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ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

EU trade negotiations from a global value chain perspective

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Summary

Global value chains require a strong global institutional framework to address new challenges and further trade liberalisation going far beyond tariff reduction with services, investment and regulatory issues gaining on importance. The EU has always been an advocate of a strong WTO and the supremacy of multilateral liberalisation. However, given that progress in multilateral trade negotiations remains relatively limited, the EU, like other economies has been engaged in bilateral trade negotiations. The revealed greater importance of bilateral trade in value-added terms with the US and Japan confirms an intense participation of these economies in global production networks. In 2013, the EU launched free trade agreement (FTA) negotiations with both the US and Japan. FTAs between the largest developed economies, if implemented according to the plan, would bring economic gains to the economies involved and potential positive spillover effects to the global economy. They would remain with no precedence in changing the global framework for international trade.

Introduction

Global value chains which have spread across the world economy require a strong global institutional framework to address new challenges and further trade liberalisation going far beyond tariff reduction with services, investment and regulatory issues gaining on importance. The EU has always been an advocate of a strong WTO and the supremacy of multilateral liberalisation. However, given that progress in multilateral trade negotiations remains relatively limited, the EU, like other economies has been engaged in bilateral trade negotiations. This paper challenges the view that bilateral agreements which are now under negotiations by the EU with its most important trading partners like the US and Japan will weaken the multilateral trade framework under the WTO. Bilateral trade agreements can be supportive if there are concluded with partners of strongly integrated economies within global value chains. These agreements should however ensure the removal of trade barriers far beyond what can be achieved at the multilateral level in the short term and remain open for new members in order to support positive spill-over effects to the global economy. This note looks first at EU trade with its most important trading partners using value-added measures of bilateral trade. Next, it sheds some light on the currently negotiated FTAs with the US and Japan. It concludes by highlighting implications for policy and future research.

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Economic and Financial Affairs

1. EU bilateral trade relations from a global value chain perspective

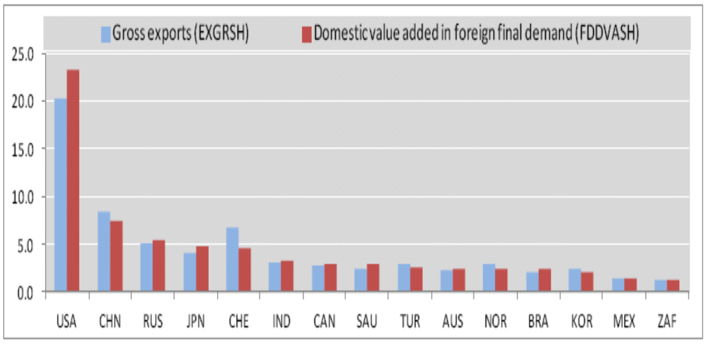
Trade patterns in the world economy have been changing over the last decades reflecting new production structures influenced by new technologies and demand patterns, trade liberalisation and gradual integration of economies into regional and global production chains. Such an economic environment created increased opportunities to relocate parts of domestic production abroad. International outsourcing changed the way trade flows occur now e.g. with an increased proportion of parts and components[1] instead of final goods in foreign trade of some countries.

However, gross trade statistics do not reflect the specific features of outsourcing, counting intermediate goods several times when they cross borders. The new TiVA database published by OECD and WTO in May 2013 which is based on international input-output tables, fills in the gap by providing several relevant indicators, including data on bilateral trade flows in value-added (VA) terms for OECD and some non-OECD countries.

According to the OECD, the domestic VA content of EU exports in 2009 stood at 86%. The relatively high proportion indicates strong regional economic integration among Member States, however, the share has decreased over time (from 90% in 1995) meaning that also the global integration of the EU economy has not slowed down.[2]

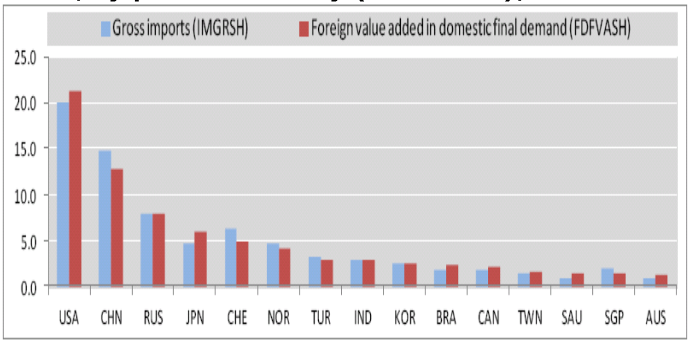
Among different indicators included in the TiVA data base, *domestic value added in foreign final demand* measures 'value added exports' of a country while *foreign value added in domestic final demand* is a proxy for imports in value-added terms. Graphs 1 and 2 compare EU-27 exports and imports in VA (as defined above) to traditionally measured gross exports and imports. Interestingly, the **US is the largest partner in both gross and VA terms**, but the share in VA for EU exports and imports from the US are higher in VA than in gross terms. For exports, this could indicate a relatively high proportion of VA created in Europe in total goods and services that end up on the US domestic market. For EU imports, a higher share in VA than in gross terms implies higher VA created by the US in EU total imports originating from different countries. The opposite is true for China, being the second largest EU trade partner. China's share was lower in VA than in gross terms for both exports and imports. The difference points at the Chinese role as an 'assembly factory' in Asia and the high content of VA in its export of other countries, in particular Japan. Relatively lower EU imports from China in VA than in gross terms also reflect the VA created in Europe embodied in Chinese exports.

Graph 1: EU exports in gross and value-added terms, by partner country (% of total), 2009



Source: OECD

Graph 2: EU imports in gross and value-added terms, by partner country (% of total), 2009



Source: OECD

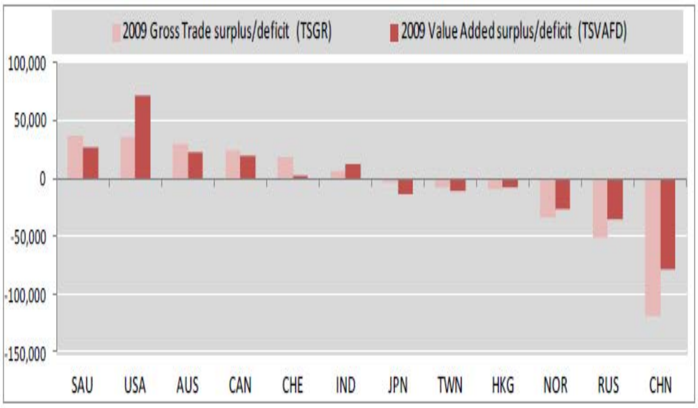
Consequently, bilateral trade balances in VA terms differ compared to gross bilateral trade balances, although the total trade balance of a country remains unaffected. Indeed, the **EU bilateral trade balances** presented

[1] See: ECFIN Economic Brief 2012: *Competing within global value chains*, Issue 17/ December 2012 point 2.2 for more information about measuring trade in intermediate goods.

[2] It should be noted that significant differences among Member States exist also in this field. However, the TiVA data base does not yet provide data for all the EU Member States.

from a VA perspective show quite remarkable differences as compared to gross values in some cases (graph 3). For instance, the EU surplus with the US is bigger in VA terms which mirrors value added created in Europe but exported to the US by other countries. The opposite is true for Japan (higher deficit in VA terms). EU trade deficits with China and Russia were smaller in VA terms in 2009 than in gross terms.

Graph 3: EU trade balances with trading partners in VA terms and gross 2009



Source: OECD

The new approach of measuring trade in VA reveals a **much greater share of services in international trade compared to gross measures.** While services comprise on average about two-thirds of GDP in most developed economies, they typically account for less than one-quarter of total trade when measured traditionally. Accounting for the value added produced by the services sector in the production of goods shows that the services content of total gross exports is over 50% in most OECD economies.[3]

The share of services in EU exports was 54% in 2009 (in VA terms) - almost twice as high as the share in gross terms. Between 1995 and 2009, the share has increased by some 10pp.

2. Current priorities in EU trade negotiations

In the long-lasting debate over the positive vs. negative relationship between multilateral and bilateral trade liberalisation which divided economists world-wide, a consensus exists that the emergence of global production networks strengthens the case of multilateralism. In this vein, preserving and reinforcing the centrality of the multilateral trading system remains the EU's long-term priority. However, given the relatively limited progress in multilateral trade negotiations, the most preferred and pragmatic policy option in the current environment remains a proactive approach toward regional trade liberalisation.

Ambitious and comprehensive trade negotiations launched in 2013 with the US and Japan which will potentially go far beyond tariff reduction have confirmed the EU strategic reorientation towards a new generation of free trade agreements. The revealed greater importance of bilateral trade in value-added terms with both the US and Japan confirms an intense participation of these economies in global production networks and it is rightly taken into account as the current priority of EU trade policy to simultaneously negotiate comprehensive FTAs with both partners. The scope and potential gains of the free trade agreements will be shortly discussed in the following section.

The US

The EU and the US account for almost half of the world GDP and one third of global trade flows. Although the US share in the EU market is falling gradually (as well as the EU's share in the US market), the US has remained the EU's major trading and investment partner, notwithstanding the rising role of China and other emerging markets. As shown in the previous section, nearly one quarter of all EU exports in value-added terms were destined for final consumers in the US in 2009, and over one-fifth of all EU imports in value added terms were sourced from the US.[4] The share of services in EU value-added exports to the US stood at some 60%.

Negotiations of the Transatlantic Trade and Investment Partnership (TTIP) between the EU and the US have been officially launched at the G8 summit in London on

[3] OECD (2013) *Interconnected Economies: Benefiting from Global Value Chains*

[4] OECD TiVA database

17 June 2013. The first round of negotiations took place in Washington in July where negotiating groups set out respective approaches and ambitions in some twenty areas covered by the TTIP. Overall, the goal is to conclude the negotiations by the end of 2014.

The TTIP will aim to go beyond the classic approach of removing tariffs and opening markets on investment, services and public procurement. In addition, it will focus on aligning rules and technical product standards which currently form the most important barrier to transatlantic trade. The goals of the TTIP can be summarized as follows:

1) Market access – the goal is a full removal of tariffs. It should be noted that although tariff protection is relatively low in transatlantic trade (WTO estimates are: 5.2% for the UE and 3.5% for the US on average), still high tariff peaks exist in certain sectors (food is a good example). Trade in services should be liberalized to the extent foreseen in the other FTAs recently signed; the same applies to liberalization in investment. New areas (like transport services) are part of the negotiation agenda, as well as liberalization of public procurement.
2) Regulatory issues/ non-tariff barriers (NTB) – the aim is to align as far as possible or mutually accept standards and procedures, by negotiating an ambitious agreement on sanitary and phyto-sanitary (health and hygiene standards, for example for food products) as well as technical barriers to trade. In addition, regulatory compatibility in specific sectors (such as chemical, automotive, pharmaceutical, and other health sectors such as medical appliances) remains the crucial part of the negotiations.
3) Common rules: on issues of mutual interest incl. i.e. trade facilitation, IPR, competition policy, environmental issues and other policy areas.

The economic impact of the TTIP on both economies is not negligible. According to a CEPR study, a comprehensive free trade agreement aiming at full tariff abolition and a reduction associated with NTB of 25% for goods and services and 50% in case of public procurement is estimated to add a permanent increase of around 0.5% of the EU GDP. The crucial part of the gains is associated with the reduction on non-tariff barriers (NTB). According to the study, some 80% of the total potential gains would come from cutting costs imposed by duplicative bureaucracy and regulations, as well as from liberalising trade in services and public procurement.

Japan

Over the last decades Japan has enjoyed a strong trade surplus vis-à-vis the EU. Even if bilateral trade between the EU and Japan has become less imbalanced recently, in value added terms, the EU deficit with Japan was larger than in gross terms in 2009. Japan was the EU 4th largest trading partner in VA terms in 2009 with some 5% and 6% shares in exports and imports respectively.

In November 2012 the Council of the EU gave the Commission a green light to start trade negotiations with Japan. The negotiations started in May 2013 and were preceded by an intense preparatory period when negotiating agenda and specific roadmaps for the removal of barriers and market opening were established. Similarly to the TTIP, an EU-Japan FTA will aim at a number of market access issues, including tariffs, non-tariff measures affecting trade in goods (including technical barriers to trade and sanitary and phyto-sanitary issues) and trade in services, further market access for services, investment and public procurement as well as specific chapters on investment protection, competition and intellectual property rights. Two rounds of negotiations have been concluded so far (mid October 2013) which were mainly focused on the negotiated text of the agreement in 14 areas.

The estimated impact of the FTA with Japan, when fully implemented, is expected to benefit the EU economy by some 0.3-0.8% of GDP (conservative and ambitious asymmetric scenarios). The assumptions on trade liberalisation are different in the case of Japan and the US agreements but in both cases the results achieved during negotiations with Korea form the benchmark. The asymmetric scenarios are designed to approach more closely the actual negotiating priorities of both sides, where EU priorities, notably the reduction in the negative trade effects of Japan's NTBs, will be negotiated against Japanese priorities, notably EU tariffs.

3. Conclusions and policy implications

Free trade agreements between the largest developed economies like the EU, the US and Japan, if implemented according to the plan would remain with no precedence in changing the global framework for international trade. If the parties involved agree i.e. on ambitious schedules for opening in goods and services sectors, public procurement and approximation of market regulations, limiting the scope of carve-out areas for which progress in multilateral context remains limited, the FTAs could change the way further multilateral negotiations under the WTO function. If the FTAs between major developed economies remain open for new members, bilateral solution and commitments in areas which have been blocked so far within the Doha round could potentially become multilateral and their geographical coverage could potentially become global.

FTAs with the US and Japan bode well for the future integration of the economies and even stronger competition between European, American and Japanese companies within global value chains. An increased level of economic activity and productivity gains created by the agreements should also benefit labour markets and consumers. For the TTIP, the CEPR study reveals an increase in wages for both skilled and less skilled workers by some 0.5%, while labour displacement between sectors will take place but should be lower than natural labour market movements within an economy. Additionally, positive spillover effects to the world economy should be expected due to potential acceleration of economic growth within the integrated area. Lower trade burdens and approximation of rules within the markets should also reduce costs for businesses from third countries.

Finally, it should be noted that even if the attention is currently concentrated on the above discussed FTAs with the US and Japan, the EU continues trade negotiations in many regions. Even if the discussion goes beyond the scope of this analysis, the ASEAN region is with no doubt an important subject for further research from the perspective of dense regional and global value chains, high trade dynamics with the EU and the ongoing FTA negotiations between the EU and some of the ASEAN countries.

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