

ACP–EU trade cooperation after 2000: an assessment of reciprocal trade preferences

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The establishment of the World Trade Organisation (WTO) in 1995 reflected and reinforced significant shifts in global orthodoxies in favour of the liberalisation of world trade, and posed problems for trading arrangements such as the Lomé Conventions between the European Union (EU) and the 70 African, Caribbean and Pacific (ACP) states, which had initially been established in the very different setting of the mid-1970s. Integral to the Lomé Conventions has been the principle of non-reciprocity, under which the EU offered preferential conditions for access to its markets by products originating in the ACP states, without any requirement for reciprocal concessions (other than most-favoured-nation status) by the ACP. These preferences are due to expire with the 4th Lomé Convention in February 2000. Because they are non-reciprocal, these preferences cannot qualify under Article XXIV of the General Agreement on Tariffs and Trade (GATT) of 1947. Being available only to a particular group of developing countries, they are discriminatory and cannot be regarded as being covered by Part IV of the GATT, or the Enabling Clause of 1979, since these measures only sanction special, differential and preferential treatment for all developing countries. As a result of the changed climate of opinion in the World Trade Organisation (WTO), emphasising the obligation of members to bring their trade measures into conformity with WTO disciplines, the EU sought and obtained a waiver from Article I (principle of non-discrimination) for the remaining duration of the Convention, leaving open the arrangements to be put into effect after 2000.

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In the public discussions and consultations on a successor arrangement to Lomé, the European Commission has emphasised the need for such an arrangement to be compatible with WTO requirements, so as to ensure the legal security of preferences. It is therefore envisaged that Lomé preferences will be available only to the least developed countries (LLDCs), but will be generalised to *all* of the least developed countries, including for example Bangladesh, Bhutan, Cambodia, Lao D.R., Maldives, Nepal and Yemen, and not just to members of the ACP Group. The Commission has proposed that the non-LLDC ACP countries should be offered a series of regional and sub-regional free trade agreements. Not only would such arrangements seek to be WTO compatible, but the Commission also sees reciprocal regional agreements as stepping stones to fully liberalised trade and the integration of the developing countries into the world economy – an important development cooperation objective of the Maastricht Treaty.

This article examines the Commission's proposals, and analyses the likely static and dynamic effects of a free trade agreement on the African ACP countries. It concludes by questioning whether the Commission's proposals would assist, rather than hinder, the regional integration and greater participation of these countries in the world economy.

THE COMMISSION'S PROPOSALS FOR NEW COOPERATION AGREEMENTS¹

The European Commission has published its assessment of the framework for a new EU–ACP agreement,² and although the details of the Commission's proposals will change over time, the broad thrust of the proposals emphasising 'mutual obligations' will remain. The proposals cover five key areas. First, strengthening the political dimension (human rights, democratic principles, and the rule of law and the prevention of conflicts), introducing greater selectivity in the management of cooperation, and engaging in a more effective dialogue before implementing conditionality. Second, refocusing cooperation,

¹ The author is grateful to Henri-Bernard Solignac Lecomte of the Overseas Development Institute, London, for a very helpful discussion of these proposals.

² *Guidelines for the negotiation of new co-operation agreements with the African, Caribbean and Pacific Countries*, COM(97)537, Brussels 29 Oct. 1997. *Recommendation for a Council decision authorising the Commission to negotiate a development partnership agreement with the ACP countries*. Draft Commission Communication to the Council, 28 Jan. 1998.

with priority being given to an integrated approach to poverty and the development of the private sector. Third, the Commission considers that Lomé preferences, though beneficial, have failed to generate sustained growth; a new concept of economic partnership is therefore said to be required, in order to help the ACP countries adjust and integrate into the multilateral trading system, and ‘strengthen Europe’s presence in the ACP countries by enabling EU enterprises to utilise the comparative advantages of the ACP countries’. Fourth, the Commission aims to simplify financial cooperation by reducing the number of instruments – to a package of programmable resources, an investment fund to promote the development of the private sector, and an emergency fund. Increases in the efficiency of aid are to be sought by focusing on a limited number of sectors, and by improved monitoring of the way in which aid is used (introduced in 1995 with the two tranches of aid), so that aid is based on merit (the efficiency with which aid is used, and the extent to which recipients honour their commitments), as well as need. Fifth, while accepting the need to maintain the unity of the ACP Group (the desirability of which was emphasised by participants in the EU-wide consultation process on the Green Paper), the Commission nevertheless emphasise their belief in the growing importance of regional integration as a factor in economic development. This, combined with the need to design cooperation agreements to respond to the needs of different ACP regions and sub-regions, has led the Commission to propose a new overall agreement with strong regional differentiation. Finally, some or all of the provisions of the future agreement might be extended to non-ACP developing countries at a similar level of development (for example, the least developed countries), and to countries in the same geographical area as existing ACP states. These proposals cover a wide range of issues and this article will concentrate on the proposals for regional trade cooperation agreements.

Proposed arrangements for regional trade agreements

The Commission envisage an evolving, multistage process with two linked sets of agreements. First, there would be an overall framework agreement, the Convention, which would establish the medium and long-term objectives of cooperation and the approach to achieving these objectives. Second, a number of regional and sub-regional EU–ACP agreements would be negotiated. Since it will be difficult to negotiate these agreements during the life of the existing Lomé

Convention, it is envisaged that these objectives will be achieved in a number of stages.

The first stage (1998–2000) will cover the framework agreement and will, among other things, define the areas of economic cooperation, identify the sub-regions and (in exceptional cases) individual non-LLDC ACP countries which will be involved in the second stage of the negotiations, and specify the general scope of the agreements, with the ultimate objective of merging the regional agreements into one overall agreement. The least developed countries will be offered access to the EU market on the basis of the present arrangements (*acquis actuel*), taking into account the EU's undertaking to eliminate, as far as possible, any discrepancies between Lomé and its generalised system of preferences (GSP) offer for the least developed countries within the WTO arrangements.

The second stage of the negotiations (currently envisaged to take place over the period 2000–5), during which the current Lomé provisions will continue, will seek to conclude regional or sub-regional (in the case of Africa) agreements which would establish free trade areas (FTAs) with the EU in conformity with WTO disciplines and the provisions of the common agricultural policy. The Protocols in the Lomé Convention covering preferential access for ACP exports of sugar, bananas and beef will be maintained. Increased aid and technical assistance will also be available to assist the ACP countries in other trade related areas. Non-least developed ACP countries which do not wish to conclude free trade agreements with the EU will have to rely on the EU's less generous generalised system of preferences for preferential access to the EU market.

A compromise between conflicting pressures

The Commission's proposals may be regarded as a compromise solution in the face of conflicting pressures. The general thrust of the section of the consultative 'Green Paper'³ on 'options for a new partnership' was to dismiss the idea of renewing the Lomé Convention, because this would require a further WTO waiver, which in turn would (for reasons that were incorrectly stated) 'severely undermine the security of preferences'. Instead, it emphasised the benefits of FTAs ('differentiated reciprocity' in Commission jargon), including the

³ European Commission, *Green Paper on relations between the European Union and the ACP countries on the eve of the 21st Century* (Luxembourg, 1997).

security and predictability of preferences. This approach has been given added strength by the opposition to, or at best weak support for, Lomé from the governments of the member states, including previous advocates such as France. The Commission's enthusiasm for regional free trade agreements stems partly from the belief that such agreements act as a powerful stimulus for structural changes (reinforcing structural adjustment policies, which have often been weakly implemented), which are essential to raise growth rates and integrate the ACP countries more fully into the world economy. At the same time, and seemingly contrary to this objective, the mercantilist lobby in the EU sees FTAs as a means of capturing markets, while at the same time protecting (i.e. excluding) 'sensitive' industries and sectors of the economy, including for example the exclusion, or very restricted entry, of competing agricultural products in all of the EU's agreements.

A second consideration facing the Commission was the political calculation of the terms on which a renewed waiver would be acceptable to WTO members. The EU development commissioner João de Deus Pinheiro expressed the view at the UK consultation on the Green Paper that any preferences accorded to ACP states would therefore be 'likely to be extended, if desired, for the least developed countries, and perhaps for some others, but probably not for all'.⁴

A third element running parallel to, but separate from, the Lomé consultation process has been discussion in the WTO of the Ruggiero initiative for free access for the exports of the least developed countries to markets in more developed countries. The EU has responded by offering to augment its GSP preferences so that the same type of preferences are available to all least developed countries, whether or not they belong to the ACP Group.

The fourth consideration has been the outcome of the consultation process on the Green Paper which revealed a strong measure of support within the EU states, led by European non-governmental organisations (NGOs), for the maintenance of the ACP as a group in the EU's relations with the developing countries. Consultation in the ACP countries showed a strong desire to maintain the Convention in its present form and a general lack of support for free trade agreements. This arose partly from a desire to continue to protect their economies, and from the view that major structural weaknesses in levels of investment, knowledge, skills and in domestic markets (both in goods and particularly in services), would make it impossible to adjust their

⁴ Opening address by Commissioner Pinheiro, 19 June 1997.

economies to free trade with the EU in anything like the ten years required by a WTO-compatible free trade agreement. A fully reciprocal FTA with the EU would create also difficulties for the Caribbean countries which currently receive special non-reciprocal preferences from the US under the Caribbean Basin Initiative and Canada under CARIBCAN, and for the Pacific countries which receive special non-reciprocal preferences from Australia and New Zealand, since these developed countries are unlikely to continue with unilateral preferences if the EU is allowed reciprocal preferences.

PRELIMINARY OBSTACLES

The Commission's proposals for replacing the Lomé Convention with a series of free trade agreements between the EU and different regional groupings of ACP and other developing states face a number of preliminary obstacles, even before considering whether they would benefit the ACP countries. The two most significant of these obstacles are first, whether the proposals are compatible with WTO obligations, and second, whether it would be possible to devise an acceptable set of African regional groupings, with which to negotiate the agreements.

WTO compatibility

Far from being fully compatible with WTO obligations, the Commission's proposals would require a series of waivers, which would in turn enable other WTO member states to impede the implementation of any arrangements which they felt to be detrimental to themselves.

First, it would be necessary to gain a waiver permitting the extension of the present Lomé arrangements beyond their current expiry date of February 2000, while negotiations for new arrangements continue to take place.

A second and more significant waiver would be required from the provisions of Article XXIV of GATT which states that FTAs have to cover 'substantially all trade', and from the stipulation of the 'Understanding on the Interpretation of Article XXIV of GATT 1994' that transitional arrangements 'should exceed 10 years only in exceptional cases'. The Commission's published documents clearly envisage a more gradual process, at least for some of the ACP countries, for example stating that the 'negotiations will take account of the level of development of the countries concerned, their capacity to adapt to the liberalisation process and to adjust their economies', and that a

review would take place ‘if necessary to modulate the rate of progress towards the *ultimate* (author’s italics) establishment of the free trade area, in conformity with WTO rules’.⁵ In addition, trade experts in the Commission have warned that the Uruguay Round has created new obligations and reinforced existing obligations in the WTO, so that significant exclusions in the coverage of an FTA would probably make it incompatible with WTO rules (as a result of a more rigorous definition and enforcement of ‘substantially all trade’), and thus liable to dispute panel litigation.⁶ EU agriculture ministers have expressed concern that this would require the inclusion of agricultural products in all FTAs;⁷ the Commission has sought to guard against this danger by stipulating that EU–ACP free trade agreements ‘must conform to the provision of the CAP’, but does not indicate how this could be made compatible with WTO rules.

Third, waivers would be needed for the Protocols providing special preferences for the ACP countries’ exports of beef, bananas and sugar. Sugar is a special case since the EU has, separately from the Lomé Convention, incorporated the ACP sugar quotas into its schedule of commitments under the Uruguay Round Agreement on Agriculture, and this may be sufficient to guarantee preferential access for the ACP sugar exports. The ruling of the WTO disputes panel on bananas has, however, created uncertainty over the legal status of country specific tariff quotas, and a further waiver would provide greater security from challenge in the WTO.

Fourth, the legal status for the EU’s extension of Lomé preferences to all the least developed countries under the GSP provisions of the WTO is also unclear, since it would discriminate between developing countries. Greater legal security for these concessions would be provided either through a WTO waiver, or through an amendment to the Enabling Clause which provides the legal basis for the GSP.

Waivers from WTO obligations either under Article IX of the Marrakesh Agreement or under Article XXIV.10 of GATT 1994 (covering free trade agreements) technically require approval by three-fourths of the WTO members, but in practice the WTO seeks to obtain a consensus, not least because this reduces the possibility of a future challenge to aspects of an agreement. It is worth noting, in the light of the successful appeal by the US and a group of Latin American

⁵ European Commission, *Recommendation* (Brussels, 28 Jan. 1998), p. 24.

⁶ *Free Trade Areas: An Appraisal*, SEC(95)322 (Brussels, 8 Mar. 1995).

⁷ *Establishment of Free Trade Areas and their Effects on Community Agriculture*, SN2295/96 (Brussels, 19 Apr. 1996).

countries against the EU's banana import regime for the ACP countries, that waivers provide legally sound exemption from the WTO obligations *for which the waiver is granted*. The Disputes Panel fully accepted the validity of the present waiver for Lomé and did not seek to challenge it, but considered that the banana import licensing procedures violated the condition of the waiver in causing 'undue difficulties for the trade of other contracting parties'; these procedures, in the Panel's opinion, were not specifically required under Article 168 of Lomé and were therefore not covered by the waiver; they were in breach of other WTO obligations; and there were other methods available to the EU to meet its obligations under Article 168 which were consistent with WTO rules. WTO waivers, if well defined to cover *what* needs to be waived and *which* obligations are being waived, are therefore legally secure, and the Commission is incorrect in implying otherwise in its list of problems of renewing Lomé,⁸ while the 'uncertainties' of the annual review which they refer to in the Green Paper do not exist, as this review is simply a formality for the purposes of transparency in the use of the waiver.

It is therefore an open question as to whether WTO members would be willing to grant an overall waiver covering the complex system of preferential agreements proposed by the Commission, which would *increase* the extent of discrimination between developing countries, or whether it would prefer to grant an extension to the existing Lomé waiver, especially if Lomé covered a wider range of developing countries than the least developed countries. A new Lomé V Convention could, for example, be based on 'open regionalism', providing automatic entry for all developing countries having regional trade links with ACP countries (for example in the Caribbean), or could include all developing countries fulfilling certain criteria of economic and social development. 'Graduation' rules, similar to those in the Community's GSP, could also be included in Lomé V to fulfil the WTO objectives that preferences are temporary, and that countries 'graduate' to full WTO disciplines and obligations. None of these, or any other possible modifications and improvements to Lomé, are considered by the Commission.

⁸ European Commission, *Green Paper*, p. 40.

Which regions?

The Commission's proposals envisage regional agreements being negotiated with the Caribbean (including the Dominican Republic), the Pacific and various sub-regional groupings in Africa. The Caribbean could possibly negotiate an agreement using the resources of the CARICOM Secretariat and the ACP Secretariat, but the Pacific lacks such an organisational structure and only has the South Pacific Forum. In the case of Africa, the Commission suggests agreements with UEMOA, UDEAC, SADC and EAC,⁹ covering West, Central, South and East Africa. There are, however, a number of practical problems with this proposal. First, these regional organisations do not comprehensively cover all of sub-Saharan Africa, but exclude nineteen countries, seventeen of which are least developed.¹⁰ Second, of the forty-eight African ACP countries, thirty-three are classified as least developed, and these have already been offered non-reciprocal Lomé parity in the enhanced GSP offer. This means that they are entitled to maintain existing restrictions on imports from the EU, whereas if they were to join a regional FTA which included non-least developed states, they would be obliged to provide free access for EU imports. The decision as to whether to rely on their existing preferences, or join a regional FTA, would therefore depend on whether the relative importance of the small amount of additional preferences available under an FTA for exports of clothing, agricultural and fishery goods to the EU outweighed the costs of opening their domestic market to EU imports, and also on whether or not Community aid was only available under a free trade agreement. If all of the least developed countries decided not to enter a free trade agreement, this would leave only five countries in SADC (Botswana, Mauritius, Namibia, Seychelles, Swaziland), two countries in UDEAC (Cameroon, Gabon), another two countries in UEMOA (Ivory Coast, Senegal), and Kenya in the EAC, which would then have to choose between reciprocal preferences

⁹ UEMOA (Union Economique et Monétaire Ouest Africaine): Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, Togo; UDEAC (Union Douanière et Economique de l'Afrique Centrale): Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea, Gabon; SADC (Southern African Development Community): South Africa (not included in ACP–EU trade cooperation), Angola, Botswana, DR Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, Swaziland, Tanzania, Zambia, Zimbabwe; EAC (East African Cooperation): Kenya, Uganda, Tanzania.

¹⁰ Least developed: Burundi, Cape Verde, Comoros, Djibouti, Eritrea, Ethiopia, Gambia, Guinea, Guinea-Bissau, Liberia, Madagascar, Mauritania, Rwanda, São Tomé & Príncipe, Sierra Leone, Somalia, Sudan; other ACP: Ghana, Nigeria.

and the standard GSP offer. Third, there are very wide differences within these regional groups in levels of economic development and, in particular, in the share of manufacturing in GDP; this has indeed been a fundamental problem limiting the potential for mutually beneficial trade integration.¹¹ These economic differences are compounded by political, cultural and historic differences. Given these large structural differences within regions, it is difficult to see how these, or any other regional groupings, could achieve a consensus on the key elements of an FTA concerning product coverage, the timing and phasing of liberalisation, and the necessary financial and technical assistance from the EU to facilitate the introduction of reciprocal preferences. In view of these inconsistencies and the substantial omissions in the Commission's proposals, it is tempting to conclude that the enthusiasm for regional agreements has more to do with a mercantilist framework for the formulation of trade policy in the EU, and the regional and sub-regional organisational structure of the EU bureaucracy, than with the development of a rational structure for ACP–EU relations.

SIMULATION OF THE STATIC EFFECTS OF A FREE TRADE
AGREEMENT

Even if these obstacles can be surmounted, the question still arises as to whether the regional free trade agreements proposed by the European Commission will provide benefits to the ACP states, sufficient to outweigh their disadvantages. The welfare increasing effects on an ACP country from an FTA will arise first, because less efficient and more expensive domestic producers, which previously only survived because of protection, will be replaced by more efficient and less expensive imports from the EU. Second, consumers of imported products will gain as a result of having to pay less for goods previously imported from the EU at tariff inclusive prices, and also being able to purchase a larger volume of imports at the lower price. These production and consumption effects together produce the welfare gain of *trade creation*. Against this must be set the welfare decreasing effect of *trade diversion*, arising from the fact that, prior to the FTA, the EU and the rest of the world (RW) were competing in the ACP market on

¹¹ For an analysis, see F. Faroutan 'Regional integration in sub-Saharan Africa; past experience and future prospects', in J. De Melo and A. Panagariya (eds.), *New Dimensions in Regional Integration* (Cambridge, 1993).

equal terms. After the agreement, when protection only applies to RW imports, ACP countries will substitute imports from the EU for goods from RW. Since it was worth importing these goods before the introduction of the FTA, we can assume that this is a substitution from a cheaper, more efficient, RW source of supply to a dearer and less efficient EU one. In addition, revenues from import duties will fall from their previous level, first, because pre-FTA imports from the EU will now enter duty free, and second, because dutiable imports from the RW will decrease as a result of the trade diversion effect.

The size of these effects can be expected to vary substantially between ACP countries, but we can indicate the key determinants of these effects and the general orders of magnitude involved. Illustrative models of the potential effects on trade flows and ACP import revenues are given in Table 1.

The trade creation effect will depend upon two factors. The first is the extent to which ACP domestic production can be substituted by imports from the EU, as a result of the abolition of duties on EU goods. The second is the effect of a decrease in the price of imports from the EU on the volume of goods imported into the ACP. These changes in domestic supply and demand can be summarised in the price elasticity of demand for imports. Given the wide differences in the structure of production and in incomes, tastes and preferences between the ACP countries and the EU, we would expect the price elasticity of demand for imports from the EU to be quite low. (These terms and their values are explained in Table 1.) The trade diversion effect will depend upon the elasticity of substitution between imports from the EU and RW. Currently, 84 per cent of African ACP imports from the EU are industrial products which typically have much lower elasticities of substitution than homogenous products, such as coffee and cocoa beans, but with values greater than unity because of competition between the EU and suppliers in the rest of the world; the models, as explained in Table I, conservatively assume values of -2 and -3 .

The calculation of the increase in imports as a result of the trade creation and trade diversion effects also requires assumptions on the level of pre-FTA tariff protection and the share of the EU in total imports. Data on tariffs on manufactured goods for twenty African ACP countries indicates that they fall into two broad groups,¹² with one group with tariffs of around 15 per cent, and a second group with

¹² World Bank, *World Development Indicators 1997* (Washington, 1997); World Trade Organisation, *Trade Policy Review: Mauritius 1995* (Geneva, 1996).

TABLE I
Simulation of the effects of an ACP–EU free trade agreement

	Initial share of EU in total imports (%)	
	33	55
Model 1 $e = -0.5$, $t = 15\%$, $\sigma = -2.0$		
Increase in total imports as a result of trade creation (%)	2.2	3.6
Increase in imports from the EU as a result of trade diversion (%)	5.3	5.6
Post-FTA share of EU in total imports (%)	39.6	64.2
Increase in EU exports (%)	22.4	16.7
Decrease in import revenues	-38.6	-60.6
Model 2 $e = -1.0$, $t = 30\%$, $\sigma = -3.0$		
Increase in total imports as a result of trade creation (%)	7.7	12.7
Increase in imports from the EU as a result of trade diversion (%)	12.5	12.4
Post-FTA share of EU in total imports (%)	49.7	71.1
Increase in EU exports (%)	60.5	45.7
Decrease in import revenues	-45.8	-67.4

Notes

e = price elasticity of import demand; values of -0.5 and -1.0 indicate that a 1 per cent decrease in the price of imports from the EU would lead to 0.5 and 1.0 increases, respectively, in the volume of demand for EU goods.

t = tariff.

σ = elasticity of substitution between imports from the EU and the rest of the world; values of $\sigma = -2$ and -3 indicate that a 1 per cent decrease in the price of imports from the EU, relative to that of imports from the rest of the world, will lead to 2 per cent and 3 per cent increases respectively in volume of demand for EU goods relative to the rest of the world.

tariffs of around 30 per cent.¹³ The EU's share of imports by African ACP countries varies from 26 per cent for Zimbabwe to 80 per cent for Angola, with an average share of 52 per cent for a sample of twenty-four African states.¹⁴ The average share for six of the nine non-least developed countries in the sample was 53 per cent and for the remaining three countries (Kenya, Mauritius and Zimbabwe) was 33 per cent; the models therefore assume values of 33 per cent and 55 per cent for the shares of the EU in ACP imports.

The parameters can be combined in a number of ways, and two basic models are presented in the table, with the second model reflecting the tendency for the more industrialised African ACP countries such as

¹³ Half the sample had average tariffs ranging from 25–38 per cent with a median value of 32 per cent, while the seven non-LLDCs had a median tariff of 30 per cent. The remaining countries had tariffs of 3–18 per cent with a median value of 14 per cent.

¹⁴ United Nations Conference on Trade and Development, *Handbook of International Trade and Development Statistics*, 1994 (New York and Geneva, 1995).

Kenya, Mauritius, Nigeria, Senegal and Zimbabwe, where we may expect higher price elasticities of demand for imports and higher elasticities of substitution between different sources of imports, to have quite high levels of border protection.

A number of general conclusions can be drawn from these observations. First, the large differences in the economic structures of the ACP and EU countries mean that the beneficial trade creation effect will, almost certainly, be significantly outweighed by the welfare reducing trade diversion effect. Only if both the initial level of tariffs and the share of the EU in imports are high, and the price elasticity of demand for imports is unity or above (i.e. the decrease in import prices leads to a proportional increase in the demand for imports), could we obtain a significant trade creation effect which could equal or outweigh the trade diversion effect. Second, the generally modest increase in total imports (as a result of trade creation) should not, even in a static sense, create serious balance of payments problems which could not be dealt with by conventional adjustment policies, if necessary assisted by short-term external financing. Third, in the static model, which assumes unchanged supply and demand curves, ACP exports will not benefit from the FTA, as they already receive preferential access to the EU market, but EU exports to the ACP gain substantially through the combination of trade creation and trade diversion.¹⁵ Fourth, revenue from import duties can be expected to fall substantially, both as a result of the removal of tariffs on imports from the EU previously subject to duties, and through the trade diversion effect reducing dutiable imports from third countries. The effect of this on government revenues will, of course, depend on the share of import duties in total government revenue, and (limited) information on this indicates levels of around 20 per cent and 40 per cent,¹⁶ implying a substantial fall in government revenue; ACP countries could therefore need assistance during the transitional period of implementing the FTA, in addition to any aid provided under structural adjustment programmes. Technical assistance could be provided to broaden the sources of government revenue and financial assistance, in the form of short-term budgetary assistance provided during the initial years of free trade. There is a

¹⁵ It is, perhaps, with this general effect in mind that the European Commission in *Free Trade Areas: An Appraisal*, Brussels SEC(95)322 final, 08.03.1995, states that ‘The EU does, however, have an over-riding economic interest in increasing its trade... [and] ...stands a good chance of achieving an improvement in its balance of trade with the FTA partner, particularly if the latter has significantly higher tariffs on products which are of interest to EU exporters’ (p. 15).

¹⁶ See, for example, World Bank, *African Development Indicators* (Washington, 1995), and *World Development Indicators 1997* (Washington, 1997).

danger that governments may try to offset the elimination of duties on imports from the EU by increasing duties on imports from the rest of the world.¹⁷ This, however, would be counterproductive, as it would strengthen the welfare reducing trade diversion effects, and further decrease the volume of dutiable imports and therefore revenues. A free trade agreement would therefore be most effective as part of a policy of unilateral trade liberalisation, reducing border protection on all sources of imports.

We have assumed that markets are competitive and that, given the generally large share of EU in African imports, domestic prices will fall by the full amount of the tariff. Markets, particularly perhaps in SSA, are often imperfectly competitive or oligopolistic, and the gains from the FTA may therefore largely accrue to ACP importers and distributors, in the form of higher profits. The small size of the domestic market and the importance of ex-colonial links can also lead to a lack of competition between foreign suppliers; there is evidence to suggest that EU exporters are able, in some markets, to charge prices which are 20–30 per cent above world prices.¹⁸ In this case, also, the trade creation and trade diversion effects will be correspondingly reduced and the FTA will simply lead to a transfer of tariff revenue to EU exporters.

This analysis only indicates the final, static, effects of a free trade agreement, ignoring the effects of alternative transitional arrangements leading to the formation of an FTA. As already noted, the 1994 GATT agreement states that duties and other restrictive measures have to be eliminated on ‘substantially all trade’, over a period which ‘should exceed 10 years only in exceptional cases’. In the case of the 1995 FTAs with Tunisia and Morocco, the EU agreed to continue the duty-free access for manufactured goods (except textiles, which will be liberalised in accordance with the WTO Agreement) first established under the 1976 Co-operation Agreements, and to provide concessions on agricultural products. Morocco and Tunisia have agreed to liberalise imports from the EU of industrial goods over a twelve-year period, with intermediate products and capital goods being imported under substantially reduced duties in the earlier part of the agreement, while

¹⁷ Most African countries which are members of the WTO have declared bound tariff rates well in excess of applied rates, so that there is ample scope, within WTO rules, for such measures, see P. Sorsa, ‘Sub-Saharan Africa’s own commitments in the Uruguay Round – myth or reality?’ *The World Economy* 19, 3 (1996), 287–305.

¹⁸ A. Yeats, ‘Do African countries pay more for imports? Yes’, *World Bank Economic Review*, 4 (1990).

the most protected consumer goods will only be liberalised to a significant extent towards the end of the agreement.¹⁹

This pattern of transitional arrangements, common to most EU agreements, has the effect of increasing the degree of tariff escalation and therefore, in general, increasing the effective protection in the EU's partner country. The rationale is presumably to provide domestic industries with a 'breathing space', during which they can adjust to free trade with the EU; but it runs contrary to structural adjustment policies, which seek to reduce the dispersion of rates of duty, so as to minimise the incentive to allocate resources on the basis of incentives artificially created by the structure of effective protection, rather than as a result of the comparative advantage of the country. Specifically, the danger with this time path of liberalisation is that producers may adopt a short-term view, and allocate resources towards sectors where profits have increased (because of the increase in effective rates of protection), rather than using the transitional period to adjust to increased competition from the EU by raising productivity and product standards, or investing in new activities in which they have a comparative advantage over imports from the EU. The Tunisian government has, with EU support, introduced a programme of financial and technical support to help firms adjust to the free trade area. This programme has, however, encountered fundamental problems in discriminating between potentially competitive and uncompetitive firms, assessing the true costs of adequate adjustment assistance, and ensuring that these resources are efficiently used for the agreed objectives.²⁰ This experience suggests that the phasing of tariff reductions should be structured so that there is no increase, and preferably a decrease over time, in the rates of effective protection. Adjustment support to local industries should be selective and conditional on the attainment of performance criteria, and the whole programme needs to be continuously monitored, and if necessary adapted, to ensure its effectiveness. In addition, the broader economic environment in terms of macroeconomic policy and the efficient operation of markets for goods, services and labour, needs to be conducive to the adjustment process.

¹⁹ For further details see B. Hoekman and S. Djankov, 'The European Union's Mediterranean free trade initiative', *The World Economy* 19, 4 (1996), 387–406.

²⁰ M. K. Nabli, 'The European Union – Tunisia Free Trade Area Agreement and some lessons for South Africa', Paper presented at the Trade and Industrial Policy Secretariat Annual Forum, Johannesburg, 22–23 September 1997.

GROWTH ENHANCING EFFECTS OF A FREE TRADE AGREEMENT

These static effects influence only the *level* of national income and, particularly for developing countries, long-run dynamic effects on the *growth* of income are probably more important. For example, access to lower cost imports of intermediate goods and capital goods could permit the production of goods not previously economically viable. Decreased levels of protection and increased competition may produce 'x efficiency' gains, while access to the large EU market may enable further economies of scale. The higher growth of income and liberalisation of trade could increase savings and domestic and foreign investment in the economy, producing a further growth in income. All of these gains, however, could be obtained through general trade liberalisation. What are the potential, specific, benefits from a free trade agreement, and are these likely to flow from ACP–EU agreements?

An FTA is a legal agreement binding on both parties, and if the FTA is a sub-regional agreement between the EU and a number of SSA countries, then any one country reimposing barriers to trade with either the EU or a member of the sub-regional group would also have to take the drastic step of leaving the FTA. In this important sense an FTA could be said to 'lock in' trade liberalisation policies, making them irreversible, and lending credibility to these policies in the eyes of domestic and foreign investors, thus providing a major impetus to the regional integration process under way in ACP countries.²¹ Also, being of indefinite duration, an FTA may be regarded as providing a more secure and stable access to the EU market than preferences, which are of limited duration.²²

The difficulty with this argument is that an FTA only 'locks in' trade liberalisation with the EU and not overall trade. On the other hand, African countries obtain on average 54 per cent of their imports from the EU and rely on the EU market for 60 per cent of their exports, and so it could be argued that an FTA would 'lock in' at least half their trade. This strong reliance on the EU market, however, is higher than for comparable regions such as Latin America's dependence on the US (37 per cent for imports and 46 per cent for exports), and South and

²¹ There is a large body of empirical evidence supporting the propositions that trade liberalisation leads to higher growth rates, and that economies which perform poorly are characterised by low levels of trade policy reform: see C. Kirkpatrick and J. Weiss, 'Trade policy reforms and performance in Africa in the 1980s', *Journal of Modern African Studies*, 33, 2 (1995), 285–298.

²² European Commission, *Green Paper*, p. 41.

TABLE 2
Growth of African exports by destination 1980–1994

	Share in non-oil exports (1994) %	EU share of exports (1994) %	Ann. ave. growth of exports to EU 1980–94 %	Regions where export growth was greater than growth to EU 1980–94 %
Food	34.3	61.7	0.6	S, SE Asia (6.5); Canada (9.4); Japan (8.1); S. Africa (3.6)
Agric. raw materials	13.3	55.8	1.6	Africa (7.7); S, SE Asia (13.8); S. America (5.3); S. Africa (5.6); W. Asia (11.0)
Ores & metals	12.2	42.9	-5.4	S, SE Asia (16.1); Australia & New Zealand (19.4); W. Asia (14.1)
Manufactures	40.2	65.0	9.4	US (13.2); S. America (11.0); Canada (9.6); Australia & New Zealand (16.0); W. Asia (13.0)

Source: UNCTAD *Handbook of International Trade and Development Statistics 1995* (New York and Geneva, 1997).

Southeast Asia's on Japan for imports (22 per cent) and the US for exports (22 per cent); it can indeed be argued that this market concentration is a source of weakness rather than strength.

Table 2 shows the growth of sub-Saharan African non-oil exports (fuels account for 55 per cent of total exports and exports to the EU) by destination over the period 1980–94. Growth rates to non-EU markets have to be interpreted with caution because they are on a relatively low base (reflecting the dominance of the EU market), but it is worth noting that exports to South and Southeast Asia and to some other markets have performed significantly better than exports to the EU. Even in the case of manufactured goods, the growth of exports to most other markets has been significantly higher than to the EU, despite Lomé preferences. These higher growth rates in turn reflect the higher growth of exports to these markets by all developing countries. The 1980s were a disastrous decade for Africa, but if we extend the period of analysis back to 1970, we find that the growth in demand for African exports by the EU has been lower than the growth in demand by developed countries as a whole, both for total African exports and for all categories of goods except manufactures. Even in the case of manufactures, the growth of exports to the USA and Canada was

higher than to the EU, despite Lomé preferences being superior to GSP preferences in the North American market.

The slow growth of ACP exports may thus in part result from their high level of dependence on the EU market – a dependence which, as previously discussed, can be expected to increase with a free trade agreement. In addition, a free trade agreement with the EU may make it more difficult for African countries to pursue policies of overall trade liberalisation. Scarce technical and administrative resources will be concentrated on the protracted negotiation of the FTA, while protectionist lobbies can be expected to demand increased restrictions to non-EU imports to compensate for increased competition from imports from the EU. A free trade agreement with the EU can therefore be regarded as a weak ‘anchor’ for trade liberalisation policies, and as an inferior substitute for liberalising trade on a global basis and ‘locking’ this in by declaring (binding) these lower tariffs in the WTO at the actual applied rates of duty, rather than the present practice of declaring tariffs at notional rates which are a substantial multiple of the actual rates. The EU market will, of course, continue to be of considerable importance to Africa for the foreseeable future. It is essential, however, that exports are increasingly diversified not only by product but also to non-EU markets. Particularly important are those countries which are rapidly industrialising, and in which African exports can be expected to grow faster in relation to total demand for imports than in the EU, because they are complementary to the expansion of production and rising income levels in those countries.

It may be possible for ACP states to obtain concessions from the EU under a free trade agreement which would not be available through other means, for example exemptions from, or EU limitations on, the imposition of other protection measures, for which WTO rules are weak. The experience of recent negotiations of EU free trade agreements, such as those with Morocco and Tunisia (Euro–Med Agreements), the Central and East European countries (Europe Agreements), and currently with South Africa, indicates, however, that the EU is not willing to go beyond WTO disciplines in its free trade agreements. This conclusion is reinforced by the Commission’s proposals which emphasise the need for both parties to accede to, and implement, relevant international conventions on trade, investment and related matters (such as intellectual, industrial and commercial property rights, standardisation and certification, sanitary and phytosanitary measures, and labour standards). In reality, these measures directly benefit EU firms, although ACP countries may gain from a

resulting increased flow of investment and technology. No mention has been made by the EU of using the FTAs as a means of going beyond such international agreements.

The case for ACP–EU free trade agreements is therefore essentially a pessimistic one. First, the argument in terms of locking in and enhancing trade liberalisation is based on the view that in the absence of an FTA, the ACP countries will engage in little or no trade liberalisation. Second, the argument in terms of guaranteeing access to the EU market is based on the view that the current phase of liberalisation of world trade may be reversed at some time in the future, and that WTO membership will not provide adequate protection against discriminatory trade barriers being used by the EU against imports from the ACP countries. The first proposition is possible but does not sufficiently recognise the extent of trade liberalisation that has taken place in Africa (albeit, erratic and subject to reversal) and does not adequately take account of the second-best characteristics of an ACP–EU free trade agreement. The second proposition, while not impossible, is contrary to current trends in international trade and ignores the substantial gains to developing countries arising from the strengthening of WTO disciplines in the Uruguay Round.²³

HUB AND SPOKE EFFECTS OF PREFERENTIAL TRADE AGREEMENTS

This analysis of the likely static and dynamic effects of ACP–EU free trade agreements leaves out of account the additional effects of the Commission's proposals for the EU to conclude separate agreements, with differing content, with a number of ACP regions and sub-regions. It also ignores the wider picture in which the EU has already concluded twenty reciprocal trade agreements with other countries, notably in Central and Eastern Europe and the Mediterranean, as well as with the EFTA countries. The 'common denominator' in all of these agreements is the EU, which on the analogy of airline routing systems, becomes an EU–EFTA bloc 'hub', with 'spokes' radiating out through bilateral agreements to other countries and groups of countries. Such an arrangement creates a lower collective increase in incomes than that generated by an overall free trade agreement; the gains from this lower level of collective income are concentrated in the hub (the EU); and the agreements damage potential 'spoke-spoke trade', both within

²³ Only eight of the forty-eight African members of the ACP Group (excluding South Africa) are not, currently, members of the WTO, and have not applied for membership.

regions, and between regions such as the ACP on the one hand, and Eastern European and Mediterranean countries on the other.²⁴

These effects can best be appreciated by comparing the decisions facing exporters and investors in the EU and ACP countries under Lomé, with the Commission's proposed preferential trade agreements. Under the present arrangements, each ACP country maintains its own border restrictions and does not discriminate between imports from the EU and other non-regional suppliers. An EU producer has therefore to decide between exporting to the ACP market, or jumping over the border restrictions and servicing the ACP local or regional market through import substituting foreign direct investment. Such decisions will depend solely on the transaction costs of exporting as against the costs of producing in the ACP country, and on the size of the market. ACP exporters (whether local, regional, or EU companies based in ACP countries) can 'cumulate origin', that is, they can use imports from the EU, other ACP countries, and local resources in any combination to fulfil the minimum processing and value added criteria of the Lomé rules of origin (necessary to prevent trade deflection, that is third countries benefiting from preferences), in order to qualify for preferential treatment by the EU. This cumulation rule, therefore, potentially encourages intra-ACP trade as well as ACP–EU trade. At the same time, third countries can still supply the ACP market, provided the price of their intermediate products are sufficiently lower than EU prices to more than offset the EU duty on the final product.

Under the proposed new agreements, imports from the EU will enter ACP countries under a variety of arrangements, ranging from non-preferential duties (ACP countries covered by the GSP, or least developed countries under Lomé-type arrangements), through varying degrees of reciprocal preferences, depending on the content of the regional or sub-regional agreements. As a result, the less economically advanced ACP countries will either become more vigilant in maintaining the integrity of their border restrictions against imports from the EU being routed via more industrialised countries granting reciprocal preferences to the EU, or they will succumb to this pressure and conclude fully reciprocal FTAs with the EU, or liberalise all of their trade. The last two options will increase regional trade and integration, while the former will increase barriers to regional trade.

²⁴ For an analysis of these issues in the context of NAFTA and the Europe Agreements, see R. J. Wonnacott, 'Trade and investment in a hub and spoke system versus a free trade area', and A. Enders and R. J. Wonnacott 'The liberalisation of East–West European trade: hubs, spokes and further complication', *The World Economy* 19, 3 (1996), 237–52 and 253–72.

Variations in the content and terms of the various regional and sub-regional agreements with the EU will require rules of origin in the regional groups to be rigorously enforced, transaction costs of intra-regional trade will rise with the increasing complexity of administration, and resources will be diverted to exploiting rent-seeking opportunities opened up by the lack of symmetry between the ACP–EU agreements.

Producers, whether from the EU or other countries, in deciding how best to service the ACP market, will have the increased incentives of economies of scale and lower transaction costs in locating in the EU rather than an ACP country, since only the EU has preferential access (guaranteed by treaty) to all of the ACP countries which have concluded cooperation and partnership agreements. ‘The hub’s special advantages (over the spokes) in trade translates into an advantage in attracting investment’,²⁵ and this investment disadvantage of the ACP countries could become cumulative.

An additional complication arises if a separate free trade agreement is concluded between South Africa and the EU. South Africa would then be able to import capital goods and intermediate goods at duty free prices which, together with its resources of skilled labour and technology, and ability to achieve internal and external economies of scale, would enable South Africa to become a focus for trade in sub-Saharan Africa (SSA). In this case, South Africa would become a spoke to the EU hub and also a hub in SSA trade, with both the EU and South Africa facing varying degrees of discrimination in competition in SSA spoke markets. Also, in such a dual-hub system, South Africa is likely to become a centre for SSA exports destined for the EU market, further increasing its attractiveness as a location for production at the expense of SSA spokes.

The position of the Caribbean (CARICOM and the Dominican Republic) and Pacific countries is somewhat different, given their much higher dependence on non-EU markets. The EU argues that a free trade agreement with the EU would allow CARICOM to conclude other regional trade agreements, such as membership of NAFTA. Indeed, the Caribbean countries would, almost certainly, have to try to conclude such an agreement, as the introduction of reciprocal preferences for the EU but not for the US and Canada would probably be regarded as incompatible with the continuation of their special preferences under the Caribbean Basin Initiative. The US

²⁵ Wonnacott, ‘Trade and investment’, p. 246.

Congress, however, has already expressed its opposition to any extension of NAFTA or NAFTA-parity arrangements. The Caribbean countries (many of which are economically small and vulnerable) may therefore be faced with a dilemma: either they can retain their existing import protection, relying on the EU's standard GSP offer while trying to retain their important preferences for sugar, bananas and rice under the Protocols; or they can liberalise their trade with the EU and North America, and thus essentially engage in unilateral trade liberalisation. Similar considerations apply to the eight Pacific countries in their trade relations with Australia and New Zealand; five of these are in any case classified as least developed countries, and will therefore qualify for Lomé equivalent preferences under the EU's enhanced GSP offer.



The fundamental test of the efficacy of the proposals to introduce a greater degree of reciprocity and a stronger regional dimension into ACP–EU trade relations, is whether they would help the ACP countries to become more competitive in world markets, increase the growth and stability of their exports through product and market diversification, and generally enable the ACP countries to integrate more fully into the world economy. The analysis in this article suggests that the proposals are unlikely to pass this test, at least for the African countries.

The static effects of reciprocal trade preferences are likely to be negative, and the recent experience of the EU's preferential trade agreements indicates that agreements with the ACP are unlikely to provide concessions which extend those already obtained under Lomé, or go beyond WTO disciplines in areas such as providing limitations on the use of contingent protection.

African economies have implemented import liberalisation programmes to varying degrees, and although forty of the forty-eight African ACP countries are members of the WTO, most have declared bound tariffs at levels well above applied rates.²⁶ Free trade agreements could potentially assist by acting as an 'anchor' for trade policy reform, since the agreements are essentially irreversible. They are, however, a limited anchor, only liberalising imports from the EU and not total trade. There is also a danger that extended trade negotiations with the EU could divert scarce specialist manpower from the development of

²⁶ Sorsa, 'Sub-Saharan Africa's own commitments'.

a general trade liberalisation programme or, even worse, induce governments to compensate for the loss of tariff revenue on imports from the EU by increasing duties on imports from the rest of the world. The ‘anchor’ principle can likewise only be effective in producing gains for the economy if import prices fall in response to the abolition of duties. African markets are generally small, imperfectly competitive and often dominated by a small group of EU exporters; and a significant proportion of the decrease in duties is therefore likely to result in higher profits rather than lower prices.

The Commission’s proposals for differentiation by region and level of development fall a long way short of the standard textbook free trade area model, and would require a greater variety of WTO waivers than a renewal of the present waiver for Lomé. It is also difficult to see how they could be implemented, since the ACP countries do not constitute homogenous regions and, given the EU’s offer for an improved GSP, there appears to be little incentive for the least developed ACP countries to agree to a reciprocal free trade agreement, unless EU aid is tied to such an agreement. Most importantly, these complex proposals would greatly increase the extent of discrimination in both ACP–EU and intra-ACP trade relations, while ‘hub and spoke’ effects would divert the gains from trade towards the ‘super hub’ of the EU and, to a less extent, to regional hubs such as South Africa. Far from encouraging regional integration and cooperation, and integrating the ACP countries more fully into the world economy, the proposed arrangements would create additional barriers between sub-regional ‘spokes’ and tie the ACP countries more closely to the EU market.

What is the best strategy for the ACP countries? First, it is important that they minimise the differences in any regional or sub-regional trade arrangements with the EU. Second, any reciprocal preferences with the EU should be part of an overall policy of import liberalisation, so as to minimise the adverse effects of reciprocal preferences. Third, they should recognise that trade preferences are not, and were never envisaged as, a permanent source of comparative advantage. Multi-lateral trade liberalisation has greatly reduced the importance of trade preferences since 1975, and significant preferences are now confined to certain sensitive agricultural and manufactured goods (principally clothing), while the margin of preference available to the ACP on these products is further reduced by the EU’s complex web of preferences with other developing countries and transitional economies. Fourth, the ACP countries should recognise that the proposals need to be interpreted in the context of the EU’s tendency to use trade policy as

a tool of foreign policy, with regional and bilateral trade agreements as the main policy instruments. It is also useful to recognise that the Commission is an efficient producer of 'complex solutions where every party can find one of its ideas',²⁷ rather than the originator of a coherent strategy to assist developing countries. The ACP countries should be aware of such pressures, negotiate as far as possible as one group, and encourage the opening up of Lomé preferences to as wide a group of developing countries as is practicable. The Uruguay Round has strengthened WTO disciplines, notably in the Disputes Procedures. As a result, preferential trade agreements are much less important as a guarantee of market access than they were when Lomé was first concluded in 1975. The more important potential benefits from further ACP–EU trade cooperation lie in negotiating policy measures and instruments which will help build the capacity of the ACP countries to export to a global market and not just to the EU market. Such aid and technical assistance agreements do not require complex preferential trade agreements, which distort the allocation of resources and distract policy makers from the essential task of integrating their domestic economies into the world economy.

²⁷ Patrick A. Messerlin, 'MFN-based free trade and regional trade: what role for the European Community?', *EU/LDC News* 4, 3 (1997), 1–11.