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Europe's trade strategy: promise or peril?

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›› Some Europeans are tempted to shift trade policy away from *laissez-faire*. As China and other emerging powers seek to lock up foreign trade, investment and resources for their firms, EU member states are tempted to respond. In straitened circumstances, and desperate for sources of growth, European governments are drumming up exports through commercial diplomacy and by brokering deals, particularly in energy. Member states differ on how far governments should directly try to steer trade strategy; but all have embarked on a more systematic engagement with trade. This is not new policy, but more countries have been pursuing it, with more vigour, since the onset of the economic crisis.

A more politicised foreign economic policy is not entirely without merit. If EU member states worked together, they might be able to induce rising powers to rely more on markets, and less on state control.

However, the current tangle of competing 'geo-economic' policies is risky, and ineffective. Fiercer competition between EU member states does not augur well for the longer-term challenge of managing relative decline. Rising powers are proving adept at playing European countries off one another to strengthen their own positions. And most grievously, the EU is ignoring what most matters: the underlying productivity of its economy. Rather than obsessing about exports to the rest of the world, the EU should focus on measures to boost demand and internal trade through the single market. This, rather than politically-motivated trade deals, is the route to improving European living standards.

HIGHLIGHTS

- Europe's growth strategy is based on a larger trade surplus with the rest of the world to make up for slow domestic growth.
- Member states have pursued commercial diplomacy, in some cases undercutting EU efforts.
- The continent's short-term problem is a lack of domestic demand. The long-term problem is a slow rate of productivity growth.

THE EXPORT CONTEST

Germany has taken so-called 'geo-economics' furthest. Chancellor Merkel's trade and investment efforts are increasingly and conspicuously oriented towards China, through a flurry of high-level visits, investment delegations and trade fairs. The German government is agreeing to more foreign arms sales: between 2000 and 2010 the number of export deals approved by the state doubled.[1] Germany has hesitated little in striking out on its own in pursuit of its interests. It negotiated bilaterally with China to agree on standards for electric cars and associated renewables-related trade, undercutting the EU. It also struck bilateral deals with Kazakhstan and Mongolia on access to rare earths in response to China's restrictions on exports, undermining parallel EU efforts.[2]

While Germany attracts most attention, nearly all member states are moving in a similar direction. Denmark has created a new post, minister for Trade and Investment, in its Ministry for Foreign Affairs, charged with helping Danish companies win contracts. The new ministry has developed individual commercial partnerships with each of the BRICS countries.[3] The Netherlands is deploying a new commercial diplomacy strategy, of which one part is improved embassy support for businesses.[4] Poland is exploring the 'globalisation of Polish foreign policy', with more emphasis on trade beyond Europe.[5]

The French government has called for a new 'economic patriotism'. Spain has given its embassies a 'specifically economic mandate' and *'Marca España'* (the 'Spanish brand') is now the guiding principle of Partido Popular's foreign policy. Spain won train contracts in Saudi Arabia and Kazakhstan, which the Spanish king lobbied for; the latter contract is worth €1 billion over 15 years. Even the free trading UK has launched an overtly commercial foreign policy. Foreign secretary William Hague has restructured the Foreign Ministry around trade. David Cameron has instructed ambassadors around the world to report back on what they have done to back British business. The prime minister led the UK's biggest ever trade delegation to India; follow-up trips by Indian ministers secured the two countries' biggest ever joint investment packages, worth more than €5 billion. The UK now strives to be 'the Gulf's commercial partner of choice': a network of new bilateral accords has been constructed across the region to back British businesses in beating the competition to contracts.[6]

Member states have pursued economic diplomacy in different forms. German state bodies plan a broad-based mercantilist strategy to boost the exports of its *Mittelstand*. The French government favours a narrower diplomatic backing of national champions to secure contracts in global markets. The UK, Netherlands and Nordic countries have become keen actively to promote exports, but are more reluctant for the state to cut overtly across multilateral rules.[7]

The Commission has become increasingly concerned about member states bending rules to support national champions in their global export drives.[8] While the Lisbon treaty enshrines a commitment to wrap bilateral investment treaties into single EU deals, in practice the scramble for exports has tipped the scales even more towards bilateralism and away from common EU approaches. Competition is increasing between member states for commercial access to emerging markets. This has not been accompanied by co-

1 Deutsche Welle, 'Arms exports show apparent hypocrisy of German foreign policy', 21 April 2011.
2 Hans Kundnani and Jonas Parello-Plesner, 'China and Germany: why the emerging special relationship matters for Europe', *Policy Brief 55*, European Council on Foreign Relations, May 2012.
3 Claus Grube, 'The international situation and Danish foreign policy in 2011', in Danish Institute for International Studies, *Danish foreign policy yearbook*, 2012, p. 24.
4 Huub Ruël and Lennart Zuidema, 'The effectiveness of commercial diplomacy: a survey among Dutch embassies and consulates', *Clingendael Discussion Paper* 123, March 2012.
5 DemosEUROPA conference, 'Poland and the world in 2030', 2012.
6 Lord Howell, Foreign Office Minister, 'UK relations with the GCC region: a broadening partnership', Speech, GCC and the City conference, 20 June 2012.
7 Maaike Okano-Heijmans, 'Power shift: economic realism and economic diplomacy on the rise', in E. Fels et al (eds), *Power in the 21century*, 2012.
8 Alex Nourry and Nelson Jung, 'Protectionism in the age of austerity – a further leveling of the playing field?', *Competition Policy International* 8: 1, Spring 2012.

ordination measures at the EU level. Support for common EU mechanisms on seeking debt purchases or investment contracts has not been forthcoming. There has also been debate in Brussels and Frankfurt about market intervention to lower the value of the euro as a means of boosting exports, in a mercantile strategy for recovery.

This uncoordinated export contest will do little to boost European prosperity in the short run. Europe's growth strategy is unduly reliant upon export growth, rather than building domestic demand. The eurozone is being reformed in Germany's image: an economy dependent on exports, with very low growth in domestic consumption and investment. But emerging economies will not be willing to buy more from Europe than they sell back, as their growth strategies are also founded on exports. Moreover, not all European countries can specialise, as Germany does, in machine tools, chemicals and infrastructure equipment that emerging economies need to build industrial capacity. The US is increasingly annoyed with the Europeans for piggybacking on American demand, rather than raising levels of consumption and investment at home.

European leaders should not fear global division of labour

For European countries to grow in the short term, they must restore domestic demand. But there has been no attempt at symmetrical adjustment to the debt crisis. The periphery of the eurozone must grow to pay down its debts. The core could help if it stopped saving so much (the inevitable consequence of a very large trade surplus) and boosted consumption and investment. Higher demand in the eurozone would help the continent to grow.

To succeed in the long term, Europe must raise the rate of productivity growth. While the Commission and several member states have introduced initiatives aimed at meeting this challenge, foreign economic policy pulls in the opposite direction. The unseemly scrabble for contracts to build Indian nuclear power stations or to sew up energy deals with Russia will do very little for domestic firms' rate of productivity growth, or for their innovative capacity. Europe's current trade strategy is mostly an exercise in states competing to select which European firms will export, rather than trying to make them become more productive companies. Long-term growth is founded upon productivity growth, not how many exports a country sells. Why else would the United States be the richest large economy in the world, but export far less than Europe? To boost living standards, Europe would do well to concentrate more on raising the level of trade between its members than increasing the volume of exports with the rest of the world. Such a strategy would deal with two unalterable facts about international trade: emerging economies are slowly producing higher quality goods and services; and to increase productivity and innovation in manufacturing and services – and thus maintain its position at the top of the value chain – Europe needs a good deal more competition between its firms.

Europe's foray into geo-economics involves a risk: it appears to neglect an understanding of the conditions that really drive growth.

EXTERNAL TRADE AND THE SINGLE MARKET

For decades before the 2008 crash, international trade grew much faster than the global economy as a whole. Trade slumped in 2009, but since 2010, this trend has reappeared. How can trade be growing faster than GDP? The answer lies in the growth of cross-border production: multinational corporations increasingly use international supply chains, so exports and imports grow faster than the economy. Container ship technology made international freight transport cheaper and faster. Governments reduced tariffs and subsidies that held back trade. The iPhone is designed in the US, while its chips are made in South Korea, and it is assembled in China.

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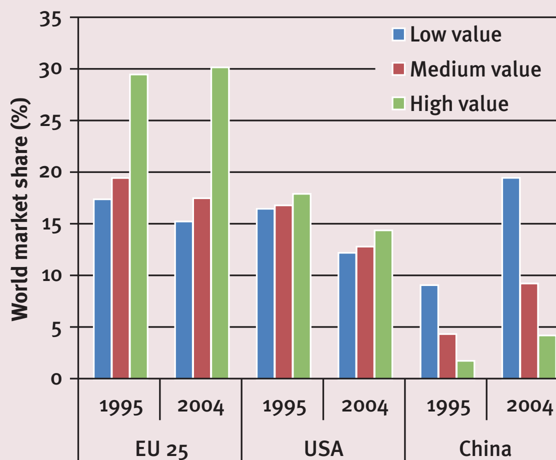
Two forms of specialisation underlie globalisation. The EU should take them into account when considering forays into geo-economic strategy. First, different countries specialise in production at different levels of quality and technological complexity, depending on the cost of land, labour and capital. In short, countries specialise in luxury or low-cost goods and services.

The trend towards specialisation by production value is long-standing. In the 1950s and 1960s, South Korea made lower 'value added' goods – textiles, steel and shipping – at scale, in vast quantities, for international markets. It had abundant cheap labour, and the government steered capital investment towards exports. South Korea specialised in goods where small margins on each unit turned into large profits when sold to millions of industrial and household consumers across the globe. China, Russia and then Brazil have since pursued the same strategy in their own way, specialising in manufacturing, energy; and agricultural and mineral commodities respectively.

To leaders in the developed world, this is double edged. Cheap goods from developing countries improve consumers' purchasing power, allowing them to buy more goods and services overall. Yet the world's markets in tradable goods are bifurcating: the developed world is losing unskilled and semi-skilled manufacturing work to the poorer, but fast growing countries. Global production is increasingly based upon factor costs: keeping high cost work with high margins in rich countries, and moving lower value added production to China and other developing countries.

This process is happening very quickly. Between 1995 and 2004, China's world market share in low and medium value goods doubled, while the American and European share shrank (see Chart 1). In the low value goods trade, Chinese companies took market share at a rate of 0.9 per cent a year. And it has plans to move into higher value goods, just as Japan has, followed by South Korea, Singapore and the other Asian 'tigers'.

Chart 1. Market shares in goods, by value



Source: European Commission, DG Trade, *Global Europe: EU performance in the global economy*, October 2008, p. 16.

However, European leaders should not fear this global division of labour. This is how the gains from trade are realised. The theory of comparative advantage holds that even if Germany is better at making low value added goods than China, it should still specialise in higher value added goods because it will make more money by doing so. There are losers in the process – namely, the poorly skilled – but this is better tackled by investment in education and by redistributive policies than by protecting domestic firms, which pushes up prices for all domestic consumers, including the poor.

The second form of specialisation is more local. Firms and workers making similar products clump together in clusters, such as biotechnology in Boston and finance in the City of London. Within countries, local communities of expertise are formed. Workers with specialist skills will move to an area where job opportunities are plentiful, encouraging firms that can use their skills to group together. Financiers specialising in particular sectors will do the same, hence the number of venture capital firms in Silicon Valley. Companies in sectors based upon scientific research, such as biotechnology, tend to cluster around universities. Nearby firms can also more easily learn from each other, borrowing innovations and headhunting innovators. And different companies in the same

supply chain – accounting firms, business consultants and multinational company headquarters, for example – reduce their transport costs if they are near each other.

As transport costs have fallen and international supply chains and markets have grown, local clusters are needed to keep a competitive edge in high value international markets. The US leads the world in information and mobile technology and applied science because of its clusters in Silicon Valley and around its world-beating universities. Germany's Rhineland manufacturing cluster is the main reason for the EU's very large trade surplus in manufactured goods: its medium and high technology cars, household durables and machine tools are of the best quality.

The EU has some significant strengths – and some big challenges to overcome – when these trends in international trade are taken into account. As China specialises in lower – and increasingly medium – value-added production, Europe has to focus on higher-value added work. The question is: how should the EU respond?

The EU's member states are still the biggest traders with the rest of the world – larger than the US. It has a strong position in high value added production, especially in pharmaceuticals, manufacturing, fashion, financial services, arms and aerospace. However, it could do better.

The EU should cultivate competition at home. Competition, among other things, drives productivity growth: when a company's profits are under threat from a more efficient competitor, it has a greater incentive to try to improve productivity. Competition also encourages more innovation. In competitive markets, consumers will quickly switch to companies that provide better quality products, or new products that satisfy an urge or an appetite, and even create new consumer tastes (mobile devices have satisfied an unrealised consumer desire for incessant communication in different formats, for example). If the EU could raise the level of competition its companies face, they would become more productive and innovative.

The obvious tool to raise the level of competition is the single market. On average, trade between the American states is four times higher than it is between EU member states.[9] This puts American companies under far greater competitive pressure: if a firm in New Hampshire has to compete with Californian firms – or those based in all 50 states – rather than those based in its own state, it must spend more resources on improving the efficiency of the production process and the quality of its products to survive. A more integrated market, with more common regulation and more mutual recognition, would raise competition between firms across the EU.

More integrated markets across the EU would also encourage firms specialising in particular industries to group together. There are still large barriers that firms – and indeed, workers – must hurdle to move from one member state to another.[10] The US also has far larger clusters of companies taking advantage of pools of skilled labour, learning from each other, and taking advantage of university-led innovation. This shows up in the proportion of workers employed in clusters: approximately 60 per cent of US employees work in industries with firms that are more clustered together in America than in Europe, compared to around a quarter of European workers employed in more clustered industries than in the US.[11] Lacking such geographic concentration, European firms do not take as much advantage of lower transport costs and specialist pools of labour, and all firms in the market do not take up new innovations as quickly.

9 Consuelo Pacchioli, 'Is the EU internal market suffering from an integration deficit? Estimating the 'home-bias effect', *Working Document,* Centre for European Policy Studies, May 2011.

10 See John Springford, 'How to build European services markets?', Centre for European Reform, September 2012, for barriers in the services sector, many of which are also prevalent in the goods sector.

11 Christian Ketels et al., 'EU vs US: A comparative analysis of geographical concentration patterns of employment across cluster categories', Swedish Network for European Studies in Economics and Business, May 2008.

European leaders would boost firms' performance by knitting Europe's markets more closely together. Policies they could deploy to do so include:

- Meaningful recognition of other member states' qualifications, and reductions in the number of regulated professions;
- Recognition by member states of each others' regulations, especially in the service economy;
- A tougher competition authority;
- A fully integrated energy system, regulated at the EU level, which would drive down energy costs;
- Policies to promote non-bank forms of finance: especially bond and equity markets for smaller European companies;
- A common corporate tax policy.

As a trade strategy, this is far more likely to be successful than trying to copy emerging economy 'geo-economic' strategy. If countries lock up commodities and agricultural products for themselves, rather than relying on market mechanisms, productivity in raw materials and farming will fall, and prices will rise. Developing economies may benefit from a fair amount of state control of investment to develop their heavy industry and manufacturing sectors. But developing economies have many more unused resources than rich countries, an so the state is more likely to pick winners than it would in an economy where resources are already largely employed and where productivity improvements are found by taking existing labour or capital equipment and deploying it more effectively in another way. In mature economies, productivity and innovation across the entire economy determine economic growth. Better productivity and innovation may mean that Europe exports more high value added goods and services. Or maybe not: more productive Europeans would have higher wages, and might decide to buy more expensive products themselves, rather than selling them overseas.

Many prominent writers have argued that Europe needs to devise a more ruthless strategy in pursuit of geo-economic interest as the core determinant of the continent's future prosperity.[12] It has become commonplace for analysts to argue that the EU needs to start meeting rising powers on their own terms. While it is convincing to urge the EU and its member states to get more serious about developing foreign economic policy, the geo-economic route is not the panacea it has become widely assumed to be. To succeed, Europe needs most of all to tend its own garden.

MAIN RECOMMENDATION

By conducting bilateral trade deals and commercial diplomacy, and brokering export sales, European governments hope that state action can drive up export sales. This strategy is wrong-headed: these deals undercut EU trade efforts, and are unlikely significantly to raise European exports as a whole.

Instead, the EU should focus on boosting trade between its member states, which will help to raise the continent's low rate of productivity growth – the key to long-term prosperity.

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[12] Stephen King, *Losing control: the emerging threats to Western prosperity* (Yale University Press, 2011); Dambisa Moyo, *How the west was lost* (Penguin, 2012); Parag Khanna, 'Europe needs a truly global action plan for 2020', in: Jan Techau (ed), *Strategic Europe* (Carnegie Endowment for International Peace, 2012).