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## **Trade Conflict and the U.S.-European Union Economic Relationship**

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Raymond J. Ahearn  
Specialist in International Trade and Finance  
Foreign Affairs, Defense, and Trade Division

# Trade Conflict and the U.S.-European Union Economic Relationship

## Summary

The United States and the European Union (EU) share a huge, dynamic, and mutually beneficial economic partnership. Not only is the U.S.-EU trade and investment relationship the largest in the world, but it is also arguably the most important. Agreement between the two partners in the past has been critical to making the world trading system more open and efficient.

Given the high level of U.S.-EU commercial interactions, trade tensions and disputes are not unexpected. In the past, U.S.-EU trade relations have witnessed periodic episodes of rising trade tensions and conflicts, only to be followed by successful efforts at dispute settlement. This ebb and flow of trade tensions occurred again last year with high-profile disputes involving tax breaks for U.S. exporters and production subsidies for the commercial aircraft sector.

Major U.S.-EU trade disputes have varied causes. Some disputes stem from demands from producer interests for support or protection. Trade conflicts involving agriculture, aerospace, steel, and 'contingency protection' fit prominently into this grouping. These conflicts tend to be prompted by traditional trade barriers such as subsidies, tariffs, or industrial policy instruments, where the economic dimensions of the conflict predominate. Other conflicts arise when the U.S. or the EU initiate actions or measures to protect or promote their political and economic interests, often in the absence of significant private sector pressures. The underlying cause of these disputes over such issues as sanctions, unilateral trade actions, and preferential trade agreements are different foreign policy goals and priorities of Brussels and Washington. Still other conflicts stem from an array of domestic regulatory policies that reflect differing social and environmental values and objectives. Conflicts over hormone-treated beef, bio-engineered food products, protection of the audio-visual sector, and aircraft hushkits, for example, are rooted in different U.S.-EU regulatory approaches, as well as social preferences.

These three categories of trade conflicts — traditional, foreign policy, and regulatory — possess varied potential for future trade conflict. This is due mostly to the fact that bilateral and multilateral agreements governing the settlement of disputes affect each category of disputes differently. By providing a fairly detailed map of permissible actions and obligations, trade agreements can dampen the inclination of governments to supply protection and private sector parties to demand protection.

In sum, U.S.-EU bilateral trade conflicts do not appear to be as ominous and threatening as the media often portray, but they are not ephemeral distractions either. Rather they appear to have real, albeit limited, economic and political consequences for the bilateral relationship. From an economic perspective, the disputes may also be weakening efforts of the two partners to provide strong leadership to the global trading system.

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# Trade Conflict and the U.S.-European Union Economic Relationship

## Introduction

The bilateral economic relationship between the United States and European Union (EU) is shaped by two outstanding trends. On the one hand, the two transatlantic economies share a high degree of commercial interaction, most notably a huge trade and investment relationship and a growing number of corporate mergers. Cooperation between the two partners has been critical to the promotion of world trade. On the other hand, the bilateral economic relationship is subject to limited, but increasingly contentious, trade conflicts that potentially could have adverse political and economic repercussions.<sup>1</sup> These include a weakening of shared interests and bonds as well as an undermining of the credibility of the World Trade Organization.

The dimensions of the mutually beneficial side of the economic relationship are well known. The United States and EU are parties to the largest two-way trade and investment relationship in the world. Annual two-way flows of goods, services, and foreign direct investment exceeded \$1.3 trillion in 2005. This sum means that over \$3 billion is spent every day on transatlantic purchases of goods, services, and direct investments.<sup>2</sup>

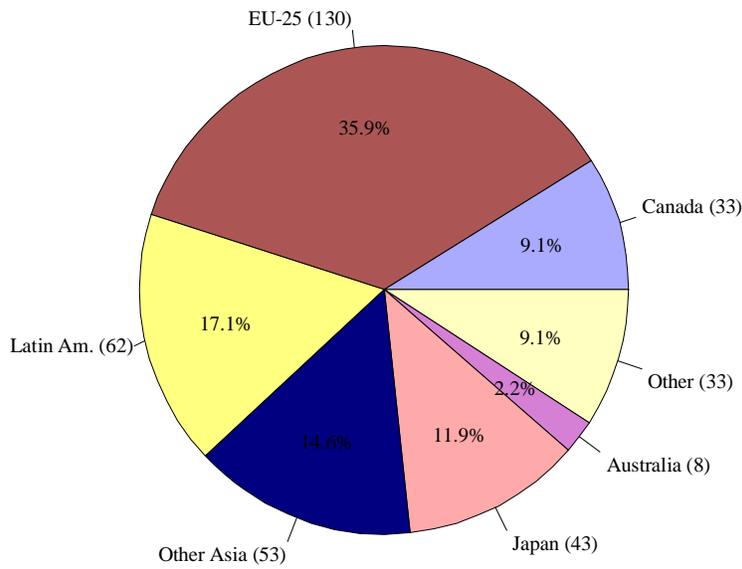
The European Union as a unit is the second largest (next to Canada) trading partner of the United States in merchandise or goods. In 2005 the EU accounted for 20.6% (or \$186 billion) of U.S. exports and 18.5% (or \$309 billion) of U.S. imports. The EU is also the largest U.S. trading partner in services. In 2005, the EU purchased slightly over 34% of total U.S. services exports (or \$130 billion). But the United States since 1993 has been importing more goods from the EU than it has been exporting. In 2005, the resulting U.S. trade deficit with the EU totaled \$122 billion or 16% of the U.S. merchandise trade deficit with the world. This trade deficit is partially offset by U.S. surpluses in services trade which have averaged around \$10 billion dollars over the 2002-2005 period.

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<sup>1</sup> For the purposes of this report, the term “conflict” is used broadly to include U.S.-EU disagreements on issues that may not have been raised in formal World Trade Organization (WTO) proceedings. The term “dispute” is used more narrowly for issues that have been subject to WTO consultations, including those requests which have led to panel and appellate review proceedings. Unless referring to a particular dispute, the two terms, however, are often used interchangeably.

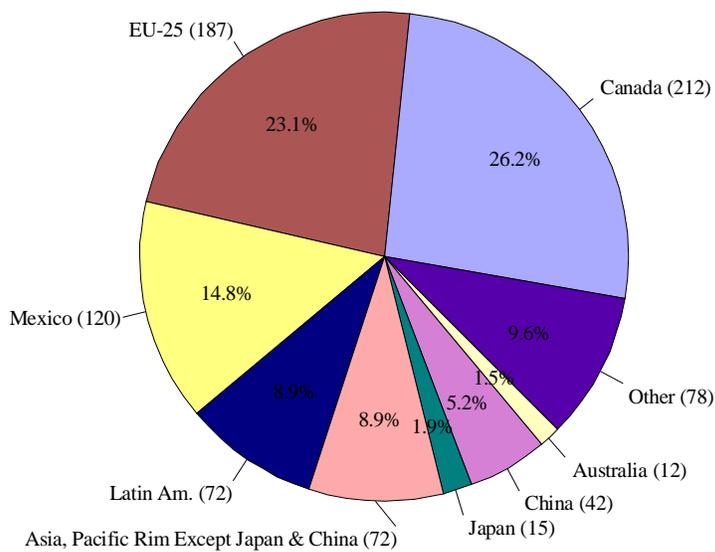
<sup>2</sup> Data sources for this section, unless otherwise noted, are drawn from the following sources: Cooper, William H., *EU-U.S. Economic Ties: Framework, Scope, and Magnitude*, CRS Report RL30608; the European Union’s profile of facts and figures on the EU-U.S. economic relationship found on-line at [<http://www.eurunion.org/profile/facts>]; and various editions of the Survey of Current Business, Department of Commerce.

**Figure 1. U.S. Exports of Services by Region/Country, 2005**  
(Billions of U.S. Dollars)



Source: U.S. Department of Commerce.

**Figure 2. U.S. Exports of Goods by Region/Country, 2005**  
(Billions of U.S. Dollars)



Source: U.S. Department of Commerce.

Based on a population of some 457 million citizens and a gross domestic product of about \$10.3 trillion (compared to a U.S. population of 289 million and a GDP of \$10.6 trillion in 2003), the twenty-five members of the EU combine to form the single largest market in the world. Given the reforms entailed in the introduction of the European single market in the early 1990s, along with the introduction of a single currency, the *euro*, for twelve members, the EU market is also increasingly open and standardized.

The fact that each side has a major ownership stake in each other's market may be the most remarkable aspect of the commercial relationship. At the end of 2004, the total stock of two-way direct investment reached \$2.2 trillion (composed of \$1.1 trillion in EU investment in the United States and \$1.1 trillion in U.S. investment in the EU), making U.S. and European companies the largest investors in each other's market. Roughly 60% of corporate America's foreign investments are located in Europe, while almost 75% of Europe's foreign investments are based in the United States. This massive amount of ownership of companies in each other's markets translates into billions of dollars of sales, production, and expenditures on research and development. In addition, an estimated 6-7 million Americans are employed by European affiliates operating in the United States and almost an equal number of EU citizens work for American companies in Europe.<sup>3</sup>

Foreign direct investment also serves to spur international trade flows. This is due to the fact that trade taking place within the same company (imports by U.S. affiliates from their EU parent firms and exports by U.S. companies to their EU affiliates) accounts for around one-third of U.S. total trade with the EU. The trade and employment linkages associated with foreign direct investment help create strong and politically active interest groups that lobby on both sides of the Atlantic in favor of maintaining friendly bilateral ties, reducing regulations, and in opposing protectionist proposals.

The United States and the European Union, acting in concert, are the superpowers of the world trading system. As shown in **Tables 1 and 2**, together they accounted for 35% of world merchandise trade in 2004 and 60% of the world's production of goods and services in 2003. Cooperation and joint leadership between the two partners have historically been the key to all previous efforts to liberalize world trade on a multilateral basis, including the creation of the General Agreement on Tariffs and Trade (GATT) in 1948 and the World Trade Organization (WTO) in 1995.

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<sup>3</sup> Hamilton, Daniel S. and Joseph P. Quinlan, *Partners in Prosperity: The Changing Geography of the Transatlantic Economy*, The Johns Hopkins University, 2004.

**Table 1. World Merchandise Trade, 2004**  
**(Excluding intra-EU trade)**  
 (Billions of U.S. Dollars)

	<b>Imports and Exports</b>	<b>% of Total</b>
United States	2,343	17.2
EU-25	2,483	18.2
U.S. and EU-25	4,826	35.4
World	13,627	100

**Source:** WTO.

**Table 2. World Gross Domestic Product, 2003**  
 (Billions of Dollars)

<b>Region/Country</b>	<b>GDP</b>	<b>% of World Total</b>
United States	10,949	30.0
EU-25	10,959	30.0
EU-25 plus United States	21,908	60.0
Japan	4,301	11.7
Latin America & Caribbean	1,740	4.7
East Asia and Pacific	2,033	6.6
China + Hong Kong	1,574	5.6
Canada	856	2.3
Middle East and N. Africa	745	2.0
South Asia	765	2.0
Sub-Saharan Africa	439	1.2
World	36,461	100

**Source:** World Bank, World Development Indicators - 2005.

Trade tensions, disputes, and rivalry coexist alongside and, in part, result from these cooperative and generally positive currents. Bilateral trade disputes have been an important part of the relationship during the Cold War as well as after. They are nothing new nor unexpected given the huge volume of commercial interactions. Historically, with the possible exception of agriculture, the disputes have been managed without excessive political rancor, perhaps due to the balanced nature of the trade and investment relationship. Policymakers and many academics often emphasize that the U.S. and EU always have more in common than in dispute, and like to point out that trade disputes usually affect a tiny fraction (often estimated at 1-2 percent) of the trade in goods and services.

### **All In the Family?**

The notion that trade disputes with the European Union generally have engendered less political rancor and bitterness than U.S. trade disputes with a number of developing countries and Japan is a popular one. Whether the proposition is valid or not, the most common explanation put forth relates to the view that transatlantic trade relations are underpinned by comparable levels of socioeconomic development and by more balanced economic interactions.

EU member states, unlike many developing countries, have wage rates and labor and environmental standards that equal or exceed U.S. standards. From one perspective, this fact shields Europe from charges of “cutthroat” competition and “unfair” trade that are often directed at low-wage developing countries possessing relatively low labor and environmental standards.

Several indicators support the argument that trade between the United States and EU takes place on a “level playing field.” As measured by the value of imports and exports of goods and services as a percentage of GDP, for example, a case can be made that both economies are similarly open to trade. In 2005, the trade openness ratios of both trading partners ranged between 25 and 30 percent.

The composition of trade and pattern of trade deficits are also used to illustrate that U.S.-EU trade ties are balanced and non-adversarial. Unlike U.S. trade with China, U.S.-EU trade is characterized by a high level of intra-industry trade, where both sides import and export similar products such as cars, computers, aircraft, and integrated circuits. Nor have U.S. merchandise trade deficits with the EU given rise to the same kind of concern that U.S. trade deficits with China have sparked. Macroeconomic factors, such as differential economic growth rates and the exchange rates, are generally thought to explain most of the fluctuation in the U.S.-EU bilateral deficit, rather than trade barriers or other structural attributes.

In the middle of this decade, however, Washington and Brussels are still at loggerheads over a number of issues, ranging from bio-engineered food products and aircraft to the treatment of agriculture in the Doha Round of multilateral trade negotiations. The conflicts have not been easy to resolve, and some of the efforts at dispute resolution have led to escalation and tit-for-tat retaliation. Instead of compromising in an effort to find solutions, policymakers on both sides sometimes appear more interested in getting even.

Congress has been in the middle of many of the trade disputes. By both introducing and passing legislation, Congress has supported the efforts of U.S. agricultural and industrial interests to gain better access to EU markets. Congress has pressured the executive branch to take a harder line against the EU in resolving a number of disputes, but has also cooperated with the administration in crafting compromise solutions.

Combined with a growing value of trade now being disputed, the political and economic effects of trade discord between Brussels and Washington are important questions. Why are many disputes so difficult to resolve? What can be done to improve dispute resolution efforts? Are the disputes undermining business confidence or efforts at economic policy coordination? Are the disputes weakening the credibility of the WTO dispute settlement system? Do the political disputes

reflect differences between the two partners in terms of basic values and orientations? If so, could the disputes force a fundamental re-evaluation of the importance of the bilateral relationship? In short, what is the significance of trade conflict to the bilateral relationship?

This report considers these overriding questions in three parts. The first part categorizes and evaluates the trade conflicts according to their underlying causes and characteristics. In light of the causes and dimensions of the disputes, the second section examines the potential for conflict management. A final section assesses the role that trade disputes may be playing in the U.S.- EU economic relationship.

## **Sources of Trade Conflict**

Changes in government regulations, laws, or practices that protect or promote domestic commercial interests at the expense of foreign interests are at the heart of most trade conflicts. While governments are the sole providers or suppliers of trade protection, there are a range of parties or interest groups that demand or request measures that result in protection for domestic parties. These include producers and workers, as well as consumer and environmental interest groups. Governments may also be the primary demanders or initiators of actions that have trade protectionist effects.

U.S.- EU trade conflicts vary according to the nature of the demand for protection. Many of the major U.S.-EU trade conflicts are classified and discussed below according to the nature of the demand for protective action. While many of the conflicts are spurred by multiple demanders and causes, an attempt is made to classify disputes according to categories that seemingly account for the overriding cause or demand for government action.

As most trade conflicts embody a mixture of economic, political, and social dimensions, there is ample room for disagreement over the dominant cause of any particular dispute. By and large, this report classifies most of the conflicts according to American perspectives. U.S.-European disagreements over the cause and nature of the controversy, of course, provides the basis for many of the conflicts. Whether the conflict is propelled by protectionist or legitimate domestic aims remains a key question in some disputes as well.

### **Traditional Trade Conflict: Producer Protection**

Some conflicts stem primarily from demands from producer or vested interests for protection or state aids. These kinds of disagreements arise when both transatlantic trade partners, in support of vested interests and key industries, craft policies that try to open markets for exports but keep markets protected from imports as much as possible. Trade conflicts involving agriculture, aerospace, steel, and 'contingency protection' fit prominently in this grouping. These are examples of traditional trade conflicts, prompted by trade barriers such as tariffs, subsidies or industrial policy instruments, where the economic dimensions of the conflict predominate.

**Agriculture.** Agricultural trade disputes historically have been major sticking points in transatlantic relations. Accounting for a declining percentage of output and employment in both the EU and United States, the agricultural sector has produced a disproportionate amount of the trade tension between the two sides. In the past, the majority of what can be called traditional conflicts stemmed primarily from government efforts to shield or protect farmers from the full effects of market forces (non-traditional agricultural disputes involving food safety and the application of biotechnology to food production are discussed below under **Regulatory Protection**).

From the U.S. perspective, the restrictive trade regime set up by the Common Agricultural Policy (CAP) has been the real villain. It has been a longstanding U.S. contention that the CAP is the largest single distortion of global agricultural trade. American farmers and policymakers have complained over the years that U.S. sales and profits are adversely affected by (1) EU restrictions on market access that have protected the European market for European farmers; (2) by EU export subsidies that have deflated U.S. sales to third markets; and (3) by EU domestic income support programs that have kept non-competitive European farmers in business.<sup>4</sup>

Agricultural conflict, particularly over the decline in U.S. exports to the EU and growing EU competition for sales in third markets, was intense in the 1980s. During this period, the majority of U.S. Section 301 cases were directed at the CAP and fierce subsidy wars were waged over third country markets. Acrimonious agricultural subsidy disputes over canned fruit, oilseeds, wine, wheat flour, pasta, sugar, and poultry between the two sides tested the GATT dispute settlement system to its limits in the 1980s.<sup>5</sup>

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<sup>4</sup> For a comparison of agricultural programs, see Becker, Geoffrey S. *Agricultural Support Mechanisms in the European Union: A Comparison with the United States*. CRS Report RL30753.

<sup>5</sup> Section 301 of the Trade Act of 1974, as amended, requires the USTR to take all appropriate action, including retaliation, to obtain the removal of any act, policy, or practice of a foreign government that violates an international agreement or is unjustifiable, unreasonable or discriminatory, and burdens and restricts U.S. commerce. In practice, it has been employed mostly on behalf of American exporters fighting foreign import barriers or subsidized competition in third-country markets.

### What Is The CAP?

The Common Agricultural Policy of the EU is a domestically-oriented farm policy whose primary objective is supporting farm income. Since its inception in 1962, the CAP has been guided by three principles: (1) a free flow of agricultural commodities within the EU; (2) community preferences whereby EU products have priority in the internal market over imports; and (3) common financing of agricultural programs.

Historically, the high support prices of the CAP have provided strong incentives for investing in EU agriculture. Since 1970, the EU has shifted from being a net importer to one of the world's largest net exporters of wheat, sugar, beef, pork, poultry, and dairy products.

One effect of the CAP has been to raise overall food prices for consumers in the EU. Most U.S. farm programs, in contrast, support farm income without raising food prices to the consumer.

Spending on the CAP accounts for over 50 percent of the EU budget. High budget outlays in the past have caused several budget "crises," leading to policy reforms aimed at curbing agricultural expenditures. EU enlargement to include a number of East European countries that have large agricultural sectors is providing additional pressures for reforming the CAP.

Tensions, however, have moderated markedly since the completion of the Uruguay Round in the mid-1990s. The 1994 Uruguay Round Agreement on Agriculture defined more clearly what both partners can do in their agricultural and trade policies, as well as defined more clearly the quantities of agricultural products that countries can export with subsidies and strengthened the procedure for settling disputes involving those rules. The agreement also contained a nine-year "peace clause" whereby WTO members agreed not to challenge other countries' subsidies with domestic cases or WTO challenges.<sup>6</sup>

For the most part, the U.S. and EU have honored their Uruguay Round agricultural commitments, including 'due restraint.' Scope for future conflict has been constrained, or perhaps redirected into areas not so clearly covered by the Agreement of Agriculture. These included a number of non-traditional disputes over beef hormones, bio-engineered food products, and geographical indicators — none of which involve domestic subsidies.<sup>7</sup>

Negotiations on agriculture in the Doha Round have continued to divide the two economic superpowers. The United States has proposed substantial reductions in domestic subsidies, expanded market access through both tariff reduction and

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<sup>6</sup> Tangermann, Stefan. "The Common and Uncommon Agricultural Policies," In *Transatlantic Relations in A Global Economy*, Mayer, Otto and Scharrer, Hans-Eckart, eds, Nomos Verlagsgesellschaft, 1999, p. 143.

<sup>7</sup> T. Josling and S. Tangermann, "Production and Export Subsidies in Agriculture: Lessons from GATT and WTO Disputes Involving the US and the EC," In Ernst-Ulrich Petersmann and Mark A. Pollack, *Transatlantic Economic Disputes: The EU, the US, and the WTO*, Oxford University Press, 2003. p 224.

expansion of market access quotas, and the elimination of export subsidies. The EU, for its part, has called on the United States to increase its offer to reduce trade-distorting domestic support but have not been willing to improve their own offer to expand market access. Unless these positions can be bridged, the negotiations may remain deadlocked.

**Aerospace.**<sup>8</sup> Claims and counter-claims concerning government support for the aviation industry have been a major source of friction in U.S.-EU relations over the past several decades. The fights have focused primarily on EU member state support for Airbus Industrie, a consortium of four European companies that collectively produce Airbus aircraft. According to the Office of the U.S. Trade Representative (USTR), Airbus member governments (France, U.K., Germany and Spain) have provided massive subsidies since 1967 to their member companies to aid in the development, production, and marketing of the Airbus family of large civil aircraft. The U.S. has also accused the EU of providing other forms of support to gain an unfair advantage in this key sector, including equity infusions, debt forgiveness, debt rollovers, marketing assistance, and favored access to EU airports and airspace.<sup>9</sup>

For its part, the EU has long resisted U.S. charges and argued that for strategic and economic purposes it could not cede the entire passenger market to the Americans, particularly in the wake of the 1997 Boeing-McDonnell Douglas merger and the pressing need to maintain sufficient global competition. The Europeans have also counter-charged that their actions are justified because U.S. aircraft producers have benefitted from huge indirect governmental subsidies in the form of military and space contracts and government sponsored aerospace research and development.<sup>10</sup>

The most recent round of this longstanding trade dispute stems from a May 30, 2005 WTO filing by the United States alleging that European Community (EC) Member States provided Airbus with illegal subsidies giving the firm an unfair advantage in the world market for large commercial jet aircraft. The following day the EC submitted its own request to the WTO claiming that Boeing had received illegal subsidies from the U.S. government. Although negotiations between the parties may yet be resumed, the WTO dispute resolution panels themselves were expected to take at least a year before reaching findings as to which parties might be at fault and assessing penalties accordingly (which in this case could, according to some observers, be levied on both sides).

Much of the ongoing debate about the Airbus/Boeing relationship stems from Airbus's December 2000 launch of a program to construct the world's largest commercial passenger aircraft, the Airbus A380. The A380 is being offered in several

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<sup>8</sup> This section was written by John W. Fischer, Specialist in Transportation, Resources, Science, and Industry Division.

<sup>9</sup> USTR National Trade Estimates Report: 2000, pp. 102-104.

<sup>10</sup> Burger, Bettina. "Transatlantic Economic Relations: Common Interests and Conflicts in High Technology and Industrial Policies," *In Transatlantic Relations in A Global Economy*, p. 110.

passenger versions seating between 500 and 800 passengers, and as a freighter. At the end of 2005, Airbus was listing 159 firm orders for the aircraft from 16 different airlines.<sup>11</sup> The project is believed to have cost about \$13 billion, which includes some significant cost overruns identified by Airbus in 2005. Airbus expects that its member firms will provide 60% of this sum, with the remaining 40% coming from subcontractors. State-aid from European governments is also a source of funding for Airbus member firms. State-aid is limited to one-third of the project's total cost by the previously mentioned 1992 Agreement on Government Support for Civil Aircraft between the United States and the European Union (EU) (now repudiated by the United States, but not by the EC).

Shortly after the A380 project was announced, Boeing dropped its support of a competing new large aircraft. Boeing believes that the market for A380-size aircraft is limited. It has, therefore, settled on the concept of producing a new technology 250-seat aircraft, the 787, which is viewed as a replacement for 767-size aircraft.<sup>12</sup> The 787 is designed to provide point-to-point service on a wide array of possible international and domestic U.S. routes. The aircraft design incorporates features such as increased use of composite materials in structural elements and new engines, with the goal of producing an aircraft that is significantly more fuel efficient than existing aircraft types. Boeing formally launched the program in 2004 and obtained 56 firm orders during the remainder of 2004. By the end of 2005 the order book for the 787 had expanded dramatically to 291 aircraft.

To construct this aircraft Boeing is proposing to greatly expand its use of non-U.S. subcontractors and non-traditional funding. For example, a Japanese group will provide approximately 35% of the funding for the project (\$1.6 billion). In return this group will produce a large portion of the aircraft's structure and the wings (this will be the first time that a Boeing commercial product will use a non-U.S. built wing). Alenia of Italy is expected to provide \$600 million and produce the rear fuselage of the aircraft. In each of these instances, the subcontractor is expected to receive some form of financial assistance from their respective governments. Other subcontractors are also expected to take large financial stakes in the new aircraft. The project is also expected to benefit from state and local tax and other incentives. Most notable among these is \$3.2 billion of such incentives from the state of Washington. Many of these non-traditional funding arrangements are specifically cited by the EC in their WTO complaint as being illegal subsidies.

Whether the WTO litigation (panel rulings are not expected to be handed down until 2007) provides an incentive for the United States and EU to resolve the dispute bilaterally remains to be seen. To date this year the two sides have wrangled over a host of procedural issues. Some analysts believe that the procedural fights do not

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<sup>11</sup> [<http://www.speednews.com/lists/05O&D.pdf>]

<sup>12</sup> Boeing has recently rethought its position on the large aircraft market. On November 14, 2005 Boeing launched the 747-8, a new stretched derivative of the venerable 747. It has received 18 orders for the aircraft in freighter configuration, but is expected to produce a passenger version of the aircraft as well.

reflect a strategy on either side to delay or drag out the procedures, but more an absence of any real bilateral cooperation.<sup>13</sup>

**Steel.** Conflict over trade in steel products has ebbed and flowed over the past two decades. Although the EU industry has undergone significant consolidation and privatization in the 1990s, the U.S. government in the past has alleged that many EU companies still benefit from earlier state subsidies and/or engage in dumping steel products (selling at “less than fair value”) in foreign markets. U.S. steel companies also have aggressively used U.S. trade laws to fight against EU steel imports by filing antidumping and countervailing duty petitions that include imports from EU countries. In return, the EU has countered with numerous challenges in the WTO against the alleged U.S. misuse of its countervailing duty and antidumping laws.

In addition to “unfair” trade disputes, President Bush in June 2001 requested the U.S. International Trade Commission (ITC) undertake a new Section 201 trade investigation on the steel industry.<sup>14</sup> The petition had broad support from Congress, the steel industry, and labor unions. The ITC subsequently ruled that much of the industry was being injured by increased imports and recommended relief measures to President Bush. On March 5, 2003, the President decided to impose three-year safeguard tariffs with top rates of 30%. He imposed the restrictions for three years on all major steel exporting countries except U.S. free trade partners such as Canada and Mexico.

The U.S. decision raised cries of indignation and protectionism from European leaders, and prompted a quick response. On March 27, 2002, citing a threat of diversion of steel from the U.S. market to Europe, the EU announced provisional tariffs of 15% to 26% on 15 different steel products. The EU and a number of other countries adversely affected by the U.S. tariffs also formally challenged the U.S. action as being inconsistent with WTO rules.

In early 2003 a WTO panel determined that the U.S. action had a number of shortcomings. The panel found that the United States had failed to adequately demonstrate that rising imports were injuring the U.S. industry. In September 2003, the ITC issued its mid-term report of the safeguards, and determined that termination of the measures was warranted. This determination, in turn, provided President Bush with leeway to avoid further international conflict by terminating the steel safeguard measures on December 5, 2003.

**Contingency Protection.** A variety of legal procedures, sanctioned by the WTO, provide domestic producers temporary protection against both “fair” and “unfair” trade practices. These include safeguard or import relief procedures for fair

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<sup>13</sup> *Inside U.S. Trade*, “EU Blocks U.S. Request for Second Panel in Aircraft Fight,” April 28, 2006.

<sup>14</sup> Section 201 relief, often referred to as “safeguard,” provides for temporary restrictions on imports that have surged in such quantities as to cause or threaten to cause serious injury to a domestic industry. The procedure is compatible with the rules of the WTO. A Section 201 case does not in itself need to demonstrate dumping, subsidization, or other unfair practices by U.S. trading partners.

trade and anti-dumping and countervailing procedures for unfair trade practices. While these procedures are sanctioned by the WTO, and often referred to as contingency protection, either sides' implementation of these procedures is often controversial.

A recent case in point has been the Continued Dumping and Subsidy Offset Act (CDSOA), or Byrd Amendment. Enacted by the U.S. Congress in October 2000, this provision required that the proceeds from antidumping and countervailing duty cases be paid to the U.S. companies responsible for bringing the cases, instead of to the U.S. Treasury. Soon after enactment, the EU and eight other parties challenged the statute in the WTO on the grounds that the provision constituted a "non-permissible specific action against dumping or a subsidy" contrary to various WTO agreements. Basically, the plaintiffs argued that the action benefitted U.S. companies doubly: first, by the imposition of the antidumping or countervailing duties and, second, by receiving the duties at the expense of their competitors.

The WTO in January 2003 concluded that the Byrd Amendment was an impermissible action against dumping or subsidization and gave the United States until December 23, 2003, to comply with the WTO ruling. When the United States did not comply with the ruling, the complaining members requested authorization to impose retaliatory measures. A WTO arbitrator determined in August 2004 that each of the eight complainants could impose countermeasures on an annual basis in an amount equal to 72% of the CDSOA disbursements for the most recent year in which U.S. data are available.

Canada and the EU began retaliating on May 2, 2005, by placing a 15% additional duty on selected U.S. exports. Mexico imposed higher tariffs on U.S. milk products, wine, and chewing gum as of August 18, 2005, and Japan placed an additional tariff of 15% on 15 steel and industrial products as of September 1.

Despite strong congressional support for the Byrd Amendment in both chambers, a provision repealing the CDSOA was included in the conference report to S. 1932, the Deficit Reduction Act of 2005, and approved in February 2006. The repeal however, allowed CDSOA payments on all goods that enter the United States to continue through October 1, 2007. As a result, the EU, Canada, and Mexico indicated their intention to keep the sanctions on U.S. imports in place as long as the disbursements continue. The EU, in particular, elected to increase the amount of retaliation by nearly \$9 million (from \$27.8 million to \$36.9 million) and expand the list of products that will face punitive duties. U.S. trade officials and some members of Congress have expressed disappointment and frustration that retaliation was not lifted in the wake of the Byrd repeal.<sup>15</sup>

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<sup>15</sup> *Inside U.S. Trade*, "EU Expands Byrd Retaliation Duties; Canada Undecided On Options," April 28, 2006.

## Foreign Policy Conflict: Clashing State Interests

This category comprises conflicts where the United States or the European Union has initiated actions or measures to protect or promote their political and economic interests, often in the absence of significant private sector pressures. The underlying causes of these disputes are quite different foreign policy goals and priorities, if not interests. Most of these conflicts have important economic interests at stake, but seldom are the economic stakes viewed as the overriding cause or explanation of the action that ostensibly precipitated the disagreement.

From the EU perspective, extraterritorial provisions of U.S. sanctions legislation and unilateralism in U.S. trade legislation are concerns that fit into this category. From a U.S. perspective, the EU's preferential dealings with third countries, the Foreign Sales Corporation (FSC) export tax-rebate dispute, and challenges to varied U.S. trade laws could be said to be driven primarily by EU foreign policy priorities.

**EU Concerns.** U.S. legislation which requires the imposition of trade sanctions for foreign policy or non-trade reasons has been a major concern of the EU. While the EU often shares many of the foreign policy goals of the United States that are addressed in the offending legislation, it has opposed the extraterritorial provisions of certain pieces of U.S. legislation that seek to unilaterally regulate or control trade and investment activities conducted by companies outside the United States. Although these issues have been relatively quiet in recent years, a number of the provisions remain U.S. law, including the Cuban Liberty and Democratic Solidarity Act of 1996 (so-called Helms-Burton Act) and the Iran Libya Sanctions Act (ILSA), which threaten the extraterritorial imposition of U.S. sanctions against European firms doing business in Cuba, Iran, and Libya.<sup>16</sup> Other EU concerns about different instances of U.S. extra-territoriality relate to various environmentally driven embargoes, export control legislation, and sub-federal (states) procurement provisions or boycott activities.<sup>17</sup>

The Helms-Burton Act, passed in 1996 after the Cuban military shot down two small U.S. based civilian planes, led to a firestorm of protest in Europe. Perhaps not since the U.S. imposed sanctions against companies doing business on a Russian pipeline in the early 1980s had the European outcry been so vociferous. The bill, which was designed to further isolate Cuba economically, imposed a secondary boycott against foreign nationals and companies that "traffic" in Cuban-expropriated properties formerly owned by U.S. nationals.<sup>18</sup>

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<sup>16</sup> The application of ILSA with respect to Libya was terminated by President Bush in April 2004.

<sup>17</sup> The EU has been particularly critical of efforts by U.S. states and cities to limit government procurement opportunities as a result of the companies' business links with particular foreign countries. A law adopted by Massachusetts focused on corporate involvement with Burma had been a considerable concern until it was overturned by the Supreme Court on June 19, 2000.

<sup>18</sup> This provision has been waived by President Clinton annually since its enactment.

Maintaining that Helms-Burton is extraterritorial and a violation of WTO rules, the EU passed countervailing legislation against its enforcement and initiated a WTO panel investigation. The U.S. responded by claiming the WTO lacked competence to investigate the matter because Helms-Burton is a “national security” issue and therefore should qualify for a waiver under section 21 of the GATT. After a year of high-level political negotiations, an understanding was reached in April 1997 that charted a longer-term solution through negotiation of international disciplines and principles for greater protection of foreign investment, combined with the proposed amendment of the Helms-Burton Act. At the May 1998 EU-U.S. Summit, the United States agreed to either implement or seek measures that would protect EU companies from any penalties called for in Helms-Burton and Iran-Libya Sanction Act.<sup>19</sup> Implementation of the Understanding, however, still awaits legislative action by Congress.<sup>20</sup>

Closely related to EU concerns about extraterritoriality are complaints about U.S. trade laws and procedures that allow for the “unilateral” imposition of trade sanctions against offending countries or companies. Most EU complaints relate to the “Section 301” family of trade provisions which authorize the executive branch to impose trade sanctions in an effort to enforce U.S. rights under international trade agreements and to combat foreign unfair trade practices. In addition to general trade barriers which the U.S. government deems discriminate against or burden U.S. commerce, other more specialized provisions dealing with government procurement barriers (often legislated by states) and intellectual property rights violations are also subject to EU charges as examples of U.S. unilateralism.<sup>21</sup>

Additionally upsetting to some American interests, the EU during this same period has filed a number of mostly technical challenges in the WTO to a variety of U.S. trade statutes, including Section 301, a law (section 337) dealing with the protection of intellectual property rights, and the U.S. antidumping laws. Some Americans view these WTO challenges as part of a systematic and concerted EU strategy to weaken or gut U.S. trade laws, perhaps in an effort to gain negotiating leverage that could be used in future efforts to arrive a transatlantic consensus on the agenda for a new round of multilateral trade negotiations.<sup>22</sup>

**U.S. Complaints.** The United States in the past has expressed concerns about the discriminatory impact of preferential agreements the EU has negotiated with third countries. These include preferential trade agreements with prospective EU members in Eastern and Central Europe and with developing countries in Africa and the Caribbean. As a result of these agreements, only eight countries including the United

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<sup>19</sup> “EU, Spain Warn U.S. of Action Over Helms-Burton Cuba Measure,” *International Trade Reporter*, August 18, 1999, p. 1364.

<sup>20</sup> EU Annual Report on U.S. Trade Barriers, 2005, p.1.

<sup>21</sup> On May 1, 2000, USTR announced the successful resolution of a dispute with Germany over procurement procedures in the heavy electrical sector, but placed the EU, Italy, Ireland, and Greece on the “priority watch list” for intellectual property rights violations.

<sup>22</sup> Statement of Senator Max Baucus, “Improving U.S. Trade Law,” Conference on America’s Trade Agenda After the Battle in Seattle, July 20, 2000.

States, Japan and Canada, now receive MFN treatment for their exports to EU. The rest of the world is accorded better than MFN tariff treatment under these agreements, which the WTO has determined, are increasingly structured to benefit the EU, not just the other signatories to the agreement.<sup>23</sup>

Some U.S. observers have also worried that enlargement and institutional deepening have become EU policy goals that are limiting its commitment to global trade liberalization. Under this view, the EU's "internal" preoccupation translates into less interest in negotiating any new MFN or WTO obligations because such obligations could intensify adjustment pressures EU firms are experiencing as a result of the drive toward a single market and the heightened import competition resulting from preferential tariff agreements negotiated with various regional trading partners.<sup>24</sup> At the same time, the United States has also supported both enlargement and deepening in the political interest of "European stability", thus raising a question concerning the compatibility of U.S. political and trade goals.

For its part, the EU has expressed fears that free trade agreements being pursued by the United States could lead to discrimination against its exports. Specifically, the EU is concerned that U.S. efforts to negotiate free trade agreements with Asia through the Asian Pacific Economic Cooperation (APEC) process and with Latin America through the Free Trade Area of the Americas (FTAA) could lead to discrimination against EU exports. This, in turn, has been a spur for the EU to negotiate its own free trade accords with Mexico, and the Mercosur countries of Latin America.

A different U.S. concern relates to the FSC provisions of the U.S. tax code. This provision allowed U.S. firms to exempt between 15% and 30% of export income from taxation by sheltering some income in offshore foreign sales corporations. General Electric, Boeing, Motorola, Caterpillar, Allied Signal, Cisco, Monsanto, and Archer Daniels Midland were among the top beneficiaries of this arrangement.<sup>25</sup>

The FSC was enacted in 1984 to replace the Domestic International Sales Corporation (DISC) — a different tax benefit for exporting that the EU had successfully challenged in the GATT. Both provisions were designed to stimulate the U.S. economy through increased exports. While the European officials may not have been fully satisfied that the FSC was fully GATT legal, they nevertheless waited thirteen years (until November 1997) to take the first steps to challenge the scheme under the WTO dispute settlement system.

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<sup>23</sup> "WTO Members Use Trade Policy Review To Criticize EU Practices, *Inside U.S. Trade*, July 14, 2000.

<sup>24</sup> Schott, Jeffrey J. "Whether U.S.-EU Trade Relations?", in Eichengreen, Barry, ed., *Transatlantic Economic Relations in the Post-Cold War Era*, Council on Foreign Relations, 1998.

<sup>25</sup> CRS Report RS20571, *The Foreign Sales Corporation (FSC) Tax Benefit for Exporting and the WTO*, by David L. Brumbaugh.

The EU argued that it challenged the FSC because it violated WTO subsidy obligations, distorted international competition, and provided U.S. exporters unfair advantages. Yet, with the possible exception of Airbus, the Brussels challenge appeared to have very limited backing from European business.<sup>26</sup> A number of European subsidiaries operating in the United States, in fact, benefitted from the FSC.

A more common explanation is that the EU challenge had more to do with an attempt to gain negotiating leverage over the United States, as well as with getting even for U.S. pressures over beef and bananas, than to redress a perceived commercial disadvantage. A *Financial Times* editorial views the challenge as “tit-for-tat retaliation for U.S. bullying in trade disputes over bananas and beef. Having won its point, the EU now seems determined — in the name of upholding trade rules — to make the U.S. squirm.”<sup>27</sup>

The EU challenge was successful, with the requirement that the United States bring the FSC provisions in conformity with the WTO by October 2000. Following the ruling, Congress passed the replacement ETI tax provision, but this law was also found inconsistent with WTO obligations in 2002. Subsequently, the WTO authorized the EU to retaliate in the absence of U.S. compliance, and the EU began imposing escalating retaliatory duties (starting at 5%) on \$4 billion of U.S. exports on March 1, 2004. After reaching 14% in December 2004, these sanctions were lifted in January 2005 subsequent to congressional repeal of the FSC-ETI provisions in the American Jobs Creation Act (P.L. 108-357) of October 2004. But a WTO ruling of February 13, 2006, determined that the act perpetuated the illegal subsidies with a two-year phase-out of the tax breaks and a grandfather clause covering exporters that had sales contracts dated before September 17, 2003.

In announcing the EU’s decision to reimpose sanctions, Peter Mandelson, the EU’s top trade official, said that “the EU will not accept a system of tax benefits which give U.S. exporters, including Boeing, unfair advantage against their European competitors.” But the reimposition of the tariffs was avoided when President Bush on May 17, 2006, signed a tax bill that among other things repealed the grandfathered FSC/ETI benefits as well as leasing contracts.

## **Regulatory Policy Conflict: Social and Environmental Protection**

This category of conflict deals with an array of domestic policies, including regulations and standards, that produce conflict by altering the terms of competition in the name of promoting social, cultural, or environmental objectives. Most generally, domestic producers benefit, either intentionally or inadvertently, at the expense of foreign producers. Many of these clashes have occurred as a result of

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<sup>26</sup> One source cites Airbus Industrie’s concerns in the early 1990s over the FSC benefits Boeing was receiving. See *Airline Business*, “Flying FSCs Anger Airbus,” May 1993, p. 21.

<sup>27</sup> “Taxing the WTO to the Limit,” *Financial Times*, September 4, 2000, p. 8.

efforts by both partners to strengthen food safety and environmental standards; others have occurred as a result of the EU's need to harmonize standards in support of its drive towards a single market. Still others have occurred as a result of a drive to maintain or promote cultural values and distinctiveness.

These disputes tend to involve complex new issues that have arisen as a result of increased economic interdependence and of significant U.S.-EU differences in regulatory approaches. The EU approach to regulation is based on the notion that every important economic activity should take place under a legal framework, whereas the central premise of the U.S. approach is that government does not need to regulate unless a problem arises.

While the impact on trade may be the same as in other disputes, these conflicts are often characterized by delicate considerations of motives. Parties that have initiated the action, often consumer or environmental groups, tend to view the protective impact as an indirect consequence of an attempt to attain some valid domestic objective. Trade barriers motivated by food safety, for example, may be considered more legitimate by the public than barriers motivated by economic protectionism. If food safety is perceived as being sacrificed to free trade, support for free trade could erode. Similarly, if food safety is used as a disguise for protectionism, support for free trade could also erode.

The four disputes summarized below are rooted in different regulatory approaches and public preferences. Disputes over beef hormone and genetically engineered crops stem primarily from stronger European societal preferences for high food safety standards. A longstanding dispute over the EU's audio-visual sector has a strong cultural basis, steeped in a perceived need to preserve West European society from the U.S. dominance. And a clash over an EU regulation banning airplanes outfitted with "hushkitted" or retooled engines ostensibly was driven by environmental demands to reduce noise pollution surrounding European airports.

Numerous other disputes could also be included in the following discussion. For example, a dispute over data privacy reflects very different approaches between the U.S. and EU, as well as popular attitudes, towards the protection of personal information that is transmitted electronically. The issue of "multi-functionality" in agriculture, where the Europeans claim agriculture is more than just another industry, has deep cultural roots that divide the two sides. Disputes involving environmental, wildlife, and animal welfare protection, such as U.S. restrictions on imports of tuna from Europe and EU efforts to ban fur imports from the United States, also reflect competing social and cultural differences.

**Beef Hormones.** The dispute over the EU ban, implemented in 1989, on the production and importation of meat treated with growth-promoting hormones has been one of the most bitter and intractable trade disputes between the United States and Europe. It is also a dispute that, on its surface, involves a relatively small amount of trade. The ban affected an estimated \$100-\$200 million in lost U.S. exports — less than one-tenth of one percent of U.S. exports to the EU in 1999. But

the dispute has played off each side's sovereign right to regulate the safety of its food against its WTO obligations.<sup>28</sup>

The EU justified the ban to protect the health and safety of consumers, but several WTO dispute settlement panels subsequently ruled that the ban was inconsistent with the Uruguay Round Sanitary and Phytosanitary (SPS) Agreement. The SPS Agreement provides criteria that have to be met when a country imposes food safety import regulations more stringent than those agreed upon in international standards. These include a scientific assessment that the hormones pose a health risk, along with a risk assessment. Although the WTO panels concluded that the EU ban lacked a scientific justification, the EU refused to remove the ban primarily out of concern that European consumers were opposed to having this kind of meat in the marketplace.

In lieu of lifting the ban, the EU in 1999 offered the United States compensation in the form of an expanded quota for hormone-free beef. The U.S. government, backed by most of the U.S. beef industry, opposed compensation on the grounds that exports of hormone-free meat would not be large enough to compensate for losses of hormone-treated exports. This led the way for the United States to impose 100% retaliatory tariffs on \$116 million of EU agricultural products from mostly France, Germany, Italy, and Denmark, countries deemed the biggest supporters of the ban. These tariffs, in turn, sparked protests among French and European farmers, who seized on the beef hormones case as a symbol of the threat posed by Americanization and globalization to European regulations and traditions.<sup>29</sup>

The U.S. hard line was buttressed by concerns that other countries might adopt similar measures based on health concerns that lack a legitimate scientific basis according to U.S. standards. Other U.S. interest groups are concerned that non-compliance by the EU undermines the future ability of the WTO to resolve disputes involving the use of SPS measures.

In October 2003, the European Commission notified the WTO that it has changed its hormone ban legislation in a way that it believes complies with international trade rules. The legislation made provisional a previous permanent ban for five growth hormones used to raise beef and keeps in place a permanent ban on the use of oestradiol 17 on the basis that it is a carcinogen. As a result, the EU argued that it should no longer be subject to punitive trade sanctions by the United States (as well as by Canada), and on November 8, 2004, took the initial step in the WTO to challenge the U.S. and Canadian sanctions still in effect. The U.S. and meat industry, however, argued that making a ban provisional for the long term does not meet WTO obligations. Nevertheless, in February 2005, the EU secured the establishment of a panel to determine whether the United States and Canada are in violation of WTO rules by maintaining punitive tariffs on a number of EU products in the dispute. A WTO dispute panel hearing on this issue was held on August 1,

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<sup>28</sup> Pollack, Mark A. "Political Economy of Transatlantic Trade Disputes," in *Transatlantic Economic Disputes*, p. 75.

<sup>29</sup> Pollack, Mark A. "Political Economy of Transatlantic Trade Dispute," in *Transatlantic Economic Disputes*, p. 76.

2005. A second hearing was scheduled for November 2005 but later was postponed to September 2006. Agreement on the selection of scientific experts has been elusive, making process of settling the dispute even more difficult. Thus, so long as the EU refuses to eliminate or modify the ban, U.S. retaliatory tariffs are likely to remain in effect.

**Genetically Engineered Crops.**<sup>30</sup> Differences between the United States and the EU over genetically engineered (GE) crops and food products that contain them pose a potential threat to, and in some cases have already disrupted, U.S. agricultural trade. Underlying the conflicts are pronounced differences between the United States and EU about GE products and their potential health and environmental effects.

Widespread farmer adoption of bio-engineered crops in the United States makes consumer acceptance of GE crops and foods at home and abroad critical to producers, processors, and exporters. U.S. farmers use GE crops because they can reduce input costs or make field work more flexible. Supporters of GE crops maintain that the technology also holds promise for enhancing agricultural productivity and improving nutrition in developing countries. U.S. consumers, with some exceptions, have been generally accepting of the health and safety of GE foods and willing to put their trust in a credible regulatory process.

In contrast, EU consumers, environmentalists, and some scientists maintain that the long-term effects of GE foods on health and the environment are unknown and not scientifically established. By and large, Europeans are more risk averse to the human health and safety issues associated with bio-engineered food products than U.S. citizens.

In 1999 the EU instituted a *de facto* moratorium on any new approval of GE products. The moratorium halted some \$300 million in annual U.S. corn shipments. EU policymakers also moved toward establishing mandatory labeling requirements for products containing GE ingredients.

For several years, U.S. trade officials refrained from challenging the EU moratorium in the WTO, partly out of fear that the EU, if it lost the case, would not comply due to public opposition. But in May 2003, facing the potential spread of the EU approach to third countries, the United States (along with Canada, and Argentina) challenged the EU *de facto* moratorium in the WTO.

Although the EU effectively lifted the moratorium in May 2004 by approving a genetically engineered corn variety, the three complainants pursued the case, in part because a number of EU member states continued to block approved biotech products. On February 7, 2006, the WTO, in an interim confidential report, ruled that a moratorium had existed, that bans on EU-approved genetically-engineered crops in six EU member countries violated WTO rules, and that the EU failed to ensure

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<sup>30</sup> Prepared by Charles Hanrahan, Specialist in Agriculture, Resources, Science, and Industry. For further discussion, see CRS Report RS21556, *Agricultural Biotechnology: The U.S.-EU Dispute*.

that its approval procedures were conducted without “undue delay.” Some other claims by the United States were rejected. With the legal battle likely to continue for several years, this dispute still has considerable potential to adversely affect transatlantic relations.

**Audio-Visual Sector.** This dispute dates back to 1989 when the EU issued a Broadcast Directive that required that a majority of entertainment broadcast transmission time be reserved for programs of European origin “where practicable” and “by appropriate means.” All EU member states, including the ten new Member States, have enacted legislation implementing the Broadcast Directive.<sup>31</sup>

Implementation of the directive has varied from country to country. In general, efforts to strengthen European content quotas have failed to materialize, but a number of countries have passed specific laws that hinder the free flow of programming. France, for example, has prime time rules that limit the access of U.S. programs in prime time. Radio broadcast quotas also limit broadcasts of American music. Italy also has a European content prime time rule, as well as requirements that large movie theaters show EU films on a “stable” basis.

Within the EU, the Broadcast directive has been controversial. Efforts to tighten restrictions have been opposed by Germany and Britain and by some elements of the European industry. Moreover, consumer demand for foreign movies, coupled with technological innovation through the introduction of cable and satellite television, have undermined movement in the direction of increased protection.

The dispute highlights European concerns, particularly in France and Italy, about creeping “Americanization” threatening to undermine their national identities and cultures. It also underlines a fundamental U.S.-EU divide over the role of cultural and social issues in trade disputes. While the U.S. tends to assign priority weight to maximizing the economic value of efficiency in trade negotiations, the EU, by attitude and law, places more weight on environmental and cultural values.

**Aircraft Hushkits.** European skies are quite crowded with aircraft, airports tend to be situated in heavily populated areas, and there is a serious noise problem. Public concerns about aircraft noise are combined with environmental policy discussions about emissions and greenhouse gases. To deal with this problem, the EU attempted in 1997 to develop an EU-wide noise standard. When it became clear that any such standard would likely impose high economic costs on European manufactures and airlines, the EU advanced a regulation that would limit the operation of “hushkitted” aircraft in European skies.

Hushkitting is a process that involves a combination of strategies, including renovated engine enclosures and replacement engine components, designed to reduce aircraft noise. Under standards adopted by the EU, it did not provide major reductions in noise levels.<sup>32</sup>

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<sup>31</sup> Office of the United States Trade Representative, *2005 Trade Barrier Report*, p. 264.

<sup>32</sup> For a full discussion, see CRS Report RL30547, *Aircraft Hushkits: Noise and* (continued...)

As formally implemented by the EU on May 4, 2000, the vast majority of aircraft affected by the regulation are of U.S. manufacture. Also adversely affected are mostly U.S. manufacturers of noise reduction technology and new engines for older aircraft. Conversely, all European Airbus aircraft are unaffected and there are no major European hushkit producers. The U.S. aerospace industry estimates that the regulation has cost its airlines and manufacturers \$2 billion.

On March 14, 2000, the United States filed a motion with the International Civil Aviation Organization (ICAO) seeking relief from the EU's regulation. The U.S. case maintained that the regulation does not comply with ICAO regulations and discriminates against U.S. interests. Proceedings were suspended pending settlement negotiations. In early 2002, a settlement was reached under which the EU repealed the regulation and the U.S. withdrew its complaint.<sup>33</sup>

## Conflict Management

The three categories of trade conflicts — traditional, foreign policy, and regulatory — appear to offer different possibilities for conflict management. This is due not only to the fact that the causes and dimensions of these categories of conflicts differ, but also because the institutional relationships and forces that affect the supply of and demand for protection are operative in varying degrees from category to category. These factors include the presence or absence of bilateral or multilateral agreements and rules that govern the settlement of the disputes, the extent to which the disputes fit into the standard free trade versus protectionism dichotomy, the relevance of underlying economic and political trends, and the effectiveness of other institutional arrangements designed to prevent or resolve the disputes.

- Bilateral and multilateral trade agreements can dampen the inclination of governments to supply protection and the private sector to demand protection by providing a fairly detailed “road map” of permissible actions and obligations. While often litigated and disputed, the obligations tend to be relatively clear-cut and help resolve disagreements. When new spats arise, built-in procedures of many agreements can facilitate a settlement or help avoid escalation.
- Conflicts that fall into the standard free trade versus protectionism dichotomy also have a built-in potential for undercutting any rationale governments may have to supply protection or private parties may use in demanding protection. This happens due to an ideological consensus in both the U.S. and EU in favor of resisting protectionism on both economic and political grounds. As a result,

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<sup>32</sup> (...continued)

*International Trade*, by John W. Fischer.

<sup>33</sup> Abbott, Kenneth W. “U.S.-EU Disputes Over Technical Barriers to Trade and the ‘Hushkit’ Dispute, In *Transatlantic Economic Disputes*, pp. 247-280.

most demands for protection from producer interests must be justified as exceptions to the generalized support for freer trade arrangements and policies.

- Diverse economic and political trends can also suppress the supply and demand for protection. For example, declining support for industrial policy initiatives, as has been the case in both the U.S. and EU, could make industry-specific pleas for government assistance less compelling. High priority political commitments, such as the EU's policy towards enlargement, may also create incentives for reform and liberalization as opposed to protection.
- Both formal and informal cooperative arrangements have proliferated over the past decade to better manage transatlantic trade disputes. These have included efforts to strengthen regulatory cooperation and the establishment of forums for bilateral consultations. By attempting to incorporate the views of a wider range of domestic interest groups, these efforts have also aimed at preventing disputes from arising.

Applying these factors to the three categories of trade disputes, there are grounds for judging that traditional trade conflicts may become less disruptive to the bilateral relationship in the future, but more limited grounds for projecting a diminution of foreign policy induced friction. The prospects for future domestic-policy related trade disputes fall somewhere in between these two extremes, with reasons for foreseeing a reduction in friction associated with some disputes, but not all. The basis for this assessment is presented below.

## **Traditional Trade Conflict**

Traditional trade conflicts, involving demands from producer interests for protection or state aids, by definition raise fairly routine commercial questions that have been addressed by governments for decades. As a result, most are governed by some bilateral or multilateral agreement or understanding. The WTO in particular provides a body of multilateral rules governing the use of tariffs and other restrictive trade practices and a forum for consultation and dispute resolution. And in the event of non-compliance with WTO rulings, retaliation can be authorized to provide incentives for compliance with WTO rulings. Disputes involving agriculture, aerospace, steel, and contingency protection have all been tempered by the WTO framework of rules and obligations.

The Uruguay Round Agreement on Agriculture significantly dampened trade conflict in the areas of EU home market protection and export subsidy wars for third country markets. The multilateral agreement on subsidies provides the terms of engagement for the current clashes over "launch" aid for the A380. Steel trade conflict in recent years has pivoted around the utilization of anti-dumping and safeguard laws, procedures that both the U.S. and EU employ with considerable frequency and which both sides in the past have considered legitimate. The fact that the steel trade battle in 2002 was so heated may stem from a mutual perception that each side is not adhering to the letter or spirit of the safeguards agreement.

Traditional trade conflicts also tend to fit into the standard free trade versus protectionism dichotomy. As in the case of the agriculture, aerospace, steel, and the Byrd Amendment, proposals or requests for additional protection or promotion will be subject to full transparency, investigation, and debate. Given that both the United States and European Union have open societies with an ideological consensus in favor of competition and open markets, petitioners for protection will have the burden of arguing that their request merits being excepted from the dominant policy orientation.

Several economic and political trends may also serve to limit future disputes involving producer protection. These include a decline of support for industrial policy in both Brussels and Washington, budgetary pressures in the EU, and a rising level of foreign direct investment and corporate mergers.

Support for industrial policy initiatives, mostly efforts to use state aids to boost the competitiveness of specific sectors or build up national champions in particular industries, were considerable in the late 1980s and early 1990s in both the EU and United States. Based on new rationales for targeted assistance from states, the support for industrial policies posed new challenges to the maintenance of free trade orthodoxy. For a variety of reasons, such policies today are viewed quite skeptically in both Brussels and Washington, thereby lessening pressures for what many observers construed as a new and disguised vehicle for protectionism.

The issue of subsidies or state aids is closely related to the industrial policy debate. In Europe, with the movement towards a single market that is deregulated and more competitive, subsidies and state aids to individual companies have been increasingly challenged, scrutinized, and curtailed. This trend, which is reenforced by budgetary constraints associated with fiscal targets required of member states participating in the European Monetary Union, could serve not only as a strong force for reducing conflict in aviation and steel, but in other sectors as well.<sup>34</sup>

A rising level of foreign direct investment and a wave of new corporate mergers are also forces for dampening demand for protection. As these trends accelerate, many formerly domestic or nationally-based industries will become increasingly globalized. The Daimler-Chrysler merger is an example where the answer to the question of 'who is us?' becomes increasingly blurred. Even in the production of a new Airbus plane, it is estimated that American suppliers will provide a considerable amount of the sourcing of the parts. These developments, in turn, tend to create forces that may moderate demands for protection.<sup>35</sup>

A number of cross currents, of course, could create a much different outlook. Historically, many industries have been quite creative and successful in justifying demands for protection based on some unique argument. This has been particularly

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<sup>34</sup> Kahler, Miles. *Regional Futures and Transatlantic Economic Relations*, European Studies Association, 1995, p. 50.

<sup>35</sup> Kahler, Miles, *Regional Futures and Transatlantic Economic Relations*, European Studies Association, 1995, p. 51.

true in the area of agriculture where both sides have argued that agriculture is not just another industry.

The strength of the European agricultural lobby rests in part on public support for it as a means of preserving a way of life and a particular kind of environment perceived as worth preserving. On-going efforts in Brussels to reform the CAP must deal with this challenge. Absent reform, the peace clause, which ends in 2003, may only prove to be a nine-year truce.<sup>36</sup>

Moreover, fundamental economic conditions can change rapidly. Bumper world crops creating an oversupply of basic agricultural commodities or an economic downturn creating an over-supply of steel could ignite old trade battles in steel and agriculture once again.

## Foreign Policy Conflict

Unlike traditional trade conflicts, foreign policy inspired trade squabbles tend to lack the same kind of institutional arrangements and pressures that dampen the supply of and demand for protection. Nor are these conflicts easily framed along free trade and protectionism lines. Some of these conflicts, but not all, may be moderated in the future by lobbying efforts of big business on both sides of the Atlantic to maintain stable commercial ties. However, if Brussels or Washington is determined to use trade to achieve foreign policy objectives, lobbying efforts are unlikely to be successful in the absence of a transatlantic agreement to treat these issues in a more coherent fashion.

In most U.S.-EU sanctions conflicts, there are no bilateral or multilateral understandings that can help resolve very basic foreign policy differences over how to respond to violations by third countries of international norms affecting human rights or security. Many trade measures taken in a foreign policy context are either exempt from WTO disciplines because they are either mandated by the United Nations or applied against non-WTO countries, or only very loosely regulated by the WTO. The latter arises because the national security provision of GATT (Article 21) provides wide latitude for countries to pursue sanctions if they deem the measures to be in their national security interest.<sup>37</sup>

WTO rules also provide little guidance and “rules of the road” concerning preferential regional agreements. While the WTO set up a new Committee on Regional Trade Agreements in 1995 to highlight abuses of Article 24 provisions that allow regional agreements to deviate from the non-discrimination principle of the WTO, few challenges have been launched. A major obstacle has been the difficulty of measuring the value of trade diverted from efficient producers to the beneficiaries of preferences granted. As a result, the drive to cut preferential deals continues to grow (along with mistrust) while the ability to challenge deals that raise new trade barriers remains quite weak.

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<sup>36</sup> Ibid.

<sup>37</sup> Schott, Jeffrey, “Whither U.S.- European Trade Relations?,” p. 59.

While the U.S. pursuit of market opening through unilateral means has declined since passage of the Uruguay Round Agreements in 1995, pressures in the United States to revisit this issue could grow. The EU's refusal to implement WTO panel findings on bananas and beef hormone, coupled with continued attacks on U.S. trade laws, could lead U.S. policymakers to reconsider this Uruguay Round bargain of limits imposed on unilateralism in return for a more binding dispute settlement process.

The dispute over the U.S. export tax benefit program raises a different issue. It can be argued that the WTO was not the proper forum in which the dispute should have been pursued. But existing WTO "rules of the road" evidently presented a target of opportunity for achieving other foreign policy goals, namely enhancing the EU's negotiating leverage vis-à-vis Washington.

Pressures and temptations to apply sanctions against countries that violate international norms, to cut preferential trade deals, to act unilaterally in the pursuit of national trade interests, and to use the WTO to achieve foreign policy objectives are unlikely to go away. Nor are efforts of big and pro-trade business lobbies to curb future actions along these lines likely to be successful in the absence of a broad diplomatic undertaking or a pledge committing both sides to refrain from such actions. Such a pledge or non-aggression pact has been suggested as a way to bring greater coherence in areas of disagreement and in helping to achieve shared goals in a less contentious atmosphere. But little progress has been made, perhaps due to the high level of mutual suspicions, differences in diplomatic approaches, and foreign policy-making machinery.<sup>38</sup>

## Regulatory Policy Conflict

U.S.-EU trade disputes have focused increasingly on differences in regulation, rather than traditional barriers such as tariffs or subsidies. Regulatory requirements established primarily with legitimate domestic concerns of consumer and environmental protection or public health in mind do not discriminate (at least directly) between domestic and imported goods and services. But they may have the secondary effect of distorting or discriminating against the free flow of international trade, which in turn leads to disputes. For this reason, transatlantic regulatory disputes can be more bitter and difficult to resolve than traditional trade disputes, in so far as both sides feel their actions are justified by democratically derived decisions. In this context, such disputes are often difficult to resolve within the context of the WTO because they require a balancing of domestic concerns with international obligations.<sup>39</sup>

In trying to resolve or prevent most regulatory disputes, the United States and the EU have tended to rely more on bilateral cooperation and negotiation than on the WTO dispute resolution system. The two sides have made much progress bilaterally

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<sup>38</sup> Frost, Ellen L. *Transatlantic Trade: A Strategic Agenda*. Institute for International Economics, 1997, pp. 54-64.

<sup>39</sup> Mark A. Pollack, "Political Economy of Transatlantic Trade Disputes," in *Transatlantic Economic Disputes*, p.71.

in mitigating divergent standards and certification systems as a source of bilateral trade conflict.

Bilateral efforts to promote regulatory cooperation have been a top priority in both governments and private sectors since the signing of the “New Transatlantic Agenda” (NTA) and “Action Plan” in late 1995. The creation of the Transatlantic Business Dialogue (TABD), a multinational corporation-led initiative to lower trade and investment barriers across the Atlantic, spearheaded efforts to focus particular attention on problems posed by divergent standards and certification systems. In addition to promoting convergence in regulatory systems through the principle of “approved once, accepted everywhere,” efforts were undertaken to negotiate mutual recognition agreements (MRAs) covering key sectors such as pharmaceuticals and medical devices, and telecommunications equipment.<sup>40</sup>

In June 1997, the two sides reached agreement on a package of MRA’s affecting six sectors, including electrical equipment, pharmaceutical products, telecommunications and information technology equipment. Each side basically accepted the others’ inspection, testing, and certification standards in these sectors. The agreements, which covered around \$50 billion in U.S.-EU trade, allowed European companies to sell products directly into the U.S. market after they have been tested and certified to U.S. health and safety standards, and vice versa.<sup>41</sup>

Under the 1998 Transatlantic Economic Partnership (TEP), the two sides agreed to begin negotiation of MRA’s in other sectors, including regulatory processes connected with biotechnology. But negotiating and implementing these agreements has proven difficult due to very different industry interests and regulatory approaches of the United States and the EU.<sup>42</sup>

There are numerous challenges raised by the application of modern biotechnology to food production. The Uruguay Round Sanitary and Phytosanitary Standards (SPS) Agreement was designed to deal with this issue. It requires countries that impose regulations or trade bans to protect the health of plants, animals, and people to base such decisions on risk assessments on sound scientific evidence.<sup>43</sup> But the SPS requirement of a sound scientific basis is open to varying interpretations.

Ambiguities in the SPS agreement are complicated because many European consumers may believe that avoidance of production practices associated with biotechnology is a value in itself. For these consumers, scientific studies showing that such technologies do not result in threats to human or animal health may not be convincing. Given these strong views, many European officials want leeway to

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<sup>40</sup> Schott, Jeffrey. “Whither U.S. -European Trade Relations,” p. 56.

<sup>41</sup> Frost, Ellen. *Transatlantic Trade: A Strategic Agenda*, p. 6

<sup>42</sup> Mark A. Pollack, “Political Economy of Transatlantic Trade Disputes,” in *Transatlantic Economic Disputes*, p. 98.

<sup>43</sup> A related multilateral code, the Agreement on Technical Barriers to Trade (TBT), covers other types of regulations such as labeling and packaging.

impose trade restrictions on a “precautionary basis” and others want to renegotiate the SPS agreement. Both avenues could open up a large loophole for discriminatory trade barriers.

More ominously, some analysts are concerned that European agricultural policy makers may be “under pressures to guarantee higher levels of safety than strictly is necessary in order to maintain consumer confidence in the food system.”<sup>44</sup> Even if these conflicts are not primarily due to the deliberate use of health, safety, or environmental standards as trade barriers, mistrust grows in terms of how much effort government authorities may have put into managing public concerns through educational efforts. Under these circumstances, one analyst has argued that trade disputes resulting from such differences are unlikely ever to be resolved; at best they can be contained.<sup>45</sup>

On the other hand, transatlantic consumer views may be converging in some areas. For example, while U.S. consumers generally have been quite receptive to genetically modified organisms (GMOs), Kraft Foods’ nationwide recall in 2000 of taco shells that contained a genetically engineered corn not approved for human consumption indicates some underlying discontent. The recall was initiated by a coalition of environmental and consumer groups critical of bio-engineered food.<sup>46</sup> Others argue that in a number of other areas, including corporate mergers and Internet privacy, the European Union’s more active role in protecting consumers will gain growing appreciation and support in the United States.<sup>47</sup> At the same time, the European Commission is seeking actively to recreate an approval process for GMO crops, moving to establish a pan-EU food agency, and proposing action to provide consumers with more information on GM foods.

In other disputes, technological progress can be a force for change. The audiovisual dispute is a case in point where EU efforts to increase protection of this sector have faced growing technological obstacles, as well as consumer resistance. Rapid technological innovation in the form of cable and satellite television, innovations strongly supported by consumers, offer new products that are difficult to block or regulate. Regulations in this environment often are too complex to enforce or, if enforced, prove adverse to the interests of European producers.<sup>48</sup>

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<sup>44</sup> Josling, Tim. “Comment on Stefan Tangermann,” in *Transatlantic Relations in a Global Economy*, p. 166.

<sup>45</sup> Vogel, David. *Barriers or Benefits?*, Brookings Institution, 1997. p. 62.

<sup>46</sup> Pollack, Andrew. “Kraft Recalls Taco Shells With Bio-engineered Corn,” *Washington Post*, September 23, 2000, p. B1.

<sup>47</sup> Richter, Stephan-Gotz, “The U.S. Consumer’s Friend,” *New York Times*, September 21, 2000, p. A31.

<sup>48</sup> Kahler, Miles. *Regional Futures and Transatlantic Economic Relations*, Brookings Institution, 1997, p. 53.

## Trade Conflict in Perspective

Mark Twain reportedly once said of Wagner's music that "it is not as bad as it sounds." Similarly, U.S.-EU trade conflicts may not be as ominous and threatening as they appear. Despite the rise in trade tensions and episodes of tit-for-tat retaliation over the past few years, the notion that the relationship between the world's two most powerful economic powers is constantly teetering on the brink of a transatlantic trade war seems a stretch. Nor does it appear that the trade conflicts represent or symbolize any kind of fundamental rift that is possibly developing between the United States and Europe.

At the same time, the disputes do not appear to be ephemeral distractions or mere consequences of a mass media that grossly distorts, sensationalizes, and defines the relationship unfairly. Nor are they products of trade negotiators, who like generals, are often accused of fighting the last war. Nor are they trivial or silly squabbles because they represent a mere 1-2% of transatlantic trade.

Trade conflicts rather appear to have real, albeit limited, economic and political consequences for the bilateral relationship. Perhaps more significantly, trade disputes may also pose very real obstacles for the two partners in their efforts to play a leadership role in promoting a more open and prosperous world economy. This is particularly evident in the way bilateral trade disputes may be testing the functioning of the World Trade Organization.

### Relationship Impact

The economic and political impacts that result from U.S.-EU trade disputes can be easily identified, but are much harder to quantify. In both cases, a variety of forces effectively contain the economic and political costs from rising or getting out of hand.

The \$300 million in retaliatory U.S. tariffs levied on European exports over the banana and beef disputes and the over \$2 billion in EU tariffs imposed on U.S. exports over the FSC (now suspended) and Byrd Amendment disputes provide the most visible economic costs of trade conflict. The retaliatory tariffs are designed to dramatically increase the costs of selective European and U.S. products, making it much more difficult for those "targeted" foreign producers to sell in the U.S. or EU markets. In theory, foreign exporters denied access to markets are expected to pressure their respective governments to change the policies that are in violation of WTO rules.

Retaliation is not, however, cost-free. The process also hurts importers, consumers, and firms dependent on those imports as inputs in their production process. These entities intensively lobby Congress and the European Commission to keep their products off any retaliation list that is drawn up. Domestic political pressures, thus, limit the scope and flexibility trade officials on both sides of the Atlantic have in devising a retaliation list. As a result, most retaliation lists tend to be dominated by luxury items or high value-added agricultural items that are produced by both economic superpowers. Under these conditions, coming up with

a list of products whose export value matches the relatively small sum of a few billion dollars is no easy task.<sup>49</sup>

Attempts by either Brussels or Washington to retaliate on a much larger value of trade could be expected to ignite a firestorm of political opposition. The huge stake each side has in the other's market through foreign direct investments, merger and acquisition activity, combined with "globalized" patterns of production, would likely serve as major counter-forces to any rise in trade warfare. These trends create extensive overlapping interests among companies and strong incentives to contain disputes. In globally traded sectors, mass production in a single location is becoming rare as companies source inputs, research, design, and marketing strategies from all over the world. This, in turn, shrinks the scope of, as well as complicates, the definition of what is domestic production or a domestic company.

In terms of political impacts, trade disputes likely have some effect on public opinion and attitudes, as well as connect in some way to other transatlantic problems. Polls indicate that there is a great deal of fear in Europe that the United States, due to the strength of its economy, has the ability to impose both economic and social changes on the rest of the world. This fear and perhaps frustration may translate into antipathy to the United States, often expressed as anti-Americanism. U.S. retaliation against Europe for not accepting hormone-enhanced beef, for example, may only fuel these generalized anti-American feelings that the United States is a bully.<sup>50</sup>

The reaction to U.S. retaliation may be even more acute among some European policymakers. By selectively targeting only those EU members that have clearly benefitted from WTO illegal policies, many European policymakers view retaliation as a frontal assault on European unity — an old-fashioned divide-and-conquer strategy.<sup>51</sup> Commenting on the U.S. proposal to rotate items under trade sanctions from product to product and country to country, French President Chirac complained bitterly that carousel retaliation is "much closer to 19<sup>th</sup> Century gunboat diplomacy than to 21st Century diplomacy."<sup>52</sup>

Whether or how these reactions affect cooperation in other problem areas is difficult to know. Clearly, if trade tensions work to undermine the notion that the

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<sup>49</sup> The task is further complicated by the incomes and tastes of American consumers. The 100% tariffs levied against European products such as truffles, jams, Roquefort cheese, chicory, specialized mustard, and biscuits have had very little impact in cutting back on sales in the United States over the past year. "Administration Still Uncertain on Carousel," *Washington Trade Daily*, September 26, 2000.

<sup>50</sup> Daly, Suzanne. "More Vehemently Than Ever, Europe Is Scorning the United States," *New York Times*, April 9, 2000, p. 1.

<sup>51</sup> Ironically, some observers see trade disputes as an instrument for promoting EU unity. This view is that trade conflict with the U.S. may provide EU policymakers with a convenient "enemy" that can help divert attention from internal problems and disagreements. While this may be true for some disputes where there is a unified EU view, on most trade disputes there are often different views and positions among the member states.

<sup>52</sup> Trade Reports International Group, *Washington Trade Daily*, September 8, 2000.

United States and Europe share common interests or lead to a view that a weaker Europe or a weaker America is in the other's interest, then the consequences could be major. But there is no evidence to suggest that this is happening as the United States and the EU to date have been able to compartmentalize trade problems to a remarkable degree.

## Leadership Impact

Trade disputes may have discernible impacts on U.S.-EU efforts to provide leadership of the world economy. The disputes absorb a significant amount of time and energy of key policymakers at the expense of efforts to pursue common interests and objectives, such as completing the Doha round of multilateral trade negotiations. Moreover, the two powers need to set an example of cooperation and adherence to WTO rules if the whole system is not to unravel.

The credibility of the WTO depends critically on a prompt, effective, and fair dispute-settlement mechanism. Unfortunately, the EU is seen by U.S. policymakers and interest groups affected by the beef and banana cases as having used every loophole to delay decisions and then refuse to comply with panel decisions. Similarly, U.S. compliance efforts in FSC and Byrd Amendment disputes are found wanting by EU policymakers. While only a handful of U.S.-EU WTO disputes have ended in withdrawal of concessions (i.e. retaliation) since 1995, non-compliance by a key member arguably weakens the authority of the WTO and serves as a poor model for the rest of the world.<sup>53</sup> Why should we comply with WTO panel decisions if the EU does not have to, many countries ask. Non-compliance by one of the two leading economic powers is also said to diminish the perceived value of negotiating new trade agreements.<sup>54</sup>

Both the U.S. and EU (bananas in the case of the U.S. and the FSC in the case of the EU) have brought complaints to the WTO that may have been motivated more by a desire to score points with domestic political interests or to rack up negotiating leverage by successfully prosecuting cases than to address serious trade problems. To the extent that a charge of capricious use of the dispute settlement process is valid, the WTO as an institution may also be weakened. Some may argue that no institution can survive for long this kind of treatment by the body's two biggest members.

To deal with the problem of non-compliance, the U.S. and EU have legalistic and diplomatic options. In the area of some of the most bitter U.S.-EU disagreements, particularly over GMOs, the WTO may be asked to make decisions on very complex issues that go deep into the domestic social and the environmental life of each side. Binding rulings in areas that have strong domestic roots can raise sovereignty issues and court a public backlash. Under these circumstances, where the formulations of right and wrong are increasingly blurred, it may be legitimate to question whether WTO panels should be asked to clarify vague rules where there is

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<sup>53</sup> "Transatlantic Trade Tensions," *Financial Times*, May 17, 2000, p. 8.

<sup>54</sup> Schott, Jeffrey. "After Seattle," *The Economist*, August 26, 2000, p. 66.

little U.S.-EU consensus, or whether trade officials should attempt to negotiate diplomatic solutions to disagreements that are so difficult to resolve.