
Swiss Relations with the European Union

Switzerland is a landlocked nation surrounded by four European Union members, including three of its largest economies: Germany, France, and Italy. Given this geographical reality, the European Union currently plays a preponderant role in Swiss trade flows and policy. For the same reason, Swiss-EU trade relations will continue to occupy a central place in Bern's thinking, even if a Swiss-US free trade agreement (FTA) becomes a reality.

This chapter considers the implications of a Swiss-US FTA for Bern's relationship with the European Union. Bern-Brussels trade relations have a long and peculiar history that is essential background for understanding the likely impact of a Swiss-US FTA. Hence, this chapter begins with a brief discussion of the main postwar steps in Swiss-EU trade ties. To explore the possible consequences of a Swiss-US FTA, we stress the political economy logic that guided the relationship. The final section considers specific problems and speculates on their outcome.

In short, we argue that a Swiss-US FTA will not cause major difficulties in Swiss-EU trade relations. Three central reasons support this stance. First, through 50 years of bilateral negotiations, the European Union has already obtained almost all of the market access it wants from Switzerland. Major barriers remain only in farm trade, but here the lack of reciprocal market access is firmly supported by the "body politic" in both Bern and Brussels. Second, except in agriculture, Swiss most favored nation (MFN) tariffs are low, so the margin of preference extended to US firms will be modest. Third, the Swiss market is a relative minor concern to EU exporters, so the modest erosion of EU preferential access implied by a Swiss-US FTA is unlikely to cause a severe backlash in Brussels.

Historical Perspective

Even today, World War II continues to shape intra-European trade relations. Its massive death and destruction, following on the heels of devastation from World War I, radically altered attitudes in Europe. All Europeans agreed that economic integration was critical to avoiding another war, but opinions differed on whether it would be enough. The Six,¹ led by France and Germany, believed that Europe's former enemies needed political as well as economic integration. Their citizens, having lived through such spectacular governmental failures, thought it was a good idea to bind their national sovereignty in supranational organizations, such as the European Coal and Steel Community (1950) and the European Economic Community (EEC, 1958). For the Swiss, the lessons of the war were exactly the opposite. Absolute national sovereignty and strict noninvolvement, they believed, were exactly what saved Switzerland from wreckage in the two world wars.

First Reaction: EFTA and the EEC

When the Six rebuffed the United Kingdom's attempt, in the late 1950s, to set up a pan-European free trade area that would include the EEC, Britain proposed creating the European Free Trade Association (EFTA), and Switzerland became a founding member in 1960.

For the next 40 years, Swiss relations with the EEC/European Union were dominated by a string of similar reactions to events decided in Brussels. The 1960s saw rapid intra-EEC and intra-EFTA trade liberalization. Discriminatory integration by the two blocs had a dramatic effect on trade patterns. The EEC's share of trade with itself rose from 30 to 50 percent,² while the share of EEC imports from other European nations stagnated or fell. This discrimination meant lost profit opportunities for exporters in both groups, but since the EEC market was more than twice the size of EFTA's, and growing faster, the EEC was far more attractive to exporting firms. This generated new political economy forces within the EFTA nations, forces that pushed for EEC membership.

The United Kingdom was the first domino to fall. Despite the United Kingdom's leading role in creating EFTA, its government reacted to new trade pressures by applying for EEC membership in 1961. Three more dominos fell

1. The European Six, original members of the European Economic Community, are Germany, France, Italy, Netherlands, Belgium, and Luxembourg.

2. See Baldwin and Wyplosz (2004). Chapter 5 gives details, while chapter 1 provides a broader historical perspective.

immediately.³ If the United Kingdom were to jump to the EEC customs union, exporters in the remaining EFTA nations would face discrimination in even more markets. In reaction, Ireland, Denmark and Norway—nations that had found it politically optimal to avoid EEC membership in 1958—also applied in 1961. But Switzerland, which wished to maintain its political neutrality in the escalating Cold War, decided to stay with EFTA.⁴

Second Reaction: Swiss-EU FTA

When the EEC finally enlarged in 1973, many more dominos fell. The impending UK accession, which would heighten discriminatory effects facing Swiss exporters, created further political economy forces. Exporters in Switzerland and the other remaining EFTA nations pushed their governments to sign bilateral FTAs with the EEC in 1973.

This second Swiss reaction set the pattern that governs Swiss-EU relations today. In retrospect, we can discern three salient points. Any EU initiative that threatens important new discrimination for Swiss exporters elicits a Swiss reaction, but Bern follows and Brussels leads. The Swiss reaction addresses the new economic realities in a way that minimizes political integration. Finally, agriculture is excluded by mutual agreement. Neither the EU members nor the Swiss have ever shown as great an interest in freer trade in food products as the United States has. Instead, both sides are happy to forgo reciprocal market access in exchange for a free hand on farm policy.

As part of this reactive pattern, Switzerland has been in a relationship that might be called a “virtual FTA union” with the European Union for the last 40 years. Each time the European Union signs a new free trade deal with a third nation, Switzerland follows suit. Again, the domino logic prevails. The 1991 EU-Poland trade deal would have given German firms an edge over their Swiss rivals in the Polish market; this impending discrimination generated new political economy forces in Switzerland that pushed Bern into signing its own FTA with Poland under EFTA auspices.

Switzerland’s list of actual and planned FTAs—negotiated under the EFTA umbrella with its partners, Norway, Iceland, and Liechtenstein—is similar to the European Union’s list. Like the European Union, EFTA partners have negotiated agreements with Bulgaria, Chile, Croatia, Israel, Jordan, Macedonia, Mexico, Morocco, the Palestinian Authority, Romania, Singapore, Tunisia, and Turkey.⁵ Unlike the European Union, however,

3. See Baldwin (1994, 1995, 2005b) for details on the “domino theory of regionalism.”

4. See Nell (1994) for a more extensive review of Swiss-EU trade relations.

5. An FTA with Lebanon has been signed, but has not entered into force.

EFTA has already concluded an FTA with Singapore, which is in force, and has recently completed negotiations with South Korea. EFTA is also negotiating with Canada and Thailand, and exploratory talks are under way with Japan. None of these countries are EU partners yet.

The Swiss-US FTA would be exceptional as the first Swiss FTA separate from its EFTA partners. In the past, apart from its bilateral FTAs with the European Union and the Faroe Islands, Switzerland has negotiated FTA pacts as part of the EFTA group.

Third Reaction: The EEA and Bilateral Accords

Switzerland's reactive pattern toward FTAs was tested when the European Union decided to radically deepen its goods and factor market integration with its Single European Act of 1986. To redress the impending discrimination, Switzerland joined the other EFTA nations in negotiating the European Economic Area (EEA) agreement. This arrangement extended the Single Market to the EFTA nations; as usual, political integration was minimized and agriculture largely excluded.

The EEA negotiations were long and difficult, since the depth of the economic integration was unprecedented in the world of commercial diplomacy. When talks were launched, nonagricultural tariffs and quotas had been gone for two decades. The negotiations concerned the free movement of capital and labor, as well as behind-the-border trade measures that were previously viewed as purely national concerns. Given the diffuse and ever-changing nature of behind-the-border barriers, extending the Single Market to EFTA would require surveillance and enforcement mechanisms akin to the European Commission and the EU Court of Justice.

The lessons from the EEA talks for the EFTA nations were crystal clear. Truly deep economic integration was almost impossible without some form of political integration. The real options facing the EFTA nations were either to accept hegemonic authority from Brussels on Single Market matters—retaining the ultimate ability to say “no” on particular issues, but only at the cost of jeopardizing the whole relationship—or to join the European Union.

This realization, in conjunction with the end of the Cold War in the early 1990s, convinced the Swiss government that joining the European Union was the best way to redress the impending discrimination of the Single Market. Indeed, by the end of EEA talks, all of the EFTA nations except Iceland and Liechtenstein came to the same conclusion.⁶

However, despite the efforts of Swiss political leaders, Swiss voters rejected the EEA agreement in a referendum held in December 1992. Brus-

6. Iceland's dependence on fishing and Liechtenstein's on private banking both reduced the impact of being outside the EU circle and increased the cost of joining, given the European Union's questionable Common Fishery Policy and its negative attitude towards bank secrecy.

sels took this vote as a rejection of membership, and Swiss accession talks never started. In essence, Swiss citizens did not share their government's conclusions that truly deep economic integration required political integration, or that the best form of political integration was membership.

The adverse 1992 referendum has dominated Swiss-EU relations ever since. Bern has struggled to redress the Single Market's discriminatory effects by negotiating a string of bilateral agreements with the European Union. As always, these have minimized political integration and included only limited concessions on agriculture. The modest opening of Swiss-EU food trade was driven by the outcome of the WTO's Uruguay Round.

From Reactive to Proactive

Switzerland's reactive stance is not unusual. Small nations around the world tend to depend heavily on a single dominant trade partner, and accordingly, their trade policies are typically shaped by that relationship.

Historically, this political economy reality has led to hub-and-spoke bilateralism. In North America and Europe, one sees many bilateral FTAs between economically small nations and the dominant economy (the United States or the European Union). An Asian hub-and-spoke system also seems to be emerging, but it appears to have two hubs, China and Japan (Baldwin 2003, 2005a).

In recent years, however, some of the "spokes" have shifted from reactive to proactive trade policies. Mexico, which is even more dependent on the US market than Switzerland is on the EU market, provides the classic example of this "anti-spoke" strategy (Baldwin 2005a). It has signed an impressive list of FTAs in recent years, two of which—with the European Union and Japan—stand out in sharp contrast to standard practice. By signing these FTAs, Mexico broke free of the traditional hub-and-spoke pattern, whereby the commercial policies of small spoke economy are narrowly focused on the dominant hub economy. Having FTAs with the world's three largest economies means that Mexico now probably has the best market access in the world from the standpoint of tariff barriers confronting its exports. Of course, trade barriers are only one component of locational competitiveness, but Mexico has used its trade policy to maximize this component. Singapore has followed a similar strategy.

The Swiss-US FTA is the most important but not the only plank in the new proactive Swiss FTA strategy. Through EFTA, Switzerland has already concluded an FTA with Singapore that is in force. Negotiations have recently been concluded with South Korea and are also under way, at different stages, with Canada and Thailand. Finally, exploratory talks are taking place with Japan.

In considering the EU reaction to a Swiss-US FTA, it is useful to examine the US view of Mexico's anti-spoke strategy. The United States has not

reacted negatively to Mexican initiatives, for four main reasons. First, given that market access is power in an FTA negotiation, the uneven market sizes meant that the United States obtained almost everything it wanted in direct market access through the North American Free Trade Agreement (NAFTA). Second, Japan and the European Union are relatively minor players in the Mexican market. Third, while the Mexican market is important, it is not a priority for most US exporters. Fourth, since Mexican MFN tariffs are now modest, US preference margins in the Mexican market were correspondingly limited in the post-NAFTA era. What all these considerations mean is that the erosion of US preferences arising from Mexico's new FTAs has caused little concern to US exporters.

Would the European Union Object to a Swiss-US FTA?

The Swiss-US FTA can be viewed as part of a strategy akin to what Mexico has pursued. A trade deal with the United States would reduce Swiss dependence on EU policy, while simultaneously improving Swiss market access to the world's largest economy. There are, however, two important factors that might make a Swiss anti-spoke strategy more of a problem for the European Union than the Mexican strategy is for the United States.

First, the European Union is a customs union with a single external tariff, while NAFTA creates a free trade area in which each partner can set its own tariffs on third-country imports. If Switzerland ever joined the European Union, it would have to withdraw from the Swiss-US FTA, unless a US-EU FTA was negotiated in the meantime, which seems remote at this point. This could pose a problem for a future Swiss government and the European Union; after all, the Swiss application to join the European Union is frozen, but it has not been withdrawn.

Second, a Swiss-US FTA would create substantial preferences in agricultural goods. Swiss MFN tariffs for manufacturing are already very low, so the Swiss-US FTA would imply very little preference erosion for EU industrial firms selling into Switzerland. The story is quite different in food trade. Swiss MFN barriers on agriculture are some of the highest in the world. If the Swiss-US FTA lowered these barriers substantially, US food exporters might take a sizeable share of the Swiss market at the expense of third-nation exporters, including EU exporters.

This development could prove to be a problem for the European Union; however, it is unlikely to become a major issue. Unlike US agribusiness, the EU farm sector does not have a tradition of aggressively pushing for better market access. To a large extent, this commercial policy stance follows from the Common Agricultural Policy (CAP), which entails domestic price floors for most major export commodities; in turn, this means that improved foreign market access only indirectly benefits EU farmers. Better export access

mainly shows up in lower export subsidies, and thus, lower EU budgetary costs. Given the indirect nature of this link, EU farm organizations have never invested heavily in lobbying for improved foreign market access. Indeed, the European Union has shown a willingness, even an eagerness, to exclude agriculture from the dozens of FTAs that it has concluded with third countries.

These features, combined with the fact that the Swiss market is a minor outlet for EU farm exporters, suggests that preferential access for US farmers would not elicit a major reaction from Brussels. As in US-Mexican relations, lopsided market size has allowed the European Union to obtain almost all of the market access in Switzerland that it wanted. Swiss-EU agricultural trade barriers remain high to this day, but largely because the European Union is content with that arrangement.

Indirect Effects on Political Forces

Swiss trade policy is driven mainly by the struggle between protrade and antitrade forces inside Switzerland. The size and political power of protrade and antitrade groups are, however, affected by Swiss trade policy. In light of the “juggernaut theory of trade liberalization” (Baldwin 1994; Baldwin and Wypolcz 2004), it is worth considering the indirect impact of a Swiss-US FTA on the political forces that will guide future Swiss liberalization with the European Union and more broadly.

Again, the Mexican example provides useful insight. Up until the late 1980s and early 1990s, Mexico followed a classic import-substitution policy: Tariffs were extreme, and not until 1986 could President Miguel de la Madrid lead a reluctant Mexico into the General Agreement on Tariffs and Trade (GATT). NAFTA, launched by President Carlos Salinas in 1992, changed all of this.⁷ Once NAFTA was implemented in 1994, Mexico had zero tariffs on three-quarters of its imports. Moreover, because the United States and Canada have very low MFN tariffs, from Mexico’s perspective, NAFTA was not much different than unilateral free trade with the world.

In textbook fashion, NAFTA’s liberalization caused massive restructuring in Mexico. By the late 1990s, almost all Mexican firms that would be harmed by MFN free trade had already been driven out by bilateral free trade. The US-Mexico bilateral arrangement—the heart of NAFTA—changed the array of protrade and antitrade forces inside Mexico to substantially lower the political cost to the Mexican government of further liberalization. The Mexican government might have followed Adam Smith’s counsel to pursue unilateral free trade, but Mexico devised what it considered to be a superior strategy: It improved market access for its own firms by signing

7. For a detailed account of NAFTA, see Hufbauer and Schott (2005).

FTAs with every important country. Simplifying to make the point, NAFTA started a juggernaut rolling across the Mexican political scene, crushing most internal opposition to further liberalization.

The Swiss-US FTA may have a similar effect in Switzerland. The main opposition to further MFN liberalization is the Swiss farm sector. If a Swiss-US FTA brings about substantial cuts in Swiss farm protection, the result will be a restructuring that ultimately shifts the balance of power towards the protrade camp. This political economy shift is likely to make the future liberalization of Swiss-EU farm trade much easier than otherwise. Although this scenario involves a good deal of abstract reasoning, it does provide an argument that a Swiss-US FTA will ultimately improve EU access to the Swiss market.