The European Union trade strategy. An empirical evaluation of preferential trade agreements' effects on EU import flows

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Abstract

The last decade has been characterised by a progressive process of enlargement and regional integration in Europe and in the rest of the world. It is worth to notice that the EU, the world's largest single market, is the first exporting country and the second importing country in the world.

It is worth to notice that according to the art 113 EC Treaty of Rome, all trade agreements with one or more States or international organizations are negotiated by the Commission representing all EU Member States. Since the post war period, the common EU trade policy has been taking two directions: a "deeper" (internal) trade integration process to reinforce the trade relationships among European countries (i.e. Custom Union, Single Market, European Monetary Union, Enlargement Process), and a "wider" (external) integration process to reinforce trade relationship with third countries (i.e. bilateral and multilateral preferential trade agreements).

The object of the paper is an empirical investigation on if and how the "wider" integration policy exerted a significant impact on European countries imports. According to our empirical analyses EU "wider" trade policy increased imports flows of about 60% on average ,while the EU deeper trade policy increased imports flow more that doubled. Therefore, as we expected, the wider effect has had a much lower impact than the deeper one.

Keywords: trade flows, regional integration, gravity model, panel data

JEL: F13, F15; C13, C23

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"…*The common commercial policy shall be based on uniform principles, particularly in regard to changes in tariff rates, the conclusion of tariff and trade agreements, the achievement of uniformity in measures of liberalisation, export policy and measures to protect trade such as those to be taken in case of dumping or subsidies…"*

(Art 113 of the EC Treaty of RomeA1957)

Introduction

The last decade has been characterised by a progressive process of enlargement and regional integration in Europe and in the rest of the world. It is worth to notice that the EU, the world's largest single market, is the first exporting country and the second importing country in the world.

The EU trade policy since the post war period has been taking two directions. On the one side, it has been trying to achieve a "deeper" integration into the European Region, through the creation of the Single Market (and eventually the Monetary Union) . On the other side, it has been trying to reinforce trade relationship with third countries ("wider" integration) by bilateral and multilateral preferential trade agreements (PTAs).

It is worth to notice that the presence of PTAs had also the effect to reduce the occurrence of trade diversion due to the European trade integration. Therefore by means of bilateral and multilateral agreements with the European Union, the outside producers could have maintained trade opportunities in EU market also after the reductions and elimination of EU internal tariffs.

For each European country the EU membership has to be considered a competitive advantage in the framework of commercial negotiations. Therefore, according to the art 113 of the EC Treaty of Rome, all the trade agreements with one or more countries or international organizations are negotiated by the Commission representing all EU Members[1] and having, by this way, much more "contractual" power than a single country.

The aim of this paper is to quantify the effect on EU members import flows of preferential trade agreements signed with third countries. In general, the expected effect of a PTAs is an increase in export and import flows. However in this paper we will examine only the effects on imports. This "asymmetry" in the empirical analysis is due to the fact when a country grants GSP preference to another one, there is reason to expect an increase in the imports of the country but no theoretical reason of an increase in its exports. This asymmetry is consistent with the structure of trade liberalization under WTO. Therefore, industrial countries reduced their trade barriers under successive trade rounds while to developing countries were accorded the freedom to keep their trade barriers under the principle of special and different treatments.

[1] The EU has a common trade policy ("Common Commercial Policy" CCP); in other words, where trade, including WTO matters, are concerned, the EU acts as one single actor, where the European Commission negotiates trade agreements and represents the European interests on behalf of the Union's 25 Member States.

The paper is organised as follows: The first paragraph presents a brief survey of the literature on the effects of the Common Commercial Policy (CCP), the second and the third provide a description of the institutional framework and EU trade instruments and of the two waves of EU PTAs. The fourth paragraph and the fifth paragraphs present the empirical strategy and the equation and estimates results. Conclusions follows.

I A brief survey of literature

(to be done)

II. The trade policy instruments: The preferential trade agreements (PTAs)

Regional integration has been the most important feature of European economic development for several decades. Starting with the Coal and Steel Union and the Treaty of Rome in the 1950s, the integration process has gradually extended to include new member countries and new policy areas[2].

In this context, one of the main objectives of the Treaty of Rome was to create a customs union between Member States in which there would be no barriers to trade and a common external tariff would be applied to imports from third countries.

Gradually successive enlargements and the consolidation of the Single Market have strengthened the Community/Union position as a major player in trade negotiations in the international framework, both in bilateral negotiations with third countries and multilateral negotiations in the GATT/WTO[3]. Since the post war period the CE/UE has therefore progressively built up a solid network of trade relations worldwide.

It is worth to notice that the scope of the CCP, as defined by Article 133, has been interpreted very broadly by the Court of Justice. However, it does not cover international negotiations and agreements relating to agriculture, services and intellectual property, areas being discussed at the moment within the WTO[4] and that caused the recent failures of the Doha Agenda.

In the last decades a broad range of instruments have been developed within the CCP:

2 "The last significant developments during the last few years are the establishment of the European Monetary Union, with 12 member countries adopting a common currency in 2001, and the entry of 10 new member countries in May 2004. These developments make the European Union the world's most comprehensive regional integration agreement, even before the ratification of the new EU constitution, which was signed by the heads of state of the 25 member countries in October 2004".(Kokko 2005)

3 Founded on 1 January 1995 by the Marrakesh agreements resulting from the Uruguay Round negotiations, the World Trade Organisation (WTO) incorporates within one structure trade negotiations on goods (GATT), services (GATS) and intellectual property (TRIPS).

4 The Council can nevertheless extend the scope of Article 133 to include these areas by unanimous agreement following consultation of the European Parliament.

i) The common external tariff. The common external tariff (CET)[5] is one of the essential features of the European customs union: it consists in applying unique customs duties to imports from third countries, whatever is the importing Member State.

ii) Trade defence instruments: anti-dumping, anti-subsidy policy, regulation on trade barriers, and protective measures. Anti-dumping policy is intended to avoid the practice of exporting goods at lower prices than those applied to similar products on the domestic market. Anti-subsidy policy is designed to prevent imports of products for which prices are kept artificially low by public subsidies in the third country of origin.

iii) PTAs and multilateral negotiations. This instruments have the scope to eliminate obstacles to trade on international markets concluding trade agreements which allow partner countries to be given special treatment. It should be noted that these preferential treatments are exceptions to the most-favoured nation clause[6] which have been authorised by the WTO.

III. The two waves of PTAs: the deeper and wider EU trade integration

From the late 1950s to the mid-1990s, the European trade integration process were mainly related to the abolition of internal tariffs and the EU PTAs were oriented, with few exceptions[7], towards the completion and widening of the Single European Market (SEM).

The aim of the SEM was to eliminate the tariff and non-tariff barriers that had been created over the preceding decades and that prevented the completion of a truly integrated internal market. The ultimate objective was to achieve the four goals set out in the Treaty of Rome: free movement of goods, labour, capital and services.

In the nineties, the EU was among the major subscribers of PTAs. The phenomenon spread quickly to other countries and mostly to the US. At present, however the European network of PTAs is still the broadest in the world. Recently it also have increasingly been designed to cover more than formal trade policies.

From 1995 to the present, the CCP was mainly oriented to a process of "wider" integration with the scope to assure new strategic markets especially in emerging countries. In particular, in 1996, the EU introduced a "Market Access Strategy" policy aimed at achieving better access to third-country markets through a more focused, systematic and coordinated use of available trade instruments.

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5 Originally, the CET was the arithmetic mean of the tariffs applied in 1957 by the Member States. On the basis of Article 28 of the Treaty, the Council, acting by a qualified majority on a proposal from the Commission, has since amended this several times, either independently or in the course of tariff negotiations.

6 Most favoured nation (MFN) is a term used in international trade. It refers to a relationship between nations as trading partners. A most favoured nation clause is a clause in a trade agreement between two nations providing that each will extend to the other any trading privileges it extends to third nations.

7 "The first EU preferential trade agreements were established in connection with the Treaty of Rome in 1957, and involved "countries and territories" that were associated to the member States: these were mainly former or current colonies in Frenchspeaking Africa that were granted preferential access to the EU market, together with some development funds. The Yaoundé Conventions (1963 and 1969) extended these preferences to some 20 newly independent African states. After the accession of the UK, the agreement was expanded to cover Commonwealth countries in the ACP (Africa, Caribbean, and Pacific) region. This agreement, signed in 1975 and known as Lomé I, provided development aid, non-reciprocal preferences, and a system to stabilize fluctuating export earnings to 46 ACP countries. During the following 20 years, the Lomé convention was extended four times, with membership increasing to 70 ACP countries".(Kokko 2005)

Tab. 1 EU PTAs

Agreement	Date of entry into force	Type reement
EC (Treaty of Rome)	1-Jan-58	Customs union
EC — OCTs	1-Jan-71	Free trade agreement
EC — Switzerland and Liechtenstein	1-Jan-73	Free trade agreement
EC accession of Denmark, Ireland and UK	1-Jan-73	Accession to customs union
EC — Iceland	1-Jan-73	Free trade agreement
EC — Norway	1-Jul-73	Free trade agreement
EC — Algeria	1-Jul-76	Free trade agreement
EC — Syria	1-Jul-77	Free trade agreement
EC accession of Greece	1-Jan-81	Accession to customs union
EC accession of Portugal and Spain	1-Jan-86	Accession to customs union
EC — Andorra	1-Jul-91	Customs union
EC — Bulgaria	31-Dec-93	Free trade agreement
EC accession of Austria, Finland and Sweden	1-Jan-95	Accession to customs union
EC — Bulgaria	1-Feb-95	Services agreement
EC — Romania	1-Feb-95	Services agreement

Source http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm1_e.htm

This second wave of PTAs signed by EU differs from the previous for geographical destination, degree of development of the partners and the thematic areas of the agreements. The "new" PTAs are not only limited at the abolishment and reduction of tariffs but include also more sophisticated forms of commercial integration[8].

Tab. 2 EU PTAs after 1995

Agreement	Date of entry into force	Type of agreement
EC — Turkey	1-Jan-96	Customs union
EC — Faroe Islands	1-Jan-97	Free trade agreement
EC — Palestinian Authority	1-Jul-97	Free trade agreement
EC — Tunisia	1-Mar-98	Free trade agreement
EC — South Africa	1-Jan-00	Free trade agreement
EC — Morocco	1-Mar-00	Free trade agreement
EC — Israel	1-Jun-00	Free trade agreement
EC — Mexico	1-Jul-00	Free trade agreement
EC — Mexico	1-Mar-01	Services agreement
EC — FYROM	1-Jun-01	Free trade agreement
EC — Croatia	1-Mar-02	Free trade agreement
EC — Jordan	1-May-02	Free trade agreement
EC - Chile	1-Feb-03	Free trade agreement
EC - Lebanon	1-Mar-03	Free trade agreement
EU Enlargement	1-May-04	Accession to customs union
EU Enlargement	1-May-04	Accession to services agreement
EC - Egypt	1-Jun-04	Free trade agreement
EC-Chile	1-Mar-05	Services agreement

Source: http://www.wto.org/english/thewto_e/whatis_e/tif_e/agrm1_e.htm

8 It is worth to notice that at the same time as tariffs have lost much of their importance as instruments of protectionism in the manufacturing sector, they remain significant in EU's agricultural trade regime.

This was due also to the fact that new kinds of non-tariff barriers to trade have emerged in the manufacturing sector during the past decades. National and regional product standards that are costly to satisfy for outsiders and government procurement practices favouring national or regional producers are only some examples of such measures. Rules of origin – specifying what share of a product's value added must originate in the exporting country in order to qualify for preferential treatment – may also limit the practical ability of outsiders to take advantage of seemingly generous trade preferences.

In such a context, preferential trade agreements were signed with the Turkey (customs union), the Western Balkans (stabilization and association agreements, with extensive free trade), Russia and Ukraine (partnership and cooperation agreements, including GSP preferences) and Mediterranean countries (free-trade area to be completed 2010).

IV. Empirical strategy and dateset

The object of our empirical analysis is to estimate if and how Trade Agreements signed by the EU exerted a significant impact on EU15 trade. In particular, we examine the effects on imports of EU trade strategy of "wider" integration in comparison with those of the strategy of "deeper" integration.

The dependent variable in our estimates are the EU15 bilateral imports flows. This is due to the fact that among the factors we control for, WTO membership and GSP scheme are of particular importance. Trade effects of WTO and GSP are related mainly to imports.[9]

The dataset is partly taken by Subramanian and Wei (2003). The equation was estimated for the UE15 countries as importing countries and 174 countries as trading partners; the time span is 1950-2000 with one observation each 5 years. The dataset contains about 15.000 observations.

We adopt an extended version of gravity model; this empirical framework has been broadly used in studies of integration processes in order to explore the main changes in geographic trade pattern and to analyse the effects of regional PTAs and currency unions on trade flows. In line with more recent works, we also control for heterogeneity and include a set of variables to proxy for "multilateral resistance index" (Anderson and Van Wincoop (2003))

We introduce in the gravity equation four sets of variables: i) standard gravity variables, ii) controls for heterogeneity, iii) dummy variables for different tariff regimes, linked to the presence of GSP status, WTO membership or free trade area, iv) dummy variable to test the effects of PTAs with third countries on EU15 bilateral import flows.

i) Standard gravity variables. Bilateral distance, as a proxy of transport costs, and the sum of importer and exporter's GDP as proxies of the "mass". We add to this standard specification a list of variables to control for different bilateral features, i.e. land area of importer and exporter, dummies for common language and colonial links, shared borders and currency, a dummy for landlocked and island countries[10].

9 When a country grants GSP preferences to another country, or when it liberalize its imports under the WTO rules, we expect an increase of that country's imports but not an increase of its exports. See Subramanian and Wei (2003).

10 Since Rose (2000), these kind of controls has been widely used in empirical works on PTAs effects on bilateral trade, so that we can consider it part of a "standard" specification of gravity models.

ii) Controls for heterogeneity. Following Baltagi, Egger and Pfaffermayr (2003) we introduce fixed effects for importing and exporting countries. Differently from these authors, we don't control for country-pair effects (i.e. the interaction effect between exporting and importing country picking up unobserved characteristics of country-pairs) because this kind of variables would include the impact of bilateral trade agreements that we want to control by specific dummies. Controlling for exporter and importer effects, we can proxy the multilateral "trade resistance index" (see Anderson and van Wincoop (2003)), obtaining a specification of a gravity equation that can be interpreted as a reduced form of a model of trade with micro foundations.[11]

iii) Tariff regimes. We want to control for all the tariff regimes applied to extra-EU partner countries which did not join bilateral agreements with EU but that joined some preferential treatment. Furthermore, in our dataset EU15 countries are also partner countries, thus we control for the "internal market factor" to "isolate" the effect on imports of external trade agreements.

Following Subramanian and Wei (2003), our specification of WTO, GSP and EU internal market relies on the fact that they involve different degrees of liberalisation; for this reason, we build our dummies in a mutually exclusively way, in order to isolate the impact of each one on imports. Therefore, WTO dummy is coded to exclude country pair belonging to the EU market or involved in GSP relationship.

iv) External trade agreements dummy. We include in our dummies all the trade agreements signed since 60ies by EU with third countries.

The empirical strategy is based on Hausman-Taylor (1981) estimator. This framework provides consistent and unbiased parameter estimates when: i) countries face some additional unobserved heterogeneity; ii) some of the explanatory variables are correlated with the error term. Indeed, in contrast with fixed effect approach, it allow to estimate coefficients of time-invariant regressors, like bilateral distance, that are part of the model (Egger (2002))[12].

The estimated equation form is the following:

$$Ln\ IMP_{ijt} = b1(\ lnSumGDP_{ijt}\ ) + b2\ lnDist_{ij} + b3\ Z_{ij} + b4\ \alpha j + b5 Bi + b6\ duDeeper_{ijt} + b7\ duWider_{ijt} + b8\ duGSP_{ijt} + b9\ duXWTO_{ijt} + b10\ duXnonWTO_{ijt}$$

where:

i) *Ln* is the natural logarithm, *i* is the exporting country, *j* is the importing country and *t* is the year

11 Anderson and van Wincoop (2003) pointed out that trade between a pair of countries depends on their bilateral trade barriers with all trading partners: trade will be stronger for those countries with a relatively low trade barriers. Rose and van Wincoop (2001) approximate the multilateral trade resistance index using country-pair fixed effects. Ritschl and Wolf (2003) and Estevadeordal et al. (2003) propose using country-group dummies; our approach follow this suggestion.

12 Anyway, we tried to estimate also by a fixed-effect estimator: regressors coefficient show very similar values and the same sign and statistical significance.

ii) Imp_{ijt} = is the imports in volume from country *i* to country *j*;

iii) $SumGDP_{ijt}$ = is the sum of gross domestic product of the exporting and importing countries, a proxy of the "mass", i.e. the dimension of the countries involved in bilateral trade;

iv) $lnDist_i$ is the bilateral distance between capital cities;

v) *Z* is a vector of time-invariant dummy variables capturing bilateral characteristic, like common language and colonial links, shared borders and currency, landlocked and island countries

vi) α_i is a set of exporting country dummy: they assumes value 1 if export flows come from exporter country *i* to each one of importing countries *j,* 0 otherwise;

vii) β_j is a set of importing country dummy: they assume value 1 if export flows come from each one of exporter countries *i* to importing country *j*, 0 otherwise;

viii) $duDeeper_{ijt}$ is a dummy that proxy the EU internal market integration process. Due to the fact that EU membership has been a dynamic process, with European countries entering into EU in different years, this dummy assumes value 1 when both EU countries were members .

ix) $duWider_{ijt}$ is the relevant *dummy* in our analysis. It includes all the trade agreements signed by EU with extra-EU countries;

x) $duGSP_{ijt}$ is a *dummy* that assume value 1 if the importing country j granted a GSP status to exporting country i;

xi) $duXWTO_{ijt}$ is a *dummy* that assume value 1 if the importing country j liberalize its imports under the GATT/WTO and at the same time exporting country i is a GATT/WTO member, where i and j are not in a free trade area or custom union and where j doen's grant GSP preferences to i at the year t.

xii) $duXnonWTO_{ijt}$ is a *dummy* variable that assume value 1 when exporter country is not a WTO member, where i and j are not in a free trade area or custom union and where j does not grant GSP preferences to i at the year t.

V. Estimates results

The estimates results are summarised in Table 3. As for "gravity standard" variables, a positive exports relationship with the mass and a negative one with distance is confirmed, in line with empirical literature findings. Also other control variables are statistically significant and with expected signs.

EU PTAs policy exerted an important impact on EU imports flows, that increased around 58% on average[13]. As we expected, the more extended impact on imports flows come from EU "deeper" integration process. EU internal confirmed to be the most successful experiment of trade liberalisation since the post war period.

On average, countries joining EU internal market more that doubled their imports with respect their previous status. The size of this effect can be explained by the importance of intra-trade share for each European countries: geographical, historical and social reason are the main factors behind these trade relationship.

13 Since the parameter of the dummy Wider is 0.46, the variation of imports induced by signing these trade agreement (Wider=1) with respect to the case of not signing (wider=0), is given, other things being equal, by [(exp0.46*1/ exp0.46*0) –1]*100=58.4%

Tab. 3. The impact of trade agreements on EU15 import flows (1950-2000)

	Coeff.	P>|z|
Ln $SumGDP_{ijt}$	0.5557555	0.00
Ln($DIST_{ij}$)	-4.285191	0.00
$DuDeeper_{ijt}$	1.204455	0.00
$DuWider_{ijt}$	0.4599715	0.00
DuXWTO	0.3840491	0.00
DuXnonWTO	0.2187564	0.00
DuGSP	0.1297899	0.066
□ □	yes	
□ j	Yes	
z	yes	

While the importer countries selected in our dataset (Eu15 countries) are WTO members, the exporter countries are not. Hence, we have considered two different dummies, depending on whether the exporter is a GATT/WTO member or not; the GATT/WTO membership implies a more favourable trade regime for exports.

Tab. 4. The impact of trade agreements on EU15 import flows: 1950-1980 and 1985-2000

	1950-80		1985-2000	
	Coeff.	P>|z|	Coeff.	P>|z|
Ln $SumGDP_{ijt}$	0.699	0.00	0.416	0.00
Ln($DIST_{ij}$)	-1.26	0.049	-3.72	-0.00
$DuDeeper_{ijt}$	0.8316	0.00	0.4798	0.018
$DuWider_{ijt}$	0.1631	0.288	0.4435	0.025
DuXWTO	0.1034	0.088	0.1425	0.462
DuXnonWTO	-0.071	-0.237	0.2623	0.209
DuGSP	0.1225	0.085	0.3586	0.072
□ □	yes		yes	
□ j	Yes		Yes	
z	yes		yes	

Like in Subramanian and Wei (2003), our results show that both dummies are positive and statistically significant, but the GATT/WTO membership implied more imports from this countries with respect the non-members. Barriers were probably higher with respect to imports coming from member countries. The positive and statistically significant coefficient of non-member dummy is probably due to the fact that EU members extended some of the benefits of WTO tariff regime to non-members.

Granting a GSP status to a developing country, had a positive impact on EU imports, that increased of 13.9% on average. We have to consider that developing countries that benefited from this preferential trade regime did not have intense trade relationship with EU15. Their

shares on European trade were small; GSP status had a positive impact but it was lower than the other effects we control for.

We control for the robustness of estimates to time span changes. In particular, being trade agreements with extra-UE countries mainly concentrated in the last part of the time span, we split our equation in 2 sub-period: 1950-1980 and 1985-2000.

Results are summarised in Table 4. The magnitude of coefficient of Wider dummy in 1985-2000 period is substantially unchanged with respect to the full time span estimate. It is worth to notice that the coefficient of Deeper dummy is considerably higher in the first part of our time span (1950-80) than in the second one (after 1985). In the first 30 years, the impact on imports of trade liberalisation was more relevant than the Single Market Program final implementation or the EMU launch.

in table 3 and 4, our panel data analysis reports the effect of PTA on imports for all the 15 EU countries as a whole. To investigate the individual effects, we disantangled our Wider dummy in 15 dummies, one for each of 15 European countries considered, the functional form of estimated equation remaining the same. Results are reported in Table 5.

Tab. 5. Disantangle EU single countries'effect (1950-2000)

	Coeff.	P>|z|
Ln $SumGDP_{ijt}$	0.5577	0.00
Ln($DIST_{ij}$)	-2.97	0.00
$DuDeeper_{ijt}$	1.1958	0.00
DuWider UK	0.682	0.00
DuWider AU	0.305	0.23
DuWider DEN	0.233	0.31
DuWider FRA	0.613	0.00
DuWider GER	0.596	0.01
DuWider ITA	0.545	0.02
DuWider NETH	0.453	0.05
DuWider SWE	-0.14	0.58
DuWider FIN	-0.48	0.60
DuWider GRE	0.442	0.05
DuWider IRE	0.200	0.38
DuWider POR	1.235	0.00
DuWider SPA	0.961	0.00
DuWider BE	0.8417	0.062
DuWider LUX	0.447	0.329
DuXWTO	0.377	0.00
DuXnonWTO	0.212	0.00
DuGSP	0.109	0.11
□ □	yes	
□ j	Yes	
z	yes	

The most developed (and bigger) European countries show a positive impact on imports flows and a similar magnitude: coefficient for UK, France, Germany and Italy are all statistically significant. The higher impact is related to Spain and Portugal, probably due to their catching up process.

VI Conclusions

According to estimates we found out the following results:

i) The European trade strategies (deeper and wider) in the last half century have been both successful in improving bilateral trade flows either between EU countries, either between EU and not EU countries.

ii) The "wider PTAs" had positive impacts on EU imports flows (mainly after 1985). The positive and significant coefficient of PTAs agreements signed by EU with third countries possibly limited the occurrence of trade diversion effects due the elimination of EU internal tariffs;

iii) The impact on imports flows coming from EU deeper integration process was very relevant, but probably higher in the first 30 years in coincidence with custom union implementation.

iv)For the main industrialised and bigger European countries, trade liberalisation process seems to have increased imports flows by a similar magnitude; catching up countries like Spain and Portugal, show the most relevant impact.

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