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Kiel Working Paper No. 1240

TAFTA – A Dead Horse or an Attractive Open Club?

by

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March 2005

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Abstract:
A Transatlantic Free Trade Area (TAFTA) has been proposed in the mid-1990s to revitalize the economic and political ties between the United States and the European Union. This paper discusses the expected economic gains from such a free trade area for its members with respect to trade in goods and services and investment flows. It then looks at potential effects for third countries, and discusses how TAFTA fits into the WTO institutional rule system for the world economy and how a TAFTA for investment flows is to be evaluated. The paper argues to include a transatlantic effort for deeper integration into the WTO framework.

Keywords: Trade, Foreign Direct Investment, Regional Integration, Multilateral Order, WTO, Discrimination.

JEL classification: F1, F2, F13, K

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* I have benefited from a discussion with Gary Hufbauer.

It has been rather silent about TAFTA, the proposal of a Transatlantic Free Trade Area between the United States and the European Union, for some time now, after the German minister of Foreign Affairs Klaus Kinkel had suggested the idea shortly before the US-EU 1995 summit and after the UK and EU trade commissioner Sir Leon Brittan had pursued the concept in 1998 without finding sufficient support in the EU-Commission. The political motivation for TAFTA was illustrated on the cover of "The Economist" in its issue of May 27 1995, showing a map of the Atlantic being zipped up by a zipper. TAFTA was seen as a driving force for a revitalized political transatlantic relationship after the fall of the iron curtain. The economic idea behind TAFTA is to allow a more intense form of integration between these two economic regions on both sides of the Atlantic than is provided by the multilateral integration of the WTO-framework. More specifically, a transatlantic free trade area would be characterized by not only dismantling tariffs and other border-related trade-impediments between its members, but also by reducing domestic barriers that hinder market access for foreigners from the other side of the Atlantic (Baldwin and Francois 1999; Donges, Freytag and Zimmermann 1997; Piazolo, Langhammer and Siebert 2002; Siebert, Langhammer and Piazolo 1996; Schott 1995). Creating a common institutional arrangement in a set of areas would be similar to a mini-single market project between North America and Europe, intensifying competition, enhancing efficiency and increasing welfare. Such an idea becomes attractive to those interested in closer transatlantic ties as a vehicle to channel the political tensions that have arisen between the United States and Europe in recent years.

In order to evaluate whether a comprehensive transatlantic trade agreement would make sense, I will look at the gains for the potential TAFTA members and potential disadvantages for non-members. I will also discuss how TAFTA would fit into the WTO set-up for the world economy.

Gains for the TAFTA Members

An important condition for a free trade area is that its members enjoy benefits that go beyond the gains made possible by the multilateral WTO arrangement. Such expected gains from integration give political momentum to negotiate a free trade arrangement.
Looking at trade in goods and services as a traditional area for integration gains for TAFTA members, both regions on both sides of the Atlantic are intensively interlinked. The US and the EU are each other's single largest trading partners in goods and services. They each account for around 21 per cent of each others trade in goods (excluding intra-EU trade), and an even larger part of each other's cross border trade in services with 35 per cent of the US total and 39 per cent of the EU's total (European Union Factsheet 2003). Both regions together make up 37 percent of world merchandise trade and 45 per cent of world trade in services (2002). Two-way cross border trade in goods and services (exports and imports) amounted to 650 bill euro in 2002 (€ 412 bill in goods and 258 bill in services).

An intensive interaction via trade is, however, only one of the conditions for a successful regional integration. The scope of benefits also depends on the level of tariffs. In merchandise trade, tariffs of the United States and the European Union are already low with average applied tariff rates in the most favored nation category slightly above and slightly below four per cent, for the European Union and the United States respectively (WTO 2004e: Chart IB1.2). Thus, zero bilateral tariffs inside TAFTA imply only small preference margins compared to MFN treatment. This means that there is really not a large potential for additional trade and additional gains from trade.

Whereas the average tariff rates are already low, there are still some sensitive sectors with high levels of protection. This includes prominently agriculture, where the average tariff rates for all agricultural products are above 5 per cent for the United States and for the EU.[1] Average tariff rates for agricultural products in the MFN category peak at 20 per cent for the EU and 30 per cent for the US, if one looks at all tariffs above 15 per cent (WTO 2004e: Chart IB1.4). In addition, there are other sensitive sectors, protected for instance by anti-dumping measures and quantitative constraints, such as steel imports, with high average tariff rates of around 20 per cent for both regions, again looking at all tariffs above 15 per cent. Furthermore, subsidies distort trade. However, while there would be noticeable potential trade gains in these sectors, it would be extremely difficult to reach an agreement between both sides of the Atlantic because vested interests are too strong.

In addition, there will be dynamic gains from trade in goods and services, and one can expect that intra-firm and intra-industry trade would benefit from a further reduction of tariffs and other border obstacles. According to general equilibrium model estimates of Brown, Deardorff and Stern (2001) including dynamic effects, US exports would increase at 18.9 per cent if world trade is fully liberalized. Assuming the US shared *pro rata* in this expansion, US exports to the European Union and EFTA would increase

[1] Final bound agricultural products, US: 6.9, EU: 5.8 (WTO Trade Statistics Database 2004).

with 19 per cent by 48 bill annually (Hufbauer and Neumann 2002); this would be 0.5 per cent of the US GDP. EU exports to the US would increase by 14 per cent, again reaching 0.5 percent of GDP. These expansions of exports and imports are not negligible. However, the figure for the increase in exports in the magnitude of 0.5 per cent of GDP should not be mistaken for the expansion of GDP itself since imports increase as well. Whereas the welfare effects of global free trade are estimated to be 5.48 per cent for the United States and 6.27 per cent for the EU and EFTA (Brown, Deardorff and Stern 2002), the positive effects of TAFTA is likely to be small, most likely below 1 per cent. Multilateral liberalizations clearly are superior to regional integrations. Scollay and Hilbert (2001) come to similar estimates with respects to exports and imports in a comparative-static model, albeit with a larger stimulation for the US. US Exports to the EU are estimated to increase by 25 per cent and EU imports to the US by 10 per cent. Older estimates indicate that the total elimination of tariffs on bilateral trade would increase US exports to the EU by about 10.8 per cent and EU exports to the US by 6.3 per cent (Schott 1995: 6). This would be equivalent to an increase of total US trade of only 2.3 per cent (1993 figures) or 0.2 per cent of US GDP. For the EU, these comparative-static effects would be even lower (1.1 per cent and 0.1 per cent). Admittedly, the results of applied general equilibrium models very much depend on the calibration of economic interdependencies. Reliable empirical estimates are difficult to be obtained if the changes whose impact is to be analyzed are small.

Political momentum for liberalization in the already liberalized sectors is not very strong while at the same time political opposition against additional liberalization is weak and diffused. This may due to the already low tariff rates. Moreover, penetration rates in many sectors are similar in both regions. Last not least, a large part of trade is intra-sector trade, where liberalization leads to the expansion of both exports and imports in the same sector; consequently lay-offs of labor in individual industries due to imports can be avoided to a large extent. All this means that opposition to liberalization is low. In the sensitive sectors, however, political opposition is strong; at the same time, support for liberalization is weak and diffused. As a result of all this, political momentum for TAFTA is weak.

Trade disputes between the United States and the European Union can be viewed as an indicator of existing trade barriers. They signal that the exchange of commodities and services does not go smoothly and can be improved. These disputes relate to market access, industrial policy and value-ridden categories (Hufbauer and Neumann 2002, Tables 5-7). Most prominent cases in the three categories were the EU's Banana regime, US steel duties and the US Byrd Amendment of 2000 whereby proceeds from antidumping and countervailing duty case have to paid out to the US petitioner companies (market access), EU and US export subsidies for agriculture, export subsidies or procurement benefits in the aircraft industry and the US Foreign Sales Corporation (industrial policy) and the EU beef ban on hormone treated beef, the EU moratorium of products containing Genetically Modified Organisms and EU complains on US unilateralism, including Section 301 and Super 301 trade policy, cultural industries, and provisions requiring politically adequate behavior from European companies as in the Helms Burton Act (on Cuba), the Iran-.Libya Sanctions Act and the Iran Nonproliferation Act (value ridden category).

These cases indicate that there are obstacles to the exchange of goods and services. Surprisingly, in dollar terms the most relevant cases only amount to about 5 per cent of both partner's exports (Hufbauer and Neumann 2002, Table 3). Thus, they seem to be small, but then they may only be the tip of the iceberg. Disputes can be settled in the dispute settlement mechanism of the WTO, some regulatory disputes may be settled in or even prevented by mutual agreements outside WTO. A TAFTA dispute settlement mechanism besides the WTO mechanism might help, but does not seem indispensible. Reviewing the arguments presented so far, benefits in the area of trade in goods and services can be expected for the TAFTA members, but the arguments in favor of TAFTA are not really overwhelming.[2]

Besides reducing border barriers for trade, a second area where benefits from a Transatlantic Free Trade Area can arise is reducing obstacles to free access for goods and services, capital, firms, and people. These obstacles arise from domestic regulation defining market access. Equal treatment of foreigners and foreign firms, i.e. non-discrimination relative to residents and domestic firms, is instrumental in reducing these obstacles to the international division of labor, but it is far from sufficient. Many aspects representing hindrances are at stake, including standard setting, product licensing, building permits, zoning laws, environmental regulation, the acceptance of patents, copy rights and trade marks, the acknowledgment of university degrees, conditions of public procurement, and the right to do business in banking, communication, the media and the film industry.

A third area of mutual benefits, albeit strongly related to the issue of free access, is to dismantle still existing obstacles to foreign direct investment. US-EU economic relations are characterized by an extensive flow of

[2] For a slightly more positive evaluation see Hufbauer and Neumann (2992).

foreign direct investment and by considerable ownership interests in the other region's capital stock. US foreign direct investment in the EU-15 accounted for 61 per cent of US foreign investment in the period 1998-2001, likewise EU foreign direct investment in the US made up 52 per cent of total EU-15 investment in the same period (European Union Factsheet 2003). Both regions together account for 54 per cent of total world inflows and 67 per cent of total world outflows (2000). Similar relationships hold for FDI stocks. US FDI stock in the EU- 15 was 46 per cent of the total US FDI stock in 2001, and EU FDI stock in the US accounted for 50 per cent of the total EU stock in the same year. Cross investment amounted to 1,500 billion euro in 2001 (EU position in the US: €870 bill, US position in the EU: 628 bill).

The mutual interlinkage through FDI is indeed a more outstanding characteristic of the EU and US economic relations than trade. A full liberalization would exploit still untapped potential of mutual benefits. According to the applied general equilibrium model by Brown, Deardorff and Stern (2001), US FDI stock placed in the EU is estimated to expand by 19 percent (109 billion US$), EU stock is estimated to increase by 15 percent (118 billion US$). Similar results are reached by Scollay and Hilbert (2001) with a tilt in favor of the US, US FDI stocks in Europe expanding by 25 per cent and EU FDI stocks by 10 per cent.

To have benefits through the mutual flows of foreign direct investment and through free access requires a different type of free trade area than the traditional one that only dismantles border obstacles for trade. It means moving towards a mini-single market. Whereas this line of a free trade area entails promising gains, the political momentum for this approach has not been too strong. A reason is that a transatlantic free trade area would require to solve many regulatory details *ex ante,* which is extremely difficult with diverging concepts on the role of markets versus government intervention and with diverging regulatory philosophies. As an example, take environmental policy. Moreover, part of free access and related issues can be dealt with in a less conspicuous way by softer forms of cooperation, for instance by mutual recognition agreements.

As softer institutional forms for transatlantic cooperation, the "New Transatlantic Agenda" of 1995, a follow-up of the less ambitious 1990 Transatlantic Declaration, led to the New Transatlantic Marketplace and eventually to the Transatlantic Economic Partnership in 1998 and the Transatlantic Business Dialogue (Fogarty 2004:183, European Commission 2004). These institutional forms have provided a meeting place for CEO's and government officials and have been a key force in harmonizing regulations. Several mutual recognition agreements, permitted under the umbrella of the WTO's 1990's Agreement on Technical Barriers to Trade (TBT), were signed dealing with such issues as measurement, testing and approval procedures in telecommunication, medical equipment, electromagnetic compatibility, electrical safety, recreational craft and pharmaceutical manufacturing practices.

In an approach moving towards a single transatlantic market, a coordinated competition policy for the joint market is a necessary element; it has to control excessive market power and its abuse. Here a convergence between US and EU antitrust policy is taking place both with respect to the underlying philosophy and the micro-economic analytical tools (Monti 2004).

In spite of these areas of cooperation, locational competition between both sides of the Atlantic should remain an important concept of economic policy, with both regions competing for the mobile factors of production through their institutional set-up, their infrastructure and their taxation system (Siebert 2002). A TAFTA should not do away with locational competition by ironing out all differences in factor endowment, skills, technologies, preferences and the institutional set-up reflecting the variety in these basic factors; competition between governments has to be used as a discovery devise.

There are other areas of a common interest, including the fight against terrorism. But this type of cooperation has to be done outside a free trade area. This also holds for environmental issues that require global solutions. It would also make no sense to overload a free trade area with the task of macro-steering of the economy - a questionable concept anyhow, or with attempting to establish target zones for exchange rates, also a dubious endeavor.

An interim conclusion then is that TAFTA would generate economic gains for its members, but they are far from being strategic. Also, they would be difficult to be obtained due to diverging regulatory approaches. The economic rationale for TAFTA does not seem to be very strong.

The Disadvantages of TAFTA for Non-Members

The benefits accruing to its members is one criterion in evaluating a Transatlantic Free Trade Area, the other criterion is how third countries are affected and how TAFTA fits into the WTO institutional arrangement for the world economy. Two interrelated questions have to be answered: Does TAFTA shift economic benefits away from the non-members to the TAFTA members? And is TAFTA instrumental in eventually moving the world to a better multilateral order?

As a regional integration, TAFTA deviates from the GATT principle of non-discrimination because of different rules being in force with regard to non-members. However, the WTO rule of non-discrimination has a waiver for regional integrations, GATT article XXIV, which departs from the most-favored-nation principle by explicitly allowing free-trade areas and customs unions under a number of conditions, one being that "the duties and other regulations of commerce …. shall not be higher or more restrictive" than prior to the formation of the free trade area (Article XXIV, sec 5b). If they are higher, compensation is required.

With respect to trade, the usual criterion of trade creation outweighing trade diversion is likely to be satisfied because the TAFTA members are intensively interlinked in trade, including intra-sector trade. However, the dismantling of tariffs in bilateral trade between members implies only small preference margins for the members compared to MFN treatment, except for the sensitive sectors. This also would mean that the trade diverting effects for third countries, which often enjoy a Generalized System of Preferences as developing countries with lower than the MFN tariff rates, would be small. Moreover, additional growth of the TAFTA region would benefit third country's exports.

This evaluation, however, is different with respect to the sensitive sectors including agriculture. Here, trade diversion is likely to outweigh trade creation, depending on the specific details of the dismantling of border barriers. Unfortunately, GATT Article XXIV is ambiguous in defining a free trade area as a group in which duties and regulations "…are eliminated on substantially all the trade between the constituent territories …" (Article XXIV 8b). This ambiguity ("substantially all") led to a large number of free trade areas among GATT members that do not fulfill the basic requirement of the GATT philosophy, namely the 100 per cent liberalization in all sectors. Moreover, anti-dumping measures, though affecting the other side of the Atlantic as in the case of limits on steel imports by the US, are primarily intended to curtail imports from developing countries. Thus, we have as an important conclusion: To exempt agriculture and other sensitive sectors would make TAFTA less worth while, but at the same time to reduce the TAFTA-internal barriers would make it more likely that trade diversion becomes more important and TAFTA becomes less acceptable from a global perspective.

Except for the case of sensitive sectors, it is likely that the growth stimulus of TAFTA would prevent an absolute welfare decline of third countries. Nevertheless, their relative position can change in that the TAFTA region's gains are relatively higher. This relative change has so far not been an economic criterion to judge regional integrations. If, however, it would be strictly employed it would mean that growth potentials remain untapped if the regional integration grows more than the non-members. Pareto improvements then would be prohibited.

In order to empirically determine whether there would be a welfare loss for third countries and for the world by comparing trade diversion versus trade creation and to specify the relative growth impact, an applied general equilibrium model would have to be used. Since, except for the sensitive sectors, there are only small preference margins for the members compared to MFN treatment, applied general equilibrium models are difficult to be specified.

TAFTA's Integration into the WTO

It has been discussed heavily in the international economics literature (Bhagwati 1992) whether regional integrations, even if they do not reduce welfare in third countries in a comparative-static sense, represent a road to an improved multilateral order. It can be argued that a more intense form of integration between two important regions of the world, such as TAFTA, can be instrumental in pushing forward the multilateral WTO-framework. When two major players of the world economy gain experience in specific areas of integration, this can eventually be extended to the multilateral global framework. However, such an integration *a la carte* for specific regions of the world gives rise to the risk of destroying the multilateral order by the formation of regional trading blocks which then engage in strategic behavior, attempting to gain benefits from the international division of labor at the costs of the other regions. In such a scenario, regionalism can appear as the prolonged arm of unilateralism. In such a world with aggressive regional blocks, the multilateral rules would erode.

Some aggressiveness can be see in each transatlantic player already attempting to organize its own hub and spoke system, with each having circles of influence around it to take advantage of neighborhood effects and defend their sphere of influence. After the creation of NAFTA in 1994, the United States concluded a Free Trade Agreement with Chile taking effect in 2004. The US is pursuing the idea of a Free Trade Area of the Americas (FTAA), with negotiations to be concluded in 2005. The US is also is a member of APEC, the Asia- Pacific Economic Cooperation, and has a free trade agreement with Singapore since 2003. The European Union has constantly enlarged itself by including new members in four rounds (southern enlargement, northern enlargement, enlargement by the neutral states, eastern enlargement), now extending to 25 states. Moreover it has the European Economic Space around it and many agreements with neighborhood countries, for instance a free trade arrangement with Turkey, and association agreements with Israel and the Maghreb states. Eventually, some agreement will be reached with the Ukraine and Russia. The EU has reached a free trade agreement with Mexico and an association agreement with Chile, and also is actively searching for a free trade agreement with Mercosur, attempting a TAFTA-South, so to say being active in the United States' backyard (Schott and Oegg 2001). Moreover, it has granted duty-free or preferential access to its markets for most of the imports from developing countries and economies in transition under its General System of Preferences. The 49 poorest countries have duty free access to the EU market under a program launched in 2001. It has a free trade agreement with South Africa and is negotiating a free trade arrangement with members of the Gulf Cooperation Council. Finally, the EU has a new trade strategy with respect to 77 ACP countries (Africa, Caribbean, Pacific).

TAFTA would have to integrate these spokes, and, admittedly, this would represent a step towards a more integrated world economy. But at the same time, it would become more apparent that others not belonging to the spokes would be excluded. Moreover, the existing hub and spoke systems do not justify TAFTA. Thus, the WTO-most favored tariffs of the

European Union only apply to nine countries of the world, among them the US and Japan. Preferential tariffs apply to all other countries (WTO 2004b). This means that preferential tariffs of the some 300 free trade arrangement in force undermine the WTO-multilateral tariffs. TAFTA would yet be another such free trade arrangement chiseling away relevance from the multilateral order.

Looking at the trends in regional integrations, TAFTA also cannot be justified as a counterweight to APEC which is so far a rather lose intergovernmental grouping of 21 member countries of the Pacific Rim. APEC intends to enhance economic growth and operates on the basis of voluntary, non-binding commitments without treaty obligations. The ambitious goal of APEC is a free trade area around the Pacific by the year 2010 for the developed countries - i.e. including the US and Japan - and by the year 2020 for all member countries. The chances for meeting the timetable of this target are mixed. APEC is a mini-WTO, with huge income and growth disparities, political rivalry, cultural differences and different historical legacies. It is therefore likely to only represent a lose form of regional integration.

In the future, China will get a much larger weight in the world economy, both economically and politically. One could view TAFTA as a preemptive move against China being tempted to arrange its own regional economic club in the future. But at the same time it would not be a good idea to set a precedent of an exception to the global institutional arrangement. China then may be tempted not to respect or to bend the multilateral WTO framework. To prevent this, no bad example should be set.

In the political sphere, the main argument against TAFTA is that other countries may feel excluded by this “rich man’s club”. Both the US and the EU have been sentenced to change their agricultural policy by the WTO’s dispute settlement procedure, the US in the case of cotton and the EU in the case of sugar. Their agricultural policy causes injury to developing economies. For the US, the verdict has been upheld by the Appellate Court of the dispute settlement mechanism in March 2005, for the EU the verdict is still pending. A TAFTA consensus in two important areas of trade, the protection of agriculture and anti-dumping in sensitive sectors, is likely to go counter to the interest of the developing countries and can be interpreted as a discrimination against them; it would not fit into a world where the distortion caused by these policies of the industrialized countries or more and more realized.

TAFTA and Investment Flows

With respect to foreign direct investment, stimulating foreign direct investment in the TAFTA region will make non-members less attractive for capital flows. The issue is whether investment flows are redirected towards the North-Atlantic Free Trade Area, i.e., whether flow creation outweighs flow diversion. The question is whether and to what extent the flows of foreign direct investment would be shifted away from non-members. Dismantling barriers to access can be expected to intensify investment flows inside TAFTA. Whereas foreign direct investment flows into third countries are not affected directly, the TAFTA region becomes more attractive for internal investment flows. This means a relative disadvantage for third countries. It is a similar effect as of a more liberal capital market in the European Union, making investment there more promising.

Attractiveness for capital depends to a large part on the credibility of investment codes, including codes in third countries. These codes have to guarantee free exit, in order to prevent a hold-up situation, for instance by a change in the taxation system or by forbidding the repatriation of capital invested or of profits. So far, the existing international agreements on the protection of investment, for instance as elements of the WTO, are weak or only extend to groups of countries and regions of the world such as the OECD, NAFTA or the European Union. Thus, the TWO Agreement on Trade-Related Investment Measures (TRIMs) prohibits trade-related investment measures such as local content requirements. The General Agreement on Trade in Services addresses foreign investment of services as one of the four modes of supply of services (Houde and Yannaca-Small 2004). The OECD Code of Liberalization of Capital Movements dates from 1961 and takes as its starting point the capital account. Investment provisions often remain general in nature. For instance in NAFTA, transparency, national treatment, dispute settlement and full and fair compensation for expropriation are the guiding investment provisions. In 1998, the OECD countries could not find consensus on a Multilateral Agreement on Investment (MAI).

It is fair to state that a similarly comprehensive world order as for trade has not been found for investment flows. Consequently, our problem here is somewhat different from trade in goods and services. With respect to the institutional set-up for investment, it cannot be argued that to improve the confidence for investors in one region of the world has to be postponed because other regions cause uncertainty for foreign direct investment in their institutional arrangement. This would mean that the poorest investment standard determines the world’s overall institutional arrangement. It would be similar as if a country not interested in a stable money would require other countries to have a lax monetary policy. This implies that the third world's argument against a more intensive agreement on both sides of the Atlantic for investment flows is not too convincing. It would mean that locational competition is not accepted as a driving force for the improvement of the world's welfare (Siebert 2002, Chapter 14).

Conclusions

Summing up, the internal economic benefits of a more intensive TAFTA trade in goods and services for its members are not strategically large; the internal political momentum in the two regions on both sides of the Atlantic for this project is weak. Part of the benefits can be obtained by mutual recognition agreements especially relevant for intra-sector trade and services. For the world economy, there is the risk of block-building doing damage to the WTO institutional arrangement. Politically, TAFTA may be interpreted as an instrument of discrimination against the developing world.

With respect to investment flows, these objections are much less convincing. It is not justified that countries are prevented from improving the conditions for capital accumulation. But in this case as well, the fear of discrimination has to be taken seriously.

We can limit the conflict between regionalism and the multilateral order by embedding TAFTA into the multilateral order of the WTO. Thus, TAFTA cannot be "exclusive". If is pursued, it must be an open club, open to any WTO member who may choose to join. The "open club concept" is similar the most favored nation clause, now also applying to the framework of capital flows. This type of TAFTA would have to be a “WTO+”, doing more dismantling of trade and investment barriers than the WTO (Siebert, Langhammer &,Piazolo 1996). But this type of free trade area would no longer be transatlantic, it would be global. Transatlantic initiatives to strengthen the WTO as the US-EU proposal in 2004 to stop agricultural export subsidies in order to get the Doha Round moving again would be welcome in this concept. An exclusive type of TAFTA, however, is dead horse. There is no use in revitalizing it.

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