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Free Trade and Prosperity

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Welcome Address by

DIETER REITER
Lord Mayor, City of Munich

Ladies and Gentlemen,

I am pleased to welcome you to the 13th Munich Economic Summit on behalf of the City of Munich. We are proud that Munich regularly serves as the venue for this conference, which has become an important forum for exchange between science, the economy and politics. I would like to thank the organisers of this conference, the BMW Foundation and the CESifo Group.

Munich's economy is export-oriented. *The dismantling of tariffs and an efficient and fair organisation of international trade rules are, therefore, in the prime interest of the City of Munich.* Under the headline 'Free Trade and Prosperity', this conference focuses on the current debate over the further formulation of global trade rules. Again, as the Lord Mayor of a major European city for which economic success and prosperity significantly depend on international business, I am well aware of the importance of this year's conference and its topic. 'Made in Munich' is in high demand globally. Successful global players like BMW, Siemens, Linde or Allianz and Munich Re have their headquarters in Munich. The success of these companies is determined by the international markets.

There is no doubt that free trade is a considerable source of our prosperity and that Munich benefits from globalisation. In the future, the significance of international trade to Munich's economy in terms of goods and services will increase even further. However, we nevertheless need to remember the downsides of globalisation.

Criticism of the current rounds of free trade negotiations is justified. For a number of reasons I share widespread scepticism regarding the ongoing rounds of free trade negotiations and it makes me critical of the negotiations concerning the Transatlantic Trade and Investment Partnership (TTIP). The root of the problem is the following: in the current negotiations on free trade between industrialised nations, there is less and less talk of the so-called 'tariff' trade barriers like, for example, duties, but increasingly of the 'non-tariff' trade barriers that are to be regulated. Of course, it makes sense and is in everybody's interest to agree on common technical standards. It is, however, problematic that the harmonisation efforts are going beyond mere technical questions and are also extending to plant and health protection. They are aimed at increasing cooperation in the drafting of legal provisions and procedural rules and also affect regulatory issues that arise from the trade in services and access to public procurement.

This wide array of issues leads to the very basic concern that the planned agreement could undermine environmental and health standards. A harmonisation in the field of genetic engineering and in the case of hormones in animal feed, etc., from a European perspective is bound to mean a watering down of our very strict regulations. The same is true of social standards and employee protection rights. Their diversity can, of course, be regarded as a trade obstruction. The concern that harmonisation could be inspired more by the lower standard is not easy to dismiss.

Is trade liberalisation a threat to the municipalities' rights to self-government? The provisions of the TTIP could affect aspects of the rights of local authorities to provide essential services. The President of the German Association of Cities and Lord Mayor of Nuremberg, Ulrich Maly, has clearly warned that the transatlantic free trade agreement could rescind the success of the first European referendum that secures the municipal water supply. The same applies to the 'investor-state dispute settlement' that is also being discussed and that would grant foreign investors a right to sue if social, health or environment laws were to threaten their anticipated profit. As a result, the public authorities could be faced with massive lawsuits totalling billions of euros.

Free trade must not become a general instrument for deregulation. Despite the undisputed growth effects that trade liberalisation generates, we have to ask ourselves whether liberalisation always comes with long-term welfare gains. I would like to remind you: the liberalisation of the financial markets has certainly generated enormous growth. But the damage caused by the financial crisis that was abetted by the liberalisation of the financial markets has not been repaired to date. Many of the regulations in the health and environment sector, in the social field and in the provision of local services of general interest that are now to be limited in the course of further trade liberalisation affect the population's 'well-being'. Well-being is affected in terms of food safety, high environmental and social standards and, last but not least, high quality in the provision of public goods. I believe that trade agreements that seek to impose deregulation in fields in which our citizens depend on state protection will fail. It will also be essential to the conclusion and success of the agreement that the public is informed of its results and that there is widespread support for it from elected governments and parliaments too.

I would like to wish you a successful and exciting conference, as well as interesting discussions, so that the Munich Economic Summit 2014 can help to answer a difficult question: how can we promote free trade and, at the same time, maintain the sovereign rights of nations and local authorities to organise their ecological, social and regulatory standards?

Thank you for your attention.

Welcome Address by

MICHAEL SCHAEFER
Ambassador (ret.); Chairman of the Board of Directors, BMW Foundation Herbert Quandt, Berlin and Munich

It is the first time that I am taking part in the Summit, and I would like to take this opportunity to express my sincere thanks to my predecessor, Jürgen Chrobog, for his excellent work as chairman of the BMW Foundation. The presence of so many distinguished participants is an impressive indication that, during over a decade, the Munich Economic Summit has grown into a successful and highly attuned European economic dialogue forum. Together with our long-time partner, the CESifo Group, we will strive to honour this commitment in the future. Professor Sinn and I have agreed that we will continue to further develop the Munich Economic Summit into a global forum.

Rarely has the Summit taken place at a more challenging time for Europe. Our governments, businesses and societies are confronted with two fundamental crises: a structural and a strategic crisis. Despite positive signs of recovery, the sovereign debt crisis in some European countries has not yet been overcome. The structural deficiencies that the crisis has revealed in the Eurozone make it necessary for governments to set a clear course for the future, and to undertake fundamental reforms. We have the choice between increased economic and financial integration, and a return to the nation-state. In my opinion, there is no in-between solution. After spending six years in Asia, it is my conviction that only a more politically integrated union will be capable of acting and thriving in a multipolar world.

Strategically, the EU presently faces a no less elementary challenge: Russia's President Putin has decided to break the fundamental post-World War II consensus – i.e. that boundaries in Europe should no longer be redrawn by force. This decision not only violates the territorial integrity and political sovereignty of the Ukraine, but also jeopardizes the stability of the European continent. We must not be mere onlookers in this process. The EU has to credibly demonstrate its resolve to jointly defend the common values that it has come to share in recent decades. These values have served as a solid foundation for the longest period of peace and prosperity Europe has ever known. If necessary, the EU has to defend these values by taking appropriate political and economic measures. Russia is, and remains, an important neighbour with whom we want to maintain close and friendly relations, but not at any price. We have to be aware that this can result in heavy economic losses on both sides. However, a firm stance on the part of the EU is the only way to restore a stable relationship in the long term.

It is against this background that we will discuss, over the next two days, key developments in economic policy that will very much define our European interests in the decades to come. We will take a look at the transatlantic partnership – which remains central for Europe, but which is no longer taken as a given by the larger public after a decade marked by crises in confidence ranging from Iraq and Guantanamo to the NSA affair. We will need to discuss how the EU will position itself *vis-à-vis* the new global economic powers of China, Brazil, and India, as well as other emerging economies in Asia, Africa, and Latin America.

Essentially, the key question is: will we manage to learn from the experiences of the 20th century and replace the logic of power and hegemony – a classic zero-sum game – with a logic of cooperation and win-win situations? Or, to put it differently: will we be able to replace the military-strategic balance of terror with a system of economic synergies that also gives structural expression to the already dynamic interdependence of our economies? These questions are equally important for all of us – no matter what part of the world we come from. This is why I am delighted to welcome representatives from a total of 20 nations to this year's Summit, including representatives from the new emerging economies.

At the heart of the discussions will be the topic of 'Free Trade and Prosperity'. The three panels will not only deal with the pros and cons of agreements – such as TTIP – which are of major importance to the EU. They will also examine the question of whether and to what extent the observable trend towards more and more bilateral, regional or inter-regional trade agreements will strengthen or weaken the international trade order espoused by the WTO.

For us Europeans, the question is how we can safeguard our interests in a progressively complex global market; a market that is increasingly defined not only by the United States, but also by the new Asian economic powers, especially China, which is about to overtake the United States to become the world's biggest economic power in absolute terms. The question is not so much whether and how to stop the trend towards a multitude of competing preferential trade agreements. Instead it is a matter of whether we will succeed in building an inclusive international trade system that, by means of free trade, ensures fair conditions for all regions and players alike. Nobody can be more interested in this than Germany, whose economy is dependent on export and foreign markets.

During his visit to Berlin two weeks ago, EU Commissioner Karel De Gucht rightly pointed out that the balance of the world economy has already shifted. The United States and Europe are already facing fundamental challenges to their economic competitiveness to which we have to find solutions as soon as possible. Will we continue to rely on a system that is determined by us, the transatlantic economies as the biggest economic space, and accept the fact that others – especially new economic powers like China – feel excluded? Or do we see our trade and investment relations as an integral part of a global trade system that is open to all? I am convinced that we either need to define convergences and agree on as many global standards and norms as possible, or we run the risk of erecting new walls and provoking the formation of new economic blocs. Surely, the latter is in nobody's interest.

This, of course, is easier said than done. The experiences of the Doha Round, which has failed to deliver results for over a decade, give rise to scepticism. While some celebrate the Bali agreement that was reached in December 2013 as a breakthrough for multilateral trade liberalization and an end to the stagnation of the Doha Round, critics see the agreement as a largely symbolic gesture. They point out that the trend towards undermining the world trade system through preferential agreements continues unabated. In fact, there are now some 400 such agreements. In the last 15 years alone, the United States has concluded no less than 36 free trade agreements, while Europe has signed 14 FTAs. Is this an indication that the industrial nations are increasingly losing interest in multilateral solutions?

The United States and Europe are currently preparing for the fifth round of negotiations for TTIP, the most comprehensive transatlantic free trade agreement ever. According to a study by the Ifo Institute, TTIP promises to generate 160,000 new jobs, as well as economic growth of up to 4 percent in Germany alone. Similarly positive trends are expected for the rest of the EU and the United States. And yet there is scepticism on both sides of the Atlantic. Some economic sectors – such as the automotive and chemical industries – anticipate major advantages from the large-scale reduction or removal of tariff barriers and the harmonization of standards. Yet critics fear that high standards in sectors such as food or health care will be dismantled; or that core principles of environmental and climate policy will be watered down. Numerous organisations complain about the lack of transparency of the negotiation process. Our discussions should try to generate a clearer picture of the anticipated advantages and disadvantages of TTIP. But it is equally essential to ask whether the conclusion of the Transatlantic Trade and Investment Partnership will ultimately strengthen or weaken the global trade system. I am sure we all agree: TTIP must not become an exclusive trade policy regime resulting in a transatlantic economic fortress.

This is equally true for TPP, the Trans-Pacific Partnership, which the United States is currently negotiating in parallel with Japan and other East Asian economic powers. But we must be aware that both processes are being perceived by some as producing exclusive trade regimes, as important players such as China, Brazil, or India are absent from both. This may trigger adverse reactions from the BRICS, which cannot be in our interest. Regional free trade agreements should thus be systems that are open to new members and that, through the harmonization of standards and the removal of tariffs, create incentives to liberalize not just bilateral trade, but to broaden the international trade regime as a whole. The WTO could play an

important role in mending these regional arrangements, and converging them into a global system with the highest possible standards shared by all. Only then will TTIP, TTP and other agreements be what they should be: namely, drivers of a new dynamic and fair world trade system.

I hope that our panel discussions today and tomorrow will provide us with answers to these complex questions. I would therefore like to ask you to contribute actively to our discussions with your expertise, your experience, as well as your criticism. Together with Professor Sinn, whom I would like to thank most cordially for his close cooperation, I wish you two inspiring and rewarding conference days.

Professor Sinn, the floor is yours.

Introduction

Free Trade and Prosperity

Hans-Werner Sinn
Professor of Economics and Public Finance,
University of Munich;
President, Ifo Institute, Munich

Ladies and Gentlemen, Excellencies,

I would like to begin by going over some of the basics. My topics are: the value of free trade as such, trade agreements, transatlantic trade, TTIP and trade diversion. For an economist, trade results from being different. *Vive la* difference! You can specialise in areas where you perform better than your neighbours and, since everyone specialises, there are gains from trade. Everyone of us specialises in some way. I specialise in being an economics professor, which means that I don't make my own shoes and I don't grow my own crops, I buy these things from others. So there are obviously gains from trade; and the same kind of gains that exist between individuals can also be seen between countries.

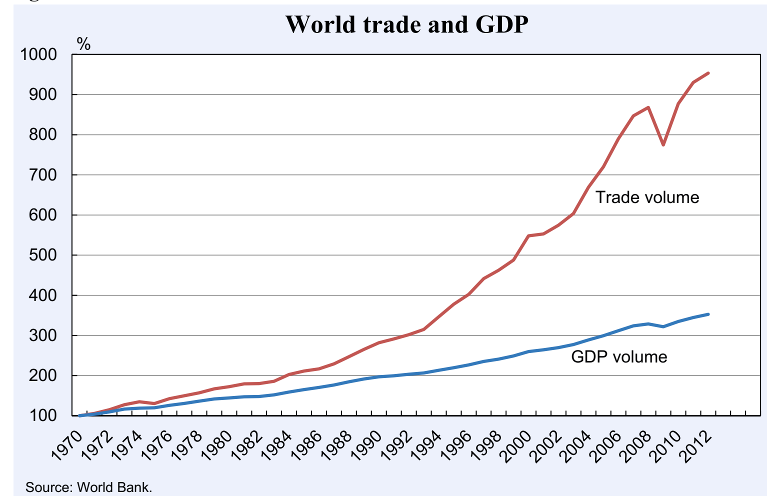
David Ricardo, one of our earliest economists, called this the principle of comparative advantage. This principle has gained even more momentum through increasing returns to scale, as pointed out by people like Murray Kemp, Wilfred Ethier, Victor Norman or Paul Krugman. If you specialise, then you can even increase your comparative advantage from trade, and the gains become even bigger. A recent NBER working paper by Ossa (2012), for example, calculates that living standards of Germany measured in terms of real per-capita income would be 50 percent lower if the country did not have access to international markets.

A look at trade flows in the world reveals that most of the trade takes place in the Northern hemisphere between North America, Europe and China in all directions; and trade has increased. If we compare the curves for world trade and GDP (see Figure 1), we see that while GDP grew from 100 percent in 1970 to 350 percent in 2012, the trade volume rose by 950 percent over the same period (Figure 2). This trend would

Figure 1

Source: WTO.

Figure 2



Source: World Bank.

be even more extreme if financial trade were to be included, but since the latter is of a dubious nature it is not included in these figures, which represent real trade. This form of trade has truly helped to advance living standards throughout the world.

Trade costs nowadays are very low, which is mainly due to the fact that shipping/freight costs are so cheap. Global companies ship their intermediate goods around the world. A good can crisscross the Atlantic several times before it reaches the final consumer. One 40-foot shipping container can hold about 1,800 laptops. Since freight across the Atlantic for such a container is about 2,400 US dollars, this means that the transatlantic transportation cost for one laptop amounts to just 1.40 US dollars. That's close to zero when you consider the value of a laptop. To cite another example, you may wonder what a bottle of water has to do with trade, but a substantial fraction of world trade is related to water. It may seem absurd, but bottled water like Perrier is shipped around the world and the empty bottles are shipped back to France.

World trade agreements and significance of transatlantic trade

Before I turn to trade agreements, let me briefly draw your attention to a paradox: a foreign country that has a cheap product wants to export it to our country, but we refuse and impose trade barriers, thus denying our consumers the gains from trade that they could potentially have enjoyed; and other countries do the same with our products. For an economist this is very strange behaviour. Why do we impose constraints on cheap imports, rather than the foreign exporters themselves imposing constraints by keeping their precious products at home? The theory is obviously that the domestic import-competing industries are highly influential and want to keep the foreign competitors out, thus hurting domestic consumers and, in fact, the entire domestic economy in net terms.

There is a good explanation for this, which is one of the most important theorems of economics, namely Olson's theory of lobbies (Olson 1965 and 1982). According to this theory, when there is a big group and a small group with divergent interests, the small group always wins out in the political process because it enjoys a higher per capita-gain from lobbying. There are other reasons for having import duties and non-tariff trade barriers. The importing country, for example, could behave like a monopsonist, trying to bring down the world market price for the good it imports. That could be a rational argument for having barriers to trade; but it is not really convincing because, by the same argument, you could have barriers to exports to exploit a monopoly position. You could have export duties, as well as import duties in order to restrict your supply to the world market to achieve a higher price for your products, i.e. better terms of trade, like a monopolist. But we don't observe very many export constraints among countries. What we observe are import constraints. Only Olson's theory can explain this.

There are some exceptions. There are some countries that try to restrict the export of certain commodities, but this mainly involves natural resources. China, for example, restricts the export of rare earth/precious metals. This, however, does not constitute a violation of Olson's theory but is rather a confirmation of it, since the buyers here are companies, not households. In line with Olson's theory, it is these firms that successfully lobby to keep the precious metals for themselves, while our companies do not have a lobbying power in China. This is really the paradox of trade and trade agreements: governments captured by lobbies, who see domestic consumers as their property, are negotiating mutually to reduce trade barriers to exchange this property, and as a by-product there are the gains from trade for their economies.

Several trade agreements like GATT and TRIPS already exist, and over 400 more successful regional trade agreements have also been formed including EFTA, ASEAN, Mercosur, the EEA and – still under negotiation – CETA and TTIP, to name just a few (see Box 1 and 2).

Box 1
General trade agreements

1948	GATT (General Agreement on Tariffs and Trade)
1962–67	Kennedy Round → adoption of an anti-dumping code
1986–94	Uruguay Round → expansion of GATT to services, capital, intellectual property, textiles, agriculture
1995	WTO (World Trade Organization)
1995	TRIMs (Agreement on Trade-Related Investment Measures)
1995	GATS (General Agreement on Trade in Services)
1996	TRIPS (Agreement on Trade-Related Aspects of Intellectual Property Rights)
2001	Doha Round
2013	Bali → reduction of bureaucracy

Box 2
Regional trade agreements

1960	EFTA (European Free Trade Association)
1967	ASEAN (Association of Southeast Asian Nations)
1991	Mercosur (Latin America)
1992	AFTA (ASEAN Free Trade Area)
1994	EEA (European Economic Area)
1994	NAFTA (North American Free Trade Agreement)
2005	TPSEP (Trans-Pacific Strategic Economic Partnership Agreement; Brunei, Chile, New Zealand, Singapore)
2010	ACFTA (ASEAN–China Free Trade Area)
2012	Pacific Alliance (Chile, Colombia, Mexico, Peru)

- CETA (Comprehensive Economic and Trade Agreement, between Canada and the European Union, near completion)
- TTIP (Transatlantic Trade and Investment Partnership, in preparation)
- New trade agreement for former Soviet republics

In terms of transatlantic trade, the United States and Europe account for just 11 percent of the world population but for 46 percent of world GDP (see Figure 3). Their share of world merchandise exports is also about 25 percent. So, it is clear that the EU and the United States constitute a powerful trade block when united. Currently, just 17 percent of total US exports are destined for the EU; and, surprisingly, the figure is the same for EU: 17 percent of EU exports (excluding internal trade flows) are bound for America. This figure is likely to increase in the future (Figure 4). Looking at Germany, 57 percent of its total exports go to EU countries: 37 percent to the Eurozone countries and 13 percent to non-Eurozone countries, while just under 8 percent of its exports go to the United States (Figure 5). A closer look at its exports reveals that industrial goods predictably account for 80.3 percent, while services account for 18 percent of exports (Figure 6).

Figure 3

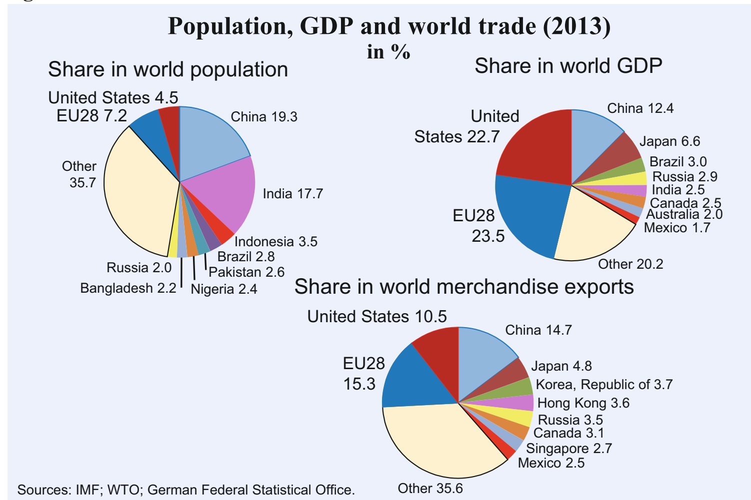
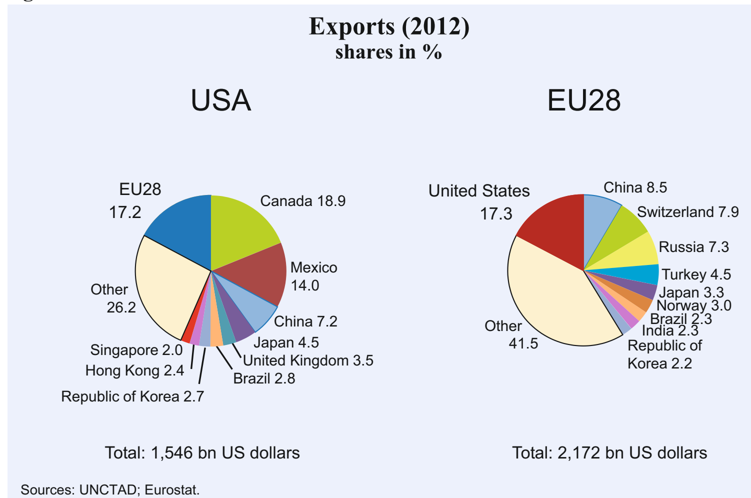


Figure 4



Transatlantic Trade and Investment Partnership (TTIP)

Let me now turn to TTIP. What are the key issues? The primary issue is dismantling pecuniary customs duties, which are currently about 3 percent. In fact, however, these duties are much higher than 3 percent due to the crisscross trade in intermediate goods across the Atlantic, which means that, before a final good has been produced, the percentage of duties may well be much higher than 3 percent. Another issue is investment protection in order to overcome the hold-up problem. This is, of course, obvious. If you bring your money to another country and subject it to the legislation there, you could be expropriated by certain measures that take away your business. You need investment protection. This is an essential ingredient of any system allowing for foreign direct investment.

A further issue is access to public procurement. Governments cur-

Figure 5

Source: German Federal Statistical Office.

Figure 6

Source: Ifo Institute, Professor G. Felbermayr, data on request.

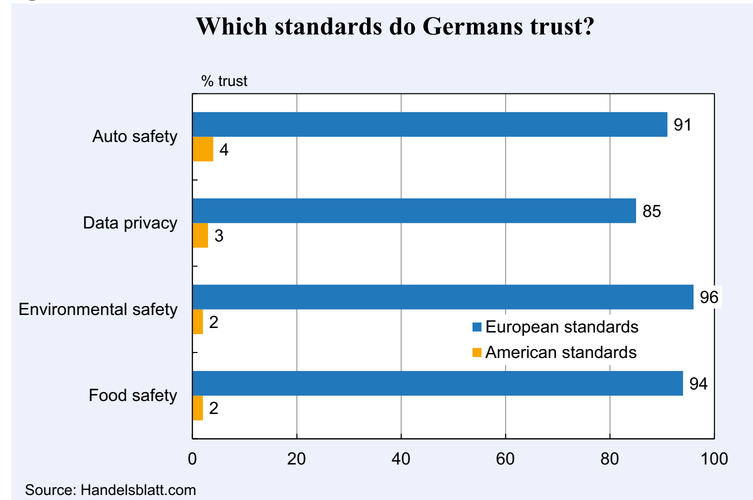
rently tend to favour domestic companies, so if US companies show up in Europe they have a hard time and *vice-versa,* creating a situation that needs to be overcome. Non-tariff trade barriers also need to be dismantled *via* mutual recognition of safety standards and technological norms. This is very important and can be compared to the case of Cassis de Dijon in Europe, which, as was initially argued, contained too little alcohol to be admitted into Germany; a ruling that was subsequently overturned by the European Supreme Court. The principle defended here was that if a good is produced legally in one EU state according to the local rules, there should be no problem with exporting it to another state. The same concept should ideally apply to transatlantic trade. However, this idea makes people nervous, as illustrated by the media debate over chlorine-washed chicken from America *versus* salmonella chicken made-in-Germany. This is not really the key issue, but it commands media attention and causes public concern.

I would now like to present the results of an opinion survey that asked Germans whether they trust European standards more than US standards in terms of auto safety, data privacy, environmental and food safety. While 80–90 percent trust European standards, they hold their American counterparts in very low esteem (Figure 7). Germans are simply not familiar with US standards, which are often, particularly when it comes to food, much better in many cases than in Europe. Americans were asked the same question, i.e. what do they think of US standards and around 50 percent were reportedly satisfied with them, which is not as high as the European figure. Americans in turn, however, disliked European standards and preferred their own (Figure 8). These results reflect ignorance and suspicion with regard to products coming from other countries. Such attitudes, of course, need to be overcome and do not constitute an economically valid reasoning, while politically, of course, they are of overwhelming importance.

What are the advantages of TTIP? The most obvious advantage is general gains from trade (consumers pay less). Poor people in Germany and Europe, in particular, would raise their living standards enormously if they could take their money and go shopping in an American supermarket; and I am very surprised that left-wing politicians in Germany are opposed to TTIP, given that their clientele would be among the biggest beneficiaries. Gabriel Felbermayr of the Ifo Institute has conducted a study on TTIP based on a model with increasing returns to scale (Felbermayr *et al.* 2014). He concludes that in the long run the real income of Germans would be 5 percent higher under TTIP than under normal conditions.

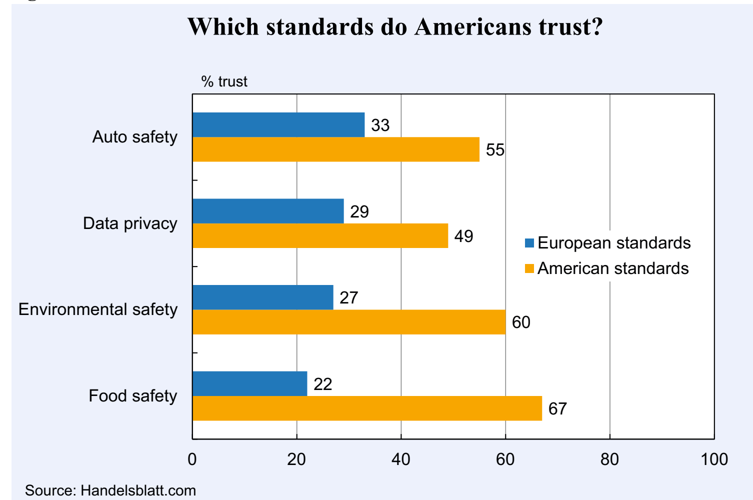
What I find particularly important is that TTIP would reduce internal European trade barriers. You may well

Figure 7



Source: Handelsblatt.com

Figure 8



Source: Handelsblatt.com

question whether such barriers still exist in Europe? Although there are no longer any formal customs, many barriers nevertheless remain due to regulations. Consider, for example, environmental standards. The EU has reduced the amount of CO_2 admissible for car producers' fleets every 5 years and is now heading towards 95g of CO_2 per kilometre, which is less than half of what most bigger cars, even the German premium class, emit. So this is clearly a measure to get rid of these cars and to direct the consumption of European consumers towards small Italian and French cars, which, by virtue of their size, produce only very little CO_2. In other words, it is a distortion of trade through measures that are sold to the public as environmentally friendly. If Europe were to have TTIP with America, this kind of game would be over as it would have to apply to American cars too, and the Americans would never accept it. So TTIP would help us internally. This fortress, which some Europeans want to erect, would be destroyed in a general trend towards greater liberalism in trade. Let me stress that I am not in favour of greater liberalism in banking regulation, but I do support it in trade.

There are, however, arguments against TTIP: namely that that it would cement old trade relations instead of forging new ones, with BRICS, for example. And what will China say? Let us be honest, TTIP is probably an attempt to keep China out (I have no illusions about the intentions of our American friends). But whatever the intentions are, the outcome could still be positive if we allow China to enter.

There is a fear of the dominance of US culture: will we only see Hollywood movies in the future, or will there still be a chance to see French films in Europe? Well, the French already have their special clause in TTIP.

What about German literature and music? Will it all be owned by Google and the like?

Secrecy is another very sensitive issue: everyone is concerned that no one seems to know what is going in these negotiations and that they are taking place in secret, but that is the nature of such negotiations.

Lastly, as I mentioned before, Europe's ability to impose social protection laws is limited. That is a possible advantage that can, of course, also be considered a disadvantage. It largely depends on how you view the situation. Rules and exceptions must be found that take European special preferences into account.

Trade diversion

My final point is trade diversion. This, of course, is always the major issue when you have bilateral trade agreements that redirect trade from buying low-cost goods from producers in third countries towards high-

cost producers in a currency union, who have the advantage of not having to pay duties. This was pointed out in the seminal work by Jacob Viner, *The Customs Union Issue,* published in New York in 1950. This is a valid argument that should not be downplayed. If the redirection of trade away from low-cost to high-cost suppliers simply because the high-cost suppliers wouldn't have to pay duties is indeed a major concern, then opening economies up to free trade may prove welfare reducing, as Viner showed. This risk needs to be taken seriously.

With this in mind, I would like to reiterate that it is essential that such a trade agreement keeps a door open to others who want to participate and enter. That is fundamental. TTIP cannot be a fortress between the United States and the EU excluding the others; it must have an open door. So if any state wants to join TTIP under the same conditions, it should be able to do so. And, of course, it would be very dangerous if the overwhelming motive for TTIP were ultimately to be the creation of a transatlantic economic NATO, keeping China and Russia out. What kind of a world would it be if we were to return to the old times of the Cold War and were to have the states of the Western Hemisphere trading only among themselves? Even in the Cold War period, incidentally, we did have a lot of trade with the Soviet Union.

So, if that is the intention – and some people definitely do have that intention in America – that is, of course, very alarming. Americans, however, don't speak with the same tongue everywhere. There are many different opinions and we must endeavour to strengthen the voices of others who are willing to be open and exclude this kind of interpretation of TTIP

I fully share the point Michael Schaefer made: we have to find a free trade agreement with the former Soviet Union that includes Russia, Ukraine, Moldavia and Georgia, rather than trying to sever these states from Russia. Trade alone fosters peace through mutual interdependence. If countries move towards autarchy, they tend to take greater risks. I read in this morning's newspaper that Putin is striving for military autarchy and no longer wishes to import components from the Ukraine for his armed forces, as he has done in the past. That is dangerous. It would also be dangerous for Germany to stop buying Russian gas and oil and to buy the US equivalent instead. *Prima facie* it's not dangerous, it gives us more security, but it is dangerous in the end if it makes us more risk prone.

It is also important not to forget the other BRICS countries and the emerging countries in general. They should and must be included in a new world order that has fewer tariffs in order to give everyone a chance to participate in gains from trade. Free trade with emerging countries is essential and they must be given the chance to benefit from trade gains as this will promote peace in the world.

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Panel 1

After Bali: Multilateralism and Mega-Regionals

Joseph Francois*

My task here is to explain why Doha seems to have failed or is stuck perpetually. Before I go any further, let me warn you that, partly due to my experience with NAFTA negotiations and subsequent agreements, I am fairly agnostic in terms of the relationship of mega-regional agreements to the WTO itself. That said, let us move on to some of the key questions, namely: what are the implications of mega-regionals for the Doha system itself? How do we reengineer the system? And, in a nutshell, how do we rebuild the governance of the global trading system?

Let us turn to the first question: why is Doha stuck and why do we have the mega-regional agreements? When considering both of these questions, it is important to consider what has changed *versus* previous rounds of regional agreements. Perhaps mega-regional agreements represent a bid to deal with new issues that the WTO is not set up to tackle yet. In other words, mega-regional agreements may, to some extent, constitute a form of experimentation. What does the WTO handle, which issues is it neglecting and what might we want to change? In my view, one of the key changes in approach is that mega-regional agreements are moving away from talking about *all things* at once with *everybody*. Massive negotiations within a big tent were effective to a certain extent in the 1960s and 1970s when only the OECD was involved, but this kind of approach has become increasingly difficult since then. Now the advantages of covering everything at once are definitely outweighed by the disadvantages. In terms of the WTO, this means that we need to think about different ways of negotiating. The agreement on trade facilitation marked a step in this direction.

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With regard to mega-regional agreements, there are a number of issues that have gained importance in recent years, but were far less significant back when the WTO system was set up. Multilateral trade negotiations (MTNs), for example, have become far more influential. Now that the Dispute Settlement Body (DSB) is working, we should be thinking about using it in other areas as well, which is perhaps another function that the WTO could offer. In terms of services, we will look at what the General Agreement on Trade in Services (GATS) did not deliver, which is another reason for the emergence of extra-WTO talks.

New regionalism

Firstly, let us take a look at the new regionalism. To follow up on Professor Sinn's comments about bilateral agreements, if you match them by country pairs and ask how much trade has been taking place within a bilateral or regional block and how deep such agreements are, it emerges that about a quarter of world trade and trade pairs that are governed by this type of agreements. In other words, a very substantial chunk of global trade is occurring under the umbrella of agreements that are not part of the WTO itself. This share is growing and will increase even further as TTIP moves forward.

The upsurge in interest in regional trade agreements is probably due to the emergence of regional production networks. This means that global trade is mostly in parts and components, which do not only move once, but are transported back and forth several times across borders, leading to far higher nuisance costs, as has already been pointed out. In addition, many firms operate in multiple markets, which means that even if they don't yet produce in some global value chain, they may be developing blueprints for releasing a product in many markets. In many cases this is simply more cost-effective. In pharmaceuticals, for example, if you develop a new drug, you have to run a billion dollar drug trial – and pharma companies do not want to repeat this process two or three times. So as more large companies manufacture products to be sold in multiple

markets, the impact of differences in national regulatory regimes on their bottom line has become more apparent. We need to think about multi-national production in this context – changes in global production chains mean that behind the border measures now matter more. As multilateral trade negotiations gather impetus, the importance of intellectual property is also growing in the context of firms operating in multiple regimes. China, as the 'dragon in the room', has been mentioned several times. With TTP more than TTIP, this is partly what has been driving the whole agenda.

Benchmarking barriers and their costs

Let us now compare the composition of the goods traded between the United States and the EU between 1997 and 2011. By composition I am referring to the share of goods of own value-added in exports *versus* the gross value. For example, for machinery shipped from the EU to the United States in 1997, the gross value relative to value added is 1.3 percent. This means that if there is 130 euros worth of goods, about 100 euros of that amount is European value added and the other 30 euros represents the cost of parts and components from elsewhere. The latter figure has now reached 1.65 percent. These numbers show that a much bigger share of the products that Europe is exporting now comes from elsewhere, and the European development is also seen in many regions around the world. So one answer to the puzzle of why the WTO's annual report has stated for fifteen years that trade is growing faster than GDP is that we were making things differently. The value-added share of trade was not growing rapidly, but the gross value was because companies now move parts and components around to a far greater degree. And because of this moving back and forth across borders, two-percent tariffs that have to be paid three or four times start to add up. In addition, paperwork for these goods needs to be filed, which also adds to costs.

Yet, according to 2008 Eurostat international sourcing statistics summarising the results of interviews with firms operating abroad, 'tariffs' is ranked third on the list of barriers to sourcing abroad, behind 'differences in legal and administrative requirements for firms operating in different regulatory regimes', ranked as the number one barrier, and followed by 'proximity to existing clients needed'.

The Ecorys study (2009)[1] was part of the initial scoping work done by the European Commission when it encouraged Washington to start up the TTIP process. This work consisted of interviews with firms and discussions on classifying the barriers that exist. One category is 'regulatory divergence', which can turn into a barrier. For example, customers want to be sure that the toasters they buy will not burn the house down. There are different ways to ensure this in terms of testing requirements. If a product has to be tested several times, this generates extra costs. Electrical appliances in the United States have a three-foot standard cord, whereas the standard length in the EU is a metre. The cords on toasters therefore have to be changed to satisfy individual country requirements. Simple incompatibilities like this all add to companies' production costs.

[1] Ecorys (2009), Non-Tariff Measures in EU-US Trade and Investment – An Economic Analysis, Study for the European Commission, Rotterdam, http://trade.ec.europa.eu/doclib/docs/2009/december/tradoc_145613.pdf.

Table 1

Estimated transatlantic trade cost reduction linked to NTMs (in %)

Sector	EU barriers against US exports	US barriers against EU exports
Food & beverage	56.8	73.3
Chemicals	13.6	19.1
Electrical machinery	12.8	14.7
Motor vehicles	25.5	26.8
Other transport equipment	18.8	19.1
Metals & metal products	11.9	17.0
Wood & paper products	11.3	7.7
Average goods	*21.5*	*25.4*
Air	2.0	2.0
Water	8.0	8.0
Finance	11.3	31.7
Insurance	10.8	19.1
Business & ICT	14.9	3.9
Communication	11.7	1.7
Construction	4.6	2.5
Personal, cultural, other services	4.4	2.5
Average services	*8.5*	*8.9*

Source: Ecorys (2009).

In econometric literature trade costs are broken down into natural costs and policy costs. The natural costs are those that cannot be negotiated away. The Japanese speak Japanese, and if you do business with them the paperwork is often in Japanese, which constitutes a barrier if you do not speak the language. As they will not negotiate away their legal system of operating in Japanese, this very real barrier is not actionable.

In addition, unlike the geometry relating to tariffs with talk of triangles and rectangles and where there is money collected, with a large share of the NTBs there is no money collected (see also Table 1). If it costs ten percent to refit a car to sell in the North American market, this represents a deadweight cost. Firms know that eliminating such costs by getting rid of regulator divergence or by aligning regulations may yield substantial gains in productivity; and this knowledge has been a driving force behind TTIP.

If we look at intra- *vs*. extra-EU market access, there is evidence that the Single Market has worked. In metals, for example, access has become easier within the EU in terms of non-tariff barriers, which suggests that the barriers still remain in the Single Market, but are lower than for goods coming in from outside. In the European Commission's view, TTIP may lead to a gradual reduction in trade barriers for all participants if a long-term mechanism is set up; and there is evidence that this may be true.

Mega-regionals and TiSA

Let us now move on to services. A massive dataset was recently released by the OECD, reflecting work on the services trade restriction index. This data tells us that the GATS commitments do not seem to be binding. If you look through the regional services agreements, many are also fairly non-committal and even less binding than GATS itself, although they sometimes compensate for this in other areas.

It is clear that cross-border trade is linked to establishments, so establishment rights are very important. FDI in trade is blurring to a growing degree, rendering simple models ineffective when we look at services. The potential gains here are actually quite large. At the end of the Uruguay Round, I remember Bob Stern presenting modelling estimates on the impact of liberalising services trade. He used Berhard Hoeken's indexes (the only measure on NTBs in services available at that time). His estimates were very rough and it is hard to say how accurate they turned out to be, since the service sector is very large and heterogeneous. In some ways modelling trade liberalisation is like lifting rocks and looking for things underneath them: because 'services is big', we expect to find big effects when we lift up the rocks. So Stern's message was not that he had exact numbers, but that he expected large effects potentially because the services sector accounts for seventy percent of a typical OECD economy, and is also pervasive in terms of cost structure. In a sense, services are also on the agenda for TiSA, TPP and TTIP and everyone is exploring ways to move forward in this area.

Furthermore, the World Bank's Services Trade Restrictiveness Index (STRI) reveals that the policies in place are much more liberal and open than the binding arrangements within the GATS and those offered under Doha. So even if the Doha Round had been concluded in terms of the GATS commitments, there would not have been much of a change. To an even greater extent than with tariffs, where there is this issue of binding overhang, there is a huge gap between the policies in place and commitments. Within the GATS, and even with all the negotiations at Doha for the GATS, little progress was made in actually closing this gap. So TTIP and TTP can be seen as a bid to close it to compensate for this failure.

Additional driving forces behind TTIP

A comparison of the revenues (measured in terms of FDI income) earned by European firms abroad through affiliates, and the revenues earned by US firms abroad shows that most of European firms' revenues come from the United States; and *vice versa.* In other words, the same firms are operating on both sides of the Atlantic. I would argue that TTP is being driven by the US State Department; while TTIP is being driven by firms operating on both sides of the Atlantic. Whether they be developing drugs or car models, these firms are present in both markets, operating and producing, and as such they would stand to benefit from the regulatory aspect of a successful TTIP. So, even if you exclude agriculture and cultural exceptions, the brick and mortar industry is pushing for changes in how we regulate. This push is different to the NAFTA of the 1960s, or other efforts that have been seen roughly every decade since. This time per-

haps it is different because production chains have changed so radically and the firms involved are more multinational than in the past.

Conclusion

Although, as I already mentioned, I am agnostic with regard to mega-regional agreements, they may nevertheless prove to be incubators for dealing with new issues. The old quad is pursuing regional initiatives outside of the multilateral framework and there are legitimate fears of countries being left out. In a sense, however, I think they are pursuing such initiatives firstly because, as far as regulatory costs and divergence are concerned, the same population of firms is operating on both sides; so there is enough political support to move forward in this direction. These are not the FTAs our fathers negotiated – the new trade-investment initiatives are deeper and reflect regional production by global firms. The welfare calculus is very different as a result. Since there is a lot we do not know, we must 'guestimate'. As I said, there are productivity linkages due to the reduced production costs of shipping parts abroad. There may be third-country spill-overs. So if the United States and the EU can agree to recognise standards, Switzerland, for example would welcome this move, as it would be make it easier for its firms to gain entry to the US market thanks to Switzerland's existing agreement with the EU on standards. So in terms of regulations, it is not clear that it is discriminatory when negotiations bring two sides together. You can have a tariff that discriminates against many countries. Indeed, there may be some ways in which, as things move closer together, third countries may actually stand to benefit. I do not know how big this effect could be, but it's possible.

When we look at TTIP, it is worth remembering the Treaty of Rome and how long it took for the treaty to eventually lead to the Single Market. If progress is to be made on regulations, it requires a process and an institutional setup; and it may take decades. Although this fact does not feature in any of the models and cannot be quantified, it is crucially important. Nobody is aiming to set up a 'Fortress Atlantic'. Moving forward, ways will be found to let other countries sign up; once the strengths and weaknesses of TTIP become clear, but this process has to start somewhere. There is a new set of issues to deal with, multilaterally or bilaterally. Despite all the worries and caveats, TTIP should be seen as an opportunity to find solutions that can be developed further in Geneva and tried out elsewhere.

Panel

Are mega deals going to overtake the Doha round? Panel chairman **Quentin Peel,** Contributing Editor, Financial Times, London, invited **Karl-Ernst Brauner,** Deputy Director-General, WTO, Geneva, to give his insider view. Brauner's response was a confident negative. On the contrary, he hopes that the Bali success will give the WTO a chance to reinvigorate the multilateral system. In his view, bilateral agreements are a second-best option. Confronting Bali's critics, Mr Brauner quoted conference guest **Simon Evenett,** Professor of International Trade and Economic Development at the University of St. Gallen, who said that Bali was "1 percent substance, 9 percent promises and 90 percent public relations". He insisted that the 1 percent substance was very important because it restarted the negotiating process. He also claimed that the 1 percent estimate was rather unfair, because trade facilitation, currently being implemented in Geneva, is expected to generate real gains for companies. He then moved onto the question of the Doha agenda to be designed within 12 months. Opinion is divided over whether the agenda should be limited or expansive, noted Brauner. However, once the agenda has been set, hard core issues like agriculture, non-agricultural market access and services need to be tackled, he warned.

Mukhisa Kituyi, Secretary-General, UNCTAD, Geneva, kicked off with a brief take on Bali. In his view, Bali gave multilateralism a boost, but to what extent are its fruits deliverable in the marketplace? Kituyi argued that, faced with the difficulty of democratising rule-making, the WTO has lowered its ambitions over the past 10-15 years and limited its agenda to achieve success, meaning that little was actually achieved. In his own words: "if you can cherry-pick what items to put on the table, and you mobilise international public opinion to accept this as important and sufficient as a harvest, then perpetually the developmental promise of Doha walks out of multilateral rule-making". While acknowledging that mega-regional agreements constitute a far more immediate response to the challenges facing the main players than the Doha round, he added that "we must not let the

pragmatic side that drives mega- regional agreements destroy the essence of the collective good that can only be dealt with multilaterally".

Nakgyoon Choi, Commissioner, Korea Trade Commission, Republic of Korea, began his presentation by describing Bali as a big step towards simplifying, harmonising and modernising customs procedures and substantially reducing global trade costs. Returning to an issue already touched upon by other speakers, Mr Choi asked what form the Doha Development Agenda should take? He urged countries to take a multi-track approach to pursue the three approaches simultaneously and, specifically, WTO members need to place more emphasis on plurilateral agreements. To revitalize the WTO, Mr Choi called for multilateral review and monitoring of regional trade agreements; and for the WTO to strengthen its role as part of a new system of global governance.

Bali is "the deal that didn't happen in the real world" according to **Paul Donovan,** Global Economist and Managing Director, UBS Investment Bank, London. Mr Donovan, an outspoken critic of the WTO, claimed that the Bali deal has not registered with companies or financial markets. On a more positive note, he expressed the hope that simplifying customs may reduce corruption related to trade. Donovan also welcomed the fact that Bali was not about tariffs and exchange rates, which tend to dominate political discussions. In his view, the first negative related to Bali was the "absolutely terrifying" exemptions related to food. He identified the second problem as the rise of regionalism. If TTIP comes to pass, he speculated that it will, "move us away from multilateralism and towards imperialism in terms of trade". Although TTIP may be a force for trade globalisation, the latter would be "on the terms of the EU and the US" warned Mr Donovan. Finally, he argued that the liberalisation of the banking sector and of trade is intertwined. Global capital flows are substantially below pre-crisis levels and subject to increasing protectionism. "We are ending up with a parochialisation of capital for political purposes", warned Mr Donovan.

The last panellist **William Zhang,** Chief Executive Officer, China Elderly Foundation, Beijing, began by highlighting the restricted nature of the WTO agreement from the very outset. It makes little or no provisions for freedom of labour force and technology transfer, observed Mr Zhang. But in his view, these are: "two pressing issues for developing countries who are eager to export their labour force and import technology, which is desperately needed for their economic development". These issues were deemed too strategic and sensitive to individual countries to be included in the WTO agreement, which focuses instead on intellectual property rights. Exclusion of this area, argued Mr Zhang, makes the WTO's approach to international trade unbalanced, although for understandable reasons. Commenting on speculation by other speakers that the WTO may be replaced by regional agreements, Mr Zhang highlighted the need to restructure the WTO's methodology and its way of thinking if the organisation is to remain a guideline for international trade. He also called for the establishment of a fair international trading order: "I think we, the Chinese people, respect the WTO, but at the same time we are not against any bilateral or regional agreements", concluded Zhang.

In the first round of questions from the floor, **Christoph von Marschall,** Diplomatic Correspondent of Der Tagesspiegel, Berlin, asked Mr. Zhang for China's perception of TTIP. Does China see its lack of involvement in TTIP and TTP as a disadvantage or even as political exclusion? Or is it perceived as good for China to be challenging standards from a consumer/corporate perspective, asked Mr von Marschall?

In response Mr Zhang stated his belief that it would be better to involve China in TTIP and TTP. However, he expressed personal doubts as to whether the proliferation of mega-regional agreements will have a positive impact on the international order of world trade. In his opinion, "it is better to sit down at the negotiating table and discuss things in a smooth way and see how we can cooperate. We do not want to enter a sort of trading conflict, which is not good for both sides".

Coming into the debate himself, Mr Peel returned to the topic of free trade in agriculture and asked Mr Choi whether it will poison the whole negotiation system until it is dealt with? Mr Choi agreed that agricultural subsidies are a complex and thorny issue. Some of the developing countries, he noted, are highly dependent on the agricultural sector, but WTO negotiations have three pillars: services, industrial goods and agricultural. A balance needs to be struck between these pillars, he argued. If developing countries only focus only on agriculture, this creates a problem. In Mr Choi's opinion, leadership by players like the

United States, the European Union, India and China is needed to resolve the deadlock situation.

In the second round of questions Simon Evenett, provocatively asked why we need the WTO if everything is settled within regional agreements? Mr Brauner gave a very clear answer: to design universal rules of origin. The WTO also deals with issues of common good that are not covered by mega-regional agreements like fishing, he added.

Oliver Wieck, Secretary General, International Chamber of Commerce, Berlin, asked the panel why they were optimistic that governments may now be readier to reset the negotiations on tariffs and start something really new? Why, in other words, are we now in a better position than in 2008 or 2009, wondered Mr Wieck? Because a great deal of tariff liberalisation has already taken place, responded Mr Brauner. Countries have not lowered their bound tariffs, but their applied tariffs have dropped considerably. This unilateral lowering of tariffs, he explained, was a bid to attract investment and gives us a better starting point for negotiations. Mr Wieck responded that Brazil had raised its tariffs, but Mr Brauner countered that this was an exception and Brazil's response to the crisis, but that the general trend in tariffs was downward.

Mr Zhang wrapped up the first panel on an upbeat note with a pitch in favour of the WTO. Since its foundation in 1995 the WTO has generated considerable profits for its member states, noted Mr Zhang. "If global trade is divided up by regional organisations the individual cakes will become much smaller", he warned, which could result in a "turmoil situation for international trade".

Panel 2

TTIP: Small Gains, High Risks?

Gabriel Felbermayr*,
Benedikt Heid* and
Mario Larch**

Introduction

In its final report of February 2013, the High-Level Working Group (HWLG) on Jobs and Growth, set up by the so-called Transatlantic Economic Council (TEC), recommended that the EU and the United States start negotiations on: "a comprehensive, ambitious agreement that addresses a broad range of bilateral trade and investment issues, including regulatory issues; and contributes to the development of global rules [that] goes beyond what the United States and the EU have achieved in previous trade agreements".

Subsequently, the European Commission adopted the draft mandate for the TTIP talks and a common position among the 27 member states was negotiated. The mandate was approved unanimously under the Irish presidency of the EU in June 2013. Negotiations started in July 2013. Since then, seven rounds have been held, alternating between Brussels and Washington.

The proposed Transatlantic Trade and Investment Partnership (TTIP) would be the largest free trade area in the world. In 2012, the two regions accounted for more than 45 percent of global value added in current dollars and for 30 percent of trade (exports and imports of goods and services) in the world. The sheer size and depth of the proposed undertaking suggest that it could have strong effects for EU member states, the United States, third countries and the world trading system.

In many EU member states the discussion of the proposed TTIP is very controversial, despite the fact that the scope and details of the agreement are still unknown to everyone. The key question is whether a TTIP is worth the effort, i.e. whether the gains outweigh the risks. The gains have economic and geostrategic components: the elimination of tariffs and other trade barriers across the Atlantic should increase trade and real per capita income, while a stronger regulatory cooperation should help impose Western standards in the world trade system of the 21st century. Critics dismiss the possible gains as small and fear that a trade deal may trigger a race to the bottom in health, safety, labour and environmental standards, and, that it will only bring economic advantages to the owners of large corporations.

This article focuses on the potential welfare gains from TTIP for European member states, the United States and third countries and employs a structurally estimated general equilibrium model. Such models have recently been used to quantify the gains from trade, but researchers are only starting to apply them to trade policy analysis.[1] This approach complements more traditional modelling efforts based on large scale computable general equilibrium (CGE) models.[2]

The central assumption in our analysis is that the proposed TTIP will affect trade costs between the EU and the United States in the same way as existing agreements have affected trade costs within other pairs of trade partners. We take an estimate of this average treatment effect of trade agreements from a large body of econometric literature and implement it into a simple model of the world economy. The main advantage of our approach is that we do not require bottom-up

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** University of Bayreuth. This article is an abridged version of the paper "Macroeconomic Potentials of Transatlantic Free Trade: A High Resolution Perspective for Europe and the World" written by the same authors. We are thankful to Sebastian Benz, Kerem Cosar, Anne-Célia Disdier, Heribert Dieter, Lionel Fontagné, Joseph Francois, Len-Kuo Hu, Sébastien Jean, Sybille Lehwald, Jacques Pelkmans, Laura Márquez Ramos, Uli Schoof, and seminar participants at Brussels, Berlin, Fudan, Göttingen, Heidelberg, Munich, Ningbo, Taipei and Vienna for helpful comments.

[1] The literature is well summarised in the chapter by Costinot and Rodriguez-Clare (2014) in the fourth edition of the Handbook of International Economics.

[2] In the context of TTIP, such an approach has been chosen by Francois *et al.* (2013) or Fontagné *et al.* (2013).

estimates of non-tariff trade barriers, and that we do not need to make external assumptions as to how the TTIP would lower them.

It is commonly understood that the import tariffs of both the EU and the United States are relatively low. As shown in Felbermayr and Larch (2013), the weighted average tariff on manufactured goods is about 2.8 percent for both regions, whereas the weighted tariffs on agricultural goods are only slightly higher (but more asymmetric). In contrast, overall trade costs are estimated to be much higher. For trade amongst industrialised countries, Anderson and van Wincoop (2004) report an *ad valorem* equivalent of international trade costs (transportation costs and border-related costs) of 74 percent. If a TTIP is to have any measurable effect, it has to be through the reduction of those latter costs.

Our analysis is based on trade and GDP data from the year 2012. In our simulations, we calculate real per capita income levels for a counterfactual scenario in which the 56 trade pairs involved in the TTIP have a preferential trade agreement. In our benchmark exercise, we find that the TTIP increases real income by 3.9 percent in the EU28, by 4.9 percent in the United States, but lowers it by 0.9 percent in the rest of the world. These numbers are substantially higher than those predicted by a study written by Francois *et al.* (2013) for the European Commission. Their results show an increase of 0.48 percent for the EU. While that study puts the long-run average gain from the TTIP in Europe at about 136 euros per capita (545 euros for a four-person household), our estimates put it at about 1,118 euros.[3]

We find that countries within the EU are affected differently. Countries in the periphery, which tend to have higher average trade costs, benefit more from the TTIP than countries in the core, which are already much more open. We also find that third countries that have strong trade ties with the EU or the United States would stand to lose out from TTIP. At the higher end, we find losses of about 3.1 percent in Canada, 2.6 percent in Mexico and 1.6 percent in Turkey. At the lower end, countries that are less exposed to the EU or the US markets, will lose less, e.g. China 0.5 percent. On average, countries not covered by the TTIP lose 0.9 percent, while the world in total will gain 1.6 percent.

These negative welfare (and trade) effects arise from the existence of trade diversion. Since Viner (1950), economists know that preferential trade liberalization is discriminatory because relative market access costs for outsiders increase. Baldwin (2011) argues that the proposed TTIP is different because it is not mainly about market access, but rather about establishing common standards from which third countries could benefit. However, in line with conclusions presented in the 2012 World Trade Report, our reading of the available empirical evidence suggests that such spillovers are by no means guaranteed.

Important facts and research strategy

Trade costs are still very substantial

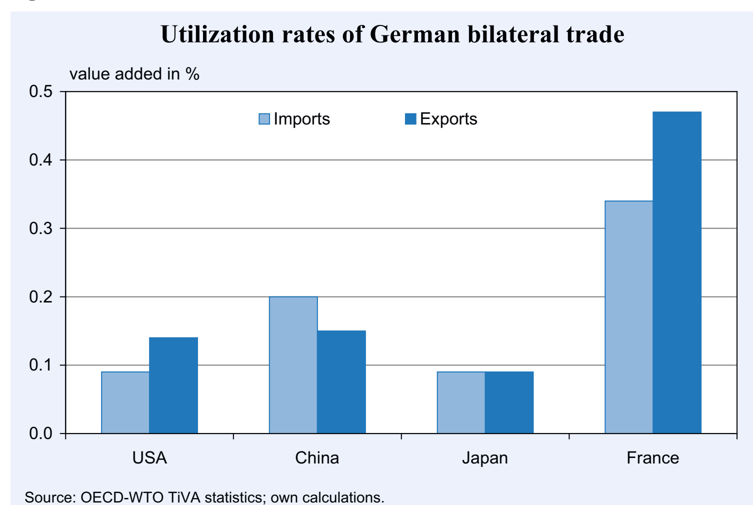
The most-favoured-nations (MFN) import duties imposed by either the EU or the United States have been lowered in various rounds of multilateral trade liberalization. As discussed in Felbermayr and Larch (2013), the overall weighted average tariff on industrial goods is 2.8 percent for both the EU and the United States; in the area of agriculture the average is slightly higher (3.8 percent in the EU, 2.8 percent in the United States).

Nonetheless, trade costs are still substantial around the world and across the Atlantic. To illustrate this, we can compare actual trade volumes to those predicted by simple trade models under the assumptions of (i) frictionless trade, (ii) identical preferences, and (iii) product differentiation. In these hypothetical textbook circumstances – see e.g. Feenstra (2004), the US imports (of goods and services) from the EU should equal the EU's share in world output (the EU's share in world GDP, i.e. 23.0 percent as of 2012), multiplied by the total US expenditure (the US GDP, adjusted for current account imbalance, amounting to 16,606 billion US dollars). This would yield imports of 3,818 billion US dollars. Actual imports, however, amount to 550 billion dollars only. The utilisation rate of potential EU exports to the United States, therefore, amounts to a mere 14 percent. Similar calculations result in an utilisation rate of potential US exports to the EU of about 12 percent.[4]

[3] These calculations are based on a GDP per capita of 28,385 euros. It is worth noting, however, that comparisons across studies are problematic. The Francois *et al.* (2013) exercise embeds its counterfactual analysis into a hypothetical future world (year 2027), projecting GDP growth trends into the future; while we use data on GDP and trade as observed in 2012.

[4] EU expenditure of 16,504 billion US dollars times US share in world GDP, 22.4 percent, relative to observed trade of 455 billion US dollars.

Figure 1



These numbers involve some overestimation, since they refer to gross trade and not to value-added trade. Using data from the OECD-WTO Trade in Value Added (TiVA) database for the year 2009, similar calculations for German bilateral trade with different trade partners reveals that the trade potential utilisation rate with the United States is lower than that with China, and a far cry from the rate observed with France – see Figure 1.

These calculations show that the assumptions (i) to (iii) made above cannot possibly hold. Assumption (i) – the absence of trade costs – is most obviously violated: tariffs in transatlantic trade are not zero, there is strong direct evidence that non-tariff measures exist and are important, and other barriers (not directly related to policy) are also pervasive. This is in line with empirical evidence (e.g. see the survey by Anderson and van Wincoop 2004; Chen and Novy 2012). In the following, we maintain assumptions (ii) and (iii) and attribute the entire gap between actual and hypothesized trade to trade costs.

Assuming the trade elasticities in the plausible range of 4 to 7, it is easy to back out the *ad valorem* equivalent (AVE) of trade costs that can generate the pattern shown in Figure 1. In Felbermayr *et al.* (2014) we estimate that the AVEs in transatlantic trade range between 33 and 65 percent, which is not too far from Anderson and van Wincoop's (2004) estimate of 74 percent for trade amongst OECD countries in the late 1990s.

Preferential trade agreements and trade costs

There are virtually thousands of estimates of the trade creating effects of preferential trade agreements. However, only few papers are able to convincingly sort out correlation from causal effect. Table 1 presents exemplary results from published articles. It shows the preferred point estimates generated in those papers and, assuming trade elasticity, translates these estimates into trade cost savings brought about by preferential trade agreements. We view the study by Egger *et al.* (2011) as the most comprehensive study in the field, since it deals with zero trade flows, heteroskedasticity and reverse causation, and draws on a very large sample of trade agreements (about 300). With our preferred trade elasticity of 7, this study concludes that existing trade agreements have reduced trade costs by between 16 and 26 percentage points, depending on trade elasticity. Applying these savings to the estimated level of transatlantic trade costs, this would imply a reduction of between 40 and 48 percent.

It is worth noting that the effects presented in Table 1 are top-down estimates of how trade agreements affect total trade costs. They include the reduction or elimination of tariffs, the alleviation of non-tariff measures, and indirect effects, such as those arising from increased private or public incentives to invest into further reduction of trade costs (e.g. language, infrastructure, etc.).

Modelling strategy

In our quantitative exercise, we use the theoretical model proposed by Egger and Larch (2011), which is

Table 1

Causal trade cost effects of existing PTAs, percentage points

Source	Point estimate	Trade elasticity 4	7
Baier & Bergstrand (JIE, 2007)	0.68	– 15.6%	– 9.3%
Egger *et al*. (AEJ, 2011)	1.21	– 26.1%	**– 15.9%**
Baier & Bergstrand (JIE, 2009)	1.08	– 23.7%	– 14.3%
Magee (BEP, 2003)	2.20	– 42.3%	– 27.0%

Source: Authors' compilation.

described in detail in Felbermayr *et al.* (2014). The model features imperfect competition *à la* Krugman (1980) and a so-called extensive margin (we take into account that the TTIP may terminate or commence bilateral trade relationships). We estimate a trade cost matrix that fits in with the observed bilateral trade data for the year of 2012 for 173 countries, assuming a trade elasticity of 7.

When we simulate the effect of a possible TTIP, we reduce trade costs between the EU member states and the United States under the assumption that TTIP has the same trade cost reducing effect as all pre-existing preferential trade agreements had on average using the estimate from Egger *et al.* (2011). By this, we assume that the TTIP will just be an 'average' preferential trade agreement. We take full account of general equilibrium effects such as adjustment in incomes, i.e. GDPs, and in price levels (what trade economists have come to label as multilateral resistance terms). This yields a new counterfactual matrix of trade flows, new vectors of GDPs, price levels, and welfare statistics (real per capita income, identical to an equivalent variation measure).

The welfare effects of TTIP

Potential gains with different trade cost functions

Table 2 reports unweighted, GDP-weighted and population-weighted summary statistics for the welfare estimates resulting from different specifications of our model. Starting with our preferred specification [1], a model that allows for selection (i.e. the fact that the TTIP could activate or deactivate trade relationships), we find that the effect of introducing the TTIP leaves the average country unaffected, but the standard deviation is relatively high (1.9 percent). The GDP-weighted summary statistics look different: the average country now gains 1.6 percent, and the standard deviation has gone up to 2.8. This implies that the TTIP increases world GDP, but its positive effect is concentrated in countries that are relatively rich to start with (the EU and the United States). Finally, population-weighted summary statistics also report a mean effect of zero: i.e. the average individual on the planet remains unaffected by the TTIP. The largest beneficiary of TTIP registers an increase in real per capita GDP of 5.6 percent (Spain), while the country most negatively affected experiences a 3.1 percent drop in its real per capita GDP (Canada).[5]

It is important to note that these effects are *ceteris paribus* changes: nothing else changes except the introduction of TTIP. Hence, all changes relative to the base line of 2012 are causally attributable to the agreement, and are not driven by assumptions regarding, for instance, changes in GDP for reasons other than TTIP, or the introduction of other trade agreements (e.g. the Comprehensive Economic and Trade Agreement – CETA) between Canada and the EU or any other agreements currently under negotiation). Clearly, higher GDP growth rates in emerging and developing markets, and the formation of other PTAs, will tend to attenuate the negative effects of TTIP on third countries.

Deactivating the selection channel (lower panel of Table 2) leads to greater dispersion on unweighted welfare effects, but otherwise does not significantly alter the summary statistics of welfare effects relative to the benchmark case. It seems that TTIP will predominantly affect the intensive margin.

Models [2] and [2'] refer to scenarios where only tariffs – as observed in 2012 – are eliminated between EU

[5] See Table 3 for results for selected countries. Felbermayr *et al.* (2014) presents detailed results for all 173 countries considered.

Table 2

Benchmark welfare effects (in %) and the roles of selection and PTA point estimates: summary statistics

Specifications		unweighted		GDP-weighted		POP-weighted			
		Mean	Std. dev.	Mean	Std. dev.	Mean	Std. dev.	Min	Max
Models with selection									
[1]	Preferred	– 0.04	1.93	1.58	2.78	– 0.01	1.73	– 3.09	5.56
[2]	Tariffs only	– 0.01	0.18	0.13	0.23	0.00	0.15	– 0.27	0.48
Models without selection									
[1']	Preferred	– 0.23	1.96	1.58	2.78	– 0.03	1.73	– 3.10	5.53
[2']	Tariffs only	– 0.02	0.18	0.13	0.23	0.00	0.15	– 0.27	0.48

Note: All specifications set the trade elasticity = 7.173 countries.

Source: Authors' calculations.

Table 3

Welfare effects: selected countries and scenarios

		[1] Preferred	[2] Tariffs only	[3] Spillovers
1	Austria	2.83	0.22	4.73
2	Belgium	2.25	0.17	4.12
3	Bulgaria	3.94	0.33	5.90
4	Croatia	3.53	0.38	5.49
5	Cyprus	4.36	0.37	6.33
6	Czech Republic	3.04	0.24	4.96
7	Denmark	3.45	0.28	5.38
8	Estonia	4.31	0.36	6.29
9	Finland	4.60	0.39	6.58
10	France	3.46	0.28	5.32
11	Germany	3.48	0.28	5.28
12	Greece	4.21	0.35	6.17
13	Hungary	3.50	0.28	5.44
14	Ireland	4.70	0.39	6.70
15	Italy	3.86	0.32	5.74
16	Latvia	4.10	0.34	6.09
17	Lithuania	3.97	0.33	5.94
18	Luxembourg	2.57	0.20	4.48
19	Malta	4.84	0.41	6.86
20	Netherlands	2.85	0.22	4.73
21	Poland	3.51	0.28	5.44
22	Portugal	4.80	0.40	6.80
23	Romania	3.87	n.a.	5.82
24	Slovak Rep.	3.40	0.27	5.34
25	Slovenia	3.14	0.25	5.06
26	Spain	5.56	0.48	7.55
27	Sweden	4.25	0.35	6.20
28	United Kingdom	5.14	0.44	7.05
EU average		**3.94**	**0.32**	**5.83**
29	**United States**	**4.89**	**0.41**	**5.95**
30	Australia	– 2.01	– 0.17	– 0.93
31	Brazil	– 0.77	– 0.05	0.06
32	Canada	– 3.09	– 0.27	– 1.82
33	China	– 0.50	– 0.04	0.13
34	India	– 0.31	– 0.03	0.65
35	Japan	– 0.51	– 0.05	– 0.04
36	Mexico	– 2.56	– 0.22	– 1.37
37	Norway	– 1.91	– 0.17	– 1.05
38	Russian Fed.	– 1.01	– 0.08	– 0.16
39	South Africa	– 1.69	– 0.14	– 0.82
40	Turkey	– 1.56	– 0.14	– 0.72
Non-TTIP average		**– 0.92**	**– 0.08**	**– 0.07**
World average		**1.58**	**0.13**	**2.73**

Source: Authors' calculations. Results on all 173 countries are available in Felbermayr *et al.* (2014). No tariff data available for Romania in 2012.

countries and the United States, but other trade costs are left untouched. Across the board, under this assumption, welfare effects are less than one tenth of those obtained when non-tariff trade costs are reduced.

Table 3 reports detailed welfare results for all EU countries, the United States and a selection of third countries. All scenarios assume selection. We discuss the possible spill-over effects of transatlantic regulatory reform below.

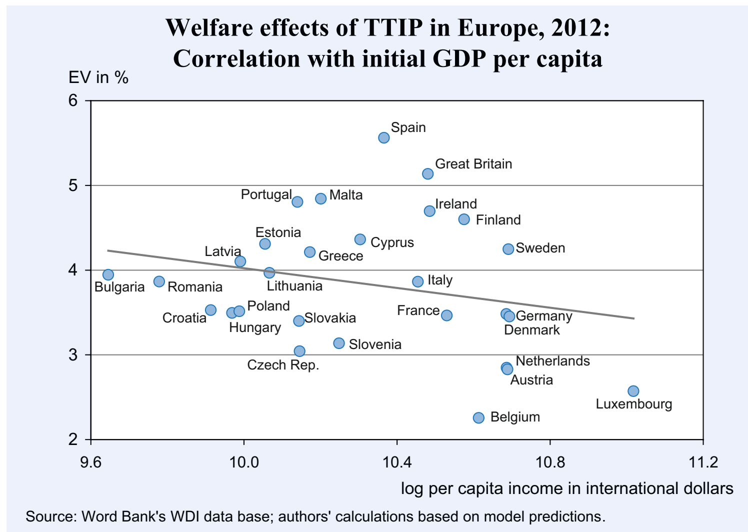
Does TTIP lead to divergence in the EU?

Let us now look more closely into the potential welfare effects of TTIP on EU countries. Figure 2 correlates the welfare gains in the EU28 with the baseline level of real per capita GDP (measured in log per-capita income expressed in purchasing power parities). The regression line indicates a negative correlation between the welfare gains and base line GDP per capita. The slope (– 0.21) is, however, not statistically different from zero at the conventional levels of significance (the robust standard error is 0.21). Nonetheless, it is important to notice that the TTIP does not appear to exacerbate real per capita GDP differences within the EU. The logic for this is clear: those countries that are already rich also tend to be rather open (like Belgium, the Netherlands or Austria, for example). They already enjoy low average trade costs with the world. Lower trade costs with the United States will not unlock large additional gains. In contrast, countries such as Greece, Spain or Italy appear to have higher multilateral trade costs, and would therefore benefit more from reduced trade costs with the United States.

Global welfare effects: who wins, who loses?

Table 3 reports the potential welfare effects for selected third countries, the EU and the United States. Europe gains 3.9 percent, while the United States gains 4.9 percent (together the TTIP partners increase their real income by 4.4 percent). The United States

Figure 2



Welfare effects of TTIP in Europe, 2012: Correlation with initial GDP per capita

Source: Word Bank's WDI data base; authors' calculations based on model predictions.

gains more than the EU. This is due to the fact that the EU is comprised of 28 separate countries, and trade among them is still hampered by border effects. Hence, the TTIP with the United States generates the trade diversion effects within Europe that dampen welfare effects. The United States, in contrast, is a homogenous country and can spare these effects. Real world GDP increases by 1.6 percent, but non-TTIP countries register losses of – 0.9 percent on average.

The TTIP would change the structure of world trade through trade diversion and preference erosion. *Trade diversion* occurs when third countries lose relative competitiveness in the EU and the United States, as firms within the TTIP see their trade costs go down. This loss of market share cannot usually be fully compensated for by increased trade with other non-TTIP countries. *Preference erosion* is a problem for countries that enjoy preferential trading conditions with either or both the EU and the United States in the 2012 baseline situation. Preference erosion happens within the EU, where the TTIP would dilute the value of the Customs Union and the Single Market. More problematically, it also happens within the bilateral agreements that either the EU or the United States maintain with third countries. For example, the United States has bilateral and plurilateral PTAs with 20 countries, the most important are with Canada, Mexico, South Korea, Australia, and with a range of South American countries. The EU has agreements with an even larger number of countries. This list includes countries that also have a PTA with the United States, such as South Korea or Mexico; European countries that are not in the European Union, as well as countries in the Middle East and North Africa.

It is well known that trade diversion and preference erosion may lead to adverse welfare effects from PTAs in third countries. Since the United States and the EU are frequently the most important trade partners for the countries with which they entertain PTAs, one also has to expect such effects in the context of the TTIP.

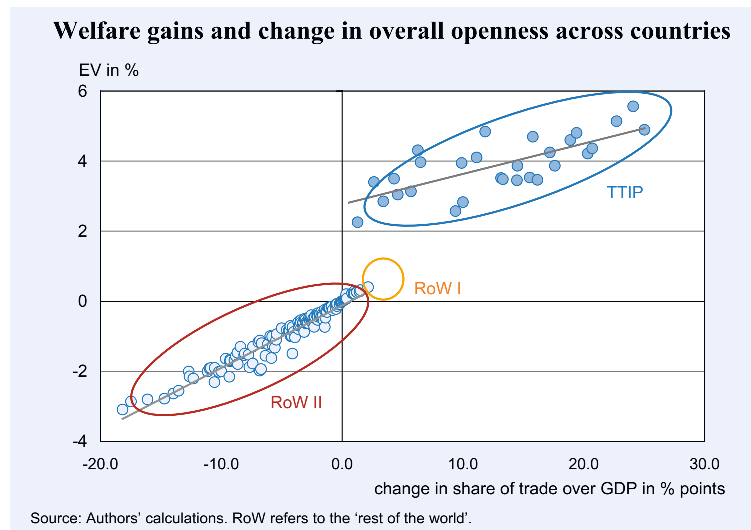
Multilateral openness, in contrast, attenuates both the negative and the positive effects of TTIP. Those countries that are relatively open in the baseline equilibrium benefit less from bilateral reforms than relatively closed economies; or, conversely, they stand to suffer less when their relative competitiveness in the United States or the EU markets deteriorates due to the TTIP. We must, therefore, expect that the non-WTO members or the countries with low overall trade openness typically tend to suffer more from TTIP than those within the WTO or with high baseline openness.

The 25 countries with the largest anticipated losses (ranging from – 3.1 to – 1.7 percent) mostly have PTAs with the TTIP members. 20 out of the 25 have a PTA with the EU, 12 with the United States, and 10 have PTAs with both the EU and the United States. Only 3 countries out of the 25 most strongly hit countries have no PTA with either the EU or the United States.

Figure 3 plots the change in per-capita real income in percent (equivalent variation, EV) against the change in the share of manufacturing trade (imports plus exports divided by two) over GDP implied by the model. Not surprisingly, there is a strong positive association: both effects are endogenous outcomes driven by the reduction of trade barriers across the Atlantic. Indeed, as demonstrated by Arkolakis *et al.* (2012), there is a unique non-linear relationship between the changes in openness and the changes in welfare generated by trade policy reforms. In some cases, the increase in overall openness due to the TTIP is predicted to be quite substantial: openness in Spain would grow from about 23.6 percent to 47.7 percent, and in the United States from about 12 percent to 36.9 percent.

Figure 3 reveals the three different groups of countries: the first is made up of the 29 countries directly

Figure 3



Source: Authors' calculations. RoW refers to the 'rest of the world'.

involved in the TTIP (the EU28 plus the United States), the second by 17 countries that remain outside of the agreement, but whose levels of overall openness and per capita incomes are bound to increase (denoted RoW I), and the third by the 127 countries bound to lose on both measures (RoW II). The non-TTIP countries that benefit are mostly small and poor, and are island states in many cases: Swaziland, Lao PDR, Brunei Darussalam, Lesotho, Palau, Micronesia, Marshall Islands, Tuvalu, Kiribati, Tonga, Solomon Islands, Samoa, Vanuatu, as well as central Asian countries such as Uzbekistan, Bangladesh, Tajikistan, and Mongolia. These countries stand to benefit, because the EU and the United States become richer and, therefore, trade more with these 17 economies. This positive effect outweighs the negative trade diversion effect in these cases.

Spill-overs: mechanisms and empirical evidence

The scenarios presented in columns 1 and 2 from Table 2 assumed that the TTIP lowers trade costs only between the EU member states and the United States. However, if the agreement were also to lower trade costs also between TTIP partners and third countries, or even amongst third countries themselves, the negative effects on the excluded countries may be attenuated, or may even turn positive (Baldwin 2011). Indeed, one may conjecture that the sheer size of the transatlantic partnership and its focus on regulatory convergence makes the TTIP systemically important, meaning that it may create positive spill-overs for other countries.

The reason for this is that firms based in the non-TTIP countries may benefit from a simplification of either the EU or the United States regulatory requirements. Kox and Lejour (2006) provide evidence that differences in services regulations can increase operating costs in different markets. This means that harmonizing those rules may result in lower costs for all exporters in a non-discriminatory fashion.

Citing this reference, Francois *et al.* (2013) include direct and indirect spill-overs in their analysis. They model *direct spill-overs* by assuming that improved regulatory conditions negotiated between the EU and the United States result in a limited fall in related trade costs for third countries exporting to the EU and the United States. This means that exporters from third countries enjoy improved access to the EU and US markets. However, there is no reciprocal benefit for the EU or the US based exporters.

Indirect spill-overs arise if third countries adopt some of the common standards agreed between the EU and the United States. This assumes that the TTIP can successfully impose global standards to which third countries also find it optimal to adhere. In such a scenario the transatlantic agreement would give firms from the EU and the United States improved access to third markets. In addition, the NTMs amongst third countries would also fall, as their standards and norms would move closer to the common model promoted by the TTIP. Therefore, indirect spill-overs would lead to lower costs and greater trade between third countries too.

Clearly, such spill-overs would further increase the overall welfare gains from a TTIP and make it much less likely that third countries would be disadvantaged. Column [3] of Table 3 reports the results of a scenario that deviates from our preferred specification and supposes, as in Francois *et al.* (2013), that a bilateral trade deal across the Atlantic would also lower trade costs between the TTIP insiders and outsiders (*direct* spill-overs, 30 percent of trade cost reduction within the TTIP), and amongst the group of outsiders (*indirect* spill-overs, 20 percent of trade cost reduction within the TTIP). Based on these assumptions, the average welfare effect for the non-TTIP countries is – 0.07, while it would be – 0.92 without spill-overs.

Major countries like China, India or Brazil would end up benefitting from the TTIP. We conclude that spill-overs from bilateral trade cost reductions to third countries can be powerful sources of additional welfare gains.

The problem with this scenario is that both its theoretical and empirical underpinnings are weak. On the theory side, authors have long stressed that preferential trade cost reductions are inherently discriminatory. Viner (1950) introduced the terms 'trade creation' and 'trade diversion' over sixty years ago to highlight the fact that the PTAs are likely to create new trade between member countries partly by diverting trade from non-members countries. If spill-overs were to be important, there should be no trade diversion. On the empirical side, there is a large body of empirical literature that explicitly quantifies the trade diversion effects for different preferential trade agreements. While Clausing (2001) finds little evidence for trade diversion for the Canada – United States Free Trade Agreement (CUSPTA),[6] Trefler (2004) and Romalis (2007) do find evidence for trade diversion for the CUSPTA and the NAFTA, respectively. While Trefler (2004) finds that trade creation does still outweigh trade diversion, Romalis (2007) concludes that the latter is so strong and actually annihilates welfare gains for the NAFTA members. Chang and Winters (2002) analyse the trade diversion effects of non-MERCOSUR exports to Brazil after the inception of MERCOSUR. They find strong negative terms-of-trade effects for non-member countries and conclude their analysis with the statement: "our results give empirical backing to the well-known theoretical argument that even if external tariffs are unchanged by integration, non-member countries are likely to be hurt by regional integration" (Chang and Winters 2002, 901).

Empirical literature on the third country effects of bilateral NTM reforms is less advanced. However, a few existing papers point towards discriminatory effects. Chen and Mattoo (2008) use panel data to analyse the effects of PTAs that include the mutual recognition agreements (MRAs). They find that while the MRAs increase trade between participating countries, the effects on outsiders are less clear cut and crucially depend on the ability of the outside countries to meet standards. As the standards are more likely to be met by developed than by developing countries, Chen and Mattoo (2008) conclude that developing countries in particular will be negatively affected by the trade diversion from any MRA that they are not part of. Baller (2007) uses a gravity model accounting for heterogeneous firms to investigate the effects of MRAs on developed and developing countries. She finds that regional harmonisation hurts developing countries' trade, but stimulates trade between developed countries. There is also a recent paper by Cadot *et al.* (2013) that highlights the trade diversion effects for non-tariff measures. They show that North-South PTAs hurt trade between developing countries. If the harmonisation is based on regional standards, exports of developing countries to developed countries are also predicted to be negatively affected. Given these results, the WTO's World Trade Report (2012, 152) concludes that: "evidence suggests that regional integration of TBT/SPS [technical barriers to trade (TBT), sanitary and phytosanitary (SPS)] measures has trade-diverting effects, especially to the detriment of developing countries".

Policy conclusions

The heated public debate on the proposed TTIP goes far beyond standard economic analysis of the pros and cons of regional trade integration. It addresses the fundamental tension between the desirability of democratic politics, open international markets, and the scope of the nation state (Rodrik 2011). In our paper, we have narrowed our focus on the potential economic impact of the TTIP down to EU member states and the world. Nonetheless, our research does offer some important insights for economic policy: firstly, our analysis suggests that the average EU citizen stands to gain substantial economic benefits from TTIP (about 1,000 euros per year). This is a larger amount than indicated in other studies that use different methods and assumptions, and a higher figure than many critical observers believe to be the case. While we do not deny the risks of a transatlantic agreement (see below), the economic benefits are big enough to tilt the balance in favour of TTIP. So, in our view, it is worth investing political capital in the project. This leads us to answer the rhetorical question asked in the title of this paper with a "No, the *potential* welfare gains are by no means small". Moreover, in contrast to wide-spread public opinion, the TTIP would not benefit core EU countries more than the periphery. While the robustness of this finding is still

[6] It is worth noting that Clausing (2001) uses prices rather than quantities in the welfare analysis, which is problematic (see Feenstra 2004). Additionally, the results from Clausing (2001) may be driven by the rapid growth of imports that would have occurred if the CUSPTA would not have been in place (see Romalis 2007).

to be ascertained, it would imply that there is no need to step up regional support programs following the conclusion of TTIP. Finally, our result that the United States stands to gain more than the EU has attracted public attention. Clearly, this possibility should have no bearing on the desirability of TTIP for the EU.

Negotiators have set their ambitions high. Our analysis remains more modest: we have assumed that the TTIP would reduce trade costs by as much as existing agreements have. However, we know that existing agreements often have holes (exceptions for agriculture, services), and that they often do not cover contentious issues pertaining to regulatory convergence or to investment (such as the much disputed investor-state dispute settlement mechanisms) – see Dür *et al.* (2014). It follows that the welfare gains from the TTIP could be substantial, even if some of the most problematic elements are dropped.

If the TTIP operates like the average existing trade agreement, it is very likely to have discriminatory effects on third countries. While it is conceivable that the establishment of global standards benefits all trading nations, we have refrained from assuming spill-overs in our main analysis: (i) there is no serious evidence yet that would support this modelling choice; (ii) the TTIP is, amongst other things, a very classical market access liberalisation exercise, e.g. in the services, public procurement, agri-food, or investment liberalization areas; (iii) in the area of regulatory convergence, the TTIP will – like the EU single market program – most likely result in mutual recognition of standards across the Atlantic, rather than in the establishment of a global standard. And even if it did, there are no guarantees that the EU or the US regulators would automatically admit goods or services from third countries that satisfy the EU or the US standards. This would depend on the small print and on the implementation of the agreement. Hence, a TTIP must be expected to have Vinerian, i.e. discriminatory, consequences for outsiders. Policymakers should work on measures to mitigate negative third country effects, e.g. by applying generous rules of origin, or by pursuing further multilateral trade liberalization at the WTO level.

Fourthly, in our analysis, we compare the long-run equilibria, but do not discuss the adjustment dynamics. We have also abstracted from distributional consequences. More research into these issues would be highly welcome. However, in the particular case of TTIP, there are reasons to be optimistic. Transatlantic trade is strongly intra-industry. This implies that adjustment processes will predominantly involve intra-industry reallocation. This should keep adjustment costs low as workers change jobs within sectors, and it should also lead to speedy adjustment. Thus, frictional unemployment on the adjustment path should remain limited. Moreover, the structure of factor endowments across the Atlantic is not too different. This leaves little scope for Stolper-Samuelson type effects. So, there are reasons to believe that the distributional consequences of TTIP should also be limited. Nonetheless, policymakers are advised not to obstruct the working of the labour market and to ensure that the TTIP does not result in more monopolistic market structures that create new barriers to entry.

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Panel

"The Economist has been fighting for free trade for 170 years", as **John Peet**, the European Editor of this prestigious journal pointed out. Since the benefits of free trade are evident, he asked the panel to more discuss the potential barriers to a freer transatlantic trade. The Transatlantic Trade and Investment Partnership (TTIP) could, in his opinion, be the last chance to set world standards and regulations. If it does not succeed, it would be a big setback for both the EU and the United States, in addition to supporting anti-EU forces in Britain.

For the European Commissioner for Trade, **Karel De Gucht**, progress on the TTIP agreement is being hindered by cultural differences between the two parties. The United States underestimated the impact of the NSA issue, which has been a boon to TTIP opponents. The major distrust over data protection must be resolved as free trade requires data flow. Another problem is the role of the social media, which is often regarded as a reflection of public opinion. This, however, is not necessarily representative as it is relatively easy to get a large number of signatures in the social media. The successful campaign against ACTA (Anti-Counterfeiting Trade Agreement) is a good example of how effective the social media can be. The opponents of TTIP are against trade and afraid of globalisation. Bogus issues such as hormone beef keep being raised because they serve political purposes. Still, there is a big difference between ACTA and TTIP and the battle over the trade agreement "can be won with sufficient ambition on both sides of the Atlantic".

Karl-Ludwig Kley, Chairman of the Executive Board of the Merk Group, observed that the United States will remain the EU's most important trade partner, not least because of the cultural alignment. A standstill in trade agreements poses a risk for both partners, which is why TTIP is needed to modernise and adjust the trade partnership. Europe has vital interests in TTIP, especially in the area of chemicals, pharmaceuticals and life science, where the United States is the reference market for many products worldwide. Chemicals, for example, are regulated differently in the United States and the EU. If these regulations could be streamlined and harmonised, the non-tariff costs would be lowered substantially and more money would be freed up for R&D. "The season for TTIP is now", but strong political leadership will be required to get it passed.

The advantages that TTIP will bring to small businesses were stressed by **Anton F. Börner**, President of the Federation of German Wholesale, Foreign Trade and Services. Since SMEs are the backbone of economic growth, their needs should also be addressed in the trade agreement. Although tariffs are already low between the EU and the United States, they still matter, and SMEs in particular have problems dealing with regulations. They would benefit greatly from a reduction in regulatory costs. It is particularly important that people be told where the everyday benefits from TTIP will lie. In his opinion, small businesses are

well aware that we live in a globalised world and that a free trade regime is necessary for peace and welfare.

William M. Drozdiak, President of the American Council on Germany, observed that President Obama lent his support to the TTIP talks when he realised that an agreement would raise working and environmental standards in the United States, and he originally received support from his party for this reason. Now, however, fears are being expressed that TTIP will be 'NAFTA on steroids'. Although this charge is unfounded, Senate Majority Leader Harry Reid has refused to give the President fast-track authority on TTIP, fearing that jobs will be lost especially in the southern battleground states. Leader Reid overlooks the fact, however, that companies like BMW, Daimler and Volkswagen have helped transform the economies in these states. If Republicans win the Senate in November, there might be a window of opportunity for passing TTIP, since a Republican Congress could give President Obama fast-track trade promotion authority. The NSA problem is being emotionally debated also in the United States with pressure from politicians on the right and the left for curbing the excesses of the NSA. Silicon Valley companies are also lobbying for NSA reform. Finally, Mr Drozidak expressed the wish that the TTIP debate be conducted on a higher level and not be mired down over minor issues.

In the discussion, **Andreas Haufler**, Professor of Economic Policy at the University of Munich pointed to the fear of law suits in connection with investor protection clauses in the trade agreement. This concern is particularly strong in Germany. Commissioner De Gucht replied that ISDS (investor-to-state dispute settlement) is necessary but needs to be modernised. **Christoph von Marschall**, Diplomatic Correspondent of Der Tagesspiegel, had the impression that too much pessimism prevails over TTIP, also at this conference. The stakeholders in the German economy are not doing enough to promote the trade agreement. Presenting a positive TTIP narrative to the public is not only a job for the politicians. **Lady Barbara Judge** wondered whether the recent conflict in the Ukraine would make it more likely for the EU and the United States to reach a free trade agreement. William Drozdiak agreed that the chilling of relations with Russia has indeed led to a new US focus on Europe and to a focus on 'the primacy of the transatlantic relationship'.

Herbert Dieter of the German Institute for International and Security Affairs wondered whether China should not be invited to participate in the trade agreements since TTIP will have a strong impact on the rest of the world. "Are we forgetting the utility of multilateral agreements?", he asked. **William Y. Zhang** of the China Elderly Foundation agreed that his country should be at the negotiating table instead of having to accept afterwards the terms that others have arranged. With regard to China's participation in the talks, Commissioner De Gucht observed that "it takes two to tango". Unfortunately, China is not ready to take part in the negotiations since it has a record of tending to block or slow down the pace of talks. Its policy on subsidies is also a major hindrance. A well-designed TTIP agreement could also be a help in relations with China. In terms of China, Karl-Ludwig Kley agreed that a "multilateral approach at this stage is unrealistic". In terms of the investor-protection problem, he pointed out that in most ISDS cases the states and not the suing companies have won.

Anton Börner reiterated his plea that "we open up our closed business club" and "talk to ordinary people about the fundamental importance of free trade". William Drozdiak expressed confidence that there will be a two-thirds majority in the next Congress for a free trade agreement. Americans are also interested in eliminating the regulatory barriers for hiring foreign firms, for example, European specialists in flood protection, which could have protected New Orleans from flooding. Whether we end up with a 'TTIP light' will depend in part on whether EU countries are successful in cleaning up the banking sector. Finally Gabriel Felbermayr stressed that joint standards make sense across the Atlantic, but that we need to give the emerging world more time. For this reason it is important that TTIP be designed as an open platform.

Panel 3

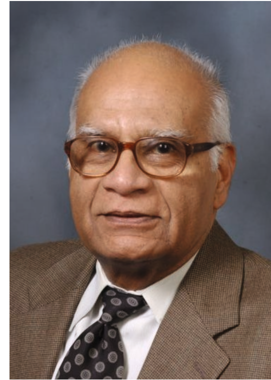
BRICS and the EU: An Oxymoron?

T. N. Srinivasan*

I want to thank the BMW Stiftung Herbert Quandt and the CESifo for inviting me to participate in the 13th Munich Economic Summit, and to introduce the panel on BRICS for Europe as part of the theme of this year's summit, namely 'Free Trade and Prosperity'. It is a privilege to address a group of high ranking politicians, scholars, business leaders, and editors of influential media.

The introducers of each panel were asked, as economists, to set 'a substrate of hard facts' to underpin the discussion to follow. In view of the belief that, despite the recent downturn, the BRICS will continue to outpace developed economies in terms of growth and dynamism; and that current and future trading opportunities with BRICS on the traditional basis of comparative advantage and specialization beneficial to all trading partners are once again large, the panel was asked to address four specific questions:

- Firstly, what can Europe do to enhance trade with BRICS?
- Secondly, what can BRICS do to enhance trade with EU?
- Thirdly, what are the most likely synergies?
- Fourthly, which are the next BRICS countries?



BRICS background

Less than 15 years ago, James O'Neill, Chief Economist of Goldman Sachs noticed that the GDP of Brazil, Russia, India and China were growing faster than the global average and coined the acronym BRIC. South Africa was added to make it BRICS in 2008 and projected that they would dominate the world in 2050. For the 'a substrate of hard facts' on the current situation, see Tables 1 and 2. I will be drawing on them as needed.

As Frances Cameron (2011) notes, with the exception of Russia, the other BRICS did not embrace the O'Neill's acronym and grouping until 2008, and then not only did they embrace the acronym with great enthusiasm, but also held five summit meetings deemed the 'first cycle' in keeping with the five members of BRICS. The sixth

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Table 1

Population and GDP: BRICS and EU comparison

	Population 2012 (in millions)	GDP at PPP (2012)		GDP growth (%)		
		in billion US dollars	Per capita GDP	2000–12	2012–13	2013–14
BRICS total	2,981.9	23,063.0	7,734			
Brazil	198.7	2,291.0	11,530	3.7	2.2	2.4
Russia	143.5	3,272.9	22,800	4.8	3.4	1.3
India	1,236.7	4,730.0	3,820	7.7	4.8	6.2
China	1,350.7	12,205.8	9,040	10.6	7.7	7.7
South Africa	52.3	563.3	7,734	3.6	1.7	2.7
EU27	500.3	14,155.5	28,294	1.2[1]	–0.4	0.1
World	7,043.9	85,986.8	12,207	2.7	2.4	3.2
Share of BRICS (%)	43.7%	28.6%				
Share of EU27 (%)	7.1%	16.5%				

Note: [1] GDP growth rate for the period of 2002–12.

Sources: World Bank's World Development Report (2014), Eurostat, IMF World Economic Outlook (2014).

Table 2

Merchandise and service trade: BRICS and EU comparison, 2014

	Merchandise trade				Commercial service trade	
	World merchandise exports		World merchandise imports		World commercial service exports (% share)	World commercial service imports (% share)
	Largest trading partner (% share)	Next largest trading partner (% share)	Largest trading partner (% share)	Next largest trading partner (% share)		
BRICS						
Brazil	EU27 (20.2)	China (17.0)	EU27 (21.4)	China (15.3)	0.87	1.87
Russia	EU27 (46.8)	China (6.8)	EU27 (41.9)	China (41.9)	1.33	2.50
India	EU27 (16.8)	USA (12.8)	EU27 (11.1)	China (11.1)	3.32	3.08
China	USA (17.2)	EU27 (16.3)	EU27 (11.7)	Japan (9.8)	4.35	6.73
South Africa	EU27 (20.0)	China (11.7)	EU27 (28.7)	China (14.4)	0.34	0.41
EU27	USA (17.3)	China (8.5)	China (16.2)	Russia (11.9)	25.03	20.21

Source: WTO Statistics.

meeting of the initial cycle and the first of the 'second cycle' are to be held in Brazil later this year.

Does this mean there is compelling economic, political and social logic for BRICS to act as an influential group in the world arena? Does the rest of the world, including the EU, treat them as such a group? Apart from normal economic interactions, particularly in trade and investment, are there any significant 'strategic' components to the EU-BRICS relationship and *vice versa*?

Diversity: strength or weakness?

The answer is far from clear. Table 1, for example, clearly shows that there is considerable diversity among BRICS in their population, GDP and GDP per capita measured in terms of purchasing power parities (PPP), economic growth and so on. In our discussion we could go into the question of whether this diversity is a strength comparable to the composition of assets in an appropriately diversified portfolio in terms of the BRICS' ability to take greater risks in the international arena; or whether it constitutes a weakness constraining the ability to both formulate and credibly implement coordinated strategic responses?

Some view the diversity as a weakness, since the BRICS economies are heterogeneous not only in economic structure, but also in terms of their cultures, institutional arrangements, etc. Of the five, China is an authoritarian single party regime and its current president has consolidated his power, Russia is an authoritarian democracy, Brazil is a democracy with an authoritarian past, India is a democracy that tried authoritarianism briefly under Mrs Indira Gandhi and, depending on today's election results, a party with an authoritarian leader could come to power. There are many problems with South Africa's democracy. Should the EU as a champion of democracy be at least cautious in dealing with BRICS an influential geopolitical group?

However, as Table 2 shows, the EU happens to be the largest single destination of exports for all BRICS, with the notable exception of China. For both China and the EU, the United States is the largest single export destination. However, for all other BRICS (excluding China) and the EU, China is the second largest export destination, while for China the EU is the second largest export destination.

As for imports, the EU is the largest source for all BRICS, and China is the second largest. For China, Japan is the second largest source of imports, while Russia is the second largest source for the EU. While none of the BRICS except China is among the EU's first or second largest trading partners, China figures as the second largest single trading partner for the EU. Thus, from a trade perspective it can be argued that firstly, China among the BRICS should be treated differently; and secondly, that the EU should bear in mind that keeping its markets open to imports from BRICS as a group is important. Before returning to the trade issues in answering the first two questions, let me devote a few minutes to what BRICS themselves view as their objectives and their role in the international arena.

The declaration and action plan of the fifth summit of the BRICS at Durban, South Africa on 27–28 March

2013, lays out some of the major objectives of BRICS leaders. In addition, Cameron (2011), European Parliament (2011), Hunya and Stöllinger (2009) and Zerby (2013) also discuss them. I will draw on all of the above.

At their fifth summit the BRICS leaders held open discussions (see www.brics5.co.za). They agreed to establish (i) a New Development Bank and indicated that the initial capital contribution to the bank should be substantial and sufficient for the bank to be effective in financing infrastructure; (ii) to set up a contingent reserve arrangement (CRA) with an initial size of 100 billion US dollars; (iii) the BRICS Think Tanks Council and the BRICS Business Council (the former will link respective think tanks into a network to develop policy options and a future long-term strategy for BRICS, while the latter will bring together business associations from each of the BRICS countries and manage engagement between the business communities on an on-going basis); and (iv) concluded two agreements under the auspices of the BRICS Interbank Cooperation Mechanism: the BRICS Multilateral Infrastructure Co-Financing Agreement for Africa and the BRICS Multilateral Cooperation and Co-Financing Agreement for Sustainable Development.

Since all development banks have to depend on developed country capital markets for resources, whether yet another regional development bank will be able to tap substantial additional resources at an affordable cost is an open question. There is no doubt that an essentially self-insurance type contingent finance by BRICS to address liquidity shocks will be costlier than a global insurance through multilateral agencies.

The leaders expressed the well-known concerns of BRICS and other groups such as emerging markets with regard to reforms of International Financial Institutions, and specifically the redistribution of IMF quotas, permanent membership of the UN Security Council, sustainable development, food and nutrition security, poverty eradication, Millennium Development Goals, etc. in the declaration.

BRICS leaders viewed the institutions such as IMF, World Bank, WTO as creations of Western Powers in which they, and particularly the United States, are dominant. They would like the United Nations and related institutions such as UNCTAD to play a greater role. Interestingly, presumably because of them being members of the G20, they did not view it as being dominated by the West, although membership of the G20 was determined by the G7 and has not changed since its creation out of G22 in 2008!

There are some deep issues in extending the concepts of equity, fairness, voice, exit and others, that are well-defined and understood when applied to groups of individuals, to organisations such as the UN, World Bank, IMF, ILO, G20, etc. whose members are nation states usually represented (although not always) by the regimes that happen to be in power in those states.

In the UN, membership is open to all states that subscribe to its charter. The nature of its governance systems, such as democratic, a monarchic, one-party authoritarianism is not a relevant consideration. In the EU-BRICS context, because not all of the BRICS are democracies, the implicit question in the EU dealing with BRICS as a geo-political group is whether the EU would have to trade-off its concern for promoting democracy by doing so.

In any case, the EU is conducting negotiations over trade and economic partnership agreements, euphemistically called free trade agreements, with BRICS with weak bargaining power. Such agreements constitute attempts by the stronger negotiating partner to extract concessions regarding intellectual property and labour standards that go beyond TRIPS, the ILO convention and other multilateral agreements. The EU's negotiations to conclude 'free trade agreements' with individual BRICS are best viewed as part of the unfortunate rise in preferential trade agreements (PTAs) since the conclusion of Uruguay Round, while the Doha Round of multilateral trade negotiations started in 2001 is still to be concluded. Incidentally the G20 conspicuously failed to deliver on their repeated promises by to conclude Doha before 2011!

I will not attempt to predict either the likely contents of an EU PTA, or any of the BRICS, let alone when such an agreement will be concluded. However, given the patterns of EU-BRICS merchandise trade in Table 2 (unfortunately the WTO database does not provide comparable data for services trade), answers could be given to the first two questions posed to this panel. Firstly, since the EU happens to be the single largest import market for China (and the second largest export market for China), by keeping its markets open to imports from BRICS, the EU can enhance its trade with BRICS. However, China is the world's manufacturing hub, Russia is an energy exporter,

nearly two-thirds of India's GDP is generated by services, not all of which are internationally tradable; although from the perspective of employment and poverty, the agricultural sector is crucial. In other words, the competitive advantage of each BRICS is different sectors calling for an across the board market opening by EU. Moreover, despite several bouts of reforms, the Common Agricultural Policy (CPA) of Europe continues to distort world agricultural trade. Since the EU is the largest source of imports for all BRICS, each of the BRICS could reduce barriers to imports from BRICS to enhance its trade with EU.

Hunya and Stöllinger (2009) point out that globally EU is the most important foreign direct investor (FDI). It is among the main investors in each of the BRICS, and the dominant investor in Brazil and Russia, although not in China and India. Clearly, for the BRICS attracting FDI in general, and the associated advanced technology of FDI, from the EU are important. However, from an EU perspective, the intellectual property regimes, as well as the labour standards of BRICS as host countries, could be a deterrent. Whether in the free trade negotiations with the BRICS, the EU will be able to extract concessions from BRICS in these two areas remains to be seen. Besides FDI, the EU is also a major foreign institutional investor (FII). Both for FDI and FII, the domestic regulatory regimes in BRICS matter. On the other hand, the regime with respect to inflows of labour into EU from some of the BRICS is important. The most important synergy between BRICS and the EU is likely to be from the technological spill-over from FDI from the EU into BRICS.

The last question as to which are likely to be the next BRICS countries, is not easy to answer since, given the diversity of BRICS, almost any country in the world is likely to have some commonality with a BRIC. That said, I believe that Indonesia is most likely to become the next BRIC.

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Panel

The panel chair, **Katinka Barysch**, Director of Political Relations, Allianz SE, Munich, directed targeted questions to each of the panel members. She asked **Philipp Mißfelder**, Foreign Policy Spokesman of the CDU/CSU Parliamentary Group, how Europe should deal with the BRICS countries. Unlike the EU, the BRICS have no political programme, replied Mr Mißfelder. They are focused primarily on economic and currency matters. "We cannot dictate policy to the BRICS nor can we expect a country like India to endorse sanctions against Russia".

The United Nations Industrial Development Organization, UNIDO, has a Senior Coordinator for BRICS Cooperation, a position currently held by **Oleg Sepelev**, a speaker on this panel. Mr Sepelev pointed to the impressive development of the BRICS economies, which are now no longer aid recipients but donor countries. UNIDO organises round-table discussions for senior government officials of the BRICS countries in awareness of the potential these countries have within UNIDO and how they can serve as examples for other developing countries. Still, UNIDO does not treat the BRICS in isolation from other countries but pursues all avenues of cooperation.

John Whalley, Director of the Centre for the Study of International Relations (CSIER) at the University of Western Ontario, emphasised that despite the institutional developments, such as the BRICS bank, at the moment the BRICS are not a negotiating group. As a result, EU negotiations must be with individual BRICS members, of which China comes first. In a world of megadeals, China itself is involved in a complicated network of negotiations and will eventually become a part of TTP (Trans-Pacific Partnership). Since power in negotiations is a factor of the strength of a country's economy, there has been some question as to whether China can maintain its target of 7.5 percent annual growth up to 2020. With the on-going improvements in the educational system, Mr Whalley believes this growth rate is still possible. Since it suffers from anti-dumping regulations in particular, China

has a strong interest in the many on-going trade negotiations.

Martin Brudermüller is Vice Chairman of the Board of Executive Directors of BASF SE. He is based in Hong Kong and responsible for the Asia-Pacific region of his company as well as serving as Speaker of APA, the Asia-Pacific committee of German industry. He stressed the huge potential for German-Chinese trade, which can act as a catalyst for EU-China relations. Since German trade consists of a large share of intermediate-goods imports from the EU, European countries also benefit from the growth in German exports. In terms of trade agreements, Mr Brudermüller favours 'a pragmatic, step-by-step approach' to EU-China trade relations with an emphasis on removing concrete obstacles to trade one by one.

The last panel speaker, **Xin Chen**, Head of the Economic Department at the Institute of European Studies at the Chinese Academy of Social Sciences (CASS), pointed out that fifty percent of Chinese exports are linked to FDI in China, and "one-third of China's exports to the EU consists of imports from other countries". In light of this, it is essential that China have a role in trade negotiations. In addition, the financial crisis has demonstrated the importance of BRICS institutions as a 'firewall for the future'.

"Why are there no free-trade agreements among the BRICS countries?", Katina Barysich asked. John Whalley mentioned that Indian manufacturing interests have been opposed to such agreements, and T. N. Srinivasan added that the many non-tradable services in the Indian economy make it difficult to reach free-trade agreements in the group. Nevertheless, as Mr Whalley observed, China has now become Brazil's largest trading partner, which will also have repercussions for the whole Mercosur area. Philipp Mißfelder added that Europe underestimates the activity within the BRICS economies, pointing out Brazil's strong relations with South Africa.

In the discussion, **Christoph von Marschall** of Der Tagesspiegel stressed that the transatlantic partnership is driven more by investment and services than by trade, unlike the relations with the BRICS economies. For this reason the free trade agreements should be open for other countries to join in future, but at the moment it would make no sense for China to join the TTIP negotiations. For **Simon Evenett**, Professor of International Trade and Economic Development at the University of St. Gallen, the "BRICS countries are very good at playing off one EU country against the other", which prevents the EU from being a strong negotiating partner.

Maria Luiza Viotti, Brazilian Ambassador in Berlin, does not regard the BRICS as a negotiating group, but the BRICS economies are important for each other and they have helped sustain the dynamism of the world economy during the recent crisis. They have even helped the IMF assist countries that have particularly suffered. Although the crisis has dampened growth in the BRICS countries, large middle classes have developed there, forming an important consumer market. She felt that the WTO should be used more as a forum for improving trade relations.

William Drozdiak wondered why so little attention is being devoted to Africa, although this continent will have some of the fastest growing economies in the coming years. Martin Brudermüller replied that BASF is in fact reopening some of its operations in Africa in light of the continent's huge potential. Because the barriers to trade are larger, Africa has some of the largest potential gains from free trade arrangements, John Whalley observed. For S. N. Srinivasan, if the African countries grow as fast as the IMF projects, this in itself will attract the attention of the markets.

William Zhang, China Elderly Foundation, noted that if TTIP is meant as a true trading group, and not a 'NATO version of an economic body', there is no reason for not inviting China to join in, especially since Chinese input and products are so widespread. This led to the question of whether TTIP is more of a political than an economic endeavour. TTIP started out as a technical, economic partnership, Philipp Mißfelder pointed out, but in the wake of the NSA revelations and the Ukraine crisis, many politicians have changed their position on the agreement. The transatlantic community nevertheless remains strong and is open to bilateral trade relations as well.

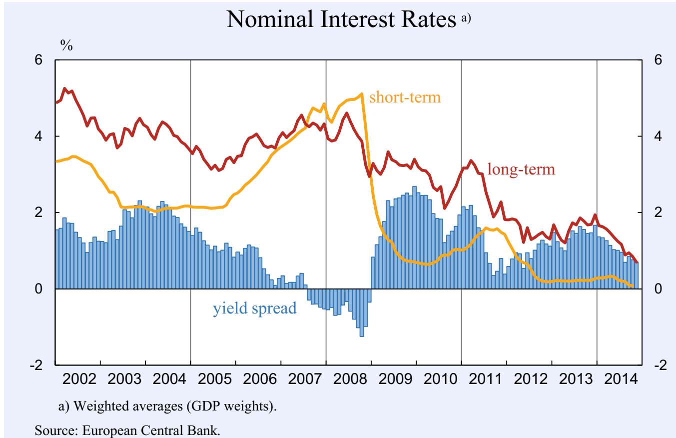
"Are the various bilateral agreements of EU countries with the BRICS a disadvantage?", Katinka Barysch wanted to know. Martin Brudermüller agreed that a more global scheme would be preferable, but "it's a matter of how we get there". Separate agreements are part of a 'pragmatic, step-by-step approach' on the way to a more global arrangement. With regard to the importance of investment and services in relation to trade, he pointed to the growing Chinese investments

in Germany encouraged by the German government, hoping that other countries in Europe would follow suit. The position of Xin Chen is that China should be included in the global trading club. TTIP as an economic agreement among partners would be no problem for China, but it would a problem if it takes on a political dimension. Mr Chen pointed out that more than 70 percent of Chinese outgoing FDI is in East Asia, so TTP may be more important for China's interests. Since China is already 'embedded in the global value chain', it makes no sense to exclude China from trade agreements.

In the final round of questions from the floor, **Jackson Janes**, President of the American Institute for Contemporary German Studies, Johns Hopkins University, wondered whether selling TTIP as 'the new NATO', as some have suggested, was a constructive strategy. **Peter Jungen**, Chairman of *Project Syndicate* asked whether competition in the future between China and the EU might not be over the pace of innovation, especially since Europe seems to be falling behind in the area of venture capital and angel investors. Finally, **Clare Pearson**, Corporate Social Responsibility Manager Asia for DLA Piper UK and based in Beijing, gave her perspective on China's dealings in Africa. China has a keen understanding of connectivity and for this reason is particularly adept at doing business in Africa: "if the water is too clear, the fish can't swim in it", she observed. "We don't need things to be transparent but just social and connected."

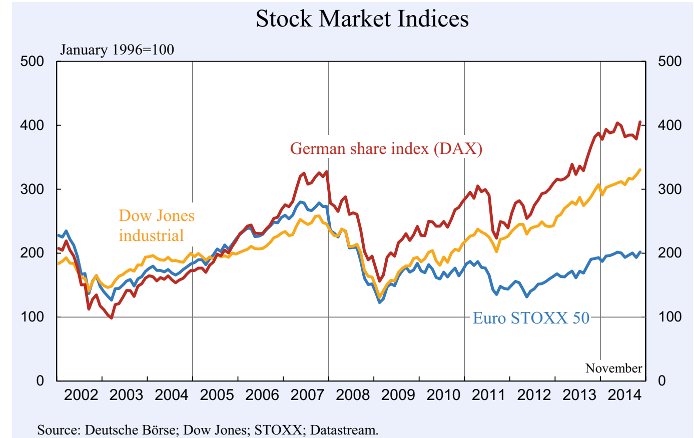
Philipp Mißfelder disagreed and stated that one of the biggest challenges for the Chinese leadership is how to deal with intransparency. He also felt that NATO has positive associations for many Europeans. Now that the EU elections are over, the anti-TTIP and anti-globalisation campaigns have receded. "TTIP now seems to be doing well in public opinion", but this of course could change. For this reason transparent negotiations are essential. Martin Brudermüller admitted that there is an innovation race between Europe and China, but he welcomes competition with a high-tech China, especially since Germany is most successful in high-tech countries. "It's the job of the companies to stay competitive."

Financial conditions in the euro area



a) Weighted averages (GDP weights).

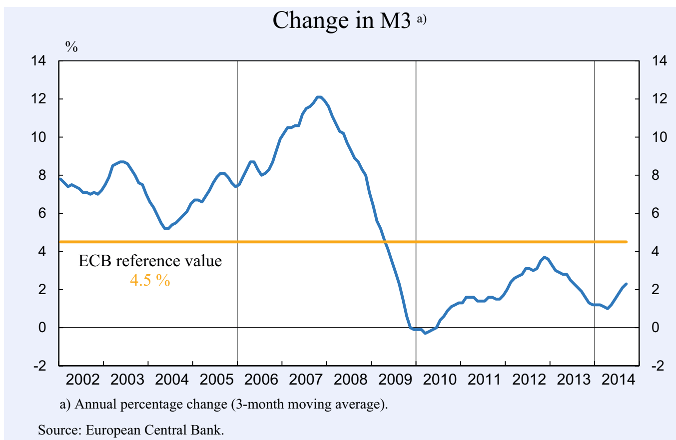
Source: European Central Bank.



Source: Deutsche Börse; Dow Jones; STOXX; Datastream.

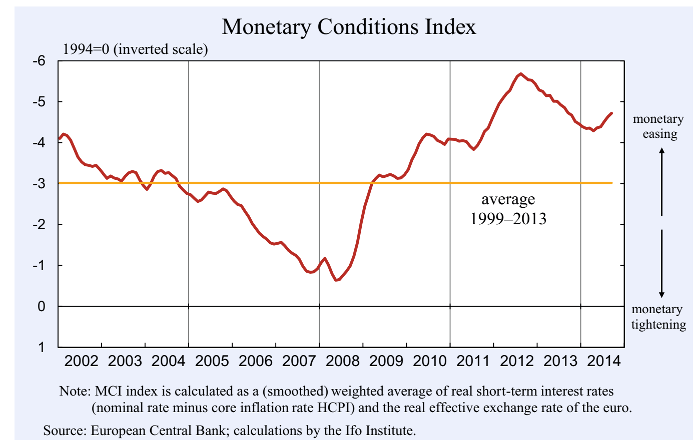
In the three-month period from August 2014 to October 2014 short-term interest rates decreased: the three-month EURIBOR rate declined from 0.19% in August 2014 to 0.08% in October 2014. The ten-year bond yields also decreased from 0.89% to 0.85% in the same period. The yield spread reached 0.76% in October 2014, up from 0.70% in August 2014.

The German stock index DAX increased in November 2014, averaging 9,981 points compared to 9,327 points in October 2014. The Euro STOXX also grew from 3,113 to 3,250 in the same period of time. Furthermore the Dow Jones International increased, averaging 17,828 points in November 2014, compared to 17,391 points in October 2014.



a) Annual percentage change (3-month moving average).

Source: European Central Bank.



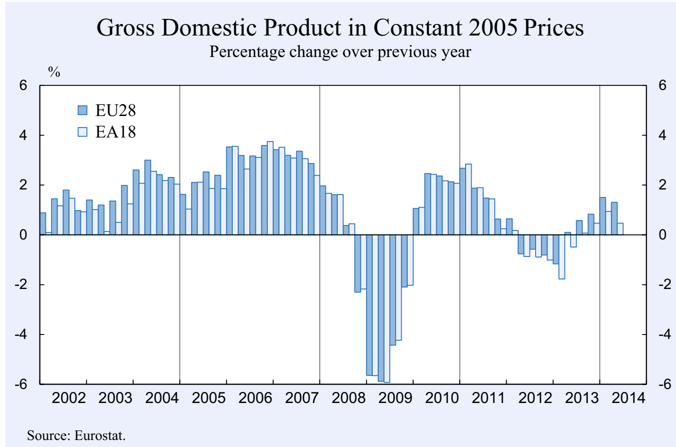
Note: MCI index is calculated as a (smoothed) weighted average of real short-term interest rates (nominal rate minus core inflation rate HCPI) and the real effective exchange rate of the euro.

Source: European Central Bank; calculations by the Ifo Institute.

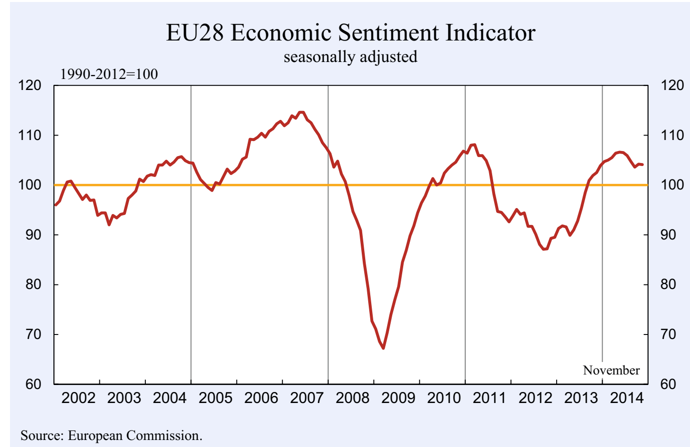
The annual growth rate of M3 stood at 2.5% in October 2014, unchanged from the previous month. The three-month average of the annual growth rate of M3 over the period from August 2014 to October 2014 amounted to 2.3%, compared to 2.1% in the period from July 2014 to September 2014.

Between April 2010 and July 2011 the monetary conditions index remained rather stable. This index then continued its fast upward trend since August 2011 and reached its peak in July 2012, signalling greater monetary easing. In particular, this was the result of decreasing real short-term interest rates. In September 2014 the index continued its upward trend, initiated in May 2014.

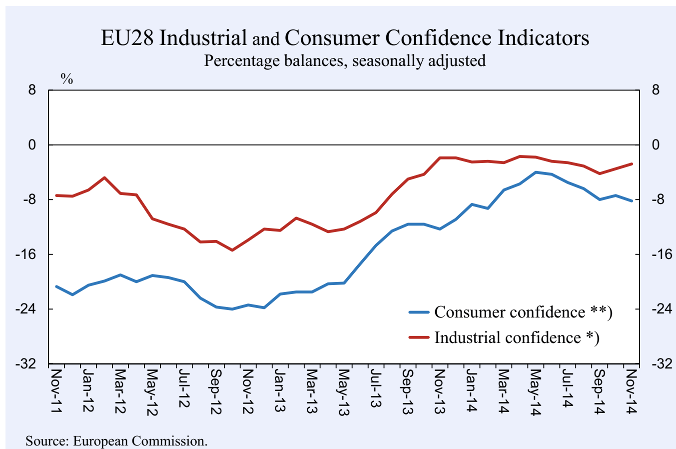
EU SURVEY RESULTS



According to the flash Eurostat estimates, GDP grew by 0.2% in the euro area (EA18) and by 0.3% in the EU28 during the third quarter of 2014, compared to the previous quarter. In the second quarter of 2014 the growth rates were 0.1% and 0.2%, respectively. Compared to the third quarter of 2013, i.e. year over year, seasonally adjusted GDP rose by 0.8% in the EA18 and by 1.3% in the EU28 in the third quarter of 2014.



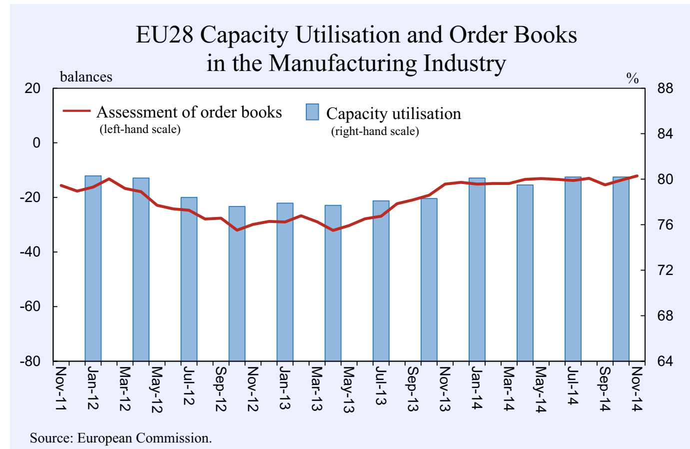
In November 2014 the Economic Sentiment Indicator (ESI) remained broadly stable in both the euro area (+0.1 points to 100.8) and the EU28 (-0.1 points at 104.1). In both the EU28 and the EA18 the ESI stands above its long-term average.



* The industrial confidence indicator is an average of responses (balances) to the questions on production expectations, order-books and stocks (the latter with inverted sign).

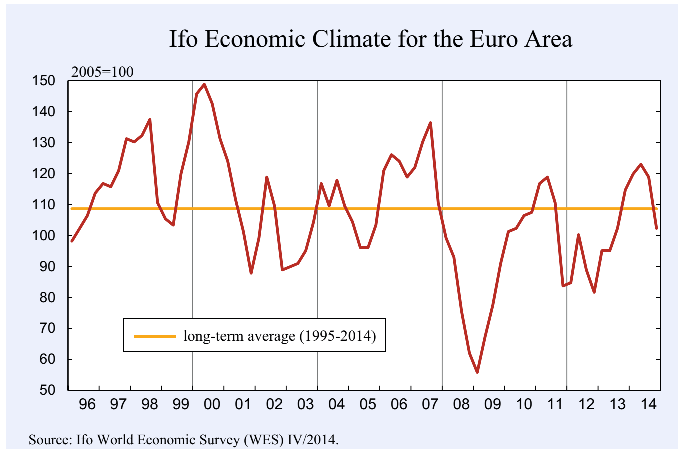
** New consumer confidence indicators, calculated as an arithmetic average of the following questions: financial and general economic situation (over the next 12 months), unemployment expectations (over the next 12 months) and savings (over the next 12 months). Seasonally adjusted data.

In November 2014, the *industrial confidence indicator* increased by 0.7 in the EU28 and by 0.8 in the euro area (EA18). On the other hand, the *consumer confidence indicator* decreased by 0.8 in the EU28 and by 0.5 in the EA18.

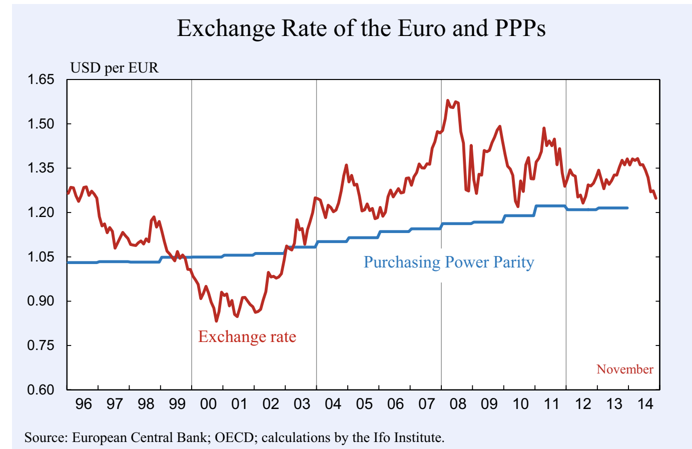


Managers' assessment of *order books* reached – 12.1 in November 2014, compared to – 13.7 in October 2014. In September 2014 the indicator had amounted to – 15.4. *Capacity utilisation* stood at 80.2 in the fourth quarter of 2014, unchanged from the previous quarter.

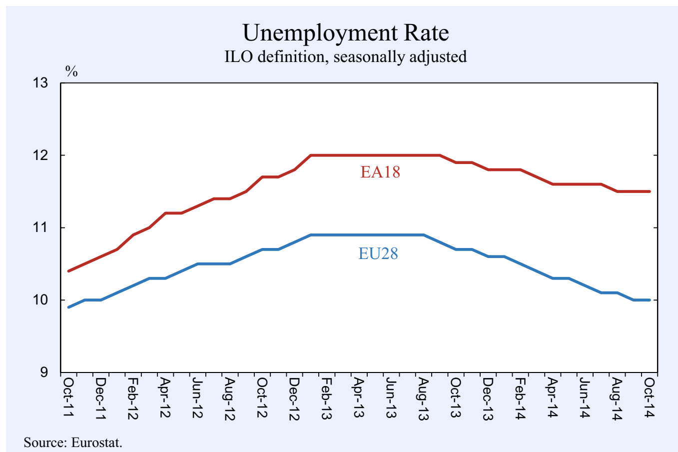
Euro area indicators



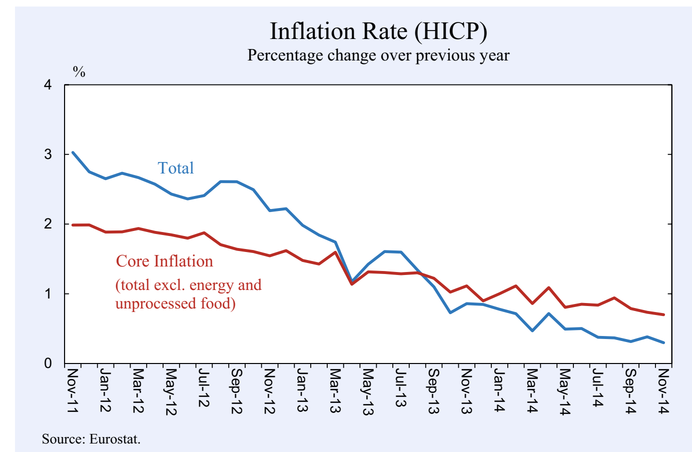
The Ifo Economic Climate Indicator for the euro area (EA18) fell from 118.9 points to 102.3 points in the fourth quarter of 2014, dropping to its lowest level since the third quarter of 2013. It is now below its long-term average. Assessments of both the current economic situation and of the six-month economic outlook deteriorated significantly.



The exchange rate of the euro against the US dollar averaged approximately 1.26 $/€ between September 2014 and November 2014. (In August 2014 the rate had amounted to around 1.32 $/€.)



Euro area (EA18) unemployment (seasonally adjusted) amounted to 11.5% in October 2014, stable compared to September 2014, but down from 11.9% in October 2013. EU28 unemployment rate was 10.0% in October 2014, also stable compared to September 2014 and down from 10.7% in October 2013. In October 2014 the lowest unemployment rate was registered in Germany (4.9%) and Austria (5.1%), while the rate was highest in Greece (25.9%) and Spain (24.0%).



Euro area annual inflation (HICP) was 0.4% in October 2014, up from 0.3% in September 2014. A year earlier the rate had amounted to 0.7%. Year-on-year EA18 core inflation (excluding energy and unprocessed foods) decreased to 0.70% in November 2014, from 0.73% in October 2014.

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