Trans-Pacific Partnership: a TiPPing point for global trade?

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Executive summary

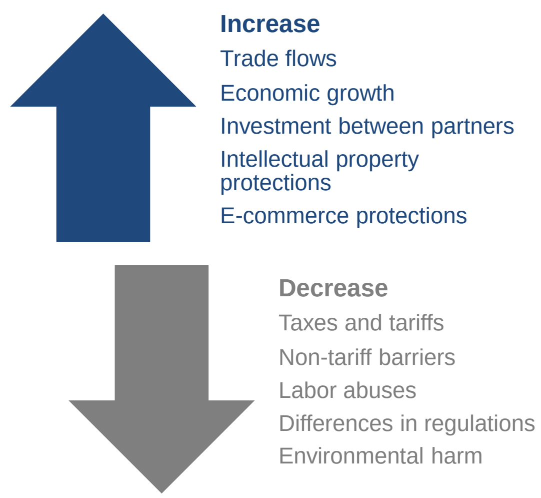
- The Trans-Pacific Partnership (TPP) is a mega trade agreement bringing together 800mn consumers and USD28tn of wealth. Once ratified by all TPP members, this new trade framework can boost regional GDP by +USD38bn over the first two years of implementation.
- Japan, New Zealand and Vietnam would benefit the most: consumers from cheaper goods, exporters from lower trade barriers in new markets. The Knowing (American R&D e.g.), The Doing (Vietnamese manufacturing) and The Having (Canadian natural resources) countries will complement one another. Chemical, Machinery and Equipment, and Electronics supply chains will benefit the most; peer pressures will help improve business practices regionally.
- Risks to TPP's adoption stem from perceived currency manipulation, possible negative impacts on key national industries (Agrifood and Automotive in particular) and social discontent. TPP success will also be conditioned on outsiders' trade policy response.

Trans-Pacific Partnership: the advent of a mega-agreement

In an attempt to promote trade on a mega-scale, 12 countries are currently negotiating a free trade agreement known as the Trans Pacific Partnership (TPP). Future member countries include Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States, and Vietnam.

TPP aims at extensive trade liberalization in goods and services via the reduction of tariff and non-tariff barriers. The agreement is also intended to promote fair labor competition, freer investment movement, enforcement of intellectual property (IP) rights, and the harmonization of legal and regulatory issues (Figure 1). The specific provisions of TPP are wide-ranging and numerous, including over 10,000 specific tariffs. Of particular interest to the United States are the reduction of tariffs on agricultural products, lower barriers in services, and protections for IP, e-commerce, telecommunications, and internet data flow. The agreement still has to be ratified by member countries to be implemented.

Figure 1: Goals of TPP



Source: Euler Hermes

TPP represents a huge potential for trade. In 2014, the scope of the agreement represented 800 million consumers, close to USD28tn (36% of global GDP) and USD11.8tn in trade (exports and imports i.e. 25% of global trade).

The Knowing, The Doing and The Having

Fostering synergies will be essential to the success of TPP. These synergies will develop as a result of the different macroeconomic characteristics of the countries and what they can offer to one another. Broadly speaking, the countries involved can be put into three major groups: *The Knowing*, *The Doing*, and *The Having* (Figure 2). The Knowing are those with high levels of innovation and R&D, high value-added manufacturing, and highly advanced services; they include the United States, Japan, and Singapore. The Doing have more competitive manufacturing bases (cheaper labor costs, higher productivity growth) and include Malaysia, Mexico, and Vietnam. The Having are rich in natural resources: primary commodities account for a significant part of their exports. The Having include Canada, Australia and New Zealand where innovation and services are highly developed; Chile, Peru and Brunei where services are developing.

Opportunity #1: Market opportunities - greater market access will allow further gains in trade and consumption within the region

To estimate the impact of TPP, we assume that during the first 2 years, it will have a framework similar to the North American Free Trade Agreement (NAFTA) with a strong emphasis on goods trade and gradual investment liberalization. Services liberalization will probably take more time as it needs further convergence in regulatory frameworks. Lifting tariffs on a majority of goods and opening markets to foreign competitors should drive goods prices lower, resulting in higher private consumption and higher exports for competitive producers. Increasing demand opportunities and relaxed investment constraints should lead to higher investment growth.

Against this background, TPP is expected to boost regional growth by +USD38bn (+0.14pp of GDP) over the first two years of implementation (Figure 3). Private consumption is likely to be the main driver, rising by +USD26bn. A sizeable impact is expected in countries such as the U.S. (+USD17bn) and Japan (+USD6bn) where the consumption base is already large.

Figure 2: The Knowing, The Doing and The Having

		Share of primary commodities exports (% country's exports)	Industry, value added (% of GDP)	Number of patents applications (per 1000 hab.)
The Knowing	Japan	1.0%	26%	2.58
	United States	10.1%	21%	1.81
	Singapore	0.6%	25%	1.80
The Doing	Vietnam	15.7%	39%	0.04
	Malaysia	15.0%	41%	0.24
	Mexico	16.3%	34%	0.13
The Having	Australia	67.3%	27%	1.27
	New Zealand	19.7%	23%	1.53
	Canada	31.8%	28%	0.99
	Chile	39.5%	35%	0.17
	Peru	47.5%	37%	0.04
	Brunei	97.1%	68%	0.03

Sources: World Bank, Chelem, Euler Hermes, last figures

Figure 3: TPP macro impact over the first two years of implementation

Cumulated change in first 2 years of implementation

		In million USD						Change in percentage points of 2014 GDP
		Private consumption	Investment	Exports	Imports	Net exports	GDP	GDP
The Knowing	Japan	5624	2114	9837	8035.0	1802	9540	0.21
	United States	17370	7289	8647	12061.0	-3414	21245	0.12
	Singapore	142	94	151	119.0	32	268	0.09
The Doing	Vietnam	253	207	1358	576.0	782	1242	0.67
	Malaysia	235	399	1654	985.0	669	1303	0.39
	Mexico	425	236	155	229.0	-74	587	0.05
The Having	New Zealand	381	187	604	500.0	104	672	0.34
	Canada	1172	1000	1191	992.0	199	2371	0.13
	Australia	572	378	113	191.0	-78	872	0.06
	Chile	39	23	52	26.0	26	88	0.03
	Peru	48	18	23	39.0	-16	50	0.02
	Brunei	33	0	7	39.0	-32	1	0.01
TPP		26296	11945	23792	23792	0	38240	0.14

Sources: UNCTAD, Euler Hermes

Meanwhile, market integration is likely to create an increase in exports of +USD24bn over the first two years of implementation. The largest contributors would be Japan (+USD9.8bn) and the United States (+USD8.6bn) due to a strong base effect (i.e., large size in global trade). Looking at net exports, which are probably the best measure to assess trade performance, the ranking would be slightly different. Japan (+USD1.8bn), Vietnam (+USD0.8bn) and Malaysia (+USD0.7bn) should exhibit the largest improvements as they would benefit the most from signing a partnership with the U.S. Countries such as New Zealand and Canada would gain from the opening of Japanese markets. For countries such as Singapore, Chile, Australia and Mexico, this new trade agreement will probably not boost trade significantly because they already have strong partnerships with the two largest countries involved (U.S., Japan). Note that total net exports variation between TPP members would sum up to 0.

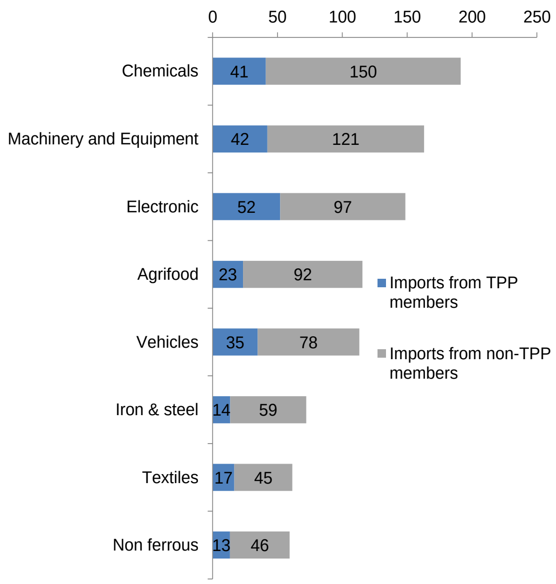
Increasing market opportunities should lead to a gradual rise in investment estimated at +USD11bn over the first two years of implementation. Further integration is likely to increase cross border and domestic investment with an expected impact of +USD7bn in the U.S. and +USD2bn in Japan respectively.

Opportunity #2: Efficient specialization - Competitive advantages will reshuffle trade routes inside and outside TPP area. Trade linchpins such as ASEAN countries will be pivotal

In the long-run, there is a significant potential for restructuring trade routes as countries' strengths complement one another. Inside TPP, the three clusters can leverage on individual advantages to reduce supply chains costs and find new sales opportunities. For instance, The Knowing could benefit from easier and cheaper access to goods from The Having, including energy, mineral, and agricultural products. The Doing could supply cheaper goods in an efficient manner to The Knowing. In turn, The Knowing could provide better access to their markets and services – including financing – to The Doing and Having countries.

Looking at non-energy specific industries, we see interesting opportunities in the Electronic, Chemicals and Machinery and Equipment sectors. First, we look at past trends (imports from TPP members and non-TPP members from 2010 to 2014) as forecasting future demand prospects for all industries is challenging. Interestingly, demand for those 3 sectors (Figure 4) was strong both inside the TPP (+USD135bn imports *per annum* over 2010-2014) and outside (+USD370bn). Second, the region can rely on industry champions that will benefit from better integration. In particular, the electronic industry (Figure 5) can leverage on: the U.S. and Japan's R&D and branding power; Chile and Australia for providing key inputs (e.g. copper, aluminum respectively); Mexico and Vietnam for products manufacturing (e.g. electronic components, electronic equipment); all TPP markets for distribution and sales; and Singapore to act as a strong re-exports hub outside TPP region.

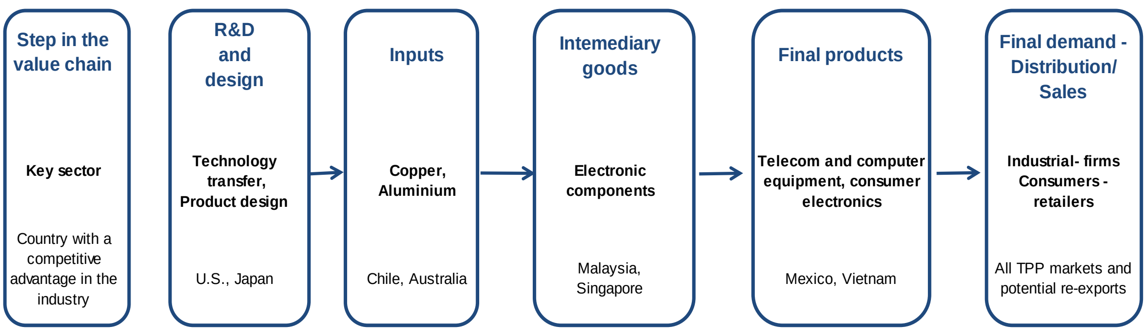
Figure 4: Import from TPP and non-TPP members (2010-2014, average change per year in USD bn)



Sources: Chelem, Euler Hermes

Similarly, the Chemical industry can benefit from: natural resource endowments (energy commodities

Figure 5: Electronics value chain with selected champions



Source: Euler Hermes

in North American and South East Asian countries and non-ferrous metals and ores in Chile and Australia); and strong players well-positioned in the value chain in the U.S. (Plastics, Pharma, Basic Chemicals), Japan (Rubber Articles) and Canada (Fertilizers). In Machinery and Equipment, the potential is significant as each country has its own specific advantage ranging from low value-added products (metallic structures, engines in Mexico) to more sophisticated products (aeronautics in Canada and the United States).

Going forward, overall competitiveness of TPP members can be enhanced and leveraged to compete outside TPP. On that front, the ASEAN members of TPP (especially Singapore, Malaysia and Vietnam) are the best positioned. Geographically, they can benefit from fast growing demand in Asia-Pacific (GDP growth above +4% while global growth is around 3%). Strategically, they are highly involved in Asian trade routes as strong drivers of regional supply chains, and key members of all main regional trade agreements (e.g. ASEAN economic community under construction, Regional Comprehensive Economic Partnership in negotiation[1]).

Opportunity #3: Better cross-fertilizing of business practices

TPP will likely lead to a gradual alignment of better business practices. Intellectual Property (IP) Protection, Technical Barriers to Trade and the Investor-State Dispute Resolution (ISDR) mechanisms call for further convergence to improve attractiveness. First, IP protection would encourage innovation and technology transfers. Second, better cooperation on technical barriers to trade (standards, conformity assessment procedures) will help companies achieve economies of scale. Third, clearer rules on ISDR should enhance business protection. Currently, the gap is huge between countries like Singapore (ranked 1st in Doing Business) and Vietnam (ranked 90th). The business climate (e.g. enforcing contracts, investor's protection, and property law) varies greatly and can be a significant impediment for cross-border trade and investment. Insolvency resolution is not easy in countries such as Brunei and Vietnam, debt collection is difficult due to poor legal frameworks in countries like Malaysia and Mexico1. All of these issues pose significant risks, especially for SMEs, which usually have less financial buffer.

And the winners are…

All TPP countries would benefit from further market integration but the potential impact is determined by underlying competitiveness. Among The Having, New Zealand should benefit the most as domestic demand would increase in line with new exports opportunities. Vietnam should top the league in The Doing cluster, taking advantage from cheaper labor costs and increasing productivity. Japan will likely be the best in The Knowing category thanks to strong trade positioning: Japan has a trade surplus with most countries involved in the partnership.

What could turn the tables? Political hurdles going forward. TPP must still be adopted by the legislative bodies of the participating countries. In the U.S. for instance, the agreement faces strong opposition in Congress which jeopardizes its ratification.

Risk #1: Currency war - Perceived currency manipulation by Vietnam and Japan

The question of currency manipulation remains one of the most debated in the U.S. and runs the risk of derailing the entire deal, despite the fact that all 12 countries have pledged, outside of the agreement itself, not to deliberately weaken their currencies to gain an export advantage. Unsurprisingly, the U.S. automotive industry has always looked at Japan's competitive devaluations with a wary eye, attributing increased Japanese exports to the U.S. and fiercer competition with Japanese automakers to the sharp depreciation of the Yen since the start of *Abenomics*. As such, it is lobbying with all its

Figure 6: Doing Business and selected components (ranking, 1=best)

	Ease of Doing Business Rank	Registering Property	Protecting Minority Investors	Enforcing Contracts	Resolving Insolvency
Singapore	1	17	1	1	27
New Zealand	2	1	1	15	31
United States	7	34	35	21	5
Australia	13	47	66	4	14
Canada	14	42	6	49	16
Malaysia	18	38	4	44	45
Japan	34	48	36	51	2
Mexico	38	106	57	41	28
Chile	48	56	36	56	58
Peru	50	35	49	69	74
Brunei Darussalam	84	148	134	113	98
Vietnam	90	58	122	74	123

Sources: World Bank, Euler Hermes

[1] The ASEAN Economic Community is the realization of the region's end goal of economic integration by end 2015. The block includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar and Vietnam. The Regional Comprehensive Economic Partnership (RCEP) is a FTA negotiation that has been developed between the ten ASEAN's members and the six countries with which ASEAN has existing Free Trade Agreements (Australia, China, India, Japan, Korea, and New Zealand).

might (and mighty it is: at c. USD140bn of exports each year, it is one of the largest export sectors for the U.S.) to include an outright ban on currency manipulation in TPP agreement (not just a pledge) which would result in trade sanctions were currencies to be manipulated. Such a ban looks highly unlikely to happen as it is, but negotiations are said to continue in parallel. All the more so since following the devaluation of its currency in August in response to China's own devaluation, Vietnam has joined Japan in the ranks of currency manipulators in the eyes of some U.S. Congressmen. This heightened focus on currency manipulation fails to acknowledge the fact that evaluating whether a currency is over- of under-valued is very complicated. So is determining whether a country is manipulating or managing its currency. The Bank of Japan implementing large-scale asset purchases that drive the Yen down cannot be labeled as currency manipulation. Furthermore, the appreciation of the USD on a trade-weighted basis since mid-2014 is primarily the result of the U.S.' own policy actions, i.e. the FED announcing that it will raise interest rates.

Risk #2: Eviction effects on key national industries (e.g. Automotive and Agrifood)

In general, the agreement is designed to boost trade but heterogeneity will prevail. Not every country will gain in every industry. Some industries in some countries will face simply stiffer competition, others even an eviction risk. For example, Asian agricultural producers may suffer from competing against large U.S. ones that will enjoy the elimination of import taxes up to 40% on fruit and poultry. The Vietnamese poultry industry has already filed an anti-dumping suit against U.S. chicken products for dumping (too low prices) even before TPP was ratified. As tariffs are removed and prices of U.S. imports fall further, similar situations could mushroom. New Zealand and Australia are also likely to make significant gains in agricultural exports at the expense of others.

National automotive industries also face eviction risk from Japanese carmakers. Under NAFTA rules, cars had to have at least 62.5% North American content to qualify as duty free, but under TPP that threshold has been reduced to 45%. Therefore some Japanese auto makers which currently export a large portion of their sales to North America could benefit from bypassing tariffs (25% on trucks going into the U.S. e.g., pressuring U.S. truck makers). Small and medium sized parts manufacturers face a similar dilemma, particularly in Canada. Under NAFTA rules, auto parts had to have at least 60% North American components to remain duty free, but TPP's new thresholds are now between 35% and 45%.

Insolvency risks and turbulence on intercompany payments could increase in the first phase of implementation of the TPP. All Free-Trade Agreements (FTAs) are Darwinian as competition becomes fiercer and supply chains reshuffle.

Risk #3: Politics and social discontent

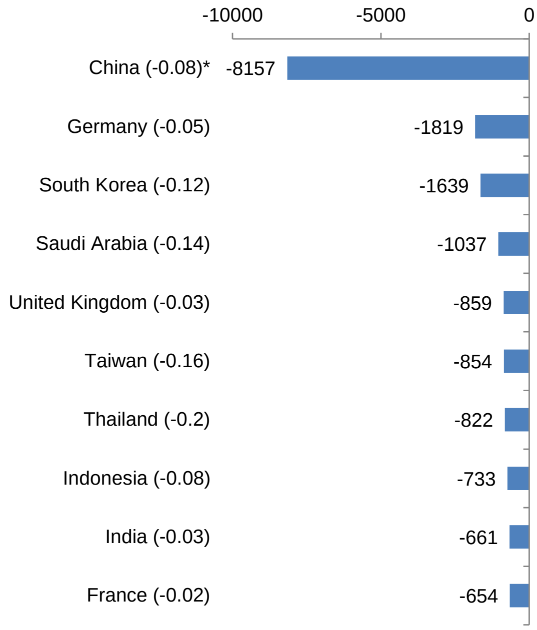
Many Americans feel that millions of jobs have been lost due to increased trade with China and business (and jobs) relocation to Mexico from NAFTA. This sentiment has proven very popular within the Democratic party which has long represented labor unions and is concerned that the agreement will lead to further job losses, lacks adequate worker protections, and will undermine environmental and health protections. Thus President Obama is facing significant resistance from his own party and will need to turn to Republicans, who are more typically pro-business, to help pass the agreement. However, Republican support is not unanimous: some are more protectionist and others are concerned about the ISDR provision which would allow foreign investors to sue the U.S. government over laws affecting domestic profits.

What are the risks for the rest of the world?

Without a (coordinated) policy answer, non-TPP members would suffer from trade diversion: TPP countries would prefer to import from other TPP members, as goods and services become cheaper. Among major economies, China will probably be the first country to be impacted negatively by TPP. In value terms, China will lose –USD8bn (over the first two years) of exports as countries would prefer to import (directly) from countries such as Vietnam or Malaysia, which are more competitive and with similar sector differentiation (Electronics for both, textile for Vietnam). Germany and South Korea would also lose -USD1.8bn and -USD1.6bn in exports respectively, mainly from direct competition with Japan as a preferred supplier. Car manufacturers will probably feel the heat with further pressures on selling prices. Finally, primary commodity exporters will have to fight The Having: Saudi Arabia will be the most impacted with -1USDbn losses in exports.

As China and the European Union (E.U.) feel left out, they decided to reinforce their economic ties. A bilateral FTA was evoked as soon as 2014 and they have launched negotiations for a Bilateral Investment Agreement (BIA). This should foster liberalization of investments by eliminating restrictions imposed on foreign investors in both markets. Including an investor state dispute settlement (ISDS) is key, but it will be contentious. Both parties allegedly want to reach a deal by end 2016. Meanwhile, China will become the first non-E.U. nation to contribute to the Juncker Plan, whereas the E.U. is considering the possibility that China becomes a member of the European Bank for Reconstruction and Development (EBRD). Last but not least, China is preparing its own mega trade deal with the One Belt One Road plan and 2016 should grant Market Economy Status (MES) to China, a game changer for its export potential. As for the E.U., the Transatlantic Trade and Investment Partnership (TTIP) with the U.S. could be a major competitor with TPP: forcing the U.S. to look east bound rather than west.

Figure 7: Direct impact of TPP implementation over the first 2 years of implementation on exports of non-TPP members (USD mn)



** China would lose USD8.2bn on exports (-0.08 pp of GDP)*
Sources: Chelem, Euler Hermes

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