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Introducing Remarks for the Conference Canada - Europe Transatlantic Dialogue: Regional Trade Agreements and EU Trade Policy, 31 October, 2014 , Mc Gill University, Montreal

CETA: The Final Product, Or What?

1. Ratification Procedures Here and There

The final text of CETA has been published end of September, and since we had quite some debates on both sides of the Atlantic about the virtues and downsides of this agreement. I will comment in my introductory notes a bit on those discussions. Let me start with a point that may be simple for many but posed some questions to me, and this is the point of the actual ratification procedures. Legal scholars may yawn but I actually had problems to properly understand the ratification processes that are supposed to come. It seems to me that it is not officially clear yet how exactly the ratification process is looking like. This holds in particular for the side of the EU where a legal strife between the Commission and national governments has been started. An expertise ordered by the German Ministry for the Economy made the case that CETA will need to be ratified also by national governments, besides having to pass the European Parliament and getting approved by the Council of the European Union. I don't think that Germany will step back from this position. The reason for this procedure is seen in the character of CETA as a mixed agreement. Such an agreement covers elements that go beyond the political mandate of the European Union as it is defined in various treaties and legal interpretations. Interestingly enough the mixed character stems mainly from the inclusion of the investment chapter - this chapter was initially not included and came only after the Lisbon Treaty into the negotiation basket. Its various details covers areas and has implications for national governments, and thus go far beyond the political reach of the EU. The hearings of the members of the Juncker College indicate that the new Commission may deviate from the position taken by the Barroso College and accept the mixed agreement-character of CETA. In a quick step Juncker curbed the mandate of the new trade commissioner Malmström who now no longer has – like her predecessor de Gucht - the sole saying on ISDS but needs to get the agreement of the new Juncker tsar Frans Timmermans. This manoeuvre did not go too well, though. Juncker received a letter signed by overall 14 national ministers responsible for Europe who stressed that the inclusion

of ISDS is part of the mandate of the Commission and thus ISDS needs to be an integral part of any agreement.

In contrast, ratification on the Canadian side looks like a piece of cake, given the reality of a majority government. Actually, the Canadian ratification process does not even give the Parliament a legally binding voice - CETA will be discussed but can't actually fail. If there is a problem on the Canadian side at all, then it is on the level of relations between federal level and provinces. CETA can only be seen as ratified when its core elements are integrated in domestic law on the provincial level. This process may be cumbersome but according to the official announcements all provincial governments – who were consulting the overall negotiations – are on board.

Ratification is always a procedure that comes with uncertainties but I trust that there will no unsurpassable hurdles. We saw already quite a number of impressive side-deals to make CETA possible and digestible for some interest groups. Also, it seems that political actors eagerly prepared the ground for compromise lines that allow appeasing critics and still pushing the agreement through. Finally, it is long-standing practice that trade agreements can start operating as soon as EP and Commission on the EU-side and its foreign counterparts gave green lights; the ratification of national parliaments in case of the EU can come later. All this suggests that CETA is well under way.

2. Will it Stay or Change?

This does not automatically imply, though, that there will not be hurdles to overcome and that the product presented in October 2014 will stay totally intact. CETA came in the European limelight when Germany's Vice Chancellor and Minister for the Economy and Technology who at the same time is the head of the Socialdemocratic Party (SPD) uttered that TTIP will not include a investor-state-dispute -settlement clause (ISDS). This positioning was somehow surprising given that Germany is living with exactly such an mechanisms since quite while; but then it only shows that trade and investment issues have become more delicate to present to a democratic public. Even though dispute clauses are integral part of about 1,400 bilateral investment agreements of the member states of the EU, it is a fact that public knowledge about hearings and the way outcomes are being decided is low. In other words, those procedures are highly arcane - and this quality has now become a political problem.

It is only logical to conclude that Gabriel's statement supposedly means that CETA will not be ratified in the German Parliament if it includes such a mechanism. As it turns out, the final text of CETA includes exactly such an investor-state-dispute-settlement clause. The question then is, whether the Socialdemocratic members of the Parliament are willing to risk the fate of CETA or eventually seal the deal. We don't know yet but I will make the argument that a compromise line already is visible.

Recently Gabriel's ministry published a expertise that made the point that the investor-state-dispute settlement language in CETA is extremely modest and erects quite high hurdles for private companies in order to sue national governments in case they find that laws and regulations violates their profit interests: 'In comparison to the existing constitutional and EU law CETA only marginally subdues the political space of the legislator to additional material-legal commitments' (Schill 2014). If this legal interpretation is being accepted on the side of the SPD, then CETA actually will not only not fail in the Bundestag but may even become the blueprint for future investment agreements, kind of. CETA can be seen as the relevant compromise case in so far as it includes the provision that all hearings and documents of actual disputes must be made public.

And yet, the more general question is whether such a mechanism is required at all, given that both contracting parties are highly developed democracies and market economies? In other words, are there no better ways to insure investors against political risks? Empirically it is interesting to see that economies that attracted large inflows of fdi like China and Brazil only have a few bilateral investment agreements, and then dominantly not with the economies from which the capital flows are stemming from. This indicates that capital flows are not closely linked to the existence of ISDS clauses. As a matter of fact, both parties would have been well advised to check the WTO practice. There, only member states and not private businesses can start complaints that then are open and fairly transparent proceedings; outcomes are open for appeal. More recent events – see above - indicate that the investor chapter will continue to be in the public debate. At the end of the day, though, I expect that CETA will include the current version of the investment chapter.

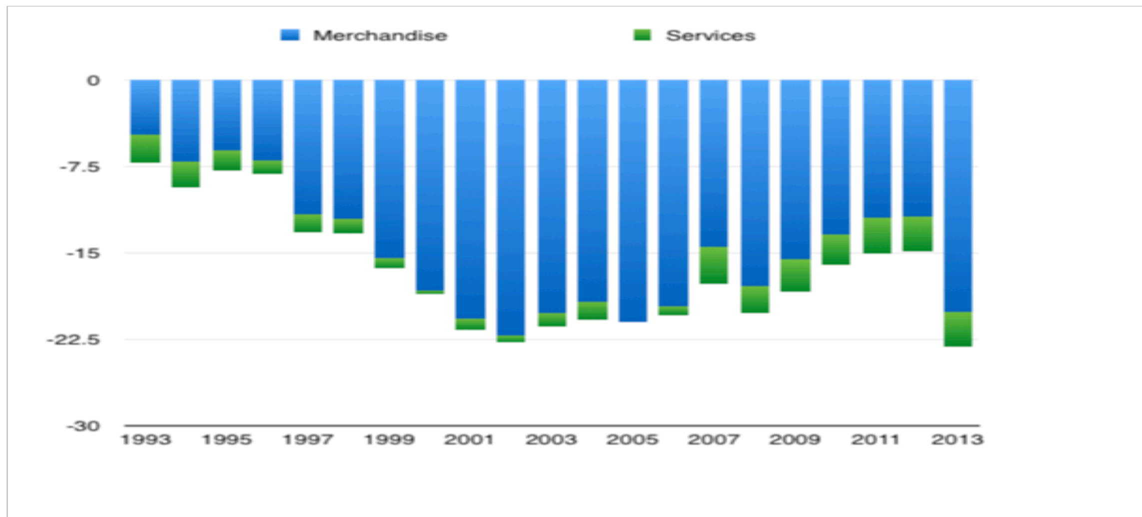
Making Use of Opportunities

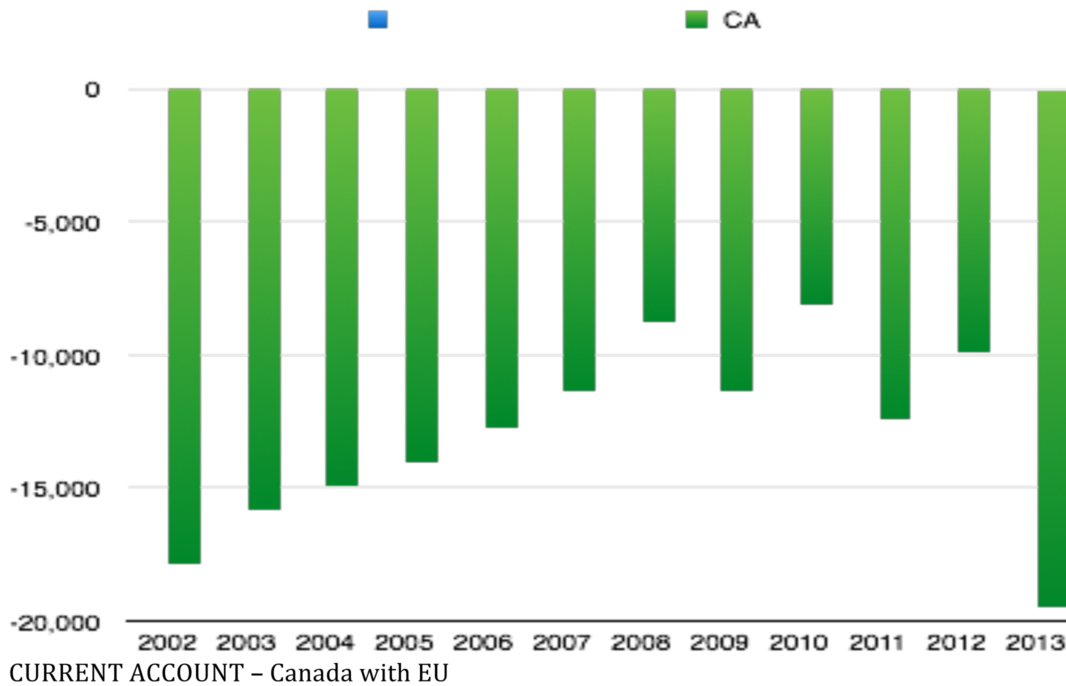
Official data about the mutual benefits of CETA are derived from an econometric exercise from 2009. To give you the gist: The economic model of the 'Joint Study' predicts annual real income gains of approximately €11.6 billion for the EU and €8.2 billion for Canada within seven years following the implementation of an agreement. Total EU exports to Canada are estimated to increase by 24.3% or €17 billion, while Canadian bilateral exports to the EU are predicted to increase by 20.6% or €8.6 billion. Half of the total expected gains for the EU are related to trade in services, a quarter to the removal of tariffs and the remaining 25% of the GDP gains can be reached by the dismantling of Non-tariff barriers (NTB). The benefits from the Agreement in the area of NTBs are estimated to result in a €2.9 billion gain for the EU and €1.7 billion for Canada. So far those figures.

The figures are the outcome of a simulation exercised that used a dynamic version of a computable general equilibrium model (DCGE). Such models necessarily come with quite a number of assumptions, and thus the model outcomes should not be mixed up with 'real world outcomes'. In other words, the widely circulated figures about mutual gains needs to be read with a lot of care.

DCGEs are helpful tools in order to simulate the effect of policy changes but need to be read with a grain of salt. This holds in particular for the calibration procedure, i.e. the way the hundred of equations of the model are given numerical values and weights.

Let me give you some brief insights in the real situation. If we take the most recent trade balance for goods and services between Canada and the EU as a starting point, then the Joint Study simulation results actually indicate that Canada's deficit with the EU will widen. Over the period 1993 to 2013 Canada never managed to achieve a positive balance with the EU in regards to merchandise and services exports. In other words, Canada is a net importer, and this position has become even larger over time. The same holds in regards to the overall current account that includes fdi-related as well as portfolio-related incomes.

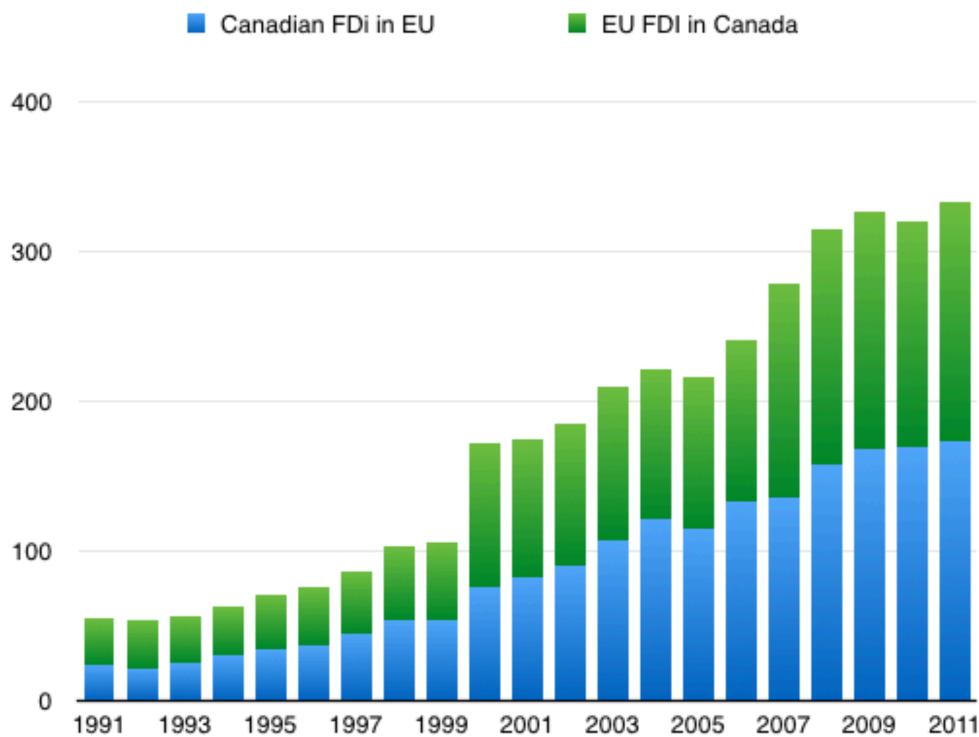




CURRENT ACCOUNT – Canada with EU

CETA opens export opportunities for both sides, and there is no good reason to expect that Canadian exporters will be overly successful in correcting the trade deficit. To be clear, CETA opens opportunities and probably net benefits for some product groups and individual companies. Canada's trade balance nevertheless may run deeper into the red zone.

Major export destinations for Canada are – by far in front – the UK, followed by the Netherlands, Germany, France, Belgium, Italy, Spain, Poland, Ireland, and Austria. In other words, it is a relatively small geographic portfolio that is dominated by the UK. In terms of imports, it is Germany that takes rank # 1, followed by the UK, Italy, France, the Netherlands, Sweden, Belgium, Spain, Austria, and Ireland.



EU and Canada are quite closely integrated in terms of foreign direct investments, with a close balance of outgoing and incoming investments.

Recently, the Bank of Canada published a research study (Binette/de Munnik/Gouin-Bonenfant 2014) that provided an analysis of Canadian non-energy exports to the US. Unfortunately, a similar study does not exist in regards to exports to the EU. The overall findings still seem to be relevant for speculating about CETA-effects. Around 45% of the overall 31 sub-sectors of non-energy exports underperformed in the period 2000 t0 2010, mainly due to structural declines in competitiveness. About 50% of all sub-sectors are highly sensitive to exchange rate movements, and thus to the volatility of process of the resource sectors. All this resulted in a continued market share loss in the US that has not been compensated by significant gains in other markets. In other words, Canada has a export problem.

In the light of this history we should be careful in making use of official suggestions about additional jobs and newly created income due to CETA. If the trends of the past continue then Canada's deficit with the EU and its member states will continue, and maybe even on higher levels. In net terms, this may imply losses rather then gains. However, I would like to make the case that this trend can be broken. Thus, rather then concluding that CETA will further hamper Canada's economic growth I

argue that CETA opens up new opportunities. Those opportunities are just that, opportunities, and it is up to well-designed public and private strategies to seize them.

To be clear, CETA has the potential to be a game changer and to make Canada to a net exporter to the EU and also to attract more foreign direct investment from the EU. To make this argument, one needs to look in more detailed ways into the make-up of the Canadian position. Provinces are in quite differing ways involved in economic relations with the EU and its member states. In 2013, exactly 50 % of all Canadian exports to the EU stemmed from Ontario, followed by a share of 20.7 % of Quebec and 10 % of the Atlantic provinces; BC had a share of 5.2 % and Alberta one of 3.8 %. Those figures can be interpreted in various ways. ‘Heavy’ trading provinces may have to renew efforts to keep up and improve competitiveness in existing activities and at the same time try to move towards new activities. Less engaged provinces seem to substantially under-trade, even in given product portfolios.

Grabbing the opportunities that stem from a trade agreement depends from a country’s ability to technologically upgrade existing production lines and to move upward to more sophisticated production lines. This ability then depends from the ‘product space’ (Hausmann) of an economy, its innovation regime, its underlying growth model and overall its degree and depth of institutional embeddedness. Empirical studies indicate that economies that show strong specialization in sophisticated products show a more solid economic growth then economies that specialize in less-sophisticated products. Hence, moving to the most promising spot in the product space seems to be a promising strategy.

This is easier said then done, though. Any transition within the product space is ridden with pre-requisites. This holds in particular for natural resource-based economies, which, on average, are positioned in a sub-optimum spot in the product space. Hausmann gives a nice illustration about the connect between product space and natural resource specialization:

‘__**Natural resources tend to trap an economy in a very disconnected part of the product space. In the case of mining for example, essentially you learn how to make holes in the ground. You develop a logistics system that typically takes the raw material from the mine to the port, but doesn’t necessarily leave you with a network of transportation systems that can trigger other economic activities.

Sometimes you do get clusters of natural resource-intensive activities – say for example, non-traditional agriculture that is based on the capacity to certify and transport quickly fresh produce. With the transport of fresh produce, a cold storage logistics system is needed. And a cold storage logistics system is a pretty sophisticated thing – you have sanitary regulations to abide by, you have food safety standards, it has to be quick, it has to get there fresh. Well, that’s a system that could be used to transport peaches, to transport fish, to transport asparagus. So there’s suddenly a bunch of

other activities that might be crowded in because the economy has now developed infrastructure and institutions that can support many other activities.'_**_

Moving in the Product Space

Creating economic clusters is a long-standing recipe for modernizing economies. This holds also for pushing for more foreign direct investment, not least because empirical data show that fdi results in relatively superior productivity outcomes. More recently, the concept of a product space has become more prominent, and so did the interpretation of national production spaces as networks. The idea here is that a high density of links between production points indicates similar high levels of synergies. Moreover, the closer those nodes or production points in geographical respect, the higher the probability of leap-frogging to new products. As mentioned, moving to optimum points in the product space is a difficult process that can't be managed solely by market forces. It needs quite substantial public input in areas like innovation, infrastructure and knowledge as well as in regional policy to make such moves happen.

The abolition of tariffs in CETA is relevant for the vast bulk of Canadian exports to the EU and EU-exports to Canada. In 2012, about 90 % of all exports (equal shares for both entities) were in the area of industrial goods. Given the already relatively low level of tariffs, those product categories will probably not become the big movers for CETA. The abolition of NTBs will over time be highly relevant, and so will be the opening of public procurement markets. Yet the real challenge will be to substantially improve the competitiveness position of Canada. This seems to me less a question of controlling real unit wage costs. Latter is actually less relevant in a resource-driven economy where strong appreciations of the currency pose much more serious costs problems then labor costs. The real problems are in the areas of productivity and innovation. Canada's performance is lackluster at the best. Let's forget about the competiveness ranking of the World Economic Forum but I should still mention that Canada slipped in 2014 to rank 14, the lowest scoring since 2006. The same holds for the Conference Board that reports that Canada is ranked 13th out of 16 peer economies when it comes to innovation. ""Canada is blessed with abundant natural resources. But it needs to do more to develop other sectors of the economy if it is to maintain a high level of employment and an equitable distribution of the fruits of growth,"- so the OECD-researcher responsible for the Canada report. There is not a single report that would not confirm the relative inferior positioning of Canada when it comes to innovation and productivity.

All this bodes not very well for Canada's gains out of CETA. To making this agreement to a Canadian success story requires quite substantial policy efforts and overall the public ability and willingness to assist and guide private sectors. Capacity building for export sectors across the country will be key.