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Economic Partnership between the ACP Countries and the EU

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Abstract
In this paper we explore the nature and effects of the Economic Partnership Agreements (EPAs) between the EU and groups of African, Caribbean and Pacific (ACP) countries. We argue that the direct economic effects from reciprocal trade liberalization - both positive and negative – may be rather limited. EPAs will only marginally increase access of ACP countries to the EU market and empirical studies on the static effects of preferential trade liberalization show a small negative effect on welfare for ACP countries. After that, we investigate ways in which the EPAs can be deepened so as to contribute to development: by increasing external financing options of firms in ACP countries; by expanding the role of the private sector and MNEs in economic development; and by supporting regional organizations.

Keywords: ACP countries, Economic Partnership Agreements

JEL classification: F15, F13, F54, O19

1 Introduction

The coming years will be decisive for the future of the special relation between the EU and the African, Caribbean and Pacific (ACP) countries, for it is marked by the prospective signing and implementation of the Economic Partnership Agreements (EPAs).[1] These EPAs should progressively remove trade barrier and enhance cooperation in areas related to trade. The EU has promised to use the EPAs as a main instrument for promoting economic development or, in the words of Commissioner Mandelson, '.... to put the EPA process under continuing review, so as to make sure that the process really does put development first." Also, cooperation based on notions of equality – for years the main selling point of the Lomé Convention - should not be at risk, or, again in the words of Commissioner Mandelson: '...the word partnership in Economic Partnership Agreement is not there by accident'.[2]

However, whether the EPAs are a turn for the better for development is hotly debated. The element of the EPAs that attracts most attention is that the trade regime between the EU and ACP countries moves from unilateral preferences by the EU given to the ACP countries to reciprocal free trade. As most of the imports from the ACP countries already enter the EU market free of duty, this change effectively means that ACP countries will open their markets for EU products, giving them preferential access when compared to third countries. Whether the ACP countries are able to cope with the increased competitive pressures or the need for adjustment and reform is questioned by academics, policy makers and NGO's alike. Hence, for effective partnership much will depend on how the benefits for free trade are shared between the ACP countries and the EU and the follow up arrangements to which the partners may commit in the future.

In this paper we argue that to make the EPAs a success for development, closer economic and political cooperation between the ACP countries and the EU is needed than is presently foreseen in the EPA arrangements. Our line of argument is as follows. We start by briefly reviewing the nature of the EPAs and the literature of such North-South preferential free trade initiatives. Together with many other authors we conclude that the overall welfare effect of a reduction in the barriers to trade (tariffs, quota) for EU exports is likely to be negative

[1] Articles 36 and 37 of the EU-ACP Agreement (Cotonou) signed in Benin on 23 June 2000.

[2] Both quotes are from a speech to ACP ministers, http://www.acp-eu-trade.org/library/files/Mandelson_EN_280606_EC_Word-Partnership-in-EPA-not-there-by-accident.pdf, December 12, 2006.

for most ACP countries. Hence, to make EPAs a success for development, they have to be deepened and accompanied by supporting measures. Where much of the literature consequently stresses the need for adjustment funds, we stress the importance of policy cooperation and policy learning. First, we argue that the EPAs provide a unique opportunity to concentrate on building and supporting institutions that induce good governance. Second, instead of focusing on market access of firms from ACP countries, to overcome supply side constraints the EPAs should support FDI and outsourcing from the EU to the ACP countries by creating a better investment climate. Third, much of the impact of the EPAs will depend on whether ACP countries succeed in attracting external private financing of economic activity. As the EU has a long history in liberalizing trade in financial services, EPAs can be used to support progress in this area.

2 The nature of EPAs between the EU and regional groups within ACP countries

The need to transform the trade chapters of the EU-ACP agreements as they were agreed first in Yaoundé then Lomé and finally most recently in Cotonou, became clear in 1995 when the Uruguay Round of international trade negotiations transformed the GATT agreement into the World Trade Organization (WTO). By their very nature, the ACP trade preferences obtained from the EU are a violation of article 1 of the WTO – the Most Favored Nation (MFN) principle – as these trade preferences are withheld to other developing countries, reserved as they are to countries selected on the base of their colonial past. In 2001, at the end of the Doha Ministerial, the ACP group of countries obtained a waiver valid until 2007. However, there seems to be no political consensus to renew this waiver after 2008.

The fact that the EU has lost several trade disputes recently over trade preferences has added to the pressure to make sure that its current trade regime is WTO compatible. For example, in the banana case against the EU it was argued that the EU violated the MFN clause of the WTO by giving special preference to its former colonies. Although giving preferences to developing countries is desirable on economic grounds - for example through the Generalized System of Preferences (GSP) - this is not allowed on non-economic grounds. Hence, retaliation measures were approved against the EU by the Dispute Settlement Body of the WTO. These damaging WTO challenges and the end of the waiver period have forced the EU to place WTO compatibility at the centre of its EPA policy. Further, due to its support in the WTO for a truly rules-based international trade regime, the EU is also putting itself under strong pressure to bring the EU-ACP relationship into conformity with WTO rules. In addition to this, the EU dislikes the concessions to third parties that the EU-ACP waiver implies and favors a move to reciprocity, as third countries (China, India, the United States) have increased their foreign trade penetration in African markets.

A second consideration for the EU to introduce EPAs relates to the poor results of the preferential and non-reciprocal trade agreements in the past. A few countries such as Mauritius clearly used these preferences – in this case for sugar – very effectively and based a successful mid-term economic strategy on them. However, economic performance in most ACP countries has not improved and in many cases has become worse during the decades of non-reciprocal preferences.[3] The core issue here that there is no point in obtaining preferences which cannot be matched at the supply side because of a poor economic and political environment, inadequate development policies, lack of transport facilities/infrastructure, conflicts and war.

The EU follows a two-step process in conducting the EPAs. First, it supports regional integration processes among ACP countries which should result in regional free trade areas. Second, the EU negotiates with groups of countries corresponding to regional organizations on the specifics of an EPA with that region. In a certain sense this process reflects the trade philosophy of the EU in that preferential trade liberalization is seen a supportive to multilateral liberalization. However, it also reflects the EU's view that regional integration among relatively small states in itself is good for development. Both these conjectures are open to debate.[4]

So far, ACP countries view agreeing to EPAs as a necessary evil to maintain their preferred trading position. However, due to the increased awareness that

[3] ACP countries share saw their share in total import by the EU reduced from 8 percent in 1975 to 2.8 percent in 2000. Nearly all commentators agree that the effects of the preferential trade relation between the EU and ACP-countries have failed to contribute to economic development. Some LDCs - of which many are member of the ACP group - utilize less than 50 percent of the size of EU preferences for their exports. Clearly, ACP countries face strong competition from the rise of non-ACP exporters in East Asia. Moreover, progressive trade multilateral liberalization and enlargement have reduced the value of trade preferences. Many studies show that these preferences have a negligible effect on the welfare in ACP-countries, see for an overview S. Laird, R. Safadi, and A. Turrini, 'The WTO and development' International Trade and Commodities Study Series, UNCTAD (2002). Hence, in the short run, increased market access for ACP-countries is unlikely to result in significant welfare gains.

[4] J. Bhagwati, J. Pravin, and A. Papagariya, Trading Blocs: Alternative Approaches to Analyzing Preferential Trade Agreements (MIT Press, Boston, 1999)

the EPAs may put strong pressure on domestic markets and industrialization processes, as the date of conclusion rapidly approaches, many ACP countries are starting to doubt whether the financial benefits from the preferred export position cover the substantive adjustment costs that come from increased competition from imports. Furthermore, there is a general feeling among the ACP countries that the EPAs tend to benefit the EU more than it does them.

To counter such claims, the EU argues that its exports - mainly industrial products - do not compete with domestic production in ACP countries. There is merit to this argument, however, manufacturing in ACP countries is an infant industry and should be given time to develop. Further, the production in ACP countries of industrial products may be low because world market prices are depressed as a result of the subsidies given by developed countries, see the support for aerospace in the US and the EU, and motor vehicles in Asia. Moreover, it is argued that domestic production is low because there is no incentive for exports to developed markets, due to high non-tariff barriers in manufacturing.

A second concern of ACP countries is that the emphasis on trade will reorient the focus of aid so as to make aid conditional on market access for EU products. The reason is that development funds for ACP countries may have to be shifted to achieve the goal of trade adjustment. Ominously, although the reciprocity of trade will entail costs of adjustment, the EU has not agreed to significantly increase the Economic Development Fund (EDF) that supplements the EU-ACP agreements.

To avoid competitive market pressures of the EPA process, the ACP countries have lobbied for the inclusion of elements of special and differential treatment (SDT) for North-South PTAs under article XXIV of the WTO, so as to increase the flexibility of preferential trade between economically unequal partners.[5] However, so far they have achieved limited success, not least because the EU seems reluctant to support the SDT initiative.[6] Moreover, a split between the EU and the ACP countries has arisen over the timing of the signing of the EPAs, as many ACP countries see the implementation of regional free trade as a prerequisite for EPAs, while the EU does not.

Another complexity is the issue of configuration. An EPA negotiation is complex in itself as it should match offensive and defensive trade interests of both

[5] B. Onguglo and T. Ito, 'How to make EPAs WTO compatible?' ECDPM discussion paper No. 40 (2003).

[6] 5 Currently, PTAs among developing countries fall under the WTO enabling clause, whereas agreements between developed and developing countries have to comply with the rules of Article XXIV.

sides. But in addition, national priorities have to be combined with a regional consensus within the ACP negotiating group. Within several of the groups some member states are bound in a customs union (CU) while others in the same group remain outside this CU. Contributions to the regional negotiating consensus on trade matters has to be reached together among the CU member states, for they have a common external tariff. This is the case for UEMOA within the West African group and for the Southern African Customs Union (SACU) within the Southern African group.

The problem becomes quite complex when member states of a CU negotiate in different groups which, for instance, is the case of the East African Community (EAC). Here, Tanzania negotiates in the Southern African group while Uganda and Kenya are in the Eastern African group. In the Southern African group, the problem is also evident as the dominant partner of SACU, South Africa, is not part of the negotiating group as it has already concluded its own free trade agreement with the EU. As the EU has agreed in article 37.5 of Cotonou that ACP countries are free to decide on membership of a negotiating group, its interventions are limited to behind the scene discussions with leaders and stakeholders in the concerned states.

A further complication is the distinction between LDC and non-LDC member states within negotiating groups. Most negotiating groups have member states belonging to both types of developing countries. Every EPA-negotiating LDC has obtained the so called everything but arms (EBA) concession from the EU, together with all non-ACP LDCs. This puts these countries in a different position to non-LDC countries that are trying to negotiate an EPA. EBA promises duty free, quota free entry into the EU market for nearly all products originating in LDCs. The effect is divisive within negotiating teams as LDC member states find themselves in a much more comfortable position in terms of market access to the EU and in no need to discuss trade concessions to the EU. Combined with the configuration issue, matters can become extremely complex.

Hence, if LDC countries opt for an EPA instead of the EBA, it may be for the 'wrong' reason. Given that most of the aid flows will be marked as aid for trade in the context of an EPA, countries that contemplate the EBA route fear that this strategy will reduce their potential for aid. Hence, many LDC countries see the trade-off as between the costs of reciprocity versus the non-reciprocal EBA and the benefits of qualifying for EU aid. Clearly, if the aid component and rules of origin of the Cotonou agreement remain intact for non-EPA members, many LDCs may switch strategy.

The same type of argument holds for the non-LDC countries. If reciprocity within the EPA would erode the competitiveness of certain important sectors too much, abstaining from the EPA would 'condemn' such countries to the GSP-system. This would severely erode their preference margin and they would have to compete with countries that have a significantly higher level of economic development.
To conclude, following the regionalization of the ACP countries, a last issue is the future of the Cotonou Agreement itself. The agreement was signed in 2000 with a validity of 20 years and beyond its trade paragraphs - which will be without substance once EPAs come into effect - there are many others aspects of association such as political dialogue, development finance support and technical cooperation. Will the political desire to keep together all ACP countries continue to exist after the signing of the EPAs? There are in principle 12 more years to consider whether this is the case, corresponding more or less with the anticipated transition period for EPA adjustments and breakdown of tariffs against the EU. Will the ACP countries survive as an independent group? There are signs that they will not. For example, most ACP states in Africa are members of new institutions such as the African Union with the idea that former colony groups could cease to be relevant. Further, two North-South organizations created respectively by the UK and France (the Commonwealth and the Francophonie) are closely associated with the EU in the preparation phases of EPAs, including the distribution of funds for research and capacity building through them. Hence, there is sufficient reason to be concerned that the EPA process ultimately will put the EU-ACP relations to an end.

3 Traditional trade effects of EPAs

Since many of the products of the ACP countries already enter the EU market free of duty, the most important change of the EPAs is that exports form the EU will enter freely on ACP markets. Hence, this section investigates the welfare effects of such preferential access and summarizes the findings of the many empirical studies that have been conducted in this area.
Standard economic theory argues that regional trade induces two efficiency gains and one loss. First, as the price of imported goods declines, real incomes rise. What is often less well understood is that this effect also (theoretically) nullifies the argument that trade liberalization causes a loss in government revenue. If a

country is small and, hence, there are no terms of trade gains from protection, domestic consumers pay the tariff for exporters to their own government in the form of higher prices. Therefore, as long as the good is imported, consumers gain more from the reduction in prices than the government wins. For this reason, a domestic lump sum tax should counter the revenue loss, while leaving the price mechanism to freely allocate goods. But clearly, when tax reform is not part of the agenda, reciprocal trade liberalization will transform public income into private income. Then, if public goods - because of externalities - create a higher social surplus than private consumption, trade liberalization entails a social welfare loss.

A second efficiency enhancing effect is that lower prices for imports make production at home wasteful in economic terms. However, this efficiency gain presumes that factors of production that flow out of the import competing sector find employment is sectors in which the country has a comparative advantage. Often, this assumption is not satisfied, certainly not in the short-term. For example, on study estimates that 75 percent of industries in Ghana will disappear following an EPA with the EU.[7] Certainly, when creative destruction of import competing industries is not matched by the creation of export sectors, many factors of production will remain unused.

The specific problem of EPAs is that they introduce preferential trade liberalization. In contrast to multilateral trade liberalization, this gives rise to the well known effects of trade diversion and deflection: Given that consumers pay the tariff to their own government - so that these cannot be viewed as a social loss- when trade diverts to less efficient producers (car producers from the EU when compared to those in, for example, China), consumers simply pay more for the same type of products. It has been argued that that the diversion effect for the ACP countries can be mitigated by lower MFN tariffs, however, this comes at the costs of an even larger fall in tariff revenues.[8] Many empirical studies have been conducted to investigate the economic effects of EPAs on ACP countries.[9] Although the effects differ for specific countries, most studies

[7] Eurostep 'New ACP-EU trade arrangements: New barriers to eradicating poverty?' (2004) Brussels, Belgium , (http:/www.eurostep.org/pubs/trade_study.pdf).

[8] L. Hinkle and M. Schiff, 'Economic Partnership Agreements between Sub-Saharan Africa and the EU: A development perspective' 27(9) The World Economy (2004), pp. 1321-1333.

[9] For the potential effects of an EPA for the Southern African Development Community (SADC) countries see M. Tekere and D. Ndlela, 'Impact Assessment of Economic Partnership Agreements on Southern African Development Community and Preliminary Adjustment Scenarios' (2003) Trade and Development Studies Centre: Harare, Zimbabwe. They find that the majority of consumers would have net benefits of reciprocal free trade but also a large trade diversion effect for most of the SADC countries. For a study on the impact of an EPA with

conclude that the EPAs will affect welfare negatively in ACP countries. The reasons are, first, that due to capacity constraints the ACP countries are unable to take advantage of improved market access. Second, trade expansion effects are likely to be small, as purchasing power in ACP countries is low. Third, trade creation effects are also likely to be small, as ACP countries lack the financial infrastructure to set up new industries for taking up the factors of production that have become obsolete in the import competing sectors. For this reason, even in the medium term the EPAs are likely to create unemployment. Fourth, although the EU already is the main trading partner of the ACP countries, trade diversion effects are likely to be large. Especially, government revenues from trade fall, whereas only part of this gain is transferred to the pockets of domestic consumers. Consequently, the EPAs will put pressure on public service provision and debt repayment.

Moreover, the negative static production effects are often seen as small relative to the potential detrimental dynamic effects of preferential trade liberalization. The reason for this is that when trade is liberalized without policy intervention, developing countries would specialize in the 'wrong' products that have low profitability in the long-term and have volatile prices for their agricultural products and natural resources. Hence, EPAs that liberalize trade may undo industrialization efforts in many LDCs.[10]

Summing up, the bulk of the empirical studies find that EPAs will reduce welfare in most ACP-countries. The main reason is that EPAs will destroy domestic production without creating new employment opportunities and, in the absence

COMESA see COMESA, 'Discussion Paper on Trade Policy Compatibility and Impact Assessment of Economic Partnership Agreements and Preliminary Adjustment Scenarios.' (2002) COMESA Secretariat: Lusaka, Zambia. This study also finds a loss of 25% of trade taxes for its members. For a study on ECOWAS that finds that the effects of an EPA are unevenly distributed over the members, where Cape Verde loses 80% of its trade taxes and 20% of government revenue, see M. Busse, A. Borrmann, and H. Grossmann, 'The Impact of ACP/EU Economic Partnership Agreements on ECOWAS Countries: An Empirical Analysis of the Trade and Budget Effects' (2004) Hamburg Institute of International Economics: Hamburg, Germany. Also for Botswana, Mauritius and Mozambique the trade diversion effects are likely to dominate the trade creation effects, see M. Meyn, 'Are Economic Partnership Agreements likely to Promote or Constrain Regional Integration in Southern Africa? Options, Limits and Challenges Botswana, Mauritius, and Mozambique are Facing' (2004) NEPRU Working Paper: Windhoek, Namibia. These findings are confirmed in an extensive survey on the impact of EPAs in ACP countries, see Price Waterhouse Coopers, 'Sustainability Impact Assessment of the EU-ACP Economic Partnership Agreements' (2005).

[10] J. Stiglitz and A. Charlton, 'Fair Trade for All: How Trade can promote Development' (2005) Oxford; Oxford University Press New York 2005); B. Greenwald and J. Stiglitz, 'Helping infant economies grow: Foundations of trade policies for developing countries' 96 American Economic Review Papers and Proceedings (2006), pp. 141-46.

of valid social security nets to support those affected, this is a very serious issue with important political implications. In addition, because of the trade diversion effect, developing countries may end up paying more, not less for their imports.

4 Deepening the Economic Partnership Agreements

In the previous section we have argued that EPAs that concentrate on reducing barriers to trade alone will have a negative effect on the economic development of ACP countries. The main reason is that the EPAs will not increase market access for ACP countries but do increase the competitive pressure on their firms. As factors of production can then only shift towards local market activities – subsistence farming, low productivity services etc. – liberalizing trade in a preferential way without meaningful opportunities to increase exports is likely to reduce welfare in ACP countries. To avoid this, the strategy of the EPAs should focus on capacity building before trade liberalization. Below, we discuss three ways in which the EPAs can be deepened to respond to these challenges.

4.1 Foreign direct investments and outsourcing

One of the most notable changes in the international economy is the increase in vertical specialization.[11] Increasingly, multinational enterprises (MNEs) are engaged in geographically separating production processes by vertical FDI towards developing countries. Hence, much of the increase in world trade comes from vertical specializing across countries, for trade are intra-firm dealings that result from vertical FDI follow from outsourcing/off-shoring.[12] For this reason, the increase in openness of many developing countries has not been driven primarily by lower barriers to trade, but by attracting investment and outsourcing contracts. Hence, a major means for the ACP countries to increase export capacity is to attract vertical FDI and outsourcing contracts and lure them away from China, India and Central Europe.

[11] D. Hummels, J. Ishii, Jun, and K.M Yi, 'The nature and growth of vertical specialization in world trade' 54(1) Journal of International Economics (2001), pp. 75-96.

[12] B. Spencer, 'International outsourcing and incomplete contracts' 38(4) Canadian Journal of Economics (2005), pp. 1107-35.

A burgeoning theoretical literature investigates what triggers vertical specialization of countries and increased intra-firm trade.[13] These papers point to the importance of reduced contract imperfections for FDI and outsourcing. Because the legal environment in developing countries improves and (intellectual) property rights are more secure, multinational firms make better use of the comparative advantages of developing countries by outsourcing labor intensive part of the production process. Consequently, as investment and supply contracts are key to trade, emphasis has shifted from reducing protection towards improvement of domestic regulatory standards as a tool for development through trade.

The EPAs can be much more creative in supporting FDI and outsourcing towards ACP countries. A first way is to include MNEs into the process and support joint initiatives between firms from the EU and the ACP countries. The EPA can function as an interface between EU firms and those in the ACP by investigating the willingness of EU firms to invest in ACP countries. Also, the EPAs can support the legal environment in ACP countries so as to encourage contracting between EU and ACP firms, for example by subsidizing ACP countries to contract under the law of EU member states.

Second, trade policies of ACP countries have to be adopted to attract vertical FDI and outsourcing. In general trade policies of ACP countries are biased against imports of intermediate products which are crucial for assembly. Certainly, although the production of intermediate goods can be an important step in the industrialization process, the poorest ACP countries first have to go through such an assembly stage to obtain a comparative advantage in low-skilled production processes. For this reason, making the imports of intermediate goods more costly for MNEs goes against the long run strategies for economic development. Moreover, ACP countries should contemplate the abolition of high tariffs on finalized industrial product, as this is only going to benefit EU firms producing in ACP countries. Clearly, when the main objective of EU firms producing in ACP countries is to export these final goods, high tariffs will not support

[13] P. Antras, 'Firms, contracts, and trade structure' 118(4) Quarterly Journal of Economics (2003), pp. 1375-418; P. Antras, 'Incomplete contracts and the product cycle' 95(4) American Economic Review (2005), pp. 1054-73; P. Antras and E. Helpman, 'Global sourcing' 112(3) Journal of Political Economy (2004), pp. 552-80; G. Grossman and E. Helpman, Innovation and Growth in the Global Economy, (MIT Press, Cambridge, 1991); G. Grossman and E. Helpman, 'Integration versus outsourcing in industry equilibrium' 117(1) Quarterly Journal of Economics (2002), pp. 85-120.; G. Grossman and E. Helpman, 'Managerial incentives and the international organization of production', 63(2) Journal of International Economics (2004), pp. 237-62.

production by domestic firms but do increase the price of those goods to local consumers. Clearly, when large MNEs from the EU have a preferred position on the markets of ACP countries, this does not imply that they will lower their prices on these markets accordingly. Hence, lowering the tariffs on finalized products on a multilateral basis creates competition for the MNEs from the EU with the result of a lower domestic price level.

Third, to help ACP countries attract FDI from non-EU countries, the EPAs should consider looser rules of origin requirements. Currently, the EU aims for 50% of value added. Clearly, such a high level reduces the attractiveness of ACP countries for FDI from China, India and Brazil.

Fourth, the theories on vertical specialization show that in the absence of (intellectual) property rights only production in later stages of the product cycle is shifted towards developing countries. The reason is that production in those stages is marked by a high degree of standardization, so that property rights are relatively unimportant. Hence, to make ACP countries attractive, not only do they have to improve their legal systems (training of judges, capacity to speed up cases etc.), but also improve technical skills in order to attract more medium skilled jobs in manufacturing.

Lastly, to make ACP countries more attractive for MNEs from the EU, the EPAs have to include provisions such as those under GATS mode 4 on the movement of natural persons. Clearly, to benefit in the long run from globalization of production, skills are an important prerequisite for citizens of ACP countries. Hence, under a EPA provision that mirrors commitments under mode 4, the EU should enhance the opportunities educational visas and actively support training for business purposes – not only for government officials. On the other side, the ACP countries should reduce the costs EU citizens to enter and live in their country, since many of them work for EU companies. Currently, no ACP country has made significant commitments on mode 4, so that two-sided commitments within the EPA process seem an appropriate first step.

So far, the idea of supporting the role of MNEs for the EU meets much skepticism in ACP countries, as it is argued that the overemphasis of the EU on rules for investment and the Singapore issues will result in the 'stealing' of African resources by EU multinationals.[14] Again, this is a legitimate concern that has to be assessed by all parties. However, given the experiences in Asia, this may simply be a stage that ACP countries have to go through to build

[14] B. Mbaye, 'The Negotiation of Economic Partnership Agreements or Broken Promises? The Case of West Africa' http://www.pambazuka.org/en/category/features/28902.

(human) capital themselves. The sharp rise in economic activity through outsourcing in Central Europe that followed from regulatory reform in the 1990s may serve as an example.

4.2 Financial services

There is ample empirical evidence that well functional financial institutions are a prerequisite for economic growth.[15] Bank and financial markets channel domestic saving towards profitable investment opportunities; they serve as institutions that provide corporate governance; and they facilitate the inflow of foreign financial capital. The principal mechanisms are that, on the domestic front, citizens save only when they can reap future profits of those savings, for which this they need a banking sector and financial markets to spread consumption over time. Further, entrepreneurs need external private financing. For this, they need to convince savers that they have overcome the moral hazard problem and will not run away with the borrowed money. For this reason, savers will only invest in domestic firms if they are able to delegate oversight of corporate governance to financial institutions.

We see four ways in which the EPA process can be supportive to financial sector development. First, there is a strong causal connection between the quality of financial regulation and the creation of financial institutions.[16] In this area, the EU has much experience in setting up regulatory environments. For example, in the accession period for countries in Central Europe the EU has used so called negotiating chapters which focus on the implementation a various parts of the acquis communautaire- support for strengthening financial market regulation was supported under the EMU chapter. The EU and the ACP countries may start a dialogue whether a voluntary cooperation on the basis of this chapter is a possibility. For example, the EU then can support ACP countries in adopting the BIS standards for banks, support the extensive regulation needed for insurance markets, and explore the possibilities for delegation of oversight to independent bodies.

Second, financial regulation only works well when it can not be changed easily. A main problem in developing countries is that governments have a vested

[15] R. Levine, 'Financial Development and Economic Growth: Views and Agenda' 35(2) Journal of Economic Literature (1997, pp. 688-726.

[16] R. la Porta, F. Lopez de Silanes, A. Schleifer, and R. Vishny, 'Law and Finance' 106(6) Journal of Political Economy (1998), pp. 1113-55.

interest in their financial system.[17] Hence, to attract external finance, governments have a problem committing to keeping good regulation in place when times turn bad. To make commitments self-enforcing, governments must make credible that retreating from previous commitments is costly. For example, the EPA process can make funds contingent of good governance or adherence to WTO standards. In the commitment context, the reason is not that such good behavior is valued intrinsically, but that the costs associated with bad behavior accrue to the government itself. This last effect makes commitment possible.

Third, it is well recognized that much of the benefits from trade integration are most likely to come from the reduction of monopoly power in domestic markets. In many developing countries, the banking system is protected against domestic entrants so that incumbents obtain rents. Through a system of mutual recognition between the EU and ACP countries – for example based on mode 2 of the GATS for commercial presence of service firms - effective undercutting of monopoly prices can come from EU firms. Clearly, the poorest ACP countries should take account of the problematic capital account flows that come along with commercial presence. However, for more developed ACP countries the benefits of increased financial sector efficiency are likely to outweigh the costs of (premature) capital account liberalization.

Fourth, as foreign entry in the banking sector erodes margins for domestic firms, trade integration induces forces to privatize state banks. The reason is that state banks are often inefficient and can not compete with foreign entrants.[18] Hence, the government feels the pressure of privatization of these banks in a hostile environment. To on the one hand support foreign entry and on the other hand recognizing the adjustment costs in the banking sector, the EU and the ACP countries should cooperate in this domain. As a first example, the EPA process can actively support joint venture projects between banks from the EU and the ACP countries or their stock exchanges. Second, the costs of privatization have to be assessed – including write offs because of bad debts – and the EU and other donors should include supporting policies to accommodate for the financial losses.

The main problem of all these recommendations is that trade diversion in ser-

[17] R. la Porta, F. Lopez de Silanes, and A. Schleifer, 'Government Ownership of Banks' 57(1) Journal of Finance (2002), pp. 265-301.

[18] R. la Porta, F. Lopez de Silanes, and A. Schleifer, 'Government Ownership of Banks' 57(1) Journal of Finance (2002), pp. 265-301.

vice trade looms at the horizon.[19] Although imports of financial services are low in ACP countries, creating an artificial competitive advantage for EU firms in ACP countries is suboptimal in industries where other countries hold a comparative advantage. For example, US banks typically are string in wholesale and investment banking. Hence, to avoid suboptimal outcomes, the ACP countries should aim to use the EU's assistance to open up the services industries on a multilateral basis by commitments in the WTO. At the moment, ACP countries have very low commitments in services. The EPA process can be used as a supported stepping stone towards multilateral services liberalization.

4.3 Institutional and political effects of the EPAs

It is often stated that trade policy reform which comes along with regional integration may catalyze institutional reform in general.[20] This matters much because - although views still differ in the relative importance - there is an emerging consensus that 'institutions rule' in economic development.[21] The main connection between institutions and economic activity is through the hold-up problem: economic activity only comes about when entrepreneurs feel assured that the fruits of their activities accrue to themselves and can not be confiscated by somebody else, including the state.

The main argument how to create such institutions is as follows. Since the introduction of endogenous growth theory it consistently has been argued that 'institutions' (rule of law, control of corruption, civil rights etc.) have a positive correlation with economic development. Such good social institutions are endogenous themselves and rely on political institutions, where the main conclusion is that democracy in the long run is instrumental in creating better political institutions. The main problem is that good political institutions require political commitment of the economic and military elite, to which there are two obstacles.

First, a commitment by the elites to share power is not credible in itself. Sup-

[19] M. Janssen, 'Services trade liberalization at the regional level: does southern and eastern Africa stand to gain from EPA negotiations?' WTO Staff Working Paper ERSD-2006-06.

[20] A. Winters, Regionalism versus Multilaterism, 1525 CEPR Discussion Papers (1996).

[21] D. Acemoglu, J. Robinson, and S. Johnson, 'The colonial origins of comparative development: An empirical investigation' 91(4) American Economic Review (2001), pp. 1369-1401; D. Acemoglu and S. Johnson, 'Unbundling institutions' 113(5) Journal of Political Economy (2005), pp. 949-95; D. Rodrik, A. Subramanian, and F. Trebbi. 2004. 'Institutions rule: The primacy of institutions over geography and integration in economic development' 9(2) Journal of Economic Growth (2004), pp. 131-65. See for a dissenting view J. Sachs, The End of Poverty: Economic Possibilities for Our Time (Penguin Press, New York, 2005).

pose that the ruler would announce that he will set in motion a democratization process. If this is believed by the citizens, it overcomes the hold-up problem, so that investments occur and the economy grows. However, economic prosperity reduces the incentives of the ruling class to share power. Introducing overnight democracy is of not much use if it can be reversed easily, for example when there are power bases in the military. Clearly, citizens often foresee such time-inconsistencies, so that the lack of a firm commitment opportunity by benevolent elites fails to induce private investment.

The EPA process can help overcome these commitment problems by making power sharing self-enforcing. As with commitment to good financial regulation in the previous section, one way to do this is by making derailing the democratization process costly to the elites. The point her is that when the public foresees that breaking promises is costly, the promises of the ruling elites become credible. Clearly, conditionality on the implementation of political reform is a sensitive topic, but benevolent rulers should acknowledge that conditionality can be used to commit to policy change. The way out seems to let ACP countries decide on their own conditionality: the ACP countries should set themselves targets for regulatory and constitutional reform and make a proposal how this should be rewarded. This will create ownership of the programs without reducing the ability to commit to policy change.

In addition, the EPAs can promote power sharing through delegation of authority to regional bodies, so that the national government loses the ability of discretionary trade policy. When the ruling elites are limited in their ability to abuse their political powers because they is shared with others, this makes it possible the commitment to better political institutions. For example, the EPAs can promote the introduction of customs unions among ACP countries, which create a common external tariff, adhere to the principle of national treatment, and use mutual recognition.

Although ACP countries can negotiate an EPA alone or in any group of countries they consider appropriate, the reinforcement of regionalism has been a major driving force of the EPA process from the beginning.[22] Consequently it is no wonder that the six groups that actually negotiate with the EU are in fact more or less configurations reflecting existing regional trade arrangements (RTA). The West Africa EPA is negotiated according to a mandate given by

[22] The strengthening of regional integration in ACP countries is an explicit objective of EPAs as confirmed in article 37.3 of Cotonou. This objective is largely inspired by the success story of regional economic integration inside the EU.

West African states grouped in the Economic Community of West African States (ECOWAS), including all francophone West African countries grouped into the West African Economic and Monetary Union (UEMOA). Mauritania, not a member of ECOWAS or UEMOA, is also attached to this group. The Central African negotiating group largely coincides with the Economic and Monetary Community of Central Africa (CEMAC). The four other negotiating groups, for Southern Africa, Eastern Africa, the Pacific and the Caribbean respectively, also correspond to some sort of existing RTA.

The EPA process should more actively support these regional bodies. To start, the EU can make it clear that regional integration is to be completed before EPAs can be concluded. The problem as it stands now is that the EPAs are seen as a threat by the EPAs. For this reason, the insistence of the ACP countries that regional integration should precede the EPAs can be regarded as a defensive position to avoid the speedy conclusion of the EPAs, so that the EPAs reduce the incentives for regional integration. Clearly, if the EPAs can be made more attractive to the ACP countries – for example by increasing the level of aid for trade – then they can be used to speed up the process of regional integration, by making regional integration a necessary stepping stone to obtain these benefits.

Further, the EU can increase the relative incentives of concluding EPAs with regional bodies over bilateral deals and the EBA initiative. One way is to make sure that the benefits of the Cotonou set-up will continue under the EPAs and cease to exist when countries opt for EBA. In addition, the EU should be cautious to discuss bilateral trade relations with economically important countries in the ACP group. For example, the conclusion of the free trade agreement with South Africa does not provide the right incentives for that country to actively support the conclusion of EPAs with regional bodies to which it is associated.

A second mechanism through which EPAs can support political institutions is by mitigating social conflicts. There is much evidence that social conflict is reduced by the creation of an economic middle class. [23] Again sequencing between trade liberalization and legal reform is important in this respect. Clearly, without any legal basis, trade liberalization in the short run is likely to increase inequality, not reduce it. Hence, some basic human rights should precede trade liberalization in developing countries. Possibly the most important step is to include in the EPAs the right of workers in ACP countries to organize, for this

[23] Rajan, R. and L. Zingales. 2003. Saving Capitalism from the Capitalists. Princeton University Press.

reduces the power of capital owners to appropriate the benefits of better use of comparative advantage in labor intensive production. For example, the EPA process can support ACP countries to fulfill commitments within the International Labor Organization or promote their participation.

When discussing these issues, it is important to take account of the fact that within ACP there is a legitimate skepticism towards the emphasis on the importance of institutions.[24] It is often argued that the developed countries have created and supported bad institutions and governments for decades to foster their own interests. So, why should recommendations to create better institutions from these countries be credible? Why not let developing countries freely decide on which institutions work best for them? To avoid these criticisms, it is essential that trade reform is supported by a bottom-up process achieved by promoting the role of civil society in the process. Hence, as in the Cotunu Agreement, it is important that the EPAs continue to support the participation of trade unions, business federations and non-profit organizations from ACP countries.

4.4 Conclusions

Given the limited amount of time for the EPAs to be concluded and the priority for the EU to make them WTO compatible, the introduction of reciprocal free trade will form the cornerstone of the agreements. The question therefore arises as to how the EPAs can be improved upon after their conclusion. The discussion in this paper offers ample suggestions.

A first recommendation is that the EPAs should support multilateral free trade in addition to reciprocal free trade. When working on the reduction of protection in ACP-countries, the EU should press for multilateral reductions in the level of protection, so as to avoid the harmful effects of trade diversion. Also, when funds are available for capacity building in ACP countries, these should be used to support trade departments that deal with both EPA and WTO.

Second, both the EU and ACP countries should realize that regulatory and institutional reform is crucial to attract economic activity. When regulatory reform is meant to attract FDI and outsourcing, the EPAs should again make sure that the benefits are multilateral, so as not to discriminate against non-EU firms. For this, it is crucial that the rules of origin requirements of the EPAs

[24] B. Mbaye, 'The Negotiation of Economic Partnership Agreements or Broken Promises? The Case of West Africa' http://www.pambazuka.org/en/category/features/28902.

are not too stringent.

Furthermore, the EU should realize that trade liberalization on economic grounds is only justified in the absence of market distortions. It is clear that when EU production is subsidized or excesses dumped, prices do not reflect comparative advantage. Hence, in that case free trade distorts the allocation of resources. The EU tends to belittle such claims by arguing that the majority of exports to developing countries are industrial products. However, the EU should recognize that cases such as the infamous tomato paste and chicken parts rows in Senegal and Ghana attract wide-spread attention in the developing world and are easily generalized. It is therefore important that the EU commits to the phasing-out of agricultural subsidies within the same time-frame as the EPAs will achieve reciprocal free trade.

The major issue discussed in this paper is if and how economic partnerships between EU and groups of ACP countries will become tools for economic development rather than simple trade rearrangements useful for the EU to obtain WTO compatibility for its trade regimes with ACP countries. If the EU, notwithstanding firm declarations from its Trade Commissioner, would wish only to preserve its special trade regimes with former colonies while making them reciprocal, then it misses the core challenge. The reciprocity issue is the specific short-term reason why negotiators have to hurry as the waiver expires at the end of 2007, but the development debate is the core issue.

The profound disappointment expressed by some ACP negotiating teams as confirmed recently in Nairobi at the April 2006 meeting of the AU Ministers of Trade, should be taken seriously and is in sharp contrast with the reassuring talk by the EU Commissioner of Trade and the Commissioner for Development as well. EPAs should become instruments to tackle supply side constraints in developing countries, to support regional integration mechanisms as they are organized by the member states themselves. What is at stake is not so much the short-term view of signing EPAs but the long-term redirection of European cooperation with its former colonies and with other developing countries as well.