

IS A US-EU FREE TRADE AGREEMENT DESIRABLE?

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If there is consensus among economists, it is around the positive benefits of trade. In this paper, Clíona Nic Dhomhnaill challenges this consensus. The essay presents the economic benefits of the EU and the US signing a Free Trade Agreement before highlighting the possible detrimental effects of such an agreement on the rest of global trade. The essay concludes by strongly questioning if such an agreement will have an overall positive impact, or if it will rather serve to undermine the progress of global free trade.

Introduction

Recent dialogue emanating from both sides of the Atlantic has indicated that a free trade agreement between the United States and the European Union is a significant possibility, backed up by genuine political will. There has been widespread praise for this development, which is justified by the potential stimulus to GDP it will provide; and on the surface, this appears to be a positive step for the global economy and for the discipline of economics. However, a closer inspection indicates that this may not be as reformative as it seems, primarily because bilateral trade agreements imply discrimination against non-member countries. This essay aims to show that there are compelling disadvantages to such arrangements by discussing the static effects of free trade agreements (FTAs), i.e. trade creation and diversion, and the dynamic effects, i.e. their impact on multilateral trade negotiations and the Doha Round. Before this, the motivations for creating a transatlantic free trade area (TAFTA) will be examined. Finally, some of the political issues that arise where FTAs are concerned will be discussed, although without losing sight of the question of whether TAFTA is economically desirable. The purpose of the essay is not to discuss whether we should have free trade, but rather to objectively examine whether free trade between individual nations is conducive to the ultimate, widely proclaimed goal of global free trade. As Schott (1989) points out, each FTA is very different and it is difficult to generalize the conclusions on the value of FTAs, thus this essay will attempt to apply these arguments to the US-EU case.

Why a Free Trade Agreement and why now?

The post-war years were marked by endeavours to reduce tariffs and encourage interna-

tional trade, in particular through the signing of the General Agreement on Tariffs and Trade (GATT). Since the 1980s however, there has been a significant shift away from the multilateral trade negotiations, now conducted by the WTO, towards bilateral free trade agreements. This has been driven by the softening of the US stance on bilateralism in what Bhagwati (1991) has coined the “Second Regionalism”, spearheaded by the US FTAs with Canada and Mexico.

After years of vague suggestions of improving the economic relationship between the EU and US, a transatlantic summit in November 2011 finally yielded definitive progress on the issue. The establishment of a High Level Working Group on Jobs and Growth was announced, tasked with delivering a report on a potential Free Trade Agreement between the US and EU. After some delay, the report was published in February 2013, providing an emphatic endorsement of a proposal which would include agreements on trade, investment, regulatory issues and the “development of global rules”.

The superficial logic behind a deal is obvious: the EU and US are each other’s largest trading partners and together account for almost one third of global trade flows (European Commission, 2012). The political will for creating an FTA is apparent, with the European Commission stating that it is a “key priority” to negotiate new FTAs in order to open further market opportunities for European firms (European Commission memo 2012) and US Secretary of State Hillary Clinton indicating the United States’ desire to progress beyond most favoured nation status with the EU (Clinton 2012). The fundamental motivation (as far as has been publicly disclosed) is to take advantage of the stimulus to GDP that an FTA would bring, which the ECORYS study (2009) commissioned by the European Commission has estimated at €122bn for the EU and €41bn for the US. This is even more significant now, against the backdrop of US sequestration and the European sovereign debt crisis, than it was when the proposal first came to public attention in the 1990s. Further fiscal stimulus is scarcely an option given the already high debt levels on both sides of the Atlantic; therefore a boost to GDP through trade would be greatly desirable. If ever there were a time for TAFTA, it is now.

On a multilateral level, there has been a distinct lack of progress towards liberalising trade. The World Trade Organization (WTO) initiated the current round of negotiations, the Doha Round, in 2001, and talks have stalled in recent years, with little indication that the impasse will be broken anytime soon. Baldwin and Jaimovich (2012) refer to the “slow multilateralism” that has characterised the development of world trade. The question this essay aims to answer is whether the Doha Round, and multilateralism in general, will be negatively impacted by a US-EU FTA. The logic is that bilateral agreements violate the WTO’s most favoured nation principle, by which all WTO member countries should abide.

Theoretical Background

To begin the analysis, we shall first define preferential and free trade agreements. Preferential trade areas include free trade areas, customs unions and common markets. A free trade area is defined as a group of countries with free trade between them, but retaining independent systems on trade with non-members (Black, Hashimzade & Myles, 2009). The most common form of preferential trade agreement (PTA) is a free trade agreement (FTA) (Bhagwati, 2008), and it is FTAs that this essay will focus on. Bhagwati (2008) postulates that we should habitually refer to FTAs as PTAs, so as to indicate that the emphasis of FTAs is on preferential treatment and not on free trade ideals. In comparison, the core principle of multilateral trade liberalization, i.e. WTO talks, is that no country is left out or discriminated against. Thus FTAs and multilateralism are inconsistent with each other.

Secondly, the theoretical justification for free trade agreements shall be examined. Bilateral trade relations create a prisoner's dilemma scenario. If countries do not have any kind of cooperation agreement, the Nash equilibrium of the payoff matrix will be that both countries impose tariffs which are a suboptimal outcome for both and reduce global welfare (Feenstra and Taylor, 2008). This is to avoid a situation whereby the other country imposes a tariff while the home country does not, causing a term of trade loss and leaving the home country even worse off. A PTA facilitates a movement towards the optimal solution to the payoff matrix, whereby neither country imposes a tariff and global welfare is maximised (within our simplified model). It does so by providing a platform upon which countries can build the level of trust necessary to facilitate cooperation and prevent tariff wars.

The controversial issue with PTAs is that there are actually two opposing forces at work, trade creation and trade diversion, as first pointed out by Jacob Viner (1950). Trade creation is the increase in trade due to the removal of tariffs and non-tariff barriers, while trade diversion is the mechanism by which imports and exports are not allocated in the most efficient way possible as tariffs distort the world market and encourage trade with a specific country. If this country is not the most efficient producer of a good, importing its goods is diverting trade away from its efficient allocation and global welfare is reduced. If trade diversion outweighs creation, then the overall welfare effect of PTAs is negative and they should be avoided, before the effects on multilateralism are even considered.

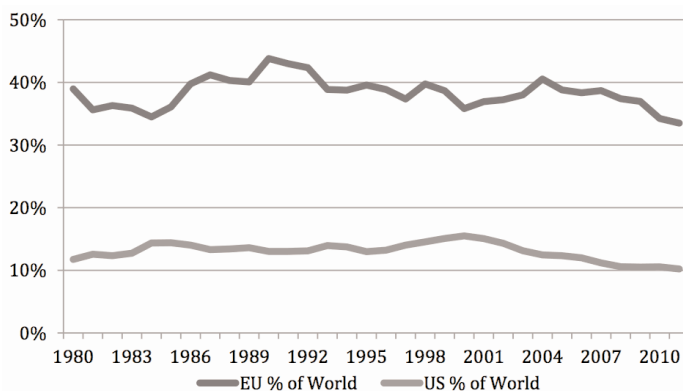
Would Trade Creation Outweigh Trade Diversion?

Wonnacott and Lutz (1989) claimed that trade creation will exceed diversion if the two countries involved are "natural trading partners". A glance at the data does suggest that this condition holds in the US-EU case - they are each other's largest trading partners, with the US accounting for 13.8% of the EU's overall trade and the EU accounting for 17.8% of US trade (European Commission, 2012). This implies that trade creation should

be high and hence justify the creation of TAFTA (at least under static conditions of analysis). However, Bhagwati (2008) warns against using this as the only measure as such figures could be inflated by previous preferential treatments, in this case for example initially low tariffs within the western world. Medvedev (2010) performs a regression of the impact of PTAs on trade flows between the member countries and concludes that North-North PTAs do not have a statistically significant impact on trade, which reinforces the view that TAFTA would not lead to significant enough trade creation to justify its conception.

Rolf Langhammer (2008) offers a different perspective from which to assess trade creation. He plots the progression of US and EU shares in each other's and in world manufacturing trade over time and concludes that the decline in both since 1980, caused by the rise of manufacturing in developing countries, implies that trade diverting potential is higher today than it was, say, in 1980. Figure 1 provides data updated to 2011 on this, clearly indicating that the trend has continued, so it can be inferred that a US-EU FTA at this point would have even greater scope to divert trade from its most efficient sources and recipients. This method, while a useful heuristic, doesn't give any indication of the starting point level of trade diversion to which it is relative, thus is somewhat limited. Bhagwati (2008) also points out that if there is intense competition in an industry, even the removal of very low tariffs can cause trade diversion, as demand will be highly sensitive to the price changes caused by tariff reductions. This is particularly relevant in the US-EU case, where tariffs are already relatively low, with the average applied tariff at 4.8% in the US and 6.7% in the EU (Erixon & Brandt, 2011). Although a definitive conclusion cannot be ascertained, the overwhelming evidence appears to suggest that trade diversion would be higher; hence TAFTA would not be desirable.

Figure 1: EU and US Shares in World Manufacturing Trade, 1980-2011

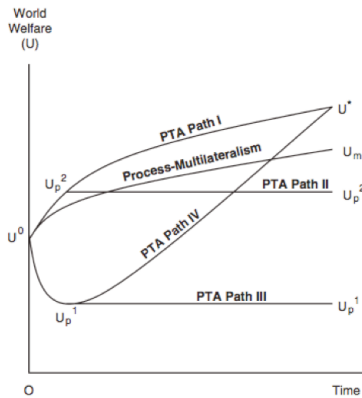


Source: WTO Statistics

The Dynamic Implications of FTAs

More important to this essay are the long-term effects of preferential trade agreements, specifically the effect they have on multilateral trade negotiations. The dynamic argument in favour of a FTA is that non-member countries will be incentivised to join, to the point where the enlargement ultimately leads to genuine free trade (Baldwin, 1993). In this case, the final outcome is the same as that of successful multilateral negotiations thus if this theory holds, PTAs help rather than hinder multilateralism. In fact, as Bhagwati (2008) shows with Figure 2, global welfare could in fact reach absolutely higher levels, i.e. U^* , through PTA-derived free trade.

Figure 2: Welfare Effects of PTAs versus Multilateralism



Source: Bhagwati, 2008, p.106

The question is thus which path is more likely - whether FTAs are a stumbling block or a stepping stone to global free trade (Bhagwati, 2008). Although some studies argue that multilateral agreements are not desirable, in particular Andrew Rose (2004), who argues that joining the WTO does not cause a significant increase in trade flows, it shall be assumed here that membership of the WTO increases trade. There are a number of factors that indicate that FTAs are detrimental to the multilateral ideal, and this essay will examine some of the most prevalent. The core issue, which leads to many other problems, is that FTAs are proliferating. Baldwin (1993) introduced the concept of the ‘domino effect’, whereby idiosyncratic preferential trade agreements are multiplied by a domino effect, incentivising other countries to request to join them, and ultimately leading to a new equilibrium consisting of larger regional trading blocs. Baldwin & Jaimovich (2012, p.4) further this argument by proving the statistical significance of ‘contagion’, defined as when “a government, which initially opposes a particular trade agreement, changes its mind due to a trade agreement signed by other nations”. Contagion operates through a channel

whereby the trade diverting effects of FTAs cause declines in the present value of firms' profits in non-member countries, leading governments to then seek FTAs as a defensive reaction. Their results also show that the more FTAs a country has, the greater the likelihood of it signing further new FTAs.

The evidence indicates that we cannot simply evaluate TAFTA as an individual arrangement, as it is likely to further encourage the spread of FTAs across the globe, creating an intricate web of heterogeneous trade agreements and patterns. This web is complicated not just by the many distinct agreements each nation has with other states, but also by the contrasting rules of origin and heterogeneous regulations in each treaty and country respectively. The High Level Working Group's interim report (2012) on TAFTA foresees this problem and claims any treaty would seek to develop rules which could also be applicable to multilateral agreements in future, and makes specific reference to "aspects of labour and environment". This implies that positive externalities could be derived which would simplify and possibly accelerate WTO negotiations by providing a framework that will have been tested by two leading trade nations. However, Krugman (1997) argues that countries should simply be left to choose their own standards and regulations as there is no economic foundation to the logic of such harmonization; the benefit of one country imposing certain standards is independent of whether other countries do the same or not. Therefore it can be argued that the TAFTA rules will not make a meaningful contribution to the likelihood of global free trade emerging, and in fact they could have a negative impact if the loss of utility derived from the reduced freedom of choice is taken into consideration.

Patterson (1988, p.354) claims this complex, "overlapping set of subsystems" created when FTAs proliferate leads to mistrust among nations. This undermines the entire logic of FTAs as described earlier, as the mechanism through which FTAs lead countries to a more desirable outcome than the Nash equilibrium in the payoff matrix of trade is the creation of trust between nations by signing a trade treaty. If FTAs cannot assure nations they are receiving the most favourable treatment from their partners, and in fact create further uncertainty, the incentive to engage in trade negotiations is greatly reduced. This could also create political tensions, which would reduce the likelihood of multilateral talks succeeding.

A general equilibrium analysis is undertaken by Melatos and Woodland (2007) to investigate which trade outcomes end up in the core allocation, i.e. are Pareto efficient and cannot be blocked by any coalition of agents, who in this case assumes the form of other trade outcomes, i.e. free trade, unilateralism or PTAs. They discover that global free trade is in the core allocation if countries are similar in terms of preferences and endowments, but the more dissimilar the countries' preferences or endowments are, the more likely that FTAs will "block" free trade and prove to be a stumbling block to multilateral trade liberalization. This leads us to infer that if the US and EU possess very similar

consumer preferences and endowments, global free trade will be in the core and TAFTA should not represent a stumbling block to the Doha Round. This is not implausible; although given the diversity within the EU itself is not guaranteed. To come to more definitive conclusions, data on the elasticity of substitution and the current factor content of trade in the US and EU would have to be collected.

The Political Economy Element of Free Trade Agreements

The political economy implications of FTAs are vast; this essay will examine selected key issues. An agreement of the nature of TAFTA, involving two hegemonic powers, would be quite unheard of in the modern era. In this sense, TAFTA doesn't follow the standard logic of FTAs as described by Baldwin and Jaimovich (2012), by which FTAs are generally formed for defensive purposes to reduce the discrimination imposed on them by other FTAs. The impact of TAFTA on the global distribution of political power could therefore be unexpectedly high.

In a speech on 9th November 2012, European Commissioner for Trade Karel de Gucht admitted his concern that the US presidential election campaign largely neglected the issue of the US relationship with Europe (2012), implying that the EU feels the US is the dominant power in their bilateral relations. This is reminiscent of Bhagwati's (2008) claim that one of the key reasons developing nations seek PTAs with hegemons is that they desire to keep the hegemon's interest in the region alive, particularly in terms of security. The estimates of the GDP effects of TAFTA reinforce the idea that the EU stands to benefit more, due the expectation that the EU would gain more from cheaper imports (ECORYS, 2009). If there are asymmetric incentives across the blocs, negotiations could be biased and remove focus from achieving the most economically efficient outcome.

We must allow for the possibility that the public perception of free trade could be transformed by TAFTA- if two of the world's largest trading areas show openness to complete trade liberalization, the political taboo surrounding free trade and the affinity with protectionism could finally be broken. Economists may have a chance to win over politicians who have ignored their calls for multilateral liberalization of barriers to trade. The reverse side of this possibility is that the third-party non-members disadvantaged by TAFTA, in particular China, could revolt against the idea of free trade. If the political balance between North and South were damaged, the Doha Round and future WTO negotiations could be significantly damaged.

Conclusion

It is by no means widely accepted in the discipline of economics that preferential trade agreements are inherently detrimental to the global economy; however there is significant evidence to suggest that widespread acceptance of the benefits of a US-EU Free Trade Agreement is questionable. It has been shown that, when evaluated on a static basis, FTAs

could be beneficial if trade creation is greater than trade diversion, although this appears unlikely to be true for TAFTA. Once the dynamic effects on multilateral trade negotiations and the political implications are considered, however, it is clear that FTAs are undesirable, and TAFTA is no exception. The resources of the respective politicians and institutions could be better utilised if directed towards reigniting and completing the Doha Round of WTO talks. Taking political economy into account provides no definitive stand either for or against TAFTA, thus not affecting our conclusion. This analysis could be furthered with data on the specific industries that would most be affected by TAFTA, e.g. agriculture or computers, which would help identify the winners and losers and thus the potential opposition from lobbyists and how to compensate them. There are still political hurdles to overcome, but the likelihood of TAFTA being realized is ever increasing, and so the issue of how to incentivise multilateral trade liberalization in the presence of a functioning transatlantic free trade agreement may soon become more pressing.

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