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Transatlantic Trade Relations: Challenges for 2003

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Introduction

Throughout the postwar period, the United States and Europe have worked closely to forge a strong political and economic alliance. Transatlantic trade and investment have been important components of that partnership. Trade and investment ties contributed to the postwar revitalization of the European economy, a robust NATO alliance during the Cold War, and the construction of a durable system of world commerce that promoted economic development and democracy around the globe.

It is not an exaggeration to say that the United States and the European Union (EU) have the world's greatest trade partnership (see table 1). Transatlantic trade in goods likely will total about $365 billion in 2002, almost double the value of a decade earlier. US merchandise trade with the EU is about the same as US trade with its NAFTA partner, Canada, and more than twice as large as US trade with Japan. In addition, transatlantic trade in services--which totaled $175 billion in 2000—far exceeds US services trade with any other region. Taken together, transatlantic trade in goods and services is the world's largest.

While the trade flows are significant, what makes the transatlantic relationship so special is that each region has important ownership stakes in the other's market. At the end of 2001, two-way US-EU direct investment was valued at more than $1.6 trillion on a historical cost basis. The European Union is the host for 53 percent (or $726 billion) of all US direct investment abroad, and contributes 72 percent (or $947 billion) of all foreign direct investment in the US market. By contrast, the value of cross-border direct investment between the United States and both Canada and Japan is only about one-seventh that of US-EU investment.

These investments go a long way in explaining why US-European trade relations have been more manageable than US ties with Japan. Roughly one-third of transatlantic trade is conducted between US or European parent firms and their subsidiaries. These firms are less prone to push for trade protection from their corporate family members, and more likely to support open trade and investment policies in both regions. They create a natural buffer against protectionism.

Nonetheless, the United States and the European Union typically have a large number of on-going trade and investment disputes simply due to the sheer size of transatlantic economic relations. But these disputes generally have not been disruptive to transatlantic commercial relations. Even the multi-billion dollar disputes over steel trade and US tax subsidies have affected only a small share of bilateral trade. The heated battle over the GE/Honeywell merger, vetoed by DG-4, may turn out to be a once-in-a-decade event, rather than a harbinger of a new round of investment wars. Many disputes involve agricultural products, which account for less than 10 percent of bilateral trade. As a general rule, trade and investment disputes have been defused in deference to the broader strategic interests of the Atlantic Alliance.

The Bush Administration in Washington and the Prodi Administration in Brussels are managing trade and investment relations with care and deliberation. Both sides worked closely together to launch the Doha Round in November 2001 despite significant differences on key agenda items. Both sides continue to use WTO processes to advance trade objectives and to adjudicate their disputes. Both sides consult on major competition policy cases, such as GE/Honeywell and Microsoft. And transatlantic trade and investment continues to flourish. But trade politics on both sides of the Atlantic are sharply divided on how to handle prospective reforms in domestic laws and regulations that may be required to implement the results of the Doha Round or to resolve current disputes.

In 2003, US-EU trade and investment relations will face critical challenges that could test the transatlantic partnership. Differences over the scope and pace of agricultural reforms threaten to stall multilateral trade negotiations in the Doha Round. Conflicting regulatory regimes, especially on genetically modified organisms (GMOs), threaten a new wave of litigation and trade protection. Ongoing "mega disputes" on the Foreign Sales Corporation (FSC) and steel could slide into retaliation. A "hard" European Union line on unbundling Microsoft would surely provoke transatlantic tension. Finally, both partners are engaged in showmanship designed to make the other appear stingy in the contest for support from developing countries. Showmanship is particularly evident in rival proposals for farm trade, GMOs, and pharmaceuticals. This kind of competition, however, is at the periphery rather than the core of transatlantic relations.

The transatlantic trade agenda in 2003 will thus look uncomfortably familiar. Problems that have lingered for decades will require heightened attention. Trade officials will have to draw on their intellectual and diplomatic skills to keep WTO talks on track and bilateral disputes on simmer. The following discussion summarizes several key issues.

Agriculture

For the past forty years, the United States and Europe have engaged in costly and subsidized competition for agricultural markets around the world (and in each other's backyard). The Uruguay Round finally established a framework of constraints on farm subsidies and modest commitments to reduce tariffs and enlarge quotas. But in practice, the Marakkesh Agreement required very little liberalization. Neither US nor EU farm policies had to be changed significantly to meet the Uruguay Round commitments. In fact, their current farm subsidies fall within the levels allowed by the WTO (even counting the additional costs of the 2002 US farm bill). Subsidy largesse hurts rural producers in developing countries (though it also benefits urban consumers). As a matter of negotiation, US and EU farm subsidies will have to be sharply curtailed in the Doha Round before developing countries will accept the substantial opening of their own industrial, agricultural and service markets – objectives sought by the United States and Europe.

To date, however, US and EU positions are far apart. As a result, WTO members may not be able to reach agreement on the "modalities" for conducting the agricultural negotiations by the deadline of March 31, 2003 mandated by the Doha Ministerial declaration. These modalities set the parameters for the maximum reforms that can be achieved in the negotiations by establishing rules and formulas for calculating changes from current policies.

In July 2002, the US proposed radical reforms in subsidies, tariffs, and quotas, which would reduce its own peak tariffs down to a maximum of 25 percent, sharply expand its tariff-rate quotas (including on sugar), and cut its domestic subsidies by several billion dollars from current levels (holding out the promise of eventual elimination). The EU paper issued in late December 2002 would replicate the limited achievements of the Uruguay Round, with modest cuts in tariffs (while maintaining tariff peaks), export subsidies, and domestic subsidies. The US offer would maximize the pain for the European Union (and Japan); the EU plan moderates the prospective changes to its own policies and seeks changes in the method of scoring subsidies that would increase the reforms required in US programs.

Both are initial bargaining positions, to be sure, but both the United States and the European Union will find it difficult to "up the ante". EU negotiators will find it hard to sweeten their offer until member states issue their often-postponed decision on reform of the common agricultural policy. US negotiators will find that any dilution in the size of the prospective Doha Round reforms will provoke resistance from US farm lobbies. Indeed, if the Doha reforms begin to shrink, farm lobbies may well prefer to maintain the generous subsidies provided by the 2002 farm bill.

While it is too early to project the terms of a final Doha Round deal on agriculture, the short-run implications of the current US-EU impasse are troubling. If WTO negotiators cannot agree on the modalities for agricultural negotiations, then officials will begin to doubt whether the Doha Round can meet the ambitious objectives set by ministers in November 2001 across the whole range of issues. Such uncertainty could put the Cancun Ministerial in September 2003 at risk. Developing countries could well respond to the cloudy signals on farm reform by withholding support for starting negotiations on the Singapore issues (investment, competition policy, trade facilitation, and transparency in government procurement). Trade officials would then have to work hard to prevent a further unraveling of the Doha agenda. At best, the pace of talks would decelerate, and they could possibly seize up.

Genetically Modified Organisms (GMOs)

The revolution in biotechnology has opened vast new horizons for production and trade, but also has raised new concerns about the long-term impact on human health and the environment. To date, there is little scientific evidence to support those concerns. On the other hand, there is no proof-positive that GMOs are harmless. As a consequence, some governments have adopted a zero tolerance policy toward GMOs, awaiting the findings of ongoing research. While these actions are an understandable political response to the strong public reaction against GMOs, they raise the legitimate concern that public health may serve to rationalize a new wave of regulatory protectionism.

Unlike growth hormones, GMOs are not banned in Europe. However, contrary to attitudes among the American public, GMOs excite considerable public fear among Europeans. In principle, the European Commission could authorize the sale of GMOs. But given the strong opposition of some member states, the EU has observed a moratorium on the approval of GMO products for the past several years. Exports of genetically modified corn from the United States to Europe have been suspended, and 13 other US products are stuck in the pipeline of regulatory approval. Meanwhile, selected agricultural advances are blocked in poor African countries, for fear that GMO products will be banned in Europe.

In the face of European reluctance to proceed with GMO approval, US officials now contemplate bringing a case to the WTO. European companies share an interest with their American counterparts in speeding EU regulatory approval. Yet even if the WTO ruled against the European Union, the GMO issue is no more likely to be resolved than the growth hormone issue. The chief obstacle is widespread fear among Europeans that GMOs will harm them, their children, or their environment. Rather than propel regulatory reform, WTO litigation could provoke a political backlash that stiffens resistance to negotiated solutions to the GMO trade problem.

Foreign Sales Corporation (FSC) and Steel

A third challenge for 2003 is to contain long-running disputes on tax policy and steel, and forestall new bouts of trade retaliation. The steel dispute is currently being litigated in the WTO to assess whether US safeguards measures introduced in 2002 conform to WTO requirements. The US case is weak, and the European Union stands a good chance of prevailing in the WTO Appellate Body. Meanwhile, both sides have cooperated in limiting the impact of the safeguards measures; as a result, a large share of European shipments has been exempted from the new duties. If the US and EU economies enjoy strong growth in 2003 and 2004, the steel dispute could, in fact, melt away.

More worrisome is the dispute over the FSC, since it raises fundamental issues about the equity of WTO rules regarding border tax adjustments. This transatlantic dispute first arose in the 1960s, was resolved in the Tokyo Round negotiation of the Agreement on Subsidies and Countervailing Measures (SCM), and then resurfaced in 1997 when the EU walked away from the earlier pact and challenged the FSC in the WTO.

The first WTO FSC panel, in its October 1999 decision, ruled that the FSC did confer illegal export subsidies because revenue is foregone (Article 1 of the SCM Code) and exports are taxed more favorably than production abroad. In February 2000, the WTO Appellate Body affirmed the panel report in all essential respects.

In their decisions, however, neither the Panel nor the Appellate Body ruled on the EU claim that FSC violates the SCM Code because exports are taxed more favorably than production for the US home market. This omission (in the context of highly technical decision) seemingly left the United States an opening to alter the contours of the FSC while preserving much of its substance. It appeared that the United States could avoid the charge of granting an export subsidy by extending its partial territorial tax system to the *foreign* production of US firms the same way it was applied to exports – thereby meet the newly created parity test. Seizing this apparent opening, in November 2000 the U.S. Congress passed the Extraterritorial Income Exclusion (ETI) Act.

The EU again challenged the US law in the WTO; subsequent panel rulings found that the new US law also conferred prohibited export subsidies. The Appellate Body concurred in a ruling; in August 2002, the European Union was authorized to retaliate against about $4 billion in US exports if US law is not brought into compliance with WTO obligations. The potential disruption to transatlantic trade is so great (more than 10 times larger than US retaliation against bananas and beef hormones combined) that retaliation on this scale would provoke a crisis in transatlantic relations.

To date, EU officials have proceeded cautiously—publishing a retaliation "hit list" but not implementing any countermeasures. There appears to be an understanding not to take actions that could disrupt the ongoing Doha Round. But since retaliation already has been authorized, so the threat of a new trade war still remains. No one expects the EU to poison the Doha Round by indiscriminate retaliation. But until the ETI is repealed, the arsenal will at the very least dampen

US initiatives aimed at curbing EU agricultural subsidies or opening EU markets to GMO products.

The United States has committed to bring its tax laws into WTO compliance. However, if the ETI is repealed with nothing to take its place, US exporters will again compete on a tilted tax field. Not only will they have to pay VAT on sales into Europe, Canada, Mexico and other countries, they will also have to pay full corporate income tax on their export earnings. Meanwhile competitors based in Europe and elsewhere will export their goods into the US market free of VAT and take advantage of sales subsidiaries located in low-tax jurisdictions. This kind of tax tilt was a driving force behind enactment of the DISC in 1971, the FSC in 1984, and the ETI in 2000. It seems unlikely that the tax discontent harbored by US exporters will melt away if ETI is repealed in 2003. Thus, there is a great deal of pressure for renegotiation of the WTO subsidy rules and/or US corporate tax reform that confers WTO-legal tax advantages to trading firms.

In sum, this issue is bigger than the $4 billion retaliation bill set by WTO arbiters. It will likely require an admixture of tax reform and WTO reform to restore the balance in the trading system that was upset by the EU decision to litigate five years ago.

Economic Sanctions

Economic aid and economic sanctions are used to promote good relations or to coerce good behavior from foreign governments. Growing commercial ties do create a web of interlocking interests, as Henry Kissinger has often said, but they also create a set of conflicting policy objectives within each country. Should political and security interests trump commercial concerns? In the Cold War era, the obvious answer was yes—and Europe generally followed US leadership on economic matters in deference to the broader strategic alliance. In the post-Cold War era, however, other interests command greater attention.

Over the past two decades, US policy has been schizophrenic regarding the use of economic sanctions. Some members of Congress and the business community have felt that trade should be unfettered and not be a handmaiden to foreign policy. Other members have put forward legislation limiting US trade with or financial assistance to countries that violate specified norms of good behavior such as human rights abuses, proliferation of weapons, and drug trafficking. Occasionally, third countries are also swept into the sanctions net – as happened in the Iran Libya Sanctions Act (ILSA) of 1996. Those sanctions, codified in law, require extraterritorial application of US restrictions unless waived for national security reasons.

In fact, extraterritorial application of ILSA was waived by both the Clinton and Bush Administrations. But the prospect of renewed conflict in the Persian Gulf could give greater prominence to transatlantic disputes about the use of economic sanctions. In principle, ILSA inflicted penalties on foreign companies investing more than about $20 million in the oil industries of Iran and Libya, two states identified as sponsoring terrorism by the United States. ILSA was immediately challenged by the European Union, and since its enactment the proposed sanctions – even though waived -- have episodically provoked transatlantic debate. The larger ideological issues—well before September 11—were the appropriate characterization of Iran and Libya, and the best way of dealing with the regimes. On these issues, there is little common ground between the United States and Europe.

Microsoft

The European Court of Justice has handed DG-4 two defeats in recent merger cases. The common thread of these cases was that DG-4 was overaggressive in blocking mergers. The cases dealt with different issues than the Microsoft litigation, and it remains to be seen whether Commissioner Monti will reach an agreement with Microsoft over bundled technology (particularly the video player feature). If an agreement is not reached, Microsoft will almost certainly take an appeal to the ECJ. Behind the scenes, the litigation will likely provoke an intense transatlantic dispute, especially since the Justice Department has settled all its claims with Microsoft. The dispute will spill over into a rehash of the GE/Honeywell merger, blocked by DG-4 in 2001.

Final Thoughts

During the past two years, trade officials have developed a *modus operandi* for bilateral relations and for their joint stewardship of the multilateral trading system—due importantly to the close working relationship of US Trade Representative Robert Zoellick and EU Commissioner Pascal Lamy. But there are limits to personal diplomacy: it is inherently unstable, since the relationship can change dramatically with a new cast of officials. Personal tensions among the trade leaders can be harmful to trade relations –witness the decision by Sir Leon Brittan to bring the FSC case to the WTO in 1997. Moreover, there is nothing comparable to the Zoellick/Lamy relationship in dealings between the Antitrust Division of the US Justice Department and the EU Directorate for Competition Policy (DG-4). Indeed, as the GE/Honeywell case showed, and as the Microsoft case could underline, quite different competition policy standards are applied in Europe and the United States.

Thus, a final challenge for 2003, should be to think about how to ensure the sound management of the trade and investment relationship in the future, whoever heads the respective agencies. Would it be useful to establish an institutional mechanism to "lock in" consultative procedures – perhaps with a wider cast of ministers? Could one take advantage of summit preparatory consultations to make progress on trade and investment issues among political leaders? The separate paper by C. Fred Bergsten and Caio Koch-Weser outlines a new "G-2" process that offers one alternative for doing so.