economic nationalism

Edited by Zaki Cooper

THE SMITH INSTITUTE

T H E S M I T H I N S T I T U T E

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Preface
Wilf Stevenson, Director, Smith Institute

The Smith Institute is an independent think tank that has been set up to undertake research and education in issues that flow from the changing relationship between social values and economic imperatives. In recent years the institute has centred its work on the policy implications arising from the interactions of equality, enterprise and equity.

The pace of globalisation is increasing, with unprecedented flows of goods, services and people between countries and companies. Levels of overseas investment and foreign ownership have risen dramatically, alongside far-reaching changes in technology, production and corporate organisation. National economies and companies are becoming ever more interdependent, and emerging economies such as China and India are competing in world markets in a way that few could have imagined 20 years ago.

The UK has long been a leading advocate of free trade and boasts one of the most open markets in the developed world. British politicians and business leaders have consistently pointed to the benefits of globalisation and argued against economic protectionism. But the "Manchester" free trade view of the world is being challenged, not least by the new "economic patriots" who call for strict limits to free trade and tighter controls over foreign ownership.

This shift towards protectionism and defence of corporate national champions – as evidenced recently by a number of high-profile takeover bids in France and Spain – raises serious concern in the UK. As the Prime Minister commented in a speech to the Confederation of British Industry "in November 2006, unless we can show that globalisation is opening up new opportunities for millions and creating more and better jobs, then people will see it increasingly as a vehicle for insecurity rather than for the potential prosperity we know to be the case.

This collection of essays opens up the debate about the benefits and costs of more open markets and discusses the winners and losers of globalisation. By way of comment, analysis and case studies, the authors provide an insight into current thinking about world trade and the resurgence of economic nationalism. In particular, the essays explore the impact on the UK of creeping protectionism and develop the argument for a stronger EU commitment to free trade and a more forward-looking and positive approach towards globalisation.

The Smith Institute thanks Zaki Cooper (Director of Business for New Europe) for agreeing to edit this collection of essays, and gratefully acknowledges the support of Business for New Europe and EDS towards this publication and the associated seminar.

Introduction
Zaki Cooper, Director of Business for New Europe

The champions of free trade and movement have been enduring a difficult period. The Doha talks have stalled, national governments are increasingly willing to block foreign takeovers, and there are signs of a backlash against free movement of labour.

Economic nationalism is a modern form of protectionism, which has surfaced in many different parts of the world. Protectionism can be considered as the opposition to the free movement of goods, services, capital or people (for reasons other than genuine national security). Economic nationalists denounce free trade and invariably criticise globalisation, viewing it as responsible for the economic, social and cultural ills affecting the nation. Economic nationalism runs counter to the forces of globalisation, which drive the dismantling of economic barriers between nation states.

There are very few absolutist free traders. Most people can see a justification for some forms of protectionism. Some forms of protectionism are informal, such as governments blocking the granting of licences and permits, whereas others are formal, such as tariff barriers.

This monograph will examine the state of play in the UK, and also look at the situation across other parts of Europe and the USA. The focus of this study is on the developed markets of the UK, with reference to Continental Europe and the US.

Football may be an unlikely starting point for an analysis of economic nationalism, but when in April this year Arsenal Football Club was first rumoured to be the object of a takeover approach from US billionaire Stan Kroenke, club chairman Peter Hill-Wood said: "Call me old-fashioned, but we don't need Kroenke's money and we don't want his sort. Our objective is to keep Arsenal English, albeit with a lot of foreign players. I don't know for certain if Kroenke will mount a hostile takeover for our club, but we shall resist it with all our might."

This episode with a traditional British institution, Arsenal, being the subject of a potential takeover bid provides a snapshot of some of the issues at play. A number of leading British football clubs, including Manchester United, Chelsea and Liverpool, have already been bought by foreign investors but this has raised shareholder, public and media concern.

The UK has been relatively open in its approach, and has tended to eschew economic nationalism. Many British companies have been bought by foreign ones, across a range of sectors encompassing telecoms, construction and energy companies. The UK's labour market has benefited from an influx of foreign labour, particularly from Eastern Europe. After the accession to the EU of eight Eastern European states in 2004, the UK opened its labour market to people from these countries.

Protectionism abroad

On the other hand, much of Continental Europe has adopted a very different approach from that of the UK. Some notable examples include the French government's attempts to encourage the merger of French firms to create corporate "national champions", the merging of Suez and Gaz de France to prevent the energy giant Enel gaining a foothold in the French market, and unsuccessful attempts to fend off a bid for Arcelor by Mittal Steel. Furthermore, the French government's interventionist approach was codified by its identification of 11 strategic sectors prohibited to foreign predators. Despite some high-profile instances of protectionism, there were 408 completed foreign acquisitions of French firms in 2006, most of which took place without any controversy.

However, France has not been the only culprit, with both Spain and Poland thwarting takeovers. Such has been the spate of resistance to foreign takeovers in Europe that in 2005 the then Italian finance minister Giulio Tremonti warned dramatically of an "August 1914 effect", referring to the months before the First World War.

Beyond the continent of Europe, the USA has disappointed many who saw it as a bastion of free trade. The US administration's opposition to Dubai Ports World's attempts to buy US ports was one of the highest-profile recent examples of efforts to protect American industry. Meanwhile, the USA has also been protective of its agricultural sector in world trade talks, and in the recent "Open Skies" agreement with the EU (concluded in April 2007) it continued with its limit of 25% share ownership of US airlines.

Whereas the UK seems to be one of the most open economies in the world, the USA, with all its free-market rhetoric, has resorted to some fiercely protectionist policies. This is somewhat ironic given the rise of the USA as the dominant economic power over the course of the 20th century, which has its roots in the 1870-1920 period when the USA's rapid economic growth coincided with the migration of tens of millions of Europeans to America. Whilst the phrase "Fortress Europe" rolls off the tongue, the USA's record has led some to speak of "Fortress America". All these forces led to the results of a poll last year showing that 51% of business executives thought that protectionism was increasing in developed markets, with only 16% believing that it was falling.[1]

There are economic nationalists all over the world, and, whilst they tend to be a minority voice in the UK debate, they are more mainstream in other countries. The protectionist camp in the USA has many supporters, especially on the Republican right. They want the USA to adopt a position of economic isolationism. Some right-wing parties in Europe, fearing the loss of national self-determination, advocate the re-nationalisation of financial markets. There are those, anxious about competition from emerging markets in Asia, who wish to build a "Fortress Europe".

A variety of perspectives

Economic nationalism has several manifestations and, in the course of the various contributions, they will be examined from a variety of perspectives. The whole debate about economic nationalism in the UK is informed by history, and Roland Rudd gives in his article an overview of world trade and Britain's past as a trading nation.

The following three contributions from David Gow, Michael Snyder and Malcolm Harbour MEP cover the different forms of protectionism, across goods, services, capital and labour. These include, first, protectionism in goods and services markets, both industrial and agricultural, which has led to the impasse in world trade talks. On services, the EU's move to liberalise services trade was only partially successful, as the directive was watered down in 2006 in the face of strong opposition, notably from France and Germany. In February 2006 more than 30,000 people protested on the streets of Strasbourg to voice their opposition to the liberalising measure.

The second form of protectionism that the contributors discuss entails resistance to foreign takeovers (capital markets), with some really high-profile examples in recent years. There have been some cases in the spotlight in Europe, which the Commission has moved to counter. Meanwhile, in the USA there have been a number of obstacles put forward to foreign takeovers and a willingness to use non-tariff barriers. Furthermore, sovereign wealth funds have provided a new avenue for foreign takeovers and have caused alarm in the UK and elsewhere.

The third form of protectionism appears in labour markets – or what the Germans have

1 Economist Intelligence Unit figures, 2006

termed *Uberfremdung*, referring to over-foreignisation of labour markets – with countries moving to prevent or restrict economic migration.

In the subsequent section of this publication, a number of UK-based business leaders from a range of sectors, including energy, legal services and telecoms, reflect on their experience of protectionism and breaking into foreign markets.

While business is an important voice in this debate, the negative impact that protectionism has on the developing world also deserves attention, and this is what Professor Anthony Venables' article addresses. Finally, the response of domestic governments and international organisations is crucial. In recent years the EU has been resolute in its determination to tackle protectionism, and the article by Internal Market Commissioner Charlie McGreevy explains how this can be done.

One of the primary means of combating economic nationalism in the current era is through multilateral institutions. The World Trade Organization offers the framework to reach agreement on world trade, although this has proved elusive up to now. The EU, with its powers to enforce the single market and take action against recalcitrant nation states, provides a means to combat economic nationalism. But, as the well known commentator Fareed Zakaria[2] points out, the critics of the EU in the UK and the USA are often "those who most fervently support capitalism and free trade", yet the EU's opponents on the Continent tend to be people who fear globalisation.

Eurosceptics in the UK find it hard to reconcile their prejudices with the fact that the EU is increasingly a tool for furthering liberalisation and competition. As the Economist Intelligence Unit has stated,[3] the Commission's regulatory capabilities have "made it an important ally of the corporate sector when firms seek to make investment decisions without political interference, among other things helping to counterbalance attempts to prevent foreign takeovers".

This collection of essays serves as a contribution to an important debate. It is to be hoped that it will act as a catalyst towards further reflection and discussion within the business community and among the domestic and international policy makers who will determine the face of the future.

2 Zakaria, F *The Future of Freedom: Illiberal Democracy at Home & Abroad* (WW Norton & Co, 2003), p243
3 *European Policy Analyst: Key Issues & Developments for Business* (Economist Intelligence Unit, 2006)

Chapter 1

Britain and globalisation – past, present and future

Roland Rudd, Chairman of Business for New Europe

Britain and globalisation – past, present and future

Being British is all about driving a German car to an Irish pub for a Belgian beer, then travelling home, grabbing an Indian curry or a Turkish kebab on the way, to sit on Swedish furniture and watch American shows on a Japanese TV. And the most British thing of all? Suspicion of anything foreign.
Anonymous

If any country could be seen as an emblem of globalisation, it is the UK. From the level of foreign investment to the number of migrant workers, the UK bears many of the hallmarks of a global economy. It is in this position because of its proud history as an outward-looking trading nation. The British Empire acted as a catalyst for free trade. As Niall Ferguson argues in his book *Empire*, "there would certainly not have been so much free trade between the 1840s and 1930s had it not been for the British Empire".[1]

The UK was at the heart of the international trading system that gathered pace with the advance of transportation and communication technologies. Between 1890 and 1914, world trade more than doubled. By the early 20th century there was growing political support for free trade. Famously, it was the issue of free trade that split the Conservative party in the early 20th century and led to its defeat by the Liberals in the 1906 general election. A steady integration in the world economy had already begun.

However, as the world economy slumped into the Great Depression of the 1930s, the UK retreated and made moves towards protectionism. Even John Maynard Keynes, who had led the battle for free trade, wavered in his commitment. In a newspaper article of 1931 he said that insofar as protectionism leads to "the substitution of home-produced goods for goods previously imported, it will increase the employment of this country". The economic slump was reflected in a decrease in foreign trade; between 1929 and 1938, for example, the ratio of foreign trade to domestic production declined by 10% in Britain, by nearly 20% in Canada, and by 25% to 40% in Japan, Germany and Italy.[2]

After 1945, world trade increased again and the UK was a prime beneficiary. The aftermath of the Second World War led to the creation of three new international economic organisations: the International Monetary Fund, the World Bank and the

1 Ferguson, N *Empire: How Britain Made the Modern World* (Penguin, 2004) p366
2 Micklethwait, J and Wooldridge, A *A Future Perfect: The Challenge & Hidden Promise of Globalization* (Random House, 2000), p12

General Agreement on Tariffs & Trade, which was established in 1947 to reach multilateral trading agreements (and was replaced by the World Trade Organization in 1995).

The establishment of the international system encouraged an upsurge in trade. World trade grew from a value of $57 billion in 1947 to $6 trillion in the late 1990s. Economists estimate that the freeing up of world trade in manufactured goods in the second half of the 20th century led to a quintupling of the world economy.[3] The advent of regional trading blocs, notably the EU (which has its origins from 1957), acted as a further stimulant for increased trade.

Interdependence of nations

The steady growth in free trade has been integral to the process of globalisation. Globalisation has been one of the most discussed concepts in recent years, and is certainly one of the dominant forces of the present era. Broadly speaking, globalisation refers to integration of economic activities across borders, so that nations become interdependent. David Henderson, former chief economist of the Organisation for Economic Co-operation & Development, defines it more precisely as "free movement of goods, services, labour and capital, thereby creating a single market in inputs and outputs".[4]

The onset of globalisation has had a profound effect on trade, capital markets and labour flows. For instance, long-term trends show that capital is increasingly international – in 1930 foreign assets accounted for 8.4% of world GDP, whereas this had increased to 56.7% by 1995.

Yet the march of globalisation has not been unchallenged. There has been a backlash against globalisation from sections of the political community, most notably the New Left (manifest in the protests and riots before world trade meetings) but also from more mainstream forces, including national governments, who have resorted to economic nationalism. Protectionist forces are strongest in predominantly nationally owned industries such as steel and agriculture. One of the indicators of this increased protectionism was a downturn in global FDI – which fell 41% in 2001, 13% in 2002 and 12% in 2003.

Unsurprisingly, given its history as a trading nation, the UK has been seen as a leading country in coming to terms with the changes caused by globalisation. Shadow foreign secretary William Hague recently pointed out:

3 Legrain, P *Open World: The Truth About Globalisation* (Little, Brown, 2002)
4 Wolf, M *Why Globalization Works* (Yale University Press, 2004) p14

The history of Britain, of trading energy, of naval prowess, of restless exploration and trusted finance, has made ours a country which always looks out to the rest of the world.[5]

The UK is seen by other world leaders as being comfortable with open global markets. As European Commission President José Manuel Barroso said in April 2007:

The Europe of the 21st century takes its inspiration in many ways from Britain … Britain has this global approach, the approach that I am trying to push forward.[6]

Through the European single market and other trade agreements, the UK has increased the volume that it trades in goods and services. In addition the UK has had a relatively open labour market policy and has benefited from an influx of workers from Eastern Europe since 2004.

The Wimbledon effect

Equally dramatically, British firms have been taken over in a range of sectors. This has been called the "Wimbledon effect" – we provide the turf, the strawberries and the umpires, other nations the key players. The takeovers have taken place across a range of sectors, such as manufacturing (Pilkington), steel (Corus) and telecoms (O2). The UK has been a magnet for foreign investors; by the end of the 1990s the UK attracted 8% of the global stock of inward investment, compared with a share of global GDP of 3%.

Whilst the UK has embraced globalisation, some of its features have caused anxiety. The proliferation of foreign takeovers of UK companies has led to anxiety among the workforces of those companies and the population at large. A Harris/*Financial Times* poll carried out in 2006 showed that 68% of British people thought it too easy for a domestic company to be taken over.[7] The government has reaffirmed its commitment to free trade by not attempting to thwart any takeovers and by asserting that the test it applies is the interest of the consumer.

The forces of globalisation and the counterforce of protectionism are high-profile phenomena of our time. While the prospect of retreating towards protectionism is tempting for many national governments, the UK has an opportunity to lead because of its economic strength and its position in the world.

5 Speech by William Hague on 2 October 2007
6 *The Times*, 3 March 2007
7 *Financial Times*, 6 June 2006

As Gordon Brown said last year:

We are well placed for globalisation not just because we are among the most stable economies in the world but because we are the most open economy. Britain is the pioneer of free trade – we have constantly advocated openness above protectionism, and our openness extends to embracing new ideas and new influences – as proven by the strength and diversity of our economy, from the City of London, to our science, and our universities.[8]

The battle for openness over protectionism has not been won. Signs of protectionism remain in different forms and guises, in all parts of the world. But the issue promises to be one of the most intriguing ones of the early 21st century.

8 Speech by Gordon Brown, 28 November 2006

Chapter 2

Protectionism in Europe – an overview

David Gow, European Business Editor of *The Guardian*

Protectionism in Europe – an overview

The UK finds itself at the heart of a fierce battle between the proponents of an open-minded, flexible approach to the benefits of globalisation and the protagonists of a hostile, protectionist attitude towards its threats and dangers.

For all the signs that the reformers in Brussels and national capitals are gaining the upper hand, UK policy makers cannot assume that this struggle between risk-taking optimists and risk-averse pessimists feeding on popular insecurity will end in assured success for their side.

The reformist, liberal European Commission under José Manuel Barroso is fighting an uphill battle to create a genuine single or pan-European market in sectors such as energy, worth billions of dollars and controlled by states predominantly in Asia and the Gulf. These are buying their way into strategic sectors of the European economy, prompting some EU leaders to demand constraints on their activity.

Already this year we have seen left-led Spain defy the repeated threat of EU legal sanctions to torpedo the hostile bid for its biggest utility, Endesa, by Germany's E.ON, forcing Europe's cash-rich largest private-sector energy group to withdraw humiliated from the field with just a handful of shares. The centre-left Prodi government in Italy has successfully blocked a Spanish bid for motorway operator Autostrade and foreign moves to take over Telecom Italia. It is worrying that Russia's Aeroflot may be the only serious prospective purchaser of near-bankrupt airline Alitalia.

Even in Germany, the scene seven years ago of the first successful hostile foreign takeover – Vodafone's acquisition of Mannesmann – the reform-minded grand coalition government of Angela Merkel has signalled that institutions such as Deutsche Bank are off-limits and is considering national or, preferably, EU-wide controls on the sovereign funds.

France, the founder of economic nationalism, has even enshrined several key industrial sectors in law as immune to foreign takeover on national security grounds – and not only defence, but casinos! New French president Nicolas Sarkozy, in whom UK leaders such as Gordon Brown once placed guarded hopes of a new prospect of reformist collaboration, has not only forcibly created a new corporate national champion in energy with the merger of Suez and Gaz de France, in effect renationalising the former, but has said he wants to do the same with state-owned nuclear operator Areva by combining it with Alstom and maybe Bouygues.

It was he who led the onslaught on competition at the EU summit in June that replaced the rejected constitution with a new draft reform treaty. Competition, he said, was a dogma that had done little or nothing for Europe, and he successfully removed it, in "free and unfettered" form, from the main text. He has since redirected his boundless energies towards trying to neuter the independence of the European Central Bank, forcing it to kowtow to political diktat – meeting irresistible opposition in Berlin and Frankfurt. Commissioners such as Neelie Kroes (on competition) and Peter Mandelson (on trade) have tried to reassert the primacy of competition, arguing that it brings greater consumer choice and lower prices.

But Sarkozy has also indicated that, through his policy of "rupture", he is keen to promote labour market reforms, notably by discarding the 35-hour week and making a renewed attempt, after the debacle over his predecessor's efforts,[1] to open up the jobs market to young, often trained people and end the scandal of persistent 20% youth unemployment rates (even higher among immigrant youths in the suburbs). He also wants to shake up employment conditions in the country's heavily unionised public services.

He has now given the unions a year-end deadline to agree voluntarily to reforms such as ending the privileged system for state employees such as train drivers which enables them to retire early on a full pension – or face legislation. (In the past such efforts have seen centre-right governments retreat or even fall in the face of widespread street protests.) He has already brought in some minor tax cuts despite a continuing budget deficit but watered down his original plans to slash the civil service by replacing only one in two who retire. There are serious doubts whether even he can replicate Thatcherite/Blairite zeal in creating a flexible labour market, which analysts say is essential to reviving France's sluggish economy and reducing unemployment of more than 8%.

In Germany, Chancellor Angela Merkel's grand coalition of Christian democrats with the social democrats has even signalled that it is prepared to tear up one of the key labour market reforms bequeathed by her SPD predecessor, Gerhard Schröder: significantly shortening the period during which unemployment benefit is available. Unleashing a ferocious argument within and between the two governing parties, Berlin now wants to prolong the period during which full dole is paid – to the consternation of business leaders.

1 The abandoned contrat de première embauche of April 2006

Insiders and outsiders in the employment market

Sarkozy's Janus-headed approach to issues raised by globalisation – such as the "delocalisation" of (mainly) manufacturing jobs, the need to enhance human capital and raise skills, and the promotion of social protection against "précarité" (insecure labour conditions) – illustrates the paradox of the responses of what André Sapir calls the Rhineland model to these phenomena. This paradox is: how to preserve the interests of the "insiders", particularly in the manufacturing industry, while encouraging "outsiders" such as the long-term unemployed or the elderly to become economically active, thereby increasing growth and prosperity. And it shows that the notion of a battle between open-minded reformers and protectionists is too schematic.

Sarkozy has been struck by the success of France's Rhinish neighbour and ally in shaking off the post-unification shame of becoming the sick man of Europe and being reborn as the eurozone's driving motor. The (Hartz IV) labour reforms initiated by Schröder, and union acquiescence in effective wage cuts, job losses and longer hours in order to preserve and strengthen the country's manufacturing base, have enabled German industrial groups to boost exports and earnings – and thus to take on the emerging prowess of the Chinese and Indians not only in low-tech but also in high-tech sectors and R&D.

Both of Britain's biggest European rivals have invested heavily in maintaining a global presence in manufacturing while encouraging the shift to services. The UK may have marginally increased manufacturing jobs in recent years but it has, under first Margaret Thatcher and then Tony Blair, in effect decided that – with the notable exception of industries such as aerospace and pharmaceuticals – the advanced services sector represents its future and the goal of policy makers is to re-educate and re-skill its people to adapt to this knowledge-based global economy.

But, arguably, the German and French are adopting a more broad-based approach that will bear fruit in the longer term by recommitting to manufacturing – and taking on many of the structural reforms Britain initiated two decades ago. This may be "economic nationalism", but it is a kind designed to achieve a great share of the growing global market – and not, as Gordon Brown claimed in his Mansion House speech of 2006, "sheltering a smaller, protected national market".

Tell that to BMW!

Of course, as Brown said then, restrictions on cross-border mergers and investment, such as those we have witnessed in energy, banking and other sectors, damage businesses and consumers. And he and others are right to point out that, while the single market has boosted EU-15 GDP by €223 billion since its inception, it could have done more – and could achieve even greater gains – if it were "more flexible and outward-looking", with barriers removed in sectors such as energy, post and telecoms. And the promised benefits of the Services Directive, finally adopted in late 2006 – some 600,000 new jobs, a 0.6% boost to GDP and lower prices – will not be gained in full, because of the amendments imposed by a coalition of centre-right and centre-left protectionist governments and MEPs.

That directive is critical to the chances of the EU even approaching its Lisbon agenda of creating sustainable growth and jobs, including employment targets of 70% overall, 60% for women and 50% for the over-55s – targets already met by Britain but not by the eurozone's big three of Germany, France and Italy. Awareness of the need for greater openness and flexibility is growing, so that even Emma Bonino – the ex-radical Italian MEP now serving as international trade minister – has acknowledged that what is required are measures to boost investment, increase skills, open up markets and remove red tape that is discouraging foreign investors, if the goals are to be achieved even partially.

But the protracted row over the Services Directive (highlighted by the same fears of insecurity that prompted the French and Dutch rejections of the EU constitution) reflected the unfinished debate between proponents of protecting "insiders" – those with contracts of employment, often governed by collective agreements – and those keen to open up opportunities for "outsiders", whether migrants or those kept outside the labour market (20 million unemployed and 93 million economically inactive within the EU). This debate has been carried forward in the arguments between business and unions about the balance within the preferred "flexicurity" social model between flexibility on the one hand and security, social protection and fairness on the other.

Policy implications for the UK

The implications for UK policy makers are several. Britain has prided itself on taking the lead in EU economic reforms, winning recent plaudits from both the Organisation for Economic Co-operation & Development and the International Monetary Fund. The latter concluded late last year, after its latest mission:

Openness and flexibility, reflecting in part the wide-ranging structural reforms undertaken over the past two decades, have paved the way for enormous benefits from globalisation.

For example, the decision to allow free movement of labour for Eastern Europeans has manifestly boosted growth (by as much as 1% or more), while containing inflation and improving the public finances.

But the government is at risk of overstating the protectionist tendencies within the "old" EU and underestimating the Continental desire to promote a more broad-based economic response to globalisation, both promoting a modern, high-tech manufacturing base and combining growth with social fairness. Yes, there are strong drives towards economic nationalism, as we have seen, and these limit the opportunities for British business to expand in Europe. But, to give just one example, 40% of the equity in France's top 40 firms is held by overseas investors. There, as in Germany, there is a greater willingness to acknowledge that firms are no longer even European but international, with access to global capital markets.

Yes, too, unions are responding to the loss of a million manufacturing jobs to Asia and the growing outsourcing of service jobs, with protectionist resistance to change. But the Nordic countries, where union density remains quite strong, are universally rated as the most competitive economies while ensuring high levels of social protection, including investment in skills and education. Their model is now being aped in countries such as France and Germany.

Britain, where official figures mask high levels of people living in extreme social precarity, can, however, rely on growing backing for the reform agenda throughout the EU – provided it is prepared to undertake amendments to its own model to ensure greater social inclusiveness and recognise the efforts being made to adapt to a world in convulsive change elsewhere.

Chapter 3

Corporate protectionism – a view from the City

Michael Snyder, Chairman of the Policy and Resources Committee at the City of London Corporation

Corporate protectionism – a view from the City

Since the birth of international trade, few doctrines have been as widely applied or enthusiastically believed as economic protectionism. And still today the protectionist way of thinking remains very alluring to millions of people around the world. In the City of London, however, you are far more likely to hear discussions about the benefits of globalisation than about the value of protectionism. This is because London's financial sector has, for centuries, been outward-looking and internationally focused. Global financial markets move very fast and this is not an area where nationalism, or national ownership, are appropriate concepts. Free markets remain the best way to deliver jobs, prosperity and rising living standards for the UK population as a whole – and so protectionism is simply not in the City's nature.

The Square Mile has many advantages as a financial centre. These include a geographical position between the US and Asian time zones, a skilled workforce, and the attractions of London itself as a place in which to live and do business. However, it is the City's approach to global competition that has allowed it to innovate, to respond to new challenges and ultimately to pull ahead of its financial rivals.

An advantage from internationalism

London is the most international city on earth, and nowhere is this diversity more in evidence than in the Square Mile. English may be the international language of business, but an observer in the dealing room of an international bank in the City will hear Arabic, Spanish, Russian, Turkish, Japanese, Korean and dozens more languages as the Square Mile engages with its global client base. It is this embrace of globalisation that has consolidated London's position in mature markets, and has also opened doors to rapidly growing economies such as India and China.

In contrast to other financial centres, which have developed primarily to serve their own domestic markets, the City's rapid growth over the last two decades has largely been due to its international credentials and to the Big Bang – the removal in 1986 of almost all barriers to overseas ownership of City firms and participation in its markets. This followed the abolition of exchange controls in 1979.

The City is internationally owned, internationally staffed and internationally managed. Its markets are innovative, competitive and highly liquid, and this brings the City great success in a wide range of international financial markets.

Today firms from all over the world are attracted to the City. In London more international mergers and takeovers are arranged than anywhere else, and more cross-border transactions take place than in any other financial centre. Certainly, many US and Japanese firms have invested in the City and the UK as a gateway to the European single market. It has the biggest foreign exchange, swaps and international insurance and reinsurance markets in the world, and more foreign banks than any other financial centre. The City may be just a square mile in the UK's capital – but its reach is truly global.

In the City, the Wimbledon analogy is often used: the UK provides the venue, the umpires and the catering while the rest of the world provides most of the players. This description may not be totally inaccurate (though it masks the growth of smaller, innovative and flexible UK-owned players in many parts of the financial sector) but it is not without critics, particularly regarding the foreign ownership of City firms, and especially of exchanges.

Overseas companies own the London International Financial Futures & Options Exchange (LIFFE), ICE Futures and Virt-X. However, the debate about foreign ownership really escalated at the end of 2006, with Nasdaq's interest in acquiring the London Stock Exchange. Nasdaq's offer was rejected by shareholders in February 2007, by which time pages and pages of newspaper copy had been written on the rights or wrongs of protectionism – whether or not the London Stock Exchange should be "protected" from foreign ownership.

The City took the view, as did the government, that any intervention to prevent the Stock Exchange from foreign ownership would undermine the traditions that have secured the Square Mile's success. This is borne out by recent research commissioned by the City of London Corporation, which found little concern among senior City figures about whether institutions were UK- or foreign-owned.[1] To try to protect "national champions" would be to damage, rather than further, the interests of London and the country as a whole.

This said, whilst the City and the government remain neutral on the nationality of ownership of exchanges, the issue of regulation is of the utmost importance. At the time of the Nasdaq bid for the London Stock Exchange, a clear message was delivered (by way of the Investment Exchanges & Clearing Houses Act) that any owner of that or any other exchange must not hinder London's ability to operate openly across world markets by importing prescriptive regulation from elsewhere. The continued promotion and expansion of the London Stock Exchange and Alternative Investment Market are also vital.

1 *The Competitive Impact of London's Financial Market Infrastructure* (City of London Corporation/Bourse Consult, April 2007)

Although seeking to “protect” the regulatory advantage the City has at present, this legislation had nothing to do with economic nationalism or the protection of national institutions. It simply sought to enable the ownership of exchanges to change without having a negative impact on the competitiveness of UK capital markets. Companies operating in London should be regulated in London, under our highly respected proportionate and risk-based regime – and the creation of the single regulator, the Financial Services Authority, by the Labour government has been beneficial in many ways.

Such an approach to regulation has given the City an advantage over protectionist regimes in other financial centres. For example, London has gained ground over its long-established rival in New York due to the introduction in the USA of over-prescriptive rules and checks, of which the Sarbanes-Oxley Act (2002) is the most obvious. Tough US immigration controls, though politically understandable, have also started to hamper New York’s ability to tap expertise from around the world. In contrast, the UK policy of allowing talented people from overseas to join our workforce has boosted our economy and brought new ideas to London.

Protectionism on the rise abroad

However, whilst there have been some gains for London from protectionism in the USA, the difficulty in persuading America to open its markets to international competition also has negative implications for UK plc – and indeed world trade as a whole. Over the past few years, protectionist feeling in the USA has increased, for instance in steel, oil and ports, and with threats of retaliation against Chinese exports and the refusal to allow foreign airlines to own or compete with domestic carriers.

In some parts of Europe, protectionism has also been on the rise. In recent times, the Spanish government has attempted to block a German takeover of its largest energy producer; the Italians have favoured domestic bidders over foreign bidders for their banks; and in France the yogurt manufacturer Danone was protected from a foreign takeover bid after being declared an asset of national and strategic importance.

We must not underestimate the threat to global prosperity from these protectionist trends. Such action can affect us all in terms of jobs, growth and prosperity. The City is therefore heartened by the government’s determination to tackle issues such as protectionism, as well as other key issues affecting the Square Mile’s competitiveness, through the Chancellor’s High-level Group on City Competitiveness (on which I, and the City’s Lord Mayor, serve).

At an EU level, the protectionist threat is being taken seriously. The Barroso Commission has been vocal on the matter, and during the German presidency, in the first half of 2007, Chancellor Merkel has strongly rejected protectionism as a solution to the challenges of globalisation. It is vital that the EU continues to fight protectionism within the Union, as well as outside. Work must continue to ensure the completion of an effective single market in financial services, as well as to break down barriers to external trade and investment. It is a battle worth fighting, as existing restrictions could cost European consumers up to €700 billion a year.[2]

The challenges we face in today's world demand international co-operation. We need to reach out, not retreat, and this is what lies behind the City of London's establishment of representation in Beijing, Shanghai, Shenzhen and, most recently, Mumbai. We must make the most of the opportunities of globalisation, not be frightened by the challenges.

The key is to explain better the benefits of globalisation, and indeed some members of the government have been making efforts to do this. Admittedly, this is not an easy task for politicians when the overall gains of globalisation are not always obvious to electorates. In contrast, the immediate costs – for instance in the decline of manufacturing jobs – are much more visible. But we need to take a long-term view.

Open markets work best

So, in summary, open markets work best. If the question is how we best benefit from globalisation, the answer can never be to resort to protectionism. It may be popular in the short term, but over time it is the route to decline. As the world becomes more globally interdependent, the winners will be those who embrace, rather than shy away from the outside world.

The City of London is one of the most successful sectors of the economy, due in large part to its openness to the world. We are determined to keep it that way – and not just for the benefit of the Square Mile itself. The success of the City is good news for the nation as a whole. The UK's current account benefits from up to £20 billion a year from financial and professional business services – not to mention the hundreds of thousands of jobs that depend on the sector, across the country.

Outward-looking internationalism has served London and the UK very well to date. Why change now?

2 Messerlin, P *The Real Cost of European Protectionism* (Institut d'Etudes Politiques, 2001)

Chapter 4

Global trade and the European single market

Malcolm Harbour MEP, Conservative Spokesman on the Internal Market

Global trade and the European single market

The single market has been the foundation stone of the EU. The vision of a truly border-free economic area, with free movement of goods, people, services and capital, was enshrined in the Treaty of Rome. Removing the barriers to trade among European countries has stimulated growth, created jobs and enhanced value for Europe's citizens through wider consumer choice. Increased competition has held down prices, stimulated productivity, growth and innovation, and led to more efficient allocation of resources, thanks to economies of scale.

But, 50 years on, the political work of building a single market still goes on. The easy work was done at the beginning – removing customs barriers, eliminating cross-border formalities, allowing people the freedom to live and work where they choose. But it has proved much harder to tackle deeply ingrained protectionism and to wean EU member countries away from state subsidy, instead encouraging competition.

In the 21st century the process of creating a single market has to be seen in a wider global context. It is an indispensable part of Europe's global competitiveness. A market of nearly 500 million citizens and the opportunities it offers are crucial advantages in securing the EU's place in a global economic system. At a time when world trade talks are stalling, the European single market will prove a crucial negotiating strength in forcing open protected markets and encouraging a free-trading global structure. How far attitudes have to change to reach this goal is clearly illustrated by the recent political arguments over a crucial piece of legislation.

To say that the EU Services Directive – arguably the most important single market initiative of the present decade – had a difficult passage from proposal to legislation would be an understatement. It was dubbed, by its opponents, the "Frankenstein Directive" (in reference to its original proponent, former Commissioner Frits Bolkestein), vilified as an "ugly liberal nightmare", made the subject of widespread trade union protests, blamed for sparking the French "non" in the constitutional referendum and, at one point, declared dead.

Now that it has been adopted, does the plan to lift remaining barriers to free movement of services in the EU hail a new era of liberalised markets, or is the final outcome a success in protecting "social Europe"? Both sides of the debate have claimed victory for the time being. This fight to secure a genuine single market in services reflects the underlying tensions in Europe and encapsulates the challenges the EU faces in retaining its competitiveness in the global economy.

As the lessons of the Services Directive demonstrate, support for free markets quickly fades when jobs are at threat from global competition. There is mounting evidence that the benefits offered by the internal market are slowing, especially since the recent enlargements which saw the EU nearly double its membership. The troubled birth of the Services Directive symbolises the underlying protectionist attitudes of many member states, combined with poor awareness and only a fragile acceptance of the single market project by European citizens.

Renewed drive for the single market

Yet there are some encouraging signs that politicians at all levels are ready to take fresh political initiatives to boost the single market. In the launch of the Lisbon agenda in 2000, single market policies had scant coverage in a long series of proposals to help the EU become globally competitive. In 2008 a strategy for the future of the single market is likely to be top of the agenda at the March economic summit. The Jobs and Growth Plan, the more focused successor to the Lisbon programme, makes it clear that a fully functioning single market is an indispensable part of Europe's competitive position in a global economy.

In this context, the importance of an effective Services Directive becomes clear. Generating an estimated 70% of the EU's GDP, the services sector is unique in permeating all areas of the economy. At the same time, it is difficult to achieve consumer and legislator trust, because services are less tangible and more heterogeneous than goods. Persisting market fragmentation means that innovative companies, which are mainly small and medium-sized enterprises, do not grow as fast as they could. Following its hard-won adoption, the Services Directive, which should be fully in force by 2010, represents real progress for the single market.

The new legislation considerably limits the grounds that member states can invoke to limit access of services providers from other EU countries, and it explicitly prohibits some of the most common protectionist practices. It also introduces a raft of red-tape cutting measures, including single points of contact for market access information. But perhaps the most significant aspect of this new directive is that, for the first time, it creates a legal duty on member states to actively promote the single market to their citizens and to screen their national legislation to ensure that they in no way violate the freedom to provide services and freedom of establishment. The Services Directive will re-energise the political will to tackle all the remaining barriers to a single market.

This dynamic process is being strongly followed through by the launch of a companion project to tackle the remaining barriers to the goods market. Under the new "goods package", now with the European Parliament, the burden of proof with regard to the admissibility of a product to a national market would be shifted from producers and importers to the member state authorities seeking to ban it – a very welcome prospect for businesses, especially small-to-medium enterprises. The draft text also provides for improved co-operation between member state authorities to cut costs and increase efficiency. In a counterpart to the services proposal, there are plans to create product contact points to act as one-stop-shops, giving information to business about local acceptance requirements, where they are still allowed.

A work in progress

The Services Directive and the "goods package" alone are not going to complete the single market. The work will never be completely finished, because the EU must continually evolve and adapt to an ever-changing global environment. But there are some important considerations for the European Commission as it sets out its 2008 plans for the single market in a global economy.

According to the European Commission's own estimates, roughly 90% of the legislation needed to make the single market work is already in place. Why then does it still fail many businesses? Companies consistently identify member states' failure in transposition of directives, poor enforcement, and their disposition to "gold-plating", or over-complex and intrusive implementation. They also fail to respect the country of origin and mutual recognition principles, as enshrined in EU law. But it is becoming more and more evident that the single market will work only if member states start to see it as their own responsibility and not something dictated by "Brussels", altogether separate from the policies that govern their national market.

Of course, Europeans can exploit the single market fully only if they are well informed about it. A concerted effort to deliver real benefits, for citizens and businesses, would help create public support and encourage member states to take more responsibility. SOLVIT centres across the EU, charged with providing practical advice on free movement and offering quick redress in cases of breach of single market rules, are already playing an important role. But, short of resources, they have not had a chance to reach their full potential. They need to be combined with the new contact points agreed for services and products into properly resourced beacons for the single market in every EU country.

The achievement of a single market of nearly 500 million people is the EU's best chance to exploit the opportunities presented by the global economy. It is crucial for innovation and the creation of higher-value, knowledge-based jobs. Completing the single market and opening up globally are two sides of the same coin. The experience of building an effective market, based on common rules and standards, is highly valued in the international arena, which means Europe can be at the helm in efforts to boost global trade through international regulatory co-operation and standardisation. The drive to finish the single market, alongside the encouragement of a world free-trade regime, should be among Europe's top political priorities.

Chapter 5

Views from business

Roger Carr, Chairman of Centrica

Peter Erskine, Chairman and Chief Executive Officer of Telefónica O2 Europe

Stuart Popham, Senior Partner of Clifford Chance

Sir John Sunderland, Chairman of Cadbury Schweppes Group

Bill Thomas, Executive Vice-president of EDS for Europe, the Middle East and Africa

Roger Carr, Chairman of Centrica

Foreign investment is vital to economic growth and business development. But foreign ownership has sparked debates around energy sovereignty and the protection of domestic markets. The proposed merger of Gaz de France and Suez, to create Europe's largest buyer and seller of gas, and Gaz de France campaign against unbundling are in stark contrast to Europe's third energy market liberalisation package, published this September.

Can we ever justify a line being drawn on foreign ownership? Even in the UK, the most liberal economy in Europe, the government suggested that such a move would face "robust scrutiny", but upheld the fundamental principle of a free market based on what is best for consumers. Today we see Great Britain's major airports owned by a Spanish firm, while four out of its six main energy suppliers are foreign owned.

The dynamics of foreign ownership benefit the UK. It is forecast to have the strongest business environment of all major European economies from 2005 to 2009[1] and it leads Europe in foreign direct investment, with $170 billion directly invested from overseas in 2006. It is part of the biggest single market in the world, which in 2006 created an additional 2.75 million jobs, boosted prosperity by €225 billion and accounted for 20% of world trade.

But the single market faces some tough challenges. The rate of progress towards liberal markets is slowing in favour of consolidation. This manifests itself in energy markets with some member states suggesting that security of supply can be achieved only through corporate national champions, on the basis that single, integrated players can negotiate supplies more effectively. However, it is not the value of transmission networks that underpins long-term supply contracts, but rather the buyer's access to markets and customers.

The need for greater co-operation

Recent power cuts across Europe in 2006/07, which left 10 million European consumers without electricity, highlight the limitations of capacity in European transmission networks and the need for greater transparency and co-operation between transmission operators. One of the European Commission's major concerns is the lack of investment by integrated electricity companies in cross-border capacity upgrades.

1 Economist Intelligence Unit figures, 2005

For Centrica, "national champions" mean a lack of access on an equal basis to regional markets and to important trans-European pipelines, including those that are important for UK suppliers seeking to access gas supplies from the East. We don't have access to market information; we need to see more transparency in the market.

This is not a simple debate about security versus competition or protectionism versus free markets. Separating suppliers from transmission networks helps achieve diversity of participants and a wider variety of energy sources, which in turn deliver a level of security that over-reliance on single sources of energy never can. The European Commission's proposed directives, if implemented, would deliver that security of supply through increased competition, generating much-needed investment.

Across Europe, concerns are surfacing about this level of reliance on a small number of suppliers. Increasing dependence on Russian gas increases exposure to disruptions in supply. Recently the UK Energy Minister was in the Caspian region discussing options for a gas pipeline from Turkey to Austria that would bypass Russia.

Free markets must be underpinned by strong regulation to oversee their enforcement and effective operation; this would deliver confidence in the European energy market and promote the growth of a genuine international market for companies like Centrica. The key is a tough compliance regime. The move to strengthen national energy regulators and create tighter cross-border co-operation between them will enforce that, especially with the establishment of a European agency for regulators.

Consolidation does not guarantee security

There is clear political acceptance in Europe that consolidation at this level does not guarantee security of supply nor benefit consumers. Corporate national champions, especially those that have not been unbundled, have little incentive to invest in greater capacity which would enable other companies, such as Centrica, to transit energy across their territories or compete with their supply affiliates. Increasing this capacity could deliver lower prices chargeable for access by third parties and could even lead to cheaper external sources of energy being made available to customers in their home market. The European Central Bank estimates that further reform to encourage competition in European network industries could yield price falls of up to 36%.

An open, competitive UK market has enabled Centrica, which is neither a national champion nor a network owner, to secure gas contracts worth billions of pounds in the most liberal economy in Europe, with the highest standards of security of supply anywhere in the world. Around 24 companies from 11 countries are currently investing £10 billion in UK energy markets – bringing great diversity of supply and thereby security.

Bigger, integrated companies are not a prerequisite for securing supply or a basis for international negotiation. Being big has not helped companies like BP and Shell eliminate difficulties in their dealings with Russia.

Allowing one partner to dominate the energy relationship increases the risk of disruption. Diversity of channels and transparency are the only ways of dealing with an increasingly global market with increased geopolitical risk. Properly functioning competitive markets are the best model for achieving two of the EU's core objectives: security of supply and competitiveness.

Free markets bring great potential. Full market opening could increase cross-border trade in electricity by 31% and reduce prices in the EU-15 by up to 13%.[2] Total savings in the EU-27 could be of the order of tens of billions of euros.[3]

But for energy companies like Centrica there is still far too much market concentration, inadequate transparency, and a lack of a clear mechanism for setting prices.

Europe's gas and electricity consumers appear to receive a poor deal. The lack of choice is demonstrated by the low switching rates for consumers and small-to-medium enterprises – in Germany, for instance, the rate is 5% in the electricity market and even lower on gas, compared with switching rates in the UK of around 50%.

Centrica is one of many companies keen to increase its presence in Europe if the right steps are taken, but we need to see more effective implementation and enforcement of directives, not just in relation to transmission but also at distribution level to ensure retail competition is successful. This is where the European Commission's move to toughen up national regulators is such an important proposal.

Spain's intervention in E.ON's bid for Endesa contravened rules already in place, and Europe's on-going investigation into alleged market abuses continues. The Organisation for Economic Co-operation & Development estimates that restrictions to competition

2 Treasury/Department of Trade & Industry figures
3 Eurostat/Treasury figures

could be reducing productivity by double-digit percentages in some EU markets.

The fundamental element of the free market, from Centrica's point of view, must be effective, well-policed unbundling, which would remove the conflict of interest that network owners have. Truly open markets would encourage owners to invest in transparency and open access, efficiency improvements and greater reliability; this would in turn then draw more producers, generators and suppliers into the market, thus ensuring that security of supply does not depend on one source of energy.

Only then would we see real competition and growth – by stimulating free trade through enabling competitors such as Centrica to enter international markets on an equal basis and improve gas flows across the continent to secure supply from increasingly global sources.

Peter Erskine, Chairman and Chief Executive Officer of Telefónica O2 Europe

President John F Kennedy once said that "the best time to fix the roof is when the sun is shining": famous words of which the EU should take heed. For, while raindrops have not yet started to fall, dark clouds are gathering on Brussels' horizon and without appropriate repairs the outlook for the European economy is bleak.

I am an enthusiastic pro-European. Running a business with almost 39 million customers across five EU member states, with over 35,000 employees, it is hard not to be. But it is because I can see the inherent economic and political sense in the nations of Europe working more effectively together that I regard it as so important to reform and refocus the EU and its institutions.

In November 2006 the mobile telecoms business of which I was chief executive, O2, received an approach from Telefónica of Spain. Telefónica's president, Cesar Alierta, made it clear to me that he wanted Telefónica to become a truly European business – rather than simply the Spanish incumbent – and that by acquiring O2 that dream could become a reality. In due course Telefónica's acquisition of O2 went through, and today I find myself running the European operations of the largest telecoms business outside China.

So what? Well, our case shows exactly just how the European single market should operate. The coming together of O2 and Telefónica, free from political interference or the promotion of narrow economic nationalistic interest, has created not simply a truly powerful European business but also a truly global one. By becoming part of the Telefónica group we are now able to provide more products and services, at increasingly competitive prices, with tangible benefits to both the European consumer and our bottom line.

Contrast that with a plethora of cases across the EU where sensible mergers or acquisitions have been blocked, delayed or permanently stalled. From overt protection of the Italian banking sector by political interests, and the outrageous shielding of French food producers through "cultural" justifications, to the on-going failure to achieve consolidation (and therefore liberalisation) in European energy markets, the EU has a poor record in this respect.

It was one of our major competitors, Vodafone, that broke the mould back in 2000 with its acquisition of the German business Mannesmann. However, moves such as this have tended to be the European exception rather than the rule, and if European businesses are to deliver real benefits from the single market to consumers then it is vital that the EU take a firmer stance against individual member states and the domestic political interests that allow economic nationalism to flourish.

A European solution

In the UK we have long been advocates of open, liberal markets in which competition can flourish. And yet it would be foolish to claim that the British model is the only way for the EU to reform. Economic nationalism also occurs within the UK (and Spain) and it is only by adopting a truly European solution that real progress will be made.

Neither am I claiming that all proposed mergers and acquisitions should go through unchallenged. There are numerous cases where ill-thought merger and acquisition activity has actually destroyed business value and made life worse for the consumer. But where the business case is clear, the consumer benefit unequivocal and the competitive need apparent, individual member states or EU institutions themselves should be prevented from using merger and acquisition activity as a political football. The European citizen deserves nothing less.

The EU already has many of the tools it requires to ensure this is the case. The Lisbon agenda, in particular, maps out clearly how the EU needs to act if Europe's businesses are to continue to generate wealth and jobs and to be globally competitive. The problem appears to be a lack of political will. Too often when faced with taking an unpopular yet necessary decision to push through on the Lisbon agenda, the EU has buckled, giving in to sectional lobbying or individual member state interests.

Take the recent case of international mobile phone roaming rates, where, led by the European Commission, the EU imposed both wholesale and retail price controls on one of Europe's most dynamic and competitive sectors. I fully acknowledge that the issue of international roaming was one the industry had handled badly, failing to understand the levels of customer confusion and anger. In any business, if you lose touch with what your customers want then you are in a very dangerous place indeed. But are we really saying that the solution to this issue was a one-size-fits-all price cap across the entire EU?

Competition within the European telecoms sector is intense, pricings are decreasing year on year, and the European consumer is increasingly getting more for less. Telecoms is also a global business where the battle for investment, skilled people and research funds is relentless. In that context the action taken by the EU on international roaming seems misguided, driven by a need to make EU institutions publicly popular rather than in the best interests of the European economy. It was also deeply disappointing to see the international roaming regulations brought forward without appropriate regulatory impact assessments or comment from the Commission's vice-president or its Competitiveness Council.

I believe that at all levels business needs to re-engage with Europe and its institutions, to help confront economic nationalism and to make the case for enterprise, wealth creation and economic reform. Looking ahead, we need to ensure that the case for job creation is argued every bit as powerfully at the European table as those siren voices are advocating job and trade protectionism.

I have always been an optimist, and I believe that there is still time for the EU, working with European business, member states and other relevant parties, to making the changes Europe's economy needs. Telefónica O2 Europe is certainly committed to playing its part in making that happen.

Stuart Popham, Senior Partner of Clifford Chance

Activity in mergers and acquisitions in the European Union in the last couple of years has seen a new wave of "economic patriotism", a term coined by Dominique de Villepin, the then French prime minister. Whether relating to the proposed takeover of Endesa, the Spanish electricity group, by German company E.ON, or to the reaction of certain European governments to the hostile takeover bid by Mittal for the Luxembourg-based steelmaker Arcelor, protectionism in all but name has shown itself capable of resurrection.

The motivation behind this recent resurgence in state intervention in the marketplace is debatable: is it a reaction to globalisation, a desire to protect and create corporate national champions, or a response to the growing economic interdependence between countries? Whatever the reason, Europe is not the only part of the world where intervention is being chosen over liberalisation.

The desire to protect a national industry, with the flawed aim of helping it to flourish while immune from competition from outside the home territory, is neither new nor uncommon. But does it have the desired effect? Accepted theory argues against activist industrial policy. There is sound evidence to suggest that, crudely, competition in a market leads to growth in the long run, making protectionist strategies a short-term vote winner but a long-term hindrance to economic prosperity.

A flourishing export

The UK market for legal services is a shining example of this in practice. The sector has experienced rapid growth as part of the transformation of the country's economy. It represents over 2% of UK GDP (with a large proportion paid for by people outside the UK). UK firms have been successful, among other reasons, because domestically they operate in a competitive market with few, if any, restrictions on overseas competitors practising here.[1] Currently 2,425 non-English qualified lawyers are partners in English law firms. International firms based in London are estimated to have generated nearly £4 billion in UK tax revenues in 2005.

1 Other factors contributing to that success include: the predominance of English law as a jurisdiction of choice in commercial contracts; the popularity of London as an arbitration centre; UK financial services providers and the many multinationals operating overseas having instructed UK lawyers in relation to international as well as domestic transactions; and the willingness of UK law firms to grow and to establish themselves overseas.

Similarly open regimes are not to be found in other key countries, however. The policy of Clifford Chance has been to follow the needs and expectations of its clients in deciding where to set up offices. Thus we are present in all the major EU economies, as well as the USA and other key growth nations. That said, every business around the world has an eye on Brazil, Russia, India and China, and law firms – in their role as facilitators of business – are no different. Of those four countries, only Russia currently allows full freedom for international firms to operate, employ people and advise upon local law.[2]

A focus on India

Focusing on India, its importance as a market now and over the next decade can be neither denied nor ignored. There are significant trade and investment opportunities for all kinds of UK businesses. While markets for goods and some services have opened up to a large extent, the market for legal services remains firmly closed. Clifford Chance has been providing services to clients based or active in India for many years, but local regulatory constraints prohibit foreign law firms from actually establishing offices. Foreign lawyers have been unable to practice in India since a court ruling in 1995 that banned foreign lawyers from offering legal services of any kind.

But who are the restrictions aimed at protecting? And do the interests of the Indian legal profession coincide with those of its clients? Surely, clients are looking for the best legal advice and services available in order to grow their businesses. The prohibition reduces the choice of lawyers and breadth of experience available to business, which must be seen as a real concern.

The main reasons for the restrictions appear to be historical barriers, and continuing opposition from the local legal profession. Indian lawyers seemingly fear that foreign law firms will take work away from them and that they will not be able to compete. Experience in other countries contradicts this, however. Clifford Chance opened an office in Paris 30 or more years ago. There were three English lawyers in the firm. Today there are about 12, but there are 200 French lawyers. In the London market in the last 10 years the number of US lawyers has doubled to 1,500. In the same period the number of English solicitors has more than doubled, from 48,000 to over 100,000. The arrival of US lawyers in London has created more work, because London can now offer advice on legal jurisdictions and multi-jurisdictional transactions. There are currently four Indian law firms in London

2 Malaysia, South Korea and others are equally restrictive (though there is a ray of hope in Korea). This in contrast to China, Hong Kong, Japan, Singapore and Thailand, where – despite certain restrictions – international firms have found a modus operandi.

adding to this breadth of expertise, and there is room for more.

An increase in the number of lawyers can be taken as a good or a bad thing to those outside the legal profession, but these figures do demonstrate that Indian lawyers' fears are unfounded. If foreign lawyers could reside and set up in India, the total volume of legal work would increase. This should be welcomed when the role of lawyers as facilitators of business is considered.

Equally, the fears about taking work away from local lawyers are misplaced. There is minimal overlap between the practice of the large international firms and the practice of domestic law firms, whose work centres typically on matrimonial, domestic conveyancing, wills, criminal law and litigation. The work of international firms, on the other hand, tends to be on behalf of financial institutions or multinationals and involves assisting in the acquisition, development and financing of businesses, including infrastructure, natural resources, the development of the capital and financial markets and privatisations, as well as foreign direct investment more generally.

That said, competition head to head with international firms would strengthen the Indian legal system and promote quality work among the top Indian law firms. Access to world-class legal expertise and experience is crucial for the development and growth of important sectors such as capital markets, energy and telecommunications, as well as being beneficial to the development of the local legal environment and infrastructure.

An unintended consequence of the ban on foreign lawyers practising in India is that there are business transactions that simply cannot be undertaken there – for example, specialist types of financial transactions, and methods of raising finance (securitisation, structured bond financings, including infrastructure, derivatives and many securities issues) because there is insufficient or no experience resident in India of how they can be done. Indian companies therefore travel to Europe, the USA and other Asian countries to find that experience and obtain advice. Having to go abroad to seek advice increases their costs and delays their actions, and there is no accretion to lawyers in India of the knowledge gained in learning about and being involved in those transactions.

The flipside is that some investors and companies that would trade with India and would bring foreign investment and jobs to India are not investing, because they cannot be certain of the risks involved and cannot get the legal advice. Total foreign direct investment from the EU last year was $300 billion, but only a little over 1% of this went to India. It is dangerous to put off investors. The increase in global trade now happening is the largest in history. The mergers and acquisitions market is at its biggest ever, and the Indian legal profession is not seeing its fair share of that because it is looking inwards when it should be looking outwards.

Benefits of opening up

A stronger presence of international law firms can help to enhance the effectiveness of regulation, assist in eliminating corruption, and ensure that the highest standards of international business practice are adhered to in areas such as competition, procurement, corruption, human rights and the rule of law generally.

In a speech delivered in November 2006, Ed Balls, Economic Secretary to the Treasury, said:

For 300 years London's success has been based on our commitment to the rule of law and the highest professional standards. And practitioners here and around the world regularly cite London's world-class business support service in areas such as law and accounting as one of its key attractions.[3]

A January 2007 report[4] commissioned by US Senator Charles Schumer and New York City Mayor Michael Bloomberg on the status of the US financial services sector found that a fair and predictable legal environment was the second most important criterion in a financial centre's competitiveness. The survey went on to say that in that regard, the USA was at a competitive disadvantage to the UK. Of those surveyed, only 15% thought the US system was better than the UK's in terms of predictability and fairness. India could also learn lessons from these findings.

Liberalisation would create more enhanced employment opportunities for Indian lawyers. Indian lawyers share with English lawyers the common law system. Indian lawyers should be as international as English lawyers in their outlook.

What should legislators do?

What can the EU and the UK do to help their industries gain the kind of access there that businesses from third countries enjoy in the European marketplace? A two-pronged approach is required: the UK must play its part in representing UK business, and the

3 Speech by Economic Secretary to the Treasury, Ed Balls MP, to the annual conference of the Institute of Chartered Accountants of England & Wales, in London, 20 November 2006

4 *Sustaining New York's & the US's Global Financial Services Leadership*

advantages of being part of a bigger trading bloc must be exploited.

Turning to the former, there is undoubtedly a special relationship between the UK and India. There is a shared history, a common legal system, a common language. But the UK must not rely on this and be complacent. Others are courting India just as much as is the UK, if not more. UK ministers have been increasingly vocal about India, and for that we are grateful.

During a trip to India earlier this year, Alistair Darling said in a speech:

In legal and accountancy services I am told that there are not enough Indian accountants and lawyers to satisfy domestic demand. India needs to press on with its process of liberalising this sector, or it will lose out to other international markets.[5]

This type of message is to be encouraged.

We would also encourage the UK to join up the work of the various government departments and ministries. UK Trade & Investment, the Ministry of Justice and the Department for Business, Enterprise & Regulatory Reform should continue to work together, alongside groupings such as the Joint Economic & Trade Committee (Jetco) set up by the UK and India in January 2005, to find ways of boosting bilateral trade and investment.

When it comes to international trade, the European marketplace – with its 500 million consumers – undoubtedly represents an attractive proposition to any trading nation. Speaking through the EU microphone will give the UK a louder voice and increase its bargaining power. The EU, in the form of both industry and governments, must continue to push for the resumption of negotiations in the World Trade Organization's Doha development round. It is the only way to continue to apply pressure – and, even more so, give encouragement – for countries to liberalise.

5 Speech by Alistair Darling MP, Secretary of State for Trade and Industry, to the third annual India/UK Jetco meeting, in Delhi, 16 January 2007

Sir John Sunderland, Chairman of Cadbury Schweppes Group

Globalisation is woven into the fabric of Cadbury Schweppes. In 1783 Jacob Schweppe perfected his process for manufacturing carbonated mineral water in Geneva, Switzerland. Closer to home, John Cadbury opened for business in Birmingham in 1824 – and the importing of cocoa beans was a critical ingredient, even then.

The early 20th century saw international trade increasing, and the first overseas Cadbury factory established to supply the Australian market. The global spread of both trade and manufacturing operations continued throughout the 1900s. Cadbury opened for business in India in 1947, and in China in 1994.

Today Cadbury Schweppes is the world's largest confectionery company, employing over 70,000 people, and our products are enjoyed in almost every country around the world.

Globalisation is a way of life for Cadbury, our employees, customers and the way we do business. And it is not just our prerogative. Free markets, free competition and free trade have become the orthodoxy of modern economics.

Globalisation has transformed the world economy. It creates wealth and higher standards of living. It opens up markets for companies and delivers greater competition and choice for consumers. It is also the best means of alleviating poverty – and of obtaining a safer and securer world. Witness the spectacular rise of China and India, which have pulled millions out of poverty as they become engaged in global trade and investment flows.

Two causes of anti-globalisation sentiment

So why the sudden rise in anti-globalisation sentiment? Two dynamics are at play. One is around individuals; the other concerns company ownership, and the debate around so-called national champions.

Let's start with individuals: here perhaps concern about globalisation is easier to understand. Globalisation is fundamentally about change. And that brings winners, but also losers in the short term.

What are the issues that cause discomfort? One is the sheer pace of change. The world is changing so fast that it is difficult for people to know where they stand. The second is changes in the workplace. Gone are the days of a job for life. Today people have many different careers, often with many different organisations. The globalisation of business has in many senses loosened the emotional ties between business and society.

The third issue is that of pay and compensation. The need to compete for the very best has helped drive up the pay of senior executive talent. But at the same time employees with basic or intermediate skills find themselves in competition with workers in low-cost economies. Against this background of individual unease, business and government have so far not done enough to communicate and emphasise the benefits of globalisation.

The second dynamic relating to the rise in anti-globalisation sentiment concerns so-called national champions. The globalisation debate started with cross-border trade in goods and services; then outsourcing and offshoring became the centre of attention. Today the focus is on company ownership. And that seems to be causing discomfort to some of our European neighbours and transatlantic colleagues, who are resorting to "economic patriotism" measures to protect their home industries.

In Europe, we see governments going to great lengths to stave off the commercial realities of globalisation and, in some countries, encouraging a culture of protectionism.

The previous French administration busied itself engineering the merger of Suez and Gaz de France to pre-empt a rival bid for Suez from the Italian energy group Enel. The Spanish government did everything in its power to ensure that Spain's energy companies remained Spanish, as it thwarted the bid by German energy group E.ON for Endesa. And the USA, a supposed champion of free trade, intervened in the Dubai Ports takeover of P&O because six US ports were part of the deal. None of these, however, can top the attempt made by the French to proclaim Danone, the yogurt manufacturer, as a national champion of strategic significance.

This behaviour is all rather puzzling to the UK, with its history of free trade. We know the alternatives to free markets; we have seen the past. It doesn't work. Sectors cannot be artificially propped up indefinitely – market forces prevail in the end. Countries and firms that refuse to face reality and accept the need for change will always suffer in the long run, as they will be the least prepared.

A better answer than economic nationalism

So if economic nationalism is not the answer, what is the right response to take advantage of the many opportunities that globalisation has to offer?

In a globalising world, domestic policy will remain critical. Competitive taxes, a business-friendly regulatory environment and quality infrastructure are the recipe to attract and retain the very best global businesses. Above all, we need to ensure that the country is equipped with the human skills necessary to compete in the global market.

International policy also has a key role to play. Global institutions must be strong in supporting free trade and open markets.

We should be concerned about "free and undistorted" competition being dropped from the EU's objective on achieving a single market in the recent treaty negotiations. It is not just a cosmetic change – it represents a long-term threat to free competition and will strengthen the hand of protectionists within the EU in the years ahead.

The UK government should take a tough stance on promoting open markets and in ensuring a level playing field on which everyone plays by the same rules. The European Commission has a responsibility to take action against member states that are not doing so and are infringing existing internal market directives. And further afield, we need to unblock the World Trade Organization talks to put in place a multilateral, rules-based approach to global trade for future generations.

The business response must be no less dynamic or ambitious. Intensification of competition will continue apace. There will be increasing mobility of all factors of production. Supply chains will be restructured and dispersed. The rate of innovation will see product life cycles continue to shorten, driving constant change in sources of comparative advantage.

Above all, business now lives in an information age. And that surely is the ultimate rebuttal to all those who advocate economic nationalism. Building protectionist barriers against trade in physical goods is difficult enough. Putting up defensive walls to prevent information flows is all but impossible.

Bill Thomas, Executive Vice-president of EDS for Europe, the Middle East and Africa

In the 19th century the economist David Ricardo wrote:

Two men can both make shoes and hats, and one is superior to the other in both employments; but in making hats he can only exceed his competitor by one-fifth or 20%; and in making shoes he can excel him by one-third or 33%: will it not be in the interests of both that the superior man should employ himself exclusively in making shoes, and the inferior man in making hats.
David Ricardo, *The Works & Correspondence of David Ricardo*

The world we live in today is the embodiment of the principle that Ricardo set out over 150 years ago. Capital, labour and investment flow to areas where they can deliver the greatest advantage; production is highly efficient, and goods and services flow around the world from producers to consumers. For the individual, efficiency in production has driven down real prices, thereby delivering economic wealth that could only be dreamed of a generation before and a level of product choice that is at times mind-boggling.

The drive for efficiency and comparative advantage, whether on the part of commercial organisations or in the public sector, is what creates a market for EDS. EDS's ability to deliver IT services, develop new software applications and manage business processes in a highly efficient and cost-effective manner makes our services attractive to organisations that cannot match EDS's efficiency and effectiveness in these areas. In turn, by delivering services in our area of comparative advantage, EDS frees up capital and resources for our clients to focus on the areas where they have a comparative advantage – whether that is manufacturing aircraft engines, delivering financial services to consumers or providing money for state pensions or benefits. The world that EDS operates in is a microcosm of the larger global economy.

Globalisation has been of economic and social benefit for the vast majority of countries and not just the Western powers of the late 19th and 20th centuries. The economies of Asia, South America, the Middle East and Eastern Europe have benefited from globalisation. Foreign direct investment has proved of benefit to both recipient and investing country alike, with countries such as the UK receiving massive inward foreign investment and making similar-scale overseas investments to the benefit of the economy as a whole.

Globalisation has encouraged democracy and economic growth, and it can be argued that those countries that have not prospered from the global economy of the 21st century are those that have been unable to participate in it for reasons of civil strife, war or isolationism. Such countries' economic stagnation is a not a consequence of globalisation, but rather the result of internal chaos and parochialism.

Globalisation under attack

Against this background, and with a track record of delivering wealth, social benefits and high levels of employment around the globe, one would assume that the structure underpinning globalisation – most importantly, the free movement of capital and goods – would be secure from attack and receive stout defence from politicians, opinion formers and the general public alike.

Increasingly, however, this turns out not to be the case. As Gordon Brown stated, when Chancellor of the Exchequer, in his 2006 Mansion House speech:

... just as the pace of globalisation has quickened since we met a year ago, just as the rise of Asia and globalisation's overall scale and scope have intensified, so too has the backlash. People talk today less of globalisation and its benefits, more of globalisation and its discontents.

During this speech, Gordon Brown highlighted that it is not just the developing countries that are showing signs of reverting to economic nationalism or protectionism, but the USA and countries within the EU.

A quick glance at the headlines of the financial press during the past 18 months also highlights the trend toward economic nationalism. Mergers, acquisitions or share purchases involving names such as Dubai Ports, Endesa, Enel, Volkswagen or Mittal have been subject to actions or threats from governments that have the potential to undermine the free movement of capital.

It is the experience of EDS that economic nationalism rears its head in more subtle and insidious ways also. In the media, any story focusing on EDS's operations in Europe will normally describe the firm as "Texan IT giant EDS", creating an image of foreign invaders rather than highlighting the 45,000 jobs we have created in Europe and the billions of euros we have invested across the EU.

Similarly, while many governments in Europe may refrain from directly involving themselves in commercial markets, they continue to defend their public sector with a vigour that defies economic sense and denies value to the taxpayer. Too often, across Continental Europe, services that could be provided more cost-effectively and better by the private sector remain under state control. The losers in this case are citizens, who pay high taxes for poor services. These services are often difficult to access and antiquated in their structure. Governments' protection of their national public sector serves no one apart from their own short-term electoral goals and the interests of vocal, though often unrepresentative, lobby groups.

Defending free trade

So, what is to be done?

Those who believe in free trade and global markets should accept that right is on their side and be unapologetic in their support for globalisation and free trade. It must be remembered that almost no issue unites economists to the extent that free trade does. Economists see that the long-term cost of subsidies and economic protection is invariably higher than any short-term gain that such economic nationalism may generate.

We also need to accept that politicians will always be susceptible to the siren call of pressure groups that seek to protect the interests of their relatively few members, to the disadvantage of the majority. This will always be the case, although it will ebb and flow with the political cycle. To counter this, we must constantly build and enhance the profiles of organisations that can rise above short-term political pressures. The World Trade Organization and the competition authorities in the EU are just such bodies, and business and consumer organisations must be vocal in their opposition when attempts are made to sideline them or undermine their authority.

While we may accept that politicians will come under pressure from interest groups to resist globalisation, this should not be seen as excusing politicians from doing the right thing when it comes to facing up to the realities of globalisation. In this context, "doing the right thing" means investing in skills and moving the national workforce higher up the value chain. In particular, for Europe and the USA there must be a focus on delivering programmes that improve the attractiveness of science for students of all ages and thus substantially increase the number and quality of science and technology graduates coming out of universities.

At EDS, we believe that Ricardo had it right. Free trade and following the rules of comparative advantage have brought economic growth, prosperity and stability to the vast majority of the globe. We will continue to be a part of the global market and focus on competing vigorously but fairly with our global competitors. In doing this, we will deliver better services to our clients, increase the wealth of their customers and deliver economic value to the global economy as a whole. This is what Ricardo envisaged and this is what governments across the globe should encourage. Economic nationalism is neither a sensible nor a feasible alternative, and in the 21st century opposition to globalisation in the name of "economic nationalism" actually undermines the economic security of a nation.

Chapter 6

The costs of protectionism – globalisation and development

Professor Anthony Venables, Chief Economist in the UK Department for International Development and BP Professor of Economics at the University of Oxford

The costs of protectionism – globalisation and development

There is now abundant evidence of the importance of exports in driving economic growth and poverty reduction in developing countries. A classification of developing countries into "globalisers" and "non-globalisers" showed that globalisers' trade as a share of GDP doubled during the 1990s, with annual economic growth averaging 5%, while non-globalisers had a stagnant share of trade in income and annual growth averaging just 1.4%.[1]

Sometimes the claim is made more emphatically, that no country has achieved a sustained period of rapid economic growth without having rapid export growth. Careful statistical work has established that growth accelerations in developing countries are typically associated with an increase in the share of exports in income of 10-15 percentage points.[2]

These broad-brush studies leave no doubt about the importance of globalisation for developing countries, but do leave open many questions. What are the mechanisms through which globalisation operates? Why is its impact different across countries, with some securing export and income growth and others left behind? And what are the policy implications – how might future changes in trade policy or the rise of economic nationalism impact on developing countries?

This chapter will point to three aspects of globalisation that are important for developing countries. The first is that globalisation has brought unprecedented opportunities for countries to gain from trade and from mobility of technology and knowledge. The second is that globalisation has changed some relative prices and increased competitive pressures, thus creating difficulties for some developing countries, as it has for some developed countries.

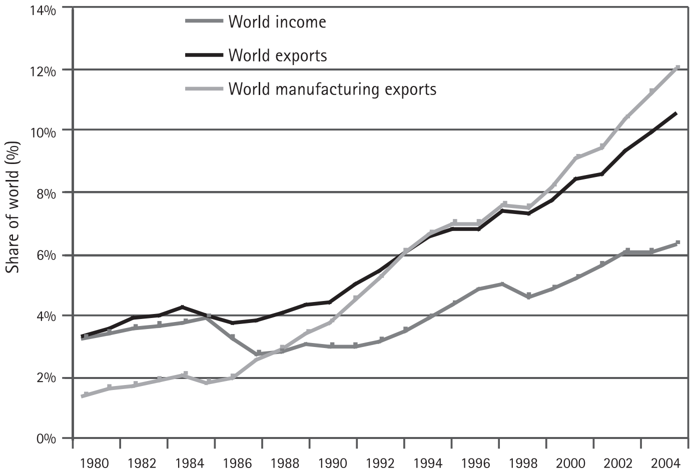
The third point is that successful participation requires that countries get over some threshold level of capability. Many countries, particularly in Africa, were below this threshold when globalisation took off but are now close to or at the threshold. This fact makes it particularly important that markets continue to open and remaining trade barriers are removed, enabling Africa to participate fully in the global economy.

1 Dollar, D and Kraay, A "Trade, Growth, and Poverty" in *Finance & Development* vol 3, no 38 (September 2001)
2 Hausmann, R, Pritchett, L and Rodrik, D "Growth Accelerations" in *Journal of Economic Growth* vol 4, no 10 (December 2005)

Globalisation and the gains from trade

The Asian experience provides the clearest example of the gains from trade. Figure 1 shows how the share of developing East Asia in world income doubled between 1980 and 2004, while its share in world exports nearly trebled, and its share in world manufacturing exports increased by a factor of nine, from 1.4% to 12% of the world total. During this period some 500 million people in East Asia were lifted out of poverty – a number without historical precedent.

Figure 1: East Asia's share of world income, exports and manufacturing exports



Many lessons follow from the Asian experience, and I shall draw out just a few of them. The first concerns the sheer speed of development. Sources of economic growth often stall because they run into diminishing returns. Production of import-competing goods for a small domestic market provides one example; another is primary-based activities, where declining stocks of resources or of land per worker bring diminishing returns. In contrast, exports of manufactured goods can be scaled up more readily. They face the world market, rather than a small local market, and manufacturing activities often have increasing returns (rather than diminishing) as the benefits of learning and cluster effects come into play. Export opportunities supported by globalisation have therefore been instrumental in the pace of Asian development.

The second lesson concerns the nature of the trade. Much international trade is now referred to as trade in "tasks" rather than trade in goods. What this means is that different tasks involved in producing a good – ranging from design through to production of intermediate components, assembly and customer support – have fragmented and can take place in different countries. Much East Asian trade is in intermediate goods as Japan has outsourced production and assembly activities; South Asia has profited from call centres and software production. Sometimes this trade takes place within an international firm that is willing to shift some of its capital and technology to a developing country.

The important point about this fragmentation is that it allows a much finer division of labour. A country no longer has to have the capability to undertake all stages in the production of a good – it can specialise narrowly in those "tasks" in which it has comparative advantage. This aspect of globalisation is fundamentally important for developing countries with a limited range of technical skills and abundance of unskilled labour. It offers a route into participation in the world economy based on just a few sources of comparative advantage.

The third lesson is that development of these export-oriented sectors has often been quite spatially concentrated within a country, as capabilities in particular goods or tasks initially builds up in quite small regions, frequently coastal cities. This development has typically led to a period of increasing regional inequality, and it is only once wages start rising in booming areas that activity begins to spread into the hinterland. Thus, in China, the ratio of wages in coastal regions to those in the interior increased for many years, and has started to fall in the last five years or so.

Competitive pressure and trading opportunities

Globalisation permits a finer division of labour, enabling the highest-skilled countries to concentrate on skill-intensive tasks, and the lowest-skilled to concentrate on low-skill tasks. As we have seen, this has been the basis on which some low-income countries have grown rapidly, driven by rising exports of manufactured goods. However, increasing trade flows change world prices, and this in turn alters opportunities for other trading countries.

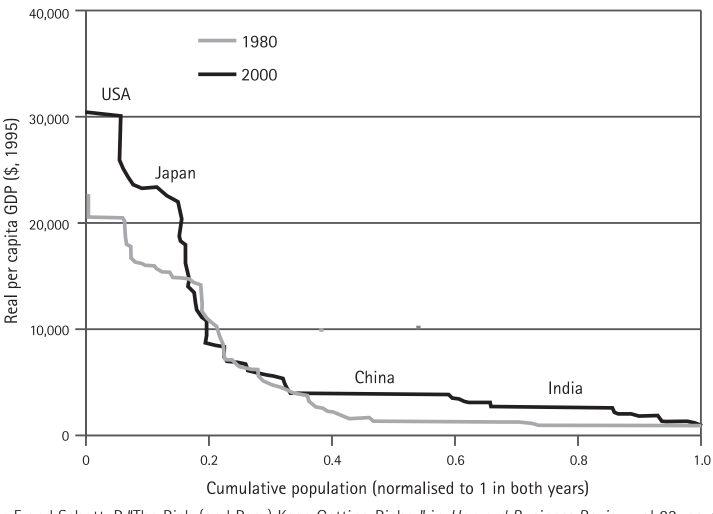
The rise of the Asian economies has recently fuelled a commodity price boom and, over a longer period, has had an impact on the price of manufactured goods. The relative price of manufactures (the manufactured commodities terms of trade) has halved over the last 30 years, driven partly by globalisation and partly by technological innovation.

Price changes of this magnitude have brought gains to consumers worldwide, but have also placed producers under pressure. The pressure has not fallen primarily on producers in high-income countries, but has instead been felt in middle-income countries producing goods that are technologically relatively unsophisticated. This is one of the reasons why globalisation appears not to have benefited many middle-income countries.

The relative income gains of people in countries at different points in the world income distribution is illustrated vividly in a figure produced by Ed Leamer and Peter Schott.[3] The horizontal axis of figure 2 is cumulative population shares, with the poorest country at the extreme right, and the richest at the extreme left, while the vertical axis is per capita income. Comparing world income distributions in 1980 and 2000, it is striking that the populations of high- and low-income countries have done relatively well. A group at the very bottom have seen no progress, and neither have the middle-income group.

Of course, this figure masks a lot of detail and it would be incorrect to attribute all the changes to globalisation. But it illustrates the point that the finer division of labour that is facilitated by globalisation encourages specialisation at extremes, while tending to squeeze the middle.[4]

Figure 2: Changes in world income distribution

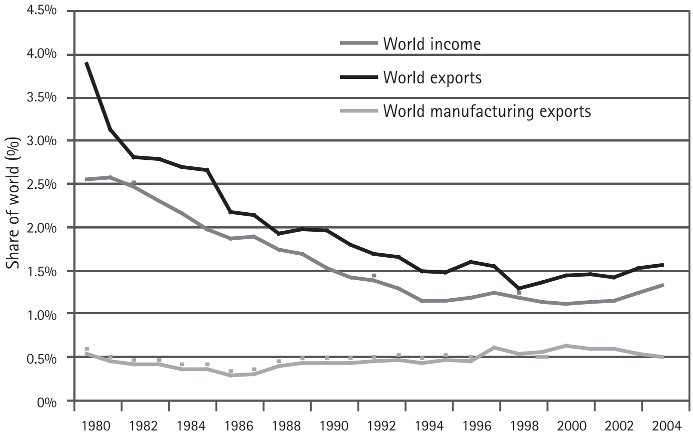


3 Leamer, E and Schott, P "The Rich (and Poor) Keep Getting Richer" in *Harvard Business Review* vol 83, no 4 (April 2005). At: http://www.som.yale.edu/Faculty/pks4/files/research/papers/ineq_draft_20050218.pdf
4 See also: Lawrence Summers "The Global Middle Cries Out for Reassurance" in *Financial Times*, 29 October 2006

Africa

Most of Sub-Saharan Africa has failed to participate in new global trade and production networks. The numbers are given in figure 3, showing the region's share of world trade halving over a 20-year period, and the area being underrepresented in exports of manufactured goods, with its share stagnating at around 0.5%, much less than its share of world income.

Figure 3: Sub-Saharan Africa's share of world income, exports and manufacturing exports



What are the reasons for this performance? One is geography; 15 of the countries in Sub-Saharan Africa are landlocked, raising the costs of trade, particularly when there is also poor transport infrastructure. Another is the presence of export earnings from natural resources, which tend to crowd out other export activities. Most important is the fact that the political and economic governance of most of the countries in the region has been too poor for them to be attractive locations from which to source imports. In the late 1990s inflation in Sub-Saharan Africa averaged more than 15%, and the business environment in many countries was very difficult.

The last five to seven years have seen a striking improvement in many aspects of African economic performance and business environment. Average inflation has fallen to 6%. There has been a significant pick-up in economic growth, and many countries are making progress on improving the business environment; Ghana and Tanzania were both in the world top 10 reformers in the 2007 Doing Business survey.

Of course, there are still many problems, both institutional and to do with infrastructure, including transport and power. Nevertheless, there are now locations in Africa that offer a business environment of a quality comparable to that of many Asian economies a decade ago. These locations have met the necessary conditions for participation in the world economy, but they face a further problem – the fact that Asia has a headstart. Many Asian economies have reaped the benefits of increasing returns and cluster effects, and the prices of their export products have declined, as noted above.

Does this imply that Sub-Saharan Africa will not be able to break into global trade and production networks? Probably not, for several reasons. One is that Asian wages are rising – fast in some places – and as this happens firms move out of basic labour-intensive products and into higher-value goods. Another is that the Organisation for Economic Co-operation & Development trade policy can be further reformed to improve African prospects.

Trade policy

What should trade policy do to enhance the prospects for poverty reduction, particularly in Africa? There are three priorities.

The first is successful completion of the Doha development round of World Trade Organization negotiations. This will demonstrate continuing commitment to a process of multilateral liberalisation, while its failure would risk increasing fragmentation of world trade into regional blocs in which the interests of the poorest nations would be sidelined.

The second priority is further agricultural liberalisation. While the main losers from current protectionist schemes are consumers and taxpayers in OECD countries, they also have significant detrimental effects on some crops and some developing countries. For example, it is estimated that removing all cotton subsidies and tariffs would raise world real income by $280 million a year, of which nearly $150 million would accrue to countries in Sub-Saharan Africa.[5]

The third point relates to the details of trade rules, in particular those in preferential trading agreements. Virtually all countries in Sub-Saharan Africa receive trade preferences under a wide range of schemes. The World Trade Organization's generalised system of preferences is used by OECD countries to offer preferences for the least developed countries, and these are enhanced by schemes such as the US's African Growth &

5 Anderson, K and Valenzuela, E *WTO's Doha Cotton Initiative; A Tale of Two Issues*, CEPR discussion paper 5567 (2006)

Opportunities Act and the EU's Everything But Arms and Cotonou agreements, currently evolving into economic partnership agreements.

While these schemes offer preferential market access (generally tariff- and quota-free) they also constrain participation. Eligibility is generally restricted to the least developed countries, which are likely to be below the threshold of being able to attract investment and benefit from the schemes. Detailed rules – such as product standards and rules of origin – often exclude precisely the products that offer prospects for export growth.

Rules of origin are particularly pernicious, as they constrain ability to engage in trade in tasks, a key element of modern globalised trade and production. A recent example makes the point vividly. The US's African Growth & Opportunities Act liberalised rules of origin for just one product class, allowing imports of African assembled garments made from imported (often Chinese) textiles. Kenya, Lesotho and Madagascar produced an extremely rapid supply response, with exports of apparel soaring to $1.5 billion a year. In contrast, the EU's Everything But Arms agreement prohibits the use of such imported inputs, so African factories producing garments for the sale in the US are unable to sell them in the EU.

These arguments all point to the fact that developed countries need to keep up a momentum of furthering and deepening globalisation. Globalisation has facilitated the most dramatic episode of poverty reduction in human history. Although Africa has been left behind, there are now reasons for optimism, and a need for trade and aid policies to enable Africa to reach the 7% growth target required for the Millennium Development Goals on poverty reduction.

Chapter 7

The EU's approach to combating protectionism

Charlie McCreevy, European Commissioner for Internal Market and Services

The EU's approach to combating protectionism

A rising tide of economic nationalism across many member states in Europe makes life difficult for the European Commission as we seek to drive forward the economic integration that is essential for Europe's long-term success.

We see it manifest itself especially in opposition to free movement of labour across the EU and through endeavours to block cross-border mergers and acquisitions to protect corporate national champions. While protectionist reflexes are understandable – in particular when economic times are tough – they are very damaging to Europe's long-term competitiveness. Far from helping member states to get out of a hole, they actually make the hole deeper. Instead of protecting long-term living standards, jobs, growth, and social cohesion, economic nationalism – or protectionism – actually undermines them.

Historically, there has been a close correlation between economic nationalism and economic failure. Flexible, open markets have invariably delivered higher growth: more consumer welfare, more jobs and higher living standards.

Economic success is driven by many things, not least by incentives, scale, innovation flexibility and competition, and by financial, labour and product market integration. Scale – driven by mergers and acquisitions and access to large markets – brings down costs. Scale enhanced by innovation – stimulated by the competition that openness facilitates – not only brings down costs and prices, it also drives up quality, enhances choice and improves service; this in turn creates higher living standards and more jobs all round. Cross-border mergers in an integrated market are so important because without them the benefits of scale are lost and Europe's competitiveness against major trading partners is undermined.

That is why over the past two years I have taken action against governments that have sought to protect "national champions" and it is why, specifically in the banking sector, I have brought forward proposals to tighten the parameters within which cross-border takeovers can be thwarted.

The dangers of protectionism

What makes protectionism so dangerous is that many of the arguments for it are superficially attractive: competition and liberalised markets pose threats for businesses that produce goods and services with price labels and designs that their customers no longer want. In the short term, change or bankruptcy may be averted for those businesses through protectionism. And protectionism will keep their managers and workers comfortable and maybe complacent.

But the route to long-term economic progress cannot be through keeping things as they are. If it were, we would all be living in caves. What future can there possibly be for an economy protected from the open markets, when it is open markets that spur the competition that delivers lower costs, better design, faster and better service and more jobs?

Who wants an economy sheltered from the things that deliver value for customers? That create markets for suppliers? That generate the tax revenues for pensions? And that redirect human and financial capital from yesterday's industries to the industries of tomorrow?

Of course if you close markets, as economic nationalists advocate, you can sustain state-subsidised jobs that drain the taxpayers' coffers and you can protect from takeover businesses that no longer have sufficient scale to deliver value, innovation and growth.

But if open markets deliver that scale and innovation, if they facilitate the creation of more self-sustaining jobs, lower prices and hence more demand, then that surely creates more employment in new businesses, which in turn generates the tax revenues that fund social provision and that can ease the transition that dynamic economies require.

Open markets in labour, capital and trade keep businesses and workers sharp and innovative, seeking out new and better ways to deliver services or make goods, and help keep other businesses that they supply competitive too. Open markets, whether in labour or capital, have a dynamic – a dynamic that destroys jobs that don't deliver value and creates jobs that do.

Of course, millions of jobs in old industries where Europe has lost competitive advantage have been destroyed. But in the economies that have been flexible and open to change, millions of new jobs have been created to replace them – better, more productive jobs that are delivering higher living standards, and higher productivity backed by modern technology. Too often in some member states the protection of existing jobs has been at the expense of the creation of new ones.

The gains from liberalisation

To those who continue to advocate protectionism, I say this: Look at the gains that have been reaped from liberalisation – in energy, in transport, in telecommunications, in the airline industry.

Is there less innovation in telecommunications since it was liberalised? Less employment? Worse service? Higher prices? Walk along any high street and the answers to those questions are obvious. There are more new inventions in telecommunications every year than there used to be in a decade.

In the member state I know best, since the telecommunications market was liberalised and opened up, a two-minute queue has replaced a two-year waiting list to get a phone. The price of calls has tumbled. The consequence: more calls, more phone owners, more jobs for retailers, manufacturers and innovators, and lower costs for business and consumers alike.

Are there fewer jobs in the airline industry and the industries that serve it, since Europe banished protectionism, opened up its skies and allowed the best competitor to win? Certainly jobs have been lost as underemployed labour in inefficient airlines has been forced to shape up, but the end result has been much more affordable air travel, an explosion in mass market air travel, and more work in the industries and support services that back it. More pilots and air stewards, more baggage handlers and ground staff, more coach drivers and caterers. More aircraft builders, more construction workers building more terminals all over Europe, and more work for hoteliers and guest-house owners. It is there for us all to see.

Those who promote economic nationalism, who sing songs about an outdated social model, who seek protection for national champions, have questions to answer. What sort of a social model is it that has 20 million people unemployed across Europe – with unemployment highest in those member states where protectionist voices are loudest?

Aside from depriving businesses of the scale and investment that cross-border mergers and acquisitions can bring, economic nationalism deprives poor consumers as well as rich of the lower costs and better quality that competition driven by open markets brings. It deprives unemployed workers of the job opportunities that higher demand for lower-cost, better-quality products and services brings. It protects those who have – those who are in a job – in the short term, at the expense of those who have not, by blocking the release of capital for new, sustainable jobs and by forcing everyone to pay higher prices and to accept lower quality than a competitive market would produce.

Economic nationalism and the responses it inspires – putting up barriers, resisting change, blocking mergers, impeding cross-border competition – are the reflexes that guarantee failure.

The challenges ahead

Over the past two years we have taken many initiatives in Europe to open markets further, perhaps the most important being the Services Directive, which provides an important base on which we can build for the future. But if Europe is to remain competitive, we need to take many more. Step by step, we need to keep pushing forward.

In the financial services area we have the potential to further deepen the integration of capital markets, further lowering the cost of capital for industry. We are working to improve the efficiency of our pan-European payment and clearing and settlement systems. We can facilitate the development of a deeper and more liquid market for venture and development capital. And with the Markets in Financial Instruments Directive we are taking a major step forward in developing cross-border competition between stock exchanges and investment banks in securities dealing.

We have also published our proposals for enhancing the pan-European framework for investment funds, in particular the Undertakings for Collective Investment in Transferable Securities Directives, in order to further open up the market and to facilitate additional efficiencies built on scale and specialisation. All of these initiatives will ensure that Europe remains at the forefront of global competition as a provider of financial services.

There are no insurmountable obstacles in Europe – only some challenging hurdles. We must resist the economic nationalism that closes markets in the hope of clinging to yesterday's jobs and job practices, producing yesterday's products and designs, delivering yesterday's services at yesterday's costs and standards.

The political challenge of galvanising opposition to economic nationalism is a huge one. The benefits of open trade may be obvious to an economist or an entrepreneur, but they are far from obvious to someone whose job is threatened by foreign or cross-border competition.

The threat to individuals is usually concentrated and direct: the textile or car worker who loses their job because of cheaper foreign imports. By contrast, the benefits of open markets and specialisation in trade are diffuse, indirect and, for most people, less than obvious. They see that their clothes, their cars, their flights and their phone calls are cheaper when markets are open. But maybe they don't consider that that leaves them with more to spend, which in turn creates more economic activity and higher demand which in turn creates more jobs.

The benefits that a properly functioning, well-integrated internal market of 500 million people can bring – to businesses, workers and consumers – are not always obvious. But they are as real as economic nationalism is destructive.

That is why, at European level and in the member states, we must provide the political leadership that will win support for change and for the kind of pan-European markets that will deliver success, markets that are integrated, that have scale economies, that are regulated to ensure competition and stop nationalism: *capital* markets that are deep, efficient, transparent and liquid; *labour* markets that are educated, mobile, skilled, innovative and flexible.

These are the kind of markets that will nurture confidence in Europe as a place to work, innovate and invest. They are the kind of markets that will create the jobs that will raise living standards for those in work and put more people back to work. And they are the kind of markets that will generate the tax revenues to fund the pensions for those too old to work, and to fund the transition for those who must re-skill to find new work.

The path ahead is not going to be easy, but we must all pull together to rise to the challenge.

The Smith Institute

The Smith Institute is an independent think tank that has been set up to look at issues which flow from the changing relationship between social values and economic imperatives.

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