Tax-free Champagne, anyone?

European and North American politicians are plotting the biggest trade deal of the 21st century: a $35 trillion, duty-free region encompassing the E.U., the U.S., Canada, and Mexico.

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Not even Franz Kafka could have dreamed this one up.

This past spring, prime ministers Stephen Harper of Canada and MirekTopolanek of the Czech Republic met with European Union mandarins from Brussels. The setting was Prague's medieval castle -- made famous by Kafka in what is perhaps the darkest novel in his moody oeuvre -- where they hatched a plan for the biggest free-trade deal of the 21st century.

How could a development of this magnitude result from a fairly routine conference between Canada and the EU? (At the time, the Czech Republic was responsible for the trading bloc's presidency, which rotates between member states every six months.) The short answer is that after decades of spinning their wheels, Canada and the EU finally agreed to begin negotiating a free-trade agreement (FTA).

That's far from a Bond-villain plot for world domination. But fast forward to last week in Ottawa, Canada, where the first round of Canada-EU negotiations reached a successful conclusion, with both sides optimistic that a deal can be signed as early as the summer of 2010.

When that happens, a push will begin for the ultimate goal behind the Prague agreement: a NAFTA-EU trade zone to counterbalance the growing economic power of Fortress Asia, and the ascendancy of the so-call BRIC (Brazil, Russia, India, China) group of countries.

"The U.S. will lose its leadership position in trade unless it comes up with a new strategy," says Steven Schrage, a specialist in international business at the Center for Strategic and International Studies (CSIS) in Washington. "It makes sense to integrate NAFTA with the EU."

Annual two-way trade between Canada and EU is about $100 billion, less than 20% of the total between Canada and the U.S. under NAFTA. But a trans-Atlantic NAFTA-EU trade zone would encompass nearly 1 billion people and account for $35.2 trillion in annual GDP, more than half the world's total.

Elimination of tariffs is only one piece of the free-trade puzzle. "The largest benefits will come from economic integration," says Jayson Myers, president of Canadian Manufacturers & Exporters (CME), the country's largest trade and industry association. By that he means increased foreign direct investment, improved labor mobility and full access to government procurement.

By comparison the combined GDP of the 10-member ASEAN (Association of Southeast Asian Nations), China and India was $7 trillion in 2008, according to the International Monetary Fund. That does not seem like an imminent threat to the economic supremacy of the West, but Asia is not standing still. Some 140 bi-lateral FTAs have been signed in the region over the past decade.

Most significantly ASEAN and China are moving towards significant tariff reductions by 2010. Also, India is set to join this burgeoning trade bloc after signing an FTA with ASEAN earlier this year, which would create a trade zone of nearly 3 billion people over the next decade. Goldman Sachs estimates that by 2050 the world's three biggest economies will be China, the U.S. and India in that order, compared to the U.S., Japan and Germany today. That represents a clear shift away from the G7.

A NAFTA-EU trade deal will likely be met with stiff opposition. "It will be a difficult sell in the U.S.," says senior economist Many Grauman with CIBC World Markets in Toronto, noting Canada is much more dependent on exports for economic growth than its biggest trading partner.

An FTA with Europe may be a hard sell, but a union of existing trade blocs is likely inevitable, says Schrage of CSIS, who has held senior positions with the U.S. State Department and helped negotiate top-level agreements with G8 nations. He points out that the preceding Bush administration had a NAFTA-EU deal on its radar, but failed to make progress. "The ball is in the Obama administration's court," says Schrage. "If they want this to happen, they can move rapidly."

The World Trade Organization's efforts to lower trade barriers under the Doha round of talks has hit a wall. The main reason is that developed countries led by the EU, U.S. and Japan cannot come to an agreement on new rules governing agriculture and industrial tariffs with major developing countries such as India, Brazil and China.

Failure of the WTO provides an added incentive for the West to forge closer economic ties. However with protectionist sentiment in the U.S. gaining momentum, helped in part by President Obama's controversial Buy-American position, getting the world's biggest economy to expand its free-trade frontier could be an uphill battle. At least for the near term.