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## THE IMPACT OF TTIP

**VOLUME 2:** POLITICAL CONSEQUENCES FOR EU ECONOMIC POLICYMAKING, TRANSATLANTIC INTEGRATION, CHINA AND THE WORLD TRADE ORDER



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# Executive Summary

- The envisaged Transatlantic Trade and Investment Partnership (TTIP) is not only of enormous economic relevance, but also has the potential to cause shifts in global governance and the global architecture of trade and welfare. Whereas transatlantic negotiations in the 1990s were generally seen as a threat to the global trade order and bore the risk of a “Fortress Atlantic”, this time the preconditions are different.
- Owing to the fragmentation of production processes and the subsequent changing nature of global trade relations, the effects of regional integration have altered. Trade creation and trade diversion have become less important; standards and investment rules are more relevant topics. So if constructed properly, TTIP may well enhance global trade and intensify the world-wide division of labor.
- In combination with the transpacific partnership (TPP), this effect may even increase. The parallel negotiations of two mega-regionals may harness the global trade order and give the World Trade Organisation (WTO) a new focus. At the same time, this trend may foster Chinese reforms and a broader acceptance of the liberal trading order.
- However, Chinese opinion on the TPP is divided. One camp regards it as a thinly veiled, US-driven geopolitical strategy to cement President Barack Obama’s ‘pivot to Asia’ and isolate China in the region. Hence, part of China’s response has been to play up regional tensions; another has been to mobilize an alternative potential regional trading bloc in the form of the Regional Cooperation in the Asia-Pacific grouping, which notably excludes the US. The other camp is rooted in economics; particularly China’s recently announced reforms. Their view is that the TPP should be harnessed as an external prop to drive domestic economic reforms in much the same way that WTO accession was used 20 years ago.
- But also internally, the attempt to reduce trade barriers and to harmonize, or at least mutually recognize, standards will not be mastered without frictions. Winners from integration may be plenty, but there will also be losers when competition increases. So, internal resistance might well be observed in the process of regional integration. In addition, recent developments in mutual intelligence surveillance have raised concerns between the partners about the true nature of transatlantic partnership.
- TTIP may also benefit the EU through supporting necessary microeconomic reforms in its member states. In the aftermath of the world financial and economic crisis and still trapped by the problems in the Eurozone, Europe needs a supply side boost. TTIP and its likely consequences on the world trade order may well help to invigorate this reform agenda and overcome vested interests that still strongly (and effectively) prevent the necessary steps to increase European competitiveness.
- Looked at from these angles, TTIP can be seen as a great opportunity for the global economic policy sphere. If Europeans and Americans overcome the opposition to a better policy framework for trade and investment not only across the Atlantic, the world may well benefit from it.

# Introduction

The envisaged Transatlantic Trade and Investment Partnership (TTIP) is not only of enormous economic relevance, but also has the potential to cause shifts in global governance and the global architecture of trade and welfare. If two of the four biggest trading units or trading blocks engage in deeper integration, implying that 40 per cent of world-wide gross domestic product (GDP) and 30 per cent of trade will take place under a common regime, one would expect major challenges for the global trade order, but also for a broader political agenda.

Several questions immediately come to mind, e.g. regarding the compatibility of a post-Bali World Trade Organisation (WTO) and TTIP; the relationships between TTIP and other regional integration areas such as the transpacific partnership (TPP); or political consequences of the formation of a trade block as big as TTIP. Furthermore, the developing world will face major challenges when TTIP or TPP is formed, since these mega-regionals will probably go substantially beyond WTO agreements and change global standards. TTIP should also be seen in the strategic geopolitical context in which it and the TPP are taking place, and from which their energy is to a significant extent derived, namely the emergence of China to global power, and behind it India and perhaps further emerging economies.

But also internally, the attempt to reduce trade barriers and to harmonize, or at least mutually recognize, standards will not be mastered without frictions. Winners from integration may be plenty, but there will also be losers when competition increases. So, internal resistance might well be observed in the process of regional integration. In addition, recent developments in mutual intelligence surveillance have raised concerns between the partners about the true nature of transatlantic partnership.

Therefore it seems of utmost interest to take a closer look at the geopolitical consequences the agreement might have. Even if it is too early to have a clear picture of the tectonic global shifts unleashed by TTIP and the TPP it is justified to speculate about them. Since the fundament of international conflict most often is laid in domestic politics and then transferred into the international sphere, we start on the European, American and transatlantic level respectively. First we consider the likelihood of regions or countries within the European Union (EU) to lose by TTIP. Then we analyze transatlantic political-economic relations in the context of what is on the negotiating table, including recent tensions about security issues. This analysis of the preferential trade agreement (PTA) itself will be called the 'low politics'. This discussion essentially concerns a number of niggling issues in transatlantic relations that, viewed as a whole, have the potential to derail negotiations. This sets the scene for a discussion of the 'high politics' that underpin the current shared desire to conclude a deal. Here we focus on the current geopolitical 'moment' in world affairs, centered on the rise of China, to a lesser extent the BRICS (Brazil, Russia, China, India and South Africa) and the challenges and opportunities this poses to western leadership of the global trade order. The final section lays out three scenarios for the TTIP and its precursor but twin bedfellow, the TPP, and their respective implications for the global trade order. Since we are positive about the implications of the TTIP for the EU, we reflect on some broad implications it holds for Europe in our concluding remarks.

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# Political Economy of Transatlantic Integration

## EU IN THE TTIP: CENTRIFUGAL OR CENTRIPETAL FORCES

Effects of a transatlantic free trade area are numerous and differ among the members of the European Union. The main question is whether this will lead to a divergence or convergence between the EU member states. To evaluate this question we rely on the study by Felbermayr, Heid and Lehwald (2013). They demonstrate the differing effects of a TTIP on import and export flows, on real per capita incomes and on the unemployment rate. They differentiate between two TTIP scenarios: one scenario comprising the full elimination of tariffs and another scenario that is more comprehensive and includes the removal of non-tariff barriers (NTBs) in addition to tariff elimination. For effects on the countries' import and export flows, they find that especially trade flows between Germany and the United States (US) could increase strongly in both scenarios. Assuming a full elimination of tariffs, German exports to the US could increase by 1.13 per cent and imports from the US by 1.65 per cent. Moreover, when assuming comprehensive liberalization (tariffs and NTBs) German exports to and imports from the USA could increase by more than 90 per cent. However, Germany's trade with other trading partners, especially Great Britain, France and China could decline owing to an alteration of trade diversion effects<sup>1</sup> which are currently in force in the EU.

A strong increase of trade flows could be also noticeable for the GIIPS (Greece, Ireland, Italy, Portugal and Spain) countries, which is especially obvious for the comprehensive liberalization scenario. Greece, Italy and Portugal could be experiencing growth rates of export and import volumes of around 90 per cent, just in line with the trade growth rates between Germany and the US. Spain could record growth in trade of around 80 per cent and Ireland of 70 per cent (Ireland is already recording a relatively high extent of transatlantic trade and will hence record slightly lower growth rates after a comprehensive liberalization).

The case of Great Britain is especially revealing. Having already a considerably high degree of integration with the USA along with low natural trading barriers (language, culture, etc.), a TTIP could nonetheless have significant effects on Great Britain's trade flows. Elimination of trade barriers between the EU and the US could thus lead to especially high trade creation effects between the US and Great Britain and corresponding trade diversion from Great Britain – EU trade to US trade. Trade volumes between Great Britain and the US could thus increase significantly (for the tariff elimination scenario 0.98 for exports to the US and 1.38 for imports from the US and for the comprehensive scenario around 60 per cent for both exports and imports). At the same time however, its integration with EU members could weaken. A decrease of trade flows between Great Britain and France (around 36 per cent), Germany (around 40 per cent) and Italy (around 45 per cent) could occur. The consequences of this development on the British inclination to leave the EU can only be guessed.

However, tendencies for convergence between EU members in the course of a TTIP become evident when looking at effects on real per capita income and unemployment

<sup>1</sup> | Trade diversion in general implies a decline in trade with efficient third country producers caused by regional integration (Viner 1950).

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rates. Predicated potential changes in real per capita income of the EU member states in the course of TTIP implementation show that all EU members would benefit from trade liberalization with the US. However, benefits depend on the countries' trade structures, its size and geographical position. Countries which are already exporting large amounts to the US benefit relatively more, as is the case for Great Britain which would experience a growth in real per capita income of 0.31 per cent for the zero-tariff scenario. Furthermore, smaller countries tend to gain more, as they are more involved in the international division of labor and benefit substantially from lower trade costs. This becomes obvious when looking at the Baltic countries, with a potential growth of real per capita income of 0.50 per cent for Estonia, 0.49 per cent for Latvia and 0.58 per cent for Lithuania (which could record the highest growth in per capita income of all EU member states). Moreover, Felbermayr, Heid and Lehwald (2013) show that countries that have a lower per capita income would gain more than those with a higher income, which underlines the tendency towards convergence in per capita incomes. For example, Romania could record a 0.38 per cent increase, while Luxembourg could only record an increase of 0.03 per cent. Predicted per capita income gains are even higher for the comprehensive liberalization scenario (EU average: 4.95 per cent). Countries potentially profiting most are the ones which have a relatively extensive trade in goods with the US, such as Great Britain. Also the Scandinavian countries and Spain record predicted per capita income growth rates above average. However, countries with a smaller trade volume with the US benefit less, such as France (2.64 per cent per capita income growth). Still, even countries predicted to benefit less from a TTIP (for example Luxembourg which could record a 0.03 per cent per capita income growth), could benefit indirectly from the increased trading by the other EU members and the US (Felbermayr, Heid and Lehwald, 2013).

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For the effects on employment<sup>2</sup>, Felbermayr, Heid and Lehwald (2013) also conclude with two promising scenarios. In the tariff elimination scenario, they find that employment would rise in all EU countries by around 0.1 percentage points. Again, Great Britain is a special case since it could experience a higher increase in employment (by 0.34 percentage points) owing to its special closeness to the US. Furthermore, convergence is again noticeable. Thus, the higher the current unemployment rate, the greater the potential reduction in the unemployment rate in the course of tariff elimination (except for Great Britain which potentially records a relatively low unemployment rate but benefits most). The effects are again significantly higher when assuming the comprehensive liberalization scenario. Here, it also becomes clear that the countries which are currently highly affected by the bank and government debt crises potentially benefit more from deep liberalization. Thus, unemployment could decrease by 0.62 percentage points in Spain, by 0.70 percentage points in Greece and Portugal; and by 0.84 percentage points in Ireland (Felbermayr, Heid and Lehwald, 2013).

One has to be careful to interpret the results of one study only. Nevertheless, judging from the results presented above there is no significant evidence that EU countries would risk drifting apart after a transatlantic liberalization. By contrast, convergences are notice-

<sup>2</sup> | Results in the study refer to long-term employment rates. They represent changes in employment independent of the economic cycle (Felbermayr, Heid and Lehwald, 2013).

able, especially with respect to per capita income growth and the unemployment rate. The literature review by Draper et al. (2014) is cautiously supportive to this conclusion.

## **TRADE INTEGRATION ACROSS THE ATLANTIC: THE LOW POLITICS**

Both the theory of regional integration and empirical evidence suggest that the overall welfare effects of this integration process will be positive. In the TTIP case the literature expects moderate but clear positive effects for the United States and the European Union (Freytag, Draper and Fricke, 2014). However, these positive effects will not necessarily be distributed evenly. Some factors of production may lose, others may win. The potential losers will oppose the regional integration efforts, as can be seen in TTIP negotiations. Consequently, we see special interests on both sides of the Atlantic opposing deeper integration (WTO+). In addition, there are growing concerns in civil society that the negotiations take place in backrooms and only please big business. Transparency has become an important issue, in particular with respect to regulations and standards.

*Welfare effects will not necessarily be distributed evenly. Potential losers will oppose regional integration efforts. In Europe, cultural and farming interests oppose negotiating their issues within TTIP from the start.*

In Europe, special cultural and farming interests oppose negotiations about their issues within TTIP from the start. Movie subsidies, investment protection, and genetically modified food are divisive issues. The latter two cases are particularly high on the agenda of non-governmental organizations (NGOs). In both cases, the predominant argument is that the interests of US big business are taken more seriously than public interest in the EU. The problem is that it is not clear what the public interest really is. So far, the risks of genetically modified food are not scientifically proven; more evidence is needed. In addition, the non-discriminating stance towards foreign investors – and therefore their protection from discrimination and expropriation – is in the interest of creating European jobs through inward foreign direct investment (FDI). A further highly criticized issue is the establishment of an investor-state dispute settlement system (ISDS). According to this mechanism, multi-national corporations (MNCs) would have the possibility to sue governments in international tribunals in case they fear a loss in profits due to public interventions or regulations, particularly in the fields of public health, environmental or social protection.

Both cases are highly emotional. This has been spurred by a number of recent political statements of European politicians such as the German environmental and agricultural ministers respectively. Especially with regard to the ISDS and the diverging guidelines for consumer protection, both ministers fear a softening of food and environmental standards in the EU (Spiegel Online, 2014). The EU trade commissioner Karel De Gucht even stopped the investment negotiations for three months in order to make sure that civil society is better informed. This seems to come at no costs since the US administration is still struggling to get trade promotion authority (TPA) which will allow it to seriously negotiate TTIP (see below).

In any event, a solution to the regulatory differences can be found in the EU's single market: the country-of-origin-principle, meaning mutual acceptance and application of consumer protection and environmental standards across the Atlantic in combination with strict labeling requirements. European consumers then may decide for themselves whether or not they wish to consume e.g. a certain maize product. The EU's experiences with this principle are very good and should serve as a model.<sup>3</sup>

<sup>3</sup> | One may consider the case of German beer. The German attempt to make the own brewing purity standards mandatory in Germany failed because of the country-of-origin-principle. Thus, all sorts of beer may be sold in Germany. The overwhelming majority of beer consumers still prefer beer brewed after German purity standards; they have become a marketing tool.

In the US, the problem is even more complicated. Despite the fact that cheap imports benefit the poorest and should thus be encouraged, the US trade debate focuses on job creating export opportunities. In addition, much depends on the question of whether President Barack Obama will be granted TPA from Congress. This has been a delicate issue since the last fast TPA mandate expired in 2007. The problem is that the Democratic Party is traditionally opposed to import liberalization. Ironically labor standards seem to be the Democrat's most prominent argument in favor of protectionism, despite their negative distributional effects.<sup>4</sup> Without TPA however, credible trade negotiations are much less likely than with TPA (The Economist, 2014).

In addition, the structure of trade policymaking changes owing to regional integration. This may also lead to different levels of protection in the preferential trade area (PTA). There is only very small theoretical literature about the political economy of regional integration, which also needs an overhaul against the background of new trade patterns or so-called 21<sup>st</sup> century trade (Baldwin, 2013). This literature deals with the general level of protection after integration. In a PTA trade policy is conducted on the national level. The general degree of protectionism is likely to be moderate because there is competition between the different countries. By contrast, in a customs union there is often a central customs office in charge of trade policy, such as the European Commission in the EU. According to Frey and Buhofer (1986), deepening integration causes a higher degree of protectionism. The reason may be that the central agency behaves like a typical Niskanen-type bureau<sup>5</sup> and wants to attract demand for protectionism (Freytag, 1995). However, for TTIP such a development is excluded.

As already mentioned, these considerations are rather relevant for 20<sup>th</sup> century trade with goods produced in one country and shipped into another. Given today's technological opportunities and low transportation and communication costs, production processes are getting more fragmented and trade policy is decentralized, since firms are taking part in global value chains (GVCs). Therefore, their interest is no longer focused so much on traditional at-the-border-measures, but rather on open markets with proper regulation. Protectionism is thus likely to move behind the borders. One may even expect globally acting firms to take the lead role in standard setting and thus in forming protective measures to lock others into their standards. These are more directed at other companies than at other countries. Furthermore, there is a tendency of regulators to form their own protection blocs as they become vested in the regulations over which they have stewardship.

#### **THE TRANSATLANTIC STRATEGIC AGENDA: NATO, THE NSA, AND THE FORMER USSR**

Trade policy is not conducted in a vacuum. Instead, it is connected to other policy areas, even if the nexus is small. In light of the so-called National Security Agency (NSA) affair between the US and her European partners, some European policymakers and EU-officials think loudly about stopping the negotiations on TTIP. This would mean that the US would abandon substantial welfare gains, which are likely to be higher than European benefits (Freytag, Draper and Fricke, 2014). To tie the two events,

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4 | Gresser (2014) shows that in the US tariff rates on cheap products are much higher than tariffs for their luxury substitutes; this holds for e.g. clothing and dinnerware. This means that the relative burden of protection is much higher for poor people than for rich people. Thereby, US protectionism hurts the poorest inside and outside the US.

5 | The Niskanen model explains the growth of bureaucracies by explaining the interactions between politicians and bureaucrats which are characterized by asymmetric information. Rational bureaucrats aim at maximizing their budget since all other utility dimensions depend on it (such as prestige or survival of the organization). This however leads to an overprovision of the provided good.

therefore, seems natural and tempting against the background to motivate the US administration to change their intelligence and surveillance practices towards their European partners.

The probability of success, however, may well depend on the real or perceived preference for TTIP in the US. This has to be calculated carefully before tying the talks to behavior in other fields. Given the protectionist nature of the Democrats, who currently are leading the Senate in Congress, one should be skeptical. Instead of pressing the US administration to rethink its intelligence approach, something that President Obama's recent speech on the subject made clear is not really on the cards, Congress might use this conflict as scapegoat to stop the deal or to raise the costs of TTIP. The strategy to tie the two issues may thus backfire. In addition, the companies at the center of the scandal – US technology giants such as Google and Apple, have been instrumental in breaking down global knowledge transfer barriers through the development of cloud computing. The consumer benefits arguably far outweigh the costs in terms of data privacy, although EU states are undoubtedly correct in pushing for more rigorous privacy standards.

*The so-called National Security Agency (NSA) affair might compromise the negotiations. Given the protectionist nature of the Democrats, who currently are leading the Senate in Congress, they might use this conflict as scapegoat to stop the deal or to raise the costs of TTIP.*

With respect to NATO, the strategy of tying may be slightly more successful. Offering a stronger European commitment to military interventions, particularly by Germany, may encourage the US Congress to give up resistance against further transatlantic liberalization. However, once again, the EU in taking this approach would be risking the benefits of TTIP. Furthermore, the EU is in much greater need of US security guarantees provided through NATO than the US is of European participation as the current crisis in Ukraine makes abundantly clear. In fact one of the most compelling geopolitical arguments the EU has for pursuing the TTIP is its relative vulnerability to Russian revisionism in Eastern Europe, or the former states of the Union of Soviet Socialist Republics (USSR).

Another argument bears closer scrutiny. It is common knowledge that, in the wake of the ongoing economic crisis that has engulfed the EU since 2008, anti-EU sentiment has increased and at some point may come to threaten the coherence of the entire EU project at a time of great global changes. If that were to come to pass then the EU, and its member states, would become much more vulnerable to external aggression from outside actors (FRIDE, 2014). By contrast, the economic benefits TTIP proffers may strengthen EU integration and cohesion, and therefore the EU's role on the global stage. Therefore, to risk throwing those benefits away in order to secure a few extra nibbles on the low politics of the trade-negotiating table would be a risky approach indeed.

Given that the US is making faster progress in negotiating TPP than in dealing with TTIP, the European position seems rather weak and tying TTIP to other issues is not so promising. To the contrary, it may be a better strategy to use TTIP as collateral in the sense that the EU wishes to build up trust across the Atlantic again, and secure continued US geopolitical commitment to Europe, by negotiating TTIP without pre-conditions. For the Europeans, the risk of being left outside a TPP mega-regional is too high to use TTIP as a strategic tool. Therefore, the scope for strategic ties seems rather limited and should not be considered seriously.

# Geo-Strategic Aspects of TTIP

Bilateral trade agreements can have significant implications for the world trading order. However, the type of initiative determines the effect it would have on multi-lateral negotiations. Most of the existing bilateral trade agreements are between two small countries (south-south) or between one big and one small (center-periphery) and are not of significant economic importance (not much tariff liberalization; not far beyond WTO commitments) with no significant effect for the multilateral trading order.

However, as TTIP would be an agreement between the biggest economies, it would definitely yield some significant systemic effects (Erixon and Pehnelt, 2009). Furthermore, from a comparative perspective, in the long-term the establishment and implementation of a comprehensive TPP may be more significant than the Transatlantic Partnership, if it lays the ground for the establishment of an APEC-wide agreement (APEC – Asia-Pacific Economic Cooperation). Such an agreement would see the establishment of one of the largest PTAs incorporating China, Japan and the USA along with a number of fast growing Asian and Pacific countries.

Third countries not included in TTIP or TPP could react in two ways. First, it might be possible that a number of further free trade agreements (FTAs) parallel to the TTIP emerge, with emerging economies aiming at establishing a counterweight to the TTIP. At the heart of this potentially negative scenario is the issue of global trade leadership; an issue central to the very notion of a global trading order. One strand of international relations theory has long adhered to the notion of “hegemonic stability” (Gilpin, 2001). This is rooted in Hobbesian notions of political power and the human need for a state to maintain law and order lest society degenerate into a struggle of all against all (Hobbes, 1651). Since the Second World War, the US has fulfilled the role of, first, leader of the Western bloc, and later global hegemon. Under US tutelage the post World War Two system of international economic order was established and maintained. Now, with the rise of China and other emerging market economies, US global leadership is increasingly being challenged. In this light the fact that the US is central to both the TPP and the TTIP takes on a new significance, and is widely interpreted as a concerted US effort to re-establish its primacy in the global trade order.

## US GLOBAL TRADE LEADERSHIP IN QUESTION

In this light, the dominant view among US trade policy makers and analysts is that the Doha round has failed and the WTO is moribund. A key factor underpinning this viewpoint is that large emerging markets, particularly China but extending to India and Brazil, are either not willing or able to take on the sacrifices that global trade leadership entails. This is one, major motivation behind the US drive to negotiate the TTIP and TPP. Related to this, another motivation is the notion that in order to forge the kind of trade rules that are needed for twenty first century trade conduct in a world of GVCs, much more can be done in regional settings than the log jammed WTO. These two factors featured centrally in the US’ decision to join the

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original TPP countries and to subsequently engage in widening the circle of participants.<sup>6</sup> They also explain the rhetoric used in explaining TPP, notably to establish an ambitious PTA.

*With the rise of China and other emerging market economies, US global leadership is increasingly being challenged. In this light the fact that the US is central to both the Trans-Pacific Partnership (TPP) and the TTIP is widely interpreted as a concerted US effort to re-establish its primacy in the global trade order. Similarly, EU leaders are motivated by both economic and strategic concerns.*

However, there is another motivation behind the TPP, which also resonates in the TTIP negotiations. Some informed trade observers note that the current United States Trade Representative, Mike Froman, was formerly Director for International Economic Affairs at the National Security Council (NSC) and National Economic Council (NEC). Given this background it is not a stretch to imagine that his enthusiasm for the TPP is at least in part informed by strategic considerations. One Chinese scholar observed that the original decision to join the TPP was cleared by the NSC, meaning the TPP was also vetted for its implications for US national security.<sup>7</sup>

Consequently, it is no coincidence that the TPP precedes the TTIP, as the geopolitical aspect of its motivation is undoubtedly aimed at China. Behind this lies a deep-seated US concern that China will not play by the rules established by Western powers to govern the global economic order. Hence the TPP is in part a strategic gambit to enmesh other countries, particularly in East Asia, in an enhanced rules structure or regime<sup>8</sup> that will present China with a fait accompli.

The countries involved in the TPP are, for the most part, ones that have either already concluded an FTA with the US, or are keen to do so, or are key US military allies, or harbor deep concerns over China's rise and what it means for them. Hence the twin US motivations described above resonate with the US' negotiating partners.

#### **WHAT ARE EUROPEAN INTERESTS?**

Similarly, EU leaders are motivated by both economic and strategic concerns. On the economic front, the potential gains from TTIP are evident and have been discussed above. These hold the potential to revitalize member state economic reforms at the microeconomic level, which is arguably where the key reforms need to be made in order to restore European competitiveness. This would boost economic growth and jobs, thereby better positioning EU member states for the rise of Asian challengers, especially China, while also assisting in bootstrapping the EU out of its current post financial crisis malaise. The TTIP also offers the prospect of sustaining western – EU in this case – leadership over the global trading system, particularly if its outcomes, in tandem with those emanating from the TPP, translate into WTO rules down the line (Transatlantic Task Force on Trade and Investment, 2012).

At the strategic level key EU states are naturally concerned about the diversion of US strategic bandwidth to Asia, crudely summarized in former Secretary of State Hillary Clinton's notion of a 'pivot to Asia' (Foreign Policy, 2011). Given the difficult political developments unfolding on the EU's doorstep in Eastern Europe, and particularly Ukraine, EU member states feel increasingly compelled to get involved in managing developments there but lack the strategic tools to do so especially compared to the resurgent Russian state. The TTIP therefore offers the prospect of keeping the US deeply involved in EU affairs, and provides a powerful counterweight to Russia's

6 | *Informal conversations with Susan Schwab, former United States Trade Representative who took the decision to bring the US into the TPP negotiations.*

7 | *Informal conversation with a Chinese professor, name withheld for confidentiality reasons*

8 | *According to Krasner (1982), regimes are the rules and norms governing international relations. These rules may be explicitly or implicitly formulated. The world trading order is embedded into a western liberal regime type.*

revival. The US seems content with this strategic rationale, and evidently shares a desire to contain Russia. But the US is likely to command a price for this continued engagement, either in the security terrain or possibly in the low politics of trade negotiations.

## CHINA, AND THE HIGH AND LOW POLITICS OF MEGA-REGIONALS

What of the other key actor in these evolving geopolitical chessboard? Chinese opinion on the TPP is divided. One camp regards it as a thinly veiled, US-driven geopolitical strategy to cement President Barack Obama's 'pivot to Asia' and isolate China in the region (Wang Yong, 2013). Japan's recent inclusion in the TPP in the context of rapidly escalating bilateral tensions between China and Japan reinforces this perspective. And as previously noted it is mirrored in the US security community, parts of which apparently want the deal to isolate China from regional supply chains.<sup>9</sup> Consequently, part of China's response has been to play up regional tensions; another has been to mobilize an alternative potential regional trading bloc in the form of the Regional Cooperation in the Asia-Pacific grouping, which notably excludes the US. In this scenario, the world is divided into competing power blocs centered on dominant regional economies; in the case of the Regional Cooperation for Asia and the Pacific (RCEP) this would include China, India and Japan in particular. Growing great power competition, expressed through attempts to carve the world up into competing trade "fortresses" via PTAs, could conceivably turn out very badly for the world. China's challenge, though, is that this negotiating group includes India, which is famously reluctant to liberalize much at all in its PTAs.<sup>10</sup>

The other camp is rooted in economics; particularly China's recently announced reforms. Their view is that the TPP should be harnessed as an external prop to drive domestic economic reforms in much the same way that WTO accession was used 20 years ago. It is not implausible: whereas in other parts of the emerging world the fascination of the Doha Development Agenda seems to have faded, the degree of interest among China's trade policy elite in the future of the WTO, and the global trading system of which it is a part, seems to run high.<sup>11</sup> Given China's recent emergence to global prominence, and the role played by open trade and investment in it, this viewpoint is perhaps to be expected. Now that China is a significant player in global supply chains, and if its current reform drive is successful, that position will become more powerful.

If the TTIP fails, Chinese trade diplomats and policy wonks probably wouldn't be surprised. One senior former trade diplomat privately described the talks as "a joke".<sup>12</sup> But if the TPP fails, the aftermath will be more interesting. The US would have failed to cement its regional leadership, while China would be freer to assert its own. Then US-China-Japan strategic rivalry in the Asia-Pacific would intensify. Furthermore, the door could open to Chinese leadership in the WTO. Ten to 15 years after the prospective round of economic reforms begins in China, who knows where that might lead?

We have already seen conflicting Chinese messages in the WTO, with implications for BRICS solidarity, among other things. For example, China has formally requested

*Chinese opinion on TTIP is divided. One camp regards it as a thinly veiled, US-driven geopolitical strategy to cement President Barack Obama's 'pivot to Asia' and isolate China in the region. The other camp is rooted in economics; particularly China's recently announced reforms. Their view is that the TPP should be harnessed as an external prop to drive domestic economic reforms in much the same way that WTO accession was used 20 years ago.*

9 | *Insights from a side-meeting on the TPP at the World Economic Forum's Summit on the Global Agenda, Dubai, November 19<sup>th</sup>, 2013.*

10 | *One Chinese participant in a WTO seminar in Beijing remarked that because RCEP includes India it will not amount to anything.*

11 | *An observation based on participation in three conferences on the WTO and China's trade policies that took place in a two week period in November 2013, in China.*

12 | *Ibid.*

to join the Trade in Services Agreement (TISA), a WTO-aligned plurilateral negotiation that aims to liberalize services trade among a group of like-minded members. Until now, the BRICS have steadfastly resisted joining such “coalitions of the willing” in order to keep the focus on the Doha round. But the services sector is a key focus of China’s domestic reforms. On the other hand, China is delaying extension of the Information Technology Agreement, an existing plurilateral that eliminates tariffs on a range of IT products. Yet China clearly has a great deal to gain through further liberalization in this area. These contradictions show that guesswork about China’s domestic economic reforms is just that.

Nonetheless, in our view, China is likely to gather pace. Of core interest is the host of potential reforms concerning domestic competitiveness in key sectors related to China’s external relations. The communiqué issued after the third plenum of the Chinese Communist Party’s 18<sup>th</sup> central committee makes reference to the private sector assuming a “decisive role” in the domestic economy. State-owned enterprises, the financial system, foreign investment restrictions, and even currency reforms are, among others, in the liberalization spotlight (China Daily, 2013; Global Times, 2013). The Shanghai free-trade pilot zone has become the reference point for experimentation; further reforms will undoubtedly follow.

There will be resistance. But President Xi Jinping’s administration seems determined to have its way. Thus it has tightened domestic political control in order to reduce opposition. The process will be less dramatic and more uneven than the reforms of the late 1970s and mid-1990s, but could be just as defining.

## **IMPLICATIONS FOR THE GLOBAL TRADE ORDER**

*TTIP and TPP might result in new liberalization efforts by third countries, by means of new liberalization propositions at the multilateral level or wishing for accession to the TTIP or TPP.*

Broadening the perspective, a positive liberalization scenario is feasible. The mega-regional agreements might result in new liberalization efforts by third countries, by means of new liberalization propositions at the multilateral level or wishing for accession to the TTIP (Diekman, 2013) and TPP. In this light, looking at the historical course of free trade agreements and multilateral negotiations, successes in multilateral negotiations often occurred in the wake of bilateral agreements. This was the case for the Kennedy-round after the formation of the European Community (EC)-customs union, and for the Uruguay-round, which followed the establishment of the European common market and the North American Free Trade Agreement (NAFTA). Hence, regional trade agreements increase the advantages that third countries could experience by multilateral liberalization, which leads to an increased willingness to compromise (Felbermayr and Larch, 2013). Moreover, a few bigger PTAs might lead to more successful liberalization efforts at the multilateral level than a number of smaller ones. Negotiations at the multilateral level might then be more successful due to reduced complexity and reduction of free-riders (Felbermayr and Larch, 2013).

*TTIP and TPP could act as leadership for defining trade policy advancement and shaping international trade politics.*

Thus the TTIP and TPP could act as leadership for defining trade policy advancement and shaping international trade politics (Erixon and Bauer, 2010; Diekman, 2013). They may give the WTO and its members ‘the jolt to get back on track again’ (Erixon and Bauer, 2010). The Transatlantic Task Force on Trade and Investment (2012) goes further in making explicit recommendations for how these new issues, and updated agreements on old issues, could be brought into the WTO with a view to multilateralising them. This logic is in keeping with Bergsten’s (n.d) argument, dubbed “competitive liberalization”, that as the USA secures PTAs with other countries, those countries become like-minded with the USA and seek to form PTAs along similar lines with third

parties. Soon those left outside emulate the PTAs, and ultimately the logic finds its way back into the WTO in the form of new agreements.

A global boost of liberalization seems also plausible in the context of GVCs, shaping the structure of international trade. With production and supply chains being more and more fragmented, firms and companies are now demanding a different kind of liberalization. Instead of market access and primarily low tariffs, other factors became more and more important, demanding deeper integration in the areas of competition policies, property rights, copyright laws and data security. A transatlantic trade agreement could account for this newly emerged demand by establishing common standards (Diekman, 2013).

The review of studies assessing the possible impact of the various mega-regional agreements makes it clear that non-tariff measures are an increasingly important consideration, and in many cases the effective protection from, and therefore the effective gains from reduction of, non-tariff measures is greater than those presented by tariff duties. This places increasing importance on “21<sup>st</sup> century regionalism” and the negotiation of agreements that are able to effectively deal with these issues. These pressures are likely to remain in place and intensify, not least because non-tariff measures impede the operation of the GVCs that structure the global trade system.

This is in keeping with Baldwin’s (1993) concept of the “juggernaut” effect, whereby major multinational companies seek regulatory convergence in order to smooth the operation of their global value chains, and lobby host governments to provide it particularly through mutual recognition of different regulatory requirements – a process pioneered in the EU and which will potentially unfold on a much larger scale in the TTIP. This pressure finds its way into other PTAs, thereby creating a juggernaut effect reinforced by competitive liberalization.

Yet the TPP and TTIP are complex negotiations, containing many potential implications, the precise nature of which are in turn subject to political economy constraints and possibilities. Consequently it is impossible to predict their final character at a detailed level, since many trade-offs across and within issues are entailed. However, the character of these agreements, as discussed in the section on economic impacts, will determine how they impact on outsiders, whether through PTA or WTO channels.

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# Mega-Agreements and the Global Trade Order: Three Scenarios

*Success would be a preferential trade agreement based on the solid consensus of all of the parties to the talks, with major trade liberalizing effects for goods, services and investments, and measurable progress in reforming some of the most intractable political economy choke-holds that a limited number of commodities have exercised on the world trade system for many decades.*

Therefore, drawing from Draper et al (2014), we now speculate, in broad terms, about three possible outcome scenarios. Crucially, this depends very heavily on how one defines success. Some parties, particularly certain civil society groups, may define success as a collapse in the talks and thus the failure of the TPP and TTIP to culminate in the envisaged FTA. Our view is that success would be a PTA based on the solid consensus of all of the parties to the talks, with major trade liberalizing effects for goods, services and investments, and measurable progress in reforming some of the most intractable political economy choke-holds that a limited number of commodities have exercised on the world trade system for many decades. This is necessarily a globally systemic view, and not one rooted in the particular interests of any country or group of countries, whether insiders or outsiders. Ultimately we believe these two negotiations do offer the prospect of positively deepening global economic integration, even as we remain alive to the challenges that poses to poorer countries less capable of matching up to the more rigorous standards this implies.

## **FULL SUCCESS**

One free trade zone spanning the Asia-Pacific region and covering 40 percent of global GDP, with tariffs completely eliminated and barriers to investment completely removed; and another covering the transatlantic space and of similar shape and magnitude, is probably the scenario that one would envisage under “full success”. It would give maximum play to the forces of competitive liberalization and its associated juggernaut. But this scenario is also commonly referred to as “utopia”, since some tariffs and some barriers to investment will inevitably remain on the most politically sensitive items, and both are only likely to go so far in tackling the now much more important issue of behind-the-border trade barriers in the form of domestic regulation. The protectionist intent lurking behind many such regulations is best unmasked in the context of dispute settlement, and for this the WTO is likely to remain the forum of choice for most, if not all parties to the TPP and TTIP.

Nonetheless, if one hews to the full success scenario, then “competitive liberalization” will roll across the planet and wrap all up in its path. Already we see that China is closely watching the TPP process, and calibrating its own domestic economic reform program to mirror potential negotiating outcomes to the extent possible. Similar, albeit more embryonic discussions are taking place in other significant developing countries such as India, Brazil, and South Africa. If China moves to join the TPP, as it has in the case of the TISA negotiations, then the pressure on outsider countries will rise enormously.

## **PARTIAL SUCCESS**

This is the more likely scenario of the three, since trade agreements always involve trade-offs and compromises, and both mega regionals are almost certain to fall somewhat short of the lofty and ambitious goals aspired to in their founding declarations. This is simply a manifestation of the age-old maxim that trade agreements involve a set of second or even third best policy choices (the best scenario always being

free trade). Be that as it may, even if the TPP manages to consolidate existing liberalization efforts undertaken by all the parties to it, and to provide domestic political cover for implementing reforms to some of the most intractable domestic economic problems in member countries (Japanese rice subsidies come to mind), this will still represent considerable progress. Similarly, the TTIP is likely to be relatively comprehensive on the tariff front but to involve numerous regulatory compromises. Obstacles such as the European Common Agricultural Policy are yet to be removed. Nonetheless that would be a significant outcome from the standpoint of promoting global trade liberalization and regulatory convergence. If it operates primarily through a mutual recognition agreement (MRA) modality, in terms of which outsiders' access to both markets is enhanced, then the result could be positive for outsiders and the global trade system.

If the partial success scenario unfolds, then outsider countries will have more wiggle room; more time to adjust their trade strategies and more policy space to pursue. However, this scenario is likely to be accompanied by ongoing stasis in the WTO, since the major developed countries that have traditionally exercised leadership over the global trading system would not have been able to decisively seize the initiative. The pressure on outsider countries to forge reciprocal trade arrangements with the major developed countries would increase somewhat, but probably not much further than where it currently stands. Much depends on the shape of the partial success outcome.

## **FAILURE**

Given the advanced stage of the TPP talks, and the enormous amount of political capital that has already been spent by leaders in such countries as the United States and Japan, it is unlikely that either negotiation will be allowed to fail. Instead, negotiators will do what General Agreement on Tariffs and Trade (GATT) negotiators did after six years of negotiations in the Tokyo Round, which is to draw a line in the sand and call failure a success.<sup>13</sup> Here one envisages a much more modest agreement that fails to provide a single tariff schedule for goods among all parties to TPP, significant exclusions in the TTIP, and with both limited to a set of largely hortatory declarations on achieving future progress in areas where the talks have proven difficult (e.g. IPR, environment, labor etc.). The domestic political economy constraints in a number of countries are formidable, in particular the US which is at the center of both negotiations: the Republican dominated House of Representatives is seemingly determined on denying President Obama any kind of positive outcomes whatsoever; the Obama Administration's commitment to trade and investment liberalization is at most lukewarm (and predicated solely on the objective of increasing US exports); and the President faces hostile opposition from much of his political supporters in the Democratic Party. The US electorate – currently in somewhat of a declining competitiveness and income equality funk – has lost much of its appetite for these kinds of deals,

*There is the oldage maxim that trade agreements involve a set of second or third best policy choices (the best scenario always being free trade). The TTIP is likely to be relatively comprehensive on the tariff front but to involve numerous regulatory compromises concerning mutual recognition.*

13 | We say this given the failure of GATT negotiators in the Tokyo Round to bring agricultural trade more fully under GATT disciplines, or to end the proliferation in vertical export restraints by concluding a safeguards agreement, both of which had to wait until the Uruguay Round.

particularly with the dominant political narrative regarding NAFTA still being that it ultimately moved many US jobs offshore. One could argue that for the USA the electoral math for a sweeping trade deal like this one just isn't there, something we are seeing now being played out in the difficulties the Obama Administration is having in just obtaining TPA, and which is something that will equally constrain both the TPP's and TTIP's ultimate scope and effects. So this is a scenario we might realistically be facing.

*If the negotiations fail, then the immediate pressure will be off outsider countries. However, there could well be a backlash from the US and the EU, since this scenario would hasten potential Chinese leadership of the global trading system.*

If the negotiations fail, then the immediate pressure will be off outsider countries. However, there could well be a backlash from the US and the EU, since this scenario would hasten potential Chinese leadership of the global trading system. In the interregnum, positioning amongst the major powers would likely be intense, and therefore pressure on outside countries to yield reciprocity in their trade relations with these powers would likely escalate substantially beyond current levels. Furthermore, this scenario would likely mean that the WTO would be stuck in the doldrums with no leadership from any quarter as the major powers move to shore up regional alliances. In the medium term outsider countries would need to adjust to a multipolar trading system. This may present some opportunities to play the major powers off against each other in order to bolster domestic economic priorities, although that can be a risky game to play. However, since the China card would be very much in play outsider countries would need to ask serious questions about Chinese trade diplomacy, its underlying interests and associated strategies for pursuing those interests. At the very least China is likely to pursue a more hardheaded approach to securing them, which, if properly harnessed could be very beneficial to outsider countries.

The thread that runs through all three scenarios is that the pressure on outside countries to adhere to rigorous behind the border regulatory norms and to liberalize trade policies is very unlikely to disappear. It may fluctuate depending on the scenario, but to stick one's head in the sand and hope it will never return does not seem like a viable strategy.

# Conclusions



Whereas transatlantic trade negotiations in the 1990s were generally seen as a threat to the global trade order and bore the risk that this mega-regional agreement would create a “Fortress Atlantic”, this time the preconditions are different. Owing to the fragmentation of production processes and the subsequent changing nature of global trade relations, the effects of regional integration have altered. Trade creation and trade diversion have become less important; standards and investment rules are more relevant topics. So if constructed properly, TTIP may well enhance global trade and intensify the world-wide division of labor.

In combination with TPP, this effect may even increase. The parallel negotiations of two mega-regionals may harness the global trade order and give the WTO a new focus. At the same time, this trend may foster Chinese reforms and a broader acceptance of the liberal trading order.

TTIP may also benefit the EU through supporting necessary microeconomic reforms in its member states. In the aftermath of the world financial and economic crisis and still trapped by the problems in the Eurozone, Europe needs a supply side boost. TTIP and its likely consequences on the world trade order may well help to invigorate this reform agenda and overcome vested interests that still strongly (and effectively) prevent the necessary steps to increase European competitiveness.

Looked at from these angles, TTIP can be seen as a great opportunity for the global economic policy sphere. If Europeans and Americans overcome the opposition to a better policy framework for trade and investment not only across the Atlantic, the world may well benefit from it.

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# Acronyms

<b>ACP</b>	Africa, Caribbean and Pacific Group of States
<b>APEC</b>	Asia-Pacific Economic Cooperation
<b>BRICS</b>	Brazil, Russia, India, China and South Africa
<b>EU</b>	European Union
<b>FDI</b>	Foreign Direct Investment
<b>FRIDE</b>	Fundacion para las Relaciones Internacionales y el Dialogo Exterior (Foundation for International Relations and Foreign Dialogue)
<b>FTA</b>	Free Trade Agreement
<b>GATT</b>	General Agreement on Tariffs and Trade
<b>GDP</b>	Gross Domestic Product
<b>GIIPS</b>	Greece, Ireland, Italy, Portugal and Spain
<b>GVC</b>	Global Value Chain
<b>IPR</b>	Intellectual Property Rights
<b>ISDS</b>	Investor-State Dispute Settlement
<b>MRA</b>	Mutual Recognition Agreement
<b>MNC</b>	Multi-National Corporation
<b>NAFTA</b>	North American Free Trade Agreement
<b>NATO</b>	North Atlantic Treaty Organization
<b>NEC</b>	National Economic Council
<b>NGO</b>	Non-Governmental Organization
<b>NSA</b>	National Security Agency
<b>NSC</b>	National Security Council
<b>NTB</b>	Non-Tariff Barriers
<b>OECD</b>	Organisation of Economic Cooperation and Development
<b>PTA</b>	Preferential Trade Agreement
<b>RCEP</b>	Regional Cooperation for Asia and the Pacific
<b>SPS</b>	Sanitary and Phytosanitary Measures
<b>TISA</b>	Trade in Services Agreement
<b>TPA</b>	Trade Promotion Authority
<b>TPP</b>	Trans-Pacific Partnership
<b>TTIP</b>	Transatlantic Trade and Investment Partnership
<b>US</b>	United States
<b>USSR</b>	Union of Soviet Socialist Republics
<b>WTO</b>	World Trade Organisation

## Biographies

**Dr. Matthias Bauer** studied economics at the Friedrich Schiller University Jena (Germany) and business administration at the University of Hull (UK). He worked as a Ph.D. student at the graduate programme “Foundations of Global Financial Markets – Stability and Change” and was Research Affiliate at the European Center for International Political Economy, Brussels. Mr. Bauer is the Coordinator of International Economic Policy in the Political Dialogue and Analysis team of KAS, which is part of the European and International Cooperation department. His areas of research include the Social Market Economy, European fiscal policy, capital market policy and international trade policy.

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**Dr. Andreas Freytag** is Professor of Economics at the Friedrich-Schiller-University Jena and Honorary Professor at the University of Stellenbosch. He has just founded the Jena Africa Study Group in the FSU. Freytag is also a Senior Associate and Chief Economist at Tutwa Consulting, a Senior Research Fellow at ECIPE, Brussels, and a Senior Research Associate at SAIIA, Johannesburg. He was working at the Kiel Institute for World Economics, at the Universities of Cologne and Cambridge as well as at the Bank of Estonia. Freytag was the 2008 Bradlow Fellow of SAIIA and has taught at the Estonian Business School and the Tallinn University of Technology, where he has been a Visiting Professor since 2003. He was a member of the executive board of the European Public Choice Society from 2006 to 2009 and has long been associated to the G8 Research Group at the University of Toronto. He is a specialist in international relations, development policy and monetary policy. Freytag has published a number of books and articles on economic policy, international trade and competition policy, development economics and international policy coordination. Andreas Freytag has also been consultant for the OECD, the European Commission and several government agencies as well as private groups in Germany and South Africa.

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