Confluence Investment Management

Weekly Geopolitical Report

By Bill O'Grady

January 27, 2014

The TTIP and the TPP

The Transatlantic Trade and Investment Partnership (TTIP) is a trade and investment treaty being negotiated between the European Union (EU) and the U.S. The Trans-Pacific Partnership (TPP) is a similar pact being negotiated between the U.S. and various Pacific Rim nations in both the eastern and western hemisphere. If enacted, both these trade agreements will have significant geopolitical consequences.

In this report, we will begin by discussing the nations involved. We will examine overall details of the proposals, focusing on how they are different from traditional trade agreements. From there, an analysis of the controversy surrounding these proposals will be presented. A look at the geopolitical aims of each agreement will follow and the likelihood that these treaties will be enacted. As always, we will conclude with potential market ramifications.

The TTIP and the TPP

The TTIP will include the U.S. and all the nations of the EU.[1] The TPP is actually an evolving treaty. Originally, it was four nations, Brunei, Chile, New Zealand and Singapore, who created the free trade area in 2005. In 2008, the U.S., Australia, Peru and Vietnam expressed interest in joining the original group. Malaysia entered negotiations to join in 2010, Mexico and Canada in 2012, and Japan in 2013. Taiwan also expressed interest in the agreement last year but it is unclear if the group will risk the ire of China by allowing Taiwan to join as a sovereign nation (China views Taiwan as a province). South Korea has also decided to hold talks about joining the group. Thus far, China is not in the group; the absence of the world's second largest economy from the TPP will be discussed at length below.

How are the Trade Pacts Unique?

The TTIP is potentially historic—the combination of the EU and the U.S. is an economic behemoth. The nations in total represent 32% of global GDP.[2] It would represent the largest regional free trade pact in history. At the same time, by including the U.S., the TPP is also huge, with the combined nations representing 27% of global GDP.[3]

There are two important ways that these proposals differ from earlier trade agreements. First, the proposals, though economically significant, are regional in nature. For most of the post-war period, the U.S. focused on multinational agreements that affected global trade infrastructure, like the General Agreement on Tariffs and Trade (GATT) or the World Trade Organization (WTO).

[1] Austria, Belgium, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the U.K.

[2] Purchasing power parity basis, international dollars; IMF

[3] ibid

During the Cold War, GATT, the predecessor of the WTO, was not involved in the regulation of the Communist Bloc's trade, but the geopolitical goal of the U.S. during the Cold War was to create a trading framework that would strengthen the free world. This isn't to say that the U.S. hasn't engaged in bilateral or regional trade agreements—the North American Free Trade Area (NAFTA) was a major treaty. But, these new proposed agreements are more significant because they will shape global trade. If both are approved, it will force non-members to adjust, at least to some extent, to the rules of the regional trade pacts.

The second major difference in these proposals is that they are less about tariffs and quotas (the traditional concerns of trade agreements), and more about harmonization of regulation. Over the years, tariffs have declined across the developed world; currently, U.S. and EU tariffs average about 3%. However, as tariffs and quotas have fallen into disfavor (mostly because of their visibility), non-tariff barriers have increased. For example, nations will use health and safety regulations to bar certain imports; U.S. genetically-modified crops are generally banned in Europe even though U.S. regulators have established the crops are safe. From a U.S. perspective, the EU is using this regulation to protect its agribusiness from legitimate competition; of course, the EU sees this issue differently.

Essentially, the proposed changes in both treaties are more about harmonizing regulations. Although tariffs will be eliminated, the most important part of these agreements are the creation of rules that will allow regulators in all the participating nations to work together on a common set of rules. Another key area is the harmonization of intellectual property regulations. The U.S. has relatively strict rules compared to Europe or Asia. Thus, American companies have the most to gain from the extension of U.S. intellectual property rules. Also, state subsidies would be reduced under these pacts. Finally, arbitration panels will be established which will adjudicate disputes. For example, if a company believes a country is using regulations to interfere with trade, the panel will decide if a violation has occurred and the country could be fined or forced to allow the good or service to be imported.

These are remarkable proposals. If enacted, it would not only create a free trade area, it would essentially create a unified common market for most goods and services. Because the changes are so significant, there is stiff opposition to both agreements. At the same time, research suggests significant efficiency gains. The OECD estimates the TTIP alone would create $1.1 trillion in gains for the U.S. and Europe. Corporations would be able to deal with a unified set of regulations that would make trade easier and expand markets.

The Controversy

Given the broad scope of these proposals, there is growing opposition to both treaties. The fact that both are being negotiated in relative secrecy isn't offering opponents much comfort and is probably increasing hostility toward the proposals. The major concerns are as follows.

Loss of sovereignty: The use of arbitration panels and the harmonization of regulations undermine the ability of nations in the pacts to establish their own regulatory environments. A nation in the treaty area that wanted to ignore a drug patent to provide cheaper medicines to its people may be unable to do so. The arbitration panel would make local court systems irrelevant on trade matters. Although the panel would, in theory, only act if the local regulation was thought to be a restraint of trade, in reality, the intent of the regulation probably wouldn't matter.

Uncertainty over regulatory regimes: Interestingly enough, this is a major concern on both the left and right wings of the political spectrum. The left worries that there will be a "race to the bottom" in terms of regulation, with the least protective regulations becoming the norm for all members of the trading bloc. In fact, those on the left are convinced these two trade proposals are being designed by corporations for their benefit. On the right, the concern is that the most onerous regulations will be adopted. For example, the left fears that the lax environmental regulations in the emerging Pacific Rim would become U.S. law. The right is concerned that European labor laws will trump U.S. labor laws.

In reality, it is conceivable we could see a combination of both "nightmares." Although corporations are often portrayed as wanting the least amount of regulation, there are good reasons for such entities to opt for strict and intrusive rules in the right circumstances. There are two reasons for this potential stance. First, corporations can more easily achieve economies of scale with unified regulations. In the case of the U.S., for example, California has often enacted stricter air quality measures for automobiles than the Federal standards. Some carmakers will simply opt to install the California level of regulation across the country rather than build specific autos for just that state and something different for the rest of the nation. In this example, the gains from scale offset the higher regulatory costs. Second, regulations, in general, raise costs which become barriers to entry. Onerous regulations tend to cause industry concentration as firms consolidate to better spread out the regulatory costs. Such concentration can create oligopolistic profits that are generally protected from new firms entering the market. In addition, fewer firms in an industry increase the likelihood of regulatory capture which means these few firms will be able to create a favorable regulatory environment.

At the same time, it is possible that, in some areas, lax regulation may dominate. This may occur when a controversial strict regulation exists in a small nation in the bloc that is opposed by this country's corporate leaders. It would not be a surprise to see these corporations pressing for the easier regulations that exist in the wider trading bloc.

The lack of any currency rules: The draft regulations for both proposals make no mention of currency manipulation. This omission has caught the eye of some leading trade and currency economists, especially C. Fred Bergsten, who argues that not restricting currency manipulation is a major problem for these treaties.

The reserve currency system creates an incentive for nations to run mercantilist trade policies to use export promotion as a development model. Of course, for that to work, the nation supplying the reserve currency must act as importer of last resort and buy all the exports these mercantilist nations want to sell. This leads to job losses in the reserve currency country and distorts the export-promoting nation's economy as well.

Mercantilist policies suppress domestic consumption through financial repression and trade barriers. Thus, the household sector has its assets essentially confiscated to build productive capacity. Interest rates on deposits are usually kept below the rate of inflation, while corporate borrowing costs are kept low and import costs are elevated by tariffs and a weak currency to restrict consumption as well. However, the only way mercantilism works in a free-trade zone is if the currency is manipulated; this is because trade barriers are eliminated in the zone. If the currency floats, the act of accumulating reserves will appreciate the exchange rate, eventually making that nation's exports less competitive.

Bergsten and others argue that there must be punitive measures against currency manipulation applied to the zones or the U.S. will surely see job losses. His criticism is likely correct.

The Geopolitics

Although the above criticisms of the two proposals have merit, the geopolitics may trump these concerns. Each pact has one overarching goal—to create *de facto* global trading rules dictated by the U.S. and its developed world allies. However, each pact achieves this goal in a somewhat different manner.

The TTIP is all about keeping Europe relevant. European leaders are becoming increasingly concerned that as their share of global GDP declines the EU's influence is shrinking as well. A broad trade pact with the U.S., sort of an EU/U.S. NAFTA+, would increase Europe's economic relevance. Given the trade zone's large share of global GDP, other nations would be forced to adopt the standards set by this trade body and would encourage rising emerging economy companies to comply with the trade pact's regulations. The cost of this deal for the EU is that it will likely be forced to adopt U.S. regulations. After all, irrelevance isn't an issue for the U.S.

The TTP is all about forcing China to adopt a U.S.-led trade regime. China is not a party to this agreement by design. The Obama administration does expect China to eventually join, but by that time the rules will already be established. For the nations in the trading zone in the Pacific Rim, the trading pact ties them closer to the U.S. and offers them additional protection from China's growing power.

The Obama administration has decided that the most effective way to establish the "rules of the road" for the global economy is not through the WTO, which has become essentially unworkable. Instead, it is opting to create large trading zones of likeminded nations that will be big enough to dictate terms to the rest of the world.

Will the Treaties Be Approved?

Although the political media continues to focus on the Affordable Care Act, whether Hillary Clinton will run for president and the midterm elections, these two trade treaties may represent the most important policy actions, foreign or domestic, by this president. It is clear that Obama has given up on the effectiveness of military action. His decision to ignore his own "red lines" in Syria along with his decision to allow France to "go it alone" in central Africa clearly show he has concluded that military action doesn't work. Instead, it appears he has decided that he wants to shape the global economy instead.

There is stiff opposition to these deals. Currently, the president lacks "fast track" authority for trade authorizations. He is asking for this authority to be restored, which limits the ability of lawmakers to add amendments to trade treaties and forces an "up or down" vote on these matters, limiting debate. Without fast track authority, there is little hope these treaties will pass Congress.

Currently, 151 House Democrats have signed a letter opposing fast track authority; they have been joined by 20 Republicans. Although there are still enough representatives to pass this measure, to do so, the president will need to rely on the GOP members for success; only 49 House Democrats have not formally opposed fast track. Given the president's difficult relations with the GOP leadership, getting such support will be very difficult. To achieve fast track, the president will be forced to use a significant amount of political capital which he simply may not possess. Thus, at this point, the odds of passage are not favorable. However, if our analysis is correct and the president has decided these trade treaties are his foreign policy legacy, expect a "full court press" with the mustering of corporate allies to push this through. In fact, the deal he may cut with the GOP is fast track for the XL pipeline.

Ramifications

Despite the lack of media coverage, these trade proposals are very important. The fact that the proposals appear to be "below the radar screen" may be a political tactic. The president may be trying to get the deals done before significant opposition can develop.

If passed, they would likely create the trading rules for the world. China will see the obvious design of encirclement but it simply may not have much choice in opposing it. Although we have serious doubts that it will lead to as much economic activity as the OECD estimates, it would likely boost growth and improve productivity.

Given the geopolitical aims, we doubt the controversies will be addressed. The goal of the treaties isn't to create U.S. jobs (although it will be sold as such), it is to solidify America's position in the world. America will only give up sovereignty where it decides to…the U.S. is the lynchpin in both agreements and can shape it as it sees fit. And, the reserve currency role will be solidified as well.

If President Obama fails to get these deals approved, one can likely assume he has achieved full "lame duck" status. That fact would raise concerns about America's ability to affect global events. On the other hand, if he can manage to attain fast track authority and gain Congressional approval, it will seal America's foreign policy situation, for good or ill, for the next generation…and may represent the most important policy legacy of this president.

Bill O'Grady
January 27, 2014