TTIP may lead to EU dis-integration, unemployment, instability

The Transatlantic Trade and Investment Partnership (TTIP), a major trade pact now under negotiation by the US and the EU, is being touted on the basis of studies which predict net economic gains for all countries involved. However, these projections are derived from questionable assumptions and flawed models; a more realistic assessment finds that TTIP would lead to loss of income and employment in the EU, with few viable policy options available to counter the decline.

by Jeronim Capaldo

The European Union and the United States are currently negotiating the Transatlantic Trade and Investment Partnership (TTIP), a major trade agreement intended to further integrate their economies.

In today’s low-tariff reality, TTIP focuses on removing non-tariff trade barriers between countries, such as differing standards set in the EU and in the US for given consumer goods and services. The underlying logic is the same as in traditional liberalizations: reducing the costs of trade – whether eliminating tariffs or other impediments – is supposed to lead to a higher trade volume and overall economic benefits.

Unfortunately, experience has shown that this appealing reasoning is often misleading.

As is common for trade agreements, TTIP negotiations have been accompanied by a series of econometric studies projecting net economic gains for all countries involved. In the EU, advocates have pointed to four main studies mostly projecting small and deferred net benefits alongside a gradual substitution of intra-EU trade with trans-Atlantic trade.

This leads the European Commission, TTIP’s main advocate in Europe, into a paradox: its proposed policy reform would favour economic dis-integration in the EU. TTIP might also lead to other serious consequences for the EU and its members. Recent literature has shown that the main studies of TTIP do not provide a reliable basis for policy decisions as they rely heavily on an unsuitable economic model.

Assessing TTIP with the United Nations Global Policy Model, a model based on more plausible assumptions on economic adjustment and policy trends, we found very different results. Evaluated with the UN model, TTIP would lead to net losses in terms of GDP, personal incomes and employment in the EU.

In particular, we project that labour incomes will decrease between 165 and 5,000 euros per worker depending on the country. We also project a loss of approximately 600,000 jobs, a continuing downward trend of the labour share in total income, and potentially destabilizing dynamics in asset prices.

Our projections point to bleak prospects for EU policymakers. Faced with higher vulnerability to any crises coming from the US and unable to coordinate a fiscal expansion, they would be left with few options to stimulate the economy: favouring an increase of private lending (with the risk of fuelling financial imbalances), seeking competitive devaluations or a combination of the two.

We draw two general conclusions. First, as suggested in recent literature, existing assessments of TTIP do not offer a suitable basis for important trade reforms. Indeed, when a well-reputed but different model is used, results change dramatically.

Second, seeking a higher trade volume is not a sustainable growth strategy for the EU. In the current context of austerity, high unemployment and low growth, requiring that economies become more competitive would further harm economic activity. Our results suggest that any viable strategy to rekindle economic growth in Europe would have to build on a strong policy effort in support of labour incomes.

Existing assessments of TTIP

Most assessments of TTIP predict gains in terms of trade and GDP for both the EU and the US. Some also predict gains for non-TTIP countries, suggesting that the agreement would create no losers in the global economy. If this were the case, TTIP would be the key to a more efficient allocation of global resources, with some countries achieving higher welfare and all others enjoying at least the same welfare as before.

Unfortunately, as Raza and colleagues (2014) have shown, these desirable results rely on multiple unrealistic assumptions and on methods that have proven inadequate to assess the effects of trade reform.

Furthermore, once the calculations are reviewed, it appears that several of these studies share the same questionable economic model and database. The convergence of their results is, therefore, not surprising and should not be taken as providing independent confirmation of their predictions.

Methodological problems


CEPR has been very influential: the European Commission has relied on it as the main analysis of the economic effects of TTIP, going as far as presenting some of its findings as facts. However, the EC’s reference to CEPR as an “independent report” seems misleading since the study’s cover page indicates the EC as the client for whom the study has been produced. Econys was also commissioned by the EC as part of a wider project encompassing economic, environmental and social assessments.

Methodologically, the similarities among the four studies are striking. While all use World Bank-style Computable Gen-
eral Equilibrium (CGE) models, the first two studies also use exactly the same CGE. The specific CGE they use is called the Global Trade Analysis Project (GTAP), developed by researchers at Purdue University. All but Bertelsmann use a version of the same database (again from GTAP).

The limitations of CGE models as tools for assessment of trade reforms emerged during the liberalizations of the 1980s and 1990s. The main problem with these models is their assumption on the process leading to a new macroeconomic equilibrium after trade is liberalized.

Typically, as tariffs or trade costs are cut and all sectors become exposed to stronger international competition, these models assume that the more competitive sectors of the economy will absorb all the resources, including labour, released by the shrinking sectors (those that lose business to international competitors).

However, for this to happen, the competitive sectors must expand enough to actually need all those resources. Moreover, these resources are assumed to lack sector-specific features, so they can be re-employed in a different sector.

Under these assumptions, an assembly-line employee of an automobile factory can instantly take up a new job at a software company as long as her salary is low enough. Supposedly, this process is driven by speedy price changes that allow an appropriate decrease of labour costs and, consequently, the necessary expansion of the competitive sectors.

In practice, however, this “full employment” mechanism has rarely operated. In many cases, less competitive sectors have contracted quickly while more competitive ones have expanded slowly or insufficiently, leaving large numbers of workers unemployed. One need only look at the experience of Europe in the last decade to see that full employment does not re-establish itself even if job seekers are willing to work informally and at relatively low pay.

A critical point is that the distribution of gains and losses is rarely uniform within economies. If workers in competitive sectors may benefit from higher salaries, while those in shrinking sectors lose, the economy as a whole may be worse off. This is because in some countries domestic demand is mostly supported by the incomes earned in traditional occupations. In practice, aside from their high social costs, these transitions have led to a drop in domestic demand that CGE-based calculations have often overlooked.

Moreover, most CGEs rely on misleading assumptions on the pattern of international trade, imposing a fixed structure on the market share that each country has in its export markets, and on a static analysis that does not explain how economies reach a new equilibrium.

For example, when Country A expands trade with Country B, the rest of the world’s economies do not simply stand still. Countries C, D and E will find that they are more or less competitive in these markets as a result of the A-and-B trade changes. This effect is known as “trade diversion”, and has been a significant by-product of recent trade integration initiatives.

Finally, the strategy chosen to simulate a “TTIP future” has a strong impact on the results. Ecorys assumes that so-called “non-trade barriers” impose a given cost on trade and that TTIP can remove up to one half of them. CEPR and CEPII borrow this approach but assume a lower share. These barriers can include what other stakeholders refer to as consumer and environmental regulations. Phasing them out may be difficult and could impose important adjustment costs not captured by the models.

Trade

All assessments project large increases in bilateral US and EU exports. In CEPR and CEPII, US bilateral exports increase by 36.6% and 52% respectively in the long term, compared to 28% and 48% for the EU. According to CEPR, the net increase in total exports will be 8% in the US and 5.9% in the EU.

However, in all cases, these increases in trans-Atlantic trade are achieved at the expense of intra-EU trade. Implicitly, this means that imports from the US and imports from non-TTIP countries through the US will replace a large portion of current trade among EU countries.

If these projections were true, higher trans-Atlantic interdependence would heighten the EU’s exposure to fluctuations in US import demand. This is an under-examined consequence of certain patterns of trade liberalization. Even if higher exports were to bring higher demand and economic activity (a link that doesn’t always work in practice, as discussed), more reliance on the US as an export market would also make the EU vulnerable to macroeconomic conditions in North America.

If Europe could effectively implement countercyclical policies, this greater interdependence would not necessarily be a problem. However, the EU’s current institutional structure lacks a central fiscal authority while in practice preventing national governments, through the Maastricht treaty, from implementing any fiscal expansion. This constellation of factors indicates that TTIP might usher in a period of higher instability in Europe.

The remaining two studies raise similar concerns. In Bertelsmann, aggregate figures for bilateral export increase and net increase are not readily available but results exhibit the same pattern as in other studies.

While bilateral exports are predicted to increase by more than 60% for the EU and more than 80% for the US, intra-EU exports are expected to decrease between 25% and 41%. This implication raises the same concerns about vulnerability to US economic shocks as the other studies.

Finally, as noted above, the rest of the world does not stand still when two economies integrate. Applying Bertelsmann’s percentages to recorded trade data with EU exports to the world as a whole, Raza et al. (2014) calculate that the overall impact of TTIP on EU global exports, including those to non-TTIP countries, would be negative.

Furthermore, Felbermayr and Larch (2013) find that TTIP will have a negative effect on non-TTIP countries’ exports, in a pattern observed after other trade agreements. In other words, both exports and imports of non-TTIP countries are projected to decrease, with uncertain or negative net effects.

CEPR and CEPII do not find negative effects on non-TTIP countries, assuming ad hoc effects (spillovers) that allow exports in the rest of the world to grow.

GDP and personal incomes

Given the small net effects on exports, most assessments predict small increases in TTIP countries’ GDP.

In Ecorys, CEPR and CEPII, GDP increases less than 0.5% in both the EU and the US. This means that, at the end of the simulation period in 2027, GDP would be 0.5% higher in a
TTIP scenario than in the baseline, non-TTIP scenario, implying negligible effects on annual GDP growth rates.

This is a defining aspect of the results: Ecorys, CEPR and CEPII point to a one-time increase in the level of GDP, not to an increase in the growth rate of GDP. Furthermore, this one-time increase is small and projected to occur only over the course of 13 years.

Bertelsmann reports higher figures (5.3% for the EU and 13.9% for the US) but provides little detail on the study’s methodology. It is, therefore, unclear how the results compare to those of other studies.

Furthermore, given the assumptions on spillover effects, CEPR estimates that all regions of the world would benefit from long-term GDP increases. However, Felbermayr and Larch (2013) indicate that this expectation contradicts previous experiences of trade agreements such as CUSFTA, NAFTA and MERCOSUR since these agreements typically affect the relative trade prices between members and non-members.

Despite the small projected increases in GDP, some studies suggest that TTIP might lead to large increases in personal incomes in the long term. In often-cited examples, Ecorys estimates that the average EU household would gain 12,300 euros over the work life of household members, while CEPR estimates that the same household would earn 545 euros more every year.

However, as noted above, these estimates are misleading since the studies provide no indication of the distribution of income gains: they are simply averages. With EU wages falling as a share of GDP since the mid-1990s, it is far from certain that any aggregate gains will translate into income increases for households living on income from wages (as opposed to capital).

Employment

Finally, most studies are not informative on the potential consequences of TTIP on employment. While CEPII does not discuss employment effects, CEPR and Ecorys assume a fixed supply of labour. This amounts to excluding by assumption any consequences of TTIP on employment – wages are assumed to fall or rise enough to ensure that all workers remain employed regardless of the level of economic activity.

On the other hand, Bertelsmann predicts that TTIP will lead to the creation, in the long term, of approximately one million jobs in the US and 1.3 million jobs in the EU. However, these positive figures are strongly dependent on the period chosen in the estimation.

Using data up to 2010, the authors estimate that economies where labour and labour income are more protected (for example, by higher unemployment benefits) suffer from higher unemployment, concluding that any cost reductions introduced by TTIP would lead to positive employment effects in those countries.

When more recent data is taken into account, this conclusion ceases to hold since all countries – not just those with stronger labour protection – appear to have experienced higher and persistent unemployment.

An alternative assessment with the United Nations Global Policy Model

To obtain a more realistic TTIP scenario, we need to move beyond CGE models. A convenient alternative is provided by the United Nations Global Policy Model (GPM), which informs influential publications such as the UN Conference on Trade and Development (UNCTAD)’s Trade and Development Report.

The GPM is a demand-driven, global econometric model that relies on a dataset of consistent macroeconomic data for every country. Two features make the GPM particularly useful in the analysis of a large trade agreement.

Firstly, the model assumes a more realistic mechanism leading to macroeconomic equilibrium. All models that make these types of projections necessarily make assumptions on the way economies will stabilize after a policy change, which in this case is the introduction of TTIP.

The most important difference between the GPM and the CGE models described is that, in the GPM, the full-employment assumption is replaced by the Keynesian principle of “effective demand”. This means that the level of economic activity is driven by aggregate demand rather than productive efficiency. Consequently, a cost-cutting trade reform may have adverse effects on the economy if the “costs” that it “cuts” are the labour incomes that support aggregate demand.

Unlike in CGE models, changes in income distribution contribute to determining the level of economic activity. The absence of this mechanism in many commonly used models has often led to major errors in assessing the impact of trade reforms.

Secondly, the GPM provides an explicit analysis of the macroeconomic workings of every world region. This, in turn, has two important benefits. It means that the model can provide well-founded information on the economic interactions among all regions, rather than just assuming that a given proportion of a country’s income will be spent on imports from other countries.

It also means that the GPM allows us to assess whether a given policy strategy is globally sustainable. For example, the GPM shows that, when sought by every country, a strategy of export-driven growth may lead to adverse consequences such as a net loss of trade.

A third valuable feature of the GPM is its estimation of employment. Using International Labour Organization (ILO) data, the GPM specifies how a given change in GDP growth affects employment growth, and vice versa.

A critical advantage of the specification used is that these growth-and-employment relationships (which economists call “Okun’s relationships”) are not constant over time. In this way, the GPM recognizes that different factors might affect the relationship between output and employment at different moments in history. Thus, the model is able to account for recent puzzles such as “jobless growth.”

Given the large amount of data that must be processed to estimate and simulate the GPM, we keep the analysis tractable by aggregating some countries into blocs. With this, we lose specific analysis for these countries.

Despite its limitations, the GPM offers a useful perspective on the consequences of agreements such as TTIP. Indeed, it offers a “big picture” and insights into several important adjustment mechanisms that are often overlooked by other models.

Simulation strategy: Global implications of existing trade projections

Our country aggregation leaves the world’s largest economies as independent units. In the TTIP area, the United States,
First, we assume that increased international competition will exert pressure on the real exchange rate. This might occur as firms in every country try to preserve their international competitiveness and increase efforts to reduce labour costs. It might also be the result of unemployment pressures and legislation that would reduce total labour compensation.

As a result, the labour share of GDP would further decrease in Europe in a downward trend toward the lower US share, weakening aggregate demand. Finally, this adjustment mechanism might also play out through a nominal devaluation. This might indeed help an economy gain higher market shares abroad, but it may also generate a race to the bottom at the end of which no country will have gained higher exports.

The second mechanism recognizes a policy strategy that has become central in recent decades, assuming that, in order to stimulate flagging domestic demand, policy authorities may increase lending. As a result, asset prices (including some financial assets) might increase, setting off the unstable dynamics that have become apparent after the 2009 financial crisis.

**Net exports and GDP**

Our simulations show that the assumed trade expansion among TTIP countries will cause a net export loss for all EU economies. Losses would be a drag on aggregate demand for all EU economies. Northern European economies would suffer the largest GDP reduction (2.07% of GDP by 2025) followed by France (1.9%), Germany (1.14%) and the UK (0.95%). On the other hand, US net exports would be higher by slightly more than 1%

A likely explanation for how EU-US trade could expand while EU net exports to the world could decline is that, in the EU’s stagnating economy, domestic demand for lower-value-added manufactures – in which the EU is relatively uncompetitive – will crowd out higher-value-added ones.

Indeed, our figures show an increase of net exports in almost every other region of the world except Europe, suggesting that higher demand for low-value-added products will lead to higher net imports from Asian and African economies and from the US.

Alternatively or additionally, TTIP could facilitate EU imports of manufactures assembled in the US with parts made in China and other regions.

Net exports are a key component of GDP. As such, the net loss of trade will directly lower EU countries’ national income. Our simulations indicate small but widespread GDP losses for the EU, in a clear contrast with existing assessments.

Consistent with our figures for net exports, Northern European economies would suffer the largest GDP reduction (0.50%) followed by France (0.48%) and Germany (0.29%). GDP would increase slightly in the US (0.36%) while GDP increases in non-TTIP countries would be positive but negligible (approximately 0.1%).

**Employment and incomes**

Following the reduction of net exports and overall economic activity, we project clear losses in EU employment and labour incomes. Recall that our model allows us to make employment projections, because it estimates the relationship between GDP growth and employment growth over several decades based on ILO data.

This is compatible with a tendency toward specialization in higher-value-added, lower-employment-intensity products, which would lead to export and output gains in a few sectors...
while adversely affecting many others.

As a result, we calculate that the EU as a whole would lose approximately 600,000 jobs by 2025, most of which are in Northern Europe, France and Germany. By comparison, this is more jobs than the EU lost in the crisis years of 2010 and 2011 – clearly Europe must avoid another job loss of this magnitude even if gradual and spread over many years.

The loss of employment would further accelerate the reduction of incomes that has contributed to the EU’s current stagnation. Indeed, labour income will continue its steady decrease as a share of total income, weakening consumption and residential investment while likely exacerbating social tensions.

The flipside of this decrease is an increase in the share of profits and rents in total income, indicating that proportionally there would be a transfer of income from labour to capital. The largest reductions will take place in the UK (with 7% of GDP transferred from labour to profit income), France (8%), Germany and Northern Europe (4%), reinforcing a negative trend that has continued at least since the early 2000s.

To emphasize the difference between our results and existing estimates of employment impact, we calculated the projected reduction of per capita employment income implied by the fall of employment and the labour share.

As mentioned above, CEPR estimates that the annual income of the average household would increase in the long term by 545 euros, while Ecorys projects an increase in working life income, again for the average household, of 12,300 euros.

Given the ongoing deterioration of income distribution, we chose to focus on working households, calculating the change in per capita employment income. Our results are clearly incompatible with both CEPR and Ecorys. Indeed, we project losses of working incomes per capita ranging from 165 euros to more than 5,000 euros. France would be the worst hit with a loss of 5,500 euros per worker, followed by Northern European countries (4,800 euros), the United Kingdom (4,200 euros) and Germany (3,400 euros). For a household with two working persons, the loss ranges from 330 euros to more than 10,000 euros. By contrast, in the US there would be an increase of employment income.

The loss of economic activity and the weakening of consumption in the EU means that tax revenue will be less than it would have been in the absence of TTIP. We estimate that the surplus of indirect taxes (such as sales taxes or value-added taxes) over subsidies will decrease in all EU countries, with France suffering the largest loss (0.64% of GDP or slightly more than 1% of the total government budget).

Government deficits would also increase as a percentage of GDP in every EU country, pushing public finances closer or beyond the Maastricht limits.

The loss of employment and labour income will increase pressure on social security systems. Using GPM employment projections and UN population data, we can calculate the economic dependency ratio, that is, the ratio of total population to employed population. This indicates how many people are supported by each job, either through family relationships or social security contributions.

According to our calculations, the ratio would increase throughout the EU, announcing more troubled times for European social security systems. By contrast, in the US, indirect taxes would not be affected while the economic dependency ratio would slightly improve.

### Asset price inflation and real devaluation

Policymakers will have a few options to adjust to the short-fall in national incomes projected by our study. With wage shares and government revenues decreasing, other incomes must sustain demand if the economy is to adjust. These adjustments have to be profits or rents but, with flagging consumption growth, profits cannot be expected to come from growing sales.

A more realistic assumption is that profits and investment (mostly in financial assets) will be sustained by growing asset prices. The potential for macroeconomic instability of this growth strategy is well known.

In this adjustment scenario, there would be a strong increase in asset prices where financial markets are more developed, especially in the United Kingdom, Germany, other Western and Northern European countries and France. Aggregate demand in these economies would be sustained by a recovery of the financial sector, stimulated by domestic lending and growing profits.

However, it is critical to note that such growth would last only as long as asset prices keep growing, requiring ever-rising levels of lending. In the current context of weak commercial lending, this might require intentional policy interventions, such as further deregulation. This road to growth has been taken before and its risks have proven extremely high.

During the most recent economic crisis, individuals and businesses quickly ran up unsustainable debts until generalized insolvency suddenly stopped economic activity. Moreover, the extent to which deregulation is successful in increasing lending, rather than just reducing accountability in the financial sector, is not clear.

Of course, a run-up in asset prices is not the only policy and economic response to the drop in aggregate demand. But it appears to be slightly more viable than alternative adjustment mechanisms. For example, it is often suggested that an opportunity might come from real devaluation. Countries might be tempted to seek this alternative by way of a nominal depreciation, a reduction of real labour costs or both.

In light of the discussion above, the latter channel does not appear viable. This is because it would prove counter-productive when applied by many countries. In other words, if the incomes of workers in every country are reduced, the demand hole is dug even deeper. Moreover, the magnitude of the cuts required could be socially unsustainable after decades of falling labour shares.

On the other hand, a substantial nominal depreciation of the euro would probably trigger defensive depreciation in other currencies before any improvement in competitiveness is achieved.

According to our projections, a real devaluation would have some effect in Germany and France but nothing that might strongly stimulate aggregate demand. Furthermore, attempts at strong devaluations are often followed by a race to the bottom in which the trading partners of the country that devalues try to regain the lost ground by devaluing as well. But even when a race to the bottom does not happen,
lasting periods of real devaluation might lead to the accumulation of external debts, as Europe’s deficit countries have experienced after 1999.

To reiterate, our model requires some form of adjustment to compensate for the drop in aggregate demand. The precise path that future policymakers will choose (if any) is of course unknowable at present. But our model sheds light on the likely macroeconomic consequences of a TTIP-induced change in trade volumes, and also on the policy responses that are more or less likely to fill the demand gap.

Discussion and conclusion

Existing studies on TTIP have focused on the impact the agreement would have on aggregate economic activity in member countries. They have done so based on detailed sectoral analyses of TTIP economies, but have neglected the impact of income distribution and other important dimensions of macroeconomic adjustment.

Our assessment of TTIP is based on the United Nations Global Policy Model, which has proven a convenient tool to estimate the impact of policy changes involving large areas of the world economy. Our simulation does not question the assumption of TTIP’s financial effects. Existing studies on TTIP have focused on the impact the agreement would have on aggregate economic activity in member countries. They have done so based on detailed sectoral analyses of TTIP economies, but have neglected the impact of income distribution and other important dimensions of macroeconomic adjustment.

Our assessment of TTIP is based on the United Nations Global Policy Model, which has proven a convenient tool to extend the analysis of TTIP’s financial effects. Going forward, valuable insights could be drawn by further extending the analysis of TTIP’s financial effects. Jeronim Capaldo is a Research Fellow at the Global Development and Environment Institute (GDAE) of Tufts University in the US. The above is based on his GDAE Working Paper 14-03 (October 2014). The full paper with tables, graphs, footnotes and references can be accessed at www.ase.tufts.edu/gdae/policy_research/TTIP_simulations.html.