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Japan External Trade Organization  
**WTO AND REGIONAL TRADE AGREEMENTS**  
**MONTHLY REPORT**

*October 2004*



*Due to the general nature of its contents, this newsletter is not and should not be regarded as legal advice.*

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## SUMMARY OF REPORTS

### Special Report

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#### **Trade Remains Low Profile Issue in Presidential Election; Kerry and Bush Indicate Some Positions on Trade**

As the November 2, 2004 US Presidential elections approaches, President George W. Bush and Senator John Kerry (D-Massachusetts) are focusing on key “battleground states.” These states include major economic centers such as Florida, Pennsylvania, Ohio, and Wisconsin. Polls from the battleground states remain within the margin of error, and the race is expected to remain tight.

As the two candidates campaign in the final stretch before the election, they have offered little indication of their positions on trade. Rather, trade has remained a relatively low profile issue during most of the campaign. The candidates themselves tend to frame trade issues within the framework of other economic issues, such as jobs and tax policy. The candidates discussed trade issues only briefly during the presidential debates. Both campaigns have highlighted some trade issues in speeches in battleground states, however these speeches have produced few details about the potential trade policies of either a Bush or Kerry Administration.

Campaign advisors and published platforms have provided more detailed information on Bush and Kerry trade policies, including at various events in Washington DC.

### United States

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#### **USTR Rejects Section 301 Petition on China Currency Practices; Favors Bilateral Negotiations Over WTO Dispute Proceeding**

On September 9, 2004, the Office of the U.S. Trade Representative (USTR) immediately rejected a Section 301 petition to investigate China’s currency policy filed earlier that day by the China Currency Coalition (CCC). The petition accuses China of undervaluing its yuan currency by 40 percent in pegging it to the US dollar and thus giving China an unfair trade advantage. The petition urges the filing of WTO dispute and imposition of a 40 percent tariff penalty to level the playing field.

The controversy over the USTR action prompted Members of Congress to file a nearly identical Section 301 petition. On September 30, 2004, the U.S. Congressional China Currency Action Coalition (CCCAC), consisting of 22 Congressmen and 8 Senators, filed a petition alleging that China is undervaluing of its currency. The USTR decision on the second petition is pending.

The Administration’s rejection of the Section 301 petition is not for lack of acknowledgement of a problem with China’s currency practices. Rather, the Administration does not favor pursuing a WTO dispute and prefers bilateral negotiations with China. Moreover, China is under increasing international pressure by the IMF and many of its trading partners to adopt a more flexible exchange rate.

## **Congress Approves FSC/ETI Repeal; Fate of EU Sanctions Remains Unclear**

After months of debate, and retaliatory trade sanctions by the European Union (EU), the US Congress has approved the repeal of the WTO-inconsistent Extraterritorial Income Act (“ETI” or previously referred to as the Foreign Sales Corporation “FSC”). Both the House and Senate adopted their versions of the ETI repeal prior to the August recess. However, delays over the appointment of conferees and disagreement between the House and Senate on who should chair the conference committee delayed work until the end of September.

The final bill, the American Jobs Creation Act of 2004 (Jobs Act) (HR 4520), replaces ETI with tax deductions for domestic manufacturing and reforms a number of international tax provisions aimed at making U.S. firms more competitive. The Act also included narrow tax breaks and other programs unrelated to the repeal of ETI, including a tobacco buyout scheme. Squabbles in the conference committee over these issues prompted a fierce debate in the Senate, which met over the weekend to consider the final bill.

Despite the repeal of ETI, the EU might maintain, or expand its trade sanctions against the US for up to two more years. The EU has cited that the bill provides a transition for the ETI, rather than an immediate phase-out. The sanctions have also become embroiled in a dispute between the EU and US over subsidies for the development of large civilian aircraft. The EU claims that Boeing, a major beneficiary under ETI, will continue to benefit from certain special tax breaks provided for in the Jobs Act.

## **CATO Trade Event Provides Outlook on the U.S. Economy, Outsourcing and Trade and the Elections**

On October 6, 2004, the Cato Institute and *The Economist* hosted a conference on international trade and the future of the American workforce. Speakers at the event included Roger Ferguson, Vice Chairman of the Federal Reserve Board; Gregory Mankiw, Chairman of the President’s Council of Economic Advisers; Senator Chuck Hagel (R-Neb.); academics and journalists. The conference covered such issues as the economy and jobs, the next wave of job creation, outsourcing and insourcing, and trade and the 2004 elections.

## **US Highlights**

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We also want to alert you to the following developments:

- GAO Publishes Assessment of U.S. Monitoring of China's WTO Compliance.
- USTR Requests Comments Regarding Expansion Of Market Access Opportunities In Government Procurement.

## **Free Trade Agreements**

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### **Congress and USTR Threaten to Exclude Ecuador and Peru from Andean FTA**

Citing protracted investor disputes and shaky judicial systems, the US Trade Representative (USTR) and members of Congress have threatened to exclude Ecuador and Peru from the final U.S.-Andean Free Trade Agreement (FTA). The investment disputes, totaling over

\$300 million according to the U.S Chamber of Commerce, arise from tax assessments by central government agencies in the Andean nations. At an October hearing before the House International Relations Committee, both Administration and private sector witnesses discussed the obstacles to resolving the disputes, and consequences should Ecuador and Peru fail to resolve the disputes.

Ecuadorian and Peruvian officials have declined to comment publicly on the status of the disputes between US companies and their governments, stating that they are before the relevant domestic courts or international arbitral tribunals. Ecuador's Attorney General has suggested that Ecuador might abrogate its bilateral investment treaty (BIT) commitments with the United States, an idea criticized by U.S. officials.

### **Deputy USTR Shiner Discusses FTA and WTO Negotiations, Combating Piracy and Other Initiatives**

On October 7, 2004, Ambassador Josette Shiner, Deputy of the Office of the United States Trade Representative (USTR) provided an update on the status of various free trade agreement and WTO negotiations, intellectual property protection, US-China relations, among other issues.

Deputy USTR Shiner provided a rather positive outlook on the status of various trade negotiations and increased efforts to address piracy worldwide. FTA and WTO negotiations appear to be moving forward, and new momentum was provided by the "July framework" agreement among WTO Members this summer. Still, difficult issues lie ahead for larger negotiating partners like Thailand and Colombia, including labor and environment concerns.

### **Free Trade Agreements Highlights**

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We also want to alert you to the following developments:

- USTR Releases Final Text US-Bahrain FTA.
- US And Afghanistan Sign TIFA.
- ITC Releases Report on Potential Economywide and Selected Sectoral Effects US-Bahrain FTA.
- USTR Zoellick Discusses Launch FTA Negotiations With United Arab Emirates And Oman.

### **US-European Union**

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#### **US Files WTO Case Against EU Customs Administration Regime; Argentina, Brazil, India and Taiwan Request To Join Consultations**

On September 21, 2004, the United States Trade Representative (USTR) announced that the United States was filing a World Trade Organization (WTO) case against the European Union regarding the EU customs administration regime. The US charges that the EU's lack of a uniform customs administration and procedures for prompt EU-wide review of national

administrative decisions is in violation of WTO rules and constitutes a trade barrier to U.S. exports. Citing their significant trade ties to the EU, Argentina and Brazil on October 11 and India and Taiwan on October 12 requested to join the WTO consultations.

Sources indicates that EU officials think the US's decision to file a case is motivated by election year politics, but US officials have denied this. The US move has also surprised some other WTO Members at a moment when many developing country Members have reluctantly agreed to launch negotiations on trade facilitation as part of the so-called "July package." It is too soon to say how this new development will influence the negotiating process.

If the consultations yield no resolution, the US could initiate dispute settlement procedures and request the establishment of a WTO panel to rule on the case. The complete dispute settlement procedure, including the appeal, lasts about 18 months.

### **US Files WTO Case Against EU Regarding Airbus Subsidies; EU Reacts With Case Against US Regarding Boeing Subsidies**

On October 6, 2004, the United States filed a World Trade Organization (WTO) dispute settlement case against the European Union alleging that European governments are providing unfair subsidies to Airbus. In an immediate countermove, the EU later the same day filed a WTO dispute settlement case against the US regarding alleged US government subsidies to Boeing. Both parties believe that the subsidies are in violation of the WTO Agreement on Subsidies and Countervailing Measures (ACSM). They also assert the subsidies violate the bilateral 1992 US-EU Agreement on Trade in Large Civil Aircraft.

Both parties have filed request for consultations. If consultations fail to bring a solution within a 60-day period, then either complaining parties may request the Dispute Settlement Body (DSB) to establish a panel that will examine the matter.

## **FTAA**

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### **Deputy USTR Allgeier Visits Brazil: IPR Enforcement and Cooperation at the WTO and FTAA Seen as Priorities**

During a recent visit to Brazil, Deputy USTR Peter Allgeier met business representatives at the American Chamber of Commerce in Sao Paulo.

Allgeier discussed the status of WTO and FTAA trade negotiations as well as bilateral relations between the US and Brazil. Among other issues, Allgeier indicated that protection of intellectual property rights constitute a priority concern for the US in bilateral relations with Brazil and in the context of the FTAA.

### **FTAA Lacks Political Will from US and Brazil; US-Brazil Collaboration on Agriculture Will be Difficult**

On September 23, the Second Brazil-US Agricultural Summit was held simultaneously in Washington, D.C. and in Sao Paulo, through videoconference. Participants from both

countries analyzed the outlook for agricultural reform, including negotiations for the FTAA and WTO negotiations in general.

Participants agreed that progress in the WTO agriculture negotiations would add momentum to the FTAA, and the EU-MERCOSUR negotiations. Speakers concluded that, although difficult agriculture issues remain, the key obstacle is the lack of political will from the US and Brazil.

Some speakers suggested that the US and Brazilian agriculture sectors would benefit from more collaboration on certain issues, particularly SPS issues. However, other speakers were pessimistic about the **prospects** for such collaboration, given the competition between US and Brazil in this sector.

## **NAFTA**

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### **Conference Reviews Impact of U.S. Increased Security Measures on NAFTA Partners**

On September 23, 2004, El Colegio de Mexico, a leading academic institution and think-tank in international relations, held a two-day seminar to discuss international relations in North America. Speakers at the September 23 conference reviewed recent security developments in North America and analyzed how NAFTA partners could achieve further cooperation in this area.

### **US Modifies HTS for Certain Automatic Data Processing Machinery and Parts; NAFTA Countries Comment on Wood Packaging Regulations**

We would like to alert you to the following NAFTA developments:

- US Modifies HTS for Certain Automatic Data Processing Machinery and Parts Imported from Canada and Mexico.
- NAFTA Countries Comment on Wood Packaging Regulations.

## **Multilateral**

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### **WTO Forecasts Global Trade Will Expand by 7.5% in 2004; Investment Analysts Predict Expansion of Latin American Economies**

In its annual report of world trade performance, the World Trade Organization (WTO) concluded that global trade is expected to expand by 7.5% in 2004. The improvement in global trade was mainly associated with two factors: (i) improved global economic growth and (ii) expansionary monetary and fiscal policies in most world regions.

In related news, investment analysts forecasted economic growth for Latin America at a conference hosted by the Inter-American Dialogue on the prospects for the Latin American economy.

### **WTO Panel Finds Against EC Sugar Regime**

A WTO Panel has ruled that certain EC subsidies for sugar violate the export subsidy disciplines of the *WTO Agreement on Agriculture*. In a case brought by Australia, Brazil and Thailand, the Panel found that the EC used profits from its domestic quota system to "cross-subsidize" sugar exports. In addition, the Panel rejected the EC argument that a footnote in the EC's Schedule granted a carve-out for subsidies on exports of EC sugar that had originally been imported from India or the "ACP" countries (Africa, the Caribbean and the Pacific). The Panel found that the EC footnote was "fundamentally inconsistent with the basic provisions of the Agreement on Agriculture" and therefore "of no legal effect."

### **WTO Members Resume Technical Negotiations and Set Date for Hong Kong Ministerial; Possible Leadership Struggle Ahead**

WTO Members have resumed work in the "Doha Round" negotiating groups in a positive atmosphere, but essentially at the technical level. The focus of work is to build upon the "July package" of framework agreements on agriculture, industrial tariffs and services, and proceeding with negotiations on trade facilitation. At this stage, no further political decisions in the Round can be expected for some months; nor are they needed.

Since negotiating bodies resumed meetings in September, the Trade Negotiations Committee has appointed the Chair of the Trade Facilitation Group and discussed preparations for the Ministerial Conference in Hong Kong in mid-December 2005. The General Council also received several nominations for the next Director-General. The process of appointing the next head of the WTO could be marked by contention, as with previous appointments.

Outside the Doha Round context, there have been important developments in WTO dispute settlement which could affect agriculture and other negotiations. There also exists increasing concern among smaller developing countries about the effects of the termination at the end of this year, of the quota system for textiles and clothing – and the negative implications of competition from more advanced countries like China and I

## REPORTS IN DETAIL

### SPECIAL REPORT

#### **Trade Remains Low Profile Issue in Presidential Election; Kerry and Bush Indicate Some Positions on Trade**

##### *SUMMARY*

As the November 2, 2004 US Presidential elections approaches, President George W. Bush and Senator John Kerry (D-Massachusetts) are focusing on key “battleground states.” These states include major economic centers such as Florida, Pennsylvania, Ohio, and Wisconsin. Polls from the battleground states remain within the margin of error, and the race is expected to remain tight.

As the two candidates campaign in the final stretch before the election, they have offered little indication of their positions on trade. Rather, trade has remained a relatively low profile issue during most of the campaign. The candidates themselves tend to frame trade issues within the framework of other economic issues, such as jobs and tax policy. The candidates discussed trade issues only briefly during the presidential debates. Both campaigns have highlighted some trade issues in speeches in battleground states, however these speeches have produced few details about the potential trade policies of either a Bush or Kerry Administration.

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##### *ANALYSIS*

We highlight below details on trade policy that have emerged since our last update on international trade policies in the 2004 election:

#### **I. Kerry Vows to Confront Global Automotive Export Barriers**

Kerry has highlighted the loss of 2.7 million manufacturing jobs during the Bush Administration, and has vowed to attack barriers to the export of U.S. made automobiles and other products. In a policy statement, Kerry cites the “[escalating] automotive trade deficits” and a failure by President Bush to enforce U.S. trade laws. He also vows to negotiate the reduction of tariff and non-tariff barriers for automobiles on a global basis, rather than in specific FTAs, such as one being negotiated with Thailand. In addition, a Kerry Administration would continue to support regulations requiring the labeling of automobiles with the location of where they were assembled and the origin of automotive parts.

The policy statement strongly suggests that the 25 percent tariff on pickup trucks would not be open to negotiation on a bilateral basis in a U.S-Thailand FTA. The Republican Party Platform, adopted in late August, makes no specific mention of the Thailand FTA or the future of tariffs on automotive goods (see below).

## **II. Labor Secretary Touts Foreign Investment**

In an attempt to deflect attacks by Democrats on outsourcing and the loss of American jobs, Secretary of Labor Elaine Chao has suggested that the gains in terms of jobs created by foreign investment outpace low paying jobs lost to China and India. The outsourcing debate has been a major political issue since the head of the President's Council of Economic Advisors, Gregory Mankiw, suggested in early 2004 that outsourcing was beneficial to the U.S. economy.

Secretary Chao's comments, made just following the Republican National Convention, drew immediate criticism from House Minority Leader Nancy Pelosi (D-California). Leader Pelosi stated that the Secretary's comments were reflective of the Bush administration's lack of concern for the loss of jobs suffered by the manufacturing sector.

## **III. WTO Developments Provoke Praise and Criticism from Kerry**

Senator Kerry has commented on several World Trade Organization (WTO) developments, and has offered both support and criticism.

### **A. Support for July Framework**

Kerry praised the frameworks achieved in late July as an important development in promoting U.S. exports, particularly in the agricultural sector.

### **B. Defense of Byrd Amendment**

Kerry sharply criticized the WTO decision authorizing retaliation against the so-called Byrd Amendment. The WTO arbitration authorizes \$150 million in retaliation against the US for its failure to repeal a program that distributes anti-dumping revenues to injured U.S. firms. Kerry described the ruling as yet another failure on the part of the Bush Administration to stand up for U.S. trade remedies. In response Chris Padilla, spokesmen for the U.S. Trade Representative, cited the high number of anti-dumping and countervailing duty orders imposed during the Bush Administration.

President Bush has expressed a desire to work with Congress to repeal the Byrd Amendment to bring the US into compliance with the WTO ruling. However, Congress, particularly the Senate, has expressed strong support for the Byrd Amendment. Though not likely to be a major campaign issue, it is likely that the US will face retaliation by WTO members while the program continues.

## **IV. Republican Party Adopts Trade Policy Platform**

As with the Democratic nominating convention, the Republican National Convention adopted a policy platform, which included trade-related elements. The policy document highlights the accomplishments of the Bush Administration, including the passage of Trade Promotion Authority (TPA), the completion of FTAs with 12 countries, the enforcement of U.S. trade laws, and the adoption of regional initiations, such as the African Growth and Opportunity Act (AGOA).

The policy platform adopted in New York, site of the Republican National Convention, contains few specifics as to where President Bush might lead the US in terms of trade policy. The document expresses continued commitment to the Free Trade Area of the Americas, as well as the Middle East Free Trade Area. The platform also focuses on the need to end currency manipulation by China, and to incorporate International Labor Organization standards in FTAs where appropriate.

## **V. Kerry and Bush Supporters Discuss Future Trade Policy**

On September 8, 2004, the WIIT Charitable Trust and Consumers for World Trade co-hosted a luncheon at the Hotel Washington in Washington, DC. The event featured a debate on international trade between Dr. Lael Brainard, supporting Senator Kerry's trade policy, and Clayton Yeutter, supporting President Bush's trade policy. The two panelists answered questions on a variety of trade topics, including outsourcing, the Trade Promotion Act, apparel and textile quotas, China, and CAFTA.

### **A. Apparel and Textile Quotas**

Yeutter noted that, in a Bush administration, apparel and textile quotas will be eliminated according to schedule at the end of this year. Despite Yeutter's comments, the Bush administration is considering imposing safeguards under China's bilateral WTO accession agreement. Administration sources have noted that a rise in the number of safeguards sought and granted can be anticipated.

Brainard did not directly answer a question on whether or not a Kerry administration would support the elimination of apparel and textile quotas, but responded that Kerry supports early action to prevent threat (of injury) and urged President Bush to put in place safeguard measures.

While Kerry is concerned about job losses that will occur as a result of the quota elimination, Yeutter insists that most job loss experienced by other industries has been due to productivity increases rather than imports.

### **B. Outsourcing**

Brainard expressed Kerry's view that a strong trade policy is critical to American competitiveness. According to Brainard, while many have the perception that Senator Kerry opposes outsourcing, he does not. Rather, he has proposed a plan to eliminate incentives to companies who outsource for tax reasons. Kerry reiterated this position during one of the presidential debates.

Yeutter stressed the need for trade adjustment assistance and training programs.

### **C. Free Trade Agreements**

Kerry supports Free Trade Agreements; however, he believes that the agreements must be enforced more effectively. A Kerry administration would undertake a 120-day review of free trade agreements and would move forward with trade agreements that are consistent with the U.S.-Jordan FTA. This position suggests that Kerry would pursue enforcement of labor and environmental standards in FTAs.

#### **D. Chinese Currency Manipulation**

In response to a question about how each candidate would resolve the problem of Chinese currency manipulation, Brainard cited the IMF as the appropriate body to raise the issue.

Yeutter agreed for the most part, and commented that the Chinese currency issue should not be raised at the WTO. He also emphasized the need to use diplomatic tools. According to Yeutter, no country can manipulate its currency successfully for an extended period of time – the Chinese need time to shift their system from what it is today.

#### **E. Trade Promotion Authority**

Although Brainard did not say whether a Kerry administration would support the renewal of the Trade Promotion Act, Yeutter was confident that a Bush administration would support renewal of the Act. Senator Kerry, subsequent to the panel discussion, has expressed his intention to seek a renewal of TPA, though Kerry has expressed a desire to amend the negotiating priorities contained within the Trade Act of 2002.

#### **VI. Kerry Positions on Sugar Appear Inconsistent**

Senator Kerry has reportedly promised Representative Collin Peterson (D-Minnesota) that, if elected, he would negotiate sugar issues, including market access and subsidies, at the WTO rather than in bilateral FTAs. Representative Peterson has touted this as a victory for those seeking to exclude sugar from the Central American Free Trade Agreement (CAFTA). Kerry's promise, delivered in the form of a letter to Peterson, could lead a Kerry administration to seek further changes to CAFTA. Senator Kerry has already vowed to strengthen CAFTA's labor and environment provisions if elected.

The Bush campaign, through Representative Gil Gutknecht (R-Minnesota) has responded by charging that Senator Kerry supports reducing subsidies to sugar producers. The statement cites various votes cast by Senator Kerry in the Senate supporting cuts to the sugar program.

#### **VII. Trade Briefly Discussed During Third Presidential Debate**

The theme of the third Presidential debate, held in Tempe, Arizona on October 13, 2004, was domestic issues such as the economy, education and healthcare. Both candidates responded briefly to questions on trade issues posed by the moderator related to job losses in the manufacturing sector.

Bush discussed Trade Adjustment Assistance (TAA) for workers, emphasizing the need to retrain displaced workers.

Senator Kerry's response zeroed in on what he described as the failure of the President to stand up for the interests of U.S. producers. Kerry mentioned as an example the WTO case recently filed by the Bush Administration over European subsidies to Airbus (suggesting the Administration's favoritism towards larger corporations like Boeing).

## ***OUTLOOK***

While trade has failed to garner significant national attention during the Presidential campaign, both candidates have made reference to the issue in stump speeches in battleground states. Senator Kerry, for example, has made trade and economic policies the center of his message in Ohio. In Ohio and other states, the manufacturing sector has suffered significant job losses during the Bush Administration. Bush has responded by focusing on issues such as taxation, and opening foreign markets to U.S. producers. He has also been buoyed by recent figures showing a steady increase in job creation.

Economic, or so-called “kitchen table” issues, are likely to figure prominently in the closing days of the campaign as each candidate tries to capture the remaining undecided voters in key battleground states. Polls in those races are tight and will likely remain so for the duration of the campaign.

Besides the presidential elections, the future direction of U.S. trade policy will also be determined by the outcome of elections in Congress. If President Bush is re-elected and Republicans maintain their majorities in both chambers, then positions toward TPA renewal, FTAs and many trade issues are not likely to change drastically. However, if the leadership of the White House, and either Senate or House of Representatives changes hands – trade policy issues might come under greater scrutiny given the divergent views among the two political parties.



## UNITED STATES

### **USTR Rejects Section 301 Petition on China Currency Practices; Favors Bilateral Negotiations Over WTO Dispute Proceeding**

#### *SUMMARY*

On September 9, 2004, the Office of the U.S. Trade Representative (USTR) immediately rejected a Section 301 petition to investigate China's currency policy filed earlier that day by the China Currency Coalition (CCC). The petition accuses China of undervaluing its yuan currency by 40 percent in pegging it to the US dollar and thus giving China an unfair trade advantage. The petition urges the filing of WTO dispute and imposition of a 40 percent tariff penalty to level the playing field.

The controversy over the USTR action prompted Members of Congress to file a nearly identical Section 301 petition. On September 30, 2004, the U.S. Congressional China Currency Action Coalition (CCCAC), consisting of 22 Congressmen and 8 Senators, filed a petition alleging that China is undervaluing of its currency. The USTR decision on the second petition is pending.

The Administration's rejection of the Section 301 petition is not for lack of acknowledgement of a problem with China's currency practices. Rather, the Administration does not favor pursuing a WTO dispute and prefers bilateral negotiations with China. Moreover, China is under increasing international pressure by the IMF and many of its trading partners to adopt a more flexible exchange rate.

#### *ANALYSIS*

##### **I. Background: China Currency Coalition's Section 301 Petition**

The China Currency Coalition (CCC) is a group of U.S. industrial, service, agricultural and labor organizations, which includes the AFL-CIO as a member and is a subgroup of the Fair Currency Alliance (FCA). On April 28, 2004, the AFL-CIO filed a Section 301 petition to seek trade remedies, including retaliatory tariffs, in response to China's unfair labor practices. USTR rejected this petition. During this time, the FCA considered filing a 301 petition on China's unfair currency practice, which the USTR responded that it too would be rejected. USTR later rejected the CCC Section 301 petition filed on September 9, 2004, and on the same day.

The CCC petition seeks to remedy China's alleged violation of trading obligations under the WTO through policies that undervalue its currency, the yuan. China's currency is estimated to be undervalued by 40 percent and has been pegged to the U.S. dollar since 1994. China is the only major trading country employing a conventional fixed-peg currency system. With China's growing export volume, a fixed-peg currency is perceived to create an imbalance in supply and demand with the U.S. China's government has not intervened to make its currency flexible and alleviate this imbalance.

## **II. Allegations of China's Violation of WTO and IMF Obligations**

### **A. WTO Allegations**

The CCC alleges that China's fixed currency policy discriminates against U.S. exports of goods and services by constituting a prohibited export subsidy. In particular, China's practices violate national treatment principles and Articles 1, 2 and 3 of the WTO Agreement on Subsidies and Countervailing Measures (ASCM).

For example, Article 1 of the ASCM holds that subsidies exist when governments confer a benefit to domestic companies, including:

- Providing financial cash contributions;
- Putting in place practices that involve a direct transfer of funds to domestic companies; or
- Providing income or price support.

The petition argues that by undervaluing the yuan, the Chinese government provides a direct transfer of funds to Chinese companies. For instance, when Chinese companies export products to the U.S. and receive dollars in return, these companies are required to exchange those dollars for yuan. Because China keeps the value of the yuan low relative to the dollar, the government may be providing a subsidy since companies are able to receive more yuan than they normally would under market conditions.

### **B. IMF Allegations**

China's currency policy may also violate Articles IV and VIII of the IMF Articles of Agreement. IMF Article IV, Section 1, Part iii states that each member shall, "avoid manipulating exchange rates...in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members." IMF Article VII, Section 3, "Avoidance of Discriminatory Currency Practices" states, "No member shall engage in...any discriminatory currency arrangements...except as authorized under this Agreement or approved by the Fund;" China has been neither authorized nor approved.

The International Monetary Fund (IMF) is pushing for China to move immediately toward a flexible exchange rate to help China's central bank better manage the effects of inflation. It stated that a flexible rate would, "improve the effectiveness of monetary policy in containing domestic demand and prices pressures, and enhance the economy's ability to adjust to shocks." The IMF urged that a flexible yuan would also enable China to capitalize on a strong economy and limit adverse effects on growth and employment.

### **III. USTR Rejection of the 301 Petition and Initial Reactions**

USTR's immediate rejection of the Section 301 petition came as a surprise to some, and provoked strong reactions from the CCC, other interests groups and several Members of Congress. These groups believe USTR acted too quickly and did not adequately examine the petition.

#### **A. USTR Rejects Section 301 Petition**

USTR indicated previously on April 28, 2004 that it would reject a Section 301 petition on China's currency practices. USTR and the Treasury Department noted that China was taking steps to liberalize capital flows and move towards a more flexible exchange policy. China, for example, is allowing foreign and domestic banks to offer foreign exchange services, and developing a foreign exchange derivatives market. The Administration also stated that Treasury Secretary Snow has built support among the Group of Seven (G7) finance ministers to encourage China to adopt a flexible exchange policy.

When USTR rejected the CCC petition on September 9, 2004, it argued that accepting the proposed 40 percent tariff remedy would, "...hurt U.S. exports, destroy U.S. jobs and endanger economic recovery... (and) be a retreat into economic isolationism."

#### **B. Congress Responds with Another Section 301 Petition; Proposed Bills**

Some Members of Congress back a tougher stand on China, and were upset at USTR's decision to reject the CCC petition. As a result, on September 30, 2004, the Congressional China Currency Action Coalition (CCCAC) filed a Section 301 petition to eliminate the undervaluing of the yuan. If China does not meet this request, the Coalition requests that USTR forgo the 45-day petition review period and immediately eliminate China's undervaluation. If China does not accept this agreement, the Coalition urges USTR to file a formal dispute settlement case at the WTO (as opposed to the CCC petition's proposed remedy of a 40 percent tariff).

The CCCAC claims the USTR rejection of the CCC petition is without merit. The intent of the latest petition, whose signatories were all Democrats except for Senator Lindsey Graham, would be to make the China currency matter a campaign issue. The Coalition also claims that China engages in currency manipulation in violation of WTO rules, and at the expense of American workers, farmers and businesses.

Among other Congressional initiatives on the China currency issue, Senators Schumer and Graham have sponsored a bill that would require China to reform its currency practices within 180 days or face a 27.5 percent tariff on all of its imported goods. The bill was proposed under GATT Article XXI to protect security interests and in response to the more than doubling of the U.S. trade deficit with China since 1998.

In related developments, in a September 14, 2004 markup of the 2005 Transportation-Treasury spending bill, the full Senate Appropriations Committee approved language that would require the Treasury Department to prepare a report by December 1, 2004 describing steps to examine more closely how the IMF determines whether a country is manipulating exchange rates. The bill would also require Treasury to clarify how the Administration implements current U.S. law that deals with examinations of foreign countries' currency

practices. The proposed bill may be, in part a reaction to the rejection of the CCC 301 petition.

### **C. U.S. Interest Groups Divided on USTR Approach**

U.S. interest groups are divided over USTR's approach to the China currency issue, including those seeking aggressive action on the matter. In response to USTR's rejection of the CCC petition, the AFL-CIO, a CCC member, criticized USTR's decision as hasty, arguing, "The nearly instant rejection of the 200-page petition raises questions as to whether it was even read by administration officials. This is undoubtedly the fastest rejection of such a petition in history." The AFL-CIO also stated that the undervalued yuan creates an unlevelled playing field and costs U.S. jobs.

However, some members of the Fair Currency Alliance (FCA) – a broader group formed to address China currency policy, oppose the petition. For example, the National Association of Manufacturers (NAM) stated that the petition is counterproductive in light of ongoing consultations with China on revaluation of its currency. The American Forest and Paper Association also stated that the timing of the 301 filing is not useful and believes the Administration is on the right track in addressing the issue.

### **III. China's Reaction to Pressure Towards its Currency Policy**

On September 28, 2004, in a meeting with CitiGroup CEO Charles Prince and former Treasury Secretary Robert Rubin, Premier Wen Jiabao stated that China would advance its currency reform in order to adapt better to the changes in market supply and demand. Mr. Wen also claimed that China has been following a managed, floating exchange rate system.

Mr. Wen pointed out that currency reform requires systemic changes, and should take the following factors into account:

- Macro economic performance;
- Social development;
- International income and expenditure;
- Progress of its banking sector reform; and
- Regional and global economic and financial situations.

Mr. Wen emphasized that China seeks to improve and maintain the stability of the yuan. However, he did not outline any specific steps or schedule to institute a flexible exchange policy.

At the recent G-7 Finance Minister meeting (where China participated for the first time), Chinese officials stated that the country is moving toward a more flexible currency, but Beijing would set the pace of reform. At the G7 meeting, Secretary Snow did not indicate whether Chinese officials were any closer to announcing a more flexible currency regime. Mr. Snow stated that, "Sustained non-inflationary growth in China is important for maintaining global growth and a market-based and flexible yuan is an important part of

achieving this goal.” He also stressed that China needs to move more quickly in this direction.

### ***OUTLOOK***

USTR’s rejection of the CCC 301 petition came as no great surprise, considering USTR’s negative reaction to the idea of a 301 petition in April 2004. Although USTR realizes the difficulties associated with a growing trade deficit with China, it prefers not to escalate trade frictions by imposing punitive duties, which might also violate WTO rules. Rather, USTR prefers bilateral, multilateral and other diplomatic channels to WTO dispute proceedings to pressure China on the currency matter.

The same fate appears imminent for the Congressional petition filed last week by the CCCAC. Treasury Secretary Snow, after the recent G-7 meeting indicated that the CCCAC petition is still pending, but its rejection appears likely. He mentioned that the subject was, “...well laid out and well articulated in connection with the prior matter,” referring to the CCC 301 petition. He also stated that, “Unless something has changed that I’m not privy to, I would expect a similar response” (from USTR).

Overall, many in U.S. government and industry recognize that China is taking gradual steps towards moving from a fixed rate currency toward a flexible exchange rate system. China’s adherence to its WTO commitments on financial services and other issues will help in this regard. Nevertheless, Chinese officials have not offered an implementation plan such as target dates or other specifics towards adoption of a flexible exchange rate.

With U.S. presidential and legislative elections looming in November, little time remains in the current Congressional session. The conflict in Iraq is a top priority, and it appears that the issue of China’s currency policy will not be resolved this year. USTR and the Administration favor negotiations with China rather than formal WTO or legislative actions. Nevertheless, USTR is devoting more attention to the recent petition by the CCCAC (as opposed to the same day rejection of the CCC petition) given the insistence of Members of Congress to the issue.

Due to the multiple Section 301 filings and the broadening U.S. trade deficit with China, the yuan’s fixed peg will no doubt remain a prominent issue for some time ahead. At some stage, USTR and Treasury need to demonstrate progress in their talks with China; otherwise, Congress might force the Administration to take more stringent actions by enacting tougher legislation on the issue.

## **Congress Approves FSC/ETI Repeal; Fate of EU Sanctions Remains Unclear**

### ***SUMMARY***

After months of debate, and retaliatory trade sanctions by the European Union (EU), the US Congress has approved the repeal of the WTO-inconsistent Extraterritorial Income Act (“ETI” or previously referred to as the Foreign Sales Corporation “FSC”). Both the House and Senate adopted their versions of the ETI repeal prior to the August recess. However, delays over the appointment of conferees and disagreement between the House and Senate on who should chair the conference committee delayed work until the end of September.

The final bill, the American Jobs Creation Act of 2004 (Jobs Act) (HR 4520), replaces ETI with tax deductions for domestic manufacturing and reforms a number of international tax provisions aimed at making U.S. firms more competitive. The Act also included narrow tax breaks and other programs unrelated to the repeal of ETI, including a tobacco buyout scheme. Squabbles in the conference committee over these issues prompted a fierce debate in the Senate, which met over the weekend to consider the final bill.

Despite the repeal of ETI, the EU might maintain, or expand its trade sanctions against the US for up to two more years. The EU has cited that the bill provides a transition for the ETI, rather than an immediate phase-out. The sanctions have also become embroiled in a dispute between the EU and US over subsidies for the development of large civilian aircraft. The EU claims that Boeing, a major beneficiary under ETI, will continue to benefit from certain special tax breaks provided for in the Jobs Act.

### *ANALYSIS*

We review here the core provisions of the Jobs Act. We also discuss the recent fallout over the EU/US dispute regarding large civilian aircraft.

#### **I. Jobs Act Provides Tax Cuts and Incentives for Domestic Production**

The Jobs Act will phase out the ETI in stages over the next two years.

- For transactions prior to 2005, ETI beneficiaries will keep all of their tax benefits.
- In 2005, taxpayers will retain 80 percent of their ETI benefit.
- In 2006, the benefit will drop to 60 percent, after which it will be fully repealed.

The ETI benefit will, however, generally remain in effect for transactions made in pursuit of a binding contract between the taxpayer and an unrelated entity if the contract was in effect on September 17, 2003 and continually remains in effect.

To offset the loss of the ETI tax benefit, the legislation creates a deduction for income attributable to certain domestic production activities for C corporations and pass-through entities, such as S corporations and partnerships. The deduction is phased in over several years. For taxable years beginning in 2005 and 2006, the deduction is 3 percent of qualified income. For taxable years beginning 2007-2009, the deduction is 6 percent. After taxable year 2009, the deduction is 9 percent, which translates into an effective 3 percentage-point reduction in the corporate tax rate. At all times, the deduction is limited to 50 percent of wages paid by the taxpayer during the calendar year that ends in such taxable year.

Income that qualifies for the deduction includes income from property that is manufactured, produced, grown or extracted in the United States. The bill includes filmmaking and the production, but not transmission of electricity. Likewise, the extraction and refinement of gas and potable water is included. The transmission of these products, post refinement, is not included. Food processing qualifies but not food preparation at the retail

level. Construction, engineering and architectural services conducted in the United States also qualify.

The Treasury Department is charged with writing much of the technical details about the application of the deduction.

## **II. EU Reacts Cautiously to ETI Repeal; Links Sanctions to Airbus/Boeing Dispute**

Despite the hopes of several members of Congress, it appears the repeal of ETI will not lead to a quick end to EU sanctions. Immediately following the passage of the Jobs Act by the Senate, EU Trade Commissioner Pascal Lamy expressed satisfaction, saying that the “EU’s patient but firm approach [had been vindicated].” Lamy also stated that the EU would closely examine the Jobs Act, particularly the transition period. In January 2004, Lamy indicated that the EU would maintain sanctions if the Jobs Act established a long transitional period.

The recent U.S. request for consultations with the European Union filed at the WTO regarding subsidies in the civilian aircraft sector has further complicated the possible termination of the EU sanctions. The EU sanctions arising from the ETI, however, must be directed towards the WTO-inconsistency of that measure – and not towards its alleged claims against Boeing in the separate dispute. In reaction to the U.S. dispute against Airbus, the EU immediately filed a case against alleged Boeing subsidies. The EU claims that Boeing is one of the biggest beneficiaries under ETI, and that the grandfathering provisions will allow Boeing to continue enjoying illegal subsidies under the Jobs Act.

EU officials have suggested that election year politics in Washington State motivated the US Trade Representative (USTR) to file the complaint against Airbus. However, concern over the EU’s subsidization of Airbus has been a growing concern in the US Congress, particularly the Senate. Prior to the August recess, several Senators took to floor and urged USTR to seek redress at the WTO.

### ***OUTLOOK***

The Jobs Act succeeds in repealing the WTO-inconsistent export subsidies provided by the ETI, but appears to raise new concerns. Among these concerns, the EU’s termination of sanctions is not certain due to the two-year transition period for the tax credits provided under the ETI. The EU has argued that ETI benefits should end immediately; otherwise, it might not lift the sanctions. The EU has the right under the WTO to impose sanctions commensurate to the damages resulting from WTO-inconsistent measures. Thus, the EU could continue to sanctions over the next two years, so long as the sanctions are equal to or lesser than the gradually declining benefits under the ETI. Sanctions against the US have been growing by 1 percent per month and will reach their 17 percent maximum in March 2005.

Moreover, in light of the recent Boeing-Airbus disputes, the EU also has expressed concern about the benefits to Boeing under the Jobs Act, and other alleged subsidies. The EU’s initial retaliation list for the ETI did not target Boeing out of respect for the 1992 Agreement on Large Civil Aircraft. However, in its request for consultations regarding Boeing, the EU indicated it reserves the right to modify the retaliation list.

The US-EU disputes over the ETI and Airbus/Boeing are taking on a more political dimension. The EU has the right to continue retaliation over the ETI, but might suspend retaliation if the two parties are able to resolve trans-Atlantic concerns like the Airbus/Boeing dispute. Nevertheless, the Airbus/Boeing dispute and the transition period for the ETI in the Jobs Act could persuade the EU to maintain, and possibly expand sanctions over the next two years. In any event, the long-standing dispute over the FSC/ETI is unlikely to be resolved in the imminent future.

## CATO Trade Event Provides Outlook on the U.S. Economy, Outsourcing and Trade and the Elections

### SUMMARY

On October 6, 2004, the Cato Institute and *The Economist* hosted a conference on international trade and the future of the American workforce. Speakers at the event included Roger Ferguson, Vice Chairman of the Federal Reserve Board; Gregory Mankiw, Chairman of the President's Council of Economic Advisers; Senator Chuck Hagel (R-Neb.); academics and journalists. The conference covered such issues as the economy and jobs, the next wave of job creation, outsourcing and insourcing, and trade and the 2004 elections.

### ANALYSIS

On October 6, 2004, the Cato Institute and *The Economist* held a daylong conference, "Trade and the Future of the American Worker." Roger Ferguson, Vice Chairman of the Federal Reserve Board made the keynote address, in which he discussed the broader implications of free trade on the American society. Senator Chuck Hagel (R-Neb.) was the lunch speaker and discussed the important role of the United States in shaping the global economy. The conference also included panel discussions on the economy and jobs, the next wave of job creation, outsourcing and insourcing, and trade and the 2004 elections.

#### I. Introductory Remarks on "Free Trade: What do Economists Really Know?"

Mr. Roger Ferguson, Vice Chairman of the Federal Reserve Board began by stating that while there is almost a complete consensus among economists on the overwhelming benefits of free trade, the public at large has been much more ambivalent. Attitudes toward free trade in principle remain generally positive, but a substantial – and, perhaps, growing – minority of Americans hold more negative views. According to a poll completed around the beginning of this year, 41 percent of respondents viewed the process of increasing international trade through reduction of barriers as proceeding too quickly; this number was up from 30 percent in 1999. Moreover, 43 percent of respondents believed that the government should try to slow or reverse the expansion of international trade, up from 39 percent in 1999.

According to Ferguson, several factors may have led to the apparent deterioration in public support for free trade over the past five years. First, the widening of the U.S. trade deficit may have exacerbated concerns about the country's international competitiveness. And more importantly, some Americans have blamed overseas competition for the job losses associated with the economic slowdown earlier in this decade. But whatever the reason, this deterioration, Ferguson believes, is quite serious. Without solid public support for free trade, achieving continued progress in reducing protectionist barriers, both at home and abroad, could become more difficult.

Ferguson then reviewed the arguments for and against free trade. In support of trade, he noted that trade increases the variety of goods available to consumers; it reduces the cost of goods and hence raises our standard of living. Trade also increases domestic productivity by both allowing economies to specialize in the activities they do best and creating heightened competition. On the other hand, Ferguson noted that some worry that trade has

led to significant unemployment and deterioration in the quality of jobs. Competition arising from free trade has given rise to large trade and current account deficits, thereby adding to the nation's debt and putting future prosperity at risk.

Ferguson next explored why it has been difficult to muster more widespread public support for the goal of open markets and addressed some of the consequences of trade protection as it has been implemented in practice. He stated that some of the public's fears might be overstated—for example, the claim that imports lower aggregate employment. But other concerns cannot be dismissed out of hand, especially the claim that trade leads to disruptions for some workers. Balancing the pain for a few against the lasting gains for the economy as a whole, economists generally view the latter as outweighing the former. But, it is admittedly difficult for many Americans to share this assessment given short-term displacement. Rather than arguing the merits of international trade in the abstract, Ferguson suggested that advocates of free trade might gain more traction by arguing against concrete examples of protectionism. For example, he cited the negative impact that protectionism, in particular the US Antidumping and Countervailing duty actions, has on consumers, downstream producers, and US export markets.

Ferguson concluded by stating that a multiplicity of narrow, targeted trade actions – such as antidumping or safeguard actions – could lead to a de facto rollback in the overall degree of free trade even without a concerted shift in national policies. Thus, it is very important to maintain public support for free trade. Critical to this effort is public education and the creation of a political environment supportive of free trade. In this respect, targeted criticisms of protectionist actions may be more effective than general paeans to free trade. Also, Ferguson stated that it is crucial to implement policies that foster stability and economic growth. Reducing unemployment and diminishing economic insecurity will likely be more effective against protectionism than speeches and policy papers. Toward that end, the Federal Reserve will do its part by working to promote stable financial conditions and sustainable, non-inflationary growth.

## **II. Panel on “The Economy and Jobs: Explaining Recent Developments”**

Speakers for the first panel include: Greg Mankiw, Chairman, President's Council of Economic Advisers; Zanny Minton-Beddoes, Economics Correspondent, The Economist; Erica Groshen, Economist, New York Federal Reserve.

### **A. Gregory Mankiw on Labor, Manufacturing and the Economic Outlook**

Dr. Mankiw's speech focused on three topics: (i) the current labor market; (ii) the manufacturing sector; and (iii) his outlook on the US economy. Regarding recent trends on the labor market, Mankiw focused on “Okun's law,” which states that there is a positive correlation between the unemployment rate and GDP fluctuation. In other words, unemployment goes down when GDP rises above its potential, making the GDP growth rate the key to job recovery. GDP growth, Mankiw stated, is driven by productivity growth, which also drives living standards (through rising real wages). With heightened productivity, however, comes job-losses. Therefore, even more rapid GDP growth is necessary to support the job market. This growth has not taken place, and its absence explains why the labor market has remained down longer in this most recent cycle.

Mankiw next focused on the manufacturing sector, seeking to explain recent and long-term trends in the sector. Regarding the long term, Mankiw stated that the percentage of US employment in manufacturing has been steadily declining for 50 years because of productivity gains. Mankiw then discussed that the recent business cycle has been particularly hard on manufacturing because of the effect of lagging investment and exports on GDP. GDP, Mankiw stated, is made up of four primary components: consumption, housing, investment, and exports. In this most recent business cycle, consumption and housing were atypically strong, and investment and exports were atypically weak. Mankiw then explained that the manufacturing sector is driven by investment and exports, and thus when those aspects of GDP are weak, manufacturing is weak, as well.

Mankiw concluded by providing his outlook on the American economy. He stated that GDP growth is back on track, with 4.8 percent growth last quarter and forecasts of 3-4 percent growth for the next year. This growth has come from renewed investment and increased exports from a rebounding world economy. Also, the domestic unemployment rate is down to 5.4 percent. Finally, Mankiw believes that greatest challenge ahead for the US economy is oil prices and the negative effect that further increases would have on GDP.

**B. Erica Groshen: Has Structural Change Contributed to a Jobless Recovery?**

Ms. Groshen stated that statistical data show the domestic employment rate has recovered at a slower rate than ever before. This fact, she believes, is due to the nature of the layoffs, which occurred during the recession. Groshen explained that there are two types of layoff: the structural change (permanent relocation) and the cyclical change (temporary, reversible layoffs). Structural layoffs cause job recovery to take longer because rehiring requires the establishment of new positions, the hiring of new workers, and job training. On the other hand, temporary layoffs temper the gravity of changes in the employment rate. Thus, less temporary layoffs lead to a less dramatic drop in the unemployment rate. Without them, the change is steadier and more gradual.

Groshen stated that data show that this most recent recession contained a much higher percentage of structural layoffs than in past recessions: 79 percent, as compared with the average of approximately 50 percent. Groshen postulated that the reason for this difference was due to three factors: investment overhangs; effective countercyclical policies; and “lean staffing,” in which employers cut costs permanently.

Groshen concluded by laying out the prospects and challenges for the future. First, as to the question of whether the jobless recovery was due to too many layoffs or too little hiring, statistics indicate that there has been too little hiring. Second, non-financial firms are not investing as they did in past recoveries, and this is slowing job gains. Finally, Groshen stated that the prospects are good: job growth is likely, but it is just slow to start. And the structural changes that were made during this recession, while painful in the short-term, may lead to stronger, steadier long-term growth.

### **C. Zany Minton-Beddoes: Jobless Recovery, Outsourcing and Public Perceptions**

Ms. Minton-Beddoes began by stating that while statistics show that job losses from outsourcing are relatively insignificant (a recent poll of economists showed that 90 percent believed outsourcing was not a problem for the US), the real problem is the fact that the American people perceive outsourcing to be a major factor contributing to the nation's jobless recovery. Such perception could lead to disruptive protectionist policies.

Minton-Beddoes stated that in reality, it is productivity growth, not outsourcing that is causing much of the unemployment lags in the US: productivity grew at 5 percent in 2003, compared to the historical average of about 1 percent. The real question, Minton-Beddoes believes, is whether such growth is sustainable. Her answer was "yes and no." Not all of the changes that caused the productivity growth rate to rise have finished, but the statistics indicate that growth is tapering off. Because of this fact, Minton-Beddoes believes that cost-cutting by employers must account for some of the current unemployment issues.

Minton-Beddoes also asserted that companies are nervous about hiring, and this nervousness is a factor in the jobless recovery. Such apprehension, she believes stems from several factors. First, firms are uncertain because economic conditions are uncertain on issues like Iraq and oil prices. Second, firms are wary of the recovery and fear another recession. Third, rising healthcare costs have affected hiring practices. And fourth, the nature of the President's economic stimulus wasn't as "job-friendly" as it could have been. The administration opted for income tax cuts, rather than cutting the payroll tax.

### **III. Panel on "What Will the Next Wave of Job Creation Look Like?"**

Speakers for the second panel include: Mike Horrigan, U.S. Bureau of Labor Statistics, Office of Occupational Statistics and Employment Projections; Daniel Pink, Author, *Free Agent Nation*; and David Wessel, Author and reporter, *Wall Street Journal*.

#### **A. Mike Horrigan: Projecting the Future Labor Market**

Mr. Horrigan stated that the next wave of job creation will reflect the dynamism of the American economy. Over the next ten years, the Bureau of Labor Statistics (BLS) expects the labor market to grow by 1.1 percent. Over the next 50 years, however, the retirement of the baby boom generation will cause the labor market to grow by only .6 percent creating the specter of labor shortages. Horrigan, however, believes that such shortages are very unlikely to occur because of two factors: (1) the ability of domestic firms to adapt through policies like overtime, subcontracting, training, productive technologies, and foreign and domestic outsourcing; and (2) productivity growth, which suggests that the demand for employment will grow more slowly.

Horrigan continued by describing the job of the BLS – to make occupational projections. These projections, he stated are difficult because without the ability to survey each job vacancy by position, the BLS must project and model the market's demand for skills. Horrigan then reviewed some of the BLS's projections, stating that by the end of the projection period, 61 percent of US jobs will require some college training (27 percent some college; 34 percent college degree or higher). He concluded by stating that these statistics underscore the need for an educated workforce.

## **B. David Wessel: Advice to an 18 year-old About the Future**

Mr. Wessel asked the audience to imagine giving advice to an 18 year-old community college student about what he should expect from the future US job market. First, Wessel counseled that one should beware the experts who make predictions, because they are almost always wrong. The typical economist mantra that “the economy’s going to be just fine, but we have no idea what lies ahead” is not a viable answer to an 18 year-old looking for advice.

Wessel stated that he believes the correct advice to such an individual is that the US economy will never run out of jobs due to productivity gains or outsourcing. The jobs that remain, however, will only be in two main categories: (1) those that require physical touch and thus cannot be physically accomplished from abroad, and (2) those that require skills, creativity, and knowledge unique to the US economy and thus can’t be outsourced.

Wessel concluded by stating that while the US job market will remain intact, government action is necessary to assist those individuals who are trapped between categories one and two—forced to accept lower wage physical labor because they cannot rise to the second category. Wessel believe that the key to the future is education, but that is neither easy nor instant, and thus some government assistance will be necessary to help those left behind. Furthermore, teachers must teach children to “learn how to learn,” so that they will be able to adapt to whatever jobs are created in the dynamic American market.

## **C. Daniel Pink: The Jobs of Tomorrow**

Mr. Pink stated that in the future of the US job market, professional education would be a necessary, but not sufficient factor in the success of the American worker. In Pink’s opinion, there are three forces shaping tomorrow: Asia, Automation, and Abundance. Outsourcing in Asia, while overhyped in the short-term, will be a major factor in shaping the US job market in the next 50 years. By 2010, India will be the largest English-speaking country in the world and will provide a seemingly endless supply of cheap labor that speaks perfect English. With the creation of technologies like medical diagnosis software and income tax software, automation has already replaced doctors’, lawyers’, and accountants’ caused routine professional services, and this trend will doubtless continue in the future. Thus, specialization is necessary. Finally, American wealth and abundance has shaped the job market, creating services like self-storage, health clubs, and coffee-houses that are unique to a wealthy society, and as our country becomes richer, new services will arise to meet the new demands of the “super rich.”

Pink stated that he believes the new central figures in the US economy will not be doctors, lawyers, and accountants, but rather artists and counselors—jobs that are “high touch” or “high concept.” Those jobs rely on a person’s “humanness” and will be the most important to the society. Current high-paying professional services, on the other hand, will no longer be at a premium – replaced by foreign labor or automation.

## **IV. Panel on “Outsourcing and Insourcing: New Threat or New Opportunity?”**

Speakers for the third panel include: Martin Baily of the Institute for International Economics; Harris Miller, President, Information Technology Association of America; and Brink Lindsey, Vice President for Research, Cato Institute.

**A. Dr. Martin Baily: Outsourcing Statistics Indicate Overall Benefits**

Dr. Baily began by discussing the impact of U.S. outsourcing to India. He noted that in India, U.S. outsourcing is currently a \$7-8 billion industry; it has improved Indian productivity, and given rise to higher wages. Much of U.S. outsourcing work to India is back-end office processing. Moreover, other jobs including in software development, computer aided design and pharmaceutical research are growing. For every dollar that the U.S. outsources to India, 33 cents stays in India. As a result, other effects include the evolution of the banking industry and better capital utilization.

Dr. Baily remarked that India is acquiring the skills to disaggregate the value chain with outsourcing tasks. However, outsourcing is not the savior of its economy since India still has a large number of unskilled workers. For India and other nations to reap benefits from outsourcing, they should avoid over regulating the industry and allow them to grow. Stronger economic growth in India and elsewhere should also benefit the US, including U.S. exports and services.

In an outsourcing study he worked on with the McKinsey Institute, Dr. Bailey estimates that for every outsourced U.S. company dollar, the company receives \$1.12 in returned value. For every outsourced U.S. job, 69 percent of those workers were re-employed within one year. Moreover, most of those works receive, on average, the same wage level. In the long run, re-employment of U.S. workers is 100 percent, although the 31 percent short-term gap of displaced workers needs to be remedied. Moreover, the U.S. re-employment rate of displaced workers from outsourcing is twice that of other OECD countries.

Dr. Baily cited that out of the 2.85 million manufacturing jobs lost during 1999-2003, about 314,000, or 11 percent of those lost jobs were attributed to international trade factors. This was due to the decline in demand for U.S. manufactured products (which also were costlier due to the strong U.S. dollar). He also asserted that manufacturing job loss would have been worse without international trade. When questioned about what conditions the US needs to benefit from outsourcing, Dr. Baily remarked that flexibility and competitiveness in the U.S. economy allows it to benefit from trade and global growth. He acknowledged, however, that there are costs along the way as trade alters the types of economic activities performed.

**B. Harris Miller: Global Sourcing Should Lead to Growth Abroad and in US**

Mr. Miller described the 2004 Information Technology Association of America (ITAA) IT workforce study and indicated that spending on global sourcing is expected to grow by \$27billion annually. India remains the largest recipient of outsourcing. As for the effects on the U.S. economy, in 2003, the study estimates the US created 90,000 new IT jobs due to global sourcing. In 2008, this figure is projected to grow to 300,000. The real wages of IT workers grew 0.13 percent in 2003; in 2008, this figure is projected to grow to 0.44 percent.

Mr. Miller also cited that of the 516,000 new jobs created due to outsourcing, 244,000 of those jobs were in the US. For IT job creation in U.S. companies, 79 to 82 percent of

those jobs are being created in non-IT companies. Non-IT companies are growing faster in their IT departments.

Mr. Miller concluded that U.S. companies own a 50 percent share of the global software services market. Restricting outsourcing is the wrong policy since it would invite retaliation. He cited, for example, that China issued a restrictive software policy because the US was being protectionist against Chinese software products with its current policies. He also suggested that the biggest threat to the IT industry and information technology in general is cyber-security.

### **C. Brink Lindsey: Outsourcing Minor in Perspective**

Mr. Lindsey began by putting the U.S. job cycle into perspective, and cited that 18 million net jobs were gained from 1993 to 2002. This figure is substantial considering that U.S. companies layoff 15 million people annually, even in good economic times. Contours of the business cycle look different today than in the past. Recessions are shallower, and because of this, growth periods do not appear to be as positive.

Mr. Lindsey noted that outsourcing is a red herring as far as layoffs are concerned, and outsourcing only constitutes 2.5 percent of all layoffs. Automation of jobs puts more people out of work than outsourcing. In the US, the technology-related job churn is treated differently than outsourcing. Rules-based jobs that can be put on paper are targeted for outsourcing and automation. More complex face-to-face jobs are the ones being maintained in the U.S. economy. In contrast, EU job eliminations are treated the same, and the EU also responds with strict regulations. Moreover, the EU is facing higher unemployment rates of 10 percent or more.

## **V. Panel on “Trade and the 2004 Elections”**

Speakers for the fourth panel include: Sebastian Mallaby, Columnist, The Washington Post; and Clive Crook, Deputy Editor, The Economist.

### **A. Sebastian Mallaby: Trade Not Central to Election**

Mr. Mallaby began by suggesting that international trade is far less important an issue in the presidential campaign, compared with the conflict in Iraq and terrorism. Nevertheless, trade issues have some implications including:

1. Outsourcing – the debate on the issue, however, is not very sophisticated; and
2. Enforcing trade laws – there has been no lack of enforcement in the past.

Mr. Mallaby wondered why trade is not central to the campaign. Although Kerry’s campaign rhetoric is anti-trade while Bush is pro-trade; neither position should be fully believed.

Mr. Mallaby commented on Senator Kerry’s Senate record and pointed out that Kerry voted in favor of trade deals. However, Kerry does not support CAFTA in its current form due to its treatment of labor provisions. Rather, Kerry wants Central American countries involved in CAFTA to adopt International Labor Organization (ILO) standards, which are

higher than their current labor standards. Kerry's record versus his stated position may be a case of 'electionitis.' Mallaby also lamented that Democrats supporting free trade are becoming harder to find in Congress, especially in the House of Representatives.

Mr. Mallaby noted that Bush in his 2000 presidential campaign was pro-trade, but has since wobbled considerably on the issue. Mallaby remarked that Bush caved in to steel protectionism in 2002, but supported Trade Promotion Authority and launched the Doha negotiations. Nevertheless, Bush might support imposing safeguards on textile products after global quotas are lifted at the end of this year.

According to Mr. Mallaby, Senator Kerry's camp is saying that if elected, Kerry intends to return to his pro-trade approaches. Mallaby was rather skeptical and suggested that Kerry may not have enough "fire in his belly" to advance the agenda on FTAs and Doha, especially since he proposes to initiate a 3-month review of all trade agreements.

Mr. Mallaby remarked that for the Bush Administration after 9/11, Ambassador Zoellick shrewdly pushed for Doha, much more quickly than the White House. He also suggested that more good things on free trade have come out of USTR in general than the White House.

## **B. Clive Crook: Current Candidates More Protectionist than their Predecessors**

Mr. Crook commented on the slow U.S. economic recovery and how anxiety is growing from outsourcing and corporate taxes. He indicated that the US has a higher corporate tax rate than most other developed countries and should be lowered. He also believes that Senator Kerry's plan to raise corporate taxes on foreign subsidiaries of U.S. companies would encourage divestment of those overseas companies. Moreover, the Bush Administration has had a poor record on certain trade issues, including the steel tariffs – which lost more jobs than were saved. Still, he remarked that Ambassador Zoellick has done extremely well.

Mr. Crook inquired why free trade is not touted during this campaign season. The benefits of free trade are diffuse but losses are concentrated. He believes that the key challenge is for politicians and the media to spell out wins and losses resulting from trade restrictions. For example, it is easier to issue a sound bite when a factory closes versus explaining a self-induced loss of competitiveness. Moreover, the inequity of protection favors the few at the expense of the many.

Regarding trade policy and its effects on jobs and outsourcing, he indicated that the EU does not have an explicit anti-trade policy stance. In the US, however, some officials like Kerry have come out with specific positions discouraging outsourcing.

Mr. Crook remarked that President Clinton was much better in his approach than Kerry toward free trade. For instance, when Clinton made up his mind about NAFTA, he advocated for its passage and promoted the benefits of globalization. Kerry, on the other hand, has a more pessimistic mindset towards globalization that is indicative of a zero sum mentality. Mr. Crook concluded that the US is fortunate that neither Bush nor Kerry is more protectionist than they already are.

### **C. Dan Griswold: Trade Not a Major Political Issue**

Mr. Griswold opened that President Bush is generally positive toward trade in its support for Trade Promotion Authority, Free Trade Agreements (FTAs) and launching the Doha Round. President Clinton, however, could not launch the Round after the Seattle Ministerial in 1999. However, the Bush administration's imposition of steel tariffs, the farm bill and potential support for textile safeguards shows that Bush bends to political pressures. Clinton did not.

Mr. Griswold noted that Senator Kerry has voted on the right side of trade issues during his 20 years in the Senate, such as opening travel to North Korea and opposition to sugar quotas. In the midst of campaign rhetoric, President Bush has found his free trade voice again, except perhaps on China. However, Bush's voice is very conventional. Kerry's rhetoric, however, goes against his trade record. Kerry also insists on a three-month review period of trade agreements and stronger labor and environmental standards in FTAs with poorer nations. Griswold believes that if Kerry wins the election, it will be close. As a result, he would be under pressure to cater to labor and environmental interests. Likewise, CAFTA may be a casualty and the Doha Round could move more slowly.

Mr. Griswold also addressed why trade is not an issue at the polls even though two-thirds of the public is skeptical of free trade. However, the vast majority of people do not care about positions on trade compared to other issues when voting. Voters want presidential candidates to rise above special interests and see the big picture.

### **D. Question on Bilateral and Regional Trade Agreements vs WTO rules**

The panel responded to a question on whether bilateral and regional trade agreements are harmful in promoting trade liberalization versus the multilateral approach in the WTO. Mr. Crook responded that the bilateral/regional approach could support multilateral liberalization. While USTR is making progress on both fronts, U.S. bilateral and regional trade agreements are being negotiated successfully with smaller trading partners. Mr. Griswold remarked that negotiations with smaller trading partners like CAFTA countries would help prepare their economies for liberalization commitments in the Doha Round.

Mr. Crook cautioned, however, that bilateral and regional agreements could cause more trade distortions. Mr. Mallaby added that constituencies of bilateral FTAs expect a template to be applied toward future FTAs as in the case with the US-Jordan FTA. Jordan's acceptance of labor provisions and Senator Kerry's expectations of labor concessions in trade agreements could impede efforts on trade liberalization.

## ***OUTLOOK***

The CATO conference provided a useful outlook on general economic trends and their political implications during an election year. It appears that anxiety among the American public over free trade is growing due to the slow economic recovery. Moreover, free trade and productivity gains have created significant job displacement, especially in the manufacturing sector. Speakers urged the next Administration to put greater effort at not only explaining the benefits of free trade, but also addressing the criticisms of open trade policies.

Some speakers commented on the stigma over outsourcing, and asserted that public perceptions are far worse than reality. For some industries like the hi-tech sector, there is a common view that outsourcing is beneficial in the long-term to American jobs and consumer welfare, and necessary for companies to stay competitive. Still, outsourcing concerns many Americans as it affects not only lower-skilled jobs, but also skilled jobs in computer-related, medical and other professional services.

Overall, senior officials and notable academics believe U.S. economic recovery is on track. Nevertheless, they caution that declining support for free trade, structural concerns like rising health care costs, and other barriers could impede the economic recovery. Moreover, U.S. businesses are also concerned about uncertain factors like rising oil prices, global security, among other issues.

## **US Highlights**

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### **GAO Publishes Assessment of U.S. Monitoring of China's WTO Compliance**

On October 6, 2004, the Government Accountability Office (GAO) released a report assessing China's compliance with its World Trade Organization (WTO) obligations, and US efforts to monitor and press for compliance by China. The report, requested by the House Ways and Means and Senate Finance Committees, notes that while China has made significant progress in implementing its WTO commitments, a number of serious problems remain. The GAO, for example, credits China for its early efforts in resolving simple trade disputes. However, the GAO cites over 100 instances of China's failure to implement its WTO commitments -- often arising from complex disputes that defy easy resolution. The study also noted the significant results achieved at the Joint Committee on Commerce and Trade (JCCT) meeting in April 2004.

The US has favored a bilateral dispute resolution approach, according to the study from 2002 to 2003, the number of high-level bilateral consultations between China and the US nearly doubled. Additionally, the US has submitted fewer questions to China through the WTO's Transitional Review Mechanism (TRM), the annual Geneva-based review of China's WTO compliance.

The GAO study also cited internal US government obstacles to monitoring China's WTO compliance. The report found that high staff turnover at agencies such as the United States Trade Representative (USTR) and the Department of Commerce, coupled with a lack of effective training diminished the ability of the US to monitor China's compliance with WTO commitments. These problems persist despite an increase in resources allotted for monitoring and enforcement.

The GAO report can be viewed at: <http://www.gao.gov/new.items/d0553.pdf>

### **USTR Requests Comments Regarding Expansion Of Market Access Opportunities In Government Procurement**

On October 7, 2004, USTR published a notice in the Federal Register (69 FR 60219), requesting written comments regarding the expansion of market access opportunities in government procurement under the WTO Government Procurement Agreement (GPA). The GPA is a plurilateral agreement that currently applies to 38 WTO Members, and includes (i) procedures that all the Parties are required to follow when undertaking procurements covered by the GPA, and (ii) market access obligations in the Appendices of the Agreement.

The comments will be used to develop US positions in negotiations to increase market access opportunities under the GPA through:

- the greatest possible extension of coverage of government procurement by the Parties, on the basis of reciprocity; and
- the elimination of discriminatory measures and practices that distort open procurement.

The GPA Parties have agreed to launch these bilateral negotiations by the end of November 2004. Public comments are due by November 1, 2004.

## **US Presents Japan With Reform Recommendations To Help Sustain Renewed Growth And Open Market For US Companies**

On October 14, 2004, at a meeting in Washington, DC, Deputy USTR Josette Shiner presented Japanese Prime Minister Junichiro Koizumi with extensive recommendations designed to (i) help sustain Japan's renewed growth and to (ii) open markets for US companies. The US exchanges these recommendations with Japan on an annual basis under the US-Japan Regulatory Reform and Competition Policy Initiative ("Regulatory Reform Initiative"), which was launched by President George Bush and Prime Minister Koizumi in 2001 as a key component of the US-Japan Economic Partnership for Growth.

The recommendations cover the following key areas:

- Information technologies;
- Telecommunications;
- Medical devices and pharmaceuticals;
- Energy;
- Competition policy;
- Transparency and other government practices;
- Commercial law reform;
- Legal system reform;
- Financial services; and
- Distribution.

The recommendations place a special focus on Japan's plans to privatize its postal businesses, which will have important implications for fair competition in the banking, insurance, and express delivery services.

The recommendations submitted by Japan and the US will serve as the basis for an annual report to Bush and Koizumi, outlining recommendations for both countries. US and Japanese working groups will begin meeting this fall to consider this year's reform proposals. These meetings will be followed by a deputies-level meeting in early 2005.

## **Free Trade Agreements**

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### **Congress and USTR Threaten to Exclude Ecuador and Peru from Andean FTA**

#### *SUMMARY*

Citing protracted investor disputes and shaky judicial systems, the US Trade Representative (USTR) and members of Congress have threatened to exclude Ecuador and Peru from the final U.S.-Andean Free Trade Agreement (FTA). The investment disputes, totaling over \$300 million according to the U.S. Chamber of Commerce, arise from tax assessments by central government agencies in the Andean nations. At an October hearing before the House International Relations Committee, both Administration and private sector witnesses discussed the obstacles to resolving the disputes, and consequences should Ecuador and Peru fail to resolve the disputes.

Ecuadorian and Peruvian officials have declined to comment publicly on the status of the disputes between US companies and their governments, stating that they are before the relevant domestic courts or international arbitral tribunals. Ecuador's Attorney General has suggested that Ecuador might abrogate its bilateral investment treaty (BIT) commitments with the United States, an idea criticized by U.S. officials.

#### *ANALYSIS*

Investment disputes between US companies and Ecuador and Peru have prompted sharp reactions by the U.S. Administration and members of Congress. We review here the developments related to the threat to exclude Ecuador and Peru from the U.S.-Andean FTA.

#### **I. USTR Vows to Press Ahead With Colombia Negotiations if Disputes Not Settled**

On May 3, 2004, USTR Robert Zoellick announced that the U.S.-Andean FTA would be expanded after receiving sufficient assurances from Ecuador and Peru on resolving outstanding investment disputes. The resolution of these disputes was viewed as an important step in creating the climate necessary to achieving and implementing an FTA. Since the announcement on the expansion of the Andean FTA, USTR has become increasingly concerned at the lack of progress in resolving the disputes. Furthermore, the apparent unwillingness Ecuador and Peru to respect the decisions of its own courts and foreign tribunals has prompted serious concern within USTR. On September 29, 2004, Deputy USTR Peter Allgeier stated that the US would not allow investment disputes to endanger completion of an FTA with Colombia.

In testimony before a hearing on the disputes before the House International Relations Subcommittee on the Western Hemisphere, Deputy Assistant USTR Regina Vargo noted that similar disputes with Colombia have been resolved, while the progress promised by Ecuador and Peru has not been forthcoming. Vargo stated that the US would be willing to move ahead with completion and approval of the U.S.-Colombia FTA if the disputes with Ecuador and Peru were not on the path to resolution.

Allgeier and Vargo's remarks come after comments made by the Ecuadorian Attorney General suggesting that Ecuador abrogate its bilateral investment treaty with the US after an

international arbitral panel found in favor Occidental Petroleum in its dispute with the Ecuadorian tax authorities. The dispute with Occidental arises from the imposition by Ecuador's national tax authority of additional taxes on the company, alleging that Occidental had failed to disclose the fair market value of commodities it was exploiting. The arbitral panel found no duplicity on the part of Occidental and has ordered the Ecuadorian government to return \$75 million.

## **II. Congress Expresses Frustration with Ecuador and Peru**

Members of Congress reinforced the terse message by USTR at an October 6, 2004 hearing before the House Committee on International Relations' Subcommittee on the Western Hemisphere. In opening remarks during the hearing, Subcommittee Chairman Cass Ballenger (R-North Carolina) expressed doubts about Ecuador and Peru's ability to resolve the disputes, and suggested that Congress may need to revisit benefits granted to Ecuador and Peru under the Andean Trade Promotion and Drug Eradication Act (ATPDE). Subcommittee Ranking Member Bob Menendez (D-New Jersey) was even harsher during his opening statement, suggesting that their exists within Ecuador and Peru and lack of respect for the rule of law, and that such a condition should disqualify either country from an FTA with the United States.

Despite the tough message, Administration officials appearing before the hearing adopted a more conciliatory tone, noting how Peru has made progress to limit the ability of its national tax authority to undertake arbitrary action in terms of the pursuit of legal action against foreign investors.

Testifying on behalf of the State Department, Assistant Secretary E. Anthony Wayne noted that while Peru has managed to resolve some disputes, Ecuador has made little progress. Wayne also noted the importance of the bilateral investment treaty with Ecuador in both future foreign investment, and in the ongoing FTA negotiations.

### ***OUTLOOK***

The admonitions by Congress and USTR come as the U.S.-Andean FTA moves closer to completion. The parties concluded their fourth-negotiating round in September, and two more rounds are expected prior to the end of the year. USTR hopes to complete the Andean FTA prior to the end of 2004, leaving a narrow window of time for Ecuador and Peru to resolve the investment disputes. At the House hearing, Vargo noted that the US is unlikely to terminate negotiations with Ecuador and Peru. Rather, USTR could chose to forgo submitting to Congress the agreement with Ecuador and Peru included, and instead proceed with Colombia and possibly Bolivia.

The threat of exclusion during or following negotiations is a rarity in U.S. negotiating practice. During the negotiations of the Central American FTA, Costa Rica faced possible exclusion over its failure to make sufficient accommodations with respect to its telecom laws, which were entrenched in its constitution. The investment issues that Ecuador and Peru face are the result of actions taken by executive agencies, instead of constitutional issues. Both governments have declined to comment extensively, noting that the matter is before the domestic courts or international arbitral tribunals. However, even in instances where both

domestic and foreign tribunals have ruled against them, Ecuador and Peru have proven reluctant to settle disputes or honor binding decisions.

## **Deputy USTR Shiner Discusses FTA and WTO Negotiations, Combating Piracy and Other Initiatives**

### ***SUMMARY***

On October 7, 2004, Ambassador Josette Shiner, Deputy of the Office of the United States Trade Representative (USTR) provided an update on the status of various free trade agreement and WTO negotiations, intellectual property protection, US-China relations, among other issues.

Deputy USTR Shiner provided a rather positive outlook on the status of various trade negotiations and increased efforts to address piracy worldwide. FTA and WTO negotiations appear to be moving forward, and new momentum was provided by the "July framework" agreement among WTO Members this summer. Still, difficult issues lie ahead for larger negotiating partners like Thailand and Colombia, including labor and environment concerns.

### ***ANALYSIS***

Ambassador Josette Shiner described ways in which the U.S. is taking a leadership role on trade, labor and environmental issues, including its relations with the developing world. She also commented on the progress of free trade agreements ("FTAs"), alleviating piracy within the supply chain and on other international trade issues.

#### **I. Status of Free Trade Agreements and WTO Negotiations**

Ambassador Shiner touted progress on pending and ratified bilateral FTAs reached under the Bush Administration. For example, the Australia FTA is expected to add immediately an estimated \$2 billion to U.S. trade benefits, eliminating the 5 to 12 percent tariffs upon the first day of its enactment (January 1, 2004).

Shiner also remarked that the Thailand FTA negotiations are still on track with the second round taking place in mid-October. However, negotiations might not conclude by the target date of the end of 2005. The next round of negotiations is scheduled for January 2005.

In regards to Doha Round negotiations, the administration expects progress in the Round before the end of next year. A conclusion of the Round would lead to a significant lowering of trade barriers and could lift 300 million people out of poverty.

Regarding the status of WTO accessions, the U.S. is engaged with many countries. It is committed to finishing Russia's accession, and to resolving outstanding matters involving Saudi Arabia, among others.

Shiner also commended China on its efforts to comply with its extensive WTO commitments. She emphasized that the US and China will continue bilateral efforts to ensure timely implementation of China's WTO obligations.

## II. Increased Efforts to Alleviate Piracy

Ambassador Shiner indicated that up to 60 percent of American products around the world are knockoffs, which threaten the reputation of U.S. companies. To help alleviate the spread of piracy, USTR is promoting:

- **TRIPs enforcement** – Working with trade partners to enforce the WTO Agreement on Trade Related Intellectual Property Rights (TRIPs Agreement). USTR will hold an out-of-cycle meeting to ensure piracy deterrence in China.
- **Infringement rulings** – Individual advocacy by U.S. companies to help secure rulings for themselves, especially with small-to-medium sized enterprises (SMEs).
- **S.T.O.P. program** –USTR has created a public-private partnership known as Strategy Targeting Organized Piracy (S.T.O.P.), an initiative to stop the global trade of pirated goods. As part of this initiative, U.S. companies need to register trademarks in countries where they do business. USTR has a hotline to help these companies. S.T.O.P is also considering U.S. legislative changes to enforce anti-corruption laws.

Among other efforts, USTR will be launching a “no trade in fakes” program, a public-private effort to help train supply chain professionals to notice fakes in their business processes. Since the events of September 11<sup>th</sup>, national security and international trade have become more intertwined, which has contributed towards reducing the influx of faked U.S. goods. Due to enhanced security, USTR is also naming known bad actor companies in its recent Section 301 report.

There is now better risk analysis in place, and information on who is bringing products into the U.S. To enhance supply chain security, the U.S. Department of Justice is working with global trading partners to enact statutes similar to the U.S. Racketeer Influenced and Corrupt Organizations (RICO) Act, which is intended to eliminate the effects of organized crime.

### OUTLOOK

Deputy USTR Shiner provided a rather positive outlook on the status of various trade negotiations and increased efforts to address piracy worldwide. FTA and WTO negotiations appear to be moving forward, and new momentum was provided by the “July framework” agreement among WTO Members this summer. Still, difficult issues lie ahead for larger negotiating partners like Thailand and Colombia, including labor and environment concerns.

Shiner spent much of the discussion focusing on new initiatives to address piracy, including in the supply chain. The enhanced security laws appear useful in this regard as customs officials have stepped up efforts to identify fakes and other pirated goods. Shiner encouraged businesses to become more vigilant, including by becoming more proactive in defending their intellectual property rights abroad.

## **Free Trade Agreements Highlights**

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### **USTR Releases Final Text US-Bahrain FTA**

On September 14, 2004, the United States Trade Representative (USTR) released the final text of the US-Bahrain Free Trade Agreement (FTA). Concluded on May 27, 2004, the FTA will eliminate duties on 100% of the consumer and industrial products and 81% of US agricultural exports.

The FTA is part of a broader goal to establish a Middle East Free Trade Area (MEFTA) by 2013. As announced on May 9, 2003, the Administration envisions a "building blocks" approach of using the FTAs the US already has in place with Israel and Jordan and recently concluded with Morocco-- as anchors to negotiate FTAs with other Middle East countries. At some point before 2013, the US intends to consolidate these FTAs to form the MEFTA

The full text is available at:

[http://www.ustr.gov/Trade\\_Agreements/Bilateral/Bahrain\\_FTA/final\\_texts/Section\\_index.html](http://www.ustr.gov/Trade_Agreements/Bilateral/Bahrain_FTA/final_texts/Section_index.html)

### **US And Afghanistan Sign TIFA**

On September 21, 2004, the United States signed a bilateral Trade and Investment Framework Agreement (TIFA) with Afghanistan. The TIFA creates a Joint Council on Trade and Investment, in which both parties will cooperate to enhance and liberalize trade and investment at the bilateral, regional, and multilateral levels. The Council will consider issues such as intellectual property, nontariff barriers, and labor and environmental standards.

Assistant USTR Ashley Wills and Afghanistan's Minister of Commerce Sayed Mustafa Kazemi signed the agreement. According to Wills, "the TIFA will enhance trade between our two countries and assist Afghanistan as it seeks to grow and diversify its economy".

TIFAs deal primarily with trade facilitation and tackling administrative and regulatory problems that can be obstacles to trade and investment. They are often used as a first step towards the possible negotiation of an FTA.

### **ITC Releases Report on Potential Economywide and Selected Sectoral Effects US-Bahrain FTA**

On October 1, 2004, the International Trade Commission (ITC) released a report entitled "*U.S.-Bahrain Free Trade Agreement: Potential Economywide and Selected Sectoral Effects*" (Investigation No. TA-2104-15, USITC Publication 3726). The report assesses the likely impact of the FTA on the U.S. economy as a whole and on specific industry sectors.

The Trade Act of 2002 requires the ITC to submit to Congress and the President within 90 days of a Free Trade Agreement (FTA) being signed a report on the potential

economic effects of the proposed FTA. USTR Robert Zoellick signed the FTA on September 14, 2004.

The report assessed the impact of the FTA in the areas of market access, trade facilitation, and the regulatory environment, concluding that the agreement would have a minimal impact on U.S. production, employment, or prices, though it is likely to increase exports to and imports from Bahrain.

The full report is available at: <ftp://ftp.usitc.gov/pub/reports/studies/pub3726.pdf>

### **USTR Zoellick Discusses Launch FTA Negotiations With United Arab Emirates And Oman**

On October 7, 2004, Zoellick announced that during the week on October 13-15, 2004, he would visit the United Arab Emirates (UAE) and Oman to prepare for the possible launch of negotiations on an FTA. The agreements would build on the TIFAs that the United States recently concluded with the UAE (on March 15, 2004) and Oman (on July 7, 2004).

The FTAs with the UAE and Oman would also be part of President Bush's initiative to establish a MEFTA by 2013.

## US-EUROPEAN UNION

### US Files WTO Case Against EU Customs Administration Regime; Argentina, Brazil, India and Taiwan Request To Join Consultations

#### *SUMMARY*

On September 21, 2004, the United States Trade Representative (USTR) announced that the United States was filing a World Trade Organization (WTO) case against the European Union regarding the EU customs administration regime. The US charges that the EU's lack of a uniform customs administration and procedures for prompt EU-wide review of national administrative decisions is in violation of WTO rules and constitutes a trade barrier to U.S. exports. Citing their significant trade ties to the EU, Argentina and Brazil on October 11 and India and Taiwan on October 12 requested to join the WTO consultations.

Sources indicates that EU officials think the US's decision to file a case is motivated by election year politics, but US officials have denied this. The US move has also surprised some other WTO Members at a moment when many developing country Members have reluctantly agreed to launch negotiations on trade facilitation as part of the so-called "July package." It is too soon to say how this new development will influence the negotiating process.

If the consultations yield no resolution, the US could initiate dispute settlement procedures and request the establishment of a WTO panel to rule on the case. The complete dispute settlement procedure, including the appeal, lasts about 18 months.

#### *ANALYSIS*

On September 21, 2004, the United States Trade Representative (USTR) announced that the United States was filing a World Trade Organization (WTO) case against the European Union regarding the EU customs regime.<sup>1</sup> Citing their significant trade ties to the EU, Argentina and Brazil on October 11 and India and Taiwan on October 12 requested to join the WTO consultations.

#### **I. Background: U.S. Allegations**

The US charges that although the EU is a customs union, with uniform customs laws and regulations, there is no single EU customs administration. The US asserted that many important aspect of customs administration in the EU are being handled differently by different member State customs authorities, resulting in inconsistencies from State to State. The US argues that this lack of uniformity, coupled with lack of procedures for prompt EU-wide review, can constitute a trade barrier to US exports, particularly for small to mid-size businesses in the agriculture and high-technology sectors.

In particular, the US alleges the following WTO violations:

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<sup>1</sup> WT/DS315/1 and G/L/694, September 24, 2004.

(a) *Non-uniform administration of customs regulations (GATT 1994 Article X:3(a))*

While the Community Customs Code,<sup>2</sup> the Commission Regulation implementing the Code,<sup>3</sup> the Tariff Regulation,<sup>4</sup> the TARIC,<sup>5</sup> and related measures set forth certain rules regarding the classification and valuation of goods for customs purposes, they appear to leave to the discretion of national customs authorities decisions in a number of key areas of customs administration. This has resulted in disparate administration<sup>6</sup> of these customs measures in a number of respects including, but not limited to, the following:

- Differences in the classification and valuation of goods;
- Differences in procedures for the classification and valuation of goods, including the provision of binding classification and valuation information to importers;
- Differences in procedures for the entry and release of goods, including use of automation in some member States but not others, different certificate of origin requirements, different criteria among member States for the physical inspection of goods, different licensing requirements for importation of food products, and different procedures for processing express delivery shipments;
- Differences in procedures for auditing entry statements after goods are released into the stream of commerce in the EU;
- Differences in penalties and differences in procedures regarding the imposition of penalties for violation of customs rules; and
- Differences in record-keeping requirements.

According to the US, the EU is in violation of **GATT 1994 Article X:3(a)** which requires WTO Members to administer “in a uniform, impartial and reasonable manner” the laws, regulations, judicial decisions and administrative rulings of general application pertaining to the classification and valuation of products for customs purposes and to requirements, restrictions or prohibitions on imports.

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<sup>2</sup> Council Regulation (EEC) No 2913/92 of October 12, 1992 establishing the Community Customs Code, including all annexes thereto, as amended.

<sup>3</sup> Commission Regulation (EEC) No 2454/93 of July 2, 1993 laying down provisions for the implementation of Council Regulation (EEC) No 2913/92 of October 12, 1992 establishing the Community Customs Code, including all annexes thereto, as amended.

<sup>4</sup> Council Regulation (EEC) No 2658/87 of July 23, 1987 on the tariff and statistical nomenclature and on the Common Customs Tariff, including all annexes thereto, as amended (the “Tariff Regulation”).

<sup>5</sup> the Integrated Tariff of the European Communities established by virtue of Article 2 of Council Regulation (EEC) No 2658/87 of 23 July 1987 on the tariff and statistical nomenclature and on the Common Customs Tariff, including all annexes thereto, as amended (the “TARIC”).

<sup>6</sup> “Administration” includes administration through all means, including but not limited to laws, regulations, handbooks, manuals, and administrative practices of customs authorities of member States of the EU.

**(b) *Lack of procedures for prompt EU-wide review (GATT 1994 Article X:3(b))***

Articles 243 through 246 of the Community Customs Code expressly provide that EU member States are responsible for the implementation of appeals procedures. Accordingly, appeals procedures vary from Member State to Member State, and the ability to obtain review of a customs decision by a tribunal of the EU does not appear to arise until after an importer or other interested party has pursued review through national administrative and/or judicial tribunals.

For this reason, the US alleges that the EU violates **GATT 1994 Article X:3 (b)** which requires WTO Members to institute judicial, arbitral or administrative tribunals or procedures for the purpose, *inter alia*, of the prompt review and correction of administrative action relating to customs matters.

**II. US Motivations to File the Case**

USTR noted in a press release that the US was filing the case for the following reasons:

- The EU enlargement on May 1, 2004 increased the trade barriers resulting from the lack of a uniform customs administration.
- Pressing the EU to develop a uniform customs administration will help to make progress in the Doha Development Agenda's negotiations on trade facilitation. For example, the EU would be able to commit to more stringent rules, instead of seeking flexible rules that would accommodate its own customs administration problems.
- Although the US has worked with the Commission to address the concerns of U.S. exporters, discussions have failed to produce the necessary systemic reforms.

***OUTLOOK***

Reportedly, EU officials have speculated that this unexpected US action is motivated more by political than economic concerns. The EU cites as reasons the timing and the lack of information from USTR regarding affected importers or the costs incurred by US firms as a result of the alleged barriers. Moreover, the Bush Administration has come under fire from Democrats for failing to initiate more WTO dispute cases. EU Spokeswoman Arancha Gonzalez also noted that the EU deplored the fact that the US had filed the case without exhausting all other options. In particular, the EU thought that the US should have raised the issue first in the EU-US Joint Customs Council.

At the same time, the US move has surprised some other WTO Members at a moment when many developing country Members have reluctantly agreed to launch negotiations on trade facilitation as part of the so-called "July package." One of the developing countries' major fears has been that by accepting new binding rules on customs issues they would expose themselves to WTO dispute settlement procedures. It is too soon to say how this new development will influence the negotiating process, but most WTO Members will certainly follow it closely.

If the consultations yield no resolution to the dispute, the US could initiate dispute settlement procedures and establish a WTO panel to rule on the case. The complete dispute settlement procedure, including the appeal, lasts about 18 months.

## **US Files WTO Case Against EU Regarding Airbus Subsidies; EU Reacts With Case Against US Regarding Boeing Subsidies**

### ***SUMMARY***

On October 6, 2004, the United States filed a World Trade Organization (WTO) dispute settlement case against the European Union alleging that European governments are providing unfair subsidies to Airbus. In an immediate countermove, the EU later the same day filed a WTO dispute settlement case against the US regarding alleged US government subsidies to Boeing. Both parties believe that the subsidies are in violation of the WTO Agreement on Subsidies and Countervailing Measures (ACSM). They also assert the subsidies violate the bilateral 1992 US-EU Agreement on Trade in Large Civil Aircraft.

Both parties have filed request for consultations. If consultations fail to bring a solution within a 60-day period, then either complaining parties may request the Dispute Settlement Body (DSB) to establish a panel that will examine the matter.

### ***ANALYSIS***

#### **I. US Files WTO Case Regarding EU Subsidies To Airbus; Terminates 1992 EU-US Agreement On Large Civil Aircraft**

On October 6, 2004, the United States filed a World Trade Organization (WTO) dispute settlement case against the European Union regarding EU Member States' subsidies to Airbus.<sup>7</sup> The US action follows a longstanding dispute between Boeing and its main competitor Airbus, whereby Boeing claims that the EU subsidies to Airbus are unfair and in violation of the WTO Agreement on Subsidies and Countervailing Measures ("SCM Agreement" or "SCM").

##### **A. US Seeks Re-negotiation of 1992 Bilateral Agreement**

The US alleges that EU subsidies violate a bilateral 1992 EU-US Agreement on Large Civil Aircraft (not incorporated into the WTO). The 1992 Agreement currently regulates aircraft subsidization. In particular, it (i) prohibits support for aircraft production; (ii) limits direct government support for development costs; and (iii) caps indirect government support for aircraft development or production. Under the agreement, the US and the EU also agreed to limit their direct subsidies to 33 percent of the production costs for new models, and their indirect support to 3 percent.

In recent months, the US has been urging the EU to renegotiate the 1992 Agreement, arguing that the subsidies to Airbus under the agreement are no longer justified because while Airbus counted for just 30 percent of the global market in 1992, it has since increased its market share to more than 50 percent, replacing Boeing as the world's largest civil aircraft manufacturer.

The US insists that a new agreement should include the following:

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<sup>7</sup> (WT/DS316/1)

- End all new subsidies to Boeing and Airbus;
- Include the definition of the term “subsidies” that is used in the WTO Agreement on Subsidies and Countervailing Measures (SCM);<sup>8</sup> and
- Include a mutual commitment for Boeing and Airbus to license each other any “government-funded patent” that could be used in the manufacture or sale of large civil aircraft.

On September 30, 2004, United States Trade Representative (USTR) Robert Zoellick met with Pascal Lamy to discuss the issue, but claimed after the meeting that the EU remained unwilling to agree with the US proposal. The US therefore decided to file a WTO case and, consistent with this decision, also terminated the 1992 Agreement.

### **B. US Complains That EU Subsidies Violate Both WTO Agreement and 1992 Agreement**

The US argues that the EU subsidies for Airbus are in violation with both the WTO SCM Agreement and the 1992 Agreement because of the following reasons:

- *Subsidy prohibited under the WTO* – Launch aid and other types of government support<sup>9</sup> to Airbus qualify as a subsidy under the SCM, and such subsidies are (i) “actionable” because they cause adverse effects, (ii) “prohibited” because they are export-contingent, or (iii) both “actionable and prohibited.”
- *Subsidy surpasses amount allowed under 1992 Agreement* – The sum of the launch aid and the loans and infrastructure that the EU provided to Airbus and the new A380 amounted to more than what is allowed under the 1992 Agreement. Also, Airbus plans to requests subsidies for a new model that it plans to release as a competitor to Boeing’s 7E7, the A350.

## **II. EU Files Counter Case Regarding US Indirect Subsidies To Boeing; Rejects US Abrogation of 1992 Agreement**

In an immediate countermove, the EU announced later the same day filed a WTO dispute settlement case against the US regarding alleged US government indirect subsidies to Boeing.<sup>10</sup> The EU argues that Boeing had benefited from “massive” indirect subsidies for the launch of its new 7E7 aircraft through:

- Tax incentives in various state programs such as the Washington State program;

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<sup>8</sup> [http://www.wto.org/english/docs\\_e/legal\\_e/24-scm.pdf](http://www.wto.org/english/docs_e/legal_e/24-scm.pdf)

<sup>9</sup> These include debt forgiveness, grants, equity infusions, and dedicated infrastructure support.

<sup>10</sup> (WT/DS317/1)

- Defense procurement;
- Research and defense (R&D) contracts; and
- Support from Japanese suppliers to Boeing.

The EU responded to the US allegations in saying that it would be agreeable to renegotiating the 1992 Agreement, but only if the agreement includes: (i) greater transparency; and (ii) clear provisions on sub-federal aid provided by third countries and US states and indirect aid, on which they disagreed with the US. The EU asserted that the US had never made a serious attempt to negotiate a new agreement, and that this cannot be done before the fall elections. Thus, the EU implies the dispute was politically motivated. The US, however has denied this allegation, responding that underlying economic factors are the driving issue in raising the dispute.

The EU repeated its arguments in a “*note verbale*”<sup>11</sup> that it sent to USTR on October 8, and wherein it rejected US allegations that it violated the 1992 Agreement as “groundless and unsubstantial.” The EU also insisted that the US’s unilateral termination of the 1992 Agreement was invalid under international law and requested bilateral consultations under the agreement, which the US refused.

### **III. EU Threatens To Link US Aircraft Challenge To ETI/FSC Dispute**

The bilateral dispute could escalate if the EU links the US challenge to aircraft subsidies to the dispute over the US’s Extra-Territorial Income (ETI) Exclusion Act (the successor law applicable to foreign sales corporations or “FSCs”) providing corporate tax breaks to U.S. companies. A WTO panel found in January 2002 that the ETI/FSC was illegal under WTO rules and authorized the EU in August 2003 to impose up to \$4 billion annually in retaliatory tariffs on US imports until the legislation was repealed. The EU is currently imposing a tariff of 12 per cent on a fraction of the allowable amount, and the tariff will reach 17 percent by next March unless the US ends the subsidy.

The US Congress passed legislation repealing the ETI after the US House of Representatives and the US Senate approved it on October 7 and October 11, 2004, respectively. The legislation, however, does not repeal the ETI immediately but provides for a two-year transition period. On September 30, Lamy threatened that the EU may not approve legislation to repeal the FSC with a two-year transition period,<sup>12</sup> and would refuse to lift its retaliatory tariffs until the transition period is over.

The EU has the right to continue retaliation commensurate with the damages created by the ETI. Moreover, it could possibly expand the product retaliation list and target products of interest to Boeing. It is worth noting that Boeing is one of the main beneficiaries of the tax breaks provided by the ETI.

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<sup>11</sup> IP/04/1198

<sup>12</sup> H.R.4520, available at: <http://thomas.loc.gov/cgi-bin/query/C?c108:./temp/~c1087gCDar>

## ***OUTLOOK***

The decision to file a WTO case against the EU was received positively by Boeing and in the US Congress, where several Congressmen, including Representatives George R. Nethercutt (R-Washington) and Sander Levin (D-Michigan), issued a statement expressing their support. It is worth noting however that Levin, who is the Ranking Member in the House Ways and Means Trade Subcommittee, also mentioned that election year politics influenced the Administration's decision to pursue a dispute.

EU officials, including EU Trade Commissioner Designate Peter Mandelson, criticized the US for failing to resolve the issue through bilateral negotiations. Mandelson also stated at an October 4 confirmation hearing before the European Parliament that he was confident of the EU's position and of the chances of success in the counter case against Boeing. EU officials have also recognized that the WTO could rule that both Boeing and Airbus receive illegal subsidies.

Both parties have filed request for consultations. If consultations fail to bring a solution within a 60-day period, then either complaining parties may request the Dispute Settlement Body (DSB) to establish a panel that will examine the matter.

Since the long-standing dispute has major political and economic implications, both parties might seek a settlement rather than pursue the matter through dispute proceedings at the WTO. For instance, they seem amenable to re-negotiation of the 1992 bilateral agreement, which falls outside the scope of the WTO. A new bilateral agreement could allow both sides to continue certain subsidies, but would likely introduce greater disciplines and more transparency. Moreover, possible linkages between the aircraft dispute and the FSC/ETI retaliation could serve to worsen trans-Atlantic ties.

## US LATIN AMERICA

### FTAA

#### **Deputy USTR Allgeier Visits Brazil: IPR Enforcement and Cooperation at the WTO and FTAA Seen as Priorities**

##### *SUMMARY*

During a recent visit to Brazil, Deputy USTR Peter Allgeier met business representatives at the American Chamber of Commerce in Sao Paulo.

Allgeier discussed the status of WTO and FTAA trade negotiations as well as bilateral relations between the US and Brazil. Among other issues, Allgeier indicated that protection of intellectual property rights constitute a priority concern for the US in bilateral relations with Brazil and in the context of the FTAA.

##### *ANALYSIS*

#### **I. Allgeier Suggests that Brazil Should Pursue More Trade with the US and the FTAA**

Deputy USTR Peter Allgeier remarked that Brazil's export growth has been narrow in its focus on commodities, and towards China. He suggested that Brazil diversify its products and markets, and place greater emphasis on trade opportunities in the region. Among his observations:

- Although Brazilian exports' growth has been significant, it is very concentrated in one market and on commodities. Allgeier expressly mentioned that although Brazilian exports have increased a lot to China, the Chinese market is only absorbing Brazilian commodities products, especially soybeans.
- In view of this, Brazil should make an effort to export more value-added and industrial products and not focus only on primary goods.
- Noted that despite Brazil being the 13<sup>th</sup> economy in the world, it is only the 25<sup>th</sup> world exporter.
- On the other hand, 80% of Brazilian exports to the US concentrate on industrial products.
- Therefore, Brazil should refocus its attention to the FTAA negotiations and particularly to its trade ties with the US.

## **II. Allgeier Stresses Importance to Control Piracy and IPR Violations in Brazil, FTAA Would Focus on Enforcement of IPR**

Among U.S. priorities, Allgeier indicated that the US sought greater protection of intellectual property rights. He made the following comments on the issue:

- Brazil, along with China and Russia, are the main countries where U.S. industries are facing piracy and IPR violations.
- In these three countries, the main problem for U.S. companies is the lack of effective enforcement of IPR commitments.
- In the FTAA, the US seeks stronger provisions on enforcement of countries' obligations under the WTO TRIPS agreement and not necessarily additional commitments from Brazil on IPR.
- He is "mystified" by a recent Brazilian proposal on IPR at the WIPO (World Intellectual Property Organization). According to press reports, the proposal argues that developing countries should be permitted to adopt lesser commitments on IPR in comparison with developed countries.
- Despite the bilateral concerns, Allgeier denied that Brazil's lack of compliance with IPR is serious enough to withdraw Brazil's eligibility under the GSP (Generalized System of Preferences).

Allgeier also mentioned that he would hold discussions with the Brazilian government on IPR issues during his visit. The consultations would be held under the "Bilateral Consultative Mechanism" framework between the two countries.

## **III. U.S. Position on NAMA at WTO May Conflict with Brazilian Defensive Approach**

Allgeier responded to a question from a representative of the FIESP (Federation of Industries of the State of Sao Paulo) on the U.S. position on non-agricultural market access ("NAMA") negotiations at the WTO.

According to Allgeier, U.S. priorities in NAMA negotiations are:

- Establish formulas in which higher tariffs would be subject to deeper cuts;
- Pursue sectoral liberalization agreements;
- Seek reduction or elimination of non-tariff barriers (for instance, in the automotive sector); and
- Allow greater flexibility for the poorest developing countries, while ensuring an appropriate level of ambition including among advanced developing countries.

Regarding the prospects for WTO “Doha Round” negotiations, Allgeier suggested that improvements in the agricultural sector (by developed countries) would require parallel progress in other areas, namely services and industrial products (especially among key developing markets like Brazil).

### ***OUTLOOK***

Allgeier’s recent visit to Brazil highlighted two main priorities in the trade relationship: 1) that Brazil must undertake significant commitments in services and industrial goods at the WTO and the FTAA if it is to gain liberalization in the agriculture sector; and 2) Brazil must improve IPR compliance, especially on enforcement of WTO TRIPs obligations.

Stronger US-Brazil cooperation in multilateral negotiations was critical to securing a deal on agriculture and other issues as part of the WTO framework agreements concluded in July. Beyond the WTO, US-Brazil cooperation is still lacking at the FTAA and on bilateral concerns including intellectual property protection.

Nevertheless, there appears to be a growing recognition by both the US and Brazil that the trading relationship can be improved in order to advance their mutual interests – as was the case recently at the WTO.

## **FTAA Lacks Political Will from US and Brazil; US-Brazil Collaboration on Agriculture Will be Difficult**

### ***SUMMARY***

On September 23, the Second Brazil-US Agricultural Summit was held simultaneously in Washington, D.C. and in Sao Paulo, through videoconference. Participants from both countries analyzed the outlook for agricultural reform, including negotiations for the FTAA and WTO negotiations in general.

Participants agreed that progress in the WTO agriculture negotiations would add momentum to the FTAA, and the EU-MERCOSUR negotiations. Speakers concluded that, although difficult agriculture issues remain, the key obstacle is the lack of political will from the US and Brazil.

Some speakers suggested that the US and Brazilian agriculture sectors would benefit from more collaboration on certain issues, particularly SPS issues. However, other speakers were pessimistic about the prospects for such collaboration, given the competition between US and Brazil in this sector.

### ***ANALYSIS***

#### **I. Protectionism Increasing Among U.S. Agricultural Producers**

Chris Garza, Government Affairs Director of the American Farm Bureau, noted the rise of protectionism among U.S. farmers. We highlight his comments below.

- Brazil and the US are partners and competitors at the same time.
- In the US there is a growing sense of protectionism. US producers are very concerned with agricultural imports to the US.
- Special and differentiation treatment for developing countries is a point of concern for the US producers.
- GMOs (genetically modified organisms) and the cotton case are also points of concern for the US.
- Brazil is very competitive in GMOs, especially in soybeans.
- The US is not the only provider of domestic support in the world. The EU and Japan are other users of those types of subsidies.
- The shifting of the blue box is a step towards the elimination of subsidies in agriculture.

## **II. Brazil and the US Could Unite Forces on SPS Negotiations**

João de Almeida Sampaio Filho, President of the Brazilian Rural Society, stressed the importance of forging an alliance between Brazilian and U.S. producers in international negotiations. He noted that:

- Brazil and the US are nowadays competitors in agriculture.
- Brazilian producers learned from the US the use of intensive capital and the development of technology in agriculture.
- The Brazilian agriculture sector respects the environment, despite allegations that it does not.
- Brazil has more 90 million of hectares that could be devoted to agriculture, and this excludes areas designated for environmental protection.
- Brazil and the US have much to gain if they work in conjunction with each other on sanitary barrier issues.

## **III. FTAA Lacks Political Will**

Marcos Sawaya Jank, President of Icone, suggested that although agriculture negotiations will be tough, the key obstacle to the FTAA is lack of political will from the Brazilian and U.S. governments to put the negotiations on track.

He agreed with other speakers that Brazil has learned and employed various ideas from the U.S. agriculture sector. We summarize his comments below.

- After the 1990s, Brazil opened up its agriculture sector and decreased tariffs to an average of 10%. There are, however, tariff peaks of 20% in some agricultural industrial products.
- Brazil and the US have much to gain from agricultural liberalization at the WTO.
- Now that there is an agriculture framework at the WTO, countries must face the most difficult part of the negotiations, which is to agree on the details to realize meaningful agriculture liberalization”.
- The trend towards shifting distortive subsidies to the “blue box” is a point of concern for Brazil. There continue to be many trade-distorting subsidies in the blue box.
- The elimination of subsidies and other trade-distorting measures would benefit above all the U.S. economy, and also Brazilian exporters.
- If there is movement in agriculture at the WTO, there should be movement in the MERCOSUR-EU and the FTAA negotiations.

- The key problem with the FTAA now is not agriculture, but the lack of political will from both countries to advance the negotiations.
- While there are signs that the EU will reduce its agricultural subsidies, the U.S. Farm Act of 2002 actually increases subsidies. Therefore, the US should be the first country to start decreasing subsidies in agriculture.

#### **IV. Brazilian and U.S. Soybeans Exporters Face Problems in China**

Carlo Lovatelli, Director of Corporate Matters at Bunge International, argued that Chinese SPS rules might cause problems for Brazilian and U.S. soybean producers. Lovatelli supported the creation and application of harmonized SPS rules. He noted the following in regards to China's SPS measures on soybeans:

- In the case of Brazilian soybeans exports to China, not only Brazilian interests were harmed. Five vessels of North American trading companies were rejected.
- The goal of the Chinese government's SPS rules was to lower the price of soybeans in the international market.
- China "is playing a game" with the soybean producers. Therefore, producers from the entire Hemisphere should unite forces and negotiate with the Chinese.
- If Brazil, the US and Argentina joined forces, they would have more leverage when negotiating with China.
- Brazil is a party to the Cartagena Protocol on Biosafety. However, the US, Canada and Argentina are not parties to this Protocol.

#### **V. U.S. and Brazilian Agricultural Producers Compete**

Sarah Thorn, International Trade Director at the Grocery Manufacturers Association, was doubtful of an alliance between U.S. and Brazilian producers. She noted the following:

- Advancement at the WTO will bring advancement in the FTAA.
- The creation of the G-20 group has benefited the agricultural negotiations at the WTO, especially during the July negotiations.
- The FTAA negotiations started to stall after the edition of the Farm Bill in the US.
- Regarding the private sector cooperation, she noted that during the November 2003 FTAA America Business Forum, the agricultural sectors from all over the Hemisphere did not agree on practically anything. Therefore, she is skeptical of the proposed cooperation between the Hemisphere's agricultural sectors.

## ***OUTLOOK***

U.S. Agriculture Secretary Ann Veneman was also present at the event and noted that both countries should develop a common strategy in promoting and defending of the use of biotechnology, and to address SPS barriers. Veneman also noted that the date for the FTAA “is not carved in stone”, which means it is flexible. However, she did not offer any indication of a new deadline for concluding the FTAA.

The FTAA has suffered from lack of political momentum. The Latin American countries generally are hesitant to enter into serious negotiations before the U.S. elections, and the U.S. Government has been preoccupied with other foreign policy initiatives, especially the war in Iraq. The FTAA could gain momentum after the November U.S. elections, when FTAA countries will have a better idea of how the current or new U.S. administration intends to proceed with the negotiations.

The FTAA would also benefit from progress in the WTO agriculture negotiations. Agreement on difficult agriculture issues in the WTO would accelerate progress at the FTAA level and, therefore, generate momentum to complete the FTAA.

## NAFTA

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### Conference Reviews Impact of U.S. Increased Security Measures on NAFTA Partners

#### *SUMMARY*

On September 23, 2004, El Colegio de Mexico, a leading academic institution and think-tank in international relations, held a two-day seminar to discuss international relations in North America. Speakers at the September 23 conference reviewed recent security developments in North America and analyzed how NAFTA partners could achieve further cooperation in this area.

#### *ANALYSIS*

Academics and policy experts on NAFTA participated in the conference. Their commentary focused on North American security after September 11, 2001, and its various implications for the future. We summarize their comments below.

#### **I. NAFTA Partners Obligated to Adopt New Security Paradigm**

Stephen Clarkson from the University of Toronto noted the adverse effects of the new security paradigm after September 11 on the trilateral relationship:

- *Adoption of New Paradigm* – After September 11, Canada and Mexico were forced to adopt the U.S. new security paradigm in order to avoid economic losses in the short term due to increased security measures by U.S. authorities at border crossings.
- *Decreasing Capacity to Influence US Policy* – After September 11, Mexico and Canada have not been able effectively to influence US policy in areas important for both countries.

#### **II. Security Issues Reshape Canada and Mexico's Relationship with the US**

Jennifer Welsh from Oxford University provided an assessment of how security has reshaped Mexico and Canada's relationship with the United States:

- *Trade flows Have Not Stalled* – Trade flows among NAFTA partners did not halt, as some skeptics predicted, but instead increased after September 11. The core of the trilateral relationship, which is strongly based on trade flows, has not changed much and the U.S. market continues to be very important for Canada and Mexico.
- *US Security Approach with Canada and Mexico Differ* – The U.S. approach to security with Canada differed strongly from the approach taken towards Mexico. For Canada, the "Smart Border Initiative" represented a border agreement long sought by Canadian officials with the US. However, for Mexico, it symbolized the end of a long-sought

immigration pact sought with the United States and new ground for conflict.

- ***Reluctance from Canada to Engage “Trilaterally”*** – Even though Canadian officials are committed to supporting further North American integration on paper, they are reluctant to engage “trilaterally” in reality.

### III. Mexico Obligated to Adopt U.S. Security Agenda

Lorenzo Meyer from El Colegio de Mexico argued that Mexico has little room to dissent from the United States after September 11.

- ***Forget the “Whole Enchilada”***– Mexico lost its greatest opportunity to seek an immigration agreement with the US –the whole enchilada-- after the September 11 attacks. Mexico stopped being the “most important relationship” for President Bush and was relegated to the end of the US foreign policy agenda.
- ***Bilateral Relationship Changed Drastically*** – Mexico’s dealing of September 11 and posture against the war on Iraq further strained the bilateral relationship. Mexico had to comply with the U.S. security requirements due to its dependency with the United States in terms of trade. Therefore, essentially, U.S. security policy also became Mexico’s policies.
- ***Controlled vs. Open Border*** –Mexico cannot have a relatively open border with the US and must adjust to a controlled border that could bring benefits in other areas (i.e. drug war).
- ***Little Room for Maneuver*** –September 11 did not change a historic fact in the U.S.-Mexico bilateral relationship: “Mexico has a strong dependency with the United States. As a result, it can only aspire to have a relative independence from the United States. It can dissent from its neighbor but only to a certain extent.”

### OUTLOOK

September 11 did not put a halt to trilateral trade, but it did detract U.S. attention from other conflict areas with its NAFTA partners, including trade disputes.

The September 11 attacks also reshaped the bilateral relations of the United States with its two neighbors. The U.S.-Canada Smart Border Initiative is a comprehensive border agreement that guarantees security, but also allows for the free flow of goods and people. In contrast, the U.S.-Mexico Border Partnership Plan is a less ambitious border agreement that seeks to secure the flow of goods, but at the same time aims to deter illegal immigration to the United States.

A key priority for the Bush administration in the near future is to tighten security and protect its borders with Canada and Mexico. Therefore, an immigration agreement with Mexico or a “Smart Border Initiative” like the one Canada negotiated with the United States

is unlikely in the near future, since it could be seen as a threat to U.S. security. The Fox administration has given up its effort to pursue what Meyer refers to as the “whole enchilada” and is concentrating on further integration with the United States and Canada in other areas (i.e. customs harmonization and energy production).

## **US Modifies HTS for Certain Automatic Data Processing Machinery and Parts; NAFTA Countries Comment on Wood Packaging Regulations**

### ***SUMMARY***

We would like to alert you to the following NAFTA developments:

- US Modifies HTS for Certain Automatic Data Processing Machinery and Parts Imported from Canada and Mexico.
- NAFTA Countries Comment on Wood Packaging Regulations.

### ***ANALYSIS***

#### **I. US Modifies HTS for Certain Automatic Data Processing Machinery and Parts Imported from Canada and Mexico**

On September 7, 2004, the President of the United States of America issued a proclamation that modifies the General System of Preferences and the US harmonized tariff schedule (HTS). The HTS modifications are intended to carry out Article 308 and Annex 308.1 of the North American Free Trade Agreement (NAFTA) relating to automatic data processing machinery and parts.

The modifications to Chapter 84 and 85 establish that the following goods imported from Canada and Mexico that are entered, or withdrawn from warehouse for consumption, on or after January 1, 2003, will be considered "originating goods".

<b>Provisions</b>	<b>Description</b>
(1) 8471.10.00, 8471.30.00, 8471.41.00	Automatic data processing machines
(2) 8471.49.10, 8471.50.00	Digital processing units
(3) 8471.49.15, 8471.60.10	Combined input/output units
(4) 8471.49.24, 8471.49.29, 8471.60.30, 8471.60.45	Display units
(5) 8471.49.21, 8471.49.42, 8471.49.48, 8471.60.20, 8471.60.70, 8471.60.70, 8471.60.80, 8471.60.90	Other input or output units
(6) 8471.49.50, 8471.70	Storage units
(7) 8471.49.60, 8471.49.85, 8471.49.95, 8471.80.10, 8471.80.40, 8471.80.90	Other units of automatic data processing machines

- (8) 8473.30 Parts of automatic data processing machines and units thereof
- (9) 8471.49.70, 8504.40.60, 8504.40.70 Power supplies for automatic data processing machines
- (10) 8504.90.20, 8504.90.40 Parts of power supplies for automatic data processing machines

## **II. NAFTA Countries Comment on Wood Packaging Regulations**

On September 16, the Animal and Plant Health Inspection Service (APHIS) published in the Federal Register (65 FR 55719) a final rule amending the regulations for the importation of unmanufactured wood articles to adopt an international standard entitled "Guidelines for Regulating Wood Packaging Material (WPM) in International Trade" that was approved by the Interim Commission on Phytosanitary Measures of the International Plant Protection Convention on March 15, 2002.

The new USDA regulation will require that wood packaging materials be heat treated or fumigated with methyl bromide to deter plant pests. Wood packaging materials must also bear an international mark indicating such treatment. The regulations will apply to all parties using wood packaging materials when importing goods into the US.

APHIS received approximately 970 comments on the proposal. Among other things, Canada and Mexico proposed that the current exemptions from the regulations for wood articles from Canada and from Mexican Border States should be extended to include WPM that is imported into the United States from Mexico. According to US NAFTA partners, this action would avoid administrative complexities and the cost of a partial exemption from Border States only, as well as avoid the production of additional export pallets from Mexico to the United States.

Regarding this issue, APHIS responded as follows:

*APHIS has already taken final action on this issue in a final rule titled "Importation of Unmanufactured Wood Articles From Mexico" that was published in the Federal Register on August 26, 2004. In that final rule, APHIS amended the regulations to remove the exemption for most unmanufactured wood, including WPM, imported into the US from Mexican Border States. The only exemption that continues for these States covers firewood, mesquite wood for cooking, and small, noncommercial packages of unmanufactured wood for personal cooking or personal medicinal purposes. The effect of that change was that all WPM from Mexico will be subject to the same requirements in Sec. 319.40-3(b) that apply to WPM from any place except Canada.*

The attached Federal Register notice discusses further issues raised by Mexico and Canada in the comments.

After reviewing all the comments, APHIS decided to make the following changes from the proposal in this final rule:

- APHIS is changing the term "solid wood packing material" to "wood packaging material" throughout the regulations; and

APHIS is excluding from the definition of wood packaging material, and thereby excluding from treatment requirements, pieces of wood that are less than 6 mm (0.24 in) in any dimension, because pieces of wood of this size are too thin to present any significant pest risk.

## **MULTILATERAL**

### **WTO Forecasts Global Trade Will Expand by 7.5% in 2004; Investment Analysts Predict Expansion of Latin American Economies**

#### *SUMMARY*

In its annual report of world trade performance, the World Trade Organization (WTO) concluded that global trade is expected to expand by 7.5% in 2004. The improvement in global trade was mainly associated with two factors: (i) improved global economic growth and (ii) expansionary monetary and fiscal policies in most world regions.

In related news, investment analysts forecasted economic growth for Latin America at a conference hosted by the Inter-American Dialogue on the prospects for the Latin American economy.

#### *ANALYSIS*

##### **I. WTO Forecasts Global Trade Will Expand by 7.5% in 2004**

The World Trade Organization prepared a report analyzing the performance of world trade in 2004. The survey analyzes worldwide developments in the structure, value, and volume of international trade flows. The report also offers global trade forecast for 2004.

The full survey is available at [www.wto.org](http://www.wto.org)

We highlight below major global trends in international trade flows with a special focus on the North American and Latin American regions.

##### **Global Trade Developments in 2003**

- World trade expanded by 4.5% in real terms in 2003. Overall, international trade flows benefited from improved economic growth of the world economy.
- The improvement in global trade was associated with expansionary fiscal policies in most world regions.
- Asia and the transition economies of the Commonwealth of Independent States (CIS) were the most dynamic trading regions, followed by North America, Latin America, and Western Europe.
- Except for North America, which registered a trade deficit, the other six world regions identified by the WTO (Latin America, Western Europe, Transition economies, Africa, Middle East and Asia) recorded a merchandise trade surplus.

### **Trade Developments in North America (US & Canada)**

- Regional trade in North America recovered in value and volume in 2003. This expansion, however, remained below global expansion levels.
- Import growth (5.7%) exceeded export growth (1.8%), leading to a trade deficit in the region. Among other world regions, North America registered the lowest export growth.

### **Trade Developments in Latin America (Mexico Included)**

- Latin America began to recover after a deep recession in 2003 mainly due to: (i) increasing import demand in the US and Asia and (ii) higher commodity prices.
- Export growth (4.2%) exceeded import growth (1.8%), leading to a trade surplus in the region. Among other world regions, Latin America registered the lowest import growth.
- Mexico, which is the largest exporter in the region, registered poor growth and weak export performance throughout 2003. This performance was mainly due to: (i) loss of competitiveness of Mexican goods in the US and (ii) decreasing U.S. demand for automotive goods.

## **II. Investment Analysts Predict Expansion of Latin American Economies**

On September 16, the Inter-American Dialogue hosted the first of a series of conferences titled "The Latin American Economy: Where does it stand? Where is it headed?" The purpose of the series is to discuss the economic challenges facing Latin America and its implications on U.S.-Latin American relations. The first session addressed the macro-economic outlook for Latin America. Head of Economic Research Michael Gavin at UBS Warburg, and Chief Economist David Malpass at Bear Stearns & Co. offered their views.

We summarize below the key aspects discussed by Gavin and Malpass regarding the economic environment in Latin America and its prospects for 2005. We focus our analysis on the economies of Mexico, Chile, Brazil, and Argentina.

#### **Mexico**

- The Mexican economy continues to be strongly linked to the US. Analysts expect that the economy will continue growing this year and in 2005, although it is possible that it experiences slower growth in 2005.
- A major question addressed regarding Mexico, was its political future and upcoming elections in 2006.

#### **Chile**

- Analysts praised the Chilean economy, which according to him is "working out great" and very well positioned for continued growth.

## **Brazil**

- Gavin predicted a 5% growth in Brazil for 2004 and a 4.5% growth rate for 2005. In 2005 Brazil should remain insulated from external financial shocks, thanks to its current account surplus. Gavin expressed optimism that the investment environment in Brazil would improve.
- According to Malpass, Brazil's Central Bank is taking the wrong approach by confronting inflation with high interest rates since this could put a significant load on the country's economy.
- Regarding Brazil's pending reforms, it is unlikely that the Brazilian Government will undertake a meaningful tax or pension reform. However, the Government is interested in pursuing reforms in other areas, including investment and infrastructure, which could prove successful.

## **Argentina**

- Argentina will not have the high rate of growth that it exhibited last year. Gavin predicted a growth of 3-4% for Argentina in 2005.
- Another relevant factor that should be considered with respect to Argentina, according to Gavin, is the damage done by the Government to the investor's confidence.

## ***OUTLOOK***

The WTO report and the perspectives offered by analysts at the IAD are generally optimistic about the future prospects for the Latin American economies, at least in the near future. The WTO forecasts that global trade will expand by 7.5% in 2004, and analysts predict that the economic recovery in Latin America will extend at least for the next two years.

Analyst at the IAD warned, however, that some factors could affect the recovery of Latin America, including the external recovery of other markets, including the United States and China.

## **WTO Panel Finds Against EC Sugar Regime**

### *SUMMARY*

A WTO Panel has ruled that certain EC subsidies for sugar violate the export subsidy disciplines of the *WTO Agreement on Agriculture*. In a case brought by Australia, Brazil and Thailand, the Panel found that the EC used profits from its domestic quota system to "cross-subsidize" sugar exports. In addition, the Panel rejected the EC argument that a footnote in the EC's Schedule granted a carve-out for subsidies on exports of EC sugar that had originally been imported from India or the "ACP" countries (Africa, the Caribbean and the Pacific). The Panel found that the EC footnote was "fundamentally inconsistent with the basic provisions of the Agreement on Agriculture" and therefore "of no legal effect."

### *ANALYSIS*

#### **I. Export Subsidies for Agricultural Products; Applicable WTO Disciplines**

The *WTO Agreement on Agriculture* includes disciplines on the use of export subsidies for agricultural products.

Article 8 of the Agreement provides what the Panel described as "a general prohibition on export subsidies." It states that "each Member undertakes not to provide export subsidies otherwise than in conformity with this Agreement and with the commitments as specified in that Member's Schedule."

Thus, in accordance with this provision, each WTO Member must ensure that any export subsidies comply with both:

- (i) the general obligations set out in the Agreement on Agriculture; and
- (ii) the specific reduction commitments enumerated in each Member's Schedule. These commitments describe, for each agricultural product or group of products, the maximum quantities for which export subsidies may be provided, as well as the maximum levels of permitted budgetary outlays. The products subject to reduction commitments, and in respect of which export subsidies may be used within the specified limits, are known as "scheduled products." (The remaining products, to which more stringent disciplines apply, are referred to as "unscheduled products.")

The Panel then referred to what it called the "specific prohibitions" set out in Article 3.3. Article 3.3 provides in part that a Member shall not provide export subsidies in excess of the budgetary outlay and quantity commitment levels specified in that Member's Schedule, i.e. for scheduled products. By virtue of Article 3.1 of the Agreement, the export subsidy commitments set out in each Member's Schedule are deemed to be "an integral part of GATT 1994", and as such are as binding as if they were part of the treaty text.

Thus, a WTO Member cannot provide export subsidies on scheduled agricultural products beyond the budgetary and quantity commitment levels set out in its Schedule.

#### **II. Panel Finds EC Sugar Footnote to be "of no legal effect"**

The complainants argued that since 1995, the EC has been exporting quantities of subsidized sugar in excess of its annual commitment levels, contrary to Articles 3 and 8. The EC admitted that its exports of sugar had been in excess of the figure listed in its Schedule.

However, the EC argued that its export subsidy commitments for sugar were in fact made up of two separate components:

- (i) one component, which has been subject to progressive reduction; and
- (ii) a second component, embodied in a footnote to its Schedule, which referred to sugar originating in the ACP countries and India. The footnote, referring to the EC's export subsidy commitments, stated that: "Does not include exports of sugar of ACP and Indian origin on which the Community is not making any reduction commitments. The average of export in the period 1986 to 1990 amounted to 1.6 mil t. [million tons]."

In the view of the EC, this footnote provided for a WTO-consistent limitation of 1.6 million tons for export subsidies corresponding or equivalent to the amount of imports of sugar of ACP or Indian origin. As discussed below, the Panel rejected the EC's position on this issue.

A. Scheduled reduction commitments cannot "circumvent" export subsidy rules

As a matter of treaty interpretation, the Panel noted that a Member's Schedule "cannot provide for non-compliance with provisions of the Agreement on Agriculture." It said that provisions in a Schedule relating to commitments authorized by the Agreement may only qualify such commitments to the extent that the qualification does not act "so as to contradict or conflict with the Members' obligations" under the Agreement. Thus, according to the Panel, the reduction commitments in a Member's Schedule "cannot be used to circumvent the broader rule-based export subsidy commitment" of the Agreement.

The Panel found that the ordinary meaning of the terms of the EC footnote "did not authorize an additional 1.6 million tonnes of subsidized sugar to be exported corresponding or equivalent to the amount of imports from ACP and India." Instead, the footnote constituted a mere "unilateral statement by the European Communities that, with regard to exports of ACP/India sugar, it is not making any reduction commitment." The content of the footnote "therefore does not enlarge or otherwise modify the European Communities' quantity commitment level" specified in its Schedule.

The Panel observed that the EC did not deny that its exports of ACP/India equivalent sugar benefited from export subsidies. The EC had argued instead it was entitled to provide such subsidies. In the Panel's view, the footnote attempted to "reduce and modify" the EC's obligations under the export subsidy disciplines of the Agreement. As such, the footnote was "fundamentally inconsistent with the basic provisions of the Agreement on Agriculture." The footnote and the export subsidy provisions of the Agreement were "mutually inconsistent."

The Panel therefore concluded that even if the footnote constituted a commitment limiting subsidization to 1.6 million tonnes of ACP/India equivalent sugar ("which it does not"), the content of the footnote conflicted with the export subsidy rules of the Agreement.

The footnote therefore could not constitute a second component of the EC's overall commitment level for export subsidies on sugar.

Consequently, the Panel found that the content of the footnote was "of no legal effect and does not enlarge or otherwise modify" the EC's quantity commitment level specified in its Schedule or its budgetary commitment.

### **III. Surplus "C" Sugar for Export: EC Violates the Agreement**

The Panel then turned to another aspect of the EC sugar regime, that of so-called "C" sugar, or sugar for export.

The EC sugar regime establishes two categories of production quotas, denominated as "A" and "B" sugar. Sugar produced in excess of these production quotas is categorized as "C" sugar.

The Panel examined whether exports of category "C" sugar were subsidized within the meaning of Article 9.1(c) of the Agreement. Article 9.1(c) provides that export subsidies subject to reduction commitments under the Agreement include "payments on the export of an agricultural product that are financed by virtue of governmental action."

The Panel stated that Article 9.1(c) required the demonstration of three elements. First, "payments" must be made. Second, the payments must be made "on the export of an agricultural product." Third, those payments must be "financed by virtue of governmental action." The Panel found that all of the elements of this test were met in the present case.

#### **A. Provision of a "payment": below-cost input to sugar producers**

The main input for the production of category "C" sugar was the sale of category "C" beet. The Panel recalled that the Appellate Body in the *Canada Dairy* dispute found that the term "payment" encompassed not just cash payments, but payments in kind, and that Article 9.1(c) contemplated that an export subsidy may include revenue foregone. It added that revenue may be foregone in instances when the price charged by the producer is less than the product's "proper value." The Panel, like the Appellate Body in *Canada Dairy*, considered that the total cost of production was an appropriate benchmark for determining such proper value.

Applying these principles to the facts of this case, the Panel stated that there was uncontested evidence that beet was sold to "C" sugar producers at prices well below the cost of production. From this, the Panel concluded that there was a "payment" (i.e. a payment in kind) made to the sugar producers to the extent that the proper value of the beet was not reflected in the price. The Panel found, therefore, that the input of beet at prices below the total cost of production involved a "payment" within the meaning of Article 9.1(c).

#### **B. Payment "on the export" of the production: export contingency not required**

The Panel also found that the payments to "C" sugar producers by way of discounted sales of beet were also made "on the export" of the product within the meaning of Article 9.1(c). The Panel rejected the EC argument that "on the export" implied export contingency.

In the view of the Panel, "a payment 'on the export' need not be 'contingent' on export but rather should be 'in connection' with export."

The Panel noted that category "C" sugar, once produced, must be exported. It said that the beet may be processed into "C" sugar, which in turn must be exported, and so payments by way of discounted sales of beet to "C" sugar producers were made "on the export" of the product.

C. "Clear nexus" shown between the financing of the payments and the EC's "governmental action"

The Panel similarly concluded that the payments in kind through sales of discounted beet were "financed by virtue of governmental action." The Panel recalled the statement of the Appellate Body in *Canada Dairy* that in order for the payment to qualify as a payment "by virtue of governmental action", there had to be a "demonstrable link" and a "clear nexus" between the financing of the payments and the "governmental action." The Panel stated that the "sale of under-priced C beet to C sugar producers is an integral part of the governmental regulation of the sugar market." The panel therefore found that "C" sugar producers received payments on export financed by virtue of governmental action.

Therefore, the Panel found that as a result of the sales of beet below the total cost of production, "C" sugar producers receive payment on export by virtue of governmental action.

The Panel recalled that a special burden of proof was provided for in the Agreement on Agriculture. Once the complainants had proven that the EC was exporting sugar in quantities exceeding its commitment levels, the burden then shifted to the EC to prove that the sugar it exported above its commitment level was *not* subsidized. The EC had failed to demonstrate that the exports of "C" sugar that exceeded the commitment levels had not been subsidized, and so the EC was found to be in violation of Articles 3 and 8.

D. "Cross subsidization" also found to be WTO-inconsistent: "sugar is sugar"

The Panel found that the "cross-subsidization" resulting from the EC sugar regime also constituted a payment on exports by virtue of governmental action. The Panel reasoned that "sugar is sugar whether or not produced under an EC-created designation of A, B or C." To the extent that the fixed costs of A, B and C were largely paid for by the profits made on sales of the domestic quota sugar, the EC sugar regime "provides the advantage which allows EC sugar producers to produce and export C sugar at below total cost of production." For the Panel, this "cross-subsidization constitutes a payment in the form of a transfer of financial resources."

The Panel found that the cross-subsidization taking place through the cumulative effect of various measures involved in the operation of the EC sugar regime, including high prices charged to domestic consumers, enabled producers to produce and sell excess "C" sugar. The Panel also noted that "C" sugar could only be sold for export. If not reclassified, "C" sugar could not be disposed of in the EC's internal market, and must be exported without further processing. Because of the legal requirement to export, the subsidies were made "on the export" of that product.

The Panel also found that this cross-subsidization payment was financed by virtue of governmental action. The Panel said that the EC's governmental action in regulating the domestic sugar market cross-subsidized sales of "C" sugar that otherwise would not be made, or would be made at a loss. The higher revenue sales for quota sugar in the internal market effectively financed some or all of the fixed costs of "C" sugar. The Panel added that the production of "C" sugar was not incidental, but rather constituted 11-21% of quota production.

The Panel stated that "the EC sugar regime is such that it creates incentives to breach the ordinary limits of domestic support by encouraging producers to produce more sugar for export in order to ensure they fulfill their quotas and prevent them from losing access to preferential quotas." The Panel added that by virtue of the high prices charged to domestic consumers and the operation of the A and B domestic quotas, exporters of "C" sugar could "cover a significant portion of their production costs and make profitable export sales." Accordingly, the EC sugar regime "uses the high profits on A and B quota sugar to cover fixed costs for C sugar and, most importantly, requires C sugar to be exported and diverted from the domestic market."

Therefore, the Panel found that the production of "C" sugar receives payments through cross-subsidization resulting from the operation of the EC sugar regime. It ruled that these payments, in the form of the transfer of financial resources financed by virtue of governmental action, were in breach of the EC's obligations under Articles 3 and 8.

The decision of the Panel in *European Communities - Export Subsidies on Sugar* (DS265) was released on October 15, 2004.

### ***OUTLOOK***

There are three particularly noteworthy features of this high-profile dispute.

First, this marks the first time that the WTO has ruled against a major agricultural subsidy program of the EC. The decision follows closely on the recent ruling against U.S. agricultural subsidies in the *Cotton* case, and further demonstrates a willingness of WTO Members, particularly developing countries, to use the dispute settlement system to challenge large agricultural subsidies granted by developed countries.

Second, the decision will likely serve as an important precedent to contest subsidies maintained by other countries. One of the most important rulings by the *Sugar* Panel related to the WTO-inconsistency of "cross subsidization." As noted above, the Panel found that the EC used the high profits generated from its quotas for domestic sugar to cover the costs of sugar exports. In doing so, the Panel applied an earlier ruling by the Appellate Body against a similar scheme maintained by Canada for dairy exports. The Panel decision reinforces the principle that exported agricultural products that incorporate inputs provided below the cost of production will be vulnerable to challenge as export subsidies.

Third, this is a highly politicized dispute, in which a number of developing and least-developed countries expressed concern about losing their preferential access to the EC sugar market. Indeed, following the release of the Panel's decision on Friday, the EC issued a statement that the decision "threatens the value of the current preferential access

arrangements which the EU has had in place for decades." Thus, as in other recent cases, such as *EC - Generalized System of Preferences*, the Appellate Body will assess legal arguments against the backdrop of contentious political differences between the parties.

Nonetheless, the Panel's decision is well-reasoned, and is firmly grounded in prior, directly relevant WTO jurisprudence, particularly the Appellate Body's ruling in *Canada Dairy*. It seems likely that this decision will be upheld on appeal.

## **WTO Members Resume Technical Negotiations and Set Date for Hong Kong Ministerial; Possible Leadership Struggle Ahead**

### ***SUMMARY***

WTO Members have resumed work in the “Doha Round” negotiating groups in a positive atmosphere, but essentially at the technical level. The focus of work is to build upon the “July package” of framework agreements on agriculture, industrial tariffs and services, and proceeding with negotiations on trade facilitation. At this stage, no further political decisions in the Round can be expected for some months; nor are they needed.

Since negotiating bodies resumed meetings in September, the Trade Negotiations Committee has appointed the Chair of the Trade Facilitation Group and discussed preparations for the Ministerial Conference in Hong Kong in mid-December 2005. The General Council also received several nominations for the next Director-General. The process of appointing the next head of the WTO could be marked by contention, as with previous appointments.

Outside the Doha Round context, there have been important developments in WTO dispute settlement which could affect agriculture and other negotiations. There also exists increasing concern among smaller developing countries about the effects of the termination at the end of this year, of the quota system for textiles and clothing – and the negative implications of competition from more advanced countries like China and India.

### ***ANALYSIS***

#### **I. Developments in the Doha Round: Technical Negotiations Resume; Setting the Course for the Hong Kong Ministerial**

As expected, following the intensive and high-level process that produced the July package, the focus of the Doha Round has switched towards technical work in Geneva within the specialized negotiating groups. Further involvement at the political level is not expected before the advent of the new Administration in the United States and the new European Commission. Since there is a great deal of essential work to be done by experts at the sectoral level – in services, for example, real negotiations on the improvement of commitments have hardly begun – this re-focusing is necessary.

##### **A. Trade Negotiations Committee: Decision on Chair of the Trade Facilitation Negotiations; Setting Course for the Hong Kong Ministerial**

The meeting of the Trade Negotiations Committee on 12 and 13 October was consequently un-dramatic. The meeting had been delayed by disagreement over the Chairmanship of the new Negotiating Group on Trade Facilitation. The “Core Group” of developing countries favored Ambassador Muhamad Noor Yacob of Malaysia whereas most developed countries had favored Ambassador Manzoor Ahamad of Pakistan, who is an expert on customs matters. Some Members were also hesitant about Ambassador Yacob due to the strong position taken by Malaysia in excluding from the Doha agenda the other “Singapore issues”, investment, competition and government procurement. Ultimately, the TNC appointed Ambassador Yacob. The TNC also appointed as Chairman of the Negotiating

Group on Rules (antidumping, subsidies and regional trade agreements) Ambassador Guillermo Valles of Uruguay. He replaces Mexico's Ambassador Eduardo Perez Motta, who has taken up the key appointment to head Mexico's Federal Competition Commission.

The TNC also discussed the Sixth Ministerial Conference, to be held in Hong Kong in December 2005. TNC Chair, Director-General Supachai Panitchpakdi advised concentration on technical work and against setting explicit targets for Hong Kong at this stage. Supachai was no doubt mindful of the tendency of Members to allow preparations for Ministerial meetings to monopolise their negotiating energies – which would be better used in substantive negotiations. (It is far from clear that the Uruguay Round decision to hold Ministerial meetings at intervals of two years has been on balance beneficial. The successes of Singapore and Doha must be set against the failures of Seattle and Cancun, and the benefits of Ministerial involvement offset against the North-South polarization which these events seem inevitably to entail in the era of universal membership.) Nevertheless, Brazil and others urged that negotiating modalities for agriculture and industrial products should be finalized at Hong Kong.

Later, at the General Council meeting on 20 October, WTO Members set the date of the Hong Kong meeting for December 13-18, 2005.

**B. Agriculture: Divisions Between Developing Countries Apparent**

A meeting of the Agriculture Committee on 6 October focused on process and the organization of technical work, and informal technical discussions on key issues took place on 7 October. A theme which could underlie the entire negotiation was the apparent differences between those developing countries seeking the preservation of preferences and others who believe their net effects to be harmful. The Group of 20 (G-20) developing countries insisted at the meeting that the key issue is the removal of trade-distorting domestic support and export subsidies in the developed world. Members will soon establish a sub-committee to oversee the negotiations on cotton; other less formal working groups on specific issues will probably follow.

**C. Rules Negotiations: Debate Over Fish Subsidies**

The Negotiating Group on Rules discussed a Japanese proposal on fisheries subsidies, which was supported by Korea and Chinese Taipei but opposed by many others on the ground that it would effectively exempt Japan's subsidies from any disciplines. These countries supported a proposal by New Zealand to prohibit all fisheries subsidies, with a few specific exceptions.

**D. Industrial Market Access Negotiations: Refining the July Framework**

In the group on Non-Agricultural Market Access little progress was made on tariff negotiations. It is clear that there will be a tariff reduction formula, but there is no agreement as to the form it would take, and some countries have even suggested that the "framework" agreed in July needs further clarification. Negotiators also attempted to meet a deadline to notify non-tariff barriers by the end of October 2004. Work on non-tariff barriers is also at the preliminary stages.

E. Services Negotiations: Some New Offers, The Old Argument Over Cultural Exceptions, and Perhaps a Different Approach Overall

The Services “cluster” of meetings was held in late September through early October. The Dominican Republic, Kenya, Gabon and Jordan submitted new offers of initial commitments. However, there are still only 48 initial offers on the table and their quality is poor: some would even imply regression from the current level of commitments, though that is not permitted by the GATS. Moreover, another 50 or so Members with important markets have yet to submit any offers at all.

At their recent meetings, services negotiators also participated in three valuable seminars – on logistics services, the movement of natural persons supplying services under Mode 4 of the GATS and cultural services. The last of these was organized in response to a draft Convention on Cultural Diversity produced in UNESCO which could have the effect of exempting from WTO rules a very wide range of cultural goods and services and cultural policies, thus re-igniting the old debate about a “cultural exception” in the GATS.

In other developments, some senior GATS negotiators have suggested that the “request-offer” approach to negotiations through submission of comprehensive lists of requests and offers might not be the most effective at this stage. Rather, efforts could be concentrated on obtaining meaningful commitments in specific sectors. The alternative is not a new approach, but would focus more directed attention at improving offers for certain sectors.

**II. WTO Dispute Settlement Findings: Far-Reaching and Perhaps Unsettling**

A series of far-reaching decisions by dispute settlement panels and the Appellate Body has underlined the growing importance of the WTO’s judicial function, whose effectiveness contrasts somewhat painfully with the halting negotiation of new disciplines. Two major decisions concerning agricultural subsidies for the cotton and sugar industries, important in their own right, will certainly affect the Doha negotiations on Agriculture.

A. Sugar and Cotton: Entrenched Programs by EU and US Found at Fault, Possible Implications for the Doha Round

First, on a complaint brought by Brazil, a panel ruled in September that U.S. cotton subsidies violate the obligations of the United States under both the Agriculture Agreement and the Subsidies Agreement. The panel called upon the United States to withdraw the subsidies “without delay,” or at latest by 1 July 2005. Though the US has appealed against the finding, this is a major victory for Brazil and for agricultural exporting countries in general, since if the decision is upheld by the Appellate Body it will establish a precedent which could be used to challenge other agricultural subsidies, in the US and elsewhere.

The decision will also facilitate future complaints under the “serious prejudice” provisions of the Subsidies Agreement, which provide that subsidies cannot cause “serious prejudice to the interests of another Member.” The panel agreed that there is no need to quantify precisely the degree of prejudice suffered and found a “detrimental impact” on Brazil’s production and trade in cotton. This was also the first major ruling on the “Peace Clause” provision of the Agriculture Agreement, which shields agricultural subsidies, mainly

in developed countries, from challenge in the WTO. The panel found that the US had not complied with the conditions for invocation of the Peace Clause.

Second, another panel has ruled on 15 October, in a case brought by Australia, Brazil and Thailand, that certain EU subsidies to the sugar industry violate the Agreement on Agriculture. The panel found that the EU used profits from its domestic quota system to “cross-subsidize” sugar exports. In addition, in response to a claim by the EU that a footnote in its Schedule exempted a proportion of its sugar exports from subsidy reduction commitments, the panel ruled that the footnote was “fundamentally inconsistent with the basic provisions” of the Agricultural Agreement and was “of no legal effect.”

The principle that Members cannot derogate from basic obligations by unilateral statements in their schedules is an important one, not only in the agricultural context. This case will also go to appeal, and the EU will argue before the Appellate Body that the decision, if confirmed will undermine the preferential access of a number of developing countries to the EU market. Nevertheless it seems likely that the panel findings will be confirmed, and will constitute another important precedent for challenges to systems of agricultural support and subsidy, which are the major issue in the Doha Round.

B. Challenges to Controversial Antidumping Remedy and Methodology: Byrd Amendment Retaliation and the Dispute Over “Zeroing”

A panel of arbitrators, at the end of August, authorized the EU, Japan, Korea, Canada, Chile, Brazil, Mexico and India to impose tariff sanctions on the US for failing to comply with an earlier finding that the “Byrd Amendment” was a violation of U.S. obligations under the Anti-Dumping and Subsidies Agreements. The complainants were authorized to impose tariff increases valued at 72 percent of the duties collected on their exports and disbursed to U.S. producers under the Byrd Amendment. The 72 percent figure is the arbitrators’ estimate of the degree to which the disbursements were “passed through” in price reductions by beneficiary U.S. companies. Three other complainants against the Byrd Amendment – Australia, Indonesia and Thailand – have agreed to an extension until 27 December of the period for U.S. compliance, and might also seek authorization to retaliate.

The Appellate Body confirmed in August a panel finding that “zeroing” methodology used by the United States in a dumping action on Canadian lumber violated the Anti-Dumping Agreement. “Zeroing” is the practice of ignoring, in calculating a dumping margin, cases where the domestic price for the good in question is *higher* than the export price: this negative margin is considered as zero, and the margin of dumping for the product as a whole is correspondingly inflated. The Appellate Body had also ruled against zeroing by the EU in the Indian “Bed Linen” case in 2001, and its new finding will be a powerful precedent in the EU’s ongoing challenge to U.S. zeroing practices.

C. Trans-Atlantic Tensions Ignite: “Divorce Proceedings” Filed Over Aircraft Subsidies and Customs Procedures

The cooperative relationship between the United States and EU, as embodied by the close ties between Commissioner Pascal Lamy and US Trade Representative Robert Zoellick, is now marked by greater tension. The two Ministers are transitioning in their terms, coincidentally, as new disputes are filed. The United States has requested consultations with

the EU on subsidies to Airbus, thus initiating the dispute settlement process. The EU has responded with its own counter-request concerning subsidies to Boeing, setting up the prospect of a case of such magnitude that some commentators fear it will stretch the system beyond its political capacity. Others have suggested that pre-Election politics in the United States have played a role in the timing, at least, of the U.S. complaint, and that the parties will aim to resolve the dispute before the issue goes to a panel. It does appear, however, that the bilateral agreement of 1992 – which has kept the peace between the two great powers as far as aircraft subsidies are concerned – will no longer serve, and that a new understanding must be found, through negotiation or litigation.

The United States also launched a somewhat unexpected dispute with the EU regarding the lack of consistency in the administration of customs procedures within the newly expanded EU's 25 Member States. EU expansion is said to add complexity and cost to the operations of U.S. exporters, and concerned industry groups, notably express delivery companies, have supported the US action. The European Commission, though it would no doubt welcome a single customs administration for the Union, has claimed that the dispute was politically motivated and could have been handled in a bilateral consultative forum (US-EU Customs Council).

### **III. The Looming Phase-out of Textiles and Clothing Quotas**

The complex system of bilateral quotas which has regulated imports of clothing and textiles into the US, the EU and some other developed markets for the past 40 years will come to an end on 31 December 2004, as agreed in the Uruguay Round Agreement on Textiles and Clothing. The prospect of unrestricted competition from China and India in particular is causing much concern among U.S. and European manufacturers, but even more among smaller developing countries which have developed textile and clothing industries on the basis of assured quotas in their biggest export markets. By capping exports from major producers such as Hong Kong, the quota system encouraged the migration of capital and expertise and was therefore largely responsible for the spread of clothing manufacture to many new locations, for example, in South Asia and Africa. Many of these countries including Bangladesh, and several African nations now fear the extinction of their export industries by Chinese and other competition.

It is ironic that the end of the textile régime, so long reviled as a violation of basic GATT principles and a barrier to development, should be regretted by many developing countries. There have been informal suggestions of an extension of the quotas beyond 31 December, but it would be impossible to reach agreement on such a proposal. Instead, seven developing countries proposed on 1 October a WTO work programme on possible solutions to the employment and other costs of the adjustment they will face. The proposal is still under discussion. The size of the problem is daunting: Bangladesh for example has said that the clothing industry accounts for 80 percent of its exports and one-third of its industrial employment, and is heavily dependent on quota access. Meanwhile, domestic industries in the US are also seeking remedy to the possible flood of imports. The United States Department of Commerce has indicated that it will consider requests for safeguard action against disruptive exports from China.

### **IV. Possible Leadership Struggles Ahead: Candidates for the Next Director-General**

The process for the selection of a successor to Dr Supachai, who leaves office at the end of August 2005, has officially begun. There are so far three declared candidates: Mr. Carlos Perez del Castillo, the former Ambassador and Foreign Minister of Uruguay; Mr. Jaykrishna Cuttaree, the Trade Minister of Mauritius; and, most recently announced, Mr. Luis Felipe de Seixas Correa, the current Ambassador of Brazil in Geneva. The former Ambassador and Trade Minister of Canada, Mr. Sergio Marchi, has announced that he will not be a candidate.

All nominations for the post must be submitted by mid-December. Afterwards, WTO Members will attempt to rally support for one candidate over another and choose a successor by summer 2005.

### ***OUTLOOK***

Negotiations in the Doha Round have proceeded at the technical level with renewed momentum after the mandate of the July package of framework agreements. WTO Members also set a new target for themselves with the next Ministerial Conference in Hong Kong on 13-18 December 2005. The course to Hong Kong will be challenging as much needs to be done at the technical level, including defining and establishing negotiating modalities for the framework agreements in agriculture and industrial market access. Moreover, service negotiations, which have been lagging due to the lack of meaningful offers, must pick up pace by the target date of May 2005 for improved offers if the opportunity for significant services liberalization in this Round is not to be missed.

Among other factors that could influence the pace of negotiations are the possible struggles over leadership of the WTO, as well as far-reaching WTO disputes. It is to be hoped that the selection of the Director-General will be less contentious than in 1999, but it could last into the summer of 2005. In other developments, the United States and EU are facing difficult disputes in agriculture with major exporting nations, and with each other over aircraft, the Byrd Amendment and other sensitive issues. Trans-Atlantic leadership and cooperation have been critical in this Round, and high-profile disputes could be disruptive.

Once new leaders are in place, it will be critical for them and their counterparts to exert political guidance as Members attempt to progress from framework agreements to modalities and improved market-access offers, and ultimately, to conclusive and meaningful reform.