Confluence INVESTMENT MANAGEMENT

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The TTIP and the TPP: An Update

In January 2014, we first discussed the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP).[1] Both pacts have moved from obscure trade proposals to highly controversial political issues. 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, we will present an analysis of the controversy surrounding these proposals. A look at the geopolitical aims of the agreements 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.[2] The TPP, which initially started with four nations, Brunei, Chile, New Zealand and Singapore, has expanded to 12 nations.[3] Taiwan expressed interest in the TPP last year, but it is unclear whether the current configuration is comfortable with engaging in the age-old dispute over Chinese sovereignty. South Korea has also decided to hold talks about joining the TPP group. Conspicuous in its absence is China.

How are the Trade Pacts Unique?

The TTIP would be a monumental event, representing the largest regional free trade pact in history. The combination of the EU and the U.S. would create an economic behemoth. The nations in total represent 32% of global GDP.[4] At the same time, by including the U.S., the TPP is also huge, with the combined nations representing 27% of global GDP.[5]

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 postwar period, the U.S. focused on multinational agreements that affected global trade infrastructure, like the General Agreement on Tariffs and Trade (GATT) and the World Trade Organization (WTO).

During the Cold War, GATT, the predecessor of the WTO, was not involved in the regulation of the Communist bloc's trade. However, it facilitated one of the geopolitical goals of the U.S. during the Cold War by creating 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) is a good example of a major regional trade agreement. But, these new proposed agreements are more significant because

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[1] See WGR, The TTIP and the TPP, 1/27/2014.

[2] 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.

[3] Australia, Canada, Japan, Malaysia, Mexico, Peru, U.S., Vietnam, Chile, Brunei, Singapore and New Zealand.

[4] Purchasing power parity basis, international dollars; IMF.

[5] Ibid.

they would effectively dictate global trade. If both are approved, it will force non-members to adjust, at least to some extent, to the rules of these regional trade pacts.

The second major difference of these proposals is that they are less about tariffs and quotas (the traditional concerns of trade agreements), and more about the harmonization of national and regional regulations. 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.

Although tariffs would be eliminated, by far the most important part of these agreements is the regulatory structure they would create which would allow regulators in all the participating nations to work together under a common set of rules. Another key area is the harmonization of intellectual property regulations. The U.S. has relatively strict IP 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, but 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 efficiency gains for the U.S. and Europe. Corporations would be able to work 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 have been negotiated in relative secrecy isn't offering opponents much comfort and is probably increasing hostility toward the proposals. The major concerns are as follow.

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. Across Europe and the U.S., populism has become an increasingly potent political force. Both varieties of populism tend to be nationalistic. Right-wing populists have been traditionally anti-immigration but have joined the left-wing populists in opposing free trade.

Uncertainty over regulatory regimes: Interestingly enough, this is a major concern for populists on both the left and right. 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 that 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 under certain conditions. There are three reasons for this potential stance. First, corporations can more easily achieve economies of scale with unified regulations. In 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. Third, it can create a form of regulatory arbitrage, where a nation or a set of firms use the TTIP and TPP frameworks to favor their situation, giving them an advantage over competitors. Essentially, lobbying could become even more important because the scale would be broader.

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. In effect, the reserve currency nation becomes a willing participant in unfair trade practices. 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. At the same time, we doubt his concerns will be adequately addressed.

The Geopolitics

Although the economics of the two trade proposals are compelling, the most important reason for the two deals is geopolitical. If enacted, they will create a global trading system where the U.S. becomes the lynchpin between two major regions, able to influence trade rules across much of the world. So, why would Europe and Asia want to adopt a system that seems to enhance U.S. geopolitical dominance?

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 TPP 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 not until after the rules are 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?

It is unlikely either will be approved, although the odds favor TPP over TTIP. The rise of populist parties in Europe has undermined support for the TTIP. In fact, German Vice Chancellor Sigmar Gabriel declared that the trade pact was "dead."[6] Populists in Europe are already furious with the EU and its rules. This is part of what led to the Brexit decision. Allowing the U.S. to influence European rules or national regulations is a "dead letter."

The U.S. Congress did give President Obama fast track authority on TPP but has not held a vote on it. Senate leaders have indicated that it will not be voted on before the November elections, a reflection of how

[6] http://www.independent.co.uk/news/world/europe/ttip-trade-deal-agreement-failed-brexit-latest-news-eu-us-germany-vice-chancellor-a7213876.html

unpopular the agreement is in the U.S. Both presidential candidates have voiced their opposition to TPP, even though Hillary Clinton declared the trade agreement as the "gold standard" of trade pacts while Secretary of State. Donald Trump found strong support for his anti-trade position among right-wing populists who are mostly affiliated with the Republican Party even though free trade has been a standard position of the GOP for years. Trump's rise has forced the Republicans into opposing free trade. Sen. Sanders's (who opposed TPP and TTIP) strong showing in the Democratic Party primaries pushed Clinton into her opposition to the two free trade pacts.

It is possible that TPP could be passed in the "lame duck" session between the election and the inauguration. Senate leaders have suggested they won't use this tactic but after the election it may be the last chance the political establishment has to get the bill through. If Sen. Clinton wins, President Obama could spare her the loss of political capital by passing it before she takes office. If Mr. Trump wins, Obama will likely redouble his efforts to get the Senate to approve the treaty but it is unlikely a GOP Senate would sign off on a policy their candidate opposed.

Ramifications

These trade proposals are very important and their failure may mark a critical retreat from U.S. hegemony. In reality, TPP and TTIP are less about trade and more about creating a trade bloc dominated by the United States. Assuming the two fail, U.S. influence will be reduced to bilateral trade arrangements and a moribund WTO.

China is prepared to replace the TPP with a trade grouping of its own, called the Regional Comprehensive Economic Partnership.[7] China, as the largest economy in this group, will be able to write the rules of Asian trade. At some point, the U.S. will have to decide if it wants to join this group under Chinese rules.

My suspicion is that if the TPP and TTIP fail to pass, then 50 years from now historians will mark the collapse of these two trade agreements as the beginning of the end of U.S. and Western hegemony. This failure is due to the inability of the political class in the West to respond to the needs of its citizens who have been adversely affected by trade.

As we have noted on numerous occasions, the costs of hegemony are high. It requires a large military and participation in conflicts that are usually not a direct threat to the superpower's sovereignty. It also requires providing the reserve currency, which distorts the superpower's economy, making it overly dependent on consumption and forcing its industries to face stiff foreign competition that, by design, is constructed to unfairly take advantage of the hegemon's openness to trade. However, the alternative to these costs is either a world without a superpower or living under the control of an emerging superpower. Sadly, the costs of hegemony are obvious; the costs of abandoning the superpower role are not as observable but are steep as well. After all, America's acceptance of the superpower role in 1945 likely prevented WWIII. It is possible that the costs of a world without a superpower will become increasingly evident in the coming years.

So, what does an investor do? In the short run, the U.S. remains the global superpower

[7] Nations currently negotiating this pact are Brunei, Myanmar, Cambodia, Indonesia, Laos, Malaysia, the Philippines, Singapore, Thailand, Vietnam, Australia, China, India, Japan, South Korea and New Zealand.

and is still providing the aforementioned global public goods. Thus, no changes are necessary in the immediate term. However, in the long run, we expect two major themes to emerge. First, hard assets will perform strongly as households, firms and nations begin to hoard commodities due to supply insecurity. Without a clear global hegemon, global insecurity will increase, raising demand for precautionary inventories. Second, these same insecurities will raise the risk of foreign investing for U.S. investors. Everything we know about the behavior of foreign markets since WWII has occurred in an environment where the U.S. provided global public goods, which are mostly of two types, international security and the reserve currency. If those public goods are no longer available, the behavior of foreign markets will likely change in ways difficult to discern at present.

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