Introduction

Free Trade and Prosperity

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Ladies and Gentlemen, Excellencies,

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

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

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

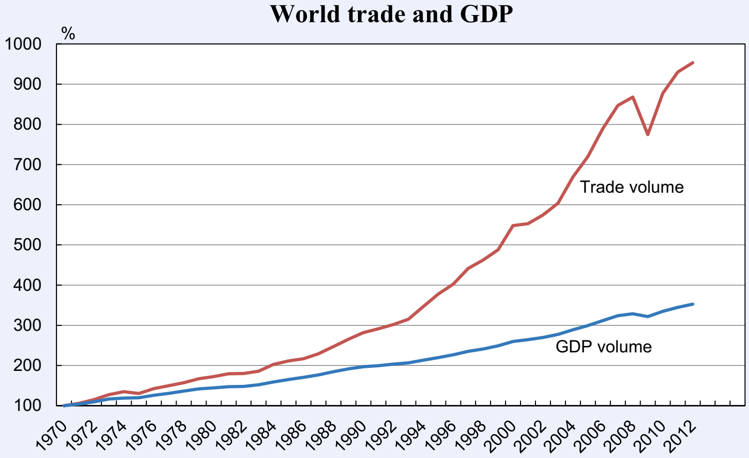
Figure 1

Global trade in 2012

Source: WTO.

Figure 2

World trade and GDP



Source: World Bank.

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

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

World trade agreements and significance of transatlantic trade

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

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

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

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

Box 1
General trade agreements

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

Box 2
Regional trade agreements

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

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

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

Figure 3

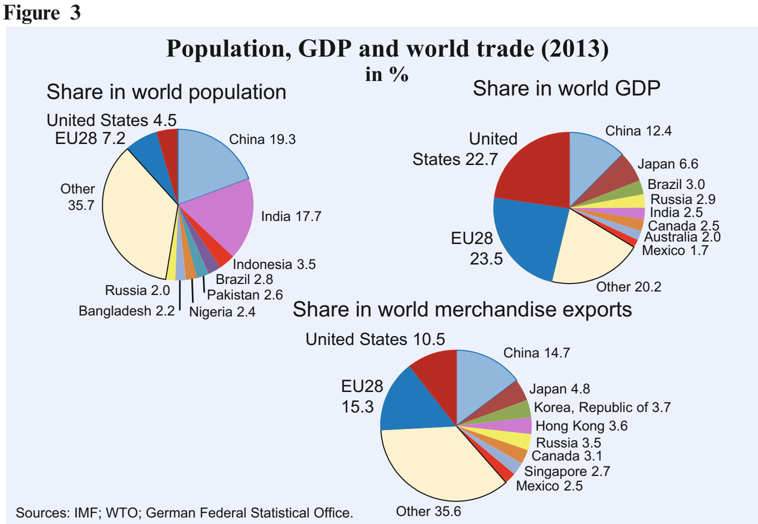
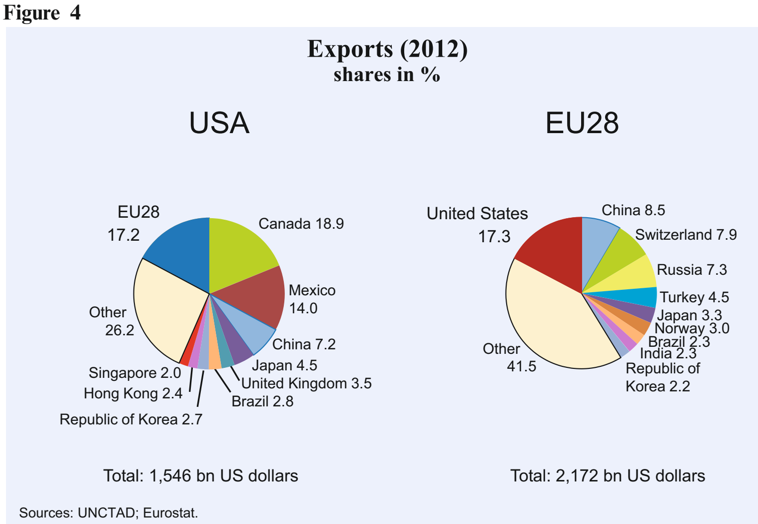


Figure 4



Transatlantic Trade and Investment Partnership (TTIP)

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

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

Figure 5

Source: German Federal Statistical Office.

Figure 6

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

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

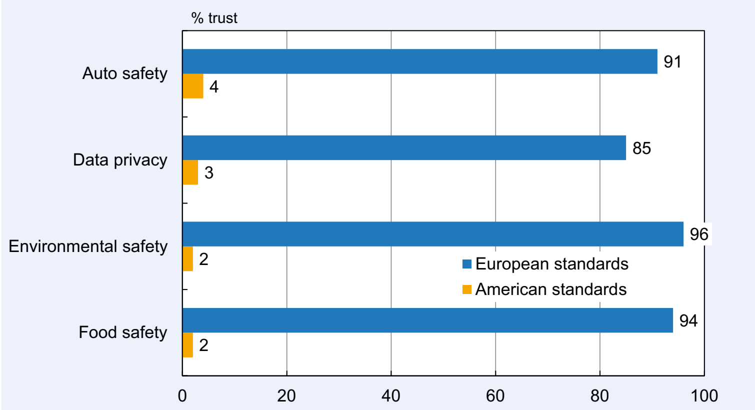
rently tend to favour domestic companies, so if US companies show up in Europe they have a hard time and *vice-versa,* creating a situation that needs to be overcome. Non-tariff trade barriers also need to be dismantled *via* mutual recognition of safety standards and technological norms. This is very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

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

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

Figure 7

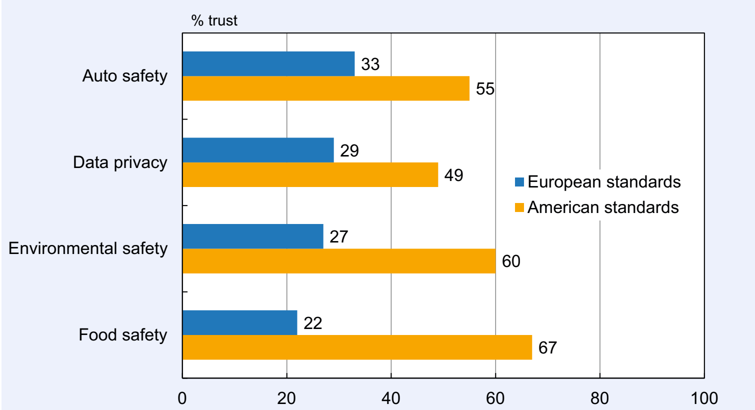
Which standards do Germans trust?



Source: Handelsblatt.com

Figure 8

Which standards do Americans trust?



Source: Handelsblatt.com

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

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

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

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

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

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

Trade diversion

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

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

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

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

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

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