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**EU REGIONAL TRADE VULNERABILITIES,
LIBERALIZATION AND POTENTIAL
LESSONS FOR UZBEKISTAN TRADE
REFORMS**

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Abstract: The aim of this paper is to present selected experiences of European Union trade liberalization, impact of globalization on vulnerable sectors of the EU. Many such experiences are discussed. Central Asian countries must consider vast amount of data, sector-specific information and aspects and still it will not be easy to say that pursued liberalization is the good direction to a wealthier nation with healthy regions, richer citizens and higher tax income for government. We start with brief introduction discussing primary motivation for European liberalization, then we focus on review selected literature sources, concluding that liberalization in general is a good thing and that there is very high probability of success but no guarantees can be drawn as every country is very specific and all policies must be pursued with high degree of attention and thorough analysis. Based on good EU examples of BFTA and CEFTA we recommend considering multilateral free trade agreement within CIS free trade area.

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Introduction

After the Second World War it has been clear that Germany must become European or the Europe will eventually become German. The motivation in minimization of the German threat was one of the main engines of European integration and watching the reactions of the German politicians during spring when it was clear that Germany will be asked to give a lot of money to save Greece from severe debt crisis and potential bankruptcy one may think that such atmosphere is still present even 65 years after the war.

In other words the German security threat forced many countries of Europe where many nationalities at least dislike each other to cooperate first economically and later also politically. Although the economic theories present 65 years ago were still considering that protectionism can be a good thing, many European countries seeing future economic cooperation and inter-dependency started to abandon their protectionist policies. These policies hurt temporarily domestic companies and also consumers through temporary increased unemployment but Europeans accepted this as it was necessary to protect from potentially harmful Germany. Europeans soon discovered that this cooperation makes them rich quite quickly and also due to the fact that everybody is richer there are smaller security tensions too.

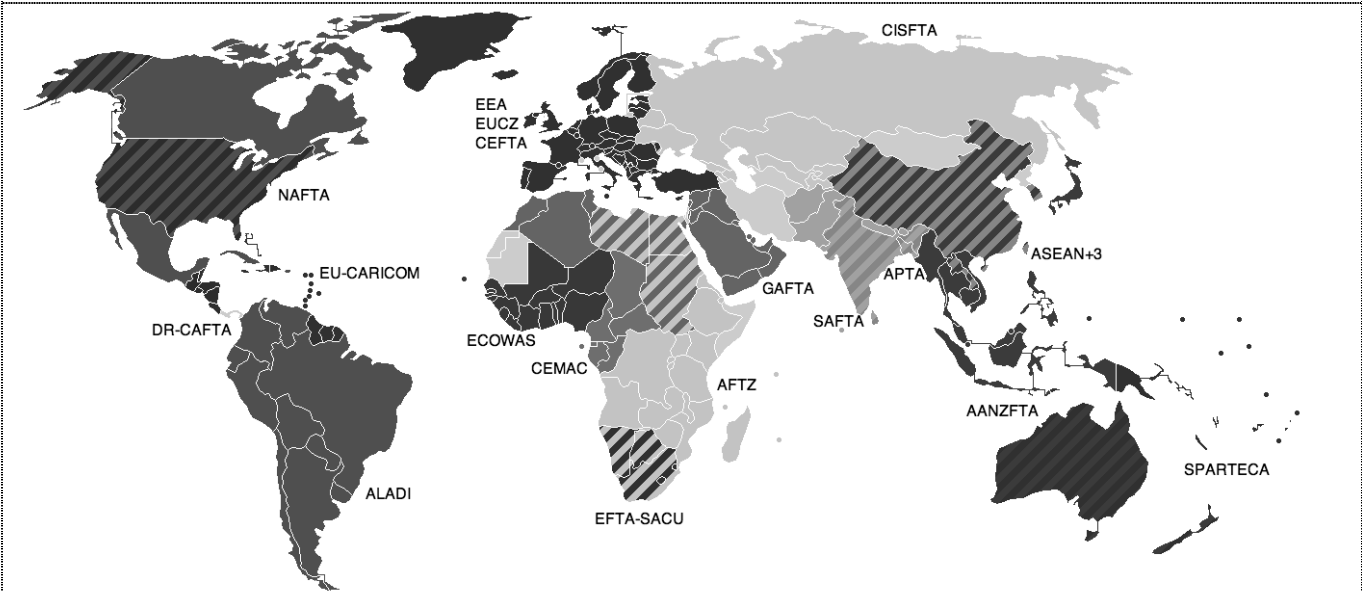
Today, in the year of 2010, it is not easy to find any reasons justifying any protectionism within the European Union itself. We could see it in 2008 and 2009 very often when facing severe global recession caused by US banking crisis of 2007 various prime ministers of EE countries were coming out with protectionist ideas (to show their citizens they care about them) but none of these ideas had any chance to get realized. The last significant liberalization in the EU was in January 2005 the lifting of customs on imports from China affecting most the textile industry within the EU. One can wonder why the EU allowed this when this will cause that many, tens of thousands citizens will lose their jobs, companies will move their production facilities to Asia seeking cheap labor but what few people realize, that this will affect maybe tens to hundreds of thousand people while millions to hundreds of millions of

EU citizens will benefit from cheaper textiles from China thus being able to spend the saved money for other goods which they could not buy if this liberalization would not happen.

We can clearly see that lifting protectionist policies does not always concern only one side – which is employees that might temporarily face unemployment (and so seeing protectionism as a savior by many) but that it also concerns the other side, a group of people that will hugely benefit from liberalization. In other words if protectionism would be any good in the long run for an economy and its citizens, then North Korea and Cuba would be probably the richest countries in the world. What has to be said is that the border between what and when to liberalize is often very thin or blurred. For example countries should not liberalize their current account without proper regulation and supervision of a banking sector as that may cause liquidity and currency crises 6-8 years later as it happened in Turkey or Thailand where capital account liberalization was motivated only by cheaper borrowing costs abroad. Another example can be problematic French agricultural policy related to EU agriculture supporting funds causing strong opposition to sugar market liberalization. This liberalization would render thousands of French farmers unemployed (or at least they would be forced to grow different crops). No French president will allow for political reasons to liberalize this market although all Europeans (hundreds of millions people) are paying about three times higher prices for 1 kg of sugar than they would pay if they could buy cheap Brazilian sugar under liberalized sugar market. This is being tackled in WTO liberalization talks and changed in 2013 when new agricultural policy in the EU will come into effect.

Winters et al. (2002) demonstrate that there can be no simple generalizable conclusion about the relationship between trade liberalization and poverty. There is a strong presumption that trade liberalization will be poverty alleviating in the long run and on average, and no evidence that it will generally increase poverty or vulnerability. As this becomes obvious to many countries in the world we can see in the following figure that nowadays many countries get involved in some sort of free trade union.

FIGURE 1. FREE TRADE AREAS



Source: Based on the WTO list with exceptions for AFTZ, ASEAN+3 and AANZFTA <http://rtais.wto.org/UI/PublicAllIRTAList.aspx>

We can see that liberalization is a good thing in general but is hard to pursue due to political restraints. Weak governments struggle to liberalize but strong governments as in China do not have problems with tackling protectionist policies and liberalize what they consider economically enriching for the country without any delays and prolonged political discussions.

Vulnerabilities within the EU, liberalization and productivity

In general, the experience of EU countries from trade liberalization is tremendous. But for developing countries the EU liberalization or external liberalization in general can have very bad consequences even if they do not liberalize at all. For example Sylvie Houriet (1998) in *The effects of international trade liberalization on the health of poorest population groups* concludes that besides positive effects of liberalization there are also very negative consequences like chronic health problems due to exposure to hazardous wastes which are imported by developing countries or pesticides which have been banned in industrial countries. She also mentions that there is trend of rising wage inequalities in the aftermath of trade liberalization, benefiting skilled workers. Another important conclusion she makes is that health is linked to GDP which is positively linked to countries that successfully pursued liberalization. In other words it is all about how to liberalize.

In a study written by Politecnico di Milano University for DG Regio in 2008 *The impact of globalisation and increased trade liberalisation on European regions* (Politecnico di Milano University, 2008) the authors analyzed how growing external competition affects regional welfare in Europe and concluded with the following statements:

- It is very important to note that the differences between [EU] regions are to a large part not defined by their sectoral structure, but that a combination of this

sectoral structure with more general factors of regional growth will have to be taken into account;

- In vulnerable sectors (metallurgy, textiles, electric and optical equipments) it may happen that if one large company on which depend many smaller companies move abroad (to an Asian country in particular), this can render into severe situation for regional economics. Some regions have lost in these sectors sectoral employment and value added in the medium term. Very important is here local connection between the company and research and development (for example Airbus in Toulouse, France or Nokia in Finland). Bad examples can be Western Hungary or Rumania show the extreme vulnerability of regions which have not been able create such anchorage because of the lack of time and the lack of investments stimulating the development of endogenous factors linked to the foreign firm. These cases provoke the question whether it is politically possible to create these anchorages, combining the factor of time (encouraging firms to stay longer) with the factor of money (investments in supporting factors). It does seem obvious, however, that a policy of attraction of FDI based on low labour costs does not allow a sustainable development of these regions if it is not accompanied by intensive policies aiming at embedding the foreign firms;
- An important factor is not the sector structure in itself, but rather the segments of production (or segments of the value chain) within that sector which are present in the region. The more is the production chain segmented, the more vulnerable it can be to globalization;
- In cases where it is not possible to embed a firm sufficiently in a region, efforts are necessary to at least ensure that the regions profits of the income, innovation and learning that the presence of large firm provides, by using these resources to support the development of endogenous capacities. In light of the very short cycles in the most vulnerable regions, this means that policies would have to act very quickly and decisively,

implying significant investments in education, innovation, etc. Finances are very important here as if the region does not make reserves for such activities, it cannot pursue them;

- It seems worth looking at the experiences of some declining regions (e.g. the Ruhr area) more in detail to study how some forms of public interventions have helped these regions to protect some of that territorial capital and how policies aimed at regional restructuring can be thought in such a way as to maintain it.

Ngo Van et al (2007) researching at University of Kiel, Germany, the impact of liberalization on productivity found that trade liberalization (i) raises (reduces) aggregate R&D spending if trade costs are low (high); (ii) raises expected exports, and lowers firms' local sales if trade costs are high; (iii) increases expected firm size provided that trade costs are high; (iv) forces the least efficient firms to leave the market; (v) reallocates market share from less to more efficient firms; and (vi) raises expected social welfare if trade costs are sufficiently low. The productivity effect of trade liberalization is shown to depend on market structure. If there is no entry of firms, a sufficient condition for trade liberalization to increase industry productivity and welfare is that trade costs are low. However, if firms adjust to trade liberalization through entry and exit, a sufficient condition for productivity to increase is that trade costs are high.

In particular, their research reproduces the stylized facts that trade liberalization (i) reduces price-cost margins; (ii) lowers domestic sales of import-competing firms (at least provided that trade costs are high, or market structure is endogenous); (iii) expands markets for very efficient firms; (iv) increases efficiency at the plant level. In addition, (v) exporters tend to be larger and more productive than firms that do not export.

Such results can be very well motivating for Central Asian countries to liberalize their domestic markets as it would force domestic companies to increase productivity (thus increasing wages for their employees). Those companies would be exporting more, would pay higher taxes and citizens would be wealthier.

With liberalization it is also very attractive to buy companies on newly liberalized market (from local owners through Mergers and Acquisitions (M&A) or from government through privatization). Also here, attention must be paid to many factors influencing the impact of liberalization on the overall and regional economics. Bertrand and Zitouna (2006) found that the less efficient firm loses market shares in its home market at the beginning of trade liberalization. Only for a more advanced level of liberalization, does it take advantage of a larger access to foreign demand. Trade liberalization may therefore harm its profits too strongly, forcing it to leave the market. However, although its incentives decrease with trade liberalization, the high-technology firm may be willing to take it over for low organizational and technological costs of firms' integration. In addition, it may buy it out even if the less efficient firm manages to stay. Then, trade liberalization affects M&A incentives depending on the technological gap.

Bchir et al (2003) discussing liberalization of EU accessing countries warned that due to significant liberalization, attention must be paid to huge swings on relative prices and big fluctuation in the real exchange rate. Such a phenomenon should be taken into account by the liberalizing countries for their decision about exchange rate arrangements.

Even within European Union there are specific free trade areas, most notably Central European Free Trade Area (CEFTA) and the Baltic Free Trade Area (BFTA). That means that even inside of intensely liberalized trade area, which the EU certainly is, there can be even more liberal trade areas having certain experience focusing on more local trade issues. This could be similar to any prospective trade area among Central Asian countries within CIS. Adam et al (2003) explored the effectiveness of the CEFTA and BFTA. Their results support the view that both CEFTA and BFTA helped expand regional trade and limit the emergence of a "hub-and-spoke" relationship between the CEECs and the European Union (EU). At the same time, despite the significant regional trade-liberalization embedded within the agreements in SEECS (Southeastern European Countries), the EU remained the dominant trading partner for all the CEECs. All SEECS are members of multilateral CEFTA since 2007 as they considered that will be more beneficial for their economies than relying on bilateral trade agreements and/or creating their own FTA.

Conclusion

The aim of this brief paper was to summarize selected issues and experience from trade liberalization across the world and especially the EU. Based on the review of literature we conclude that liberalization is a good thing in general but many issues have to be tackled, nothing is guaranteed and so if not managed well, even liberalization of trade which significantly improves the state of economics in the long run can go wrong and create very huge short term costs for the economy.

Policy-makers and governments have higher probably of success providing successful trade liberalization if they are strong with little opposition, if this trade liberalization is accompanied by sound supervision and regulation of banking sector or financial sector as a whole, if they can select competitive sectors that can quickly become internationally competitive (preparing the vulnerable ones for oncoming liberalization) and from there begin quickly freeing up current account for the whole economy (~lowering customs for other sectors of the economy), and also considering multilateral free trade agreement with neighboring countries which goes further than the second order FTA.

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