



CENTRE FOR EUROPEAN REFORM

NARROWING THE ATLANTIC

The way forward for EU-US trade and investment

Philip Whyte





CENTRE FOR EUROPEAN REFORM

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Narrowing the Atlantic

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ABOUT THE AUTHOR

Philip Whyte is a senior research fellow at the Centre for European Reform. He was previously a senior economist at the Economist Intelligence Unit and an analyst at the Bank of England. His other CER publications include the ‘The Lisbon scorecard IX: How to emerge from the wreckage’, co-authored with Simon Tilford; and ‘State, money and rules: An EU policy for sovereign investments’, co-authored with Simon Tilford and Katinka Barysch.



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1 Introduction

Since the end of the Cold War, it has been tempting to dismiss the transatlantic relationship as a historical relic. When the Berlin wall fell, numerous observers questioned whether NATO could survive once the common Soviet threat that had held it together had disappeared.¹ The debate has its counterpart in the economic sphere. Until the early 1990s, the transatlantic axis was easily the most important artery in the world economy. Since then, its centrality has been challenged by the emergence of new economic powers such as Brazil, China and India. Given the huge influence which these economies are now having on the international flow of goods, services and capital, it seems natural to conclude that the world economy's old transatlantic core is being gradually displaced and marginalised. This report challenges this increasingly common assumption.

¹ Kenneth Waltz, *The emerging structure of international politics*, *International Security* 18, 1993.

It argues that the transatlantic economy remains easily the largest inter-regional link in the world economy – and that the phase of globalisation which began in the early 1990s has tightened this relationship, not weakened it. The belief that the world economy's old transatlantic core is being displaced by the emergence of new economic powers is in part an optical illusion created by astonishingly rapid changes in international trading patterns. The EU and the US now import more goods from China than they do from each other – a fact that would have seemed inconceivable only a decade ago. But to draw conclusions from trade in goods can be misleading, particularly in the context of the transatlantic economy. The reason is that it does not capture everything that Europeans and Americans sell to each other – nor, more importantly, the channel through which they do so.

Markets do not operate in a vacuum. They are embedded in a world of states – and this has important consequences for transatlantic commerce. The good news is that trade and investment across the Atlantic has boomed despite periodic diplomatic strains, not least over the war in Iraq. The profit motive has proved a powerful transatlantic adhesive. The bad news is that political boundaries continue to throw up barriers, both deliberate and unintended, that limit the economic benefits the EU and the US could derive from their commercial ties. The two sides have periodically committed themselves to removing such obstacles. But their longstanding ambition to create a ‘transatlantic marketplace’ remains a work in progress – and is still a long way from becoming reality.

Globalisation rests on political foundations. Markets are opened by political fiat, and can be closed by it. So a central question currently facing the EU and the US is what appetite they have for further market opening – with each other and the rest of the world. The omens are not good. Public support for globalisation has been falling on both sides of the Atlantic for several years. And what looks like the deepest recession since the 1930s will not be the most propitious time to push for further market opening. Indeed, most domestic pressure is currently in the opposite direction: for protecting ailing firms from foreign competition, rather than exposing them to more of it. In current circumstances, the greatest challenge facing the world may be to stem a dangerous drift to protectionism – or what is now euphemistically known as ‘economic patriotism’. Patriotism, Samuel Johnson once said, is the “last refuge of the scoundrel”. He neglected to mention that it is a perennial temptation of the desperate politician.

Between the end of the Second World War and the end of the Cold War, Europeans and Americans conducted their bilateral economic relations primarily through multilateral institutions. But since the early 1990s, they have developed bilateral initiatives to remove regulatory barriers to commerce. To date, bilateralism has coexisted peacefully with multilateralism. However, certain forms of

bilateralism could undermine multilateralism and should therefore be resisted. This report argues against two recent proposals in particular. One would be to conclude a transatlantic free trade agreement in an effort to exert leverage over China and India in the Doha round. The other would be to deepen the transatlantic relationship to construct a more effective ‘shield’ against globalisation. The first option would weaken the multilateral trading order, not advance it. The second would mark a wholesale retreat from multilateralism – and do little to solve the problems it is intended to tackle.

Chapter two of this report discusses the nature of the transatlantic commercial axis, and why it remains the key nexus of the world economy. Chapter three describes the kinds of barrier that still impede commerce between the EU and the US and outlines how the two sides could benefit from their removal. Chapter four looks at how traditional tariff barriers to trade might be cut, while the removal of regulatory barriers is tackled in chapter five. Chapter six looks at the reasons behind the decline in public support for free trade and globalisation and discusses what sort of obstacle this might prove to a market-opening agenda. The report concludes with some policy recommendations – and some warnings.

2 The transatlantic axis in the world economy

The EU and the US are, respectively, the first and the second largest economies in the world. For much of the period since the end of the Second World War, their bilateral commercial relationship has dominated the world economy. However, the new phase of globalisation which took off in the early 1990s with the collapse of communism and the onset of the information technology revolution has transformed longstanding commercial patterns. What impact has this phase of globalisation had on the world economy's old transatlantic core?

Merchandise trade and the transatlantic economy

Look at data for merchandise trade and it is tempting to conclude that the transatlantic axis has already been displaced by the Asia-Pacific region. Both the EU and the US now trade more goods with Asia-Pacific than they do with each other. In 2008, the value of goods entering the US from countries in the Asia-Pacific region totalled \$730 billion – twice the value of goods that the US imported from the EU. Merchandise imports from China, which have surged since the country's admission to the World Trade Organisation (WTO) in 2001, accounted for half of all imports into the US originating from the Asia-Pacific region. In 2007, China had not yet replaced the EU as the leading supplier to the US market. But it is likely to do so very soon. The pattern of US goods exports also points to the growing importance of trade with Asia-Pacific. In 2008, US goods exports to the region totalled \$333 billion – \$62 billion more than the value of US merchandise exports to the EU.

Europe's own trade patterns have experienced similar changes. Until the 1990s, West European countries traded overwhelmingly with other OECD countries. This is less true today. EU countries still trade primarily with other member-states. But there has been a marked shift in their non-EU trade away from developed economies towards emerging ones. The scale and pace of this change has been astonishing. As recently as the mid-1990s, the value of US goods entering the EU was four times higher than that of Chinese goods entering the EU. Today, the value of Chinese goods entering the EU exceeds that of US goods. The shift in the pattern of EU exports has not been quite as marked, but it has still been striking. In 2007, non-OECD countries accounted for 65 per cent of EU countries' export earnings from outside the EU – up from 50 per cent in 2000. The EU is now the second largest supplier of goods to emerging Asia (behind Japan, but ahead of the US).

The picture that emerges from changing international patterns of merchandise trade seems clear: the rapid growth of emerging economies, allied to their growing integration into the world economy, is driving a massive reorientation of international trade in goods – to the detriment of the transatlantic economic axis. Globalisation seems to be loosening the economic ties that bound the US to Western Europe during the Cold War. In reality, the story is not as straightforward as the data for trade in goods suggests. There are two problems with viewing the transatlantic economy through the prism of international trade in goods. One is that the EU and the US are increasingly service-centred economies. The other is that they are tied together by deeper forms of integration than international trade.

Services in the transatlantic economy

On both sides of the Atlantic, services now make up over 70 per cent of GDP. Many services are inherently less tradable than goods, because they must be delivered where they are consumed. Even so, cross-border trade in services has been expanding strongly. In 2008, the US earned \$544 billion from exports of services – up from \$256

billion a decade earlier. This is still much less than the \$1.3 trillion which the US earned from exports of goods. But it still amounts to more than a third of the US's total export earnings. More than half of the US's earnings from service exports still come from royalty fees, transport and tourism. But declining communications costs have also supported strong growth in exports of 'other private sector services' such as education, financial services, telecommunications, legal services and accounting. Over half of the increase in US earnings from service exports since 1997 has come from these types of services.

The main market for the growth in US service-sector exports has been Europe – not the Asia-Pacific region. In 1995, the US earned more from its exports of services to the Asia-Pacific region than it did from those to the EU. This is no longer the case. US service-sector exports to the EU have tripled in US dollar terms since 1995, reaching \$198 billion in 2008 – \$62 billion more than the US earned from exporting services to countries in the Asia-Pacific region. Trade in services has grown almost as rapidly in the other direction across the Atlantic. In 2008, the EU exported \$152 billion worth of services to the US – up from \$46 billion in 1995. At a time when many Americans and Europeans worry about the 'offshoring' of service-sector jobs, a comparison with India is instructive. The value of US imports of services from India surged between 2003 and 2008. But in 2008 they still only amounted to just 8 per cent of the value of US service-sector imports from the EU.

Foreign direct investment in the transatlantic economy

Important though it is, trading at 'arm's length' across national borders is a more superficial commercial relationship than establishing a physical presence to produce and sell goods and services directly in a foreign country. And in the transatlantic economy, it is the second mode that dominates.² Since the early 1990s,

² Daniel Hamilton and Joseph Quinlan, 'The transatlantic economy 2007: Annual survey of jobs, trade and investment between the US and Europe', January 2008.

globalisation has been driven by foreign direct investment (FDI), which has expanded even faster than international trade. Contrary to widespread belief, this dimension of globalisation has not consisted primarily of companies relocating business units from high-cost to lower-cost countries. Such operations have, of course, taken place. But they represent a tiny share of global FDI flows. Global FDI has been, and continues to be, dominated by flows between wealthy countries.

³ *United Nations Conference on Trade and Development, 'World Investment Report', 2008.* Consider the bald numbers. In 2007, the global stock of inward FDI is estimated to have totalled \$15.2 trillion.³ Of this, \$10.5 trillion – or 69 per cent of the global total –

went to developed countries. Since Japan receives very little FDI given the size and wealth of its economy, the EU and the US attract the lion's share of FDI in the developed world. A large amount of FDI in the EU is, of course, intra-regional – that is, firms in one member-state investing cross-border into another EU country. But the largest non-European investors in the EU are American companies. In 2007, the stock of US FDI in the EU totalled \$1.4 trillion – over three times more than the stock of US FDI in the whole of the Asia-Pacific region. And for all the fuss about China, the stock of US FDI in that country totalled just \$28 billion in 2007 – less than a tenth of what US multinational enterprises have invested in the Netherlands. US outward FDI, in other words, still goes primarily to Europe.

The presence of US companies on their territory has long entered the consciousness of Europeans. It is the reason they often conflate globalisation with Americanisation (or 'coca-colonisation'). But Europeans often overlook the fact that EU firms have invested almost as much in the US as US companies have in Europe. In 2007, the stock of EU FDI in the US amounted to \$1.3 trillion – only slightly less than the stock of US FDI in the EU. The largest EU investors in the US are British firms. But globalisation is not the monopoly of Anglo-Saxons. French and

German companies have also been active investors abroad – notably in the US. Indeed, German and French firms have invested more in the US than US ones have in Germany or France. The stock of French FDI in the US, at \$168 billion, is more than twice as large as the stock of US FDI in France, at \$68 billion. In the 1960s, a French commentator famously worried about the challenge posed by US firms.⁴ But FDI ⁴ *Jean-Jacques Servan-Schreiber, 'Le défi français, not a défi américain', 1967.*

A possible objection at this point might be that today's transatlantic FDI stocks reflect yesterday's flows. FDI stocks in the US and the EU may be sizeable, the argument would go, but only because American and European multinationals have been investing across the Atlantic for decades. By contrast, FDI stocks in much of Asia may still be low in absolute terms, but this is only because countries like China are relative newcomers to the world economy. All the future growth, however, will be in large emerging economies like China and India. The argument sounds plausible, but is it borne out by the evidence? The answer is: not really – or at any rate, not yet. Compare, for example, the geographical distribution of US outward FDI flows. In 2007, US firms invested \$175 billion in the EU, more than three times the amount (\$54 billion) they invested in the Asia-Pacific region. And US companies invested almost as much in Ireland as they did in Brazil, China, India and Russia combined.

The enduring scale and depth of transatlantic commercial links is not that surprising. Contrary to widespread belief, tax rates and wage costs are not the principal determinants of firms' decisions on location – and they are usually not even the most important ones. The belief that footloose multinationals are closing plants *en masse* in wealthy, highly taxed countries to take advantage of lower taxes and labour costs in poorer ones is not supported by the evidence. There are many motives for companies to invest abroad, from gaining access to natural resources such as oil and gas to taking advantage of lower labour costs. But numerous studies have shown

that the most important determinants of FDI by far are the size and wealth of the host market, the stability of the host country's political system, and the predictability of the business climate. On all these

⁵ *Economist Intelligence Unit, 'Business environment rankings', April 2008.* measures, the EU and the US are vastly more attractive destinations for FDI than most other parts of the world.⁵

The nature of the transatlantic economy

It is easy to be beguiled by the growing impact of emerging economies on international trade in goods. But to draw conclusions from changing patterns of international trade in goods is misleading because it does not fully capture what the EU and the US sell to each other or how. FDI has been expanding faster than visible trade for years; sales by foreign affiliates easily outstrip earnings from arm's length international trade; and services account for a rising share of transatlantic trade and investment. Even where physical goods still cross the Atlantic, such movements are influenced by FDI, as over half of all transatlantic trade in goods is intra-firm trade – that is, cross-border trade between different units of the same firm. The manufacturing sector still accounts for 33 per cent of EU FDI in the US and 21 per cent of US FDI in the EU. But both these shares have been falling and will continue to do so over the years ahead. Services, not manufacturing, will drive the future growth of transatlantic FDI.

3 Barriers to transatlantic trade and investment

The world economy may be more integrated than it was 20 years ago. But it is less 'globalised' than is often supposed. The reason is that markets are implanted in a world of states. And political boundaries have a huge influence on the nature, scale and pattern of cross-border commerce. Take the EU. No other region in the world has expended anywhere near as much energy trying to create a single market between its members. Yet after more than two decades of legislative efforts to bring one about, the EU still looks more like a patchwork quilt of national markets. Integrating 27 jurisdictions – all with their own tax systems, regulatory regimes and consumer preferences – has been a hugely difficult task.⁶

⁶ *Simon Tilford and Philip Whyte, 'The Lisbon scorecard IX: How to emerge from the wreckage', CER report, February 2009.*

What is true within the EU holds with even greater force for the transatlantic economy. The latter may be the deepest inter-regional link in the world economy. But goods, people, capital and services do not move freely across the Atlantic: they are subject to various restrictions, both deliberate and unintended. What forms do these barriers take? How do they impede transatlantic commerce? And what would the EU and the US gain from their removal?

Obstacles to trade in goods

Restrictions on transatlantic commerce start with traditional barriers 'at the border'. Successive rounds of multilateral trade liberalisation have dramatically reduced tariffs, but transatlantic trade in goods is still not tariff free. In 2007, the average US tariff applied to imports from other WTO members was 4.8 per cent. Averages, of course,

conceal wide variations across tariff lines. US tariffs on imports of agricultural goods (which average close to 9 per cent) are much higher than those for imports of manufactured goods (which average 4 per cent).⁷ The EU's own tariff structure is similar to the US's. In

⁷ World Trade Organisation, 'Trade policy review of the United States', May 2008.

⁸ World Trade Organisation, 'Trade policy review of the European Communities', January 2007.

2006, EU tariffs on imports from other WTO members averaged 6.9 per cent. Like the US, the EU extends higher levels of protection to imports of agricultural goods than to manufactures. In 2006, EU tariffs on imports of manufactures averaged 4 per cent, compared with 18.6 per cent on imports of agricultural products.⁸

The transatlantic market is impeded by other types of barriers that do not affect trade within the EU or the US. Trade, for example, can be disrupted by anti-dumping measures – that is, increases in duties on imports that are deemed to be sold at less than cost. Both the EU and the US have made extensive use of anti-dumping duties. At the end of 2007, the US had 232 anti-dumping measures in place. True, most of these measures were targeted at emerging economies such as China. But the US still had 36 anti-dumping measures in place against EU countries. It is also true that the EU and the US have been relying less heavily on anti-dumping duties than in the past – at least in relation to each other. Such duties now affect less than 0.5 per cent of transatlantic trade in goods. But anti-dumping duty cases are inversely correlated to the business cycle: they tend to fall when GDP is growing strongly, but rise when economic activity weakens. Given the weakness of the current economic backdrop, it would be no surprise to see anti-dumping cases starting to rise again.

Customs procedures add to the cost of transatlantic trade – and these are becoming more onerous. Goods exported from the EU to the US, for example, are subject to harbour maintenance bills and merchandise processing fees. Customs procedures, moreover, have tightened significantly since the terrorist attacks on the US in 2001. EU firms complain that more stringent customs procedures are

having discriminatory effects. The US Container Security Initiative, which is designed to counter terrorist threats to the international maritime container trade system, has been imposing additional costs and delays on shipments from the EU to the US. And security and filing requirements are set to increase markedly following the adoption of the US SAFE Port Act of 2006: from 2012, the Act will require all containers on a US-bound vessel to be scanned before being loaded.⁹

⁹ European Commission, 'United States barriers to trade and investment: Report for 2006', February 2007.

Traditional barriers 'at the border' are not the only obstacles to transatlantic trade in goods. Regulatory barriers 'behind borders' can have an even more disruptive effect. Trade in food, for example, has been repeatedly impeded by differences in health and labelling standards. The EU does not import much poultry from the US because most American producers wash chicken in chlorine-based disinfectants – a practice banned by the EU on environmental and health grounds. Nor does the EU import US beef treated with hormones. Changes to the regulatory environment in the EU have provoked a sharp fall in US exports of genetically modified crops to the EU since the late 1990s (and brought a challenge from the US in the WTO). And US firms fear that the entry into force of the EU's REACH regulation, which requires manufacturers of chemicals to register their products with a new European Chemicals Agency, could have an adverse impact on their own sales.¹⁰

¹⁰ REACH stands for Registration, Evaluation, Authorisation and Restriction of Chemicals.

Obstacles to trade in services

Unlike goods, internationally traded services are neither tangible nor storable. As such, most escape traditional border barriers such as tariffs. Even so, services can be subject to a number of barriers. A particularly egregious example is the US maritime sector. The Jones Act reserves cargo services between two points in the US for ships that are registered and built in the US, owned by an American firm and on which at least 75 per cent of employees are US nationals.

Successive US administrations have repeatedly refused to dismantle these restrictions or to negotiate cabotage (in other words, the right of foreign maritime companies to operate between US ports). Why?

¹¹ Bruce Stokes, 'Trade negotiations' in David Andrews et al, *The future of transatlantic economic relations: Continuity among discord*, European University Institute, 2005.

Because US maritime firms have targeted campaign contributions to key members of Congressional committees to make sure that such rights are not extended to foreigners.¹¹ In other words, restrictions in the US maritime sector have been determined by the pork barrel, not the public interest.

Few other service sectors are subject to barriers quite as flagrant as those affecting US maritime services – although the air transport sector used to come close. Air transport is supposed to be one of the great enablers of globalisation. Yet it has long been a highly restricted sector, with bilateral agreements between governments limiting the routes that international air carriers are allowed to fly, as well as the number of flights they can schedule. Air transport across the Atlantic was liberalised in March 2008. But the agreement between the EU and the US is not a full 'open skies' agreement. EU airlines can now fly from any point in the EU to any in the US – and vice versa. But cabotage is not allowed and EU carriers are still prohibited from taking more than a 25 per cent stake in US carriers. Residual restrictions across the Atlantic contrast with what has happened within the EU and the US, where air transport has been opened to competition – with great success.

Restrictions exist in several other sectors too. Belgium, France and Italy limit the availability of US popular entertainment by applying broadcasting quotas on radio and television. Professional services such as lawyers, accountants and architects are subject to numerous registration and licensing procedures in individual EU countries and US states. And regulations have long restricted competition in postal, courier and express delivery services on both sides of the Atlantic. Changes are admittedly afoot in the EU. The EU's Services Directive, which will come into force in 2010, should make life slightly easier

for US service providers in the EU. And the EU's Third Postal Directive should do the same for postal service providers. However, even in sectors where competition already flourishes, regulations can still impose burdens on service providers. For example, because of conflicting accountancy standards, companies that have to file with both EU and US regulators have long had to keep two sets of financial books – at enormous cost in time and money.

Obstacles to the free movement of capital

By and large, capital moves relatively freely across the Atlantic – more so, in all likelihood, than between any other two regions in the world. The relative openness of the transatlantic economy to capital movements is illustrated, among other things, by the high levels of EU foreign direct investment in the US (and vice versa). Even so, potential obstacles to capital movements still exist. In theory, both the EU and the US sides are committed to the principle of national treatment, which commits them to treating foreign companies the same way as domestic ones. In practice, there are sectoral and legal exemptions to this principle. Even when cross-border investments are explicitly permitted by legislation, moreover, political factors can still interfere. It is not unusual, for example, for politicians to seek to deter foreign investment through public statements. Such interference is as much of a problem within the EU as it is between the EU and the US.

European companies wanting to invest in the US face two possible legal hurdles. The first are sectoral restrictions – such as those in force in the air transport and maritime sectors – which limit the stake that foreign firms can take in US ones. Although the US justifies these restrictions on public interest grounds, EU firms complain, rightly, that they have more to do with investment protectionism. The other legal hurdle is the 1988 Exon-Florio amendment to the 1950 Defence Production Act. This empowers an inter-agency body, the Committee on Foreign Investment in the United States (Cfius), to review foreign takeovers and block them if

they are deemed to pose a threat to national security. In practice, the vast majority of foreign takeovers have taken place smoothly without a Cfius investigation. But some bids can become politicised – as happened when the US Congress acted to prevent Dubai Ports World from taking over the management of certain US ports following its acquisition of P&O (Cfius had already cleared the acquisition on national security grounds).

The position in the EU is more complicated than in the US, because policy towards foreign investment differs widely across its 27 member-states. Like its US counterpart, the British government is legally empowered to block foreign takeovers on grounds of national security. In practice, however, it almost never does so. (The last time it did was in the 1980s, when it limited the stake that the Kuwait Investment Authority, a sovereign wealth fund, could take in British Petroleum). Over the past 20 years, the UK's foreign investment regime has been more open than perhaps any other in the world. Foreign takeovers of domestic firms have not just been tolerated. In some cases, they have been actively encouraged – even in sectors that many countries consider to be 'strategic'. For example, where many EU countries have sought to deter foreign firms to protect their 'national champions' in the energy sector, the UK government has actively supported them – as it did with Electricité de France's acquisition of British Energy in 2008.

France is more reticent than the UK. Although it is more open than it is often given credit for abroad, foreign investment remains politically contentious. In 2005, for example, it took only the rumour of a takeover of Danone, a French dairy company, by Pepsico of the US, for the government to issue a decree listing 'strategic sectors' in which foreign participation would require prior ministerial approval. The compatibility of the decree with EU law has been challenged by the European Commission. But France has a longstanding tradition of subordinating its legal obligations to political considerations (*volontarisme d'état*). EU law, for example,

requires France to open its energy market to foreign competition. But in 2007, the government engineered a 'Franco-French' merger between Suez and Gaz de France to block a mooted foreign takeover of Suez. The Caisse des Dépôts et Consignations (CDC), a state-owned institution, is also often leant upon by politicians to acquire stakes in French 'national champions' to make them less vulnerable to foreign takeovers.¹²

¹² In November 2008, President Sarkozy set up a new strategic investment fund, managed by the CDC, for this purpose.

The gains from liberalisation

The transatlantic marketplace is not seamless – and never will be. The question is: what share of transatlantic commerce is affected by the various barriers just described, and what would the EU and the US gain from their elimination? Although trade in goods is not tariff free, average tariff rates are modest and the few sectors that are protected by exorbitantly high rates – agricultural products, textiles and clothing – make up less than 10 per cent of transatlantic trade. The main obstacles to transatlantic commerce are now non-tariff barriers 'behind' national borders – such as regulations. The incidence of these barriers varies across sectors. Regulatory obstacles tend to be higher in the EU than in the US, because state ownership is more widespread and EU countries are more prone to rely on regulations such as planning laws to meet economic and social objectives. Barriers to foreign investment, by contrast, tend to be slightly lower in the EU than in the US. But there are wide variations across the EU, with restrictions higher in, say, France than they are in the UK.

Lowering the various barriers that currently gum up transatlantic commerce would boost American and European living standards in two ways. First, it would encourage a more efficient allocation of resources (the so-called static gains from trade). Second, by encouraging greater competition, it would boost productivity growth (the so-called dynamic gains from trade). A number of

attempts have been made to estimate the total gains from transatlantic liberalisation. One of the most authoritative studies, carried out in 2005 by the Organisation for Economic Co-operation and Development (OECD), estimated that a package of reforms that included the elimination of all remaining tariffs on goods, allied

¹³ OECD, *The benefits of liberalising product markets and reducing barriers to trade and investment: The case of the United States and the European Union*, May 2005.

to the removal of competition-restraining regulations and restrictions on FDI, would permanently increase GDP per head by up to 3.5 per cent on both sides of the Atlantic. Over the course of a working life, this could amount to over a year's worth of earnings.¹³

4 Lowering traditional barriers to trade

The EU and the US would gain economically from lowering – or, better still, eliminating – the tariff barriers that still impede their bilateral trade. The question is: how should they do so? There are three possibilities: multilaterally, bilaterally or unilaterally. It is often assumed that the way countries free up their external trade is of no great importance: any reduction in trade barriers, on this view, adds to the sum total of freer trade. This chapter argues that this assumption is mistaken. Free trade agreements (FTAs) do not always live up to their name. The problem is not just that some are foreign policy instruments with little economic import – trade-free agreements, rather than free trade agreements. It is that most of them damage the international trading system. As the world's largest economies, the EU and the US have a special duty not to weaken the multilateral trading system they supposedly support.

Multilateralism and the World Trade Organisation

Since the end of the Second World War, the EU and the US have reduced their bilateral tariff barriers only through multilateral agreements. Thanks to a succession of such agreements, transatlantic trade is now much freer than it was in the late 1940s. But trade negotiations have become more protracted with every passing round, and multilateralism seems to be running into the sand. Why?

One reason is that the talks have become more complex. Whereas early rounds focused on the straightforward task of lowering tariffs on industrial goods, later rounds have dealt with more difficult areas such as non-tariff barriers to trade and the liberalisation of previously protected sectors such as services, agriculture and textiles.

But the more fundamental reason is that the EU and the US are finding it harder to exercise leadership. In the 1950s, the General Agreement on Tariffs and Trade (GATT) was a small club of developed countries. This is no longer the case. Whereas only 26 countries participated in the Dillon round in 1960, 151 are involved in the current trade liberalisation negotiations, the Doha round. The growth in the number of participants, allied to the emergence of fast-growing and increasingly influential economies in Asia and elsewhere, has diminished the ability of the EU and the US to set the agenda and impose their terms on the talks.

Domestic constraints are also sapping the ability of the EU and the US to exercise leadership in Doha. One is the decline in public support for globalisation and free trade on both sides of the Atlantic (see chapter six). Another is that lobbies pressing for open markets have been less engaged in the Doha round than protectionist lobbies. In earlier rounds, business groups in favour of free trade played a key role in counterbalancing the constituencies opposed to market opening. During the Uruguay round, for example, US multinational enterprises were active in driving forward the agendas on services and intellectual

¹⁴ Peter Kleen, 'So alike and yet so different: A comparison of the Uruguay round and the Doha round', *European Centre for International Political Economy*, 2008.

property. But business groups have been less active in the Doha round.¹⁴ There are several reasons for this: world trade has grown buoyantly even as multilateral trade talks have stalled, and many of the areas in which business has lobbied most strongly were settled before Doha was launched. But another reason may be

that businesses have become disenchanted with the snail-like progress of multilateral trade talks, at a time when international competitive pressures require rapid decision-making at corporate level.

Multilateral liberalisation through Doha

The Doha round is centred on development – not transatlantic trade. The key bargain being negotiated is the extent to which developed economies such as the EU and the US should 'trade' reductions in

subsidies to their highly-protected agricultural sectors in return for reductions in tariffs and increased services access in developing countries (in WTO terminology: 'non-agricultural market access', or NAMA). Although transatlantic trade is not the central focus of the Doha round, it would still be affected by any bargain reached: cuts in agricultural subsidies and industrial tariffs would free up trade between the EU and the US. But Doha is floundering. It is now the longest-running round of trade liberalisation talks ever held. In the 1950s, trade liberalisation talks were typically wrapped up within six months. Doha has already lasted seven years.

The main stumbling block in the Doha round has been the failure to find a trade-off between agricultural subsidies and NAMA. Both the EU and the US believe they have gone as far as they can in their offers to cut agricultural subsidies, and would like greater NAMA in developing countries. The latter, meanwhile, would like to see deeper cuts in American and European agricultural subsidies, without participating in tariff elimination on products such as chemicals, electrical machinery and medical technologies. In addition, China, India and a number of other emerging economies would like to have the freedom to raise barriers to protect their farmers from surges in food imports. Developed countries are prepared to allow these countries to adopt such measures. However, they believe that the circumstances under which emerging economies take them should be more circumscribed.

Despite periodic expressions of public optimism by trade negotiators, it is far from certain that these sticking points will be resolved any time soon. The last ministerial meeting in Geneva in late July 2008 showed that negotiating positions were still too far apart. In November, the G20, meeting in Washington DC against the backdrop of a rapidly deteriorating world economy, 'instructed' trade ministers to reach a framework deal by the end of the year – to no avail. In early December, the WTO's director-general, Pascal Lamy, dropped plans to call a ministerial meeting on the grounds that it would run "an unacceptably high risk of failure". The talks

are now likely to be put on hold until well into 2009. The multilateral liberalisation of transatlantic trade is therefore hostage to the stasis in Doha. In these circumstances, how else might the EU and the US liberalise their bilateral trade?

Bilateral trade liberalisation

One option might be to do so bilaterally. The EU and the US have already made extensive use of preferential trade agreements (PTAs) with other countries and regions. Over the years, the EU has concluded PTAs with prospective member-states, neighbours, and countries with which EU countries have close historical ties (such as former colonies). The EU's web of PTAs is now so extensive that there are only nine countries with which it trades on a most-favoured nation (MFN) basis (a central principle of the WTO regime). One of these is the US. The US, for its part, is a more recent convert to PTAs. Until the 1980s, it had resisted signing them. But like many converts, it has since embraced them with gusto. When the US started signing PTAs in the 1980s, it was partly out of frustration with its failure to launch a new round of multilateral trade liberalisation. Since then, it has pursued a twin-track policy. It has pressed for multilateral liberalisation while continuing to cut bilateral deals.

The former US Trade Representative, Robert Zoellick, called this strategy "competitive liberalisation". As he put it in an article for *The Economist*, "by moving forward on multiple fronts, the US can exert its leverage for openness, create a new competition in liberalisation, target the needs of developing countries, and create a

¹⁵ Robert Zoellick, 'Unleashing the trade winds', *The Economist*, December 7th-13th 2002.

fresh political dynamic by putting free trade on the offensive".¹⁵ The logic seems compelling – and the implications for the EU and the US obvious. The two sides do not have a bilateral trade agreement with each other and the liberalisation of transatlantic trade is hostage to the impasse in Doha. So why not liberalise transatlantic trade by cutting a bilateral deal? Influential

commentators have started advocating just this course of action. A 'mega-regional' deal, they argue, would not just free up one of the major arteries of the world economy. It would also put pressure on China and India to play a more constructive role in the WTO.¹⁶

¹⁶ Bill Emmott and Roy MacClaren, 'Liberalising transatlantic trade', *International Herald Tribune*, September 4th 2008.

There are two problems with this argument. The first is that there is no evidence that PTAs have helped to advance multilateral trade talks. If anything, countries increasingly see them as a substitute. PTAs are not vanguards of multilateralism, but symptoms of its failure. The second problem is that the assumption of the argument – that PTAs free up international trade – is unwarranted. PTAs may lower trade barriers between signatories. But they effectively raise them for outsiders. Consider the impact of the EU's numerous PTAs on transatlantic trade. Under WTO rules, the EU is supposed to treat the US as a 'most-favoured nation' – meaning that it extends its lowest tariffs to the US. In practice, the countries with which the EU has signed PTAs often enjoy lower tariffs still. So far from being one of the EU's 'most-favoured nations', the US is one of its 'least-favoured' ones.¹⁷

¹⁷ Jagdish Bhagwati, 'Termites in the trading system: How preferential agreements undermine free trade', *Council on Foreign Relations*, 2008.

The proliferation of PTAs across the globe means that the world is moving away from a multilateral system based on non-discrimination. Instead it increasingly resembles a dense and complex web of discriminatory agreements. This 'spaghetti bowl', as it has been called, has obvious economic costs. To start with, it gives rise to 'trade diversion' – that is, it shifts trade from efficient, low-cost countries outside the PTA to higher cost countries within it. (A good example is imports of lamb into the UK. Before joining the EU, the UK imported most of its lamb from New Zealand – one of the world's cheapest producers. After joining the EU, however, imports of New Zealand lamb into the UK became more expensive because they were subject to the EU's common external tariff. As a result, the UK started importing more lamb from higher cost

producers such as France. So trade was ‘diverted’ from New Zealand and ‘created’ between the UK and France). By interfering with the global allocation of resources, a spaghetti bowl of discriminatory bilateral agreements reduces international gains from trade. It also complicates the task of companies that have to manage supply chains across national borders. Every time a PTA is signed, a further layer of complexity is added to the already fiendishly difficult rules of origin with which businesses have to comply. This affects the way they organise their supply chains and imposes onerous costs.

So the EU and the US, need to think carefully about the way they free up their bilateral trade. The method they choose will have important consequences for the wider global trading system. A bilateral free trade agreement would have plenty to be said for it if it did not discriminate against outsiders. The trouble is that a transatlantic trade deal would almost certainly end up looking like the agreements that the EU and the US have reached with other countries – that is to say, it would discriminate against non-members. This would be an abdication of responsibility and would deal a major blow to the multilateral trade regime that Americans and Europeans designed. Appealing as it might be if the Doha round ends in failure, the EU and the US should resist the temptation of reviving bilateral schemes like a Transatlantic Free Trade Area (TAFTA) – particularly as there are other options available that might not damage the rules-based system administered by the WTO.

Unilateral trade liberalisation

If discriminatory bilateralism is an undesirable option, how else might transatlantic trade be freed up? Another way would be for the EU and the US to do so unilaterally – that is, on their own initiative and without waiting for the other to reciprocate. This, after all, is what standard trade theory says they should do. Why? Because contrary to widespread belief, the gains from trade come from imports, not exports (see box on page 26). If the US or the EU wants to raise its living standards by reducing trade barriers, the classical case says

that they should follow the Nike strategy and ‘just do it’ without waiting for others to do likewise. This is just the approach that many developing countries have pursued since the early 1980s. Over the past 25 years, developing countries have reduced their weighted average tariffs by more than 20 percentage points. Unilateral cuts accounted for two thirds of the total reduction, whereas only a third was the result of multilateral or regional agreements.

The EU and the US could take inspiration from developing countries and offer complete, unconditional, tariff-free access to all industrial goods entering their markets. Such a move would have several advantages. It would serve an important political purpose by sending a signal to the rest of the world that Europeans and Americans remain committed to an open trading system – a desirable signal, given the cynicism that their protectionism in the agricultural sector has engendered. And the move would roll back the tide of discrimination that has accompanied the rise of PTAs. In other words, unilateral tariff cuts would allow Americans and/or Europeans to occupy the moral high ground while pursuing their narrow economic self interest. Sadly, there is little prospect of either the EU or the US seizing this opportunity. Unilateral trade liberalisation may have economic logic on its side. But it is highly unlikely that the US or the EU will cut their tariff rates on this basis.

Why? Partly because of ‘GATT-think’ – that is, the mercantilist logic that underlies trade negotiations. In multilateral negotiations, dismantling import barriers is considered to be a concession for securing access to foreign markets. The ideal seems to be to secure free trade abroad, rather than at home. It is, of course, a way of thinking influenced by producer interests and protectionist lobbies. The underlying assumption is that exports are inherently good (no matter how expensive they are to produce in terms of other opportunities foregone), while imports are bad (no matter how many resources they release for other uses). Since trade protection hurts the country that imposes it, opening one’s markets only if others reciprocate is

rather like promising not to inflict self-harm only if others do likewise. Still, political realities mean that trade liberalisation in the EU and the US will proceed on the basis of inverted logic – or not at all.

The case for free trade

What is the classical argument for free trade? In essence, it is that countries will produce (and hence consume) more if they trade with each other than they would under autarchy. Gains from trade arise because countries can specialise in producing goods in which they have a 'comparative advantage'. The theory of comparative advantage is widely

¹⁸ Paul Krugman, 'Ricardo's difficult idea', 1994, <http://web.mit.edu/krugman/www/ricardo.htm>.

misunderstood.¹⁸ It is often confused with absolute advantage – the idea that what counts in trade is the absolute cost of producing a good. But the theory of comparative advantage gets at something quite

different: it says that two countries can gain from trading with each other, even if one produces everything more efficiently than the other. How can this be?

When a country puts up barriers to imports, it effectively diverts resources away from producing the goods and services that it makes most efficiently to producing goods and services that it makes relatively less efficiently and which it could have imported. The underlying idea can be captured by a domestic analogy. Consider a highly-paid lawyer who is able to carry out every administrative task more efficiently than any secretary he could employ. The question is: should he still hire one? The answer is yes. The reason is that every time he carries out an administrative task, he is effectively foregoing the income he could otherwise earn as a lawyer. And because lawyers earn more than secretaries, it pays the former to employ the latter. This domestic analogy is worth bearing in mind, because it highlights the absurdity of much fashionable commentary on international trade. Trade is not a zero-sum game in which countries compete with each other – any more than a lawyer's standard of living is damaged by his decision to employ a secretary.

Could flexible multilateralism be the answer?

Unilateral liberalisation does not look politically viable. A bilateral free trade deal between the EU and the US would probably be discriminatory – and consequently economically undesirable. And the Doha round in its current format could end in failure. Even if Doha is eventually concluded, moreover, the final deal may be so shorn of ambition that it does little to liberalise world (and transatlantic) trade in practice. The reason is that multilateral trade negotiations focus on countries' 'bound' tariffs – that is, their ceilings. In practice, however, the tariffs that countries apply are often lower than their bound rates. Because of this difference (which is known in WTO jargon as 'tariff water'), a cut in bound rates will not necessarily result in a reduction in applied rates. So unless Doha lowers countries' bound rates below their current applied rates, it will not actually have liberalised trade. This would not make Doha useless. But it means it would look more like an insurance policy against protectionism than a genuinely liberalising round.

Does this exhaust all the available options? Not quite. Multilateralism could be made more flexible. The Doha round is currently being negotiated on the basis of the 'single undertaking' – a principle which states that nothing is agreed until everything is agreed. In theory at least, the single undertaking improves the chances of concluding multilateral deals because it allows the participants to make complex trade-offs across different sectors. In practice, it has not worked this way because possible deals in some areas (such as industrial tariffs) have become hostage to the absence of progress in others (such as agricultural tariffs and subsidies). The single undertaking is a device. It should not become a sacred cow. Abandoning the principle could allow a critical mass of countries to forge ahead and cut 'plurilateral' deals on industrial tariffs and, possibly, services. The idea is not as radical as it sounds. In the late 1990s, agreements were reached on this basis within the WTO in sectors such as financial services, information technology and telecommunications.

The EU and the US need to consider alternatives if Doha fails or produces little actual liberalisation. Plurilateralism could be the answer. If they were really ambitious, the EU and the US could, for example, try and put together a ‘coalition of the willing’ committed to the total elimination of all remaining tariffs on industrial goods (a move, incidentally, that might have the desirable consequence of weakening some PTAs). A ‘zero-for-zero’ agreement between the

¹⁹ Bruce Stokes, ‘Manufacturing first: A new way forward for global trade’, CER working paper, May 2004.

world’s key industrial nations would represent an important step forward for the world trading system.¹⁹ However, a plurilateral agreement would have to meet a key condition: its benefits would have to be extended to all

WTO members, whether they had signed up to the deal or not. Anything less would make the agreement look like a giant PTA – and would therefore be inconsistent with the core WTO principle of non-discrimination.

5 Deep integration: Lowering regulatory barriers

Tariffs are no longer the main barriers to transatlantic commerce. These are now to be found in regulatory and other obstacles ‘behind borders’. Although non-tariff barriers (NTBs) have been tackled at a multilateral level since the Tokyo round of trade talks (1973-79), since the 1990s the EU and the US have relied more on bilateral initiatives to try and lower them. But the end goal – to create a seamless transatlantic marketplace – has proved elusive. This chapter discusses why and asks whether the most recent bilateral initiative, driven by a new Transatlantic Economic Council (TEC), stands much chance of success.

The evolution of transatlantic governance

Until the 1990s, Western Europe’s bilateral relations with the US were dominated by security concerns. There was no economic counterpart to the North Atlantic Treaty Organisation (NATO). The Western European democracies and the US dealt with each other primarily through multilateral institutions such as the GATT, the OECD, the IMF and the G7. Since the early 1990s, however, the EU and the US have developed new institutions to manage their bilateral economic relationship. Three factors have influenced their formation. First, the end of the Cold War increased the salience of economic issues in transatlantic relations. Second, the growth in trade and FDI deepened commercial links across the Atlantic – but also increased the scope for bilateral regulatory friction. Finally, the project to complete the EU’s internal market and the growing remit of European institutions established them as the US’s principal interlocutor on commercial matters in Europe.

Transatlantic economic governance evolved in response. The first official declaration after the Cold War was the Transatlantic Declaration of 1990. This was primarily a statement of common values, but it identified economic liberalisation as a goal and laid some institutional founding stones by establishing “regular and intensive consultations” between the EU and the US. But the declaration was vague and lacked a detailed agenda to give it substance. The New Transatlantic Agenda, signed in 1995, was more precise. Like the Transatlantic Declaration, its coverage was not limited to commerce. But it was accompanied by a joint action plan which identified areas for deeper co-operation. The economic chapter called for the establishment of a liberalised ‘transatlantic marketplace’ and gave particular attention to bilateral regulatory co-operation. The New Transatlantic Agenda established new mechanisms for senior officials to co-operate between biannual summits.

Overall, the New Transatlantic Agenda proved a disappointment. Bilateral co-operation did not live up to expectations, and the Agenda failed to prevent a number of high-profile trade disputes from breaking out – notably over the EU’s banana regime and its ban on hormone-treated beef. Against this backdrop, the EU and US signed a Transatlantic Economic Partnership in 1998. The main aim of the Partnership was to reduce bilateral regulatory hindrances to trade. The action plan which accompanied it placed particular emphasis on regulatory co-operation and on possible standards harmonisation. It also committed the two sides to removing technical barriers to trade in areas such as food safety, services, intellectual property and biotechnology. The Partnership established new institutions at expert level – a steering group and a number of working groups reporting to it – and instituted an ‘early warning system’ to flag up potential trade and regulatory disputes.

What has transatlantic regulatory co-operation achieved?

Since its inception, transatlantic regulatory co-operation has produced few eye-catching results. This is hardly surprising, given

the hurdles the process must overcome. To start with, the institutions of transatlantic governance are inevitably weaker than are those within the EU, because the complex system of shared sovereignty that operates at EU level does not exist at transatlantic level. In the absence of common rule-making institutions, the EU and the US have to work with a limited tool box. Legislators and regulators either side of the Atlantic can be encouraged to pay more attention to the external impact of rules when framing them; to reduce ‘friction’ between established rules; and to cobble together solutions when clashes occur.

Transatlantic regulatory co-operation has had to contend with a further difficulty: the confederal structure of the EU and the federal structure of the US. In the EU, regulatory policies are set at both EU and national level. National regulatory policies, though often subject to minimum EU standards, can still differ widely across member-states. Even within the EU, the Commission has found it difficult to use the principle of mutual recognition to prise open national markets in general services, because member-states have jealously guarded their ability to set their own rules in these areas. The same dynamic can be observed in the US. Unlike EU countries, US states are at least bound together by a ²⁰ *The exception is Louisiana.* common legal tradition.²⁰ But US states still have jurisdiction over areas such as public procurement, legal services and insurance. And many are reluctant to become entangled in international commitments that curtail their ability to set their own rules in these areas.

Persuading inward-looking legislators and regulators to think of the external consequences of their policies has often seemed an impossible task, not least given the domestic concerns and collective preferences to which they have to respond. A good example is trade in biotechnology. Since 1992, the US Food and Drug Administration (FDA), relying on scientific evidence, has treated genetically modified food and crops as largely equivalent to their conventional counterparts. As a result, most processed foods in US groceries are

now derived from genetically-modified organisms (GMOs). EU regulators, by contrast, have had to operate in a political climate which has been influenced by food scares such as ‘mad cow’ disease. They have adopted more restrictive procedures for the approval and marketing of GMOs – hitting US exports to the EU. Bilateral talks spanning more than a decade have failed to bridge this gap in regulatory approaches.

Protracted and ill-tempered commercial disputes have added to the impression of failure. For years, the EU and the US have traded accusations about illegal subsidies to their respective manufacturers of civil aircraft, Airbus and Boeing. Each has filed complaints about the other to the WTO – and the two sides have refused to return to the negotiating table ever since. As noted in chapter three, trade in food has proved notoriously contentious, because of conflicting standards. For years the US has smarted over EU food standards that ban the import of beef treated with hormones or of poultry meat processed using pathogen reduction treatments such as chlorine. Despite a ruling in favour of the US in the WTO, the EU has yet to lift its ban on hormone-treated beef. The food bans infuriate the US. For the US, they have become a test of how seriously the EU takes the regulatory co-ordination agenda.

Transatlantic regulatory co-operation has often looked like a quixotic exercise. Since the process was launched in the mid-1990s, progress towards a transatlantic marketplace has been, at best, modest – and, at worst, close to non-existent. The only agreement to have delivered genuine market-opening between 1995 and 2008 was the open skies agreement in 2007 – and, as noted in chapter three, even this fell short of introducing full competition in air transport because cabotage was excluded. Moreover, other bilateral agreements have struggled to live up to expectations. In 1998, for example, the EU and the US adopted a framework for transatlantic mutual recognition agreements. When it entered into force, the framework was hailed as a “milestone” in regulatory co-operation. But it has produced few results. Unsurprisingly,

enthusiasm for mutual recognition has waned since the late 1990s and the two sides have often had to explore different forms of regulatory co-operation.

Has the TEC made a difference?

In 2004, the European Commission conducted a review of the framework for bilateral relations. It noted that the transatlantic agenda lacked strategic focus and was buckling under the weight of highly detailed regulatory issues. A study for the Commission also expressed concern that more strategic agenda-setting would be impossible without some renewed political commitment at the highest level.²¹ The Commission’s reviews were allowed to gather dust for a couple of years. However, many of their concerns were eventually taken up by the German chancellor, Angela Merkel. As holder of the EU’s rotating presidency in the first half of 2007, she proposed improved institutional arrangements to drive regulatory convergence forward. In place of the largely voluntary and non-binding dialogues between regulators, she suggested a new framework that would strengthen top-level political commitment to the process and increase the accountability of regulators.

The result was a ‘Framework for advancing transatlantic economic integration’, which the EU and the US signed in April 2007. The framework’s main institutional innovation was the creation of a Transatlantic Economic Council (TEC). The TEC, which meets biannually, is headed by ministerial-level appointees with cabinet rank. In theory, this high-level representation endows the TEC with the political clout that previous transatlantic institutions have lacked. The framework’s other contribution was the identification of areas (‘lighthouse priority projects’) that would “significantly enhance” transatlantic economic integration and on which the two sides resolved to make progress. These areas, which can be updated as and when necessary, are currently cargo security, intellectual

²¹ *European Commission, ‘Review of the framework for relations between the EU and the US: An independent study’, 2004.*

property, financial markets, investment, and innovation and technology. The hope is that the new structure will provide fresh impetus by placing more emphasis on results than process. Has it managed to do so?

There are tentative signs that it might. True, the first two meetings of the TEC – in November 2007 and May 2008 – produced few concrete results. The most notable achievements of the first meeting were the drawing up of a road map on trade facilitation, the issuance of a joint report on regulatory impact assessments, and the launch of an investment dialogue – worthy initiatives, but not quite the “substantial progress” that the TEC boasted about. The joint statement of the TEC’s second meeting struck a more sober note. It conceded that neither side was completely satisfied that its concerns were being addressed. The US complained that the issue of poultry exports had not yet been resolved, and that the implementation of the REACH regulation was already having the feared consequences on American companies’ sales of chemicals in the EU. The EU, for its part, underlined its continued anxiety about the entry into force of the US SAFE Port Act.

But by the TEC’s third meeting, in December 2008, signs of progress were beginning to emerge. The TEC’s joint statement acknowledged that “progress to date in resolving some key issues has been inadequate” – a coded reference, among other things, to the EU’s continued failure to lift its longstanding ban on imports of US poultry. But the third meeting was able to take stock of progress in other areas. With the EU recognising the equivalence of the US’s Generally Accepted Accountancy Principles (GAAP) with International Financial Reporting Standards (IFRS), the two sides finally agreed to recognise each others’ accountancy standards. They also agreed to strengthen provisions requiring legislators and regulators to consider the effects of new rules on international trade and investment. And the US welcomed steps taken by the European Commission to ensure that the entry into force of the REACH regulation would not have discriminatory effects on US firms.

Transatlantic regulatory co-operation: What next?

There does, therefore, seem to have been a modest improvement in transatlantic regulatory co-operation since the TEC was established. The question now is whether momentum can be maintained. The most immediate challenge is political transition in the US and the EU. Few Democrats have taken an interest in transatlantic regulatory co-operation in recent years, and those who have done so have criticised the agenda for being too narrowly focused on cutting the costs of regulation to business.²² President Obama, ²² Bruce Stokes, ‘Beyond bickering’, *National Journal*, March 22nd 2008. moreover, has more pressing issues to deal with than Europe’s treatment of US poultry. The good news is that he looks as if he will give the TEC a chance to prove its value. But the burden of maintaining impetus does not just rest with the US. Europeans must also ensure that they stay committed to transatlantic regulatory co-operation in a year when a new Commission will take office and elections to the European Parliament are to be held.

Political commitment to the TEC will only be maintained if the latter can demonstrate that it is worthwhile. The way to do so, of course, is to continue delivering results. The two sides must redouble their efforts to remove some of the irritants in their relationship. The US, for example, could show that it takes seriously Europe’s concerns about the commercial effects of new legislation on cargo security. It could, for example, examine whether there are risk-based alternatives to scanning all cargo destined for US ports. But Europeans need to reciprocate. It is disappointing that the EU has still not lifted its ban on imports of US poultry – and that the issue has now moved from the TEC to the WTO. The poultry issue may be economically trivial, but it is symbolically important. The ban is hard to justify (since the EU does not prohibit salads from being washed in chlorine). And Americans rightly ask what purpose the TEC serves if it cannot remove this kind of irritant.

The TEC must also show that it can help to contain protectionist pressures in the transatlantic marketplace – and promote further

market opening. With economies contracting and unemployment soaring, the greatest challenge in the short term will be to ensure that new barriers to trade and investment are not erected. At a summit in Ljubljana in June 2008, the EU and the US signed up to a commendably robust statement on the need to maintain open investment regimes. Given the centrality of FDI to the transatlantic economy, the TEC's Investment Dialogue should make sure that the two sides stick to this commitment. Longer term, the TEC could demonstrate its value by freeing up long-protected services markets. One prize would be the creation of a transatlantic market for air transport. The EU and the US should complete the second phase of transatlantic liberalisation by allowing cabotage and removing restrictions on foreign investment in air transport.

Finally, the TEC must show that it can prevent unnecessary regulatory friction on either side of the Atlantic. The risks of such friction currently loom particularly large for firms in the financial sector. Legislators and regulatory authorities in both the EU and the US are set to embark on a comprehensive tightening of regulatory rules. Capital adequacy rules are set to be overhauled; previously unregulated institutions, such as private equity firms, hedge funds and credit rating agencies are set to become regulated (to a greater or lesser extent); and accountancy rules could be revised. The TEC will play no role in designing the new rules, but it will be able to serve a useful purpose if it can help to ensure that new rules on the two sides of the Atlantic do not cut across each other or impose unnecessary costs. This will not be an easy task. But making sure that new regulations are aligned, as far as possible, on the two sides of the Atlantic was precisely the task for which the TEC was conceived.

Creating a positive dynamic is essential

Ever since the transatlantic regulatory convergence agenda was launched in the 1990s, the process has struggled to gain impetus in the absence of political direction from above. By the same token, top-level political interest has proved hard to sustain because of the

relatively meagre results that the process has delivered. It is too early to tell whether the TEC will succeed where other initiatives have failed. But two things are clear. One is that the TEC needs political support from the very top. Without such support, it will lack clout and achieve little. The other is that the TEC will only manage to maintain such support if it starts delivering results. It is therefore essential to create a dynamic that sustains political commitment to the process. Otherwise, the process is likely to run into the sand.

6 The political economy of transatlantic commercial relations

Globalisation is often presented as an immutable, technology-driven process. It is not. Technology has undoubtedly played an important part in integrating global markets. But open markets are ultimately dependent on enabling political conditions. The first age of globalisation drew to a close in the 1930s, when the domestic political conditions that had supported it broke down.²³ Globalisation is neither inevitable nor irreversible: political decisions have opened domestic markets to international competition – and they can close them again. This chapter discusses how politics impinges on the transatlantic commercial relationship. It argues that the transatlantic economy has shown remarkable resilience to strains in diplomatic relations, but that it is more vulnerable to recent trends in domestic politics.

Diplomatic relations and the transatlantic economy

In the run-up to the US-led war in Iraq in 2003, political relations across the Atlantic came under huge strain, when only half of Europe lined up to support the US. Seasoned observers had long predicted that the glue that had held the transatlantic alliance together during the Cold War would weaken once the Soviet threat had disappeared. The war in Iraq seemed to vindicate such predictions. Not only did France actively oppose the US in the UN Security Council. France and Germany lined up with their erstwhile Cold War opponent, Russia, to form a ‘coalition of critics’. Gaullist France had, of course, been a longstanding critic of the US ‘hyper power’. But President Chirac’s open advocacy of a multipolar world, his ambition to build the EU as an explicit counterweight to

American hegemony, and his frontal opposition to the US in the UN appeared to signal a weakening of the transatlantic alliance.

Yet while Europeans may have demonstrated *en masse* against the war in Iraq, and US politicians poured French wine down drains, the commercial relationship remained largely unaffected. One reason is that the political elites on either side of the Atlantic went out of their way to make sure that commercial relations were insulated from diplomatic strains. At the height of tensions over the war in Iraq, speeches by senior trade officials were markedly more constructive

²⁴ Johannes Linn, 'Trends and prospects of transatlantic economic relations', *Brookings Institution*, April 2004.

than those of defence officials.²⁴ But a second reason is the underlying strength of the profit motive. Flows of FDI surged in both directions across the Atlantic after 2003 – testifying to the resilience of commercial relations. Making

money proved a powerful transatlantic adhesive at a time when diplomatic relations were strained.

Domestic disenchantment with open markets

The trouble, however, is that the openness of the transatlantic economy may be more vulnerable to domestic political trends than to the state of diplomatic relations between European countries and the US. Every year, a US polling organisation, the Pew Research Centre, carries out a survey of public attitudes around the world. The results of its two latest surveys have been striking. On the surface, they are comforting. In the 2007 survey a majority of respondents in each of the 47 countries polled said that foreign trade was “a good thing” for their countries – an apparently solid endorsement of globalisation. But scratch beneath the surface and two worrying trends emerge. The first is that support for open markets is falling on both sides of the Atlantic – so much so in some countries that the majorities in favour of openness are now wafer thin. The second is that support for

²⁵ Pew Research Centre, 'Global attitudes survey', 2007.

international commerce is now lower in the EU and the US than in any other region in the world.²⁵

The decline in American citizens' support for open markets has been particularly dramatic. Although 53 per cent still think that free trade is a good thing, this is a lower share than that recorded in any other country surveyed – and is sharply down on 2002 when support stood at 78 per cent. Support for FDI is even lower than for trade – and it has fallen on both sides of the Atlantic since 2002. According to Pew's 2008 survey, the country most hostile to foreign investment is Germany, where 78 per cent think foreign ownership of domestic firms “a bad thing” (just 20 per cent think it a good thing). Large majorities hostile to foreign ownership are also to be found in the US (where 67 per cent think it a bad thing, and just 25 per cent a good thing) and France (67 per cent and 33 per cent respectively).²⁶ Given the importance of FDI to the transatlantic economy, the depth of hostility on both sides of the Atlantic to foreign ownership of domestic firms is worrying.

²⁶ Pew Research Centre, 'Global attitudes survey', 2008.

A protectionist drift in the transatlantic axis?

Public concerns about open markets are finding an echo in political rhetoric. In the US, the campaign for the Democratic presidential nomination was striking for rhetoric on trade that echoed Ross Perot's jeremiads against the “giant sucking sound” of jobs moving to Mexico if the North American Free Trade Agreement (NAFTA) was signed. During the campaign, Hillary Clinton and Barack Obama competed in their rhetorical hostility to free trade. In a debate in Cleveland in February 2008, Clinton argued that the US should opt out of NAFTA unless core labour and environmental standards could be renegotiated. Obama agreed, saying that the threat of opting out was essential to ensure that labour and environmental standards were enforced.²⁷ Campaign rhetoric can be

dismissed as just that – particularly when it is held in a struggling blue-collar city such as Cleveland. But rhetoric on the stump can harden into commitments which politicians feel they must honour.

²⁷ Sallie James, 'Race to the bottom? The presidential candidates' positions on trade', *Cato Institute*, April 2008.

Anyway, Obama's voting record when he was a senator in Congress suggests that his campaign rhetoric on NAFTA reflects his true views on trade. He is, for example, an opponent of the Central American Free Trade Agreement (CAFTA). Opposing a PTA is quite compatible with being a free trader – as chapter four argued. But the evidence suggests that Obama is a fair trader, not a free trader. Manufacturing jobs are being lost, he believes, because the US's trading partners are not 'playing by the same rules'. His views on labour and environmental standards have, in fact, been quite consistent. He has argued that they should form part of negotiations in the WTO (a position to which developing countries are bitterly opposed). There is every indication, moreover, that the US Congress, which is now dominated by the Democrats, shares many of Obama's views on trade. Many Democrats are close to organised labour and have been voting against FTAs for years.

Most of the arguments that are regularly heard in the US sound familiar to European ears. Since 2004, the EU has admitted twelve additional members to its ranks – mostly poorer countries formerly belonging to the Communist bloc. These countries have had to endure the same populist brickbats as the Mexicans in NAFTA. Politicians of all stripes in the wealthy old member-states regularly blame unemployment on 'unfair competition' in the new members (conveniently ignoring that unemployment was already high before they joined and that it declined after they did so). The belief that unemployment is caused by companies closing plants in the wealthy West to take advantage of lower wage costs and weaker labour and environmental standards in the East is now firmly established in the public mind. In France, for

²⁸ A recent example of the genre is Emmanuel Todd, 'Après la démocratie', Gallimard, 2008.

example, it is rare to hear a public discussion of unemployment without some reference to offshoring or 'social dumping'.²⁸

Are fears of open markets justified?

What explains the recent decline in support for open markets? On each side of the Atlantic, the reason is broadly the same. It is the

fear that globalisation is a zero-sum game that Americans and Europeans are destined to lose as emerging economies with large labour forces and low wages become increasingly integrated in the world economy. Globalisation is blamed for destroying jobs, depressing wages and widening income inequalities in the developed world. The same arguments feed public debates on both sides of the Atlantic. Manufacturing jobs are said to be disappearing because firms are moving factories to take advantage of low wages in poorer countries with no labour or environmental standards. Service-sector jobs are heading the same way, abetted by advances in modern communications. And income inequalities are rising in the developed world because workers face competition from cheap imports and fear pricing themselves out of a job.²⁹

²⁹ Gabor Steingart, 'The war for wealth: The true story of globalisation, or why the flat world is broken', McGraw Hill, 2008.

Many of these claims are plausible because they rest on real world evidence. Jobs in the manufacturing sector are declining. Some American and European firms are relocating to emerging economies to take advantage of lower wages. And income inequalities have risen over the past 20 years in the developed world. The question is: to what extent does globalisation explain these trends? The answer is: not nearly as much as is generally believed. The reason is that there is another force at work that rarely gets mentioned in public debate: technological change. This is unfortunate because the evidence suggests that technological change is a more powerful explanation than globalisation for the losses of jobs in manufacturing and the widening of income inequalities in the EU and the US. Globalisation has played a part in both of these trends. But technological change has been the dominant factor: how the EU and the US produce has been more important than what they produce.

Consider the fall in the manufacturing sector's share of GDP and employment. Many believe that this reflects the developed world's 'failure to compete' with emerging economies – and that the trend would be arrested if more protective trade policies were adopted.

³⁰ Daniel Ikenson, 'Thriving in a global economy: The truth about US manufacturing and trade', *Centre for Trade Policy Studies, Cato Institute, August 2007.*

This story is difficult to reconcile with the facts. In 2006, US manufacturing output reached its highest level ever in real terms – despite the surge in imports from China.³⁰ So why is manufacturing's share of GDP declining? The answer is that as households

become wealthier, they spend more of their income on services. What of job losses? Manufacturing jobs have unquestionably been lost as a result of trade. But the main reason they are declining is that productivity in manufacturing has been rising faster than output. So declining employment in manufacturing is primarily a sign of the sector's strength, not its weakness. And it would occur even if the US or the EU hid behind protective trade barriers.

Similarly, most research indicates that technological change has contributed more than globalisation to the increase in income inequalities in the developed world. The EU and US are economies that place a growing premium on highly skilled workers: on both sides of the Atlantic, the wages of skilled workers have risen relative to the wages of the less skilled. If trade were responsible, the trend would be concentrated in internationally-exposed sectors. It is not. And if technological change had not been responsible, employers would have an incentive to replace highly skilled (but expensive) workers with lower skilled (but cheaper) ones. This has not happened. It is, of course, possible that China's growing integration into the world economy is increasing trade's influence on income inequalities.³¹ Even so, trade still plays a smaller role than

³¹ Paul Krugman, 'Trade and wages reconsidered', *February 2008.*

technological change. Most studies suggest that trade only explains about a fifth of the rise in income inequalities in the developed world.

Why protectionism is not the answer

Why is protectionism a perennial temptation? Part of the answer is that it is much easier for politicians to blame impersonal forces outside their control than to design domestic policies for which

voters would hold them to account. Yet the evidence points to the overwhelming importance of domestic policies and institutions in determining economic and social outcomes. Countries which are serious about creating jobs or reducing income inequalities should be looking to reform education, labour and welfare policies – not raise protective trade barriers. In the EU, the Nordic countries have shown that a judicious mix of flexible labour markets, outstanding education systems, and generous (but conditional) welfare provision can produce enviable social outcomes – and populations at ease with open markets.³² Their example is one that other countries in the transatlantic area could learn from.

³² Philip Whyte, 'Why free markets have little to do with inequality', *Financial Times, June 2nd 2008.*

Politicians on both sides of the Atlantic should resist succumbing to the populism that blames external scapegoats for domestic problems. And they should have the courage to explain that globalisation is not primarily responsible for many of the trends that Americans and Europeans worry about. Chinese imports are not the main explanation for falling employment in the manufacturing sector. In any given year, job losses that result from imports or offshoring represent only a tiny share of the overall number of jobs lost in an economy – so they generate more publicity than they deserve. Besides, it is perverse to worry about the impact of globalisation on jobs. Surging imports from China did not prevent the unemployment rate in the EU from falling in 2007 to its lowest level since the early 1980s. And while unemployment is now rising sharply on both sides of the Atlantic, the cause is the impact of the international financial crisis on the real economy – not China's integration into the world economy.

7 Conclusion

This report has argued that the EU and the US share the world's largest commercial relationship, but that various obstacles, at and behind the border, still gum up bilateral trade and investment. Removing these barriers would deepen their bilateral relationship and increase the economic benefits they derive from it. For much of the period since 1945, Europeans and Americans relied on multilateral trade agreements to free up their commercial links. Since the early 1990s, however, the two sides have developed bilateral institutions to tackle regulatory barriers behind borders. As a result, transatlantic barriers are now tackled by two parallel processes: the traditional multilateral one, and a newer bilateral one. To date, these processes have been broadly complementary. The EU and the US should make sure they remain so. This means, among other things, eschewing the temptation to conclude a discriminatory bilateral trade deal to exert leverage in the Doha round.

Europeans and Americans should continue supporting the multilateral economic institutions they built – not undermine them at a time when emerging markets are increasingly embracing them. Exercising leadership may be more difficult in a multipolar system with so many new economic powers. But the EU and the US need to summon what reserves of leadership and imagination they can still muster. This means doing all they can to bring the Doha round to a conclusion. Even if they succeed, however, Doha will do less than previous rounds to liberalise trade across the Atlantic. So regardless of the outcome of the Doha round, the two sides need to think hard about alternative ways to reduce their bilateral tariff barriers to trade. One option they could consider would be to liberalise trade plurilaterally within the

WTO: the EU and the US could, for example, explore the possibility of forging a coalition of the willing in the WTO to reduce all remaining tariffs on manufactured goods to zero.

Bilateral initiatives between the EU and the US should be limited to the painstaking task of reducing the regulatory barriers that interfere with transatlantic commerce. Progress to date on this front has been frustratingly slow. But the regulatory convergence agenda is not entirely quixotic and is worth persevering with – not least as barriers behind borders now present significantly greater obstacles to transatlantic trade and investment than tariffs. Since tariffs on most transatlantic trade are already low, trade facilitation measures, such as improving customs procedures, are likely to do more to increase transatlantic trade than cutting all remaining tariffs to zero. Neither politicians nor the media usually take much interest in the transatlantic regulatory convergence agenda. This is not altogether surprising, given how dull and technical many of the underlying issues are. But given the economic pay-off from lowering such barriers, the agenda deserves more attention than it receives.

A programme to forge ahead with further market opening may sound utopian at a time when the world economy faces its deepest crisis in 80 years. Rhetorically at least, world leaders have made much of the need to avoid a repeat of the 1930s (when the US Congress passed the Smoot-Hawley Tariff and the US's trading partners retaliated by erecting tariffs of their own). In November 2008, for example, the G20 adopted a declaration rejecting protectionism. Its members undertook to refrain from raising new barriers to trade and investment “within the next twelve months” and “instructed” trade ministers to bring Doha to a successful conclusion before the end of 2008. Words, however, are cheap. Within weeks, the head of the WTO, Pacal Lamy, decided not to convene a ministerial meeting on the grounds that an outline deal was still well out of reach. And several members of the G20 had raised tariffs and other import barriers.

Could protectionist pressures start weighing on the transatlantic axis? Possibly. True, there is little risk of the EU or the US increasing their tariffs, because neither has much ‘water’ to play with: unlike many developing countries, the tariffs that the EU and the US apply are almost identical to their maximum bound rates under WTO agreements.³³ There is therefore little scope for the EU and the US to raise tariffs without breaking their WTO commitments. But there is a danger that the two sides could resort to non-tariff measures. ‘Buy American’ clauses found their way into the Obama administration’s draft fiscal stimulus programme. Having approved bail-outs of banks, politicians on both sides of the Atlantic have faced demands to support firms in sectors such as automotive manufacturing. And anti-dumping cases could proliferate as economic activity contracts and job losses mount. Against this backdrop, simply resisting demands for protection would be an achievement in itself.

³³ Patrick Messerlin, *Walking a tightrope: World trade in manufacturing and the benefit of binding*, German Marshall Fund policy brief, 2008.

Import barriers are economically irrational. They ensure that domestic resources are used inefficiently. They subject domestic consumers to higher costs. And by raising input prices, they tend to lower output and employment in downstream industries. The overall costs of protection can be extraordinarily high. One estimate in the US suggests that the cost to the economy per job ‘saved’ is three times higher than the wages paid to workers in those jobs.³⁴ But import barriers are not just irrational. They are also ineffective instruments for dealing with the problems they are intended to tackle. The idea that trade barriers are a solution to rising income inequalities or to the loss of manufacturing jobs in the developed world is hard to reconcile with the evidence. Since globalisation is not the main cause of falling employment in manufacturing or rising income inequalities, it is hard to see how either of these trends would be reversed by a protectionist retreat behind national borders.

³⁴ Robert Krol, *Trade, protectionism and the US economy: Examining the evidence*, Centre for Trade Policy Studies, Cato Institute, September 2008.

8 A response: Why the multilateral trading system must take priority

Dick Cunningham & Iain MacVay, Partners, Steptoe & Johnson

Philip Whyte's paper 'Narrowing the Atlantic: The way forward for EU-US trade and investment' makes a strong and well-reasoned case that the transatlantic trade relationship remains important, and that broader global issues should not completely distract the US and EU from the important task of improving that relationship and removing barriers to transatlantic trade.

Also worth praising is the emphasis on reducing regulatory barriers. Indeed, the paper could have made the point that this is a particularly propitious time to seek greater regulatory consistency and co-ordination, given the entry to office of a US government that is significantly less committed to doctrinaire free market economics than was the Bush administration.

The paper rightly calls attention to the importance of including services trade in any overall analysis of the trade relationship. But there is some concern that it could be read as belittling the importance of trade in merchandise. The US and Germany are among the global leaders in manufacturing exports and other EU countries still have major international manufacturing industries, especially in high technology products ranging from sophisticated capital goods to medical devices, pharmaceuticals and emerging green technology. We do not, therefore, agree with the statement in the paper that "Services, not manufacturing, will drive the future growth of transatlantic FDI."

We fully endorse, on the other hand, the strong message of avoiding protectionism and of not blaming economic ills on globalisation. The political temptation to retreat from the multilateral trading system that has brought hundreds of millions out of poverty in the past 50 years must be resisted at every opportunity, and this paper offers a good opportunity to emphasise this message.

The problem with focusing trade policy on the transatlantic market

But this brings us to an over-riding concern that we have about the report. Despite the inclusion of admonitions that the US and EU should continue “supporting the multilateral institutions they are building” and that they should be “doing all they can to bring the Doha round to a successful conclusion,” the paper’s overall themes are that:

- ★ progress toward multilateral trade liberalisation is largely at an impasse;
- ★ resistance to globalisation has been rising in both the US and the EU, a trend which the current global economic downturn could exacerbate;
- ★ and that the US and the EU should therefore shift their emphasis away from multilateralism by liberalising transatlantic trade and forging ‘coalitions of the willing’ in the WTO (in the form of plurilateral agreements).

The themes of transatlantic focus and plurilateralism among leading, and willing, trading countries (about which there is further discussion below) are at the core of the paper and have been picked up in the early thinking of influential thinkers around the new US administration and in the EU. The transatlantic theme and possibly that of plurilateralism could, if acted upon by the US and the EU, lead to a damaging shift away from the difficult task of maintaining the multilateral rules-based trading system.

We therefore regard this thematic core of the paper as extremely unfortunate and feel that it is advanced at precisely the wrong time – not only because of its echo in the new administration’s thinking but also because of the current state of the international economy. Now, more than at any time since the 1930s, the economic challenges are global in nature. Moreover, these global problems are inextricably bound up with trade flows, and particularly with trade between surplus countries and deficit countries. Addressing the massive imbalances that now exist should be the focus of US and EU trade policy, and that necessarily means pressing for liberalisation at a multilateral level.

To be more specific on this point, we feel that the paper does not fully address the two key features of today’s immensely troubled economy.

The first is the emergence over the past two decades of massive imbalances between countries with high rates of savings which have built their economic growth on exports, and countries with low savings rates (even dis-saving) which have artificially stimulated domestic demand by massive borrowing. Domestic demand growth in the deficit countries – notably the US and the UK – will inevitably have to ‘re-set’ to lower levels. In the short term, governments in the deficit countries are attempting to revive domestic demand through massive fiscal stimuli, but this is at best a temporary stop-gap and indeed may not work at all. In the meantime, surplus countries like China, Germany, Japan and Korea have been hard hit by the collapse of demand in the deficit countries. In the long run, the necessary solution must be to unwind these global imbalances. China and the other surplus countries must reduce savings and shift to a growth model that is more reliant on domestic consumption. Meanwhile, deficit countries such as the US and the UK must rebalance their economies, notably by increasing their domestic savings rates.

The second key feature of the global economy is that the developing world is increasingly driving world demand for agricultural and

manufactured goods. However, many developing countries also maintain substantial barriers to imports. These barriers must be a focus of trade liberalisation if current-account deficits in parts of the developed world are to narrow. Initiatives that do not address these barriers in developing country surplus countries are not appropriate to the current economic climate.

Viewed in this light, the US and EU do have a commonality of interest, but not in the way Philip Whyte's paper suggests. While it is important to continue with efforts to reduce regulatory and other barriers that inhibit transatlantic trade, such efforts will do nothing to reduce the global imbalances that lie at the heart of the current economic crisis.

The need for a transatlantic focus on multilateral liberalisation

The US and EU need to develop a united approach to trade negotiations that will bring about a manageable transition to a trading system that is more nearly in balance. This will require, among other things:

- ★ ensuring enough stimulus to cushion and bring to an end the present collapse in demand;
- ★ rebuilding the consensus for pursuing trade liberalisation to rectify global imbalances, with an emphasis on removing barriers to imports through the enforcement of existing rules and the negotiation of new rules (preferably under the auspices of the WTO);
- ★ avoiding protectionism (as much as possible), which would be counterproductive – particularly if import barriers in countries with large external surpluses are to be removed;
- ★ and eliminating trade-distorting agricultural supports (in the

US) and opening agricultural markets (primarily in the EU), so as to encourage surplus countries to further open their own markets.

This strategy could be seen as tilting against windmills, running directly counter to the protectionist, anti-globalisation drift of domestic politics in both the US and Europe. That concern is legitimate but fails to take account of two points.

The first is that although political leadership will be needed for this strategy, the academic and business communities need to provide the intellectual ballast to support such acts of leadership. Political 'will' does not arise solely from the instincts of leaders but depends on active support from key stakeholders, especially in the current environment where the protectionist siren is so alluring. Political leaders today find themselves in uncharted territory in their efforts to deal with, and to find the right policy prescriptions for, the most serious economic challenges the world has faced since the Great Depression. Surely the goal must be to encourage our leaders to take bold action – not to cave in to domestic pressures.

Second, a new administration has entered office in the US. It is still groping for an understanding of how trade fits in with its other policies. Yes, it faces constituencies that want protectionist solutions. And President Obama said some things on the campaign trail that seemed sceptical of trade agreements (although not with respect to multilateral liberalisation). But the trade debate within the Obama administration is still in its infancy. So it is critical that as many voices as possible argue in favour of the rules-based multilateral system. An administration that recognises the importance of multilateralism will be more likely to show leadership in the WTO. And US leadership will be critical in 2009 – particularly given upcoming elections in India and changes in the EU (where a new Commission is due to take office and elections to the European Parliament are to be held).

Early indications of President Obama's trade policy direction

The president's trade policy agenda, issued on 27 February, as well as statements by the new United States Trade Representative (USTR), Ron Kirk, make it clear that the initial priority for trade policy will be to "promote adherence to the rules-based international trading system". The administration has made it clear that it intends to make sure that existing rules are enforced.

Of course, a rules-based international trading system requires all members to accept its importance. Failure to accept the need to enforce rules, or to comply with the results of dispute settlement procedures brought under the system, could lead to damaging tit-for-tat disputes and the risk of retaliatory trade sanctions. Leaders of the international business community have a big role to play in identifying barriers and helping governments to build the case against them.

The president's trade policy agenda also points to the need to address the kind of "behind the borders measures and other non-tariff barriers" to trade in goods and services addressed in the CER's report. The agenda highlights the need to "negotiate for improved transparency and due process in our partners' trade practices and policies, including government procurement and the crafting of market regulations." And it specifically points to the need to "pursue advances in trade facilitation and consumer product safety, through plurilateral negotiations if appropriate". (The option of plurilateral arrangements will be further addressed below.)

The agenda also makes clear, however, that trade policy will form part of the president's strategy of "reorienting our economy to meet today's challenges – energy, environment and global competitiveness". Trade policy will therefore be part of a 'tool kit' to address such challenges. Crucially, the agenda states that "We should ensure that climate policies are consistent with our trade obligations, but we also should be creative and firm in assuring

that trade rules do not block us from tackling this critical environmental task." In other words, there is a danger that if the current structures of multilateral trade hinder rather than help the efforts to tackle the challenges identified by the president, those structures will be overridden.

It is precisely at this juncture, therefore, that the new US president and other leaders around the world need to be hearing the right message from respected sources such as the CER. A message of "multilateral liberalisation is politically too difficult, so let's lower our sights and emphasise the transatlantic issues" is exactly the wrong message. It is important to emphasise instead the need to make the multilateral system work, notably by supporting and enforcing existing rules and by holding creative negotiations that extend liberalisation in as many countries as possible – especially those with current-account surpluses which have the capacity to inject demand into the current global economy. The rules-based multilateral trading system must be incorporated into economic policy as part of the solution to the big problems facing the international community; otherwise, it risks being sidelined as part of the problem.

A postscript on plurilateral initiatives

As suggested by the analysis above, we have a strong preference for US-EU trade policies that focus on multilateral trade liberalisation. Thus we would like to see a bold new initiative in which the US and the EU improved their offers in Doha, contingent on access-improving responses from Brazil, China, India and others.

However, it is also prudent to be developing a 'Plan B', to move the liberalisation agenda forward as quickly as possible in the event that the WTO's institutional limitations prove too difficult to overcome. In that regard, a plurilateral alternative is worth considering. But the report's discussion of this alternative both misunderstands the type of plurilateral initiatives that are now under consideration and fails to address what we see as the problem that needs to be solved.

The report envisions the US and the EU working to put together a ‘coalition of the willing’ to reduce all tariffs on manufactured goods to zero. But the paper adds that

“... a plurilateral agreement would have to meet a key condition: its benefits would have to be extended to all WTO members, whether they had signed up to the deal or not. Anything less would make the agreement look like a giant preferential trade agreement – and would therefore be inconsistent with the core principle of non-discrimination.”

This is not the type of plurilateral initiative that is likely to gain political support if the Doha negotiations are not concluded. In both the US and Europe, there is substantial resistance to the current status of Doha negotiations, precisely because the US and EU do not think they are being offered new market access from developing nations. This explains why the president’s trade policy agenda makes it clear that “it will be necessary to correct the imbalance in the current negotiations”, citing in particular the flexibilities available to developing countries in the current draft texts.

A plurilateral deal among developed nations that offers to non-participating developing countries a ‘free ride’ – full access to the US and EU manufactured goods markets without any improved access for US and EU exports – is going to make it very difficult to gain support for the acts of political leadership needed to move the trade policy agenda forward. Instead, political leaders will be attracted to a plurilateral agreement that confers duty-free access only on those countries that sign the agreement. Countries that wish to join the agreement will be free to do so, but only if they make the same commitment to tariff elimination.

The report’s concern over this approach is certainly understandable. Assuming that the ‘willing’ participants are predominantly developed countries, the developing world would see this as precisely the sort of exclusion from the big boys’ club that they have railed

against since (at least) the failed Seattle ministerial. Moreover, a plurilateral agreement limited to manufactured goods would not meet the requirement in GATT Article XXIV that a free trade agreement or a regional trade agreement must eliminate tariffs or other restrictions on substantially all trade.

But it is important to keep in mind the goal we seek to achieve: namely, supporting an open trading system at a time of contracting trade flows and unsustainable global imbalances. The imperative of reducing global imbalances by increasing exports from countries with external deficits (instead of the protectionist alternative of reducing imports from surplus countries) is – as a trade issue – a matter of enforcing current market access rules, negotiating tariff reductions, and lowering non-tariff barriers in the countries that have unsustainably large trade surpluses. Many of the most trade restrictive tariffs and other barriers to trade that exist today are in developing countries. So any trade policy initiative that does not have any impact on these barriers is not going to address effectively the problems facing the global economy.

From this standpoint, there would be some logic to a plurilateral deal among developed countries that did not extend tariff elimination to non-participants, but that invited the latter to join. Even better would be a plurilateral agreement that included China and other developing countries with large current-account surpluses as participants. To that end, it would be much better that the plurilateral agreement extend beyond manufactured goods to agriculture and perhaps also to services. Nothing like this is currently under consideration. But the gravity of the current economic crisis may require us to bite some bullets.

There are grave dangers arising from this kind of plurilateral approach – particularly, as alluded to above, in respect of GATT Article XXIV and in terms of the institutional arrangements of the WTO. It may be possible to gain acceptance of a plurilateral deal within the confines of the WTO structures. However, if plurilateralism becomes necessary

because the multilateral approach through the WTO has been exhausted, there may not be the time or the will to integrate plurilateral negotiations with the institutional structures currently in place. So it is important to ensure that new rules be extended as widely as possible at the multilateral level and cause as little disruption to the existing rules-based system under the WTO.

Conclusion

The important challenge for the business community, think-tanks and others in the policy community is to ensure that the rules-based multilateral trading system survives the pressures it is currently coming under. Our focus should therefore be on supporting market opening strategies in as many surplus countries as possible through a combination of enforcement efforts and negotiation. Making sure that the current multilateral system works well means ensuring that agreements are, as far as possible, consistent with multilateral rules and embrace as many countries as possible. In the absence of progress at the multilateral level, a very carefully crafted plurilateral negotiation strategy could serve to support rather than undermine the multilateral system, by taking some of the pressure to move forward off the WTO as a whole. The ultimate goal of such a strategy would, however, be to integrate the new rules with the multilateral regime based on the WTO at the earliest opportunity.

The US and the EU need to work together to ensure that liberalisation continues to progress in the transatlantic market. They also need to find common ground on addressing the need for further liberalisation and on resisting the dangers of protectionism. Transatlantic regulatory reform may be an important element in the wider trade policy agenda. But the core of that agenda must be focussed on the bigger picture of maintaining and improving the rules-based multilateral system.



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NARROWING THE ATLANTIC

The way forward for EU-US trade and investment

Philip Whyte

The financial crisis has provoked a dramatic contraction in world trade. With economic activity declining and job losses rising, protectionist pressures are mounting. The EU and the US, which have built their mutual prosperity on open markets, must make sure they resist such pressures. But holding the line against protectionism is not enough. The EU and the US must recover their appetite for market opening and lower the barriers that still impede their commercial relations – with each other and the rest of the world. This means working bilaterally to reduce the regulatory obstacles that still gum up trade and investment flows across the Atlantic; and providing new impetus to trade liberalisation efforts within the WTO.

Philip Whyte is a senior research fellow at the Centre for European Reform.

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