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## EU and Australia: Europe's Challenges and Policy Options for Future Trade

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### Introduction

At this point, Europe's trade relationships with the Asia-Pacific region have entered a period of constant activity following a general reorientation of its policy priorities since the 'Global Europe' strategy. The 2006 statement of future trade policy recognised the shift in economic growth patterns towards Asia and aimed to establish closer links with the region.

By 2015, the European Union (EU) had already concluded its first 'next-generation' free trade agreement (FTA) with Korea, in force since mid-2011, followed by Singapore, the Andean Community and Canada. There are a number of bilateral negotiations ongoing with other countries, including Japan, India and Malaysia. The Transatlantic Trade and Investment Partnership (TTIP) was launched in mid-2013 and its fate remains unclear.

Meanwhile, on the Asia-Pacific stage, one major and important development has been the Trans-Pacific Partnership (TPP) negotiations. The talks included Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States of America

(USA) and Vietnam.<sup>1</sup> Other influential actors in the region, including South Korea, the Philippines, Taiwan, Thailand (and even China), have formally or informally shown their interest in joining the negotiations or acceding to the agreement (Bauer et al. 2014).

The TPP negotiations were a response to a rapid progression that marks the Asia-Pacific region as the emerging global economic centre: intra-regional trade in this region has more than tripled since 2000 (Bauer et al. 2014). The region has undergone a process of profound change marked by the extraordinary rise of China and growing intra-regional industrial linkages, especially strong in East and Southeast Asia. This has resulted in a staggering increase of the intra-regional trade and investment, with China increasingly gaining weight at the expense of other trading partners outside of the region, mainly the EU and the USA.

The EU has reacted only recently to these developments with the launch of trade negotiations with Japan and the USA. However, Australia and New Zealand are not yet in negotiations with the EU, a trade policy blind spot that is yet to be addressed. The markets of Australia and New Zealand taken together are considerable in terms of gross domestic product (GDP). EU trade with these two countries is underdeveloped, and roughly equivalent to EU trade with Singapore or the United Arab Emirates.

Meanwhile, Australia is increasingly more embedded in its own hemisphere. Australia had already made its own 'pivot to Asia', an inevitable trend given its geographical location and the structure of its economy. In preparation for the TPP, Australia has concluded an FTA with Japan. Outside the TPP context, Australia has also concluded an FTA with Korea (2014) and, more recently, one with China (2015).

In assessing the impact of these developments, it becomes clear that both sides of the EU–Australia relationship are organising their trade affairs in a wider global context. If Asia is considered the hub of the wheel, Australia and the EU are two spokes to the region that complement each other; but this does not exclude a strut between the two, which would reinforce both—namely, through an Australia–EU FTA. Such an

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1 In January 2017, President Donald Trump withdrew the USA from the TPP negotiations. This was part of a broader move away from trade agreements. However, in May 2017 the remaining 11 members of the TPP announced they would continue to pursue the agreement, the negotiating text of which remains that released on 26 January 2016.

agreement might not be of central significance in the region, but might play a supporting role in areas of more specific interest to both parties and offer them complementary advantages to the wider agreements already in place.

## Europe's challenges in the Asia-Pacific region

Europe and the creation of the single market is proof that geography is a central theme. Geographic proximity was, and still is, a powerful and growing force in the way economies integrate with the world. Natural trading trends in the region are pointing towards more intra-regional trade, with or without policy-induced liberalisation through FTAs. Europe is already competing against the Asian economies, which are, naturally, integrating and consolidating their supply chains in the region and with the USA. In goods trade, almost half of US exports are already destined for countries that are participating in the TPP negotiations, while the equivalent EU number is closer to 30 per cent—even with exports to the USA included.<sup>2</sup> The picture is especially worrisome for EU exporters of agricultural products (Messerlin 2012).

This is why Europe's challenge is to minimise the degree of policy restrictions in its trade with the Asia-Pacific region—even in the absence of competing liberalisation from the TPP. In the absence of full-scale multilateralism, this liberalisation needs to take place as coherently as possible within the region.

The combined effect of natural and policy-induced market integration will change the competitive relationship between European and local firms already present in the Asia-Pacific region. Any delay in engaging with TPP members could be too costly: the TPP will be the first competing trade agreement that is large enough to cause measurable negative impact. The estimates by Kawasaki (2011) demonstrate that the EU's aggregate income (in terms of purchasing power) falls by 0.1 per cent as a result of the trade diversion created by the TPP. While Europe has negotiated bilaterally with some TPP countries, it has no strategy equivalent to the TPP, which could address tariffs and regulatory divergences with the economies in the

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<sup>2</sup> Calculations based on UN Comtrade (2013).

Asia-Pacific region. This is why Europe is likely to address the Oceania blind spot by negotiating FTAs with Australia and New Zealand, using its own template.

In sum, these FTAs with the TPP signatories are primarily not about additional market access—but are to maintain the current baseline and defend existing market shares. By doing so, Europe maintains its current utilisation rates in manufacturing, employment and profitability in services and its agenda-setting powers in world trade.

It is worth mentioning that the EU faces other competing geometries besides the TPP. The Association of South-East Asian Nations (ASEAN) is on a trajectory towards transforming itself into a common economic area. The Regional Comprehensive Economic Partnership (RCEP) aims to create a region-wide free trade area by merging ASEAN's existing FTAs (including China, India, Japan and Australia/New Zealand) and the proposed trilateral China–Japan–Korea FTA, although the future of this one is uncertain due to recent geopolitical tensions.

The RCEP is built on existing (and relatively weak) old-style tariff-centric FTAs, while the TPP could achieve market access and regulatory disciplines on new trade issues that are ‘World Trade Organization-plus’ (‘WTO-plus’). In contrast, the TPP is the agenda-setting pillar in the region, not the EU FTAs. TPP membership has now reached 37.5 per cent of global GDP, or 60 per cent of world trade, and other potentially standard-setting FTAs (including TTIP and RCEP) will follow the TPP in terms of timing (Bauer et al. 2014).

## Australia in Europe’s map over the Asia-Pacific region

The EU trade strategy is, by default, multilateral, while its bilateral FTAs were not necessarily commercially motivated and instead aimed at specific goals and problems in its neighbourhood around the Mediterranean and the pre-accession countries in Eastern Europe. Almost 10 years after the Global Europe strategy, the plan to trial FTAs in the Asia-Pacific region, starting with Korea, still holds. This is an operation of economy of scale—to conclude a large number of FTAs in the region based on a European model text. By and large, this strategy was sustained until the opening of the TTIP that pivoted political attention back to the Atlantic.

Interestingly, any ventures that have boldly gone beyond that objective—for instance, when the EU attempted to negotiate with economies that are yet to sign FTAs with the USA—have either failed or been subject to delays. These include the failed regional deal with ASEAN, India and Mercosur.

Europe already negotiates bilaterally with some TPP countries and has already concluded a few agreements, some quite recently. Yet it has no strategy equivalent to the TPP that builds a larger framework in the Asia-Pacific region and addresses future trade issues. This European lack of initiative is merely an expression of the absence of a much broader vision and a ‘grand map’ in Europe on what trade relations with the Asia-Pacific region should evolve into.

On the European map of FTAs, it has already signed agreements with three TPP members: Mexico, Chile and Peru. Singapore and Canada Comprehensive Economic and Trade Agreement (CETA) negotiations have been concluded but await ratification. Moreover, the EU is already in negotiations with the USA, Japan, Malaysia and Vietnam, leaving only three TPP alliance economies (Australia, New Zealand and Brunei) to be negotiated with.

Both Australia and New Zealand have favourable business climates and consistently ranked high in terms of ease of doing business in the past decade, and Australia in particular has trade that is expanding quite rapidly by the standards of a mature Organisation for Economic Co-operation and Development (OECD) economy. However, their trade with Europe is lower than economies of similar economic size—Australia has a smaller share of EU trade than Canada, while New Zealand falls behind Peru and Vietnam (Eurostat 2013).

There are a number of arguments for Europe to open up negotiations with Australia. Firstly, Australia maintains tangible trade barriers with an average tariff near 9 per cent, which is relatively high for a developed economy (WTO 2013). This suggests there is a plain mercantilist case and an export-driven rationale for liberalising trade between the EU and Australia. Exports, or the prospects of export-led growth, are rarely the biggest gains of FTAs compared to consumer gains and the long-term impact of increased dynamic competition, leading to more competitive economies. However, Europe—suffering from overcapacities and anaemic growth at home—often acts on such mercantilist instincts.

Table 1. Economic performance of TPP signatories

Country	Average applied tariff, MFN	Ease of doing business rank, 2000–14 average	Real growth in trade (%) 2000–14 average	Services barriers STRI (1–100), 2000–14, average	Share of EU trade (%), 2013
<b>TPP signatories with EU FTAs</b>					
Singapore	0.63	1.0	7.9	22.7	1.4
Canada	3.88	8.0	1.2	51.1	1.7
Peru	8.92	58.0	8.3	24.6	0.3
Mexico	14.17	49.0	4.6	35.8	1.3
Chile	6.62	41.7	7.1	9.5	0.5
<b>TPP signatories with ongoing EU FTA negotiations</b>					
USA	2.96	3.7	3.1	65.2	14.2
Japan	6.76	13.3	2.7	48.8	3.2
Malaysia	4.26	23.0	5.3	25.4	1.0
Vietnam	18.2	90.3	17.2	30.1	0.8
<b>TPP signatories without EU FTA negotiations</b>					
Australia	8.88	9.3	5.9	58.9	1.2
New Zealand	4.02	2.0	3.9	52.2	0.2
Brunei	5.15	91.0	2.2	4.4	0.0

MFN, most favoured nation; STRI, Services Trade Restrictiveness Index

Sources: UN Comtrade 2013; World Bank 2014a, 2014b; OECD STRI 2014; Eurostat 2013.

Secondly, the competition Europe faces on the Australian market from similar, high value-adding economies is evident. Looking at Australian consumption and import penetration, Europe is outcompeted in each of its key export sectors: on the transport equipment sector, which includes railway equipment, the market share of the USA is five times larger; and on passenger cars and motor vehicles, Japanese exports hold more than half of the Australian market and outcompetes Europe by 50 to 1. The USA leads on other key EU export interests such as machinery and chemicals and, interestingly, Europe only enjoys a sizeable lead on food, beverage and agriculture, areas that are traditionally sensitive for Europe.

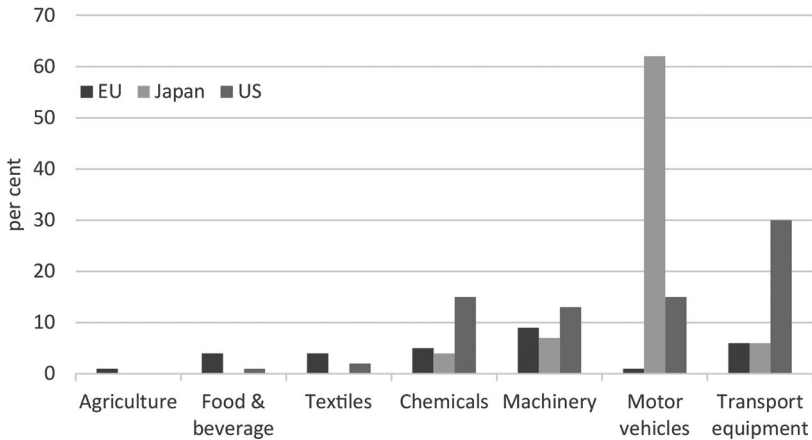


Figure 1. Import penetration, Australia in select sectors

Sources: OECD STAN 2013; UN Comtrade 2013.

## Europe's sensitivities

Minerals and natural resources such as coal, gold and copper account for one-third of Australia's exports to the EU, which is consistent with Australia's trade with the world. However, agricultural products account for an additional 21 per cent. This is dominated by beef, wine and seeds, while other basic staples in Australia's agricultural trade such as wheat, cotton and barley are missing (UN Comtrade 2013).

Table 2. EU imports from Australia, top 20 categories

Top 20 EU import products from Australia	% of EU imports from Australia
Coal	23.0
Rape or colza seeds	9.4
Gold	6.3
Wine	4.7
Unwrought lead	3.7
Copper ores and concentrates	3.3
Zinc ores and concentrates	3.2
Diamonds	2.4
Wool, not carded or combed	2.3
Unwrought nickel	2.3
Lead ores and concentrates	2.0

Top 20 EU import products from Australia	% of EU imports from Australia
Silver	1.9
Medicaments	1.8
Orthopaedic appliances	1.8
Meat of bovine animals	1.5
Other nuts, fresh or dried	0.9
Radioactive chemical elements	0.9
Titanium ores and concentrates	0.9
Meat of sheep or goats	0.9
Niobium, tantalum, vanadium, etc.	0.8

Source: UN Comtrade 2013.

Agriculture is a central determinant of trade policy for both the EU and Australia. Whereas Europe maintains its common agricultural policy (CAP), which consumes 40 per cent of its budget, Australia has some of the most efficient agricultural producers in the world, including items that are among the most sensitive for Europe, especially regarding crops. Currently, the level of agricultural support (in terms of gross farm receipts, i.e. revenues) is 10 times higher in the EU than in Australia.

However, given the fiscal position of the EU, it is evident that CAP is being forced to reform. With a 13 per cent cut in subsidies approved in the 2013 multiannual financial framework, it is evident that the EU will orient itself towards export-driven agriculture, especially in sectors where the EU has comparative advantages, such as processed agricultural products, wine, pork or dairy (European Commission 2013a, 2013b).

Given the EU is facing unilateral reform in agriculture, the bargaining chips of agricultural tariffs and tariff rate quotas will quickly pass their due dates. Europe's choice on CAP is either to put agriculture up for negotiation now or lose them as bargaining chips in FTAs through inevitable unilateral reforms. But with 2.5 per cent of GDP coming from agriculture (compared to 1.4 per cent in the USA or 1.7 per cent in France) (FAOSTAT 2012), and more than half (52.8 per cent) of its territory being arable land (World Bank 2013), Australia has also the capacity to scale up its production if given the opportunity. OECD and Food and Agriculture Organization of the United Nations (OECD-FAO) projections show that it is likely to do so in the coming 10 years (OECD-FAO 2014).



## Regulatory divergences

Australia and New Zealand may be smaller players internationally. However, they are like-minded polities with extensive mutual recognition agreements (MRAs) signed in 1999 covering telecom equipment, electronics, pharmaceutical products, medical devices, machinery and pressure equipment.

Australia and New Zealand are also signatories of the United Nations Economic Commission for Europe (UNECE) agreement of 1958 that sets common automobile standards, championed by the EU to become global standards. The centrality of these standards in recent EU trade negotiations (including Korea, Japan and TTIP) is evident. But it is worth noting the USA (which follows its own competing regional standard—the federal motor vehicle safety standards) is outperforming the European car industry on the Australian market despite the commonality of standards between the EU and Australia.

Where New Zealand has concluded a series of comprehensive sanitary and phytosanitary agreements and achieved data privacy adequacy with the EU, Australia also has a wines agreement in place that protects some European geographic indications.

TPP countries have a divergent view on geographic indications going back to the Doha Round, when the EU tabled a proposal to secure geographic indication protection through the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) that would create *prima facie* assumptions for their legal protection among WTO members, while Australia endorsed a voluntary system.

In conclusion, the manner that regulatory divergences are addressed plays an increasingly important role in market integration. Current FTAs dedicate a fair amount of negotiation time and political capital (or finger-pointing in case of failure) on sanitary and phytosanitary issues, technical barriers to trade and sector annexes on non-tariff measures. Especially for the EU, these annexes are a necessity to advance key export interests such as the pharmaceutical, chemical or automobile sectors.

Australia and New Zealand already enjoy the level of regulatory cooperation that the EU generally achieves through its FTAs.

This is particularly true for the recognition of conformity assessment bodies that allow parties to maintain their own standards while avoiding duplicate testing. This supplements the approach where the EU seeks outright adaptation of its own regulations or standards, as the case of UNECE car safety regulations or FTA provisions on e-commerce that are directly transposed from internal EU directives. Previous generation FTAs, modelled on the EU–Korea FTA, addressed regulatory divergences through positive integration of EU internal rules. Whereas the EU single market is built on mutual recognition, the EU does not seek (or achieve) similar comprehensive mutual recognition or functional equivalence through its external agreements (Kenyon & Hussey 2011).

Europe's current difficulties in the TTIP and EU–Japan FTA negotiations show that any notion of 'shared values', 'like-mindedness', common heritages or geopolitical interests is no match against old mercantilist interests that awaken in every FTA negotiation. However, the pre-existing state of regulatory cooperation with Australia and New Zealand provides a starting point that did not exist with other counterparts before negotiations began.

## Wider regional perspectives

Australia is also tied to New Zealand through the Closer Economic Relations (CER) trade agreement, which is the most comprehensive FTA between two OECD countries and the only cross-border market integration that incorporates elements that comes close to the European single market. The CER even incorporates elements that go beyond the European single market, with full liberalisation of services on a negative list basis. The full mutual recognition (provided through the Trans-Tasman Mutual Recognition Arrangement, TTMRA) also covers professional qualifications, and individuals registered to practise an occupation in each jurisdiction are entitled to practise an equivalent occupation in the other, without the need for further testing or examination.

The CER and its construct offer an interesting alternative approach to the EU FTAs. Unlike the single market, the CER achieves market integration through decentralisation and avoids institution building and supra-national harmonisation of standards and regulations. Instead, the CER

is built on mutual recognition using existing judicial systems of its signatories, presenting a model that may be more suitable to bilateral FTAs than Europe's own internal integration.

Moreover, the common economic area created by the EU, Australia and New Zealand would have an economic output the size of the ASEAN or North American FTA (NAFTA), but where the socioeconomic disparities (such as income and wages) would not exceed the already existing differences within Europe (Eurostat 2014; WTO 2013).<sup>3</sup> A three-party negotiation of EU–CER is not unlikely, whether it takes place through two separate FTAs that is later consolidated into a common and singular framework in the following phase, or whether the parties decide to conduct a TPP-style negotiation based on bilateral negotiation on market access overarched by common rules and annexes.

Australia and New Zealand are also tied through their joint FTA with ASEAN (AZEAN–Australia–New Zealand Free Trade Agreement, AANZFTA)—the most ambitious FTA concluded by the ASEAN bloc. This phased out 96 per cent of the tariffs, introduced simplified rules of origin, trade facilitation and sanitary and phytosanitary agreements. The AANZFTA is unusual as it liberalises services significantly, notably in educational, financial and telecommunication services, and provides transparency and national treatment, limiting anti-competitive practices (Vitalis 2015). The multiparty FTA also contains horizontal commitments on domestic regulation, facilitation of business movement, and investment rules (with investor–state dispute settlement, ISDS), electronic commerce, intellectual property and competition policy. The agreement achieves some level of recognition of equivalence through a 'comply or explain' approach that is applied horizontally to all regulatory divergences.

Australia's successful venture of integrating with Southeast Asia should be seen in the light of Europe's own failed attempt to negotiate a region-to-region FTA with ASEAN. The completion of FTAs between the EU and both Australia and New Zealand could open up options that are not available to European trade policy today, including region-to-region integration with either the CER, or CER and ASEAN, or eventually both.

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3 Eurostat 2014; World Bank, World Development Index 2013.

## Europe's policy options

The lack of rapid response and comprehensiveness in addressing the competition from the TPP could be costly for the EU. Nonetheless, whether it is due to agricultural sensitivities or negotiation fatigue, EU trade policy could choose to remain passive on remaining countries in the Asia-Pacific region that it has not opened up negotiations with. The EU and Australia are already part of a few plurilateral negotiations in the trading system, including the Trade in Services Agreement (TiSA) and the Environmental Goods Agreement that could, at least in theory, provide some WTO-plus commitments. Both are also parties to some WTO plurilaterals (Information Technology Agreement and General Agreement on Trade in Services (GATS) additional protocols on services) but not all of them: Australia is yet to accede to the Agreement on Government Procurement (signed by New Zealand in 2015) or the plurilateral agreement on pharmaceuticals.

Such non-action would have short-term negative effects coming from trade diversion. Over the long term, further negative effects could be expected because of the impact of the TPP on non-participating countries.

As TPP and other intra-regional agreements are likely to incorporate at least some form of trade or regulatory standards, European exports will certainly face some new compliance costs, further increasing the productivity gap between the EU and the USA. TPP disciplines on corporate governance, investment, competition and state-owned enterprises could substantially transform the business environment of the signatories, and lead to higher returns, while the returns on the European home markets will remain relatively low.

This raises two issues. The first concerns the timing because, as the earlier discussion on CAP suggested, Europe's negotiation leverage against Australia would deteriorate with successive unilateral reforms. Moreover, a conclusion of the TPP could turn Europe into rule-takers rather than rule-makers, and leave it unable to advance its own priorities (for example, on issues like automobile standards, geographic indications or public procurement) in the world's most expansive economic region.

The second question is closely linked to the first, and concerns sequencing—that is, the order with which trade negotiations will take place and concessions will be given. When an economy seeks regulatory

convergence, it will seek to harmonise its rules with the largest potential market first, as it would give them the best chance to reap the reciprocal benefits. This is the pattern followed by many Asian economies (e.g. Korea, Japan, Singapore) that opened up negotiations with the USA first, and went subsequently into smaller negotiations where they gave away concessions they had already made in the first deal to others. The threat of trade diversion is often a leverage that is used to open up negotiations with reluctant partners.

As the world's largest trading bloc, sequencing tends to come out reverse logic. The EU tends to start with the smaller (and thereby less threatening) and more flexible counterpart first (Lee-Makiyama 2015). This would allow Brussels to receive a better first offer in terms of both market access and excluding its sensitive products. The strategy was deployed against Korea/Japan, and to some extent also CETA/TTIP.

As Australia's GDP is eight times larger than New Zealand's, Europe's sequencing strategy could be its default strategy towards Oceania. While the market potential of Australia is larger in terms of GDP, and Australia's exports into the EU are three times larger than New Zealand's, less of its trade is currently exempt from duties. Australia's agricultural exports are far more diversified, with considerable quantities of products where EU subsidy reforms are still pending.

## Conclusions

EU trade policy is shaped by the long-term economic developments where the world economy pivots towards the Asia-Pacific region, at the same time as the relative importance of Europe's domestic markets are declining. In order to counter the aggregate income drop expected from the TPP, the EU has very few policy options except to negotiate bilaterals with all TPP countries to advance its own FTA template. Following this logic, FTA negotiations with Australia and New Zealand may be just a matter of time.

Europe's offensive export interests tend to be in highly regulated sectors where technical standards play a major role for market access. Achieving regulatory compatibility and avoiding regulatory compliance costs matters for export competitiveness, especially in sectors like automobiles, machinery, pharmaceuticals, medical devices and chemicals—and EU

firms are already underperforming vis-à-vis their TPP competitors on these sectors in Australia. If the TPP succeeds in setting new regulatory standards, EU exports will inevitably face additional compliance costs where their TPP competitors do not. On agriculture, European exports could even be locked out from the TPP markets, making domestic agricultural reforms even costlier and riskier to undertake.

But the prospects of Australia–EU FTA negotiations raise some new and interesting questions. The first question concerns Australia’s link to New Zealand and the CER. As described above, past negotiation strategies and agricultural sensitivities suggest that Europe could start negotiating with Australia’s smaller neighbour first. But given the free movement of goods and services guaranteed under the CER, it would become untenable in the long run to conclude an FTA with only one of the CER countries, as goods and services move freely between Australia and New Zealand. Similar problems would arise if both FTAs were concluded, but with highly asymmetrical outcomes (e.g. where tariffs are cut in Europe for a certain good from one CER country, but not for the other), especially if rules of origin in the two FTAs are not harmonised.

Unlike Europe’s customs union with Turkey, Australia and New Zealand do not apply common external tariffs. Australia and New Zealand have concluded both joint and individually negotiated FTAs. But whenever a major FTA was concluded by one of the CER countries, the other moved in swiftly to negotiate its own FTA. However, there are also some divergent interests between Brussels, Canberra and Wellington—especially on agriculture, where New Zealand is more specialised than Australia. A region-to-region agreement between the EU and CER could be constructed in various ways and built on individual schedules, as in the AANZFTA or TPP.

Relatively ambitious agreements on regulatory cooperation already exist between Australia and the EU. The pre-existing levels of regulatory cooperation are on a par with some relatively recent EU FTAs. Should the Australia–EU FTA include a chapter and annexes on regulatory issues, its provisions are likely to be on the same level of ambition as the goals on recognition of equivalence currently negotiated under the TTIP or TPP; otherwise, it would have little value added compared to the pre-existing MRAs.

Regulatory harmonisation and cooperation bring about another dimension of complexity, in areas where the CER and TTMRA go beyond the internal liberalisation in the EU, notably on services and professional qualifications (Kenyon & Hussey 2011). Assuming that the EU cannot adopt and implement similar high-level standards internally, the scope of the Australia–EU FTA is constrained by the functional limits of the single market. Finally, there are certain discrepancies with the relationships that would need to be addressed: for example, Australia has concluded a wine agreement with the EU, and New Zealand has received an adequacy ruling on data privacy rules, allowing for open cross-border data flows.

Both questions could either be resolved through a ‘race to the top’, where all parties agree to the highest standard prevailing in the three-party relationship, or ‘cherry picking’, where each party maintains the flexibility to define their own agreement with the other two according to the problems in that relationship. The determinants that will shape the form of the final EU–Australia agreement will be the need for such flexibility that will be balanced against the risks of asymmetrical, or even incomplete, liberalisation between the EU and Oceania.

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This text is taken from *Australia, the European Union and the New Trade Agenda*, edited by Annmarie Elijah, Don Kenyon, Karen Hussey and Pierre van der Eng, published 2017 by ANU Press, The Australian National University, Canberra, Australia.