The Transatlantic relationship

Mutual benefits, costs of continued barriers

Presentation at the State Department
Washington DC
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The Transatlantic relationship has many different dimensions. At the OECD, we have recently focused on one of the economic facets that rarely makes headlines, perhaps because it is less amenable to passionate exchanges. But it is a dimension that matters a lot for our common prosperity.

Specifically, we have tried to evaluate the macroeconomic benefits that would arise from a large reduction of the barriers still inhibiting trade, foreign direct investment and product market entry in the US and the EU (EU15).[1] Incidentally, this assessment will soon be expanded to cover the whole OECD area.

This work shows that, while Europe may be losing political momentum in its drive to open product and services markets, the economic rationale for such liberalisation remains compelling.

The starting point for this work is the observation that the process of economic convergence that benefited Europe for several decades stalled during the 1980s and Europe has entered a period of relative decline since the early 1990s [**SLIDE 1**]. On current policies, and because of ageing, Europe's lag in terms of GDP per capita is set to worsen.

This, we diagnosed, can be related in part to the fact that labour market reforms have tended to stall, with only a few encouraging exceptions.

However, one area where substantial progress has been achieved over the past five years is product market reform. At least, this is what our indicators show.

Losing momentum would be sad. And it has an opportunity cost. The cost of inaction. Our work on Transatlantic economic integration tries to quantify the gains that could be achieved by deepening our liberalisation efforts on both sides of the Pond. It also evaluates the positive spillovers that would accrue for other countries in the OECD.

We began by identifying across the OECD the countries which have, in one sector or another, the most flexible regulatory framework. And computed what would happen if every country aligned itself on "best practice" so defined.

The barriers that were relaxed in this thought experiment comprised:

- Product market regulations (or PMRs, in our jargon), including barriers associated with state control of companies and state involvement in business operations in the form of barriers to start-ups, administrative opacity, barriers to competition and so forth [**SLIDE 2**]. Clearly, PMRs are more of a hindrance in Europe than in the US, especially inward-oriented ones. Think of German regulations on

[1] See "The benefits of liberalising product markets and reducing barriers to international trade and investment: The case of the United States and the European Union", OECD Economics Department Working Paper No. 432, May 2005.

shopping hours. That said, some EU countries score better than the US on some PMRs: this is true for Ireland and the UK in the case of barriers to entrepreneurship.

- Tariffs, including for agriculture [**SLIDE 3**]. Note that these are comparatively low on both sides of the Atlantic.[2] However, they are more dispersed – and therefore more distortionary – in the EU.

- Obstacles to FDI, in particular on foreign ownership, for example in the case of airlines [**SLIDE 4**]. Barriers to FDI are if anything marginally lower in Europe. But this partly reflects intra-EU freedom, except in the UK, where the regime is indiscriminately very open.

In all these areas, we have constructed a large number of structural policy indicators. These have then been used in panel data econometric work to analyse the determinants of trade and FDI flows, employment and growth. Having accumulated a vast body of empirical evidence over the years, we were in a position to quantify the effects of dismantling barriers in the EU and US.

A crucial caveat, however, is that in this exercise we left aside most public interventions in agriculture, environmental or safety regulations, all of the labour and financial market regulations, and the distortions induced by welfare systems.

This exercise was thus about quantifying the consequences of a deep but not a broad cut in regulations.

Even so, it showed that the ensuing benefits are substantial, with international trade receiving a major boost [**SLIDE 5**]:

- In Europe, GDP per capita would be boosted by 2 to 3½ per cent, depending on the analytical approach used to estimate the gains. This is equivalent to one to two years of growth at trend rates. Note that the gains would be particularly substantial in the largest and somewhat lethargic three euro area members.

- In the US, GDP per capita would increase by 1 to 3%, which is also significant.

- Spillovers outside the EU and the US could be large: over 2% for Canada and Mexico, 1½ per cent or more for Turkey, Japan and Central Europe [**SLIDE 6**].

Gains would be stronger in Europe because it is more tightly regulated to start with. Product market deregulation rather than tariff lowering would provide the bulk of the economic gains. This is consistent with the fact that today the main obstacles to Transatlantic trade are not classical tariff and non-tariff barriers, which are in any case rather small, but domestic product regulations themselves. Especially in services.

A few words about methodology. We used three alternative approaches to evaluate the gains from transatlantic liberalisation:

- Two empirical reduced-form econometric approaches.

- One more theoretical approach based on general equilibrium modelling.

[2] Non-tariff barriers cannot be quantified precisely enough to include them. But to some extent, they are covered by PMR indicators.

The first approach was to explore how a reduction of barriers would affect trade and FDI flows, building on recent econometric work at the OECD, and then to estimate the impact of higher trade openness on economic efficiency and output. The useful rule of thumb here is to remember that an increase in trade openness of 10% boosts the level of GDP by around 2%.

The second approach is complementary to the first one and can be seen as a check. Here we focused on the benefits to be obtained by reducing domestic PMR. We know from past research that lower PMR stimulates competition, innovation and ultimately total factor productivity. Higher productivity in turn spurs additional investment.

More concretely, past OECD research shows that, in those sectors and countries where the regulatory framework is most rigid, aligning regulation on best, flexible, practice could increase output by some 10%.

At the end of the day, it turns out – reassuringly – that the gains from deregulating product markets look quite similar whether they are estimated through the trade channel or through productivity catch-up. In both cases, deregulating product markets would increase GDP by 3% in the EU and "1% plus" in the US. So the Bolkenstein services directive may have some merits after all.[3]

The third approach, based on general equilibrium, is less empirical but enables a more systematic and transparent assessment of the overall impact of liberalisation, since it explicitly takes into account feedback effects. It is key to evaluate spillovers beyond EU and US borders, but I will spare you the minutiae.

The magnitude of the estimated output gains is in our view very significant. But some European audiences have voiced reservations, on two grounds. First, the objection goes, our estimates don't take into account adjustment costs associated for instance with displaced labour, while these costs could be big. Second, in relation to these putative high adjustment costs potential gains may be too modest.

Granted, adjustment costs should not be neglected but their magnitude is hard to assess and depends a lot on the quality of adjustment policies and the flexibility of the economy. Insufficient flexibility should not serve as an excuse not to push ahead with promising reforms.

I should further stress that our estimates of the gains of liberalisation err on the prudent side. We have only factored in the "static" gains associated with greater international trade specialisation and better resource allocation. We refrained from also including the "dynamic" gains from liberalisation, which stem from the fact that more open product markets stimulate research, innovation and technical progress.

Let me elaborate. We are able to quantify the link between more competitive markets and innovation. And we know that the reforms we have simulated could increase R&D expenditures by 10%. But the trouble is that the impact of stronger R&D on growth is hard to pin down precisely.

Our earlier work at the OECD finds a very strong impact from R&D. It suggests that a 10% increase in R&D spending could boost output growth by 0.2 to 0.4% per annum for a number of years. Thus, dynamic output gains may well exceed the static gains. Other studies, however, have come up with smaller estimates for the impact of R&D on growth. Hence, we prefer to focus here on static gains alone, at the risk of understating the gains from liberalisation.

[3] See also "The EU's Single Market: At your service", OECD Economics Department Working Paper No. 449, October 2005.

Let me turn to the sectoral implications of this study. Although it did not formally model the sectoral consequences of reforms, it provided ample evidence of anti-competitive regulatory settings and of relatively high levels of protection in a range of service sectors and in agriculture. This suggests that the output gains outlined above will require very ambitious reforms in these sectors. But with a focus that differs across countries:

- Competition-restraining regulations in most EU15 countries would have to be lowered significantly in domestic air, rail and road transportation, electricity and gas, and/or telecommunications. In the US, reform efforts would have to concentrate on electricity and rail transportation.

- The required easing of restrictions on FDI in the US would be largest in transportation services, while in the EU it would be particularly extensive in electricity generation.

- Reductions in EU tariffs would have to be concentrated in agriculture. In the US, tariff reductions would imply relatively more adjustment to rates of protection on textiles, apparel and other manufactured goods.

In conclusion, it may look odd to model the outcome of a joint liberalisation on both sides of the Atlantic, knowing that in any case unilateral liberalisation is already beneficial. There are nonetheless at least two good reasons to consider such a joint approach:

- In a spontaneously mercantilist world reciprocity matters: the gains from liberalisation are easier to visualise when you gain market shares abroad than through a diffuse increase in purchasing power at home.

- The second reason is spillovers. If everyone participates in liberalisation, the collective gains are higher.

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Economic benefits to Europe/North America and costs of continued barriers

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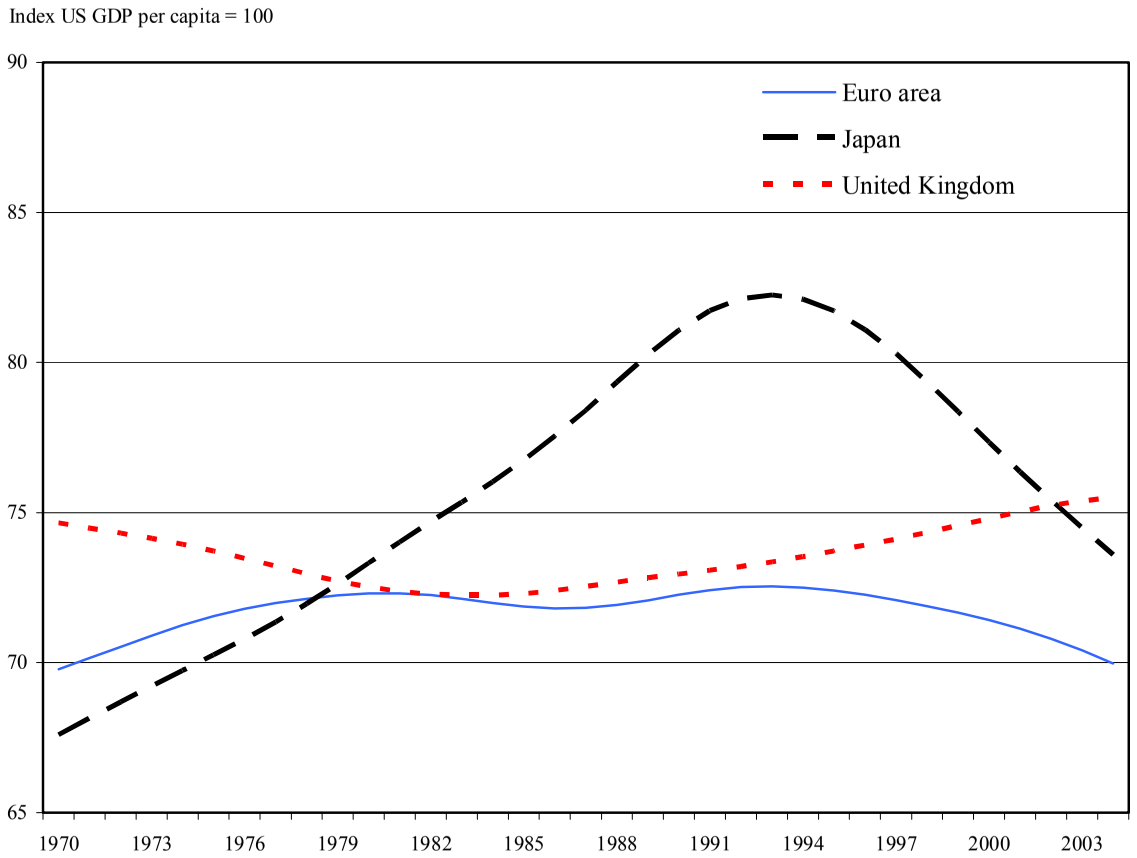
Real per capita GDP relative to the United States

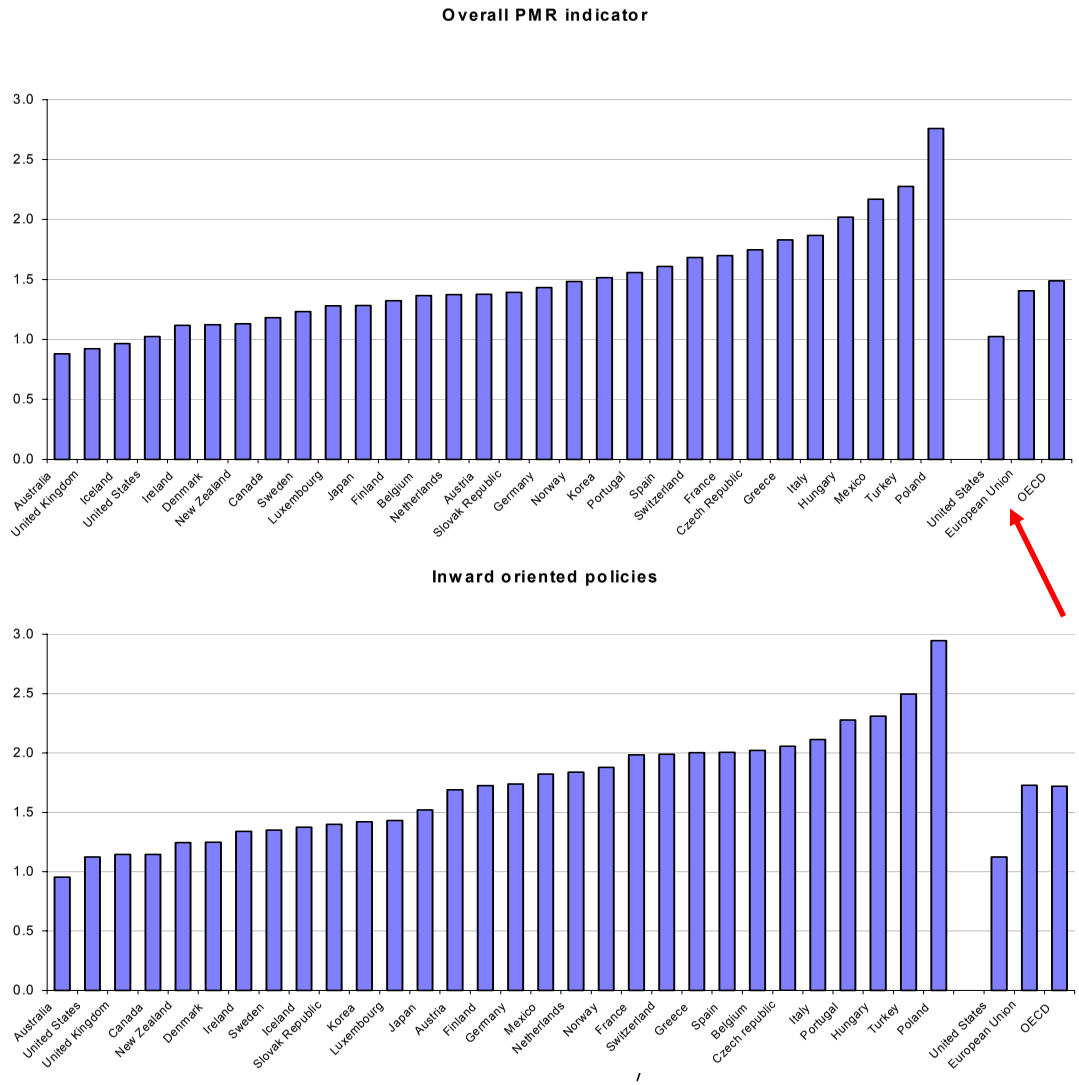
Trend indices, based on 2000 PPPs and 2000 prices [1]



1. The trend is calculated using a Hodrick-Prescott filter (smoothing parameter set to 100) over a period which includes projections through 2010.

Source: OECD *Annual National Accounts.*

Product market regulation indicators in the OECD[1]



1. The indicators range from 0 (least restrictive) to 6 (most restrictive).

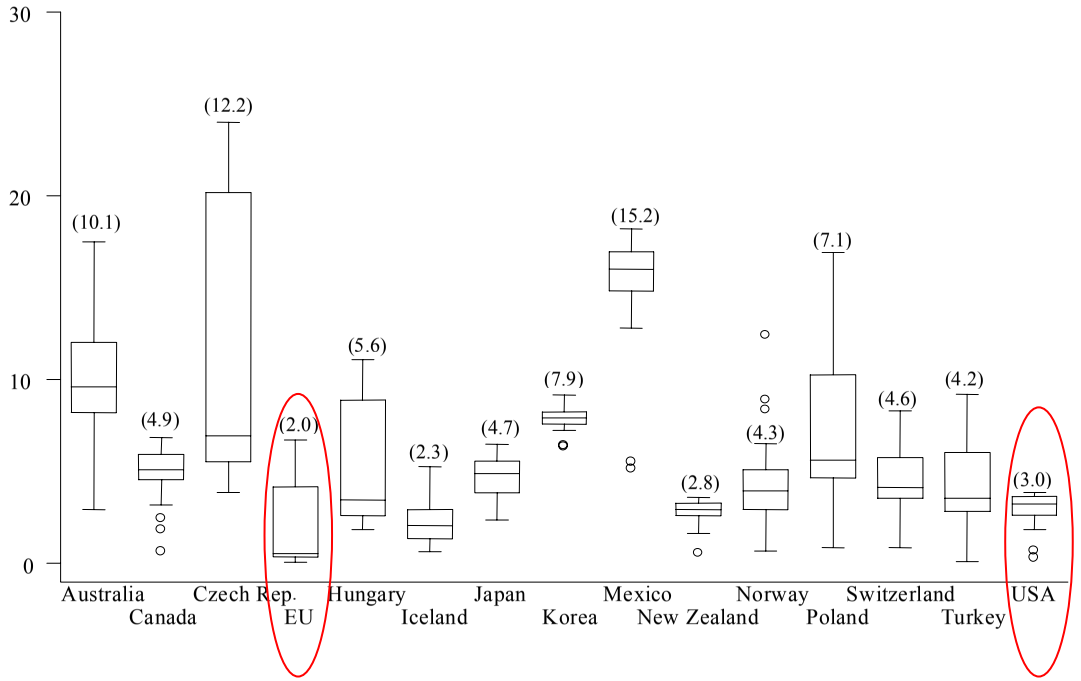
Source: OECD

Applied tariff levels in the EU15, US and other OECD countries

Median and dispersion of bilateral applied tariffs by importing countries in 2001[1]

(Average values in parentheses)

Dispersion reflecting the compound effect of regional preferences and OECD import product mix[2]

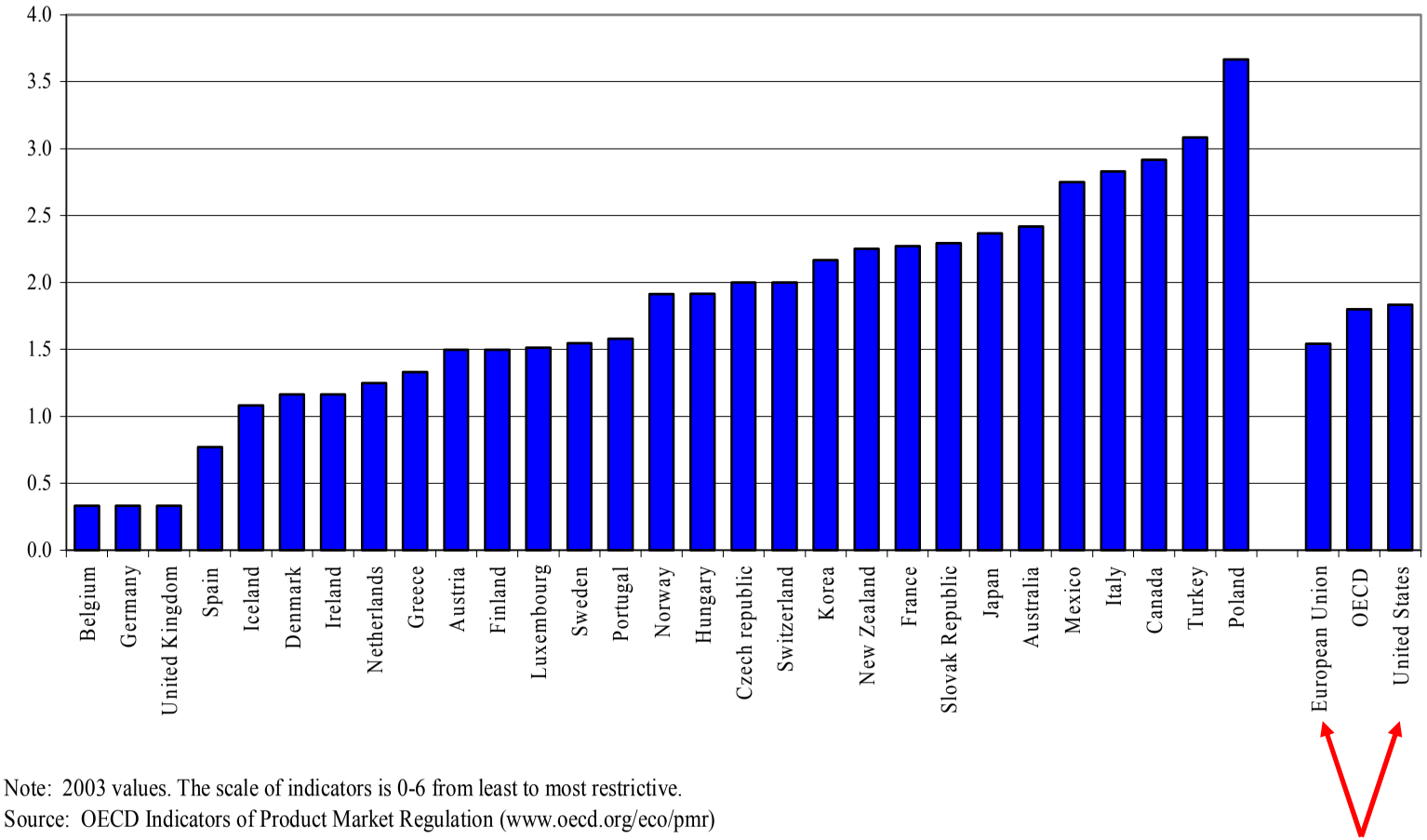


1. The box plot shows, for each country, the variation in the tariffs imposed on imports from partner countries. The median value of the tariff is depicted by the horizontal line in the box, the third and second quartiles of the cross-country distribution by the edges of each box, and the extreme values by the two whiskers extending from the box. Dots identify outlier observations.

2. ISIC rev.3 two-digit industry-level tariffs were aggregated to national level using the weights of the OECD import product mix.

Source: International Trade Center, Geneva and CEPII, Paris.

OECD indicators of FDI restrictions



Note: 2003 values. The scale of indicators is 0-6 from least to most restrictive.
Source: OECD Indicators of Product Market Regulation (www.oecd.org/eco/pmr)

Impact of reforms on GDP per capita levels via trade using OECD panel data studies: EU15 and US

% increase in GDP per capita levels

Country	Reduction in bilateral tariffs	Easing FDI restrictions	Reduction in domestic regulation	Total impact of reforms
Austria	0.1	0.3	3.0	3.4
Belgium	0.1	0.1	0.8	1.0
Denmark	0.2	0.3	2.2	2.8
Finland	0.2	0.3	2.7	2.9
France	0.2	0.4	3.4	4.0
Germany	0.3	0.3	3.0	3.6
Greece	0.2	0.5	2.7	3.3
Ireland	0.1	0.0	0.6	0.7
Italy	0.2	0.3	2.8	3.3
Netherlands	0.1	0.2	1.7	2.0
Portugal	0.1	0.4	2.7	3.3
Spain	0.1	0.4	2.7	3.2
Sweden	0.2	0.3	2.1	2.5
United Kingdom	0.4	0.2	2.4	3.0
United States	**0.9**	**0.4**	**1.7**	**3.1**
EU15	**0.3**	**0.3**	**2.8**	**3.5**

Source: OECD

Impact of reforms on GDP per capita levels via trade using OECD panel data studies: Other OECD economies

Contribution of policy reform in the EU15 and the US to GDP levels in other OECD countries

Country	Reduction in bilateral tariffs	Easing FDI restrictions	Reduction in domestic regulation	Total impact of reforms
Australia	0.3	0.1	0.7	1.1
Canada	1.2	0.4	0.9	2.5
Czech Republic	0.8	0.1	0.6	1.5
Hungary	0.7	0.2	0.6	1.4
Iceland	0.8	0.1	0.8	1.6
Japan	0.8	0.2	0.9	1.7
Korea	0.5	0.2	0.5	1.2
Mexico	1.1	0.3	1.0	2.3
New Zealand	0.3	0.1	0.4	0.8
Norway	1.2	0.3	1.2	2.7
Poland	0.7	0.1	1.1	1.9
Switzerland	0.9	0.2	1.2	2.2
Turkey	0.5	0.1	0.9	1.6
United States	**0.9**	**0.4**	**1.7**	**3.1**
EU15	**0.3**	**0.3**	**2.8**	**3.5**
OECD	**0.6**	**0.3**	**1.8**	**2.8**

Source: OECD