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U.S.-EU Trade Tensions: Causes, Consequences, and Possible Cures

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Summary

The United States and the European Union (EU) share a large and mutually beneficial trade and investment relationship. Given a huge volume of commercial interactions, trade tensions and disputes are not unexpected. While trade tensions in the past have tended to ebb and flow, some observers believe that this year's threat of a trade war is more serious than before. A dispute over steel trade is the proximate cause of rising trade tensions, but other high-profile disputes involving tax breaks for U.S. exporters and the treatment of genetically-engineered (GE) products lurk in the background. The steel dispute is characterized by feelings on both sides of the Atlantic that the other side has taken actions that are unreasonable and inconsistent with the rules of the World Trade Organization (WTO). Moreover, both Washington and Brussels have played hardball in crafting retaliation lists aimed at influencing each other's domestic political process. While fears of an all-out trade war are likely exaggerated, the trade disputes may impede U.S.-EU cooperation in other areas. A number of ways have been suggested to diffuse current trade tensions including greater reliance on compensation as opposed to retaliation and greater emphasis on diplomatic as opposed to legalistic solutions to disputes. While potentially helpful, the fact that some of these high-profile disputes have been unresolved for decades suggests the difficulty of finding permanent solutions. Congress has a strong interest in these disputes and plays a significant legislative role, particularly on the export subsidy issue. This report will be updated as events warrant.

Introduction

The United States and European Union (EU) are parties to the largest two-way trade and investment relationship in the world. Annual two-way flows of goods, services, and investments now exceed $1 trillion. While only a tiny fraction of these interactions lead to disputes, the dominant role that both economic powers play in the world economy makes settlement of the disputes particularly important.[1]

[1] For background, see CRS Report RL30608, *EU-U.S. Economic Ties: Framework, Scope, and Magnitude*, by William H. Cooper, and CRS Issue Brief IB10087, *U.S.-European Union Trade* (continued...)

U.S.-EU trade tensions have ebbed and flowed in recent years. During the summer of 2000, the two sides bickered over the EU's discriminatory policies affecting imports of bananas and beef treated with hormones. The United States imposed 100% tariffs on about $300 million of mainly luxury items such as Danish ham, truffles, Roquefort cheese, and Italian handbags. The EU countered by challenging a U.S. tax benefit for export sales known as the Foreign Sales Corporation (FSC). This case eventually provided the EU with a huge bargaining chip – authorization from the WTO to impose trade sanctions on a value of U.S. exports that could range from $1 billion - $4 billion. A WTO arbitration panel is scheduled to decide the exact amount by June 17, 2002.[2]

With the onset of the Bush Administration in 2001, cooperation began to supercede confrontation. Pascal Lamy, the EU Commissioner for Trade, and Robert Zoellick, the U.S. Trade Representative, reached agreement on the banana dispute and U.S. retaliatory tariffs associated with bananas were lifted in April. The two sides agreed to disagree on the hormone dispute, and the EU consented to provide the United States more time to bring its tax law in conformity with its WTO obligations. Moreover, Lamy and Zoellick collaborated to launch a new round of WTO negotiations last November in Doha, Qatar.

Last year's lull in trade threats was broken on March 5, 2002 when President Bush announced his decision to impose fairly steep, albeit temporary, tariffs of up to 30% on approximately $8 billion in steel imports. Canada, Mexico, Israel, and Jordan – countries that have a free trade agreement with the U.S. - were exempted from all tariffs.[3]

The President's decision to rely on a trade remedy and to impose the tariffs in a selective fashion raised cries of indignation and protectionism from European leaders, and prompted a quick response. On March 27, 2002, citing a threat of diversion of foreign steel from the U.S. market to Europe, the EU announced provisional tariffs of 15% to 26% on 15 different steel products. More provocatively, the EU took initial steps under an untested provision of the WTO to impose retaliatory tariffs by June 18, 2002 on U.S. exports without an explicit authorization to act.

If Brussels decides on swift retaliation rather than waiting for the WTO to rule on whether the U.S. steel tariffs are a violation of world trade rules, U.S. trade officials will be under great pressure to retaliate against the retaliation. In this context, U.S.-EU trade tensions are likely to escalate and potentially more explosive disputes involving the U.S. tax benefit for exports and the EU's policy towards approval of new GE products could become more difficult to manage.[4]

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[1] (...continued)
Relations: Issues and Policy Challenges, by Raymond J. Ahearn.

[2] For background, see CRS Report RS20746, *Export Tax Benefit and the WTO: Foreign Sales Corporation (FSCs) and the Extraterritorial (ETI) Replacement Provision*, by David L. Brumbaugh.

[3] For background, see CRS Report RL31107, *Steel Industry and Trade Issues*, by Stephen Cooney.

[4] For background on the GE products dispute, see CRS Report RL31107, *Agricultural Trade Issues in the 107th Congress*, by Charles Hanrahan, Geoffrey Becker, and Remy Jurenas.

Causes

Escalation of U.S.-EU trade tensions in 2002 has been spurred by three factors. First, each side views actions the other has taken as unreasonable and motivated by narrow political considerations. Second, each side believes that the other is skirting WTO rules and shirking WTO obligations. Third, each side sees the other playing political hardball in crafting retaliation lists that clearly attempt to influence internal political deliberations.

Narrow political actions. Balancing divergent domestic and foreign goals – a strong domestic economy, responsiveness to domestic political interests, promotion of an open world trading system, and fostering strong relationships with key allies – is part of trade policy decision-making. When decisions are skewed toward achieving one of these objectives, controversy often ensues. In this context, the Bush Administration's steel decision was viewed as unreasonable by many Europeans who saw it as driven primarily by narrow domestic political calculations, not broader domestic economic or foreign policy interests. Whether valid or not, many Europeans believed that the decision was motivated by electoral considerations. Moreover, many Europeans were incensed by the discriminatory manner in which the tariffs were implemented, targeting the EU hardest and excluding countries that have a free trade agreement with the United States.

On the contrary, Washington has been irked by EU actions that appear to have narrow political motivations of another kind. The EU's decision to challenge a provision of the FSC export tax benefit is a case in point. While the FSC was enacted in 1984, the EU did not challenge the provision until November 1997. Many on the U.S. side suspect that the challenge had much to do with an attempt by the European Commission to gain negotiating leverage over the United States, as well as with getting even for U.S. pressures over beef and bananas. The fact that few European companies were complaining about the FSC as disadvantaging them commercially further suggests a calculated political motive for launching the case.

Skirting WTO rules. The EU aggressive reaction is related, in part, to its belief that the conduct of the U.S. steel decision violates numerous WTO rules. An essential element of the EU's complaint is that its steel exports to the United States declined by 33 percent between 1998 and 2001, and that the WTO Agreement on Safeguards permits temporary restrictions on imports only when imports are increasing. EU officials also question whether the U.S. decision adequately links the remedy to the actual level of injury caused by imports as opposed to other causes. In addition, they are skeptical that the U.S. decision to exclude its free trade partners from the tariffs is permitted under the most-favored nation principle of the WTO.

U.S. officials say that EU concerns about whether its steel action complies with its WTO obligations should be determined by a formal WTO dispute settlement panel– a process that normally takes up to two years. But the EU maintains that the WTO safeguards agreement allows it to adopt countermeasures immediately because the United States did not show an absolute increase in imports over the most recent three year period. Accordingly, the EU has argued that it is entitled to retaliate as of June 19, 2002 on about $320 million worth of U.S. exports. U.S. trade officials have responded that any immediate unilateral retaliation against the United States would be unprecedented in the history of the WTO and would "strike at the heart of the multilateral trading system."

Retaliation and domestic politics. The WTO permits retaliation (imposition of very high tariffs on a trading partner's exports) when recalcitrant governments fail to comply with dispute panel rulings against them. While it is used sparingly, both the United States and EU have imposed or threatened retaliation in ways that have sparked a raw nerve on both sides of the Atlantic.

When the Clinton Administration levied retaliatory tariffs on European exports over the banana and beef hormone disputes in 2000, the hope was that the Danish, German, Italian, and French exporters affected by higher prices would lobby their respective governments to change the EU policies that were in violation of WTO rules. While some of the "targeted producers" did lobby to change the policies, the retaliation may have stiffened the resolve of other Europeans not to give in to U.S. pressures. This is because many Europeans view retaliation as a frontal assault on European unity – an effort to set one Member State off against another in an attempt to influence EU decision-making.[5]

Despite its condemnation of retaliation as a trade weapon, the EU in the aftermath of the Bush steel decision emulated previous U.S. efforts to devise a retaliation list with domestic political considerations in mind. The EU list includes products from regions such as citrus from Florida, steel from the mid-west, and textiles from North Carolina that are considered politically important to President Bush. Leaving no mistake about intent when he released the list, EU Trade Commissioner Pascal Lamy expressed hope that the threatened countermeasures would help persuade the U.S. Administration to lower its steel barriers.

Consequences

On the one hand, the good news is that the U.S.-EU steel trade spat and associated disputes are unlikely to get out of hand. Some trade disputes may even facilitate greater trade liberalization and industrial restructuring over time if they serve as a prelude to international negotiations. On the other hand, the bad news is that the current tensions and mutual recriminations may make U.S.-EU cooperation in other areas more difficult, and they clearly threaten the viability of the WTO trading system.

Good News. An all-out trade war between the two sides appears remote due to domestic political opposition and the high level of economic integration that now exists. As retaliation hurts consumers, retailers, and companies dependent on "targeted" products for inputs into their production processes, these groups lobby Brussels and Washington intensively to keep specific products off any retaliation list that may be drawn up. Moreover, given the huge stake each side has in the other's market through direct investments and merger and acquisition activity, both European and American multinational companies (MNCs) serve as powerful lobbies that caution restraint. Any imposition of across-the-board and high trade barriers could create massive disruptions in the worldwide production arrangement of MNCs and also deflate economic activity on both sides of the Atlantic. These factors, in turn, limit the scope and flexibility that U.S. and EU trade officials have in devising a politically acceptable retaliation list or in imposing across-the-board and high trade barriers.

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[5] For background, see CRS Report RS21185, *Trade Policymaking in the European Union*, by Raymond J. Ahearn.

Selective trade disputes may have consequences that some view as positive. For example, President Bush's decision to raise steel tariffs reportedly was motivated in part to enlist the support of legislators from steel producing states for passage of Trade Promotion Authority (TPA) legislation. USTR Zoellick argued that the President's willingness to raise tariffs was a short term necessary step for obtaining the leverage TPA may provide for negotiating new sweeping trade liberalization agreements later on. In addition, the Bush Administration argued that higher U.S. tariffs would help spur international negotiations to facilitate the restructuring of the steel industry worldwide.

Bad News. Escalating trade tensions, however, are not cost-free. Polls indicate that trade disputes likely have some effect on public attitudes, contributing to a perception of each other as inward-looking, egotistical, and hypocritical free traders. Trade tensions and mutual recriminations may also make cooperation in other areas more difficult. This includes efforts to settle other trade disputes if media and public pressures intensify for linking disputes. Most assuredly it also includes efforts to make quick progress in the recently launched Doha Round of multilateral trade negotiations. Transatlantic trade tensions over agriculture, for example, stalled progress on the Uruguay Round of trade negotiations for several years in the early 1990s.[6]

What impact trade tensions may have on cooperation on broader foreign policy issues, such as the war on terrorism, remains uncertain. But high profile trade disputes are likely to raise sharper and more critical questions concerning the benefits of such cooperation. If trade tensions work to undermine the notion that the United States and Europe share common values or lead to a view that a weaker America or a weaker Europe is in the other's interest, then the consequences could be more significant.

The most serious consequence of escalating trade tensions may be the strain placed on the WTO system itself. As the EU and U.S. are the WTO's two biggest parties and most important leaders, their relationship and example are critical to the smooth functioning of the multilateral trading system. When either party does not comply with WTO obligations, acts unilaterally, or uses the dispute resolution system to score political points, the WTO-centered world trading system arguably suffers.

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[6] Recent passage of U.S. farm legislation could serve as an additional complication in efforts to move the Doha Round forward. The increased spending for U.S. farmers could serve as an excuse for the EU to avoid further agricultural liberalization or as a prod to serious negotiations.

Possible Cures

Several cures or recommendations to ameliorate current trade tensions have been put forth. These include greater reliance on compensation (as opposed to retaliation), and greater emphasis on diplomatic as opposed to legal solutions to disputes. While helpful, the fact that some of these high-profile trade disputes have been on-going in one form or another for several decades suggests how difficult dispute resolution can be.

Compensation Instead of Retaliation. When a country refuses to comply with a final dispute resolution ruling, the primary enforcement mechanism is WTO authorized retaliation. Many observers maintain that the system should place more stress on trade compensation in order to limit the negative consequences of retaliation. Trade compensation would require the defending country to open other markets in compensation for the markets it restricts. Instead of restricting trade, compensation would bias dispute resolution towards lowering trade barriers - the essential goal of the WTO.

The hurdles to greater reliance on compensation are both political and legal. In the steel safeguards case, for example, if the United States were to reduce tariffs on textile imports as compensation for raising tariffs on steel, one industry would be asked to "pay" for another industry's protection. Moreover, payment of compensation before the WTO rules whether the U.S. steel safeguard action was imposed consistent with WTO rules could be viewed as admission of wrongdoing.

Greater Emphasis on Diplomatic Solutions. The U.S. and EU are the heaviest users of the WTO dispute resolution system. Some of the disputes between the two sides have been submitted to a WTO panel for resolution without strenuous efforts at resolving the dispute beforehand. Some disputes arguably have been initiated out of a desire to score political points by winning cases that show the other side in technical violation of WTO provisions. Once the dispute panel is formed, neither side is inclined to seek a negotiated solution out of fear of compromising important principles and obtaining a ruling on who is "right" or " wrong." In the process, numerous disputes have become acrimonious and have hurt the credibility of the WTO as an institution.

To deal with problems accompanying a confrontational approach, many observers have emphasized the desirability of greater reliance on a diplomatic approach that stresses conciliation and problem-solving over legal precision. In a sense, this is the route U.S. trade policymakers may be taking in the steel dispute by offering selective EU member states favorable consideration of their exporters' requests that specific products be exempted from U.S. steel tariffs. Exemption from U.S. tariffs, in turn, may help shore up opposition in member states such as Germany, Sweden, and Great Britain to precipitous EU retaliation. Another form of diplomacy may be helping resolve the FSC dispute – a dispute where the EU has repeatedly emphasized that it does not want to retaliate against the United States, but rather wants the United States to comply with the WTO panel ruling. To show good faith that it is moving in that direction, congressional leaders are reportedly discussing a process for changing the U.S. tax provision in dispute.[7]

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[7] *Inside U.S. Trade*, "Thomas Sees Procedural Arrangement for FSC If Legislation Fails," May 10, 2002.