFTA countries¹⁰, all of which are considered as potential members by the EU. They have, therefore, the greatest incentive – and receive the greatest help – to fulfil the EU's foreign policy objective. This applies in particular to Turkey and the Balkan countries, which are clearly intent on joining the EU. The EFTA nations, on the other hand, show no sign of wanting to join the EU at the moment, but nor do they pose any foreign policy challenge to the EU. Most of these countries already enjoy very close economic ties with the EU in the framework of bilateral arrangements that ensure free movements of goods, services and capital.
2. The second group includes the ten Mediterranean countries¹¹ and the six former Soviet republics¹² belonging to the European Neighbourhood Policy (ENP), which was developed in 2004 in order to provide an economic and political framework for countries that border the EU but have little or no prospect of joining it in the foreseeable future or, for those outside Europe, even later. The aim of the ENP was 'to share the benefits of the EU's 2004 enlargement with neighbouring countries in strengthening stability, security and well-being for all concerned. It is designed to prevent the emergence of new dividing lines between the enlarged EU and its neighbours and to offer them the chance to participate in various EU activities, through greater political, security, economic and cultural cooperation'¹³. As far as economic policy is concerned, the ENP envisages preferential trade agreements and financial cooperation as well as the prospect of a stake in the EU's single market, but excludes the free movement of workers. It does not, however, contain concrete steps for moving the agenda forward. The Commission recognised as much in 2006 and proposed a number of concrete actions to strengthen the ENP, including in the area of short-term labour mobility¹⁴. At the moment the ENP remains incomplete. Nevertheless, with time it can be expected to build upon the bilateral free trade agreements in goods that were already in place for most Mediterranean countries before the ENP was launched.

3. Russia is not part of the European Neighbourhood Policy. It is simply too big and too important to be lumped together with 16 other countries, of which six are its own neighbours and former satellites. Instead the EU and Russia decided in 2003 to develop a 'strategic partnership' through the creation of four common spheres: a common economic sphere, including and with specific reference to environment and energy; a common sphere of freedom, security and justice; a sphere of cooperation in the field of external security; and a sphere of research and education, including cultural aspects. The EU-Russia energy dialogue initiated in 2000 – dealing with issues such as security of supply, energy efficiency, infrastructure, investment and trade – is a key component of the partnership.
4. The Gulf Cooperation Council, a customs union grouping together six oil-producing Arab countries¹⁵, has been negotiating a free trade agreement in goods with the European Union since 1990. Progress has been hampered by sensitivities on both sides regarding a limited number of product categories, mainly petrochemicals, aluminium and fisheries. The negotiations, however, have made good progress recently and are likely to be concluded in 2007.
5. Iran and Iraq are not included in any of the EU's preferential schemes.

These different arrangements point to two important conclusions. First, as one would expect on foreign policy grounds, the closer the geographical proximity between the EU and a neighbour, the deeper their economic relationship. It is surprising, however, that the ENP makes no formal distinction between European and non-European neighbours. It risks, therefore, sending a confusing political message to both sets of countries. Does belonging to the ENP mean that one will never become an EU candidate, even if one is a full member of the Council of Europe and therefore 'certified' as European? Or does it mean the opposite, that belonging to the ENP gives one hope of acquiring one day the status of EU candidate, which non-European Morocco has already sought twice in the past?

The second conclusion is that the EU still lacks the political will seriously to address its prime foreign policy objective of a stable, secure and prosperous neighbourhood defined in a broad sense rather than in the narrow sense of the ENP. An ambitious neighbourhood economic policy would amount to the construction of a true single market encompassing all eastern, Mediterranean and Gulf neighbours. This single market would provide for free movement of goods, services, capital and labour. Compared to the existing patchwork of bilateral free trade areas between the EU and individual neighbours, it would constitute a plurilateral arrangement and extend free trade to all goods (agricultural products are either excluded or severely

restricted in the existing arrangements) and services. It would also ensure free movement of capital. There would also be free movement for certain categories of labour in accordance with a joint migration arrangement, which would obviously require the creation of an EU migration policy superseding the migration policies of the EU member states, at least for the relevant categories of labour. In addition to free movement, the single market should encompass a certain number of flanking policies, including competition policy and energy policy. This clearly requires the creation of an EU external energy policy.

As the chapter by Coby van der Linde correctly notes, the European Union is already competent for two of the three European energy policy objectives: competitiveness, with the EU internal market and competition policy; and environmental sustainability, with the EU environment policy. By contrast, it has no competence in the third area, security of supply. In particular, there is no EU external energy policy.

At the moment energy diplomacy is purely a matter of national responsibility. Whenever European energy companies require the backing of public authorities in an international context, they naturally turn to their national governments with which they often entertain close relationships. The problem with this arrangement is twofold. First, it tends to perpetuate the power of the old national champions, thereby thwarting efforts to complete the single market and achieve the competitiveness objective. As the EU Competition Commissioner Neelie Kroes recently remarked¹⁶: “Supply security should not translate into incumbency security”.

The second reason for concern about the lack of an EU external energy policy is that the global energy market is turning decidedly harsh. On the one hand, energy demand is increasing rapidly, especially in the emerging countries. On the other, fossil fuel reserves are depleting and concentrated in few countries, generally in the hands of states. The combination of high demand and state-controlled monopolistic supply has created the conditions for a seller’s market, where European companies face strong state actors.

It is against this background that in January 2007 the European Commission put forward a communication, ‘An Energy Policy for Europe’, which makes the case for a common external energy policy. The chapter by Coby van der Linde examines the likelihood of such a development and concludes that the odds are relatively low. Her main argument is that vast differences among member states in terms of import dependency, preference for certain energy mixes and foreign policy ties will long prevent the EU from ‘speaking with one voice’ on energy. Nonetheless, she acknowledges the Commission argument that the EU holds one strong card: it already

speaks with one voice in the field of trade. Bilateral or regional trade agreements with energy-producing countries could, therefore, be used to negotiate equal energy security terms for all member states. This approach is particularly relevant vis-à-vis the neighbours, including Russia, with whom the EU has the closest trade ties.

Conclusion

To paraphrase the quote from the Commission communication cited at the beginning, there is clearly a need for an *integrated, coherent* foreign economic policy in order to meet Europe's global and regional challenges. Yet, after careful assessment, Benoît Coeuré and Jean Pisani conclude that current arrangements for Europe's foreign economic policy 'are both complex and evolving, that their efficiency is questionable, and that the choice of governance models are inherited from history rather than based on efficiency criteria'.

Complexity and inefficiency imply that Europe has difficulties in meeting its foreign economic policy objectives. This is the case not only at the global level, where it has to contend with other economic powers, but even at the regional level, where it is the sole economic power.

Presently, the only successful neighbourhood policy is enlargement, a strategy that clearly cannot apply to all countries in the EMENA region surrounding the EU, and certainly not to Russia, the Middle East or North Africa. The lack of effectiveness of the EU in relations with these neighbours owes a great deal to the complete or partial absence of a common policy in two areas of prime mutual interest: energy security and migration. A common external energy policy and a common migration policy are *sine qua non* conditions for the EU to develop solid and healthy relationships with neighbours who possess vast energy and/or human resources that are vital to its security and well-being. However, this objective cannot be achieved as long as some member states, usually the larger ones, continue to live with the false impression that they can tackle these issues with their own foreign policy initiatives.

Obviously, the issue of delegating new competence to the EU cannot be separated from the issue of who the 'delegate' would be and what its mandate would be. Coeuré and Pisani-Ferry show that the conditional or supervised delegation model is the only viable choice. They argue in favour of a uniform governance model across the different policy areas in order to ensure coherence. They do not take a position as to whether the delegate, or agent, should be the Commission or the Council, though their implicit choice clearly favours the former, as is already the case in trade policy, an area where the EU has operated with relative simplicity and efficiency.

One strong argument is favour of choosing the Commission as the delegate is that it already occupies this function in all the areas that relate to the internal market (trade, competition, financial markets). On the other hand, it could be argued that these are precisely areas where the foreign policy dimension is relatively minor and where, therefore, member states are least reluctant to cede sovereignty. The same cannot be said of energy security and migration policy, where the foreign policy dimension is probably larger than the economic or competitiveness dimension normally associated with the action of the Commission.

One solution would be to delegate responsibility for foreign economic policies like energy and migration, where the foreign policy dimension prevails, to the new High Representative of the Union for Foreign Affairs and Security Policy envisaged by the draft Constitutional Treaty. The minister will wear two hats: he or she will be appointed by the European Council, with the agreement of the president of the European Commission, and will be one of the vice-presidents of the Commission. The minister's role will be to conduct the Common Foreign and Security Policy (CFSP) and the European Security and Defense Policy (ESDP), using all the instruments at his or her disposal. However, since the High Representative will have a double affiliation, it would be natural that he or she also oversees an expanded common development policy, which would bring together the current EU policy and the policies of the member states that badly require centralisation.

The foreign affairs template could also be used for economic and monetary affairs, where the president of the Eurogroup could be jointly appointed by the members of the European Council belonging to the euro area and the president of the European Commission. Like the High Representative of the Union for Foreign Affairs and Security Policy, the High Representative for Economic and Financial Affairs would therefore be a member of both the Council and the Commission, which would greatly facilitate the external representation of the euro.

The changes suggested here appear crucial if Europe is to speak with one voice in foreign economic policy and to overcome its 'fragmented power' status. These changes would allow the EU to take a more active role in the system of global governance, which is in dire need of reform to accommodate the rise of new global economic powers. These changes are also essential to enable the EU to speak on an equal footing with the United States and to promote partnership aimed at effective multilateralism. In addition, they will help Europe to strengthen its relations with its neighbours and consolidate stability in a region prone to volatility.

Notes

- 1 See 'A Citizen's Agenda for Europe', adopted by the Commission in May 2006, the 'EU's renewed Strategy for Sustainable Development', adopted by the Council in June 2006, and 'Europe in the World', adopted by the Commission in June 2006.
- 2 The EU's neighbours are defined here as the rest of geographical Europe outside the EU27 (the members of the European Free Trade Association (EFTA), the Balkan countries, Turkey, Russia and six other former Soviet republics, plus the Mediterranean and the Gulf countries (including Iraq and Iran).
- 3 At the end of 2006 the EU's neighbours as defined here held 70 and 80 percent of the world's proven reserves of, respectively, oil and natural gas. Source: The PennWell Corporation, 'Oil & Gas Journal', vol. 104.47 (December 18, 2006).
- 4 For simplicity, the group of emerging developing countries is defined as developing Asia and Latin America.
- 5 See Sapir (2005).
- 6 Meanwhile the acronym TAFTA has also been taken. It now refers to the Thailand-Australia Free Trade Area, which entered into force in 2005.
- 7 See Véron (2007) for a fascinating analysis of the development in this area.
- 8 Burwell (2007).
- 9 Albania, Bosnia-Herzegovina, Croatia, Macedonia, Montenegro and Serbia.
- 10 Iceland, Norway and Switzerland.
- 11 Algeria, Egypt, Israel, Jordan, Lebanon, Libya, Morocco, Palestinian Authority, Syria and Tunisia.
- 12 Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine.
- 13 European Commission (2004). 'European Neighbourhood Policy – Strategy Paper', Communication from the Commission, COM (2004) 373.
- 14 European Commission (2006). 'On Strengthening European Neighbourhood Policy', Communication from the Commission to the Council and the European Parliament, COM (2006) 726.
- 15 Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates.
- 16 Quoted in Röller *et al.* (2007).

2

The governance of the European Union's international economic relations: how many voices?

Benoît Coeuré and Jean Pisani-Ferry¹

In the 'legacy' paper he posted at the end of his mandate as the European Union's trade commissioner, Pascal Lamy (2004) gave a sanguine view of the EU's ability to play a leading role on the world economic stage: 'The lesson to be taken from the experience of the past five years,' he wrote, 'is that, when it chooses to pursue a truly federal policy, the EU can play a decisive role on the world stage. Together, we have a far greater 'weight' than the sum of the member states. We have the ability, not only to resist initiatives that we do not support [...], but also to set the international agenda.'

However, another senior European policymaker gave an unequivocally downbeat view. In a controversial paper entitled 'Powerless Europe: Why is the Euro Area Still a Political Dwarf?', Lorenzo Bini-Smaghi, the European Central Bank board member in charge of external relations, wrote that Europe 'has much less influence over international policy issues than would be expected on the basis of its relative economic weight. This is particularly the case in international institutions like the International Monetary Fund (IMF) where, as compared to the World Trade Organisation [WTO], Europe is much less influential than the United States' (Bini-Smaghi 2006a). As a precondition for a stronger EU voice in the IMF, Bini-Smaghi advocates the consolidation of European chairs.

Depending on the issues and the fora, the EU is indeed sometimes a leader and sometimes a follower, sometimes a vocal player and sometimes a silent one. While the US exercises leadership over the entire scope of international economic relations, Europe can be characterised as an 'accidental player' (Pisani-Ferry 2005), whose international behaviour lacks consistency.

As a remedy to this situation, a consistent school of thought – illustrated by the quotation from Bini-Smaghi – emphasises the fragmentation of European external representation or the weakness of the governance arrangements in place for coordinating the member states' positions, and advocates a further federalisation of external economic policies. Yet other explanations can be offered to account for a high degree of variance in the external economic role of the European Union. To start with, the EU could have more to gain in developing an external economic policy in certain fields than in others. Also, the desirability of a common policy depends on the degree to which the member states agree with each other. It is by no means obvious that more centralisation will systematically result in improving the welfare of Europeans.

Bruegel's project on Europe and the global economy provides an opportunity for clarification. By systematically evaluating EU external policies across a range of sectors, it offers a basis for assessing where and why Europe has or has not been an effective player.

Against this background, our chapter is intended to serve several purposes:

- First, to provide a broad-brush overview of the governance arrangements in place, their legal basis and their evolution over time;
- Second, to offer an analytical framework for organising sector-specific evidence on the governance of external economic relations and to provide normative criteria for choosing among alternative external governance models;
- Third, to evaluate the extent of preference heterogeneity across policy domains;
- Fourth, to assess whether the diversity of existing arrangements can be accounted for within our framework and whether the corresponding choices can be deemed optimal;
- Fifth, to provide some policy recommendations for improving the effectiveness of the external economic relations of the EU.

What we do not do in the chapter is trace the history of current arrangements and provide explanations for the current situation in each and every policy field. We do not address global governance issues either (our standpoint is that of a welfare-maximising EU citizen, altruism allowed). Finally, we do not discuss the content of the EU policies.

The structure of the chapter is as follows: we start in the first section by briefly reviewing the evidence on the size of the EU as a global player. We present existing external governance arrangements in the second section. In the third section, we

Table 2.1: Indicators of size and openness, EU25 and US

percentages

SIZE	EU25	US	OPENNESS	EU25	US
MACROECONOMICS					
Share of world GDP (current US\$)	30	28			
Share of world GDP (PPP)	20	20			
TRADE					
Share of world trade*	18.1	16.7	Trade as a share of GDP*	19.2	20.8
ENERGY					
Energy consumption	16.8	21.6	Share of imports in energy consumption	72.1	42.2
ENVIRONMENT					
CO2 emissions	15.5	22.9			
DEVELOPMENT					
Share of official development assistance	52	26	Share of ODA in GDP	0.41	0.22
FINANCE					
Share of world financial markets**	22	46.9	Share of foreign assets in total holdings***	33.1	10.2
MIGRATION					
Share of world immigration****	20.9	20.2	Share of foreign-born in population*****	8.6	12.9

Source: IMF, Eurostat, IEA, OECD, World Federation of Exchange, BIS, WDI, CIPS.

(* Intra-EU25 trade excluded; (**) Sum of stock market capitalisation and domestic debt securities issued by the private sector; (***) Intra-EU25 foreign asset holdings excluded; (****) Share of world foreign-born population; intra-EU25 migration not excluded; (***** Intra-EU25 migration not excluded.

try to make sense of existing arrangements and discuss whether they can be regarded as optimal. Policy conclusions are offered in the fourth and final section.

The EU: how big a player? How much is at stake in external relations?

In discussions on European external economic relations, the US is almost always taken as a benchmark. But is this correct? Is the EU as big a player as the US? To answer those questions, Table 2.1 provides a series of comparative indicators on the size and openness of the EU25 and the US in the fields covered by the project.

It is apparent that the EU is very similar to the US in economic size and weight in world trade. It has a somewhat lower share of global energy consumption, as a consequence of differing consumption habits. The same is probably true for migration, for which statistics are imprecise (they do not distinguish between intra-EU migration from third countries; proper accounting would lower somewhat the share of the EU). Only in financial markets is the EU a significantly smaller player, because of its comparatively lower degree of financial development. However, the EU is a more significant player than the US in official development assistance (ODA): its share in the total ODA of OECD countries is twice as large as that of the US.

Turning to openness, the EU is as open as the US for trade, but is much more open regarding energy and financial assets. It has therefore more to gain or lose in the functioning of the international system. Only for migration is the EU more closed than the US.

All in all, size and openness put the EU and the US in the same category. Both are very big players – depending on the indicator, they jointly account for between 35 and 70 percent of the world total – and both are open economies vulnerable to external shocks and impacted by one another's decisions.

An overview of current arrangements

The distribution of external competence between the EU² and the member states and the arrangements for exercising it are diverse, evolving and contentious. They are diverse because there is no single template for assigning external competence or for organising external representation. Significant variation can be observed across sectors and even within sectors. They are evolving because the Treaty establishing the European Community (hereafter the EC Treaty or 'the Treaty') has been amended many times since 1957 but also because there are only a few cases in which it explicitly defines the external competence of the Union. In most cases that competence is implicit and derives from internal competence. The arrangements are contentious because the issue has been the matter of numerous legal battles between the Commission and the Council. In many fields where the Treaty does not explicitly allocate competences, it is the European Court of Justice (ECJ) which has eventually taken responsibility for defining them.

We start here by reviewing the legal dimension of the issue. We then outline a framework for analysing the governance of external economic relations in various sectors. Next, we provide some quantitative evidence on the importance of external governance. Finally, we apply that framework to the fields under review.

Legal dimensions³

The general Treaty provision covering international agreements between the Community and states or international organisations is Article 300, which originates in the Treaty of Rome. This article however does not include provisions regarding the *scope* of such agreements (beyond the very general first sentence). It only determines the procedure to be followed for concluding agreements.

There are two ways for the Union to acquire external competence. First, the Treaty can

explicitly grant it such competence. This is particularly the case for trade policy (Article 133), for international monetary and exchange rate matters (Article 111) and for development (Article 177). External dimensions are also mentioned in the Treaty in connection with migration (Article 61) and the environment (Article 174), but in a cursory manner.

Second, external competence can derive *implicitly* from internal competences and their evolution over time. This follows the landmark 1971 'AETR' (French acronym for European Road Transport Agreement) ruling by the ECJ and the subsequent jurisprudence, which the Constitutional Convention tried to summarise in its characteristically equivocal Article I-13 of the Constitutional Treaty: 'The Union shall also have exclusive competence for the conclusion of an international agreement when its conclusion is provided for in a legislative act of the Union or is necessary to enable the Union to exercise its internal competence, or insofar as its conclusion may affect common rules or alter their scope.'

The absence of a clear delimitation of competence led already at the time of the European Coal and Steel Community to the emergence of mixed agreements to which both the EU and (some or all of) the member states are parties (Louis 2006). The later proliferation of such agreements vividly illustrates the complex and disputed character of the external representation issue.

The notion of implied competence

The 1971 AETR ruling was a watershed because it introduced for the first time the notion of implied (or implicit) competence. The issue was to determine who had competence for entering into an international agreement concerning the work of crews in international road transport⁴.

The rationale for the Court decision was that external competence derives from internal competence. It recalled that 'the Community enjoys the capacity to establish contractual links with third countries over the whole field of objectives defined by the Treaty' and most importantly, that 'each time the Community, with a view to implementing a common policy envisaged by the Treaty, adopts provisions laying down common rules, whatever form they may take, the member states no longer have the right, acting individually or even collectively, to undertake obligations with third countries which affect those rules or alter their scope'⁵. Furthermore, following what Loukas Tsoukalis (1977) called the cumulative logic of integration, the Court explicitly stated that 'as and when such common rules come into being, the Community alone is in a position to assume and carry out contractual obligations

towards third countries affecting the whole sphere of application of the Community legal system.’

An evolving jurisprudence

The Court’s philosophy led it to lay down in a series of subsequent rulings precise conditions for the EU to be assigned an implied external competence: first, it must have been given the corresponding internal competence; second, this competence must be effectively exercised by the EU; and third, the external agreement must be conducive to achieving Treaty objectives. This means for example that for the EU to enter into international agreements on, say, international bank transfers, it needs to have been granted competence in the field (which is the case through the single market provisions), to exercise this competence (which is also the case since the adoption of a European bank payment standard), and to establish that entering an agreement with a third country contributes to achieving Treaty objectives (such as economic efficiency and free capital movements)⁶. However, if only the second of those conditions fails to be fulfilled, member state competence remains transitorily. According to the Court’s early jurisprudence, the second condition (effective exercise of internal competence) could also be softened if common external action is indispensable for achieving Treaty objectives.

In 1994 an important issue arose when the Court had to decide on the relative competence of the EU and the member states concerning the services part of the Uruguay Round agreement. The Commission’s view was that the EU had exclusive competence in the field, as for trade in general. Member states held the opposite view on the grounds that the agreement included elements that were not traditionally regarded as commercial policy (such as intellectual property rights).

The Court did not side with either of the parties. It ruled that some modes of service provision were akin to trade and therefore belonged to the exclusive remit of the Union, while for others, which imply a movement of persons and can be assimilated to the free movement of people, the basis for deciding on competence could not be Article 133 of the Treaty. Furthermore, the Court decided that in the absence of ‘complete harmonisation’ of the rules governing access to a self-employed activity in the services sector, there was no basis for granting exclusive competence to the EU. In other words, the incompleteness of the single market for services implied a limitation on the exercise of a virtual external EU competence. This interpretation of the Treaty paved the way for a multiplication of shared competence cases.

The Open Skies agreements with the US entered into by a number of member states

during the 1990s seemed to confirm the move to a more restrictive, less integrationist Court philosophy (Dehousse and Maczkovics 2003). In the mid-1990s, after several member states had concluded bilateral agreements, the Commission brought the case to Court, which rejected the Commission's claim that the matter was exclusive EU competence. In the opinion of the Court, there was a wide grey area between agreements which are clearly in conflict with common rules (and are thus unlawful), and agreements that cover the same subject matter as those governed by common rules (and are thus unlawful on the basis of the AETR judgment). The Open Skies agreement was deemed to belong to this middle category; the Court's view was that the risk of distortions 'did not suffice for that purpose since such distortions could easily be avoided by other means.' In particular, the Court noted, 'there is nothing in the Treaty which prevents the institutions from arranging, in the common rules laid down by them, concerted action in relation to non-member countries or from prescribing the approach to be taken by the member states in their external dealings'¹⁷.

The matter is however still evolving. In 2006, the Court concluded the examination of another case (the Lugano Convention on the states' judicial competence) by stating that 'detailed analysis must be carried out to determine whether the Community has the competence to conclude an international agreement and whether that competence is exclusive. In doing so, account must be taken not only of the area covered by the Community rules and by the provisions of the agreement envisaged, insofar as the latter are known, but also of the nature and content of those rules and those provisions, to ensure that the agreement is not capable of undermining the uniform and consistent application of the Community rules and the proper functioning of the system which they establish'¹⁸. The mention of the content of the rules leaves room for pragmatism in determining if and when a matter falls under EU competence.

The governance of external relations

While the delimitation of external competence is not fully laid down in the EC Treaty, the relative role of EU institutions is more precisely defined.

According to Article 300, the responsibility for deciding to open or to conclude negotiations belongs to the Council, while the responsibility for conducting them belongs to the Commission. Furthermore, the Council is granted supervisory powers through the appointment of special committees overseeing the conduct of the negotiation. In economic jargon, the Council is thus without ambiguity the principal, while the Commission is the agent. However, by making recommendations to the

Council as regards the opening of negotiations, the Commission also exercises its right of initiative in the external field. It therefore acts both as agenda-setter and agent.

The same pattern applies to the association agreements as governed by Article 310 (the difference being that they need to be approved by unanimity). It also applies to trade negotiations as governed by Article 133. There are however two differences here: first, the leash is kept somewhat shorter as Article 133 states that 'the Commission shall report regularly to the special committee [actually known as the '133 Committee' in EU parlance] on the progress of negotiations.' Second, the article explicitly prohibits agreements that would result in internal harmonisation where the Treaty rules it out. This is meant to be a safeguard against the EU using external agreements to increase its internal powers. At French insistence, cultural, audiovisual, educational and social services are explicitly mentioned as being covered by this safeguard. Furthermore, the Treaty explicitly rules that agreements in those fields 'fall within the shared competence of the Community and its member states and that they shall be concluded jointly by the Community and the member states.' At Nice, therefore, both shared external competences and mixed agreements explicitly made their way into the Treaty (Louis 2006).

In the case of shared competence, the ECJ clearly considers that member states act as agents of the Community and have a duty of cooperation with the institutions of the Community, in particular with the Commission. In its 1993 opinion on the International Labour Organisation (ILO) Convention on safety in the use of chemicals at work, the Court stated that 'cooperation between the Community and the member states is all the more necessary in view of the fact that the former cannot, as international law stands at present, itself conclude an ILO convention and must do so through the medium of the member states', and that 'it is therefore for the Community institutions and the member states to take all the measures necessary so as best to ensure such cooperation'⁹.

Finally, Article 111, introduced by the Maastricht Treaty, governs the external aspects of Economic and Monetary Union. The pattern is different here, first, because the Council takes over from the Commission the role of external representative¹⁰ and, second, because the European Central Bank (ECB) intervenes as a third agent of the Community besides the Commission and the Council. The Commission unambiguously has a subordinate role to the Council (it is only 'fully associated with the negotiations') and on exchange rate matters it even loses its right of initiative since it can be bypassed if the Council acts on a recommendation from the ECB (see Bini-Smaghi 2006a for a full discussion of Article 111).

The fields under review therefore exhibit significant variation in extent, legal basis and clarity, as well as stability, of the distribution of competence between EU and member states. In some fields, such as trade in goods, the situation is homogeneous, unambiguous and stable. In others such as financial services or the environment, it is heterogeneous, ambiguous and unstable.

Governance models

How competence is distributed between the EU and the member states certainly provides the primary characterisation of the governance of external economic relations in a given field. However, this does not suffice. As the discussion of the legal dimension makes apparent, there are various templates for organising representation and decision-making in a field which has been assigned to the EU. Not only are there different possible choices of agent to represent the EU (it can be the Commission, a Community agency such as the ECB, the Council acting through its presidency, or even the member states themselves), but there are also various possibilities for organising the relationship between the principal (the Community) and the agent. Moreover, the mere fact that representation in a certain field has not been delegated to the EU does not mean that the EU has no role at all. There can be softer forms of coordination among the representatives of the member states.

We therefore have to introduce both various degrees of centralisation of external economic relations and various models for their governance. This leads us to distinguish three basic models for the governance of EU policies, which apply to both internal and external dimensions (we discuss the specific external dimension in the next section).

In the first model, *unconditional delegation*, competence to act is entirely assigned to an EU body according to, and within the limits of, a predefined mandate. This body then retains full discretion within the limit of its mandate and can only be made accountable on an ex-post basis. This applies for example to the Commission's competition policy decisions (including when they have extraterritorial effect) or to the monetary policy decisions of the ECB¹¹. The only constraints on the autonomy of the agent are its mandate, the threat of an appeal to the Court of Justice, and possibly to non-jurisdictional checks and balances such as the reaction of public opinion and/or protests or retaliation from non-EU countries.

The second model, *supervised delegation*, is one in which an EU body acts as an agent while the member states (and generally also the European Parliament) actively monitor and steer its behaviour. The standard case in this respect is trade

policy where the role of principal is exercised by the 133 Committee made up of trade officials nominated by the member states, which meets frequently to monitor the negotiation process and give guidance to the trade commissioner. *Mutatis mutandis*, a broadly similar pattern applies in other fields such as environmental negotiations, with the difference that the Council presidency plays the role of agent.

The third model, *coordination*, is one in which member states do not delegate responsibilities or external representation roles to the EU but coordinate among themselves while retaining their seats and speaking with their own voice in international fora. This could be regarded as a soft commitment, but as already noted the ECJ considers that in those areas that fall within the competence of the EU, member states have the legal duty to coordinate among themselves and with the institutions of the EU.

As an example, the EU cannot formally be a member of the IMF under the Fund's current bylaws, but European member countries have to speak with one voice and coordinate with the Commission when it comes to trade or single market issues. Increasingly, they aim at defining common positions on major topics of discussion. Since the Vienna European Council (1998), prior discussions take place within the Council of Ministers ('Ecofin'), the Economic and Financial Committee (EFC) made up of treasury officials, and a special EFC sub-committee on IMF-related issues, which result in the adoption of common understandings¹². In turn, those common understandings are expected to influence the positions taken by the member states in international discussions, but in most cases they are not binding in character. Prior discussions seem smooth enough: neither the Commission nor the ECB have ever asked the ECJ to force member states to abide by common positions in areas such as trade, competition or money, or more generally on first pillar issues (as was the case for the ILO convention mentioned above).

Table 2.2 provides a presentation of our three models as well as examples of fields in which they are used.

This classification involves some simplification as there is in fact more continuity between models than suggested by the table. There is not much difference between unconditional and supervised delegation if the agent's mandate is limited in time, as its renewal depends on the principal agreeing to the agent's behaviour. In the same way, there is not much difference between supervised delegation and coordination if supervision involves a committee that meets continuously and issues frequent guidelines. Nevertheless, the classification can serve as an instrument for organising analysis.

Table 2.2: Governance models for EU external economic relations

Model	Main features	Examples
Unconditional delegation	Policy responsibility delegated to EU institution; Monitoring by member states, if any, not binding on decisions by EU institution.	Competition policy (no monitoring)
Supervised delegation	External representation and negotiation authority delegated to EU institution; Council exercises supervision through issuing guidelines and monitoring implementation.	Trade in goods (supervision by committee) Environment (supervision by committee)
Coordination	No delegation of external representation to EU institution; member states coordinate among themselves and with EU institutions and may or may not commit to follow guidelines.	Representation on IMF Board (ex-ante coordination within subcommittee of EFC)

The increasing international content of European law

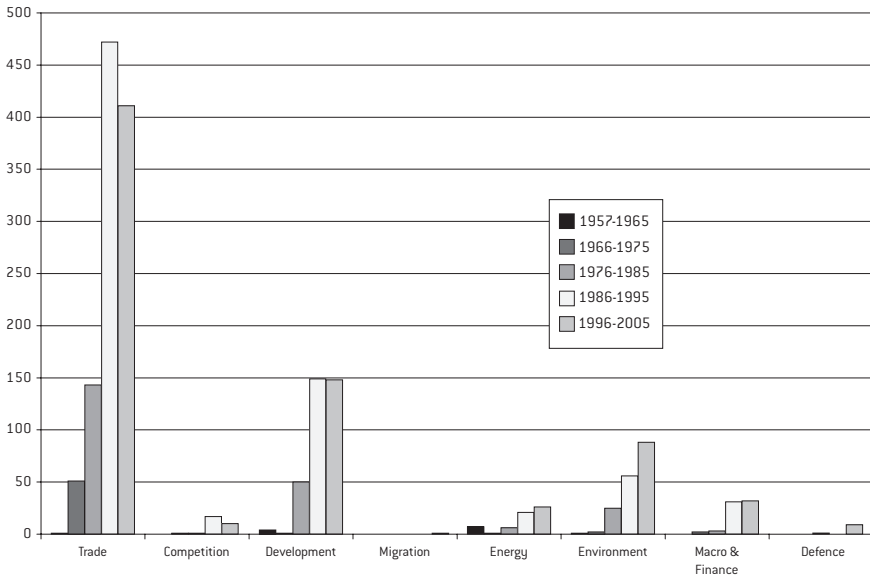
How important is the international dimension in current EU legislation? Quantitative evidence does not say everything, but at least it provides a comprehensive picture. In order to answer this question, we have dug into the EUR-lex database, which contains all EU legislation since 1957¹³. EU legislation includes directives (ie European framework laws), regulations (European laws), secondary legislation such as decisions of the Council or the Commission and agreements with non-member states and international organisations. We have studied the evolution of the latter category over time, in absolute numbers and as a proportion of total EU legislation, in the eight fields under review. The results are summarised in Figures 2.1 and 2.2, while detailed tables are to be found in Appendix 3.

There has been an expansion of EU legislation with the total number of texts increasing from 9,776 in the period 1966 to 1975, to 45,062 in the period 1996 to 2005. Over the entire period 1957-2005, the biggest contributing field has been trade, with 36 percent of all texts produced, followed by macroeconomic policy and finance (10.3 percent), then development (8.7 percent). External dimensions have therefore played a major role in the development of EU legislation.

When it comes specifically to agreements with non-member states and with international organisations, there was a steady increase until the mid 1990's, with the total number of agreements increasing from 360 in the period 1966 to 1975 to 1,251 in the period 1986 to 1995, then only 967 in the period 1996 to 2005 (Figure 2.1). In relative terms, however, agreements with non-member states represented a much higher share of overall legislation in the 1960s (Figure 2.2).

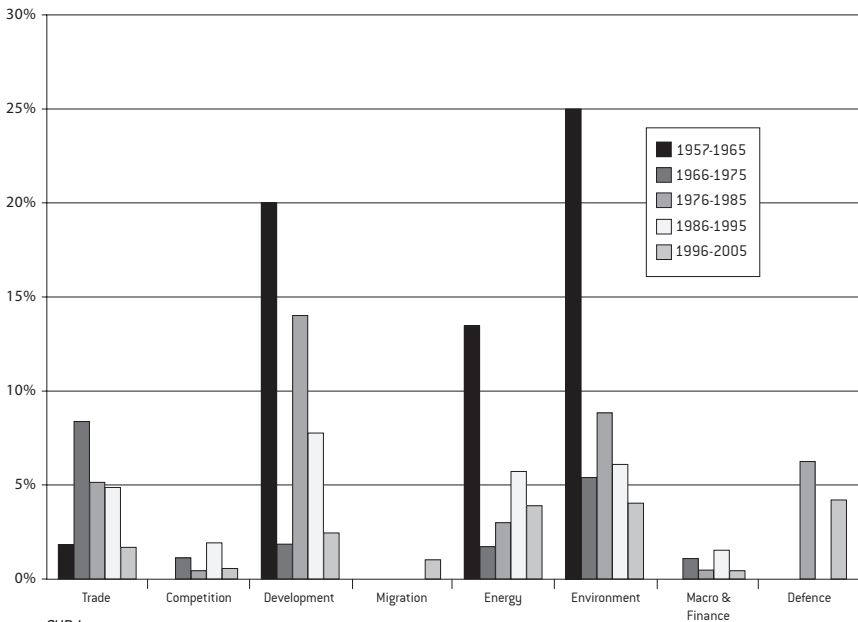
Interestingly, even though trade dominates the absolute number of agreements

Figure 2.1: Number of agreements with non-member states and international organisations



Source: EUR-Lex.

Figure 2.2: Number of agreements with non-member states and international organisations, as a percentage of total legislation in the respective policy field



Source: EUR-Lex.

from 1957 to 2005, the most 'internationally exposed' policy fields, as seen from the *relative* importance of international agreements to the total number of texts over the same period, are energy (4.5 percent of legislation passed has an international dimension) and environment (4.4 percent), followed by development (4.1 percent), defence (3.9 percent) and trade (2.7 percent, a very low ratio that results from the large number of EU trade-related acts which do not have the character of an international agreement). Other fields lag significantly (see Appendix 3). In relative terms, development has played an important role historically, but it has now been outpaced by defence, the environment and energy (Figure 2.2).

An overview of the situation in eight policy fields

We can now use our framework to provide an overview of the situation in eight fields: the seven under detailed review in this book plus environment. Information for preparing this assessment was provided to us by the authors of sector chapters using a common questionnaire (Appendix 1)¹⁴.

Table 2.3 provides an overview of the situation regarding both competence and governance. A few observations can be made.

First, there is considerable variation both across and within fields in the nature of issues involved, the legal provisions governing international relations and the corresponding governance arrangements. Trade (at least for goods), competition, development, migration and international money are homogeneous in those respects. Financial markets, energy and the environment are by contrast aggregations of heterogeneous subfields with differing degrees of EU competence and different governance arrangements. For example, in spite of the overall agreement on an EU energy strategy, there is little in common between oil, which is not a matter for EU policy, nuclear energy which is covered by a specific treaty, and electricity which is part of the single market.

Second, there are only three fields where the EU has exclusive competence, as a result of explicit Treaty provisions: trade, competition and the euro exchange rate. In all other cases, EU competence (if any) derives from jurisprudence and it is shared to some extent at least with the member states. This frequently goes with fuzzy delimitations and the resulting controversies, as indicated under 'clarity' in Table 2.3. Significant cases in this respect are financial markets, energy and the environment. All three are heterogeneous and, in all three, a combination of competition and cooperation between the EU and member states can be observed, frequently resulting in mixed and unstable agreements in which both levels participate.

Table 2.3: An overview of competence assignment and governance arrangements in eight sectors

	Trade	Competition	Financial markets	Development
<i>Sector homogeneity</i>	Medium	High	Low	High
Competence assignment				
<i>Competence</i>	Exclusive EU for goods; shared for services and investment	Exclusive EU competence (above threshold)	Shared competence	Specific EU policy alongside (and 'complementary to') MS policies
<i>Legal basis for EU competence</i>	Explicit (Art. 133)	Explicit (Art. 81ff)	Implied based on single market competence	Explicit (Art. 177)
<i>Clarity</i>	High for goods	High	Low	High
Governance				
<i>Number and nature of international agreements</i>	High; multilateral, regional and bilateral	Low; bilateral	High; multilateral and bilateral	High; multilateral and bilateral
<i>Decision regime</i>	Mostly QMV	Does not apply	QMV	QMV
<i>External representation</i>	Commission on basis of Council mandate	Commission	Commission and MS	Commission and MS
<i>Delegation/coordination mechanism</i>	Supervised delegation to Commission	Unconditional delegation to Commission/some coord. via ICN	Coordination	Mix of supervised delegation to Commission and coordination
<i>Implementation mechanism</i>	Common customs policy (goods) and EU directives (services)	Direct implementation of EU policy by Commission	EU directives	Direct implementation of EU policy by Commission

Third, the nature of the international activity also varies from field to field. In some, such as trade, financial markets or the environment, the core activity is to enact rules through negotiating multilateral or regional/bilateral agreements. In others such as competition, development and international money, the emphasis is on case-by-case decisions, ie quasi-judicial or executive functions.

Table 2.3 continued: An overview of competence assignment and governance arrangements in eight sectors

	Migration	Energy	Environment	International macro/money
<i>Sector homogeneity</i>	High	Low	Low	High
Competence assignment				
<i>Competence</i>	MS but Commission has initiative. Also visa policy coordination in Schengen space	Shared competence	Shared competence (except marine biological resources, which are exclusive EU competence)	Exclusive EU for money & exchange rates (euro area). MS in other fields
<i>Legal basis for EU competence</i>	Explicit (Art. 61) derived from free movement of persons	Implied except for nuclear energy (EAEC Treaty, Art. 101-106)	Implied based on Treaty provision on environment protection (Art. 174)	Explicit for exchange rates (Art. 111), implied for coordination (Art. 99)
<i>Clarity</i>	High	Low	Low	High
Governance				
<i>Number and nature of international agreements</i>	Low; bilateral	High; bilateral	High; multilateral	Low; multilateral
<i>Decision regime</i>	Unanimity, possibility of QMV	QMV for internal market	QMV	QMV for X rates (but does not apply)
<i>External representation</i>	Does not apply	Commission and MS	Generally Council presidency with Commission support	Mostly MS, also ECB (G7, BIS), Eurogroup and Commission (G7)
<i>Delegation/coordination mechanism</i>	Coordination	Coordination	Mix of supervised delegation to presidency and coordination	Mix of unconditional delegation to ECB and coordination
<i>Implementation mechanism</i>	Does not apply	EU directives	EU directives	National decisions (or ECB policy)

Source: author's compilation of answers to the governance questionnaire (Appendix I)

Fourth, the decision-making rule is generally qualified majority voting (QMV), but there are exceptions such as trade negotiations on services and migration. Furthermore, QMV may not be enforced because of the search for consensus within the EU and because the existence of mixed agreements formally gives the member states veto power over the ratification of agreements negotiated by the EU. The practice therefore is much more complex than the theory (Meunier 2000).

Fifth, the governance mechanisms in place are diverse. All three models identified above are in use and are implemented in various ways. For example, the Treaty grants the ECB and the Commission unconditional delegation in some areas (money, competition) while, as regards supervised delegation, the agent can be either the Commission (for trade, development) or the Council (for the environment, although there is considerable diversity within the sector). The Treaty also makes room for future evolution: as noted above, this is the case for external representation in areas relevant to Economic and Monetary Union (Article 111(4)).

Summing up, there is considerable variation regarding the arrangements in use in the sectors under review. The question, then, becomes whether there is an underlying rationale for different choices as regards degrees of centralisation and governance arrangements, or if they are purely the result of history and/or are mechanically derived from internal arrangements. This is what we intend to investigate next.

How efficient are existing arrangements?

Having presented the existing arrangements, we now move on to discuss them. The two issues we need to explore are, first, assignment of powers, ie whether a given policy should be carried out at a decentralised level or if there should be some form of centralisation – a question usually referred to as that of *competence* in EU parlance; and, second, governance, or how best to organise joint decision-making when there is a degree of centralisation.

These are obviously not completely separate questions: actually, the governance issue has stronger relevance when competence is neither completely decentralised (in which case there is nothing to govern) nor completely centralised (in which case the international dimension vanishes). But it makes sense to examine them successively.

In what follows, we take up the competence issue first, before turning to governance, starting in each case with analytical issues before trying to make our approach operational. We then sum up.

Competence

Lessons from the literature

Since Tiebout (1956), Olson (1969) and Oates (1972), theories of federalism have studied the allocation of public goods by different levels of government. In this line

of thinking, decentralised decisions match best the preferences of citizens, unless preferences are homogeneous and economies of scale are significant enough to justify devolution to the federal level. The modern literature on political unions builds on the same insight, ie a trade-off between economies of scale and the heterogeneity of preferences, as in the model of Alberto Alesina, Ignazio Angeloni and Frederico Etro (2005). For scholars of Europe, this echoes the familiar trade-off between deepening and widening.

Introducing the external dimension into this framework does not lead to significant changes. In spite of Guido Tabellini's (2003) sobering warning ("What mandate can be given in the realm of foreign policy? The only feasible mandate is to pursue the common interest of the EU. But what does that mean in practice?"), we do not see major reasons why the standard approach should not apply. What matters to EU citizens is how their welfare will be impacted by the choice of separate or joint decisions. The economies of scale/heterogeneity of preferences framework applies with only one proviso: that economies of scale have to be understood in a broad sense, ie including the gain to EU member states from jointly exercising market power or from pooling their votes in international organisations¹⁵. The same criteria can provide guidance for choosing between degrees of centralisation.

Think for example of immigration policy: there are externalities across member states because individuals holding a residence permit in one EU country can more easily move to another, and this favours the centralisation of visa policy, at least for internationally mobile migrants. But if some countries favour increasing immigration and others stopping it, the loss from a common policy can be significant. And if implementing the common policy implies setting up common consulates across the world, it involves additional costs that can make the net benefit unclear, at least in the short run.

Centralisation is therefore warranted for policies involving limited heterogeneity of preference with strong economies of scale and externalities across countries, as well as low transaction costs. Otherwise decentralisation should be preferred¹⁶.

Measurement

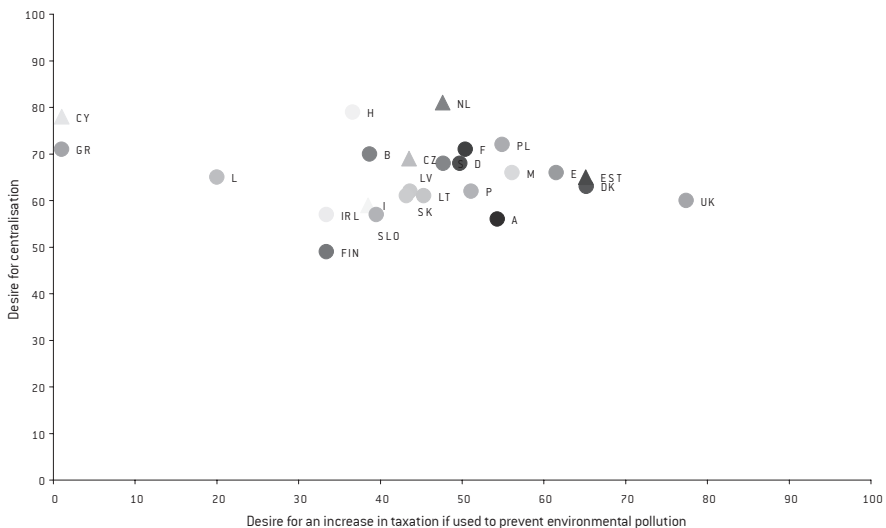
Opinion surveys such as the European Commission's regular Eurobarometer, and specific surveys of international public opinion, provide consistent information on many policy issues. While the degree to which they accurately measure national preferences is a matter for discussion, their advantage is that they facilitate comparison across policy domains and (for Eurobarometer surveys at least) over time.

Figure 2.3 presents the type of information we start from, here taken from the Eurobarometer survey and the European Values Survey (EVS). We plot on the horizontal axis a measure of substantive policy preference (in this case a measure of the price citizens are willing to pay for a cleaner environment, which we take as an indication of the implicit value of the environment for citizens) and on the vertical axis the proportion of citizens who respond that environmental policy should be allocated to the EU level. We regard the latter as a measure of the perceived economies of scale/spillovers.

As the figure immediately illustrates, there is considerable convergence on assigning environment policy to the EU level but considerable divergence on the desirable content of that common policy. This is understandable: citizens (rightly) consider that cross-border pollution and global climate change can only be tackled at the EU level (if not at global level) but this does not lead them to converge on the actual features of that common policy. From geography to population density, income levels and overall tax burdens, there are many reasons why they might diverge.

We have collected similar information for a wide range of policy issues, drawing on opinion surveys from a variety of sources (Appendix 2). Indicators of the desire for centralisation are available from the regular Eurobarometer surveys and cover a wide array of domains. Public opinion preferences as measured by this survey are

Figure 2.3: Public opinion preferences on environmental policy, EU25, 2000



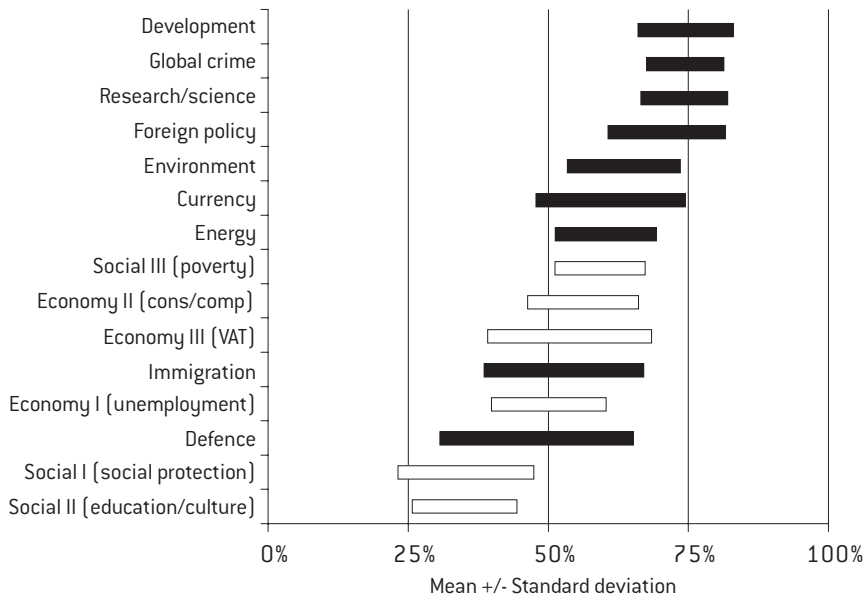
Source: EB 64.2 (2005), European Values Survey (1999-2000).

remarkably stable over time – we do not observe important shifts following the broadening of EU membership. (Changes mostly reflect the overall evolution of public opinion about Europe as well as reactions to events. For example, the 9/11 terrorist attacks in the US resulted in a clear increase in the demand for allocating the fight against terrorism to the EU level).

However, there is significant heterogeneity across countries. Figure 2.4 plots the distribution or preferences for centralisation for 15 policy fields considered in the Eurobarometer surveys. Policies with a significant external dimension are plotted in black; policies that are mostly internal are plotted in white. The length of the bar corresponds to two standard deviations (across countries), thus the longer the bar, the greater the heterogeneity within Europe as regards the desirability of centralisation.

On the whole, public opinion preferences broadly conform to the economists' criteria of economies of scales and externalities. Desire for centralisation is strong in fields where public opinion rightly perceives that spillover effects from national policies are high (research) or that national states do not have the required dimension (global crime). However this is not always the case: there is only weak support for

Figure 2.4: Preference for centralisation, 1989-2005



Source: Eurobarometer surveys. Economy I, II and III are categories grouping questions related to unemployment and labour markets (I), consumer protection, competition and industrial policy (II) and value added taxation (III). Social I, II and III refer to health insurance and pensions (I), education and culture (II) and poverty and exclusion (III).

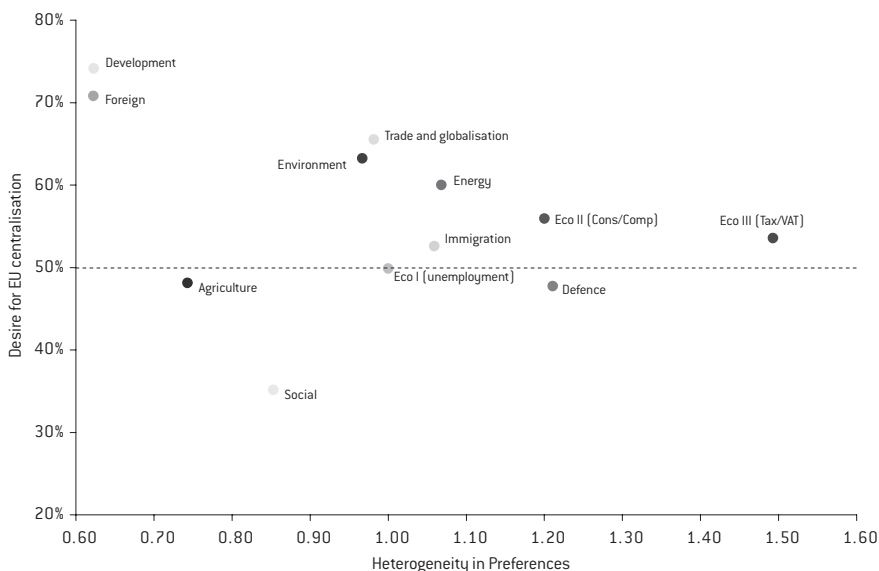
centralising competition policy/consumer protection/industrial policy (which have been aggregated because questions asked often cut across sub-domains). There is also a preference for centralisation in fields with an external dimension, although with the exception of defence (where heterogeneity is high). For example, European opinion clearly regards social protection as an essentially national competence, but development assistance is overwhelmingly considered a European affair.

Comparing substantive policy preferences across fields is more delicate. First, one has to rely on a variety of sources, some of which only cover a subset of EU member states. Second, available measures are provided by responses to questions that are by nature specific to a certain policy field. To make it possible to compare preference heterogeneity across fields, we have first collected a large number (90) of responses to surveys on the issues we are interested in, conducted in the 1990s or the 2000s. Second, we have defined aggregate categories by grouping questions having to do with the same field (for example, eight different questions on the environment). This helps eliminate cross-country variations attributable to question specificity (for example, some questions ask whether citizens are willing to pay more taxes for the environment and some whether they could accept reductions in their standard of living). Third and finally, in any given field we take as an indicator of substantive preference heterogeneity across countries the average standard deviation of the responses to the questions belonging to the field, divided by the average standard deviation of responses for all fields. This approach is intended to eliminate or at least to limit the effects of variations due to the wording of the questions. We have also verified that the two dimensions are independent, namely, that responses on the desirable degree of centralisation are not determined by the heterogeneity of preferences¹⁷.

Results are given in Figure 2.5, where we have plotted on the horizontal axis the heterogeneity of preferences as measured by the intra-EU variance of national responses, and on the vertical axis the desire for centralisation (measured by the proportion of EU citizens who respond that the corresponding policy should be allocated to the EU level). Candidates for centralisation should be found in the north-west corner while decentralisation should be preferred in the south-east corner. Other situations are ambiguous¹⁸.

What Figure 2.5 shows is that as far as public opinion is concerned, development and foreign policy are the prime candidates for centralisation. The environment and trade-related policies come next, however with a markedly higher index of policy preference heterogeneity. A third group is composed of energy and immigration, for which support for centralisation is somewhat weaker and preference heterogeneity

Figure 2.5: Desire for centralisation vs heterogeneity of preferences



Source: Eurobarometers, EVS, ESS, ISSP.

somewhat stronger. Unemployment and labour market policies are regarded as mostly national, and this applies to a larger extent to social policies. Economic policies, especially in the fields of competition and consumer protection, as well as unemployment and the labour market, clearly face a trade-off between a desire for centralisation and evident heterogeneity of preferences.

Implementing the approach

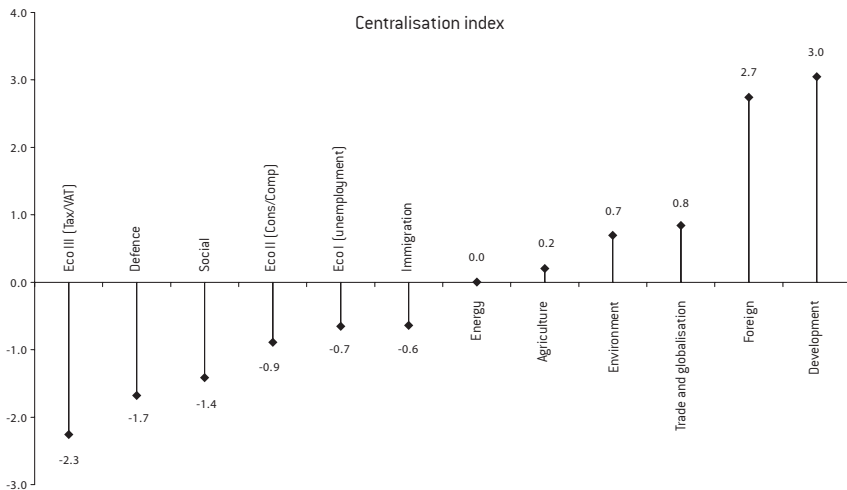
We now have the ingredients for assessing the distribution of competence. We were only able to collect survey data for six of our eight categories. We order policies using a 'centralisation index' I that combines the two dimensions of preference for centralisation and heterogeneity of preference (Figure 2.6). Graphically, I measures the distance of a given policy to the north-west corner of Figure 2.5. We find that the case for centralisation is very strong for development assistance (and for foreign policy, which is beyond the scope of this chapter) and strong for trade and the environment. It is weaker for energy and weak for competition and migrations, fields which actually involve both internal and external dimensions.

There is only an approximate correspondence between our results and the current assignment of competences. Development assistance is not centralised (at least

for the most part) while trade and competition (above thresholds) are. Energy is currently very decentralised (but the case for a EU approach is being discussed); the situation varies in the field of environment.

Trade is interesting because it is a policy that has been centralised since the early days of the European Community, while opinion- and policymakers exhibit a fair degree of preference heterogeneity. This heterogeneity is actually underestimated in our data because we had to exclude surveys covering only a few countries, such as the German Marshall Fund's trade and poverty surveys (US German Marshall Fund 2006). From judgement of the effects of trade opening to specific trade policy prescriptions, opinion in France and the UK exhibit in this survey a high degree of divergence across a wide range of trade-related issues – and national governments frequently behave in accordance with public opinion preferences. This must be taken as an indication that a common policy can be run in spite of diverging preferences, provided the governance structure allows decision-making. However, European trade policy is notoriously contentious within the Union.

Figure 2.6: Desire for centralisation and preference heterogeneity in the EU: the centralisation index



Source: European surveys (Eurobarometer, EVS, ESS and ISSP, see Appendix 2) and authors' calculation. To establish this graph, three categories (High, Medium and Low) were defined for both the desire for centralisation and the heterogeneity of preferences. A very strong case for centralisation corresponds to a high preference for it and low heterogeneity. The case for centralisation is assessed by giving equal weight to both criteria. The 'centralisation index' is $I = \hat{c} - \hat{h}$ where c is the desire for centralisation, h is the heterogeneity of preferences, and $\hat{x} = \frac{x - \bar{x}}{\sqrt{Vx}}$

Governance

Lessons from the literature

For a given level of centralisation, how should external relations be governed and, more specifically, what should guide choice among the three models of unconditional delegation, supervised delegation and coordination? This is what we will investigate next.

The design of efficient contracts has been a central topic in the theory of corporate governance (see Becht, Bolton and Roëll 2002 for a survey). Since corporate managers typically have to deal with multiple principals such as shareholders, creditors and employees, the theory of the firm has naturally addressed common agency problems, which are relevant for our study. Ownership of the firm amounts to exercising residual control rights in those cases not covered by the contract. Recent research on constitutional design has drawn on this literature to assess the efficiency of policymaking institutions. Attention has especially focused on the choice a government faces between exercising direct responsibility in a policy field and delegating it to an agency such as an independent central bank or regulatory authority.

An additional aspect introduced by the external dimension is the possibility of forming coalitions among players (say, between countries on the IMF Board or in the negotiation of environmental protocols) or of giving a time-bound or subject-specific negotiation mandate to an agent representing the EU (as for international trade negotiations). The question then becomes: what rule, if any, should be used to aggregate member state preferences? When should simple majority, qualified majority and unanimity be chosen? This is a major issue for the EU in general and one that has particular implications in the external field.

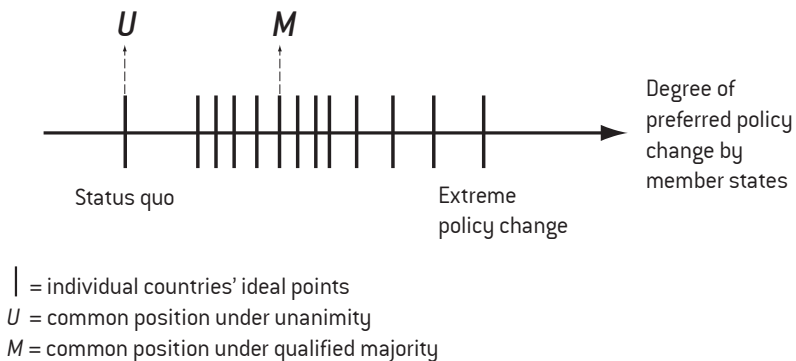
Frieden (2004) and Meunier (2000) explicitly address the issue in a simple case where preferences about a policy choice can be represented along a single dimension and the choice is made by majority voting. They point out that the gain from pooling votes within the EU depends on the distribution of preferences and that some EU member states can actually lose out when forming a European coalition because their own preferences are closer to those of other players (in plain terms, Britain or Poland would have lost from a European coalition over the war in Iraq because their preferences were closer to those of the US).

In a case study of EU-US trade negotiations, Sophie Meunier relies on a similar

approach but introduces a further distinction. She shows that in those fields where member states have an 'offensive' or 'reformist' agenda, ie when their objective departs from the status quo, it is efficient for them to give the Commission a broad mandate so that it can extract more concessions from its partners. On the contrary, when Europeans have a 'defensive' or 'conservative' agenda, ie when they intend to maintain the status quo, it is safer for them to keep the Commission on a short leash so as to make sure it will not deviate from the status quo. The more conservative a member state is, the more it favours avoiding delegation.

An example of a 'defensive' agenda for Europe was the agricultural negotiation during the Uruguay Round, while reciprocity in public procurement is an example of an 'offensive' one. The difference between a 'short' and a 'loose' leash can be expressed in terms of the extent of the negotiation mandate but also in terms of internal voting rules: by nature, unanimity is more conducive to conservatism than majority voting. This is illustrated by Figure 2.7.

Figure 2.7: Voting on the EU common position



Source: Meunier (2000).

There are therefore two dimensions in governance models. The first is the *delegation model*: should the agent be accountable to the people, or should it be a non-elected bureaucracy such as the Commission or an independent agency? How often should the mandate be redefined? The second dimension is the *voting rule* used to decide on the substance of the mandate. We address these two dimensions in turn.

Choosing a delegation model

Alberto Alesina and Guido Tabellini (2006a, 2006b) and Eric Maskin and Jean Tirole (2004) have discussed the choice between government by politicians and govern-

ment by bureaucrats (or 'judges' in Maskin and Tirole's language). The idea is that politicians are selected in elections and are motivated by re-election, while bureaucrats are meant to be technically competent and motivated by career concerns. Politicians therefore may bend too easily to private interest groups, and the voters who elect them should (but do not necessarily) have a clear vision of whether they have the required abilities. As a result, independent bureaucrats should manage the policies for which social preferences are clear and stable enough to be written down in a mandate, that are characterised by strong and possibly evolving technical content, and involve a risk of pandering to special interests (whereby the minority can inflict large negative externalities on the majority)¹⁹.

This does not directly solve our problem since the choice here is between government by states or by an EU agency. But we posit that the same approach can be extended and that the choice of a model depends, as in the closed economy set-up, on the nature and effects of the policy and on the (predetermined) structure of the international discussion. The setting up of an independent agency broadly corresponds to the *unconditional delegation* model, the 'bureaucrat' being the European Commission or some independent agency. Politicians relinquish all control rights, with the agent being accountable only *ex post*. The mandate sets out the obligations of the agent, and the principals cannot withdraw the authority that has been given nor monitor the implementation of the mandate²⁰. As in the Maskin-Tirole-Alesina-Tabellini set-up, unconditional delegation is to be preferred when technicality is prevalent, preferences are stable, the risk of pandering to special interests is high, and overall distributional effects across generations are limited²¹.

At the opposite extreme, policies that involve uncertainty about the *ex post* preferences, or about large redistributive effects within the population giving rise to policy tradeoffs, and which face a lower risk of pandering to special interests, are better managed by elected politicians. In our setting, this can be implemented either directly through intergovernmental coordination or by keeping bureaucrats on a short leash, giving them a mandate that is frequently checked and possibly redefined. This corresponds to the *coordination* and to the *supervised delegation* models (the agent being either the Commission or the Council presidency, or a technical agency)²².

Summing up, reasons for unconditionally delegating policy responsibility to a European agency can be that:

- The field requires technical expertise, and policymaking involves real-time response (such as crisis management or decisions on rapidly evolving matters);

- National governments are excessively sensitive to specific interests, for example those of national companies²³.

Reasons for choosing instead supervised delegation or coordination are that:

- Policies systematically involve significant redistribution across states and therefore cannot be decided upon by an agency because there is no mandate that can give it authority for deciding on equity across states²⁴.

Finally, reasons for excluding intermediate solutions and for favouring the corner solutions of decentralisation and unconditional delegation are:

- The changing character of the agenda. In such a case, the cost of constantly renegotiating a common position or a mandate can be high and the resulting inertia can be detrimental to efficiency.

Choosing a voting rule

As regards the voting rule, Figure 2.7 speaks for itself: unanimity is more conducive to the status quo than majority voting. This is also true when member states 'vote on votes', as illustrated by the stalemate over the voting rule on tax issues during the Nice negotiations. It should be noted, however, that rules used to aggregate member state preferences are not necessarily well described by *de jure* voting rules. Majority voting is often postponed until some kind of consensus has been reached. Under the 'Luxembourg compromise', an informal agreement dating back to 1966, a member state can veto a majority decision if it deems that its 'vital interests' are at stake. Also, the complex rules of the 133 Committee allow case-by-case decisions on the voting rules for some areas of trade negotiations such as intellectual property (see Meunier and Nicolaïdis 1999). In another area, the ECB Governing Council decides by consensus on monetary policy even though it formally uses majority voting²⁵.

The need to adopt a voting rule that facilitates decision-making – QMV rather than unanimity, straight ballots rather than consensus-building, and double majority rather than the Nice system – is thus higher where the EU has an 'offensive' interest, meaning that its members' preferences are further away from the status quo than those of its negotiation partners. A good example here is global warming: a majority rule that unites Europe around a common position strengthens the bargaining power of the EU vis-à-vis the US and other countries²⁶. When the EU's (stated) interests are defensive – say on agricultural protection – its bargaining position

is strengthened by an inefficient voting system.

Implementing the approach

Our analysis suggests four empirical criteria for implementation:

- Nature of the task. We distinguish between the negotiation and implementation of rules and case decisions that can have a judicial or quasi-judicial nature (as regards competition policy) as well as an executive nature (the IMF Board). There is more need for autonomy of the representative agent in the latter case.
- Evolving nature of the agenda. We distinguish between fields in which matters for negotiation are constantly changing and fields in which they are more stable. Evolving agendas make the defining and renegotiating of mandates difficult and therefore call either for leaving the representation to the member states, or for relying on unconditional delegation.
- European negotiation stance. We distinguish between offensive and defensive stances. An offensive stance where the majority of the EU advocates changes to the status quo calls for majority voting, while a defensive stance in favour of preserving the status quo calls for unanimity or supermajority. There is obviously a difficulty here, as deciding whether European interests are offensive or defensive in a given field involves judgement, but the EU stance can be observed and documented.
- Distributive effects among states. We distinguish between those decisions that are likely to affect some states disproportionately and those that have little distributional impact. The stronger the distributional effects, the more the voting rule needs to preserve the interests of the minority.

We are not able to quantify all four criteria and we have to rely on qualitative judgement instead, drawing on the answers to our questionnaire (Table 2.4).

Putting together all four criteria, we find that the need for an autonomous agent is strong in competition, and international macroeconomic policy and finance, which are characterised both by an evolving agenda and by the prevalence of case decisions over rule-making. The need is somewhat weaker for financial markets, development, energy and the environment. Again, we find a surprising outcome concerning trade: the case for an autonomous agent seems to be weak, because the main responsibility is the negotiation of rules and because the agenda evolves slowly. This provides an interesting benchmark, as it is hard to dispute the fact that the trade commissioner needs some leeway to negotiate.

Table 2.4: Determinants of choice of governance model and voting rule

	Trade	Competition	Financial markets	Development	Migration	Energy	Environment	International macro/money
Governance								
Nature of the task	Negotiation and implementation of rules	Case decision	Negotiation and implementation of rules	Negotiation and implementation of rules	Definition and implementation of rules	Negotiation and implementation of rules	Negotiation and implementation of rules	Case decision
Evolving character of agenda	Low	High	Medium	Medium	Medium	Medium	Medium	High
Case for agent autonomy	Weak	Strong	Moderate	Moderate	Weak	Moderate	Moderate	Strong
Vote								
Negotiation stance	Defensive and offensive	Defensive and offensive	Defensive and offensive	Offensive	Defensive and offensive	Offensive	Offensive	Defensive and offensive
Distributive effects among states	High	High	Medium	Low	High	Medium	Medium	Low
Case for efficient voting rules	Weak	Does not apply	Moderate	Strong	Weak	Moderate	Moderate	Medium

We also find that efficient voting rules are needed most for development and international macroeconomic policy and finance, as well as for financial markets, energy and the environment. In those fields, Europe has an offensive agenda and decisions involve (relatively) low distributive effects across member states.

This assessment remains mostly based on judgement and this is a weakness. Making progress towards quantitative, rather than qualitative analysis of governance criteria should be a goal for further research.

Putting things together

We now have answers to the three questions: Is centralisation desirable? Should the agent be given some leeway in negotiating with outside partners, or should it be kept on a short leash? When deciding on the agent's mandate, should the voting rule support the majority or protect the minority?

The results are the following. First, as we have already discussed, we find that the policies for which centralisation is the most justified are development, followed by trade and the environment and, further behind, energy, immigration and competition (Table 2.4). With the exception of competition, those conclusions are supported by the sectoral chapters in this volume²⁷.

Second, as regards the governance model, we find it desirable to give at least some autonomy to the EU's agent (Table 2.4). This especially applies to competition, international macroeconomic policy and finance, and to a lesser extent to financial markets, development, energy and the environment. The main reason is the evolving nature of the fields under consideration, which calls for flexibility and the ability to change the negotiation agenda rapidly.

Third, as far as voting rules are concerned, the picture is more mixed (Table 2.4). We find a need for efficient voting rules for development and international macroeconomic policy and finance, to a lesser extent for financial markets, energy and the environment. We must admit that this conclusion partly depends on somewhat subjective delimitations between offensive and defensive interests. It would need to be supported by more objective criteria for determining the nature of the EU agenda in a given field, which we regard as a topic for future research.

These results do not map existing institutional arrangements. They highlight three fields where reform of governance would seem appropriate:

- **Development.** The current combination of partial centralisation and loose coordination is hard to justify on economic grounds. As argued in the chapter by Arne Bigsten in this volume, its persistence comes from the member states' desire to use development assistance as a way to enhance their political influence, and from dissatisfaction with the way EU development policy is run. Those are not strong economic rationales. If European development policy is inefficient it should be reformed, not decentralised.
- **Environment.** Climate preservation is the closest possible thing to a global public good and Europeans exhibit a high degree of unity in respect of it. The complexity of the current arrangements whereby the Union and the member states compete for competence is hardly satisfactory. The changing nature of the agenda calls for giving the European negotiator sufficient autonomy, while the offensive character of the European negotiation stance, which has been illustrated by the EU's decision to implement the Kyoto Protocol in spite of widespread resistance in the rest of the world, calls for an efficient voting procedure.
- **International macroeconomic and monetary affairs.** Ahearne and Eichengreen in their chapter emphasise the case for centralisation in this field. We add that because of the evolving nature of the agenda, there is a need to delegate representation to an EU or euro area representative with sufficient autonomy.

Conclusion

The chapters in this volume highlight that current arrangements for Europe's external economic relations are both complex and evolving, that their efficiency is questionable, and that the choice of governance models is inherited from history rather than being based on efficiency criteria. The question we would now like to address is whether there is a potential for improving existing arrangements.

Before answering this question, we need to emphasise that reaching normative conclusions is not easy. As developed in this chapter, economic analysis provides criteria for choosing between decentralisation and centralisation but the devil is in the detail of implementation: it is hard to assess empirically the degree to which further centralisation or decentralisation is justified and even harder to provide a robust empirical basis to the choice of governance model. We have tried to make use of opinion surveys, and we think that this approach provides useful insights, but we are also conscious of its limits. After all, the history of the EU did not begin in 1950 with a survey asking the French and the Germans whether they would agree to have a common coal and steel policy. Furthermore, reliance on opinion surveys rests on the assumption that citizens are able to assess and compare the externalities and economies of scales that economists themselves find hard to measure.

As regards governance, we have provided a framework for organising thoughts on the issue and we do see scope for an empirical approach to issues identified by the literature as impacting governance choices, such as the evolving character of the policy agenda, the risk of capture by special interests, or the offensive or defensive nature of Europe's interest, but corresponding empirical measures are not provided in this chapter. Any conclusion must therefore be tentative.

A final limitation of the chapter is that we do not address complementarities across policies. For example, we do not discuss whether competence assignment for trade has consequences for competence assignment in some aspects of environment policy. This is a significant shortcoming, as indicated by the rising number of issues involving both dimensions. Complementarities also exist between internal and external policies. The reason why the Treaties do not provide a single template for international representation might just be the diversity of arrangements for internal policies. The easiest way to address complementarities across policy domains could well be enforcement of a single governance template for all those domains, as is more or less the case in individual nations. Complementarities would then be internalised at ministerial level. But this is not the nature of the EU. In the absence of such a single template, the relevant fora to address policy complementarities across domains are the Commission and the European Council. Whether or not this is done properly (we are doubtful) would require another paper²⁸.

Turning to recommendations, we do not see much scope for further unconditional delegation in the fields we have reviewed. As explained in the text, the conditions for this model to be efficient are strict and they do not appear to be fulfilled, except where (competition, monetary policy) authority is already delegated.

In all other domains, the choice is between coordination and conditional delegation. The case for coordination is generally weak on legal and efficiency grounds. On legal grounds, as noted above, the ECJ has increasingly taken the view that member states should be considered (and should behave) as agents of the EU in external talks that impinge, or might impinge, on EU competences. It can then be argued, on efficiency grounds, that a single representation minimises transaction costs and provides for more stability in international discussions. Also, as already noted, the conditional delegation model is very flexible. In particular, one can get close to unconditional delegation by granting long-term mandates and by limiting the agent's remit to general principles with full operational flexibility, as is the case for governors of central banks. At the other extreme, short mandates allow member states to retain and exercise control rights and can be regarded as a way to structure coordination.

The question then becomes how to improve on the conditional delegation model. A first issue, not addressed in this chapter, is the choice of agent. We have not discussed competence assignment between the EU's two executive branches, the Commission and (in its executive capacity) the Council. We have argued however that complementarities across policies suggest moving towards a unified governance template, as in fact clearly stated in the Treaty.

A second question is the definition of the agent's mandate. Here, we suggest mirroring what is in the US called the 'fast-track' system for trade negotiations²⁹: the Council and (depending on Treaty provisions in the field under consideration) the Parliament would vote and grant the agent (say, the Commission) negotiating power for a given term and within a given remit.

The term could be longer or shorter depending on the field. The traditional case for long mandates rests on independence from vested interests, continuity and flexibility in international negotiations, and the need to build experience and acquire knowledge in technically complex areas. Incidentally, this favours delegating to the Commission or to a specialised agency rather than to the Council, unless the Council finds a way to escape from the rotating presidency and introduce more stability (as it is the case now for the Eurogroup, which elects its president for a two-year term).

The remit could be more or less general. It could encompass a given negotiation only (say, a bilateral energy agreement, or a UN convention on climate change), or be granted for a full Commission mandate. At the end of the mandate, the agent should be accountable to the Council and the Parliament for the results obtained or the decisions taken.

As the EU role evolves with globalisation and moves from internal governance towards participation in global governance, clearer and more efficient arrangements are required. The approach we propose would bring more clarity and transparency in a domain which has become extremely complex and which provides public opinion as well as foreign partners with too many opportunities for confusion.

Notes

- 1 We are grateful to Jérémie Cohen-Setton for excellent research assistance in the preparation of this chapter. The opinions expressed in this chapter are those of the authors only and not of the institutions they belong to. We are grateful for comments to Vesa Vihriälä, Barry Eichengreen, André Sapir, and the participants in the conference of 12-13 October 2006. We also thank the authors of sector-specific chapters for exchanges on the governance of international relations in their fields, Nicolas Théry for similar exchanges in the environment field, and Jean-Victor Louis for his observations and remarks on legal matters.
- 2 In this chapter, for the sake of simplicity, the 'EU' will in many cases refer to the European Community. We will not enter into the debate on the legal identity of the EU, even though it bears important consequences for its external representation. Under the EC Treaty, only the Community has a legal identity and can participate formally in international treaties and conventions. The areas covered are therefore restricted to the so-called 'first pillar' covered by the EC Treaty, ie economic, social and environmental policies as well as asylum, migration and judicial cooperation, which have been transferred from the third pillar by the Amsterdam Treaty. The Constitutional Treaty would have abolished the pillar structure and included Common Foreign and Security Policy and Police and Judicial Cooperation on criminal matters.
- 3 We are grateful to Jean-Victor Louis for his remarks on an earlier version of this section.
- 4 A negotiation had been concluded by individual member states under the auspices of the United Nations Economic Commission for Europe in Geneva. As similar work had been undertaken at EU level, a discussion within the Council on the conduct of negotiations within the United Nations had developed, and the Council had decided to confine itself to taking note of the cooperation established between the member states in the course of that negotiation and to express its political approval of its outcome. This prompted a successful application by the Commission for the annulment of the proceedings of the Council.
- 5 ECJ Judgement C-22/70 of 31 March 1971.
- 6 See in this volume the chapter by Marco Becht and Luis Correia da Silva.
- 7 ECJ Judgement C-466/98 of 5 November 2002.
- 8 ECJ Opinion 1/03 of 7 February 2006.
- 9 ECJ Opinion 2/91 of 19 March 1993. Interestingly, labour safety is an area where there is no exclusive competence of the Community, which only sets minimum standards through directives. The Court nevertheless considered that member states could not undertake additional international commitments outside the Community framework.
- 10 Art. 111(4): 'The Council acting by a qualified majority on a proposal from the Commission and after consulting the ECB, shall decide on the position of the Community at international level as regards issues of particular relevance to economic and monetary union and on its representation'. Note that one possible application of the enabling clause would be for the Council to delegate external representation to the Commission. Note also that any external representation arrangement should comply with the allocation of powers laid down in the Treaty (eg it may not infringe on the independence of the ECB).
- 11 Exchange rate policy is more ambiguous. The Treaty does not identify exchange rate policy with monetary policy and it even allows the Council to issue 'general orientations for exchange-rate policy' (Art. 111). However, the two main instruments of exchange rate policy, namely official rate changes and foreign exchange interventions, are in the sole hands of the ECB. Furthermore, the Council has agreed to use this provision in exceptional circumstances only.
- 12 Bini Smaghi (2006a) provides an informed and detailed account of those changes.
- 13 In a different context, Alesina, Angeloni and Schuknecht (2005) have also used a quantitative analysis of EU legislation.

- 14 We also thank Nicolas Théry of the European Commission's DG Environment for having provided information on this sector.
- 15 Remember we implicitly assume that the policy objective is to maximise the welfare of EU citizens, not that of a citizen of the world. Hence we regard market power as a gain even if it has adverse consequences abroad.
- 16 At this point it should be noted that it is not at all the same to look at the distribution of preferences *across countries* and *among individuals*. This is related to the question of voting rules.
- 17 This possibility was pointed out to us by Barry Eichengreen. Informed citizens could reject centralisation in a field where they perceive the rationale for it because they perceive that citizens in other countries have very different preferences and therefore fear to be in a minority, should decisions be centralised. In that case, the two dimensions could not be considered independent. However, the correlation between heterogeneity of preference and desire for centralisation appears to be insignificant. Though theoretically valid, the objection thus does not seem to have empirical relevance.
- 18 Only those policies for which we have been able to obtain measures of both the degree of centralisation and the heterogeneity of preferences are plotted in Figure 2.5. However, partial information is available for a wider range of policies.
- 19 An option also envisaged in the literature is direct democracy: people vote at any point in time on policy decisions. Although it is not institutionally feasible in a European context, this option is worth mentioning since one could envisage specific instances (such as a trade, energy or environmental crisis triggering widespread public debate) where decision-making would be led by the tyranny of opinion.
- 20 A pure example is monetary policy: the risk of pandering to special interests is limited (except perhaps to banks, which favour low short-term interest rates and high long-term yields), it is fairly technical and voters are clearly in favour of price stability. This is why monetary policy has been handed over to inflexible bureaucrats, a.k.a. central bankers.
- 21 An important aspect which is overlooked in this approach is that external policies imply interaction with non-EU actors. What would be needed here is a model of strategic delegation by a group of principals to agents participating on their behalf in a non-cooperative or cooperative game (in which other participating agents could also have several principals). We are however not aware of the existence of such a model.
- 22 An example is budgetary policy: it is less technical than monetary policy, it has many redistributive consequences and *ex-post* preferences of the voters are unclear. Consistent with theory, it is decided by elected parliaments.
- 23 Another possible reason is that the agent's own preferences depart from those of the states in a way that is efficient. For example, the Commission is probably keener than most member states on ensuring budgetary sustainability and coordinating fiscal policies. It is also more market oriented than most member states when it comes to trade and competition. As is well known in the case of monetary policy (Rogoff 1985), it may be the right thing to do for member states to delegate their competence to a 'conservative' agent to enhance their credibility. However, this motive for delegation raises issues of political sustainability and calls for drastic constitutional protections such as central bankers' irrevocability and extended mandates.
- 24 It could be argued that the Commission retains some distributive power through its role in the preparation of the EU budget. However, though the Commission makes the initial proposal for the Financial Perspectives (the EU's multiannual budget framework), the negotiation is conducted by the presidency and the perspectives are adopted by unanimity.
- 25 Article 10.2 of the Statute of the European System of Central Banks and of the European Central Bank. The voting rule is simple majority of the Governing Council (which comprises the six mem-

bers of the Executive Board and all euro area governors) as long as the number of euro area member countries does not exceed 15. It will then depend on a complex rotation principle (Decision 2003/223/EC of the Council, 21 March 2003).

26 Another example is representation on the IMF Board. Ahearne *et al.* (2006) point out that moving to a single EU or euro chair while retaining the Nice Treaty system could reduce, rather than increase, European influence in the IMF.

27 We do not have the data that would have allowed us to decide on macro-financial matters.

28 In a previous work (Coeuré and Pisani-Ferry 2004), we have discussed policy complementarities at the euro area level and the roles of the Commission, the Eurogroup and the Council of Ministers.

29 The name has changed, but the procedure remains.

Appendix 1: Governance questionnaire

The following questionnaire is intended to provide a framework for the exchange between the authors responsible for the 'governance' chapter and the authors of the sectoral chapters. This will help in gathering additional information on governance in the different fields covered by the book.

Comments on the contents of the questions as well as on the method are welcome. If there is information you think relevant to add, please feel free to do so. Answers can be filled directly in the blank spaces provided below.

Definition of the field

What is/are the policy domain(s) you are covering?

Are arrangements for external relations homogeneous in this domain? If not, what are the relevant subfields? *(Please use a consistent field breakdown in your answers to the questions below).*

Competence Assignment

Who has the authority to negotiate international agreements? (eg the Commission, an agency, the Council presidency, a subgroup of countries, etc.)

What is the legal basis for delegating authority to negotiate to the authorised agent? (eg explicit Treaty provisions for external representation, extension to international agreements of Treaty provisions on internal competence assignment, intergovernmental agreement, ad hoc assignment...).

Is the authority to negotiate unconditional or based on a specific mandate? Is this mandate time-limited?

What responsibilities for external representation/negotiation remain within the remit of member states?

By means of which mechanism(s) do member states agree on a common position? What is the voting rule (unanimity, qualified majority, consensus) for taking common decisions? Who is then in charge of representing this position?

How has competence assignment evolved through years? In particular, does it pre-

date Community/EU arrangements?

Enforcement

Who is in charge of implementing the policies agreed at international level?

How is the mandate of this 'agent' defined?

How would you assess the degree of control exercised by member states over implementation by the agent?

Do member states enjoy leeway to enforce policies at national level? To what extent? Does competence assignment between member states and the agent result from a historical/practical arrangement, or is it legally defined?

Is there a settlement mechanism in the case of conflict between member states and the agent? Same question in the case of conflict between different norms with different governance schemes (eg competition versus trade)?

Criticisms and suggestions

What are the criticisms most often encountered towards the decision-making process in your field?

To which extent do you consider these criticisms relevant?

What are the main reform proposals of governance in this field? What is your own view?

Did the draft Constitutional Treaty include specific arrangements that might have improved governance in your field?

Any other comment

Appendix 2: Sources for preference indicators

Economic analysis of competence assignments relies on the notion of heterogeneity of preferences in the population. Empirical assessment of this is scarce,

however, and impedes fact-based analysis. In this section, we present a simple framework to fill that gap. Following the literature on the ‘European political space’ perspective (Hooghe and Marks 1999, Gabel and Hix 2002, Gabel and Andersson 2002, Hooghe *et al.* 2002, Imig 2002, Marks and Steenbergen 2002) we rely on quantitative evidence to shed light on the issue.

More precisely, we aim to answer two questions: Do Europeans agree on competence assignment? Do they agree on the substantive content of policies? We try to provide answers for the different policy fields.

Decision-level dimension

Standard Eurobarometers (EB) are well suited to providing information on whether a policy area should be assigned to the EU level, because they ask Europeans that question every year (the exact wording is: ‘For each of the following areas, do you think that decisions should be made by the (nationality) government, or made jointly within the European Union?’). We exclude other questions on the preferred decision-making level that are asked in Special Eurobarometers or in certain parts of the standard Eurobarometers (namely the part concerning foreign policy). The reason for this is that we fear that emphasising the problems Europe faces on a certain subject is likely to affect the answer to the decision-level question, whereas the risk of a framing bias is less pronounced when the question on the decision level is asked for several areas one after the other. The noticeable stability in the answers we get for the different decision-level questions (it is especially noteworthy since the number of countries included in the EU aggregate is all but stable during that period of time) supports this hypothesis. Following this strategy, we were able to assemble information on the decision-level dimension for 38 policies over 17 years (1989-2005).

Contents dimension

There is no single source we can rely on to assess the contents dimension for public opinion. Our strategy has therefore been to gather as much relevant information as possible for several policy areas. Four main sources were used: the European Values Surveys (EVS), the European Social Surveys (ESS), studies from the International Social Survey Programme (ISSP) and the Eurobarometers. The German Marshall Fund Transatlantic Trend Survey was also used but much less often. Other international sources are interesting but lack a sufficient number of observations (typically fewer than 10 European countries) to enter our empirical strategy (for example the Pew Trends surveys).

To choose the relevant questions in each policy field, we used when available the

empirical political literature on policy positions to get a first insight into the conflict lines in each field (we mainly rely on Dobbins, Schneider, Zimmer 2005). We then complement it with our own knowledge of the fields and the sector chapters of this book.

Appendix 3: International dimension of EU law

Table A: Number of EU legislative acts

	1957-1965	1966-1975	1976-1985	1986-1995	1996-2005	1957-2005
ALL	1,467	9,776	23,099	28,114	45,062	105,305
Trade	55	609	2,779	9,692	24,292	37,947
Competition	23	89	229	885	1,763	2,890
Development	20	54	357	1,918	6,052	9,199
Migration	2	2	1	10	98	1,684
Energy	52	58	200	367	667	1,455
Environment	4	37	283	919	2,177	3,180
Macro & Finance	53	183	629	2,019	7,116	10,889
Defence	0	3	16	15	190	232

Table B: Number of agreements with non-member states and international organisations

	1957-1965	1966-1975	1976-1985	1986-1995	1996-2005	1957-2005
ALL	35	360	858	1,251	967	3,125
Trade	1	51	143	472	411	1,010
Competition	0	1	1	17	10	27
Development	4	1	50	149	148	379
Migration	0	0	0	0	1	1
Energy	7	1	6	21	26	66
Environment	1	2	25	56	88	141
Macro & Finance	0	2	3	31	32	73
Defence	0	0	1	0	8	9

Note: totals in the 8 sectors do not add up to the grand total ('all').

Table B continued: Agreements with non-member states and international organisations as a percentage of legislation

	1957-1965	1966-1975	1976-1985	1986-1995	1996-2005	1957-2005
ALL	2.4	3.7	3.7	4.4	2.1	3.0
Trade	1.8	8.4	5.1	4.9	1.7	2.7
Competition	0.0	1.1	0.4	1.9	0.6	0.9
Development	20.0	1.9	14.0	7.8	2.4	4.1
Migration	0.0	0.0	0.0	0.0	0.1	0.8
Energy	13.5	1.7	3.0	5.7	3.9	4.5
Environment	25.0	5.4	8.8	6.1	4.0	4.4
Macro & Finance	0.0	1.1	0.5	1.5	0.4	0.7
Defence	-	0.0	6.3	0.0	4.2	3.9

Definition of fields (EUR-lex numbering)

0811 Cooperation policy	Aid policy, humanitarian aid, cooperation policy
0821 Defence	Defence policy, armed forces, military equipment, arms policy
20 Trade	Trade policy, tariff policy, trade, international trade, consumption, marketing, distributive trades
24 Finance	Monetary relations, monetary economics, credit & financial institutions, free movement of capital, financing & investment, insurance, public finance, budget, taxation, prices
2811 Migration	Migration, international migration
4031 Competition	Competition law, restrictive trade practice, competition policy, restriction of competition
52 Environment	Environmental policy, natural environment, deterioration of the environment
66 Energy	Energy policy

Definition of documents

All treaties	EU treaty, EC treaty, EAEC treaty, accession treaties, other treaties and protocols
All legislation	
- Secondary legislation	Regulations, directives, decisions, other acts
- International agreements	Agreements with non-member states and international organisations, agreements between member states, acts of bodies created by international agreements
Case-law	Court of Justice, Court of First Instance
Preparatory documents	Preparatory acts, other documents from the institutions
Parliamentary questions	Written questions, oral questions, questions at question time
EFTA documents	

3

Trade policy: time for a rethink?

Simon J. Evenett¹

The European Union is the world's largest trader, a fact that on the face of it ought to convert into considerable clout in international commercial negotiations. Yet, since the World Trade Organisation's (WTO's) creation in 1995, it is difficult to point to a string of successes for the European Commission's (EC's) often beleaguered trade negotiators. Even the enthusiasm associated with the launch of the Doha Round in 2001 has dissipated as these negotiations have repeatedly stalled, with many questioning what can feasibly be accomplished at the WTO in the near to medium term. A 2006 EC decision to abandon its moratorium on negotiating new free trade agreements [FTAs] seems more of a stop-gap measure to maintain some negotiating momentum than a systematic strategy to leverage European clout. Worse, it carries the risk of seriously undermining the multilateral trading system if EC negotiations with Korea tempt Japan, and in turn possibly even the United States, eventually to seek preferential access to the European Union's markets. With so little to show for the last 10 years and the future of the multilateral trading system decidedly uncertain, a fundamental rethink of the ends and means of European trade policy is in order.

That rethink needs to take account of the following realities: a shift away from a bipolar towards a multipolar WTO; recognition of the fact that the principal liberalising accomplishment to date of the multilateral trading system has been the freeing of manufactured goods trade between industrialised countries and that many other potential reforms have either stalled or proved, on implementation, to be highly controversial; substantial opposition among many prominent groups in the leading trading powers to further trade reform (even in countries experiencing fast economic growth or export growth); and a greater emphasis on signing bilateral and

regional free trade agreements (whose liberalising intent and impact is often highly circumscribed).

Once the superficial attractions associated with the scramble for preferential market access in Asia fade, European trade policymakers ought to confront these realities. At a minimum, the search will then be on for a *modus vivendi* with the new trading powers. This will require thought to be given to the likely future offensive and defensive commercial interests of all concerned, bearing in mind the differences in level of development and overseas corporate exposure and organisation. The ultimate goal should be to identify the potential basis for future multilateral trade accords. Properly conceived, future European trade strategy could contribute significantly to the renewal of one of the most successful post-war international economic institutions.

The EU's evolving trade policy

The EU is the world's largest exporter of goods and services and the second largest importer. In 2005 approximately \$3.6 trillion of goods and services crossed its external borders, more than any other nation or customs union. With a single trade policymaker wielding considerable powers of initiative – the European Commission – representing the interests of 27 nations and more than 450 million people, one might have expected EU trade policy to have both considerable clout and a string of recent successes to point to during the past ten years. In fact, the EU has not much to show for its negotiating efforts. The Doha Round has repeatedly stalled and even if it is concluded in 2007 – which few experts anticipate – then it will be on terms that fall far short of the EU's original negotiating objectives. The multilateral trading system is important to the EU because, despite the numerous preferential trading schemes the EU has negotiated or created over the last fifty years, approximately three quarters of imports by the EU still enter on non-preferential terms. For sure, few policymakers world wide have emerged from the Doha Round with much credit. Even so, the question does arise as to whether the content and strategy of EU trade policy require a rethink.

The case for a rethink is all the stronger when one considers how the world trading system has developed since the signing of the Treaty of Rome fifty years ago, when six European countries began to pool their sovereignty on commercial policy matters. Then, European nations and the United States dominated the General Agreement on Tariffs and Trade (GATT) and continued to do so for another forty or so years. Now, Brazil, China and India have come forward to challenge the bipolar domination of the world trading system. Back in 1957, the liberalisation of merchandise

trade between industrialised countries still had a long way to go. Now, though some tariff peaks remain, such liberalisation has almost been completed. Moreover, throughout much of the post-war period trade liberalisation by industrialised countries took place within the context of reciprocal trade agreements. Now, many nations unilaterally lower their trade barriers and appear reluctant to bind their reforms in trade accords. These and other factors indicate that the multilateral trading system, which has served European commercial interests well, is moving into new territory and the question arises what constructive role the EU can play in shaping its future trajectory. (It is taken as given in this chapter that, by and large, multilateral measures to reduce discrimination against foreign commercial entities and to reduce the policy-related uncertainties associated with international commerce is decidedly in the interests of the EU's producers and consumers].

The purpose of this chapter is to describe the evolution of the EU's trade policy since 1995, highlighting the changing international trade policy terrain and the arguably inadequate response from European trade policymakers to those changes. Rather than gear up for the task of revitalising a multipolar trading system and exploring the basis upon which future multilateral trade agreements could be signed, an October 2006 policy paper ('communication') from the Commission advocated joining the scramble for preferential access to Asian markets, a proposal which on closer examination is likely to yield far less than some anticipate. Once the challenges of negotiating with a mercurial India, an inchoate Association of Southeast Asian Nations [ASEAN], and a weak Korean government become clearer, the alternatives to multilateral trade accords may seem less attractive. At that point, probably towards the start of the next term of office of the Commission in 2009, further attention ought to be given to securing Europe's proper place in a multipolar World Trade Organisation.

Considerations of space necessitate some prioritisation on my part as to which of the many facets of the EU's trade policy should receive more attention in this piece. Developments at the multilateral level and the negotiation of reciprocal free trade agreements and the like receive more attention here, not least because of the emphasis on the former in the recent past and the likely priority to be given to the latter in the near term. Far less attention is given to the non-reciprocal trade initiatives undertaken by the EU, to its neighbourhood policies, and to relations with important countries such as Turkey, Russia, and the Ukraine. This is either because the associated negotiating processes are operating on a clearly established timeline, such as the negotiations with the African, Caribbean and Pacific (ACP) nations, or because they are driven by a very specific set of circumstances and are likely to have limited systemic impact.

The remainder of this chapter is organised as follows. The next section briefly describes the current allocation of competences and decision-making powers over commercial policy in the EU. In the third section the major developments in the EU's trade policy since 1995 are described, as are the underlying factors that have been shaping the international trade policy landscape in recent years. The most recent (October 2006) communication from the Commission on its external trade policy is also described in this section. This communication is assessed and, in short, is found wanting in certain respects. The fourth section identifies a number of the current and future challenges facing European trade policymakers as the bipolar trading system gives way to a multipolar alternative. Some concluding remarks are offered in the fifth section.

The allocation of competence and associated decision-making in EU trade policy

At a minimum, commercial policy refers to those state measures and (unilateral, bilateral, regional, and multilateral) accords between states that influence the degree of discrimination against foreign suppliers of goods and services or in favour of domestic rivals. In the EU, as a general proposition, the Commission is said to have sole competence over the conduct of commercial policy although, as noted below, this does not mean that the member states play no role in European trade policy decision-making or in selective areas of commercial policy.² The chapter of the revised Treaty establishing the European Community concerning a common commercial policy is relevant here, in particular the provisions of Article 133, as amended.³ Under Article 133(2) the Commission has the right of initiative as far as trade negotiations are concerned but must seek and obtain a mandate from the Council of Ministers. Article 133(3) allows the Council to authorise the Commission to negotiate and obliges the Commission to report frequently to the Council. Article 300 of the amended Treaty sets out the constitutional requirements for the intra-EU procedures governing ratification and implementation of a treaty which the Commission has negotiated.

The Commission must seek a mandate from the Council for any negotiation that it plans on undertaking, which may or may not be time bound. The mandate issued by the Council gives broad objectives for the negotiation but is not so detailed that the Commission must repeatedly come back to ask for changes in the mandate. There is an interesting question how long a given mandate lasts when no time limit has been set, nor the terms upon which a mandate is superseded by another mandate. Both the terms of the mandate and the absence of any time limit can thus create ambiguity which can be exploited by the Commission. The Commission must also seek approval of any agreement that it negotiates with a trading partner or for any

unilateral measures – such as the imposition of anti-dumping duties – that it is in principle empowered to take. With a few exceptions, all such decisions are made in the Council by qualified majority voting. The Council can offer interpretations to the Commission of any international obligations that the latter has signed up to.

There exist a number of venues where the member states can express their views to the Commission as to the merits of various actions. The so-called 133 Committee meets weekly with senior officials from the Commission's Directorate-General for Trade. On anti-dumping matters a separate advisory committee has been established. Informal polls of member state opinions are undertaken in these advisory groups and committees, providing member states with a way to signal to the Commission how they are minded to vote on a matter should it reach the Council. Typically, records of deliberations in these advisory groups and committees are not made public and it is particularly difficult to ascertain precisely what has gone on behind close doors. Nevertheless on some trade policy matters, such as anti-dumping, there have been repeated leaks to business newspapers and the specialist press concerning the positions of various member states and the likely outcome of a Council vote. With these leaks it has been possible to identify distinctive patterns in many member states' voting records and to identify a number of 'swing' member states that may well swap their votes on certain trade policy matters for other *quid pro quos* (see Evenett and Vermulst 2005 for details).

Although the member states set the Commission's negotiating mandate, it would be wrong to believe that their next official chance to oversee the Commission's work occurs at the conclusion (if any) of the negotiation. Member states can and do express themselves forcefully when they believe the Commission has exceeded, or is likely to exceed, its negotiating mandate. In recent years nowhere has this been more apparent than in the agricultural negotiations of the Doha Round.⁴ France has maintained a coalition numbering more than half of the member states which has repeatedly warned the Commission not to exceed the relevant negotiating mandate, which in this case refers to the outer limits of the agricultural reforms that the member states agreed to undertake earlier in the decade. In Evenett (2006a) I documented the steps taken by France and her allies to shore up this coalition throughout 2005, when European trade negotiators came under considerable pressure from their trading partners to liberalise agriculture. With the subsequent accession of Bulgaria and Romania press reports have suggested that this coalition has been strengthened. To date, this coalition has been relatively robust. However the ultimate test of its strength may come about when member states see more clearly what overseas commercial opportunities they will have to relinquish if they persist in defending their agricultural interests in this manner.⁵

On a few occasions there have been outright public disagreements between the EU member states and the Commission over trade policy priorities and measures. Moreover, members of the European Parliament have not been adverse to engaging in such disagreements either. Such discord has arisen during the negotiations between the Commission and the ACP countries over Economic Partnership Agreements (EPAs). The Commission has sought, amongst others, to include provisions on investment policies, government procurement and competition law in these EPAs. The UK government, for one, has repeatedly argued against this negotiating position, often in public⁶, as have leading European parliamentarians. One may wonder what the effect of such public disagreements have on the negotiating tactics of both the ACP nations and the Commission. Do the former view the latter merely as an awkward intermediary that can be bypassed by appealing directly to the member states, some of which were (after all) former colonial rulers and may have residual affinity for the ACP nations? Or is the concern about not concluding a free trade agreement under the EPA, with its implied loss of a certain preferential market access to the EU market, sufficiently strong that the ACP nations view the Commission as their principal interlocutor?

This brief description of the manner and procedures associated with the delegation of trade policy competences from the member states to the Commission highlights both the enormous power of initiative that the latter has and the various means of oversight, some more subtle than others, available to the former. Given the use of qualified majority voting and the differences in the levels of economic development between the first 15 members of the EU and the relatively newer member states, one factor that may become more important over time is how aggressively the 12 new member states encourage the Commission to pursue their commercial policy interests over other interests that have received considerable attention in the past. For example, the new member states may be less interested in supporting measures to strengthen intellectual property rights (IPR) regimes abroad and opening foreign financial markets, preferring instead measures that bolster foreign direct investments and outsourcing in general and better access to the merchandise sectors of middle-income developing countries. In short, EU enlargement may well affect the trade-related negotiating priorities of the Commission more in the future than it has done in the past.

Major developments in EC trade policy since 1995

Charting the major changes along the many dimensions of EU commercial policy requires some organising themes and inevitably some selectivity on the author's part. Here I seek to identify not only the major trade policy action taken by the EU since

1995, and its apparent underlying logic, but also the significant factors shaping the international trade policy landscape in recent years. Several factors are almost certain to persist and will influence the options and trade-offs faced by European trade policymakers in the future, points picked up and developed later in this chapter.

In what follows I start by characterising EU trade policy just after the creation of the World Trade Organisation in 1995. Then I describe the subtle differences in the rationales for EU commercial policy advanced by the two most recent predecessors of current European Trade Commissioner Peter Mandelson, and manifested in official Commission communications and other documentation from 1996 to 2004. Third, I discuss developments in bilateral and regional trading fora. Then I describe the principal developments in the multilateral trading arena since 1995. Finally, an assessment of the last Commission communication on current trade policy, issued in October 2006, is presented. Throughout these discussions the goal is to identify the internal and external factors that appear to have a significant influence on EU trade policy formation and on the effectiveness of such policy.

EC trade policy at the creation of the WTO and the enduring commercial significance of 'most-favoured-nation' (MFN) tariffs.

On 1 January 1995 the EU⁷ and member states became founding members of the WTO, and in so doing signed up to the core multilateral agreements of the world trading system as well as the plurilateral Agreement on Trade in Civil Aircraft and the plurilateral Agreement on Government Procurement. The expansion in the EU's membership in that year to include Austria, Finland, and Sweden required consolidation of their trade commitments with those of the existing 12 member states and some renegotiation of Europe's WTO commitments with major trading partners followed.⁸

In the Uruguay Round of multilateral trade negotiations concluded in 1993 and which began to come into effect in 1995, the EU agreed to bind all of its tariff lines. With respect to agricultural products, the EU agreed to reduce its bound tariff rates by 36 percent on average (the EU also committed to cut each tariff by a minimum of 15 percent). The EU made commitments on the use of tariff quotas on the imports of agricultural products and agreed to cut total financial support for agriculture (specifically, the so-called Aggregate Measure of Support) and both the value and volume of export subsidies for agricultural products (WTO 2000).

As far as non-agricultural goods are concerned, in the Uruguay Round accord the EU agreed to cut its average rate of duty from 6.9 percent in 1995 to 4.1 percent at the

Table 3.1: Indicators of trade policy stance for the EU and selected trading partners

<i>Trade policy indicator</i>	EU	USA	Brazil	China	India
Tariff binding coverage, %	100	100	100	100	73.8
Simple average applied tariff rate for agricultural goods, %	5.9	n.a.	10.3	15.9	15.4
Simple average applied tariff rate for non-agricultural goods, %	4.0	3.3	12.7	9.1	37.6
MFN duty free imports, % total imports	53.1	46.8	22.2	34.0	2.1
GATS service sectors with commitments	115	110	43	93	37

Source: WTO Country Profiles obtained from <http://stat.wto.org>

end of the relevant implementation period. As a result of the Information Technology Agreement, which was subsequently agreed to at the WTO Ministerial Conference in Singapore, from 1997 many information technology-related products entered the EU free of tariffs. This was to lower the average tariff on non-agricultural products to 4 percent. Agreements to eliminate tariffs on pharmaceuticals and on spirits led to further European market opening after the conclusion of the Uruguay Round (WTO 2000). Table 3.1 provides a summary of the trade barriers currently erected by the European Union and compares them to several of its major trading partners.

The schedule of Specific Commitments made by the EU on services in the Uruguay Round covers all service sectors except the audiovisual sector and, to some extent, maritime services and air transport services.⁹ Derogations from MFN treatment in services applied to audiovisual services, transportation services, and subsidies. To these Specific Commitments were added obligations to liberalise basic telecommunications and financial service sectors, as negotiated in sector-specific initiatives after 1995 (WTO 2000).

After the conclusion of the Uruguay Round, the EU retained the right under prevailing WTO rules to impose quotas on imports of textiles and clothing. Like other WTO members, the EU agreed to eliminate such quotas by the end of 2004, a commitment it held to. In the interim the average rate of quota expansion was to be increased from 16 percent on 1 January 1995 to 25 percent on 1 January 1998 (WTO 2000).

Such was the network of preferential agreements between the EU and its trading partners in 1995¹⁰ that the WTO secretariat, in its EU Trade Policy Review, noted:

'The vast majority of the Union's trading partners qualify for free trade area or other preferential treatment. Although the EU has no more than a handful of purely MFN suppliers, the largest value of imports enter under non-preferential conditions, reflecting the economic weight of the suppliers concerned, limits in the coverage of the preferential trade schemes, and the high share of imports qualifying for zero MFN rates. The multi-layered network of free trade, association, and other preferential agreements between the EU and its trading partners has consolidated and expanded significantly over the last few years. Certain preferences have decreased in economic importance as other trading partners have secured improved access to the Union's markets' (WTO 1995, pp. 17-18).

In February 2007, when the last WTO Trade Policy Review of the EU was published, only nine WTO members¹¹ conducted their trade with the EU on a purely MFN basis (WTO 2007). Of these nine, three (Hong Kong, China; Republic of Korea; and Singapore) were graduated out of the EU's Generalised System of Preferences (GSP) regime on 1 May 1998 and their exports therefore subsequently faced MFN duties. WTO (2004) notes that these nine WTO members account for 36 percent of the EU's merchandise trade.¹² This report further observes:

'The [European] Commission estimates that 74 percent of the EC's trade is under the MFN regime; this implies that MFN trade with its preferential partners represents some 38 percent of its overall trade'. (WTO 2004, p.22).

Despite the accession of 10 member states in 2004 and two more member states in 2007, the signing of more Europe and Association Agreements, the Cotonou Agreement, the Everything But Arms (EBA) Initiative, a reformed GSP system, the conclusion of FTAs with Chile, Mexico, South Africa, and (essentially) Switzerland, and the establishment of the Euro-Mediterranean Free Trade Area, nearly three quarters of the EU's imports are conducted on a MFN basis. There are, for sure, some WTO members whose exports to the EU take place overwhelmingly under certain preferential trade regimes (see Curran *et al.* 2006 for details), but for most WTO members this is simply not the case, again highlighting the importance of the multilateral trading system for Europe's trading partners. In this regard it is worth noting that the EU is the second largest importer of merchandise in the world (see Table 3.2 for the magnitude of trade flows across the EU's external borders in 2005).

The evolving rationales and objectives of EU trade policy since 1995

I now turn to a discussion of two distinct yet related official conceptions of the chal-

Table 3.2: *Extra-EU trade flows, 2005*

<i>Extra-EU trade flow</i>	US\$ billions	Ranking in the world	% world total
Total merchandise exports	1,320	1	17.12
Total merchandise imports	1,461	2	18.03
Total services exports	432	1	27.08
Total services imports	384	1	24.39
Grand total exports and imports	3,597	1	
<i>Memo.</i>			
Total GDP, PPP.	12,097	2	
Implied total trade/GDP ratio: 0.297	n.a.		

Source: *WTO Country Profiles for the EU (25 member states)* obtained from <http://stat.wto.org>

lenges facing EU trade since 1995, one associated with Sir Leon Brittan's tenure as trade commissioner and the other with his successor, Pascal Lamy. Arguably both perspectives partially inform EU trade policy today and, as I will argue later, the latest (October 2006) communication from the EC on trade policy is in many respects closer in spirit to the former approach.

Although globalisation is much discussed today, it is worth recalling that, in the mid-1990s, the integration of national economies into world markets was seen as an important factor too. A 1996 trade policy communication entitled 'The Global Challenge of International Trade: A Market Access Strategy for the European Union,' mentioned the 'relocation' of business and the potential for dislocation that this could cause. The connection between opening foreign markets and the ability of European firms to exploit their competitiveness was also made (European Commission 1996). Furthermore, the rising might of Asia was already on the minds of European policymakers, and the WTO Trade Policy Review of the EU in 1995 noted that a 1994 Commission paper 'asserts a need to accord Asia a higher priority than in the past' (WTO 1995).

Having painted a global picture of commerce, the 1996 communication characterised the trade policy challenge for the EU as follows:

'Greater access to markets world wide should be one of the prime objectives shaping the deployment of Community resources in the months and years

ahead. To achieve significant increases in market access is necessarily a long-term process. Both in tackling pressing problems under existing rules and in developing new rules to remove other obstacles to trade and investment, the Community will be successful if it produces a clear analysis of its own priorities and works closely with its trading partners, developed and developing alike. We should concentrate on actions which respond to the demands and priorities of industry and which result in tangible and direct benefits for our exporters and investors' (European Commission 1996, p.19).

This quotation is worth reflecting on for a moment. First, market access is the lens through which policy instruments are assessed, whether they are directly tariff related or not. Second, non-tariff barriers receive significant priority. Rules for these barriers would not be developed for their own sake, but because they constitute an impediment to market access. (It is noteworthy that in the 1996 communication the following non-tariff barriers are specifically mentioned: the failure to protect intellectual property rights, rules of origin, selected government procurement practices, investment policies, and competition policies). Third, the beneficiaries of this policy would be exporters and investors, that is, commercial interests only. The strategy would be market access and demand driven (European Commission 1996), developing bilateral and multilateral approaches as appropriate.

By 2003 Sir Leon Brittan's successor as trade commissioner was characterising the challenges facing EU trade policy and its rationale in a different light. It may well be that the high-profile protests by some elements of civil society against the multilateral trading system, and globalisation more generally, had some bearing on the rationales offered by EU trade policymakers. In a report at the end of his tenure as trade commissioner, Lamy noted that from the very start he had set himself a goal of '*la globalisation maîtrisée*' (European Commission 2004, p.3). In his view European trade policy had to be 'properly integrated' with the other goals of the EU:

'And much of the responsibility for that [integration] lies with the European Commission, not just to regulate trade with third countries but to ensure we properly manage the interface between our external policy and the internal EU market, and of course the European Model' (European Commission 2004, p.3).

Lest anyone be in any doubt about the relative importance of market access in Lamy's scheme, he went on to argue:

'But the opening of markets is not an end in itself, but is a way of making progress. Moreover, while necessary, market opening is not sufficient. It does not

by itself ensure development. Internal policies have to be right too, not least to ensure that the distribution of its benefits is more equitable' (European Commission 2004, p.3).

A broader audience and set of outcomes is conceived, then, for EU trade policy. Lamy notes that it is 'critical' to keep a sizeable majority of the European public in favour of open trade policies, and opening markets abroad may not be enough in this respect. He acknowledges that these changes have made trade policymaking more difficult and affect the assessment of such policymaking. In his view the links between trade policy and transparency and legitimacy, development and cherished values and sectors are important too, not just the amount of market opening and number of trade agreements signed. Arguably, therefore, this perspective reflects a distinct evolution from the thrust of the 1996 communication discussed earlier, although some common tenets recur.

In his assessment of the trade policy-related accomplishments of the Commission of Romano Prodi, of which he was a member, Lamy argued that the EU was still able to resist trade policy initiatives that it did not like and to 'set the international agenda'. He argued that the 'priority given to development in the Doha Agenda, or the agreement on medicines are evidence of this pivotal European role'. Interestingly, Lamy's assessment also included the following reflection:

'Our arguments in favour of a better regulated multilateral world have thus been less effective. Indeed, arguably as a result, trade policy or the WTO has too often been the sole focus for efforts to strengthen international governance, which risks weakening its legitimacy both internally within the Union, and in the outside world. I don't believe the WTO can or should remain the sole island of governance in a sea of unregulated globalisation' (European Commission 2004, p.5).

The experience of the ill-fated Singapore Issues, recounted below, three of which were eventually dropped from the Single Undertaking of the Doha Development Agenda in 2004, may well have influenced this judgement. Whatever the motivation for international rules on non-tariff policies, it is apparent that the challenges described in the 1996 communication had not been adequately resolved by this 2004 account of EU trade policy.

The principal reason for contrasting the 1996 communication with the 2004 assessment was to highlight the evolution in the perceived purpose of EU trade policy, from an approach centred on market access to a multi-faceted view that sought

to address a wide range of matters at a time of considerable public discourse about the merits of globalisation. That Lamy was instrumental in launching the Doha Development Agenda in 2001, and the relative consistency with which EU trade policy has been applied since then, probably accounts for the continuing influence of some of the ideas expressed above on European trade policymaking.

Having described the EU's point of departure (in trade policy terms) in 1995 and two sets of ideas that appear to have shaped EU trade policymaking over the last ten years, I now turn to a discussion of selected important aspects of preferential and multilateral trade initiatives negotiated by the Commission since the conclusion of the Uruguay Round.

Developments in the EU's bilateral and regional trading relationships since 1995

In developments outside of the multilateral trade arena a distinction has to be made between agreements negotiated with nations in Europe's so-called neighbourhood, including those nations seeking to accede to the European Union, and preferential arrangements with other countries. With respect to the former, as the series of WTO Trade Policy Reviews of the EU can attest, Europe has been assiduously strengthening economic ties with almost every country which it borders or is geographically proximate to. These agreements vary in terms of obligations, where steps to adopt more or less of the EU's *acquis communautaire* are often complemented by packages of aid and technical assistance, and have often been motivated by diplomatic and security considerations as well as commercial interests.

The EU has also made important changes to the non-reciprocal preferences it offers different groups of developing countries. On 23 June 2000, the ACP-EU Partnership Agreement was signed in Cotonou, Benin. Apart from the EU, this agreement has 77 developing country signatories, mostly former European colonies from the African, Pacific, and Caribbean regions, and 40 of which are classified as least-developed countries (LDCs) by the United Nations. The EU grants these countries duty-free access to its markets for industrial products, processed agricultural goods and fisheries products, but there are exceptions (including separate regimes for sugar, beef and veal). These are interim measures, however, and are due to lapse on 1 January 2008. By then it is expected (hoped?) that the EU will have completed negotiations on EPAs with the 77 signatory countries. These agreements are to be reciprocal, to respect WTO rules, and are expected to include flexibilities concerning the depth of liberalisation, transition periods, product coverage, and exceptions. In addition to enhancing market access, the EPAs are supposed to foster sustainable development and to promote regional integration among developing countries.¹³

Changes have also been made to the GSP that the EU unilaterally offers to qualifying developing countries. Over time there has been a tendency to simplify the EU's GSP programme as well as to sharpen the incentives it contains for beneficiaries to promote internationally accepted labour standards, tackle specific environmental concerns, and combat drug production and trafficking. Of particular note is the EBA initiative that the EU instituted in 2001. This extends duty-free market access to those LDCs not covered by the Cotonou Agreement, although there are separate phase-in periods for three sensitive products. Another feature of the GSP regime is that the EU reserves the right to graduate a developing country which meets certain criteria, at which point the EU deems that the country's exports no longer need preferences effectively to sell into the EU. As noted earlier, three jurisdictions were graduated from the EU's GSP regime in 1998, implying that their exporters now face MFN duties. The EU also reserves the right to graduate individual sectors within a GSP beneficiary even if the beneficiary country is not entirely excluded from the GSP regime.¹⁴

The spread of preferential market access to the EU was the subject of discussion in Brussels in the mid-to-late 1990s. The WTO's Trade Policy Review in 1997 noted that preferential market access was 'the subject of debate within the EU over the last two years' (WTO 1997). Furthermore in April 1997 the Council called for close scrutiny of new preferential arrangements and argued that 'the fundamental architecture of the EU's policy on preferential agreements has been put in place and should be preserved', a remark that the WTO secretariat concluded 'implicitly left little scope for the further expansion of the current network of agreements' (WTO 1997). This effectively led to a moratorium on the launch of new negotiations towards FTAs, a moratorium that was adhered to until publication of the October 2006 communication on the EU's external trade policy.

From their launch in 2001 the Doha Round negotiations provided another way to deflect any pressures for new FTA negotiations. It was often argued that a multilateral agreement would deliver many more commercial opportunities than any particular FTA. Moreover, there was a concern that concluding FTAs with the largest of the EU's trading partners would undermine the multilateral trading system. The fear was that, if the big players can effectively deal with each other outside of the WTO, then the need for multilateral rules would be much diminished.

In the intervening years, however, the EU was able to conclude a far-reaching FTA with Chile (in 2002) that included provisions on political dialogue and cooperation on a wide range of state and non-state matters, as well as the more traditional trade-liberalising measures. An FTA with Mexico came into force on 1 July 2000 and

included a range of obligations in the field of tariff and non-tariff measures, including rules of origin, technical regulations, sanitary and phytosanitary measures, safeguards, trade in services, government procurement, competition policy, investment policy, intellectual property rights and dispute settlement. This agreement included a liberalisation schedule whereby the EU committed to eliminate its tariffs on Mexican imports four years before Mexico had to reciprocate. FTA negotiations between the EU and Mercosur and the EU and the Gulf Cooperation Council states, in contrast, were not concluded. With the latter negotiations stalled, the focus of the EU's trade-liberalising efforts shifted increasingly towards the WTO and I now turn to an account of developments in that arena since 1995.

EC trade policy and the multilateral trading system since 1995

Developments at the WTO have, one way or the other, consumed much of the attention of senior European trade policymakers since 1995. The EU has played an active, even central, role in every WTO Ministerial Conference and in the many mini-ministerials and other events that have come to dominate the WTO timetable. Initially, the market access perspective provided the lens through which a wide range of multilateral initiatives were put forward by the EU for inclusion on the WTO's agenda. But this was to change in the late 1990s and the early part of this decade, with the EU arguing increasingly that new rules brought their own benefits to WTO members. In addition to rules on labour standards, the EU made its position known on the following trade-related matters in preparation for the WTO Ministerial Conference in Singapore in 1996: competition policy, investment policy, trade and the environment, intellectual property rights, and technical barriers to trade (WTO 1997). The EU sought to expand the remit of the WTO further, sometimes into areas where a multilateral agreement existed and sometimes where new rules would have to be created from scratch. This was in addition to the EU's stated goal of completing the unfinished business of the Uruguay Round (the so-called Built-In Agenda) and the timely implementation of multilateral commitments agreed in 1993.

Even though other WTO members, notably the United States, also wanted to expand the remit of the WTO's rules in the mid-to-late 1990s, such initiatives were not universally accepted by the WTO's membership. In fact, around the same time many developing countries asserted that the terms and costs of implementing a number of the Uruguay Round agreements were so onerous that they sought redress for these grievances. Outright renegotiation of existing multilateral accords was unacceptable to the EU, the US and to many other industrialised countries. However, concessions were made in the interpretation of provisions and concerning the implementation of obligations taken on in the Uruguay Round. These concessions went

only some of the way towards satisfying certain developing country members of the WTO which, having failed to obtain all they wanted, began to oppose more vigorously the negotiation of new multilateral rules. The consequences of such opposition would become clear for all to see at the three WTO ministerial conferences that followed (namely those in Seattle, Doha, and Cancun).

There were a number of significant developments in 1999. First, the EU sought and received from the Council a negotiating mandate in advance of the third WTO Ministerial Conference in Seattle. This mandate envisaged launching what was then referred to as the Millennium Round. Second, sharp disagreements over whether rules on labour standards should be included in the multilateral trading system led to the breakdown of the Seattle Ministerial Conference and there was no consensus on launching a new round of multilateral trade negotiations. Third, the European Commission of President Jacques Santer collectively resigned over allegations of budgetary mismanagement and fraud. This Commission was replaced by one led by Romano Prodi and included Lamy as trade commissioner. As noted earlier, the growing sentiment against globalisation among 'civil society', so forcefully expressed on the streets of Seattle, may well have begun to influence the manner in which the ends and means of EU trade policy were articulated. Perhaps the calculation was that if Europe's public was unwilling to support further trade liberalisation at home, how could European trade negotiators persuade other countries' officials to open up their markets? An interesting question is whether the year 1999 saw the strengthening of domestic policy constraints on the level of ambition of EU trade policy, constraints that arguably remain to the present day.

The next round of multilateral trade negotiations was in fact launched in 2001, at a WTO ministerial conference in Doha, Qatar. While some were preparing for the launch of the round, the attacks in the United States on 11 September 2001 created the geopolitical imperative to demonstrate that the world's governments could cooperate at a time of heightened uncertainty. Arguably this was a very important contributing factor to the launch of the Doha Round. So was the commitment, apparently extracted by developing countries and probably with the fulsome support of Lamy, to raise the profile of development-related considerations in this round. Not for nothing was this round of negotiations to be guided by the Doha Development Agenda. It is unclear whether negotiators had considered all of the ramifications of this step, not least because the concept of development is so broad. Was the WTO to become a development institution, similar in some respects to the regional and multilateral development banks? Did the development focus imply that developing countries would receive redress for what they perceived as an unbalanced Uruguay Round agreement? If renegotiation of prior agreements was unacceptable to some,

how would the development focus influence the negotiation of new multilateral obligations? What would the 'development' label imply for business support for the round? Without good answers to these questions (which have been posed since the round's launch) – and arguably trade negotiators have preferred to muddle through rather than address them head on – it should not be surprising that in moments of despair many poorer WTO members have concluded that the 'development mandate' was a ruse. And many business leaders have wondered what stake remains for them in the multilateral trading system. In the light of these considerations, and after the gestation period of an elephant, the launch of the Doha Round proved to be a fraught birth, with a barely recognisable sick infant taken off quickly into intensive care.

At the Doha Ministerial Conference the EU representatives argued for a shorter (in their view, preferably a three-year) negotiating timetable. Moreover, they called for proper consideration to be given to matters of sustainability in all aspects of the WTO's work programme and the right combination of trade and trade-related government measures in order to attain the round's broad objectives. The EU also accepted a compromise text on the launching of negotiations relating to the four so-called Singapore Issues (trade and investment policy, trade and competition policy, transparency in government procurement, and trade facilitation). This text would prove to be important at, and in the run-up to, the following WTO ministerial conference.

The years 2002 to 2003 saw three significant developments. First, the budget for (and by implication the sequence of reforms to) the EU's Common Agricultural Policy (CAP) was agreed for the years through to 2013. Included within this agreement was a programme of reform, essentially to cut the cost of the CAP, which would effectively allow some flexibility to the EU's trade negotiators on agricultural matters. Proponents of the CAP, however, sought and received assurances that the Commission's trade negotiating mandate on agricultural matters would go no further than the reforms agreed in the revised CAP budget. The proponents were tenacious and dogged in holding the Commission's trade negotiators to this commitment from 2003 on, and in particular in 2005 when the EU was under considerable external pressure to make further reforms on agricultural trade policy matters. One effect of limiting the Commission's ability to offer concessions on agriculture was effectively to constrain what the Commission could reasonably demand of its trading partners in agriculture and elsewhere. These considerations go a long way to account for the EU's position, whether it liked it or not, in the camp of WTO members with relatively lower market access-related ambitions in the Doha Round, whatever the rhetoric that emerged to the contrary.

In the years leading up to the Cancun Ministerial Conference, the EU tabled a wide range of proposals at the WTO. The WTO's Trade Policy Review of the EU in 2004 included the following survey of the EU's contributions thus far to the Doha Round:

'It [the EU] has spearheaded initiatives in the liberalisation of trade, strengthening of WTO rules, and promotion of sustainable development. On market access for goods, it is of the view that liberalisation should be carried out on a comprehensive basis, rather than in a sectoral manner, and that negotiations should help developing countries get better access to the markets of developed countries; and that trade barriers between developing countries should also be significantly lowered. On agriculture, it proposes to reduce its import tariffs and trade-distorting farm support by more than a half and has offered to eliminate export subsidies on a list of products of interest to developing countries. It also stresses that the negotiations on agriculture must take into account non-trade concerns as well as the better protection of geographical indications. Further market access for services is also advocated. The EC has presented more than 100 initial requests for improved access to third-country markets and has received several initial requests from third countries. It advocates the need for multilateral environmental agreements to mesh smoothly with agreements in the multilateral trading system in mutually supportive ways. The EC has called for tariff- and quota-free access for goods from least-developed countries, as well as special and differential treatment based on the level of development and the capacity of developing countries. It has also been behind initiatives to finance and support trade-related technical assistance aimed at helping developing countries to accede to the WTO, to implement WTO rules, and to participate more actively in the multilateral trading system. As regards trade defence measures, the EC has been advocating stricter mechanisms and greater transparency. It also argues for improvements in trade facilitation rules; a more transparent and predictable climate for investment; and the promotion of fair competition and procurement policies' (WTO 2004, p. 24).

The next major developments were the Cancun WTO Ministerial Conference and the so-called July 2004 package. These two events are related as, arguably, the latter helped get the Doha Round negotiations back on track after the breakdown in talks at the former. In the run-up to the Cancun Ministerial Conference the EU and the US were asked by other WTO members to narrow their differences on agricultural trade matters and to make a joint proposal. The EU and US took up this challenge and produced a compromise text that was promptly rejected by the G20 (the group of 20 or so developing countries led by Brazil, China, India, and South Africa). Worse was still to come, in what proved to be for a variety of reasons an acrimonious ministerial

conference, when the African group of developing countries formally objected to the launch of negotiations on any of the four Singapore Issues, which was an important objective of the EU. This impasse arose even after the Commission agreed to drop two or three (it was unclear precisely how many to observers) of the Singapore Issues from the Single Undertaking. This impasse was the proximate cause of the collapse of the ministerial conference and was followed by recriminations between many WTO members for the remainder of 2003.

In addition to rejecting an expansion of the WTO's remit, perhaps the lasting significance of the Cancun Ministerial Conference was the emergence of reasonably robust groupings of developing countries (the G20, G33 and G90) that sought to assert their rights in this important multilateral forum. Until this ministerial conference the EU and the United States (sometimes with the assistance of Japan and Canada), had by and large dominated deliberations at the WTO. A bipolar WTO had given way to a multipolar alternative.¹⁵ So, on top of the fraught questions concerning what constituted a development round and what are the boundaries of the WTO came a governance challenge. How to attain consensus in an organisation where every member has a veto and is more inclined to use it? Problem compounded problem. Stalemate and frustration ensued.

At a general council meeting in July 2004 WTO members sought to rejuvenate the Doha Round negotiations. In addition to dropping three of the Singapore Issues from the Single Undertaking for the duration of the Doha Round and allowing negotiations on one of them (trade facilitation) to commence, it was agreed that a formula approach be adopted in negotiations on cutting tariffs on imports of non-agricultural products. This formula was such that larger tariffs would be cut more than smaller tariffs. Provision was also made for lower cuts by developing countries, consistent with the agreed principle of less-than-full reciprocity accorded to poorer WTO members. Timetables were elaborated for 2004 and 2005 for the important elements of the negotiations, and there was still much talk of the need for an ambitious outcome for the round, especially from the United States, Brazil and some other agricultural exporters.

From the perspective of understanding European trade policy formation, the year 2005 was significant. During that year the EU came under relentless pressure to make further concessions on agricultural market access and domestic support (subsidies) to farmers. Elsewhere (Evenett 2006a) I have documented the steps taken in 2005 by those member states that opposed such external pressure to expand the Commission's negotiating mandate on agricultural matters beyond the CAP reforms agreed in 2003. Time and again the external pressure was rebuffed

until the EU's large trading partners began to appreciate (perhaps in October/November 2005 for Brazil, perhaps later for other trading partners) just how little room for further agricultural concessions on agriculture the EU had. Without such concessions on agriculture many of the EU's trading partners (especially the large developing countries) refused to make more ambitious offers to liberalise their service sectors and tariffs on industrial products that were of direct concern to EU commercial interests.

The level of ambition in the Doha Round collapsed faster than a house of cards. It should not be surprising, therefore, that every previously agreed deadline for setting the modalities for negotiations were missed in 2005 and that the Hong Kong WTO Ministerial Conference in December 2005 produced limited progress. This progress included commitments to eliminate the (relatively small in financial terms) export subsidy programmes on agricultural products by 2013, agreement to extend duty-free and quota-free access on 97 percent or more of industrial countries' tariff lines to developing countries (a commitment that was relatively easier for the EU to meet given its existing non-reciprocal preference regimes), and commitments totalling more than \$10 billion on to-be-specified 'Aid for Trade' programmes for developing countries.

On reflection perhaps the most significant event at the Hong Kong WTO Ministerial Conference, if the specialised press reports are to be believed, was the realisation by Brazil that it would have to choose between its geopolitical ambitions (which at the WTO manifested itself in its leadership of the G20) and its agricultural trade negotiating objectives. Apparently, after the commitment to eliminate agricultural export subsidies was secured, Brazil tried to persuade its G20 partners to push for greater agricultural market access commitments and was rebuffed. Brazil may well have concluded, therefore, that its principal vehicle for extracting agricultural concessions from the United States and Europe (that is the G20) could only deliver a lower level of liberalising ambition. As was to become clear in 2006, once Brazil allied itself with the low-ambition camp of WTO members, which included the EU and India amongst others, this effectively left the US alone among the big players seeking an ambitious outcome for the Doha Round. The foundations for the subsequent suspension of the Doha Round were falling into place.

The Hong Kong WTO Ministerial Conference elaborated another set of deadlines for negotiators in 2006. The looming expiry of the US Administration's trade negotiating authority from Congress (deadline 30 June 2007) injected some urgency into the deliberations. Even so, the sequence of deadlines, each dealing with a separate negotiating topic, was unable to break the mutually-supporting factors holding the

round to a low level of ambition. Worse still, personnel changes at the highest level of the US trade negotiating team were interpreted as a diminution of interest by the US Administration in the round's completion, or as a reduction in that Administration's expectations of a successful conclusion of the round. Moreover, new US trade representatives cannot be seen back home to be making large concessions at their first major meeting with foreign counterparts, further slowing progress. As the first half of 2006 went by, the shadow of the US mid-term congressional elections loomed larger, making it harder for US trade negotiators to offer concessions on sensitive agricultural matters without substantial balancing concessions from trading partners on agricultural market access, in particular from the larger developing countries.

Senior trade negotiators met in June and July 2006 to discuss the so-called 'headline' numbers around which a final agreement could be built. They were unable to narrow their differences sufficiently and WTO Director-General Lamy suspended the Doha Round in July 2006. It was thought that such a suspension might open national policymakers' eyes to the possibility of outright failure and that this would result in more concessions being made to restart the negotiation. In fact, despite protestations of their commitment to complete the Doha Round on the part of the world's most senior political leaders, no such concessions were made. The US need for an ambitious outcome within agriculture (and not just across the entire round) did not square with any of its major trading partners' priorities. Seen in these terms, perhaps some sort of stalemate in 2006 was almost inevitable, as was the resulting isolation of the United States.

After the US congressional elections were held in November 2006 more WTO members began to question both the value of suspending the Doha Round negotiations and just how much progress in negotiations could be made at ministerial level. Soon after, informal and then formal consultations by the chairpersons of the various WTO committees were permitted. Moreover, more intensive bilateral discussions at the level of officials took place in early 2007. US and EU officials, for instance, met regularly to examine whether a deal on agriculture could be 'reversed engineered', that is, to examine the terms of any of the various exceptions specified so that negotiators could better understand what actual liberalisation would follow from any set of proposals. Discussions have continued on a bilateral basis, principally among the Group of Six countries¹⁶ that have taken the lead in negotiating this round since the July 2004 Framework Agreement, and this has caused some consternation among other WTO members. There is a continuing tension between the apparent need to make progress negotiating in small groups and having an inclusive multilateral negotiation process in which every WTO member has, in principle, a veto over the

outcome. Many smaller developing countries, in particular, question whether the development-related needs are best taken into account in this informal, bilateral negotiating process.

This account of the European Union's actions in the multilateral trading system has emphasised a number of factors that have influenced the nature and success of the EU's initiatives. These factors include: a domestic political climate more sceptical of globalisation's benefits (and those of open borders, more generally); the launching of an ill-defined multilateral trade round (both in terms of new issues and priorities, including the development mandate, and no apparent prior agreement on the approximate level of liberalising ambition); tenacious EU member states constraining the concessions offered on agriculture and contributing to the lowering of the round's overall level of ambition; the rise of several new trading powers that ended the bipolar domination of the multilateral trading system; and the legacy of the Uruguay Round agreements, at least as perceived by many developing countries. The consequence was that much of the rule-making envisaged by Commission officials, partly as a guard against unfettered globalisation and partly linked to commercial considerations, was jettisoned early on and the traditional market access objectives of the EU's trade policy remain as yet unfulfilled. Current EU trade policy, however, was not to be shaped solely by these multilateral developments as the Commission unveiled a new set of commercial policy priorities in late 2006, an account of which I turn to now to.

A brief overview and assessment of the European Commission's October 2006 communication on external trade policy¹⁷

A communication titled 'Global Europe: Competing in the World' was issued by the Commission on 4 October 2006. Significantly, this document was subtitled 'A Contribution to the EU's Growth and Jobs Strategy', indicating the linkages sought and contribution of the EU's external trade policy to the Barroso Commission's overall economic policy objectives, in particular supporting the renewed Lisbon Strategy. The communication identifies the following seven steps as being important components of future external trade policy:

- Maintain our commitment to the Doha Trade Round and the WTO as the best way of opening and managing world trade.*
- Make proposals on priorities in trade and investment relations with China as part of a broad strategy to build a beneficial and equal partnership.*
- Launch a second phase of the EU IPR enforcement strategy.*
- Make proposals for a new generation of carefully selected and prioritised FTAs.*

- *Make proposals for a renewed and reinforced market access strategy.*
 - *Propose measures to open procurement markets abroad.*
 - *Conduct a review of the effectiveness of our trade-defence instruments.'*
- (*European Commission 2006a, pp. 18-19*).

Beyond affirming its commitment to the WTO and expressing the desire to revive and conclude the Doha Round negotiations, this communication has very little constructive to say about the future of the multilateral trading system.¹⁸ With respect to the proposals for negotiating a new set of FTAs, the communication contends that 'if approached with care' these agreements can complement multilateral trade initiatives. The communication identifies 'market potential', levels of protection against EU exports, the FTA strategies of the EU's major trading partners, and the potential erosion of preferential market access enjoyed by EU firms as being factors influencing the selection of countries as potential FTA negotiating partners for the EU. On the basis of these criteria, the communication identifies ASEAN, Korea, and The Southern Common Market (Mercosur) as 'priorities' for EU FTAs. India, the members of the Gulf Cooperation Council, and Russia are said to have some of the required attributes and so are included as potential FTA partners. Interestingly, China is not identified as a potential FTA negotiating partner 'because of the opportunities and risks that it presents'¹⁹.

Arguably the 4 October 2006 communication reflects an evolution rather than a revolution in the Commission's thinking about the EU's external trade policy. The prominence given to market access, non-tariff barriers, and other economic considerations (such as jobs and economic growth) indicates a shift in the Commission's thinking back to 1996. It also represents a shift away from perceiving negotiated rules as being valuable in their own right and possibly a useful instrument in strengthening European public support for globalisation and for international market integration. This is not to suggest that rules go unmentioned in the 2006 communication, rather that their justification is principally couched in commercial and economic terms. Perhaps underlying the apparent differences in the perceived role of rules is the view that European public support for integration will be stronger if the populace is seen economically to benefit from openness (in terms of jobs, growth, and prices), rather than the view that rules allay fears about globalisation and its compatibility with European values.

Also implicit in this communication is an apparent differentiation between Europe's poorer trading partners. The developing country label is no longer enough to get an EU trading partner an undemanding non-reciprocal package of access to the EU market. Large, faster-growing, and relatively richer developing countries can in the

future, it seems, expect to be treated in a manner similar to industrialised countries. However not all promising developing countries can assume that they will become potential FTA partners with the EU, as the case of China shows. Moreover, while the potential for market growth and the level of existing trade barriers may well be factors in the EU decision-making on FTA partners, it would not be a surprise if the capacity of a developing country's exporters to cause adjustment in a sensitive European sector did not become *de facto* another criterion.

Elsewhere (Evenett 2006b) I have presented a more detailed assessment of the implications of this communication's abandonment of the moratorium on negotiating new FTAs. I will summarise the main points made. First, the apparent desire of the EU to join the scramble for market access in Asia is probably unstoppable, but it is likely to be far less commercially important than some might think. This is not least because, for better or for worse, the two largest economies in Asia (China and Japan) are not on the Commission's list of potential partners to negotiate FTAs.²⁰

Second, given the current asymmetries across member states in export performance to India, Korea and several ASEAN nations, evidence is presented (in Evenett 2006b) which strongly suggests that the boost to the EU's exports from less competitive European firms catching up with their more successful European rivals would be multiples of the increase in trade that typically follow from signing FTAs. Therefore, EU firms can make much more of the market access that they already have and are not beholden to these FTA initiatives to increase their market shares in the fastest-growing region of the world economy.²¹

The third reaction relates to the treatment by the EU of non-tariff barriers and trade-related domestic policies in its future FTA negotiations. The Commission has rightly identified many such government measures as potential impediments to European exporters but what is unclear is how to deal with these challenges. The proliferation of FTAs in the last ten years ought to have provided a wealth of experience and approaches upon which to draw – understanding what types of negotiated binding provisions potentially have bite and which matters ought to be dealt with in other non-binding international fora. In fact, however, there seems to be insufficient empirical research on the effects of different types of FTA provisions to guide EC trade negotiators in this matter.²² Moreover, the vehement opposition to the Singapore Issues in the Doha Round and in the ongoing EPA negotiations alluded to above will almost certainly taint new proposals for further rules on non-tariff barriers and trade-related domestic policies in FTAs. The bitter aftertaste may take some time to overcome. Here the EU may find that it has to blend incentives (perhaps in the form of dedicated technical assistance and financial support) with obligations

if trading partners are going to accept anything but the most token commitments in these policy areas.

The next set of factors concern the likelihood of successfully completing ambitious FTA negotiations with India, Korea and the ASEAN nations. India's sheer ambivalence (or worse) during the Doha Round negotiations must raise some questions about its willingness to sign a FTA with the EU. Now it is true that countries can, and some have, taken different positions about the commitments they are prepared to make in FTAs and in WTO agreements. Moreover, it may well be true that India has made several overtures to the EU, indicating a willingness to sign a FTA. But how deeply and how widely felt is that conviction, especially in a country whose central government is relatively weak? A careful reading of articles in Indian newspapers in 2006 and in the first quarter of 2007 reveals that on no occasion has a senior Indian government minister publicly called for FTA negotiations with the EU.²³ Instead there were plenty of promises to 'look into' proposals for a potential FTA negotiation, but no serious political capital has been put on the line in New Delhi. There is a substantial risk here of the EU being portrayed as the requesting party in any FTA negotiation, whatever overtures there have been between technocrats. Moreover, Indian officials have indicated that they expect this FTA negotiation with the EU to take five or six years to complete, which if it came to pass would be well beyond the planning horizon of the current, and possibly the next, college of European commissioners.

A further source of concern is the large number of exceptions that India has sought in FTA negotiations with other countries. India sought to put 840 items on a sensitive list (down from an initial demand of 1400 items!) in its FTA negotiations with ASEAN, and rejected an ASEAN demand that India remove import duties on 90 percent of its product lines by 2011. (The ASEAN-Indian FTA negotiations were suspended on 25 July 2006). Thailand faced similar challenges in its negotiations with India, with the latter seeking to impose very restrictive rules of origin that would have reduced the amount of goods able to enter India on a preferential tariff basis. The EU may be able to strike a far better deal with India than the ASEAN nations together or Thailand on its own, but no-one should doubt the defensive nature of India's negotiating position on trade in goods, the most basic trade commitment, let alone the non-tariff and behind-the-border policies that, according to the recent communication, are key Commission negotiating objectives.²⁴

Despite the signing in April 2007 of an FTA between Korea and the US, the former's offensive interests in automobiles, textiles and electronics are likely to cause difficulties for certain member states. Moreover, Korea may use its FTA negotiations

with the EU to seek changes in Europe's trade defence instruments, which are a very delicate matter within the EU. There is also a question mark over the capacity of Korea's government to obtain legislative approval of any FTA (including the one signed with the US), given that the current (very unpopular) president faces a large opposition majority in the Korean National Assembly. The next presidential elections in South Korea, in December 2007, may well clarify the degree of political support for trade reform in Korea.

Matters in ASEAN are not much better and again the specialised press reports on the protracted negotiations between the US and Thailand and the US and Malaysia on their respective FTAs make for sobering reading. (It is worth noting in this respect that in March 2007 the US abandoned its FTA negotiations with Malaysia). Leaving aside the 2006 coup in Thailand, which may make some EU member states reluctant to be seen to be negotiating – and potentially rewarding – a military-sponsored government, it is inconceivable that any Commission negotiations with ASEAN will involve that latter operating as a coherent, unified group. Some differentiation within the ASEAN grouping will be needed not least to take account of Myanmar, with whose government the EU member states are most unlikely to allow negotiations. Taken together, these considerations imply that negotiations with the ASEAN nations may actually amount to negotiating separately with a core group of countries (possibly Malaysia, Singapore, Cambodia and maybe Vietnam). As a result, the likelihood is slim that emerging from this process will be an ASEAN-wide set of disciplines that would significantly cut red tape and barriers facing European business. Again, there is much less here than initially meets the eye.

The purpose of this section was, first, briefly to outline the principal components of the EU's new trade policy, as described by the Commission in a communication issued in October 2006. Then several points were made about viability and likely pay-off of the decision to launch FTA negotiations with several Asian nations. It was argued that, at least in the near term, this scramble for preferential access to Asian markets is unlikely to bear significant fruit, in terms of both better market access for European firms and greater disciplines on behind-the-border measures. Moreover, little or no thought appears to have been given to the relationship between these potential FTA negotiations and resolving the impasse in the Doha Round of multilateral trading negotiations. The very coherence of the near- to medium-term trajectory of EU trade policy can thus be questioned.

The EU in a multipolar trading system

The multilateral trading system can and should remain the cornerstone of EU trade

policy, even though the Doha Round of trade negotiations has frequently been at an impasse. Whether or not these negotiations are concluded satisfactorily in 2007, it will take a few years for any agreement to be implemented and for a new US Administration team of trade officials to be put in place. This two-year or so interregnum should be used to assess what role the EU can profitably play in a multipolar trading system. Given the size of the EU's own market and its considerable foreign investments, there is a strong case for engagement. The alternative – essentially becoming a veto player over the agendas proposed by others – may seem appealing to some battered and bruised egos after the difficult Doha Round, but this would imply foregoing Europe's extensive internal experience in the formation and preservation of coalitions.

The first step in any such assessment of the EU's potential future role must surely be to identify the current and likely future offensive and defensive interests of the new trading powers. Direct domestic political constraints are a consideration here and, if the discussions around the Doha Round are anything to go by, are generally not well understood abroad. Elsewhere (Evenett 2007b) I have argued that the fast growth in the number of Indian and Chinese multinationals, along with strong (but distinctive) ties between big business and government in both of these countries, may well lead these governments' trade policymakers to identify their future offensive interests with those of their overseas multinationals. As greenfield foreign investments in Europe are relatively unrestricted, even encouraged in many jurisdictions, restrictions on takeovers and mergers by foreign firms may well become more contentious (as the recent takeover of a continental steel company Arcelor by a nominally Indian company Mittal Steel made clear). The treatment of such transactions, and of multinationals more generally, may well entail that many traditionally domestic measures affecting the national business environment become topics of common interest for the leading trading powers. In trade policy parlance, stronger and/or wider disciplines on national treatment may well be sought. These arguments suggest that a rules-based agenda for further multilateral trade negotiations may well be attractive.

The preservation of existing market access, which underpins the substantial export growth recorded since 2000 by Brazil, China, and India, may well cause those nations' governments to seek further disciplines on the various discretionary policy instruments available to restrict imports. Again, this is only one possibility and the question arises whether other potential areas of common interest exist. With respect to a market access-improving negotiating agenda, one challenge that must be recognised is that the political arguments in favour of reciprocal trade negotiation (with its goal of mobilising export interests to counter the domestic political

influence of import-competing firms) may not resonate at all well in the political systems of the new trading powers. In fact, I have argued previously that neither China nor India has ever undertaken serious trade reform in the context of a reciprocal trade agreement (Evenett 2007b). They have done so as a condition for joining the WTO or unilaterally.²⁵ To the extent that this practice continues and domestic opposition to trade reform can be overcome (without mobilising export constituencies), in the future the market opening role of the WTO may become secondary. A counterargument is that when average tariff rates fall to low levels, export interests are needed to back trade reform as the remaining import-competing interests are particularly strong politically. Chile's experience is sometimes mentioned in support of this argument. Apparently its switch from unilateral to reciprocal trade liberalisation occurred once average tariffs fell to approximately 10 percent.²⁶ Having said that, it remains to be seen if in the future the new trading powers see value in the WTO's capacity to deliver reciprocal trade reform.

Once the topics of common interest have been identified the next step is to carry out rough assessments of their commercial or other value to each party. This will require considerable new work, as the commercial value of many trade rules has rarely been the subject of serious empirical analysis, and perhaps may account for some of the scepticism of their value (and preference of some for market access liberalisation, whose consequences are on the basis of existing tools easier to estimate²⁷). After that, it will be necessary to explore what permutations of measures are likely to garner greater support among the leading trading powers, recognising that the possibility of gains does not guarantee that agreements will be forthcoming. The latter point highlights the continuing need to understand better the combinations of domestic policies and technical capacities necessary to enhance the benefits of trade-related reforms. With all of this information the potential basis for different possible future multilateral trade deals might be identified.

One consequence of this analysis is the realisation that certain commercial or other cherished European goals may stand little or no chance of commanding support among the leading trading powers, either as stand-alone priorities or as topics where bargains can be made. International trade rules as they relate to medicines may well now fall into this category, given the bad odour attached to the associated WTO rules. This may call for a refinement in either the proposed rules (perhaps sweetening the proposed obligations with technical assistance or financial support) or in the constituencies supporting trade reform (and may involve some commercial parties no longer having their interests served as well as before).

Conclusion

It is widely recognised²⁸ that the multilateral trading system has produced substantial benefits to the world economy in the post-war era. By fostering liberalisation (at least in merchandise goods trade among industrialised economies) and encouraging compliance with rules that help reduce the uncertainty associated with exporting and importing, multilateral trade accords have resulted in better allocation of resources and, if some studies are to be believed, in higher rates of national economic growth. The EU's member states and the European Commission can share much of the credit for securing this beneficial outcome as, together with successive United States administrations, they ran the multilateral trading system for most of the post-war era.

It is in part thanks to the relatively open markets for manufacturers created by this bipolar system that several large developing countries have become trading powers themselves and now seek to influence the trajectory of the world trading system. As the Doha Round has proceeded, these new trading powers have repeatedly reminded the EU and the US that they no longer jointly determine the trading system's destiny. Various European proposals for new trade rules have been rebuffed and America's aggressive market-liberalising objectives will almost certainly not be met. The question is: what next for the multilateral trading system and what role for the EU?

With an economy producing an annual \$12 trillion in added value and with more than 450 million relatively well-off customers, the EU will be able to remain at the top negotiating table in the decades to come. The question, then, is to what purpose? Here there may well have to be changes. In the past both the EU and the US have sought to project their commercial interests and values onto other nations through bilateral, regional, and multilateral trade agreements. With the rise of at least three new trading powers, the first order of business is to establish what is the potential basis for future multilateral deals and the trade-offs associated with such future deals. Market access liberalisation measures alone are unlikely to form such a basis, especially if the new trading powers continue to liberalise border barriers on their own. But if the traditional alternative to market access reform, namely rules, is to be the basis of a future deal, what rules are likely to be the subject of multilateral negotiation? As each of the new trading powers increasingly has an overseas multinational footprint, then perhaps the new agenda could²⁹ be based on rules that further restrict discrimination by national governments in the design and implementation of non-tariff barriers and domestic policies. Stronger and broader national treatment disciplines could be an area of mutual interest to the current and new

powers of the world trading system. This implies that, despite the setbacks with the Singapore Issues in the Doha Round, the boundaries of the WTO have probably not been set in stone.

An associated question concerns what happens to the multilateral provisions that Europeans say they value, such as those associated with labour and environmental standards, but which their trading partners are not interested in. In my view, the right European response here is not to disengage from the WTO (or worse, raise trade barriers) because apparently cherished goals do not receive the weight we might want. Rather, it is to consider alternative combinations of formal obligations, incentives (both positive and negative), and other international initiatives to advance those values. Industrialised countries have aid budgets and other measures available to them to pursue these cherished goals. Moreover, much more could probably be made of bodies such as the International Labour Organisation.³⁰ Related considerations probably imply that attempts to extend the WTO's reach beyond commercial obligations (into, for example, social and environmental policies) are likely to founder on the opposition of the new trading powers.

The opposition of the new trading powers to certain types of trade provision, or proposals for such provisions, may call for changes in the business and political coalitions that, *de facto* or *de jure*, are assembled to support trade reform in Europe. For example, the window for further improving intellectual property rights through trade agreements may well have closed for the time being. Or the future price demanded by trading partners for including new provisions is likely to be so high that the pro-trade reform constituency may have to be organised without some of the European corporations that have prominently supported trade reforms over the past 15 to 20 years. Those doubtful of these alternatives might well recall the paucity of accomplishments over the last 10 years when one objective after another was piled on to EU trade policymaking.³¹ The watchwords for the future are likely to be common ground, pragmatism and accommodation, all of which the member states of the EU and European Commission officials have plenty of experience with.

The policy recommendations in this chapter have focused on the multilateral trading system, in part because that is where the greatest long-term and systemic challenges lie and because of doubts about the likely pay-off from negotiating preferential trading agreements. This is not to say, however, that the European Union will not need to meet a number of specific and important challenges in managing its commercial relations with certain neighbours in the years to come, in particular with Russia, Ukraine and Turkey. No doubt foreign policy as well as commercial considerations will together continue to influence negotiations and trade policy initiatives

with these countries. Such matters, with their propensity to generate headlines and to absorb policymakers' attention, should not distract European trade strategists from the necessary task of establishing a new *modus operandi* for the multilateral trading system.

Notes

- 1 I thank Michael Meier for his dedicated research assistance. I am very grateful to numerous DG Trade officials, other EC officials, former EC officials, and representatives of European business interests for meeting with me in September 2006 to discuss the prospects for EC trade policy. Those very helpful discussions were for background purposes and no direct quotations or references are made to them in this chapter. Thanks also to Patrick Low, Jean Pisani-Ferry, and André Sapir for comments on an earlier draft of this chapter. I alone bear the responsibility for the views expressed here.
- 2 For instance, certain investment provisions, certain service sectors, and the transport sector remain in the competence of the member states.
- 3 This treaty also specifies the objectives of EU trade policy. As noted on page 19 of WTO (2007): *'The EC Treaty establishes the overall objectives of its trade policy. Under Article 131 of the Treaty of Nice, the EC common policy aims to "contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and the lowering of customs barriers"; Article 133 sets out the scope, instruments and decision-making procedures. This objective underscores the general aims of the Treaty, i.e. "to promote, throughout the Community, a harmonious, balanced and sustainable development of economic activities, a high level of employment and social protection, equality between men and women, a high degree of competitiveness and convergence of economic performance, a high level of protection and improvement of the quality of the environment, the raising of the standard of living and quality of life, and economic and social cohesion and solidarity among Member States."*
- 4 If press reports are to be believed then the European Council met every day of the December 2005 Hong Kong WTO Ministerial Conference to review the status of the agricultural and other multilateral trade negotiations.
- 5 Optimistic former (European and non-European) trade negotiators have made precisely this point to me and argue that it may be easier to isolate the French government and its 'diehard' allies than the newspaper reports tend to imply if a credible Doha Round agreement is floated.
- 6 See, for example, UK (2005).
- 7 Unless otherwise specified, throughout this chapter the European Union is referred to and not its predecessors.
- 8 Under Article XXIV:6 of the GATT Agreement.
- 9 In an interesting aside, the WTO Trade Policy Review of the European Union quotes the following statement from an EC document about the nature of the EC's GATS schedule of Specific Commitments. The schedule: *'was a function of progress in the creation of the single market, and consisted of translating its internal achievements in this field to the multilateral stage'* (WTO 2000, p. 29).
- 10 That network included the European Economic Area, the so-called Europe Agreements with many central European states, FTAs with the Baltic States and others, Partnership and Cooperation Agreements with members of the Commonwealth of Independent States, the Lomé Convention, the Generalised System of Preferences (GSP), a Customs Union with Turkey and Association Agreements with Cyprus, Israel, and Malta and 'Euro-Med' Agreements with Morocco and Tunisia. Closer cooperation agreements that could lead to the negotiation of reciprocal preferential trade

- agreements were also in place with selected Latin American and Asian countries.
- 11 Australia, Canada, Chinese Taipei, Hong Kong, Japan, Republic of Korea, New Zealand, Singapore, and the United States.
 - 12 According to WTO (2007, p. 24) these nine jurisdictions accounted for approximately 30 percent of the EU's total imports in 2005.
 - 13 As noted earlier, an interesting feature of the EPA negotiations has been the willingness of leading member states and European Parliamentarians openly to criticise the negotiating stance taken by EC officials.
 - 14 For an evaluation of the research on the utilisation and effectiveness of the EU's GSP regime see Evenett (2007a).
 - 15 For a longer account of the factors responsible for the fall of the bipolar WTO, see Evenett (2007b).
 - 16 Australia, Brazil, the EC, India, China and the United States.
 - 17 For a more extensive assessment of this communication see Evenett (2006b) and the contributions to the special issue of the journal *Aussenwirtschaft* (in which Evenett (2006b) is published). This special issue was published in December 2006.
 - 18 I accept that, with the Doha Round being suspended in July 2006 and the 'you first' nature of negotiations experienced throughout so much of the Doha Round, that the EC may have decided that the second half of 2006 was not the right time to offer any substantive reflections on the future and potential reform of the multilateral trading system.
 - 19 In this regard it is worth noting that the EC issued a separate communication on relations with China on 24 October 2006.
 - 20 As currently conceived of in the 4 October 2006 communication, the plans for future potential FTAs omit two countries that alone amount to 55 percent of the 'market potential' in the Asian region. In the statistical annex to the communication a table of EU trading partners is reproduced, reporting the estimated value in euros of their market potential over the years 2005-2025. The total value of the market potential of the Asian nations in that table (including Australia) is €474 billion. Of that total €278 billion is accounted for by China and Japan, neither of which are mentioned as possible FTA partners in the communication. In contrast, India, ASEAN and Korea, which are listed as FTA targets, have a combined market potential of €160 billion. Now, access to a market potential of €160 billion is not peanuts, but it does represent only just over a third of the total size of the economic potential of the Asian market. Asia may appear vast and full of promise, but it is important to remember that the EC's FTA strategy only envisages securing better market access to a slice of it.
 - 21 This empirical finding might lead some to oppose the launch of negotiations on FTAs between the EC and selected Asian nations, a view with which I have a certain amount of sympathy. However, the horse has almost certainly bolted and slamming the stable door in disgust has only theatrical value. Another implication of the empirical finding mentioned above is that, although European commercial interests may eventually benefit from these FTAs, they are not the only way in which the EU can make inroads into Asian markets. So the EC should be prepared to walk away from cosmetic, face-saving FTAs and drawn out negotiations. This point could be communicated to potential FTA partners at the beginning of the negotiations and, to demonstrate its seriousness of purpose, the EU Council of Ministers should give the EC a fixed two-year mandate to complete the negotiations of each FTA. Two years is long enough to negotiate a complex deal if the partners are willing. Foreign prevaricators would, thus, be put on notice. Plus, this timetable would ensure that any results are secured before the end of the Barroso Commission's term. There may be an instinctive reaction within the EC against the loss of discretion implied by a fixed-term mandate, but consideration should be given to the tactical and strategic value of this constraint as well as to the harm and bad blood created by never-ending FTA negotiations.
 - 22 There is a growing number of legal analyses, and in some cases even taxonomies, of FTA provisions

in selected policy areas but these are not the same as empirical analyses of the effects of such provisions. I make these claims having just completed an in-depth assessment of the available economic and other literature on the effects of five types of FTA provision dealing with non-tariff barriers and trade-related domestic policies.

- 23 These newspaper articles can be readily searched and downloaded from the *Factiva* database.
- 24 Defenders of India's FTA strategy point to its FTA with Singapore, which includes measures modestly to liberalise India's service sector. Even here certain restrictions on the establishment of commercial presence through foreign direct investment have been retained by India. It should be noted that this agreement also contains numerous exceptions to liberalising goods trade between the parties. A total of 6551 tariff lines were excluded outright from tariff liberalisation. A further 2407 tariff lines will only see a phased reduction of 50 percent in the applied tariff rates. Together these exclusions and phased reductions account for approximately 76 percent of India's tariff line commitments in its FTA with Singapore. In my view the latter indicates a distinct reluctance by India to commit to across-the-board goods trade liberalisation in the context of a reciprocal trade agreement with a nation whose economy is less than five percent of the size of the Indian economy (when these economies are measured in purchasing power parity terms).
- 25 China's WTO accession is seen here as involving unilateral and not reciprocal trade reform.
- 26 I thank C. Fred Bergsten for pointing this argument out to me.
- 27 An analogy with the proverbial drunkard looking for his keys under street lamps – precisely because that is where the light is – comes to mind.
- 28 Although not universally accepted.
- 29 Notice the word is 'could' not 'should'. This wholly pragmatic exercise is about the art of the possible.
- 30 I accept that, far too often, many of the supporters of international social, labour, and environmental standards have been fobbed off by trade experts arguing that other international organisations can take the lead with these matters. What I have in mind is giving serious consideration to strengthening the ambit and resources of the latter organisations.
- 31 With Michael Meier, I have made a similar argument with respect to the future of United States trade policymaking (see Evenett and Meier 2007). More generally, there is probably a strong case for believing that the trade policies of the leading industrialised countries have been asked to support a far too diverse set of objectives.

4

Development policy: coordination, conditionality and coherence

Arne Bigsten

In recent decades the world has undergone a rapid process of globalisation or integration. Greater interdependence means that Europe's development increasingly depends on the fate of the rest of the world. Europe's main economic relationships are still with the non-European parts of the Organisation for Economic Cooperation and Development (OECD), but the weight of poorer regions is rapidly increasing. It is in Europe's interest to have functioning and flourishing states in the developing world to increase the scope for trade and growth, and to reduce risks of instability and terrorism. Closer links between Europe and the poorer regions also make Europeans increasingly aware of, and sensitive to, poverty in poorer countries. There are thus two motivations for European development policy *vis-à-vis* developing countries: self-interest in a stable and prosperous world, and solidarity with the world's less fortunate citizens. Therefore, European foreign economic policy should include support for development and poverty reduction in poorer countries.

How should the EU shape its development policy? A key issue is the extent of coordination of foreign aid between the European Community (EC)¹ and member states. Should the EC really be an aid vehicle alongside bilateral efforts? The official argument is that the EC has comparative advantages in some respects, but this is not evident in what the EC currently does. The EC does more or less the same things as its bilateral members, which means that it is just one more aid player making coordination more difficult. The EC does not effectively fill any coordinating function.

Nor is it clear that EC aid is more efficient than bilateral aid – rather the reverse. So it is hard to see what the added value of EC aid is relative to bilateral aid. One conclusion that could be drawn is that the EC should leave aid to the member states.

However, there is an alternative route that has some promise: to go in the opposite direction and let future EC Development Policy Statements also cover the aid programmes of member states. In the longer term this could even go so far as to let the bilaterals pool their resources in EC coffers. This would be a huge political challenge, and it is hard to see that it can be realised in the near future. If EC aid instead continues more or less on its present scale (the likely scenario in the short term), consideration needs to be given to how coordination can be improved between EC aid and bilateral aid – and with aid from other donors. Providing more general forms of aid, such as balance of payments support, would lessen the coordination problem and increase ownership. To the extent that different donors finance the same project or programme, one donor (bilateral or EC) could act as the coordinating agent responsible for government contacts and follow up.

The EC may also have a comparative advantage relative to the bilaterals and the international financial institutions (IFIs) when it comes to pushing for democracy and governance. Since these areas will probably become more important, this may be a reason not to abandon EC aid.

The EU is committed to providing 0.7 percent of gross national income (GNI) in aid no later than 2015, and to support the debt reduction initiatives that are in place. These commitments need to be taken seriously, but a number of the old (pre-2004) member states and, in particular, the newcomers (who joined the EU in 2004 and afterwards) are unlikely to live up to this commitment. Moreover, EC aid allocation is geared to commercial interests, although it takes a very altruistic stance in official proclamations. There is a need to take the EU's aims and the commitment to achieving the UN Millennium Development Goals more seriously, and to shift country allocation in favour of the poor countries with, of course, due consideration for their ability to handle the resources effectively.

Trade is the most important area within the development policy framework. The economic arguments for eliminating trade restrictions on the exports of poor countries are obvious, but the political influence of specific groups hinders this extremely important policy change. The mishandling of the Doha Round and the continued pursuit of the Common Agricultural Policy (CAP) is a disgrace. Both trade-distorting domestic support measures and trade restrictions distort agricultural markets. Aid efforts are countered by trade policies locking exporters from less developed countries (LDC) out of the European market. All EU countries and the EC should change their policies to make their trade and agricultural policies coherent relative to the development goals. Since this is an area where the EC handles the WTO negotiations for all member states, this is a natural area of strong EC involvement.

The EU has often reiterated the need for policy coherence for development. Coherence in this context means that each country as well as the EC should make sure that they pursue policies that support the stated development goals and do not undermine them. They need to make sure that aid, debt and trade policies support each other. The present situation leaves much to be desired!

The remainder of this chapter provides the underpinning of the conclusions summarised above. It starts with a brief review of the changing global economic environment and then goes on to examine the EU's development policy. The areas covered are aid, debt reduction and trade. Some policy areas (for example migration and security), which the EC considers as parts of its development policy, will be covered by other chapters in this volume. In the light of the results of this review I will discuss the policy changes that should be made to better equip the policy to achieve the stated targets.

The global economic environment

In recent decades the dependence on foreign trade among the countries of the world has increased (Table 4.1). At the same time the relative weight of the OECD and the EU in world trade has declined, while the importance of the emerging economies, particularly East Asia and the Pacific, has increased (Table 4.2). In other words, Europe is becoming more and more economically dependent on the economic health of its developing country partners.

Recent economic development in the world's poorer regions has generally been encouraging. We see in Table 4.3 that East Asia and the Pacific, as well as South Asia, are catching up, and they represent a very large share of the world population². The economic improvements that many parts of the world have experienced are certainly related to their successful integration into the international economy (see Cline and Williamson 2005 for a review of the evidence). There are no countries that have achieved significant economic success in isolation.

In total, the global incidence of poverty, as measured by the World Bank indicator of one dollar per day in consumption expenditure, declined from 40 percent to 21 percent between 1981 and 2001 (Table 4.4). Poverty reduction in Asia has been spectacular, but poverty has not declined in sub-Saharan Africa, the world's poorest region. Parts of the former eastern bloc have seen poverty increase since the break-up of the Soviet Union, but most of those countries have seen considerable recovery in the last few years. Latin America has not made much progress in terms of poverty reduction, but poverty is still at a comparatively low level.

Table 4.1: Export of goods and services (% of GDP)

	1990	1995	2000	2004
High income: OECD	17.1	18.8	21.9	*20.4
European Monetary Union – EU12	26.9	29.3	36.7	36.5
East Asia & Pacific	24.4	29.4	36.1	42.9
Eastern Europe & Central Asia	23.7	31.1	40.9	41.9
Latin America & Caribbean	17.1	18.7	20.6	25.7
Middle East & North Africa	26.3	25.9	28.4	33.9
South Asia	8.6	12.5	14.8	19.0
Sub-Saharan Africa	27.2	28.7	32.4	32.3
World	19.0	21.2	24.6	*23.9

Source: World Bank (2006a). * 2003.

Table 4.2: Share of world exports of goods and services (%)

	1990	1995	2000	2004
High income: OECD	73.3	70.1	66.6	63.9
European Monetary Union – EU12	35.2	32.4	28.4	31.1
East Asia & Pacific	3.9	6.2	7.7	9.8
Eastern Europe & Central Asia		4.7	5.0	6.8
Latin America & Caribbean	3.9	4.3	5.3	4.8
South Asia	0.8	0.9	1.1	*1.2
Sub-Saharan Africa	1.8	1.4	1.4	1.5

Source: World Bank (2006a). * 2003.

Table 4.3: Relative GNI per capita (PPP), current international dollars

	1990	1995	2000	2004
High income: OECD	100	100	100	100
European Monetary Union – EU12	89.6	89.1	88.6	87.0
East Asia & Pacific	8.0	11.4	13.2	16.6
Eastern Europe & Central Asia	33.4	22.6	22.5	26.0
Latin America & Caribbean	25.7	26.2	24.9	23.9
Middle East & North Africa	17.6	17.5	16.9	17.9
South Asia	7.1	7.6	8.0	8.9
Sub-Saharan Africa	7.2	6.2	5.7	5.7

Note: High income OECD = index 100. Source: World Bank (2006a).

The economic take-off in large countries such as China and India, as well as most countries in East and South-East Asia, has also meant a reversal of, or a stop to, the increase of global income inequality, which began in earnest with the industrial revolution 200 years ago. Global inequality as measured by the Gini-coefficient, and with countries weighted by populations and ignoring income inequality within countries, suggests that inter-country inequality actually started to decline in around 1980 (Table 4.5). Bourguignon and Morrison (2002) have computed the Gini-coefficient for the world for the period 1820-1992 attempting to allow for changes in within-country inequality. According to their estimates the global Gini-coefficient increased consistently until about 1950, while the changes thereafter have been comparatively small.

The debate on these estimates continues (Milanovic 2006), but it is clear that large parts of the developing world are growing more quickly than the richest countries. They are thereby reducing the inter-country income gap. The countries at the bottom of the income hierarchy, however, are slipping even further behind. If we measure inequality as the gap between the people in the industrialised world and the poorest 10 percent in the world, mainly in sub-Saharan Africa, the gap continued to increase until the turn of the century. Since then Africa has seen some economic recovery following the commodity boom, as well as a series of policy reforms that have improved the policy environment (Pattillo, Gupta, Carey 2005). But Africa's plight remains the key development challenge facing the international community.

Table 4.4: Percentage of the population living on less than \$1 per day, 1981-2001

	1981	1987	1993	1999	2001
East Asia & the Pacific	57.7	28.0	24.9	15.7	14.9
[China]	63.8	41.0	28.4	17.8	16.6
[excluding China]	42.0	27.0	16.7	11.0	10.8
Eastern Europe & Central Asia	0.7	0.4	3.7	6.3	3.6
Latin America & Caribbean	9.7	10.9	11.3	10.5	9.5
Middle East & North Africa	5.1	3.2	1.6	2.6	2.4
South Asia	51.5	45.0	40.1	32.2	31.3
[India]	54.4	46.3	42.3	35.3	34.7
Sub-Saharan Africa	41.6	46.9	44.1	45.7	46.4
Total	40.4	28.4	26.3	21.8	21.1
[excluding China]	31.7	28.4	25.6	23.1	22.5

Source: Chen och Ravallion, 2004.

Table 4.5: World distribution of income (Gini-coefficients) 1900-1998

Year	Gini	Year	Gini
1900	0.393	1970	0.539
1913	0.427	1980	0.544
1929	0.458	1985	0.531
1938	0.448	1990	0.526
1950	0.530	1995	0.498
1960	0.521	1998	0.496

*Note: the numbers are based on data for 49 countries for GDP per capita in 1990 prices adjusted for purchasing power. Countries are weighted by population shares.
Source: Balho and Tonniolo, 2000, p.7.*

Overall it is encouraging that poverty and inter-country differences are declining, but very much remains to be done and that is why EU development policy remains important. The needs vary by region, and the policy needs to take this into account.

The structure of EU development policy

EU development policy has gradually changed from a focus on aid to former colonies, to include global trade issues and efforts to promote peace and stability. In its relationships with developing countries, the EC considers the political, commercial and social aspects. Apart from discussing EC development policy we will also touch on the bilateral development policy of the member states. The goals and policies of the EC and the member states are complex and sometimes contradictory. Policy coherence and coordination among the European institutions will therefore be discussed in this chapter.

EC policy

Many actors are involved in EC development policy. The prime movers are the European Parliament and the Council of Ministers, which take decisions on the general direction of the policy. The European Commission initiates policy formulation and implements development policies. Within the European Commission the Directorate-General for External Relations is responsible for political governance through country strategies for different regions (except Africa), as well as aid with political content such as human rights and security. The Directorate-General for Development deals with policy and formulation of development cooperation and is responsible for the country strategies for Africa. The European Commission Office for Humanitarian Support (ECHO) is responsible for the management of humanitar-

ian aid channelled through NGOs and to some extent United Nations (UN) organisations. Finally, the Directorate-General for Trade and the Directorate-General for Enlargement are also active in areas that are important for development goals. The member states provide the funds for the general EC budget and the European Development Fund. The Court of Auditors is responsible for overseeing how efficiently the money is spent, and the European Court of Justice controls compliance with treaties.

Article 177 in the Maastricht Treaty spells out that EC policy should foster sustainable economic and social development in the developing countries, and more particularly the most disadvantaged among them. Policy should also smooth the gradual integration of developing countries into the world economy, and combat poverty in the developing countries. The EC is to promote democracy and the rule of law, and respect for human rights and fundamental freedoms.

The ambition is that the EC should intervene in areas where it has a comparative advantage relative to the member states. The areas selected (European Commission, 2000a)³ are the link between trade and development, support for regional integration and cooperation, support for macroeconomic policies, transport, food security and sustainable rural development, and institutional capacity building, particularly in the areas of good governance and the rule of law. EU interventions have in practice not been limited to these six focal areas, however. The Commission is also committed to assisting developing countries in achieving the UN Millennium Development Goals.

There are two mechanisms for Commission aid. First, there is the European Development Fund, which is replenished from time to time by member states. This money is used for aid to the African, Caribbean and Pacific (ACP) countries. It is governed by the Cotonou Agreement of 2000, which lasts for 20 years and guides the EU's collaboration with ACP countries⁴. The main aim is to help these countries reduce poverty. The agreement also covers trade, with planned future collaboration arrangements known as Economic Partnership Agreements (EPAs). Secondly, there is the general EC budget that allocates money for development assistance to all other regions.

The EPAs are a major new feature of the relationship between the EU and the ACP countries. They differ from earlier agreements in two major ways. First, they are more reciprocal in nature, to ensure WTO-compatibility. Second, they are not between the EU and the ACP states as a whole but between the EU and various regional groupings. The aim is to create free trade areas between the EU and the

regional EPA negotiating blocs. The agreements are intended to cover liberalisation of trade in goods and services, promote regional integration, provide development finance and cooperation, and support improvements in institutional rules for business (Gasiorek, Winters 2004). The EPAs are scheduled to come into force on 1 January 2008. However, they are controversial and so far no negotiations have been successfully concluded. Until the WTO-compatible EPAs enter into force, the non-reciprocal Lome IV preferences will continue to be applied despite being WTO incompatible.

Already before the launch of the EPAs, EU agreements with developing countries generally covered development cooperation, political dialogue, and trade. They are thus broader than the typical aid programmes of bilateral institutions. The ongoing programmes are the European Development Fund for the ACP countries, the programme for South Asia, external assistance to Asia and Latin America (ALA), support to Mediterranean and Middle East countries (MEDA), the technical assistance programme for Eastern Europe and Central Asia (TACIS), EC assistance for reconstruction, development and stabilisation of the Balkans (CARDS), and the pre-accession programme for Eastern European countries (Phare).

A new EU Financial Perspective (a multiannual EC budget framework) applies from January 2007. In the consultations about the EU's future development policy, carried out in 2005, a clear majority of stakeholders agreed that poverty eradication should remain the main goal of the policy and that there should be a continued focus on the achievement of the UN Millennium Development Goals (European Commission 2005). It was also argued that development policy should not be subordinated to the Union's common foreign and security policy nor to its migration policy. Rather other policies, particularly trade and agriculture, should be aligned with development policy (see the recent proposals in European Commission 2006). The 'European Consensus on Development' (European Parliament, Council, Commission 2006) states that 'the primary and overarching objective of EU development cooperation is the eradication of poverty in the context of sustainable development, including pursuit of the Millennium Development Goals'.

Member state policies: the UK example

The member states handle the bulk of EU development assistance (80 percent). Possibly the most interesting bilateral donor is the UK, where the Department for International Development (DFID) has been at the forefront of the debate in recent years and has gone further than most other donors in introducing new thinking. So we will start by looking at UK policies.

In the late 1990s the UK's Overseas Development Administration was upgraded to the Department for International Development with its secretary of state becoming a member of the ministerial cabinet (OECD 2002). This raised the profile of aid issues and helped to promote the coherence of policies across departments. An interdepartmental working group on development, chaired by the secretary of state for international development, was created to help mainstream development policy. This group includes a dozen departments whose policies affect development. Since that time, the UK's ambition has been to play a key role internationally. Former finance minister Gordon Brown pushed development finance concerns in the IFIs, and former prime minister Tony Blair successfully engaged world leaders for increased aid, to Africa in particular, at the G8 Gleneagles Summit in 2005.

The UK set out its trade and development policy in its Globalisation White Paper, which outlined a strategy to enable LDCs to gain from international economic integration. The UK has actively tried to influence the global trade agenda, and pushed to make the Doha Round a development round. The UK was also actively involved in the debate on the EU's Everything But Arms initiative, to open up to all imports from the LDCs except weapons⁵. As in other countries, there are domestic lobbies actively working against free trade initiatives in some areas (such as sugar).

The UK has followed up the report of the Commission for Africa (2005) and the G8 commitments of 2005, as well as the Paris Declaration, with a white paper on its aid policies (DFID 2006a). There, it spells out how it will work to increase its development budget to 0.7 percent by 2013. It emphasises that its aid will be based on the recipient committing to reduce poverty, uphold human rights and international obligations, and to improve financial management, governance and transparency. It aims to work to improve the international system and for improved accountability of recipient countries. The UK wants to work more closely with its European partners on development issues. It will participate in multi-donor arrangements in all developing countries where it has a bilateral programme and it will develop more joint strategies and co-financing arrangements with the EC and other EU member states.

The thinking in the UK is not unique, but reflects trends within the donor community generally. The Nordics and the Netherlands have moved in a similar direction, as have other European donors, though to a lesser extent.

Aid volumes

The EU is the world's leading development aid provider. Jointly the EC and the member states account for around 55 percent of total overseas development assistance

(ODA). The total volume of OECD Development Advisory Committee (DAC) aid was about \$80 billion in 2004 and \$106 billion in 2005. The increase was mainly due to \$19 billion in debt relief granted to Nigeria and Iraq by the Paris Club (World Bank 2006b). Debt forgiveness grants will remain significant in 2006, but then the promised increases in ODA will have to take the form of transfer of resources, which will put more pressure on donor budgets. In the last few years we also saw considerable increases in non-debt private flows in the form of foreign direct investment (FDI)⁶ and inward remittances.

Total aid varies considerably between EU countries. The total contribution of the 15 pre-2004 EU members increased only slightly between 2001 and 2004 from 0.33 percent of GNI to 0.35 percent (Table 4.6). Only Denmark, Luxembourg, the Netherlands and Sweden reached the 0.7 percent target set by the UN decades ago. This was reaffirmed as a goal for 2015 at the Gleneagles summit, as suggested by the UN (2005) and the Commission for Africa (2005). The EU has adopted the goal of 0.7 percent of GNI for 2015, with an intermediate goal of 0.56 percent by 2010 (European Parliament, Council, Commission 2006, §5). For some countries, such as Italy at 0.15 percent, it will be a major effort to reach the intermediate goal. The countries that joined the EU in 2004 so far contribute little. The share of foreign aid from the old EU members channelled through the EC was 22.6 percent in 2001, but declined to 20.3 percent in 2004.

Because of the poor performance of Africa, foreign aid has increasingly been concentrated on that region, and Africa is by far the most aid-dependent region (Table 4.7). When looking at per capita aid flows in Table 4.8, however, we see that sub-Saharan Africa does not stand out relative to Eastern Europe and Central Asia, or the Middle East and North Africa. There have been heated debates about the development impact of foreign aid, but the general conclusion is that aid does have some positive growth effects (in addition to mitigating short run problems) (see Clemens, Radelet, Bhavnani 2004, and Tarp 2006).

At Gleneagles the G8 leaders promised an increase in aid to Africa by \$25 billion per year by 2010, more than doubling current flows, and DAC members agreed to expand aid to all developing countries by \$50 billion. The EU is expected to provide the major share of these new resources. This could be done through the EC or by member states bilaterally. It is not obvious that the donors will abide by their pledge, and so far not much has happened in terms of increased actual flow. To speed up the increase Gordon Brown has suggested that donors should use future aid as collateral for bonds to raise money that could be used in the short term. However, this kind of frontloading may be risky, since it is shifting money from

Table 4.6: Net overseas development assistance of DAC and non-DAC members 2001 and 2004

DAC countries	2001		2004	
	ODA (current US\$ millions)	ODA (percent of GNI)	ODA (current US\$ millions)	ODA (percent of GNI)
Austria	633	0.34	678	0.23
Belgium	867	0.37	1,463	0.50
Denmark	1,834	1.03	2,037	0.85
Finland	389	0.32	655	0.35
France	4,198	0.31	8,473	0.41
Germany	4,990	0.27	7,534	0.28
Greece	202	0.17	465	0.23
Ireland	287	0.33	607	0.39
Italy	1,627	0.15	2,462	0.15
Luxembourg	139	0.76	236	0.83
Netherlands	3,172	0.82	4,204	0.73
Portugal	268	0.25	1,031	0.63
Spain	1,737	0.33	2,437	0.24
Sweden	1,666	0.77	2,722	0.78
United Kingdom	4,579	0.32	7,883	0.36
EU members total	26,388	0.33	42,886	0.35
(of which through EC)	(5,961)		(8,704)	
Australia	873	0.25	1,468	0.25
Canada	1,533	0.22	2,599	0.27
Japan	9,847	0.23	8,906	0.19
New Zealand	112	0.25	212	0.23
Norway	1,346	0.80	2,199	0.87
Switzerland	908	0.34	1,545	0.41
United States	11,429	0.11	19,705	0.17
DAC members total	52,435	0.22	79,512	0.26
Non-DAC countries total*	1,178	0.13	3,726	0.17

* Czech Republic, Hungary, Iceland, Kuwait, Korea, Latvia, Lithuania, Poland, Saudi Arabia, Slovakia, Turkey, United Arab Emirates and other bilateral donors. Source: OECD DAC database, compiled in World Bank (2006b).

Table 4.7: Total aid (% of GNI)

	1990	1995	2000	2004
East Asia & Pacific	1.2	0.8	0.5	0.3
Eastern Europe & Central Asia	0.3	1.1	1.2	0.7
Latin America & Caribbean	0.5	0.4	0.3	0.4
Middle East & North Africa		1.5	1.0	1.7
South Asia	1.5	1.1	0.7	0.8
Sub-Saharan Africa	6.4	6.2	4.2	5.3

Source: World Bank (2006a).

Table 4.8: Total aid per capita (current US\$)

	1990	1995	2000	2004
East Asia & Pacific	4.9	5.7	4.8	3.7
Eastern Europe & Central Asia	7.6	24.6	23.0	25.1
Latin America & Caribbean	11.8	13.3	9.7	12.6
Middle East & North Africa	46.2	21.9	16.3	35.0
South Asia	5.4	4.2	3.1	4.7
Sub-Saharan Africa	35.1	32.3	20.2	35.8

Source: World Bank (2006a).

future aid to current aid initiatives. We cannot be sure that there will not be serious problems in the future when aid may have to be cut drastically.

There has also been a debate on the need for donors to shift from loans to grants for the poorest countries. It does not make sense to give loans to countries that are unable to service their loans unless they get more loans. Some International Development Association (IDA) resources are now actually used for grants rather than (very favourable) loans. Cline and Williamson (2005) recommend that the World Bank opens a third window with grants only.

There is at present an increasing interest in aid through so-called innovative financing mechanisms. The hope is that they can help increase the volume further and increase the predictability of flows. The International Finance Facility for Immunisation (IFFIm) is set up as a pilot IFF. Alongside this there is an advanced market commitment proposal being developed, and some countries are thinking about using airline departure taxes to finance the International Drug Purchase Facility (IDPF) as proposed by France. The pilot IFFIm has received pledges from

some donors and will launch its first bond issue in 2006. So far, the impact of these initiatives remains uncertain, but they could become useful channels to transfer non-government resources in a more coordinated fashion than is usually the case.

One key challenge for EU development policy during the coming years is to increase aid volumes as promised. Looking back at history there are plenty of reasons for scepticism as to the ability or willingness of member states to provide so much aid.

Country allocation of aid

The EU and its member states have stated goals for aid, and we will here discuss whether the aid practice reflects the stated aims. Donor aid allocation may be influenced by their self-interest, recipient needs, and recipient merit. Self-interest may be either geopolitical (giving aid to like-minded or potential political allies) or commercial. Aid can be used to build up and develop commercial links such as trade and FDI. The use of aid-tying is one example of own commercial interests influencing aid allocation. The development motive is first and foremost the desire to help the poor, that is countries with a low *per capita* income; typically this is contrary to commercial interests (at least in the short term). Merit indicators are typically governance and the quality of policies and institutions.

In Berthélemy's analysis of country allocation of aid the most striking result is that neither recipient needs nor recipient merits play any significant role in the allocation of EC aid (Berthélemy 2006b). He finds instead that the special relationships built between the EC and the ACP countries since the 1970s have a significant influence. Another observation is that the EC aid allocation is strongly influenced by British commercial interests, which suggests that the UK has been successful in lobbying for its own commercial interests in Brussels. These features of EC aid suggest that in part at least it is *de facto* motivated by other factors than the officially declared aims.

Commercial interests are also important for the bilateral allocation of aid, but there is considerable variation across EU states. France and Italy are the most selfish and allow aid allocation to be governed by trade links. The least selfish are the Scandinavian countries, Ireland, Austria and the Netherlands (Berthélemy 2006b). Berthélemy (2006a) also notes that France and Italy provide aid to highly indebted countries, which could be seen as defensive lending to protect outstanding debt. The bilateral bias in favour of trading partners means that African countries with low exports in particular lose out (Berthélemy 2006b). Although EC aid strongly favours ACP countries, bilateral EU member state aid surprisingly does not.

Other multilaterals, such as the World Bank, let their aid allocations be influenced by needs as measured by *per capita* income and debt ratios. In this respect they are similar to the bilaterals. It thus seems as if the countries that make up the World Bank are more able to impose their 'home-grown' values on the World Bank than EU member states are able to do on the EC.

Table 4.9 shows the broad distribution of EU member state and EC aid across regions. About one fifth of total EU member state aid is channelled through the EC. We see that the member states allocate a larger share to Africa than the EC, which instead allocates more of its aid to Europe (mainly the Balkan states). This may reflect the fact that the EC has a broader range of objectives with its aid than poverty reduction. Still, the recent EU development policy (European Parliament, Council, Commission 2006) states that 'the Community should find ways to increase the focus on the poorest countries with a special focus on Africa.' This is a reasonable emphasis given the state of the world. It is further stated that the EU should use 'standard objective and transparent resource allocation criteria based on needs and performance,' but the evidence provided above shows that the EC is far from this target. The distribution of donor activity across countries is uneven and country choices are not coordinated. This has created 'donor orphans' that are helped by few, while many donors seek to aid the 'donor darlings'. The EU aid agencies should coordinate to achieve a more sensible distribution of activities by country.

Donor coordination

Coordination of donor activities may be required to manage the inter-country allocation of aid, but the main debate has been about how to coordinate aid to individual countries (Bigsten 2006). This is because of the desire to avoid coordination failures (Halonen-Akatwijuka 2004). Since aid activities are often complementary,

Table 4.9: Regional allocation of aid by EU members and the EC, 2004 (%)

	EU member states	European Commission
Middle East & North Africa	12	20
Sub-Saharan Africa	53	43
Latin America & Caribbean	12	8
Other Asia/Oceania	8	5
South and Central Asia	10	10
Europe	5	15
<i>Share of total EU aid</i>	<i>79.7%</i>	<i>20.3%</i>

Source: EC-OECD, 2006, p.19 and the OECD-DAC database.

donors need to coordinate to avoid inefficient aid allocations. The difficulty of coordinating donors depends on the similarity of their preferences. Donors may have different views on what matters for development, or different national interests. In spite of general proclamations about coordination, it has been hard to achieve in practice. Each donor has his own goals, which he pursues even if they are in conflict with those of the recipient government or those of other donors. One advantage of multilateralism is that it may help reduce the influence of vested interests in the various donor countries [Kanbur 2000, 2003].

The scope for harmonising activities also varies according to the circumstances of the recipient country. DFID (2006b) makes a three-way distinction. In well-performing aid-dependent countries, they argue that one can reduce donors' demands, which overload recipient governments, and give resources with fewer strings attached. In fragile states with weak capacity, donors need a strategy for interacting with the government and others to improve decisions and support service delivery. Finally, in non-aid dependent countries donors may provide policy input rather than financial resources.

One important aspect of EU development aid practices is therefore coordination: of EC activities, between the EC and the bilateral activities of EU member states, and with the non-EU development community. Is the EU just one more donor creating coordination problems, or is it a force for better coordination? EU aid aims to complement that of bilateral donors and focus on different aspects. The Maastricht Treaty states that EC development cooperation is to be guided by the principles of coordination, complementarity, and coherence. Compared to bilateral donors, such as Sweden's SIDA (Swedish International Development Cooperation Agency), the EC has a much broader range of instruments. The Commission has a variety of policy areas and financial instruments, but coherence between the goals is sometimes lacking. The general development policies are similar in, for example, Sweden and the EU, but in the actual implementation there can be substantial differences.

When aid volumes increase, the requirement for coordination also increases⁷. Coordination can take the form of pooled budget support⁸ as well as pooled capacity-building efforts. This may require joint programming, joint strategies and possibly joint offices as well. There should also be a better division of labour at sector level. Donors can try to overcome coordination problems by better information-sharing.

Disch (1999) found it is easier to reach agreements on policies (at least in principle), but it is harder to do so with regard to procedures and practices. Differences in how projects or programmes are implemented generate a huge burden and high

transaction costs for both donors and recipients. Therefore coordination at this level offers large potential gains.

There are some interesting initiatives under way. For example, in April 2006 EU ministers agreed on a new format for EU country programmes, to be adopted on a voluntary and gradual basis by member states. The EC will use it for the development of new country programmes for ACP countries. This might possibly serve as a basis for joint multiannual programming with the EU member states and other donors. DFID still expects to develop its own strategies alongside the EC (DFID 2006b). The Nordic+ donors⁹ have set out an agenda to improve the division of labour among donors. The aim is to delegate responsibility through measures such as appointing lead donors or delegating authority, and limiting the number of donors operating in each sector. At country level, the coordination must be based on the Poverty Reduction Strategy process. Donors tend to say that they need to concentrate their aid efforts in fewer countries, but *de facto* this does not happen. The importance of a global presence seems to weigh more heavily than aid efficiency considerations, both for the EC and member states. At present the World Bank and the DAC are collaborating to enhance the Consultative Group Round Table processes.

The donors are aware of the importance of donor coordination and have recently issued two declarations¹⁰ on the issue. The EC should be able to act as a coordinating agency¹¹, but the evidence available does not suggest that the EC is so far able to fulfil this role. It is functioning rather as just another aid agency, but one with more complicated decision-making and more bureaucratic procedures. Much therefore needs to be done before one can say that EC aid is coordinated. There does not seem to be any evidence suggesting that it is more efficient than bilateral aid. One solution would be to phase out EC aid altogether and thereby reduce the number of players. On the other hand, if one is optimistic about the ability of the EC to reform, one could move in the other direction and try to strengthen the role of the EC as the overall coordinator of EU member state aid policies. The EC could then increase its scale of activities and really coordinate EU actions. It has a broader range of instruments at hand that can be used to pursue more comprehensive approaches covering also, for example, trade and security issues, which the bilateral donors do not normally cover. Mackie *et al.* (2005) discusses the complementarity of EC and bilateral aid, and considers the possibility of going for a future EU Development Policy Statement that also covers member states' aid programmes. This would be a challenging task, and it does not seem to be a likely outcome of the current reform process. Nor is the likely outcome a complete abandonment of EC aid. Therefore we will here discuss ways of gradually improving the current system.

Aid modalities

The Paris Declaration (OECD 2005a) provided a comprehensive agenda for aid processes. It covered five areas:

Ownership: meaning that there should be nationally owned and led development strategies linked to the budget process in recipient countries. The aim of the new Poverty Reduction and Growth Facility (PRGF) is to give aid recipients more policy space. There has been a modest reduction in the extent of conditionality relative to the old structural adjustment programmes. The constraint is that the reduction of conditions that donors are willing to accept depends on whether recipients are able to put adequate reporting systems in place. Policy-making in Africa today is based on the Poverty Reduction Strategy system demanded by the donors. Donors should provide resources to help implement the national strategies.

Alignment: meaning that aid flows should be aligned with the national priorities of recipient countries. This means that aid should go through the government budgets. Donors should work with the recipient government to ensure that procurement and financial management systems are acceptable. This may require support for national capacity-building programmes that make it possible for the partner country effectively to manage aid resources as well as own resources. Donors should strive to provide joint support to these programmes¹². Donors should use partner procurement and financial systems whenever they have confidence in them¹³. They should also use flexible financing such as budget support to a higher degree. They should avoid setting up parallel systems for project implementation. They should make aid more predictable and provide information on disbursement plans in good time for the budget process.

Harmonisation: meaning that one should use common arrangements and procedures. This would mean a shift of resources from projects to programmes when conditions allow it. Donors should seek joint analyses of joint missions, and shared documentation, and they should also support country-led analyses.

Managing for results: meaning that donors should work jointly with recipient governments and other donors to develop a common framework for monitoring progress.

Mutual accountability: meaning mutual assessments of progress and a mutual accountability mechanism. The mechanisms for aid delivery are very important for how effectively aid is used. Aid recipients still have to deal with dozens of official

donors and NGOs, and hundreds of separate projects and programmes. The Paris Declaration is strongly reflected in the recent EU paper on aid policies (European Parliament, Council, Commission 2006).

The quality and effectiveness of EC development collaboration in particular has been questioned (slow disbursements, bureaucratic procedures, lack of poverty focus, etc., see eg Dearden 2002), but some reforms have been undertaken in recent years (Berlin, Resare 2005). The reforms of 2000 and the adoption of the UN Millennium Development Goals have partly been a response to criticisms of a lack of poverty focus, but at the same time the share of aid going to countries in the neighbourhood has increased at the expense of aid going to the poor ACP countries.

The programming methodology for Commission aid has changed since 2000. When it comes to budget support there is extensive use of performance indicators. The structural adjustment lending during the 1980s and 1990s was based on *ex ante* conditionality, that is, promises of policy reforms. Since this did not work very well, there has been an argument that donors should shift to *ex post* conditionality, that is to say aid based on recipient performance according to certain ultimate goals.

The European Commission pioneered this type of aid allocation, and since 1999 financing conventions with ACP countries include a 'variable financing tranche', where aid transfers are based on the outcomes of certain social and economic variables (Adam *et al.* 2004). The idea is that performance-based contracts will lead to better ownership, which in turn is considered essential for good performance. It will make it possible for the recipient country to define its own policy packages, reduce the problem of donor coordination, and increase predictability of resource flows. This new modality was introduced gradually and in several instances existed alongside conventional conditionality. Adam *et al.* (2004) evaluate four country cases where it was more fully implemented. They found first that there was no significant shift in ownership, partly because the new modality only covered a relatively small fraction of the aid. It is also noted that in the early stages of the reform the donor still relied extensively on intermediate indicators rather than impact indicators, which means that the difference, relative to traditional policy conditionality, was small. It is also hard for recipient governments in poor countries to collect impact data. Here is an area where donor efforts would be useful.

The results of policy reforms in Africa have been limited, although the period since 1995 has seen some improvements in economic growth. Policy reforms, even sensible ones, have not been enough to bring about an economic take-off in Africa. Clearly there are constraints hindering the effective implementation of policies and,

in the recent literature, poor institutions have generally been found to be the major growth constraint in Africa¹⁴. An important question in this context is therefore whether the international community, including the EU, can change institutions through aid and conditionality.

When it comes to the analysis of aid impacts it is therefore important to consider how the donor-recipient relationship is organised and how it affects institutions and implementation. The EU was successful in influencing institutions in Eastern European countries by requiring reforms as a condition for EU accession. Since African and other developing countries are not candidate countries, the EU cannot exert such an influence. But the issue is certainly worthy of consideration.

Types of aid

Collier (2006) argues that if we want scaled-up aid to have an effect we need to find new areas where aid can be effectively used. Moreover, aid packages must be adapted to different recipient environments. This is clearly a sensible approach. In Africa, he identifies three different types of countries that need different strategies.

The first category is resource-rich countries that have large and often corrupt government sectors, since they earn sizeable resource rents which accrue to the government. The key for this group is improving the efficiency of their public spending. Knowledge transfers and governance conditionality can be used to try to make governments more accountable to their citizens. Good systems of public spending can be supported by appropriate technical assistance. For rents to be effectively used it is probably necessary that power is widely diffused. This is currently very important as African countries are experiencing a resource boom. It is crucially important that this windfall is used well. This requires accountability.

The second category is resource-scarce coastal economies that can develop by diversifying exports. Their engine of growth will be private exporting firms. What is needed is an environment that is conducive to new exporters; aid should be geared to support this. It can support critical export infrastructure and provide guarantees against expropriation. The customs service, the administration of taxation, the operation of ports, and the regulation of production has to be brought up to international standards. Other infrastructure for exports should be put in place. A special concern here is the risk of 'Dutch disease', which needs to be counteracted by, for example, trade liberalisation. Aid needs to be properly sequenced to help this process.

The third category is resource-scarce and landlocked countries. These have the

most serious problem. They are likely to remain poor for a long time and will therefore need aid for their poor populations. There is no clear engine of growth unless neighbours grow faster. Therefore they need a broad-based development strategy with emphasis on rural development.

Collier (2006) distinguishes several failures of policy choice in Africa in recent decades. The first is the corrupt elite that benefits from a dysfunctional government. Policy conditionality is one option, but it has not worked very well. The alternative is governance conditionality aimed at weakening the dominance of the governing elite¹⁵. Unfortunately there is a knowledge gap about how to implement governance conditionality. When there is lack of knowledge the key is knowledge transfer. A parallel constraint is a lack of administrative capacity in the civil service, which needs to be developed by various forms of technical assistance. Already about \$20 billion or roughly a quarter of aid is in the form of technical assistance, but it needs to be aligned with the new paradigm of ownership and control.

Democracy has two important dimensions: electoral competition, and checks and balances. Resource-rich countries in particular need democracy to avoid elite capture of rents, but checks and balances are needed to prevent elections from being converted into corrupt patronage games financed by the resource rents. System scrutiny is needed to achieve honesty, and other systems are needed to achieve efficiency. Since scrutiny is a public good, it is subject to collective action problems, and donors could in this respect help to organise citizens. They could probably also stimulate peer-group evaluations. The scrutiny process also has a severe agency problem. To reduce this, donors could help improve information for the principals, build the capacity to analyse it, and promote incentives for agents to perform. Once a system is in place, donors have an important role to play by insisting that rewards and penalties are built in and implemented. Audit systems and parliamentary scrutiny are key areas for intervention.

A key aim for donors should be to improve governance and implementation capacity in recipient countries. This requires governance conditionality combined with technical assistance to build up systems that can handle government resources transparently and accountably. The World Bank has been reluctant to push for accountable governance, but EU countries and the EC can take the lead because they are less constrained than the IFIs when making politically sensitive interventions.

Debt reduction

Debt issues have been high on the global agenda in recent years. The HIPC (heavily

indebted poor countries] programme was proposed by the World Bank and the IMF in 1996 and an extended version came in 1999. The purpose of it was to reduce debt in developing countries to a sustainable level, that is, a level at which they can service their debts. Countries that qualify for IDA and Poverty Reduction and Growth Facility can benefit from this. The countries undertake to implement economic reform programmes, and at the decision point the net present value (NPV) debt/export ratio is not to exceed 150 percent and the debt/tax revenue ratio 250 percent. Other debts are handled by the Paris Club, which provides debt reduction as part of debt clean-up operations. The Paris Club consists of governments with large outstanding debts in developing countries. It is an informal group that attempts to coordinate solutions to the debt problems for heavily indebted countries. The HIPC debt relief was expected substantially to reduce debt service ratios. For the 29 countries concerned the NPV of debt is set to decline by two-thirds when they reach the completion point.

The G8 proposal from June 2005, now called the Multilateral Debt Relief Initiative (MDRI) will cancel 100 percent of the debt that heavily indebted poor countries owe to the African Development Fund (AfdF), the International Development Association and the International Monetary Fund. The complete debt reduction will occur when they have reached the completion point under the HIPC arrangement. This initiative will give a further reduction of \$50 billion. This initiative does not propose parallel reduction of bilateral or commercial debt. The cancellation is contingent on sound macroeconomic performance, implementation of a Poverty Reduction Strategy, and public expenditure management systems.

For this initiative to benefit poor countries there is need for additional donor financing, so that the capacity for IDA, for example, to lend to poor countries is not undermined. The idea is that donors will provide baseline funds as usual, plus extra money to compensate for the reduction in reflows from debtors.

The donors have promised to replenish the IDA funds fully to compensate for debt reduction. Whether this is additional money or money that is taken from the regular aid budget remains to be seen, but one would suspect that the latter share may be significant. This means that spending on other projects will have to be cut back. It is not self-evident that the resource flow to LDCs will increase because of this new initiative, although it seems likely.

Debt reduction will create more fiscal space for those countries to be used for poverty reduction measures. This will require good fiscal expenditure management as well as sound management of post-relief public borrowing. The MDRI commits donor

countries to provide additional resources to the three funds to prevent a reduction of future support for poor countries. For the 29 countries poverty-related expenditures have increased from about six percent of GDP in 1999 to about nine percent in 2005.

Most of the increase in aid in 2005 (according to the accounting practices of DAC) represents debt write-offs. Since what is written off is sometimes export credits that have not been serviced and were given originally to subsidise the exports of European firms, it arguably should not be part of the aid definition. DAC EU countries in 2005 provided \$55.7 billion in net ODA. Of that, \$14.7 billion was in the form of debt relief grants (Addison 2006).

A problem with the initiative is that money is shifted from countries that have managed their debt service carefully to countries that have not. One may also ask what the signals are for the future. Will countries in the future be interested in managing their debt services well and will people be willing to lend to those countries? Is it meaningful to undertake these transfers unless there is a guarantee that reforms are undertaken? Otherwise the money may end up once again in a black hole.

Debt reductions make it possible for governments to shift money to improve their infrastructure and institutions and/or make it possible to tax firms less harshly, but they do not change fundamental inefficiencies in institutional systems. This must be done by the countries themselves and it may be necessary to do it in the face of opposition from powerful vested interests. The discussion of conditionality above is relevant also here.

The EC has contributed to HIPC and other debt relief initiatives. The policy of the EU in this area should be to continue to support international initiatives and to make sure that its other activities do not undermine the ambition of achieving sustainable debt situations for the poorest countries.

Trade, the Common Agricultural Policy¹⁶ and development

Trade policy *vis-à-vis* developing economies is possibly the most important component of the EU's development policy. Estimates using the linkage model of the global economy (Anderson, Martin, van der Mensbrugge 2006, and World Bank 2006b) suggest that a full liberalisation of merchandise trade would increase world GDP by \$287 billion per year by 2015 with \$86 billion of this accruing to developing countries¹⁷. These estimates furthermore disregard gains from service trade liberalisation and trade facilitation, as well as the productivity effects of opening up. Sub-

Saharan Africa would experience an income increase of \$4.8 billion or 1.1 percent of its GDP, which seems modest but still represents a relative income gain for the region that is double the world average. Two thirds of the gains are due to reforms in other countries and one third is due to its own reforms. As much as 78 percent of the gains for sub-Saharan Africa would come from agricultural reforms, and essentially the whole gain from EU liberalisation would derive from reforms in agriculture. These reforms would also have a very positive distributional impact in the developing countries, since it is farmers and unskilled labour that are most likely to gain from trade liberalisation (Hertel, Winters 2006).

However, full liberalisation of merchandise trade is not likely in the short term. An attempt has been made during the last five years to reach a multilateral agreement within the WTO framework. The aim of the Doha Round was to achieve multilateral, reciprocal, non-discriminatory trade liberalisation. Successful completion of the round would have implied significantly lower levels of protection, although still some way from full free trade. Anderson, Martin, and van der Mensbrugghe (2006) simulate various possible outcomes of the negotiations and find that the effect on global real income by 2015 would be in the range of \$75-\$120 billion. In these scenarios, however, almost all of the gains accrue to the reforming high-income countries, while the impact on sub-Saharan Africa specifically would be modest. Thus, the 'concessions' that the EU and other industrialised countries are willing to make would largely benefit themselves. For the Doha Round to benefit Africa, much more is needed. It would be important to transfer some of the gains from liberalisation from the EU¹⁸ to Africa in the form of more aid, for example, to develop supply capacities in sub-Saharan Africa via improvements in transport and market infrastructure, training, and extension (see Hertel and Winters 2006).

Computable general equilibrium models capture the static gains from a better allocation of resources, but trade may also be associated with dynamic gains. Cline (2004) has reviewed the many studies that have been done on the trade-growth relationship. This is controversial literature since it is hard to show clearly a causal relationship¹⁹, but it is abundantly clear that the countries that have succeeded in increasing income levels substantially have also been successful in the export markets. The gains are partly static gains of specialisation and partly due to dynamic gains in the form of positive effects on total factor productivity.

To be able to integrate with the world economy, developing countries need to have systems in place that make it possible for them to be an arena for outsourcing and FDI generally. This requires systems that can guarantee quality and timely deliveries. If products are part of process and a marketing drive it is fatal to deliver late.

Stability and security are therefore essential for LDCs if they are to benefit from the forces of globalisation. The World Bank (2006b) notes that a typical import transaction in Africa takes 58 days versus 14 days in industrialised countries, and that each day of delay reduces exports by one percent. At Gleneagles there was a lot of interest in 'aid for trade', that is support for developing country efforts to expand their exports. The EC announced in June 2005 an increase in trade-related assistance by €300 million, and the UK has also announced that it will increase its aid-for-trade rapidly until 2010.

The ACP countries should be the main concern for EU development policy. In recent decades they have been marginalised in the world market. Their share of world exports was 3.2 percent in 1970, but had fallen to 1.8 percent by 2003. The fall in the share of the ACP countries in the EU market was even more dramatic with a decline from 4.1 percent to 1.0 percent over the same period (Borrmann, Busse, Neuhaus 2004). Thus, the EU Generalised System of Preferences does not seem to have had any significant effect. The fact that other parts of the world have done much better in terms of export expansion suggests that there are major supply-side constraints in the ACP countries. In the last couple of years the resource boom in prices of oil and other natural resources has increased export incomes, and sub-Saharan Africa saw incomes from merchandise exports increase by 27 percent in 2005 (World Bank 2006b). This also reflects ongoing liberalisation including the elimination of quotas on textile and clothing exports in January 2005. So there have been some improvements in recent years because of the boom, but how long this will last is an open question.

It is hard to measure the overall impact of the full set of trade restrictions, so therefore the World Bank has computed overall trade restrictiveness indices (OTRI) in recent years. An OTRI is the uniform tariff equivalent of different protective measures observed for a country that would generate the prevailing level of trade. It is shown that OTRIs are negatively correlated with GDP. The richer the country, the lower the OTRIs on its imports, as well as on its exports (World Bank 2005). Between 2002 and 2005 the global OTRI fell by two percentage points (Table 4.10), but we may note that the poorest region, that is sub-Saharan Africa, still has high tariffs. Still, average tariffs in developing countries fell from 16.3 percent in 1997 to 12.2 percent in 2005 (World Bank 2006b). Sub-Saharan African countries not only face high tariffs in the developed countries, but even higher tariffs on their trade with other developing countries (World Bank 2005). So while sub-Saharan Africa exporters face low barriers in manufacturing, the restrictiveness on export of agricultural goods is higher than that faced by developed countries.

Table 4.10: Developing country overall trade restrictiveness index (OTRI) by region and changes 2002-2005

Importing country group	2005	Change 2002-2005
East Asia & Pacific	16	-5.3
Eastern Europe & Central Asia	11	-1.2
Latin America & the Caribbean	17	-1.1
Middle East & North Africa	27	-4.3
South Asia	19	-4.0
Sub-Saharan Africa	23	0.0

Source: World Bank (2006b), p.95.

The trade restrictiveness confronting exports from low-income countries is above the world average in spite of the preferences granted. This reflects the continuing importance of non-tariff barriers to trade (NTBs). For poor countries, the NTBs for agricultural products that matter most. Even sub-Saharan Africa countries face low manufacturing tariffs, they face high restrictions in their most important export: agriculture.

Tariffs are still high with the EU for a range of agricultural products that are important to developing countries, with tariffs on sugar being as high as 250 percent (Dimaranan, McDougall 2002). Table 4.11 shows that there were also considerable tariffs on textiles and clothing, which means that overall protection against developing country exports has been substantial. It should be noted as well that the countries that are eligible for the EU's Everything But Arms duty-free entry account for a very small part of EU imports. The numbers in Table 4.11 therefore reflect the level of protection experienced by the bulk of LDCs trying to sell to Europe. The CAP and high level of agricultural protection in Europe are major problems for LDCs. This has had negative consequences on farmers in the LDCs, and with the recent agreement between France and Germany it seems unlikely that much can be achieved in terms of liberalisation and deregulation during the current programme period.

Agriculture has been in focus in the Doha Round, but this is a politically sensitive sector, although it is no longer very important economically in the richer regions including the EU. The protectionist measures applied within the EU are reducing the welfare of EU citizens at the same time as holding down incomes in, for example, Africa. It should be easy to get an agreement between the parties, but the agricultural lobbies in the north are very strong. The Doha Round of negotiations for a multilateral tariff reduction was suspended in July 2006 and is unlikely now to be finalised before the US Trade Promotion Authority expires in July 2007. It was suspended because of a failure by the US, the EU, Japan, Brazil, India and Australia to

Table 4.11: Aggregate measures of protection against developing countries (% tariff equivalents)

Sector	United States	European Union
Agriculture	19.9	46.4
Textiles and clothing	10.9	11.6
Other manufacturing	2.1	3.2
Oil, other non-agricultural raw materials	0.9	0.6
Aggregate measure of protection	4.0	9.5

Source: World Bank (2006b), p.95.

agree on three issues, namely market opening in the agricultural sector (particularly by the EU)²⁰; cuts in subsidies paid to farmers (by the US); and increased market openings for industrial goods (in which Brazil and India are key). This was very disappointing, since the Doha Round represented an opportunity to make the world trade system fairer for all participating countries. It is too early to say whether it will be possible to get the round on track again.

So for the time being the EU will have to concentrate on bilateral negotiations which, from a development policy point of view, should be focused on Africa and the ACP countries. There is a system of trade preferences in place, which matters somewhat for poor African economies. In 2005 the EC introduced a more generous system of preferences, offering duty-free access for 80 percent of the dutiable tariff lines to a set of poor countries that meet certain criteria. Still, one would be able to achieve better results for sub-Saharan Africa and distort their overall trade less by using other forms of trade assistance. Such measures should include a drastic reduction of most favoured nation (MFN) tariffs, and other entry barriers to the EU, on goods and services that sub-Saharan Africa can effectively supply.

The existing system of trade preferences for the ACP countries is against WTO rules. They discriminate against LDCs that are not in the ACP group, and they lack reciprocity, which is another requirement. The EU and the ACP countries did not manage to finalise a new arrangement during the Cotonou negotiation, so therefore the WTO granted them an eight-year waiver that expires at the end of 2007. The EPAs, covering trade relations and EU assistance measures plus measures to enhance intra-regional and international integration, therefore needs to be put in place shortly (unless another extension can be obtained).

There still remain EU tariffs on, for example, agricultural goods. These are very detrimental to African countries in particular, and they should be eliminated. There is

also scope for reforms in several other areas, such as rules of origin, technical standards, quotas and subsidies. The African and other ACP countries should be allowed to reduce their tariffs on EU exports at a slower pace. Such an asymmetric timetable will be acceptable to the WTO, but it has to end within a reasonable period of time. Milner, Morrissey, and McKay (2005) suggest that 10 years would be a reasonable timeframe estimate, meaning markets would be open by 2018. Services trade should also ultimately be included in these arrangements. Regulatory systems should also be improved to facilitate investment, and institutions that facilitate trade need to be developed.

Simulations of the effects of EPAs (eg Milner, Morrissey, McKay 2005) find that the short-run welfare effects will be limited, and it is also shown that African economies would have relatively more to gain from unilateral liberalisation against all countries, not just the EU. Such measures would be more growth enhancing since they would be less discriminatory.

The LDCs in particular have relatively little to gain, with regard to trade, from entering into EPAs, since they already have almost free access to the EU market under the Everything But Arms initiative. They will get even better access in the future as the remaining tariffs and quotas on bananas, rice, and sugar will be phased out by July 2009. The LDCs will then have full and free access to the EU market (including the commodities currently subject to the EU's commodity protocols with the ACP countries). However, these countries still face the risk that the EU may use various safeguard clauses to stem export surges, and countries may be eliminated from the generous treatment when they graduate from the LDC category.

It may be hard to entice the 39 LDCs in the 79-strong ACP group to enter into EPAs unless further benefits are offered. These could include simpler and less restrictive rules of origin, concessions in trade in services, reduction in non-tariff barriers, financial support to help the LDCs deal with the adjustment costs, and technical assistance to help them develop their exports (Borrmann, Busse, Neuhas 2004). The non-LDC members will see larger benefits from entering into the EPAs, since they do not have the same advantages at present. It would also be more beneficial than the more restrictive GSP option.

The EPAs will lead to reduced tariff revenues, which often contributes a substantial share of government revenue in sub-Saharan Africa. This is a concern if the expected expansion of export incomes is slow in coming, which would be the case in the least efficient economies. They need to replace the tariff revenues with other government incomes, avoid substantial trade diversion, regulate liberalised services

industries, and manage intra-regional trade more effectively [Hinkle, Schiff 2004]. For the EPAs to have major positive effects, they need to be combined with other types of reforms (as discussed by for example Hinkle and Newfarmer (2006)).

In spite of these adjustment problems the ACP countries need to open up to international competition, so the EPA process may have beneficial long-term effects. It needs to be supported by other measures to facilitate export expansion in ACP countries. The EPAs should be utilised as instruments of development [Hinkle, Schiff 2004]. EPAs should be followed by measures in other areas in sub-Saharan African countries, such as exchange rate policy, trade facilitation measures, improving the investment climate, and competition policy and infrastructure investment. Multilateral liberalisation might be superior, but even if the countries follow that path, they could still have EPAs as well to get some of the non-trade benefits associated with them [Gasiorek, Winter 2004]²¹.

Countries that do not enter into EPAs will be left with the GSP, and they may lose the extra aid disbursements and technical assistance associated with the EPAs. They will face a considerable erosion of the margin of preferences they will receive on exports to the EU. They can then avoid making reductions on their import tariffs, but that is not an advantage since they need to adopt a more outward orientation. The really poor countries are in any case in great need of institutional, technical and financial assistance. Regional integration may help to increase export supply, but the major challenge is to improve domestic policies and institutions.

So the WTO track would be the best option, but given that this is presently stuck, the current key challenge is to concentrate on agreements with the poorest countries, largely African countries. This is in accordance with the strategy suggested by Cline and Williamson (2005) for the US. They recommended that the first track in a reform strategy should be a 'deep multilateral liberalisation involving phased but complete elimination of protection by industrial countries and deep reduction of protection by at least the middle-income developing countries albeit on a more gradual schedule. The second track is immediate free entry for imports from 'high-risk' low-income countries (HIPCs, LDCs, sub-Saharan Africa) coupled with a ten-year holiday from taxes imposed by developed countries for direct investment in the high-risk low-income countries.'

Cline and Williamson also discuss the inclusion of intellectual property rights under the WTO. They acknowledge that extended rights are a stimulus to innovative activity, but they note that this comes at the expense of the ease and cheapness of diffusion. The international community eventually accepted the arguments from

developing countries and allowed them access to low-cost generic pharmaceuticals. The Doha Declaration of 2001 recognised the right to grant compulsory licences to manufacture generic drugs to deal with HIV/AIDS, tuberculosis, malaria and other epidemics (WTO 2001). This was followed by an agreement that countries which could not produce the drugs themselves would be allowed to import them from other developing countries.

The need for policy coherence, that is to say consistency between aid interventions and other EC policies, has been emphasised for years in EU documents. This includes coherence between development policy and foreign policy in general, and trade policy in particular. The three major EU initiatives, Everything But Arms, EPA and GSP, need to be coherent with other development initiatives.

Still, there are many problems for developing country exporters because of the rule of origin restrictions, which means that they cannot freely export goods to the EU if the raw materials going into those goods are largely imported from other parts of the world. Also the strengthening of WTO rules may make it harder to provide extra preferences to a certain set of countries. There are also sanitary measures that may be problematic for African producers. Among WTO members it is now not only tariffs that are used as protectionist measures. There are also safeguards in case the expansion is too fast.

After a decade-long transition period, during which Europe should have adjusted its textile and clothing sectors, imports were liberalised at the beginning of 2005. But after only a couple of months with rapidly increased exports from China, both the EU and the US put pressure on China to hold back their exports, and some import restrictions were re-imposed. This is remarkable after an agreement had been signed with developing countries and a ten-year preparation period. It is easier to expand aid a little than to accept free trade, which has consequences for specific sectors of the economy. The costs of aid are widespread, while the negative effects of opening up to trade are concentrated on certain groups.

Thus, Europe still has considerable trade protection for certain types of production, and most developing countries have even higher levels of protection for their industry. Basic trade theory suggests that the static effect of a tariff introduced to protect the importables sector does indeed protect it, but it hurts exportables production even more, and so welfare declines. But could there be dynamic effects that more than compensate for the short-term misallocation of resources? Europe is mainly protecting agriculture and some less sophisticated industrial activities. These are hardly the sectors where we expect dynamic effects that will compensate for the

static losses plus the loss of dynamic effects in the unprotected sectors. That Europe would gain in welfare from a shift to free trade is obvious. Europe therefore does not need to be a tough negotiator demanding compensation for sacrifices from trading partners in the developing world, since Europe is not sacrificing welfare. Europe is sacrificing the interests of some special interest groups, such as farmers, but the losses they experience should be handled with compensatory adjustment measures.

The future development policy of the EU

EU development policy covers several areas, and we have here discussed aid, debt reduction and trade issues. Here we sum up the recommendations in those areas, but one really needs to consider them in relation to other aspects of EU development policy.

Coordination of aid between the EC and member countries: Should the EC be a channel of aid or should this be left to the individual member countries? Since the EC mainly duplicates bilateral aid and does not help coordinate the activities of member countries, it may be seen as an extra institution that just makes coordination more difficult and makes it even harder for the recipient countries to manage aid flows from Europe. Since EC aid is not seen as particularly efficient it may seem hard to argue for the preservation of EC aid.

Still, there are actually some arguments for a move in the opposite direction. Such a move could imply that member countries would let future EC Development Policy Statements also cover their own aid programmes or even channel all EU aid through the EC. A potential drawback of the abandonment of country programmes could be that popular support for aid in various EU countries would decline. Still, in the short term neither the abandonment of EC aid nor the radical option of having all aid in one pot seem likely, so the immediate practical task is to improve coordination between EC aid, bilateral aid and aid from other donors. This is very high on the official aid agenda of most donors, and has been so for many years, but progress has been limited (Easterly 2006). Still, by shifting aid towards more general forms of aid, such as balance of payments support, donors may reduce the coordination problem and possibly also increase ownership. When different donors finance the same projects or programmes, one donor should be nominated to act as the coordinating agent responsible for government contacts and follow-up. There is a range of improvements of this type that could be implemented.

Aid volumes: The industrialised countries including the EU have committed them-

selves to provide 0.7 percent of GNI in aid no later than 2015. This will be a major challenge for many of the old EU members that provide a much smaller share, while it will almost certainly be too ambitious an aim for the newcomers. This is still a valid goal for the older members and the EC needs to monitor the progress of member countries towards this goal.

Country allocation of aid: EC aid allocations are more geared to commercial interests and less to the needs of the recipient countries than aid from the bilaterals. This means that a shift in the allocation of aid from bilateral aid to the EC level may shift the emphasis of the aid programme away from the more altruistic stance that EU members tend to take at national level. The EU aid agencies need to coordinate their decisions better to achieve a more sensible global distribution of activities.

Governance conditionality: We have argued that institutions and governance are crucial development constraints, and that the impact of aid on those is very important. Collier (2006) proposed that there should be a shift from policy conditionality to governance conditionality. The former undermined accountability to citizens, while the latter would reinforce it. A good system would be common to all donors, predictable and agreed. This is an area where the EC could have a comparative advantage relative to the member states. This would both push European democratic values, while at the same time improving efficiency. If the EC can perform a useful role here, it is not sensible to abandon EC aid altogether.

Governance of global institutions: The governance of global institutions has not been dealt with in this chapter, but it is worthy of serious consideration²². The EU should develop a policy on the IFIs. It should review the international aid architecture and evaluate if a better division of labour can be envisaged. One needs a better system of allocating resources to the multilaterals²³. The EU should also take a stance on the governance of global economic institutions. On the whole, Europe is overrepresented in these and if the EC takes over more of the European role, national representation could be reduced to leave room for important developing countries like China, India and Brazil.

Debt reduction measures: The conclusion here is simply that the EU should continue to support the debt reduction initiatives that are in place, and to make sure that it lends responsibly in the future to the least-developed countries.

Trade: Europe would gain and the poor countries would gain and have a better chance of taking off economically if Europe would open up its markets even further. It is hard to find any policy area where the self-interest of Europe and the interests

of solidarity are both served to this extent. Since this is an area where the EC handles WTO negotiations for all EU members, EC involvement is crucial. Within the aid segment of EC development policy it would be natural to let aid-for-trade be a key area.

Coherence: The EU and the whole of the OECD have often reiterated the need for policy coherence for development (OECD 2003b). Sweden has adopted an official policy of trying to ensure that all policies are consistent with the desire for global development and poverty reduction in poor countries (Sweden 2001). The EU has formulated it as follows: 'Efforts must be made to ensure that Community development policy objectives are taken into account in the formulation and implementation of other policies affecting the developing countries. The way to achieve this is to make a systematic and thorough analysis of the direct and indirect effects of measures in especially sensitive areas and to take development problems into account in the Commission decision-making process' (OECD 2002, p.43). Policies across various ministries as well as across various countries should thus support the overall goal of development in LDCs and create synergies among each other. This ambition to achieve policy coherence matters both from an altruistic perspective and a self-interest perspective.

Action on coherence among decision-makers is limited and there is a lack of capacity to monitor policy coherence. It may be overambitious to seek to take the development impact of all policies into account, but EU members should at least try to improve the coherence of the policies that are most important for LDCs. Of the policy areas discussed in this chapter, the politically most problematic for policy change is not aid policy but trade policy and the CAP. This is a challenge to EU policy makers, since the latter areas are probably the most important to change if we take our commitment to development seriously.

Notes

- 1 The term 'European Community' (EC) is used throughout this chapter to refer to the joint development effort of the European Union's member states acting as the European Community, and drawing on the Community's budget and the European Development Fund, as opposed to what EU member states do individually.
- 2 A social indicator supporting the notion that the situation for people around the world generally has improved is life expectancy at birth. Here sub-Saharan Africa is an exception: it actually saw a decline from 49.2 years to 46.2 years between 1990 and 2004 due to the HIV/AIDS pandemic. South Asia is also lagging behind, but life expectancy still saw an improvement from 58.7 years to 63.4 years over the same period. The EU countries saw an increase from 76.2 to 79.4 during the same 14 years (World Bank 2006a).
- 3 See the discussion in Maxwell and Engel (2003) and Mackie *et al.* (2005) for an evaluation of this

Development Policy Statement.

- 4 This replaced the Lome Convention that guided collaboration from 1975 to 2000.
- 5 This generalised system of preferences was accepted by the EC in 2001 and now covers 49 countries.
- 6 Foreign direct investment is an important source of investment, but it still represents less than ten percent of world investment (except in the boom around 2000). Between 1990 and 2004 the share of foreign direct investments in GDP globally increased from 1.0 percent to 1.6 percent, in East Asia and the Pacific it increased from 1.6 percent to 2.5 percent, in Latin America and the Caribbean from 0.8 percent to 3.0 percent, in South Asia from 0.1 percent to 0.8 percent, and in sub-Saharan Africa from 0.4 percent to 2.2 percent.
- 7 Hansen and Tarp (1999) found that there are declining returns to aid and that the positive effect of aid inflows ceases when aid is about 25 percent of GDP
- 8 According to a Strategic Partnership for Africa survey about 28 percent of aid to 14 countries in Africa comes in the form of budget support (World Bank 2006b, p. 81). It is also noted that memorandums of understanding underpinning budget support have helped reduce transaction costs.
- 9 The Director-Generals of Denmark, Finland, Ireland, the Netherlands, Norway, Sweden, and the UK have presented a joint action plan for harmonisation and alignment of donor practices.
- 10 The Rome Declaration (OECD 2003a) and the Paris Declaration (OECD 2005a).
- 11 Donors also coordinate their handling of the debt problems of LDCs through the Paris Club.
- 12 Kanbur *et al.* (1999) argued for a common pool approach: 'The objectives are (i) to reduce day-to-day interference in the management of the aid program, (ii) reduce fragmentation within and across projects and policies, (iii) improve "ownership" of the development strategy by the domestic political economy of the recipient country, and (iv) still give donors the right to modulate their funding based on recipient characteristics. The concept works as follows. Aid flows support the overall program of the government rather than this or that project. After a period of dialogue, with the donors but more importantly with its own population, the government puts forward an overall program of expenditures, with alternative scenarios based on different level of aid flows. The donors look at this, and put resources into a common pool that will finance the overall program along with domestic and other resources. At no time is a particular part of the program identified with a particular donor. All aspects of aid are folded into this structure.'
- 13 The Commission for Africa (2005, p. 364), as an interim solution, proposed that donors should mutually recognise each other's procedures. This has worked within the European Union, where the members have accepted each other's procedures as valid without requiring harmonisation around a specific procedure.
- 14 An ambitious study trying to explain African economic growth, or rather the lack thereof, has been undertaken by the African Economic Research Consortium (O'Connell 2004, Collier and O'Connell n.d.). Four different anti-growth syndromes are identified. First, there is the regulatory syndrome which refers to excessive government intervention in markets. Second, there is the redistributive syndrome, where efficiency-reducing resource transfers play a dominant role in the formulation of government policy. Third, there is the inter-temporal syndrome, which redistributes resources from the future to the present via for example looting by the elite or unsustainable government spending booms generally followed by sharp adjustments. Fourth, there is the state breakdown syndrome, in other words civil wars or severe political instability. Finally, there are also some countries that are characterised as syndrome free. The empirical analysis shows that an absence of syndromes increases the growth rate by almost 2 percentage points per year. The main conclusion of the study is that African growth has faltered due to dysfunctional political-economic configurations or syndromes.
- 15 DFID wants to reform conditionality and not relate it to specific policy decisions by the partner

countries. Instead they want to monitor progress against agreed benchmarks drawn from the partners' PRSs. It will consider withdrawing aid when the recipient moves away from commitments to poverty reduction, human rights and other international obligations, plus sound financial management.

- 16 There is also a Common Fisheries Policy (CFP) with similar features, but it is less important than the CAP.
- 17 Cline (2004) found that the impact of a complete removal of tariffs on developing countries would be a long-run income gain of about \$200 billion per year and that about half of this would be due to removal of developed countries' import tariffs against developing countries. He also found that the impact on poverty would be large.
- 18 EU25+EFTA would gain \$65 billion according to these model simulations.
- 19 See for example the critical review of the evidence by Rodriguez and Rodrik (2001)
- 20 The EU offered some reforms of the CAP in the WTO negotiations. It proposed phasing out of export subsidies, major cuts in domestic support and improvements in market access. The EU estimated that the agricultural tariffs would have fallen from 23 percent to 12 percent on average.
- 21 When it comes to the liberalisation of services, Jansen (2006) concludes that in general the multilateral route seems preferable. Why only allow EU firms entry, if there are better alternatives available elsewhere?
- 22 See the discussion on the international financial architecture in Goldstein (2005).
- 23 DFID has developed its multilateral effectiveness framework, which is to guide it in its allocation of resources to multilaterals.

5

External monetary and financial policy: a review and a proposal

Alan Ahearne and Barry Eichengreen¹

To the question 'How does the EU organise its external monetary and financial relations,' the immediate answer is 'not easily'². One source of complexity is that international monetary and financial relations are organised as an overlapping set of institutions and groupings in which participation and representation are heavily influenced by political and historical circumstances.

European countries are generously represented in these institutions (see Table 5.1), but their representation bears only a loose relationship to the current condition of the world economy. European countries have eight members on the 24-person Executive Board of the International Monetary Fund (nine when Spain periodically chairs its predominantly Latin American constituency). This is because a set of small European countries had a head start in their industrial and financial development and figured disproportionately in international trade and financial transactions when the Fund (IMF) was established in 1944, and because representation in these institutions is slow to change.

The G10 is constituted as it is³, with seven European members, because a handful of European countries had substantial dollar balances in the 1960s, making them the logical parties to address the US gold problem that dominated the international monetary agenda at the time. The G7 is made up as it is, with a majority of European members, because the states in question were the obvious candidates for the steering committee for the international monetary and financial system when the latter entered a period of flux in the 1970s. European countries are therefore generously represented in all of the venues in which international monetary and financial relations are considered.

Table 5.1: Selected international forums, member countries*

IMF Executive Board	G7	G10**
Germany	France	Belgium
France	Germany	France
United Kingdom	Italy	Germany
Belgium	United Kingdom	Italy
Netherlands	Canada	Netherlands
Italy	Japan	Sweden
Finland	United States	Switzerland
Switzerland		United Kingdom
United States		Canada
Japan		Japan
Venezuela		United States
Australia		
China		
Canada		
Egypt		
Saudi Arabia		
Malaysia		
Kenya		
Russian Federation		
Iran		
Brazil		
India		
Peru		
Rwanda		

* European countries listed first.

** The G10 was established in 1962; Switzerland joined in 1964.

The question is whether this situation is sustainable in a world where the balance of economic power is shifting toward emerging markets. The increasingly evident answer is 'no'. The underrepresentation of emerging markets on the boards of the IMF and World Bank is the mirror image of Europe's overrepresentation. The danger is that emerging markets, having accumulated massive amounts of international reserves, may set up regional rivals to these multilateral institutions so that they have more voice in deciding their financial fate. In addition, in September 2006 the United States and China agreed to conduct regular bilateral consultations. The first of these talks took place in Beijing in mid-December 2006 and the US delegation included senior officials such as Treasury Secretary Henry Paulson and Federal Reserve Chairman Ben Bernanke. One can imagine how these consultations could develop into an alternative to the G7 process, since China – soon to be the world's

second largest national economy – is unrepresented there. If Europe refuses to share its place at the table, it may find itself increasingly short of dining partners of consequence.

The other source of complexity is Europe itself. Switzerland is a member of the G10, which is appropriate insofar as its policies have an impact on international financial markets, but it is not a member of the European Union. That Norway is a large reserve holder and sometime chair of an IMF constituency but not an EU member, is a source of additional complication. The United Kingdom is a member of the European Union but not of the euro area⁴. In addition, membership is not static: the composition of the EU and the euro area has and will continue to evolve.

There are a number of different ways of organising Europe's external monetary and financial relations:

- Foreign financial and monetary policy could remain, as has traditionally been the case, a national competence. It is said that there is no more appetite in Europe for a single foreign financial policy than for a single foreign policy generally⁵. This implies at most updating the prevailing state of affairs to remove the worst inefficiencies but not changing it fundamentally.
- Member states could more closely coordinate their international monetary and financial policies in order more effectively to counterbalance the United States and advance the common European position – on the assumption that there is in fact a common European position.
- Finally, Europe's representation in international forums could be unified. This would entail delegating responsibility for its formulation to the European Commission and appointing a single EU representative to communicate with the Union's interlocutors in the various global forums.

This is, of course, just a specific instance of the larger debate over which competences should be assigned to the European Union and which responsibilities should continue to reside with the member states. The European convention that met from 2002 through 2004 to decide on a draft treaty establishing a Constitution for Europe, and the subsequent difficulties in ratifying the draft treaty, remind us that Europe has not yet reached the nirvana where there exists agreement on a particular approach⁶.

How then should European countries and their citizens go about reaching such agreement? The theory of fiscal federalism provides the standard tools for deciding how responsibilities should be allocated across levels of government. It suggests

assigning to the most encompassing level of government, in this case the EU, issues where tastes are homogeneous and where there exist economies of scale associated with centralised provision – and, conversely, leaving to lower levels of government, in this case the member states, issues over which national tastes diverge and economies of scale are absent. In the present context, the existence of economies of scale in provision means that Europe's positions in international forums can be represented more effectively when representation is centralised; Europe will be better able to express and achieve its goals. Homogeneity of tastes means that European countries have similar objectives and foreign policy goals. We will argue that foreign monetary and financial policy comes reasonably close to qualifying on both counts. Thus, we conclude that Europe should move toward closer coordination and greater centralisation of its representation in external monetary and financial affairs.

If this hypothesis is correct, it points to the difficult question of why the EU has not already delegated responsibility for formulating a common position on monetary and financial affairs to the Commission. Some will say that its reluctance to do so falsifies the hypothesis – that either we exaggerate the efficiency advantages of centralised provision, or else we minimise the extent of preference heterogeneity. The failure of member states to assign their foreign financial and monetary policies to the EU is *prima facie* evidence against the hypothesis.

An alternative is that the null is correct but there are significant fixed costs of change. For instance, negotiating a change in EU constituencies in the Bretton Woods institutions involves negotiating with non-EU countries, which in many cases cohabit with EU member states in the same constituency⁷. It means asking EU members that presently chair constituencies to give up that privilege in favour of a single EU chair. Inevitably these negotiations will force governments to expend valuable political capital. Moreover, policymakers are risk averse, which creates a status-quo bias. Uncertainty about whether change will really deliver a welfare improvement lends inertia to existing arrangements. Thus, even though consolidated European representation would be better, inertia has prevented it from taking place. Sympathetic as we naturally are to our own hypothesis, we are more inclined to this interpretation of the facts.

This interpretation points to the need for a strategy for overcoming status-quo bias. Here we build on theoretical work inspired by the problem of transition from plan to market in the formerly centrally-planned economies, in the context of which it has been argued that experience with limited reform may help to convince otherwise sceptical stakeholders of the positive effects of further reform (Dewatripont and

Roland 1992). This suggests investing first in the development of unified representation and common policies toward a set of issues and in a venue where the case for doing so is strongest. If the results convince the sceptics that this enhances the efficiency and effectiveness of Europe's voice and influence, without forcing unacceptable compromises in national positions, it may be possible to emulate this example in other venues and issue areas.

Concretely, we recommend starting by consolidating Europe's representation at the IMF. One can imagine consolidating Europe's representation into a single chair or a pair of chairs, one for the members of the euro area and the other for other EU countries. (Our incremental approach emphasising the advantages of learning by doing suggests starting with a pair of chairs). The rationale for consolidating EU representation at the IMF is stronger than the analogous rationale for doing so at the World Bank, G7, G10, G20 and Financial Stability Forum. In the case of the IMF, the infrastructure needed to establish a single European position is relatively well advanced. Increasingly, the reluctance of EU member states to give up their seats on the IMF Executive Board is seen as a major obstacle to comprehensive governance reform and thus as undermining the legitimacy of the institution⁸. Europe is going to have to negotiate over these issues whether it commits to unified representation or not. It might as well make the most of the process.

The IMF is also the right place to start because preferences on IMF-relevant issues are relatively homogeneous. To the extent that the IMF is historically concerned with issues revolving around exchange rates, the fact that half of EU members have the same currency and therefore the same exchange rate points strongly in this direction. That the euro area, not individual member states, has been invited to participate in the IMF's first multilateral consultation on the topic of global imbalances is more evidence of the point.

Finally, the IMF is the right place to start because economies of scale in representation are strong. Analytical work by Leech and Leech (2005) and Bini-Smaghi (2006b) suggests that a single seat, or even a pair of EU seats, will make the EU, with its cohesive block of votes, a key swing voter. The EU will be better able to achieve its goals, which is precisely what is meant by economies of scale in provision and representation. Another factor reducing the costs of moving in this direction is that the EU has already made progress in coordinating national policies in the Fund by creating SCIMF, a subcommittee on IMF-related issues in the Economic and Financial Committee, for which the Directorate-General for Economic and Financial Affairs ('DG Ecfm') of the European Commission acts as secretariat, and EURIMF, an informal committee of EU countries' representatives in the IMF.

Thus, the three key considerations – negotiating costs, preference homogeneity, and economies of scale in provision – all have as their starting point the rationalisation of Europe’s representation at the IMF⁹. If doing so proves successful, EU member states will then be more likely to contemplate similar reform in the case of other issue areas and venues.

The state of play

A traditional reason for scepticism that the EU is prepared to cooperate more closely in managing its foreign monetary and financial affairs is that it has not made much progress in cooperating on foreign policy more broadly. After all, foreign monetary and financial policy is simply a subset of foreign policy generally. Preferences are heterogeneous. For example, European countries have different attitudes regarding the extra-European powers: consider the UK’s special relationship with the United States, France’s long-standing ties with Russia, or Germany’s historical and current economic connections with Turkey.

It is tempting to make the same point with respect to monetary and financial affairs. From the founding of the modern G10, France has been more sceptical than other European countries about the exorbitant privilege of the United States in the international monetary system. Germany has been especially concerned about the moral hazard and inflationary bias associated with international rescue packages. The UK has been relatively keen on financial deregulation and liberalisation, seeing this as giving London an advantage in the competition for international financial business. The Netherlands and the Scandinavian countries have placed a priority on development assistance and concessionary finance for the poorest countries. Every EU country that had colonies feels a special responsibility for its one-time possessions and feels that monetary and financial policies should be adapted to help meet their special needs.

At the same time, foreign monetary and financial policies clearly differ from other foreign policies. To date 13 European countries share a single currency and they can only have a single exchange rate against the dollar. They can only have a single foreign exchange market intervention strategy. They must take a single decision on whether to adapt monetary policy to exchange rate developments and to conditions in the rest of the world. They must reach a collective view on the immediacy of economic and financial risks and on how the ECB should respond. The very existence of monetary union is an indication that there exists a relatively high degree of preference homogeneity in this domain. The fact that 13 European countries share a single currency and single central bank shows that there should be economies of scale from

greater centralisation of Europe's representation in arenas concerned with international monetary and financial affairs.

Not surprisingly, the result is a compromise in which member states and the EU institutions share competences. The member states remain the dominant players, reflecting the weight of history and institutional inertia. The Treaty of Amsterdam (1997), in which the member states sought to take the external monetary and financial implications of the euro on board, stated that 'the Council, acting by a qualified majority on a proposal from the Commission and after consulting with the ECB, shall decide on the position of the Community at the international level as regards issues of particular relevance to economic and monetary union and on its representation...' Thus, the Council, where the member states are represented, retains the power to decide whether or not there will be a common European position, although the Commission and the ECB both have agenda setting power.¹⁰

At the European convention, the idea of unified representation for the EU was advanced by the Parliament and the Commission. Pedro Solbes, then EU economic and monetary affairs commissioner, made declarations both inside and outside of the convention in favour of a single EU representative on the IMF Board (Louis 2003). The draft constitution sought further to amplify the voice of euro area countries by authorising the Eurogroup to elect a president for two and a half years to represent the euro area on the international stage. It proposed to allow euro area members to decide, voting among themselves, on financial relations with the outside world. The Eurogroup would be allowed to decide 'positions on matters of particular interest for economic and monetary union within the competent international financial institutions and conferences.' But the implications for unified representation were tempered by other provisions making clear that decision-making authority still ultimately resided with the member states represented in the Council of Ministers. In particular, the draft constitution empowered the Council to 'adopt appropriate measures to ensure unified representation within the international financial institutions' (Corrales-Diez 2003).

In practice, member states have concentrated on coordinating their policies without pressing for actively unifying their representation. It was agreed at the informal Council of Ministers ('Ecofin') meeting in Oviedo in 2002 that the EU should rely on informal coordination in order to develop common positions (Crelo 2005). There are no *ex ante* commitments to develop common positions. EU representatives are encouraged to coordinate their views, but nothing commits them to doing so.

Arguably, soft coordination has increased since Italy's presidency of the EU in the

second half of 2003. Some observers attribute this to officials like Lorenzo Bini-Smaghi, who long stressed its desirability. The focus of this process is weekly meetings of European executive directors (EDs) in both the IMF and World Bank. Their goal is to discuss national positions and, where interests coincide, to devise strategies for pursuing them.

The International Monetary Fund

These arrangements are relatively well developed at the IMF. SCIMF prepares the work of the Economic and Financial Committee (EFC: high-level finance ministry and central bank officials) on IMF and related issues. (SCIMF was set up as a working group in 2001 and made a permanent subcommittee of the EFC in 2003). It meets in Brussels roughly eight times yearly and comprises representatives of each country's finance ministry and central bank plus two from DG Ecfm and two from the ECB. The Commission acts as SCIMF's secretariat, preparing agendas and minutes, although it does not take an active part in discussions. The two members of DG Ecfm speak in meetings on behalf of the Commission but do not vote. The European executive director chairing EURIMF also attends these meetings to ensure consistency with what goes on in Washington DC.

Documents agreed by SCIMF go first for endorsement to the EFC and are then transmitted to European EDs at the IMF. However, EDs are not obliged to follow them. Moreover, the fact that meetings occur at roughly six-week intervals can be a problem, since SCIMF does not always meet with the timeliness needed to feed opinions and common positions to members of the IMF Board (Eurodad 2006). This is indicative of the limits of soft coordination.

Complementing SCIMF is EURIMF, a grouping of all EU countries' representatives in the Fund established in 1998 to foster EU coordination. A representative from the Commission Delegation in Washington and one from the ECB participate in this group. The core of EURIMF activities is the 'EU presidency grey mechanism'. Before each board meeting, each constituency prepares a position paper known as the 'grey'. On questions relevant to the EU there is a coordination of greys. In addition, the European ED chairing EURIMF may make an introductory statement at IMF Board meetings on issues related to the world economy that reflects the common European view¹¹.

Finally, there are ad hoc 'one-per-chair' or 'one-per-office' meetings. These gather representatives of European countries occupying chairs on the IMF Board. They function as a kind of mini-EURIMF.

Importantly, the ECB is not represented in these meetings. This situation changes slightly when deliberations move to the Executive Board, where the ECB has observer status. The ECB is empowered to speak in Board meetings on matters of European monetary policy – for example, on staff reports on Article IV consultations with the euro area – but only if it is first admitted to the floor.

In 1998 the Commission proposed that it should also enjoy observer status – more precisely, that the executive director of the member state holding the euro area presidency ‘assisted by a representative from the Commission’ would represent the euro area in Executive Board meetings. However, the Council rejected the Commission’s proposal on the grounds that accepting it would be seen as ceding authority [Corrales-Diez 2003].

Some officials argue that IMF surveillance suffers from the fact that the president of the ECB has only observer status on the International Monetary and Financial Committee (IMFC), where a number of central banks are represented. At the spring meetings of the IMF in 2006, Eurogroup President Jean-Claude Juncker (Luxembourg’s Prime Minister) diplomatically described this as “stupid and ridiculous”¹². The president of the Eurogroup of finance ministers is represented but only if a place is surrendered [Atkins and Schieritz 2006]. To be sure, the finance minister of the country holding the presidency of the EU Council of Ministers delivers a speech at the IMFC biannual meetings. But that speech, prepared by SCIMF in Brussels, is a very general document, since it must reflect the common ground of all members. Hence it lacks specifics and has little ability to shape the agenda. And the fact that the EU presidency rotates every six months undermines continuity and the establishment of durable contacts between the EU presidency and IMF staff [Eurodad 2006, Phillips 2006b].

The World Bank

EU participation at the World Bank is less advanced; no EU institution even possesses observer status on the Board. While the Commission is an observer in the joint IMF-World Bank Development Committee, as an observer it does not have the right to speak nor is it provided with internal documents [Phillips 2006b]. Since 2004 the EU commissioner for development has made a speech on behalf of the European Community to the Development Committee, but again it is not formally represented [Eurodad 2006].

European representatives at the Bank meet regularly in Washington, but no structure analogous to SCIMF exists in Brussels. Since 2000 several European presiden-

cies have attempted to organise meetings in Washington focusing on World Bank board agendas. In November 2003, Europeans signed an agreement stipulating that such meetings should occur every two weeks and possibly more often. In practice they have occurred once a week, usually on Fridays. The main function is to exchange information. An official from the Commission's delegation in Washington attends these meetings as an observer (Eurodad 2006).

As at the IMF, coordination is hindered by the fact that some member states are in joint constituencies, while others have constituencies of their own. Coordination is further complicated because, compared to the IMF, there is greater heterogeneity of background among European EDs, about half of whom come from finance ministries, a third from development and cooperation ministries, and the rest from foreign ministries.

Despite all this, European directors have occasionally issued joint policy statements, such as their statement of support for the Wolfowitz candidacy for the Bank's presidency. In November 2003 European EDs agreed on a list of procedural issues of common interest (Eurodad 2006). However, directors in joint constituencies did not participate (Phillips 2006b).

G7/8

At G7/8 meetings, the ECB represents the European monetary authorities when monetary and financial issues are discussed. But in the remainder of the meeting the ECB leaves in favour of the heads of the national banks of France, Germany and Italy (Truman 2004). The president of the Eurogroup participates, but so do the three European finance ministers.

Predictably, the big EU member states that monopolise representation in the G7 are not keen on sharing it with smaller member states. This creates problems when the G7 drafts initiatives that commit other member states, as was the case with the recent Multilateral Debt Relief Initiative (Phillips 2006b). Munchau (2006) has called for replacing the G7/8 with a G4 composed of the US, the euro area, Japan and China. Kenen *et al.* (2004) have called for replacing it with a Council for International Financial and Economic Cooperation with the US, the euro area, China, Japan and the UK as permanent members and ten other countries rotating on and off. Countries like Italy, France and Germany (not to mention the UK, in the Munchau variant) that face losing national representation will presumably resist either proposal in the absence of further steps to establish a common European position and agreement on the desirability of assigning such competences to the euro area or EU institutions.

Financial Stability Forum (FSF)

The Financial Stability Forum was created in April 1999 in the wake of the Asian crisis to address issues of systemic stability in international financial markets. Its members include national authorities responsible for financial stability in significant international financial centres, international financial institutions, sector-specific international groupings of regulators and supervisors, and committees of central bank experts. Of the EU countries, France, Germany, Italy and the UK have their central banks, finance/economy ministries and securities regulators represented, while the Netherlands has its central bank. Other European countries are not represented. The ECB is represented but not the Commission. There is little evidence of institutional progress toward the coordination of European policies on the FSF.

How has the state of affairs affected particular issues?

We now consider how this state of affairs has affected particular issues such as IMF policy, exchange rate policy, and the correction of global imbalances.

IMF policy

Compared to the United States, European countries have tended to adhere to a hard line on the extension of IMF assistance to crisis countries. European directors have regularly argued that IMF loans should be subject to explicit ceilings as a way of addressing moral-hazard problems. More recently some have suggested that exemptions from the conventional 300 percent of quota limits should require an open letter from IMF staff explaining in detail why an exception is proposed. Various directors have also suggested that agreement to waive normal access limits should require a supermajority vote (National Bank of Denmark 2001).

But this scepticism about the merits of large loans has not prevented the granting of them. Thus, while two European directors dissented from the decision to provide another loan to Argentina in August 2001, this did not prevent that loan from being granted, largely on the initiative of the United States (Mussa 2002). One can imagine that things would have been very different had Europe been able to speak with one voice.

European countries have also been in the vanguard of IMF members pushing for a more rules-based approach to sovereign debt restructuring. A number of European countries strongly supported the proposal for a Sovereign Debt Restructuring Mechanism (SDRM), which would have specified procedures for officially-led

restructuring negotiations. But the constituency to which Spain belongs opposed the SDRM, since the views of emerging-market borrowers in that constituency – Venezuela, Mexico and Colombia in particular – prevailed. The UK was sceptical, since it was accustomed to a contractual approach to restructuring (through the use of collective action clauses) rather than a statutory process. One can imagine that the European view would have carried more weight had all European countries lined up behind it.

Finally, European countries have punched below their weight in the debate over reform of the internal organisation and day-to-day operations of the organisation. The UK Treasury has argued for constructing a firewall between the Fund's surveillance and lending functions – for making the surveillance function independent so that it would not be influenced by the loan officer's familiar tendency to identify with his customer (Balls 2002). The governor of the Bank of England has called for greater independence for management as well as staff as a way of insulating the institution's operations from national self-interest and political short-termism (King 2006). Other European countries, in contrast, have argued for the strengthening of political oversight of staff and management, who have excessive freedom to set and pursue their own agendas. Similarly, European countries are split over the debate on how to simplify the Fund's quota formula, since their voting shares would be differentially affected by quota revision (see below). These contradictory positions leave Europe with less influence than it would otherwise have.

European exchange rate policy

A second case is intervention in foreign exchange markets¹³. Traditionally, intervention has been arranged on the sidelines of G7 meetings, between finance ministers in consultation with their respective central banks. This reflects the uneasy situation in most G7 countries where central banks are responsible for monetary policy, but finance ministers decide on exchange rate policy, including the need for intervention¹⁴.

A problem in this context is that there is no euro area finance minister. The president of the Eurogroup does participate in G7 meetings, though his mandate is less than clear. French, German and Italian finance ministers, accustomed to being full partners in G7 meetings, may be reluctant to defer. All this makes it difficult for the euro area to reach agreement with the US, Japan, the UK and Canada on concerted intervention. It makes it difficult to respond with the speed required to meet events in foreign exchange markets. It makes it difficult to coordinate the 'open mouth operations' that go along with intervention. Even among the Europeans, coordination to ensure consistency in public statements on exchange rates is far from perfect. As

Bini Smaghi (2006a) puts it, '[i]n theory only the President of the ECB and the President of the Eurogroup should speak on exchange rate issues. Such discipline has not always been easy to implement.'

A complication is the fact that the ECB plays a larger role in the decision of whether to intervene in foreign exchange markets than other G7 central banks¹⁵. Finance ministers cannot simply instruct the central bank to intervene¹⁶. The central bank (more precisely the Eurosystem made up of the ECB and national central banks) must agree, giving it *de facto* veto power. Thus, it is not always clear whether the relevant interlocutor for other countries is the president of the Eurogroup of finance ministers; the president of the EFC, the working party that gathers both finance ministry and central bank officials; or the president of the ECB, who was charged with responsibility for external contacts according to an understanding reached by EU officials at a meeting in Finland in 1999. This last possibility is particularly difficult, insofar as other countries' finance officials preferred to negotiate with elected officials and those responsible to them rather than with appointed central bankers.

These ambiguities significantly complicated efforts to coordinate intervention in foreign exchange markets when the euro fell to 90 US cents in autumn 2000. As described by Henning (2005), it was not clear to other countries whether their interlocutor should be the three euro area finance ministers, the Eurogroup president, the president of the EFC, or the president of the ECB. It was not clear to the foreign partners whether different euro area agents were responsible for deciding intervention, drafting the joint statement on it and issuing it to the press, or how to coordinate negotiations with these separate parties. (In practice, the Europeans agreed that the Eurosystem was 'solely competent' for deciding on intervention, but that the press statement would be negotiated between the central bank, the EFC president, and the Eurogroup president). Efforts to enforce what European participants thought was an international understanding, not only on actual intervention but also on public statements, 'began to unravel almost immediately'¹⁷. It is indicative of these problems that the second time the Europeans intervened, in November 2000, they did so unilaterally without attempting to coordinate with their G7 partners¹⁸.

The fact that the president of the Eurogroup now serves for a longer period alleviates these difficulties but does not make them go away. Clean solutions would include transforming the G7 into a G5 where the euro area and the president of the Eurogroup replace France, Germany, Italy and their respective finance ministers. But what is appropriate for finance G7s is less appropriate for G7 meetings concerned with other issues where the euro area is a less relevant entity. The president of the Eurogroup has less influence than finance ministers over national policies, so

that substituting him for the French, German and Italian finance ministers might be seen as reducing European leverage. France, Germany and Italy may resist this change even if there are efficiency arguments in its favour.

Finally, if Europe allows the issue of reconfiguring the G7 to be raised, changes are unlikely to stop with the substitution of the president of the Eurogroup for three finance ministers. Bergsten's (2006) proposal for collapsing the G7 into a G4 made up of the US, China, Japan and the euro area will surely be placed on the table. Other countries with a stake, like the UK and Canada, are less certain to go along.

Global imbalances

US and Chinese current account balances have widened alarmingly in recent years. The threat to stability posed by a possible disorderly unwinding of these imbalances prompted the IMF to launch in summer 2006 a multilateral consultation process involving China, the euro area, Japan, Saudi Arabia and the United States. The euro area's current account has remained close to balance, suggesting to Europeans that they are not part of the problem¹⁹. Nonetheless, Europeans are concerned that they may end up bearing a disproportionately large burden of adjustment if the euro ends up rising sharply against the dollar, curtailing exports to the US, without at the same time falling against the renminbi, stimulating offsetting exports to Asia.

Moreover, a sharp fall in the dollar leading to a flight to quality could make it more difficult for central and eastern European countries that are not yet members of the euro area to finance their often-large current account deficits. If they allow their currencies to depreciate in response, they may jeopardise attainment of their goal of euro-area accession. If, on the other hand, they seek to defend their currencies, they may court a financial crisis that would have repercussions elsewhere in Europe (including in the banking systems of the western European countries that have been providing much of the external finance). Clearly, Europe has a stake in the orderly resolution of the problem, with unsustainable imbalances wound down gradually and the dollar adjusting gradually rather than with a crash.

Putting external balances on a sustainable footing will require policy changes by all the major players, including adjustments to produce higher public and private saving rates in the US, and a greater reliance on domestic demand in Asia. In particular, changes in China's exchange rate regime to allow greater appreciation of the renminbi will almost certainly play a role in reducing China's enormous current account surplus. Here European countries have sent mixed messages. Moreover, while it remains underrepresented at the IMF, China will be reluctant to engage constructively in the

Fund's multilateral consultations process. China's IMF underrepresentation is the flipside of Europe's overrepresentation, as we have shown. Thus, reform of European representation seems a necessary condition if talks on global imbalances are to have a chance of success.

A proposal

How might the situation be rationalised? In this section we argue that it is desirable to consolidate European representation in international organisations and groupings, from the IMF and World Bank to the G7, G10, G20 and Financial Stability Forum, in a smaller number of chairs. In the Bretton Woods institutions, one can imagine existing quotas and votes being grouped under two chairs initially, one for the euro area and one for other EU countries (as in Bini Smaghi 2004). Ultimately these two chairs might be consolidated into one. The EU could become a single member of the IMF and the World Bank, with quota formula applied to it formally as if it were a single economy. In groups like the G7 and G10, it again makes sense for European countries to have a unified representation or at most two representatives for a transitional period, one for the euro area and one for other EU countries.

Such reform is desirable both for Europe and the rest of the world. For Europe, the preference heterogeneity and difference in outlooks that impede movement toward a single European foreign policy are more limited in the case of foreign monetary and financial policies than other foreign policy issues. To be sure, there remains heterogeneity of preferences – between, say, Ireland and Italy about the stance of ECB policy, reflecting different degrees of dynamism of their economies – but this has not prevented 13 European countries to date from moving to a single monetary and exchange rate policy, indicating their perception that the advantages of scale economies in provision dominate.

Consolidating Europe's representation would also enhance the continent's influence. Voting as a group, the EU or even the euro area would have the single largest block of votes in the IMF and World Bank. A single EU chair would not need the support of many other members to form a winning coalition. Bini Smaghi (2006b) and Leech and Leech (2005) calculate that it would become a critical swing voter in these organisations. In the G7, the G10, and the G20, the euro area or, even more, the EU would represent an economic area as large as the United States and larger than Japan and other members, whether measured in terms of production, trade or financial flows, giving its arguments weight and giving the member states more leverage over outcomes.

Consolidating Europe's representation is also in the interest of the rest of the world insofar as doing so frees up seats for underrepresented emerging markets. The G7 and G10 are poorly configured for addressing a range of important economic and financial issues because systemically significant emerging markets – China most prominently – are not represented. While replacing the G7/10 with the G20 has the advantage of including such systemically significant emerging markets, 20 is too large a number for efficient negotiation²⁰. (In a way, the G20 epitomises the irrationality of Europe's present representation, in that it includes the four European G7 members – France, Germany, Italy and the UK – but also the European Union). What is needed is a smaller body, for example a G4 made up of the US, Europe, Japan and China (Bergsten 2006) or a G4 plus, composed of these four entities with a rotating cast of additional characters, depending on issue (Kenen 2005).

Similarly, consolidating European representation at the IMF and World Bank into a smaller number of chairs would make it possible to provide more chairs at the Board table for emerging markets while not increasing the size of the Board, where the latter is to be avoided for efficiency reasons. While discussion at the September 2006 annual meetings of the IMF and World Bank focused on changes in quotas and voting shares (see below), there also was a recognition that giving emerging markets more voice in these institutions, and thereby enhancing the legitimacy of their operations, will require giving them more seats on their Executive Boards. With European countries (including two non-EU members: Norway and Switzerland) occupying as many as nine out of 24 seats on those Boards, freeing up chairs for other countries would require some European members to give up theirs. The reluctance of smaller European countries to volunteer is increasingly seen as an obstacle to progress.

Europe also plays a key role in the redistribution of voting shares in the Bretton Woods institutions. There was agreement at the IMF-World Bank meetings in September 2006 on an *ad hoc* increase in quotas for four underrepresented emerging markets (China, Turkey, Mexico and South Korea), amounting to an aggregate increase in IMF quotas of 1.8 percent, with a promise of more comprehensive quota reform to follow by 2008. It is no coincidence that the US has been a proponent of quota revision, since its current voting share is, in fact, less than implied by current quotas²¹. In contrast, many European countries, especially a number of smaller ones, tend to be overrepresented. The more comprehensive reform will utilise an updated quota formula, presumably based on some combination of country size, openness, and balance-of-payments variability. But the IMF Board has decreed that the quota formula should be simplified in the interest of transparency, which presumably means an even heavier weight on GDP and less on

ancillary variables. The representation of smaller EU countries will be further reduced if the revised quota formula reduces the weight attached to the export ratio²². Thus, it is not surprising that they are more sceptical about more comprehensive quota reform. But without European support or at least acquiescence, it will not be possible to marshal the 85 percent support needed to push through quota revision.

Clearly, there is intense pressure for reform of country representation at the Bretton Woods institutions and in the world's other economic steering committees. Europe's numerical overrepresentation is unsustainable. The alternative to reducing Europe's chairs and shares, at the same time consolidating European representation in order not to lose influence, is for the international organisations and groupings to which European governments attach importance to continue to lose legitimacy and influence. Asian countries would set about multilateralising the Chiang Mai Initiative and strengthening regional surveillance mechanisms as steps toward creating an alternative to the IMF. They would likely continue to accumulate foreign exchange reserves at a rapid pace in order to protect themselves from having to borrow from the Fund again. European countries would find themselves blamed for blocking meaningful governance reform and further weakening the legitimacy and influence of the multilateral financial institutions, or else they would have to agree to having their shares and chairs reduced without accompanying changes that work to maintain their influence.

Incrementalism as learning by doing

If these arguments are compelling, then why is there such reluctance to move in this direction? Some European countries may fear that consolidated representation will end up forcing them into positions inconsistent with their national interest. They may worry that Europe lacks the infrastructure and experience to carve out common positions and that its influence in these venues will be reduced.

A logical way of alleviating these concerns is to move forward incrementally, in one venue. If experience in one organisation reassures the member states that they will not be forced into uncomfortable positions, that arrangements for reaching such decisions are adequate, and that reform in this area does not mean that member states' competences in other areas related to foreign policy will inevitably be infringed upon, then there may develop a greater willingness to consolidate European representation in other monetary and financial groupings.

As noted above, this incremental approach can be justified in terms of the literature

on gradual policy reform in transition economies, where it is argued that experience with limited reform may help to convince otherwise sceptical stakeholders of the positive effects of more broad-based reform (Dewatripont and Roland 1992). If it is necessary to compensate losers (a country like Belgium that stands to lose its chair in both the IMF and the World Bank, as well as the profile it enjoys by virtue of the importance of the G10, of which it is a member), then the cost of compensatory concessions in other issue areas will be more limited (given that Belgium would be losing only one of these three prerequisites at a point in time); this may in turn make such concessions easier to extend for the winners. If the EU follows through on its promise to compensate Belgium with concessions in other issue areas, then its commitment to make compensatory side payments in return for agreement on further consolidation will become more credible.

The objection to incrementalism in the context of transition was that structural reforms are interdependent – that one reform will have positive effects only if it is adopted simultaneously with others. This is less obviously true of reform of European representation in the Bretton Woods institutions and the world economy's other steering committees. Admittedly, the fact that the World Bank and IMF work together, through *inter alia* their Development Committee, debt reduction initiatives and financial stability reviews, means that reform of European representation in one of these organisations without accompanying reform in the other would create complications. But this general argument, that reforms in different areas are strongly complementary, clearly holds less water in the case of governance reform.

The IMF as the place to start

The logical place to start is with European representation at the IMF. It is not clear that different European countries have very different preferences regarding country surveillance, multilateral surveillance, and emergency lending, the IMF's three core activities. The major European countries are unlikely to have to resort to the IMF for financial assistance. To be sure, individual member states may have different attitudes regarding assistance for non-EU countries insofar as there are differential implications for their residents. Thus, Spain and Italy were more sympathetic to arguments for an international rescue package for Argentina in the summer of 2001 because their banks and households had high levels of exposure there. But it is not clear that this heterogeneity of exposures with respect to external financial conditions is any greater than heterogeneity in domestic exposures (some European banking systems are more exposed than others to, *inter alia*, European housing markets), and this has not hindered the adoption or pursuit of a common monetary policy by around half the members of the European Union²³. As Europe develops a

more integrated financial market with pan-European banks whose shares are held by residents of all European countries, and not just residents of the country where the bank was founded, national differences will figure even less in this calculus.

The same point applies to the IMF's multilateral surveillance and consultations over issues like global imbalances. Insofar as members of the euro area are concerned about a disorderly correction of global imbalances, they will be affected through the same channel, namely, appreciation of their common exchange rate against the dollar. They thus have a common interest in preventing the euro from appreciating excessively. That the members of the euro area have this shared interest has already been acknowledged by the IMF, in that it has invited the euro area, and not individual European states, to participate in its first multilateral consultation on the issue of global imbalances. To be sure, European countries differ in their dependence on the US and Chinese export markets (see Table 5.2), but these differences are not pronounced enough seriously to hinder the adoption of a common policy stance.

Indeed, the very existence of the euro provides a rationale for consolidating euro area representation in the Fund that does not also carry over to the World Bank, the G7 or the G10. The IMF is fundamentally concerned with the management of balance-of-payments problems, something that cannot exist within a single currency area. Historically it has focused on exchange rates, and the euro area has only one exchange rate vis-à-vis each extra-euro-area country. IMF quotas are traditionally set using formulas that attach weights to a member's external trade and payments, and

Table 5.2: Euro area trade with China and the US (percent of GDP)*

	Exports to				Imports from			
	China		US		China		US	
	1998	2005	1998	2005	1998	2005	1998	2005
Austria	0.3	0.8	1.2	2.4	0.4	0.9	1.1	0.9
Belgium	0.7	1.4	3.5	5.4	1.1	3.6	4.9	4.4
Germany	0.5	1.1	2.3	3.1	0.6	1.6	1.4	1.4
Spain	0.2	0.2	0.8	0.7	0.5	1.1	1.1	0.7
Finland	1.4	1.2	2.5	2.1	0.5	1.3	1.6	1.1
France	0.5	0.5	1.7	1.6	0.4	0.9	1.6	1.2
Greece	0.1	0.1	0.4	0.4	0.5	1.0	1.1	0.8
Ireland	0.5	1.0	9.7	10.3	0.8	1.1	7.9	4.7
Italy	0.4	0.5	1.7	1.7	0.4	1.0	0.9	0.8
Netherlands	0.4	0.7	2.0	2.8	1.9	5.6	4.7	4.5
Portugal	0.1	0.2	1.0	1.1	0.3	0.4	0.9	0.7

* Source: Ahearn and von Hagen (2006). Data for Slovenia are not included.

the advent of the euro suggests removing intra-euro-area trade and payments from these calculations.

In addition, the infrastructure for reaching joint positions is relatively well advanced. As described above, SCIMF prepares the work of the EFC on the IMF and related issues. Documents agreed by SCIMF and endorsed by the EFC are then passed to European EDs with the intent of defining a common position. There is also the EURIMF, the grouping of European representatives, which seeks to coordinate European greys, and the EU presidency grey mechanism in which European EDs attempt to reach agreement on support for the EU presidency grey. These arrangements can provide a springboard for further moves in this direction.

Finally, the swing-voter analysis of Bini-Smaghi (2006b) and Leech and Leech (2005) suggests that Europe can reduce its voting share without weakening its influence if it at the same time undertakes reforms that allow it to vote as a bloc.

If the advantages of a unified position are so pronounced, why are European countries not more open to the idea? One factor here is mixed constituencies (see Table 5.3). A number of the constituencies headed by European countries include also other countries with very different characteristics and preferences. European countries in such constituencies (Belgium, Netherlands, Spain, Italy, Ireland, Denmark, Finland, Sweden and the Baltic states) must temper their positions in order to reach common ground with non-European and non-EU members. This is less of a problem than it once was, insofar as eastward expansion has brought all members of the Nordic-Baltic constituency except for Iceland into the EU. The constituency of which Belgium is the largest member includes ten countries, only three of which (Belarus, Khazakstan and Turkey) are not EU members. In the constituency of which Italy is the largest member, only Albania, San Marino and Timor-Leste are not EU members, and it might be argued that this trio is too small to affect much the position of their director. But Poland and Spain are both in constituencies with seven non-EU members. The Netherlands and Cyprus are in a constituency with 10 non-EU members. Ireland is in a constituency with 11 non-EU members. Clearly, these countries may find it difficult to subscribe to a common EU position.

Another factor is that the IMF Articles of Agreement make no provision for admitting the euro area or the European Union as IMF members; they recognise only individual countries. But if the Articles of Agreement are an obstacle to sensible action, then they can be changed. The Articles have in fact been amended repeatedly in the past. If amendment is difficult, then the Articles can be interpreted flexibly, as was the case when Egypt and Syria sought to form the United Arab Republic in the

Table 5.3: IMF constituencies*

United States	Japan	Germany	France
United Kingdom	Austria , Belarus, Belgium , Czech Republic, Hungary, Kazakhstan, Luxembourg , Slovak Republic, Slovenia , Turkey	Armenia, Bosnia Herzegovina, Bulgaria, Croatia, Cyprus, Georgia, Israel, Macedonia, Moldova, Netherlands , Romania, Ukraine	Costa Rica, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Spain , Venezuela
Albania, Greece , Italy , Malta, Portugal , San Marino, Timor-Leste	Australia, Kiribati, Korea, Marshall Islands, Micronesia, Mongolia, New Zealand, Palau, Papua New Guinea, Philippines, Samoa, Seychelles, Solomon Islands, Vanuatu	China	Antigua and Barbuda, The Bahamas, Barbados, Belize, Canada, Dominica, Grenada, Ireland , Jamaica, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines
Denmark Estonia Finland Iceland Latvia Lithuania Norway Sweden	Bahrain, Egypt, Iraq, Jordan, Kuwait, Lebanon, Libyan Arab J. Maldives, Oman, Qatar, Syrian Arab Rep., U.A. Emirates, Yemen, Rep. of	Saudi Arabia	Brunei Darussalam, Cambodia, Fiji, Indonesia, Lao People's Dem. Rep., Malaysia, Myanmar, Nepal, Singapore, Thailand, Tonga, Vietnam
Angola, Botswana, Burundi, Eritrea, Ethiopia, Gambia, Kenya, Lesotho, Malawi, Mozambique, Namibia, Nigeria, Sierra Leone, South Africa, Sudan, Swaziland, Tanzania, Uganda, Zambia	Azerbaijan, Kyrgyz Rep., Poland, Rep. of Serbia, Switzerland, Tajikistan, Turkmenistan, Uzbekistan	Russian Federation	Afghanistan, Algeria, Ghana, Iran, Morocco, Pakistan, Tunisia
Brazil, Colombia, Dominican Rep., Ecuador, Guyana, Haiti, Panama, Suriname, Trinidad & Tobago	Bangladesh Bhutan India Sri Lanka	Argentina Bolivia Chile Paraguay Peru Uruguay	Benin, Burkina Faso, Cameroon, Cape Verde, Cen. African Rep., Chad, Comoros, Congo, Dem. Rep., Congo, Rep., Côte d'Ivoire, Djibouti, Equatorial Guinea, Gabon, Guinea, Guinea-Bissau, Madagascar, Mali, Mauritania, Mauritius, Niger, Rwanda, São Tomé Príncipe Senegal, Togo

* Euro area countries in bold

1950s. Finally, it is not clear that meaningful reform requires recognising the euro area or the European Union as an IMF member. It might simply be possible to reorganise constituencies so that the members of the euro area are all members of one constituency, which is then free to elect or choose its own chair, while other EU member states are members of a second constituency with the same prerogative. The members of these two constituencies could ultimately be consolidated into one constituency, if the members so chose, without requiring a change in this provision of the Articles of Agreement.

Another variation on this theme would be to reorganise Europe not into two constituencies but into six or seven. Truman (2005) has previously suggested that the consolidation of European representation might be done in stages so as not to overreach the development of political will. A first step would be to transfer EU members (Poland, Spain, Ireland) not presently in EU-headed constituencies to EU-headed constituencies. The second step would then be to transfer non-EU countries (Kazakhstan, Timor-Leste, Armenia, Bosnia, Croatia, Georgia, Israel, Macedonia, Moldova, Ukraine) to other non-EU headed constituencies. Later the EU-headed constituencies could be consolidated. This would be a more modest variation on our proposal²⁴. It would also be consistent with the strategy of learning by doing through incremental reform.

The positions of the members

Although Bini Smaghi (2006b) and Leech and Leech (2005) suggest that the members of the euro area, were they to form a coalition, would become critical swing voters in the IMF, individual member states might lose voice or voting power as a result of forming such a coalition. Smaller euro area countries that currently possess a seat at the Board table would be concerned about losing voice, since they would not have the same capacity to contribute to the formulation of a consensus among directors on important policy questions²⁵. They would be compensated, however, because the single European representative would be even more influential in the development of that consensus, insofar as voice is correlated with the number of votes possessed by his/her constituency.

They could be further compensated by adopting internal voting rules giving heavier weights to smaller countries for deciding the positions of the European director. In an extreme case, one can imagine a process whereby all members are weighted equally – one country, one vote as in the Executive Board of the ECB. Naturally this is unlikely to be congenial to large European countries accustomed to having more votes in the Fund than their smaller neighbours. In fact, Leech and Leech (2005)

show that all EU countries would gain voting power in the Fund if the constituency's position is determined by simple majority voting using current IMF weights and on the basis that the single European chair would have the same voting power as the US²⁶. Even here, individual EU members would see their effective voting power strengthened, compensating them in part for giving up their separate seats at the Board table²⁷.

Given this, what are the prospects for reform? The European Parliament seems favourably inclined, adopting in March 2006 a resolution on the strategic review of the IMF. This called on member states 'to work towards a single voting constituency – possibly starting as a euro constituency, with a view, in the longer term, to securing consistent European representation, involving the Ecofin Council presidency and the Commission, subject to the European Parliament's scrutiny.'

Ultimately, however, the prospects for reform depend on the attitudes of the member states. Italy has probably been the most strongly supportive of coordination in the Bretton Woods institutions. Phillips (2006b) suggests that it may be inclined toward more centralised European representation because it is already in a constituency with Portugal, Greece and Malta and therefore has some experience with cooperative decision making²⁸.

France and Germany, traditionally the motors of European integration, have been sympathetic in the past. Phillips (2006b, p.19) reports that both countries 'have previously stated a willingness to consider single European representation or a combined seat in the [Bretton Woods institutions], although these proposals were perhaps made because they were inherently unlikely to be implemented (and in the context of enhancing Franco-German friendship rather than in the context of genuine commitment to global governance reform).' In 1998 the French Finance Minister, Dominique Strauss-Kahn, publicly floated the idea of a Franco-German chair at the IMF²⁹. In 2003 the German Development Ministry proposed a double-majority voting system for the Bretton Woods institutions, which would give more voice to populous developing countries (German Ministry for Economic Cooperation and Development 2003). A Franco-German contribution to the European Convention, from 22 December 2002, stated that: 'With respect to the external representation of the euro area, France and Germany share the view that a single representation in IFIs such as the IMF will be the adequate voice of an integrated Europe' (cited in Eurodad 2006, p.21).

More recently, positions appear to have hardened. German Bundesbank President Axel Weber recently urged caution about IMF reform, saying: 'A broad package has to

be found for a more transparent and fair representation of all IMF members. To that end, European Union countries should not prematurely relinquish their own justified positions and claims' (EurActiv 2006). Germany's seemingly dimmer view of the notion of a unified European seat brings the German position more in line with the results of the voting power analysis above, and may also reflect some recent ebbing of enthusiasm for closer European integration. Following the IMF/World Bank annual meetings in September 2006, German's Ministry of Finance included Germany in the set of countries that are underrepresented in the IMF (Steinbrück 2006). German Finance Minister Peer Steinbrück told reporters in Singapore that as the world's third-largest economy – after the US and Japan – Germany deserved to keep its influence in the IMF (Deutsche Welle 2006). He balked at US suggestions that the size of a country's GDP should be given a predominant role as part of the planned overhaul³⁰. Germany was similarly behind the statement prepared by European Union members for the G20 meeting in Sydney in October 2006. This argued that any redistribution of voting rights within the Fund should favour only 'the most underrepresented members' and warned that 'it would be premature to press for changes in the size and composition of the executive board'³¹.

The UK's position is likely to be similarly sceptical, since the country has reservations about anything that smacks of euro-federalism. But the UK Treasury and Bank of England have been outspoken about the need for IMF reform, and this makes it difficult for the country now to obstruct other EU countries' efforts to consolidate their representation. Moreover, the precedent of monetary union suggests that the British government will not stand in the way if other EU member states wish to go ahead. This suggests that, initially, consolidation will take the form of the members of the euro area joining together in a single chair.

But these observations also suggest that consolidating under a second chair representation of the UK, Sweden, Denmark and those central and eastern European member states that have not adopted the euro may be less feasible in the short run. Even were the UK to be made the permanent representative on the board of that constituency, it would be unlikely to welcome a switch from exclusive representation to a constituency in which it would have to reach common positions with other members, at least in the short run. This suggests that the first step, a single chair for the members of the euro area, is likely to come more quickly than the second step, a single chair for other EU members. Again, however, there is no reason why Europe might not move incrementally.

Conclusion

Europe's fragmented representation in the arenas where international monetary and financial policy is made causes it to punch below its weight. Although the US is no bigger than Europe, it has been able to exert more influence in the operation of the Bretton Woods institutions, and the other venues where these issues are discussed, precisely because it speaks with one voice. Europe's numerical overrepresentation on the boards of the International Monetary Fund and World Bank and in the G7 and G10 is also seen as undermining the legitimacy of these organisations. Europe's reluctance to cede seats on these global steering committees causes it increasingly to be regarded as an obstacle to fundamental governance reform. The ultimate result of this reluctance may be that Europe will be amply represented on a set of irrelevant committees, as emerging markets use their international reserves to set up regional rivals to the IMF and World Bank and the US substitutes bilateral consultations with China for the G7 process. Together these observations constitute a compelling argument for unifying Europe's representation so that chairs can be freed up for underrepresented emerging markets, enhancing the legitimacy of existing global institutions, but without diminishing – and, indeed, with the possibility of enhancing – Europe's influence over their operation.

But the obstacles to progress in this respect remain formidable. The difficulties of EU member states in attempting to define a single foreign policy carry over to foreign monetary and financial policies. Member states with different views of monetary and financial issues are not convinced that their positions would be more effectively advanced by a single European representative. Smaller member states that have inherited privileged positions resist calls for self-sacrifice. They are reluctant to give up what remains their most visible link to their historical status as global powers. But this dilemma is artificial; to repeat, if EU members do not give up their excessive numerical representation in the institutions of global monetary and financial governance, those institutions will fall by the wayside.

This lends urgency to the efforts to reorganise Europe's representation in these arenas. We have suggested an incremental strategy. Start with the IMF, where preferences are relatively homogeneous, and the infrastructure conducive to the harmonisation of member states' positions is relatively well developed. If the member states discover, as we expect, that their influence is strengthened without forcing them significantly to compromise their views, then it will be possible similarly to move forward in other international organisations and groupings. The strategy may be risky, but the alternative is less pleasant to contemplate.

Notes

- 1 For helpful comments we thank our discussant, Thomas Wieser, and other participants at the conference on Europe and the Global Economy, Brussels, 12-13 October 2006.
- 2 In this chapter, we focus on the EU's monetary and financial relations with the rest of the world rather than its economic relations generally, or its trade policies in particular, since EU trade policy is organised very differently, this competence long ago having been given to the European Commission.
- 3 See Tables 5.1 and 5.3 for membership of selected international forums, and for International Monetary Fund constituencies.
- 4 Like Sweden, Denmark, and 11 of the 12 new EU member states at this stage.
- 5 See for example Mahieu, Ooms and Rottier (2003), who argue that the EU member states would be prepared to become a full-fledged single member of the IMF only if they were willing to assign to the Union responsibility for a common foreign policy.
- 6 We will describe below how the monetary and financial issues that are the subject of this chapter were treated at the convention.
- 7 The 180 plus members of the International Monetary Fund and the World Bank are organised into 24 constituencies or groups of countries, each of which is represented by one member on the institution's Executive Board.
- 8 See eg Phillips (2006a).
- 9 There are other arguments as well, as we detail in the fourth section of this chapter, notably that the underrepresentation of Asian countries on the Executive Board, which is increasingly viewed as the mirror image of Europe's overrepresentation, poses a challenge to the legitimacy of the institution. In other words, the rationalisation of European representation that has as a byproduct the freeing up of additional chairs for other regions would lessen the pressure for Asian countries, in particular, to set up a rival regional arrangement on the basis of the Chiang Mai Initiative, weakening the existing multilateral framework.
- 10 In practice, things are even more complicated. For example, officials of the European Commission have dealt directly with the heads of the World Bank and the IMF, without the intermediation of the Council, to discuss issues such as international financial assistance to the Balkans. The Commission is a member of the Financial Action Task Force on countering money laundering along with most EU member states (Truman 2004). On these international economic issues, the Commission and not the Council appears to take the lead role.
- 11 Bini-Smaghi (2004) argues that this is made possible by the fact that European countries share common views on matters of multilateral surveillance of the major economies and the world economy. But it can also be argued that the EURIMF's president's speech is weak soup because it cannot contain anything objectionable to any of the EU countries represented on the Board. Again, this is indicative of the limits of soft coordination.
- 12 Dolan and Bull (2006).
- 13 A previous analysis of this case, on which we rely here, is Henning (2006).
- 14 'Uneasy' because only if sterilised intervention is effective, on the grounds that domestic and foreign bonds are imperfect substitutes for one another, is it possible for finance ministers to attempt to move the exchange rate without getting a concession from the central bank to alter monetary policy. The literature on the effectiveness of sterilised intervention is large. See *inter alia* Dominguez and Frankel (1993).
- 15 Generally speaking, 'the ECB decides on and carries out operations in the foreign exchange market. The overall framework in which exchange rate policy is conducted is the competence of the Eurogroup, in consultation with the ECB' (Bini Smaghi 2006a). The way that responsibilities for

- exchange rate policy are shared among the different European institutions is set out in Article 111(1) of the EU Treaty.
- 16 As Henning (2006, p.12) puts it, European finance ministers decided that 'it would not be appropriate to attempt to force or instruct the Eurosystem to intervene.'
 - 17 Henning (2006), p.24.
 - 18 Although the decision to proceed unilaterally may have also reflected the approach of the US presidential elections, which left that country's treasury preoccupied by other matters.
 - 19 Ahearne and von Hagen (2006) and Lane and Milesi-Ferretti (2006) offer European perspectives on global imbalances.
 - 20 Some will observe that there are 24 members of the Executive Boards of the International Monetary Fund and World Bank, as mentioned elsewhere, but this is a much more heavily institutionalised context. Directors meet three times a week throughout the year, which enables them to routinise their procedures to a much greater extent than G7 principals and deputies. In any case, a number of authors (eg Truman 2005) argue that the IMF Executive Board could be usefully streamlined by reducing its size.
 - 21 The US has, in fact, committed to not asking for an increase in its share in the course of the current quota revision process.
 - 22 It would of course be further reduced if intra-EU transactions were not included in this calculation, which of course is not likely in the absence of more far-reaching reform.
 - 23 It can also be argued that there exists similar heterogeneity within the US, but that this has not prevented the country from agreeing on a policy toward the IMF. Recall the conflicts between large money centre banks and smaller banks in the interior of the country over developing country debt (and the difficult of getting the latter to participate in the Baker Plan). Or recall Paul O'Neill's criticism of the IMF in 2001 that it was squandering the hard-earned savings of American plumbers and carpenters. This again alludes to the fact that not all segments of US society felt the same way about the merits of emergency lending.
 - 24 It is sometimes argued that reorganising the constituency situation so that EU members were represented in exclusively EU constituencies might also have a downside. The increasing politicisation of the International Monetary Fund partly reflects the division of the institution into lending and borrowing countries (Rajan 2006, Mahieu, Ooms and Rottier 2003). Mixed European constituencies have provided at least one counterweight to this. That moderating influence would be weakened by the move to a single European chair. We are not entirely convinced by this argument. Which countries are borrowers and lenders in the Fund is not set in stone – Asian countries that have borrowed in the past but are now flush with reserves are considerably less likely to borrow in the future, for example – making the design of the constituency system less than ideal for addressing this polarisation. Others like Kenen *et al.* (2005) and King (2006) have suggested alternatives for addressing this problem.
 - 25 Thus, for example, the Dutch have been vocal opponents of any reorganisation of the IMF Board that might result in their losing their existing chair. See Zalm (2006).
 - 26 A not unreasonable assumption in view of the quota formula and balance of power within the Fund.
 - 27 This is less likely if the EU position is decided by the double-majority voting procedure of the Nice Treaty, which would require the agreement of a substantial supermajority before the European chair could take a position. In this case the EU would be unable to act as the decisive swing voter on many issues (where the requisite supermajority was absent).
 - 28 But the country has not always been consistent here: Italy encouraged Timor Leste to join its constituency in 2002, in a step away from exclusive European representation.
 - 29 Corrales-Diez (2003) reports that the French government has also supported the concept of a single chair, at least in principle.

30 Also in Singapore, the Netherlands expressed reservations about the complex plan on the opposite grounds that it would see its voting power diluted. The formula needed to be improved and could not be prejudged, Dutch Finance Minister Gerrit Zalm said.

31 Both quotes are from Swann and Louis (2006).

6

Competition policy: Europe in international markets

Olivier Bertrand and Marc Ivaldi¹

Changes in the institutional, technological and economic environment raise new challenges for European competition policy. First, firms' behaviour, particularly through international mergers and acquisitions (M&A) and hard-core cartels, could undermine benefits from globalisation. Together with the evolution towards more economic liberalisation, markets have been reshaped by important technological improvements, putting forward new issues in terms of antitrust policy, as shown recently by the Microsoft case. Lastly, these changes have been progressively accompanied by a new institutional competition framework. The dramatic increase in the number of competition authorities incurs a waste of resources for multinational firms and antitrust authorities and the risk of conflicting decisions between competition authorities. In parallel to these modifications, the EU has launched a vast programme of reforms to modernise European antitrust policy. Both the institutional framework and substantive laws are under reconstruction. It has notably driven an ongoing decentralisation process of antitrust law enforcement and the creation of the European Competition Network (ECN).

In this context, it is timely for European authorities to appraise the external dimension of European competition policy as well as its link to current internal reforms. Globalisation can increase the costs of monitoring and seriously reduce the ability of European authorities to tackle cross-border anti-competitive conducts. In addition, conflicts are exacerbated by industrial policy motivations – sometimes called economic patriotism – and 'beggar-thy-neighbour' policy.

As it is unlikely that the sole application of the territoriality and extraterritoriality principles to competition rules can yield an optimal international competition sys-

tem, globalisation calls for higher levels and types of cooperation. Given that bilateral cooperation, especially the implementation of comity principles, may be of no value when laws or interests are sources of international conflicts, three main paths could be therefore encouraged: the continuous harmonisation of rules through the joint action of OECD and the International Competition Network (ICN) especially in the context of new-technology-based industries, which are a source of divergence among antitrust authorities; more cooperation in confidential information exchange; the establishment of global antitrust institutions.

However, if the World Trade Organisation (WTO) could serve as an institution to regulate global markets, especially thanks to its reliable dispute settlement body, it could certainly be relevant to distinguish trade and non-trade related competition affairs. Although WTO is legitimate in judging questions related to market access and entry barriers, it is less equipped to assess international hard-core cartels or M&A reviews. As a substitute for WTO, a multi-level system, like the EU system, could be promoted. For political and pragmatic reasons, it could be composed as a first step of a core of countries like the EU, Japan and the US. It could be associated with the creation of an international court of justice for competition. In addition to these external reforms, some internal reforms might be required. Competition authorities have to develop further competition advocacy to give a higher priority to competition issues in other EU policies and national regulation. A parallel and complementary reform could consist in making the European competition agency independent from member state interference.

Competition policy challenges

Competition policy and its enforcement face new challenges with the world wide development of trade and investment liberalisation, as well as widespread changes in technologies and institutions. This chapter has a threefold objective. It describes this new context; then it explains how European competition policy accounts for this evolving situation; finally it proposes guidelines which should or could be followed in the future.

With the advent of globalisation, market structures and the economic environment have been deeply transformed. Improvements in transport and communication, together with the gradual removal of tariff barriers, have lowered transaction costs. They have also stimulated trade flows, which has tended to reduce domestic prices and widen the range of goods available to consumers and industries. Coupled with a less strict foreign investment regime, trade liberalisation has also encouraged foreign direct investments (FDI) and the expansion of multinational firms (MNE).

Trade and FDI could be associated with pro-competitive effects on host countries. However, these gains have appeared quite fragile and reversible. In the 1980s, benefits from trade liberalisation eroded with the appearance of less transparent non-tariff barriers and contingent protection. One decade later the concern that, without the intervention of competition authorities, firms' behaviour could in addition undermine market integration and international competition became more pronounced. State barriers could be substituted by private barriers, especially through vertical contracts, as in the famous alleged Kodak/Fuji case in 1996² (Kojima 2002). In addition to vertical arrangements, companies could be tempted to recover profits and to restore market power, weakened by economic openness, through cross-border M&A or international hard-core cartels.

Cross-border M&A activity has played an increasingly acknowledged role in the growing globalisation of production since the beginning of the 1990s. They progressively replaced greenfield investments as a means of entering foreign markets throughout the 1990s³. The composition of FDI changed radically.⁴ During this period, about 80 percent of FDI transaction value took the form of M&A (UNCTAD 2000). The 1990s indeed saw a spectacular surge in M&A activity⁵ (eg Bertrand *et al.* 2007, Evenett 2003, and Hijzen *et al.* 2005). This phase was mainly characterised by the dramatic growth of cross-border operations. In 1999, the value of completed cross-border M&A was around \$720 billion (UNCTAD 2000). In the 1990s, cross-border M&A represented more than one quarter of total M&A transactions in deal value. This wave of cross-border M&A seems to have been induced by economic openness, although there is a lack of clear-cut empirical and theoretical evidence, as research on international M&A is still in its infancy⁶ (Bertrand and Zitouna 2006b).

Two strands of empirical study are noticeable. First, the welfare impact of cross-border M&A is considered as ambiguous (eg Horn and Persson 2001, Norback and Persson 2004 and 2007). However, there are reasons to expect positive welfare gains. Indeed efficiency gains could be greater for cross-border M&A due to a higher complementarity between merging partners, creating for instance a larger diffusion of know-how within the firm. In addition, reduction in competition could be less prevalent due to a smaller overlap of markets. Second, recent empirical studies seem to confirm rather positive effects of M&A on productivity or R&D activity (eg Arnold and Smarzynska 2005, Bertrand and Zitouna 2006a, Bertrand and Zuniga 2006). However, M&A continues to raise many concerns, especially in the public debate, as shown by the strong reaction of French politicians to the rumour of a take-over of the French company Danone by Pepsi Co and the reaction of US politicians after the attempt of the Chinese company CNOCC to acquire the American

petroleum firm Unocal. Concern is accentuated by the ineffectiveness of domestic competition policies when these operations could entirely or partially fall outside the control of national jurisdictions. The years 2001-2002 marked the end of the fifth wave in contemporary capitalism. The very recent years seem to indicate a recovery in M&A activities, and notably in cross-border restructuring (European Commission 2006d).

Besides M&A, international hard-core cartels also jeopardise benefits from globalisation⁷. The presence of international cartels has been highlighted by the condemnation of the lysine, citric acid and vitamins cartels. Connor (2004) registers around the world more than 160 international cartels discovered between 1990 and 2003. All together they were fined an amount of \$10 billion. Modern international cartels have distinct features (Connor 2004, Evenett *et al.* 2001, Levenstein *et al.* 2004). Their members come mainly from the developed world, ie the US and the EU, but also sometimes from Asian countries, particularly Japan and South Korea. They involve large multinational firms, selling products and services made globally. These companies are fully aware of antitrust rules. Multinational firms are more frequently in contact. The risk of collusion might be higher⁸. They could also be more readily suspected anyway of anti-competitive behaviour, such as blocking entry or using predatory pricing. Indeed, multinational firms might be endowed with higher market power. MNEs are operating in concentrated markets with high entry barriers (UNCTAD 1997). They usually make huge investments in R&D and marketing. These intangible assets confer large scale economies. They sell complex and differentiated products too. They have deeper pockets and fewer external financing constraints. They might also manipulate transfer prices to their benefit.

Nevertheless, the clandestine nature of much anti-competitive behaviour makes it particularly difficult to know if this recently observed trend is a statistical fact attributable solely to an improvement in the methods and means of detection of competition authorities or, if not, to understand why international cartels are more and more frequent. As with international M&A activity, economic literature on international cartels is also lacking. However, this phenomenon is again doubtless related to globalisation. For instance, globalisation improves communication and then fosters coordination and more collusive market outcomes. There is a conjecture that, with economic integration, some markets could become more concentrated, which could also facilitate collusion⁹. Most notably, harm to competition, efficiency and welfare could be substantial, especially for developing countries endowed with weak anti-cartel regimes. For all these reasons it is not surprising that, for several years now, international cartel prosecution is a high priority on the agenda of the EU and US authorities. Without information-sharing and coordination between

antitrust authorities, the ability of authorities to prosecute international cartels can be seriously hampered. As there are major difficulties in collecting the necessary evidence and interviewing witnesses abroad, as explained by Schoneveld (2003), cooperation between competition authorities has become crucial.

Together with the trend towards more economic liberalisation, markets have been reshaped by major technological improvements over the last twenty years. These technological changes have been partly related to trade openness. Larger product markets stimulate innovation involving high fixed costs of research and infrastructure, as they offer larger expected returns. One of the main features of recent technological progress has been the development of network-based industries (Röller and Wey 2002, and Evenett *et al.* 2000). These are characterised by a high level of concentration. The leverage of market power from one product to another could lead to global dominance and its abuse, as some parties have argued in the Microsoft case. Network externalities tend to favour industrial concentration too: the value of a consumer product depends on the number of other consumers. Firms are then encouraged to gain first-mover advantage by lowering prices and expanding sales, reinforcing demand. Consumers can benefit from national and international externalities and complementarities, but may also be hurt by associated switching costs and lock-in effects. As network effects can favour concentration and/or cooperation among firms, eg on standard-setting, product compatibility, or licencing, regulators need to rethink the economic framework and to adapt the tools of competition policy. This will constitute a new source of antitrust debate and thereby likely disagreements among academics and competition authorities, as shown again very recently by the case of Microsoft¹⁰.

The economic and technological changes have indeed been progressively accompanied by a new institutional framework for competition policy. For some years now, there has been a dramatic increase in the number of competition authorities. In 1989, only eleven developing countries and twenty OECD members had competition laws (Schoneveld 2003). By 2003, more than one hundred countries had adopted competition rules. As a consequence, the overlapping of domestic regimes has entailed duplicate legal costs and a waste of financial and human resources for multinational firms. It also represents additional costs for antitrust monitoring as a result of multiple reviews, redundant filing and reporting. Besides, it is a source of political and business uncertainty. Different authorities' decisions on a given case can be contradictory, leading to conflict and even the risk of trade war as in the Boeing/McDonnell Douglas case¹¹. All these drawbacks are amplified when antitrust rules are different from one country to another and/or when the expected impact of alleged anti-competitive behaviour differs across countries.

The modification of the institutional, economic and technological environment poses new challenges to current European competition policy, which has been under continuous reconstruction for several years. It is important to recall that the beginnings of European antitrust regulation are traceable to the Treaty of Paris and the creation of the European Coal and Steel Community in 1951. European competition laws were formally established in the Treaty of Rome in 1957. Competition policy basically aims to promote and safeguard competition and the operation of the market to the benefit of the economy. Antitrust rules are to be found in Articles 81 to 89¹². The core of European competition policy is Article 81 on horizontal and vertical restrictive agreements and Article 82 on the abuse of dominant positions¹³.

Merger regulation was born later, in 1989¹⁴. The European Commission is setting up one-stop-shop regulation and introducing guidelines with the aim of reducing business uncertainty. Both reforms were supported by the business community (OECD 2005b). The increasing number of large European cross-border mergers called for more transparent and quick scrutiny. The single market programme also demanded a stricter enforcement of competition rules.

The EU has again launched a vast programme designed to modernise the European antitrust regime. Both the institutional framework and substantive laws are being reformed. First, there has been an ongoing process of decentralisation, with joint responsibility of the Commission and national authorities for enforcing antitrust laws. It was accompanied by the creation of the European Competition Network (ECN) in May 2004 and the application of the new 2003 regulation^{15,16}. Second, the notification system for agreements has been abolished. The legal exemption regime shifts from an ex-ante to an ex-post monitoring system. It permits the reallocation of European resources to the prosecution of hard-core practices. The Commission has been endowed with new powers in terms of investigation, sanction and decision. Finally, substantive laws are switching from a more legalistic to a more economic approach, affecting all antitrust fields.

This policy of reform is driven by the momentum in the liberalisation process of sectors like gas, electricity or telecommunication, and the enlargement to the central and eastern European countries. It implies the rationalisation and reorganisation of the antitrust regulation framework. Furthermore, the modernisation of merger policy through the new merger regulation of 2004 was inevitable since several decisions of the Commission were rejected by European courts in 2002 (as in the case of *Airtours/First Choice*, *Tetra Laval/Sidel* and *Schneider/Legrand*)¹⁷. These developments led to the dissolution of the Merger Task Force after 2003 and the hiring of a chief competition economist. More generally, the evolution of antitrust laws stems

from an increasing awareness of the importance of sound economic analysis in policy and decision-making.

This awareness of the EU has been stimulated by discussions and work carried out in different institutional arenas, such as the International Competition Network (ICN) or the OECD. European competition reforms should also be seen in the context of the EU's Lisbon Strategy for growth and employment. For a long time, the main objective of European competition policy was the construction of an integrated European market. With the progressive achievement of the internal market, the objective of market integration is less of a priority. It has been progressively replaced by economic efficiency aims. This new objective was enhanced in 2000 with the agreement on the Lisbon Strategy. The goal is to make the EU 'the most competitive and dynamic knowledge-based economy in the world capable of sustaining economic growth with more and better jobs and greater social cohesion' by 2010¹⁸. As clearly underlined by the Commission's 2004 annual report on competition policy, the task of the European authorities is to enforce and foster competition in order to improve economic efficiency, increase productivity growth and promote the competitiveness of the EU on global markets (Monti 2003, 2004a, 2004b).

In this context of ongoing reforms driven by multiple but convergent factors, the international dimension of European competition policy is becoming more prominent, raising new issues. It is necessary fully to understand these issues and to take account of both the external and internal dimension of European reforms. A key point is that globalisation can increase the costs of monitoring and seriously reduce the ability of European authorities to tackle cross-border anti-competitive conduct. In addition, conflicts are exacerbated by industrial policy motives – sometimes called economic patriotism – and 'beggar-thy-neighbour' policy. Since the territorial and extraterritorial application of competition rules is, on its own, unlikely to lead to an optimal international competition system, globalisation calls for a higher level of cooperation. This cooperation involves the adoption of a package of hard and soft laws, at a bilateral, plurilateral – notably via the inclusion of antitrust provisions in regional trade agreements – and multilateral level through different institutions such as the ICN, the WTO or the OECD. This requires a higher degree of neutrality and credibility of action, as well as the influence of European competition authorities within Europe.

The second section of this chapter describes the institutional aspects and the different instruments of the external dimension of European competition policy. The third section recalls the theoretical and empirical arguments presented in the economic literature that are the basis for designing competition policy in international

markets. The final section draws on these elements to provide some recommendations for the European competition policy of today and of tomorrow.

The external dimension of European competition policy

While Articles 81 and 82 of the Treaty of Rome are the cornerstone of European competition legislation, they do not define the scope of European jurisdiction explicitly, as noted by Kojima (2002). They state that alleged practices ‘may affect trade between member states’ and may have ‘an anti-competitive effect in the common market’. The impact of trade can be ‘direct or indirect, actual or potential’ (Sugden 2002, Hamner 2002).

European rules apply to practices impacting inter-state trade (Grisay 2005). Abuses of dominant position and prohibited arrangements are subject to EU law if they affect intra-European trade, irrespective of whether the abuse originates in the EU or in non-EU countries, ie regardless of the nationality of the parties to the abuse. It is usually the situation of a company whose activity covers several member states. It is also required that the anti-competitive impact takes place within the single market. The rules guarantee free competition within the EU.

This section depicts the institutional and political framework of external features of European competition policy, in other words the application and interpretation of the extraterritoriality principle over time in Europe, the bilateral and plurilateral agreements established with main trading partners (mainly through regional trade agreements) and the multilateral negotiations in the framework of the WTO, OECD, ICN and The United Nations Conference on Trade and Development (UNCTAD).

The extraterritoriality principle

Articles 81 and 82 are consistent with the objective of an integrated European market, as they define the geographic application of EU law and specify the competences of the European Commission and the member states. Nevertheless, they are silent as to the behaviour of companies outside the EU. Thus, the EU was obliged to use two other principles to solve this question of competence: the so-called economic unit and extraterritoriality principles (Grisay 2005).

Both in the Dyestuff case in 1972 and in the Continental Can case one year later, both the European Court of Justice (ECJ) and the Commission refer to the unity of a group of firms¹⁹ (Davison and Johnson 2002). This principle assigns responsibility for the practices of affiliates established within the EU to their parent company

located abroad. The parent company has indeed a decisive influence on its subsidiary. The foreign parent is therefore viewed as acting within the EU. Increases in prices could be decided outside the EU and implemented by affiliates within the European market. This principle is consistent with the *territoriality principle*.

The *extraterritoriality principle* is applied when companies involved do not have affiliates within the EU market (Falvey and Lloyd 1999). It consists of the prosecution of firms whose anti-competitive behaviour affects a territory, irrespective of their country origin. National laws are applied to companies located within the territory of another nation. In 1977, the Commission stated for instance that they 'can act against restrictions of competition whose effects are felt within the territory under their jurisdiction, even if companies involved are located and doing business outside the territory, and of foreign nationality, have no link with that territory, and are acting under an agreement governed by foreign law' (Kojima 2002).

In the Wood Pulp case in 1988, the ECJ confirms the use of the extraterritoriality principle by the Commission²⁰. In 1984, companies from the US, Canada, Norway, Portugal and Spain were accused by the Commission of collusion on prices in the European wood pulp market, breaching Article 81. Defendants claimed that the EU lacked jurisdiction over them, since they were not established within the EU. Many of the defendants indeed had no affiliate within the EU. They also explained that one of the US defendants was involved in an export cartel which was legally authorised in the US. Thus, they argued, action against the cartel by the EU would have violated the public international law duty of non-interference. The ECJ rejected both these claims. First, asserting jurisdiction was justified on the ground that 'the producers implemented their pricing agreement within the common market. It is immaterial whether or not they had recourse to subsidiaries, agents, sub-agents, or branches within the Community in order to make their contacts with purchasers within the Community' (Sugden 2002). The justification for jurisdiction was based on the effects of their actions, and not on their location or nationality. This has been called the *implementation doctrine*^{21,22}. What matters is not the place where the agreement or the decision is made but where it is implemented, ie where products are sold. Here, the pricing agreement was implemented within the EU (Kojima 2002, and Fiebig 2005). Jurisdiction is grounded on the territoriality principle and thus recognised by public international laws. Second, the alleged breach of the public international law duty of non-interference was also rejected. It only occurs when the duties in one country are prohibited by the laws of another country. The ECJ finds no conflict in this case, since US laws were not infringed. US laws regulating export cartels do not include any requirement that firms should be exempt from EU competition laws (Sugden 2002, and Hamner 2002).

There was another judicial step with the Gencor/Lonrho case in 1999²³ (Davison and Johnson 2002). This case involved a merger between two South African companies. The Court of First Instance examined the geographic scope of the merger regulation and referred to the Wood Pulp case to confirm that the action of the Commission was legal²⁴.

This extraterritoriality principle, as all unilateral economic policy, presents some important drawbacks. Political limits are clear. Depending on the power of antitrust regulators, this principle can settle international antitrust issues. However, it can also amplify conflicts and thereby generate serious tensions. For instance, the Boeing/McDonnell Douglas case was accompanied by rumours and speculation of conflict escalation and retaliation by the US against the EU if the Boeing/McDonnell Douglas merger had been effectively sanctioned²⁵ (Aktas *et al.* 2000). There are also judicial limits. Countries have adopted measures to prevent what they often consider to be a violation of their sovereignty. We return later to the political impact of the extraterritoriality principle.

Bilateral agreements and regional trade agreements

The EU authorities have signed bilateral agreements to enhance information-sharing, the coordination of procedures and convergence on substantive issues²⁶ (Röller and Wey 2002). There exist different levels of bilateral cooperation, ranging from notification to negative comity (Bode and Budzinski 2005, Haucap *et al.* 2005).

First, cooperation could imply *notification*. A country aware of some potential anti-competitive practice notifies it to the relevant competition authority. Second, there could be *consultation*. Authorities help each other on the substance of an investigation, notably through an exchange of information. Two other cooperation mechanisms exist: negative and positive comity. They are less frequently included in agreements and take the form of non-binding commitments. They aim at preventing the extraterritorial application of domestic laws. The *negative comity* principle states that an authority has to take into account the consequences of its actions on the other country (Bode and Budzinski 2005). Each authority respects the sovereignty and interests of other countries. The *positive comity* principle states that a domestic authority acts on behalf of the foreign country against domestic firms adopting anti-competitive behaviour abroad. The domestic authority refers to its domestic laws to protect the interest of its partner country.

The EU has signed bilateral agreements with all its main trade partners (Grisay 2005). First, bilateral cooperation has been used to impose upon EU neighbour

countries a similar model of competition regulation. A first example is the European Economic Area and the Porto agreement which was signed in 1992 between the EU and the European Free Trade Association (EFTA) states. It aims to ensure identical conditions of competition and design of competition rules. It is based on a one-stop-shop principle where cases are allocated either to the EU or the EFTA authorities or on deep cooperation in terms of exchange of information or administrative assistance. A second example is the regional free trade agreement with the central and eastern European countries, in which competition provisions were included. A major condition for their accession was respect of European competition rules. Similarly, the Euro-Mediterranean free trade agreement contains competition provisions designed to promote convergence of laws and cooperation. Note that regional trade agreements, which are mainly signed between developed and less developed countries, have in recent years represented the main channel for disseminating antitrust rules. Provisions are often expressed in terms of market access. The purpose is to avoid trade agreements being undermined by anti-competitive practices (Evenett 2005a).

Second, links with non-neighbour countries aim to contribute to a higher level of cooperation and to some degree to convergence (Davidson and Johnson 2002). The Commission has formal cooperation agreements with Canada, Japan and the US. The Commission also maintains a relationship with Australia, China, Korea, and Mexico (OECD 2005b). The most important and comprehensive bilateral agreement was signed with the US antitrust authorities. Because of its economic importance and scope, we describe it in some detail.

Cooperation between the US and the EU was established in 1991. The agreement came into force in 1995 after being accepted by the EU Council of Ministers. In addition to notification of cases and exchange of information on general matters, the 1991 agreement is based on the traditional concept of (negative) comity, while it also includes the instrument of positive comity (Bevin and Echevarria 2005). Articles V and VI respectively refer to the positive and negative comity principle²⁷ (Montini 1999). None of these two articles implies binding obligations. A second agreement was signed in 1998. It seeks to give more details about the place of positive comity (Davison and Johnson 2002, and Bevin and Echevarria 2005). Indeed the previous agreement lacked a test determining when the positive comity principle can be implemented by authorities. For this reason Article III of the 1998 EU-US agreement adopts a new definition of the positive comity principle²⁸. A party can request the competition authorities of the other party (the requested party) to launch an investigation even if the presumed anti-competitive behaviour does not violate the other party's competition laws and even if the competition authorities of

the other party have no interest in taking any enforcement measures. The request party then has a general duty to act in conformity with the request (Montini 1999). Since it was amended in 1998, the positive comity principle has been used only once, in the Sabre/Amadeus case in 1998²⁹.

These arrangements have nevertheless facilitated coordination in merger and cartel cases – especially with simultaneous international cartel investigation and inspection, as in 2003 in the plastic additives industry (Bevin and Echevarria 2005). Cooperation has also led to major convergence on leniency programmes. The EU revised its leniency programme in 2002, making it more transparent and credible³⁰. It should be pointed out that the EU-US agreement does not include merger control. A specific protocol on merger reviews was adopted in 2002. It is designed to facilitate cooperation through parallel timing of investigation and sharing of information.

However, the cooperation agreement has proved inadequate because of a limited exchange of information owing to confidentiality rules and the persistence of inefficiencies linked to multiple competence and jurisdiction. Besides, cooperation does not seem to be resistant to serious political and economic turmoil.

Multilateral framework

A first attempt at multilateral cooperation goes back to the Havana Charter in 1946-1947. The Havana Charter was related to the International Trade Organisation. It included an important chapter (Chapter V) on restrictive business practices which could be harmful to trade. Concerns were related to the behaviour of German cartels and Japanese zaibatsu in the pre-war period. However, the Havana Charter was never ratified as it was rejected by the US Congress, which did not want to abandon part of its sovereignty. Part of the charter was integrated into the General Agreement on Tariffs and Trade (GATT), signed in 1947 and applied from 1948. The GATT, a multilateral agreement designed to provide a framework of rules and a forum to negotiate lowering of trade barriers among nations, contains no explicit provision on antitrust issues. Their introduction was discussed before the Uruguay Round in the 1990s but they were finally removed from the negotiations. However, there were some indirect references to competition issues, especially in relation to public procurement, as noted by Messerlin (1995).

The OECD and UNCTAD have been also used as a forum for encouraging multilateral cooperation on competition matters since the 1990s. The OECD has adopted different recommendations over time on anti-competitive conduct affecting trade, as well as directives on multinational firms' behaviour (Messerlin 1995). The OECD

recommendation on anti-competitive practices affecting trade goes back to 1967. It has been revised several times, such as in 1973, 1979 and 1986. In 1995, the OECD underlined the need for cooperation among national authorities in the investigation and prosecution of anti-competitive practices via the exchange of information, automatic notification and enhanced coordination of proceedings. It also fostered a voluntary conciliation procedure and the application of the positive comity principle to prevent and solve conflicts of competence (Grisay 2005). In 1998, for instance, the OECD issued a recommendation on effective action against hard-core cartels. As recently as 2005, it adopted a recommendation on merger review best practice. There was also an active debate within UNCTAD on the behaviour of multinational firms in developing countries and the control of restrictive business practices (particularly the condemnation of international cartels). It resulted in the adoption of a set of 'best endeavours' principles in 1980. UNCTAD's efforts proved to be very useful, especially in providing technical assistance to developing countries.

Another instrument of multilateral regulation is the World Trade Organisation. Following the different GATT rounds, the WTO was set up in 1994. The WTO is now an important player in multilateral trade policies. It seeks to resolve trade conflicts and monitor national trade policies. Member states are obliged to respect rules set by the WTO. There exists an effective dispute settlement system to ensure the legitimacy and enforcement of rules. Countries affected by alleged misbehaviour on the part of other countries can turn to the WTO for a remedy.

In the early 1990s, the EU launched the idea of including a competition policy regime in the WTO. It was first suggested by Sir Leon Brittan in 1992 at the Davos World Competition Forum, and then proposed in the 1995 Van Miert Report (Kojima 2002, and Evenett *et al.* 2000). The EU proposal contains several elements, as explained by Grisay (2005): binding cooperation (automatic procedure, exchange of non-confidential information, introduction of the negative and positive comity principle); the definition and adoption of minimum standard laws (core principle) related to restrictive business practices and the abuse of market power (in parallel with the principle of national treatment and non-discrimination and that of transparency); the implementation of a dispute settlement procedure, but only for breaches of common principles, and its enforcement. A WTO working group was set up in 1996 at the Singapore ministerial meeting to examine the EU initiative and the problems it raised. So far, there has been no progress on these competition matters. However, new WTO agreements on trade in services (GATS), on intellectual property rights (TRIPS) and on investment (TRIMS) recognise the need for regulation against anti-competitive behaviour. But they do not go beyond the status of a simple recommendation. For instance, the services sector, especially telecommunications, could

be exposed to the dominance of large firms and to a low degree of contestability. GATS therefore includes some provisions to preserve competition and promote neutral regulation of foreign monopolies. State members have to ensure that a monopoly supplier will not abuse its dominant position when competing to supply services beyond the activities of the authorised monopoly. Similarly, intellectual property rights confer a legal monopoly position. In all these cases, trade might potentially be affected by anti-competitive conduct. Hence it is relevant to examine the question of trade in the context of imperfectly competitive markets.

While the EU has promoted the WTO and the enforcement of binding laws, the US supports a less institutional multinational framework via the International Competition Network (ICN), a multilateral cooperation forum. The ICN was initially known as the Global Competition Initiative. The idea for such a forum came from the International Competition Advisory Committee formed in 1997 by the US authorities. At that time, the US authorities were starting to worry about the increasing number of cross-border merger reviews and the relative ineffectiveness of its competition instruments abroad in terms of scrutiny and enforcement. In September 2000, both the US and EU authorities officially expressed their support for the creation of the ICN, which was established in 2001.

The ICN consists of an informal network of antitrust agencies from OECD and non-OECD countries (for instance, Hoekman and Saggi 2005, Bode and Budzinski 2005, or Todino 2003). The ICN is not an intergovernmental body. It was first led by the US and the EU, but quickly attracted more than 80 other jurisdictions from all around the world. Other institutional members such as the WTO, the OECD, and UNCTAD, as well as private actors, participate in this network too³¹. The ICN seeks to improve cooperation on a voluntary basis, and thereby to reduce conflicts, by sharing information through benchmarking and mutual learning. Its aim is to foster the convergence of national merger review regimes by developing best practice guidelines for enforcement. The ICN's role is only to initiate projects on competition issues. It favours discussion and consensus among its members, especially via the constitution of working groups. Different working groups exist, such as the working group on mergers or cartels. The ICN also includes the development of competition advocacy in order to influence government decision-makers. It should be pointed out that all proposals to harmonise rules and adopt best practice are, as for instance the OECD recommendations, non binding and purely voluntary (Jenny 2003, Bode and Budzinski 2005). They are therefore often called 'soft laws'. Unlike in the WTO, there is no sanctions mechanism in the ICN (or OECD) framework.

Having described the unilateral, bilateral and multilateral institutional instruments

of EU competition policy, we now analyse antitrust problems emerging from market globalisation. The investigation of the pros and cons of the instruments available to policymakers is mainly based on existing empirical and theoretical evidence.

Which competition policy in international markets?

Interactions, conflicts and efficiency in competition policy: theory

Competition authorities make decisions in order to maximise a general objective function. Basically, this objective function is composed of the merging firms' profit (insider), the non-merging firms' profit (outsider) and the consumer surplus. The weight attributed to each of these components is likely to differ from one authority to another. We return to this point later. The interdependence of antitrust regulations can take two different but related forms, called *negative spill-over* and *distortion effects* (Falvey and Lloyd 1999). Negative spill-overs can be defined as the situation where the action of one country reduces the welfare of another country. Distortions occur when this intervention also has the effect of reducing world wide welfare. The non-internalisation of externalities could lead to authorities imposing either an excessively strict or an excessively lax competition regime as regards the global welfare criterion. Economic literature thus usually distinguishes 'type I' errors from 'type II' errors committed by competition authorities. Type I errors correspond to the case when a practice (for instance a merger) is wrongly blocked by national regulators even though it would result in an increase in world wide welfare. Type II errors occur when conduct reducing world wide welfare is nevertheless approved by national regulators³². Fundamentally, these distortions at an international level come from unequal geographic distribution of gains and losses across countries.

Cross-border externalities and competition regimes

First, we investigate implications for competition policy under the different regimes of territoriality and extraterritoriality when authorities maximise national welfare (as assumed by economists in most theoretical models). Second, we consider why countries cooperate and how difficult it is in practice. It is important to point out the limited number of theoretical and even more limited number of empirical studies on this question. In addition, research papers usually focus on M&A only.

The territoriality principle refers to a situation where a country applies its domestic laws only to its own domestic companies. The design of competition policy in a closed economy is usually determined by a classic welfare trade-off between domestic consumer surplus and domestic firms' profits at home. In the context of

open markets, the optimal policy is identical for net importing industries (and more generally a net importing country) to a situation without trade, since the country has no influence on foreign firms exporting goods to it. It is not able to control foreign firms. In net exporting industries (and countries), authorities fully take into account the anti-competitive effects from domestic firms on domestic consumers, but not on foreign consumers. As a result, authorities tend to be laxer (Guzman 1998, 2004). Thus, competition policy is often viewed as being too lax compared to an optimal global policy, irrespective of the net country and industry trade balance. Export cartels are a perfect example of underregulation and of beggar-thy-neighbour competition policy. Export cartels decrease foreign welfare while raising that of the home country (Evenett *et al.* 2001). An export cartel can simply be defined as a group of exporters allowed to work jointly when selling products abroad. Thanks to this cooperation, these firms are more likely to be engaged in price-fixing behaviour. This could result in a reduction of trade flows and lower consumer welfare abroad³³. When consumers hurt by anti-competitive practices are foreigners, the trade-off of competition authorities is reduced to the maximisation of domestic firms' profits. Antitrust intervention is deemed irrelevant since export cartels do not affect domestic consumers.

Note that over the last decade a lot of countries have eliminated explicit antitrust exemption for export arrangements (Levenstein and Suslow 2004). The European Commission and most EU members states have abandoned an explicit regime and adopted an implicit one, while the US and Australia, for instance, continue to maintain an exemption (with notification). The US adopted the export exemption in 1918 in the Webb-Pomerene Export Trade Act, which was revised in 1982 by the Export Trading Company Act³⁴.

As with export cartels, if an industry exports all its production, authorities have an incentive to approve anti-competitive national mergers, since they harm foreign consumers only and favour domestic firms. The assumption of underregulation is supported by some theoretical research in economics. Tay and Willmann (2005) conclude that competition policy is too lax without coordination between authorities when mergers are regulated under the territoriality principle. In their theoretical model, competition authorities have jurisdiction only over mergers located within their territory. Therefore, they are not able to block purely foreign mergers that negatively impact their home country since these mergers do not fall under their jurisdiction. Territorial regimes are thereby more likely to induce type II errors. This is confirmed by Head and Ries for international M&A (1997). Some mergers may not be banned even though they reduce global welfare if the countries whose consumers are harmed do not have jurisdiction over the merger. When consumers and

firms are not located in the same place, the likelihood of type II errors increases. Results from Barros and Cabral (1994) confirm this. Competition authorities may ban domestic mergers that a global authority would allow if the share of domestic demand exceeds the share of domestic supply (and *vice versa*). Jurisdictions with a high (low) share of consumers relative to non-merging firms have more incentive to enforce strict (lax) competition rules³⁵. Thus, in net exporting industries, they will authorise an anti-competitive domestic merger affecting foreign consumers, generating type II errors. Symmetrically, it could lead to a type I error in net importing industries. For instance, authorities might not take into account positive efficiency effects on foreign consumers. It might be the case of domestic mergers decreasing the cost of supplying foreign markets and lowering competition at home. The main conclusion from economic research is as follows: an increasing asymmetry in the distribution of consumers and producers or company headquarters across countries leads to welfare inefficiency, since authorities do not internalise the cross-border effects on other jurisdictions.

The government can therefore decide to adopt the principle of extraterritoriality to remedy cross-border effects from anti-competitive behaviour conducted abroad (Falvey and Lloyd 1999). It then applies its national laws to companies located within the territory of another nation. Under a regime of extraterritoriality, competition policy could on the contrary become too tough (Guzman 1998, 2004). A net importer country clearly has an incentive to tighten its competition policy to condemn alleged anti-competitive practices by foreign companies. It tends to overregulate to defend its consumers to the detriment of foreign firms. Net exporter countries continue to apply laxer competition rules. Therefore, when laws differ from one country to another, the relevant international regime might be a package of the strictest elements of national laws, as illustrated by the case of *Hartford Fire Insurance Co. v. California* involving British companies in 1993 (Guzman 2004). Certain practices of British reinsurance companies were permitted under UK law, but prohibited under US law. The US Supreme Court stated that there was no true conflict between UK and US law. British firms could comply with both US and British laws. In this case, the US authorities were clearly being encouraged to sanction the behaviour in question, since it harmed US consumers while benefiting UK firms only. Thus, under extraterritorial regimes, a country might more frequently prohibit efficient as well as inefficient practices, generating more type I errors but fewer type II errors.

This is confirmed by some more formal models. If authorities block every merger that would be harmful, irrespective of the merging firms' nationality as in Tay and Willmann (2005), world wide welfare-reducing mergers will never be allowed. Head

and Ries (1997) show that, if all countries affected by an international merger have jurisdiction over it, there will be no merger which reduces global welfare. Interestingly, the repeated interaction between authorities may reduce type I errors (Cabral 2005). In a dynamic framework, each country would accept an international merger proposal that reduced its welfare, but increased global welfare. The loss from the negative externality would be lower than the cost of being punished when deviating from a cooperative strategy.

To sum up, global competition without global regulation could lead to too strict and too lax antitrust rules. However, this conclusion should be qualified because of the practical difficulty of enforcing the extraterritoriality principle (Grisay 2005, for instance). First, international public law prevents states from exercising their power of enforcement on foreign territory. Second, the power of the Commission to obtain information and documentation abroad is low. It might in some cases be impossible for a country to detect and/or get evidence of the alleged anti-competitive conduct. In Europe, affiliates established within the EU must comply with the request for information, even if the information is located overseas. When companies are located abroad, the Commission can request information from them but without using its coercive power. Information is supplied on a voluntary basis. In addition, some countries like the UK, Australia, France or South Africa have enacted blocking legislation, mainly to counter US application of the extraterritoriality principle (Senz and Charlesworth 2001, or Falvey and Lloyd 1999). Some laws prohibit the collection and transfer of evidence to foreign bodies, the enforcement of foreign judgments or compliance with orders of foreign authorities. There could also exist 'claw-back' statutes. They allow 'an entity that is the subject of a foreign judgment executed against its foreign assets to recover the judgment sum against assets of the foreign judgment creditor that are situated in the local jurisdiction' (Senz and Charlesworth 2001, p79). In addition, the enforcement of the extraterritoriality principle differs greatly among countries depending on the size of the business activity of foreign firms and their assets in this country. The credibility of sanctions for ill-behaved firms varies from one country to another. Only a government which has a grip on foreign firms by seizing their assets or restricting their activity can regulate domestic and foreign firms equally, independently of the foreign firms' location. In the EU, the Commission cannot compel companies outside the EU to pay a fine. They can only impose monetary sanctions on European affiliates of non-EU companies. The Commission can only use the power of commandment and not that of coercion to terminate prohibited practices. Finally, authorities have to bear in mind the legitimate interest of other states to avoid conflicts of competence, as noted by Grisay (2005).

The enforcement of extraterritoriality could create serious political tensions and amplify conflicts, as shown in the Boeing/McDonnell Douglas case. It could trigger retaliation. The extraterritoriality principle then represents one useful, but limited, mechanism for solving the issue of cross-border effects of anti-competitive conduct. On the contrary, cooperation through bilateral or multilateral agreement can constitute a mechanism for internalising negative externalities from competition policy decisions. It can allow the achievement of higher global welfare to the benefit of all countries. More broadly, it facilitates mutual understanding and discussion. However, negotiating a deal will be feasible only with a monetary or non-monetary compensation system, since some countries may lose from an agreement. When going from an extraterritoriality (territoriality) to a cooperation regime, net importing (exporting) countries are likely to lose from a laxer (stricter) optimal regime. Asymmetry in the enforcement of extraterritoriality will increase claims for compensation from powerful countries, as predicted by Tay and Willmann (2005)³⁶. In addition, transfers can incur some transaction costs as noted by Guzman (1998). These costs notably stem from agency problems and political pressures exerted by industrial lobbyists or voters. Besides, imperfect information makes the evaluation of gains and losses from an agreement difficult. There could also be well-known free-riding behaviour. Some winners from the agreement might prefer not to compensate the losers. These costs are probably lower when the number of countries involved is low and their characteristics are similar.

In practice, current cooperation has experienced some major drawbacks. Exchange of information is very often limited by confidentiality rules (Montini 1999). The US signed the International Antitrust Enforcement Assistance Act in 1994 with Canada. It waives confidentiality restrictions under some circumstances³⁷. Exchange of information has been more limited with Europe because of possible criminal sanctions and the treble damages rule in US civil suits. More generally, it is difficult for competition authorities to support publicly an improvement in exchange which is potentially to the detriment of their domestic firms. There is a risk of information leakage to competing rivals or foreign governments. The difficulty of collecting the necessary evidence and interviewing witnesses abroad can seriously reduce the ability of authorities to prosecute and punish international cartels (Schoneveld 2003). The executives of firms can organise the formation of the cartel (meetings, information exchange) outside their home country. Besides, difficulties linked to multiple competences and jurisdiction remain. Let us take the example of cartel prosecution. The non-coordinated accumulation of fines could force the target firm into bankruptcy, which could have a very negative impact on market structures. The ECJ thus rejected the principle of *nec bis in idem* (one single sanction) (Grisay 2005). On the contrary, national laws can be ineffective in deterring international

cartels, as observed by Evenett *et al* (2001). In the context of a multi-market effect, a fine and deterrence mechanism based on the domestic market only could be irrelevant. The level of fine could prove to be too low to deter firms from engaging in an international cartel. Leniency programmes could also be less efficient, since a firm would risk being condemned in other countries if it provides some information at home. It could lead to an inefficient outcome if the antitrust monitoring process is not carried out in parallel. The same argument could be extended to structural and behavioural remedies for mergers and more generally to merger scrutiny. Procedural disparities (difference in timing of merger review) can hinder effective cooperation. Lastly, non-binding cooperation on key antitrust cases could prove to be insufficient and too fragile in some political and economic contexts, as shown by the Boeing/McDonnell Douglas and GE/Honeywell conflicts.

The setting up of a binding global antitrust framework enforced by one single centralised authority might appear to be a theoretical solution to remove all costs related to multiple antitrust reviews and to impose some effective discipline on countries. But the literature on federalism suggests that responsibility should be assigned to the level of government that is capable of internalising economic externalities. It is called the subsidiarity principle. Centralisation would be appropriate only when the gains from the internalisation of externalities are large enough relative to the costs incurred by a central authority. This institutional solution may indeed create new kinds of economic inefficiency. Centralisation may generate additional bureaucracy costs (Fox 2003). Moreover, authorities would be distant from the markets they are in charge of monitoring, which would accentuate any asymmetry in information. The law applied might be less suited to the local environment. There might also be an accountability concern. Authorities could pursue their own goals and favour particular interests. This problem may be reinforced by lower political pressure from less well-informed citizens. There could be a dilution of local influence in the adoption of laws. Concerted action is also more difficult. There is a higher risk of capture to the benefit of the business community³⁸. Finally, the setting-up of a single global authority will *de facto* imply the absence of any competition among antitrust authorities and thus the removal of benchmarking practices.

A source of conflict: antitrust objectives and interpretation

There can also be some disagreement between competition authorities not only because of differences in interests, but also in objectives or economic interpretation. Let us take the example of the GE/Honeywell case in 2001. This merger conflict is interpreted by many commentators as the outcome of a different view of how this conglomerate merger could have affected competitive market structure

[Bannerman 2002]. Based on the portfolio effect theory, the EU prohibited the American merger. The European Commission assumed that merging partners would have been able to drive competitors out by bundling goods and services, to the detriment of consumers. Competitors would not have been able to match this newly merging entity. The US authorities thought differently. Efficient mergers by leading firms benefit consumers, even if they can hurt rivals in the short run. In addition to a difference in economic doctrine, some economists discern underlying industrial policy motives [Patterson and Shapiro 2001]. For some, the Commission gave too much weight to the interests of European competitors. This argument was also frequently used to explain the conflict in the Boeing/McDonnell Douglas merger in 1997. Note that in all these cases, the EU strongly denies the allegation that it was preserving the interests of competitors to the detriment of consumers.

In this part of the text, we compare the antitrust regime in Europe and US. The US antitrust laws were established at the beginning of the 20th century to safeguard competition in the interest of consumers [Niels and ten Kate 2004, and Kurlde 2005]. A major change occurred in the economic doctrine in the 1970s and 1980s under the influence of the Chicago school, which advocated a less interventionist policy. The main idea was that antitrust policy had to protect the process of competition and not competitors. The ultimate goal is consumer welfare, not competition in itself. Indeed, a market structure can be highly competitive, generating low prices and high-quality goods and services, even if the number of incumbent firms is low. Efficiencies benefiting consumers were to be promoted even if they harmed competitors [Kolasky 2004]. On the other hand, EU competition policy is based on the 1957 Treaty of Rome and, until very recently, as emphasised in the introduction, one of the main objectives of European competition policy has been market integration and the formation of a unified European market. This objective would explain, for instance, the condemnation *per se* of firms practising price discrimination tending to segment European markets. This approach is not necessarily consistent with maximising economic efficiency and consumer welfare [Motta 2004].

As underlined by Evenett [2005b], competition laws have not just focused on a single objective, ie consumer welfare, over time and across countries, but have more or less explicitly included other objectives, such as the employment level, income redistribution, small business protection, fairness and equity or the dispersion of political and economic power [also Motta 2004]. Conflicts are most likely to occur when authorities pursue industrial policy goals. According to the World Bank, industrial policy can be defined as ‘government efforts to alter industrial structure to promote productivity-based growth’³⁹ [Evenett 2005b]. In this context, the formation of national champions has often been supported by some countries using dynamic

efficiency arguments. Domestic firms would need to reach some critical size threshold to be competitive on global markets. The national champion policy is assumed to improve the competitiveness of domestic firms abroad. It is frequently argued that, as a consequence, government should relax competition rules to facilitate this restructuring process. Fundamentally, the national champion policy increases disputes between competition authorities because of political interference and national preference. In a theoretical paper, Neven and Röller (2000) point out that, with market integration, there would be fewer conflicting decisions since regulators would tend to define the global market as the relevant market. Regulators assess competitive effects within the same global relevant market when choosing to ban or to authorise a merger⁴⁰. As a result, divergence tends to occur not because regulators do not protect consumers, but because they pursue national industry interests. Inherently, the national champion policy has indeed a discriminatory approach towards foreign firms, which is not really justified by economic argument⁴¹ (For a comparison of comparative effects of domestic and cross-border M&A, see eg Bertrand and Zitouna (2006a), and Bertrand and Zuniga (2006). For a discussion of the industrial policy conducted by individual EU member states, see Veron (2006)).

In addition, competition and industrial policy do not inherently diverge⁴². They can be complementary. Competition policy exerts a positive effect on the productivity of domestic firms by sanctioning non-efficiency practices. Moreover, competition policy can promote not only static but also dynamic efficiency. It is wrong to assert that competition policy necessarily hinders the development of R&D activities. First, the relationship between industrial concentration and innovation activities is ambiguous. Some studies conclude that there is a positive link between concentration and innovation, as in Mansfield (1968) or Geroski (1995), while others find a negative link or a more complex inverted-U relationship (Scherer 1967 and 1980, Aghion *et al.* 2002). There is, then, no real robust evidence that laxer competition policy entails higher innovatory activity. Second, as stressed by Evenett (2005c), dynamic efficiency has already begun to be considered by major jurisdictions in their decisions.

Even if antitrust authorities share similar objectives, disputes can also arise because of differing economic interpretation. It is usually said that the US approach puts more trust in market forces overall (Niels and ten Kate 2004). On the other hand, it is said that European authorities are more sceptical about market self-regulation mechanisms. This would explain why the European Commission pays more attention to leading firms' behaviour and dominant practices. In addition, the Commission's competition policy decisions have been criticised on the grounds

that they lacked sound economic analysis. For a long time, the role of economists remained limited in Europe as compared to the US. The appointment of a Chief Competition Economist was the sign of a new priority given to the economic approach at the Commission. Now, a real convergence of doctrine between the US and the EU, as with the new merger regulation and horizontal merger guidelines of 2004, has been the order of the day for several years (Coppi and Walker 2004, and Walker 2005). In the case of the legal economic test for mergers, the EU has partially abandoned its standard dominance criterion (the creation or strengthening of a dominant position) in favour of a test closer to that used by the US (a substantial lessening of competition).

In the past, the Competition Directorate-General of the European Commission used a structural analysis based on market share and a concentration ratio to test dominance. It is related to the idea that a concentrated market reflects high market power and weak competition. However, a merger in a differentiated product industry could lead to significantly higher prices over a localised range of products, even if the merging firms are not the leading firms in the market. This merger could be prosecuted only with some difficulty using the dominance standard. The new European merger guidelines of 2004 call for an assessment of the change in prices attributable to the merger, the so-called unilateral effects (Walker 2005). The convergence of approaches between the US and the EU has been even greater in the analysis of the coordinated effects of mergers. In the new European merger guidelines, the risk of tacit collusion occurs only if four necessary conditions are simultaneously met: a common understanding on the terms of coordination (such as price, quality or market division); a monitoring capability of firms; a sanction mechanism when a firm deviates; a lower capacity of non-participant firms to undermine the coordination (maverick firms and potential entry). This view is now closer to the US checklist approach. In the past, the European Commission did not consider this whole set of conditions as necessary. The EU approach on the efficiency defence has also evolved, although the European Commission attributes less importance to efficiency gains produced by mergers.

However, there still remain some important practical differences in merger reviews between the US and EU approaches (Coppi and Walker 2004, and Walker 2005). For instance, there is little sign of convergence on market delineation issues and market definition. Unlike the EU, the US gives a reduced role to the concept of market definition since concentration tests are considered less important than merger simulation models. Besides, US market definition is narrower than in the EU method. The US analysis starts from the product sold by the merging firms, while the European approach considers more standard industry segmentation. In addition,

the EU takes into consideration supply-side substitutability, which is not necessarily the case for the US authority. In other antitrust fields, vertical restraints continue to be a controversial area (Haucaup *et al.* 2005). The European approach treats vertical restraints with more suspicion. Some practices like retail price maintenance may be prohibited *per se*. In the US, vertical practices are evaluated under a rule of reason⁴³. There is a detailed investigation into the price and quantity effect of this practice. Differences also still persist in competition laws in relation to cartels⁴⁴.

Given these differences, the European Commission might tend towards stricter competition policy, although this fact is questioned by Lévêque (2005). Differences in the design of competition policy, that is, in the procedural and institutional framework, can accentuate it (Akbar 2002). *Ex ante* monitoring is more likely to be rigorous in Europe since *ex post* sanctions can be greater in the US compared to EU. So far there has been no possibility of private suits, treble damages or criminal conviction in Europe⁴⁵. The European authorities are therefore more wary about potential anti-competitive conduct. This could be reinforced by the fact that referring a decision to the ECJ is possible but usually takes an excessively long time. Commission decisions prove to be quite irreversible given the number of current investigations, although the recent decision in the Sony/BMG case shows that the ECJ may also overturn an approval given by the Commission. Nonetheless, a systematic analysis of the effectiveness of competition policy in the US and the EU is lacking. One may expect differences in approach to shrink with the ongoing reform of European competition laws.

Meanwhile, the development of the new economy, partly stimulated by globalisation and the access of firms to larger market outlets, gives rise to new challenges. Network industries experience a natural trend towards industrial concentration because they require high R&D expenditures on infrastructure networks. Usual competition tools to evaluate dominance and horizontal mergers have to be adjusted to take account of the specificity of these industries⁴⁶. However, so far, there has been no clear consensus among economists on the right way to regulate these new high-technology sectors. As a result, cross-border disputes are likely to increase (Röller and Wey 2002, and Evenett *et al.* 2000). The new economy will certainly represent a new source of divergence on antitrust issues in the near future, as already suggested by the difference in the behaviour of the European and American authorities on the very recent Microsoft case. In addition, benefits from cooperation (eg on standard-setting, product compatibility and licencing) may lead to amplifying of conflicts owing to industrial policy issues.

Trade and competition policy

The import-discipline hypothesis states that economic openness increases competition in the home market by increasing the imports of goods (Cadot *et al.* 2000, Evenett *et al.* 2000). Openness creates a pro-competitive effect on market structure. Exposure to international competition prevents domestic companies from adopting anti-competitive behaviour. Therefore, it is expected that, as trade liberalisation progresses (ie through lower tariffs and non-tariff barriers), it will become less crucial to enforce strict domestic antitrust regulation⁴⁷. Trade openness could thus be a substitute for costly implementation of competition policy. This substitution hypothesis relies on the robust observation that imports and price-cost margins of domestic firms are negatively correlated. This inverse relation between foreign competition and domestic market power usually seems to be corroborated by empirical investigation⁴⁸. Theoretical models in a static setting also usually confirm that trade liberalisation and active competition policy could have similar effects in terms of welfare (Neven and Seabright 1997).

This substitution argument may be particularly relevant for small, open and/or developing countries that lack administrative competence and financial resources. It is certainly less appropriate for the European Union, where trade openness might be insufficient to discipline the practices of domestic firms. Moreover, import discipline is not extendable to non-trade sectors (ie services), which is an essential industry in our modern economies. Of course, in non-traded sectors, greenfield FDI could serve as a substitute for imports (UNCTAD 1997). The liberalisation of FDI regimes (ie lower statutory obstacles to FDI and relaxing of foreign ownership restrictions) could contribute to the contestability of national markets in services industries. Nevertheless, the disciplining mechanism could be limited in its effect, since start-up fixed costs could be too large to induce foreign firms to enter a domestic market only because of a moderate increase in prices, at least in the short run. In addition, companies can attempt to protect themselves from foreign rivals using various private strategies: product differentiation or vertical arrangements between distributors and manufacturers⁴⁹. In other words, trade regulation by the state might be replaced by private barriers to entry. In this case, trade and competition policy should be viewed as complementary rather than as substitutes.

Vertical arrangements as a strategic private tool to restrict foreign market access have been well known since the Kodak case and the related conflict between US and Japanese competition authorities⁵⁰. Vertical restraints can take different forms, such as exclusive distributors (distributors cannot sell foreign products), exclusive territory (distributors cannot sell outside a specific geographic area) or different

discount designs to discourage distributors from selling foreign products (Levinshon 1996, and Nagoaka 1998). Exclusive dealing, vertical integration and refusal to deal may be used to increase the cost of rivals' entry, and then to reduce competition on the product markets (inter-brand competition). Restricted access to distribution networks, or barriers to setting up supplier-producer linkages (to get local credit, for instance) could block the entry of foreign companies. Territorial constraints (via the prohibition of parallel imports) could be used to operate discriminatory prices between countries (intra-brand competition). In this context, lax competition policy towards the practice of vertical agreements could harm international trade.

Two main points directly stand out in the debate about the import-discipline hypothesis. First, trade affects domestic competition, and reciprocally. Trade liberalisation has some implications for antitrust authorities since it affects competition. Trade and FDI competition could be a new source of competition. The actions of foreign exporters and investors have to be evaluated by antitrust authorities, as is usually the case, when delineating the relevant market in antitrust issues⁵¹. Voluntary export restrictions as well as trade-restrictive measures (product standards, government procurement etc) can facilitate anti-competitive practices (like collusion) on domestic markets. Second, without any competition rules, trade can be greatly affected by anti-competitive conduct linked to vertical arrangements, but also for instance M&A and cartels.

Conflicts over the objectives

Trade and competition policy can enter into conflict. For instance, vertical arrangements could be welfare-improving and beneficial to consumers. Indeed, incumbent firms can use vertical restraints to improve their efficiency. Price discrimination can also be beneficial to consumers. An antitrust policy focusing on consumer welfare might accept such practices. Trade policy would refuse them if they impede trade flows and market access.

Protectionism and competition policy can also diverge. Trade policy mainly shelters the producers' interests, while competition policy aims to protect national consumers. Anti-dumping measures are an interesting example of a clash between trade and competition policy⁵². Anti-dumping measures can consist of compelling exporting firms not to sell below an agreed price or of imposing anti-dumping duties equal to the dumping margin (Brühlhart and Matthews, 2003)⁵³. As for antitrust rules, anti-dumping seeks to control price discrimination strategies in segmented markets. They might be considered as complementary if anti-dumping rules were

directed towards foreign firms, while antitrust rules addressed domestic behaviour⁵⁴ (Wooton and Zanardi 2004). Actually, their real objectives prove to be different, since anti-dumping measures shield industrial businesses and are very often motivated by political considerations.

The EU has frequently resorted to anti-dumping measures. From 1991 to 2001, there was a slightly increasing trend in EU anti-dumping cases. The relationship in the EU between competition principles and anti-dumping policies is rather weak, as explained by Messerlin and Reed (1995). Bourgeois and Messerlin (1998) show that less than 10 percent of anti-dumping cases investigated by the European Commission relate to predatory anti-competitive behaviour⁵⁵. Anti-dumping procedures play an increasing role in trade policy as a substitute for tariff and non-tariff barriers to trade. Indeed, the likelihood of success in an investigation is high, notably in Europe (Messerlin and Reed 1995). In addition, the cost of applying for anti-dumping measures is low compared to alternative strategies (a price war, for instance). Anti-dumping measures raise rivals' costs by increasing the production cost of foreign firms or the risk related to the export activity (Messerlin 1995). It may thus produce a lower level of domestic competition. It may in particular facilitate the survival of cartels⁵⁶. Cartels sometimes seek state intervention and anti-dumping duties to block entry⁵⁷ (Levenstein *et al.* 2004). For instance, companies producing ferrosilicon from the US (one of them a subsidiary of a Norwegian firm) wanted to use anti-dumping laws in the US and Europe to block entry.

Competition law as an instrument of trade policy

As trade liberalisation progresses, competition policy becomes more and more important. Influenced by political pressures and lobbying activity, competition policy can be used as a strategic trade policy to promote national, but also industry, interests. It is a well-known fact that companies are much more organised in their efforts to alter policy decisions compared to consumers. The US has often been accused, notably by the United Kingdom, of using competition policy as a trade instrument to facilitate foreign market penetration, which goes against the non-discrimination principle of the WTO. Export cartels are another example.

With trade liberalisation, countries are not able to use trade policy to improve their domestic welfare. Competition policy may then be used a substitute to achieve the same goals. While competition policy controls the market power of domestic firms, strategic trade policy attempts to shift rents away from foreign countries by using the market power of domestic firms (Levinshon 1996). Decisions in competition matters can raise the market share of domestic producers and shift rents.

In a theoretical model, Horn and Levinsohn (2001) examine changes in competition policy when it consists of determining the optimal industrial concentration. Trade barriers affect competition policy. With open markets, foreign firms can sell in the home market, and domestic firms can export. Under some conditions, authorities could be persuaded to operate a stricter competition policy (ie to increase the number of domestic firms) in order to increase export market shares. Governments' behaviour can thereby invalidate the substitution hypothesis. Richardson (1999) comes to identical conclusions in a similar theoretical framework⁵⁸. However, these authors emphasise that it is quite difficult to expect any clear and robust relation between trade and competition policy⁵⁹. It is unclear if trade liberalisation encourages beggar-thy-neighbour competition policy and if such a beggar-thy-neighbour policy induces stricter or laxer competition policy. For instance, in a different framework, De Stefano and Rysman (2004) come to the inverse conclusion that government could have a bias towards laxer competition policy, to encourage the emergence of a national champion. A less competitive market structure induces the other country to choose less aggressive taxes⁶⁰.

We have described the current institutional and political situation of the EU regarding competition issues in international markets. We have also dealt with questions arising from market integration and have provided potential answers to the issues raised. The next and last section provides some related guidance for policymakers against the backdrop of the current internal and external reform of European competition policy.

International challenges to European competition policy

External reforms of European policy

The deepening of market integration brings new challenges which call for both external and internal reforms of European competition policy. The extraterritorial application of European competition rules is a way to remedy the cross-border effects of anti-competitive behaviour. However, as explained by many commentators, it is certainly not sufficient for regulating the world wide strategies of multinationals and exporting firms, even for a powerful antitrust authority. Besides, as explained in the previous section, the extraterritorial principle is often viewed as an infringement of national sovereignty and can thus be a source of international political instability and conflict. Policymakers guided purely by national welfare maximisation should therefore be very careful if they wish to avoid harmful retaliatory measures. Nevertheless, the benefits of improving the application of the extraterritoriality principle should not be overlooked. An enhanced capacity to enforce EU

laws abroad would increase the bargaining power of the EU in current negotiations and will allow EU authorities to defend their position more credibly.

Cooperative solutions are, however, very clearly to be preferred. For instance, cooperation between the US and the EU has produced numerous successes over the last decade, especially during merger investigations⁶¹. But present bilateral or plurilateral agreements do not seem fully satisfactory. They do not appear able to prevent beggar-thy-neighbour policy and conflict whenever key interests of countries are at stake. Because of differences in antitrust frameworks and unequal distribution of gains and losses across countries, sharing information and communicating is not enough. It does not remove the different costs from multiple antitrust reviews either. Global rules and/or a global supervisor with enforcement power could be the answer. Unfortunately, the idea of world wide regulation sounds politically unfeasible at this point in time. Even with political support, designing an optimal competition policy would be particularly tricky, all the more so as there can be contradictions between trade, competition and other policy objectives, as explained previously. No clear consensus has been reached.

In the future, three main objectives must be pursued: harmonisation of rules, especially with the emergence of the new economy; closer cooperation in the confidential exchange of information; the creation of international institutions and mechanisms to tackle antitrust cases which generate international spill-overs. These three elements are of course not exclusive. In practice, besides bilateral and plurilateral agreements, there are usually two main institutional proposals (eg Bode and Budzinski 2005). The first one consists of building upon the WTO. Some support this option since the WTO already possesses dispute settlement procedures which might be extendable to antitrust issues. Besides, in the Doha Declaration (2001), governments agreed to enter negotiations on antitrust matters. The second proposal is to promote more informal discussion, mainly through the International Competition Network.

With harmonisation and convergence of antitrust laws, competition rules become more closely aligned, which should remove conflicts related to antitrust goals and interpretations (Gerber 1999, Kudrle 2005). As underlined before, efforts to harmonise should not be relaxed because of the risks of antitrust divergence related to the new economy. Convergence can be achieved by unilateral reforms or (binding or non-binding) cooperation and the adoption of common (minimum or not) standards. This was the case with the spread of leniency programmes. Frequent contact, discussion and acknowledgement of best practice facilitate this process. However, the objective of perfect convergence may just be an illusion, and thus even more

risky (Shenefield 2004)⁶². This process is not irreversible, even without adjustments in substantive rules. It could vary with the composition of antitrust authorities and courts and thus varying interpretations of antitrust provisions. Government authorities have some discretion in the enforcement and interpretation of laws, which they can use for their own benefit⁶³. More importantly, one-size-fits-all competition law could prove to be harmful. Law has to be tailored to the local political, cultural and historical environment in order to be really effective (Jenny 2003). In addition, antitrust analysis and theories about market structure and firms' behaviour change over time. Especially in new technologies, best practice could evolve rather quickly, requiring frequent adaptation. Cooperation basically implies communication, consultation and information-sharing (Kudrle 2005).

The effectiveness of antitrust enforcement in relation to foreign conduct is highly dependent on transfers of information. For instance, information-sharing is particularly crucial in large-scale cartel investigations. Unfortunately, confidentiality of business activity has been a serious impediment to real cooperation so far⁶⁴. To facilitate the exchange of information, agencies need to obtain waivers from private parties. Companies can profit from information-sharing if it reduces the cost of submitting evidence to several authorities and avoids contradictory decisions. But firms are frequently reluctant to share information on account of the risk of information leakage and misuse⁶⁵. Therefore, a new international legal framework, especially involving the US, is a high priority in order to promote the exchange of confidential business information. This point was underlined by European Competition Commissioner Neelie Kroes in 2005. It should be clarified when information-sharing is permitted and how the exchange of legally protected information can be developed under secure conditions⁶⁶. It could replicate the exchange of information in the field of tax and financial securities or in criminal matters. The mutual assistance agreements allow the exchange of highly confidential information but for criminal activity only. The US-Australia agreement is one of the rare agreements which facilitates the exchange of confidential information.

In practice, in addition to bilateral and plurilateral agreements, the convergence of substantive laws and the exchange of information could be encouraged by the ICN mechanism. The ICN is designed to simplify cooperation, facilitate voluntary convergence and develop best practice guidelines (Haucap *et al.* 2005). Another instrument could be used more in order to overcome informational limits. Based on the positive comity principle, a country can refer a case to another country's authority. Investigation of the alleged conduct may be more straightforward since the country in charge of the enquiry has better access to relevant information. The positive comity principle presents other advantages. Competition enforcement could be

more effective since domestic authorities have greater power to terminate anti-competitive conduct. Positive comity also serves to avoid some duplicated costs and reduces conflict by giving sole responsibility for the investigation to the country where the anti-competitive behaviour takes place. It substitutes for the application of the territoriality principle. However, positive comity relies on a high degree of trust. From practical experience, public officials (like R. Pitofsky) have tended to be much less enthusiastic about this tool. It is of no value when laws or/and interests are in conflict, as shown in the main conflicts of Boeing/McDonnell Douglas, GE/Honeywell or the Microsoft case (Klodt 2001). Domestic authorities cannot prosecute domestic firms when they respect national laws, but not foreign laws. Moreover, comity clauses are non binding, which is insufficient to prevent real conflict of interest (Haucap *et al.* 2005). In this context, a further and logical step will be to integrate more binding elements into existing agreements. Nevertheless, it is important to bear in mind that, so far, this type of agreement has tended to exclude small, less developed countries from cooperation agreements, generating potentially harmful discrimination.

In order to tackle these different aspects, the real cornerstone of any reform of international relations is to set up some form of supranational regulation. Theoretically, a global antitrust supervisor would allow economic externalities to be internalised across frontiers and thus a higher level of global welfare. Unfortunately, countries are not ready to abandon part of their sovereignty in competition matters. Besides, enforcement of global rules may require a compensation system, which would be very difficult to set up. For instance, in M&A reviews, in addition to the stochastic nature of M&A, there is no tradition of compensation in antitrust policy, in contrast to international trade issues⁶⁷ (Tay and Willmann 2005, Evenett 2001). Therefore, in order to succeed negotiations on competition issues must be placed in a wider multilateral framework. Countries losing out in antitrust fields could be compensated by beneficial measures in other areas, such as in trade or the environment.

In this context, the WTO might appear to be the most suitable existing instrument. Its competence is well recognised by the international community. Given its credibility and legitimacy, the WTO could facilitate the adoption and monitoring of minimum binding competition rules. This would reduce the likelihood of divergent and conflicting decisions between countries (Bode and Budzinski 2005). Furthermore, the WTO already includes a reliable dispute settlement body, which is gaining credibility over time. This institutional mechanism for settling trade disputes constitutes a credible threat to WTO members. However, this institutional solution does not seem plausible in the near future after the failure of WTO ministerial conferences in Cancun in 2003, Hong Kong in 2005 and, in general, the difficult and drawn-out

discussions over the Doha Round. Negotiations are arduous because of the large number of members and conflicts of interest. Developing countries are in particular very sceptical about inclusion of competition rules within the WTO⁶⁸. Besides, it should be noted that the proposal of the EU in this field is limited in scope. It does not consist of establishing a supranational body to enforce international competition rules and to monitor cross-border cases. Private firms would not be able to lodge a complaint with the WTO Dispute Settlement Body. The body would only check that domestic competition laws respect core principles stipulated in the WTO agreement or that national authorities have made a genuine effort to investigate alleged cases. Therefore, costs from multiple reviews would not entirely disappear. Perhaps more importantly, the WTO is still dominated by a mercantilist approach and is usually criticised for lack of expertise in antitrust regulation⁶⁹ (Bode and Budzinski 2005). Issues on market access within the WTO mainly focus on producer interests, and welfare or efficiency. As emphasised by US officials (such as J. Klein), by attributing antitrust responsibilities to the WTO, there is a danger of politicising international antitrust policy even more (Hurdle 2005).

The ICN, on the other hand, has been founded only very recently. Because of its young age, it is said that the ICN has less credibility and reputation than the WTO⁷⁰. In addition, it relies on non-binding and voluntary mechanisms. Cooperation mainly depends upon peer pressure and the credibility of the authorities involved. On the basis of an empirical study on the degree of national conformity with four merger-related recommended practices of the ICN, Evenett and Hijzen (2006) doubt that soft laws will lead to widespread convergence of national merger regimes because of resource constraints and political pressure faced by many authorities (Evenett 2005d). Moreover, like the WTO, the cost of multiple reviews will not be reduced to zero even if laws converge. But the ICN has the major advantage that it focuses on competition matters. Countries are more likely to engage in a dialogue within the ICN because of its informal and soft nature. In this perspective, the ICN could be seen as a useful complement to the WTO. It could constitute a first step before signing a more formal and binding agreement. Binding commitments can be negotiated more easily once countries get more experience in antitrust issues. With experience, the expected size and distribution of the costs and benefits of any reforms appear less uncertain (Hoekman and Saggi 2005). However, because the ICN mainly promotes best practice between professional antitrust authorities through proposals, the action of the ICN needs to be complemented. ICN initiatives could usefully be linked to OECD intervention. Indeed, the OECD involves inter-state discussion leading to the adoption of recommendations. The importance of inter-state negotiation should not be understated in the political context of decision-making. Because the OECD assigns a less important role to less developed countries, joint

action with UNCTAD might also facilitate dialogue and cooperation among developed and less developed countries.

However, if the WTO is to serve as the global markets regulator, it will certainly be relevant to distinguish trade and non-trade related competition affairs. The WTO is more qualified and has more legitimacy in judging market access and entry barriers, but less in carrying out hard-core international cartel and M&A reviews.

As a substitute for the WTO a multi-level system, such as that of the EU, could be promoted. This supranational institution could be coupled with an international court of justice guaranteeing the rights of defendants. It might be composed as a first step of a nucleus of countries such as the EU, Japan and the US. With the intensification of economic relations, this solution appears politically feasible in the long run. In particular, the US authorities might agree to more cooperation, as the cost of non-cooperation would rise, just as they did in the past when they recognised the limits of the extraterritoriality principle. The design of a supranational body could be analogous to the relationship between the Commission, the member states and the European Court of Justice in the EU model. Powers would have to be allocated between national jurisdictions and a global authority depending on the amplitude of cross-border effects. Such one-stop-shop regulation would eliminate the costs of multiple reviews and internalise the externalities of competition policy within the area covered by the arrangement.

This system would be a useful step towards the introduction of a global welfare criterion into antitrust regulation. Of course, the decisions of this antitrust authority could be detrimental to outside countries, especially less developed or developing countries. Nevertheless, this problem of discrimination could be dealt with separately. Indeed, more generally, the impact of competition policy on developing countries would need to be debated, especially the question of poverty reduction in poor developing countries. To be coherent with European aid policy towards developing countries, European authorities should take into account the interests of these countries when making decisions, even though this incurs costs – a direct cost such as for enforcement and an indirect cost such as a reduction in domestic welfare when helping developing countries sanction and prosecute European companies. Moreover, with the threat of failure of WTO negotiations, progress on international antitrust issues has mainly been in the form of bilateral agreements or the inclusion of competition provisions into regional trade agreements (Evenett 2005a). These forms of cooperation necessarily entail discrimination.

Internal reforms of European policy

As we have seen, the achievement of European competition objectives depends on external instruments. Conversely, internal policies affect the economic relationship of the EU with its partners and thus its external influence. Internal and external policy have therefore to be coherent⁷¹. The internal relationship between the Commission and EU member states must also be aligned with the external dimension. With the decentralisation of European competition policy to national agencies, interpretation of substantive laws could differ within the European Union. It could be a new source of divergence within the EU and between the EU and the US authorities⁷². In addition, reforms are needed in order to make the international policy of Europe more coherent and to reconcile different objectives. As previously shown, competition and trade policy can prove to be contradictory. For many years, trade relationships and common trade policy were virtually the only instruments of EU foreign policy (Brühlhart and Matthews 2003).

To address these different points, one important first internal reform could consist of creating more awareness of, and giving greater weight to, competition issues in other decisions taken by EU bodies and national regulators, through the instrument of competition advocacy. Because other government policies may affect European market structure, because various policies are not under competition authority supervision, notably trade and FDI policy (with the exception of cross-border M&A) and because some firms or sectors could benefit from exemptions to antitrust legislation, competition authorities should in such circumstances go beyond enforcing competition law in order to ensure competition. Competition authorities have to develop competition advocacy further. By 'competition advocacy', we refer to 'those activities conducted by the competition authority related to the promotion of a competitive environment for economic activities by means of non-enforcement mechanisms, mainly through its relationships with other governmental entities and by increasing public awareness of the benefits of competition' (ICN 2002). Recently, competition advocacy has been extensively discussed in international forums (at OECD, WTO, ICN). It mainly consists of issuing reports on, and performing reviews of, existing and proposed laws and regulations, providing advice on potential anti-competitive state measures, educating the public and policymakers and making them aware of competition issues through seminars, newsletters, the media etc (ICN 2004, Evenett 2006c).

When addressed by other state bodies, competition issues should be dealt with in a way that is consistent with competition regulation. Competition authorities are confronted in some cases with sector-specific regulators. These regulators may

have considerable powers of monitoring and control, such as in the financial or telecommunication sectors⁷³. Although their decisions are mainly based on technical expertise, these regulators might adopt different objectives than those of competition authorities, notably in terms of industrial policy (Jenny 2003). Competition authorities should be entitled to comment on regulations governing trade and FDI. The European Union still maintains in place strong barriers to shelter some sensitive sectors (Brühlhart and Matthews 2003). For instance, trade in the services sector still remains to be liberalised fully. Anti-dumping should be better controlled in regard to antitrust matters too⁷⁴. Competition should not override all other objectives, such as the preservation of jobs, the promotion of exports, or national security. But the trade-off between objectives has to be made clear and transparent (Bannerman 2002). Second, trade or sector-specific regulators might be beholden to particular interest groups. Competition issues might also fall under the influence of lobbyists owing to their redistributive impact. Authorities are more likely to be subject to criticism when the control of the business community becomes stricter and fines more substantial. In any case, the role of competition advocacy could be important to counter and neutralise anti-competitive measures initiated by the business community. It could discourage lobbying, which will decrease wastage of resources and the risk of regulatory capture.

Of course, competition advocacy is not the panacea. It needs to be well designed if it is to play an important and effective role (ICN 2004, Evenett 2006c, Clark 2004). The role and scope of the competition agency in regard to other state bodies should be clear and codified in law to avoid competition advocacy being ineffective. This means that institutional rules must be laid down to compel other bodies to dialogue and take into account the view of the competition agency, which is not the case today. In this context, the role and legitimacy of competition will need to be discussed and debated, especially in relation to other social or political objectives. The competition advocacy policy must also be entirely independent of political influence and properly funded in order to be legitimate and credible vis-à-vis workers, consumers and business (Clark 2004). There are many other practical questions. Which state measures should be covered by competition advocacy? What proportion of available resources should be dedicated to enforcement and advocacy? How to rationalise the procedures and screening of the legislative process⁷⁵? How to quantify the impact of competition advocacy and then improve it⁷⁶? In spite of all these questions, competition advocacy would prove to be a real complement to competition policy enforcement⁷⁷. By promoting competition, competition advocacy would reduce the likelihood of anti-competitive conduct and thus decrease economic inefficiency. A full enforcement of competition rules would give more credibility to antitrust authorities and then strengthen competition advocacy. Thus,

in the last few years, the Directorate-General for Competition has increasingly been screening proposals from other departments of the Commission (OECD 2005b). But the Commission's competition department does not have a separate unit for competition advocacy. Each sectoral department of the Commission is in charge of drawing up the impact assessment for its own draft legislation, including an evaluation of the consequences of the initiative on competition. It would certainly be better to give the entire responsibility for assessing competition aspects of new laws to the the competition department because of its greater expertise in competition matters. Moreover, making more transparent the opinions and comments of competition agencies and the response of other bodies would increase the cost of political interference in antitrust decisions.

A parallel and complementary reform could consist in making the European competition agency more independent. Different factors may hinder the effectiveness of competition policy: insufficient institutional and budgetary independence; overlapping jurisdiction with other regulators and unclear division of responsibilities; a complex set of relations between the courts and competition authorities; insufficient investigatory or enforcement powers; inadequate human and financial resources. In the past, some decisions of the EU competition authorities have been heavily criticised. They were adjudged to lack transparency and be influenced by political pressure from member states (Sleuwaegen 1998). This seems to be less true today, according to the OECD (2005b), while other econometric studies tend to show that European regulation is protectionist (Aktas *et al.* 2004). The channel of political influence can be direct when a higher level of administration gives recommendations or instructions, but it can also be indirect. Independence can be structural or operational (Clark 2004). Structural independence means a separate body (ie not part of a ministry) directly responsible to parliament for its budget. Operational independence relates to the capacity of authorities to comment freely and to participate in government business. This relates to competition advocacy. Nevertheless, the optimal design of a competition agency is a complex issue. There is a wide range of institutional arrangements which might be suitable and provide a form of independence. These will vary according to the political and historical context. For instance, in the case of total structural independence, the competition body could in some circumstances lack access to information and government decision-making. Some experience tends to show that even where they are under the responsibility of a minister and form a part of government, competition authorities can achieve a form of independence (OECD, 2003c).

EU commissioners are politically connected to governments. There is a persistent risk of political interference. The independence of a European competition agency

would improve its market credibility and legitimacy at international level. By decreasing the likelihood of interference from industrial interests and beggar-thy-neighbour action, it could lower conflicts generated by the application of the extraterritoriality principle and introduce a sound economic approach to antitrust issues during negotiations with foreign partners. It could take the form of an independent agency separate from the Commission, based on the model of the European Central Bank. The London-based European Medicines Agency is another example of the allocation of EU functions to an outside agency [Bannerman 2002]. It would be reinforced by competition advocacy prerogatives. Note that enhanced independence should go in hand with the greater transparency in the work of the competition department. An efficient internal sanction and control mechanism should be implemented to prevent internal private interests from influencing decisions. It is also important to say that this discussion about the independence of antitrust authorities is not directly related to the question of the role of the judge in antitrust issues. This question will become particularly important where criminal sanctions are imposed for antitrust practices. Even in a US-style system, the Commission's competition department, in its role as a public prosecutor, would have to make independent choices.

Conclusion

Changes in the economic, technological and institutional environment pose new challenges to European competition authorities.

With the advent of globalisation, economies and market structures have been deeply transformed. Globalisation has stimulated trade and FDI, generating pro-competitive effects in host countries. However, firms' behaviour, particularly in the form of international M&A and hard-core cartels, could undermine the benefits of globalisation. Together with the trend towards more economic liberalisation, markets have been reshaped by major technological improvements, raising new issues in terms of antitrust policy. These changes have been progressively accompanied by a new institutional framework for competition. The dramatic increase in the number of competition authorities incurs duplication of costs and a waste of resources for multinational firms and antitrust authorities.

Over the last few years, the EU has been conducting a vast programme of modernisation of the European antitrust regime, mainly driven by the liberalisation of new sectors and enlargement of the EU to the central and eastern European countries. The gradual deepening of market integration calls for new internal and external reforms of European competition policy.

The extraterritorial application of European competition rules proves to have its limitations as a means of remedying the cross-border effects of anti-competitive behaviour, although a greater ability to enforce EU laws abroad might increase the bargaining power of the EU in the international arena. The EU must clearly support cooperative solutions. But past experience shows that bilateral cooperation, and especially the implementation of comity principles, may be of no value when laws or interests conflict significantly. Three main ways forward should be encouraged: the continuous harmonisation of rules through the joint action of the ICN and the OECD, especially in the context of new technological industries, a source of divergence of antitrust opinions; closer cooperation in the exchange of confidential information; the setting-up of global antitrust institutions. A multi-level system, such as the EU architecture, could be promoted. For political and pragmatic reasons, it might be composed as a first step of a nucleus of countries such as the EU, Japan and the US. It should then be decided how to allocate competences between national jurisdictions and a global authority, depending on the amplitude of cross-border effects. The creation of an international court of justice for competition should also be discussed. One-stop-shop regulation would eliminate the cost of multiple reviews and internalise externalities of competition policy within the area covered by the arrangements.

In addition to these external reforms, some internal reforms may be required. Higher priority should be given to competition issues in other EU policies and national regulation. Competition authorities must further develop competition advocacy. To support this process, internal institutional reforms should lead other EU departments to take account of competition concerns as articulated by the Commission's competition department. A parallel and complementary reform might consist of making the European competition agency independent from member states' interference. The EU bears great leadership responsibility for designing competition rules world wide. It should serve as an example to other competition authorities. Last but not least, the new challenges faced by the European authorities call for a new research agenda focusing on the effectiveness of competition policy in international markets. There is a clear lack of empirical and theoretical investigation, which could provide some guidance to policymakers in the design of competition policy. In particular, it would be interesting to investigate whether the different fields of competition policy (abuse of dominance, mergers, hard-core cartels) are affected differently by globalisation and, if so, what implications this may have.

Notes

- 1 We are very grateful to Laetitia Driguez, Sean Ennis, Frédéric Jenny, Georges Molins-Ysal, Gunnar Niels, Valérie Rabassa and André Sapir for their insightful comments and suggestions.
- 2 In the Kodak/Fuji case, US authorities accused Japan of not sanctioning vertical restraints. Fuji's control of the local film distribution system would have restrained the access of the US firm Kodak to the Japanese photographic film market.
- 3 A greenfield investment can be defined as the establishment of a new production facility in contrast to cross-border M&A where a firm purchases shares of an existing foreign firm. We do not distinguish between the terms merger and acquisition.
- 4 The surge in cross-border operations has been parallel with the outsourcing strategy and the fragmentation of the production process across countries. [Evenett *et al.* 2000]. With trade and FDI liberalisation, the number of available input buyers increases, which diminishes hold-up behaviours. Vertical disintegration has some implication for antitrust authorities, since inter-firm transactions are indeed more exposed to antitrust scrutiny than intra-firm transactions.
- 5 While the 20th century witnessed several waves of M&A activity, the latest merger wave is unprecedented in terms of its size, sectoral coverage, and the number of nations whose firms participated in this wave [Evenett 2003]. M&A activity peaked in 1999 when its total value amounted to an equivalent of 8 percent of world GDP. In comparison, this percentage was 0.3 percent in 1980 and 2.0 percent in 1990 respectively, these two years being the peaks of the last two waves of M&A. [UNCTAD 2000.]
- 6 It is beyond the object of this chapter to examine international M&A. For empirical papers, see for instance Bertrand *et al.* [2007], Hijzen *et al.* [2005], Di Giovanni [2005], Gugler *et al.* [2003] or Raff *et al.* [2006]. Theoretical aspects have been addressed for example by Bertrand [2005], Bjorvatn [2004], Kabiraj and Chaudhuri [1999], Lommerud *et al.* [2006], Qiou and Zhou [2006] or Neary [2004].
- 7 International M&A and cartels could be related. M&A by reducing the number of competing rivals could facilitate the formation of cartels. It is also frequently emphasised that sanctioning cartels heavily could encourage firms to merge [or form joint ventures] in order to restore market power. [Evenett *et al.* 2001.]
- 8 See the literature on multi-market contacts, for instance Scott [1989 and 1991] and Bernheim and Whinston [1990].
- 9 Higher transparency enables buyers to search for the best product, which can undermine collusive discipline. However, more blurred frontiers make the natural geographic division of markets less obvious.
- 10 See The Economist, 'Microsoft on Trial', April 28th, 2006.
- 11 Conflicts are of course not confined to US-EU relations. South Africa complained in 1996 about the prohibition of the merger between Lonrho and Gencor. US authorities also blocked mergers between European companies approved by the European Commission, eg the BOC/Air Liquide merger in 2000.
- 12 Note that Articles 87 and 88 refer to state aid. The Commission's Directorate-General for Competition ensures that state aids do not distort intra-European competition. A complete analysis of the impact of state aid and its enforcement by DG Competition and other European bodies is beyond the scope of this text.
- 13 Articles 85 and 86 of the Treaty of Rome [1957] were replaced by Articles 81 and 82 of the Treaty of Amsterdam [1997].
- 14 Before 1989, merger regulation was based indirectly on Articles 81 and 82. The first prohibition of a merger took place in 1971 with the Continental Can acquisition.

- 15 See Council Regulation [EC] No 1/2003 of 16 December 2002 [OJ 2003, L1].
- 16 The ECN is a network of EU competition authorities exchanging information, allocating cases and undertaking joint investigations. It is designed to guarantee homogeneity of application of EU rules.
- 17 See Council Regulation [EC] No 139/2004 of 20 January 2004 [OJ 2004, L24].
- 18 In this chapter, we do not provide a full account of the interaction between competition policy and the intellectual property regime. [Crampes *et al.* 2005.] The EU grants no intellectual property rights, except trademarks. These rights are enforced at member-state level. It is complemented by the European patent convention signed in 1973. The European Patent Office permits one-stop-shop review by proposing a bundle of national patents.
- 19 Imperial Chemical Industries Limited v European Commission, case 48/69, 1972, ECR 619. Continental Can, case 6/72, 1973, ECR 215. See Grisay [2005].
- 20 A Ahlström Osakeyhtiö and others v Commission, case 89, 104, 114, 116, 117, 125, 1988, ECR 5193. See Grisay [2005].
- 21 The implementation doctrine is called the effect doctrine in the US. In practice, these two concepts are rather similar even if there is no clear consensus. According to Kojima [2002], the Commission adopted the effect doctrine, while the ECJ used an objective territorial principle. Differences between the effect doctrine and the implementation doctrine may exist when an agreement implemented outside the EU produces some effects on the EU market. [Davison and Johnson 2002.]
- 22 The US Supreme Court examined the extraterritorial principle for the first time in 1909 for the American Banana Co. v. United Fruit Co. This principle was denied since actions did not occur within the US. A US-based trader in Costa Rica accused another US-based trader in Costa Rica of anti-competitive practices on the Costa Rican banana trading market [Sugden 2002 or Kojima 2002]. The US applied the extraterritorial principle the first time for the Alcoa case in 1944. It fines an agreement by companies outside the US which has the effect of reducing exports to the US [Kojima 2002]. The Foreign Trade Antitrust Improvements Act in 1976 prosecuted foreign behaviours that have a direct, substantial and reasonably foreseeable effect on US commerce. This is the theory of intended effect discussed by Kojima [2002]. In the 1980s, US antitrust authorities used the consumer welfare approach in international issues. Jurisdiction can pursue foreign firms involved in imports for conduct that hurts US consumers. In the 1990s, the enforcement policy was officially extended to harmful practices to US exports of goods and services, ie to US companies. [Falvey and Lloyd 1999]. This extension first appeared in the 1980s in a context of trade deficit and tension, notably with Japan. This extension was criticised by the EU. It is important to emphasise that the EU has refused to extend the extraterritorial principle to the defence of EU exporters and to introduce motivation in terms of market access.
- 23 Gencor Ltd vs. Commission, case T-102/96, 1999, ECR II-0753.
- 24 It was more complex to define the geographic scope of jurisdiction in this Gencor/Lonrho case because of the already existing test of the EU dimension. A concentration has an EU dimension only if the combined aggregate world wide turnover of all the undertakings involved exceeds €5 billion and the aggregate EU-wide turnover of each of at least two of the undertakings involved exceeds €250 million, unless each of the undertakings has more than two-thirds of their EU-wide turnover within the same European member state. This criterion applies to all firms irrespective of the place where they are registered and produce.
- 25 Boeing agreed to give up its exclusive contracts with airline companies. Note that the Commission could not have prohibited this operation, but only imposed a heavy fine (up to 10 percent of turnover). Purchase of Boeing or McDonnell Douglas aircraft by European companies could have been forbidden too.
- 26 See the website of the European Commission Competition Directorate-General for a complete list of

- bilateral and multilateral agreements.
- 27 'If a party believes that anti-competitive activities carried out in the territory of the other Party are adversely affecting its important interests, the first Party may notify the other Party and may request that the other Party's competition authorities initiate appropriate enforcement.'
- 28 Article III states that 'The competition authorities of a Requesting Party may request the competition authorities of a Requested Party to investigate and, if warranted, to remedy anti-competitive activities in accordance with the Requested party's competition laws. Such a request may be made regardless of whether the activities also violate the Requesting party's competition laws, and regardless of whether the competition authorities of the Requesting Party have commenced or contemplate taking enforcement activities under their own competition laws.'
- 29 The US Department of Justice formally requested the European Commission to investigate allegedly anti-competitive practices by European airlines against US enterprises.
- 30 Cooperation on merger reviews is more active than on cartels or other anti-competitive practices because of the firms' lobbying. Companies support more coordination among authorities in M&A transactions since they have to face several procedures from different regulators. Firms are more reluctant about such coordination for cartel prosecution.
- 31 There exist some clear differences between the OECD and the ICN (see discussion in Kudrle 2005). The ICN only focuses on competition issues and is open to all countries, contrary to the OECD. The ICN has no permanent secretariat. While the OECD makes recommendations, the ICN guides countries towards best practices through reports and proposals only. The ICN is more a complement than a substitute for the OECD forum.
- 32 As remarked by an attentive reader, the mechanisms that we describe are not really 'errors', but rather conscious decisions only to address domestic welfare and not to take into account externalities.
- 33 Export cartels can however enhance efficiency. By cooperating in the marketing and distribution of export products abroad (eg through a common sales agency), firms are able to share the fixed costs of exporting. Thus, the effect of export cartels could be positive, even for foreign consumers. Efficiency considerations and the promotion of export abroad were questioned in the past, especially in the US. Export cartel exemption was very often employed by multinational firms in the 1950s and 1960s, and not by small and medium-sized firms. Today, this issue is less clear and should certainly not be overstated (Levenstein and Suslow 2004).
- 34 There exist three different regimes as discussed by Levenstein and Suslow (2004): explicit (with or without notification and authorisation), implicit and no statutory exemption (no mention of the geographic market). There is an implicit exemption when export cartels are not subject to national laws.
- 35 Barros and Cabral analyse the external effects of mergers, ie the impact on consumers and non-merging firms – called outsiders in Shapiro and Farrell (1990). Effects on merging firms (called insiders) are neglected, assuming that these firms decide to merge only if the operation is profitable.
- 36 Since developing countries are usually net importer countries, they should be compensated for a loss in developed countries, which is not realistic because of wealth constraints.
- 37 Companies have some interest in authorising the discussion and the exchange of confidential business information, especially for M&A investigations (as in the WorldCom/MCI case investigated by both the US and the EU authorities). It alleviates some costs from multi-jurisdictional merger review (conflicting analyses and remedies, time and money commitments, etc.). Companies are much more reluctant to waive these restrictions in cartel prosecutions.
- 38 However, it is not clear why this risk could be higher with an international rather than a national regulation office. In addition, a powerful interest group from one country could be counter-balanced by a more powerful interest group from another country (Guzman 2004).

- 39 The concept of industrial policy and of its instruments is not very well defined (Evenett 2005b). For example, some people underline that industrial policy seeks to facilitate the structural transformation of industries. Instruments of industrial policy are not clearly defined. This could include investment subsidy, tax credit, import protection etc. The European Commission provides its views on the definition and contents of industrial policy in different documents. See for instance http://ec.europa.eu/enterprise/enterprise_policy/industry/com_2005/com_2005_474_en.pdf.
- 40 In their theoretical framework and under the assumption of an extraterritoriality regime, conflicts emerge when authorities define an excessively narrow relevant geographic market.
- 41 In some sectors, foreign takeovers can be forbidden (eg for security reasons) or be reviewed more strictly by competition authorities.
- 42 In addition, exemptions from competition policy can be granted as (and particularly) in the regulation of state aid.
- 43 It can be illustrated by the Virgin/British Airways case in 2001. According to Niels and ten Kate (2004), the US did not declare British Airways guilty of restraint of trade and attempted monopolisation. Virgin would have failed to prove any anti-competitive effects on price, output and product quality. Also, it did not show the existence of predatory behaviour. On the contrary, the European Commission concluded an abuse of dominant position. The EU would have condemned the incentive scheme *per se* of British Airways on travel agents, without evaluating the effect on competition.
- 44 There could be some differences in competition laws on cartels among countries in terms of justifications (deterrence, punishment, compensation for damage), sanctions (pecuniary fines, prison for executives, action for damages and disqualification of executive from running the company) and mitigation of sanctions via leniency programmes (immunity from fines and imprisonment) and authorised cartels (exempted export cartels) (Schoneveld 2003).
- 45 In recent speeches, EU Competition Commissioner Neelie Kroes advocates the development of mechanisms by which individuals and companies could be compensated for the negative effects of antitrust activity. These mechanisms would be part of competition policy as devices to fight anticompetitive practices.
- 46 Consumers indeed can benefit from a concentration in an industry where network externalities and complementarities play an important role. However they can be harmed by the presence of switching costs and lock-in effects.
- 47 See for instance Cadot *et al.* (2000) for an exhaustive review of the literature.
- 48 See Jacquemin and Sapir (1991), Levinshon (1993), Roberts and Tybout (1997) or eg Thomson (2002). For instance, Jacquemin and Sapir measure this effect in Europe. The disciplinary effect of imports seemed to be more important for extra-EU imports than intra-EU imports. Thomson (2002) gets more mixed results in the 1970s in Canada. There is no clear evidence of pro-competitive effects from trade.
- 49 Trade liberalisation could also induce domestic mergers (on this point see for instance Ben-Ishai 2005).
- 50 See also for instance the case of Airbus. Airbus has been allegedly engaging in vertical arrangements with its European suppliers (via eg standards discrimination against foreign suppliers). It is claimed to have restrained sales of non-European suppliers.
- 51 For instance, the Korean government blocked a merger in a chemical industry because of the excessive level of trade barriers, preventing foreign competition. Similarly, the US took into account the US quota policy which limits the capacity of foreign firms to increase their production in the case of an anti-competitive merger.
- 52 See for instance Niels (2000) for a review of the literature.
- 53 See Bourgeois and Messerlin (1998) for a more detailed description of the institutional anti-dump-

- ing framework in the EU.
- 54 There is some confusion between predatory dumping and normal dumping commonly used in price discrimination. Dumping is not in itself an anti-competitive practice. Dumping is a component of international trade. Because of competition, domestic prices could be lower to the benefit of consumers. Foreign firms have indeed to accept smaller margins abroad due to trade costs. Predatory dumping could drive competitors out of the market and thereby reduce competition. It should be kept in mind that price differences might not be due to an asymmetry in productive efficiency only.
- 55 See also for instance Deardorff and Stern (2004).
- 56 Consistent with WTO rules, the complaint in the EU should be supported by EU industry, ie 'by those Community producers whose collective output constitutes more than 50 percent of the total production of the like product produced by that portion of the Community industry expressing either support for or opposition to the complaint' (Bourgeois and Messerlin 1998). This rule favours collusion.
- 57 Cartel members may also use tariff barriers or non-tariff barriers (quotas) to sustain collusion over time by preventing entry or punishing deviating firms (use of trade and statistical reports and import surveillance). For instance, the citric acid cartel members asked the government for tariff protection from China (Levenstein *et al.* 2004).
- 58 These models are related to horizontal consolidation and practices. They overlook vertical arrangements and the foreclosure of domestic markets.
- 59 The presence of foreign consumers gives an incentive to increase the degree of concentration (assuming that there are no foreign firms). Collusion is then good. With the presence of foreign competitors, the relation is now ambiguous because of rent-shifting between foreign and domestic competitors. In addition, there is a third effect taken into account by authorities: industrial concentration affects home country welfare too.
- 60 See also for instance Dixit (1984) or more recently Saggi and Yildiz (2006). Dixit analyses how domestic welfare is related to the number of home and foreign firms, as well as export tariffs and import subsidies.
- 61 It is frequently noticed that cooperation was close and efficient in the cases of Gencor/Lonrho, Exxon/Mobile, Worldcom/MCI, MCI WorldCom/Sprint, BT/AT&T, Air Liquide/BOC, AOL/Time Warner and Oracle/People Soft.
- 62 For instance, according to Jenny (2003), it is not so obvious that US-EU cooperation has really fostered convergence only because agreements on antitrust affairs are observed. It could simply be explained by no or symmetric effects across US and EU.
- 63 In the Kodak case, the US authorities reproached Japan for not applying existing competition rules on vertical integration for keiretsu.
- 64 Authorities are even less free to share and release information in cartel cases because of local laws strictly controlling information during investigations. For instance, in the US or the EU, the identity of amnesty applicants or information provided without the authorisation of the applicant cannot be disclosed.
- 65 EU companies fear for instance private civil prosecution in the US.
- 66 The prosecution in cartel cases requires more past information on firms' activity than information on future strategic plans as in M&A control. Information required in cartel cases is less confidential. Pre-merger reviews could require materials on sensitive trade secrets or prospective business plans.
- 67 For instance, there is no package where a merger reducing the domestic welfare but increasing the global welfare will be accepted by a country in exchange of compensatory measures (over time or not). Each case is evaluated separately.

- 68 Some countries argue that they do not have experience enough to enforce and to negotiate antitrust issues (Mehta 2003). They worry that their interests will not be fully considered during this negotiation (Bode and Budzinski 2005). They see it as an attempt to achieve even greater access for foreign multinational firms to their markets. Others think that the non-discrimination principle would undermine their industrial policy, notably the national champion policy.
- 69 As pointed out by another attentive reader, WTO negotiations are more dominated by the mercantilist approach than the settlement of trade disputes.
- 70 However the action of ICN is progressively gaining respectability due to its effective role in promoting cooperation.
- 71 For instance, the leniency programme should be revised to allow firms to be immunised in several markets simultaneously based on damage in all markets (Schoneveld 2003). Transparency of European decisions facilitates the convergence of rules at an international level since it allows authorities to better understand similarities and differences in antitrust procedures.
- 72 For example, the relationship between the EU leniency programmes and national agencies has to be clarified (OECD 2005b). There is no one-stop-shop companies can address. Some member states do not have a leniency programme, or programmes differ from one country to another.
- 73 Recently, in 1995, the Competition Directorate-General initiated investigations in finance and energy to detect potential private constraint and public regulations.
- 74 Antitrust laws could be included in the anti-dumping procedure (Hoekman 1997). As proposed, a two-tier approach could be adopted. Alleged anti-dumping practices could first be judged using the antitrust criteria (Wootong and Zanardi 2002).
- 75 Proposals can be numerous during a legislative session. Competition agency resources are limited and should be focused on antitrust issues of importance only (Clark 2004).
- 76 It is difficult to assess the effect on legislators and/or regulators. Institutional effects could be visible or occur only in the very long run.
- 77 In parallel to competition advocacy, the OECD is currently supporting the self-assessment of competition issues by non-competition bodies through the development of 'assessment toolkits' (OECD 2006b). Indeed, unsolicited advice from competition authorities could imply a hostile reaction from other bodies. Besides, it could absorb excessive competition authority resources. However, let us stress again that this step of self-assessment should be formally codified in law to be effective, and requires an active role on the part of competition authorities as promoter, adviser, and designer of the assessment toolkit.

External financial markets policy: Europe as global regulator?

Marco Becht and Luis Correia da Silva

The European Union of 27 (EU27) as an economic grouping has the largest banking sector, the largest insurance sector and the largest payments system in the world (see Table 7.1). It also has the largest private sector fixed income market. Its derivatives and equity markets are starting to rival or merge with those of the United States. The EU27 is a sleeping financial regulation giant. As financial integration deepens, the EU could become the world's leading financial services regulator.

In some areas this is already happening. The EU is promoting international standards it has adopted itself for the prudential regulation of banks and for accounting. These standards are being adopted in Asia and Latin America. The standards have not yet been adopted in the US and the resulting regulatory duplication and incompatibility are hampering global market integration.

To understand why it is so hard to develop a common approach to international financial regulation we develop a simple taxonomy based on the economic analysis of standard-setting in the presence or absence of externalities. We augment this analysis by considering the need for supervision and enforcement in home as well as in host countries. We use our framework to classify existing regulatory arrangements at the European and global levels.

Financial regulation is complex because it includes many different types of 'regulation'. Each type of regulation has its own economic trade-offs. We distinguish between prudential regulation standards, investor protection standards, technical standards, supervision of institutions and market participants, enforcement and ancillary regulation, for example financial regulation designed to combat crime.

*Table 7.1: The comparative size of financial markets (euro billions for the year 2005)**

Indicator	EU	US	Japan
Bank assets	7,628	2,689	461
Insurance premiums	1,385	1,189	335
Non-bank payments	177,215	47,336	18,129
Derivatives	14,287	25,944	n/a
Equity market capitalisation	7,082	11,677	5,181
Equity turnover	10,151	17,047	3,227
Bond market capitalisation	8,638	665	6,551
Bond turnover	7,590	1	5
Debt insurance	5,692	2,428	189

Note: Bank assets – External positions of reporting banks vis-à-vis all sectors, Derivatives – Notional amounts of over-the-counter and exchange-traded derivatives, Debt issuance – All papers, all issuers, by nationality of issuer. Bond market data for the US is New York Stock Exchange only.

** Except insurance premium data, which is for the year 2004.*

Source: Bank of International Settlements, Organisation for Economic Cooperation and Development, World Federation of Exchanges, Datastream.

Prudential regulation seeks to prevent macroeconomic crises caused by micro level market failures. It is comparable to safety regulation designed to protect vital economic infrastructure. The key economic issues are cost and moral hazard. Investor protection regulation seeks to overcome the inability of unsophisticated investors ('widows and orphans') to protect themselves from financial manipulation and fraud. It has much in common with consumer protection legislation. The central economic issue is the trade-off between the level of protection and its cost.

Technical standard setting regulation is crucial whenever interconnectivity is required, such as in clearing, settlement and payments systems. This type of financial regulation is closely related to industrial standard-setting for mobile phones, the internet or satellite communications. The main economic issues are network externalities, the optimal choice of quality and natural monopolies.

The supervision of market participants and service providers is the financial services equivalent of on-site meat-packing plant or restaurant inspections. Enforcement entails complex legal issues rooted in administrative and private international law.

The economics of regulation suggests that in the presence of strong externalities the adoption of harmonised international rules is desirable. In general we can apply the insights from industrial standard-setting with network externalities. Critical

mass matters, and when the EU adopts a common standard it has the potential to become a global standard. At least, the EU is in a good starting position to negotiate a compromise standard internationally.

In practice, this rarely happens because the EU is incapable of adopting Union-wide financial regulation. We single out two main factors that are responsible for this. First, there is widespread disagreement within the EU over the adoption of any common standard. Member states have heterogeneous preferences and pay-offs. Standards battles are as likely between states as between private companies. Some member states might even see a competitive advantage in adopting their own or a non-EU standard. Second, when prudential, technical or investor protection standards are inseparable from supervision, European regulatory standards also require a common approach to supervision and enforcement. This is only feasible when enforcement power can be vested in an EU body and member states are prepared to give up sovereignty.

As a result the EU adopts less harmonised regulation than a pure externality analysis suggests it should. Consequently the EU plays a smaller role in global standard-setting than suggested by the size of its financial systems. In practice this results in the adoption of a non-EU standard by some EU market participants or member states, leading to fragmentation, incompatibility and duplication.

When externalities are weak, economists generally favour local regulation with mutual recognition over uniform standards. Unfortunately full mutual recognition in financial services is only feasible in sectors or for products that require little supervision and enforcement in host countries. In these exceptional cases the EU is well represented externally through bilateral agreements between individual member states and non-EU countries.

In most cases supervision in the home and host country is required, if not for practical then for political reasons. Mutual recognition does not work and internal regulatory policy has extraterritorial consequences, particularly when it comes to enforcement. This situation is typical for securities regulation within the EU, but also in the global context. The regulators and US courts will seek to investigate and prosecute anybody suspected of having defrauded US resident investors, no matter where the suspect resides.

To complicate matters further, even when it is feasible in principle, regulatory competition with mutual recognition is rejected because it allegedly leads to a 'race to the bottom' or an 'uneven playing field'. In these cases there are calls for minimum

standards, preferably at the global level. Alternatively there will be calls for additional regulation in the country of destination designed to 'level the playing field' or 'protect the public interest'. In these cases it is hard to distinguish between market failure and protectionism.

In all areas of financial regulation, the keys to enhanced international cooperation are intensified dialogue and cooperation with the US, the international enforcer of its own, transatlantic and global regulatory standards.

The remainder of the chapter is structured as follows. The second section sketches the current international institutional framework. The third section analyses in turn prudential regulation, investor protection, technical standard-setting, the supervision of market participants and enforcement. The fourth section provides conclusions.

Institutional arrangements

In practice, regulators set product standards. They define who can buy and who can sell financial products, determine who can operate in financial markets, define rules of conduct for markets, market participants and service providers, maintain registers of supervised entities and products, monitor the conduct of the various entities, are often (but not always) the repository of disclosure documents, vet the content of disclosure documents, provide guidance, supervise and bring enforcement action. As we will show, it is the complex interaction of these elements that makes it difficult to design an integrated international financial regulation framework.

Regulators and politicians are aware that financial systems are in principle integrated at the global level. If there was any doubt, the Asia-Russia-Brazil crisis of 1997 and 1998 convinced even those who remained sceptical that financial stability and contagion are international concerns. The Asian crisis was important because it extended traditional financial stability cooperation in monetary policy at the macro level to new areas like fiscal transparency, accounting, auditing, payment and settlement, corporate governance, market integrity and insolvency.

The new thinking was reflected in the creation of the Financial Stability Forum (FSF), which held its first meeting in April 1999 in Washington. Currently the FSF brings together representatives of government ministries, central banks and financial service regulators from eleven countries¹, along with the European Central Bank (ECB) and international organisations and committees². The FSF is hosted at the Bank for International Settlements (BIS) in Basel, Switzerland, but meets regularly in different locations.

Global thinking on financial stability and regulation after the Asia crisis is enshrined in twelve standards published by the FSF³ (see Table 7.2). These cover the traditional areas of macroeconomic policy and data transparency, as well as institutional and market infrastructure and financial regulation and supervision. The issuing bodies of the standards are the 'Who's Who' of international standard-setting in financial systems regulation. While the International Monetary Fund (IMF) is responsible for the macro-standards, as one would expect, the World Bank has the lead on insolvency, the OECD on corporate governance, the International Accounting Standards Board (IASB) on accounting, the International Federation of Accountants

Table 7.2: Financial Stability Forum (FSF) Regulatory Standards

Area	Standard	Issuing Body
Macroeconomic policy and data transparency		
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	IMF
Fiscal policy transparency	Code of Good Practices on Fiscal Transparency	IMF
Data dissemination	Special Data Dissemination Standard/ General Data Dissemination Standard*	IMF
Institutional and market infrastructure		
Insolvency	(pending)**	World Bank
Corporate governance	Principles of Corporate Governance	OECD
Accounting	International Accounting Standards (IAS)***	IASB****
Auditing	International Standards on Auditing	IFAC****
Payment and settlement	Core Principles for Systematically Important Payment Systems Recommendations for Securities Settlement Systems	CPSS CPSS/IOSCO
Market integrity	The Forty Recommendations of the Financial Action Task Force/ 9 Special Recommendations against Terrorist Financing	FATF
Financial regulation and supervision		
Banking supervision	Core Principles for Effective Banking Supervision	BCBS
Securities regulation	Objectives and Principles of Securities Regulation	IOSCO
Insurance supervision	Insurance Core Principles	IAIS

* Economies with access to international capital markets are encouraged to subscribe to the more stringent SDDS and all other economies are encouraged to adopt the GDDS.

** The World Bank is coordinating a broad-based effort to develop a set of principles and guidelines on insolvency regimes. The United Nations Commission on International Trade Law (UNCITRAL), which adopted the Model Law on Cross-Border Insolvency in 1997, will help facilitate implementation.

*** Relevant IAS are currently being reviewed by the IAIS and IOSCO.

**** The International Accounting Standards Board (IASB) and the International Federation of Accountants (IFAC) are distinct from other standard-setting bodies in that they are private sector bodies.

Source : <http://www.fsfforum.org>

(IFAC) on auditing, the Committee on Payment and Settlement Systems (CPSS) on payment and settlement and the CPSS and the International Organisation of Securities Commissions (IOSCO) jointly on market integrity. Banking supervision is dealt with by the Basel Committee on Banking Supervision (BCBS), securities regulation by IOSCO and insurance supervision by the International Association of Insurance Supervisors (IAIS).

The governance of the various institutions differs substantially (Table 7.3). Institutions like IAIS and IOSCO have as members public sector regulators from more than 100 countries. In contrast, the BCBS only has 13 members from Canada, the US, Japan and the EU; the CPSS has 14 members from Canada, Hong Kong, Japan, Singapore, the US and the EU. The IASB and IFAC are altogether different: IFAC is a professional organisation and has 163 member organisations from 120 countries; the IASB has 14 members appointed by the International Accounting Standards Committee (IASC) Foundation, which has 22 mainly private sector trustees from Europe, North America and Australasia.

The interaction between international standard-setting, the EU's financial integration efforts and regulation – including enforcement – at the level of the EU member states is complex and slightly different for each FSF standard (see Figure 7.1). In the case of banking, for example, the BCBS has no formal authority. The standards it publishes are not binding and they are not necessarily adopted by all countries with a seat on the committee. In the EU, the practical implementation of the BCBS standard takes the form of an EU directive, but many member states will not wait for the EU to agree on a directive and instead immediately implement the international standard.

The type of regulation matters. Next we analyse in turn prudential regulation, investor protection, technical standard-setting, the supervision of market participants and enforcement.

What regulation?

Prudential regulation standards

There is agreement among policymakers that prudential regulation is required to avoid crises in financial systems with negative consequences for the real economy. Policymakers also agree that there is a risk of a domino effect with financial crises spreading rapidly throughout the global financial system ('contagion')⁴.

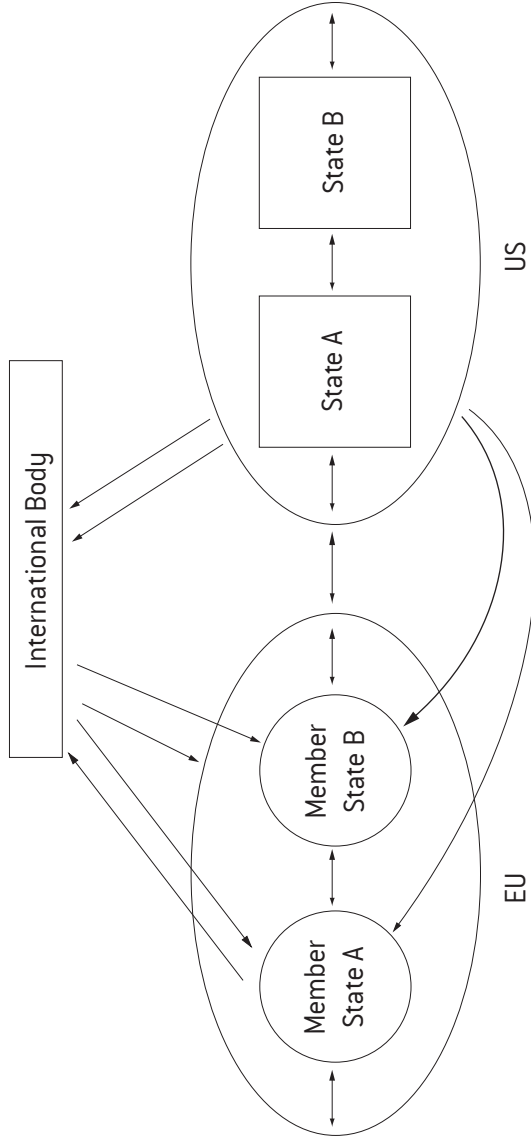
Table 7.3: EU representation in international standard-setting organisations

Country	G8	G10	FSF	BCBS	IASB*	IAIS	IOSCO	CPSS	CGFS
Austria						x	x		
Belgium		x		x		x	x	x	x
Bulgaria						x	x		
Cyprus						x	x		
Czech Republic						x	x		
Denmark						x	x		
Estonia						x	x		
Finland						x	x		
France	x	x	x	x	x	x	x	x	x
Germany	x	x	x	x	x	x	x	x	x
Greece						x	x		
Hungary						x	x		
Ireland						x	x		
Italy	x	x	x	x		x	x	x	x
Latvia						x	x		
Lithuania						x	x		
Luxembourg				x		x	x		
Malta						x	x		
The Netherlands		x	x	x	x	x	x	x	x
Poland					x	x	x		
Portugal						x	x		
Romania						x	x		
Slovakia						x	x		
Slovenia						x	x		
Spain				x	x	x	x		
Sweden		x		x		x	x	x	x
United Kingdom	x	x	x	x	x	x	x	x	x
European Commission									
ECB			x						
Australia			x		x	x	x		
Brazil					x	x	x		
Canada	x	x	x	x	x	x	x	x	x
Hong Kong			x			x	x		
India					x	x	x		
Japan	x		x	x	x	x	x		
People's Republic of China					x	x	x		
Russia	x					x	x		
Singapore			x			x	x		
South Africa					x	x	x		
Switzerland		x	x	x	x	x	x	x	x
United States	x	x	x	x	x	x	x	x	x

* Private sector body with individual representation; table indicates nationality of trustees.

Figure 7.1: *The transatlantic regulatory framework in financial services*

Figure 7.1 illustrates the complex interaction between different levels of regulatory decision-making in the relationship between the EU and the US alone. The International Body could be the Basel Committee for Banking Supervision or any other body in Table 7.3. Standards are negotiated at international level and then 'passed down' directly to the level of EU member states in the EU and to the Federal Government in the US. They are also passed down to EU level and internal EU negotiations commence about applying the standard throughout the Union. This can take much longer than adoption by individual member states. In the US adoption is also complex because it can involve the US administration, the US Congress, the Senate and – potentially – the US courts and other parties. In the meantime mutual recognition negotiations are being conducted between the US government, individual EU member states and the Union as a whole. These negotiations can have a direct impact on negotiations within the Union, for example if one member state feels it can gain an advantage by striking a bilateral agreement with the US excluding the rest of the EU. Given the complex nature of the regulation it is remarkable that anything can be achieved at all.



In banking the main prudential regulatory standards are capital adequacy requirement standards for banks developed by the Basel Committee on Banking Supervision (BCBS)⁵. The 'Basel I' standard or 'Basel Capital Accord' was developed in 1988 and has been adopted by almost all countries with banks. The 'Basel II' standard is a revision proposed in June 1999. Following a long period of consultation with the international financial community and regulators, the final standard was published in June 2004. It has not been adopted yet by all OECD countries.

The Basel II standard illustrates two fundamental problems in the development of international standards. First, the required level of the standard can differ across countries and sectors. During the consultation phase for Basel II, smaller banks complained that the standard was too onerous for them. Second, standards that are proposed by an international committee like the BCBS are not automatically adopted by all countries. The BCBS cannot even force the member countries of the committee to adopt the standards it proposes.

Despite these difficulties in the world wide implementation of the Basel II standard there is little to worry about in prudential standard-setting. There tends to be widespread agreement among European banks, insurance companies, governments and regulators that the EU27 needs a single prudential regulation standard and that such a standard should be set at an international level, without any obligation for adoption for individual countries. The EU's size helps in persuading the international community that the prudential standard proposed internationally should be adopted as the global standard. The difficulty here is not the standard-setting but the supervision and enforcement. We return to these points below.

Technical standards

Technical standard-setting regulation is crucial whenever interconnectivity is required, for example in clearing, settlement and payments systems. The main economic issues are network externalities, the optimal choice of quality and natural monopolies. Standard-setting is political because electorates might have different quality preferences and rival networks might use their political connections to try and win standards battles.

One problem is the choice of the 'correct' standard in terms of quality and user preferences [Farrell and Saloner 1985, Katz and Shapiro 1985, Besen and Farrell 1994, Liebowitz and Margolis 1996]. Even more relevant are lock-in effects and path dependence caused by network externalities [Arthur 1989, 1990, David 1985, Liebowitz and Margolis 1990, 1995]. It is very hard to persuade national regulators

to abandon a particular standard once it has been chosen, in particular if the number of users is large.

If standard-setting is left to the market, inferior or inappropriate standards can be chosen. The outcome is the result of a bargaining game. Depending on the pay-offs the game is a variant of the prisoners' dilemma or the 'battle of the sexes' [Katz and Shapiro 1994]. Even though it would be globally desirable to have the same technical standard this is not the equilibrium outcome of the bargaining game. In the 'battle of the sexes' both governments would prefer to have one standard, but each one has a national favourite. The bargaining process is usually entertaining but does not guarantee an agreed outcome.

To illustrate these points, consider a simple technical standard like identification numbers for securities such as publicly traded stock and bonds. These numbers are a technical standard because they are used by information technology systems to identify a single issued security. There are clear network externalities because the larger the number of data vendors and investors who use the number, the more useful the number is for the vendors and the investors. If there are competing numbers there is a chance that the market might 'tip' with one number becoming the dominant standard. If the standard is owned by a company this company has market power and can charge users for the use of the number⁶. The case becomes complicated if the company has a clearly identifiable national base and political influence.

In normative terms it is clear what should happen. Securities identification numbers should be assigned as an international open standard. The tricky question is: whose numbers will be used? Here the installed base matters. If Europe has one particular type of number system, rather than 27 different types, it has a better bargaining position *vis-à-vis* the United States or other large countries⁷.

In practice Europe hardly ever agrees on a common technical standard in financial services. The first reason is internal reluctance to abandon national standards in favour of an EU standard. It would be extremely difficult, for example, to persuade European countries to introduce a single postcode system. Member states would not want to bear the cost and there would be popular objections for sentimental reasons. An even more powerful reason is vested interests. Network externalities in combination with a large national installed base gives market power that tends to escape the scrutiny of the competition authorities. Member states and private companies are extremely reluctant to give up such privileged positions.

A remarkable exception is international accounting standards. The EU promoted the

creation of the international (private) institutions that issue the standards. Exceptionally, the EU also managed to make the international standard compulsory for all EU-listed companies. Finally, the international body successfully persuaded other countries to adopt the multilateral standard. The installed base is so large that it will be very hard for other countries to refrain from adopting the standard, even countries the size of the US.

A second area with great potential is payment standards. There are substantial network effects that arise in the development of financial systems for bank payments. The service offered by a bank payments system is the transfer of funds. As such, the value of a bank payment network is dependent on the number of other parties that can make and receive transfers. With such strong network effects, it is efficient to have a single network for bank payments at the European and international level.

Bank payment systems are a good example because a key factor is the standard used for communication. The system developed to handle bank transfers relies on these standards. As such, these are the most important consideration in terms of the internal and external competence of bank payment systems.

The development of bank payment systems in Europe has been a significant issue with the launch in 2002 of the single European payments area (SEPA) and the European Payments Council (EPC). These initiatives have focused on integrating the bank payment systems across Europe for the three types of service originally considered: credit transfers, direct debits and card transactions. The SEPA initiative was launched by the European Commission, with its high-level requirements and implementation timelines defined by the European Central Bank. The EPC was created to monitor the development of SEPA. Since 2004, the EPC has developed the bank payment systems framework, publishing rulebooks on credit transfers and direct debits, and developing frameworks for cards and cash.

In terms of the standards implemented within SEPA, the EPC has decided to implement ISO 20022 – the Universal Financial Industry (UNIFI) message standard. Furthermore, the EPC has appointed SWIFT (the Society for Worldwide Interbank Financial Telecommunication) to develop the messages for the SEPA credit transfer and SEPA direct debit. ISO 20022 is the international standard for inter-bank transfer messages. It was and continues to be developed by the ISO. Within this framework, SWIFT is the registration authority for ISO 20022, and participates actively in the ISO committees that affect the development of ISO 20022.

SWIFT was established in 1973 by 239 banks from 15 countries. It is an industry-

owned limited liability cooperative society established under Belgian law. It currently serves 7,400 financial institutions in 198 countries, although 66.6 percent of SWIFT FIN messages are within Europe. Oversight of SWIFT is carried out according to a special agreement between the central banks of the G10 countries, which appointed the National Bank of Belgium (NBB) as the central bank in the country in which SWIFT is based, to act as the lead overseer of SWIFT, with the support of the G10 central banks. The Bank of International Settlement's committee on payment and settlement systems is briefed on the oversight regime and may provide direction on the focus of the NBB's oversight activities.

Therefore, both internal and external competence within the EU lies with the three pillars underlying SEPA – the European Commission and ECB and, most significantly, the EPC. However, with regard to standards, the EPC has adopted the international ISO standards, although these were principally developed by SWIFT, the oversight of which is undertaken by the NBB and the other G10 central banks.

SEPA will have a large installed base compliant with an international standard, creating critical mass. The EU has also agreed that non-banks can use the standard, making the system highly competitive. If SEPA is successful, it is likely that other countries will follow, leading to the creation of a truly international payment system with substantial cost saving for users.

Investor protection standards

Investor protection standards are closely related to prudential regulation. Some economists have argued that prudential regulation is best understood as investor protection (Dewatripont and Tirole 1993). Depositors in banks and policyholders of insurance companies may be widely dispersed and might not take collective action against a bank or insurance company. Indeed, even if they decided to take action it could be difficult because they may not have voting rights and their only recourse would be the courts. To resolve this problem, regulators step in and act on behalf of these dispersed investors. The same logic applies to other financial sectors, such as publicly traded companies with widely-dispersed shareholders, and investment companies with dispersed fund investors.

However, investor protection standards are more complicated analytically and from a policy perspective than prudential regulation. In prudential regulation there is widespread agreement that a meltdown in the banking system or insurance sector in one country can have negative spillovers (externalities) for the real economy and other countries (contagion). Hence, there is general agreement about the overriding

need for international prudential regulation standards. This is not true for investor protection regulation.

The principal source of disagreement is the level of investor protection needed in each instance. Differences in market structure across jurisdictions can lead to genuine disagreement over the type of investor protection standard needed. One current example is equity markets. Following the corporate governance scandals in the US and Europe (Enron, Worldcom, Parmalat) the US Congress passed legislation seeking to increase the protection of dispersed investors in widely held, publicly traded stock corporations in the US. In Europe and other parts of the world there is a feeling that the US has gone too far and that the cost of the new investor protection measures outweighs the benefits. Europeans like to argue that equity investors are more sophisticated because most publicly traded shares in Europe are owned by institutional investors. Provided that institutional investors are given sufficient contractual rights they can protect themselves. US regulators respond that most shares in the US are still held directly by households, stressing the need for stronger investor protection. Another current example is hedge fund regulation. Hedge funds like to argue that they do not need to be regulated because they contract directly with sophisticated institutional investors. Regulators worry that, through funds of funds and other channels, hedge fund products are directly sold to households who need representative protection.

Disagreements over the appropriate level of standards are also common in prudential regulation, as we saw in the case of Basel II. In the case of investor protection there is an additional consideration that adds a further level of complexity. As with technical standards there can be strong externalities that should lead regulators to adopt common protection standards. The most prominent example is disclosure.

Enforcement

Enforcement and supervision pose the most challenging problem in international financial regulation⁸. Enforcement is either public or private and is dealt with through an administrative procedure or the courts. Public enforcement through an administrative procedure is typically carried out through a regulatory agency that has been granted executive power. The US Securities and Exchange Commission (SEC) for example has the power to launch investigations, call witnesses and freeze assets. Public enforcement can also take the form of public prosecutors or regulatory agencies bringing cases before court. Similarly, in private enforcement, a plaintiff can lodge a complaint with public authorities or bring a case to court.

In international comparisons of securities regulation enforcement, the US is a global outlier. Jointly the SEC, the state securities commissions, the Department of Justice, the National Association of Securities Dealers and the New York Stock Exchange brought an average of 5,103 enforcement actions per year between 2000 and 2002 with fines of \$1,864 million, 2,146 suspensions, expulsions and censures and 13,509 incarcerations and probations (Jackson 2005, Table 3). There were 2,214 private enforcement actions resulting in fines of \$2,027 million (Jackson 2005). No European country brings this level of enforcement to bear on the securities industry, not even when adjusting for population or gross domestic product (Jackson 2005).

The economic consequences and desirability of the level of US enforcement zeal is subject to debate and has been the subject of recent high-level policy reports (the 'Paulson report' and the 'Bloomberg report', see Coffee 2007). In the international regulatory policy context, the difference in enforcement levels across countries and regions poses a major political challenge and has resulted in friction between the EU, the US and other countries. While the prudential and investor protection standards on the books might be converging, the level of, and attitude to, enforcement are clearly not. This explains the reluctance to accept home supervision without host supervision and enforcement in the international context, as well as the 'extraterritoriality' tendencies of US securities enforcement action.

A recent example is accounting standards and auditing. Even if international accounting standards were to become the global norm they still require verification and enforcement. There is great reluctance in particular on behalf of the US after Enron to accept accounts that have been certified by auditors who are not registered and have not been vetted by the new US Public Company Accounting Oversight Board (PCAOB)⁹. The PCAOB will happily work with other regulators but reserves the right to send its own inspectors to monitor the implementation of its guidelines and to enforce its rules if necessary. The motivation is largely political. It is very hard for US politicians to place the supervision and enforcement of regulatory measures intended to protect US investors into the hands of non-US officials. In the EU case it is not even clear in whose hands to place them. The PCAOB has held extensive discussions with the European Commission but these have been mostly on protection standards and enforcement *rules*. The actual enforcement and supervision of auditors continues to rest with individual member states. Since the EU authorities cannot guarantee the quality of enforcement locally it appears reasonable that agreements are bilateral in nature.

Even within the EU there is no clear solution to the enforcement issue. Pan-

European operators must register with a multitude of regulators. Supervision and enforcement takes place in the home as well as the host country. Exactly the same logic applies. It is hard for politicians from country A to explain to local investors that a common EU standard will be enforced as vigorously by the regulator in member state B against an operator from member state C as by the regulator in country A.

Extreme cases

The preceding analysis showed that the EU might have the potential to become a global regulator in terms of its economic size, but that its potential is limited by the difficulty it has in agreeing common standards, and its reliance on member states for supervision and enforcement. In this section we provide two further examples to illustrate the point. The first case shows under what conditions the EU is well represented externally by a single member state. The second case shows that an internationally desirable regulatory agreement is almost impossible to reach when all four of the elements of financial systems regulation we have identified are involved.

The first case analyses Undertakings for Collective Investment in Transferable Securities (UCITS). UCITS are a rare case where approximation of European rules has led to full mutual recognition of an investment product. The EU is well represented externally by Luxembourg and Ireland, the 'market leaders' for UCITS within the EU. The external representation works because UCITS require relatively little supervision and enforcement in the destination country.

The second case is clearing and settlement, which combines all four elements of financial system regulation we have identified. There are strong technical standard externalities, but agreement is required on investor protection standards, on home-versus-host supervision and on enforcement. In addition there are complicated competition policy issues associated with the technical standard-setting. Currently there is no agreement on clearing and settlement regulation within the EU and no agreement at international level.

Undertakings for Collective Investment in Transferable Securities (UCITS)

Collective investment schemes are used globally within the asset management industry as a means of financial intermediation for retail investors. Collective investment schemes have proved to be an effective means for a large number of people to invest in a range of financial instruments. Globally, there is a wide range of different collective investment schemes, reflecting the investment needs and regulatory concerns of different countries.

UCITS are a form of collective investment scheme that has been specially devised within the EU. UCITS were initially elaborated in 1985 as part of the development of the EU internal market. As such, UCITS benefit from a 'passport' that allows any registered and authorised UCITS fund to be offered, subject to notification, to retail investors in any EU member state. However, the regulatory framework for UCITS has required some revision since 1985, as witnessed by the recent implementation of the UCITS III directives.

In addition to the 'passport', and to ensure the effectiveness of a single European market in transferable securities, UCITS benefit from increased investor protection. This is achieved through stricter investment limits, capital requirements, disclosure requirements, asset safe-keeping and fund oversight.

The UCITS market has, relative to other financial systems, few externalities. There are no significant network effects in UCITS. Although certain markets have gained substantial UCITS market shares – ie Luxembourg and Ireland – this does not appear to be due to network effects. The attraction of these domiciles for UCITS is attributable to the characteristics of these locations and their fund management industries, rather than to the attraction of locating to the same domicile as other UCITS.

Similarly, there are low fixed costs or sunk costs associated with UCITS, again particularly relative to other financial systems. Although investment in various IT systems would be necessary for the operation of UCITS, these are predominantly based around accessing other networks to enable transactions to be executed. The most significant sunk costs would occur in terms of the marketing of the UCITS.

The majority of the UCITS market is made up of domestic funds, ie funds that are registered and offered in the same country. In terms of the number of funds, excluding 'round-trips' (funds operated in country A, domiciled and registered in country B and then sold back into country A), in 2003 only 16.1 percent of the UCITS market was made up of cross-border funds. However, the proportion of cross-border funds has been increasing, from 13.2 percent in 2002 to 16.1 percent in 2003. The majority of these cross-border funds are domiciled in Luxembourg and Ireland.

Table 7.4 shows the make-up of the European UCITS market and the international equivalent. This table also shows the breakdown of the domiciles of UCITS in both the European and international markets. Almost 70 percent of the European market for UCITS is domiciled in four countries: Luxembourg (27.5 percent), France (22.4 percent), the UK (10.0 percent) and Ireland (8.9 percent). Along with the US, these four countries make up 71.6 percent of the international market for collective

investment schemes by domicile. Table 7.4 also shows the ratio of the assets under management to gross domestic product and the ratio of the international market share to share of global GDP. This shows that, in the global market for collective investment schemes, both Luxembourg and Ireland are significantly more important than their share of global GDP would suggest.

Table 7.4: Assets under management (AuM) of UCITS by country of domicile (Q1 2006)

Country	UCITS AuM (euro bn)	European market share (%)	International market share (%)	Ratio of UCITS AuM to GDP	Ratio of international market share to share of GDP
Austria	113.1	2.0	0.7	460.41	0.96
Belgium	115.4	2.1	0.7	385.99	0.81
Czech Republic	5.1	0.1	0.0	50.53	0.11
Denmark	66.8	1.2	0.4	319.75	0.67
Finland	43.5	0.8	0.3	275.83	0.58
France	1,244.4	22.4	7.5	727.29	1.52
Germany	273.0	4.9	1.6	121.54	0.25
Greece	27.2	0.5	0.2	149.73	0.31
Hungary	5.6	0.1	0.0	64.05	0.13
Ireland	492.1	8.9	3.0	3,046.46	6.36
Italy	372.9	6.7	2.3	262.55	0.55
Liechtenstein	13.4	0.2	0.1	N/A	N/A
Luxembourg	1,526.1	27.5	9.2	51,924.44	108.34
The Netherlands	82.2	1.5	0.5	162.29	0.34
Norway	35.9	0.6	0.2	150.74	0.31
Poland	17.3	0.3	0.1	70.77	0.15
Portugal	26.6	0.5	0.2	179.99	0.38
Slovakia	2.8	0.1	0.0	73.99	0.15
Spain	278.4	5.0	1.7	307.13	0.64
Sweden	123.1	2.2	0.7	426.37	0.89
Switzerland	118.9	2.1	0.7	402.01	0.84
Turkey	17.8	0.3	0.1	61.13	0.13
United Kingdom	557.7	10.0	3.4	310.93	0.65
All EFAMA members	5,559.2	100.0	33.6	479.26	1.00
United States	8,024.4		48.5		
Japan	463.3		2.8		
Canada	430.2		2.6		
Hong Kong	446.7		2.7		
Australia	744.5		4.5		
Brazil	479.8		2.9		
Others	397.1		2.4		
International total	16,545.3		100.0		

Note: All EFAMA members shown.

Source: EFAMA, 'Quarterly Statistical Release No. 26', Sept 2006, 'International Statistical Release 2006: 01', IMF, World Economic Outlook Database, September 2006.

Table 7.5 shows that the French and UK market share is largely domestic, while Luxembourg and Ireland serve the European market as a whole. This table also shows the market share of foreign sellers – ie those domiciled in a different country – within different European countries. Foreign sellers have a substantial market share of the collective investment schemes market in Belgium, Germany and Italy. Table 7.5 also shows the countries in which these schemes are principally domiciled. Throughout Europe it is clear that the principal domicile for foreign collective investment schemes is Luxembourg, and that the secondary domicile for foreign collective investment schemes offered in Germany and Italy is Ireland.

UCITS domiciled in Luxembourg are sold into 150 countries around the world, including both the US and Japan. UCITS domiciled in Ireland are sold into 60 countries around the world, including the US. These countries trust the UCITS investor protection standard and its enforcement by Luxembourg and Ireland. However, in the case of the US this does not preclude private or public enforcement against fund issuers based in Luxembourg or Ireland if there is a suspicion that securities fraud has been committed involving ‘US persons’ (US-based investors). Hence even here mutual recognition with the US at the enforcement level is limited, which is why most UCITS prospectuses contain explicit clauses stating that the funds are not offered to US investors¹⁰.

Clearing and settlement

Clearing broadly includes all functions that occur between agreeing a trade and the settlement of that trade, and it is generally undertaken by clearing houses acting as central counterparties (CCPs). The key function of CCPs is to perform the legal role of standing between the two parties to a trade, acting as buyer to the seller and as seller to the buyer (a process called ‘novation’). In the CCP structure, appointed clearing members take over the default risk faced by the original trading parties in respect of the other side of the original transaction (the trading parties are often also the clearing members). This is an efficient form of risk management in securities trading markets, which reduces total transaction costs and increases market liquidity.

An additional way in which many CCPs reduce transaction costs is by netting transactions before settlement. The lower number of post-netting settlements required for a given volume of trades not only reduces direct settlement costs, but also eases liquidity constraints on participants in the settlement process and helps to manage IT and operational investment costs, and in some cases it can reduce capital requirements.

Table 7.5: Pan-European market for UCITS – no. of firms (2004)

Domicile	Country of notification																Total	
	AU	BE	DK	FN	FR	DE	GR	IE	IT	LU	NL	NW	PT	ES	SW	CH		UK
AU						129			16							1		146
BE	10		1	4	81	15			32	83	86	1		1	1	52		367
DK						33				12		21				31	21	118
FN															2			2
FR	39	21				65		11	9	22	14		2	10		49	2	244
DE	347	43			21		7		19	83	16		11	7	16	126	16	721
GR																		
IE	491	139	82	176	266	607	52		284	165	282	139	44	361	251	355	500	4274
IT																		
LU	1844	1017	159	747	1696	2564	440	463	1659		1281	636	439	1491	1114	1914	1263	19091
NL	2	12			6	12			1	4				1		6	6	50
NW			4	41											13	7		6
PT																		
ES													1					1
SW		1			24							24						49
CH	40					47				40	4				1		4	136
UK	54	29	1	3	33	51		21	9	30	32	22	18	20	9	15		374
Total	2854	1262	227	997	2103	3591	499	550	2030	440	1741	822	515	1891	1429	2626	1913	26030

Note: This shows the number of funds by their registration and domicile, excluding domestic funds, round-trips and funds promoted in only one other country.
Source: PriceWaterhouseCoopers, Pan-European UCITS Distribution, 2004.

Settlement constitutes the completion of a transaction whereby the seller transfers securities to the buyer and the buyer transfers money to the seller. The central securities depository (CSD) undertakes settlement of securities transactions by moving securities from the seller's account in the CSD to the buyer's account in the CSD. The corresponding money transfer from the buyer to the seller usually takes place outside the CSD (via appointed settlement banks and/or national central banks), but the CSD plays an important role in sending and receiving payment instructions and confirmations. Ensuring finality of these movements is a key role for the CSD and its infrastructure.

It is important to note that access to CCPs and CSDs is, in general, only offered to institutions, namely clearing members and custodians. Retail investors and institutions that cannot (or do not wish to) access CCPs and CSDs use other intermediaries directly, creating a multi-tier intermediary structure. The overall efficiency of the clearing and settlement process therefore depends on efficiency of operations in all tiers of the system, including CCPs, CSDs, clearing members and custodians.

Clearing and settlement functions are characterised by significant network externalities, and they play an important role in ensuring the stability of financial systems. Overall, post-trading activities in securities and derivatives markets are associated with significant network externalities. The way in which these externalities arise, however, differs between different post-trade functions. In clearing of securities, network effects arise because increasing the number of transactions in a given security/asset class cleared through one CCP increases the potential for netting of trades and efficiency of risk management services.

Netting economies means that the more trades that are cleared by the same CCP, the greater the potential for netting efficiencies. These economies of scale are security by security or within an asset class (since netting is usually done at the level of individual securities or asset classes). On the money side, economies of scale are even larger since money netting usually occurs across securities and asset classes. These scale advantages are potentially indefinite. On the security side the optimal solution may be to have all trades in a particular security cleared by a single CCP. This minimises the number of settlement transactions requiring post-netting. On the money side, the optimal solution may be to have all trades in all securities cleared by the same CCP. This minimises the amount of money that needs to be set aside for the settlement process.

Risk management economies means increasing the number of participants and volume of clearing, thus providing better diversification of replacement cost risk facing

CCPs. Increased participation and activity in a CCP would therefore allow the achievement of the same overall risk protection with lower collateral margin requirements and default funds, thereby reducing total costs of clearing operations.

In settlement of securities, network effects arise because it is less costly to make settlement on the accounts of the same CSD than settlement involving accounts of two CSDs. Therefore increasing the number of market participants that settle their securities in a given CSD increases the cost-efficiency of that CSD.

A well-functioning clearing and settlement system provides efficient and uninterrupted servicing of trading activity, mitigates counterparty risk and reduces potential for contagion, thus ensuring stability in financial markets.

Although CCPs eliminate bilateral counterparty risk, they can act as a channel for contagion in financial markets. Systemic risk in this context can be understood as the risk that activities in a wide range of markets will face disruption, with the CCP acting as the channel of contagion. In the extreme case of a CCP failure, trade in a wide range of markets would cease, and open positions in a large amount of assets would be unable to close. Even where outright failure does not occur, extreme and/or unexpected margin calls in one market (a requirement that members increase their collateral to cover variations in prices beyond the initial margin) can put pressure on members to sell assets in another market, driving down prices in that market.

The practices adopted by different CCPs – including membership requirements, margining requirements, and collection of supplementary default resources – can thus affect the ability of financial systems to withstand financial shocks (eg the failure of a large market participant, or significant movements in asset prices in a particular asset class).

Integration of European markets potentially increases the importance of post-trade services in ensuring stability of the financial system. In particular, increased consolidation and development of interlinkages between clearing and settlement infrastructures can potentially increase the likelihood of contagion of financial market shocks across countries. For example, with respect to integration of CCPs, establishing inter-CCP links is likely to introduce inter-CCP risks, whereby the failure of one CCP could potentially result in financial losses for related CCPs (and, in an extreme case, result in their failure). The nature of these cross-market risks will depend on regulations, operational procedures and other features of inter-infrastructure agreements.

Securities clearing and settlement in the EU has historically evolved at a national level, whereas cross-border activity has been limited. Taking advantage of large network externalities and economies of scale, clearing and settlement providers in different countries have gone through a consolidation process, which has generally resulted in the establishment of domestic monopoly providers. Some of these infrastructures fulfil only one function (ie either clearing or settlement), while others are organised in vertical silos that simultaneously provide clearing and settlement (and trading) services.

Although domestic clearing and settlement services in the EU are generally recognised as relatively efficient, significant inefficiencies remain on a cross-border level. In its 2001 assessment of post-trading markets in the EU, the Giovanni Group identified fifteen barriers (so-called 'Giovanni barriers') to efficient cross-border activity in the EU :

- Diversity of IT platforms/interfaces;
- Restrictions on the location of clearing or settlement;
- National differences in rules governing corporate actions;
- Differences in the availability/timing of intra-day settlement finality;
- Impediments to remote access;
- National differences in settlement periods;
- National differences in operating hours/settlement deadlines;
- National differences in securities issuance practice;
- Restrictions on the location of securities;
- Restrictions on the activity of primary dealers and market-makers;
- Withholding tax procedures disadvantaging foreign intermediaries;
- Tax collection functionality integrated into settlement system;
- National differences in the legal treatment of securities;
- National differences in the legal treatment of bilateral netting;
- Uneven application of conflict of law rules.

Following identification of these barriers, the European Commission started work on a variety of practical initiatives aimed at eliminating them. The work is being done together with the Committee of European Securities Regulators (CESR) and the European Central Securities Depositories Association (ECSDA) and other parties.

In its January 2003 resolution, the European Parliament acknowledged that clearing and settlement arrangements that exist in the EU do not enable efficient and safe cross-border activity. Since then, the Commission has engaged in a variety of practical initiatives aimed at eliminating Giovanni barriers and generally improving

the environment for cross-border trading activity in EU security markets.

Regulatory/supervisory framework

A key aspect of the European securities clearing and settlement industry is the absence of an agreed common regulatory and supervisory framework. At a national level, regulatory authorities have responsibilities for protecting the safety of the clearing and settlement industry, both from the point of view of investor protection and financial market stability. In the context of cross-border activity, supervisory bodies also need to ensure that all activity across markets satisfies the safety and stability requirements that apply at a domestic level.

The Commission and various stakeholders have identified the lack of common regulatory and supervisory arrangements as a potential concern (eg in the absence of a common framework, it is more difficult to establish an efficient cross-border link between infrastructures). In order to mitigate potential problems associated with the lack of a common regulatory framework, the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR) have launched a working group (the ESCB/CESR Working Group) to develop common standards for EU clearing and settlement providers.

In 2004 the ESCB/CESR Working Group issued its report on 'Standards for securities clearing and settlement in the European Union'. The report focused on adapting to the EU environment the recommendations for securities settlement systems issued by the Committee on Payment and Settlement Systems (CPSS) and the International Organisation of Securities Commissions (IOSCO).

Importantly, these standards are not mandatory and do not supersede national legislation, thereby affecting implementation of these recommendations by national authorities. Although the standards do not have EU law status, it is envisaged that the relevant regulators, supervisors and overseers will, within their respective competencies, monitor the implementation of the standards.

Notably, in addition to their recommendations for settlement (which were used by the ESCB/CESR Working Group), the CPSS and the IOSCO have more recently issued recommendations for clearing. Their report aims to set out comprehensive standards for CCP risk management, providing a basis for the design of internal procedures by CCPs. These standards are intended for CCPs and national authorities, to serve as a basis for the assessment of whether the CCPs in their jurisdiction have implemented the recommendations, and for developing implementation plans where

necessary. The standards are voluntary and do not supersede national legislation.

Implications

As long as the enforcement power of European institutions in financial services is limited, the EU has externally to rely on member states. When supervision and enforcement standards diverge within the EU, this arrangement will continue to cause substantial friction with the EU's international partners. There is a clear contradiction between the EU's desire to integrate its financial markets and the need for bilateral supervision and enforcement agreements with the rest of the world.

The policy implications of our analysis are that technical standard-setting is a particularly promising area of international collaboration where Europe has an important leadership role to play. Critical mass is important in these cases and the EU has the required size to prevail in case of disagreement, provided member states can agree among themselves, which can be difficult.

In most other areas, there is a need for supervision and enforcement in the host country. Even when prudential and investor protection standards can be harmonised at the global level, enforcement is typically local. Regulation is a bundle consisting of standards, rules, supervision and enforcement. Even when the rules are the same, the overall bundle is not. This imposes a cost on international financial institutions, stalls competition, contributes to the fragmentation of financial markets and can lead to diplomatic tension. In the absence of a global enforcement agency the concept of 'lead regulator' appears promising and could be applied more often in the international as well as the European context.

Collective investment schemes and other financial services that require little supervision in the host country are exceptional. The current arrangements work well and will work even better when the single market is complete, for example in the case of prospectuses. Paradoxically some level of harmonisation is required to make mutual recognition feasible. Even here the scope for mutual recognition at the international level is limited by host country enforcement through litigation. Further legal agreements in the area of private as well as international public law are required.

In practical terms, European representation in international institutions – with few exceptions – lacks coherence and design. A fundamental discussion of Europe's representation in these institutions will be required. The related discussion of IMF membership discussed in chapter 5 of this volume is indicative.

To a great extent the EU's potential for becoming a global financial services regulator depends on the future evolution of its internal regulation. There are a few examples where the absence of a common EU approach does not matter from an international perspective, because regulation and its external dimension can be left to member states. The most prominent cases we present are collective undertakings in transferable securities and prospectuses. Yet even here a common EU minimum standard was needed to achieve mutual recognition.

EU prudential and investor protection and technical standards will have an impact internationally when there are externalities and the EU achieves critical mass. This will only happen if the EU overcomes internal divisions and diverging interests. To a large extent this will depend on the attitude of the major EU players, in particular Germany, France and the United Kingdom. The potential of the EU to play a major role also depends on the attitude of other large economies like Japan and, in the future, China and India. Japan and the EU27 combined outweigh all other OECD country groupings. Yet Japan has been remarkably timid when it comes to global financial standard-setting, at least in public. China and India are underrepresented on most international standard-setting bodies, at least on a *per capita* basis.

To play a major international role in supervision and enforcement the EU would have to develop a 'Community interest' approach and place the supervision of financial institutions and markets with an EU-wide dimension into the hands of an EU institution, as it has for competition policy. This European enforcer would be in a position to enter into cooperation agreements with enforcers in other countries, as does the US Securities and Exchange Commission.

Notes

- 1 Australia, Canada, France, Germany, Hong Kong special administrative region, Italy, Japan, the Netherlands, Singapore, the United Kingdom and the United States.
- 2 The International Monetary Fund (IMF), World Bank, Bank for International Settlements (BIS), Organisation for Economic Cooperation and Development (OECD), Basel Committee on Banking Supervision (BCBS), International Accounting Standards Board (IASB), International Association of Insurance Supervisors (IAIS), International Organisation of Securities Committees (IOSCO), Committee on Payment and Settlement Systems (CPSS) and the Committee on the Global Financial System (CGFS).
- 3 <http://www.fsforum.org/compendium/about.html>.
- 4 The consensus among policymakers is frequently challenged by the financial intermediation literature, but there is hardly any danger that international cooperation in prudential regulation will be abandoned as a result. For a comprehensive recent survey of the financial intermediation literature see Gorton and Winton (2004). The authors cite numerous articles to show that despite the presence of prudential regulation, financial crises still occur. For example Lindgren, Garcia, and Saal (1996) study financial 'crises' in IMF member countries between 1980 and 1995. They find that

133 of the 180 member countries experienced an significant problem in the banking sector, despite the presence of prudential regulation.

- 5 The equivalent standards for insurance companies are referred to as 'Solvency I' and 'Solvency II'.
- 6 The same analysis applies to postcodes and it is a fact that the UK Post Office charges a hefty price for a full electronic database of UK postcodes.
- 7 The United States has a single postcode system, the EU does not. Most webpages will have address registration templates that follow the US ZIP code system. The size of the installed base matters.
- 8 For a general survey of enforcement in law see Polinsky and Shavell (2006).
- 9 The PCAOB website is very instructive because it clearly illustrates the division between registration of entities that are supervised, standards, rules, inspections (supervision) and enforcement.
- 10 The situation is similar to other types of securities issuance, for example prospectuses for publicly listed equity securities.

8

Migration policy: at the nexus of internal and external migration

Herbert Brücker and Jakob von Weizsäcker¹

Within the borders of their own country, citizens can generally travel without internal checkpoints and move to wherever they want. By 2014, European Union citizens will enjoy a similar freedom to travel and move within the entire EU27, almost as if the EU were one country. But there are no plans to extend this freedom to the EU's neighbourhood countries, let alone world wide, in the foreseeable future. The citizens of the world will continue to be restricted in their travel.

Those citizens of the world who are not EU citizens – we shall call them third country nationals – are subjected by the different EU member states to a restrictive and diverse set of immigration policies. But does this heterogeneous yet restrictive set of national migration policies make sense? Might not the same logic that supports fully harmonised and totally unrestrictive migration rules for EU citizens call for more harmonised and possibly less restrictive rules for third-country nationals?

These are by no means purely academic questions. The matter is firmly on the political agenda as the EU tries to develop a common immigration policy by 2010². The time has arrived to review migration policies for third-country nationals. The benefits of coherent migration policies and the costs of haphazard migration policies are increasingly apparent for at least two reasons.

First, migration policies in Europe are exposed to rising migration pressures. Those tens of thousands of Africans risking their lives on dangerous boat trips to enter the EU are a humanitarian tragedy. At the same time, they are only the tip of the iceberg as far as the underlying economic forces are concerned. A growing proportion of the

world's population has access to the necessary information and the funds to engage in economic migration. A major proportion of the world's poor population lives on the EU's doorstep and proximity plays a significant role in migration decisions. While the EU is ageing rapidly, the number of young people in prime migration age (most people migrate between the ages of 20 and 35) continues to increase in the EU's greater neighbourhood.

For better or for worse, the 'wall called the Mediterranean'³ made some implicit migration policy choices for Europe in the past. In the future, Europe will need to rely more on explicit policy choices. The US experience, with high levels of illegal immigration from neighbouring Mexico, could be reproduced in the EU and its neighbourhood, presenting a major policy challenge.

The second reason why the benefits of a coherent EU migration policy are becoming apparent is the phenomenon of reduced barriers to migration within the EU. This naturally increases the need for coordination among EU member states. For example, where border controls have been abolished as part of the Schengen agreement, third-country nationals can now – like EU citizens – freely cross intra-EU borders. In some areas, like the control of external borders, this can lead to a need to coordinate on more restrictive policies. But it is often overlooked that failure to coordinate on migration may also lead to overly strict policies. For example, there is a risk of a downward spiral with regard to the decent treatment of irregular migrants. With open internal borders, member states might be tempted to drive irregular migrants away to neighbouring EU countries by treating them poorly. Individual countries which treat irregular migrants decently anyway might end up attracting more than their expected share of irregular migrants.

In view of this need for greater coordination and harmonisation of migration policies, member states have equipped the EU institutions with greater decision-making powers in recent years, and are set to continue to do so. But the creation of a common immigration policy requires more than a stronger institutional mandate. It also requires a solid conceptual basis, which still appears to be wanting. The political and scientific controversies continue about what is desirable migration and what is not. As a consequence, there is also little agreement to what extent differentiated national migration policies are needed to cater for the different dimensions of heterogeneity among the 27 member states. This makes it difficult to agree which aspects of migration policy can and should be harmonised at EU level.

The aim of this chapter is to provide insights regarding the conceptual foundations for a common EU migration policy. For this purpose, our natural starting point is the

economic case for free migration, which is similar to the better known arguments for free trade and free capital mobility. Economic migration allows people to move from places where they are less productive to places where they are more productive. Global economic output is thereby increased. Furthermore, migration helps to decouple economic opportunity from place of birth. Global equality of opportunity is improved as a result.

Economic historians have underpinned the argument for free migration by showing that relatively free migration during the nineteenth century contributed more to income convergence across the globe than trade. Looking forward, freer migration can help substantially to increase global output since dramatic geographic productivity differences persist across the globe. These productivity differences are often linked to poor institutions or simply poor geographic location. Clearly, free trade, free investment and generous development assistance can help to smooth some of these differences. But it appears certain that, for hundreds of millions of people around the globe, migration will remain the best option for achieving a decent livelihood in the foreseeable future.

The optimistic view is that the potential gains from free migration will make it an irresistibly attractive proposition⁴. According to that view, any adverse distributional consequences could be dealt with by redistributing some of the gains from migration to potential losers. However, voters in the EU are somewhat more sceptical when it comes to the benefits of free migration. In a recent FT/Harris poll on migration attitudes⁵, 40 percent of the respondents in France and more than 60 percent in the other countries surveyed (United Kingdom, Italy, Spain, Germany) replied that there were too many immigrants in their country and that their country's immigration policy was making it too easy for migrants to enter legally. Why is the call for more restrictive immigration so widespread despite the advantages outlined above?

Clearly, there are concerns about failed integration and the risk of an ethnic underclass emerging in a number of European countries. Because of recent terrorist attacks and incidents involving Muslim immigrants, there are worries about Muslim fundamentalism among immigrant populations. Negative personal experiences with immigrants, sometimes too readily generalised when undercurrents of xenophobia are present, can also play a role. But perhaps the most important reason for the negative public response to immigration is widespread uncertainty about the consequences of substantial further immigration. What will be the impact on employment and wages? What will be the impact on the budget and welfare systems? What will be the impact on local communities, on public institutions and on the identity of the host country in the long run?

That uncertainty leads to caution when it comes to immigration policy. As a result, the prevalent approach to migration policy in most European countries today is restrictive. But by restricting legal immigration to the human rights essentials, non-economic immigration such as family reunion and humanitarian migration have come to dominate. Since the migrant stock is already relatively low-skilled in most EU countries because of previous guest worker programmes and immigration from former colonies, family reunions in particular often have a low-skill bias.

Furthermore, low-skilled jobs are more readily organised than high-skilled jobs in the informal economy. This gives rise to significant inflows of low-skilled economic immigrants on an irregular basis, as seen in the US and increasingly in Europe. By contrast, high-skilled potential immigrants are less likely to engage in irregular migration. Not only would it be more difficult for them to find a suitable job in the informal economy, high-skilled migrants also have better legal alternatives. Traditional immigration countries such as Canada and Australia welcome high-skilled migrants with open arms.

As a consequence, the EU's present legal restrictions on economic migrants, which may appear skill neutral or even marginally favourable to high-skilled immigration, in reality act as a skill filter that favours low-skilled immigration. We see a danger that this low-skill immigration bias might result in a repressive downward spiral for European migration policies. As we will argue, the net benefit of immigration to the host country is generally lower when the skill-mix of immigration is lower. Therefore, the low-skilled bias of our immigration policies makes it politically more difficult to argue the economic case for immigration in host countries. As a result, policies might become even more restrictive, potentially increasing the skill bias further while placing reduced political emphasis on the decent treatment of migrants.

We believe that a harmonised approach to welcome high-skilled immigration to the EU would not only make good economic sense but also help to immunise the migration discussion in Europe against such a political downward spiral. At the same time, we find that a considerable degree of heterogeneity of national immigration policies for low-skilled and, to some extent, mid-skilled immigration may well be justified on account of the heterogeneity of member states. But since it would be difficult to sustain differentiated policies if all third-country nationals were granted full intra-EU mobility, we caution against the rapid further extension of intra-EU mobility rights for low-skilled immigrants.

Finally, we identify a need for more EU harmonisation regarding the regularisation of irregular migrants. The reason is that irregular migrants enjoy *de facto* intra-EU mobil-

ity within the Schengen area. Therefore, member states may have an artificially reduced incentive to treat them decently and create a humane and dependable path towards regularisation that would seem desirable for humanitarian, security and economic reasons. In order to deal with that coordination problem, more generous and harmonised regularisation rules combined with substantially delayed integration into European welfare states for regularised immigrants should be considered.

These building blocks for a common immigration policy could help improve the skill-mix of immigration into the EU while leading to greater openness towards legal immigration overall. According to our simulation, such an outcome could not only be attractive for the EU but would also benefit developing countries on account of a greater openness to migration overall.

In the next section, we lay the groundwork for our argument by providing an overview of the EU's governance of migration, and the stocks and flows of different categories of migrants across the EU. Our primary focus is on immigration from outside the EU. However, intra-EU migration of EU citizens and third-country nationals is also discussed in some depth. The reason is that intra-EU migration flows have the potential at least partially to offset external migration flows to any one EU member state. For a discussion of nationally differentiated external migration policies, it is important to understand to what extent such offsetting of migration is to be expected.

In the third section, we then develop the argument why the migration impact on the host and the source country may vary significantly by skill level, and how this might impact migration policies. In particular, we explore the skill effects of immigration through a general equilibrium simulation that models the impact of immigration on wages, unemployment and public finances in both source and host countries. The simulation suggests a fairly uniform positive impact of high-skilled immigration on the host country. By contrast, the impact of low-skilled immigration is less positive and differs greatly as a function of the institutional set-up in different host countries. At the same time, the impact of migration on developing source countries is found to be generally positive due, not least, to remittances. But it is more positive for low-skilled than for high-skilled emigration.

Finally, the fourth section develops policy conclusions on the basis of the findings.

Migration status quo

The migration policies of the EU are presently characterised by a dual approach. Internal migration of EU nationals has been harmonised at the EU level, becoming

essentially free by 2014 for the whole EU27. By contrast, external migration rules are not harmonised as they generally fall within the responsibility of each individual member state. In this section, we first explore the institutional arrangements that govern migration within the EU and from outside the EU. In a second step, we explore the scale and structure of internal and external migration as captured by the available migration statistics. This contributes to our understanding of the differentiated effects that the present migration regime has across the EU.

Migration rules and governance

The control of external borders and the decision on who is allowed to enter and who is refused entry is traditionally considered one of the core elements of state sovereignty. Against this background, it was a bold vision by the founding fathers of the EU that citizens from any EU member state should be allowed to travel without border controls and migrate across the entire EU with hardly any legal restrictions. The implementation of that vision is now nearing completion. Implementation rests on two pillars: free mobility for EU workers and the Schengen agreement. By contrast, national policies with regard to the external entry and lateral movement within the EU of third-country nationals remain diverse. Only in recent years have efforts towards greater coordination and harmonisation in this area intensified.

Free mobility for EU workers

Free mobility for workers within the EU has been a basic principle since the 1957 Treaty of Rome. Over the decades, numerous directives and court decisions have strengthened the implications of this right, which is now central to the legal definition of EU citizenship⁶. In recent years, free mobility for EU workers has increasingly been extended to include strong mobility rights for inactive EU citizens. In particular, Directive 2004/38/EC 'on the rights of citizens of the Union and their family members to move and reside freely within the territory of the member states' has gone a long way towards establishing free mobility for EU citizens, whether economically active or not. One of its key provisions establishes that, after five years' residence, even inactive EU citizens are eligible to full welfare benefits in any member state⁷.

When countries join the EU, their citizens also become EU citizens and, as a consequence, also benefit from the right freely to move, reside and work anywhere in the EU. If the state joining the EU is substantially poorer than the average, this can initially trigger significant migration flows. During the 2004 and 2007 enlargement rounds, there were concerns in old member states about the prospect of mass immigration from eastern Europe. In order to address these concerns, the so-called 'two-

plus-three-plus-two' rule was agreed as a transitional arrangement governing labour mobility from new member states. According to the agreement, old member states were allowed to delay the introduction of free movement for workers from the new member states in eastern Europe⁸ for a period of up to seven years in total. Any restrictions would have to be reviewed after the initial two years and then after another three years with a view to lifting the restrictions should they no longer be deemed necessary. A third extension to the transitional period by a final two years is permissible in the presence of serious domestic labour market imbalances.

Germany and Austria are particularly reluctant to lift restrictions, possibly on account of their geographic proximity to eastern Europe as we shall see below. But irrespective of whether these restrictions may have made sense for some old member states, they will have to be lifted soon. All restrictions on citizens of the eight new member states in eastern Europe that joined the EU in 2004 (NMS-8: Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovakia and Slovenia) will be lifted by 2011 at the latest. For the two new member states that joined in 2007 (NMS-2: Bulgaria and Romania) restrictions will be lifted by 2014 at the latest. Since the focus of this chapter is on the future challenges posed by immigration from outside the EU, we will in the following take the internal mobility for EU workers as given, although it will technically only be achieved by 2014.

The Schengen Agreement

In 1985, France, Germany and the Benelux countries signed the Schengen Agreement with a view to abolishing controls at their joint borders. To address some of the potential problems of such a move, not least with regard to third-country nationals, the Schengen Agreement includes a number of additional provisions on the harmonisation of external border controls, on policy cooperation between signatories, and on the creation of the common Schengen visa for the Schengen area.

By 2001, all member states of the then EU15 with the exception of the UK and Ireland had joined and implemented the Schengen Agreement. It is expected that by 2010 almost all of the new EU member states (and all EFTA countries – Iceland, Norway, Switzerland and Liechtenstein) will have fully implemented the agreement. Therefore, travel without controls at all land borders is rapidly becoming a reality throughout the entire EU27⁹.

Mobility of third-country nationals

The legal admission of third countries nationals as economic migrants to the EU

remains largely the responsibility of individual member states. The admission rules of member states are characterised by great diversity. The great variety of admission schemes for high-skilled migrants may serve as an example that admission policies in different countries often have relatively little in common.

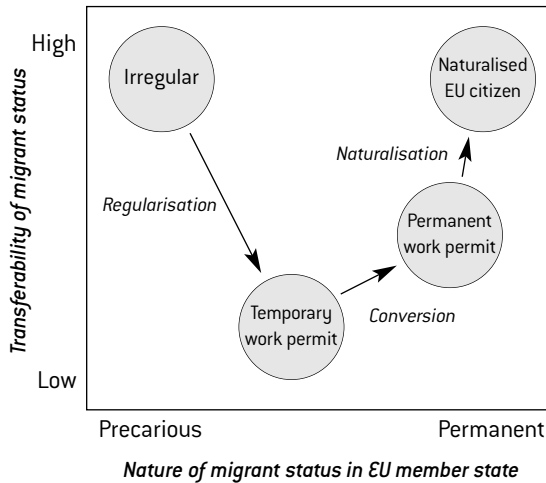
Virtually all EU member states have special immigration schemes in place for highly-qualified third-country nationals. Around half have schemes that go beyond highly-specialised categories such as researchers, artists, and intra-corporate transferees. Among those with more extensive schemes, some use minimum salary thresholds (which vary enormously between countries), others use skill criteria such as academic degrees or past work experience. Some use a mix of the two. At least four member states have several categories of high-skilled workers for which different entry and/or residence conditions apply. The existence of a firm job offer or job contract is not required in the UK but is in all other member states. Some countries require that the employer demonstrate that no local can be found to fill the job, others do not. Also, some countries admit those high-skilled immigrants who qualify for admission on a temporary basis only or at least initially, while others admit them on a permanent basis. However, there is one important common feature of these different schemes. They are generally so restrictive that the immigration inflow under them tends to be only a small fraction of total immigration.

Member states are also relatively free to decide on the conditions governing status changes for their migrants from third countries. Specifically, it is up to member states to decide on the regularisation of irregular migrants, on the extension of temporary work permits and on the conversion of temporary to permanent work permits. However, there exist some EU-level rules governing status transitions. Perhaps most significantly, legal migrants are to be accorded permanent residence after five years in a member state¹⁰. Finally, member states set their own naturalisation rules.

But to what extent can migrant status, once it has been established in one member state, be transferred within the EU? A stylised summary of transferability of migrant status in the EU is given in Figure 8.1.

Irregular migrants can easily migrate from one country in the Schengen zone to another, where they will still be irregular migrants. In that unusual sense, their status is fully transferable. By contrast, third-country nationals with a legal work permit generally cannot transfer that permit within the EU. Their residence and work permit only have validity for the member state where it was issued. This limits their mobility inside the EU, unless they are prepared to relinquish their legal status and start working irregularly in another EU country. Usually, such a step would be unattractive.

Figure 8.1: Transferability of migrant status within the EU



However, this option may become relevant when their legal stay is about to expire. But this scenario has, in essence, already been captured by the observation that irregular migrants enjoy status transferability within the Schengen area.

By contrast, for third-country nationals with permanent work permits, an important element of transferability of status has been introduced. Third-country nationals with long-term resident status are to enjoy transferability of their status when they move from one EU country to another, according to Directive 2003/109/EC. However, this directive will only become fully effective once transitory restrictions on worker mobility for EU citizens from new member states have been lifted by 2014. The legal reason for this is that no third-country worker must be given greater rights of mobility than, say, an EU citizen from Romania whose mobility may be restricted until 2014. Even after 2014, member states may impose restrictions on the mobility of workers from third countries with long-term resident status, on grounds of labour market imbalances. It appears likely that a number of open questions in this area will have to be resolved in the courts over the next decade or so. Ultimately, the only legal third-country migrants who enjoy full portability of status in their own right (and for their close family members who may not be EU citizens) are naturalised EU citizens.

EU migration governance

For future coordination and harmonisation of the EU's diverse migration policies towards third-country nationals, the EU's governance structures matter greatly. They

have been substantially strengthened in recent years and stand to be further reinforced if qualified majority voting on migration is retained in a compromise solution for the stalled Constitutional Treaty.

Before 1993, European cooperation in the area of justice and home affairs policy (including migration) had essentially to be dealt with at the intergovernmental level outside Commission and treaty structures. In 1993, justice and home affairs policy was formally included under the so-called 'third pillar' of the Maastricht Treaty and therefore continued to be dealt with in practice at the intergovernmental level. Not least due to dissatisfaction with progress under the weak structures of the third pillar, the Amsterdam Treaty of 1997 subjected the area of border controls and migration policies to a decision-making procedure that is essentially in line with normal Community procedures (after a five-year transition period). The Amsterdam Treaty also incorporated the Schengen Agreement into the EU framework. However, Ireland and the UK retained their right to adopt Schengen provisions selectively, while Denmark opted out of substantial parts of the Amsterdam Treaty while continuing its Schengen participation on an intergovernmental basis.

In 1999, the European Council met for a special meeting in Tampere in order to provide the initial guidelines for the work in the area of freedom, security, and justice during the first five years under the Amsterdam Treaty. This Tampere programme called for the development of a common EU migration policy. It also suggested that the legal status of third-country nationals who are long-term residents in the EU should receive mobility rights similar to those of EU nationals, resulting in the cornerstone Directive 2003/109/EC that has already been mentioned.

The Hague programme for 2005 to 2010 is very much a continuation of the Tampere programme, aiming to develop a common migration policy by 2010. In the framework of that current work programme, the European Commission plans to present five proposals for directives in the area of migration, covering the admission of high-skilled migrants, remunerated trainees and intra-corporate transferees.

Under the Constitutional Treaty that did not enter into force, the unanimity requirement for decisions on border controls and migration policy only partially amended by the Nice Treaty was to be fully replaced by qualified majority voting. Further, the Commission was to be granted the sole right of initiative in this area. This streamlined decision-making process would certainly make it easier to coordinate and harmonise EU migration policy and, as such, would appear to be a desirable feature of any rescue package for the Constitutional Treaty.

Migration numbers and trends

In this section, we first explore the overall migration patterns of the EU member states. After that, we attempt to disaggregate those numbers into different categories to assess their relative importance. Furthermore, we explore the future migration potential from the EU's greater neighbourhood.

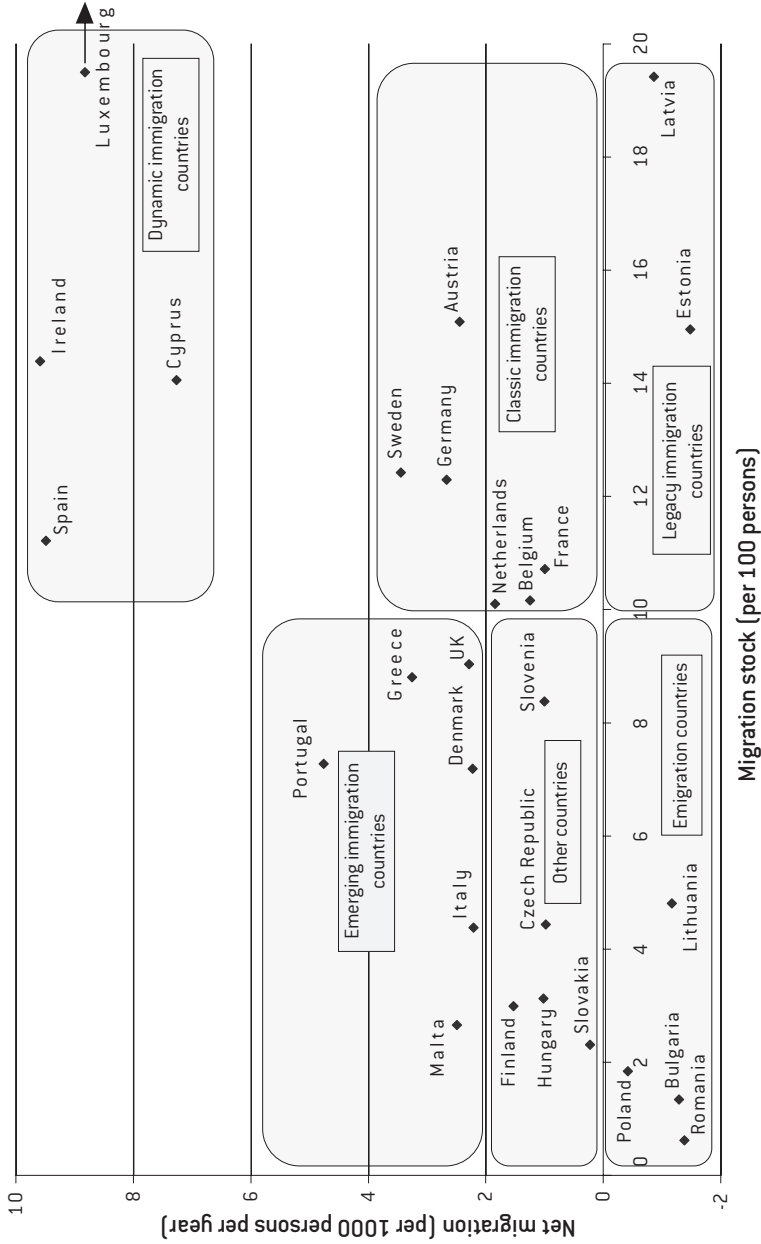
A simple migration typology of EU member states

The most important quantitative measures of migration are the stock and flow of migrants. Using these, the migration experiences of member states can be described by six different categories as indicated in Figure 8.2. Those countries with a high stock of migrants (above 10 percent of the total population) are grouped into three different categories according to their net migration inflows. Dynamic immigration countries (Spain, Ireland, Cyprus, and Luxembourg) rapidly add to their already elevated stock at net immigration rates of around eight per 1000 per year. Classic immigration countries (Austria, Belgium, Sweden, Germany, France, and the Netherlands) have low but positive immigration rates of around two per 1000 per year. And legacy immigration countries (Estonia, Latvia) have experienced a large influx of migrants in the historic (Soviet) past but are now experiencing modest net emigration of around one per 1000 per year.

The EU countries with less than 10 percent foreign population are also grouped into three categories. Emerging immigration countries (Portugal, Greece, Malta, UK, Denmark, Italy) have net immigration inflows scattered around three per 1000 per year. Source countries (Romania, Bulgaria, Lithuania, Poland) display net emigration of around one per 1000 per year. The remaining EU countries do not currently display a very pronounced migration profile, with foreign-born populations below 10 percent and net immigration rates at around one per 1000 per year.

As a next step, we attempt a breakdown of migration by country of origin and by skill level. Due to data limitations, we shift in migration definitions between foreign-born and foreign citizens. The difference is significant as a result of different approaches to naturalisation and differences in the numbers of foreign-born expatriates returning home. Also, the numbers that we present have different base years, which can lead to substantial deviations, especially for emerging and dynamic immigration countries where stocks have been rapidly increasing over recent years. Despite these limitations, the breakdowns yield important insights.

Figure 8.2: Classification of immigration regimes in EU27 by migration net flows and stocks in 2005



Source: World Bank, *World Development Indicators 2006*, Washington D.C.
 Belgian stock of foreign born – Institut National de Statistique (Registre National)

Decomposing immigration by country of origin

The stock of foreign citizens in the EU15 makes up roughly six percent of the total population in the EU15, as summarised in Table 8.1. It reveals a surprisingly simple decomposition of the population with foreign citizenship by region of origin. Roughly one third of foreign citizens in EU15 countries come from the EU27. One third originates from the broad EU neighbourhood that includes the Balkans, Turkey, EU neighbourhood countries around the Mediterranean and eastern Europe, and Russia. The final third comes from the rest of the world.

This also leads to an important observation regarding the historic propensity to migrate to the EU15 from different regions. The EU27 and the EU neighbourhood each have a population of just below 500 million. Since their contribution to the EU15's foreign resident population is also comparable, the propensity of their inhabitants to migrate to a (different) EU15 country is also comparable. Broadly speaking, this is attributable to two factors. First, mobility inside the EU is not particularly high, despite the absence of legal barriers, not least because of relatively small income differentials. Second, mobility from the EU's neighbourhood is significant, despite the

Table 8.1: Foreign citizens in the EU15 by region of origin of migrants (2005 or nearest available year).

Host country	EU27	<i>Of which EU15</i>	<i>Of which NMS12</i>	Neighbouring regions*	World	Total
<i>foreign residents in % of total population</i>						
Austria	2.6	1.6	1.1	5.6	1.2	9.4
Belgium	5.6	5.5	0.1	2.1	0.9	8.6
Denmark	1.3	1.1	0.2	1.2	2.5	4.9
Finland	0.7	0.4	0.3	0.7	0.7	2.1
France	2.0	1.9	0.1	2.2	0.9	5.1
Germany	2.7	2.0	0.7	4.0	2.1	8.8
Greece	1.4	0.5	0.9	4.9	1.8	8.1
Ireland	1.8	1.8	N/A	N/A	4.4	6.2
Italy	0.8	0.2	0.6	1.9	1.4	4.1
Luxembourg	36.3	33.2	3.1	N/A	2.7	39.0
Netherlands	1.4	1.3	0.1	1.4	1.5	4.3
Portugal	0.6	0.6	0.0	0.0	1.6	2.3
Spain	2.5	1.5	1.0	1.5	3.9	7.8
Sweden	2.4	2.1	0.3	0.8	2.2	5.3
United Kingdom	1.8	1.6	0.2	0.2	3.1	5.0
EU15	2.0	1.6	0.5	2.1	2.1	6.2

* Neighbouring regions: Balkan countries, Turkey, EU neighbourhood countries in the Mediterranean and Eastern Europe, Russia.
Source: Eurostat population statistics, European Labour Force Survey, calculations by the authors. Totals may not necessarily add up as a result of rounding.

legal restrictions, not least because of geographic proximity and the substantial income differentials.

The rest of the world has a population of just above five billion. Hence, the implied propensity to migrate to the EU is only roughly one tenth of that from the neighbourhood. This crude arithmetic confirms that distance is an important determinant of migration. But of course the distinction between the EU neighbourhood and the rest of the world is evolving. Thus, there are two important scenarios leading to greatly increased migration to Europe. First, the legal and *de facto* barriers to migration from the EU neighbourhood might decrease. Second, a number of countries in the greater-EU neighbourhood who currently fall into the 'rest of the world' category might increase their emigration rates to Europe to levels that make them in effect EU neighbourhood countries for our purposes. In particular, this might occur for a number of countries in sub-Saharan Africa and in the Middle East.

Of course, it should be borne in mind that this simple picture of migration to the EU15 is the outcome of very varied circumstances in different member states, as can be seen by breaking down the data to the country level. For example, the bulk of foreigners in the UK come from the rest of the world, resulting largely from old colonial ties. In Germany, most immigrants hail from the neighbourhood region, not least due to Germany's former guest worker programme. And in Belgium foreign citizens from the EU15 dominate in part because of the role of Brussels as the capital of Europe.

One important aspect of immigration that is not properly captured by these statistics is irregular migration. While precise numbers are not available for obvious reasons, some four to eight million irregular migrants can be expected currently to be living in the EU27, with as many as half a million arriving each year¹¹. It seems plausible that rising immigration pressure from the EU's wider neighbourhood, detailed in the section on proximity and income differences below, could result in further increases in the stock and flow of illegal immigrants.

Decomposing immigration by skill

Another breakdown of migration that is critical to our argument is breakdown by skill presented in Table 8.2, which compares key immigration countries in Europe with North America and Australia. It shows that classic immigration countries such as Australia and Canada both have a much higher percentage of foreign-born population than the classic immigration countries in Europe such as France and Germany, and a much higher percentage of foreign-born with tertiary education. It is worth noting that Australia and Canada attract a more highly-skilled immigrant population than

Table 8.2: International comparison of the extent and skill composition of migration

Country	Foreign born in % of population (15 years plus)	% with tertiary education		High-skilled foreign born in % of population (15 years plus)
		Among natives	Among foreign born	
United Kingdom	8.3	20.1	34.8	2.9
France	10.0	16.9	18.1	1.8
Netherlands	10.1	19.5	17.6	1.8
United States	12.3	26.9	25.9	3.2
Germany	12.5	19.5	15.5	1.9
Canada	19.3	31.5	38.0	7.3
Australia	23.0	38.6	42.9	9.9

Source: Dumont and Lemaitre (2004).

France and Germany while their native population is also significantly more skilled.

Sometimes, it is argued that Europe is not attracting high-skilled immigrants because it already has enough high-skilled locals, whereas manual labour is lacking. But are the skill requirements of the Australian and Canadian economies really that much higher than in Europe?

It would appear more plausible that the numbers of high-skilled immigrants are to a considerable extent influenced by immigration policy. Australia and Canada organise their economic immigration through points systems that favour skilled immigration. By contrast, France and Germany have restrictive immigration policies that, as discussed above, imply a low-skill bias.

This interpretation is reinforced by the high percentage of high-skilled immigrants into the UK, where immigration policies have for some time been more favourable towards high-skilled migrants. In addition, it is obvious that English, as the world's international language, is an important asset for anglophone countries attempting to attract high percentages of skilled migrants. What is less clear is why France and Germany respond to this disadvantage by offering less rather than more attractive conditions for high-skilled immigrants than anglophone countries.

It is suggestive qualitatively to reference the skill-mix of immigration to the political difficulties with immigration in recent years. In Table 8.2, Germany, the Netherlands and France stand out as countries with particularly low percentages of the tertiary educated among the foreign-born population. These would also appear to be the countries where the political discourse on immigration has been the most tense in recent years. By contrast, Canada and Australia have been able to sustain a much higher inflow of high-skilled and of low-skilled immigrants as a percentage of their

total population with fewer political difficulties. And the US and the UK would fit this pattern as intermediary cases here. The notion that the skill-mix of immigration might influence the economic benefits and thus the political acceptability of immigration in the host country is underpinned by the general equilibrium simulation of the impact of immigration in the next section.

Internal migration and enlargement

In Table 8.1 we have seen that internal EU migration is relatively small. One reason is that numerous small legal obstacles remain for migration within the EU. For example, the differences in the organisation of social insurance and welfare states across the EU can turn portability of social entitlements into a nightmare. At the same time, income differences within the EU15 are relatively small, and one would expect this to reduce migration. Where income differentials within the EU are larger, as is the case between the EU15 and the new member states, fairly substantial migratory movements can be observed (Table 8.3).

Table 8.3: Residents from the NMS-8 in the EU15, 2000-2006

See footnotes for information on structural breaks and extrapolations.

	2000	2002	2003	2004	2005	2006
	<i>1000 persons</i>					
Austria ⁱ	60.4	44.6	41.0	53.7	80.5	78.9
Belgium ⁱ	9.3	12.2	9.5	15.6	25.6	59.9
Denmark ⁱⁱ	8.7	10.0	10.2	10.5	11.3	13.3
Finland ⁱⁱⁱ	12.9	14.8	15.8	16.5	18.3	17.8
France ⁱ	37.8	44.9	35.1	43.0	46.8	29.6
Germany ^{iv}	416.5	453.1	466.4	480.7	438.8*	481.7*
Greece ⁱ	13.8	14.9	16.4	15.2	20.6	20.1
Ireland ^v	6.4	8.6	49.1	54.1	58.5	58.5
Italy ^{vi}	34.4	41.5	42.2	55.6	67.8	79.8
Luxembourg ⁱ	1.1	1.2	1.1	1.1	0.7	0.7
Netherlands ^{vii}	9.4	11.2	12.2	13.1	17.9	23.2
Portugal ^{viii}	0.4	0.7	0.6	0.7	0.8	0.3
Spain ⁱ	10.6	30.0	41.5	46.7	61.8	74.3
Sweden ^{ix}	23.0	22.9	21.4	21.1	23.3	26.9
United Kingdom ^x	52.7	62.0	78.6	81.4	180.8	328.6
EU15	697.3	772.3	841.1	909.0	1,053.4	1,293.5

Notes: i) Eurostat Labour Force Survey 2006.-- ii) Statistics Denmark [population statistics].-- iii) Statistics Finland [population statistics], 2006: Eurostat LFS.-- iv) Statistisches Bundesamt [population statistics], all data refer to 12/31 of previous year. 2006 and 2005 not comparable to previous years due to data revision.-- v) 2002: population census; 2005: LFS, other values estimated.-- vi) 2004-06: ISTAT [population statistics]; 2000-03: Council of Europe, recent demographic developments in Europe.-- vii) Statistics Netherlands [population statistics].-- viii) 2000-02: Eurostat Labour Force Survey; 2003-06: estimates and extrapolations.-- ix) Statistics Sweden [population statistics], 31.12.-- x) Eurostat Labour Force Survey 2006; national LFS data report for 2005 240,000 and for 2006 365,000 citizens from the NMS-8.-- Statistical break [data revision].

Sources: National population statistics and Eurostat Labour Force Survey 2006.

The changing regional pattern of migration from the new member states in eastern Europe suggests that the selective application of transitional periods across the EU, and in particular the fact that Germany has taken a restrictive stance, has triggered a substantial diversion of migration flows towards the UK and Ireland. Interestingly enough, this does not hold true for the Scandinavian countries. Although Sweden has opened its labour market completely, and Denmark to a great extent, net migration flows into these two countries have been – at some 6,000 persons – almost negligible in the two years since enlargement. Language, and perhaps differences in labour market institutions, might have played an important role in shaping the direction of east-west migration flows.

It is striking that there has also been a substantial migration flow from Bulgaria and Romania into the EU15 during the past few years, although both countries were not part of the EU before 2007. Based on bilateral agreements, Spain admitted roughly 360,000 migrants from Romania and Bulgaria between 2000 and 2005. The number of foreign residents from Bulgaria and Romania has also substantially increased in Italy, but to a lesser extent than in Spain. Again, we see a diversion of migration flows. In Germany, which was the main destination for migrants from these countries in the early 1990s, the number of residents from Bulgaria and Romania declined from 260,000 to 130,000 during the last decade.

The diversion of migration flows has influenced two subsequent policy decisions. First, even those countries that opened their labour markets to workers from the NMS-8 at the beginning of enlargement were reluctant to extend this free movement to Bulgaria and Romania on their accession in 2007. The fear of receiving an extraordinarily high share of migrants from these countries has certainly affected the decision to keep the doors closed to Bulgaria and Romania in countries such as Ireland and the UK. Second, a number of EU15 countries decided to open their labour markets to workers from the NMS-8 when the first two-year period of the transitional arrangement expired in May 2006¹². The rationale behind these policies is that second-mover countries, ie countries that open their labour markets after the others, receive only a relatively small share of migrants. Given that regional migration patterns are relatively stable over time – due in part to network effects, language barriers and so on – this expectation is not unreasonable.

Although the key decisions on the transition towards full labour mobility in the entire EU27 by 2014 have now been made, the recent enlargement experience is not only of historical interest. It illustrates well the possible pitfalls of coordination failure. And it warns that if immigration from those highly educated and culturally close new member states in eastern Europe had the potential to be controversial, immigration

may be even more controversial from still nearby but much poorer countries in the EU neighbourhood.

Box 8.1: Were the forecasts of the potential for east-west migration wrong?

The large number of migrants from the NMS-8 moving to UK and Ireland has triggered a public debate about whether migration forecasts made before the EU's eastern enlargement underestimated the migration potential. These studies relied as explanatory variables on extrapolations of south-north migration in Europe during the 1960s and 1970s, surveys among the population of the new member states or econometric estimates considering *inter alia* differences in income levels and labour market conditions across countries. Under the counterfactual assumption that free movement would be introduced in all EU member states at the same time, the majority of these studies predicted a long-run migration potential of 3-5 percent of the population from the NMS-8, and a short-run net inflow of about 300,000-400,000 persons per annum (see eg Boeri and Brücker 2001, Alvarez-Plata *et al.* 2003, Krieger 2003, Layard *et al.* 1992, Bauer and Zimmermann 1999). There also exist studies which have obtained significantly lower (Fertig 2001, Fertig and Schmidt 2001, Dustmann *et al.* 2003) or higher projections (Sinn *et al.* 2001)¹³.

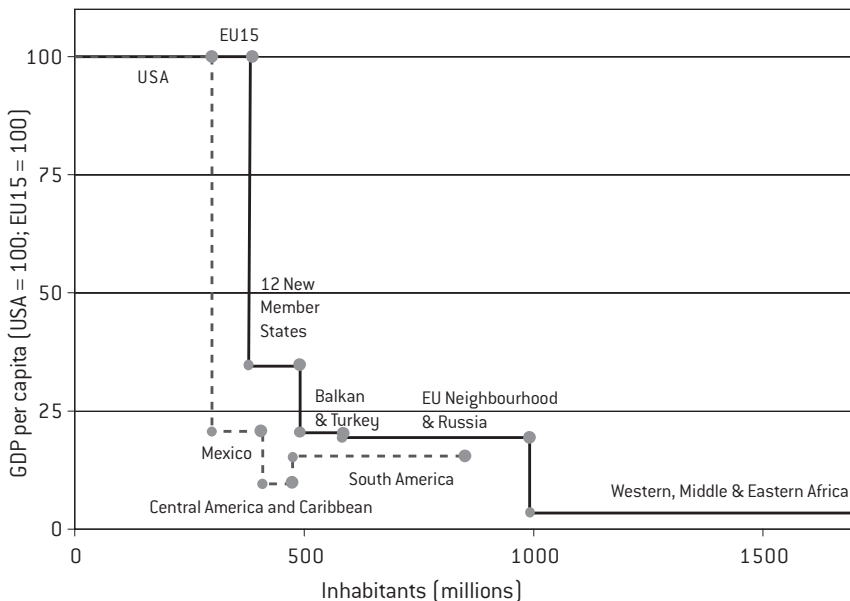
Thus, the aggregate scale of east-west migration within the enlarged EU does not contradict the predictions of most migration projections, albeit the migration conditions in the first two years following eastern enlargement do not allow a verification or falsification of the forecasts. However, the net increase in foreign residents from the NMS-8 in UK and Ireland has been well above the projections before enlargement (10,000-20,000 persons per annum, see Dustmann *et al.* 2003, Alvarez-Plata *et al.* 2003). It is worth noting that those projections relied on the counterfactual assumption that all EU member states would open their labour markets at the same time. It was already anticipated before enlargement that countries that opened their labour markets before others would attract a substantially higher share of migrants than projected under this counterfactual assumption (eg Alvarez-Plata *et al.* 2003). However, there have not been any quantitative estimates of those diversion effects, since no historical precedents exist, and even today it is hardly possible to quantify the scale of diversion. Altogether, there is still a considerable amount of uncertainty surrounding all estimates of migration potential from the NMS.

Proximity and income differences as drivers of migration

This type of proximity migration from much poorer countries in the neighbourhood of the EU, similar to the massive influx of migrants from Mexico to the US, might well play a much more important role for the EU in the future. It is estimated that there are currently some 12 million Mexican immigrants living in the US, of which roughly 60 percent are illegal. The illegal inflow from Mexico may exceed 400,000 migrants per year. Geographic proximity and the income gap with Mexico appear to be key drivers of that development. As we have seen above, the EU numbers of between four million and eight million irregular migrants and an annual inflow of up to 500,000 may already be comparable.

In order further to assess the similarities with the US-Mexico situation, Figure 8.3 compares the income gaps of the EU15 and of the US with their respective neighbourhoods using a synthetic conversion rate that is an average of the current exchange rate and the purchasing power parity. The reason for this unusual choice of conversion rate is that migration decisions are in part driven by purchasing power parity comparisons, but also in part by current exchange rate comparisons in view of remittances and the possible return of the migrants with savings accumulated

Figure 8.3: Income gaps of the EU15 and US with their respective neighbourhoods



Data: IMF 2005.

Note: the unweighted average of current exchange rate and purchasing power parity is used for comparing GDP per capita.

abroad. Figure 8.3 shows that the income gap between the US and Mexico is significantly greater than between the EU15 and the 12 new member states that joined the EU in 2004 and 2007.

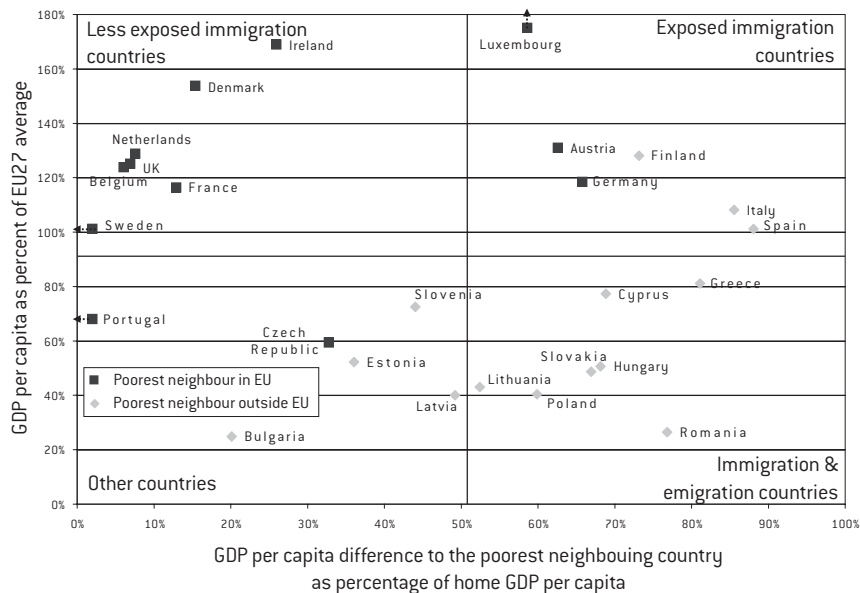
However, the US-Mexico gap of roughly a factor of five is very similar to the gap between the EU15 and the average of EU accession and neighbourhood countries around the Mediterranean and in eastern Europe. But Mexico only has around 100 million inhabitants, roughly one third of the US population. By contrast, the EU accession countries, the neighbourhood countries and Russia taken together have roughly 500 million inhabitants, which is about the same as the population of the entire EU27. In that sense, the migration challenge in the EU neighbourhood for the EU can be said to be three times as large as the migration challenge from Mexico for the US. Looking further to Latin America from the US and to western, middle and eastern Africa from EU15, the comparatively greater immigration potential for the EU is also apparent.

Yet Figure 8.3 does not capture the important effect of actually having a common border which increases migration pressures further, as the example of the US and Mexico illustrates. But even in that respect, migration exposure is not equal within Europe. In particular, migration exposure between neighbours Spain and Morocco is extreme. However, some other countries in Europe are clearly much less exposed to income differences with immediate neighbours. Figure 8.4 presents a classification of the migration exposure of the EU27 by looking at both the income difference with the poorest adjacent country and the GDP per capita level.

Countries with high income levels but without poor immediate neighbours like the UK or Denmark can be thought of as *less exposed immigration countries*. They are attractive to migrants because they are rich, but they are not particularly exposed to neighbourhood migration pressures. Countries with high GDP per capita and comparatively poor neighbours like Spain, Finland, and Germany are *exposed immigration countries*. The reluctance of Austria and Germany to open their labour markets to citizens from the new member states neatly illustrates this fear of greater exposure. However, the migration diversion experience of the UK and Ireland suggests that shielded countries may still attract many migrants if exposed countries in between refuse to admit migrants. This leapfrogging of exposed but closed immigration countries is greatly facilitated by the availability of cheap air travel in the EU.

Then there are relatively poor countries such as Poland and Romania bordering poorer countries still, like Ukraine and Moldova. These are potential *immigration and emigration countries* which face the challenge of managing both aspects of migration

Figure 8.4: Exposure of EU member states to income differentials with neighbouring countries



Data: IMF 2005.

Note 1: The unweighted average of current exchange rate and purchasing power parity is used for comparing GDP per capita.

Note 2: Countries separated by less than 100 km of sea were treated as neighbouring countries.

simultaneously. These countries are also likely to be popular transit countries. Finally, there are the countries with below-average income but without extremely poor neighbours where likely migration pressures are more difficult to predict.

Figure 8.4 also shows that very large income differences between neighbouring countries within the EU (as indicated by the squares) have already become the exception within the EU. They mainly concern Germany and Austria. By contrast, large income differences across external borders of the EU (as indicated by the diamonds) abound. This underlines the importance of developing a common policy for the immigration of third countries nationals. This is where the main net migration flows of the future are to be expected, which will outpace those from the new member states by far. If mishandled, these pressures could turn into large-scale illegal immigration inflows, accompanied by growing public resentment in host countries. These illegal immigrants might then further increase the need for coordination and harmonisation within the Schengen area.

In sum, it appears quite certain that proximity and income differences will be important migration drivers for the EU. We believe that they are a far more important factor

for the future of immigration to Europe than Europe's demographic crisis, which is frequently also cited as a major factor. Econometric research suggests that the reverse demographic development, namely the baby boom, did have some impact on wage levels of different age cohorts¹⁴ but that this impact was minimal compared to international wage differences. We should therefore expect that the changes in cohort size due to the 'baby bust' will also have a significant impact on wages. But again, these effects are likely to be small compared to existing international wage differences.

It may even be that Europe's demographic crisis develops into a deterrent for immigrants. As we have already seen in many parts of the European countryside, ageing can accelerate the exodus of young people. And at least for young high-skilled immigrants, it may not be particularly attractive to move to European countries that impose a high burden on the young through unreformed pension systems. In that sense, Europe should perhaps address its demographic crisis in order to attract migrants rather than attempting to attract migrants in order to avoid the difficult reforms necessitated by its demographic crisis.

Winners and losers: a simulation of the migration impact

Immigration policies are largely driven by real or perceived benefits and losses from migration, which to an important extent depend on the human capital endowments of the migrants. This section explores the economic benefits and costs of migration by skill type in two steps. First, we provide a basic conceptual framework for thinking about the issue. Second, we use a simple general equilibrium model to simulate the economic implications of migration for the host country, the source country and the migrants themselves. In particular, we explore how institutional differences among EU member states might translate into heterogeneous preferences with regard to migration.

Disentangling the migration impact by skill type

To analyse the impact of migration, it is useful to distinguish three perspectives: the perspective of the host country, of the source country and of the migrants.

Host country perspective

In the host countries, immigration will typically increase economic output. In that sense, immigration is a source of GDP growth. However, only part of that increased output will accrue to local workers and local owners of capital. A substantial portion

of the increased output will go to the migrants. Another portion of the gains will go to foreign owners of local capital. Only the remainder will accrue to native workers and native owners of capital. The impact of migration on wages and employment in the host country is likely to be negative for those native workers who have skills similar to those of the immigrants. By contrast, the impact on wages and employment is likely to be positive for the native workers who have skills that are different and complementary to those of the immigrants and for owners of capital.

Most empirical studies find that the wage and employment effects of immigration are relatively small, and many find no effects at all (Longhi *et al.* 2005, 2006). At the upper end of the range, Borjas (2003) estimates that an immigration influx of one percent of the population in the host country reduces the wages of local workers who are similar to the immigrants for labour market purposes by 0.3 to 0.4 percent. But when are immigrants similar to locals with respect to the labour market? In pursuing that question further, Ottaviano and Peri (2006) find that the labour market treats locals and immigrants as near substitutes only for low-skill groups. By contrast, the labour market profiles of mid- and high-skilled migrants and locals appear to be sufficiently different so that they generally do not hurt each other's employment and wage prospects. In other words, the wage and employment impact of high-skill immigration appears to be relatively unproblematic. However, the empirical literature has not been able comprehensively to dispel the distributional concerns regarding low-skill immigration. The fact that European labour markets for low-skilled workers are generally less flexible than the labour markets for high-skilled workers may further aggravate any adverse impact of low-skilled immigration.

Fiscal and social policies in rich host countries tend to redistribute from the rich to the poor and from the working-age population to the inactive population and pensioners in particular. Hence, the net fiscal impact of a high-skilled immigrant tends to be substantially more favourable than the net fiscal impact of low-skilled immigrants. But because immigrants are overwhelmingly young adults when they migrate, even relatively low-skilled immigrants may have a positive net fiscal impact. Bonin (2002), for example, finds that the average immigrant has a positive net fiscal impact in Germany across his or her lifecycle, despite the high proportion of low-skilled immigrants. However, a similar study by Roodenburg *et al.* (2003) for the Netherlands finds a negative net impact of immigration on public finances. Overall, there is little doubt that Europe is fiscally more vulnerable than the US to a large scale influx of low-skilled immigrants on account of Europe's larger welfare state. This potentially reduces the EU's optimal degree of openness to low-skilled immigration compared to the US.

Overall, the impact of immigration on wages, employment and public finances of the host country would tend to be positive for high-skilled immigration while the net impact of low-skilled immigration is less clear.

Source country perspective

By moving a factor of production abroad, migration is likely to decrease the economic output of the source country. In that sense, emigration may slow GDP growth in the source country. However, that decrease in output will, to a large extent, be borne by the emigrants who expect to be better off abroad and may send remittances back home. Some of the decrease in output is likely to be borne by local and foreign owners of capital.

Low-skilled emigration or 'brawn drain' would tend to increase the wages and employment of low-skilled workers in the source country by making low-skilled workers relatively more scarce. By contrast, the wages of skilled workers would probably be reduced since they are becoming relatively more abundant. Taken together, the effect would be to reduce inequality. High-skill emigration or 'brain drain' would tend to increase the wages of the high skilled and reduce the wage of the low skilled, thereby increasing inequality in the source country. To the extent that wage inequality is undesirable, the effect of low-skilled emigration would appear to be somewhat preferable to that of high-skilled emigration. Moreover, brain drain could have a negative impact on the growth potential of the source country's economy by depriving it of its innovation potential.

But brain drain may not be entirely negative for the source country. The option to emigrate may substantially increase the expected returns on education, thereby improving private education incentives. Also, if migrants return to their country of origin, and many of them do, the skills and savings that they have acquired abroad become a powerful force for development. Moderate levels of brain drain, therefore, may actually be beneficial for the source country as is argued, for example, by Beine *et al.* (2003).

Finally, there are altruistic links between migrants and locals in the source country. Migrants feel altruistic towards their families back home and help them by sending back remittances on a grand scale easily exceeding development aid budgets. But altruism is also relevant in the other direction. Many parents in poor countries would welcome it if their children found a better life abroad, even in the total absence of remittances. This last aspect is often overlooked but may offer an important explanation why so few attempts are made by source countries to impose at least some

financial restrictions on emigration, such as asking high-skilled emigrants to pay back their education subsidies.

Migrant perspective

Migrants migrate because they expect to be better off as a result of the move. And despite some disappointments because of exaggerated expectations or plain bad luck, the overwhelming majority of migrants can be regarded as winners in the migration process.

Figure 8.5: A simple impact matrix of migration by skill level

High-skilled migration	+	?	++
Low-skilled migration	?	+	++
	Rich host country	Poor source country	Migrants

Figure 8.5 summarises the arguments: from a host country perspective, it seems likely that high-skilled immigrants would tend to have a net positive impact on the locals in the host country, as indicated by a '+' in the impact matrix. The case appears to be somewhat less clear cut for low-skill immigration, as indicated by a '?'. In contrast, it seems plausible that low-skilled emigration would tend to have a positive impact on the locals in the source country, as indicated by a '+' in the impact matrix, while the impact for high-skill emigration is ambiguous, indicated by a '?'. Finally, both low- and high-skilled migrants are prospective winners from migration, indicated by a '++' in the impact matrix.

A simulation of the migration impact

Having established the basic structure of the argument, we now explore it further by simulating the impact of migration on output, wages, employment and public finances in host and source countries. For this purpose, a highly stylised general equilibrium model is used that builds on Boeri and Brücker (2005)¹⁵. Each country (initially just one host country and one source country) produces one good with skilled labour, unskilled labour and physical capital with a standard constant elasticity of substitution (CES) production function. The framework is comparative-static. However, we employ two assumptions regarding the adjustment of the capital stock.

In the short run, it is assumed that the physical capital stock is fixed, while in the long run we assume that the capital stock adjusts perfectly such that the interest rate remains constant.

In contrast to the overwhelming share of the literature, the simulation incorporates a model of wage rigidities which would appear to be an essential feature in the European context. Within the framework of the simulation, migration can therefore result in unemployment. The labour market module is based on the right-to-manage model where trade unions and employer federations collectively bargain over wages and where firms hire workers until this set wage equals marginal productivity. Both parties in the wage negotiations are aware of this. In this setting, wages adjust to migration in- and outflows, albeit imperfectly. As a consequence, migration involves falling wages and increasing unemployment for workers of the same skill type. The (semi-)elasticities between the wage and the unemployment rate have been taken from the empirical literature (see Blanchflower and Oswald 1995).

For convenience, we assume that individual labour supply is fixed. Following the overwhelming share of the literature, we model the native and foreign labour of the same skill type as perfect substitutes. The alternative assumption, namely that migrant labour of the same skill type is an imperfect substitute (or even a complement) for native labour would mitigate the wage and employment impact of migration on natives (eg Ottaviano and Peri 2006). In this sense, the actual impact of migration might be more favourable for natives in host countries.

The model takes into account that the unemployment rate of low-skilled workers is typically higher than that of skilled workers. Consequently, a higher elasticity of the wage rate with respect to the unemployment rate is used for skilled workers. Moreover, the model assumes that the unemployment risk of migrant workers is twice as high as that of natives in the same segment of the labour market. This matches current conditions on average in EU15.

The model also reflects the impact of migration on the welfare state by assuming that unemployment benefits exist. Unemployment benefits are financed by a proportional tax levied at the same rate on skilled and unskilled labour. Initially, we assume that the net replacement rate for the unemployed stands at 60 percent in the destination, and at 30 percent in the source country. This broadly matches the average proportions in the EU and the typical countries of departure.

The parameters of the model are chosen in such a way that they match the economic conditions between the EU15 and the average of the source countries of European

immigrants, ie Turkey, the Balkan countries, North Africa and Eastern Europe. The parameters of the model together with the technical details are presented in Brücker and von Weizsäcker (2007).

Overall, migration has an impact on native incomes through three channels when a (semi-) rigid labour market is assumed. First, by a change in the pre-tax wage and interest rate, second by a changing unemployment risk and, third, by variations in the tax rate required to fund unemployment benefits.

Simulated migration impact by skill mix

Using this model, we simulate the migration impact of a migration shock of one percent of the population of the host and the source country. As a benchmark, we consider the textbook example with flexible labour markets and a fixed capital stock. In this case, the aggregate GDP of the host and the sending country increases substantially by around 0.33 percent. But there are important distributional implications. Earnings of capital owners increase by more than 0.3 percent in the host country and fall by up to 0.46 percent in the source country. The net earnings of blue-collar workers after transfers fall by between 0.1 and 0.9 percent in the host country, with greater losses if the skill mix of immigration is lower. The impact on white-collar workers can be positive or negative, with low-skilled immigration favouring high-skilled natives. Labour generally wins in the source countries. The main winners however are the migrants themselves: their income increases by between 230 and 300 percent [see Table 8.A in the Annex].

Next, we introduce wage rigidities. In that case, a one-percent migration shock increases the unemployment rate in the host country by between 0.1 and 0.2 percentage points. At the same time, unemployment declines by between 0.1 and 0.25 percentage points in the source country. The overall unemployment rate in the region tends to fall since, by assumption, the source country has a higher unemployment rate than the host country to start with. The aggregate GDP gain is marginally smaller than for flexible labour markets since some of the migrant labour now remains idle. In the presence of wage rigidities, natives in the host countries tend to lose between 0.05 and 0.08 percent of their aggregate earnings. By contrast, natives in the source countries tend to gain. The size and the distribution of gains and losses between the different types of labour depend on the skill mix of the migrant population.

The assumption of a fixed physical capital stock may be relevant to describe the short-term adjustment of migration to an unexpected migration shock. The long-run impact of migration, ie the impact of migration if the capital stock adjusts either by

international capital mobility or domestic capital accumulation, is much more beneficial. Simulating such an influx of migrant labour *and* foreign capital, we find that GDP in the host country rises by between 0.8 and 1.0 percent, and the aggregate GDP of the sending and receiving country is raised by some 0.6 percent. This roughly doubles the gain in GDP compared to the case with a fixed capital stock.

Again, the native population in the host country wins if the migrant population is sufficiently skilled and the gains from migration in the source country decline with the skill level of the emigrants. But, as is to be expected, the impact of migration on wages is reduced once the capital stock adjusts.

Remittances

Up to now, the impact of migration on natives in source countries has been ambiguous, while the earnings of migrants increase substantially. The distribution of the benefits and losses from migration changes however if remittances from the migrant population are added to the picture. In order to analyse the effects of remittances, we make the relatively generous assumption that migrants uniformly remit 10 percent of their income to their relatives in the source country. We assume furthermore that the families of migrants belong to the same group in the home country, ie unskilled migrants remit income to unskilled, and skilled migrants remit to skilled natives in the source country. These simple assumptions allow simulation of the effects of remittances on the distribution of income (Table 8.B in the Annex).

With remittances, the aggregate income of natives in the countries of departure increases unambiguously. The aggregate income of the native population increases by between 0.2 and 0.4 percent for an emigration shock of one percent of the source country population. Both high-skilled and low-skilled labour will generally win in the presence of remittances. Losses can only arise under the extreme assumption that all migrants are either skilled or unskilled. In this case the non-migrating group does not receive any remittances while suffering from the exodus of a complementary factor of production.

However, despite these generally encouraging findings of the distributional impact of remittances, it should not be forgotten that they increase the inequality of income within the groups of unskilled and skilled labour because not everybody is lucky enough to have a remitting relative. Moreover, remittances do not necessarily compensate for the adverse fiscal impact of high-skilled immigration since remittances are often difficult to tax.

Taxes and transfer payments

Since we have established that migration can produce both winners and losers, the next natural question concerns the size of transfers that would be needed to assure that everybody wins from migration. In order to organise such compensating transfers, redistribution within the three groups (natives in source country, natives in host country, and migrants) may not always be sufficient. Instead, redistribution between groups may be required, for example via a special tax on migrants to compensate natives in the receiving country or a Bhagwati tax (Bhagwati and Dellarfar 1973) on migrants to compensate the source country.

In order to analyse the magnitude of redistribution which would be necessary to create a win-win situation, we consider two cases. First, we assume that a perfect tax-transfer system exists, which allows redistribution of income from migrants and other groups without any costs. Second, we assume that redistribution involves costs, ie that 25 percent of the tax-transfer payments are lost through administrative costs and economic distortions. Migration may actually aggravate this 'leaky bucket' phenomenon as an increasingly mobile tax base is ever more difficult to tax.

For the calculation of the tax-transfer requirements we have to make an assumption about the groups whose rents will be taxed, since there are several winners from migration. We assume that all rents within the native population of the host and source countries are redistributed first, and only if this has been exhausted and losers remain will the migrants be taxed. While this is of course hardly realistic, we use this as a benchmark (see Table 8.C in the Annex for details).

In the short-term scenario with semi-rigid wages and a fixed capital stock, the required tax burden on the gains of the migrant population to compensate the host country would be substantial. Low-skilled migrants would have to transfer 22 percent of their income to natives in the receiving country in order to compensate them for their losses, while skilled migrants would have to transfer seven percent of their earnings on the assumption of a perfect tax-transfer system. If we assume that 25 percent of the transfers are lost, these numbers increase to 26 and eight percent, respectively.

However, if we assume that the physical capital stock adjusts to the in- and outflow of migrants, the requirement for income redistribution shrinks substantially. Low-skilled migrants would have to transfer 14 percent of their income to the native population in the host country, whereas no transfer from high-skilled migrants would be required as they generate a surplus for the host country population.

Thus, in order to create a 'win-win' situation a redistribution of migrant earnings to natives particularly in the receiving countries may be needed according to our simulations. The tax-transfer systems of many European countries may already to some extent act in this way. As already mentioned, Bonin (2002) finds that immigration creates a substantial net fiscal gain in Germany. Although migrants pay lower taxes than average workers and are more than proportionally affected by unemployment and welfare dependency, they create a substantial surplus for the pay-as-you-go pension system which outpaces other losses for the welfare state by far.

Heterogeneous host countries

So far, we have modelled the EU as one homogeneous region. However, in reality there are substantial differences across European countries with regard to their economic characteristics, the flexibility of their labour markets and the institutions of the welfare state. Moreover, we observe that process of integration of migrants into the labour markets differs substantially across the EU. Consequently, the migration impact differs. This in turn has important implications for European migration policies: the more heterogeneous the migration impact, the more difficult it is to harmonise European immigration policies.

Hence, we examine the impact of these differences in the framework of our simulation model. We consider country differences in five relevant dimensions: (i) the GDP gap between the receiving and the source countries, (ii) the degree of labour market flexibility, (iii) the unemployment rate, (iv) the unemployment risk of the migrant population, and (v) the replacement rate for unemployed individuals. Table 8.4 gives an overview of the country differences in these dimensions.

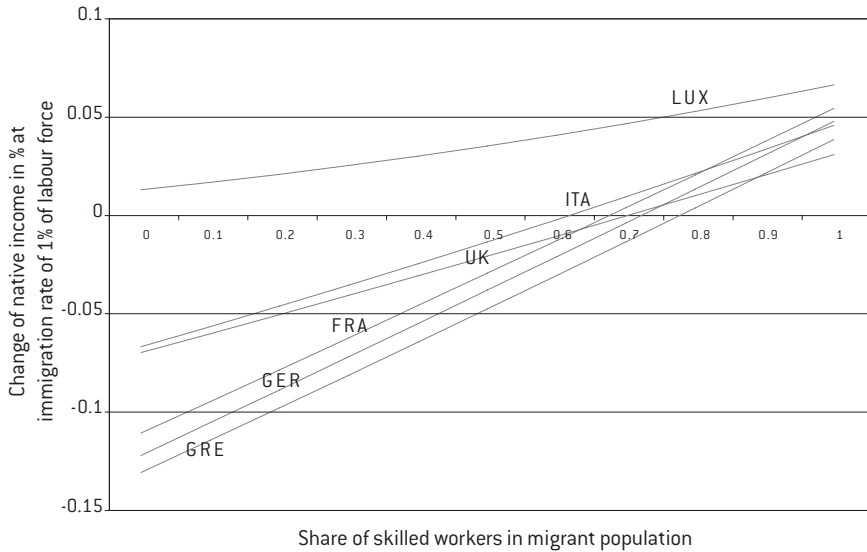
Table 8.4: International comparison of the extent and skill composition of migration

	GDP per capita ⁱ	Unemployment rate ⁱⁱ	Unemployment risk of migrants ⁱⁱⁱ	Net replacement rate ^{iv}
Luxembourg	2.4	4.5	4.0	85.0
United Kingdom	1.1	4.8	1.8	45.0
France	1.0	9.6	2.1	73.0
Germany	1.0	9.5	1.7	61.0
Italy	1.0	7.7	1.6	54.0
Greece	0.8	10.5	1.2	48.0
EU15	1.0	7.1	2.2	61.0

i) Index: EU15 = 1.-- ii) Unemployment rate in % (ILO-Norm).-- iii) Unemployment rate in the foreign labour force divided by the total unemployment rate.-- iv) Replacement rate in initial phase of unemployment for single earner household with 100 % of average income in 2004.

Sources: World Development Indicators 2006; Eurostat; OECD; calculations by the authors.

Figure 8.6: When do natives in EU countries benefit from migration?



Source: authors' calculations.

Using these different country parameters, we have simulated the differences in the migration impact in the EU15 in the long run, ie with the capital stock adjusting to the migration influx. For ease of presentation, Figure 8.6 only displays the simulation results for the two extreme cases in the EU15, Luxembourg and Greece, and for the four largest EU countries only. The findings confirm that the impact of high-skilled immigration is generally positive for the host country while the impact of low-skilled migration tends to be less favourable. But, in addition, the simulation suggests that there is substantially greater variation between countries regarding the impact of low-skilled migration compared with that of high-skilled migration.

Policy recommendations

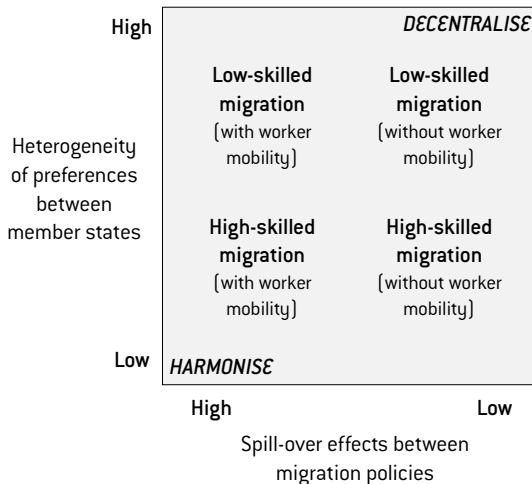
In the previous section, the simulation found that the heterogeneity of migration preferences between member states is likely to be more pronounced for low-skilled migration than for high-skilled migration. This is plausible since the impact of differences in the welfare state and a different organisation of the labour market is more pronounced for low-skilled than for high-skilled immigration.

Furthermore, the second section pointed to the importance of proximity for migration outcomes. Differences in proximity to likely source countries add an additional layer of heterogeneous preferences regarding *migration policies*, especially concerning

low-skilled immigration, even if preferences on *migration outcomes* were identical (which they are not).

At the same time, the importance of spill-over effects between EU member states is more pronounced if there are no restrictions on intra-EU mobility for third-country nationals. This observation is reinforced by the low labour mobility of EU citizens (with the exception of one-off enlargement episodes), which would only partially offset restrictions on third-country nationals through increased mobility of EU nationals. These insights on the importance of spill-over effects and the heterogeneity of preferences for different categories of migrants are summarised in Figure 8.7.

Figure 8.7: Heterogeneity of preferences and spill-over effects of immigration
(skill level of immigration in bold, intra-EU mobility status in brackets)



Within the EU context, those policy issues where spill-over effects are low and heterogeneity of preferences is high should be decentralised to member states. That is likely to be the case for low-skilled immigration without intra-EU mobility for those immigrants. By contrast, if spill-overs are important and the heterogeneity of preferences is low, then a harmonised, EU-level solution is called for. This would tend to be the case for high-skilled immigration in the presence of intra-EU mobility.

The situation is politically most challenging when the heterogeneity of preferences is high while spill-over effects are significant. In principle, it may be possible to cooperate by devising sophisticated incentive mechanisms to deal with any spill-over effects. In practice this often does not work and one is left with a dilemma: either to harmonise despite a pronounced heterogeneity of preferences, or to decentralise

despite spill-over effects. According to our logic, this policy dilemma is likely to surface with low-skilled immigration in the presence of intra-EU mobility, and in particular with irregular migration.

Differentiation of intra-EU mobility by skill level

It should be noted that the decision on how mobile third-country immigrants are to be within the EU is itself an EU policy choice. Current EU policy is described by the mobility U-curve from Figure 8.1. Irregular migrants have full transferability of status within the Schengen area. Third-country nationals with a legal but short presence in a member state have no transferability of status within the EU. Longer-term residents enjoy partial transferability of status. Finally, naturalised citizens benefit from free movement for workers and thus have fully transferable status.

Setting aside the special but important case of illegal immigration, intra-EU mobility rights are thus essentially a rising function of the duration of the legal stay of the migrant. In principle this makes good sense. In the short run, the spill-over effects of immigration are reduced by mobility restrictions. Hence, there is less scope for regulatory arbitrage, and the effects of national migration policy choices are better internalised. As time goes by, the immigrants get used to their host country which increases the costs to them of further moves inside the EU. These higher *de facto* migration costs kick in as the *de jure* restrictions diminish with length of stay. Hence, spill-over effects between national policies remain limited, while some of the economic benefits that come with internal mobility are gained.

In particular, the internal mobility of third-country migrants is important to allow for an efficient adjustment to regional economic shocks. Take the hypothetical example of the closure of a manufacturing plant in an EU member state. If the local labour market cannot absorb all displaced workers, then cross-border migration will be a helpful adjustment mechanism to cope with the shock. And the plant's migrant workers would tend to have less pronounced local ties than native workers. Therefore, an efficient migration regime would allow migrant workers to move abroad so that more local workers can stay at home where they like it best. In other words, the economic rationale for granting third-country nationals intra-EU mobility is made stronger precisely because many EU citizens are so reluctant to move, as witnessed by the low migration rates of EU citizens.

But further initiatives to relax intra-EU mobility constraints require care. As Figure 8.7 shows, free intra-EU mobility for low-skilled third-country nationals could make the European coordination problem intractable. By contrast, further relaxation of the

conditions for intra-EU mobility of high-skilled workers could be more readily accommodated because of lower heterogeneity of preferences with respect to high-skilled migrants. At the same time, the efficiency gains from intra-EU mobility may be particularly important for high-skilled migrants. An improved match-up of highly specific demand and supply in the typically thin markets for highly specialised human capital is likely to lead to significant benefits for the EU economy.

On this basis, we recommend that a further relaxation of intra-EU mobility should be differentiated by skill. While high-skilled migrants could be granted full intra-EU mobility upon legal entry, intra-EU mobility for low-skilled migrants could for the time being be kept at the current five-year waiting period.

The Blue Card proposal

A simultaneous harmonisation of high-skilled immigration rules and more generous intra-EU mobility for this category of third-country nationals would be an attractive EU policy. It could be implemented through the introduction of an EU-wide 'Blue Card' (von Weizsäcker 2006), granting high-skilled workers comprehensive access to the entire EU labour market without the current five-year delay. This European version of the US Green Card could be allocated through a harmonised points system that takes into account various characteristics of potential immigrants, including their education, their age, and their language skills.

The Blue Card would help to attract more highly skilled migrants to the EU than purely national schemes because of its greater option value for subsequent employment. Accepting a first job in Vienna is more attractive if the search space for the next job is the whole of the EU, not only Austria. In addition, this Blue Card scheme would result in greater economic gain for the EU per high-skilled worker admitted, by securing a better match of their talent with the requirements of the EU economy.

But how would the expected net increase in high-skilled immigration through a Blue Card system be distributed over individual EU member states? Small member states stand to benefit most since the difference in option value of any national scheme compared to an EU scheme would be greatest. But large member states are also likely to benefit as they would gain in attractiveness compared to key competitors for top talent such as the US, Canada and Australia. The European Commission was preparing a draft directive on high-skilled immigration for September 2007. This opportunity should be used to participate more effectively in the global competition for talent.

The Blue Card also has an important development aspect. By granting high-skilled migrants from developing countries permanent residence status immediately, brain circulation is encouraged. The Blue Card would act as an insurance policy for high-skilled migrants wanting to return to their country of origin. If a high-risk career project at home does not work out, they would still have the option to return to Europe.

Skill mixing and irregular migration

High-skilled emigration or brain drain need not substantially hurt the country of origin because of remittances and because of better incentives to invest in human capital. But it also seems clear that the development impact of low-skilled emigration is likely to be more benign than that of high-skilled emigration. In addition to improved development assistance, not least in the area of education, it may therefore be desirable to provide for a skill mix of migration that balances the interests of source and host countries. In this context, it is sometimes proposed to introduce temporary work permits for low-skilled migrants from developing countries¹⁶.

But such a scheme would require a substantial administrative effort to overcome the experience-based observation that there is nothing more permanent than temporary migration. And even if the temporary scheme could be made to work, it would raise a number of problems. In particular, new investments in training and in basic integration would be required every time the old temporary migrants are exchanged for new ones. Finally, the hope that such a scheme would help substantially to reduce the inflow of irregular migrants may prove unfounded. The total migration potential from the EU neighbourhood is likely to remain substantially greater than total irregular migration and the envisaged temporary migration combined. Thus, irregular migration pressure may not be impacted in a major way by the temporary migration scheme.

It would certainly appear paradoxical to set up an administratively challenging scheme of low-skilled temporary migration from developing countries while, in parallel, investing increasing amounts in the equally challenging task of controlling irregular inflows of migrants. For the time being, it may instead be preferable to use any political room for manoeuvre regarding the increased admission of low-skilled immigrants to ease the challenge of irregular immigration.

However, finding a good solution in the EU context for irregular migration is far from straightforward. We have seen that spill-over effects are considerable for irregular migration in the Schengen area and the heterogeneity of preferences among member states appears to be relatively high. Furthermore, the flow of irregular migration

is likely to increase over the coming years, so that the coordination problem is likely to get worse. The underlying economic forces driving irregular migration are simply too powerful for it to be stopped by acceptable means. Increased expenditures on border controls, reinforced efforts to fight human trafficking and closer collaboration with transit countries can slow the increase in irregular migration somewhat but probably no more than that.

Heterogeneity of preferences among member states may be even stronger for irregular than for legal migration for non-economic as well as economic reasons. Concern about the corrosive effect of tolerance of obviously illegal phenomena may be more pronounced in some member states than in others. The human rights implications of cracking down harshly on irregular immigration may be interpreted differently in different member states. Finally, the economic benefits derived from irregular migration may vary subtly between member states. For example, countries with strong tax distortions that provide excessive incentives for high-skilled women to engage in home production of household services might find the economic impact of irregular migration more beneficial than countries where such tax distortions are weaker. The reason is that in countries where such tax distortions are strong, irregular migration is likely to increase more substantially the supply of high-skilled (female) labour in the official labour market.

Because of highly heterogeneous preferences, a harmonised approach to irregular migration is likely to remain elusive for some time to come. But increased coordination should still be possible.

First, more stringent standards governing the treatment of irregular migrants could be agreed. With open internal borders, some member states might otherwise be tempted to drive irregular migrants away to neighbouring EU countries by treating them poorly. Individual countries that treat irregular migrants decently might in any case end up attracting more than their expected share. Stricter standards for the decent treatment of irregular migrants could help resolve this problem.

Second, a basic framework for regularisation procedures could be defined, recognising the advantages of timely regularisation. In particular, it is often overlooked that irregular immigrants who are regularised in one member state have a strong incentive to stay there because their legal status is not transferable. This provides an incentive for migrants to build themselves a local network and to learn the local language. In doing so, the effective mobility costs of those regularised migrants increase substantially. In that sense, a country that regularises irregular migrants to some extent locks them in, thus reducing spill-over effects.

This effect may have been overlooked in the debate regarding Spain's recent mass regularisation. France was concerned that a substantial part of these regularised migrants would stay in Spain for five years only in order to obtain long-term resident status and then move to France. However, because of the lock-in effect outlined above, it would be surprising if this movement turned out to be very strong, especially compared to how many irregular migrants might have moved from Spain to France had Spain not provided attractive conditions for them.

A more proactive regularisation policy stands to alleviate future integration problems. It took European societies too long to acknowledge that their guest workers were immigrants who required an integration investment. There is a risk that we are today making a similar mistake with irregular immigration. Regularisation schemes could in fact be used to encourage integration by providing accelerated regularisation for those irregular migrants on the basis of language skills and similar integration achievements.

The principal negative effect the proposed policy direction on irregular migration is that it makes irregular migration *ex ante* more attractive to potential migrants. Hence, for any given enforcement level, the inflow of irregular migrants could be expected to increase somewhat as a result of these policies. This is precisely the reason why, in our view, it makes sense to reform policy on irregular immigration, using the limited political room for manoeuvre for increased low-skilled immigration generated by successful high-skill immigration schemes.

In sum, the proposed policy recommendations could help to improve the skill mix of immigrants into the EU while helping to defuse the challenge of irregular immigration. The developing countries also stand to benefit on account of the greater openness to immigration overall that the proposal entails.

Notes

- 1 The authors would like to thank Alexandre Janiak for his excellent research assistance.
- 2 European Council, Presidency Conclusions, 5 November 2004 (includes the Hague Programme, the EU's work programme on migration policy 2005-2010).
- 3 Sebastian Mallaby, *Washington Post*, 30 April 2007, p. A15.
- 4 See Legrain (2007) for a forceful argument along these lines.
- 5 George Parker and Jimmy Burns, *Financial Times*, 20 October 2006.
- 6 Free mobility for workers has proved so attractive that European Free Trade Association [EFTA] countries such as Switzerland are also joining in.
- 7 Directive 2004/38/EC, Article 16[1].
- 8 The new member states were also given the right to impose restrictions on old member states, although such reciprocal restrictions have mostly symbolic significance.

- 9 Although the UK and Ireland have opted out of Schengen, their only land border has been without formal border controls ever since Ireland became independent in 1922.
- 10 With the exception of the UK, Ireland and Denmark who have opted out of this regulation.
- 11 See Düvell (2006) for a comprehensive discussion of the various estimates.
- 12 Finland, Greece, Italy, Portugal, Spain opened their labour markets completely, and some other countries increased quotas and removed barriers at the sectoral level (Belgium, Luxembourg, Netherlands).
- 13 For a detailed review of these studies and a test of the forecasting performance of different estimation techniques see Brücker and Siliverstovs (2006).
- 14 Macunovich (1998).
- 15 See also Levine (1999); Bauer and Zimmermann (1997) for similar models.
- 16 eg Pritchett (2006), World Bank (2007), European Commission (2007a).

Annex

Table 8.A: Migration impact on recipients, senders and migrants.

Share of skilled labour in migrant population		fixed capital stock						capital stock adjustment		
		flexible labour markets			semi-rigid labour markets			0.3	0.5	0.7
		0.3	0.5	0.7	0.3	0.5	0.7	0.3	0.5	0.7
<i>Change in % at immigration (emigration) of 1 % of labour force</i>										
Total GDP	Host country	0.53	0.56	0.59	0.42	0.46	0.50	0.82	0.90	0.98
	Source country	-0.75	-0.84	-0.94	-0.60	-0.71	-0.82	-0.88	-1.05	-1.21
	Total region	0.30	0.31	0.32	0.25	0.27	0.29	0.54	0.58	0.62
Total income	Host country	0.00	0.00	0.00	-0.09	-0.07	-0.06	-0.04	-0.02	0.00
	Natives	0.00	0.00	0.00	0.14	0.12	0.10	0.09	0.05	0.02
	Total region	0.00	0.00	0.00	-0.05	-0.04	-0.03	-0.02	-0.01	0.00
<i>of these</i>										
Manual labour	Host country	-0.68	-0.39	-0.09	-0.70	-0.43	-0.17	-0.43	-0.15	0.14
	Source country	0.14	-0.08	-0.29	0.31	0.06	-0.19	0.11	-0.17	-0.46
	Total region	-0.42	-0.29	-0.16	-0.39	-0.28	-0.17	-0.27	-0.16	-0.04
Non-manual labour	Host country	0.02	-0.15	-0.32	-0.15	-0.27	-0.40	0.12	0.02	-0.08
	Source country	0.14	0.48	0.82	0.32	0.64	0.97	0.12	0.41	0.70
	Total region	0.04	-0.06	-0.15	-0.08	-0.15	-0.21	0.12	0.07	0.03
Capital owners	Host country	0.30	0.32	0.34	0.24	0.26	0.29	0.00	0.00	0.00
	Source country	-0.43	-0.48	-0.54	-0.34	-0.40	-0.47	0.00	0.00	0.00
	Total region	0.22	0.23	0.24	0.18	0.19	0.21	0.00	0.00	0.00
Income of migrants		219.86	201.88	186.85	248.04	228.72	212.59	249.08	229.80	213.70
<i>Change in % at immigration (emigration) of 1 % of labour force</i>										
Unemployment rate	Host country	-	-	-	0.20	0.16	0.12	0.12	0.08	0.03
	Source country	-	-	-	-0.15	-0.09	-0.02	-0.09	-0.01	0.06
	Total region	-	-	-	-0.04	-0.03	-0.02	-0.05	-0.03	-0.02
Manual labour	Host country	-	-	-	0.41	0.25	0.09	0.30	0.13	-0.04
	Source country	-	-	-	-0.16	-0.04	0.08	-0.09	0.04	0.18
	Total region	-	-	-	-0.03	0.01	0.05	-0.02	0.02	0.06
Non-manual labour	Host country	-	-	-	0.03	0.09	0.15	-0.03	0.03	0.08
	Source country	-	-	-	-0.14	-0.29	-0.43	-0.10	-0.24	-0.38
	Total region	-	-	-	-0.05	-0.07	-0.09	-0.07	-0.10	-0.12

Source: authors' calculations. See text for assumptions.

Table 8.B: The impact of remittances

	Semi-rigid labour markets and capital stock adjustment					
	Without remittances			Remittances as 10% of income		
Share of skilled labour in migrant population	0.3	0.5	0.7	0.3	0.5	0.7
Native income in source country	0.09	0.05	0.02	0.34	0.33	0.31
<i>Of these:</i>						
Manual labour	0.11	-0.17	-0.46	0.51	0.11	-0.29
Non-manual labour	0.12	0.41	0.70	0.42	0.91	1.40
Income of migrants	249.08	229.80	213.70	214.18	196.82	182.33

Source: authors' calculations. See text for assumptions.

Table 8.C: Tax-transfer requirements if native income remains constant

	Perfect tax-transfer system			25% leakage		
	0.3	0.5	0.7	0.3	0.5	0.7
Share of skilled labour in migrant population	0.3	0.5	0.7	0.3	0.5	0.7
Transfer (tax) requirement of/for						
Migrants (to/from host country)	-16.87	-13.61	-10.62	-21.09	-17.01	-13.28
Migrants (to/from source country)	5.43	4.35	3.35	6.79	5.44	4.19
Manual Labour						
Host country	0.68	0.43	0.17	0.85	0.53	0.21
Source country	-0.31	-0.06	0.19	-0.39	-0.08	0.24
Non-manual Labour						
Host country	0.15	0.27	0.40	0.18	0.34	0.50
Source country	-0.31	-0.63	-0.95	-0.39	-0.79	-1.19
Capital Owners						
Host country	-0.24	-0.26	-0.29	-0.30	-0.33	-0.36
Source country	0.34	0.40	0.47	0.43	0.51	0.59
<i>Memo item</i>						
Leakage in % of GDP	0.00	0.00	0.00	0.06	0.06	0.06
Migrants (to/from host country)	-7.66	-4.06	-0.76	-9.57	-5.07	-0.95
Migrants (to/from source country)	3.30	1.97	0.74	4.12	2.46	0.93
Manual Labour						
Host country	0.43	0.15	-0.14	0.54	0.18	-0.17
Source country	-0.11	0.17	0.46	-0.14	0.22	0.58
Non-manual Labour						
Host country	-0.12	-0.02	0.08	-0.15	-0.02	0.10
Source country	-0.12	-0.41	-0.70	-0.15	-0.51	-0.88
Capital Owners						
Host country	0.00	0.00	0.00	0.00	0.00	0.00
Source country	0.00	0.00	0.00	0.00	0.00	0.00
<i>Memo item</i>						
Leakage in % of GDP	0.00	0.00	0.00	0.03	0.01	0.01

Source: authors' calculations. See text for assumptions.

External energy policy: old fears and new dilemmas in a larger Union

Coby van der Linde

Energy has shot up the national and European Union political agenda and a proposal is now on the table to create a common energy framework which enables the member states to address the long-term policy goal of creating a competitive and low-carbon European economy. To this end, the Commission advocates an ordering of priorities for energy policy at EU level: reasonable price, security of supply and environmental sustainability. The EU is already competent for the internal energy market, which is the main policy instrument for achieving reasonable prices. The EU is also responsible for climate change policies and thus carbon dioxide (CO₂) emission levels. However, security of supply and the national energy mix have so far remained within the field of competence of the individual member states. The Commission now proposes to include security of supply in the common EU energy framework, so that the EU can 'speak with one voice' in its energy diplomacy with third-country producers. Will member states play ball?

These proposals are not new. In earlier periods of EU policymaking, notably in the 1960s, 1970s and early 1980s, the Commission attempted without much success to unify the member states' energy security policies. National member states' interests stood in the way of progress. The liberalisation of EU energy markets was the first breakthrough. The international energy market circumstances from the late 1980s onward – a buyers' market – helped convince the member states to reform their energy markets and reap the benefits of widely available international oil and gas flows and more efficient organisation of the EU market. Energy security was not a issue, or at least was not deemed to be an issue which the market could not deal with. With the liberalisation process underway, the switch to a sellers' market at the turn of the century forced the member states to rethink energy security matters. The

growing dependency on imported oil and gas, the declining energy production in member states and in other 'safe' producer countries, and the climate change agenda rekindled old fears and, as a result, created new dilemmas for the member states.

The sense of urgency in both EU energy and climate matters has been boosted by energy security concerns. The widely expected dash for gas as a result of climate change policies has increased dependency on gas imported from only a few exporting countries. In the expected rapidly globalising world where international relations are increasingly driven by privatised economic interests, these import dependencies were apparently not viewed as problematic. But in the emerging new international political relationships after 2001, where competition for resources has replaced the situation of widely available energy flows and where energy-producing countries have re-emerged as strategic and national players, energy security matters.

The switch to a low-carbon economy is driven both by climate concerns and by energy security concerns. Diversifying away from fossil fuels will cut CO₂ emissions and reduce the structural dependency on oil- and gas-exporting countries. However, this strategy provides only a long-term solution to what are also more immediate problems and does not relieve the pressure on member states to address energy security problems in the short and medium term. The presidency conclusions of the European Council of 8-9 March 2007 reflect these dilemmas. The discussion about implementation and organisation of this strategy has only just begun.

This chapter attempts both to analyse the development of energy policymaking in the EU and to discuss the energy security dilemmas that confront the member states in the short and medium term. The central issue here is how security of supply and a sustainable energy system can be achieved in a market environment, which is the main thrust of the Commission's proposals, while at the same time government intervention in international energy markets is on the rise.

It is suggested that the mismatch between the level of government involvement and the market model in the international energy sector has become more pronounced lately and impacts upon the security of supply and demand policy toolset of consumer and producer countries. Arguably, the switch from an international oil and gas buyers' market to a sellers' market has not only rekindled resource nationalism in producer countries but also stimulated a certain preference for bilateral energy relations over multilateral ones in some consumer countries in an attempt to secure supplies. Chinese energy diplomacy in Africa and elsewhere is a good example of bilateralism, while some member states also deem the Nordstream pipeline project to be an example of energy bilateralism on the part of Germany. The latter project was clearly

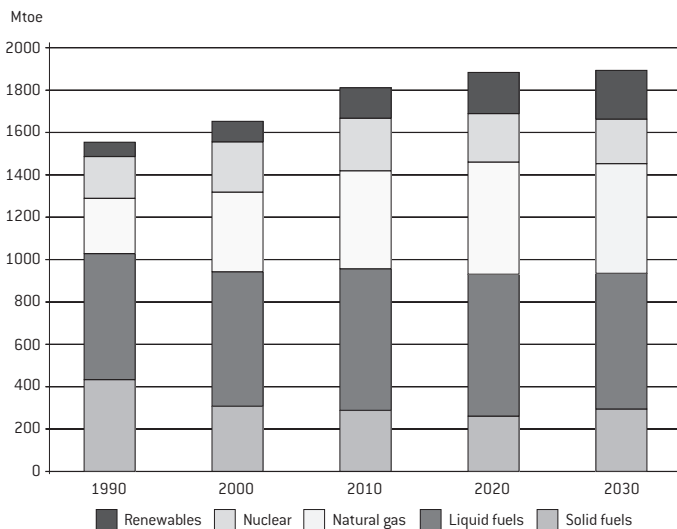
a trigger for the current EU proposal on external energy relations, encouraging member states to ‘speak with one voice’. However, it will be argued in this chapter that the asymmetry in import dependency among the member states, the preference of member states for a certain energy mix, the member states’ competitive position in world markets and different foreign and security approaches, will make ‘speaking with one voice’ a lot harder to achieve than in climate change matters.

This chapter first gives some facts and figures about European energy. It then discusses both past and current energy policy in the EU. The issue is raised whether the strategic energy interests of the member states are best achieved at the national or at the supranational (EU) level. In the following section, recent developments in international energy markets and in oil and gas value chain management serve as the stepping stone for an evaluation of the current internal and external energy policy proposals of the EU. The final section is a conclusion.

Some facts and figures

The EU energy economy’s dependence on fossil fuels is still very large. In 2004, the primary energy mix was 80 percent dependent on fossil fuels (18 percent on solids, 38 percent on oil and 24 percent on gas, see Figure 9.1), while electricity generation was 54 percent dependent on these three fuels (European Commission 2007b).

Figure 9.1: EU25, total primary energy supply (baseline scenario)



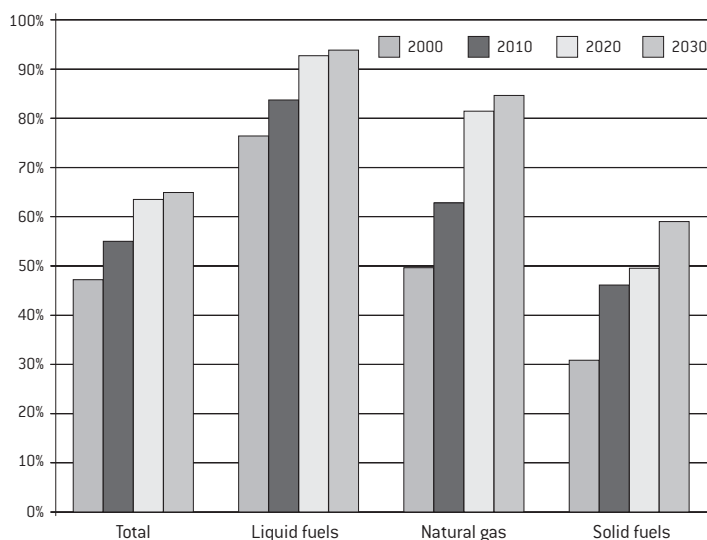
Source: European Commission

In the primary energy mix, nuclear contributed 14 percent and renewables six percent, while in electricity generation the shares of nuclear and renewables were 31 percent and 14 percent respectively in 2004. The contribution of domestic EU production to the primary energy mix (54 percent of the solids, 37 percent of gas and 18 percent of oil) in 2004 is still significant but will decline in the coming decades. Although the figures presented here are based on a baseline scenario and do not include the recently contemplated additional measures to stimulate renewables, it is clear that despite these efforts the EU energy mix will remain largely dependent on fossil fuels up to 2020 and beyond. This is partly the reason why new energy and climate strategies include clean fossils. But the technology to capture CO₂ in aquifers and old oil and gas fields is far from developed. In general, the combined energy and climate strategy as promoted by the Commission and the European Council depends on quite a few technology breakthroughs and cost reductions.

Import dependence is already substantial and will continue to grow in the period to 2030 (see Figure 9.2). The import dependence on oil (mainly for the transport sector) is already very high, and with the modest resources in OECD countries in decline, will not only increase further but oil supplies will also become more concentrated.

The combination of declining domestic supplies and growing demand results in a rapidly increasing import dependency on natural gas. Despite growing liquified natural gas (LNG) supplies, gas imports are also predicted to remain very concentrated

Figure 9.2: EU25, development of import dependence to 2030 (baseline scenario)



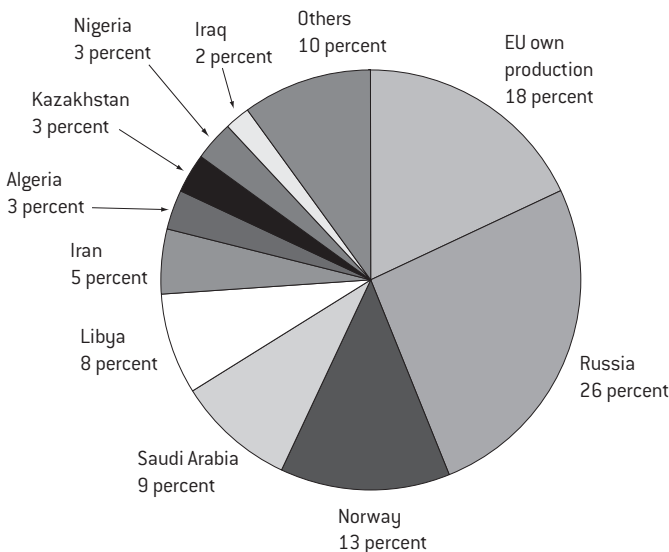
Source: European Commission

for large parts of the EU. The concentration of suppliers is already relatively high for the EU as a whole, but is very concentrated indeed for the north-west and eastern European gas markets where Russian pipeline supplies dominate. LNG development will only marginally relieve the structural import dependence because the line of arbitration between Russian pipeline gas and LNG will be unlikely to shift that far north and east to include large parts of the German, Austrian and Swiss markets, let alone those of the eastern European member states.

The EU imports from a relatively small number of fossil fuel suppliers, particularly in gas and oil [see Figures 9.3 and 9.4]. Some countries are important suppliers in all three fossil fuels [see Figure 9.5]. For instance, in 2004, Russia supplied eight percent of the EU's coal imports, 29 percent of its gas imports and 26 percent of its oil imports, while Algeria supplied 13 percent of gas imports and three percent of oil imports. Norway supplied 17 percent of gas imports and 13 percent of oil imports. Saudi Arabia is an important oil supplier with nine percent and South Africa an important coal supplier. In general, coal imports, despite the projected increase, are not considered a problem with regard to security of supply. This is due to the larger domestic supplies, the wider variety of suppliers and the national policies of most of these exporting countries.

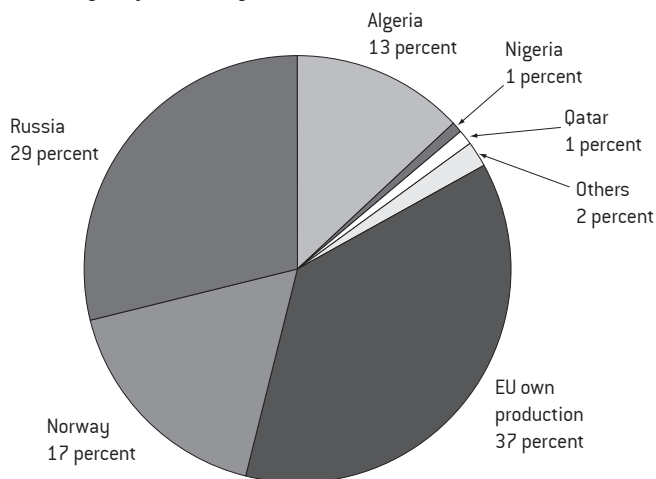
The current energy mix and the outlook in respect of climate change and security of

Figure 9.3: EU 27, origin of oil, 2004



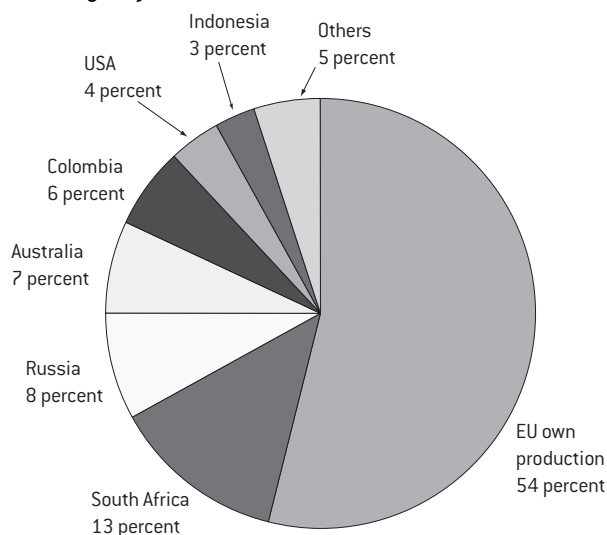
Source: European Commission

Figure 9.4: EU 27, origin of natural gas, 2004



Source: European Commission

Figure 9.5: EU 27, origin of hard coal, 2004



Source: European Commission

supply (concentrated on a few net exporting suppliers of which most are economically and/or politically unstable in the short or longer term) are the main drivers for the proposed structural changes in the energy economy of the EU and its member states. In the case of Russia, both the uncertainty about the internal developments in the country and a combination of regional and geopolitical rivalry, have soured relations

with the EU in the past few years. Energy has played a major role in this development, in which the Russian-Ukraine dispute was taken as a cue for some EU countries to steer away from a larger dependency on Russia. However, the imports from Russia will be very difficult and costly to replace by alternative flows and fuels. The longer-term drive to achieve a more sustainable energy system, not only on account of climate change but also in terms of structural political and economic dependence, could be at the source of short- and medium-term problems in energy security. In addition to a possible reluctance of producing countries to invest in fossils to provide sufficient capacity in the short- and medium-term, the difficulty of the EU strategy is that this new public interest should be achieved in a manner that does not impede the EU and its stakeholders in their global competitive position. International fossil energy prices, the price for CO₂ and the organisation of the energy sector, among other things, therefore play an important role in achieving these policy goals.

Energy policy in the EU

The run up to the new initiatives

Recent increases in energy price levels on world markets, partly due to high political risk premiums on energy, increasing demand in newly emerging economies, underinvestment in all parts of the value chain, the rising cost of new oil and gas flows, access to resources and markets, and renewed sentiments of energy or resource nationalism and a renewed sense of urgency concerning climate change have contributed to the intensifying international and European energy debate.

Since 2005 a certain degree of willingness among the member states has begun to develop in favour of closer cooperation on energy policy issues. Security of delivery and security of supply are issues which have gained prominence as a result of increasing energy trade flows among the member states and growing import dependency on third-country supplies, in addition to the environmental agenda. The idea that market forces alone could provide the member states with sufficient security of supply began openly to be doubted against the background of the renewed emphasis on national interests by producer country governments. They raised the issue of security of demand against the background of investment requirements and intensified transition plans to include more sustainables in the energy mix in consumer countries, such as the EU.

Moreover, the liberalisation of the EU energy market had not from the outset been properly accompanied by crisis policy mechanisms, such as the International Energy Agency (IEA) mechanisms for oil, which gave rise to doubts about the policy

direction. At the same time, the implementation of the internal market itself required more coordination than merely taking away barriers to trade and regulating natural monopolies. Coordination of security of supply policies also proved to be more difficult, particularly in gas, where the dedicated infrastructures and trade depend on long-term commercial and government relations between member states and third countries. The absence of a structural crisis, such as the 1973 oil crisis, made member states more reluctant to trade their long-term bilateral energy relations with relations managed from Brussels that would not necessarily benefit the security of the individual member states. Moreover, nervousness was growing about the liberalisation agenda regarding the position of national champions and the future organisational structure of the sector. In general, these uncertainties in turn created an unstable investment climate.

At the EU's Hampton Court European Council meeting in autumn 2005, a paper was presented that invited the member states to tackle some of the outstanding issues on the internal energy market, and to examine how progress could be made with regard to the environment. This debate kick-started the current energy policy discussion. At the meeting, the Commission was invited to prepare a green paper, which was published in March 2006. While the Commission was preparing the paper, the impact of the January 2006 Russian-Ukrainian gas crisis emphasised the urgency also to include a view on external energy relations. The 2006 Commission Green Paper, 'A European Strategy for Sustainable, Competitive and Secure Energy' and Commission Directorate-General for Competition's sector enquiry, were the stepping stones for the energy discussions leading to the Strategic Energy Review 2007 (SER 2007), also referred to as the 'energy package'. On 10 January 2007, the Commission presented 'An Energy Policy for Europe' (European Commission 2007c). With this energy package the Commission calls on the member states to tackle the triple challenge of future energy security and an environmentally sound energy system, while also embracing the Commission's view on how to realise or complete the internal energy market. These proposals include wider competences in energy for the EU both in internal and external energy policymaking. From the EU presidency conclusions of 8-9 March 2007 we learn that the competency issues have not been resolved and that the Council continues to take a much more evolutionary approach.

The EU market model is not yet set in stone. Policymakers, politicians, regulators, academics, companies and other organisations differ in what they see as the preferred market structure or market model and the way in which security of supply and environmental policies and the costs they incur should fit into this framework. More importantly, member states are still uncertain how the framework will deal with the asymmetric security of supply risks and different energy mix preferences.

The differences of opinion are strengthened by the different national interpretations of the directives on national market models. Among the member states and other stakeholders, the preferences vary between those that are proponents of de-integration of the value chain and those that favour more integration of the value chain, and they vary between those that prefer a national champion and those that do not. Very often in the EU debate, those that are proponents of a certain level of integration of the value chain are denounced as being anti-competitive, thus denying the merits of models of competition in which, for instance, vertically integrated firms compete for markets. The level of integration or de-integration (or unbundling) can be particularly important for the efficiency and reliability of the European energy sector. Particularly with regard to the dependency on foreign supplies in markets that are very concentrated and/or suffer from resource nationalism, a certain degree of purchasing power on the part of companies can help secure flows for the European market. Such a model, with larger companies competing for international resources and markets, is possible within the rules and regulations of the EU. It is clear that some member states prefer this model over a market structure that is more atomised.

The discussion about the preferred organisational structure of the market also reflects the desire to capture both short-term and long-term benefits in an industry that has typically longer-term cycles. The outcome of this struggle also impacts on the way external energy relations are conducted because of the apparent attempt to move the long-term costs on to third countries. Both consumer and producer countries are engaging in rent-seeking behaviour. The producer countries are aware of this process of offloading the long-term costs of security of supply onto them and respond with strategies that secure their return on investment in production and transport. Forward vertical integration and producer cooperation become options in the face of developments in consumer markets which suggest that the costs and benefits of energy trade are becoming unbalanced.

In order to understand the longstanding debate about a European energy policy, it is important to understand the national interests of the member states, but more importantly also the role of the state in the organisation of the (international) energy sector. In energy, the state (or government) has always been involved, often as an owner but also as a regulator. Regulation of the energy sector is not only about creating a level playing field, efficiency, a certain market structure or about the lowest possible prices for consumers, but is also important from a national security perspective. Energy is a sector with high economic rents that not only attract companies but also governments (van der Linde 2000). Energy is a major contributor to tax incomes of producer, transit and consumer countries. For that reason alone, governments will continue to intervene in the energy sector. Before turning to energy policy

developments, the role of government (the state) and the role of companies in the political and social construction of the member states should be analysed.

State versus market

In energy, the state and the market cannot easily be separated. Energy touches on the core functions of the state. Energy is not only a crucial and basic input to our economies, determining the competitive position of nations and its industries and welfare, but also a crucial element in the security of the state (law and order, international, foreign and security interests). The intervention in the market to reduce market imperfections by way of regulation or ownership (for instance to overcome natural monopolies), is different from state intervention for national security reasons (for instance to guarantee energy supplies for military purposes and in general to promote geopolitical and geo-economic prominence). Often these functions can be combined when sufficient energy supplies can be delivered to the consumer markets without the political threat of supply disruptions. However, in a situation where geopolitical and geo-economic tensions are increasing, or where energy resource regions are deemed unstable, the security of the state imperative will compel the government of consumer countries to intervene to secure supplies.

Even in resource-rich countries the security of the state can compel the government to take charge of the energy sector. In Russia, for instance, the oligarchs were deemed a risk to the interests of the Russian state when they challenged the government (and in the eyes of certain elites, the integrity of the state) with their amassed riches. Since the intervention in the oil sector in the Yukos affair, but also with the restructuring of Gazprom, the government has consistently reduced the grip of the first generation of oligarchs on the economy and replaced them with managers considered more loyal to the state's interests. (Finon and Locatelli 2007, Stern 2005) Moreover, energy riches can also promote a state's geopolitical importance, as is currently evidenced by the countries in the Middle East, the Caspian Sea region and Russia. For this reason, states will not easily leave security of supply to the market.

After the limits of the centrally planned economies were reached in the late 1980s, a general sense of optimism about a global market-led economic system prevailed. At the end of the cold war, free trade and free capital movements were expected to include the previously non-integrated nations into the world economic market system. The foundation of the World Trade Organisation (WTO), as a successor organisation to the General Agreement on Tariffs and Trade (GATT), underlined this expectation of global integration. In a world where international relations can become

economised and as a result fairly de-politicised, an economic or market approach would also deliver an efficient model for organising the (international) energy sector. The drive to liberalise the energy sector in Europe is, in addition to specific internal EU dynamics, part of this wider international political and economic process. However, recent energy-related geopolitical conflicts suggest that the economisation of international relations has been arrested and security of supply risks have increased.

More often than not, energy is part of the political and strategic function of the state where the market approach (partly) fails to deliver the type of security the state needs or wants to achieve. Governments can then opt to play an active role, to varying degrees, in tweaking market players to produce security for the state. The state, for instance, can facilitate deals for its domestic companies with friendly producer countries (and conversely the producer state can facilitate access for its companies to markets of friendly consumer countries), the state can subsidise domestic companies to create a competitive edge in investments, a state can deliver substantial fringe benefits to resource-rich countries ranging from roads, telephone networks, technologies and military equipment, a state can bestow preferential political and economic treatment on another country, and a state can facilitate inclusion of another state in the international community despite human rights or other political failings. A state will thus opt to use the full range of economic, political and strategic instruments. Energy policy, both in producer and consumer countries, is therefore about balancing the economic and political-strategic interests of different stakeholders across national borders. In our market-oriented societies this reality is often forgotten, or at least not openly acknowledged.

Energy is also a high economic rent industry in which governments have been successful in capturing rents through taxation or ownership. In return, market players in the energy sector need governments to secure their long-term investments at home and abroad. The energy industries are for that reason an important part of the political and socio-economic model of the member states (Finon and Locatelli 2007). An economic approach to energy policymaking will leave important issues of security of the state unaccounted for and explains the ongoing reluctance to bundle energy interests in the EU. It is in the strategic and symbiotic relationship between energy (and the players) and the state that the EU must convince the member states that it can deliver. But even if the EU is kitted out with all the necessary competences in energy, the absence of competence in the foreign and security policy field, and the absence of strong state institutions, prevents the EU from performing as a state. The EU was simply not designed to perform as a state but is rather an economic project with institutions for removing barriers to trade and the free flow of production factors. The question is, therefore, how much sovereignty and which powers

could or should be elevated to the EU level and which policy instruments can be used to optimise the value of EU policies to the member states, without giving up control over the security of the state?

The rationale for a common energy policy

With the implementation of Economic and Monetary Union, the final stage of economic integration, it is logical to include sectors of the economy that had remained largely in the realm of member states' policymaking. The energy sector was one of those sectors where national policies prevailed. In particular, the gas and electricity sectors were public utilities, mostly run by local authorities. Large efficiencies were possible with a different organisation of the sector, not only in individual member states but also in the EU. In a period where government intervention was reduced to regulatory functions in many public utility or (previous) natural monopoly sectors and where competition across EU borders was introduced, the gas and electricity sector also became part of this effort. This process of implementing the internal energy market began in earnest the 1990s. In this period energy supplies were amply available in Europe and on world markets and security of supply risks were considered low.

Early on in the internal market implementation process, member states first tackled the reorganisation of their domestic sectors, in order to ready themselves for opening to EU competition. The approaches and choices governments made in reorganising the sector differed widely among the member states. In the UK, public utilities were first privatised and only later was the market liberalised, while in most other countries the process was exactly the other way around. In France, the sector was already centralised in two large companies, while in other member states assets first needed bundling into larger entities to gain the economies of scale and scope for this effort. The market structure and the size of the companies were first and foremost geared towards domestic market needs. Moreover, the restructuring process was part and parcel of the political and socio-economic model of the member states and, although the European market played a role in the choices about how best to shape the sector, they were still national choices. In Germany, for instance, the unification of the country also played a role in the efforts to restructure the sector. The previously East German assets were bundled with West German interests and readied the newly formed companies for a strong European position. National choices thus play a major role in the discussion about market design today, and competition among member states to push their market model for copying at the EU level is understandable. The current unbundling discussion is promoted by the UK, where the sector and its regulators would gain an edge in competitive

information and experience over other member states if they were to follow that model. Understandably, larger member states resist certain changes to their market model, particularly when the measures are unpopular with the domestic players and voters appear reluctant to embrace [more] changes. Moreover, the appetite for change depends on a proper balance between benefits and costs.

The Strategic Energy Review 2007, however, failed to show clearly enough how to strike the balance between competition, sustainability and security, except by stating that this balance is important. The fact that the Council embraced the 20-20-20 goal (20 percent reduction in CO₂ and a 20 percent share of energy production from renewables by 2020) reflects political direction but the devil in this case is in the detail of implementation and distribution of cost. Insufficient analysis is included to show exactly what trade-offs exist between the approaches to the internal market, environmental policies and external energy relations. For instance, high prices are helpful in energy saving and the introduction of cleaner fuels, but do not serve the consumers' short term interests. A stable and intense relationship with a large energy supplier which supplies a large share of the market may help security of supply, but may limit diversity of resources and competition on the market. Member states are aware that the internal market approach alone will not secure results in the other policy areas. The market is a coordination mechanism for scarce resources but cannot by itself produce the transition to a larger sustainable fuel base nor generate a consistent crisis policy mechanism or other public goods such as long-term security of supply (Helm 2006). The large time lag between investment and consumption, the dedicated assets in an energy system and the life of the capital goods creates a different market organisation and development than a market for consumer goods (Helm 2005a). The interaction between the market and government intervention should reflect these dynamics.

EU energy policy must seek positive trade-offs among these policies rather than approaching them predominantly from the angle of internal market powers alone. Just as competition policy does not suffice as a single all-encompassing solution, the strategic energy review does not provide alternative answers (Helm 2005b, Henningsen 2006). The current proposals do not reflect sufficient awareness that internal energy policy and external policymaking require a fundamental willingness to weigh the costs and benefits of balancing the policies, to consider adapting policies to developments in international markets, to accept that there are more models of competition and that policymakers should also attempt to synchronise policy with sector developments in order to let markets evolve. On weighing the costs and benefits of policymaking, the past, rather unyielding, approach to long-term contractual arrangements, for example in the interests of the consumer, is at vari-

ance with the cost of obliging all member states to maintain strategic gas reserves. Other flexible options, such as stimulating dual-firing capacities, are considered for security of supply policies but are not considered to be part of crisis management policies. It all comes down to creating a proper mix of market and government instruments to optimise the balance between the market and public interest issues, such as security of supply, and understanding that the asymmetries in fuel mixes and import dependencies require different local policy mixes. In a recent study, an attempt was made to quantify security of supply measures in a market environment (de Jong *et al.* 2006). Although this approach and discussion is only a beginning in tackling this complex issue, it is clear that a more thorough understanding of the interlocking dependencies within our energy systems, the costs and benefits of various policy options, and the impact at the member state level will greatly help in finding balanced trade-offs.

Progress in the implementation of the internal energy market since the 1990s has created interdependencies among the member states that require coordination of the security of delivery policies.¹ Obviously, the increase in transborder energy trade and the more intense linkage of networks creates new vulnerabilities when the system fails. The recent electricity disruption originating in Germany managed to spread very quickly through large parts of the European market. Technical and operational cooperation among system operators on protocols and early warning systems can help reduce the impact of a power failure somewhere in the system. With more interconnections, supplies can more easily reach other member states' markets, while prices will converge to the marginal connected power plant in the larger system, reducing the price differences between national markets.

The targets of the Kyoto Protocol regarding CO₂ emission reductions are another major reason to cooperate. In general, coordination or perhaps harmonisation of energy policies regarding renewables is logical because these industries are in an early stage of development.² Like the Euratom Treaty, which was concluded before the nuclear sector got off the ground in Europe, it was relatively easy with few embedded interests and the wish to create a level playing field to agree on a common framework. The new sustainable energy industries are not yet as embedded in the socio-economic structure of member states. The window of opportunity will close rapidly when initiatives get underway. However, policymaking at the EU level should not yet be seen by governments and companies as a threat to existing policies. With the sense of urgency driving achievement of a low-carbon economy, policies at the EU level are attractive to create a level playing field among the member states and the main stakeholders.

With regard to security of supply, coordination is more difficult, particularly where gas is concerned. Gas depends on dedicated infrastructure and gas trade is part of long-term commercial and diplomatic relations between producer and consumer countries. In oil, the nationalisation of the upstream oil assets by OPEC countries had already enforced a fundamental restructuring of energy relations, and therefore paved the way for a coordinated oil crisis policy in the IEA. Because such a crisis has not materialised in the international gas business, member states are much more reluctant to trade their long-term bilateral energy relations with relations managed from Brussels, particularly when pressure to change the relations is mounting, as is the case with Russia. EU enlargement is currently driving a more assertive relationship with Russia than certain member states would like.

Finon and Locatelli (2007, p.28) eloquently emphasise the essence of the dispute among the member states and the Commission about the market model and security of gas supply by stating:

'[...] But if the major gas companies would be weakened in the name of the principles of short-term competition, their bargaining power and their financial capacity to handle larger import operations would be reduced. This is the basic conflict between the Community's objective of promoting competition at all costs and its goal of guaranteeing long-term security of supply. There is undoubtedly a certain logic in wanting to disperse gas company assets in the name of market principles on the one hand and to create a single European negotiating authority on the other. But member states are bound to wonder how such institutional choices might improve their national gas supply when local buyers would be able to achieve his more easily by falling into line with government objectives.'

For a common energy policy to emerge, member states must become convinced that energy policymaking at the EU level is more effective in achieving results in all three priorities of energy policy – reasonable prices, security of supply, and environmental sustainability – than policymaking at member state level. In the face of rising resource nationalism and more intense competition for resources from other consuming countries, the argument for the bundling of external energy policies is that it would lend more traction to the EU's position in the world, representing a large consumer market. For the EU to make a difference in international energy relations it must have something to offer in negotiations. The problem is that access to the EU market is already open to third-country companies and reciprocity in opening up thus cannot be used as a market power tool to negotiate access to supplies. Moreover, the EU no longer represents a dynamically growing consumer market for

oil and gas, particularly not given the enhanced efforts to achieve sustainable energy, reduced CO₂ emissions and energy efficiency. The importance of the EU market for oil and gas producers has weakened compared to other more dynamic markets. And given the rising share of other consumer countries in world energy demand, the EU's importance will continue to weaken.

The EU's market power exists by virtue of its efforts to reduce the carbon content of its energy mix. The speed at which the EU is prepared to generate, and the cost it is willing to incur to replace cheaper oil and gas with initially more expensive fuels, does create a position of power in energy diplomacy. The low-carbon economy is a direct threat to producer countries that eventually stand to lose market share to new fuels and new companies that compete for their traditional markets. Many producer countries are also dependent on oil and gas export income and feel threatened. The intense debate about security of supply and demand is about the security of the state and the longer term geopolitical and geo-economic landscape.

The rationale for maintaining national competence

The battle for future geopolitical and geo-economic dominance is partly played out in the international energy markets. Energy policy, both at member state and EU level, should not only be concerned with the longer-term perspectives for new energy systems and new fuels but must include the creation of circumstances in the short and medium term to make a transition away from oil and gas or to avoid such a switch. It is in this aspect of energy policy where member states are reluctant to trade their stable energy relations for more uncertain relations at the EU level, where a different agenda - the longer-term one - is being promoted. The member states realise that as long as the low-carbon economy has not materialised, their dependency on imported oil and gas (and coal) remains very large. At the same time, producers are also tied into their traditional markets, despite their maturity, in order to stabilise income from energy exports. The markets of Europe, Japan and the US cannot be replaced overnight by new consuming countries.

For the member states it is important to determine whether the international political and economic muscle of the EU, which is based on the low-carbon strategy and a competitive market structure, gains any strength when it is bundled with a unified voice in security of oil and gas supply matters or whether these issues should, for geopolitical, domestic political and socio-economic reasons, rather be separated and pursued as a two-pronged approach. This would leave those elements of energy policymaking where the interests of the state are at stake firmly in the member states' realm, and would leave the EU with partial competences in energy matters.

Competence

The EU's energy competences are incomplete, in particular security of supply policies, but management of domestic resources and the energy mix also fall within the realm of the member states. In reality, the EU's competence in energy is mainly based on internal market and competition powers. In the fifty years of the European integration project, energy has always managed to stay within the domain of member states' national policymaking. The Commission's Green Paper 'Towards a European Strategy for the Security of Energy Supply' had already concluded in 2000 that: 'The European Union must take better charge of its energy destiny. We are obliged to acknowledge that, despite the various crises besetting the European economy in the last thirty years, there has been no real debate on the choice of energy resources and even less an energy policy regarding security of supply.' (European Commission 2000b, p.3) The March 2006 green paper made a renewed attempt to elevate energy policy to EU level. When European leaders called for 'an energy policy for Europe' after discussing the March 2006 green paper (European Commission 2006e), which at least suggests that national energy policies should be made more coherent, they were reluctant to move on the competence issue. From the Austrian EU presidency's statement at the conclusion of the meeting, it was clear that the energy policy for Europe had to be realised within the confines of the current competences of the EU. Furthermore, the Austrian presidency³ stressed that national sovereignty on key strategic decisions such as the choice of energy mix – including nuclear – would be preserved at the member state level. The member states evidently wished to keep the right to intervene in the fuel mix, in addition to their right to employ their own depletion policies. The consequence is the absence of a real and open debate about a common energy market framework. Such a debate is a prerequisite for understanding the current and future dilemmas at the EU and member state level, which in turn should be an important input for policy-makers to make the trade-offs between market, security and environment and between the national and the supranational levels. Despite the reservations of the Council, the Commission has again proposed to widen the competences of the EU, in particular with regard to external energy policy and oil and gas crisis mechanisms in its strategic review (European Commission 2007c).

The issue of sovereignty over energy policy has cropped up repeatedly in the history of European integration.⁴ A 1994 EU directive allows member states the right to deny access to upstream activities in the member states to third countries or third-country nationals on the grounds of national security. Moreover, the primary energy mix of the EU member states varies substantially and member states also differ widely on what their preferred energy mix is for the power sector. Moreover in terms

of import dependency there are persistent structural differences among the member states, which have also led to different approaches to security of supply. Diverging energy systems have made energy discussions at the EU level a delicate and intricate issue, which has only been further complicated by the different foreign policy approaches after EU enlargements. How do member states thus intend to shape energy policy in the context of the new internal and external challenges? And how does this relate to the Commission's latest proposals laid down in the strategic review?

Europe's long road towards a common energy policy

The European energy debate and attempts to agree on a European energy policy have a long history (Lefeber and van der Linde 1987, 1988). In the run up to the establishment of the European Economic Community [EEC] at the Messina conference in 1956, negotiators from the six original member states discovered an important flaw in the draft Treaty of Rome. The Suez crisis of 1956 had uncovered the growing dependence of the founding member states on oil imports. Yet neither oil nor gas were specifically covered by the Treaty of Rome, nor was there a separate treaty in the making covering oil and gas, such as the European Atomic Energy Community Treaty and the existing European Coal and Steel Community Treaty. The founding fathers of the EEC, taking perhaps a too technologically confident view of the future, believed that the EEC would rapidly develop from a coal-based economy into a nuclear economy. They had not envisaged that both oil and gas would become dominant contributors to the European fuel mix. Neither could they have foreseen that in the future a variety of sustainable energies would enter the energy picture, each with its own value chain management and international peculiarities that also need to be accounted for by energy policy.

However, when the Spaak Committee indicated that oil would become important for the European economy, the treaty negotiations were too far advanced to include a part on those energy sources which were not yet covered in the sectoral treaties. It was thus decided that, immediately after the Treaty of Rome was ratified and when the implementation process had started, negotiations to remedy the situation would commence. However, the six member states never managed to overcome the deep differences in make-up and interests in their energy sectors. The importance of the coal sector for the economy in Germany and the choice of France, Italy and the Netherlands, with smaller and less efficient coal sectors, to switch rapidly to oil-based economies in the late 1950s, could not be translated into a coherent European energy policy. The discovery of gas in the Netherlands and the development of the gas market in the 1960s based on these resources further separated

the member states on energy policy issues. These issues have persisted ever since.

The preference for intergovernmental crisis management

When the member states, except for France, decided in 1974 to join the International Energy Programme (IEP) of the IEA and run their oil crisis policies through this new agency, the need for a common external energy policy dissipated. The decision to join the IEP (November 1974) was made just prior to a Council meeting in which a common energy policy was to have been adopted (December 1974) and member states had expressed a preference for intergovernmental over intragovernmental policymaking in the energy field.⁵ Thus the common energy policy as imagined by some in 1974 never got off the ground and, in 1984, the Commission announced that it would no longer pursue this policy.

In the 1980s, governments began to review their role in the economy. The recession of the early 1980s, after the second oil price crisis, left many member states' public finances in arrears. Governments ran up against the limits of the demand-management model of the economy. Cutting public expenditure would rule out investments in an economy that needed to be revitalised in order to compete effectively with newcomers on the international trade and investment scene. Liberalisation and privatisation became the new mantras of besieged governments. The demand-management model of government began to give way to more market-based models of the economy or, perhaps more accurately, regulation-based economies, because governments never really withdrew from the scene.

In the market-oriented economy, the role of government as an owner and producer had to be replaced by a government that would define and manage markets, including sectors that were natural monopolies or had natural monopoly segments in the value chain, through regulation. This process of redefining the role of the government in the economy was, and still is, uneven in pace and scope among the member states, because the reinvention of the economy was not so much a European but a predominantly national process with European influences.

The EU was often no more than a tool in the national process, and was designed to be a determining factor in the national outcomes. The fact that leaders such as Margaret Thatcher in the UK, François Mitterrand of France and Helmut Kohl of Germany were united under the market model banner should have been a warning that, when it came to the detail of implementation, the inevitably huge ideological differences would surface about how exactly this internal market would be defined and would work.

Nevertheless, in its resolution of 16 September 1986⁶ the Council identified an integrated, barrier-free internal energy market with a view to improving security of supply, reducing costs and improving economic competitiveness as an objective of the energy policy of the EU and the member states. In the context of the mid-1980s, with energy prices rapidly declining after a period of high OPEC oil prices and with diversification away from oil starting to show in member states' energy mixes, freeing up energy trade among the then 12 member states was the next step in benefiting from the new diversity in energy mixes and thus helping security of supply. Large flows of gas had been secured from the Soviet Union by Italy, France and Germany, and France had built up a large nuclear capacity. Moreover, the UK, Norway and the Netherlands provided substantial European supplies of gas, and the North Sea also produced sufficient amounts of crude oil to limit, in the new market circumstances, the power of OPEC to set prices. In general, the security of supply risk at that time was predominantly a security of oil supply risk. Diversification into gas, coal and nuclear, in addition to diversification of oil suppliers, was deemed a successful solution for the strategic dependence on oil in the 1970s.

However, the gap between freeing up energy trade among the member states and creating an internal market with some organisational coherence was large, because organisational structure varied widely among the member states and among the various parts of the energy sector, such as gas, coal, oil and electricity. Not only the size and scope of the energy companies varied but also public ownership structures. In some countries regional and/or city authorities owned local gas and electricity companies, while in others ownership rested with the central government. Freeing energy trade required not only removing barriers between member states but also a certain degree of reorganisation of national sectors, while arguably oil trade was already free. Particularly member states with small, locally organised gas and electricity companies realised that they needed some rebundling of their energy sectors which would allow the new, larger entities to participate in cross-border trade and benefit from economies of scale and scope. This rebundling took place predominantly at a national level. At the same time gas imports already required companies of substantial size, or close cooperation among the smaller entities, in order to conclude large long-term contracts with gas exporters such as the Netherlands, Norway, Russia and Algeria.

It is clear that the initial concept of the internal market was designed in an energy buyers' market, which with hindsight created favourable conditions for the structural changes envisaged. At the time, domestic oil and gas production levels were substantial and in electricity production spare capacity was available. In such circumstances, it is easy to imagine that with ample supplies available, energy industries

could become more efficient by removing barriers to trade and by ensuring competition in and between member states. However, ample supplies are a precondition for competition in the mid- and downstream to produce the price levels for consumers that reflect the efficiency gains. It is in this context that there is a call to break up long-term contracts and destination clauses arise, because consumers do not have to pay for long-term security of delivery and supply, nor for the investment risks. However, in a sellers' market, particularly when at the same time domestic supplies are declining, ample supplies are no longer available and competition for scarce resources can actually produce higher prices when security and investment risks become priced in again. An important precondition for the internal market, as it was politically imagined, is now missing from the equation. The gas market, like oil, has also changed into a sellers' market, and gas-producing countries seem careful to avoid investing in speculative export capacities. Competition has now moved from the mid- and downstream part of the value chain to the upstream part of the value chain and has changed from competition for consumers to competition to secure enough supplies to the market. It is in such a market that the conditions which suppliers wish to attach to their deliveries become important again, particularly when certain consuming parties are keen to secure long-term supplies and it is harder to play producers off against each other.

Ownership of reserves is significant too because national depletion policies, investments and demand and supply developments do not necessarily match the needs of the EU market. Most of the oil and gas reserves in the world are preserved for development by national oil/gas companies and only about a third is available for foreign direct investments. The current debate between the EU and its external suppliers is a debate over who can capture the economic rents, where end-user taxes compete for the consumers' wallet with premiums on prices. In a buyers' market, it is usually the consuming countries that capture these rents (through taxes and excise duties and the benefit of low prices) and in a sellers' market it is usually the producer country that can capture a large share of these rents.

The producer countries have no interest in creating oversupply, which is very costly, and therefore wish to assure market access for their product, security of demand, either through long-term contracts or the ability to vertically integrate into the consumer market. The (partial) state ownership of many producer-country oil and gas companies, and the idea that foreign governments will use their ownership to further national interests, run counter to the idea of open markets with a level playing field (European Commission 2006f). The resistance to mergers and takeovers by (partly) state-owned companies can be explained by the fear of foreign political pressure. The paper of the Commission/SG/High Representative for

the European Council (European Commission 2006f) states their fears in the following way: 'Increasing dependence on imports from unstable regions and suppliers presents a serious risk. Some major producers and consumers have been using energy as a political lever. Other risks include the effects on the EU internal market of external actors not playing by the same market rules nor being subject to the same competitive pressures domestically'. Although not specifically articulated in such terms, this citation summarises the discussion about Russia after the gas crisis at the beginning of 2006. The distrust of Russia was further kindled by the recent oil and gas disputes with Belarus and does not bode well for a positive and expedient outcome of the discussions on the new partnership and cooperation agreement between the EU and Russia. From this perspective, long-term gas contracts between upstream suppliers and mid- and downstream companies in the EU, endorsed by member state governments, and where price and volume risks are shared, could suddenly become an attractive alternative to the potential political arm-wrestling between the EU and Russia.

Steps towards an internal energy market

Ironically, declining energy prices in the late 1980s and 1990s created new pressures on governments to restructure their energy industries to improve their competitive strength and reduce government costs. Oil by then was predominantly used in the transport and chemical industries, while gas was rapidly replacing coal as a competitive and clean feedstock in new power plants. In Germany, the government continued to protect the coal industry to maintain a certain market share, while in the UK the growth of the domestic gas industry was used to break the political hold of the coal industry on the economy (Helm 2003). Both commercial and environmental arguments were used to phase out domestic coal when privatisation of the British electricity sector came with the freedom to choose the input fuel. The outdated coal industry very quickly lost its market share to gas, which was coming on stream massively in the North Sea. The efficiency gains in the British power sector were large, although it was never clear how much of these efficiency gains were due to the different organisation of the sector and how much was due to the switch to gas. In France, with its large nuclear capacity, the discussion about restructuring the energy sector was not really an urgent issue. After the accidents in Harrisburg and later in Chernobyl, the urge to place the nuclear industry on the market was low, and only the oil industry was restructured and privatised. In Italy, the state oil company ENI was also privatised with 63 percent of the shares on the market and Spain also privatised its oil industry. Germany followed a national approach to energy restructuring, underpinned by German energy and industrial policy. As a result, Eon Ruhrgas, RWE and Vattenfall emerged as dominant companies on previously very localised electricity

markets. Both RWE and Eon Ruhrgas have also developed dominant positions in the German and European gas markets through acquisitions. With national expansion exhausted, electricity companies have embarked on European expansion.

European electricity companies are expanding their interests in mid- and downstream gas markets, including in eastern Europe, while some have also moved downstream in both Europe and abroad to create a certain percentage of own supplies. The consolidation in the European gas and electricity markets is still underway. The consolidation of energy interests in large, often multi-energy companies, thus creating an oligopolistic market model, and the efforts of the European Commission to promote competition in gas and electricity markets, have not converged yet in a shared vision of the internal and external energy policy needs of the EU. While German, French, Dutch and Italian companies, with mostly open or implicit support from their governments, have secured long-term gas supplies from Russia in partnership deals along the value chain with Gazprom, and while Norway has bundled Norske Hydro oil and gas interests in Statoil, further underpinning the oligopolistic and vertically integrated market structure, the EU Commission is, according to the recent strategic review, still focusing on horizontal unbundling of the mid- and downstream part of the value chain to promote competition.

Companies and some member states governments have apparently already decided that competition in the coming years will predominantly be focused on securing third-country supplies. In this, the renewed focus of governments on security of supply and the companies' efforts to spread their risks by gaining a wider European market share and diversifying their supplies through both vertical and horizontal integration, seem to converge. Government-to-government relations are used to secure business-to-business deals on both supplies and the infrastructure to facilitate these supplies, as both the Nordstream and Bluestream II projects show. That said, the active role of government required in these deals is a far cry from the ideal expressed in the 1990s that only markets would provide sufficient flows of energy.

The energy sector is a typical example of where government and markets meet continuously, for instance to issue permits for pipelines, generation capacity, LNG terminals, influence the energy mix and negotiate complex gas trade deals with governments and companies from third countries. The market and government do not have strictly defined spheres of operation but rather function in a dynamic relationship, where the market is introduced where government previously ruled and *vice versa*, depending on the prevailing political and economic conditions. The boundaries are therefore unclear and need to be confirmed or adjusted continuously, while at the same time maintaining a stable and predictable investment climate.

European energy in a new international context

Paradigm change

As we have seen, the current European energy discussion must take place against a different background than the discussions in the 1990s leading to the process of energy market liberalisation. In the 1990s energy markets were amply supplied and, after the break up of the Soviet Union and with the weakness of the OPEC economies, optimism reigned about the chance to renew the link between the upstream and downstream markets in oil and gas through foreign direct investment. Globalisation would reduce government involvement in the energy sector and help advance an internationally competitive market structure. It was against this backdrop that the member states, with varying degrees of enthusiasm, embraced the internal energy market.

The privatisation of the European oil sector was largely completed in the 1990s. Majority holdings in large international oil companies, such as BP, Total and ENI, were sold in the latter part of the 1980s and 1990s. Yet liberalisation of the EU energy market has never focused on the oil industry. Access to oil pipelines and refineries was never an issue in the policy debate, partly because oil (product) transport is less dependent on one mode, as in the case of gas and electricity, although the cost structure of certain modes of transport could arguably pose a barrier to entry. The consolidation of some American oil companies and the subsequent sale of refinery capacities and distribution networks in Europe allowed newcomers, including national oil companies from producing countries, to enter the market.

Cross-border trade in oil and oil products in the EU was not a problem. Traditionally the oil industry has been an international, vertically integrated industry, with companies active in many countries. After the large reserve assets in the OPEC countries were to a large extent nationalised, international trade in crude oil replaced the traditional long-term contracts and inter-company crude oil flows. Trade in oil products among the vertically integrated oil companies became increasingly competitive when capacities in refining and petrochemicals were reorganised in the 1980s and companies began to run the distinct parts of the value chain much more as separate profit centres.

From 1984, international competition for crude oil was quite strong, despite OPEC's efforts to manage the market. Oil prices are internationally arbitrated and the international oil and oil product markets are very liquid. Backward integration in foreign upstream activities was welcomed as an efficient way to provide sufficient and

secure supplies. Vertical integration of European oil companies was seen as useful for the EU and other consuming countries. Moreover, the EU and member state governments actively supported initiatives to open up the upstream sectors in Russia, the Caspian Sea region, the Middle East and other producing countries to foreign direct investment. At the same time, the market for new refinery and pipeline capacity was limited, initially due to overcapacity and later because of cumbersome licencing and permit procedures for greenfield petrochemical sites, and companies from third countries could in principle only enter the downstream market through mergers or takeovers. Such operations took place to a limited extent in the 1980s through national companies from Venezuela, Kuwait and Saudi Arabia and some independent refiners. Yet these national companies pursued only a limited forward vertical integration strategy, which was predominantly focused on the US market.

Developments in the oil value chain, and particularly in the way companies managed their own oil interests, offer interesting insights that can be valuable for understanding the gas value chain, despite the differences between these two fossil fuels. Currently, there is renewed interest on the part of producing countries in forward integration in both oil and gas markets. In an attempt both to manage the large investment risks and secure the benefits from these investments, producer countries or their national companies are interested in accessing the main consumer markets. In the oil industry, the maturity of the traditional markets has made further forward integration less attractive in comparison to the expanding markets of the emerging economies. Also, the process of forward integration into the US and European markets by national oil companies was arrested in the 1990s when oil prices were low, and some governments required their companies to increase domestic (non-oil) investments to compensate for lower government income and expenditures. Tight government budgets in producer countries from 1985 to 1999 also led to the expectation that international private oil companies would increasingly regain access to oil reserves through joint ventures with the national oil companies. In the 1990s, Iran and Kuwait's offshore developments were opened for foreign direct investment, and Venezuela, until Hugo Chavez became president, was making similar moves. After 1999, when crude markets became tighter, this process was arrested and national companies are once more in a process of overseas expansion, concluding long-term contracts with countries such as India and China. Their focus is mainly on gaining access to the new Asian markets, where greenfield developments are possible and where governments are open to investment by national companies from large net exporting countries in order to underpin their security of supply policies. Concurrently, national companies from these same Asian countries are also actively seeking access to upstream developments in producer countries.

The rationale for the strategy of producer and certain consumer countries to meet in long-term contracts and forward and backward integration strategies of their national companies is to be found in the large investment costs. Security of supply and demand concerns are thus matched without having to address ownership issues that the private international oil companies bring with their investments. At the same time, the investment opportunities for large international oil companies in new oil fields are in decline, reducing not only their future prospects of profitability in oil, which are mainly in upstream activities, but also their role in safeguarding the supplies of consumer countries such as EU member states. Increasingly they will face competition in downstream markets from vertically integrated national companies. The dependency of the transport sector on oil is far from resolved, and will increasingly put pressure on governments in turn to push energy and car and truck companies to reduce reliance on oil products.

In the gas industry, long-term take or pay contracts fulfilled the role of sharing risks and benefits between the producer and consumer, until these contracts were questioned by the authorities of consuming countries when they engaged in the opening of their energy markets. The rapid expansion of LNG in recent years, combined with the prospect that these new LNG projects would be developed by the international oil companies, often in joint ventures with national companies, stimulated the belief that new and diversified flows of gas would reach the market and that the terms of pipeline flows could increasingly be adjusted to the new supply reality. The development of some large LNG projects in the late 1990s without underlying contracts in consumer markets fed this optimism. However, the modularity of LNG projects and their limited size compared to large export pipelines, and the emerging tight market for gas, very quickly dampened the optimism that LNG could rapidly break the long-term supply contracts open without risking supply security. The fact that LNG terminals in consumer countries fell under the third party access (TPA) regime made it hard for LNG suppliers to link up the various parts of the value chain. Suppliers that developed new LNG projects began to worry that consumer countries would not be able to provide the required gasification capacities to match their upstream developments. In the US, the Hackberry decision has removed this obstacle for investors that want to bring their own gas to the market and in the EU exemptions have helped the first projects on their way.

Nevertheless, the EU cannot expect LNG to be a panacea for its gas market liberalisation or its security of supply problems. Dependence on imported pipeline gas will continue to grow⁷. Uncertainty about long-term contracts for gas and potential competition from LNG has stimulated the traditional pipeline gas suppliers to the EU, Gazprom of Russia and Sonatrach of Algeria, to look closer into forward integration

options to maintain their share of the EU market - a tried and tested strategy in oil. The political uproar surrounding a rumour that Gazprom was interested in buying Centrica of the UK in February 2006 was telling for the state of relations between the EU and Russia, but also for the growing wider distrust between certain consuming and producing countries. In Norway, developments are underway to maximise gas and oil export options by creating internal arbitrage between oil and gas export prices through both pipeline and LNG options and the ability to inject gas into oil fields when oil fetches a higher price in the market. This is designed to provide the country with more security of demand and reduce the position of being a captive producer to the UK and Continental Europe. The recent bundling of oil and gas assets by merging the gas assets of Norske Hydro into Statoil will help to realise this strategy of optimising their oil and gas assets in the longer term. In the run up to the G8 meeting in St Petersburg, where energy security was prominent on the agenda, security of supply and security of demand interests could not have been further apart. In the conclusions of the meeting on energy the wording of the statement can be seen as a reflection of consensus among the countries but, in reality, the wording delicately leaves room for individual interpretation.

Thus, at the turn of the century, it became clear that the expected international competitive market structure was not going to come about. The buyers' market that had prevailed since the mid-1980s turned into a sellers' market when investment levels, both foreign direct investments and domestic investments in producing countries, had not kept up with increasing demand. Low energy prices, uncertainties about the investment climate in producing countries and surging demand in certain emerging economies such as India and China quickly reduced spare capacity in the international energy market. As a result, energy prices began to increase and producer governments were in such circumstances less keen to embrace the globalisation-inspired energy policies in order to promote their national interests.

A new sense of urgency began to develop in Europe about managing the energy agenda as a result of the higher oil and gas prices, the race with other consuming countries for scarce resources, the changing geopolitical climate, the emerging resource nationalism in some producing countries, the continued instability of the Middle East (a resource-rich region), the expected decline in non-OPEC production after 2010 and the consequent greater dependence on OPEC, and the EU's increasing import dependency in oil and gas (CIEP 2004, Hoogeveen and Perlot 2005, van der Linde 2005). The 2000 EU Green Paper on security of supply and the subsequent conclusions had already unearthed many of the challenges that lay ahead for the member states. Any subsequent green paper would have to respond to the raised expectations of an integrated approach to the internal market, security of

supply and the environment, and inconsistencies of approach in these three policy areas would have to be tackled. An intense energy debate was then suggested to help overcome member states' reluctance to create a common energy framework that would be equipped with the necessary competences. Such a debate would not only have to involve discussing internal market design and would have to include a thorough analysis of the value chain of energy, its organisation, the dynamics within and between the various energy resources and the interaction with demand and supply management. With more and more energy imported from third countries (International Energy Agency, 2005), energy policy in the member states and the EU would increasingly require an external relations approach with regard to securing non-EU primary energy supplies for the EU. The lack of a consistent external energy policy and the weaknesses still prevalent in EU foreign policy pose additional challenges to the Commission's recent energy policy initiatives (AER/AIV 2006). These issues have not become easier to tackle following the 2004 and 2007 EU enlargements, with the entry of the eastern European countries that were highly dependent on Russian resources.

At the same time, third countries also have reason to worry about the developments in the EU and about their ability to manage their own interests. In many ways, the new strategies of gas-producing countries to reduce their position as a captive producer of the EU market on the one hand and the interest in vertical integration in the EU market on the other hand are ways of deflecting the impact which EU policies may have on them (van der Linde *et al.* 2006).

Third-country producers that mainly derive their political and strategic importance from their energy resources seem, at the moment, particularly sensitive to energy policy measures by consumer countries that could thwart their ambition to play a more prominent role in managing the value chain. At the same time, consumer countries are sensitive to changes in the organisation of the upstream sector that would increase security of supply risks. The latter's call for more access for FDI is not only based on their belief that competitive conditions throughout the value chain create efficient energy industries, but is also derived from their preference for suppliers without political affiliations. The reality is that the international political and economic system, and the rules of the game belonging to that system, are less a given than previously thought (van der Linde 2005). It is not certain that important producer countries, under more uncertain international relations, will soon fully embrace the market as the coordination mechanism but may prefer for the time being a more politically controlled attempt at reforming the economy. The political experience in Russia with liberalisation of the oil sector is, among other things, likely to have resulted in a backlash against market reforms in the energy sector and the

wish of the central government to exert greater control. In this sense, the proposed strategic partnerships offer opportunities for dialogue that bridge these different approaches in the coming years. Building trust and recognition of sometimes opposing interests in value chain management must be an important element in EU external energy policymaking. The wish 'to build up a wide network of countries around the EU, acting on shared rules or principles derived from the EU energy policy' (European Commission 2007c, p.18) could, if trust is lacking, easily be seen as a way to impose a regulatory and market structure model on third countries which does not lead to 'mutual benefits'.

With EU oil and gas production declining and the consequent growing dependency on third-country energy supplies, a new approach to matching internal and external energy policy is required (AER 2005). Merely bolting on external energy policy to the existing internal energy policy, which is basically competition policy, will not overcome the existing inconsistencies but, on the contrary, risks reinforcing them. Internal EU energy policy has up till now been mainly concerned with facilitating efficient distribution, conversion and sales of energy, which really implies a focus on the mid- and downstream part of the value chain, while upstream policies - and more importantly connecting the upstream and downstream parts of the value chain in terms of organisation and regulation - have not been addressed. Upstream policies were either left to national member state level, at the member states' insistence, or left to international market developments, in other words relying on large international oil companies to supply the market. But international oil companies encounter increasing difficulties accessing new reserves and, even if successful, access comes at a much higher cost than before. Unfortunately these issues were tackled neither in the 2006 green paper nor in the 2007 strategic review, leaving crucial inconsistencies in the proposed policy approaches unaddressed.

Globalisation and national approaches to energy security

In autumn 2006 the Japanese government first expressed its concern about the changing role of international oil companies in their security of supply policies. As a result the Japanese government intends to promote Japanese energy companies or a Japanese national energy company to gain a share in upstream developments elsewhere in the world, a strategy similar to Chinese and Indian companies. These companies offer, in addition to upstream investments and access to the domestic market, a wide-ranging package of investments in producing countries which are actively supported by the government. These consumer governments thus engage in government-to-government bilateral deals to facilitate both private and national companies' access to oil and gas. This more specific support for certain companies

replaces the more general support of OECD consumer governments to international oil companies to gain access to upstream developments as part of the globalisation drive of the last two decades.

In the EU, there is also movement in the security of supply strategy, the most prominent example being German involvement in the Nordstream pipeline project. This project also involves the forward and backward integration of the activities of partner companies along the value chain. This development seriously challenges the role of international oil companies in member states' future security of supply policies. The French and Italian governments have recently moved in a similar direction, concluding long-term supply contracts for Russian gas. The Dutch are expected to follow soon. The contracts for gas, transport etc all involve companies rooted in the domestic market of these countries and governments negotiating on behalf of their (joint) domestic companies interests. Efforts to include international oil companies have failed because this would have run counter to the interest of the producer country company seeking access to the market themselves. The inclusion of a direct upstream competitor would not have made any strategic sense.

European governments have not yet openly admitted that they are beginning to doubt their own reliance on international oil and gas market principles alone to provide security of supply. But the recent bilateral deals can certainly be seen as a hedging strategy in case globalisation or the free market approach fail to deliver this public good. This is particularly true for the gas market but in the international oil market bilateralism is also increasingly being used to match security of supply to security of demand.

Moreover, from the IEA projections we learn that OECD energy supplies are expected to decline, and that resources that can be developed through FDI elsewhere cannot be expected to compensate for this. Instead, oil and gas supplies are increasingly offered on the international market by national oil/gas companies. The latter's assertions of sovereignty over energy resources was one issue, but increasingly they also assert value chain management through forward vertical integration. This is most pertinent in the gas sector, but national oil companies also engage in these practices. It is therefore important to review the approach to internal and external energy policies in this new context.

Competition and market structure

Part of the 'crisis' in EU energy policymaking that has emerged in the past year or so is a crisis in the belief that competitive energy markets would provide lower prices

but would also provide security of supply by offering an attractive market for energy. The fact that prices have increased rather than declined as a result of liberalisation is usually seen as proof of the incompleteness of liberalisation and competition. The discussion on interconnection capacity but also on deep unbundling are based on this notion. However, the diversity of cost to generate electricity and the fact that electricity prices are set at the level of the marginal producer is a better explanation for rising electricity prices. The cost of electricity generated in new electricity capacity is high compared to existing capacity. The incumbents have a large stake in the older, low-cost capacity (despite CO₂ pricing), while new competition must come from higher cost (gas-based) producers. Prices for electricity are determined by the marginal supplier to cover final demand, in the case of EU gas-based electricity. The higher prices for gas therefore greatly benefited the producers of nuclear, coal and hydro-based production, because the price of gas sets the electricity price. The reality that liberalisation itself has increasingly decoupled production costs from price formation in electricity is, according to Henningsen (2006), not properly addressed.

The re-emergence of security of supply as an important policy issue, together with growing concerns about the environment, has refocused energy policy on these public goods. In addition to national strategic industrial interests, the realisation that the market alone cannot produce these public goods has taken some of the zeal away from those supporting the efforts of the Commission to break up national incumbent interests. The deal, as it appears now, is that the Commission can pursue the longer-term goal of the low-carbon economy, within the constraint that the member states remain free to pursue of their own security of supply policy in the widest sense of the word. Some of the proposals in the strategic energy review are at variance with member states' preferences. For instance, the continued emphasis on transport and distribution unbundling immediately led to firm opposition from France but admittedly led to a somewhat more subtle answer from Germany. The solution is to be found in the recommendation to work with independent system operators. Also, the recommendation to unbundle storage facilities, without providing any clarity about what type of storage is meant (seasonal or not), and to re-regulate access to these facilities, will be very unwelcome for those companies that have built the facilities to store their long-term gas or domestically produced gas. Moreover, these proposals go against the grain of the complex long-term German, French and Italian arrangements with Gazprom.

The Commission's conclusion that regulators are not equipped with sufficient independent powers and are sometimes seen as too close to incumbent interests could be true from a market perspective. The Commission's drive to unbundle the

electricity and gas value chain into the smallest possible unit of organisation in order to deplete the rents and manage the profits at every stage in the value chain, thus using competition policy as the only energy policy instrument, is however flawed in the current context of international energy markets. The short-term approach that competition policy entails runs counter to the new long-term strategies of some large member states to serve the public interest to secure supply and protect the environment in this new international context. Although every government is interested in capturing energy rents through taxation, and has been successful in doing so, managing the rates of return on transport and storage reduces the incentive of energy companies to invest if they are no longer allowed to mix high-risk investments with lower-risk investments. These risks are usually balanced along the value chain.

The fact that the upstream and part of the transport sector in third countries does not fall under EU regulatory control is a fundamental flaw in the Commission's approach. Rents can shift in the value chain as world energy markets have found to their cost in recent years. Third-country producers and their companies are now focused on strategies that prevent too many rents from being captured in the mid- and downstream part of the value chain. Producer, transit and consumer governments are involved in rent-seeking behaviour, which has led to somewhat irritated debates at the EU level and has perhaps been an additional stimulus for the recent intensified national approaches. In an approach where security of supply policies rest on a complex system of government-to-government agreements to facilitate the business-to-business deals with multi-faceted commercial paybacks, the conflicting recommendations of the Commission in the strategic energy review will be fortunate to survive the internal discussions in the February 2007 Energy Council meeting and the March 2007 European Council meeting.

Oil and gas value chains

The point of departure in creating the internal energy market has been the gas and electricity end-consumer market as it was organised in most member states by local public distribution companies. Taking the relatively small public distribution companies as a point of departure for regulation, the gas value chain in particular – as far as that chain falls under the jurisdiction of the EU, ie foreign production and sovereignty over production and depletion policies in member states – is completely different than the one prevalent in other fossil fuel markets.

The oil value chain is largely self regulating. Risks, investments and competition are managed through international vertical and horizontal integration, and mergers and

take-overs along the value chain. Why gas is not treated like the other fossil fuels, particularly because international oil companies also perceive gas as their core business and develop business models based on their experience in the oil industry, is increasingly hard to understand against the background of the development in the international gas market. The differences between the power sector and the gas sector are also interesting from a market organisation point of view.

Electricity production is relatively local to the market it is to serve and can take gas, oil, nuclear, bio-fuels and coal as an input. Some plants have dual-firing capacities. The markets for input fuels, except for gas, are largely self regulating or at least are not part of the internal energy market regime. The inputs can compete for access to the power market. This competition depends on the price, CO₂ emissions, investment cost and output flexibility, depending on which market segment the plant seeks to serve. Electricity networks were and are mainly a national affair, with few interconnections. These interconnections are and need to be enlarged to allow electricity to be traded across member state borders and increase efficiency. Other differences that warrant special regulatory treatment of electricity are that electricity cannot be stored, and therefore requires a different value chain management, and electricity cannot be transported over long distances as compared to primary fuels.

The 'revolution' in the organisation of the electricity sector in the past thirty years is that local, sometimes city-specific, companies were linked in larger national networks and are now increasingly integrated in cross-border networks to capture economies of scale and scope. TPA helped to connect consumers to markets for power production outside the local and, increasingly, the national network. In this case, taking the end-consumer as a point of departure increased efficiency.

Gas is increasingly produced outside the EU and the value chain of gas has many similarities with the oil value chain, albeit with oil at an earlier stage of development of the oil market. Gas has recently been developing, because of the growing importance of LNG, into an international market. Prices will increasingly be determined at international level. At current prices, LNG from any source can be delivered anywhere in the world, although producers will remain sensitive to the length and cost of the trading route. This sensitivity exists because the cost of setting up an LNG train is still high compared to oil tanker trading. The flexibility of oil trading is partly due to the availability of oil tankers and existing widespread capacity for oil processing. Any tanker can be diverted to any market to fetch a higher price.

In the oil sector, the value chain is to a large extent part of vertically integrated com-

panies that prospect, produce, transport, process and distribute oil products in many countries around the world and thus also manage their risks in the oil value chain. The international oil sector is considered competitive and there is, rightly, no intention in the EU to separate oil production and export transport from processing. Crude oil is traded before and after processing, and refineries can be built without asking the Commission for exemptions, at the risk of the investor. Furthermore, the international oil companies are considered important market participants that help secure flows of oil to the EU market and that have become experts in dealing with oil market-related risks. As a matter of fact, access to the reserves of these companies is a main issue in external energy relations in relation to supporting the efforts of international oil companies.

Compared with oil, gas is still a relatively young international market and LNG a very young offshoot. Gas transport used to be very inflexible and depended largely on pipeline routes from gas fields to regional markets. Only recently has LNG added to the flexibility of sources with the possibility of transporting gas overseas at a competitive price. However, LNG terminal capacities are only developing. In future, when more shipping and terminal capacities are available around the world, trading before and after the terminal can take place on a wider scale than currently possible. The question is how these capacities are best allowed to materialise, through the international market or through regulation? Currently, the European Commission for instance treats LNG terminals as part of the pipeline network on which a TPA regime rests (as for electricity). The Commission has already had to acknowledge (for political and economic reasons) that export pipelines and terminals were best exempted from TPA in order to attract investors into these capital-intensive projects. The fact that the Commission has opted to continue the exemption policy and not apply a general rule that any investor who wishes to build a terminal may build one subject to local planning permission, despite its proposal in the 2007 review to develop clear and transparent criteria, shows that government and Commission wish to keep their options open for management of the market in LNG terminals. Apart from the question whether they are equipped sufficiently to synchronise their decisions with international gas market developments, exemptions can also make governments and Commission susceptible to lobbying for specific stakeholder interests. The Commission could, on this relatively small issue, have shown its intention to create a positive investment climate and, like the US authorities in their Hackberry decision, could have announced that TPA is not applicable to LNG terminals. Moreover, such a signal would have been important for public and private foreign stakeholders too and could have taken away some of the concerns of third-country exporting countries on access to the EU market.

The boundaries of the EU and external relations

Energy policymaking increasingly includes foreign policy issues. A strategic partnership with Russia cannot be considered without firm ideas about the foreign policy approach to the Caspian Sea region, the Caucasus, Belarus and Ukraine. Also, the discussions with Turkey about EU membership, however far away from completion, also influence the foreign policy approach to Russia. Moreover, the issue of where the EU begins and where its membership will end are at the root of any successful partnership with Russia. Europe must be able to define and present itself to any potential partner. And again competence plays a role.

In the paper from the Commission/SG/High Representative for the European Council [European Commission 2006f], the legitimate right of member states to pursue their own external relations for guaranteeing security of energy supplies, in addition to their rights over supplies and the energy mix, is confirmed. This greatly limits the possibilities of identifying a common energy structure in which solid external energy relations can be embedded and which goes beyond voluntary and, sometimes, menu-driven cooperation. Large member states will consider their external energy policy as part of their foreign and security policy, and prefer different outcomes from member states that pursue only an external energy policy. In this respect larger member states are no different from the US, China and Russia. The different approaches of member states to Russia are telling in this regard. Some are clearly seeking to secure energy supplies and other political and economic interests through strong bilateral ties, while others are indifferent because they rely less on these relations.

Since the 1990s, foreign relations on the post-cold war European continent have exhibited somewhat binary characteristics – a country is either a potential EU member state or not. This approach to relations on the continent has replaced the more diverse relations among European countries in the period prior to 1990, when free trade agreements and other types of alliance reflected more tailored foreign relations. Apart from the internal difficulties that enlargement has brought the EU (institutional and redistributive), the fact that the (politically inspired) enlargement strategy was not sufficiently backed up by a strategy for relations with important non-potential member states now haunts policymakers, particularly when they are important energy resource holders (van der Linde 2005).

The proposals for the 'long-term framework for the external energy dimension' in the SER 2007 or in the March Council's conclusions are not more concrete than those voiced in the European Commission/SG/High Representative paper and ensuing

communication (European Commission 2006g). The Commission's statement that 'energy must become a central part of all EU external relations' and that 'effective energy relations with all its international energy partners should be based on mutual trust, cooperation and interdependence' (SER 2007) sounds completely different from the type of communication with Russia we have witnessed in 2006.

Moreover, the EU continues to attempt to export its *acquis communautaire* in energy matters to these same non-potential member states without showing the positive trade-offs, both in energy and in the wider political and economic relations, to those third countries. The proposals concerning the neighbourhood energy policy, including a neighbourhood energy investment fund, only emphasise this drive to engage in regulatory exportation. The positive trade-off for the EU of such an approach, realising that it did not have jurisdiction over the upstream and some parts of the mid stream of the value chain, is clear. The EU and Russia are openly engaged in regulatory and control competition over the mid stream assets in transit countries. How this competition fits into an external energy policy where mutual trust, cooperation and interdependence must flourish is unclear. The Commission's proposals are unlikely to satisfy the potential partner countries that strategic partnerships with the EU are based on equality or win-wins for both sides of the partnership. It is no wonder that, in his summary of the G8 Summit, Vladimir Putin refers to the interests of producers in sharing risk in the face of the huge investment requirements:

"We also stressed the need for better risk-sharing between all stakeholders in the energy supply chain through economically sound diversification between different types of contracts, including market-based long-term and spot contracts, timely decision-making and appropriate adherence and enforcement of contractual agreements." (G8 Summit 2006)

Moreover, the Commission now proposes to use its competence in trade negotiations in external energy relations and thus wishes to discuss reciprocal liberalisation of trading conditions and investments in upstream and downstream markets. How far this will complicate WTO entry for Russia and other energy producers is unclear.

Interestingly enough, the SER 2007 also calls for an Africa-Europe energy partnership. Both the United States and China are already very active in Africa's oil and gas sectors. Not so long ago, Africa was considered part of the EU backyard. Given the drive of all consuming countries to diversify resources, the EU cannot, for more reasons than energy alone, leave Africa aside. The proposal to offer Africa new energy

technologies and to use all the policy instruments available to the EU heralds a new round of competition for Africa's resources. A strategic energy partnership with the continued weak governments of Africa sounds like a foreign policy nightmare for the coming years, where issues of human rights and energy will make an easily combustible cocktail for EU policymaking.

The EU stresses that the regular talks with various producer groups, such as OPEC, should be continued. They should be seen as important instruments to create trust among producers and consumers. The main aim of these discussions should be to create more transparency in terms of investments, production capacity, state of infrastructure, contracts, etc, to meet predictable supply and demand expectations. Creating transparency would also be an impetus for intra-European transparency in these matters.

The Commission is right in stressing the importance of the relations with producer countries. Yet, these discussions can also stimulate producer coordination. Discussions with oil exporting countries cannot be conducted without discussing with OPEC. The context of the EU-OPEC talks is changing, with the OPEC countries bound to capture a larger share of world oil trade in the coming years. This will elevate these talks to a more strategic and political level when competition for oil among consuming countries increases. Also, in these discussions, market access and downstream development of state oil companies and other energy-related companies will feature. But discussions about oil are further developed than those on gas. The structure of the International Energy Foundation (IEF) is well established, and most regional or bilateral discussions can easily be fitted into the structure of the IEF. Trust-building in oil relations has been going on for much longer than in gas, which is still a predominantly regional business. Only with the growing share of LNG will the international gas market gain in international importance. Discussions on gas have been included in the framework of the IEF meetings but the bilateral nature of most relations continues to predominate. In recent years, gas-producing countries have oriented themselves towards closer cooperation in an attempt to prevent 'divide-and-rule' approaches by large consuming countries/blocs. The unhappiness of the producer countries with the Commission's position on long-term contracts and market access and the EU's attempts at regulatory expansion could have sparked the producer countries into considering a producer cartel, despite the different approaches of Russia and the other main gas-exporting countries, such as Algeria and Qatar.

Discussions between the EU and producer-country groups, however, only go so far. At some point, the EU's discussion partners expect to be able to talk with mandated

delegations and it is in its mandate that the EU's external energy relations remain weak. In a world where the economy talks, the construction of the EU is strong. In a more politicised world, the construction of the EU, which is not a state, can be a weakness. Together with the EU's undefined borders, the construction of the EU itself is the main hindrance to external energy relations. The EU's strongest card is the large consumer market it can offer to producers, both private and public. Market access and the ability to earn a decent return on investment in this fairly mature market for fossil fuels, further exacerbated by the low-carbon economy strategy, is crucial.

In a mature market barriers to entry are generally high. It is likely that mergers and acquisitions can play an important role in the future EU energy market. Not only within the EU market but also involving third-country companies engaging in takeovers. The current uncertainty about whether such takeovers will be accepted by the Commission and by member state governments lies at the core of the current debate about security of supply and demand. The member states promote EU companies to engage in backward integration to gain access to resources with the idea that these resources can then easily flow to the EU market, and producer governments are keen to promote forward integration of their companies to gain market access. The political importance of ownership of the energy value chain (and the ability to capture the rents) is obvious in the current stressed energy relations.

The EU and its member states show, by their reluctance to open their markets to third-country national or hybrid public-private companies, little faith in their own competition rules and governance structures. Moreover, the recent outcry over certain joint ventures allowing companies to integrate along the value chain and create cross-interests in each others' energy sectors is, against the background of fifty years of integration, a strange strategy to create wealth and defuse conflict. Much of this debate is geared towards the fear of Russian dominance of the European energy sector. Too little of this debate has been about Russia's ability to produce sufficient oil, gas and coal to supply both the domestic market and the European markets and thus its capacity to dominate. The transition to a low-carbon economy, where fossil fuels are increasingly replaced by sustainable energies, will be a long process that will barely have begun in 2020. The member states should therefore continue to pursue robust policies to secure the flow of fossil fuels to the EU market. In the current international energy market context, even with its higher prices, it is clear that Europe and other OECD countries cannot rely on sustainable energies providing the same quick escape as North Sea oil, Alaska and nuclear power did in the 1970s. This is the big difference now. Moreover, the fossil reserve base and production capacity do not rest with the large international energy companies that are

headquartered in OECD countries. These companies nevertheless play an important role in supplying the marginal oil barrel and gas molecules. These supplies could determine the coordination power of producing countries, the space for market domination and thus the future structure of international energy markets. The outcome of this change in the market structure will provide the preconditions and context for a low-carbon economy to emerge.

The recent rivalry between the EU and producing countries can be best summarised as a struggle over rents in both the traditional fossil fuel value chains and the future ones. But it is also as a 'system' struggle, in which regulatory regimes, ownership, supply routes, trade, and neighbourhood policy are all part of the external relations toolset.

Conclusion

EU energy policymaking must create benefits for member states that override the incentives to adhere to a national approach. Creating benefits is an important precondition for the member states to agree to transfer sovereignty to the EU level. These benefits lie in a proper balancing of the three priorities of energy policy at the level of the individual member states and at the EU level, but also in the avoidance of radical market structure changes that have a large impact on the political and social contract of society. The EU has to create benefits for all member states, although they differ widely in terms their energy mix, import dependencies, energy resource endowments, and the structure (organisation) of their energy markets. These different energy structures function within different political, economic and social systems and are derived from the dominant political-economic model in the member states. These differences not only reflect past preferences for a certain economic model of society or the organisation of the sector, but they also reflect to a large extent current differences in approach.

Preferences are not easily changed, although there has been a strong belief among proponents of globalisation that 'the market' as an ideological concept would also change the political, social and legal mores of a country (van der Linde 2005). Despite nearly fifty years of European integration, member states still function mainly within their own political-social models and the relationship between the state and the market is still largely shaped by their own model (centralist or decentralist; social compromise model or corporatist). Of course integration in the EU has forced member states to adapt their systems but they have not been forced fundamentally to change them yet. European integration is thus in many ways both a prime example of the success and, to some extent, the limits of the economy as the

main tool for political and social change. In areas where the EU touches the core competences of the state, beyond its economic competences, decision-making has been very difficult indeed. This complicates the discussion about EU energy policy-making because the member states are now not only invited to agree on a common energy framework in which the public interests of security of supply and the environment are secured at the EU level but, at the same time, they are also challenged to agree on restructuring their energy markets beyond the economic efficiency rationale alone. Member states are reluctant to give up their sovereignty to the EU because they are not convinced that the EU can deliver to their societies either a desirable political and social contract, or external relations that suit the strategic interests of the member states. This is particularly true for securing oil and gas flows, where government-to-government relations are a crucial part of business-to-business deals. Because the EU is not a government, member states doubt that the EU will be able to deliver security for their societies.

The EU must address the fact that the switch of the international oil and gas market from a buyers' to a sellers' market requires different management of the value chain. In a buyers' market, economic rents can more easily be captured by consumers, whether they are consumer governments, companies active in consumer markets or end-consumers themselves. The liberalisation of the EU energy market was inspired by the notion that competition in the EU energy market, ie in the mid- and downstream segment, would deliver more benefits to end-consumers in the form of lower prices when inefficiencies were competed away, while governments could continue to capture energy rents through taxation. In a buyers' market, the cost of security of supply is very low because of overcapacities in supply over demand. Third party access is an efficient manner for a company to obtain a price for unused transport capacity, with the possible loss of market share when newcomers compete for the same customers. Companies will engage in asset-sweating and will be reluctant to make capacity expansion investments when they cannot pass the investment costs onto consumers. In a sellers' market the economic rents are captured at the upstream end of the value chain. End-consumers are exposed to the price effects of scarcity and the costs of security of delivery and supply, while governments continue to capture their rents through taxation. Competition for consumers shifts to competition for supplies, which in Europe implies that competition on the European market becomes less significant for end-consumer prices. Because parts of the value chain have been regulated (TPA and regulated tariffs) competition cannot play a role here, while tight supplies determine world prices for oil and gas. Long-term supply contracts can reduce the cost of security of delivery (eg by not having to pay spot prices) and supply because the contract balances cost and benefits over a longer period of time and over the entire value chain.

Energy is both part of the economic and the political realm. This is true both for the member states and for other consuming and producing countries. The fact that countries and regions are not self sufficient automatically introduces foreign policy aspects into energy relations. As long as member states disagree on the security and foreign policy agenda, it will be very difficult to agree on an external energy policy agenda. The weakly developed proposals in the energy package are proof that this part of the strategic energy agenda is not ready for implementation yet.

How then to move forward on EU energy policy? It is clear that the external relation proposals are not sufficiently developed to convince the member states that they can safely abandon pursuit of their strategic external energy interests to the supra-national level. This implies that the balance between internal and external policy-making will not easily be achieved in the short run. The geopolitical importance of oil and gas, and to a lesser extent coal, in the context of diverging energy mixes and import dependencies will imply continued member state involvement in managing these relations.

The Commission carefully proposes to use its trade competence and coordination of bilateral relations with both producers and consumers to negotiate equal terms for all member states rather than propose outright new competences in external energy relations. The drive for a more sustainable energy economy in the EU will slowly align the external energy interests when new fuels gain a more prominent place in the EU energy mix. Managing the internal market for renewables offers new opportunities for the Commission to take the lead in setting a proper framework for such fuels to be produced, transported and consumed. The fact that member states are more willing to 'speak with one voice' in climate change policy matters offers the prospect of future cooperation in all energy matters. However, the long-term view cannot replace the immediate stresses and strains in energy policymaking. The current determination to reduce CO₂ emissions, increase energy efficiency and increase non-fossil energy could in the short and medium term, with carbon capture and other necessary breakthroughs unavailable at commercial terms, lead to increased dependency on imported gas. How that squares with the strategy to reduce structural dependence on certain producer countries and regions remains unanswered. The debate about an energy policy for Europe has only just begun.

Notes

- 1 Security of delivery is fundamentally different from security of supply. Security of delivery is the ability to technically and physically satisfy, every day, energy demand at reasonable prices and without interruption. To this end, sufficient infrastructure and production capacity must be available and investment failures must be avoided. Companies must also be healthy enough to deliver

energy resources to their clients. Security of supply refers to the long-term certainty that sufficient supplies are available to satisfy demand. Security of supply refers to economic and geopolitical risks of a supply failure. The two notions are used interchangeably in the Commission's paper 'An Energy Policy for Europe'.

- 2 Given the member states' insistence on maintaining national competence in the energy mix, unification of policy is however unlikely when it comes to including nuclear in the CO₂ emission reduction policies.
- 3 Presidency conclusions 23-24 March 2006, 7775/1/06 Rev 1.
- 4 For example, in the so-called 'upstream directive' 94/22/EC, OJ L 164, 30 June 1994, pp.3-8, the issue of sovereignty of member states was addressed. In this directive the sovereignty over hydrocarbon resources on the member states' territories was confirmed and allowed member states to determine their own depletion policy.
- 5 At the same Council meeting, the nine member states also decided to engage in the Euro-Arab Dialogue, which was strongly promoted by France.
- 6 See Official Journal C241, 25 September 1986, p.1.
- 7 ExxonMobil, 2005 Energy Outlook.