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

Fredrik Erixon

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Executive Summary

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

First, it would generate significant economic gains. An elimination of tariffs alone would generate gains sizeable enough to make the effort worthwhile. In combination with a reduction in non-tariff barriers and regulations that inhibit trade in services, the gains would be significantly higher than through any other trade agreement that could realistically be achieved in the medium-term future. Thus, those who argue that sclerotic growth in the West is a strong argument against launching transatlantic trade initiatives fail to understand the economic logic of trade agreements. The EU and the US remain the two largest economies in the world; freer trade between them would generate significant additional growth because they are already large economies.

Second, a transatlantic free trade agreement would generate a new dynamic in the world trading system that would make many other countries change their current defensive attitudes towards multilateral liberalisation. It has been demonstrated in the past that significant preferential liberalisation has this effect on other countries. If other countries oppose significant liberalisation—or if they increase their own trade barriers—the best counter-strategy is to press ahead with other forms of liberalisation that increase the costs of the status quo.

The Doha Round of trade negotiations has stalled for many years and no change in situation is in sight. In the event that there is liberalisation within the World Trade Organization 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. Such leadership could create positive tensions in the world trading system that would motivate the transatlantic and other key economies to favour stronger liberalisation within the WTO.

1. Introduction

This is a paper about transatlantic economic integration. Its purpose is to present the case for deepened trade and investment policy cooperation between the European Union and the United States, to be crowned by a free trade agreement (FTA). However, the paper goes a step further and examines the arguments used over the past two decades against such an FTA. There is now a heightened 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 within the World Trade Organization (WTO), now into its tenth year without any chance of negotiations closing within the foreseeable future.

As both Europe and the United States clearly move towards bilateral FTAs as the prime form for new trade agreements, it is not surprising that people are starting to think about a trade deal between the two largest trading powers in the world. Since these two giants of the world economy both face competition from China as the source of global economic and regulatory order, the proposition of deepened transatlantic cooperation appeals to a growing number of people. Some see it—wrongly in my view—as a way to ‘gang up’ on China. Others quite rightly see it as the reasonable consequence of sharing an understanding of and support for the core principles of an open global economy, and of an interest in maintaining those principles at a time of dysfunctional multilateralism.

This is not the first time that the idea of a transatlantic trade deal has attracted attention. And on every occasion that it has been discussed more widely in the past, it has provoked strong reactions, including from those within the transatlantic community. Some of the previous arguments against a transatlantic deal to free up trade have been valid. The question now, and for this paper, is whether they still carry weight. I believe they do not—and, more importantly, I believe that there has been a profound change in global trade policy that reinforces the case for a transatlantic trade deal. Therefore, I will spend a considerable part of this paper discussing the common arguments against such a deal and why they should not be of concern today.

If the old arguments against a transatlantic trade deal have become weaker, some will argue, it is because the world economy and world's economic powers have changed to such a degree that transatlantic economic cooperation no longer feels relevant. There is no doubt that the world economy has changed. Today it is considerably different in structure from the world economy of only 20 or even 10 years ago. Consequently, the balance between the world's economic powers has changed, too. The West is no longer the undisputed hegemon that can establish its own set of rules and expect the rest of the world to follow. Nor is it in its interests to do so. Some of the profound economic challenges, both today and in the near future, concern parts of the world other 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 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 on global trade and investment liberalisation. Transatlantic trade cooperation is thus a strategy for global leadership.

The next section of this paper attempts to put transatlantic economic cooperation into 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 section 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 integrate markets with the fast-rising economies in Asia would be far higher. There follows an examination of 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 economic cooperation began in 1944 with the creation of the Bretton Woods institutions: the International Monetary Fund (IMF) and the World Bank. These institutions are called the Bretton Woods twins, but the original plan was to put in place a three-legged stool for global economic governance. The missing leg, owing to opposition from the US Congress, was what is today called the World Trade Organization: an international body for the negotiation and supervision of trade agreements. A stripped-down version of the original plan was agreed to in 1947 when participating countries set up the General Agreement on Tariffs and Trade (GATT).

The Bretton Woods agreement was crafted by Europe and the US, 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 of escalating protectionism in the interwar period—declining prosperity and the forces of political nationalism—were still staring the Bretton Woods designers in the face. Moreover, the financial collapse in

Europe and the US, 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 through intertwined financial markets.

The World Bank, or the International Bank for Reconstruction and Development, as it was initially named, aimed to spur investment, growth and development. Yet the institution was unable to become fully operational immediately.The bulk of the public investment entering Europe from foreign countries in the initial post-war period came via the Marshall Plan instead. This initiative, meant to help Europe rebuild its crisis-stricken continent, was substantial. A recent estimate has suggested that if an equivalent initiative had been introduced between 2003 and 2007, it would have equalled $740 billion in modern monetary terms.[1] The Marshall Plan was also an initiative that in several ways came to define the structure of transatlantic economic cooperation in future decades.

The Marshall Plan is pertinent to this paper because it shows how strategic considerations about transatlantic matters have rested on three different modes of action: positive autonomous action, bilateral cooperation and cooperation through multilateral organisations. The notion, heralded by some, that transatlantic cooperation on trade and investment matters should only be channelled through multilateral organisations is a recent invention. In the formative years

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

just after the end of the Second World War, it seemed natural for both the US and most parts of Europe to advance cooperation on all three fronts. One can, of course, claim there were special circumstances at that time that steered the two continents towards a multi-track approach. This raises another key point in the argument of this paper: there is no point being dogmatic about the exact form of strategies; it is context and circumstance that determine which strategy will work best. Sometimes the best strategy is multilaterally oriented; at other times a bilateral or unilateral approach is better. A great trading power typically acts on all three fronts. That is what the US as well as key European economies did in the post-war period, and it is, as I will argue below, what they should do today as well.

Multi-track cooperation was also the intention and a pivotal element of the Marshall Plan. As the body financing the Marshall Plan, the US government demanded that it had to be a European plan—a plan designed by and for Europe, not just for a single country. The Marshall Plan was intended to forge stronger economic cooperation in Europe and aimed to be a lightning rod for future bilateral economic cooperation across the Atlantic. It was also a plan rooted in contemporary strategic challenges, especially in its goal to offer 'Western' paths to prosperity to countries that might be susceptible to the power or influence of Moscow. Finally, 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 global peace, democracy and market capitalism.[2]

[2] F. Erixon and G. Pehnelt, 'A New Agenda for Transatlantic Economic Cooperation', ECIPE Working Papers no. 09/2009 (Brussels: ECIPE, 2009).

Muted bilateralism after the era of post-war recovery

In fact, Europe and the US never really considered negotiating a free trade agreement in the post-war era. There were a number of reasons behind this tacit understanding.

First, a free trade agreement, or free trade area, is an ambitious form of trade agreement in the sense that it is meant to liberalise 'substantially all trade', in the words of the GATT. At a time when tariffs were generally high in America as well as Europe, liberalising 'substantially all trade' by eliminating tariffs against the other transatlantic partner was considered too ambitious. It is one thing to garner political support for the elimination of tariffs and other barriers when they are comparatively low, as they are today. It was another thing to do so at a time when the average tariff stood at around 20% or more.

Second, a few decades after the end of the Second World War, Europe and the US were the dominant trading powers in the world, and an agreement to eliminate tariffs with each other would effectively have meant liberalising 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. The process, however, took a long time to complete. By the end of the 1960s it was operational, and by then the Common

Market had also affected some of the immediate preferences in US strategy towards Europe. Many US exporters understood that the establishment of the Common Market would have negative consequences on their competitiveness in the European market. Their European competitors would now have tariff-free access to the European market, giving them an advantage over US competitors. This concern was also shared by exporters in some other countries, resulting in the decision to jointly demand a new and very ambitious GATT round to bring down tariffs in Europe (and elsewhere of course) as a strategy to mitigate the adverse effects of the Common Market. This round, known as the Kennedy Round, finished in the late 1960s and is still the most ambitious tariff-cutting round the world has experienced.

Fourth, the US and the Europe had a joint interest in cementing the GATT as the chief forum for trade negotiations. The US in particular, supported by European partners, wanted to use the GATT system to forge closer relations with its 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) and partly by Cold War realpolitik—varied somewhat in the decades after the Second World War. At times the notion of any transatlantic economic cooperation was contested. Yet the strategy of anchoring free trade ambitions to the GATT system and combining this with stronger regionalism in Europe and ad hoc EU–US initiatives survived until the end of the Cold War.

The fall of the Iron Curtain was also important to foreign economic policy. Afterwards, transatlantic economic cooperation came to lack a strategic economic and political purpose. The Cold War had glued Europe and the US together, and both 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 could help to convince people sceptical, if not hostile, to the economic arguments for trade liberalisation. Bilateral relations between the two were no different: bilateral cooperation and joint global economic leadership continued to be lauded in speeches, but few political leaders considered them central to foreign economic strategy.

It is not difficult to understand the absence of a transatlantic spirit in post–Cold War trade policy. The geographical dispersion of global welfare and growth has increased remarkably, especially with the economic rise of Asia, and has helped to change the immediate agenda for market-access concerns. Both Europe and the US have faced bigger trade problems with other countries, and hence have invested their time in designing foreign economic strategies to address them rather than solving problems in their bilateral trade relations. The rapid economic development in emerging markets in the

1990s and 2000s has taken primacy over most other economic ambitions and strategies in the past 10 or 15 years. The interest in being part of that market growth has mostly been channelled through the WTO; simply convincing China to join the WTO in 2001 was an enormous task.

Yet the interest in further building upon the GATT system as the key forum for transatlantic trade policy was also reflected in the end of the Uruguay Round and the creation of the WTO in 1994, which opened a new era of great optimism. At this time globalisation had just become a buzzword and it was believed, not without good reason, that the WTO could deliver many ambitious new trade agreements in the near future. And so it did. After the Uruguay Round, several ambitious sectoral and multilateral agreements were negotiated, the most important one being the Information Technology Agreement (ITA) which freed up trade in information and communication technology (ICT) goods and facilitated the explosion in ICT trade from the late 1990s onwards. These agreements stimulated WTO optimism. As the world was about to enter the new millennium, the WTO was at its peak. The ship of the WTO seemed unsinkable; its future looked bright.

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

Then came 9/11, and the ambition for a new global trade round once again edged its way into the debate. In the eminent spirit of forging stronger economic integration in the world after 9/11, countries meeting in the Qatari capital, Doha, agreed to start a new round—the Doha Round. Ten years later, this round is still ongoing, at least in strictly formal terms. For all practical purposes, however, the round ended a few years ago—without results—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 initiated in 2001. If we had known then what we know today, the round would never have started. At the time, however, there were few dissenting voices (apart from people on the fringes and non-governmental organisations on the extreme left). The many failures of the Doha Round, however, have prompted both the US and Europe to reinvigorate their agendas for bilateral economic cooperation.

Recurring attempts at a transatlantic free trade agreement

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 interest in a free trade agreement, or the equivalent, between the EU and the

US in the early 1990s. Yet the feeling 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. It then returned in the middle of the 2000s, leading the two sides to create the Transatlantic Economic Council (TEC) in 2007 after strong pressure from German Chancellor Angela Merkel, who at the time chaired both the G8 and the EU.

This cycle of interest in transatlantic free trade hides something that is important for understanding why new initiatives have never 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. Thus, calls for transatlantic free trade have not primarily been made, if at all, on the economic merits of such initiatives; such initiatives have rather been the ‘olive branch’ of transatlanticism, the gift you hand over to repair a relationship that has grown sour. And if this has been the premise for initiatives to free up transatlantic trade, it should not come as a surprise to anyone that the energy in these talks quickly petered out.

The TEC has also proven to be unsuccessful. This is not to say that it has been useless—clearly this is not the case. Some progress has been made, for example, in forward-looking talks on a new agreement to combat intellectual property infringements and in the establishment of trade principles for ICT services. Cooperation on competition policy has also yielded satisfactory results. The talks have been designed specifically to avoid clashes between the EU and the US on issues relating to merger and antitrust reviews. Yet the TEC was predominantly established to promote regulatory harmonisation between the two—or, if harmonisation was not feasible, to reduce regulatory incoherence across the Atlantic.

It is obvious that the negotiators have fallen short of this ambition. In some areas, especially in a highly prioritised 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 rethinking their approach to regulatory incoherence, and one idea is to focus on avoiding incoherence in new regulations, such as those regarding nanotechnology and e-health, rather than in 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 new regulations that would add to current regulatory problems. Yet for regulatory cooperation to really have a positive impact on the economy, both parties also need to find a way to address existing regulatory barriers.

Despite the failure of the TEC and the absence of solid economic motivations for past initiatives, in recent years there has been renewed interest in a 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) remains cautious.

The US Chamber of Commerce has taken the lead in a new trade initiative and has expressly called for a transatlantic free trade agreement—or a zero-tariff agreement—to become the cornerstone of 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 receive 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 American Federation of Labor and Congress of Industrial Organizations.[4] The EU is not seen as a trading partner that will amplify wage competition with American workers, and the high social and environmental standards in the EU have served to counter the 'race to the bottom' argument often used by American trade sceptics. Consequently, much of the opposition to recent US trade agreements is unlikely to surface if a transatlantic trade initiative is launched.

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[3] US Chamber of Commerce, *Jobs Agenda*, accessed at http://www.uschamber.com/trade on 31 December 2012.

[4] Erixon and Pehnelt, 'A New Agenda for Transatlantic Economic Cooperation'.

Furthermore, the European Parliament has expressed its support for a transatlantic initiative to create a barrier-free transatlantic marketplace 'in the very near future',[5] and some EU Member States 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 towards such an initiative, is also showing an interest in revisiting the arguments in favour of and against a transatlantic trade agreement. Obviously, the dark outlook for the Doha Round has particularly stimulated an interest in how the EU and the US—which share core principles and ambitions for the global trading system—can undertake new initiatives that will change the dynamic in global trade talks, incentivise countries to make progress with 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] This effort was reaffirmed when, on 30 January 2012, the European Council issued a statement calling for the Working Group to 'consider all options for boosting EU/US trade and investment'.[7] Obviously, the premise of the group is to consider trade initiatives more ambitious than those of the current TEC.

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

6 EU–US Transatlantic Economic Council, 'Joint Statement', 29 November 2011, accessed at http://trade.ec.europa.eu/doclib/docs/2011/november/tradoc_148385.pdf on 31 January 2012.

7 Statement of Members of the European Council, 'Towards Growth-Friendly Consolidation and Job-Friendly Growth', 30 January 2012, accessed at http://consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/127599.pdf on 2 February 2012.

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

3. 'Go East, young man, not West'

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 will primarily be for European and American firms in the coming decades. Barriers to market access are also much higher in Asian markets than they are on the transatlantic market. So why place emphasis on a trade relationship that is already working remarkably well? Why not put all the 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 on 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, while others back the view up with substantive arguments. There is also one wing that takes the argument further and argues that transatlanticism in general is passé, an outdated notion. However 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 bold new initiatives should be with emerging Asian powers, not with old and declining Western powers.

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

Why choose between East and West?

It is obvious that an entity like the EU could initiate trade negotiations with many different countries and regions. In fact, it is necessary for large trading powers like the EU and the US to do so. The EU has recently implemented a trade agreement with South Korea, has completed trade negotiations with Colombia and is currently negotiating with Canada. It is also working on FTA-like arrangements with African countries and has recently embarked on FTA negotiations with countries in South-east Asia. So it is obviously possible to negotiate trade agreements with more than one country. A new trade agreement with the US would not alter that fact. It especially makes sense to negotiate free trade agreements with different countries if multilateral trade negotiations are, as today, dysfunctional.

Bilateral trade agreements can be supported 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 motive for engaging in bilateral trade agreements. In today's world of globalised supply chains and integrated cross-border production structures, it makes sense for an FTA strategy to cast a wide net. Ideally, a bilateral strategy should aim to cover many of the countries that form parts of integrated production structures, partly to avoid having rules-of-origin regulations disrupt market-based supply-chain networks.[8] And if the strategy is to 'go with the market flow'—that is, to reduce borders in a supply chain rather than create disruptions—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, one that forces or incentivises 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 that dynamic will yield other trade agreements, but it has certainly prompted activity on the part of other countries.[9] That

[8] Rules-of-origin regulations are of no relevance if tariffs are eliminated, which is the pupose of FTAs.

[9] The EU also sought an FTA with South Korea for this reason. The US had already launched FTA negotiations with South Korea and to avoid trade diversion effects on the EU Brussels asked for a similar agreement. Furthermore, some of the EU's past FTAs have been motivated by similar concerns. The EU negotiated an FTA with Mexico after the establishment of the North American Free Trade Agreement (NAFTA), and an FTA with Chile after the US had signed one.

activity, however, follows a copycat strategy: countries such as Japan have courted the EU for a similar agreement in order to avoid negative effects on Japanese exports to the EU as a consequence of the EU–Korea agreement. A better dynamic, however, is when a preferential initiative has positive systemic consequences; that is, when it gives other countries reason to strongly favour multilateral agreements or general (rather than preferential) liberalisation that reduces the adverse effects emanating from the new trade initiative.

There are some recent examples of such initiatives. The creation of the Common Market in Europe in the 1950s and 1960s triggered, as previously discussed, increased action that was directed towards the GATT, especially on the part of the US. When the North American Free Trade Agreement (NAFTA) and the single market in Europe matured in the early 1990s, both had significant effects on other countries' willingness to constructively engage in the Uruguay Round, and even to expand the scope of the negotiations into new fields favoured by the EU or the US.[10]

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 for

[10] Erixon and Pehnelt, 'A New Agenda for Transatlantic Economic Cooperation'.

the EU and the US, as well as for China. If it ever happens, it will be at least a decade or two from now. A bilateral agreement with Japan could also create systemic dynamics, but only in a limited way. The basic conclusion, therefore, is that FTAs with Asian countries can be driven by economic ambitions to spur trade and growth, but that 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

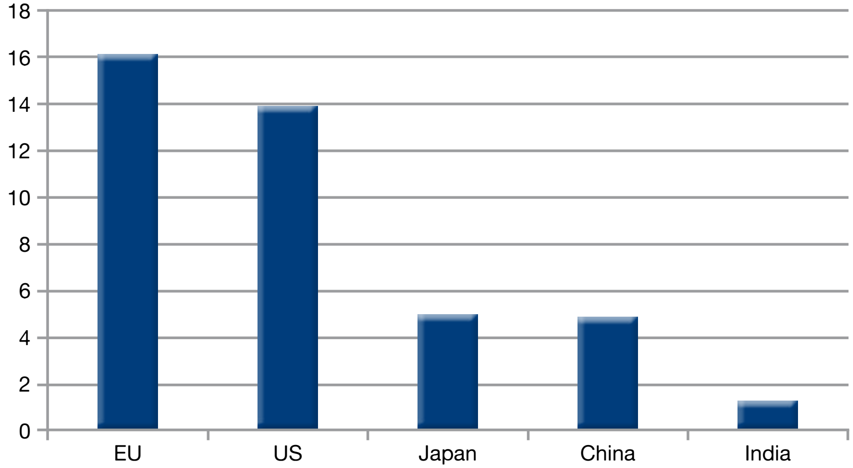
There are also reasons to challenge the economics underlying the claim that future market growth for firms will only occur in the Far East. The assumption that trade agreements with Asian countries will generate greater economic gains than a transatlantic deal will simply does not stand up to scrutiny.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

There has been a remarkably high growth rate in Asia in the past decade. China has maintained growth rates of over 10% for more than a decade, but this is slowing and will likely level out at around 6%–8% in the next few years. However, these are still high growth rates. Other Asian countries have boosted their economies, too, and a country like India has huge potential for growth in the future. Yet the 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 major global economies, as Figures 1 and 2 on the next page demonstrate. Figure 1 shows the size of a selected group of economies measured at current exchange rates, while Figure 2 exhibits their relative share of the world economy.

Even if Asia does experience much higher economic growth than the West in the next decade, there is still a big gap between the sizes of their economies, especially when 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 that of the EU. Despite the current high growth rates in India, its economy represents less than 10% of the entire EU economy. This may be the Asian century—and the next 10 years may be described in future literature as the era of Western declinism—yet the American and European economies remain considerably larger than other economies in the world.

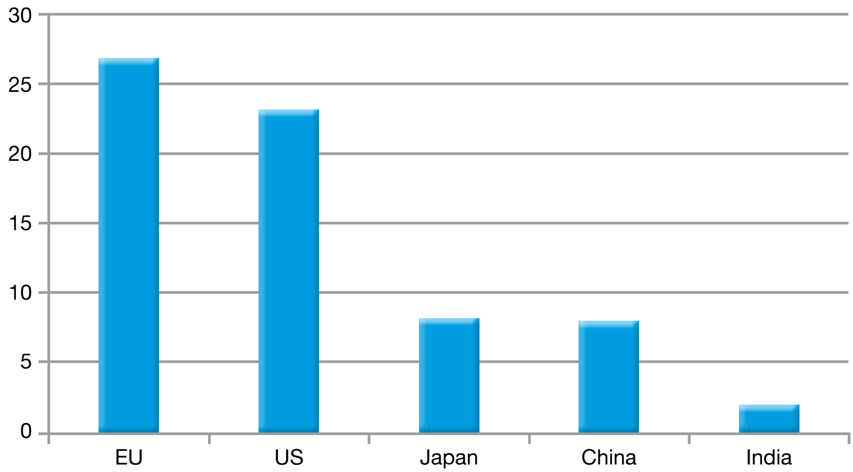
The size of the economy matters if one judges an agreement according to the gains it generates. And it matters in many different ways. For instance, low growth rates in a large economy may still generate more new market demand than very high growth in a smaller economy. If the former economy experiences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



Source: World Bank, 'GDP (current US$)', *Data*, accessed at http://data.worldbank.org/indicator/NY.GDP.MKTP.CD on 31 January 2012.

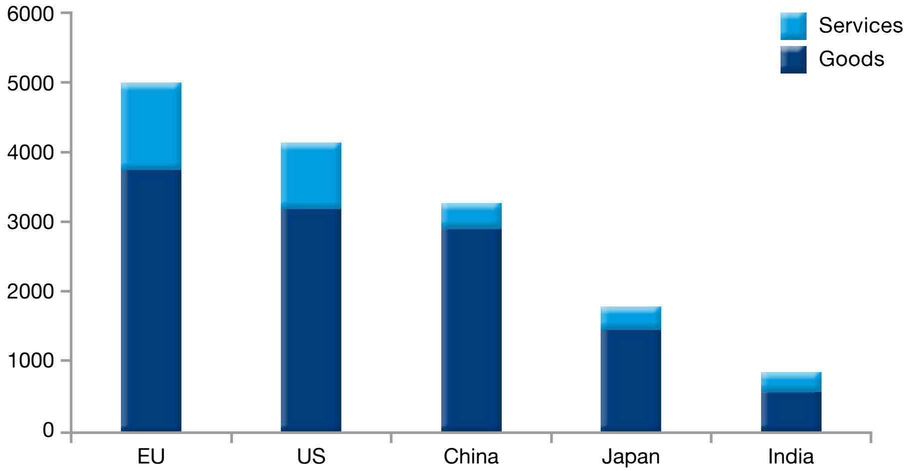
Figure 2. Relative share of world GDP in 2010 measured in current US$ (%)



Source: World Bank, 'GDP', *Data*, accessed at http://data.worldbank.org/indicator/NY.GDP.MKTP.CD/ on 31 January 2012.

The differences in trade volumes between these selected countries are smaller. This is shown in Figure 3. In aggregate, the EU and the US are still larger traders than China and India, but the gaps between the EU and the US and China and India respectively are not as significant as they are in GDP. And if services are discounted, the gaps shrink even further. China particularly confirms this pattern. China's trade sector is not only big but also bigger than one would expect for a country of its size and development status. Yet despite its level of development, China has successfully been using trade to expand its economy. It has established itself as a trade hub in East Asia for many multinational firms that have invested in factories to assemble parts and components imported from other countries in the region. China's heavy reliance on imports 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 larger than India's trade sector.

Figure 3. Total trade in 2010 (billions of US$)



Source: World Trade Organization, *Statistics Database*, accessed at http://stat.wto.org/Home/WSDBHome.aspx?Language=E on January 31, 2012.
Note: Intra-EU trade is excluded.

The conclusion suggested by these brief trade statistics is not that Asian markets do not matter, nor that they will not be growth markets for American and European firms in the next decade. Clearly they will. Consequently, improved trade relations with these countries will be important, too. The relevant point is rather that the role of Western markets in trade and market demand is likely to be far higher than 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 greater effects on trade than trade liberalisation between smaller economies, even when—or perhaps because—the two economies in question are already deeply integrated. Most of the FTAs signed in the past have been between two smaller economies, or between a large economy and a small economy. The gains for a large economy in the latter sort of agreement are typically small. For instance, an estimate of the GDP effect in the EU from the recently established EU–Korea Free Trade Agreement put the result at 0.08%.[11] According to the US International Trade Commission, the GDP effect in the US from full tariff elimination in trade with Korea is 0.1%.[12]

It follows that EU and US trade deals with economies smaller than the Korean economy will have an even smaller effect on GDP. This is not to say such deals are unimportant or that they do not provide benefits. The point is rather that the size of an agreement's effect 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 merchandise. 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.

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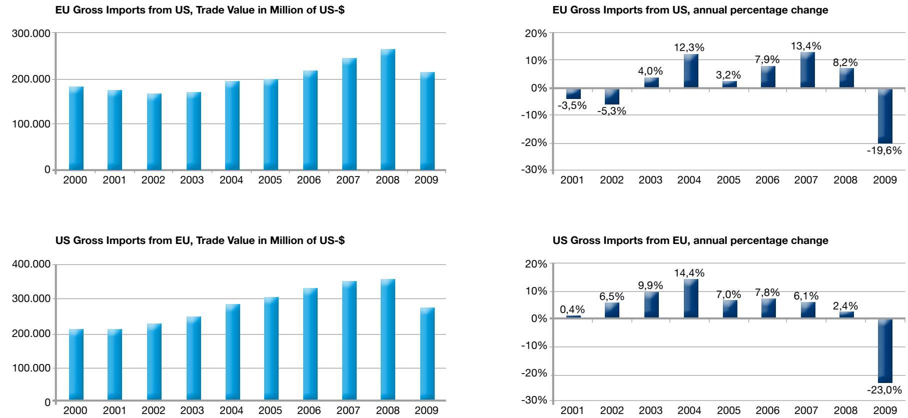
11 CEPII/ATLASS, *The Economic Impact of the Free Trade Agreement Between the European Union and South Korea*. Report for the European Commission (May 2010), accessed at http://trade.ec.europa.eu/doclib/docs/2010/may/tradoc_146174.pdf on 31 January 2012. One should bear in mind that Korea is a medium-sized, rather than small, economy.

12 United States International Trade Commission, *US–Korea Free Trade Agreement: Potential Economy-Wide and Selected Sectoral Effects,* USITC Publication no. 3949 (Washington, DC: USITC, 2007).

Transatlantic trade has increased considerably over the last decade. Prior to the 2008–9 financial crisis, EU exports to the US were growing by an average of nearly 7% a year. US exports to the EU were growing by approximately 5% 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 was lower than Europe's in the decade leading up to the recent financial crisis. Like all other trade relations, transatlantic trade took a sharp hit during this crisis. EU imports of goods from the US fell by almost 20% in 2009, and the contraction in US merchandise imports from Europe was even larger. Despite this decline, bilateral trade in goods remains extensive, as shown in Figure 4.

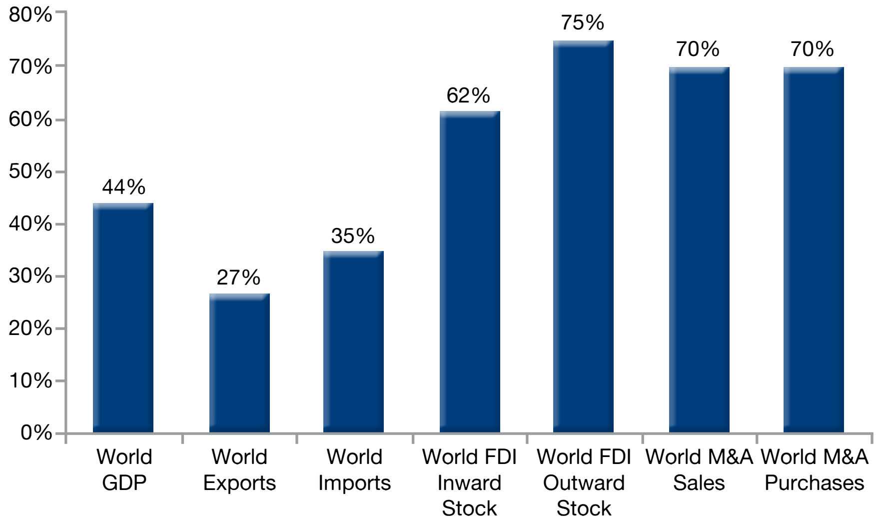
Figure 4. Transatlantic merchandise trade at a glance



Source: Data compiled from the World Bank, *World Integrated Trade Solution (WITS)* service, accessed at http://wits.worldbank.org/wits/ on 31 January 2012.

Figure 5 gives a few other indicators that put the size of transatlantic economic relations in context. The transatlantic economy still represents more than 40% of total world GDP. Its role in trade is smaller, but the two transatlantic partners represent a vastly larger share of the world total of foreign direct investment (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.[13]

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).

13 D. Hamilton and J. Quinlan, *Deep Integration: How Transatlantic Markets Are Leading Globalization* (Washington, DC/Brussels: Center for Transatlantic Relations/Centre for European Policy Studies, 2005), iii.

These observations on 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 this 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% of global GDP and with $600 billion in total bilateral trade, eliminate tariffs and non-tariff barriers in their bilateral trade, it will have a clear effect on competition and, consequently, on the dynamic effects of trade.

Yet there are 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 some indicators of these close business relations. For example, half of all US foreign affiliates are in Europe, and 60% of the assets held by US foreign affiliates are in Europe. The equivalent figure for EU affiliates in the US is 75%. Estimates have suggested that intra-firm trade represents a third of total transatlantic trade.

Why is a high density of foreign affiliates an important factor for trade? There is a high level of intra-firm trade between foreign affiliates—that is, significant trade within a firm. Thus even if tariffs are low they constitute 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 therefore higher than simply 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: US Department of Commerce, Bureau of Economic Analysis, *International Data: Direct Investment & Multinational Companies (MNCs)*, accessed at http://www.bea.gov/iTable/index_MNC.cfm on 31 January 2012.

Table 2. European affiliates at a glance

Majority-owned US affiliates by European country of ultimate beneficial owner, 2007							
		Millions of dollars					
	Number of affiliates	Total assets	Sales	Net income	Compensation of employees	Number of employees (thousands)
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**
Europe in %		*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
UK	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

Source: US Department of Commerce, Bureau of Economic Analysis, *International Data: Direct Investment & Multinational Companies (MNCs)*, accessed at http://www.bea.gov/iTable/index_MNC.cfm on 31 January 2012.

Second, the final structural aspect that merits special consideration in transatlantic trade is intra-industry trade (IIT)—that is, inward and outward trade within 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 in 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, with the two parties exporting similar goods to each other within the same sector.

A high degree of IIT suggests that the competition effect of an elimination of tariffs could be significant. Since there is competition between firms in these sectors, the dynamic effect could be considerable once tariffs are eliminated. A higher degree of competition is one of the key dynamic effects of trade liberalisation: liberalisation forces firms to behave more productively. Sectors with a high degree of IIT receive further competition incentives—and such an effect leaves a clear imprint on the larger economy.

Let us now turn to existing estimates of the gains from transatlantic free trade. What are the likely gains from a transatlantic trade agreement? In a recent study I co-authored, I estimated the potential gains from a transatlantic zero-tariff agreement—that is, an agreement that only eliminates tariffs—to be significant.[14] Tariffs between the EU and the US are comparatively low (the average of the applied tariffs is 4.8% in the US and 6.7% 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%

14 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, 2010).

for the EU and 0.15% 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% for the EU (or $46 to $69 billion) and 0.99%–1.33% for the US (or $135 to $181 billion).

The estimated change in EU exports to the US is 7% (or $28 billion) in a static scenario and around 18% (or $69 billion) in a dynamic scenario. The US is estimated to increase its exports to the EU by 8% (or $23 billion) in the static scenario and by 17% (or $53 billion) in the dynamic scenario.[15]

Since the highest tariffs are currently applied to agriculture-related sectors and textiles, those industries are likely to expand significantly as the result of tariff reductions. In terms of export creation in the EU, the textile, manufacturing and agriculture-related sectors are expected to experience the highest relative increases 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 the textile and manufacturing sectors.

In absolute terms, it is the machinery and chemical 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 would be the automotive industry. In

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

the EU, the automotive industry, together with the machinery, chemical and textile industries, would account for 65% of the total rise in exports to the US. For the US, increased exports of transport equipment are likely to contribute significantly to the overall increase; machinery, vehicles, electrical machinery, transport equipment and chemicals would account for 75% of the rise of total exports to the EU.

The differences in GDP effects can be attributed to the methodological aspects of the estimates, such as the terms of trade. There are also a few other explanations that warrant consideration. The US economy is smaller than the overall EU economy, which is one reason why equal trade expansion would have a greater effect on the GDP of the US than on that of the EU. Moreover, a greater share of the EU goods sector has previously been exposed to foreign competition (through internal EU 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 than for the EU in terms of value added.

Finally, considering the scope of the tariff reductions, we can likely 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% 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, licences and so on). It is well known that NTB elimination would generate significant economic gains in most trade relations, because NTBs are typically much higher than the barriers posed by tariffs. This is also true 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 in 2018 are estimated to be 0.7% and 0.3% higher, respectively, with only a 50% NTB reduction. Exports are expected to increase with the reduction of NTBs; EU exports will go up by 2.1% and US exports by 6.1%.

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

These different studies cannot be combined in order to arrive at a complete figure on estimated gains from the elimination of tariffs and reduction of NTBs. Yet it is clear that there are great gains to be reaped. Moreover, the potential gains would also increase if one could add gains achieved through the liberalisation of trade in services, which is a rapidly expanding field, yet one which is still covered by severe restrictions.

[16] ECORYS Nederland BV, *Non-Tariff Measures in EU–US Trade and Investment—An Economic Analysis.* Report for the European Commission (2009), accessed at http://trade.ec.europa.eu/doclib/docs/2009/december/tradoc_145613.pdf on 31 January 2012

Reductions in barriers to investment would also produce sizeable gains. Yet there are no existing studies that have estimated these potential gains.

Summary

There is no doubt that Asian markets—and emerging markets more generally—are increasingly important to sales from Western firms, and that they will become more important over the next decade. However, this does not that mean that the transatlantic market is no longer important, nor that it cannot generate substantial increases in sales in the future. The main conclusion from this section is rather that a strategic approach by the EU and the US in their future bilateral trade policy needs to target more and different countries and that they will need a multifaceted approach that can take account of various types of market growth in high- as well as low-growth economies. Therefore, the EU and the US should move towards a free trade agreement that frees up trade and investment across the Atlantic. Such an agreement would generate significant gains—and the more sectors that the agreement covers and the broader it is, the greater will be 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 an older argument 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 US 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 the countries involved 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 assumptions that the EU and the US are so dominant 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 other’s markets. An alternative version of the argument is that the EU and the US have a strong interest in acquiring improved market access to other economies, and that this transatlantic energy is necessary to initiate and drive negotiations forward within the WTO.

The first challenge for this argument, however, is that it makes a bold assumption: that other countries have the appetite to negotiate with the EU and the US within the WTO. Indeed, the wider implication of the argument is that there will be equivalents to trade negotiation rounds at the WTO in the near future that could help to liberalise trade in a meaningful and comprehensive way. But if the analysis is that the prospects for comprehensive liberalisation in multilateral negotiations are doubtful, then it is difficult to see how this argument can remain valid.

And there are good reasons to expect future negotiating activity within the WTO to be limited. The Doha Round has now run for more than 10 years, and there is nothing today that suggests that this round will finish in the near future. Nor are the reasons behind the Doha stalemate easy to address in trade negotiations. The Doha Round has failed due to structural problems entrenched in the world economy and the rapid changes it has undergone in the past decade. Until 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 originate in the unwillingness of emerging economies to open up their markets, especially in areas where competition from other emerging economies is likely to be forceful.

The second challenge to this argument is that there are some new structural problems built into the trading system. One of them concerns 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 large, rapidly growing emerging markets—riding the system for free. These emerging markets now also need to offer real market access in trade negotiations in order for the EU and the US to be prepared to open up their own economies further.

Another structural problem is that old issues (tariffs) that were central to trade policy a few decades ago can no longer generate sufficient interest to drive negotiations. Today other barriers to trade, such as NTBs and regulations prohibiting trade in services, are more significant obstacles to real access to foreign markets and to a world trade characterised by free competition. Yet such barriers are more difficult to negotiate, let alone reduce, than tariffs.

Third, preferential trade policy is also undergoing change. For many years such trade agreements have tended to err on the side of caution. They were—with a few exceptions—often driven by motivations other than generating trade and economic growth (e.g., by foreign policy). Consequently, these agreements had no real influence on actual trade, and often the influence they did have caused trouble for supply-chain globalisation due to their complicated rules-of-origin regulations. There is now new interest in using preferential trade agreements for more strategic economic purposes.

If there is something today that could help to drive multilateral trade policy forward, it is external dynamics and tensions that might provoke some countries to change their attitudes towards the ambitions of multilateral trade negotiations. One such external dynamic is a transatlantic free trade agreement —or the initiation of progress in that direction. Thus, there are good arguments to be made in favour of a transatlantic trade deal as a way to once again direct attention to negotiations in Geneva.

Multilateral versus bilateral trade policy

The debate over forms of trade policy is too often slanted in an ideological fashion, focusing on multilateral versus bilateral trade policies. There are many interesting discussions which engage in the specific qualities and conditions of WTO-based negotiations and various bilateral initiatives. But the debate itself suffers from serious flaws. One is that idealised and stylised versions of multilateralism and bilateral initiatives often are far from the political and economic reality of trade policy. Such debates become dogmatic 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 within the WTO is a pipe dream. Trade policy has always been—and probably always will be—too complicated to be squeezed into one particular folder. Trade liberalisation has always occurred in different ways, with the various approaches to liberalisation underpinning each other. More generally, when trade and market reform agendas have been on the back-burner, all forms of trade liberalisations—multilateral, regional, bilateral and unilateral—have been stagnant. In contrast, when there has been a political desire to open up markets, all formats have tended to work 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 move forward on multilateral trade policy, but initiating bilateral initiatives does not exclude that desire. If recent history teaches us anything, it is probably that bilateral or regional initiatives can actually help to advance multilateral trade ambitions. References have already been made to two occasions in the past 50 years when preferential initiatives were crucial in advancing multilateral trade liberalisation: The Kennedy Round on the GATT was largely a US-driven negotiation 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 rearrange their preferences in the Uruguay Round to favour ambitious and rapid negotiations rather than limited ambitions or the maintenance of the status quo.

There are two particularly strong arguments regarding the positive effects on multilateralism that would result from a transatlantic initiative. The first argument is the need to inject some new dynamics and tensions into the system in order to motivate countries to change their preference regarding the 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 US as well as in other countries. Agriculture has always been a sensitive issue for the US and most parts of Europe in trade negotiations. The US continues to have a more outward-looking agricultural sector than Europe does, yet it remains supported by government subsidies that distort trade. Europe has a large subsidy programme for farmers, but it also protects its agricultural sector through 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 while Europe and the US have been unwilling to substantially cut their 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 the move would be preferential to a market that could offer real competition in many agricultural goods.

Second, a transatlantic deal would also inject a new dynamic into the world trading system that would likely change the way some large emerging markets look at trade liberalisation. Currently there is a particular resistance to liberalisation in the industrial sector from large economies including Brazil, China and India. Brazil has a highly protected industrial sector and its average bound tariff rate for manufactured goods is approximately 31%,[17] while its average applied tariff is closer to 13%. China's industrial sector is much less protected—its average bound and applied industrial tariffs stand at around 9%—but Beijing has rejected calls to open the Chinese market further in the Doha Round. China has also been a source of new NTBs that have targeted US and European firms operating there. India, like Brazil, has high bound and applied tariffs (35% and 17%, respectively) and has opposed attempts to reduce tariffs substantially in the current trade round.[18] However, although there is hardly any difference at all between bound and applied tariffs in the EU and the US, the differences between bound and applied rates in subsidies are bigger in the transatlantic economies.

Why would a transatlantic trade agreement change the preferences of countries such as Brazil, India and China? The EU and US markets remain the biggest destinations for exports in the world. It matters to every country if one of these economies—or both of them together—designs a preferential trade agreement that gives an advantage to a

[17] In 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.

[18] Tariff data is from the World Trade Organization, *Trade Profiles*, accessed at http://stat.wto.org/CountryProfile/WSDBCountryPFHome.aspx?Language=E on 31 January 2012.

country that, like the emerging markets, is a big exporter. The risk of losing current trade and missing out on future trade increases, because 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 further than they are today if that is what is needed to reduce trade-diversion effects emanating from a bilateral agreement between the US and the EU. It is not just in this particular case that such an initiative is likely to stimulate activity outside the agreement itself. Bilateral trade agreements between large economies have system-wide effects.

Multilateral trade policy is now at a point where new dynamics need to be brought into the system. Many WTO members share the blame for the stagnation of the Doha Round—old giants like the EU and the US as well as the 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. This is not a new form of resistance in trade negotiations. Yet this time it has been complemented by complacency over the state of world trade—a complacency that has grown quickly despite real progress in negotiations—and a general defensiveness in many matters related to improving competition.

In the event that ways can be found to finish the Doha Round, with some agreement or none at all, there may be some new negotiating activity at the multilateral level in the next 10 years. But this activity is likely to be muted, and incremental at best. It is highly unlikely that a new round will begin soon after the end of the Doha Round. There are ways for leaders to change the conditions for WTO negotiations, but such leadership is likely to manifest itself outside the WTO system, or at least outside WTO negotiations premised on the condition of a single undertaking. One such game changer would be an ambitious transatlantic trade deal. It would certainly be criticised by some countries, but such criticism can easily be countered. There is not one large-economy member of the WTO that is not engaged in bilateral negotiations today or that does not have such an agreement on the books. The EU and the US—in contrast to some other large economies—tend to negotiate economically motivated FTAs and do not satisfy themselves with quick-and-dirty agreements with many exemptions and few commitments that go beyond what has already been agreed to within the WTO. Furthermore, it 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 complete negotiations with Canada. Of the three NAFTA economies, soon it will only be the US that is not part of the Europe–North America FTA. What is more, those who criticise such a move towards an FTA are likely to take any chance they can to join such an agreement—inside or outside the WTO—assuming 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 a future path for dealing with the new types of barriers to trade that are increasingly causing problems. Many of the necessary reforms to market access and rules that should take place to improve the conditions for market-based exchange can only be led by the US and Europe. This is not to say that others will resist them, only that the EU and the US are the only trade leaders with the requisite economic, political and institutional interests to do so.

Many of these reforms aim to improve current discipline in areas that have become increasingly controversial in world trade. Subsidies for firms is one controversial issue that should be addressed by stricter rules. The regulations surrounding state-trading enterprises are another. Trade-related changes in the fields of competition, investment, government procurement and raw materials form a third set of necessary reforms. The list goes on. What is significant for all these areas is that they are partly addressed by existing agreements, but coverage remains weak and inconsequential.

Advancements in these issues are also central for the relevance of trade policy in the future. Even if there is unfinished business to be addressed regarding certain 'old' trade issues—such as tariffs on merchandise goods—a WTO with renewed authority as the central place for negotiating trade policy needs to take account of the 'new' issues. As other issues come to be of lesser concern, new trade problems should fill the void. A WTO system that neglects them or continues to treat them merely as step-children will have difficulty in generating interest from key WTO members.

Yet it is no surprise that these issues are not central to the current Doha Round. Some of them were given a prominent place in the negotiating agenda agreed upon 10 years ago but have subsequently been downplayed or discharged. This reflects some of the divisions that these areas have triggered. There is generally a much greater appetite in the EU and the US to raise these issues in trade negotiations than there is in emerging economies. As a consequence, it is only through persistent leadership by the transatlantic economies that reforms in these areas can be achieved.

A transatlantic free trade agreement would be helpful in the areas of non-tariff barriers and the liberalisation of trade in services, among others. Adopting new rules on these issues will demonstrate more clearly what it is that these economies want to achieve, and why they feel so strongly about it. Furthermore, transatlantic partners could also develop standards and methodologies that might 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 crucial that some economies take the lead in developing the ambition and standards for future negotiations.

Summary

In a previous era of trade policy—when the so-called Quad (or more precisely, the Quadrilateral group: the EU, US, Japan and Canada) dominated 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 then might have diminished the role of multilateral trade policy, especially if the timing had collided with new multilateral initiatives. But the world is different now. The EU and the US are no longer so dominant in the trade system that they are the only economies that really matter for future increases in trade and sales. Furthermore, many of the new issues causing irritation in world trade are more controversial than other previous issues, and there is greater opposition to the notion that trade policy should address them.

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

The problem in current trade policy is not opposition to the idea that tariffs will eventually 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 relatively new types of trade issues. This is where divisions will occur in the medium-term future. Yet on many of the central issues for future trade policy, it is highly unlikely that such principles will be able to grow out of group work within the WTO. Rather, they will have to come from persistent leadership by the EU and the US. Inevitably, a transatlantic free trade agreement that begins 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. Some other countries may dislike it, but an initiative that heralds the principle of free, market-based trade will eventually trigger activity in that direction by other countries, too.

5. Conclusions and recommendations

It should be clear to 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 in the policy world. Now is the time for the two partners to take the next step in evolving their trade and investment relationship, 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 could generate dynamic gains in the region of 0.5%–1% of GDP. Reducing NTBs by 50% could spur GDP by another 0.3%–0.7% (taking just static gains into account). If a trade agreement were also to do away with restrictions to trade in services and possibly establish a new bilateral investment agreement, the benefits would likely increase even more. Such gains are far larger than the economic gains the EU and the US could achieve from negotiating other FTAs.

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

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 use their economic power as leverage on emerging economies. The EU and the US will have to find a way outside of the WTO system to trigger greater action on the part of these economies. For the moment, emerging economies 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 upon imports from emerging economy countries. A country like China has been able to introduce many new restrictions on trade, knowing that the appetite to obtain a good share of the rapidly growing Chinese market is enough to cool the anger over 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 the trade policy of 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-term future should start from the presumption that the alternative to bilateral trade agreements is not going to be substantial multilateral liberalisation and the improvement of rules.

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

The EU and the US have already begun a joint examination of 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 the Working Group will suggest it is time for FTA negotiations or if instead they see future transatlantic trade cooperation taking a different shape. Yet the creation of this Working Group signals that political leaders on both sides of the Atlantic are prepared to revisit the arguments for and against a transatlantic free trade agreement. This is a good start.

About the author

Fredrik Erixon is a director and co-founder 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 J. P. Morgan and a consultant to governments, ministries and international organisations on many economic matters. He has written numerous papers on transatlantic economic relations and in 2011 initiated the Transatlantic Task Force on Trade and Investment.

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