

Transatlantic Free Trade: An Agenda for Jobs, Growth and Global Trade Leadership

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Executive Summary

This paper takes stock of the key arguments against a transatlantic free trade agreement. It concludes that they are no longer convincing and that it is time for the European Union and the United States to launch negotiations over a free trade agreement. There are two key arguments for such an agreement.

First, it would generate significant economic gains. Only an elimination of tariffs would generate gains sizeable enough to motivate the effort. In combination with reduction of non-tariff barriers and regulations that inhibit trade in services, the gains would be significantly higher than any other trade agreement that could realistically be achieved in the medium-term future. Consequently, those who argue that sclerotic growth in the West is a strong argument against launching transatlantic trade initiatives has failed to understand the economic logic of trade agreements. The EU and the US remain the two biggest economies in the world, and freed up trade between them would generate significant additional growth because they already are big economies.

Second, a transatlantic free trade agreement would generate a new dynamic in the world trading system that will make many other countries change their current defensive attitudes to multilateral liberalisation. It has been demonstrated in the past that significant preferential liberalisation have such effects on other countries. If other countries are opposing significant liberalisation – or if they are increasing their own trade barriers – the right counter-strategy is to press ahead with other forms of liberalisation that increases the costs of status quo.

The Doha Round of trade negotiations have been stalled for many years and no change is in sight. In the event there will be liberalisation at the WTO in the near-to-medium term future, it is likely to be incremental. The old argument against a transatlantic free trade agreement – that it will destroy trade multilateralism – has hence already been invalidated. In fact, it is arguably more relevant today to look at big-economy leadership outside the WTO system as a way to salvage trade multilateralism by creating positive tensions in the world trading system that could motivate the transatlantic economies and other key economies in the world to favour stronger liberalisation at the WTO.

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1. Introduction

This is a paper about transatlantic economic integration. Its purpose is to set out the case for deepened trade and investment policy co-operation between the European Union and the United States, crowned by what in trade parlance is called a Free Trade Agreement (FTA). But the paper takes a step further; it is also concerned with the arguments used over the past two decades against such a Free Trade Agreement. There is now an ascending interest in deepened transatlantic trade and investment integration. This interest is partly driven by the failure to free up trade in the Doha Round of trade negotiations in the World Trade Organisation (WTO), now into its tenth year without any chance of being finished anytime soon.

Moreover, as both Europe and the United States are clearly moving towards bilateral Free Trade Agreements as the prime form for new trade agreements, it is not surprising that people start to think about a trade deal between the two biggest trading powers in the world. As these two giants of the world economy are also facing competition from China as the source of global economic and regulatory order, the proposition to deepen transatlantic cooperation appears appealing to a growing number of people. Some see it, wrongly in my view, as a way to “gang up” on China. Others see it, quite rightly, as reasonable consequence of having a shared understanding and support of the core principles of an open global economy and an interest in maintaining those principles at a time of dysfunctional multilateralism.

Yet it is not the first time that the idea of a transatlantic trade deal has attracted attention. And every time in the past that it has been discussed more widely, it has provoked strong reactions, also from people inside the transatlantic community. And some of the arguments in the past against a transatlantic deal to free up trade have been valid. The question now, and for this paper, is if they still do carry weight. I do not believe they do – and, more importantly, I believe that there has been a profound change in global trade policy that has enforced the case for a transatlantic trade deal. Therefore, a considerable part of this paper will discuss the common arguments against such a deal – and why they should not be of concern today

If old arguments against a transatlantic trade deal have become weaker, some will argue, it is because the world economy and world economic power have changed to such a degree that transatlantic economic cooperation no longer feels relevant. No doubt the world economy has changed. Today it is considerably different in structure from the world economy only 20 or even ten years ago. Consequently, the balance between world economic powers has changed, too. The west is no longer the undisputed hegemon that can establish its own set of rules and expect that the rest of the world will follow. Nor is it in their interest to do so. Some of the profound economic challenges today, and in the near future, rather concern other parts of the world than America and Europe. So has the idea of transatlantic trade cooperation been outdistanced by world economic realities? I do not think so. The case for transatlantic economic integration is not solely based on the bilateral relations, and the gains that can be generated in two-way trade and investment flows. Equally, if not more

important are the effects that such an initiative will have for global trade and investment liberalisation. Transatlantic trade cooperation is hence a strategy for global leadership.

The next chapter of this paper attempts to put transatlantic economic cooperation in perspective. It examines the historical roots of this cooperation and especially considers the interplay between bilateral and multilateral cooperation, two forms of cooperation that are often seen as the Scylla and Charybdis of trade policy. The subsequent chapter examines one of the key arguments used against deepened transatlantic trade cooperation – namely that both continents are yesterday's news and that the payoff from a strategy to bend up markets in the fast-rising markets in Asia would be far higher. There follows a discussion about the risk that transatlantic trade cooperation would destroy the fabric of trade multilateralism, which is another key argument used against an EU-US trade initiative. The paper ends with conclusions and recommendations.

2. Transatlantic economic cooperation in perspective

Bretton Woods, the Marshall Plan and the GATT

Modern transatlantic world-economy co-operation started in 1944 with the creation of the Bretton Woods institutions. These institutions are called the Bretton Woods twins – the International Monetary Fund (IMF) and the World Bank – but the original plan was to have a three-legged stool for global economic governance. The missing leg, due to opposition from the United States Congress, was what we today call the World Trade Organisation: an international body for negotiation and supervision of trade agreements. A stripped-down version of the original plan was agreed in 1947 when countries agreed to set up a General Agreement on Tariffs and Trade (GATT).

The Bretton Woods agreement was crafted by Europe and the United States, and it aimed to establish solid conditions for global economic exchange in the post-war era. Protectionism and competitive devaluations had to be avoided in order to sustain peace and promote economic development. The consequences from the interwar period of escalating protectionism were still staring Bretton Woods designers in the face: falling prosperity and forces of political nationalism. Moreover, the financial collapse in Europe and the United States, which started with the fall of the Austrian bank Kreditanstalt in 1931, pointed to the need for better management of global finance in order to avoid another crisis cascading from country to country in intertwined financial markets.

The World Bank, or the International Bank for Reconstruction and Development (IBRD), as it was initially named, aimed to spur investment, growth and development. Yet that institution could not become fully operational immediately. The bulk of the public investment that entered Europe from foreign countries in the immediate part of the post-war era rather came through the Marshall Plan. This initiative, to help Europe re-build its crisis-stricken continent, was substantial. A recent estimation has suggested that if an equivalent initiative had been introduced between 2003 and 2007, it would in modern monetary terms equal

740 billion dollars.¹ It was also an initiative that in several ways came to define the structure of transatlantic economic co-operation in the next decades.

The Marshall Plan is of interest for the theme of this paper as it shows how strategic considerations about transatlantic matters have rested on three different modes of action: positive autonomous action, bilateral co-operation, and co-operation through multilateral organisations. The notion, heralded by some, that transatlantic co-operation on trade and investment matters should be channelled only through multilateral organisations is a recent invention. In the formative years just after the end of the Second World War, it rather seemed natural for both the United States and most parts of Europe to advance co-operation on all fronts. One can of course claim there were special circumstances at that point in time that steered the two continents towards a multi-track approach. And this is a key-point also for the argument of this paper: there is no point being theological about the exact form of strategies, it is the context and the circumstances that will determine which strategy that will work best. Sometimes the best strategy is multilaterally oriented; at other times is bilateral or unilateral. A great trading power typically acts on all fronts. That is what the US as well as key European economies did in the post-war period, and it is, as we will argue in subsequent chapters of the paper, what they should do today as well.

Multi-track co-operation was also the intention and a pivotal element of the Marshall Plan. Financed by the United States, it was a demand by the US government that it had to be a European plan, a plan designed by and for Europe, not only for a single country. The Marshall Plan intended to forge stronger economic co-operation in Europe, and had as an aim to be a lightning rod for future bilateral economic co-operation across the Atlantic. It was also a plan rooted in contemporary strategic challenges, especially it aimed to offer “Western” paths to prosperity for countries that could have been susceptible to the power or influence of Moscow. Furthermore, the Marshall Plan was built on a spirit of internationalism that stretched beyond transatlantic ties: it was intended to be part of the West’s case for peace, democracy and market capitalism.²

Muted bilateralism after the era of post-war recovery

Europe and the United States, however, never really considered negotiating a Free Trade Agreement in the post-war era. There were a number of reasons behind that tacit understanding.

First, a Free Trade Agreement, or Free Trade Area, is an ambitious form of a trade agreement in the sense that it should liberalise “substantially all trade”, in the words of the GATT agreement. At a time when tariffs generally were high in America as well as Europe, it was seen as being too ambitious to liberalise “substantially all trade” by eliminating tariffs against the other transatlantic partner. It is one thing to get political support for elimination

¹ G. Behrman, *The Most Noble Adventure: The Marshall Plan and the Time when America Helped Save Europe*. New York: Free Press, 2007

² F. Erixon and G. Pehnelt, *A New Agenda for Transatlantic Economic Cooperation*. ECIPE Working Papers No. 09/2009. Brussels: ECIPE

of tariffs, and other barriers, when they are, as today, comparatively low. It is a different thing to do it at a time when the average tariff stood at around 20 percent or more.

Second, a few decades after the end of the Second World War, Europe and the United States were also the dominating trading powers in the world, and an agreement to do away with tariffs with the other trade giant would effectively have meant that they would have liberalised substantially *all* their trade.

Third, Europe made the strategic decision to establish its own free trade structure on the continent. The Common Market, a core element of the Treaty of Rome from 1957, established a Common Commercial Policy in Europe: internal tariffs were eliminated, and a joint external tariff structure was established. That process, however, took a long time to finish. By the end of the 1960s it was operational, and by then the Common Market also had changed some of the immediate preferences in the United States' strategies towards Europe. Many US exporters understood that the establishment of the Common Market would have negative consequences on their competitiveness on the European market. Their European competitors would now have tariff-free access to the European market, which would give them a favour vis-à-vis US competitors. This concern was also shared by exporters in some other countries – and the conclusion was to jointly push a new and very ambitious GATT round to bring down tariffs in Europe (and elsewhere of course) as a strategy to mitigate the adverse competitiveness effects of the Common Market. This round, known as the Kennedy Round, finished in the late 1960s and still is the most ambitious tariff-cutting round the world has experienced.

Fourth, the US and the EU had a joint interest in cementing the GATT as the chief forum for trade negotiations. Especially the US, supported by European allies, wanted to use the GATT system to forge closer relations to cold-war allies. With an increasing number of members in the GATT, the group of countries in favour of capitalism and free markets expanded. Enlarging the GATT therefore became a strategic imperative in US foreign policy.

The combination of strategies in transatlantic economic relations – motivated partly by the European wars (to tie Europe into another international economic order), partly by cold war *realpolitik* – varied somewhat in the decades after the Second World War. At times it was also contested that there should be any transatlantic economic cooperation. Yet the strategy to anchor free-trade ambitions in the GATT system and combine it with stronger regionalism in Europe and ad hoc EU-US initiatives, survived till the end of the cold war.

The fall of the Iron Curtain was important also to foreign economic policy. From then transatlantic economic co-operation came to lack a strategic economic and political purpose. The Cold War had glued them together, and both of them had seen a strong geopolitical rationale for underwriting the multilateral trading system. But now they were bereft of an overarching strategic narrative for global trade policy, one that also could help convince people sceptical, if not hostile, to the economic arguments for trade liberalisation. Bilateral relations between the two were no different. Bilateral co-operation and joint global economic leadership continued to be lauded in speeches, but few political leaders considered them central parts of foreign economic strategy.

It is not difficult to understand the absence of a transatlantic spirit in post-cold war trade policy. The geographical dispersion in world welfare and growth has grown remarkably, especially with the economic rise of Asia, and helped to change the immediate agenda for market-access concerns. Europe and the US have faced bigger trade problems in other countries, and hence invested their time in designing foreign economic strategies to address them rather than solving problems in their bilateral trade relation. The rapid economic development in emerging markets in the 1990s and the 2000s has taken primacy over most other economic ambitions and strategies in the past 10 or 15 years. The interest to be a part of that market growth was mostly channelled through the WTO; only to get China to join the WTO in 2001 was an enormous task.

Yet the interest in the WTO as the key forum for transatlantic trade policy also reflected that the end of the Uruguay Round, and the creation of the WTO in 1994, opened a new era of strong WTO optimism. Globalisation had just become a buzzword and it was believed, not without good reasons, that the WTO could deliver many new ambitious trade agreements in the near future. And so it did. After the Uruguay Round, a couple of ambitious sectoral and plurilateral agreements was negotiated, the most important one being the Information Technology Agreement (ITA) which freed up trade in ICT goods and facilitated the explosion in ICT trade from the late 1990s onwards. These agreements spurred WTO optimism. So when the world was about to enter the new millennium, the WTO was at its peak. The ship of the WTO was unsinkable. Its future only looked bright.

But a good part of that optimism proved to be naïve. The first failure came in the late 1990s when the attempt to start a new big trade round collapsed amid street riots in Seattle. President Bill Clinton, then on his way out, was effectively the one who pulled the plug of the ambition to start a Millennium round at this meeting. Afraid of upsetting key trade unions in the United States close to a presidential election, President Clinton signalled that the US was not prepared to accept the terms for this negotiation.

But then came 9/11 and the ambitions of a new global trade round was again edging its way into the debate. In the eminent spirit of forging stronger economic integration in the world after 9/11, countries agreed in the Qatari capital, Doha, to start a new round – the Doha round. Ten years later, this round is still ongoing, at least in strict formal terms. For all practical purposes, the round ended a few years ago – without a result – and the only thing that keeps it formally alive is that no country wants to take the lead in declaring it dead.

It is easy to argue today that this round should not have been kicked off then. If we then had known what we know today, the round would never have started. Back then, however, there were few dissenting voices (apart from fringe people and NGOs on the extreme left). All the collapses of the Doha round, however, have pushed both America and Europe to reinvigorate their agendas for bilateral economic cooperation.

Recurring attempts at a transatlantic free trade accord

While strategic cooperation to advance trade and the market economy through the world trading system weakened after the end of the cold war, there were signs of some interests

to consider a free trade agreement, or equivalent, between the EU and the US already in the early 1990s. Yet it was muted, and shared only by a few. That interest, however, resurfaced again in the late 1990s, before the move towards launching a new multilateral round in Seattle in 1999. Then it returned again in the middle of the 2000s, leading the two sides to jointly create the Transatlantic Economic Council (TEC) in 2007 after strong pressures from the German Chancellor, Angela Merkel, who then chaired both the G8 and the European Union.

This cycle of interest for transatlantic free trade hides something that is important in order to understand why new initiatives never have yielded any real results. Calls for deepened transatlantic cooperation have always surfaced shortly after profound transatlantic rifts over wars. These initiatives came shortly after the first Iraq war, the US led Nato intervention in the former Yugoslavia in the late 1990s, and the second Iraq war. Hence, calls for transatlantic free trade have not primarily been made, if at all, on the economic merits of such initiatives; transatlantic trade initiatives have rather been the “olive branch” of transatlanticism, the gift you hand over to repair a relation that has grown sour. And if that is the premise for initiatives to free up transatlantic trade, it should not come as a surprise to anyone that the energy in these talks soon petered out.

The Transatlantic Economic Council (TEC) has also proven to be an unsuccessful strategy. This is not to say that the TEC has been useless. Clearly, it has not. Some progress has been made, e.g. forward-looking talks on a new agreement to combat intellectual property infringements and the establishment of trade principles for ICT services. Cooperation on competition policy has also yielded satisfactory results. They have especially been designed to avoiding clashes between the EU and the US on issues related to merger and antitrust reviews. Yet the TEC was predominantly established to progress regulatory harmonization between the two – or, if harmonization was not feasible, reducing regulatory incoherence across the Atlantic.

It is obvious that negotiators have failed on that ambition. In some areas, especially in a highly prioritized area for regulations – financial services – there is an increasing regulatory incoherence. Assurances from leaders about regulatory cooperation in this field, expressed especially at the G20 summits, have not been honoured. EU and US authorities are currently re-thinking their approach to regulatory incoherence, and one of the new ideas is to focus on avoiding incoherence in new regulations, e.g. nanotechnology and e-health, rather than areas where there are already established regulations. It is important to avoid structural regulatory obstacles in these areas and, to make a broader point, it is also imperative that the EU and the US find a way to avoid any form of new regulations to add to current problems with regulatory incoherence. Yet for regulatory cooperation to really have a boost on the economy, parties need to find a way also to address existing regulatory barriers.

Despite the failure of the Transatlantic Economic Council, and the absence of solid economic motivations for past initiatives, there has been, in recent years, a resurfacing interest for new transatlantic initiative to liberalise trade and investment. This interest is visible on both sides of the Atlantic, even if official rhetoric from trade-policy authorities and business associations (especially in Europe) remain cautious.

The US Chamber of Commerce has taken the lead for a new trade initiative and expressly called for a transatlantic free-trade agreement – or a zero-tariff agreement – as a cornerstone in a new US trade strategy.³ Policymakers on the American side are also warming to the idea, especially as there is scope for designing a new trade agenda in the US now that the trade agreements with Korea, Colombia and Panama have been approved by the US Congress after years of stalemate. Trade policy remains controversial in US politics and all new trade initiatives in the near future are likely to get a tough treatment. Yet an EU-US initiative is likely to prove less controversial than most other initiatives. To begin with, a transatlantic trade initiative has actually been suggested by one of the key organised sources of protectionism in the US – the trade union AFL-CIO.⁴ The EU is not seen as a trading partner that amplify wage competition to American workers, and the higher social and environmental standards in the EU has served as protection against the oft-used “race-to-the-bottom” argument by many American trade sceptics. Consequently, much of the opposition to recent US trade agreements is unlikely to surface if a transatlantic trade initiative is launched.

Furthermore, the European Parliament has expressed its support for a transatlantic initiative “in the very near future” to create a barrier-free transatlantic marketplace⁵ and some of the member states in the EU have made such an initiative a central plank in their desired bilateral trade agenda. The European Commission, which has for many years been a source of scepticism to such an initiative, is also showing an interest in revisiting the arguments in favour and against a transatlantic trade agreement. Obviously, the dark outlook for the Doha Round has particularly spurred an interest in how the EU and the US – which share core principles and ambitions for the global trading system – can take new initiatives that will change the dynamic in global trade talks and incentivize countries to progress trade liberalisation and improve rules for global trade and investment.

At the EU-US summit in late November (2011) the two sides also decided to set up a High Level Working Group for Jobs and Growth, tasked to examine new trade initiatives.⁶ Obviously, the premise of the group is to consider trade initiatives more ambitious than the current TEC.

This is a good starting point for revisiting the arguments in favour and against a transatlantic trade initiative that would spur economic integration. This is also what the remainder of this paper will do. More precisely, it will take account of what have been – and perhaps still are – the main arguments used against a transatlantic trade initiative.

3. “Go East, Young Boy, Not West”

³ It is part of the Chamber’s Jobs Agenda. <http://www.uschamber.com/trade>

⁴ F. Erixon and G. Pehnelt, *A New Agenda for Transatlantic Economic Cooperation*.

⁵ European Parliament, *Report on a New Trade Policy Under the Europe 2020 Strategy* (2010/2591(INI)). June 28, 2011. Brussels: European Parliament

⁶ EU-US Transatlantic Economic Council, *Joint Statement*. November 29, 2011, accessed at http://trade.ec.europa.eu/doclib/docs/2011/november/tradoc_148385.pdf

Let us start with what is the prime argument used today against a transatlantic free trade initiative. It is an argument that largely challenges the economics – or the notion that there are sizeable economic gains – of such an agreement, and, consequently, why priority should be given to such an agreement. The argument, in somewhat crude terms, goes like this:

The structure of the world economy is moving eastwards. That is where market growth primarily will be for European and American firms in the next decades. Barriers to market access are also much higher in Asian markets than they are on the transatlantic market. So why put emphasis on a trade relation that is already working remarkably well? Why not put all focus on negotiating better access to Asian markets? Furthermore, at a time of economic sclerosis in the West, time and energy is much better spent at creating economic alliances with rising emerging markets.

Many things could be said about this argument. Some people present it in a shallow way without supporting evidence. Others do back the view up with substantive arguments. There is also one wing that takes the argument further and argues that transatlanticism more generally is passé – an outdated notion. In whatever way we dissect the future shape of the world economy and world economic power, they argue, it is Asia that will bring a new dynamic to international affairs. Consequently, any new bold initiatives should be with emerging Asian powers, not with old and declining Western powers.

This view is not without appeal, and it is one that is powering the views of influential policymakers in the Far East. Yet it is a profoundly flawed view. It misreads the economics and politics of trade agreements. And it heralds the strange view that there has to be a choice between doing trade deals with the East and the West. Let us start with this part of the argument, next we will focus on the economics.

Why make a choice between East and West?

It is quite obvious that an entity like the European Union could initiate trade negotiations with many different countries and regions. In fact, it is quite necessary for big trading powers like the EU and the US that they do. The EU has recently implemented a trade agreement with South Korea, has finished a trade negotiation with Colombia, and is currently negotiating one with Canada. It is also negotiating FTA-like agreements with African countries – and has recently embarked on FTA negotiations with countries in Southeast Asia. So it is obviously possible to negotiate trade agreements with more than just one type of countries. A new trade agreement with the United States would not alter that fact.

It also makes sense to negotiate free trade agreements with different countries, especially if multilateral trade negotiations are, as today, dysfunctional. Bilateral trade agreements can be motivated by at least two solid arguments.

First, they should be oriented to increase trade and economic growth as much as possible. Hence, there should be a good economic *motif* for engaging in bilateral trade agreements. In today's world of globalized supply chains and integrated cross-border production structures,

it makes sense to cast a wide net in a FTA strategy. Ideally, a bilateral strategy should aim to cover many of the countries that form part of integrated production structures, partly to avoid that rules-of-origin regulations would disturb market-based supply-chain networks.⁷ And if the strategy is to “go with the market flow” – that is, to reduce borders in a supply chain rather than create disturbances – then it makes sense to combine FTAs with Asian countries with FTAs elsewhere.

Second, bilateral trade agreements should aim to trigger a positive dynamic of liberalisation in other countries. In other words, a good FTA is one that creates positive tensions in the world trading system; an FTA that forces or incentivizes other countries to open up markets and seek similar trade agreements.

Agreements such as the one between the EU and South Korea have certainly triggered a positive dynamic. It remains to be seen if the dynamic will yield other trade agreements, but it certainly has triggered activity on the part of other countries.⁸ That activity, however, follows a copycat strategy: other countries, like Japan, have courted the EU about a similar agreement in order to avoid negative effects on Japanese export to the EU as a consequence of the EU-Korea agreement. A better dynamic, however, is when a preferential initiative has positive *systemic* consequences: initiatives that give other countries reason to more strongly favour multilateral agreements or general (rather than preferential) liberalisation that reduce the adverse effects emanating from the new trade initiative.

There are some examples in recent history of such initiatives. The creation of the Common Market in Europe in the 1950s and 1960s triggered, as previously discussed, increased action especially on the part of the United States that was directed towards the GATT. When the ideas of a Nafta and the single market in Europe matured in the early 1990s, they both had strong effects on other countries’ willingness to constructively engage in the Uruguay Round, even to expand the remit of the negotiations into new fields that the EU or the US favored.⁹

There are bilateral EU and US trade agreements with Asian countries that could create a positive systemic dynamic in global trade talks, possibly helping to salvage some elements of the Doha Round. But it is difficult to imagine how one agreement between the EU or the US, on the one hand, and an Asian country, on the other, could have such an effect. A bilateral trade agreement with China would no doubt create systemic dynamics, but such an agreement is completely off the radar screen for the EU and the US as well as for China. If it ever will happen, it is at least a decade or two away from now. A bilateral agreement with Japan could also create systemic dynamics, but only in a limited way. The conclusion, therefore, is basically that FTAs with Asian countries can be driven by economic ambitions to

⁷ Rules-of-origin regulations are of no relevance if tariffs are eliminated, which is the purpose of FTAs.

⁸ The EU also sought an FTA with South Korea for this reason. The United States had already launched FTA negotiations with South Korea, and to avoid trade diversion effects for the EU, Brussels asked for a similar agreement. Furthermore, some of EU’s past FTAs have been motivated by similar concerns. The EU negotiated an FTA with Mexico after the establishment of Nafta, and an FTA with Chile after the US had signed one.

⁹ F. Erixon and G. Pehnelt, *A New Agenda for Transatlantic Economic Cooperation*.

spur trade and growth, but they will not provide enough tension in the trading system to motivate others to take initiatives with positive systemic consequences.

Transatlantic trade: estimating size and gains

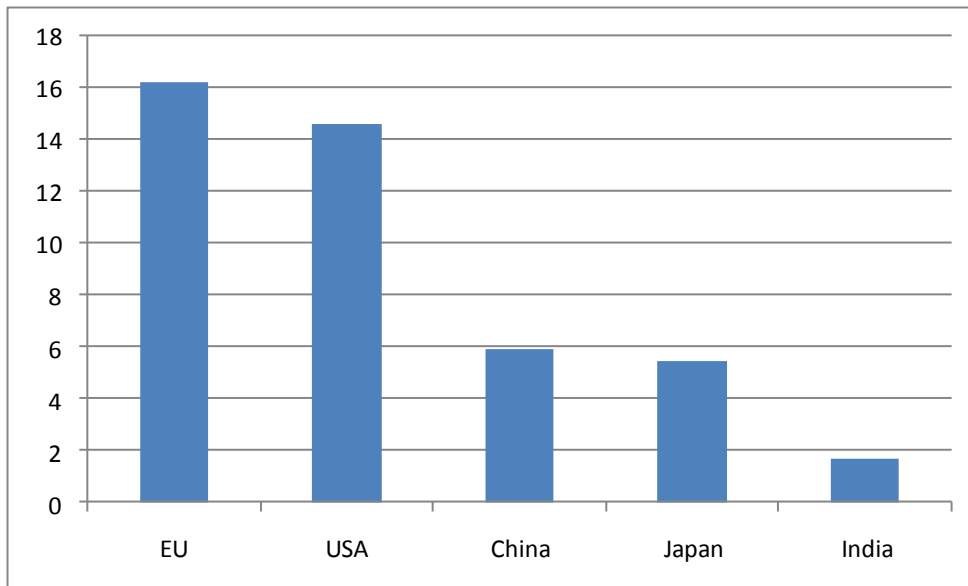
There are also reasons to challenge the underlying economics in the claim that future market growth for firms is only going to occur in the Far East. The assumption that trade agreements with Asian countries are going to generate bigger economic gains than a transatlantic deal simply does not stand up to scrutiny. To understand why, we need to take a closer look at the world and the transatlantic economy.

Growth in Asia has been at remarkable high rates in the past decade. China has maintained growth rates in the ten-plus region for more than a decade. Chinese growth is moderating, and will likely level out in the 6-8 percent region in the next few years, but that are still high growth rates. Other Asian countries have boosted their economies, too, and a country like India has a huge growth potential in the future. Yet growth of production and value added is not the same thing as the stock of production and value added. And there is a big difference in the current size of the economies, as figures 1 and 2 below demonstrates. Figure 1 shows the size of economies measured at current exchange rates while figure 2 exhibits the relative share of the world economy represented by a selected group of countries.

Even if Asia will have much higher economic growth than the West in the next decade, there is still a big gap between the size of the economies, especially when they are measured at current exchange rates. The EU economy is more than three times the size of China's economy, and the US economy is not far behind the European Union. Despite the current high growth rates in India, its economy represents less than 10 percent of the entire EU economy. This may be the Asian century – and the next ten years may be described by future literature as the era of Western declinism – yet the American and European economies remain considerably bigger than other economies in the world.

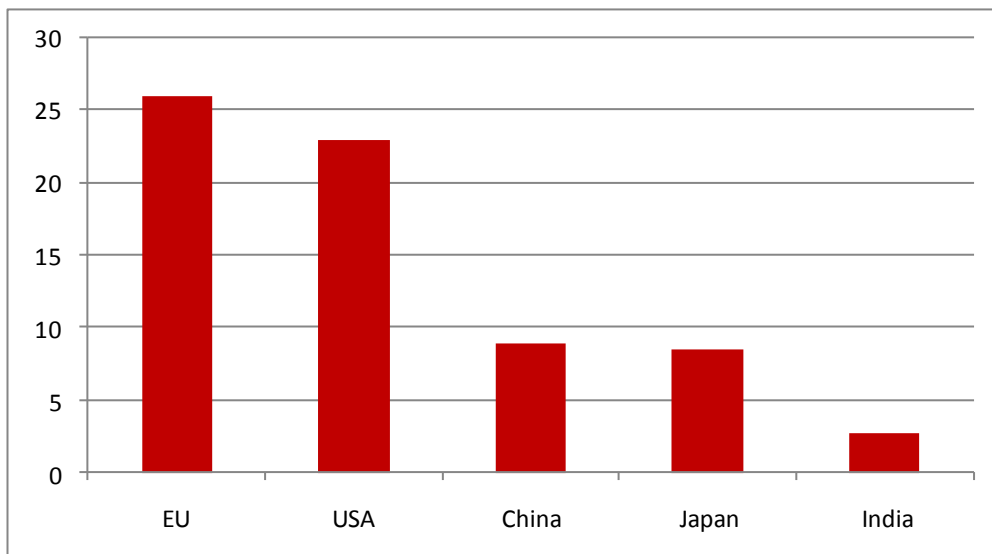
The size of the economy matters if one judges an agreement upon the gains it generates. And it matters in many different ways. For instance, low growth in a big economy may still generate more new market demand than very high growth in a smaller economy. If the former economy has demand growth higher than its rate of GDP growth, and if the latter economy has much smaller demand growth than its rate of GDP growth (e.g. because of propensity to save rather than consume new income), market-demand growth in the low-growth economy may be much higher than in the high-growth economy.

Figure 1. Size of GDP in 2010 measured in current USD (trillions)



Source: The World Bank, data available at <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD>

Figure 2. Relative share of world GDP in 2010 measured in current USD (%)

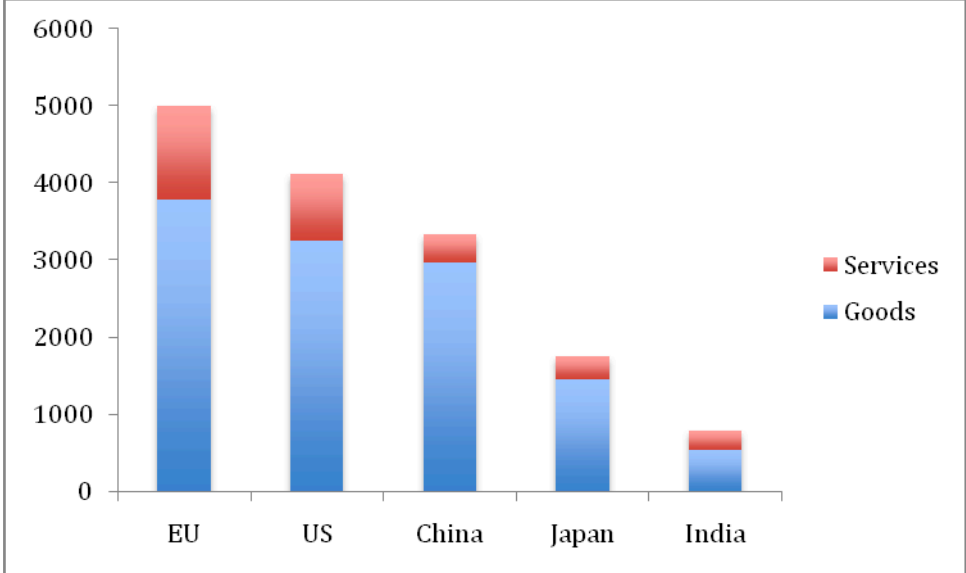


Source: World Bank, data available at <http://data.worldbank.org/indicator/NY.GDP.MKTP.CD/>

The differences in trade volumes between these selected countries are smaller. This is shown in Figure 3. The EU and the US are in the aggregate still bigger traders than China and India, but the gap between the countries is not as big as they are in GDP. And if services are discounted, the gap shrinks even further. It is particularly China that differs from the pattern. China's trade sector is not only big but also bigger than what one would expect for a country of that size and development status. Yet China has successfully been using trade to develop its economy. It established itself as a trade hub in East Asia for many multinational firms that

invested in factories to assemble parts and components imported from other countries in the region. China’s heavy reliance on import in order to export – so called processing trade – boosted total trade (import and export) in China’s early development phase. China’s trade sector is more than four times bigger than India’s trade sector.

Figure 3. Total trade in 2010 (billion USD)



Source: World Trade Organisation, International Trade Statistics; Eurostat
Footnote: Intra-EU trade is excluded.

The conclusion of these brief trade statistics is not that Asian markets do not matter, or that they are not going to be growth markets in the next decade for American and European firms. Clearly they will. Consequently, improved trade relations with the will be important, too. The relevant point is rather that the role of Western markets for trade and market demand is likely to be far higher than what many people expect. Low market growth in big economies will still add up to considerable volumes of potential increases in export sales for firms.

Intuitively, trade liberalisation between big economies has bigger effects on trade than trade liberalisation between smaller economies, even when – or perhaps because – the two big economies in question are already deeply integrated. Most of the FTAs signed in the past are between two smaller economies, or between a big economy and a small economy. The gains for a big economy in the latter form of agreements are typically small. For instance, an estimate of the GDP effects in the European Union from the recently established EU-Korea Free Trade Agreement put the result at 0.08 percent.¹⁰ According to the United States International Trade Commission, the GDP effect in the US from full tariff elimination in trade with Korea is 0.1 percent.¹¹

¹⁰CEPII/ATLASS, *The Economic Impact of the Free Trade Agreement between the European Union and South Korea. Report for the European Commission.* May 2010. Accessed at http://trade.ec.europa.eu/doclib/docs/2010/may/tradoc_146174.pdf One should bear in mind that Korea is not a small but medium-sized economy.

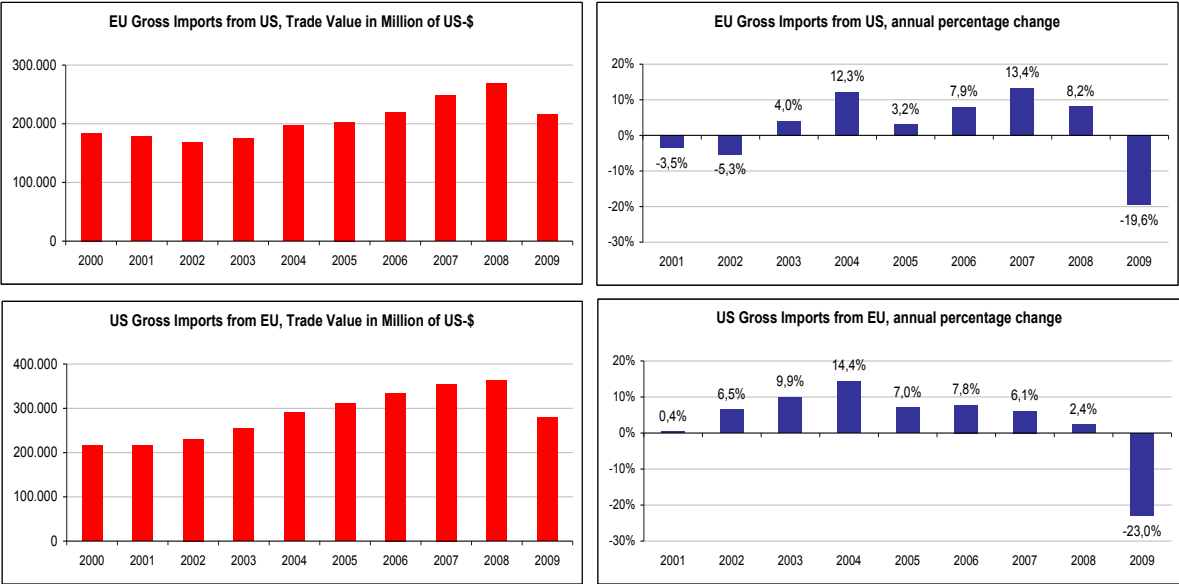
¹¹United States International Trade Commission, *U.S.-Korea Free Trade Agreement: Potential Economy-wide and Selected Sectoral Effects.* USITC Publication No. 3949. Washington, DC:

Consequently, EU and US trade deals with economies smaller than the Korean economy have even less effects on GDP. This is not to say such deals are unimportant or that they do not provide benefits. The point is rather only that the size of the effect of an agreement is to a large extent a reflection of the size of the partnering economy.

EU-US trade and investment is already significant, and it is easily the largest bilateral economic relationship in the world. China is now edging itself into that duo, if one looks only at trade in merchandises. And China is certainly competing with the two at the top of the world trade league. But in bilateral economic relations, trade is only one of the factors driving cross-border integration.

Transatlantic trade has increased considerably over the last decade. Prior to the 2008-9 financial crisis, EU exports to the US grew by an average of nearly 7 percent a year. US exports to the EU grew by approximately 5 percent a year. This is a good record, especially as both economies contracted in the wake of 9/11 and experienced a marked slowdown in trade growth as a consequence. In the first two years of the 2000s, US exports to the EU fell, which is why US export growth is lower than Europe’s in the decade leading up to the crisis. Like all other trade relations, transatlantic trade took a sharp hit during the recent crisis (2008-9). EU imports of goods from the US fell by almost 20 percent in 2009, and the contraction in US merchandise imports from Europe was even larger. Despite this fall, bilateral trade in goods remains extensive, as is shown in Figure 4.

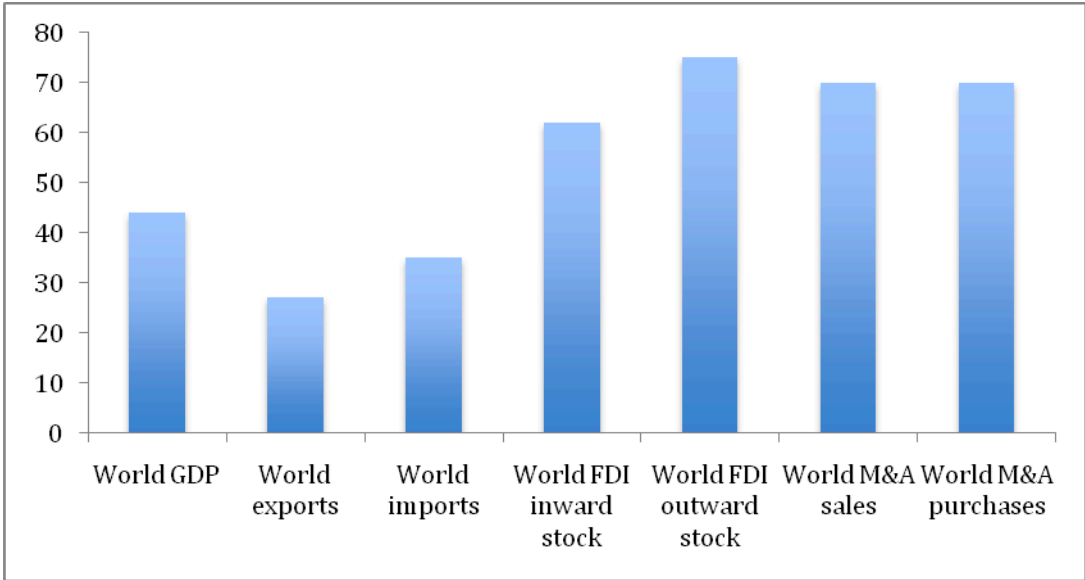
Figure 4: Transatlantic merchandise trade at a glance



Source: Data compiled from the World Bank’s World Integrated Trade Solution (WITS) service, available at <http://wits.worldbank.org/wits/>.

Figure 5 gives a few other indicators that put the size of transatlantic economic relations in context. The transatlantic economy still represents more than forty percent of total world GDP. Its role in trade is smaller, but the two transatlantic partners represent a vastly bigger share of the world total of FDI and mergers and acquisitions. Hence, the transatlantic economy has moved beyond trade, and integration today runs deeper. “Investment first, trade second” is the modern credo for the transatlantic economy.¹²

Figure 5: Comparing the transatlantic economy with the world (share of world total)



Source: D. Hamilton and J. Quinlan, *The Transatlantic Economy 2010: Annual Survey of Jobs, Trade and Investment between the United States and Europe*. Washington, DC: Center for Transatlantic Relations, 2010.

These observations of the transatlantic economy reinforce the point made above: the size of the gains from a Free Trade Agreement reflects the size of the partnering economies. And it matters particularly for the potential effect on productivity from such an agreement. When two of the biggest economies in the world, representing more than 40 percent of global GDP and with 600 billion US dollar in total bilateral trade, eliminate tariffs and non-tariff barriers in their bilateral trade, this will have a clear effect on competition and, consequently, the dynamic effects of trade.

Yet there are also two other structural reasons to expect a transatlantic trade deal to have a considerable effect on trade.

First, another factor central to understanding the transatlantic economy, and the potential gains from eliminating trade barriers, is the high degree of intra-firm trade driven by foreign affiliates. Much of the economic integration between the US and the EU is driven by the thousands of affiliates that operate in each other’s markets. Table 1 below gives us some

¹²D. Hamilton and Quinlan, *Deep Integration: How Transatlantic Markets are Leading Globalization*. Washington, DC/Brussels: Center for Transatlantic Relations/ Centre for European Policy Studies, 2005.

indicators of these dense firm relations. For example, half of all US foreign affiliates are in Europe and 60 percent of the assets held by US foreign affiliates are in Europe. The equivalent figure for EU affiliates in the US is 75 percent. Estimates have suggested intra-firm trade to represent a third of total transatlantic trade.

Why is a high degree of foreign affiliates an important factor for trade? There is a high degree of intra-firm trade between foreign affiliates – that is, there is significant trade within a firm. And even if tariffs are low they represent an international “tax” on what would otherwise be a normal intra-firm transfer. Tariffs also require administrative costs to be managed. And it is well known in trade economics that these costs can be significant. The effective costs of tariffs are hence higher than just the tariff.

Table 1: US affiliates at a glance

| US affiliates in Europe in which investment was reported, 2009 | | | | | | |
|-------------------------------------------------------------------------|----------------------------------------------------------------------------------------|-----------------------|------------------|----------------|---------------------------|---------------------------------|
| | Number of affiliates with assets, sales, or net income (+/-) greater than \$25 million | Millions of dollars | | | | Number of employees (thousands) |
| | | Total assets | Sales | Net income | Compensation of employees | |
| | (1) | (2) | (3) | (4) | (5) | (6) |
| All countries | 26,961 | 22,087,177 | 5,718,931 | 900,474 | 548,726 | 12,961.5 |
| All Europe | 13,815 | 12,034,933 | 2,897,824 | 523,512 | 298,057 | 4,774.9 |
| Top EU | 10,702 | 10,268,434 (D) | 2,226,154 | 430,567 | 247,169 | 3,711.0 |
| Belgium | 553 | (D) | 129,831 | 18,158 | 12,850 | 147.0 |
| France | 1,242 | 400,751 | 210,780 | 8,527 | 34,752 | 566.8 |
| Germany | 1,602 | 1,002,826 | 394,296 | 13,014 | 52,826 | 677.5 |
| Ireland | 617 | 796,463 | 249,072 | 63,797 | 7,638 | 104.8 |
| Italy | 685 | 210,374 | 144,255 | 8,805 | 16,013 | 259.8 |
| Luxembourg | 518 | 1,248,352 | 33,971 | 91,065 | 1,440 | 16.8 |
| Netherlands | 1,719 | 1,633,444 | 249,599 | 133,851 | 18,028 | 239.2 |
| Spain | 583 | 195,862 | 101,130 | 8,558 | 12,561 | 210.7 |
| United Kingdom | 3,183 | 4,617,394 | 664,142 | 71,945 | 87,775 | 1,336.6 |
| Other EU/Other Europe | 3,113 | 1,766,499 | 671,670 | 92,945 | 50,888 | 1,063.9 |
| Note. D=Suppressed to avoid disclosure of data of individual companies. | | | | | | |

Source: Source: Bureau of Economic Analysis, US Department of Commerce, http://www.bea.gov/iTable/index_MNC.cfm

Table 2: European affiliates at a glance

| Majority-Owned U.S. Affiliates by European Country of Ultimate Beneficial Owner, 2007 | | | | | | |
|----------------------------------------------------------------------------------------------|-------------------|---------------------|-----------|------------|---------------------------|---------------------------------|
| | No. of affiliates | Millions of dollars | | | | Number of employees (thousands) |
| | | Total assets | Sales | Net income | Compensation of employees | |
| All countries | N/A | 12 012 130 | 3 277 167 | 103 301 | 403 606 | 5 520 |
| All Europe | N/A | 9 094 374 | 1 998 241 | 58 710 | 267 187 | 3 595 |
| <i>Europe in %</i> | | 76% | 61% | 57% | 66% | 65% |
| Top EU | | | | | | |
| Belgium | N/A | 112 604 | 47 014 | 1 194 | 5 124 | 141 |
| France | N/A | 1 262 812 | 253 627 | 10 288 | 39 723 | 516 |
| Germany | N/A | 1 825 362 | 442 648 | 1 844 | 55 375 | 654 |
| Ireland | N/A | 60 622 | 23 942 | 140 | 4 786 | 68 |
| Italy | N/A | 139 378 | 37 717 | 790 | 5 234 | 115 |
| Netherlands | N/A | 1 000 675 | 323 524 | 16 040 | 28 113 | 391 |
| Spain | N/A | 233 165 | 24 916 | 557 | 2 599 | 58 |
| United Kingdom | N/A | 2 216 961 | 499 412 | 27 638 | 70 299 | 949 |
| Other EU/Other Europe | N/A | 2 242 795 | 345 441 | 219 | 55 934 | 703.0 |

Source: Bureau of Economic Analysis, US Department of Commerce, http://www.bea.gov/iTable/index_MNC.cfm

Second, the final structural aspect that merits special consideration in transatlantic trade is intra-industry trade (IIT) – that is, inward and outward trade in the same sector. Basic trade theory suggests that countries that trade will specialise in different directions – and that the profile of trade will be a factor of different structures of production and resource endowments. This is partly true. However, it is equally true that countries with similar structures of production and resource endowment trade significantly with each other.

Transatlantic trade has a very high degree of intra-industry trade – the two parties export to each other similar goods within the same sector.

A high degree of IIT suggests that the competition effect of an elimination of tariffs can be significant. As there is competition between firms in those sectors, the dynamic effect could be considerable once tariffs are eliminated. A higher degree of competition is one of the key dynamic effects from trade liberalisation: liberalisation forces firms to behave more productively. Sectors with a high degree of IIT get another competition boost – and it is such effects that leave a clear imprint on the larger economy.

Let us now turn to existing estimates on the gains from transatlantic free trade. What are the likely gains from a transatlantic trade agreement? A recent study by the author of this paper estimated the potential gains from a transatlantic zero-tariff agreement– that is, an agreement that only eliminates tariffs – to be significant.¹³ Tariffs between the EU and the US are comparatively low (the applied tariffs average at 4.8 percent in the US and 6.7 percent in the EU). Consequently, the static effect from tariff elimination is not substantial when measured in relation to existing trade. The static positive effect on GDP from a transatlantic zero-tariff agreement is estimated to be 0.01 percent for the EU and 0.15 percent for the US. However, dynamic gains – accounting for improved productivity as a result of competition, and reduced trade costs – are estimated to be 0.32-0.47 percent for the EU (or \$46 to \$69 billion) and 0.99-1.33 percent for the US (or \$135-\$181 billion).

The estimated change in EU exports to the US is 7 percent (or \$28 billion) in a static scenario and around 18 percent (or \$69 billion) in the dynamic scenario. The US is estimated to increase its exports to the EU by 8 percent (or \$23 billion) in the static scenario and 17 percent (or \$53 billion) in the dynamic scenario.¹⁴

Since the highest tariffs are currently applied to agriculture-related sectors and textiles, those industries are likely to expand significantly from the tariffs reductions. In terms of export creation in the EU the textiles, manufacturing and agriculture-related sectors are expected to experience the highest relative increase in trade. The result is similar for the US; exports from agriculture-related sectors would generally benefit most from the elimination of tariffs, followed by textiles and manufacturing.

In absolute terms, it is the machinery and chemicals industries that will contribute most to the overall rise in exports for both the EU and the US. In the EU, another substantial contributor to the overall rise in exports is the motor vehicle industry. In the EU, the motor

¹³ F. Erixon and M. Bauer, *A Transatlantic Zero-tariff Agreement: Estimating the Gains From Transatlantic Free Trade in Goods*. ECIPE Occasional Paper No. 04/2010. Brussels: ECIPE

¹⁴ Static gains from trade can be described as gains achieved through trade liberalisation due to elimination of tariff costs and greater efficiency as a result of exploiting comparative advantage and economies of scale, along with a reduction in trade-distorting practices. These refer to direct gains not accounting for any period of time. In contrast, dynamic gains are those that could potentially occur over a longer period of time. Dynamic gains also account for bigger changes in the behaviour of market participants as a consequence of freer trade.

vehicle industry together with the machinery, the chemical industry and textiles account for 65 percent of the total rise in exports to the US. For the US, increased exports of transport equipment is likely to contribute a lot to the overall increase; machinery, motor vehicles, electrical machinery, transport equipment and chemicals account for 75 percent in the rise of total exports to the EU.

The difference in GDP effects can be attributed to methodological aspects of the estimations, like terms of trade. In addition, there are also a few other explanations that warrant consideration. The US economy is smaller than the overall EU economy, which is one reason explaining why an equal trade expansion is having a bigger effect on the US than the EU GDP. Moreover, a greater share of the EU goods sector has previously been exposed to foreign competition (through EU internal liberalisation), which is why the effect of trade liberalisation is greater in the US. The composition of output changes appears to be more favourable for the US in terms of value added.

Finally, considering the coverage of the tariff reductions, we are likely to expect there to be exemptions from the agreement in order to protect sensitive sectors. However, even if we allow for a very generous definition of a sensitive sector, the trade covered by exemptions would represent less than 3 percent of total trade.

Let us now turn to so-called non-tariff barriers (NTBs)– barriers to trade in goods that are not manifested by a tariff (e.g. differences in product standards, safety regulations, licenses, et cetera). It is well known that NTB elimination would generate significant economic gains in most trade relations, because NTBs are typically much higher than the tariffs. This is true also for transatlantic trade. For instance, compared to a base scenario of no NTB reduction, the largely static GDP gains of the EU and the US are estimated to be 0.7 percent and 0.3 percent higher respectively in 2018 with only a 50 percent NTB reduction. Exports are expected to increase with reduction of NTB's; EU exports will go up by 2.1 percent and US exports by 6.1 percent.

The main output effects from economy wide NTB elimination would be in the sectors of electrical machinery (29 percent in the US; EU 5.5 percent), motor vehicles (EU 5.7 percent; US 1.4 percent) and chemicals, cosmetics, pharmaceuticals (EU 2.2 percent; US 3.3 percent). In addition, it can be noted that a convergence of the regulations of intellectual property rights (IPR) in the EU and the US is estimated to generate a static increase in national incomes by €0.8 billion (\$1.1billion) in the EU and \$4.8 billion (€3.7 billion) in the US.¹⁵

These different studies cannot be added up together in order to get a full figure on estimated gains from elimination of tariffs and reductions of NTBs. Yet it is clear that there are big gains to be reaped. Moreover, the potential gains would also increase if one could add gains for liberalisation of trade in services, which is a rapidly expanding field of trade, yet one still covered by severe restrictions. Reductions in barriers to investment would also produce sizeable gains. Yet there are no existing studies that have estimate these potential gains.

¹⁵Ecorys, *Non-tariff Measures in EU-US Trade and Investment: An Economic Analysis. Report for the European Commission*, 2010

Concluding remarks

There is no doubt that Asian markets – and emerging markets more generally – are increasingly important to sales from Western firms and that they will grow more important over the next decade. However, that does neither mean that the transatlantic market is no longer important nor that it cannot generate substantial increases in sales in future. The main conclusion from this section is rather that a strategic approach by the EU and US in their bilateral trade policy in future needs to target more and different countries, and that they will need a multifaceted approach which can take account of various types of market growth in high as well as low growth economies. Consequently, the EU and US should move towards a free trade agreement that would free up trade and investment across the Atlantic. Such a trade agreement would generate significant gains – and the more sectors that an agreement would cover, and the wider it would be, the bigger are the gains generated from the agreement.

4. “The end of trade multilateralism”

The second type of argument that has been used against a transatlantic trade agreement builds on a desire to maintain the WTO as the main organisation for trade policy. This is one of the older arguments and it has been particularly strong in Europe, leading many policymakers to refute the notion of a transatlantic free trade agreement. The argument goes like this.

Europe and the United States are the biggest trading blocks in the world. If they decide to address their trade concerns outside the WTO system, there would no longer be enough interest in the WTO from these countries to maintain focus on long and arduous multilateral negotiations. In effect, it would spell the end of trade multilateralism.

This argument against a transatlantic trade deal is different from the first argument in so far as it rests on the assumption that the EU and the US are so dominating in the world economy that only they have the capacity to drive multilateral negotiations and that their core interest is to achieve greater access to each others market. An alternative version of the argument is that the EU and the US have a strong interest to get improved market access to other economies, and that this transatlantic energy is necessary to initiate and drive negotiations forward at the WTO.

The first challenge for this argument, however, is that it makes a bold assumption: that there is an appetite from other countries to negotiate with the EU and the US at the WTO. Indeed, the wider implication of the argument is that there will be equivalents to Rounds in the near future at the WTO that could help to liberalise trade in a meaningful and comprehensive way. If the analysis rather is that the prospect for comprehensive liberalisation in multilateral negotiations are dark, then it is difficult to see how this argument can remain valid.

And there are good arguments to expect future negotiating activity at the WTO to be limited. The Doha Round has now run for more than ten years, and there is nothing today that suggests this Round to finish anytime soon. Nor are the reasons behind the Doha stalemate easy to address in trade negotiations. The Doha Round has failed because of structural reasons entrenched in the world economy and the rapid change it has gone through in the past decade. Before those impediments are addressed there will be little trade liberalisation emanating from the WTO.

Some of the structural problems stem from an inability of the EU and the US to substantially reform sectors coddled by government subsidies and protection. Other problems emanate from unwillingness by emerging economies to open up their economies, especially in areas where competition from other emerging economies are likely to be forceful.

Second, there are also some new structural problems built into the trading system. One of them concern leadership: the US and the EU remain the only entities that can offer real leadership, but they are no longer such dominating giants in world trade that they are prepared to accept all forms of developing countries – especially rapidly growing big emerging markets – to free ride in the system. They, too, need now to offer real market access in trade negotiations for the EU and the US to be prepared to accept opening up their own economies further.

Another structural problem is that old type of issues (tariffs) that were central to trade policy a few decades ago, can no longer generate sufficient interest to drive negotiations. Other barriers to trade, like NTBs and regulations prohibiting trade in services, are today more important barriers to real access to foreign markets and to a world trade characterized by free competition. Yet those barriers are more difficult to negotiate, let alone reduce, than tariffs.

Third, preferential trade policy is also undergoing a change. For many years such trade agreements tended to err on the light side. They – with a few exceptions – were often driven by other motivations than generating trade and economic growth (e.g. foreign policy). Consequently, they had no real influence on actual trade, and not seldom the influence they had was to cause troubles for supply-chain globalisation by their complicated rules of origin regulations. Now there is a new interest to use preferential trade agreement for more strategic economic purposes.

If there is something today that could help to spur multilateral trade policy it is external dynamics and tensions that would provoke some countries to change their attitudes toward the ambitions in multilateral trade negotiations. One such external dynamic is a transatlantic free trade agreement – or the start of a process in that direction. Consequently, there are good arguments to be made in favour of a transatlantic trade deal as a way to direct the attention again to negotiations in Geneva.

Multilateral versus bilateral trade policy

The debate over forms of trade policy is too often slanted in an ideological fashion. Often the debate concerns multilateral *versus* bilateral trade policy. There are many interesting discussions to engage in over the specific qualities and conditions of WTO based negotiations and various bilateral initiatives. But the debate itself suffers from serious flaws. One is that idealized and stylized versions of multilateralism and bilateral initiatives often are far from the political and economic reality of trade policy. It becomes a theological debate rather than a dispassionate account of what works best at a specific point in time.

The purist idea that trade policy should only be conducted at the WTO is a pipe dream. Trade policy always has been – and probably always will be – too complicated to be squeezed into one particular folder. Trade liberalisation has always occurred in different ways, with different approaches to liberalisation underpinning each other. More generally, when trade and market reform agendas have been on the backburner all forms of trade liberalisations – multilateral, regional, bilateral and unilateral – have been stagnant. On the other hand, when there has been a political desire to open up markets, all formats tend to have worked well.

It is difficult to understand the argument that bilateral initiatives poison multilateral trade policy. There is much to agree with in the desire to progress multilateral trade policy, but initiating bilateral initiatives do not stand in opposition to that desire. If recent history teaches us anything in this context it probably is that bilateral or regional initiatives actually can help to advance multilateral trade ambitions. References have already been made to two occasions in the past 50 years when preferential initiatives were crucial for advancing multilateral trade liberalisation: The Kennedy Round in the GATT was largely a US-driven Round to liberalise trade in order to reduce possible trade diversion emanating from the creation of the Common Market in Europe. And the Uruguay Round would perhaps never have yielded a positive result if it had not been for the initiatives to establish a North-American Free Trade Area and a single market in Europe. Those initiatives forced other countries to re-arrange their preferences in the Uruguay Round – to favour ambitious and rapid negotiations rather to favour status quo or limited ambitions.

There are two particularly strong arguments about positive effects on multilateralism from a transatlantic initiative.

The first strong argument is the need to inject some new dynamics and tensions into the system that can motivate countries to change their preferences for status quo. A transatlantic trade deal can be helpful in this regard in two different ways.

First, it can change trade-policy preferences in Europe and the United States as well as in other countries. Agriculture has always been a sensitive issue for America and most parts of Europe in trade negotiations. America continues to have a more outward-looking agricultural sector than Europe, yet it remains supported by government subsidies that distort trade. Europe has a big subsidy programme for farmers, but it also protects its agriculture sector by high tariffs. It has been a problem throughout the Doha Round that many developing countries have not been willing to advance real market access in other areas as long as Europe and the US have not been willing to substantially cut its protection of the agricultural sector. A transatlantic trade deal could help to change the opposition to

agricultural reform in the US and the EU by exposing the sector to greater competition. Such cuts would initially be preferential, but it would be preferential to a market that can offer real competition in many agricultural goods.

Second, a transatlantic deal would also inject a new dynamic into the world trading system that is likely to change the way some big emerging markets look at trade liberalisation. Currently there is a resistance to especially liberalisation in the industrial sector by big economies like Brazil, China and India. Brazil has a very protected industrial sector and its average bound tariff rate¹⁶ for manufactured goods is approximately 31 percent while its average applied tariff is close to 13 percent. China's industrial sector is much less protected – its average bound and applied industrial tariffs stands at around 9 percent – but Beijing has rejected calls to open the Chinese market farther in the Doha Round. China has also been a source of new non-tariff barriers that have targeted American and European firms operating in China. India, like Brazil, has high bound and applied tariffs (35 and 17 percent respectively) and has been opposing attempts to reduce tariffs substantially in the current trade round.¹⁷ The EU and the US, however, hardly have any “water” at all between their bound and applied tariff rates. However, the differences between the bound and applied rates in subsidies are bigger in the transatlantic economies.

Why would a transatlantic trade agreement change the preferences of these countries? The EU and the US markets remain the biggest destinations for exports in the world. It matters for all countries if one of these economies – or both of them together – is designing a preferential trade agreement that gives an advantage to a country that, like the emerging markets, are big exporters. The risk of losing current trade, and miss out on future trade increases, because of trade diversion is likely to have an effect on how these countries look at their own tariffs. It is not far-fetched to assume that other countries would be prepared to lower their own trade barriers farther than today if that is necessary to reduce trade-diversion effects emanating from a bilateral agreement between other countries. It is not only in this particular sector that such an initiative is likely to spur activity outside the agreement itself. Bilateral trade agreements between big economies have systemic-wide effects.

Multilateral trade policy is now at a point where there needs to be new dynamics brought into the system. There are many WTO members that share the blame for the stagnation of the Doha Round – old giants like the EU and the US as well as new emerging markets. Ultimately, what has destroyed the Doha Round is the unwillingness among countries to make real liberalising progress in sectors where they have defensive interests. That is not a new force of resistance in trade negotiations. Yet this time it has been complemented by complacency over the state of world trade – it has been rising quickly despite real progress in negotiations – and general defensiveness in many matters related to improvement of competition.

¹⁶In the WTO tariff negotiations are about the bound levels of tariffs – the highest possible tariff a country can apply. Applied tariffs are often lower than bound tariffs, but they can still be raised to the bound levels without violating commitments.

¹⁷ Tariff data is from WTO Country Profiles, accessed at <http://stat.wto.org/CountryProfile/WSDBCountryPFHome.aspx?Language=E>

In the event that ways can be found to finish the Doha Round, with a light or no agreement, there may be some new negotiating activity at the multilateral level in the next ten years. But that activity is likely to be muted, and at best incremental. It is highly unlikely that a new big Round will start soon after a finished Doha Round. Yet there are ways for leaders to change the conditions for WTO negotiations, but that leadership is likely to manifest itself outside the WTO system, or at least outside WTO negotiations premised on the condition of single undertaking. One such “game-changer” is an ambitious transatlantic trade deal. It will, for sure, be criticized by some other countries. But such criticism can easily be countered. There is not a big economy, member of the WTO, that is not engaged in bilateral negotiations today or that has such an agreement on the books. The EU and the US, in contrast to some other big economies – tend to negotiate economically motivated FTAs and not satisfy themselves with quick-and-dirty agreements with many exemptions and few commitments that go beyond what has already been agreed in the WTO. Furthermore, it also makes sense for the EU and the US to negotiate a trade deal as the EU already has one with Mexico, and is on track to finish negotiations with Canada. Of the three Nafta economies, it will only be the US that is not part of Europe-North America FTA. What is more, those who criticize such a move towards an FTA are likely to take any chance they can to join such an agreement – inside or outside the WTO – if they are prepared to join on the same or similar conditions.

The second strong argument to be made in favour of a transatlantic initiative is that it could address, and set the future path for, “new” types of barriers to trade that increasingly are causing problems in world trade. Many of the necessary market access and rules reforms that should take place to improve the conditions for market-based exchange can only be led by America and Europe. This is not to say that all other will resist them, just that the EU and the US are the only trade leaders with requisite economic, political and institutional interest to do so.

Many of these reforms aim at improving current disciplines in areas that have become increasingly controversial in world trade. Subsidies to firms are one set of controversial issues that should be addressed by stricter rules. Rules for state-trading enterprises are another set of issues. Trade-related reforms in the fields of competition, investment, government procurement, and raw materials form a third set of necessary reforms. The list could continue. What is significant for all these areas is that they have some coverage in already existing agreements, but coverage remains weak and inconsequential.

Advancements of these issues are also central for the relevance of trade policy in future. Even if there are unfinished businesses to be addressed in some “old” type of trade issues – e.g. tariff on merchandise goods – a WTO with regained authority as a central place for negotiating trade policy need to take account of these “new” type of issues. As other issues cause less of a concern today, new types of trade problems should take a greater role. A WTO system that neglects them, or continues to treat them step-motherly, will have difficulty generating interest on the part of key WTO members.

Yet it is no surprise that these issues are not central to the current Doha Round. Some of them were given prominent places in the negotiating agenda agreed ten years ago, but have

subsequently been downplayed or discharged. This reflects some of the divisions that these areas are triggering. There is, generally, a much greater appetite in the EU and the US to elevate these issues in trade negotiations than there is in emerging economies. As a consequence, it is only by persistence leadership by the transatlantic economies that reforms in these areas can be achieved.

A transatlantic free trade agreement can in these areas – and some others: non-tariff barriers and liberalisation of trade in services – be helpful. Having new rules on these issues will demonstrate more clearly what it is these economies want to achieve, and why they feel strongly about them. Furthermore, they could also develop standards and methodologies that could be difficult to establish in global trade talks with more than 150 members. In other words, for further advancements to be made in these areas, it is central that some economies take the leadership to develop the ambition and standards for negotiations.

Concluding remarks

In a previous era of trade policy – when the so-called Quad (or, more precisely, the quadrilateral group: EU, US, Japan and Canada) was dominating world economic affairs and when tariff reductions remained the central ambition of trade policy – a bilateral free trade agreement between the EU and the US was not essential. Indeed, such an agreement could then have diminished the role of multilateral trade policy, especially if the timing had collided with new multilateral initiatives. But the world looks different now. The EU and the US are no longer dominating giants in the trade system in so far as they are the only economies that really matter for future increases in trade and sales. Many of the new issues that cause irritation in world trade are more controversial and there is greater opposition to the notion that trade policy should address them.

In future there will have to be greater leadership for global trade policy that occurs and grows outside actual negotiations. Arguably, the dispersion of power in the world economy will open up for new ways to advance trade liberalisation (also multilateral trade policy) outside the WTO system. The rise of new trade concerns – hitherto only marginally addressed in multilateral trade agreements – makes that necessary.

The problem in current trade policy is not opposition to the guiding idea that tariffs eventually will be eliminated. Most countries of significance in the WTO share that ambition, even if they oppose it in the short term. The problem now is rather about establishing guiding principles – and perhaps also setting ambitions – for “new” or “new-ish” type of trade issues. This is where the divisions will be in the medium-term future. Yet on many of the central issues for future trade policy, it is highly unlikely that such principles can grow out of group work at the WTO. They will rather have to come by persistent leadership by the EU and the US. Inevitably, a transatlantic free trade agreement that starts the work on the principles and ambitions for issues such as subsidies, state-trading enterprises, competition, investment, intellectual property and government procurement will be felt elsewhere in the world. They may dislike it, but an initiative that heralds the principle of free, market-based trade will eventually trigger activity on the part of other countries in that direction too.

5. Conclusions and recommendations

It should be clear for everyone with an interest in post-war economic history that the EU and the US occupy a special place in that history and that their bilateral relationship has been intense – in the real economy as well as the policy world. Now it is time for the two partners to take the next step in evolving their trade and investment relation – and that step is to press ahead with a free trade agreement.

Such an agreement would generate significant gains, provided it is properly designed. The gains from tariff elimination are likely to be significant. Full tariff elimination can generate dynamic gains in the region of 0.5-1 percent of GDP. Reducing NTBs with 50 percent could spur GDP by another 0.3-0.7 percent (only taking account of the static gains). If a trade agreement also would do away with restrictions to trade in services, and possibly establish a new bilateral investment agreement, the benefits are likely to increase even more. Such gains are far bigger than the economic gains the EU and the US could get from negotiating other FTAs.

Add to that the gains from reducing non-tariff barriers and we will have an agreement generating unprecedented economic gains. Hence, the notion that these two Western economies are sclerotic and of no interest to each other when pondering strategies to deliver growth and jobs in the near future, is wrong.

Behind a renewed interest in the EU and the US for an ambitious preferential trade agreement should also be the desire to find ways to leverage their economic power toward emerging economies.

The EU and the US will have to find a way outside the WTO system to trigger greater action on the part of these economies. For the moment they are in a comfortable position and can largely neglect friendly calls or confrontational demands to open their markets. They know that any protectionist action by the US and the EU would primarily hurt these Western economies as they are increasingly dependent on imports from these countries. A country like China has been able to introduce many new restrictions on trade, knowing that the appetite to get a good share of the rapidly growing Chinese market is enough to cool the anger towards Chinese protectionism.

It is arguably an error to describe a transatlantic free trade agreement as a blow to the multilateral trading system. Trade policy in the next 20 years will inevitably look different from trade policy in the past 20 years. While the past witnessed the high era of trade multilateralism, the medium-term future for the WTO looks bleak. Regardless of the source of current problems in the WTO, an honest judgment of any bilateral trade agreement in the near-to-medium future should start from the presumption that the alternative to bilateral trade agreements is not going to be substantial multilateral liberalisation and improvement of rules.

The EU and the US need a game-changer to continue to leverage their foreign economic power in future. A transatlantic free trade agreement is likely to be such a game-changer. An initiative that opens markets preferentially between the two and starts important work on many of the new trade issues will force some of the other countries to favour new global trade liberalisation. The risk of losing current exports to these Western markets, and to be disadvantageously positioned in competition over new trade opportunities there, will be a strong motivation to develop a more liberalisation-friendly posture. An ambitious transatlantic trade initiative can hence achieve something more than the benefits that will be derived from reducing barriers between each other.

The EU and the US have already started a joint process to examine the case for a more ambitious transatlantic trade initiative. By the end of 2012, the new High Level Working Group for Jobs and Growth will report to political leaders about the shape of future trade cooperation. It remains to be seen whether this Group will suggest it is time for FTA negotiations or if they see future transatlantic trade cooperation in different shades. Yet the creation of this Group signals that political leaders on both sides are prepared to revisit the arguments for and against a transatlantic free trade agreement. That is a good start.

6. About the author

Fredrik Erixon is a Director and cofounder of the European Centre for International Political Economy (ECIPE), a world economy think tank based in Brussels. Previously he was the Chief Economist of Timbro, the leading Swedish think tank. He has been a macro-analyst at JP Morgan and a consultant to governments, ministries and international organisations on many economic matters. He has written many papers in the past on transatlantic economic relations and initiated in 2011 the Transatlantic Task Force on Trade and Investment.

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