TTIP: A Transatlantic Bridge for Worldwide Gains

Lucian Cernat and
Nuno Sousa[1]

At a time when the global economy still faces challenging headwinds and many countries continue to struggle with high unemployment, the global trade agenda is seemingly at a crossroad, more divided than ever between multilateralism and bilateralism (regionalism). This dichotomy may seem obvious to many but the contradictory policy orientation is arguably less clear-cut than many believe. Rather than a strategic fissure in the approach to trade liberalisation it may be in fact reflecting a necessary adjustment to the increasing complexity of trade relations and to the requirements of a coherent and effective trade policy agenda.

Of particular importance have been the discussions about global value chains (GVCs), notably since the launch in 2010 of the Made in the World initiative by the former WTO Director General, Pascal Lamy. They have fundamentally shifted attentions to the need to better understand how trade and investment linkages between countries are nowadays being shaped. The recently released ground-breaking global databases like WIOD and TiVA showcase well their complexity, triggering a reflection about the role of trade policy in effectively promoting both imports and exports and in responding to the needs of large and small companies that are increasingly dependent (directly or indirectly) on multiple foreign markets and suppliers.

But, while from the WTO's 'Made in the World' perspective this definitely points to an agenda grounded on the importance of multilateralism, arguably the issue does not lend itself to a fully-fledged one-sided approach. In fact, the idea of a world economy increasingly organised along GVCs can also provide a compelling argument in favour of bilateral/regional trade arrangements that can be sufficiently comprehensive and deep in order to really make a difference in responding to the needs and aspirations of large multinational firms (that are at the forefront of GVC growth) as well as of those SMEs that see in the GVCs a means to jump onto the globalisation bandwagon. Furthermore, in some respects the growth of GVCs challenges some aspects of the long-standing rationale on the drawbacks of bilateralism. For example, the old Vinerian 'trade creation' and 'trade diversion' concepts need to be revisited in the light of the new quantification of trade according to the origin of the value added they contain (which can now and be easily gauged by looking at the WIOD and TiVA databases): in fact whenever new trade among FTA members contains value-added from non-members, there may be 'trade in value added creation' in the old concept of trade diversion.

Against this background what seems to be emerging in terms of global trade governance is what could prove to be the building blocks of a 'multilateral *chapeau*' along with an ongoing 'bilateral *renaissance*', paving the way to what many call the 'mega-FTAs'. The ones that grab the news headlines these days are the Trans-Pacific Partnership (TPP) negotiations, spearheaded by the United States, and the Trans-Atlantic Trade and Investment Partnership (TTIP) negotiations between the EU and the United States. Several other FTAs involving large trading partners are also in the making, like for example EU-Japan or EU-Canada FTAs.

In the mind of those convinced of the importance of multilateralism to promote sustainable and inclusive trade openness this new wave of mega-FTAs raises concerns. However, in the remainder of this paper, we will argue that this needs not be the case and in many respects the opposite conclusion might be true. And the key to this insight lays in the nature of deep and comprehensive of the future mega-FTAs (such as TPP

[1] European Commission. The views expressed herein are those of the authors and do not necessarily reflect an official position by the European Commission.

and TTIP), and on their relationship with the multilateral rules.

Deep bilateral integration and multilateralism

For several decades, the trade literature delved into the dichotomy between bilateral and multilateral approach to trade liberalisation. The debate mainly revolved around the economic theory behind preferential tariff reductions, and was often centred on trade diversion and trade creation effects. This reasoning is also deeply anchored in WTO legal texts and several key principles and provisions, being the GATT Art. XXIV the most relevant in this context. In addition, there was also the longstanding debate on negotiation dynamics and systemic effects, and about the role of FTA rules on the future development of multilateral disciplines.

These questions often concluded with 'it depends' kind of answers. So, what is new in the possible future interaction between mega-FTAs and multilateralism? Some might argue that while not much is genuinely new but there is a novel angle to this that can clearly add various interesting elements to the analysis.

One fundamental difference between 'old FTAs' and the new mega-FTAs is the size of the parties involved. Both TPP and TTIP are set to deepen trade and investment linkages across a very large share of the world economy. Their 'critical mass' and associated systemic implications are now not just theoretical conjectures but an impending reality. A second fundamental difference is their declared scope and level of ambition. Unlike most old FTAs, mega-FTAs are not primarily about reducing tariffs (which in the case of the United States and the EU are on average at very low levels). Instead, they have a very ambitious agenda on 'beyond the border' issues that affect a whole range of regulatory and non-tariff measures that are critical for the future GVC-driven competitiveness. Given that not all non-tariff measures and regulations are discriminatory trade barriers, and that not all regulatory barriers can (or should) be negotiated away the exact boundaries of this beyond the border agenda are still unclear. But what these FTAs eventually manage to achieve in reducing the costs of diverging regulatory processes and the type of policy instruments they will favour for this, matter for the rest of the world and for avoiding the fracturing of the global economy.

One of the most important implications related to size and level of ambition of the mega-FTAs, is that they may also spur greater trade integration well beyond the confines of their jurisdictions. Petri *et al.* (2012) – one of the most comprehensive and robust analysis of the estimated TPP effects – shows clearly that the launch of the TPP process coincided with a new impetus for further regional integration in Asia that could lead to sizeable economic gains. The TTIP can also be expected to trigger similar reactions elsewhere given its impressive economic potential.

TTIP: what are the economic stakes?

The CEPR (2013) study estimates that an ambitious and comprehensive TTIP could bring significant economic gains once it is fully implemented and the economies have had the time to adjust. These would amount to a 0.5 percent and 0.4 percent increase in EU and US GDP respectively relative to their levels without the TTIP in place. And, this is mostly due to increased trade. According to the study, total exports would increase by 6 percent and of 8 percent in the EU and in the United States respectively, or in other words, TTIP would bring an additional 220 billion and 240 billion euro worth of sales of goods and services for EU and US based producers, respectively. Total imports will increase by 5 percent in the EU and the United States, or 226 billion and 200 billion euros respectively. While the increase in bilateral trade is as expected the major driver behind the growth in trade activity: EU exports to the United States go up by 28 percent (or 187 billion euros) while EU imports from the United States will also increase by 159 billion euros. But, in addition it is important to note that EU and US sales to the rest of the world would also increase by over 33 billion and 80 billion euros respectively. EU and US imports from the rest of the world would go up by 67 billion and 13 billion euros.

These impacts were computed using GTAP data combined with the regulatory data from Ecorys (2009) and a 'traditional' CGE-based methodology, which despite its limitations remains state-of-the art for trade policy analysis. While they point to substantial gains these could well be qualified as conservative given that they are based on relatively cautious policy scenarios. Even the ambitious simulations (which the figures quoted in this paper refer to) are based on fairly restrained expectations that that non-tariff barriers (NTBs) in goods and services would be reduced by

25 percent and that public procurement barriers would be reduced by 50 percent. The tariffs on EU-US trade would be reduced to zero. Moreover, it is also important to note that standard CGE simulations underestimate the potential gains from the liberalisation of services as they only partly cover GATS modes of supply. Therefore, the impact of the liberalisation efforts under TTIP on FDI activity, a substantial part of trans-Atlantic economic exchanges (especially in services) remained outside the scope of the CGE analysis presented in that study.

TTIP and the rest of the world

There are two important takeaways from CEPR (2013) to consider in the reflections about the wider impact of TTIP: firstly, is that reducing NTBs is the crucial driver of the expected gains. As much as 80 percent of the total potential gains could come from cutting costs imposed by bureaucracy and regulations, as well as from liberalising trade in services and public procurement. Second, the TTIP would not only boost growth in the EU and the United States but also elsewhere. The study finds that the agreement would have a positive impact on worldwide trade and income, increasing income in the rest of the world by almost 90 billion euros. The benefits to the EU and the United States will not be achieved at the expense of the rest of the world.

The two findings above are intrinsically linked to one of the modelling of the spillover effects associated to NTBs reductions. More specifically, in the CGE simulations of the impact of TTIP direct spillover effects were taken into account to capture the extent to which lowering the cost of doing trade *via* reducing NTBs that the TTIP will achieve if EU and the United States can work together towards better trade rules and less regulatory divergence in the future, will also benefit other partners. To be more precise, as many companies around the world export to both Europe and the United States for many products they currently need to comply with two sets of standards and regulations, often requiring separate production processes. Any increased regulatory compatibility between the United States and EU should thus have a direct positive impact on exporters from these countries by reducing the fixed costs of supplying an integrated transatlantic marketplace. This argument is closely linked to the reality of what happened after the creation of the European Union's Single Market.[2] There is a good case to argue that the same can happen – though likely to a lesser extent – if rules across the Atlantic are made more compatible.

Moreover, the changes in regulation to allow market access to firms across the Atlantic will in some cases be bound to be *de facto* MFN in the sense that the legal changes to be introduced cannot discriminate suppliers from third countries. This is what could happen if, for example, the United States would agree to adopt UNECE car safety standards. With all this in mind, the model explicitly introduces the possibility that 20 percent of regulatory barriers are not removed for bilateral trade between the TTIP partners but also for any exporter to the EU or the United States.[3] In addition, CEPR (2013) also accounts for the possibility of an indirect spillover effect of TTIP on other countries resulting from the fact that the economic size of the EU and the United States is such that partner countries will themselves have an incentive to move towards any new transatlantic standards that TTIP creates. The result would be an improvement in market access conditions between the EU, the United States and those countries. It would also reduce trade barriers between those countries themselves. These are modelled at half of the 20 percent rate assumed for direct spillovers.[4]

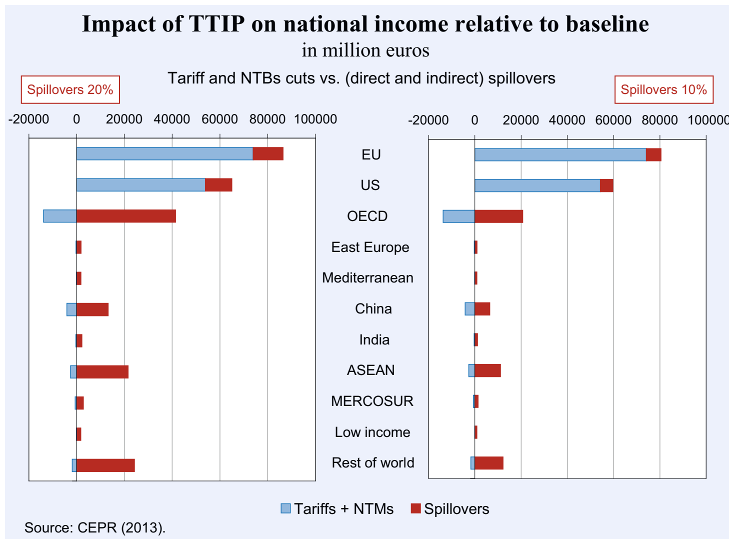
The exact magnitude of the direct and indirect spillover effect depends on many factors and in particular on the specific outcome of the ongoing TTIP negotia-

[2] Unfortunately, there is little empirical evidence of market access spillovers from regulatory convergence. Unsurprisingly the most telling evidence available comes from the only real example to date of a process of trade integration that was characterised by deep regulatory convergence across a significant economic block: the creation of the European Single Market. Head and Mayer (2011) show, using a gravity model approach that while the Single Market deepened the economic integration across Europe this was not achieved at the expense of third countries. On the contrary, they show that producers from Japan, and especially from the United States, also benefitted, albeit not in a uniform fashion across sectors. The authors suggest that a reduction of production costs due to the harmonisation and simplification of European standards as a probable explanation but their analysis stops short of exploring that hypothesis fully.

[3] This was modelled as 20 percent of the bilateral trade barrier reductions. For example, where we have a 5 percent trade cost reduction between the EU and the United States, there will also be a 1 percent trade cost reduction for third countries exporting to the EU and the United States. Simulations were also carried out setting the direct spillovers parameter at 10 percent in order to check the robustness of the overall results to the different orders of magnitude for the spillover effects.

[4] These indirect spillovers were modelled at 50 percent of the direct spillover rate. This means that, for example, for a 5 percent trade cost reduction between the EU and the United States, and with 20 percent corresponding direct spill-overs, we will have a 1 percent (direct spillover) reduction for third countries exporting to the United States or EU, and a 0.5 percent (indirect spillover) reduction for EU and US export costs to third countries, and for trade between third countries. If the direct spillover effects are set at 10 percent the reduction in trade costs between the EU and the United States and third countries, and for among third countries is set 0.025 percent.

Figure 1



Source: CEPR (2013).

tions. While this is hard to prejudge and assess *ex-ante,* considering two rather low spillover scenarios gives a sense of the importance of such effects and the sensitivity of the overall TTIP gains to the magnitude of spillover parameters. Beyond this *ex-ante* uncertainty, the fact remains that at least part of the cost savings achieved by the reduction of NTBs (notably those associated with the streamlining of EU-US regulations and the convergence of EU-US standards) will not be limited to the bilateral trade flows largely explains the increase of EU and US exports to the rest of the world. It is also largely driving the 1.04 percent increase of exports from the rest of the world, and for the 0.14 percent increase in the GDP in the world economy (minus the EU and the United States). Note that these gains are well spread out across the global economy but they are particularly noticeable in the regions that are most dependent on trade like the ASEAN. In contrast, CEPR (2013) clearly suggests is that, if TTIP would involve a purely bilateral process of tariff reductions, the effect on certain trading partners would likely be net trade diverting, and would entail a reduction in welfare in third countries.

What are the broader implications?

The importance of the so-called '21st century regulatory agenda' in mega-FTA negotiations holds the key not only for maximising the gains from trade liberalization but also for understanding the positive contribution that the renewed bilateral impetus to trade policymaking among the world's leading economies can give to trade liberalisation efforts at the multilateral level. Once we take into account the MFN spillover effects of deep regional integration processes, we can appreciate that mega-FTAs produce positive economic effects on non-members, something that in the 'old' Regional Trade Agreement debates did not feature prominently.

Going back to the TTIP negotiations, if for instance, as elaborated above, the process through which the regulatory costs reductions are achieved involves adhering to current or future international standards, any trading partner following such standards would see its overall trading costs with both the United States and the EU *unilaterally* reduced, without being a TTIP member. Plus, even in cases where the EU and the United States do not decide to follow international standards, notably in new areas where the standardisation process is underdeveloped, the adoption of a common regulatory setting across the Atlantic will still allow third countries to benefit from economies of scale when deciding to supply the newly integrated marketplace. Furthermore, one can also imagine a second-round spillover effect given the economic might of an integrated EU and US market that there would be a strong incentive to non-members to gradually evolve towards greater convergence with these new standards. In doing so, the mega-FTA will reduce costs *reciprocally* both between members and non-members, and among non-members, on an MFN basis. This indirect MFN liberalisation dynamics would increase the chances for eventually 'multilateralising' the mega-FTAs, a process bound to have both economic and systemic positive effects at multilateral level.

This challenges the long-standing and well-known economic and legal arguments on the systemic implications of RTAs. The Kemp-Wan theorem of 'Pareto optimal' preferential liberalization,[5] extended by Panagaryia and Krishna (2002) to the case of FTA formation, stated that any new FTA could enhance global welfare if, member countries within the FTA individually import the same vector of quantities from the rest of the world in the post-FTA equilibrium as in the pre-

[5] See Kemp-Wan (1976) for the original theorem, Panagarya and Krishna (2002) for its extension to the case of FTAs and Cernat *et al.* (2008) for an empirical assessment.

FTA equilibrium. For traditional FTAs based on tariff elimination agenda, this condition could be achieved for instance by simultaneous multilateral liberalization *vis-à-vis* the rest of the world. However, what we would like to highlight is that if they follow an ambitious regulatory agenda, mega-FTAs can satisfy the Kemp-Wan-Panagaryia-Krishna condition thanks to the MFN direct and indirect spillovers effects which could ensure that trade between FTA partners and rest of the world, and potentially even among non-FTA members, would also increase (Cernat 2013).

Concluding remarks

TTIP is not the only large FTA in formation involving the EU and the United States. The existence of the spillover effects, as we argued above, hinges crucially on the strategy led by the EU and the United States in articulating coherent regulatory convergence across their various bilateral initiatives. More specifically the 'direct spillovers' from TTIP can only become a reality if the EU and the United States in their other mega-FTAs do not undermine the market access benefits awarded to third parties. Likewise, the 'indirect spillovers' hinge on the incentives given to third parties to adopt mega-FTAs standards: the clearer and more extensively used these are the more effective such incentives will be. Ultimately, the pivotal role of the EU and the United States is crucial for eventually turning mega-FTAs into stepping-stones of multilateralism. From that point of view the TTIP can be the catalyst of this transformation of the global trade governance, as it ties in the two main engines of what can be an 'open bilateralism' trade agenda that could complement and strengthen rather than replace the multilateral channel.

For this to take place full transparency about the regulatory changes to introduced mega FTAs is crucial, not only regarding how they affect trade both the member of such agreements but also for trade with third countries. Effective transparency disciplines that would reduce market opacity and increase predictability for firms bother 'within' and 'outside' could plant the seeds for endogenous multilateralisation of market access improvements.

With their ambitious negotiating agenda on regulatory barriers the newly launched FTAs among pivotal trading partners such as the EU and the United States have the potential to produce coherent results and act as platforms for improved global trade rules while promoting deeper regional integration around the world. In doing so, TPP and TTIP may act as powerful stepping-stones for further MFN liberalisation under the *aegis* of the WTO. The latter would not take on a lesser role in global trade governance going forward but would take up an additional responsibility of one of ensuring that bilateralism would be pursued under full transparency, and with full respect for the interests of third countries.

References

CEPR (2013), *Reducing Transatlantic Barriers to Trade and Investment: An Economic Assessment,* Study prepared under implementing Framework Contract TRADE10/A2/A16 for the European Commission.

Cernat, L. (2013), "TPP, TTIP and Multilateralism: Stepping Stones or Oceans Apart?", *VoxEU*, 8 November.

Cernat, L., B. Onguglo and T. Ito (2008), "RTAs and WTO Compatibility: Catch Me If You Can? The Case of EPA Negotiations", *Journal of Economic Integration* 23, 489–517.

Ecorys (2009), *Non-Tariff Measures in EU-US Trade and Investment – An Economic Analysis,* Report prepared by Berden, K., J.F. Francois, S. Tamminen, M. Thelle and P. Wymenga for the European Commission, Reference OJ 2007/S180-219493.

Head, K, and T. Mayer (2011), *Effet Frontière, Intégration Economique et "Forteresse Europe",* Paris: Centre D'Etudes Prospectives et D'Informations Internationales.

Kemp, M.C. and H. Wan (1976), "An Elementary Proposition Concerning the Formation of Customs Unions", *Journal of International Economics* 6, 95–98.

Panagariya, A. and P. Krishna (2002), "On Welfare Enhancing FTAs", *Journal of International Economics* 57, 353–367.

Petri, P.A., M.G. Plummer and F. Zhai (2012), *The Trans-Pacific Partnership and Asia-Pacific Integration: A Quantitative Assessment,* Policy Analyses in International Economics 98, Washington DC: Peterson Institute for International Economics.