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Article

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Free Trade between Switzerland and the United States

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Between July 2005 and January 2006, Swiss and US trade officials conducted exploratory talks to determine whether a free trade agreement (FTA) would be economically desirable and politically feasible. In January 2006, the talks were recessed when the Swiss Federal Council decided that – while an FTA would be economically desirable – free trade in agriculture was not politically feasible. The FTA talks may be resumed after the conclusion of the WTO Doha Development Round; meanwhile, Switzerland and the United States have launched a Trade and Investment Forum with a view to reaching agreements on discrete topics. While official FTA exploratory talks were underway, the Institute for International Economics undertook a detailed study, authored by GARY CLYDE HUFBAUER and RICHARD BALDWIN, titled: 'The Shape of a US-Switzerland FTA'. The Institute will publish the full study in 2006, and this article summarizes the findings. The analysis indicates that a comprehensive FTA would sharply increase bilateral trade, as tariff peaks and residual barriers are swept away. Agricultural exports could possibly expand by several hundred million dollars annually in each direction, with large Swiss gains in exports of cheese, chocolates and organic foods, and large US gains in bulk grains and meats. Two-way trade in manufactures (about 90 percent of total two-way merchandise trade, which amounts to about \$20 billion annually) might double, concentrated in sectors where it is now hindered by tariff peaks. Foreign direct investment in Switzerland would probably get a sharp boost, as Switzerland enhanced its appeal as a European base for multinational corporations based not only in the United States but also in Asia and elsewhere. Two-way trade in business services, which amounts to \$16 billion annually, would also expand, though the models are not well specified for this sector.

Keywords: Swiss–US free trade agreement, Trade and Investment Forum,
WTO Doha Development Round

Jel-Codes: F00, F14

1 Introduction

At first sight, a free trade agreement between Switzerland and the United States seems implausible. Despite centuries of friendship, the countries are not political or military allies, and they do not share the same continent or the same language. While both countries are rich and mature, subscribe to market capitalism, and are relatively open to the world economy, these similarities can be read as reasons not to enter a free trade

* This article is adapted from GARY CLYDE HUFBAUER and RICHARD BALDWIN, *The Shape of a US-Switzerland FTA*, Institute for International Economics, Washington DC, 2006. AGUSTIN CORNEJO and MAYA SHIVAKUMAR assisted in drafting the book and this article.

agreement. After all, what's the purpose of an FTA between two rich countries that embrace similar economic constitutions and are already quite open to each other's exports? Won't another FTA just add to the 'spaghetti bowl' of confusion that threatens to undermine the world trading system?¹ Finally, in the closing months of the WTO Doha Development Round,² does it make sense to distract diplomatic and legislative energy from the overarching goal of global trade liberalization?

Some observers, both in Switzerland and the United States, will find in these queries their definitive answer: A bilateral FTA makes no sense. Others, including myself and co-authors at the Institute for International Economics, argue that each skeptical question can be turned into an argument for a bilateral FTA.

In 2005, the Institute undertook a study of a possible Swiss-US FTA, and the initial draft has been posted on the Institute's website (www.iie.com). The final version will be published in 2006. Our study will be of most interest to observers who do not foreclose the possibility of a Swiss-US FTA. Before sketching the major issues, it's worth seeing how the skeptical questions can be turned into positive arguments for a Swiss-US FTA.

1.1 Is the Geographic and Political Distance too Great?

Prior to the mid-1990s, free trade agreements and customs unions were dominated by pacts between neighboring countries that were already, or in the process of becoming, political allies – the European Union, the Association of Southeast Asian Nations, the North American Free Trade Area, and the Mercosur. In a way, the European Free Trade Area (with Switzerland as a founding member) – a purely economic venture – seemed the exception that proved the rule, as several members peeled off to join the European Union. In short, experience up to the mid-1990s, led many commentators to see FTAs as building blocks for political integration among neighboring countries.

1 The virtues and vices of bilateral free trade agreements have been widely debated. For a critical view, see WTO (2005b); for a sympathetic exposition, see SCHOTT (2004).

2 The Doha Development Round should conclude no later than early 2007 if the terms are to be ratified by the US Congress before US Trade Promotion Authority expires on June 30, 2007. Otherwise an extension will be required, entailing another legislative battle.

Simply put, this vision proved wrong. By one count, some 176 new trade agreements have been notified since the birth of the WTO in January 1995, and the total number threatens to exceed 300 (WTO 2005a). Yet many of the post-1995 FTAs are 'out of area' and draw no inspiration from existing or anticipated political alliances: US FTAs with Chile and Singapore; the same is true of EU FTAs with Mexico and Chile; Japan's FTA with Singapore; and Switzerland's FTAs (under EFTA auspices) with Chile, Singapore and South Korea.³ Rather than forming tightly knit geographic units, centered on a major power, FTAs are creating criss-cross networks spanning the globe, where there is no clear separation between 'hubs' and 'spokes'. A Swiss-US FTA is perfectly compatible with this model.⁴

1.2 Are There Real Benefits to an FTA?

Since both Switzerland the United States are rich, subscribe to market capitalism and practice open economic policies, does an FTA have a real point? This query echoes the textbooks of an earlier day to the effect that additional trade and consequent economic gains are greatest when two highly dissimilar countries open commerce with one another. According to the 'classic' exposition, large national differences portend sharp comparative advantages and disadvantages, and hence big static gains from free trade. In a world of fixed technological attributes, no economies of scale or scope, exchange limited to final goods and services, complete factor immobility, perfect competition, and only static gains from trade, the classic thesis is still good textbook material. But these characteristics were never accurate descriptors for the world economy.

Recent econometric research demonstrates how misleadingly small are the projected volumes of new trade and size of economic gains when models are confined to the classic assumptions.⁵ Instead, when the realities of modern economic systems are given room to play – learning from new competition and new markets, significant economies of scale and

3 The EFTA-South Korea FTA was signed on 15 December 2005.

4 CEGŁOWSKI (2005) finds that geographic distance has much less significance for bilateral trade in services than trade in goods. Other research (e.g., PORTES and REY, 1999) finds that distance is not an important variable for bilateral direct or portfolio investment. Since services and investment are essential elements of the economic glue between the United States and Switzerland, these findings reinforce the plausibility of an FTA.

5 For a short survey of the econometric methods for sizing up the gains from freer trade and investment, see BRADFORD, GRIECO and HUFBAUER (2005).

scope, huge trade in intermediate goods and services that play an economic role similar to basic factors of production, international investment, and erosion of monopolistic margins – the models and experience reveal that similar countries can gain enormously from free trade and investment, even when they already practice open economy policies.

In the context of Swiss-US relations, it is simply wrong to assert that little or nothing remains to be gained from bilateral free trade and investment. Even though both countries are relatively open, they both have significant barriers. Agriculture, selected manufactures, some services, and government procurement are far from the ideal of free trade and investment. Our own econometric research, discussed later, indicates that elimination of bilateral barriers could significantly increase two-way trade as well as foreign direct investment in Switzerland.

1.3 Is the Timing Wrong?

Perhaps the strongest argument against a Swiss-US FTA is the matter of timing. Why distract attention from the final push to complete the Doha Development Round? For both countries, the political and economic payoff from a successful WTO negotiation far exceeds whatever achievements can be realized on a bilateral basis. The timing argument would be persuasive if the Swiss-US FTA and the WTO Doha Round were alternatives. But the two agreements are complements, not substitutes. Over the next year, the central focus of the Swiss-US FTA should be negotiation, not ratification, either by the US Congress or the Swiss Confederation. The ratification process should be merged with approval of the Doha package.

Moreover, the Swiss-US FTA can liberalize trade in goods and services to a far greater extent than the Doha Round.⁶ At best, within the WTO, modest progress seems possible on agricultural market access barriers, although cuts will be agreed in farm subsidies.⁷ The service negotiations are making very little headway.⁸ WTO members are dickering to improve

6 Perhaps the greatest achievement of the Doha Round will be unilateral market opening around the globe for the exports of the least developed countries. This is significant, but it will have very little impact on the vast bulk of world commerce.

7 See JOSLING and HATHAWAY (2004) and ICONE (2005).

8 The Global Services Coalition, a group of Australian, Chilean, European, NASSCOM, Japan, and US providers, met with WTO officials in Geneva on June 24, 2005, and circulated an alert titled: 'WTO Services Negotiations in Crisis: Political Will Must be Mobilized Urgently'. The December 2006 WTO Ministerial in Hong Kong did not change this bleak outlook.

non-agricultural market access, but the foreseeable outcome is far from zero tariffs on manufactured goods. By contrast, in all these areas and others, the Swiss-US FTA should go far beyond what can be achieved in the WTO.

1.4 Will the Agreement Comport with GATT Article 24?

Both the United States and Switzerland have entered into numerous free trade agreements.⁹ In the past (apart from its special agreements with the European Union), Switzerland has negotiated all its FTAs in conjunction with the EFTA group. None of the US or EFTA free trade pacts have been found in violation of GATT Article 24 – perhaps for the simple reason that Article 24 reviews invariably either say nothing or convey only bland misgivings (SCHOTT 2004).

Nevertheless, it is fair to say that US FTAs generally come close to the Article 24 ideal – eliminating barriers on substantially all the merchandise trade of the partners. The free trade pacts negotiated by the EFTA group fall somewhat shorter of the Article 24 ideal, in that they achieve a very limited degree of liberalization in agriculture. Set against their agricultural shortcomings, the FTAs agreed both by the United States and EFTA liberalize services and investment, areas that the GATT barely touches. If Switzerland and the United States reach a free trade agreement, it should come as close to the Article 24 ideal, but like other FTAs will contain reservations on agriculture.

1.5 Can Switzerland Get in the Queue?

The United States is engaged in free trade talks with many potential partners. Given the long list of potential FTA partners, the US Trade Representative, Ambassador PORTMAN, will inevitably establish priorities. Priorities will depend of a variety of considerations, among them political alliances, prospective economic payoff, speed and ease of negotiation, quality of results.

⁹ Apart from NAFTA, the United States has FTAs with Israel, Jordan, Chile, Singapore, Australia, Morocco, CAFTA-DR, Bahrain and Oman. EFTA has agreements with Bulgaria, Chile, Croatia, Israel, Jordan, Lebanon, Korea, Macedonia, Mexico, Morocco, the Palestinian Authority, Romania, Singapore, Tunisia and Turkey. Additional FTAs are under negotiation, both by the United States and Switzerland.

In its post-September 11th FTA diplomacy, the Bush Administration places a high priority on US national interests in Muslim countries. Morocco was first on the post 9/11 FTA list and Bahrain was second. Egypt, Pakistan and Indonesia are all prospects. Obviously, on a national security scale, Switzerland ranks near the bottom of the FTA queue.

That said, on an array of quantitative and qualitative indicators that enable a comparison of Switzerland with other present and prospective US FTA partners, Switzerland ranks at or near the top. Quantitative indicators measure foreign direct investment stocks, merchandise trade, services trade, and MFN tariff rates for agricultural and non-agricultural products. Qualitative indicators include a corruption index, two economic freedom indexes, and indexes for labor and environmental standards. Switzerland's only shortcoming, in this indicator list, is the high profile of agricultural barriers. Counterbalancing that challenge, a Swiss-US FTA could break new ground on services, government procurement, and other frontier subjects.

2 Agricultural Trade

Agriculture will be the most difficult negotiating subject in bilateral talks. Both countries maintain high barriers to protect sensitive products. Many Swiss and US farm goods simply cannot be produced at prevailing world prices. Therefore, the stakes go beyond market access and lower prices for households; free trade raises the social question of agriculture's place in national life. Yet dispassionate analysis of current and projected trade flows, and the past negotiating experience of both countries, suggest that an understanding that expands opportunities for Swiss and American farmers and food producers can be reconciled with societal objectives enshrined in the Swiss Constitution or US farm policy.

Switzerland relies heavily on foreign agriculture both for domestic consumption and for agrarian inputs to its world-renowned exports. The United States ranks not only among the world's top agricultural producers, but also among the top exporters and importers. Nevertheless, agricultural trade between the United States and Switzerland remains well below potential. In 2004, the United States and Switzerland exchanged agricultural goods with a total value of about \$400 million – only 2 percent of their total merchandise trade. This figure is very low compared to agricultural trade with other partners, notably the European Union, and

is less than bilateral farm trade between Switzerland and the United States in the recent past (see table 1).

Swiss agricultural exports to the United States have grown rapidly in recent years (table 1). By removing barriers, a free trade agreement would encourage this trend, by putting Swiss farmers and food processing companies on a level playing field with agricultural producers that already enjoy preferences in the US market – for example, Australia and Canada.

Meanwhile, US agricultural exports to Switzerland have not done well. Part of the reason for the decline is disagreement over labeling that involves genetically modified organisms (GMOs) and animal hormones. For commercial reasons that go well beyond agricultural trade with Switzerland, the United States does not certify ‘GMO-free’ soy meal or ‘hormone-free’ beef exports.¹⁰ Because of consumer preferences, Switzerland has correspondingly increased its purchases of European agricultural products. Between 1998 and 2003, the share of EU farm produce in Swiss agricultural imports rose from 69 to 72 percent. Recent Swiss-EU agreements expand Europe’s margin of preference in the Swiss market. From the US perspective, an FTA with Switzerland could level the playing field with respect to EU and other suppliers.

The gravity and computable general equilibrium models reported later predict substantial agricultural trade gains – at least a doubling annually in both directions (tables 2 and 3). These forecasts are based on the elimination of tariffs and quotas, but the models do not reflect restrictions through other means, such as sanitary and phyto-sanitary measures. Hence the forecasts could be conservative.¹¹

2.1 Tariffs and TRQs

The simple average tariff on agriculture stands at 9.8 percent in the United States and 36.2 percent (on *ad valorem* equivalent basis) for Switzerland. These figures are significantly higher than the tariffs on other products (3.7 percent and 2.3 percent respectively). For that reason alone, agricultural barriers will be a major focus of FTA talks.

10 US agro-business firms fear that labels of this sort will result in negative perceptions of GMO products, and essentially kill the market.

11 It should be stressed that the large proportional increases apply to small base year levels of trade.

While the United States is a very open economy, certain agricultural sectors enjoy exceptional levels of protection. Tariff peaks (tariffs above 15 percent) are common among tobacco products, peanuts, sugars and sugar confectionery, nearly all dairy items, preparations of fruits and vegetables (table 4). US tariff peaks effectively choke off trade in some of Switzerland's traditional agricultural exports: chocolates, cheeses and certain food preparations.

In the NAFTA negotiations with Mexico, the United States allowed long transition periods towards bilateral free trade in agricultural products.¹² Likewise, in its recent FTAs, the United States has not only embraced long phase-out periods, running from 12 to 25 years (e.g. beef and dairy in the US-Australia FTA), but has also requested and accepted outright deviations from the free trade ideal (e.g., sugar in the US-Australia FTA and CAFTA-DR; beef and wheat in the US-Morocco FTA; corn in CAFTA-DR). All US free trade agreements provide recourse to special safeguards for sensitive agricultural products, sometimes triggered automatically once a price or quantity threshold is reached. A Swiss-US FTA would undoubtedly include similar phase-out and safeguard provisions.¹³

The average applied Swiss agricultural tariff (36.2 percent, see table 5) is higher than any previous US FTA partner, with the exception of Morocco. High Swiss tariffs on meats and grains (table 5) will attract particular attention from US negotiators. These tariffs correspond to core US export interests; in this connection, it is worth noting that top US agricultural exports to the European Union and the world, such as wheat, corn, and soybeans, fare poorly in the Swiss market. Swiss tariffs on animal and vegetable oils, edible vegetables, and dairy will also draw attention. However, it should be pointed out that 15 of the top 35 US agricultural exports to Switzerland enter duty-free or pay only nuisance tariffs (below 3 percent). An important reason is that many agricultural products are used as inputs for processed Swiss goods.

Another magnet for US negotiating attention will be Swiss tariff-rate quotas (TRQs). Switzerland has some of the highest average out-of-quota TRQ rates in the world and applies 28 TRQs to 282 tariff lines (WTO,

12 In 2002, eight years after implementation of NAFTA, average US applied agricultural tariffs were still 2.7 percent on imports from Mexico. NAFTA allowed indefinite agricultural barriers between the United States and Canada; and, in 2002, the US applied agricultural tariff was still 4.4 percent on imports from Canada.

13 The IIE study describes in detail the phase-out and safeguard rules in previous US FTAs.

2004). The simple average in-quota and out-of-quota tariff rates are 11.2 percent and 118.8 percent respectively. Cut flowers lead the way (336 percent), followed by durum wheat (199 percent), pork and poultry (153 percent), grapes and grape juice (143 percent), vegetables (125 percent), cereals (120 percent) and grains (112 percent).

Switzerland has not used its extensive network of bilateral FTAs, including agreements with its own European Free Trade Association (EFTA) partners, to slash the average level of agricultural protection. Indeed, Swiss FTAs negotiated under EFTA auspices exclude agriculture almost entirely. However, the Swiss-EU Bilateral Agreement on Agriculture and recent modifications to Protocol 2 of the 1972 Swiss-EU FTA liberalize certain products where both parties have a particular interest. These agreements fully liberalized access in cheese, and partly liberalized access in some other products such as other dairy, fresh vegetables, fruits, and certain processed items (e.g. chocolate, pasta, soups, sweets, and biscuits).

2.2 Other Agricultural Barriers

Farm subsidies and antidumping rules are clearly important, but by common consent (and US insistence) they are off the table in FTA negotiations. However, a Swiss-US FTA would enable both countries to seek a *rapprochement* on geographical indications, sanitary and phyto-sanitary measures and labeling of genetically modified products.

Switzerland contends that the US trademark system does not adequately protect geographical indications – such as Gruyère for cheese, or ‘Swiss style’ for yoghurt – from misleading use. Swiss authorities advocate protection of geographical indications through a registration system, as applies to some wines and spirits under the TRIPS Agreement in the WTO. In previous trade agreements the United States has tried to promote its ‘first-come-first-served approach to trademarks’, but it has also recognized specific geographical indications (for example, in the US-Chile FTA). Similar recognition, on a mutual basis, should be negotiated in the Swiss-US FTA.

A US-Swiss FTA should also tackle outstanding sanitary and phyto-sanitary issues: US import restrictions on meat products related to ‘mad cow’ disease (BSE); Swiss recognition of US meatpacking facilities; Swiss approval of US products derived from biotechnology; and the scope of

Swiss labeling requirements.¹⁴ While there is a pressing need to find far-reaching solutions to these complex issues, it is unrealistic to expect that the FTA negotiation itself can resolve all of them. Some can be addressed in the FTA text, and others should be assigned to a Working Party of senior experts, to be resolved over a period of years.

2.3 Recommendations

Market access barriers in agriculture have a long history in both the United States and Switzerland, and the barriers are fiercely defended by farm lobbies – however great the costs to society at large. In Switzerland, cows grazing at altitude fit this category. In the United States, cheese quotas are a classic example. The failure of previous trade agreements to ease these barriers will certainly give Swiss-US FTA negotiators reason to pause. But past failures should not be an excuse for abandoning the quest. Rather, the most difficult agricultural products should be liberalized on very long timetables – up to 25 years. Only a very few products should be entirely excluded from liberalization. Long phase-out schedules will give farm owners and workers time to find alternative land use and employment, and the government time to implement green payments as a means of income support.

To balance the political economy of Swiss liberalization, the United States should recognize designated Swiss geographical indications (and Switzerland should reciprocally recognize US geographical indications). Further, a Working Party of experts should devise acceptable labels for genetically modified products. The United States and Switzerland both accept the labeling of ‘organic products’, based on criteria that have nothing to do with science-based evidence on health or safety. The Working Party should oversee the mutual recognition of organic standards. The same Working Party should have a standing mandate to address sanitary and phyto-sanitary issues that cannot be resolved in the FTA, as well as issues that arise in the future.

14 The most significant biotechnology barrier in Switzerland stems from the attitude of skeptical consumers, farmers and food retailers – not the Swiss government. In recent years, a coalition of environmental groups, consumers and farmers has petitioned for a five-year moratorium on genetically modified (GMO) crops in Switzerland. The Swiss Parliament rejected this petition twice on grounds that existing legislation adequately protects humans, animals and the environment. However, the question was put to popular referendum on 27 November 2005, and almost 56 percent of voters supported the moratorium. Swiss farmers will not be allowed to grow GMO crops until 2010, but the moratorium does not prevent the importation of GMO produce.

3 Manufactures Trade

Manufactured goods dominate merchandise trade between the United States and Switzerland, accounting for more than 95 percent of two-way commerce.¹⁵ In 2004, two-way trade in manufactured goods (excluding gold) reached nearly \$17 billion (table 6).

Both countries have very low average tariffs on manufactured imports, and in most categories, where trade between the United States and Switzerland is substantial (e.g. machinery, instruments, chemicals and pharmaceuticals), the commerce is either tariff-free or pays only nuisance duties (table 7). However, barriers are significant for a few tariff lines.

3.1 Tariffs and Tariff-Rate Quotas

Manufactured goods affected by high tariffs will be of great interest to negotiators. According to Swiss authorities, in 2004, high tariffs (those exceeding 5 percent) obstructed about 10 percent of Swiss industrial exports to the United States, but less than 1 percent of US industrial exports to Switzerland.¹⁶ The United States applies high tariffs on leading Swiss exports such as clocks and watches, and chemicals (excluding pharmaceuticals).

By contrast, high tariffs (above 5 percent) do not affect any of the current leading US manufactures exports to Switzerland. However, in a number of tariff-lines, potential US exports would face high tariffs. In both countries, high tariffs are the rule for textiles and clothing.

3.2 Safeguards, antidumping duties, and countervailing duties

Switzerland does not maintain or intend to establish any safeguard measures as envisaged under Article 19 of GATT-1994. At present, the United States has no safeguards on imports of manufactured goods from Switzerland.¹⁷

15 Manufactured goods are defined as all products covered in HS Chapter 25 through 97, except gold.

16 Currently, there is no manufactured product that faces a tariff exceeding 10 percent that records imports over \$15 million at the 6-digit level (Switzerland) or the 10-digit level (United States).

17 There is one safeguard issue that concerns Switzerland: the US practice of excluding NAFTA and other FTA partners from the application of its safeguard measures, even though US imports from the partners are considered in evaluating trade injury. Under US practice, NAFTA and FTA partners are included in the safeguard remedy only when they contribute in a significant way to total imports and to the injury suffered by the domestic industry.

The United States does not currently apply antidumping duties to any product originating in Switzerland, and in recent years, Switzerland has not applied anti-dumping measures against any country.¹⁸ However, if the United States applies future AD duties on imports from Switzerland, the Byrd Amendment could be a matter of concern.¹⁹ There are no outstanding issues with respect to countervailing duties (CVDs).

3.3 Standards and Technical Regulations

International standards are sometimes contradicted by US standards and purposefully not adopted in other instances. Thus, US standards on electrical and electronic products differ from international standards (EU COMMISSION 2004). Likewise, US standards for non-destructive testing require that the personnel be certified twice, whereas the international standard is a single certification (EU COMMISSION 2004). In the pharmaceutical area, the European Union (EU COMMISSION 2004) claims that Food and Drug Administration (FDA) approval of new medicinal products takes much longer for new non-US drugs than it does for new US drugs.²⁰ In the textile and leather trades, US custom formalities are intrusive and costly.

To ensure that manufactures meet standards and technical regulations, the United States often relies on third party conformity assessment procedures (EU COMMISSION 2004). By contrast, the norm in other countries, including Switzerland, is self-assessment. Third party assessment can imply additional costs for foreign suppliers of industrial goods.

By contrast with the long list of complaints heard about US standards and technical regulations, few grievances are heard from Switzerland's trading partners. As in the United States, Swiss federal departments and agencies develop standards and technical regulations, if the Parliament has granted

18 There is no current legislation in Swiss law on the application anti-dumping duties. The last reference in Swiss legislation dates from the Tokyo Round of Multilateral Trade Negotiations. For more information, see WTO document G/ADP/N/1/CHE/1.

19 The Byrd Amendment distributes a large portion of the revenues collected from the imposition of AD measures to firms in the affected US industry. The Byrd Amendment was ruled illegal by the WTO Appellate Body, and recently the US Congress has accepted its repeal.

20 The European Union also takes exception to the US 'over the counter' (OTC) procedure in which active substances that have been approved for an array of medicinal products by the FDA are put on an approved list (EU Commission 2004). The approved active substances can then be sold without a prescription as long as they have a US market history. This limits market access for OTC products that come from the European Union and Switzerland, despite an equivalent regulatory system for pharmaceuticals.

authority. In 1996, the Federal Law on Technical Barriers to Trade (LETC) entered into force. This law, which applies to regulations at the federal level, states that technical legislation has to be drafted in such a way that it does not create trade barriers.²¹ To this end, product standards must be harmonized with the most important trading partners, normally the European Union.

Unlike the United States, Switzerland has entered into mutual recognition agreements (MRAs) dealing both with product standards and with conformity assessment procedures. Switzerland has concluded MRAs with Canada (1999), the European Union (2002), the EFTA/EEA States (2002) and is negotiating with Australia and New Zealand, as well as the United States (on a separate track from FTA talks).²²

3.4 Rules of Origin

Defining the rules of origin that determine which goods are eligible for preferential FTA tariff rates will be a crucial aspect of the negotiation.²³ Many sectors in Switzerland rely heavily on foreign inputs to make exported goods. Producer associations have commented that the benefit of reduced and zero tariffs on manufactured goods will critically depend on whether the FTA contains liberal rules of origin.

For the majority of traded goods, FTA preferences will be meaningful only if the cost of compliance with the rules of origin is modest – otherwise firms will simply pay the MFN tariff and avoid the hassle. Three general issues are sure to arise in negotiating the rules of origin: the convention on cumulation; the rule on remanufactures and the method of certification.

The cumulation issue centers on the designation of countries whose products qualify for meeting the rules of origin set forth in the free trade

21 Today, the legal competence for all technical regulations resides at the federal level, not at the cantonal level as in former times. The WTO (2004) reports that Swiss efforts to harmonize technical requirements across cantons and with the European Union have been successful.

22 Independently of future FTA negotiations, regulatory cooperation already exists between the Swiss and US health authorities in the field of good manufacturing practice (GMP) for pharmaceuticals (Memorandum of Understanding on Cooperation between the US Food and Drug Administration and Swissmedic, dated September 22, 2003). Swiss authorities believe that this cooperation might eventually lead to mutual recognition practices.

23 The legitimate purpose of rules of origin is to avert 'trade deflection' – the practice of routing third country imports into the FTA partner with the lowest MFN tariff, and then re-exporting the same goods into the other partner (the one with a higher MFN tariff), taking advantage of the FTA preferential tariff rate.

agreement. The approach taken by EFTA to the cumulation issue accords with the model adopted by the European Union, where goods from a number of countries that are linked by trade agreements with identical rules of origin can qualify for the negotiated tariff preference, and the result is called 'diagonal cumulation'.²⁴ By contrast, as a normal practice, the United States has adopted a 'bilateral cumulation' approach in its FTAs, meaning that only products manufactured in the partner country, whether sold final goods or as inputs, qualify for meeting the rules of origin.

Remanufactures are industrial products assembled from 'recovered goods' that have been cleaned, inspected, and tested. The United States contends that remanufactured products should qualify under the rules of origin, regardless of their original source.

The third rule of origin issue is certification. While US bilateral FTAs require certification of origin by the importer, Switzerland accepts a declaration by the exporter. The Swiss practice is less cumbersome, since the exporter is better placed to know the origin of goods than the importer.

3.5 Recommendations

Manufactured goods are the heart of merchandise trade, and the IIE study recommends that US and Swiss duties on 95 percent of tariff-lines for manufactured goods should be eliminated immediately. Phase-outs of 4 years should apply to no more than 3 percent of tariff-lines, and phase-outs of 5 to 10 years should apply to no more than 2 percent of tariff-lines.

To facilitate manufactures trade, each country should accord mutual recognition to approved conformity assessment bodies based in the other country. Moreover, the parties should establish a Working Group on Standards to recommend products where US and Swiss technical standards should be harmonized, and products where the mutual recognition principle should apply. The Working Group should also identify products where self-assessment by the manufacturer can replace third-party conformity assessment.

24 Under a strict interpretation, diagonal cumulation with third partners linked to both the United States and Switzerland by bilateral FTAs (such as Chile, Singapore or Mexico) would not be possible, since the rules of origin established by these FTAs differ somewhat. However, a liberal interpretation would enable diagonal cumulation, and in time, as more FTAs are negotiated, this practice would yield substantial benefits.

Finally, the Swiss-US FTA should establish a Working Group to examine US and Swiss free trade agreements, with a view to identifying ways in which inputs from third countries could qualify as inputs under a liberal interpretation of the cumulation principle. The initial FTA rules should allow remanufactures, adopt the least burdensome cumulation method, and otherwise embrace liberal rules of origin.

4 Services and Investment

4.1 Services

By international norms, the service sectors of Switzerland and the United States are already open. However, Swiss and US barriers still persist in some industries, such as financial services, network industries, and the audiovisual complex, and assorted obstacles hinder the cross-border delivery of professional services. A Swiss-US FTA could push the envelope of service-sector liberalization, especially at the canton and state levels, and promote freer movement of personnel. By removing barriers, both countries could benefit from faster transmission of advanced technology and management skills. Moreover, US firms could take better advantage of Switzerland's geography and commercial expertise.

Two-way trade in private services, amounting to about \$16 billion annually, puts this sector close to manufactured goods in magnitude (table 8). The most important barriers are behind the border, such as licensing requirements and public and private monopolies. In its FTAs with Singapore and Australia, the United States has negotiated WTO-plus provisions that the Swiss-US FTA could readily adopt. But the Swiss agreement should go further and set a higher standard: In particular, it should extend unconditional most favored nation (MFN) rights with respect to services, advance the process of mutual recognition of educational and professional credentials, and extend national treatment to responsible insurance firms based in each country.

4.2 Investment

Investment is the bedrock of Swiss-US commercial relations, and the synergy between direct investment and trade is now widely recognized. US and Swiss two-way stocks of FDI exceed \$200 billion. These powerful in-

vestment links foster \$17 billion of two-way trade in manufactured goods annually, \$16 billion in services, and another \$20 billion in FDI income flows. The relatively free flow of two-way trade in goods, services, and income cycles back to promote further investment between the two countries. Rough calculations suggest that additional direct investment, inspired by an FTA, could boost two-way trade in manufactured goods, perhaps by a quarter. It would also foster the movement of skilled personnel, synergies in science and technology, and the creation of intellectual property embodied in patents, copyrights, and trademarks. Switzerland would enhance its evident attractions as a headquarters country for multinational enterprises.

On every investment question of global importance, Swiss and US policies are closely aligned. Both nations agree that investment should be unfettered to the maximum extent; both respect property rights; both adhere to the principles of national treatment and MFN treatment; both are skeptical of state corporations; and both take a critical but not altogether hostile view of public subsidies for infant and senescent industries.

Still, a Swiss-US FTA could eliminate minor barriers and provide a framework for resolving future disputes. Both governments need to further liberalize sectors dominated by public monopolies, relax impediments to foreign ownership in selected sectors, allow easier access to temporary employees, and review conditions for licensing professional personnel. The FTA should proclaim the rights of private investors with respect to national treatment, and ensure appropriate compensation in the event of public taking of private property. It should also establish arbitration procedures for resolving disputes between private investors and host states, including an appellate body to ensure the consistent application of legal principles.

5 Estimates from Gravity and CGE Models

Quantitative assessments of the trade expansion and income gains fostered by a Swiss-US free trade agreement (FTA) require detailed consideration of economic structure and multilateral trade patterns. To carry out this task, the IIE study used both gravity and computable general equilibrium (CGE) models. The IIE gravity model is an augmented version of

ROSE's (2004) framework,²⁵ applied to examine disaggregated merchandise trade. The CGE model is the comparative static framework of world trade and economic activity designed by the Global Trade Analysis Project (GTAP). The GTAP model disaggregates world merchandise trade by sectors, and also (unlike the IIE version of the gravity model) covers world trade in services. While the gravity model is grounded in the empirical tradition of trade analysis, the CGE model rests foremost on theoretical foundations. Hence, each model serves as a check on the other.

The CGE model presents 'before and after' comparisons, assuming that all trade barriers that have been measured in the model's database are eliminated; it does not attempt the more exacting task of modeling the phase-out, over time, of tariffs, quotas and other non-tariff barriers. Similarly, the gravity model attempts to show what a Swiss-US FTA might accomplish in merchandise trade expansion over a period of several years, based on the average experience of prior FTAs and customs unions.

The quantitative results from the gravity and CGE models concur that an FTA between Switzerland and the United States would significantly expand bilateral two-way trade between the two countries. The gravity model estimates gains of about 100 percent for total trade while the GTAP projects more modest gains of between 32 percent (Swiss imports from the United States) and 12 percent (US imports from Switzerland), averaging out to an increase of about 20 percent in bilateral two-way trade (table 3). Both models suggest that much of the expansion in bilateral trade might be focused in agriculture (tables 2 and 3), as the two countries currently maintain significant protection for domestic producers of dairy, grain, livestock and other farm products, owing to the political strength of the agriculture lobbies in both countries.

Gravity models of foreign direct investment (FDI) suggest that a free trade area might increase the stock of FDI in Switzerland by some 40 percent, giving a strong push to Swiss technology and trade in services and manufactured goods. Although the CGE model calculates that the projected increase in two-way trade would lead to negligible changes in US and Swiss GDP levels, the IIE study views this result with skepticism for Switzerland. The CGE modeling framework does not reflect the benefits of adopting improved technology in the wake of more intense competition,

25 ANDREW ROSE is well known for his contentious insistence that GATT/WTO membership plays a modest role in promoting trade. The IIE study cites Rose for his contribution to the technical gravity model and for his database – not for his analysis of the GATT/WTO system.

the exit of less-efficient firms, and greater scale and network economies. Based on alternative methodologies the annual GDP gains to each partner from expanded trade could be on the order of \$1.1 billion. For Switzerland, this amounts to a permanent gain of about 0.5 percent of GDP. The expansion of inward FDI stock would add significantly to this figure.

The general equilibrium estimates of the GTAP model point to particular sectors of both economies that would benefit from the expansion of bilateral exports. These include the dairy, grain, oilseed, and other manufacturing sectors in the United States, and dairy, raw animal products, and select manufacturing sectors in Switzerland. The CGE model calculates a very modest increase in two-way services trade of about 12 percent, but this figure reflects CGE limitations in modeling services trade and estimating the height of barriers. By contrast, sector-specific studies suggest strong positive effects from liberalizing services trade (COPENHAGEN ECONOMICS 2005). Moreover, using a gravity model for trade in services, CEGLOWSKI (2005) estimates that bilateral trade in services for partners to a regional trade agreement is almost 40 percent higher than for non-partners. CEGLOWSKI (2005) also estimates an expansion in two-way services trade by 6 to 7 percent for every 10 percent expansion in two-way merchandise trade. The IIE gravity model predicts a 100 percent expansion in two-way merchandise trade for a Swiss-US FTA. Hence CEGLOWSKI's results suggest an upper-bound estimate of 60 to 70 percent increase in two-way services trade resulting from a Swiss-US FTA.

Estimates of trade diversion under the hypothesized Swiss-US FTA are modest in magnitude. In the case of the European Union and NAFTA, adverse spillover effects are largely the result of leveling the playing field for Swiss and US exporters. This happens because of the dilution of preferences enjoyed by competing Canadian and Mexican exporters in the US market, and EU exporters in the Swiss market.

6 Swiss-EU Relations

Given the geographical reality of Switzerland's location on the global map, the European Union plays a preponderant role in Swiss trade flows and policy. In fact, Switzerland has more than 100 commercial treaties with the European Union (HEWITT ASSOCIATES 2002). Swiss-EU trade relations will continue to occupy a central place in Bern's thinking, whether or not a Swiss-US FTA becomes a reality.

The Swiss-EU Bilateral Agricultural Agreement contains an 'evolutionary clause' that commits the two parties to regularly review their agricultural trade.²⁵ While this is far from an unconditional MFN clause, Switzerland's geographic, political, and economic circumstances ensure that the European Union will carefully examine commercial concessions granted to the United States. The Swiss-US FTA would be exceptional as almost the first Swiss FTA separate from its EFTA partners.²⁷ However, a Swiss-US FTA would, at most, inflict a degree of 'preference dilution' on the European Union, and might come to be regarded by Brussels as a benign 'reverse hub-and-spoke arrangement'.

A Swiss-US FTA should not cause major difficulties in Swiss-EU trade relations. Three central reasons support this argument. First, through 50 years of bilateral negotiations, the European Union has already obtained almost all of the market access it wants from Switzerland. Major barriers remain only in farm trade, but here the lack of reciprocal market access is firmly supported by the 'body politic' in both Bern and Brussels. Neither the EU members nor the Swiss have ever shown as great an interest in freer trade in food products as the United States. Instead, both sides are happy to forego reciprocal market access in exchange for a free hand on farm policy. Second, except in agriculture, Swiss MFN tariffs are low, so the margin of preference extended to US firms will be modest. Third, the Swiss market is a relative minor concern to EU exporters, so the modest erosion of EU preferential access implied by a Swiss-US FTA is unlikely to cause a backlash in Brussels.

Brussels has historically respected the Swiss tradition of operating on a different and somewhat independent commercial track. Ideally, the European Union will show the same tolerance for a Swiss-US FTA as the United States has shown for the Mexican-EU FTA. The Swiss-US FTA is the most important plank, but not the only plank, in Switzerland's new proactive FTA strategy. Through EFTA, Switzerland has already concluded an FTA with Singapore that is in force. Negotiations have recently been concluded with South Korea and are under way, at different stages, with Canada and Thailand. Exploratory talks are taking place with Japan. Just as the United States has no objections to the numerous free trade

25 The bilateral agreement is formally known as The Agreement between the European Community and the Swiss Confederation on Trade in Agricultural Products, signed in 1999. Article 13 is the evolutionary clause.

26 In the past, apart from its bilateral FTAs with the European Union and the Faroe Islands, Switzerland has negotiated FTA pacts as part of the EFTA group.

agreements negotiated by Mexico since NAFTA, so the European Union should have no objection to Switzerland's forays into commercial diplomacy on a global basis.

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Tables

Table 1 Swiss agricultural trade (Millions of current dollars)

	1998	2000	2002	2004
Total agricultural exports	2089	2047	2205	3129
to the European Union (15)	1394	1169	1282	1952
to the United States	128	116	137	184
Total agricultural imports	4937	4610	4963	6505
from the European Union (15)	339	311	3537	4695
from the United States	270	275	230	240
Shares of Swiss agricultural imports (%)				
European Union (15)	69%	68%	71%	72%
United States	5%	6%	5%	4%

Source: COMTRADE

Table 2 Gravity model estimates of bilateral trade expansion, Swiss-US FTA

Product category	Estimate increase in bilateral trade
Disaggregated trade *	102%
Agriculture (SITC 0&1)	142%
Raw material (SITC 2&4)	101%
Fuels (SITC 3)	26%
Manufacturing goods (SITC 5–8)	140%
Total trade (SITC 0-9)	104%

* The simple average excludes the estimate for total trade (SITC 0-9).

Source: Author's calculations based on generalized least squares estimation of the ROSE (2004) gravity model with random effects, using a combined version of the ROSE (2004) and the FEENSTRA-LIPSEY (2005) data sets.

Table 3 CGE model estimates of bilateral trade expansion, Swiss-US FTA

	US Imports		Swiss Imports	
Total imports	0.1%		1.9%	
From partner	12.3%		32.4%	
From rest of the world	-0.1%		-2.0%	
Imports from partner (millions US dollars)	Base year	With FTA	Base year	With FTA
Agriculture				
Grains	0	0	8	37
Oil Seeds	0	0	10	23
Plant Based Fibers	0	0	4	3
Other Crops	7	10	57	69
Dairy Products	35	153	2	212
Other Food Products	102	131	123	251
Raw Animal Products	8	11	32	963
Manufactures				
Textiles and Clothing	172	291	65	105
Wood Products	27	28	17	19
Paper Products	78	79	88	111
Chemicals	2797	3118	1451	1494
Ferrous Metals	36	40	36	39
Non-ferrous Metals	465	481	223	223
Metal Products	276	340	52	61
Motor Vehicles	336	348	597	615
Electronic Equipment	408	407	514	516
Machinery and Equip.	3939	4266	1241	1275
Other Manufactures	659	731	2029	3496
Services				
Non-traded Services	20	20	16	16
Traded Services	5316	6004	4240	4660

Source: Initial data from the GTAP6 database (DIMARANAN and McDOUGALL, 2005). Estimates from simulation results

Table 4 US Tariff Peaks in Agriculture (2002)^a

HS Chapt.	Product category	Number of tariff lines above 15%	Average peak ^b
02	Meat and Edible Meat Offal	7	25.0
03	Fish, Crustaceans, Mollusks and other	2	15.0
04	Dairy Items	117	35.6
	of which, cheese	83	33.4
	Milk and cream	14	30.9
	Other dairy	20	47.8
07	Edible Vegetables and Certain Roots and Tubers	16	22.1
08	Edible Fruit and Nuts; Peel of Citrus Fruit or Melons	7	23.8
12	Oil Seeds and Oleaginous Fruits and other	2	147.8
15	Animal or Vegetable Fats, Oils, and Waxes	3	18.7
16	Preparations of Meat, Fish, Crustaceans, or other	5	36.5
17	Sugars and Sugar Confectionery	12	49.0
18	Cocoa and Cocoa Preparations	16	31.7
19	Preparations of Cereals, Flour, Starch or Milk	24	32.2
20	Preparations of Vegetables, Fruit, Nuts or Other	24	36.2
23	Residues and Prepared Animal Feed	1	17.0
24	Tobacco and Manufactured Tobacco Substitutes	14	187.5
21	Miscellaneous Edible Preparations	23	33.8
22	Beverages, Spirits and Vinegar	7	25.3
52	Cotton (HS 5201–5203 only)	3	34.5
^a Tariff peaks are defined as tariffs above 15 percent on an ad valorem equivalent basis. ^b Average of all tariff lines above 15 percent within 4 digit category, based on ad valorem equivalents.			

Source: USITC.

Table 5 Summary of Swiss MFN tariffs in agriculture (2004)

Product category	Tariff lines ^a	Simple average tariff ^b (%)	Standard deviation (%)	Imports 2003 (US\$ million)
Agriculture ^c	1613	36.2	87.9	6336
Live animals and products thereof	131	109.0	229.4	528
Dairy products	52	77.4	113.7	236
Coffee and tea, cocoa, sugar, etc.	345	29.7	48.0	1428
Cut flowers and plants	73	23.3	69.4	463
Fruit and vegetables	427	34.1	64.4	1287
Grains	54	42.8	63.5	150
Oil seeds, fats, oils and their products	217	34.4	49.5	237
Beverages and spirits	100	23.2	40.5	1226
Tobacco	13	10.0	11.0	200
Other agricultural products	201	6.6	23.9	580
Non-agriculture ^d	6137	2.3	4.1	85452
By stage of processing				
Raw materials	1052	18.6	54.4	6207
Semi-processed products	2388	4.5	17.2	17759
Fully processed products	4329	9.7	48.2	71237
Total	7769	9.3	42.5	95204
a Lines with no <i>ad valorem</i> equivalents are excluded. b <i>Ad valorem</i> equivalent figures. c WTO definition d Excludes petroleum				

Source: WTO Trade Policy Review on Switzerland and Liechtenstein (2004).

Table 6 Manufactured exports in leading 2-digit HS chapters (2004)
(Millions of current dollars)

Product Category	Description	Swiss Exports to the United States	US Exports to Switzerland
Manufactures			
HS 91	Clocks and watches and parts thereof	1695	120
HS 84	Nuclear reactors, boilers, machinery; parts	1675	906
HS 90	Optical, cinematographic, medical instruments; parts	1590	731
HS 30	Pharmaceutical products	1289	1305
HS 29	Organic chemicals	1191	163
HS 85	Machinery, electrical apparatus and instruments; parts	765	322
HS 71	Precious stones, metals, pearls and articles thereof	446	812
HS 39	Plastics and articles thereof	182	76
HS 88	Aircraft, spacecraft, and parts thereof	164	344
HS 97	Works of art, collectors' pieces and antiques	155	936
HS 82	Tools, implements, cutlery; parts	153	21
HS 32	Tanning or dyeing extracts; dyes, pigments, paints, varnishes	120	107
HS 73	Articles of iron or steel	101	68
HS 33	Essential oils; perfumery, cosmetic or toilet preparations	88	102
HS 48	Paper and paperboard; articles of paper pulp	83	na
HS 38	Miscellaneous chemical products	62	105
HS 95	Toys, games and sports requisites; parts	52	19
	Subtotal	10388	6607
All other products			
HS 7108	Gold	15	2283
HS 98	Special classification provisions ^a	832	280
HS 01-24	Agricultural products	184	240
HS 01-98	Total	11419	9410
^a Trade under "special classification provisions" includes repairs and alterations of previously imported products; donated pharmaceuticals, textiles and food products; non-identified military equipment; small transactions; and US goods returned without having been advanced in value or improved in condition while abroad.			

Source: Dataweb USITC (2005).

Table 7 Trade weighted tariffs on bilateral trade in manufactures
Trade-weighted average tariffs affecting industrial trade flows
of the partner country^a

Description	Weighted Average Tariff	
	United States	Switzerland ^b
Works of Art (Ch. 97)	0.0%	0.0%
Clocks and Watches (Ch. 91)	3.8%	0.3%
Optical, Measuring and Medical Instruments (Ch. 90)	0.1%	0.3%
Aircraft (Ch. 88)	0.0%	0.2%
Machinery, electrical apparatus and instruments (Ch. 85)	0.0%	2.5%
Boilers, Machinery and Mechanical Appliances (Ch. 84)	1.1%	3.3%
Pearls and Precious Metals and Stones (Ch. 71)	1.0%	na ^c
Other Chemicals and Plastics (Ch. 32–40)	3.8%	4.4%
Pharmaceuticals (Ch. 30)	0.0%	0.0%
Organic Chemicals (Ch. 29)	5.5%	0.0%
All bilateral manufacturing trade	1.2%	0.8%
Simple average for all non-agricultural tariff lines	3.7%	2.3%
<p>a Calculations based on trade exceeding \$10 million at 6-digit or 10-digit level. Calculations for Switzerland are at the 6-digit level; those for the United States are at the 10-digit level.</p> <p>b Based on <i>ad valorem</i> equivalents at the 6-digit level as reported by UNCTAD.</p> <p>c <i>Ad valorem</i> equivalents not reported by UNCTAD.</p>		

Sources: USITC and TRAINS

Table 8 Cross-border services trade between the United States and Switzerland (2003) (Millions of current dollars)

Service category	US exports to Switzerland	US imports from Switzerland
Travel	624	570
Passenger fares	185	351
Other transportation	485	525
Royalties, licence fees	2715	2202
Other private services	4005	4700
Total private services	8014	8348

Source: Bureau of Economic Analysis