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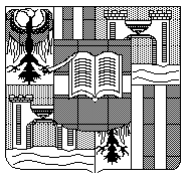
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Issues of US-EU Trade Policy

by

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Working Paper No. 0203
May 2002

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Issues of US-EU Trade Policy

by

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May 2002

Comment on

“Trade and Investment: An American Perspective” by G. Hufbauer and F. Neumann

“Old and New Issues in EC-US Trade Disputes” by André Sapir

Transatlantic Perspectives on the US and European Economies: Convergence, Conflict and Cooperation

CBG, Kennedy School of Government, Harvard University
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1 Introduction

A critical look at history is an important, if not indispensable element of any attempt to evaluate future risks and opportunities. This also holds true for policies aimed at trade and investment relations between the US and Europe. The two papers by Hufbauer/Neumann and Sapir provide differently focused accounts of the history and significance of EU/US trade disputes, juxtaposed with some empirics of trade and foreign investment. I find them very illuminating, interesting to read, and thought-provoking. I see no immediate policy proposal on US-EU trade and investment issues that can be drawn from their analyses, but in my view that is a virtue: They make us think further, instead of jumping to quick conclusions and swift action. I start off with a brief interpretation of what I see as the main messages of the two papers, before presenting some complementary evidence, as well as critical remarks and developing a few ideas of my own.

Hufbauer/Neumann portray an empirical picture according to which US/EU trade flows and foreign investment show signs of mature stability. In the 1990s, cross-atlantic trade and investment have been rising in line with general economic globalization, but there is little indication of dramatic change. This is not to say there are no opportunities to miss. Indeed, Hufbauer/Neumann stress that there is significant scope for mutual gains from further liberalization. Moreover, even though there was no landslide-type change in the 90s, I will show below that a closer inspection of their data does reveal a few interesting developments that are worth pointing out.

As regards trade conflicts, a principal message is that they generally affect only a relatively small portion of existing impediments. But again, this does not say that such conflicts are inconsequential. For various reasons – some of which are also stressed by Sapir – bilateral EU-US conflicts are important much beyond their quantitative significance. In particular, they are instrumental in propelling or impeding cooperation between the two Unions, and they are of vital importance also through their signaling effect to third countries, and to the world-trading-system as a whole.

In their analysis, Hufbauer/Neumann propose a categorization which distinguishes *market access* disputes from *industrial policy* conflicts, and sets these two apart from a third category of dissent which lies in the realm of *ideology*. Market access disputes are characterized by a relatively low policy-profile, and by direct reliance on the WTO-DSM (dispute settlement mechanism). According to Hufbauer/Neumann, they have little potential to disrupt trade in any fundamental way. Trade disputes may, however, also extend into the realm of industrial policy which gives them a higher policy profile, while at the same time making them less amenable to the WTO-DSM. Moreover, they carry more disruptive potential, unless dealt with under what Hufbauer/Neumann call a “*modus vivendi*” (see below).

The conflicts that Hufbauer/Neumann list under these two categories are also dealt with by Sapir, but my reading of Sapir is that he would categorize individual cases differently. Thus he would probably call the steel case an industrial policy dispute, while Hufbauer/Neumann treat it under the market access category. Moreover, by comparing the trade disputes of the 80s with those of the 90s, Sapir points out that it is not the issue as such which makes a dispute amenable to the legal provisions of the multilateral system. Specifically, certain issues can be drawn into the legal framework by a change in that framework. I shall return to this below.

The ideology-class of conflict clearly lies beyond the *traditional* WTO-domain. In these conflicts, commercial and economic interests are of only secondary importance. Basically, under this category trade policy is used as a vehicle to achieve non-economic ends, related to world-power-politics, the environment, human rights, or social and labor standards. These issues are not dealt with by Sapir who is less prepared to venture into issues of the future than Hufbauer/Neumann.

Against the background of this classification, Hufbauer/Neumann offer an outlook and some suggestions regarding future cooperation and convergence between the US and the EU. First, they see no likely scenario of escalation in any of the three categories considered. Regarding market access conflicts they suggest that both parties take WTO-rulings more seriously, and that they resort to ad-hoc arbitration where the WTO-DSM is not directly helpful or relevant. As to industrial policy conflicts, they seem to favor negotiated solutions and cooperation, but see little hope for much progress. Their likely scenario is a persistence of the “modus vivendi” approach.

On ideological conflicts, they are even more sceptical. My reading of their conclusion in this part is that they are sceptical on both positive *and normative* accounts. Not only will negotiated convergence be much more difficult to achieve, but it may also be a less desirable objective to pursue, fundamentally, than cooperation in matters of industrial policy. I will argue below, that certain caveats are also warranted for industrial policy cooperation.

While Hufbauer/Neumann concentrate on the most recent episode of conflicts in the 90s, Sapir offers an interesting juxtaposition of the two episodes in the early 80s and the late 90s, identifying similarities, but also important differences. He explains the significant increase in the number of trade disputes in the 80s by a) an unfavorable macroeconomic environment (exchange rate misalignments, economic downturns, accumulating trade imbalances) and b) ambiguities in the GATT subsidies code agreed upon in the Tokyo-round. As regards the sectoral incidence of disputes, there is a major parallel: In both episodes agriculture and steel are the principal subjects of disagreement and conflict, although the issues and instruments have changed.

As regards the instruments used, the earlier episode features little use of GATT-rules which

were by-passed by “grey-area” measures (basically voluntary restraint agreements, VRAs). In the 90s, due to the success of the Uruguay-round, some trade disputes were brought back into formal use of WTO-rules (particularly “safeguard-measures” under Article XIX). But Sapir points out that this is no clear success story at all: There is now a tradition of non-compliance to WTO-rulings, and Article XIX has turned out to put industrial policies under a time-inconsistency problem; see below.

Sapir also offers an interesting numerical view on dispute cases in each episode. The significance of both the US and the EU has diminished in the overall picture of GATT/WTO-disputes, being more closely in line with the pattern of trade in the 90s than was the case in the 80s. Moreover, the relative frequency of bilateral EU/US litigation has diminished as well. A particular feature, which is very important and characteristic of the 90s, is that both the US and the EU are more heavily engaged in preferential trade agreements (PTAs), and that almost no litigation took place with PTA-partner countries. Indeed, the use of PTAs to solve, or avoid, trade conflicts is a notable feature of the international trading-system that has evolved in the 90s. This point is not taken up by Hufbauer/Neumann and not pursued any further by Sapir, which is regrettable. I will take this up briefly below.

2 On the empirics of US-EU trade and investment

On the empirical side, I agree that there have been no landslide changes in US-EU trade and investment in the 90s. But the Hufbauer/Neumann data reveal a few interesting points worth mentioning.¹ First, although the EU is not much smaller than the US (indeed, bigger in terms of population, while slightly smaller in terms of GDP) it is still significantly more open in terms of external trade as a share of GDP (excluding intra-EU international trade): 18.3 percent (19.6 percent) for exports (imports) of goods and services, compared to 10.8 percent (14.6 percent) for the US. More importantly, both shares have risen markedly during the 90s for the EU, from 15.3 percent for exports and from 13.3 percent for imports. There is thus no aggregate sign of *trade diversion* (or of a fortress Europe) due to the single market program of 1992.

Contrary to what might have been expected, there is also no aggregate sign of EU-trade diversion from the cross-atlantic route to eastern Europe. Thus, the share of EU exports going to the US rose from 14.2 percent in 1990 to 21.1 percent in 2000, although if expressed as a share in US imports the same figures amount to a small reduction from 22.1 to 20.9 percent. EU

¹ All of the figures that I present in this section are calculated from Tables 1,2 and 4 in Hufbauer & Neumann (2002).

imports coming from the US have remained stable at 16.6 percent if expressed as a share of total EU imports, but have fallen slightly from 25.6 percent to 24 percent if expressed as a share of overall US exports. The diminishing importance during the last decade of the EU as a source of US imports and a destination of US exports reflects trade effects from NAFTA. Both the US and the EU have been engaged in deepening and extending their respective *trade blocs*, but on the aggregate level the expected trade effects – increasing intra-bloc trade and lower external trade – so far show up only for the US. However, it is worth taking at least one step of disaggregation. In *services trade*, the EU has gained importance as a destination of US exports (from 28.2 to 31.6 percent), although the US as a source of EU services imports has fallen (from 17.2 to 16.2 percent). In sum, we observe a marked increase in the role of the US as a destination of EU exports, a slightly diminishing role of the EU as a destination of US merchandise exports, with an increasing role of the EU for US services exports, and more or less constant shares of the two regions as origins in respective imports.

Sapir notes that *bilateral* EU-US trade is of little importance for both regions. The relevant figure to look at here is trade relative to GDP. But here again, one can note an interesting detail. Trade was about equally important for both regions in 1990 (between 2.2 and 2.5 percent), but by the end of the 90s an asymmetry has arisen on the export side: Exports to the US amount to 3.9 percent of EU GDP, while exports to the EU amount to only 2.6 percent of US GDP. This difference is mainly due to merchandise trade. For services exports, the shares are roughly equal for both regions (around 1 percent).

Some noteworthy change can also be detected in FDI. The US does seem to lose importance as a host country for EU outward investment (down to 25.8 percent from 28.9 percent). Here, the opening up of eastern Europe in the 1990s certainly plays a role. But these same figures amount to an increase in the EU as a source of US inward FDI (from 57.9 percent to 64.8 percent). At the same time, the EU has also gained importance as a host to US outward foreign direct investment (up to 46.1 percent from 42.7 percent), while these same stocks have slightly fallen relative to all EU inward FDI (from 24.9 percent to 24.1 percent). In sum, the EU has become a more important FDI-partner for the US, while the US has lost some of its importance as an FDI-partner for the EU. The data seem to suggest that the EU has only recently caught up to the US in terms of the overall importance of its external FDI activity.

3 Gains from further liberalization

Hufbauer/Neumann cite evidence from numerical simulations suggesting that there is room for further increase in bilateral trade in the course of future trade liberalization. The results reported

are from a CGE exercise which is based on a scenario of abolishing post-Uruguay-round MFN tariffs plus service barriers. Two things are worth pointing out.

First the relevant tariffs are rather low, and they vary across regions, with the US and the EU both among the low-tariff regions. According to non-weighted tariff averages calculated by the Worldbank, the US and the EU presently apply average import tariffs in the vicinity of no more 5 to 6 percent. For manufactures they are lower (about 4 percent) than for agricultural goods. Interestingly, agricultural tariff protection is not much higher in the EU (10 percent) than in the US (8.7 percent), but it does entail more tariff escalation.² The OECD (1997) calculates production-weighted averages of 7.7 (10.7) and 5.2 (7.9) percent for overall trade (agricultural trade) for the EU and the US, respectively.

Brown et al. (2001) use a CGE model of world trade to calculate the trade and production effects, as well as the welfare effects of a multilateral removal of post-Uruguay-round tariffs. Hufbauer/Neumann seem to be more comfortable with the trade effects than with the welfare effects. The latter are indeed quite staggering: an increase in US welfare in the amount of 5.4 percent of GDP for the US, with a corresponding figure of 6.2 percent for the EU (including EFTA). The usual explanation for such high estimates invokes “modern trade theory elements” incorporated in such models (scale economies, pro-competitive effects). In this regard, Hufbauer/Neumann indicate some scepticism and argue that these effects should be treated as upper bounds. I would argue that the trade effects calculated by Hufbauer/Neumann should similarly be seen as pretty much an upper bound. The reason is that the underlying scenario is one of *multilateral* liberalization where, as argued above, the EU and the US are both low-tariff-regions. The overall trade effects calculated for these two regions therefore also reflect tariff reductions by other high-tariff-regions, and it seems questionable to conclude increased *bilateral* EU-US trade on a pro-rata-basis from these overall trade effects.

The second point I want to raise is that the tariff liberalization scenario captures only a relatively small fraction of trade policy. Specifically, it leaves out much of what both papers discuss in their accounts of trade disputes. Nor does it cover dispute-prone issues where trade policy is used to tackle new challenges (labor standards, environment); see for instance Bhagwati (2002) and Irwin (2002). For several reasons, these issues are difficult to cover in a CGE exercise. Trade impediments arising in such disputes are often of a non-tariff form, and they are typically temporary in nature. Both makes them less amenable to formal modeling than plain MFN tariffs that remain in existence until explicitly negotiated in the next round of trade talks. Nonetheless,

²Finger et al. (1996) have 2.2 percent for the US and 3.7 percent for the EU (quoted from Irwin (2002, p. 181)). The above data are from http://www1.worldbank.org/wbiep/trade/TR_Data.html

they surely play a role in shaping the future trading environment.

I would be hard pressed to say whether leaving them out in the computational scenario makes the trade effects upward- or downward-biased. Hufbauer/Neumann argue that the more classic trade disputes “*pick only at the edges of existing barriers*”. Hence, one might argue that they make little difference to the multilateral liberalization scenario. However, the point is that the general prevalence of, or the perceived likelihood of getting caught in, such disputes might well act like a permanent trade restriction. Hence if the frequent occurrence of such disputes also in the more recent episode of cross-atlantic trade development, as documented in both Hufbauer/Neumann and Sapir, can be turned around and brought down, this would most probably have a trade and welfare enhancing effect beyond the numbers reported from CGE analyses. On the other hand, if governments should exhibit an increased and firm willingness to use trade policy towards macroeconomic or industrial policy objectives, and to new issues in the area social and environmental policy, or even ideological issues, then this would amount to a severe trade depressing force not captured by CGE analyses. We seem to be left with two neglected issues which involve potentially offsetting risks for trade.

A final point to note here is that some of some non-tariff measures argued about in such disputes, violate the free trade idea not as trade impeding forces, but by means subsidizing trade. Agriculture is a classic example. Getting rid of them almost certainly increases welfare, but it may reduce, rather than increase, actual trade. The welfare potential for future trade liberalization (including a reduction of trade subsidies) should therefore not be associated too closely with an increase in trade flows. Overall, though, I fully agree with Hufbauer/Neumann that, low bilateral trade shares in each region’s GDP notwithstanding, a more free-trade-oriented posture of trade policy should entail non-negligible welfare gains for both the US and the EU.

4 US and EU regionalism

While economists stress the gains from multilateral trade liberalization, policy makers often place more hope on regional agreements. For the US, this is for instance witnessed by plans to erect a Free Trade Area of the Americas (FTAA) by 2005, and by negotiations, scheduled for completion in summer 2002, towards a bilateral free trade agreement with Chile. On the European side, in addition to eastern enlargement, examples include the Euro-Mediterranean trade initiative (“Barcelona process”), an FTA with South Africa and the Cotonou Agreement with the ACP-countries. More recently, the EU is seeking to extend its PTA initiatives into the US sphere of influence (Mexico, Chile and Mercosur). It remains to be seen whether this entails a potential for EU-US conflict.

But even if their respective regionalisms should not cause much trade conflict between the US and the EU, this does not mean that they are conducive to good and beneficial world trade policy as a whole. The Vinerian caveat of trade diversion is still relevant, and it does not always appear to receive due attention in policy makers' readiness to engage in regional trade negotiations. Moreover, the multitude of simultaneous PTAs in the form of free trade areas (as opposed to customs unions) generates a policy environment characterized by complex rules of origin which are liable to be abused with protectionist intent; see Bhagwati et al. (1998). On the other hand, Ethier (1998a and 1998b) points out that the "new regionalism" of the 1990s, for which the afore-mentioned PTAs independently pursued by the EU and the US are prototype examples, is different in important respects from earlier instances of regionalism, and he argues that these differences make US- and EU-type regionalisms less damaging to the world-trading-system than may appear from a Vinerian perspective.

As regards bilateral US-EU trade disputes, one can envisage different scenarios, with correspondingly differing verdicts. If, for whatever reason, trade with respective regional partners can be pursued with less conflict than EU-US trade, then such PTAs might lead to a diminished perceived importance of EU-US trade disputes, on both sides of the Atlantic. In a sense, these disputes may in time be "marginalized" and defused. On the one hand, this seems like a welcome development for the multilateral trading system. On the other hand, one can also argue that, with the EU and the US losing interest in each other's violation of free trade, they would no longer play their roles as mutual vigilantes with the same effort. And if there are no other regions with sufficient power and incentives to step in, this would make it easier for both to maintain protectionist policies. This could be reinforced by tailoring ones own PTA environment so as to avoid any interference with these policies.

An alternative scenario is that such PTAs could draw other regions into existing EU-US conflicts. Instead of being "marginalized", these conflicts would then gain importance, putting more strain on the multilateral trading system. Indeeds, PTAs might even raise new issues of conflict that have nothing to do, directly, with EU-US trade. The EU banana regime which is related to the Cotonou-ACP agreement is a case in point.

The verdict must also depend on whether such PTAs are genuine free trade areas with significant scope for beneficial trade, or whether they include crucial exemptions, so that a large part of the gains-from-trade potential remains just that: a potential. The evidence is that PTAs often contain sectoral exemptions (the usual sensitive sectors: agriculture, textiles, steel). More generally, if such PTAs are largely tailored to serve special interest groups in the respective countries, then they must be seen as a harmful setback for the case of beneficial multilateral trade liberalization.

5 On categorizing trade disputes

In their analysis of trade conflicts, Hufbauer/Neumann apply a categorization that distinguishes market access from industrial policy conflicts and ideological disputes. I found this illuminating, but I kept wondering whether from a trade theory point of view it would seem more appropriate to categorize the *specific measures* in use, rather than the *conflict* as such. In some sense this is implicit in categorizing conflicts, but the main lines of reasoning are more revealing if specific measures are at the center of analysis. A categorization that comes to mind here is Bhagwati's (1988) distinction between "high-track" and "low-track" actions. I do not want to go into details here, but a few complementary remarks may be worthwhile, doing little more than just point out certain criteria that are important to judge the potential damage arising from a certain trade policy instrument.

First, there is the issue of whether an instrument is rule-based versus rule-bypassing. Trade economists normally have a clear preference for rule-basedness. A safeguard tariff is rule-based, while a VRA is not. The analysis by Sapir suggests that to some extent the Uruguay round seems to have been successful in getting issues back onto a rule-based track. However, I will argue below that this is a mixed blessing.

Secondly, trade policy may be aimed at simply fixing a rule, thereby implicitly accepting whatever quantities of trade will emerge, or it may aim to directly fix the (allowed) quantities traded. Here again, trade economists have a clear preference for rule-fixing over quantity fixing. Setting a tariff fixes a rule, while VRAs often amount to fixing quantities. Of course, if a rule is designed flexibly enough, the difference may be elusive: One can fix quantities implicitly by adjusting the "rule" whenever the market outcome deviates from certain targeted quantities. In my view, the safeguard provisions are liable to be used in this way.

Then there is the issue of industrial targeting which is typically prevalent in high-track actions that often use voluntary restraint agreements, but also in safeguard actions. General systems of subsidizing export credits, either through government guarantees or government-sponsored agencies, lack this type of targeting. So does the US policy pertaining towards foreign sales corporations. One might therefore argue that such policies should not be listed under the industrial policy conflict category. The reason why Hufbauer/Neumann nonetheless do so, I presume, is that they are often used as bargaining chips in a "modus vivendi" approach to "solve" policy conflicts arising with respect to particular industries. An example for this is "*modus vivendi on farm supports in exchange for a modus vivendi on tax preference*".

A further criterion is the degree of "porousness". Economists sometimes argue that voluntary restraint agreements (VRAs) are often only moderately efficacious in terms of causing harm, because they literally invite hidden circumvention. In a benign interpretation, such measures

may therefore pass the test in that they are a valuable element in a pro-trade government's policy portfolio which faces political-economy-type constraints; see Bhagwati (1988). If this is a legitimate interpretation, then bringing industrial-policy-type trade disputes back into measures based on WTO-rules, a feature of the more recent episode according to Sapir, would be a mixed blessing. The reason simply is that such measures are typically less porous. I will add a further caveat based on the observation of a de-facto susceptibility to a highly questionable "modus vivendi" below.

Finally, there is the old concern that WTO-rules (specifically on safeguard, antidumping, and countervailing duties) may be "captured and perverted" into plain protection which runs counter to the potentially beneficial role that they have been designed for in a well-functioning world-trading-system; see Bhagwati (1988). This is perhaps the most difficult criterion to apply, for two reasons: First, the beneficial role is hard to define – and views may differ already on this general level. And secondly, application to a specific case (say steel) is likely to suffer from all sorts of empirical problems and problems of interpretation. The degree to which an abuse and perversion of these rules takes place is, therefore, difficult to measure.

But incentives can be identified, and set appropriately. Moreover, as emphasized by Bhagwati (1988 and 2002), institutions can be designed to guarantee a balanced representations of all interests involved (foreign and domestic, producer and consumer). The Byrd amendment is probably not the kind of incentive one would like to set. On the other hand, the use of revenues generated by such policies in a "closed-loop-way" towards plaintiff-industries is not entirely beyond economic rationale. This is particularly true if the ultimate aim is to aid structural adjustment of the industries affected by imports. However, as I will argue below, it is always a somewhat dangerous to bring industrial policy issues on the trade policy agenda, and vice versa.

6 Negotiated progress versus "modus vivendi"

Hufbauer/Neumann see a continuation of the "modus vivendi" approach as the most likely future course of transatlantic trade policy. Is there anything particularly bad about this approach? What is the alternative? Hufbauer/Neumann don't seem to find anything terribly wrong with the status quo, but they envisage a more ambitious alternative agenda where policy makers might try to achieve negotiated convergence in matters of industrial policy. I should like to voice moderate dissent on both accounts.

Without falling victim to perfection, I think the "*modus vivendi*" approach must be criticized. What it amounts to, basically, is a mutual exchange of misbehavior and threats. In all likelihood, this is coupled with repeated lack of compliance with WTO-rulings, hence it

undermines Hufbauer/Neumann's first recommendation to make more honest attempts to rely on WTO-dispute-settling. More fundamentally, it reflects a central weakness of the present world-trading-system which I would describe as follows.

First, whether or not the WTO bites at all is put under the member countries' discretion. More specifically, whether a given violation of trading-rules by any one country is brought before the WTO, depends on some partner becoming active in litigation. Hufbauer/Neumann argue that this will be the case only if two conditions are met: a) an arguable violation plus b) a commercial interest in litigation. And they say that these conditions are typically met only for a small fraction of actual violations. Hence, a large part of violations remains un-sanctioned.

But I would go further in arguing that these conditions are not even sufficient for actual litigation. They are necessary for a *credible threat* of litigation, but incentives may be such that actual litigation ever takes place. If two countries mutually accumulate credible threats of bilateral litigation, the expected pay-off structure may be such that a situation where both countries abstain from litigation is politically efficient. It then boils down to whether or not a cooperative non-litigation solution is sustainable. Even if litigation does take place and there is a WTO-ruling, this may be followed by a mutual tolerance of non-compliance, which can be seen as a more or less implicit exchange of granted retaliations.³ In such a case, the WTO framework is abused as a vehicle of supporting violations of, rather than enforcing adherence to, the idea of free trade. This is, admittedly, not a very benign way of reading the "modus vivendi" approach, but it is not entirely inconsistent with the accounts of disputes given in the two papers by Hufbauer/Neumann and Sapir.

Where, then, lies the alternative for future EU-US trade relations? Hufbauer/Neumann envisage openly *negotiated convergence on industrial policy conflicts*. I have reservations here as well. My fundamental point is that the trade policy table is the wrong place to form industrial policy. I do not dispute that if any one country pursues an active industrial policy, then, in a world of integrated markets, other countries will in some way be affected. My point is that going to the trade policy table too soon is likely to cause ill-guided policies. Industrial policy should aim at correcting *distortions*, and trade economists have repeatedly pointed out that such distortions are very seldom pure *trade* distortions. Tackling them with an eye on trade

³Bhagwati has recently suggested to calculate the monetary value of sanctions not by looking at the amount of total trade affected, but instead by using some measure of the gains from trade that are lost at the margin through a given violation of free trade. See Jagdish Bhagwati, "Trade: The Unwinnable War", *The Financial Times* January 29, 2002. This might provide a partial solution also to the above mentioned problem, as it would make the "market for retaliations" thinner.

relations is likely to distract attention from the heart of the problem. This is not to say that they should not be tackled on an international, or multilateral level. Everything depends on whether the basic distortion (say increasing returns to scale) is *national* or *international*.⁴ If it is international in scope, then negotiations should be conducted on an international level, but I would suggest that they be carried out under auspices other than the WTO, so as to keep trade concerns as such at a safe distance.

This does not mean that the WTO is useless. It has a key role to play in facilitating efficient outcomes if, for whatever reason, governments are unable or unwilling to abstain from exploiting trade relations in pursuit of national policy goals. In general, this will involve some variant of the term-of-trade effect.⁵ Bagwell and Staiger (1998 and 1999) have shown that in such a world there is an efficiency rationale for the WTO; I will return to this below. A more ambitious role would be to prevent governments from pursuing such exploitative trade policies in the first place. According to this view, expressed for instance by Krugman (1993), the key role of WTO-like international agreements is to shield governments from internal interest-group pressure. Thus, *political-economy-type* constraints provide ample rationale for the WTO. But if looked at from a *normative* perspective, the basic tenets of the WTO are much less convincing. Indeed, as shown by Krugman (1991), they have a distinct mercantilist orientation, which should be kept at a safe distance from EU-US (or indeed any international) negotiations on industrial policy issues.

An issue closely related to industrial policy is governments' desire to support painful structural change. It cannot be ruled out that this may in some cases justify a "closed loop" channeling of revenues generated by safeguard or anti-dumping measures towards plaintiff industries, although one should carefully watch the incentive structure. More fundamentally, however, a trade policy approach towards facilitating and supporting structural change is flawed. As noted by Bhagwati (1988) and Feenstra (1998) it causes an unwarranted focus on damage caused by imports, as opposed to pain caused by structural change as such. Whether or not trade plays a role should not make a difference for the policy stance towards structural change. There is a more subtle point which is rightly emphasized in the paper by Sapir: Trade policy options, if formally laid down in international trade law (as with the safeguard provision), may put an adjustment-oriented industrial policy under a problem of time-inconsistency. Hence, such an approach might indeed impede, rather than support, structural change.

⁴There is a large body of theoretical literature dealing with both. See, for instance, Ethier (1982) on international economies of scale, or Grossman & Helpman (1992) on international spillovers in R&D.

⁵Note that this includes all of the recent trade policy arguments based on imperfect competition; see Bhagwati (2002, pp. 14-24).

As regards the US and the EU, there is a double-asymmetry that may cause further problems with negotiations on trade implications of industrial-policies. First, there is the oft-quoted point that the EU has no government. Whatever the details worked out by the “constitutional convent” installed at Laeken, the future EU will likely continue its present *inter-governmental* approach, rather than establish strong *federal* structures. More importantly, while trade policy has long been firmly entrenched as a common policy within the EU framework, the same is not the case for industrial policy as a whole. Whatever the underlying reasons for this asymmetry, it is not going to make negotiations on industrial-policy trade disputes easier. A similar asymmetry explains why the EU is less prone than the US to use trade policy as a vehicle to pursue foreign policy, or ideological objectives more generally. The reason quite simply is that – some recent change and progress notwithstanding – there is also no common European foreign policy. I have no firm opinion on whether this is lamentable from a European or world point of view. The inability of the EU to rely on trade policy as a vehicle for a consistent European foreign policy may be bad for foreign policy, but it is certainly *not* bad for trade policy.

7 On the ideological dimension

This brings me to ideology. Of course, ideology has many different dimensions, but in almost all dimensions that I can imagine, I fully agree with Hufbauer/Neumann that the US and the EU should probably abstain from attempting to reach too much convergence. Such convergence may *evolve*, but it is hard to imagine how it should be *negotiated*. Meanwhile, the two continents will have to live with the fact that pursuing different ideological positions will at times entail mutual infringements via trade and investment. This holds true not only for classic issues of ideology as the ones described by Hufbauer/Neumann, but also for some of the new challenges that have come up in connection with the agenda of future trade negotiations (e.g. environment, labor and social standards). Suffice it to say that such infringements could be significantly reduced by realizing that policy instruments pertaining to trade and investment are generally inefficient (second-best at most) to achieve specific goals related to these challenges; see Bhagwati (2002) and Irwin (2002).

However, there is a different issue related to ideology which, in my view, has not been sufficiently acknowledged in discussions of the world-trading-system. Until 1989/90, the post-World-War-II world-trading-system was essentially dichotomized. There was state-trading among socialistic planning-economies on the one hand, and market-oriented trade (subject to the GATT) among capitalistic “western” economies on the other, with very little trade between the two blocs. Choosing between the two systems was largely seen as a matter of ideology. Supported

by more recent events, however, one might argue that the apparent economic performance of the two models has moved the choice from ideology into the realm of plain facts, with a clear win for the capitalist system. Does this mean that world trade as a whole is no longer characterized by an ideological divide, moving ever closer to the neoclassical textbook model?

This is true only up to a point. Ideological differences between countries are likely to prevail, and I would argue that they are not adequately captured the theoretical paradigm that – explicitly or implicitly – underlies our thinking on trade policy (disputes). Freeman (2001) presents empirical evidence supporting the notion of capitalism as a concept which allows for diversification. While it is true that different forms of capitalism show differences in economic performance, there is no clear-cut dominance of one particular form over all others. The reason is that performance has more than one dimension. The choice may then again be seen as one of ideology, and the outcome, even in the long-run, most likely is a world of *diversified capitalisms*. And pivotal to this choice are labor market institutions. To quote Freeman (2001): “*The labor market is potentially the most idiosyncratic market in advanced capitalism.*”

Thus, suppose that the EU continues to adhere to its European form of capitalism where welfare-state ideas are coupled with relatively rigid and centralized labor markets, while the US adheres to its more extreme form of capitalism, hallmarked by free and flexible labor markets.⁶ If the two forms were pursued in two isolated worlds, then this would pose no interesting trade issue. However, the EU and the US are related to each other via trade and investment. Hence the question: What does it imply for trade policy and the world-trading-system, if – due to deep-rooted ideological differences or entrenched habits – they pursue different models of capitalism, each characterized by extreme forms of labor market institutions? Surprisingly, this question has so far received relatively little attention from trade theorists. In particular, it has not played a prominent role in economic treatments of the world-trading-system. I cannot present a full-

⁶The Lisbon summit of March 2000 has, admittedly, envisaged a somewhat different future for the EU, whereby deregulation and market liberalization are cornerstones of an economic catching-up strategy. A 10 year process involving convergence to the US version of capitalism, so the Lisbon-credo, shall make the EU the most competitive region of the world economy. However, the progress made so far seems to support my basic assumption: To the extent that such convergence has started to materialize it relates to “classics” of regulated commodity markets (electricity, telecommunications, postal services), while on labor markets new regulation has been introduced which reinforces divergence from, rather than convergence to, the US form of capitalism. A quick impression of this is obtained from a series of commentaries on EU summits in *The Economist*: “Liberalize? Regulate? Both” on March 8th 2001, “From Lisbon to Stockholm” on March 29th 2001, “So much for dynamic” on November 1st 2001, “The need for shock treatment” on March 7th 2002, and “Energy and lethargy” on March 21st 2002. On an assessment of the most recent summit in Barcelona, see also “Assessing Barcelona” in *The Wall Street Journal Europe* March 18, 2002.

fledged analysis of the issue in the remainder of this comment, but I should like to drop a few quick thoughts.

As I have indicated before, one of the models which rigorously describes an economic rationale for a GATT-WTO-type world trading system is Bagwell & Staiger (1998 and 1999).⁷ I cannot go into details here, but an important implication of “double-peak” capitalism is quickly pointed out. The implication follows from a combination of the Bagwell-Staiger paradigm with the model proposed by Davis (1998) in order to analyze the implications of European-type wage rigidity for trade between the US and Europe.

The Bagwell-Staiger model shows that the key principles of the GATT-WTO-approach, viz. non-discrimination and reciprocity, are instrumental in achieving efficient policy equilibria. They provide vehicles for internalizing externalities that arise in a multi-country world where governments try to achieve their objectives through policies affecting the terms of trade. Indeed, if terms-of-trade are the sole concern of national policy makers, then a “non-discrimination cum reciprocity approach” to world trade can sustain *efficient international policy equilibria*. This is true irrespective of the specific reason why governments try to influence the terms-of-trade; it could be normative, as well as of a political-economy nature. The important point is that it is *only* the terms-of-trade that matters. As long as this is the case, a GATT-WTO-approach is *politically* efficient in that it allows governments to achieve cooperative outcomes.

Now, suppose Europe has an exogenously fixed real wage rate. In principle this wage restriction might be non-binding, but evidence points to the contrary. Intuitively, if a wage constraint is binding, this is because full employment of labor would require production of certain (labor-intensive) goods in excess of demand, mirrored – according to Walras’ Law – by excess demand for other goods (intensive in other factors). The point emphasized by Davis (1998) is that, with trade between the two regions, *European* labor bears the full brunt of adjustment from *world* commodity markets, as opposed to European markets alone. Davis does not investigate trade policy, but the implication is clear: Any trade policy pursued by the US which – other things being equal – reduces its excess demand (and thus world excess demand) for those goods where labor is used intensively, would alleviate the European unemployment problem.⁸

Bhagwati’s theory of distortions, of course, should lead us to stress that the first-best policy to get rid of European unemployment is to directly tackle the wage rigidity itself. However, suppose that, in line with the afore-mentioned role of ideology, Europe does not regard this as

⁷It is perhaps important to note that there are alternative approaches towards an economic understanding and evaluation of the GATT-WTO system; see in particular Ethier (1998b).

⁸In an appendix note, I offer some formal analysis underlying this point.

an available (or desirable) policy option. Suppose, therefore, that the European policy goal is to achieve low unemployment *at the given real wage rate*. The Davis model then implies that there is an international policy externality which runs through *quantities* traded, rather than the *terms-of-trade*, as assumed in the Bagwell-Staiger model. As noted before, any trade policy that reduces the excess US (and world) demand for the labor-intensive good at the commodity price implied by the European wage restriction exerts a positive externality on Europe.

Thus the *quantity effects* of trade policies become important in their own right, and we are in a policy environment which is fundamentally different from that of the Bagwell-Staiger model. This is not the place for an in-depth analysis of mutual policy externalities arising in such a world, but two general conclusions must be pointed out: a) The Bagwell-Staiger rationale for a GATT-WTO-type world-trading-system *may* not hold in a world of “double-peak” capitalism. And b), the options and incentives for bilateral EU-US policies pertaining to international trade and factor movements in such a world may be quite different from what we would expect from traditional trade theory which largely assumes a “single-peak” world.

8 The role of macroeconomic imbalances

An observation made by Sapir brings me to a further point where this issue of “double-peak” capitalism is of some relevance. In explaining the resurgence of protectionist attempts and the attendant increase in GATT litigation in the 80s, he refers, among other things, to *macroeconomic conditions*: exchange rate misalignments, growth downturns, and trade deficits. This begs the question of whether the macroeconomic environment has also played a role in the recent episode of trade disputes, particularly with respect to the US and the EU. However, a more interesting question to ask is whether the macroeconomic imbalances among key world trade regions that have accumulated in the 1990s are likely to put future attempts at further liberalization under strain. In answering this question it seems particularly important to acknowledge the previous point: Not only is European unemployment an important macroeconomic imbalance, but its relatively rigid economic system and institutions, particularly with respect to the labor market are likely to persist in the future. In a first rough thought experiment it may be warranted to ignore differences between European countries, and to use the model sketched in the previous section to explore avenues of potential conflict arising from other macroeconomic imbalances that have accumulated in the 1990s.

These are in fact well known and don’t need much description: a) an un-sustainable path of recurring current account deficits in the US (which was not reverted during the recent recession), b) huge bad debts in the Japanese banking system and an un-sustainable path of deficits and

accumulating debt of the Japanese public sector, c) a Japanese monetary policy environment which is characterized by deflation and a liquidity, d) an undervalued Euro against the Dollar, e) increasing output gaps in both Europe and Japan, coupled with a productivity gap vis á vis the US, e) institutional “imbalances” causing structural rigidities in both Europe and Japan, and finally, f) the notorious European unemployment problem.

There are, of course, several ways to correct these imbalances, and it is difficult to foresee what will happen. However, it is not difficult to imagine that such a correction will put the international trading-system under strain, either through currency revaluations and associated *expenditure switchings*, or through adjustments in *expenditure levels*. From a European perspective, in particular, one might be afraid that a turn-around in the US current account position, and a consolidation of the Japanese banking system and public sector budget might depress demand also for European goods and, thus, aggravate the European unemployment problem. Indeed, it is hard to imagine any adjustment without this effect. But there is a further effect which is somewhat more subtle and which can be identified using the Davis model sketched above.

Any adjustment of expenditure *levels* in specific macroeconomic aggregates relevant for this scenario (e.g. US private households, Japanese public sector) will also involve a shift in the *commodity composition* of world demand, quite irrespective of whether or not the European current account position (which is almost in balance) will change or not. In terms of the Davis model, this implies – other things being equal – that there will be a structural shift in the non-European excess demand system. It is not clear, a priori, whether this shift will be such that the European unemployment is aggravated or alleviated. Either is possible, depending on whether the shift is in favor of those goods using those types of labor intensively where the European wage constraint is binding. In other words, the policy goal of correcting the above mentioned macroeconomic imbalances and the goal of reducing European unemployment without abandoning the European version of capitalism may be *complementary*, or in *conflict*. Clearly, this is a question which can be answered only by means of empirical analysis.

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Appendix Note to “Issues of US-EU Trade Policy”

by Wilhelm Kohler
May 2002

Transatlantic Perspectives on the US and European Economies: Convergence, Conflict and Cooperation

CBG, Kennedy School of Government, Harvard University
Conference, April 11-12., 2002

This note contains some formal analysis underlying the arguments in the final two sections of this comment

Assumptions and notation:

1. Usual 2-dimensional Heckscher-Ohlin framework, good 2 labor intensive
2. Notation:
 - y_1, y_2 – outputs, d_1, d_2 – demands
 - linearly homogenous technology represented by unit-cost functions $c^i(w, r)$
 - p_2 relative price of good 2, good 1 is numeraire: $p_1 = 1$
 - w – wage rate, r – capital rental
 - K – capital endowment, L – labor endowment, both given exogenously
 - linearly homogenous technology represented by unit-cost functions $c^i(w, r)$
3. The two economies are the US and Europe:
 - (a) The US has perfectly flexible prices
 - (b) Europe has an exogenous *real* wage restriction. If $Q(1, p_2)$ is the European expenditure function, then this wage restriction requires

$$w = \bar{w} \times Q(1, p_2) \tag{1}$$

The European Economy:

1. Zero profit conditions of a competitive equilibrium:

$$\begin{aligned} 1 &= c^1[\bar{w} \times Q(1, p_2), r] \\ p_2 &= c^2[\bar{w} \times Q(1, p_2), r] \end{aligned}$$

These conditions determine the capital rental and the price of good 2, given the normalization $p_1 = 1$.

$$r = r(\bar{w}) \tag{2}$$

$$p_2 = p_2(\bar{w}) \quad \text{where} \tag{3}$$

$$\partial p_2 / \partial \bar{w} > 0 \quad (\text{given the factor intensity assumption}) \tag{4}$$

Substituting $p_2(\bar{w})$ back into the wage restriction also gives the wage *in terms of good 1*:

$$w = w(\bar{w}) \quad (5)$$

2. I now look at the output quantities that would need to be produced for full employment, given the wage restriction. I deliberately don't require goods market equilibrium:

$$L = c_w^1[w(\bar{w}), r(\bar{w})] \times y_1 + c_w^2[w(\bar{w}), r(\bar{w})] \times y_2 \quad (6)$$

$$K = c_r^1[w(\bar{w}), r(\bar{w})] \times y_1 + c_r^2[w(\bar{w}), r(\bar{w})] \times y_2 \quad (7)$$

Hence, the full employment outputs are

$$y_1 = y_1(\bar{w}, K, L) \quad (8)$$

$$y_2 = y_2(\bar{w}, L, K) \quad \text{where} \quad (9)$$

$$\partial y_2 / \partial \bar{w} > 0 \quad (\text{given the factor intensity assumption}) \quad (10)$$

These output equations have the usual Rybczynski-property.

3. I now look at European excess demand that would arise if Europe were to fully employ its labor at a wage rate $w = w(\bar{w})$:

$$\delta_2(\bar{w}, K, L) = d_2[1, p_2(\bar{w}), w(\bar{w})L + r(\bar{w})K] - y_2(\bar{w}, L, K), \quad (11)$$

where $d_2[1, p_2(\bar{w}), Y]$ is a Marshallian demand function and δ_2 is excess demand for good 2. Excess demand for good 1 follows from Walras' law (as I have assumed all factor markets to clear). The idea is to have all disequilibrium implications caused by the wage restriction appearing in the excess commodity demand system. If $\delta_2(\bar{w}, K, L) > 0$, then the wage restriction would not be binding in the EU *under autarky*, if the restriction actually says $w \geq \bar{w} \times Q(1, p_2)$ (instead of requiring equality).

EU-US trade and EU unemployment:

The US has a normal excess demand system, as it is not crippled by any wage restriction. This can be written as

$$\delta_2^* = \delta_2^*(p_2, S) \quad (12)$$

where for my purpose S is a shift parameter, representing in particular US trade policy and macroeconomic policies determining the level of US absorption.

The crucial question now is what US excess demand looks like at the point $p_2 = p_2(\bar{w})$, which is the terms of trade implied by the European trade restriction. If it turns out that $\delta_2^* = \delta_2^*[p_2(\bar{w}), S] > 0$, then trade alleviates the European unemployment system relative to autarky, and vice versa. The model can also be used to see how certain trade policy measures work in such a world of "double-peak capitalism".

A further avenue of analysis relates to trade policy incentives, policy externalities, and the rationale (efficiency) of the WTO.

Global macroeconomic imbalances and EU unemployment:

The term S can now be interpreted as determined, among other things, by the size of the US current account deficit. The point made in the final section of my comment relates to the question of whether a reduction in the US current account deficit increases or lowers δ_2^* (through its effect on S). The general fear is that correcting macroeconomic imbalances that have accumulated during the 1990s would lower δ_2^* . But the above analysis suggests that this is not necessarily the case. Although the model does not easily generalize to many dimensions, it is clear that such corrections will in general involve a commodity shift in the “non-Europe excess demand system” (δ_2^* in the simple model above). And this shift may, in and of itself, aggravate or alleviate the European unemployment problem. This is a question which can only be answered empirically.