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EUROPE'S TRADE STRATEGY FOR THE AGE OF GEOECONOMIC GLOBALISATION

The EU, China and the US Competing in the Face of the Global Megatrends of Climate, Technology and Demographic Change

Christian Johannes Bluth

Respect

BertelsmannStiftung

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About the author

Christian Bluth is Senior Expert for Globalisation, International Economics and Trade Policy at Bertelsmann Stiftung. From January to June 2020, he also held a Policy Leader Fellowship at the School for Transnational Governance at the European University Institute, during which most of the research for this book was undertaken. Bluth's research activities focus on various aspects of EU trade policy and the reform of the World Trade Organization.

Bluth holds a PhD in Politics and International Relations from the University of Cambridge and a Master's degree in Economics and Public Policy from SciencesPo Paris.

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Preface

Dovete adunque sapere come sono dua generazione di combattere: l'uno con le leggi, l'altro con la forza: quel primo è prorio dello uomo, quel secondo delle bestie: ma, perché el primo molte volte non basta, conviene ricorrere al secondo. Per tanto a uno principe è necessario sapere bene usare la bestia e lo uomo. [...] Il che non vuol dire altro, avere per precettore uno mezzo bestia e mezzo uomo, se non che bisogna a uno principe sapere usare l'una e l'altra natura; e l'una sanza l'altra non è durabile.

Sendo adunque, uno principe necessitato sapere bene usare la bestia, debbe di quelle pigliare la golpe e il lione; perché il lione non si defende da' lacci, la golpe non si difende da' lupi. Bisogna, adunque, essere golpe a conoscere e' lacci, e lione a sbigottire e' lupi. Coloro che stanno semplicemente in sul lione, non se ne intendanno. [...]

It should be understood that there are two types of fighting: one with laws and one with force. The first is most suitable for men, the second is most suitable for beasts, but it often happens that the first is not enough, which requires that we take recourse to the second. Therefore, it is necessary for a prince to know how to act both as a man and as a beast. [...] This can only mean, this trainer who was half beast and half man, that prince needs to know how to use either one or the other nature and the one without the other will never last.

Since it is necessary for the prince to use the ways of beasts, he should imitate the fox and the lion, because the lion cannot defend himself from snares and the fox cannot defend himself from the wolves. Therefore, it is important to be a fox in order to understand the snares and a lion in order to terrify the wolves. Those who choose only to be a lion do not really understand'.

Machiavelli, Il Principe, Chapter XVIII

The nature of globalisation is changing – and fast. The globalisation that we see today differs substantially from the globalisation that we witnessed just a few years ago. We no longer live in a world where our chief concern is to enhance economic growth and prosperity. Geoeconomic considerations have risen in importance. But they are not the only objective to be satisfied. In fact, globalisation and trade need to respond to a multitude of challenges that emerge from political as well as non-political trends. Climate change, demographic change, technological change, an increased frequency of epidemics but also protectionist populism, a weakening of international cooperation – these are the forces that will shape globalisation for the foreseeable future. The European Union is a strong actor in a globalised world. The von der Leyen Commission has labelled itself the 'geopolitical' Commission. But if geopolitics is increasingly being pursued by economic means, that implies that the EU needs to overhaul and revamp its trade strategy in order to respond to this new objective. The intention of this book is to contribute some fresh ideas to this challenge. It is the fruit of my work as a Policy Leader Fellow at the School of Transnational Governance at the European University Institute in Florence. Florence has

proven to be the perfect inspiration for my work. Never a particularly large city, it has for a long time proven its ability to adapt to new eras of globalisation and power dynamics, to trade internationally, drive commercial innovation and compete with its rivals. Its ability to adapt, to invent and to use its sources of power effectively have been important factors behind the rise of Florence. Yet, at the centre is an incredible soft power based on humanism, reflected in the art, literature and philosophy of this city, which has never failed to impress and inspire. These manifold inspirations are hopefully palpable in this book, where it serves as a remote backdrop to the EU's response to profound challenges. Machiavelli, one of Florence's engineers of power, offered an insight that is very relevant to the EU in its formulation of its geopolitical ambitions. It is part of the EU's DNA to seek to resolve conflicts through law rather than raw power politics. The EU has to find a way to remain true to this noble DNA and the philosophy it represents but it also needs to be able to affirm its position in the contest with other players, using their power uncloaked by law. For the EU it is vital to find out how it can become more affirmative but also project its power in a manner consistent with its strength and its values.

Much of this book was written in Spring 2020, when the pandemic had brought the world into turmoil and many political certainties no longer applied. It was sometimes not easy to see the signal in the noise caused by the epidemic around the globe while the streets were quiet. It was sometimes difficult to identify clearly what was a lasting trend to be reckoned with and what was a momentary distraction. While I am writing this preface, some of the dust has settled and I believe it is possible to see more clearly which elements can be expected to exert influence over global politics and economics and which other ones are negligible from a long term point of view. But the COVID-19 pandemic has made us aware that unforeseeable events can alter globalisation profoundly and within a short period of time. Trying to identify global long-term megatrends is the only way to prepare for the future, but it may not be sufficient protection against the impact of short-term turmoil.

Christian Bluth,
October 31st, 2020.

Executive Summary

Since the EU published its most recent trade strategy just five years ago, the world has changed dramatically and with it the objectives to which trade policy needs to respond. The most important of these changes is likely to be the increasingly geoeconomic nature of globalisation. Trade is used more and more as a tool for power projection rather than for the generation of prosperity. Big powers use trade and investment to generate networks of dependencies, rather than building institutions to underpin rules-based free trade.

While this is the central challenge for the foreseeable future, trade strategy has a multitude of other challenges and objectives to respond to, from climate change to the growing frequency of epidemics, from populist protectionism to big power competition.

Non-Political Megatrends

The central non-political megatrends are the fundamental changes in the world's climate and demography, developments in technology and the increased risk of future epidemics.

Climate change is a challenge for trade policy in several ways – especially since big trading nations are increasingly making use of aggressive carbon pricing in order to meet their emission targets. This risks profoundly changing the costs of production and as a consequence the localisation of production around the globe. In order to prevent leakage, i.e. production moving to low carbon price locations, the EU is contemplating introducing a Carbon Border Adjustment Tax (CBAT), which other trading powers may see as an illegitimate protectionist distortion of trade. I argue that a CBAT is a second-best solution and that the EU should make use of a political window of opportunity to create a plurilateral agreement with other large industrial nations on coordinating carbon pricing efforts which would also serve CBAT's environmental objectives without creating similar distortions. The EU should also seek Free Trade Agreements (FTAs) with countries that have low-cost clean energy in order to bolster the global competitiveness of energy-intensive EU industries.

Climate change also threatens the world's food supply. While populations are rising, soil surfaces suitable for **agricultural production** are decreasing and extreme weather events make yields more volatile. Trade can play an important role in addressing local food shortages. This implies that the rules governing agricultural trade ought to be adjusted to meet the demands posed by rising global temperatures.

The size and wealth of populations are an important determinant of a market's attractiveness. **Global demographic dynamics** therefore have important implications for trade policy. While the EU will remain a wealthy region, its relative share of the global population is declining. It is also unlikely to be a region of the world with the most dynamic growth patterns. This will translate into a gradual depreciation of the EU's bargaining power in trade policy, relative to other more populous and economically emerging

world regions. Generally, the world will be ageing which alters global investment and consumption patterns, a structural change which trade policy can accommodate. Africa's population is expected to rise dramatically, increasing the need to create economic opportunities for a young population.

Technology is becoming an increasingly important factor determining competitiveness but also geoeconomic vulnerability or strength. Europe's capacity to innovate is lagging behind that of the US and China. It is vital that the EU increases its innovative capabilities if it is to remain globally competitive. It is also well known that the EU is underperforming when it comes to exploiting the opportunities of the digital revolution. It is important that the EU makes it easier for domestic digital business models to grow and scale up, improving its global competitiveness in this area. While defending important values, such as privacy and data protection, the EU should not succumb to digital protectionism, since the availability of digital solutions also matters for Europe's more traditional industries. In areas where digital solutions or platforms leave it geoeconomically vulnerable, the EU should consider developing its own capabilities or diversifying the services deployed on its territory.

Finally, as the COVID-19 pandemic has shown, epidemics can have severe economic repercussions. As the **frequency of epidemics is rising**, this is increasingly a concern for trade policy. It is vital that critical medical supply chains continue to be operational and that – from a global perspective – production clusters in one location are avoided. Efforts to monitor supply and demand developments together with increased public stockholding can prevent further recourse to export bans, as in Spring 2020.

Political Megatrends

As important as these non-political megatrends are, the political megatrends constitute a more urgent threat, which EU trade policy needs to respond to. This is particularly true for the accelerating big power competition between the United States and China, but also for the tendency of 'weaponising interdependencies', the continued prevalence of protectionist populism and the weakening of multilateral institutions.

Both the EU and the United States, along with many other countries, share several concerns about **the trade implications of China's competition distorting policies.** Both find it difficult to obtain a serious policy reaction from China – the US trade war has not yielded much by way of substantial results, the EU's negotiations with China are slow to make progress. It is time for both trade policy powers to join forces and construct a multilateral initiative to address the distortions of the level playing field – in China, but also within other trading nations. The EU and the United States should also use their influence to shore up the multilateral trading system and increase regulatory cooperation in order to maximise their normative influence.

A core feature of 'geoeconomic globalisation' is the '**weaponisation of dependencies**'. Trade powers would hereby seek to create asymmetric inter- dependencies which give them political leverage over a trading partner. The EU should therefore be careful about the dependencies it is entering into with other trading powers. However, the response should not be reshoring of production and the pursuit of autonomy. Rather, the EU should closely monitor its supply network, diversify production chains and try to avoid dependency on a single actor (company, country, or region). In addition, the EU should create strong defence instruments that can be deployed if a trading partner is weaponising the EU's dependency on it. Such instruments should be defensive in nature, aimed at acting as a deterrent, and the EU should make it clear that it does not intend to use such instruments aggressively, as Europe benefits from global trade integration and an over-assertive strategy may cause trading partners to reduce their dependencies on the EU in turn. If the deterrent is to become credible, the EU should also seek more streamlined decision making mechanisms in foreign and security policy.

Rising populism is a serious challenge for EU trade policy. Political developments in trading partners and potentially in the EU and its member states, might make trade policy less reliable and more difficult owing to increased politicisation. I argue that dealing with protectionist tendencies is best done with domestic policy tools, notably by improving the welfare state and its efficiency; providing insurance against trade-induced shocks. At the same time, it is important to maintain a societal consensus to embrace open trade, which also requires that rules and values are incorporated into trade agreements and enforced adequately.

For the EU as a strong trading power, the **weakening of multilateral institutions**, in particular the World Trade Organisation (WTO), is another growing challenge. There is a risk that multilateral policymaking falls victim to big power competition and geoeconomic globalisation. For the EU, it is vital to defend the liberal globalisation embodied in rules-based trade governance. The EU should therefore be careful to avoid any undermining of global economic trade governance, invest political capital in the system and play a constructive role, together with other nations supportive of liberal global trade, in modernising the WTO by making it more flexible and effective.

CHAPTER 1

Introduction: The EU in Global Trade and the COVID-19 Pandemic

What is a trade strategy for? Not long ago, many would have argued that its chief purpose is to enhance economic welfare. While this remains an important objective of trade policy, it would be naive to believe it is the only one. As we find ourselves in a transition from the liberal globalisation that dominated the second half of the 20th century to a geoeconomic globalisation that is likely to dominate the first half of the 21st century, trade strategy will have to respond to new challenges.[1] At the same time, geoeconomic competition is only one of many challenges to which a trade strategy must respond to. Demographic, technological and climate change all present huge challenges for trade policy, which have only been exacerbated by the implications of COVID-19 for the global trading system.

Prosperity, resilience, sustainability, competitiveness, geoeconomic and normative power are all legitimate objectives of trade policy. Between them however, inherent trade-offs need to be solved and the inconsistencies between the different objectives addressed. A trade strategy provides an overarching framework that ensures coherence among these different aims. The current EU trade strategy dates from 2015, from a time before Trump and Brexit, when there was a stronger multilateral trading system and more confidence in regulatory cooperation as a tool to advance the liberal order.[2]

The aim of this text is first, to identify the long-term trends to which trade policy should respond and second, to outline the options for the shape of the response. It is beyond the ambition of the text to offer fine-grained trade policy solutions. It aims to be more of a map than a blueprint, providing a backdrop for more precise policy proposals to follow. The time horizon it attempts to cover is the upcoming decade. In areas where projections beyond 2030 are possible, as in the area of demographics, it will attempt to go further. This is regrettably not generally possible, especially at a time when many policy processes seem to be undergoing secular change and are clouded in uncertainty.

In this text, I distinguish between political and non-political megatrends. By megatrend, I understand a long-lasting economic, societal and political process of change. The non-political megatrends are demographic, technological, climate change related, as well as the growing frequency of epidemics. While the governance and response to these megatrends is inherently political, their origin is exogenous to the political process. This is different for other groups of megatrends, which arise specifically from political struggles.

1 In this text, I understand geoeconomics and geopolitics as the two components of geostrategic policymaking. While geopolitics in my understanding refers to the more traditional tools of diplomacy and warfare, geoeconomics means the employment of economic means to achieve strategic aims within a clearly defined geographical space.

2 European Commission (2015).

These megatrends are characterised by a tension between different goals or groups and the competition between these aims is going to have a strong bearing on the design of trade policy. Examples include the struggle between the 'old' liberal globalisation, not yet dead but not as strong as it was, and the 'new' geoeconomic globalisation. The struggle between protectionism and globalism, between the United States and China matter in a similar way. This competition among political concepts and their outcomes will determine the future of multilateral trade governance and the role of the EU as an actor in trade policy.

Before moving into discussing these megatrends and the options they present to EU trade policy, it is important to take a step back and reflect on the current state of EU trade policy and trade strategy. This will be the subject of this first, introductory chapter.

It is also not possible to reflect on the future of trade policy without taking the COVID-19 epidemic and its economic implications into account. Still being far from the end of the COVID-19 crisis at the time of writing, it is not easy to distinguish which changes induced by COVID-19 will be short-term and insignificant in a longer perspective and which are here to stay. What is becoming increasingly clear is that COVID-19 works as a catalyst, it accelerates policy developments that were already visible on the horizon before. For example, before the COVID-19 pandemic, the trends towards further digitalisation and increased emphasis on industrial policy would be cases in point. Another question is to what point COVID-19 is part of a newly emerging megatrend. The case has been made by Laurence Summers and others, that the world is witnessing a higher frequency of epidemics.[3] If this is indeed true, it is of critical importance to build resilience – not just at national level but to find more effective trade governance structures that prevent a collapse of basic trade functions in a way that was seen in the early stages of the COVID-19 epidemic.

Hence the remainder of this chapter discusses the purposes of a trade strategy for the EU and its objectives. It continues outlining the role the EU plays as a trade policy actor, how this squares with the trade strategy of 2015 and the new impulses that emanate from the von der Leyen Commission and the COVID-19 crisis. A reader well-versed in EU trade policy might skip this first chapter, which is mainly intended to provide a backdrop for the subsequent chapters. The next two chapters discuss the role of non-political and political megatrends respectively, before a fourth chapter tries to distil the main implications for the future of EU trade strategy. As I fear that many of my readers will not have the time to read this book from beginning to end, I have tried to write it in a way that enables them to jump into sections of particular interest to them. This unavoidably generates a few regrettable repetitions, for which I have to ask you, the patient reader, for forgiveness.

3 Laurence Summers at a panel discussion hosted by the London School of Economics' Institute of Global Affairs and the School of Public Policy, entitled "Now or never: crafting the global COVID-19 response", on April 21st, 2020.

1.1 COHERENCE AND OPPORTUNITY: THE PURPOSE OF A TRADE STRATEGY

The question of what objectives trade policy should aim for is central to defining a trade strategy. The view that trade policy should aim at enhancing economic prosperity through facilitating a more efficient allocation of resources remains important and central to any trade strategy. But other objectives have gained in importance and ought to be taken into account when devising a new trade strategy. The list below enumerates the main points that are currently being discussed in conjunction with trade policy:

- **Prosperity:** Trade is first and foremost an economic activity, despite its manifold political implications. It is usually undertaken by private actors for the purpose of economic gains.[4] The point of trade policy is to strategically steer trade and market access. This can take on a liberal interpretation where the state's policy aims at diminishing trade barriers with the largest number of partners possible in order to maximise welfare gains. Trade policy can also be used for different purposes such as maximising customs revenue, fostering strategic trading relationships with preferred trading partners, promoting economic development, etc. Whatever the objective(s) chosen, harnessing the welfare enhancing possibilities of trade and promoting prosperity ranks highly among them. The welfare gains stem from a variety of sources. Exporters gain because they have access to markets beyond their home market, and can produce larger quantities and exploit economies of scale. Consumers also gain because they have access to a larger variety of goods and – through increased competition – at lower prices. There are various other gains. Trade is linked to increased levels of investment, transfer of know-how, better public institutions and a lesser likelihood of a country going to war with its trading partners.[5]

- **Competitiveness:** The goal of competitiveness is closely aligned with prosperity. In terms of trade policy, measures to attract investment in critical areas, immerse a country in emerging sectors, etc. can have implications that aim more specifically at strengthening competitiveness *vis-à-vis* other trade powers, rather than simply seeking increased prosperity. Trade and investment can contribute considerably to improving a country's ability to compete on global markets. This can be because domestic producers improve their products so they remain attractive in comparison to imports. More often, improvements in competitiveness are linked to foreign direct investment (FDI). Investors from abroad who either engage in greenfield investment, i.e. build up production plants from scratch, or who acquire domestic companies and modernise them, tend to bring with them know-how and innovative capacity. Policies can aim at increasing the degree to which investment and trade can contribute to

4 While it is true that public enterprises also engage in trade activities, which is historically not a new phenomenon, this does not diminish the dominant role of the private sector in trade.

5 On the link between trade and investment, insights are provided by Duval (2008); on the link between trade and technology transfer, Hoppe (2005); on trade and quality of institutions, Islam & Montenegro (2002); on trade and peace, Hegre et al. (2010).

improved competitiveness. A well-known example is the requirement that companies that wish to invest in China are obliged to enter joint ventures with local partners. Through these measures, Chinese entrepreneurs were able to obtain access to new technology and know-how; it was a fundamental driver of China's development strategy. At the same time, an objective of trade policy can be less to acquire new technology and know-how and more to defend existing competitive advantages against inroads from foreign competitors. In such a case, rather than fostering FDI, a suitable strategy might be to control or limit the acquisition of domestic companies by foreign competitors or to seek assurances on the protection of intellectual property.

• **Resilience:** With trade comes openness. More open countries are also more susceptible to importing shocks from abroad. If there is, for whatever exogenous reasons one might imagine – a financial crisis, an epidemic, political unrest – a contraction in the market of a close trading partner, this will reduce the demand in this country for imported goods. This in turn hurts the exporters in countries with close trading relationships. An objective of trade policy should therefore also be to think about strengthening resilience, i.e. the ability of a country to cope well with adverse shocks and recover from them quickly.[6] Resilience can be supported by measures that are in the realm of trade policy, such as a diversification of trading partners, which would reduce the risk of being hit by an exogenous asymmetric shock. Such a strategy does not, however, provide protection against a symmetric shock, i.e. one that hits all trading partners simultaneously. Resilience can also be improved by additional complementary measures that lie outside the boundaries of trade policy. For example, a strong welfare state can act as a safety net against ported from outside. An argument has been made, that countries with stronger welfare states are better able to build a social consensus embracing openness and globalisation.[7] The objective of resilience has been frequently mentioned in the context of the Great Financial Crisis (GFC) and the COVID-19 crisis, a topic that will be discussed in more detail below.

• **Sustainability:** Trade can potentially yield unsustainable outcomes. In fact, one of the most frequent criticisms of trade and globalisation is that it undermines the state's ability to regulate, as production can easily be shifted to places with less stringent regulation, thus leading to a regulatory race to the bottom. This concerns societal norms and the respect of human rights as much as it concerns environmental sustainability. Especially in the latter instance, a regulatory race to the bottom endangers attempts to internalise environmental externalities, i.e. makeproducers responsible for paying the true cost of production including the use of public goods. Trade policy, understood as a tool for rules-setting, can mitigate the risk of a regulatory race to the bottom and therefore can help make trade compatible with sustainability concerns.

6 A more complete discussion of the concept of resilience can be found in Brinkmann et al. (2017).
7 Lindbeck (1977); Cameron (1978); Rodrik (1998).

- **Normative Influence:** The point of normative influence is closely linked to sustainability but goes beyond environmental and social norms. Its focus is the outward projection of values rather than an inward-looking ability to regulate – the focus of the sustainability goal. Trade can also be used to support other normative concepts. Sometimes, this is described as the 'trade and ...' agenda. The idea here is to link trade to a compliance with specific normative aims – human rights, good governance or the empowerment of women are frequent examples. Trade works both as a stick and a carrot: the reward for implementing improvements in non-trade areas that are important to one trading partner is an enhanced trading relationship; the punishment for failing to do so is the reduction of trade and the benefits that it brings. Attaching normative influence to trade serves the objective of spreading normative conceptions but also of satisfying domestic demands for the respect of norms in trade.

- **Diplomacy:** The use of trade as a tool for diplomacy is closely related to the above point on normative influence but may go beyond. In the same way that trade can be used both as a stick and a carrot to achieve specific normative influences, it can also be used to obtain political influence. This geostrategic function of trade is becoming increasingly important. Two recent examples are the Chinese 'Belt and Road Initiative' (BRI) that consists primarily of a set of infrastructure projects linking countries to China and thus helping both the trade relationship but arguably also China's political influence within the BRI countries. Another example would be the Deep and Comprehensive Free Trade Agreements (DCFTAs) of the EU with Georgia, Moldova and Ukraine which are part of Association Agreements that link these countries closer to the EU Single Market. These tools have been particularly designed to strengthen the pro-European political forces in these countries.

This list of possible trade strategy objectives is non-exhaustive. It covers the most important objectives of trade policy to date but it is likely that further objectives might be pursued in the future through the means of trade. As we will see, there is sometimes tension between the different objectives. Maximising prosperity is sometimes at odds with sustainability, normative or political objectives. A trade strategy should identify clearly where trade-offs exist between them. Ideally, a trade policy provides a backdrop for how these tradeoffs should be addressed, i.e. which objectives should be given priority or – if such a general prioritisation is not possible – establish a mechanism for an ad-hoc resolution of the tradeoff.

A trade strategy is shaped by external and internal factors. Policymakers react to changes in the political and economic environment in which they operate but they are also subject to domestic policy pressures. In the foreground of this analysis are the external factors shaping trade policy, such as global megatrends of political and non-political nature. These can constitute both challenges and opportunities. While they might force a change in the way trade is conducted, rewards might be reaped through quick adaptation to new megatrends. For internal trends, however, there is a rich literature that links trade policy

to domestic political economy factors. The political preferences of important political groups or of lobbyists can have a significant bearing on trade policy.[8] Policymakers sometimes simply cannot ignore the pressures and are forced to respond to them. As some of these domestic pressures are linked to the megatrends at the centre of my analysis, I will not ignore them completely. For example, one section below deals with the rising tendencies towards protectionist populism but this is not the only political trend that might impact EU trade strategy. Another example would be how the success of Green parties in the 2019 European Parliament elections has had a strong impact on the overall political strategy of the von der Leyen Commission, in particular in devising the Green Deal in order to make the EU net carbon neutral by 2050. In a similar way, future elections to the European Parliament or in key member states will inevitably change EU trade policy and alter the order of priorities in its objectives.

1.2 THE EU AS A STRATEGIC TRADE POLICY ACTOR

Together with the United States and China, the EU is among the three largest trade policy players. The strategy of such a large actor matters and impacts the functioning of the global trading system as a whole. This section is meant to provide a backdrop for the future orientation of EU trade policy by providing a description of the status quo. It does this in two subsections. The first discusses the EU as a global trading power and provides some basic statistics on EU trade performance. The second discusses its current trade strategy, Trade for all, an overhaul of which was announced by (the then) Trade Commissioner Phil Hogan in June 2020 and to which this book wishes to make a contribution.[9]

The Treaty on the Functioning of the European Union (TFEU) establishes the Common Commercial Policy of the EU member states.[10] The EU is granted the authority to represent the member states in commercial policy. The European Commission negotiates trade agreements on behalf of the member states and represents the European Union in the WTO. The European Council and the European Parliament '*shall adopt the measures defining the framework for implementing the common commercial policy*'.[11] Article 206 sets out as an objective that '*...the Union shall contribute, in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers*'. The legal allocation of competencies between the EU and its member states is however complex and could be part of a reform of the way the EU pursues its foreign policy and therefore will be further discussed in Chapter 3.

8 e.g. Grossman & Helpman (1994).
9 European Commission (2015).
10 European Union (2012), Part Five, Title II.
11 European Union (2012), Article 207(2).

1.2.1 The EU as a Trade Policy Actor

Market Size, Imports and Exports – How Does the EU Compare?

Size matters in international trade. It matters because it is an important component of bargaining power in trade negotiations. A large economy has a large number of consumers and this makes its market an attractive export destination. In order to receive preferential access to this attractive market, trade partners are willing to make larger concessions of market access to their own domestic markets.[12] A large trading power can also influence the setting of international standards, i.e. as rule-maker as opposed to rule-taker. If goods destined to such a large market must comply with certain standards, producers might find it cheaper to apply the same standards for the entirety of, or a large share of, their production in order to reduce production prices. The effect may even be that the rules also get applied in other markets, even though there is no legal obligation to do so but simply because it is conducive to business efficiency.

Another aspect of why size matters has to do with the increasingly geoeconomic nature of international trade relations. Having larger trade flows with other nations generally implies having greater leverage than countries with smaller trade flows – provided that the dependency on imports doesn't turn trade relations into a two-edged sword. But generally, the possibility to politically leverage trade flows and dependencies on them is a significant power asset in a geoeconomic world.

But size is not the only determinant of bargaining power. Dynamics matter too. They matter because in expanding markets it is easier for companies to conquer a larger market share than in mature and stable markets. Dynamic growth can also be perceived as a path to future economic size. Developed trading nations have an incentive to secure privileged access to emerging, high-growth markets for their companies. At the same time, emerging markets can benefit from the large established markets of developed nations.

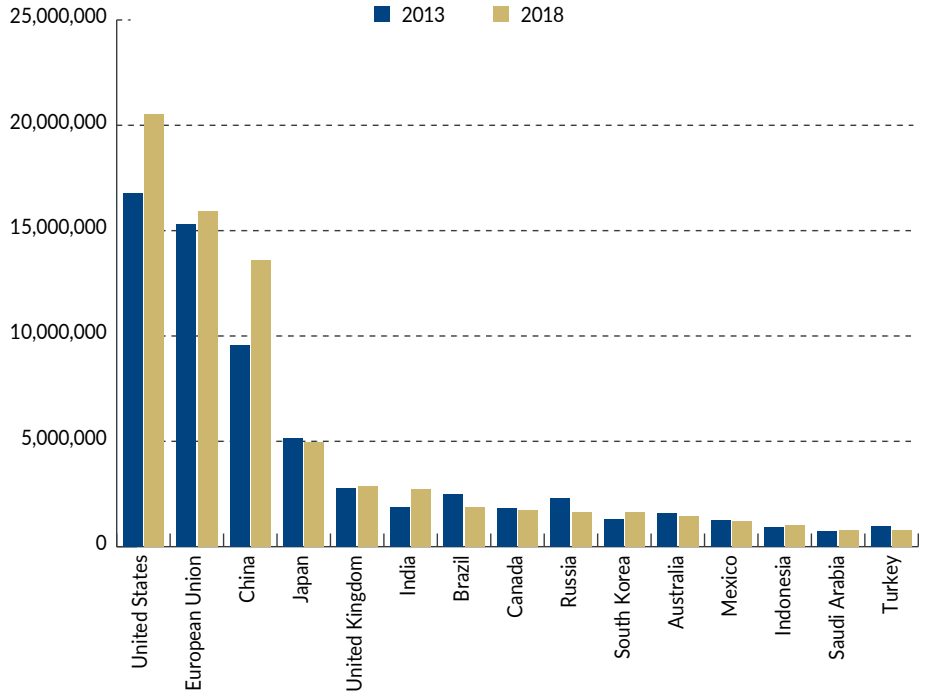
Where does the EU currently stand in international comparison? How large is its current market size compared to other major trading powers? Who are its most important trading partners? Which goods and services is it predominantly trading in? And how do its dynamics compare to those of other players? To answer these questions is precisely the purpose of this section.

Several indicators reveal the comparative size of a trading nation. While GDP does not provide much information about its trade activities, it captures the size of its economy. Generally, larger economies are also attractive export destinations. Figure 1.1 presents the

12 In trade theory there is also a discussion about the possibility of large trading nations to implement optimal tariffs to influence world prices and tilt its terms of trade to its favour. Gros (1987).

15 largest economies.[13] The United States is still the largest economy in the world, followed by the EU and China. It is clearly visible though that China has experienced extraordinary growth between the two observations shown, 2013 and 2018. If GDP is measured in purchasing power parity, China is already the largest economy in the world, followed by the United States. Japan, the United Kingdom and the other countries presented in this overview follow far behind. It is striking that several economies, have shrunk over the observed time period – this is the case for Japan, Brazil, Canada, Australia, Mexico and Turkey. The EU has not shrunk, but it cannot match the growth dynamics of the United States, let alone China's.

FIGURE 1.1 THE 15 LARGEST ECONOMIES IN THE WORLD, MEASURED BY GDP (IN CURRENT PRICES, IN MILLION USD)



Source: World Bank

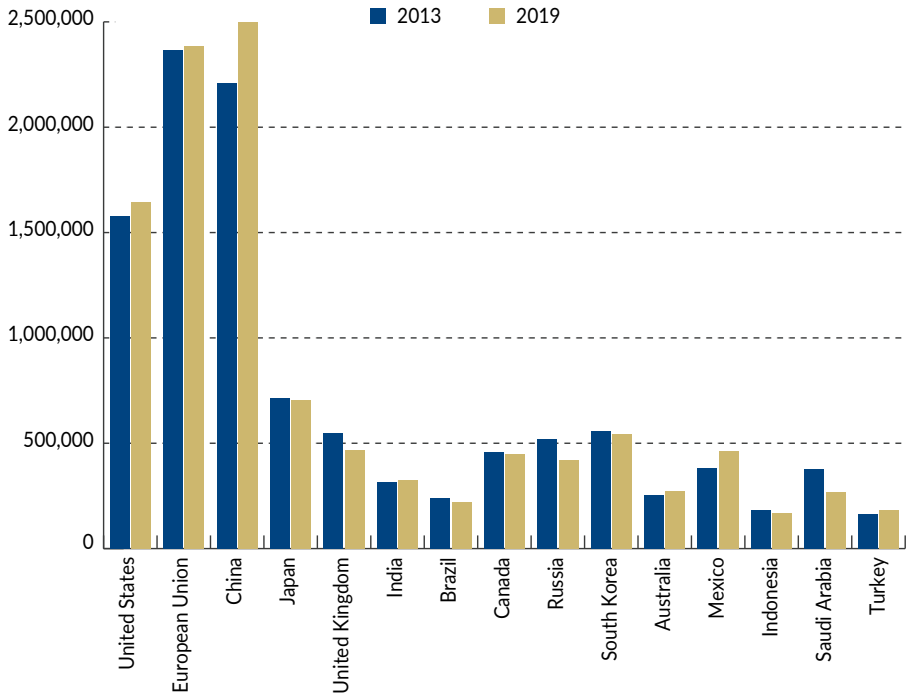
Let me now turn to statistics more directly linked to trade, looking at exports and imports. There are different ways to measure the EU's trade performance. One can evaluate the EU either examining its overall trade performance – i.e. also including intra-EU trade between its member states – or one can simply look at the trade of the EU with third countries. Under the first measure, the EU dominates international trade statistics,

13 As this text deals with the EU as the relevant actor in trade policy, I focus on EU values and not the values for member states. An exception has been made for the UK given that as of 2020 it is no longer an EU member state. As the data is for 2013 and 2018 and the UK was a member state of the EU at that time, it is also included in the data for the EU.

owing to the intensive and close-knit trading relations between its member states. In order to compare the EU to China or the United States, it makes more sense though to look only at the trade performance of the EU with third countries. While the Single Market is not quite as frictionless as the internal market of the United States, it is a trading space that goes much further in integration than any other preferential trading model in comparison.

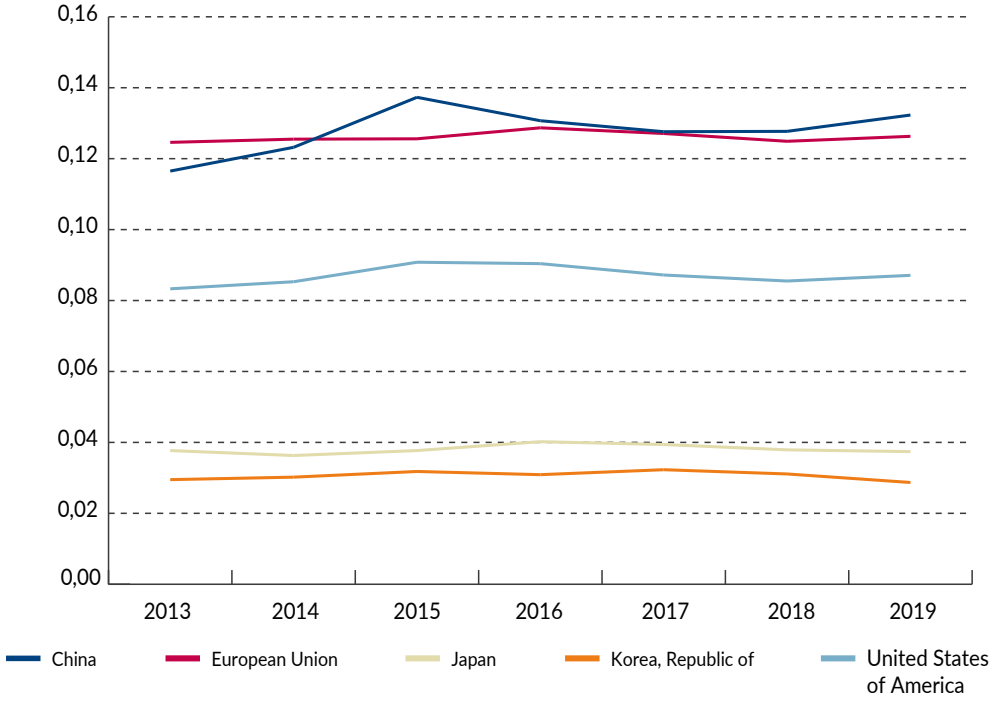
Figures 1.2 and 1.3 shed more light on the merchandise export performance of the world's largest economies. As becomes evident from Figure 1.2, the United States might be the largest economy in the world, but it is not the world's largest exporter. Here China leads the group, which has overtaken the EU as the world's largest exporter. This statistic would look different if trade among EU member states were also considered, in which case the EU's performance would be much stronger than China's. Japan, as the fourth largest exporter, is much smaller than the top three – and the value of its exports has been declining. Figure 1.3 looks at the top five exporters and their share in global merchandise exports. Again, we see that China has overtaken the EU. It's also notable that the shares – perhaps with the exception of China's – remain remarkably stable over time and from 2015-2018 there has been a downward pressure on the exports of the EU, the United States, Japan and South Korea.

FIGURE 1.2 MERCHANDISE EXPORTS OF THE 15 LARGEST ECONOMIES IN THE WORLD (IN MILLION USD)



Source: WTO

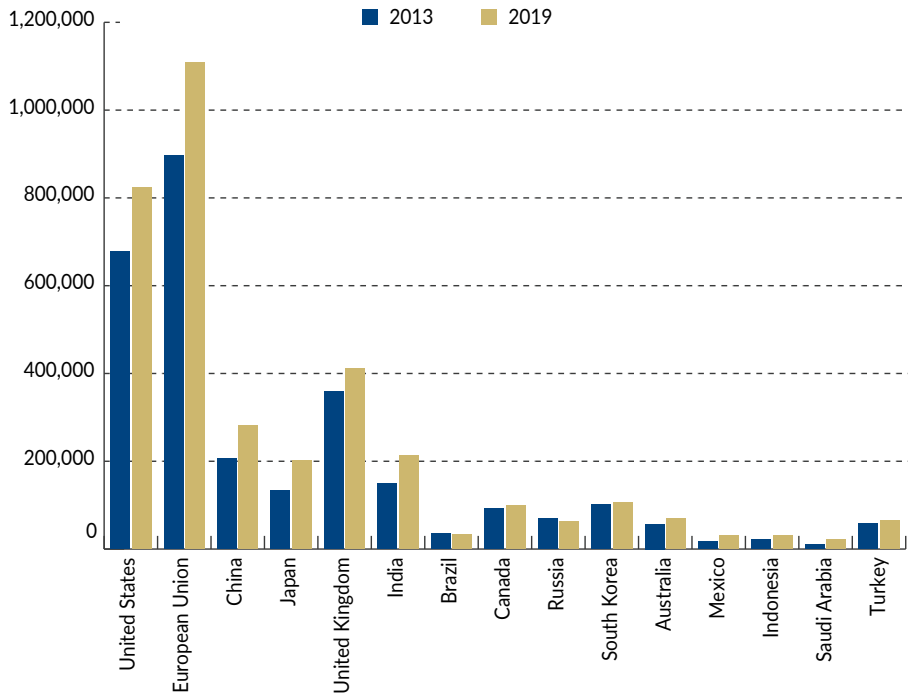
FIGURE 1.3 SHARE IN WORLD MERCHANDISE EXPORTS FOR THE TOP FIVE EXPORTERS



Source: WTO

The picture is slightly different if we consider the export of services. Here, the EU is by far the largest exporter. The United States takes second place. China is comparatively small, a much smaller economy such as the United Kingdom outperforms it in exporting services by a considerable margin. It is also interesting to note that growth rates are much higher than for trade in goods. The levels, however, remain below those for trade in goods. For example, in 2019, the EU exported 1,107,610 million USD in services and 2,386,425 million USD in goods to third countries (again, I am leaving out intra-EU trade). Thus, services make up roughly one third of total EU exports.

FIGURE 1.4 SERVICES EXPORTS OF THE 15 LARGEST ECONOMIES IN THE WORLD (IN MILLION USD)



Source: WTO

After the export side, let us now turn to a comparison of imports. Figure 1.5 presents merchandise imports of the largest economies. The United States is the world's largest importer, followed by the EU and by China. The United States and China have both seen the amount of imports increase while they remained stable for the EU. Services imports are presented in Figure 1.6. The European Union is not only the largest exporter of services but also the largest importer. The United States import marginally more services than China.

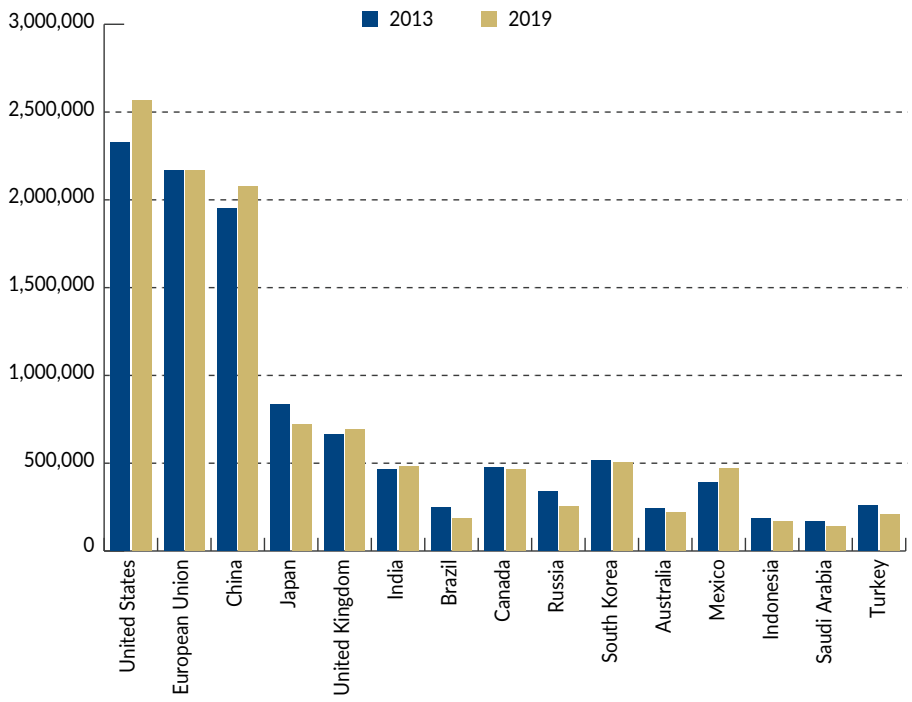
Another measure to compare trade performance is to put it in relation to GDP. This is done through the openness ratio, *O*, which is defined as

$$O=\frac{X+M}{Y}$$

where *X* and *M* represent exports and imports respectively and *Y* is GDP. The openness ratios are presented in Figure 1.7. The results appear surprising. Here the EU, the United States and China appear to be much smaller than in the other figures presented above. In fact, it is South Korea that is exhibiting the largest openness ratio (of the countries in the sample). However, if a larger set of countries were considered, we would find that often

relatively small economies have particularly large openness ratios. This makes sense because producers from these countries need to trade in order to have access to larger markets, whereas in big economies producers have a large home market at their disposal. What is more interesting about this figure, is that both for China and the United States, openness has decreased. This implies that both countries are relying increasingly on their internal market. For the EU, openness has slightly increased.

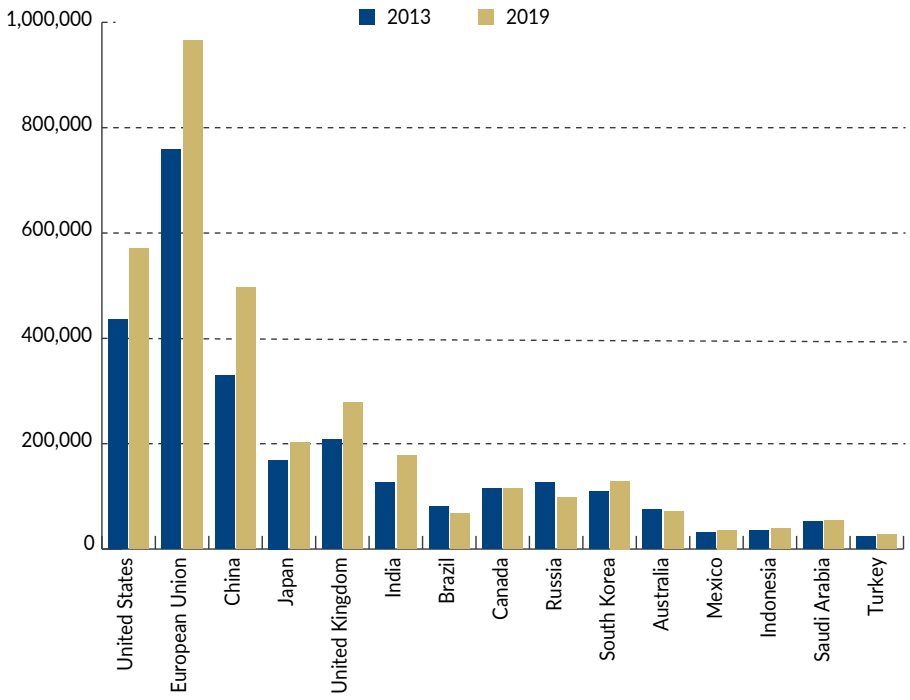
FIGURE 1.5 MERCHANDISE IMPORTS OF THE 15 LARGEST ECONOMIES IN THE WORLD (IN MILLION USD)



Source: WTO

The EU is a substantial player in international trade. It is amongst the strongest exporters and importers, even if only extra-EU trade is considered. Over time, exports from and imports to the EU have grown, thus making the European economy more open. This is a good thing because it shows that EU firms are competitive abroad and consumers can choose from a variety of products, including from foreign countries. This helps to make the EU's internal market competitive and creates lower prices, which translate into economic gains for consumers. However, it also exposes the EU. Exports can be hurt by third countries imposing trade restrictions. There is a similar danger associated with high levels of imports: if imports are no longer shipped – as we have experienced for certain product groups at the height of the COVID-19 crisis – it might be difficult to find substitute products made in the EU.

FIGURE 1.6 SERVICES IMPORTS OF THE 15 LARGEST ECONOMIES IN THE WORLD (IN MILLION USD)



Source: WTO

With Whom Does the EU Trade - and What?

It is also important to understand with whom the EU predominantly trades and in which goods and services it specialises, as regards its exports and imports. This is summarised by Figure 1.8 which provides an overview of the EU as exporter and importer.

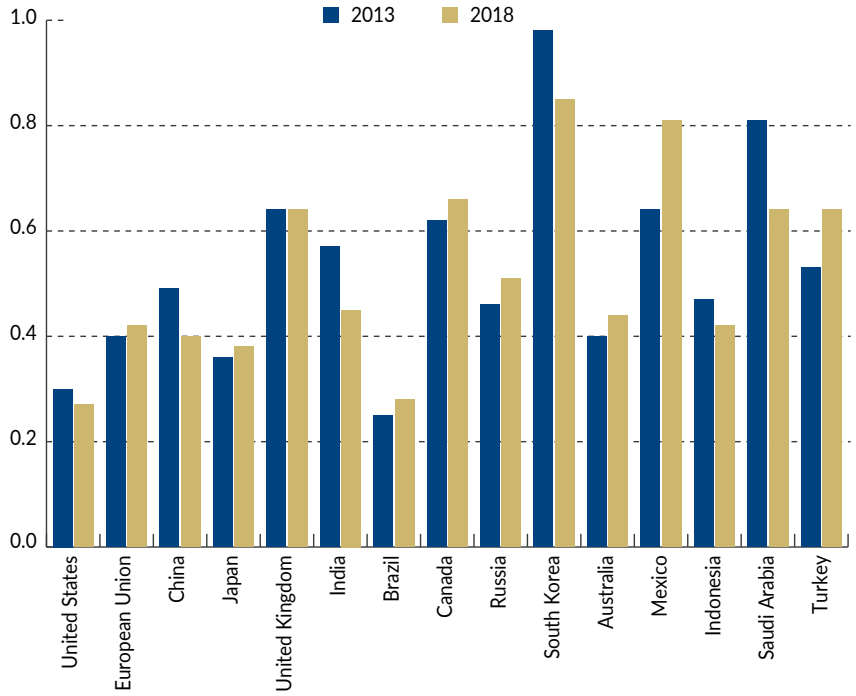
The main export destinations for goods from the EU are the United States, China, Switzerland, Russia, Turkey, Japan, Norway, South Korea, India, Canada and Brazil. To these countries, the EU is predominantly exporting goods belonging to the categories of 'Machinery and vehicles', 'Chemicals' and 'Other manufactured goods'. On the import side, China is the main source of EU imports, followed by the United States, Russia, Switzerland, Norway, Turkey, Japan, South Korea, India, Canada and Brazil.[14] The types of imports are more varied than exports. Imports from Russia and Norway are largely energy. The imports from Brazil and Canada feature a significant share of raw materials, plus 'Food and drink' in Brazil's case. For the remaining trading partners, 'Machinery

14 The EU has a network of bilateral free trade agreements, including with some of the countries mentioned here. This will be further discussed in the next subsection.

and vehicles' and 'Other manufactured goods' are dominant, with Switzerland exporting a particularly large share of chemicals into the EU.

A final comparison is how the EU comes out internationally in terms of tariffs. While consecutive negotiating rounds in the General Agreement on Tariffs and Trade (GATT) and WTO have lowered tariffs worldwide considerably, some still remain in place. As shown in Figure 1.9, applied Most Favoured Nation (MFN) tariffs[15] are highest in India and lowest in Australia. The United States have tariff levels that are only slightly above those of Australia. European Union tariffs are a little higher than those of the United States but still relatively low in international comparison. China's tariffs are roughly double of those of the EU but those of Turkey, Korea and Brazil are even higher.

FIGURE 1.7 OPENNESS RATIOS OF THE 15 LARGEST ECONOMIES IN THE WORLD (IN PERCENT)



Source: Own calculations, based on WTO and World Bank data.

The EU's tariff policy is mostly in line with that of other developed economies. Tariffs tend to be higher in emerging economies. Generally speaking, comparing over the period of 2013-2018, tariffs have not changed substantially. If anything, they have tended to go down slightly.

15 Most favoured nation tariffs, i.e. tariffs applied on imports from all WTO members who do not have a preferential trade agreement.

FIGURE 1.8 EU TRADE RELATIONSHIPS

Source: Eurostat.

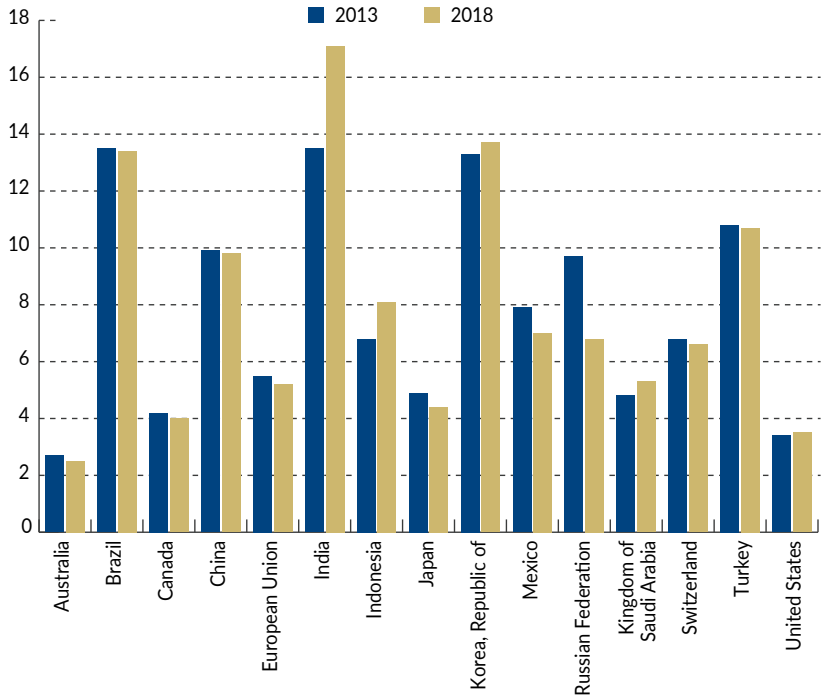
1.2.2 Trade for All: The Current EU Trade Strategy

The EU already has a trade strategy, entitled 'Trade for all – Towards a more responsible trade and investment policy'.[16] It was presented in 2015 under Trade Commissioner Cecilia Malmström. It introduced a series of policy innovations, in particular with regards to the negotiation of bilateral trade agreements, which had come under critical scrutiny from a large proportion of the public in the wake of the discussion around The Transatlantic Trade and Investment Partnership (TTIP). However, the trade strategy preceded Brexit, Trump, the US-China trade war, the demise of the WTO's Appellate

16 European Commission (2015).

Body and the COVID-19 crisis – all momentous events in trade policy. It did however respond to the big challenges foreseeable at the time. It addressed the specific needs of trading in Global Value Chains (GVCs), a higher level of public scrutiny of EU trade policy and the increasing difficulties in advancing trade policymaking through the WTO.

FIGURE 1.9 APPLIED MFN TARIFFS IN 2018 (IN PERCENT, SIMPLE AVERAGE)



Source: WTO

Responding to new trade economics

The trade strategy recognises that the nature of trade has changed and identifies GVCs and trade in services as new and mutually complementary priority areas. The notion of GVCs refers to the fact that production is increasingly split up into small steps taken in different places around the world. This allows for particularly efficient production that makes use of local specialisation and comparative advantages. GVC trade can be supported by a variety of measures, from a specifically designed tariff policy via increased regulatory cooperation to promoting trade in services and achieving a level playing field globally.

The implications for tariff policy are based on the insight that due to GVC trade, trade in intermediaries is increasing. This implies that tariffs on imports designed to protect domestic producers may in fact harm them. This can be the case if imports of intermediary goods are rendered more expensive through the tariff. The domestic producer will have to

pass on that extra cost when selling the good after adding his own value. One consequence may be that domestic producers benefit when import tariffs are lowered. *Trade for all* also contains a commitment to improvements in trade facilitation, i.e. making customs procedures more efficient and less bureaucratic in order to further contribute to lower trading costs and higher competitiveness.

Regulatory cooperation matters too. The different regulations with which producers need to comply with across different markets in order to sell their goods, are often pursuing the same objectives. While regulations in practice may be different, very often they do not lead to significantly different outcomes. Regulatory cooperation aims at lowering the costs of producers in adjusting to a multitude of domestic regulations by accepting regulations from trading partners as equivalent or achieving regulatory harmonisation.

Promoting trade in services makes sense for the EU, as the principal exporter of services. This is, however, a complicated policy agenda, as promoting services trade is very much designed to ease restrictions on exercising services professions outside one's own jurisdiction – travel restrictions, recognition of professional qualifications, etc. EU trade strategy also refers to the development that companies traditionally engaged in manufacturing activities increasingly offer services complimentary to the goods they sell.

Supporting digital trade is another element placed on the agenda by *Trade for all*. Digital trade lacks a unique definition but can be understood as trade in goods and services through digital means, such as a product ordered from a foreign online selling platform. Different countries have different regimes regarding consumer protection, liability, warranties, data protection, etc. Restrictions on cross-border digital trade are increasing and still lack an overarching governance framework.[17] Other digital trade restrictions can take the form of data localisation requirements, obligations to reveal source codes, etc.

The trade strategy also shows its concern over distortions of competition on the world market. It calls for a 'level playing field' for all trade participants. Many see this as an indirect criticism of China, which has been frequently accused of distorting competition through industrial subsidies, non-respect of intellectual property, privileging state-owned enterprises (SOEs), etc. However, China is not the only country engaging in such competition-distorting activities, as the Global Trade Alert shows.[18] In fact, 'subsidies' has been the fastest rising category of trade obstacle since the financial crisis of 2008/2009.

In addition, *Trade for all* contains promises on securing access to energy and raw materials as they constitute critical inputs for the EU economy, on boosting mobility and migration and protecting innovation.

Looking back, one can find many elements of the *Trade for all* strategy in the trade policy outcomes. The EU has concluded a series of FTAs with strategic partners within which

17 e.g. Ferracane et al. (2018).
18 Draper et al. (2020).

it has reduced almost the entirety of its tariffs to zero – which makes sense in a GVC perspective. Many of these FTAs have also contained chapters on regulatory cooperation and on digital trade. The 2017 WTO Ministerial Conference in Buenos Aires also started a plurilateral initiative on e-commerce of which the EU is part and which is coherent with the aim of strengthening digital trade. On the other hand, apart from FTAs, not much has been achieved in the areas of trade in services or dealing with competitive imbalances in the global trading system. The main reason is, however, not a low level of ambition among EU trade policymakers but more the deadlock of the WTO and the difficulty in advantaging forward looking policy issues on a multilateral basis.

Responding to Public Demands

The public reaction to the negotiations of TTIP and the Comprehensive Economic and Trade Agreement (CETA) changed the EU's approach to trade policy. When the EU started trade negotiations with Canada for the CETA agreement (launched in 2009) and the United States for the TTIP agreement (2013), it did so in the same way it had conducted trade negotiations before. This meant that much of the negotiating was done in secrecy, including drawing up the negotiating mandate. This was meant to help achieve a better and more balanced deal as it would prevent excessive lobbying efforts. Before CETA and TTIP, criticism of this practice had not been widespread.

This changed for two reasons. First, these trade agreements were with much larger trading partners than before, in particular TTIP would have been the largest FTA ever concluded by the EU by a large margin. Second, these agreements were meant to go much further in dealing with non-tariff barriers to trade (NTBs) and in regulatory cooperation than earlier agreements before.[19] It is understandable that public interest in these agreements was high and that the lack of transparency raised questions.

In 2015, criticism of TTIP and CETA, particularly in the German-speaking countries of the EU, gained traction.[20] The fear that these trade agreements would lead to a weakening of EU regulation was widespread, in particular in the areas of agriculture and labour standards.[21] As a response to this criticism, the Commission introduced a series of innovations in the way trade negotiations were conducted. These focused in particular on improved transparency. Trade negotiating mandates were now published after each negotiating round, EU officials would hold a public briefing on the progress of the negotiations, the areas where agreement had been achieved, and those where negotiations were still ongoing. There was also increased consultation with representatives from civil society, NGOs, trade unions and other stakeholders. The Commission began to communicate more openly about trade negotiations and examined new formats that convey the benefits of trade agreements better.

19 Griller et al. (2017).
20 For an analysis of the spreading of the criticism see Bauer (2016).
21 Bluth (2016).

This is reflected in *Trade for all*, whose very title seems chosen precisely to dispel the notion that trade could be simply something for the few, the privileged. It promises that each initiative in a trade negotiation will be subject to impact assessment, in order to ensure that any agreement does lead to 'better Regulation'. A further promise is that transparency will continue to be enhanced and will cover all stages of the negotiation process and other trade policy areas.

These innovations are certainly an improvement. Transparency makes it easier to dispel false claims about the content of trade negotiations. Consultations ensure that NGOs have a chance to be heard and that their concerns can be taken into account. However, these innovations were incapable of saving the TTIP negotiations. Public opinion was so strongly against this project – at least in Germany and Austria – that it would be have been extremely difficult to approve such a trade deal in the European Parliament and national legislatures.[22] Once TTIP was officially suspended, public opposition to CETA and other subsequent FTAs subsided in most EU member states. The new measures came too late to save TTIP but they might still help EU trade policy in future negotiations.

Responding to WTO Stagnation

The last section of *Trade for all* amounts to a reflection on the means by which the different, previously described trade policy objectives ought to be reached. It proposes a two-pronged strategy that would both aim at strengthening the WTO and making progress through bilateral trade deals.

The WTO was already in crisis in 2015 – although this was not as pronounced as it is today. While the GATT/WTO system has for a long time been the focal point of trade policy, the attention of core members was already moving away in 2015. The main reason was frustration with moving ahead in trade negotiations at the WTO. It had proven impossible to find a consensus so as to conclude the Doha Round (or Doha Development Agenda, DDA), yet many WTO members were reluctant to start new negotiations in the WTO and move on from the DDA.[23]

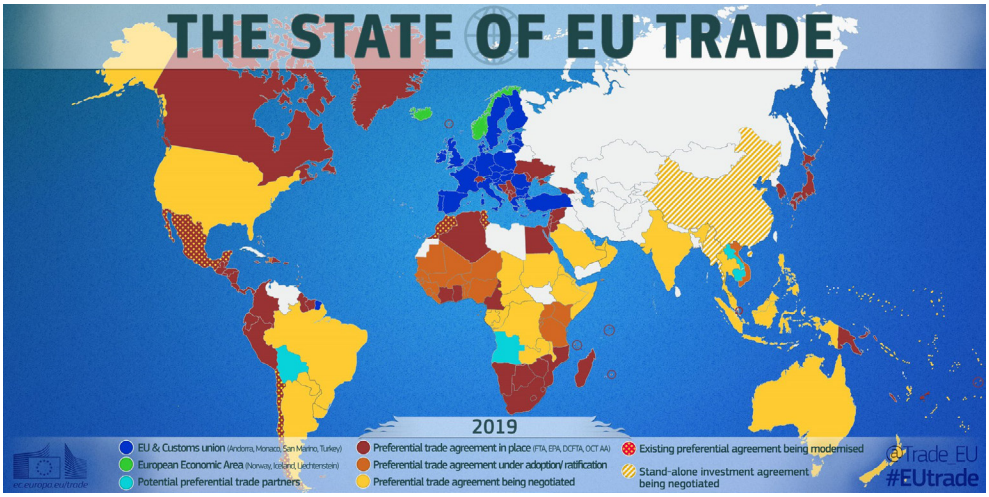
In *Trade for all*, the EU calls for moving beyond the DDA and using the upcoming Ministerial Conference in Nairobi (MC10, 2015) to start a new WTO agenda focused on intellectual property, customs facilitation, digital trade and good regulatory practices. The EU also proposes shifting from the concept of a 'Single Undertaking'[24] and allowing for plurilateral cooperation in the WTO, i.e. enabling a subset of the membership to go ahead with further cooperation, proving other members initially unwilling to do so may join later.

22 Bluth (2016); European Commission (2016).
23 On overview of the reasons for the failure of the DDA is provided by Kessie (2010).
24 'Single Undertaking' means that trade negotiations are done in negotiation rounds for which negotiation areas would be defined on the outset and which were only concluded once agreements had the found an all negotiation areas.

Trade for all recognises that this is not enough if the root cause is not addressed: 'There has been a major shift in the relative economic power of the major trading partners [...]. As a result, there is a growing imbalance between the contribution large emerging countries make to the multilateral trading system and the benefits they derive from it.'[25] The European Union is calling for emerging and developing nations to take more ownership of the WTO as a system and rebalance the relationship between the legitimate pursuit of national interest and responsibility for the system as a whole.

Some of these elements have been taken up within the WTO trade policymaking. Since the 2017 Ministerial Conference (MC12) in Buenos Aires, there are plurilateral initiatives under negotiation that still come under the roof of the WTO. One of these deals with issues of the digital economy. Customs facilitation has also been advanced through the conclusion of the 'Trade Facilitation Agreement' of 2017. No significant landmarks have, however, been achieved in the other two priority areas for the EU: the protection of intellectual property and regulatory cooperation.

FIGURE 1.10 OVERVIEW OF THE EU'S FTAS



Source: European Commission

Given the frustration with policymaking in the WTO, the EU is identifying the enhanced use of bilateral and regional trade agreements as a second strand of its trade policy. The EU's current FTAs in force and under negotiation are presented in Figure 1.10. The trade strategy presents them as a laboratory for new ideas for the WTO and calls for these agreements to be concluded 'in a manner that supports returning the WTO to the centre of global trade negotiating activity'.[26] The EU establishes as criteria for FTAs that they deliver on jobs and growth and that the priorities for opening negotiations will primarily

25 European Commission (2015), p.28.
26 European Commission (2015), p.29.

rest on economic criteria. This is noteworthy, as FTAs can also be used as geoeconomic tools and TTIP and CETA have been described as an 'economic alliance' among the Western trading nations.[27]

When it comes to priority trading partners for concluding FTAs, the United States and Canada figure first. Followed by a call for 'a strategic engagement in Asia and the Pacific region'. Here, the EU prioritises an FTA with Japan in addition to the current FTA with Korea, the concluded negotiations with Vietnam and the strategic outreach aimed at an ASEAN-EU-FTA. FTAs with Australia and New Zealand are also envisaged.

No FTA with China is foreseen until China undertakes significant domestic economic reform and complies with the conditions expressed in the EU-China 2020 strategic agenda. The EU is, however, seeking a bilateral investment treaty with China, aimed at improving the situation of European investors in China.

The text further calls for developing relations with Africa, Latin America and the Caribbean, improving the customs union with Turkey and extending the DCFTA tool within the EU neighbourhood policy to new partner countries. Looking back at what has been achieved since the publication of Trade for all, the EU has made some progress on the bilateral path. The most important trade negotiations concluded are:

- CETA with Canada in 2017 (provisionally applied)
- EU-Singapore FTA in 2019, which is part of an effort to negotiate bilateral FTAs with all ASEAN countries
- Economic Partnership Agreement (EUJEPA) with Japan in 2019
- EU-Vietnam FTA, ratified by the Vietnamese National Assembly in summer 2020

An agreement in principle has been reached with Mercosur and Mexico and negotiations with Australia and New Zealand have been launched.[28] The TTIP negotiations are formally suspended; whether they will eventually resume under the TTIP name is questionable given the polarised reactions to this FTA. With this track record, the EU has concluded FTAs with its largest trading partners, except for the United States, China and Russia. A task that was unforeseeable in 2015, is negotiating the future trade relationship with the United Kingdom post-Brexit. Negotiations for a FTA are currently underway with the goal of putting an agreement in place by the end of 2020, when the transition period ends.

The Objectives of *Trade for all*

At the beginning of this chapter, I discussed some of the objectives that might be considered in terms of a trade strategy: prosperity, resilience, competitiveness, sustainability,

27 Flockhart (2013).
28 An updated overview of the status of ongoing negotiations is available under European Commission (2020c).

normative influence, diplomacy. Efforts to respond to some of these objectives can also be found in *Trade for all*. The primary objective therein is for trade to contribute to prosperity.

This becomes evident from the objective to give priority to FTAs that are likely to bring the highest economic benefit, with the focus on optimising GVCs, etc. This is not a criticism, trade as a tool is first and foremost best suited to achieving prosperity above any other goals. The fact a trade strategy now has to satisfy additional objectives does not diminish the point that the prosperity objective is rightly at the centre of a trade strategy. Resilience is not referred to specifically in Trade for all. But it does argue that 'trade can be a stabilising force in tough economic times', which can again be read as a reference to the prosperity objective.[29] Competitiveness is frequently referenced in particular with reference to GVCs and optimising their potential, being attractive as an investment destination and harnessing the potential of digital trade. While there is a reference to a level playing field in global competition, the text does not create the impression that the competitiveness of European companies is under acute pressure. There are no calls for screening FDI, for 'national' or 'European champions', or the fear of falling behind in artificial intelligence which is very far from the state of play in discussions about European competitiveness today.

Sustainability does feature prominently in *Trade for all*. This is true particularly with regards to supporting sustainable development and the Sustainable Development Goals (SDGs). In particular, the FTAs that the EU is concluding should include strong provisions in terms of promoting sustainability. There is no specific mention, however, of decarbonisation, nor of measures akin to a Carbon Border Adjustment Tax, one of the projects of the von der Leyen Commission, which is discussed in greater detail below.

Issues such as normative influence and diplomacy are palpable but not explicit. In the section on promoting and defending human rights, there is a reference of trade as a tool of foreign policy. The DCFTAs as tools of the Neighbourhood Policy, arguably one of the sharpest geoeconomic tools of the European Union, are mentioned only under the heading of 'Stability and prosperity in the EU's neighbourhood'. It is striking that geoeconomic considerations are largely absent from Trade for all. China's Belt and Road Initiative (BRI) initiative is mentioned but only in the context of possible European participation.[30]

Again, this is less a criticism of *Trade for all* rather than a sign of how rapidly and momentously the trade policy world has changed in just five years. In particular the von der Leyen Commission has discussed a series of changes in the priorities of European trade and industrial policy which will be examined in more detail in the next section.

29 European Commission (2015), p.8.
30 European Commission (2015), p.31.

1.3 THE 'GEOPOLITICAL' COMMISSION

During the final years of the Juncker Commission, some discussions about whether Europe is well prepared in terms of economic strategy to match global competition had already started. Significant turning points were the takeover of the German robots manufacturer Kuka by the Chinese investor Midea and the blocking of the Siemens-Alstom merger by the European Commission. Even before that, there had been a persistent debate about Europe's lack of large digital companies to match American or Chinese companies, such as Google, Facebook, Apple, Alibaba, etc.

In May 2016, Midea launched an offer for Kuka. The bid was eventually successful but triggered a debate in Germany whether Chinese companies in particular are buying up German technology leaders strategically and whether the government should have additional means to ban such takeovers. As a consequence of that debate, Germany strengthened its legislation on approving mergers and acquisitions (M&A) activities, in particular for companies providing public interest services, such as hospitals, electricity grids, harbours, etc.[31]

In early 2019, the European Commission blocked the merger of Siemens' and Alstom's rail branches. The German and French firms are Europe's largest suppliers in this market and the merger had the blessing of both German and French governments. However, the Commission blocked it on grounds that it would have led to a dominant market position in Europe and harmed competition for signalling systems and high-speed trains.[32] This decision was met with fierce criticism, in particular from Germany and France, which argued that Europe needed a 'European Champion' in order to remain competitive in global markets. Shortly thereafter, a *Franco-German Manifesto for a European industrial policy fit for the 21st Century* was issued.[33] This proposal rested on three pillars: a joint pooling of resources in order to enable large scale investment in innovation, a stronger European foreign investment screening framework and an overhaul of EU competition policy.

The debate surrounding Europe's lack of large digital companies cannot be as easily tied to a specific event. The feeling that Europe is lagging behind in digital business models, be it digital networks and platforms, the provision of software solutions, etc. gave rise to a multitude of European policy projects, from the Digital Single Market (DSM) to the General Data Protection Regulation (GDPR), the European Digital Strategy, et al. which were important elements of the Juncker Commission's strategy.

In addition to these intra-European debates, the US Presidency of Donald Trump also forced the EU to rethink some of their policy priorities. Three dimensions of his policies had particularly strong repercussions for European trade policy. First, there was

31 Hooijmaaijers (2019); Jungbluth (2018).
32 European Commission (2019a).
33 Bundesministerium für Wirtschaft und Energie & de l'économie (2019).

the continued dismantling of the WTO – through an unwarranted use of the 'national security' escape clause in order to levy tariffs on a large number of countries, including the EU, and through undermining the dispute settlement system by blocking the nomination of new members to the Appellate Body. Second, the reinstatement of sanctions against Iran which affected the EU because any EU companies doing business with Iran were threatened with sanctions against them in the United States. And third, and perhaps most important, the US-China trade war that also forced the EU to rethink its approach to China and the latter's economic policy.

This mix of developments both within and outside the European Union led to several new policy priorities that were proposed by Commission President Ursula von der Leyen or by some of her Vice-Presidents and Commissioners. The most important of these initiatives that touch upon trade policy are presented in the following subsections.

1.3.1 Geopolitics and Trade

In her first press conference after her election as Commission President, Ursula von der Leyen said that she would lead a 'geopolitical Commission'.[34] This meant a new focus on external action, including a new 'external coordination' body to be created to bridge the work of different Commissioners. A series of publications, from von der Leyen's quasi-manifesto as Commission President and her mission letters to the different commissioners, outlines more precisely what the priorities of the 'geopolitical Commission' are and how the external policy dimension intertwines with the missions set for different policy areas.

In her quasi-manifesto, outlining the guidelines for her Commission, one of the priorities was entitled 'A stronger Europe in the World'.[35] The corresponding chapter starts with trade policy and also features a more active EU external policy in general and the creation of a European Defence Union. In the trade policy section, she reconfirms the commitment of the EU to open and fair trade and promises efforts to strengthen a 'balanced and mutually beneficial trading partnership with the United States' – which could be seen as a nod to the ongoing talks on the removal of punitive tariffs on EU steel, aluminium, and cars or indicate a more ambitious project.[36] She also affirms her willingness to make progress in the bilateral partnerships with Australia and New Zealand and be open for new opportunities. A commitment to the 'highest standards of climate, environmental and labour protection and a zero-tolerance policy on child labour' also features prominently.[37] This fits closely with the ambitious Green Deal that figures for the first time in the opening section of the same document in which she also announces the intention to introduce a Carbon Border Adjustment Tax (more detailed discussion below). There is also a promise 'to lead the efforts on updating and reforming the World Trade Organization'. Perhaps more surprising is the new idea of creating a Chief Trade Enforcement Officer tasked with

34 Bayer (2019.
35 von der Leyen (2019a).
36 von der Leyen (2019a), p.17.
37 von der Leyen (2019a), p.17.

ensuring compliance with and enforcement of EU trade agreements. This is novel and a sign that the EU will hold FTA partners to account about their contractual commitments. In the other sections, related to external action and defence, she talks of the need to develop a comprehensive strategy for Africa, a European perspective for the Western Balkans and an ambitious and strategic partnership with the United Kingdom. Critically, however, she promises to strengthen Europe as a global actor and give it a more united voice. This should include qualified majority voting as 'the rule' in the area of external action. Notably absent is any reflection on the relationship that such an EU would have with the United States.[38]

The mission letter from Ursula von der Leyen to the (then) new Trade Commissioner, Phil Hogan, fleshes out some of these policy priorities in greater detail.[39] In particular, the letter refers to four areas of action:

- **A level playing field for all:** In this section, there is a commitment to the rules based global trading system. The reform of the World Trade Organization ranks high on the agenda. The issues that such a reform should tackle are subsidies, forced transfer of technology and dispute settlement, as well as making progress in the negotiations on e-commerce. Europe should also make better use of defensive trade instruments against unfair trade practices. This also includes the implementation of a screening framework for FDI. The plan to appoint a Chief Trade Enforcement Officer also reappears.

- **Strengthening Europe's global leadership:** Europe is to become a leader in global trade. In particular, this section covers the bilateral agenda. First, it mentions again the need for a 'balanced and mutually beneficial trading partnership with the United States'.[40] Second, Hogan and his successor, Valdis Dombrovskis, is handed the task of completing the negotiations with China on an Investment Treaty by the end of 2020. This was a relatively short deadline, especially given the concern of many that negotiations with China are advancing too slowly in this regard. Again, there is a reference to a partnership with Africa and the long-term ambition to form a 'continent-to-continent free trade area' between the CFTA and the EU. Other ongoing bilateral negotiations should be brought to conclusion and new negotiations started where appropriate.

- **Trade for sustainable development and climate action:** Trade should support sustainable development. Hogan is expected to work closely with the Chief Trade Enforcement Officer to ensure that the provisions regarding climate, environmental and labour regulations are enshrined in FTAs and in fact respected. In addition, von

38 von der Leyen (2019a), p.18.
39 von der Leyen (2019b).
40 von der Leyen (2019b), p.5.

der Leyen calls again for the introduction of a Carbon Border Adjustment Tax, which should be WTO compliant.

- **Making trade more transparent:** In this section, it is made clear that the other European institutions and civil society should be closely associated with the policymaking process in trade and that transparency is key to 'debunk myths and that our trade policy responds to citizens' concerns'. This is largely in line with the transparency that was also called for in *Trade for all*.

It is also interesting to look at the mission letter von der Leyen wrote to Josep Borrell, the High Representative for Foreign Policy and Security Policy. Von der Leyen writes that 'We must use our diplomatic and economic strength to support global stability and prosperity, as well as making ourselves competitive and better able to export our values and standards'.[41] This link between economic strength and the use thereof in global normative competition has not been made this clearly before. To reach this goal, von der Leyen wants the EU to become 'more strategic, more assertive and more united' – which entails qualified majority voting (QMV) in the area of common foreign and security policy. In addition, Borrell will chair a coordination committee for all those commissioners whose area of work has implications for the EU's external policy. Finally, it calls for the EU's external financial investment instruments 'to be used more strategically, to contribute to the wider political aims and enhance Europe's leadership and influence in the world'.[42]

Von der Leyen outlines in these mission letters the vision of an EU that is a stronger foreign policy actor. The difficulties it had in the past of reconciling different views across member states are to be overcome by the use of QMV.[43] With that, the EU should be able to play a stronger role as a player in its own right in international relations.

1.3.2 Technological Sovereignty

As discussed above, an important element of the discussions on Europe's role in the international economy had to do with industrial policy. This topic is of course closely linked to trade policy, in multiple dimensions. One element is to improve competitiveness in sectors expected to be key in the future. It is also linked to trade policy, as other global economic players, notably but not only China, engage in industrial policy and subsidise the emergence of strategic sectors. Finally, it is linked to concerns about 'weaponised interdependence' (cf. Chapter 3.1 for a more detailed discussion) and aims at limiting dependence on other countries. Therefore, the European vision for industrial policy does not only have an element of developing competitiveness in growth sectors but also achieving 'sovereignty' in the sense that the EU retains vital technological capabilities that mean it is not reliant upon any other nation for such capabilities. In the von der

41 von der Leyen (2019d), p.4.
42 von der Leyen (2019d), p.5.
43 von der Leyen (2019d).

Leyen Commission, the area of industrial policy is in the portfolio of Thierry Breton, Commissioner for the Internal Market. The most important element in the mission letter from von der Leyen to Breton is that he is tasked with developing a 'comprehensive long-term strategy for Europe's industrial future' which should cover 'all aspects that affect industry and its competitiveness, from investment and public procurement to trade, skills, innovation and supporting small and medium-sized businesses'.[44] Two other elements of the mission letter are particularly relevant in relation to trade policy: First, there is the mission to enhance Europe's technological sovereignty which means – among other elements – 'jointly defining standards for 5G networks and new-generation technologies'.[45] This seems particularly relevant in light of the discussions about the Chinese communication technology provider Huawei and controversy about using its technology in the 5G network (this will be discussed in greater detail below). Second, Breton is handed the task of ensuring a level playing field 'throughout the single market and contribute to the work addressing the distortive effects of foreign subsidies, in particular in public procurement'.[46] The mission of ensuring a level playing field and addressing distortions caused by the industrial subsidies of foreign actors is shared with the Commissioner for Trade, Phil Hogan. While Hogan is tasked with addressing this issue in the WTO, Breton is tasked with developing a defensive strategy to mitigate the effects and ensure that Europe's industrial capacity does not suffer any long-term harm thereby.

Thierry Breton was also among those Commissioners who were most outspoken about the need to make the EU more independent in the production of critical goods. For example, in an interview with the German newspaper *Frankfurter Allgemeine Zeitung*, he calls for European producers in the pharmaceutical but also in the automotive sector to rethink their supply chains and ensure Europe's 'autonomy'.[47] These ideas can also be found in the EU's industrial strategy which was announced in March 2020 and which will be discussed in more detail in the section covering technological megatrends.[48]

1.3.3 Green Deal and Trade Policy Implications

The core project of the von der Leyen Commission – next to an enhanced geopolitical role for the EU – is the Green Deal. Executive Vice-President Frans Timmermans is tasked with implementing this ambitious project that aims at making Europe the first carbon-neutral continent by 2050. While it would go beyond the ambition of this text to go into the detail of the EU's Green Deal, it does have implications for trade policy which I will briefly introduce here but discuss in more detail below when reflecting on climate change as one of the megatrends that trade policy will have to reckon with.

44 von der Leyen (2019c), p.5.
45 von der Leyen (2019c), p.4.
46 von der Leyen (2019c), p.5.
47 Kafsack (2020).
48 European Commission (2020a).

To reach the carbon-neutrality goal and substantial carbon reductions beforehand, two tools are fundamental: carbon pricing and taxation. The EU already has an emissions trading scheme (ETS) in place, through which emission rights can be traded. However, the price of carbon in the ETS does not reflect the true social cost of carbon emissions.[49] Therefore, the cost of carbon emissions is likely to go up, either through the ETS or through outright taxation of carbon intensive industries. If such measures are implemented, this is likely to increase the cost of production in Europe.

Such an increase would entail two effects. First, there might be the temptation for European producers to shift their production to locations with lower carbon prices and ship the produced goods from there to Europe instead. This is known as carbon leakage. If it occurs, it would weaken Europe's industrial base while not effectively contributing to meeting the global carbon reduction objective. The second effect is that if European producers are faced with higher prices for carbon emissions and their international competitors are not, this might reduce their competitiveness on global markets.

The introduction of a Carbon Border Adjustment Tax (CBAT) is an attempt to reduce leakage and ensure a level playing field at least on the European market. The basic idea behind it would be that it would even out the difference in carbon emission costs between Europe and the rest of the world. If, for example, a car is imported into the EU from a country of origin without carbon pricing, the tax would be equal to the carbon emission price that a European producer would have had to pay for producing the car in Europe. This would include not only the carbon content of the car but also the carbon emissions linked to manufacturing the car. For destinations where there is a carbon pricing mechanism but the price is lower, the tax would equalise the difference between the two carbon prices and, if there is an identical price, the tax would be zero.

So far, there has been little empirical evidence that increases in carbon prices in the ETS do cause leakage but that might be due to such increases being so far much smaller than what is likely in future.[50] Von der Leyen first mentioned the CBAT in her quasi-manifesto and reiterated it in the mission letters to Hogan and Timmermans. She asks however that a CBAT should be introduced in such a way that it is WTO compliant.[51] If such a tax were implemented, it is likely that this would cause considerable dismay among the EU's trading partners. This is true particularly for the United States which has withdrawn from the Paris Climate Agreement under which signatories are obliged to introduce some form of carbon pricing.[52]

Beyond carbon pricing, the Green Deal relates to trade policy when it comes to regulations in trade agreements that aim at ensuring sustainability and environmental protection.

49 Tol (2009).
50 Franzen & Mader (2018).
51 WTO compliance of CBATs is a discussed issue among trade lawyers, for a detailed discussion of the argument, cf. Pauwelyn (2013).
52 United Nations (2015).

It is likely that such regulations will become more widespread and tougher in nature and that they will be enforced more rigorously.

1.4 COVID-19 AND TRADE POLICY

The previous sections have discussed the changes to EU trade policy that were introduced or planned in the early days of the von der Leyen Commission. But her Commission was still young when the global trading system was hit by the COVID-19 pandemic. The pandemic had severe consequences for global supply chains and hence triggered a series of additional suggestions and policy responses in the wake of the crisis. At the time of writing, many of the policy proposals are still under discussion. There is also very little data on how companies might reorganise their supply chains in the long-run because of their experiences in the crisis. Nevertheless, it seems that the repercussions could be substantial and hence this section discusses which changes have been proposed and what has materialised so far.

The outbreak of a disease linked to a new type of coronavirus was first discovered in the Chinese city of Wuhan in December 2019.[53] From there, it quickly spread worldwide. In the EU, Italy was the first country to register a substantial number of cases, in particular in two clusters in Lombardy and Veneto which emerged in February 2020. As the attempts to contain the spread of the virus to these clusters failed, the Italian government introduced a nationwide lockdown on March 10. In order to limit further contagion, citizens had to stay at home, non-essential business activity was suspended, flights grounded and borders closed. This decision was soon emulated by other European Union member states and other countries worldwide as COVID-19 began to spread rapidly within them as well. Some countries also imposed export bans for critical medical equipment, pharmaceuticals and in some cases agricultural products.[54]

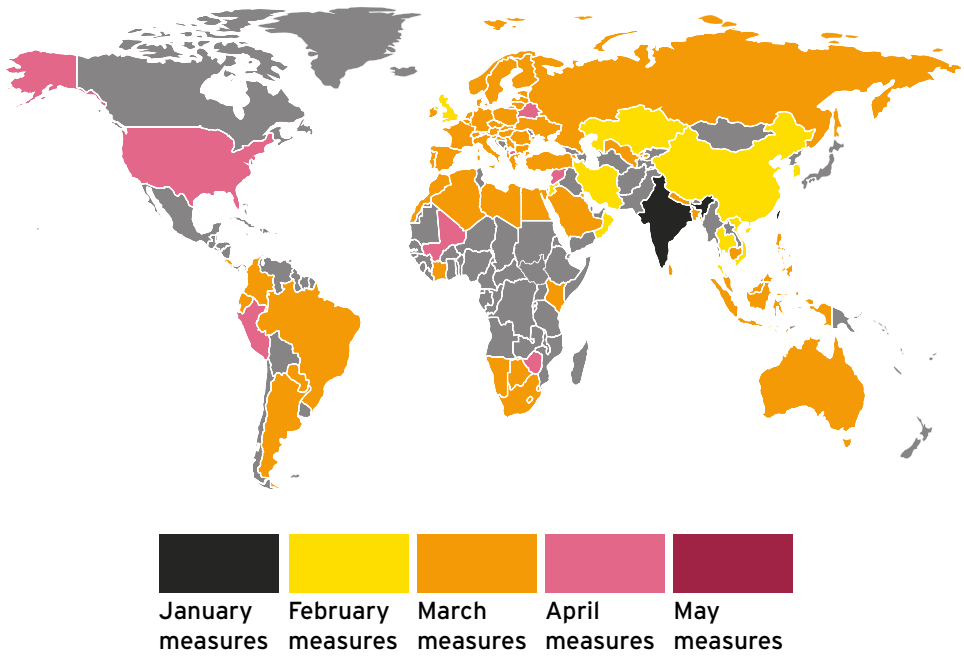
Since these measures were taken almost simultaneously by a large number of countries worldwide, there were severe disruptions to supply chains. Some of this disruption was caused by the fact that owing to the lockdown measures, businesses were no longer able to produce. The (temporary) reinstatement of border checks for goods within the Schengen area also contributed to some production difficulties.

A particularly strong policy response was, however, caused by the export bans on critical goods. The Global Trade Alert database (GTA) has kept track of the measures introduced in the wake of the COVID-19 crisis from early on.[55] The Figures 1.11 to 1.14 provide an overview of the measures taken and to what degree they remain in force.[56] The logic was that governments were worried they might be unable to procure enough medical equipment to protect their own health workers. In order to ensure no critical good for

53 World Health Organization (2020).
54 European University Institute et al. (2020).
55 Global Trade Alert (2020).
56 As of June 4, 2020.

which a shortage was foreseeable could be exported, export bans were put in place. This was of course a self-reinforcing mechanism: export bans in one country can cause a shortage of a critical good in another which then in turn might consider imposing an export ban even if it did not intend to do so in the first place. Since export bans often also covered intermediate medical goods, they upset supply chains. One example is that of a Swiss manufacturer of respirators that relied on parts from Romania which were (temporarily) subject to an export ban and threatening respirator output.

FIGURE 1.11 OVERVIEW OF EXPORT RESTRICTIONS ON MEDICAL EQUIPMENT BY TIME INTRODUCED



Note: Exports of medical supplies and medicines: 89 jurisdictions are reported executing a total of 156 export controls since the beginning of 2020. Updated on 29 May 2020.

Source: GTA

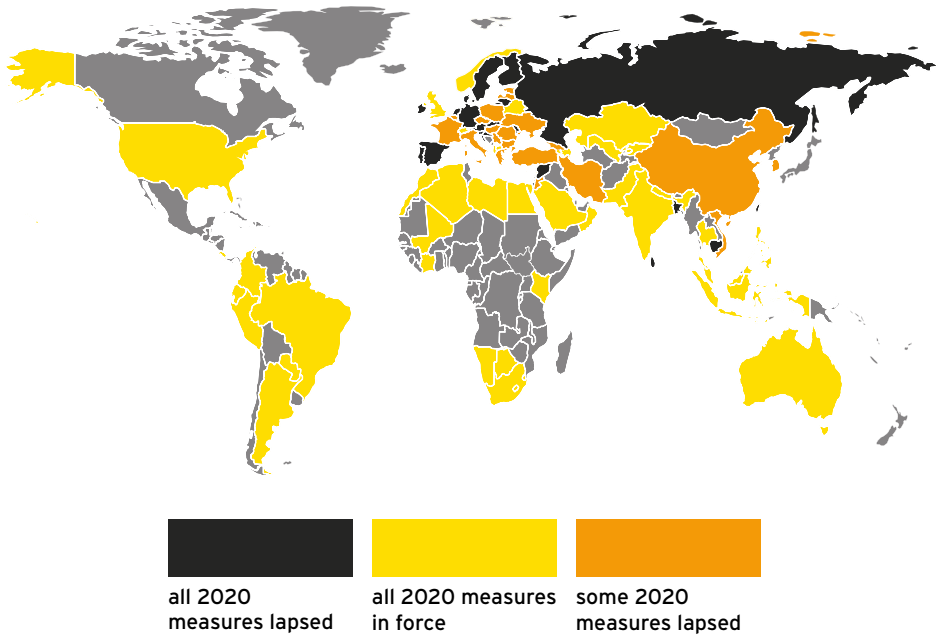
A similar logic applies in the case of food export restrictions. In some cases, there were even outright requisitions of medical goods, even if they were destined for different countries.[57] The mushrooming of restrictive measures on exports was substantial and caused a lot of headaches among global policymakers. If in times of need supply of critical goods can be disrupted that easily and substitutes are difficult to find, it is hard to argue for a continuation of an exposed production model. Therefore it is not surprising that calls for supply chain diversification or repatriation have been frequent.[58] The good news from the

57 a good description is provided in Hoekman, Fiorini & Yildirim (Hoekman et al.).
58 e.g. Laidi (2020).

data of the Global Trade Alert, however, is that over time, some of these export restrictions were retracted, partially or in full, as the epidemic got under control.[59]

These are not the only disruptions that COVID-19 is likely to cause in the trade world. Another issue, which is of a more short-term nature but could still give rise to political repercussions, is the possible mismatch of demand and production. The problem is that production was halted in many countries but not in all. Similarly, owing to lockdown measures, consumption was also in many cases considerably lower. This is likely to have caused production in excess of demand for certain kinds of goods. Not all of these goods will be consumed once the lockdown measures are relaxed. Therefore, there is a likelihood that some countries will attempt to sell these products below costs (i.e. dumping) in other markets – which in turn might retaliate with anti-dumping measures. Depending on the size of this problem, this might lead to a further deterioration in the global trading climate.

FIGURE 1.12 OVERVIEW OF EXPORT RESTRICTIONS ON MEDICAL EQUIPMENT BY CURRENT STATUS



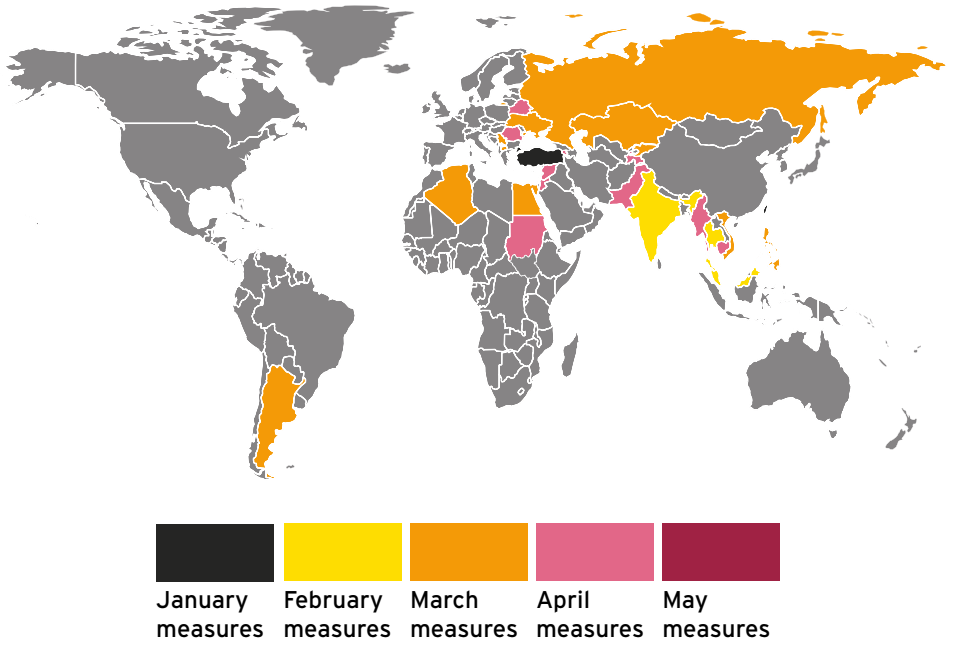
Note: Exports of medical supplies and medicines: 89 jurisdictions are reported executing a total of 156 export controls since the beginning of 2020. Updated on 29 May 2020.

Source: GTA

59 The flipside of export restrictions is a large number of measures reducing barriers to imports from countries that primarily import medical equipment. This is also documented by Global Trade Alert (2020).

COVID-19 not only disrupts the trading of goods but, also has severe repercussions for investment activities. On the one hand, the economic contraction and the uncertainty around the length of the pandemic and the future of global economic relations meant that much investment has been held back. At the same time, owing to the collapse of stock markets, the fear has grown that some investors might exploit the sharply lower equity prices by taking over companies on the cheap. To limit this prospect, the European Union urged member states to make full use of their investment screening schemes or set up appropriate frameworks during COVID-19 in order to 'protect Europe's strategic assets'.[60]

FIGURE 1.13 OVERVIEW OF EXPORT RESTRICTIONS ON FOOD BY TIME INTRODUCED



Note: Exports of agricultural and food products: 27 jurisdictions are reported executing a total of 40 export controls since the beginning of 2020.

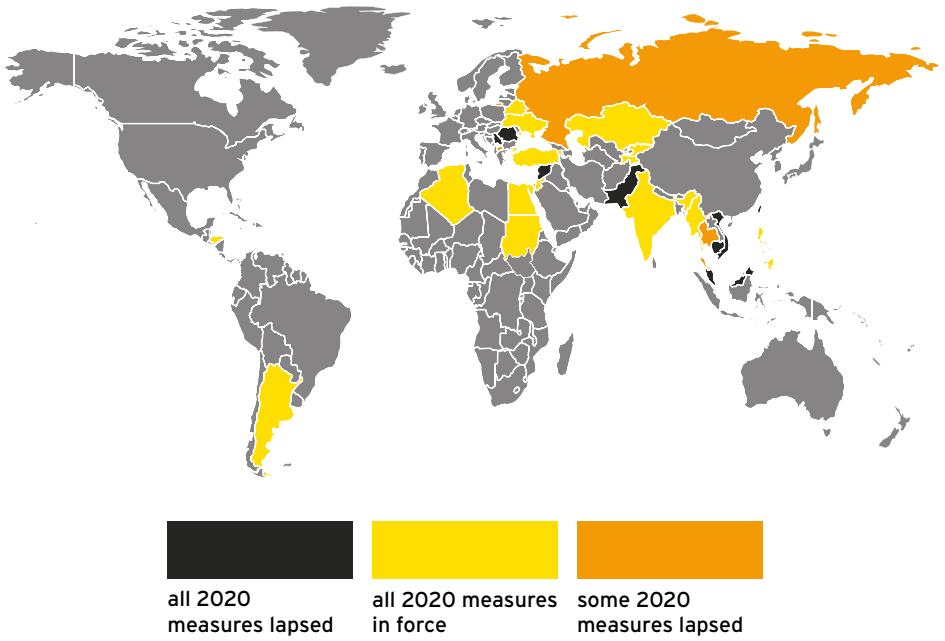
Source: GTA

A more long term repercussion of the COVID-19 pandemic is likely to arise from aid and recovery packages. Many governments have stepped in to bail out businesses that were particularly damaged by supply and demand shortages. To make this possible, the EU temporarily relaxed state-aid rules for its member states. Similarly, recovery packages are likely to contain stimulus or subsidy programmes. Both the bailout and the recovery packages could upset the global level playing field and lead to further distortions of competition. COVID-19 is not only the most severe pandemic that the world has seen in recent history. It is also producing an economic fallout expected to be far worse than that

60 European Commission (2020b).

of the Global Financial Crisis. The IMF expects a recession of 3% for the world economy as a whole – for developed economies, with 6.1%, it expects the recession to be much worse.[61] Similarly, for 2020, the WTO expects a contraction of global trade (in volumes) between 12.9% and 31.9%.[62] Both institutions expect a rebound in 2021 but this rests on the assumption that no further large scale lockdowns will be necessary.

FIGURE 1.14 OVERVIEW OF EXPORT RESTRICTIONS ON FOOD BY CURRENT STATUS



Note: Exports of agricultural and food products: 27 jurisdictions are reported executing a total of 40 export controls since the beginning of 2020

Source: GTA

An economic disruption on this scale is likely to have lasting effects on the global trading system. While it is impossible to identify which long-term trends will arise from this crisis, in the few months since the eruption of COVID-19, the discourse on globalisation has considerably changed. Some of the ideas that even pre-date the pandemic have received added backing – such as technological sovereignty (now extended to medical supply chains), level playing field concerns, etc. There is also some rethinking underway around GVCs which have been forecast to move away from 'just in time' to 'just in case', i.e. balancing efficiency concerns with the ability to buffer shocks to the production chain.[63] A geostrategic argument is being made, what's more, for example by Borrell (2020): '[...] we must accept a compromise between security needs and ensuring the

61 International Monetary Fund (2020).
62 World Trade Organization (2020).
63 Petersen & Bluth (2020).

lowest possible cost for consumers. In the wake of the crisis, we need to acknowledge that the interests of citizens must take precedence over the interest of consumers. [...] It is not a question of re-establishing sectors in Europe that have been relocated, but there are certainly strategic market segments that need, now more than ever, to be kept in Europe'.64 With such arguments in play, it is possible that COVID-19 will lead to a substantial change in the way the global economy operates – or equally possible that most of the disruptions are primarily temporary in nature and soon enough companies will return to their established way of doing business. Any prediction about the long-term impact of COVID-19 on globalisation must remain highly speculative at this point.

Whatever the impact of COVID-19, new megatrends will undoubtedly have an impact on the future of globalisation, on the way global business is conducted and how people and countries interact around the globe. The next chapter will discuss the impact that some non-political megatrends are likely to have on globalisation and how EU trade policy can prepare for these.

CHAPTER 2

Trade Policy and Non-Political Megatrends

Megatrends are trends that are global, sustained and have a strong bearing on the economic and political sphere. Megatrends can be either political – such as the rise of populism or the US-China big power competition – or they can be non-political in nature. The latter are trends in the environment, in technology or elsewhere that would be present even without any political intervention. The response to these megatrends is certainly political but the megatrend as such is not a product of politics.

Globalisation is of course a core development when it comes to reflecting on trade policy. But is globalisation a megatrend in its own right or is it merely a consequence of other megatrends? Is globalisation a political or non-political megatrend? Certainly globalisation fits the criterion of being a global, sustained trend that has significant impact on economics and politics. Fuelled by technology and supported by adequate policies, globalisation has been a force to reckon with for hundreds of years. As episodes like the interwar period (1918-1939) show, politics can bring globalisation to halt. If globalisation is unsupported by the removal of barriers to trade and the flow of capital, it can be brought to a halt. But political constraints don't seem to withstand the forces of globalisation for long: the opportunity costs of foregoing its benefits are too large to be ignored in the long run. Globalisation is indeed a megatrend in its own right, albeit closely interwoven with other political and non-political megatrends. At its core, globalisation is driven by non-political factors, first and foremost technological developments that make increased interactions between economies around the globe possible. But like any megatrend, it has strong bearing on the economic and political sphere; it takes on stronger political hues, especially since it has strong redistributive effects. That being said, I have decided that the best way I can give justice to globalisation here is by focusing on the effects of other political and non-political trends on changing the face of globalisation. As an introduction to the section covering non-political megatrends, I shall offer a very short brief on the state of globalisation. But this text is more interested in the ways globalisation is changing as a result of the other developments being discussed more closely, so I will focus more on the changes than on the state of globalisation.

Globalisation is an excellent example of how trade policy can make use of megatrends and harness their full potential. As powerful as new technological tools and the new ways of production that they enable are on their own, in order to develop their full potential, they need to be accompanied by appropriate policies. Politics can halt globalisation but it can also foster it and direct it in ways that harness their potential. Without successive liberalisation of trade, economic globalisation would have been impossible. When looking

at the non-political megatrends in this section, the underlying question is what they mean for trade policy and how this in turn can adapt for these trends to develop their full potential in reaching policy objectives.

So, what is the current state of globalisation? When one looks at typical metrics of globalisation, such as the global openness ratio, i.e. comparing global exports and imports to global GDP, our world is now more globalised than ever before. This is illustrated by Figure 2.1. What may not emerge from this graph is evidence that since the GFC, global trade has been growing at a slower pace than before. The GFC has clearly been a trend break for trade growth.[1] Before the beginning of the US-China trade war, it looked like growth rates in trade volumes were developing positively. Since then, the picture has been volatile and the COVID-19 pandemic has led to a sharp contraction in trade and the shape of the recovery remains far from clear.

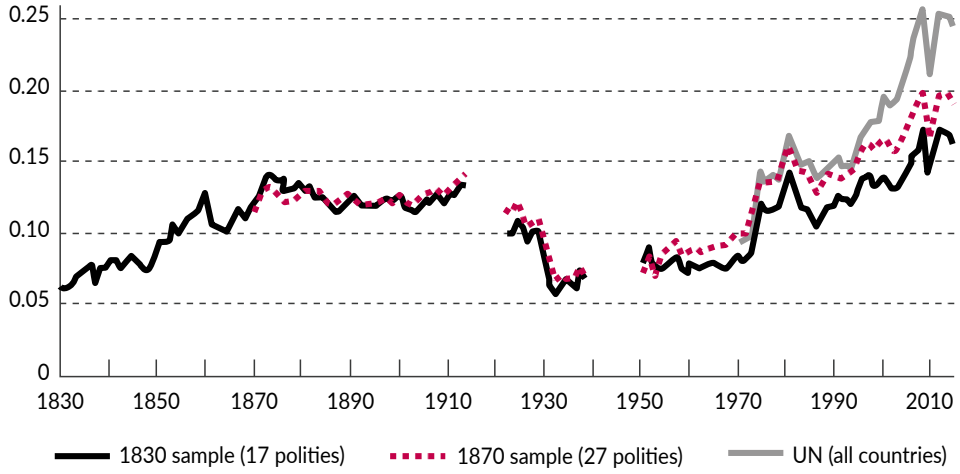
Of course, trade is not the only metric of globalisation. Financial flows around the globe are certainly an important element, along with migration. Financial globalisation – measured by global cross border capital flows – had risen strongly before the GFC but in the aftermath collapsed and has since remained at levels similar to those of the early 2000s. Global migration has risen strongly in recent years, a trend partly fuelled by internal conflicts in several countries.

From a historical perspective, the second wave of globalisation has only recently reached levels above the peak of the first wave, prior to WWI. Even so, globalisation is still lagging behind the pace it took on in the second half of the 20th century. With the various pressures globalisation is facing, it is difficult to say whether it will return to a strong growth path, enabled by technology and better connectivity or whether it will face a setback, due to big power competition, protectionist populism and other factors. The historical moment we are living through may turn out to be an inflection point for globalisation. It is precisely because of this that the trade strategy and actions of the big players can now make a fundamental difference.

The megatrends interacting with globalisation, which will be the focus of the remainder of this chapter, are the rising frequency of epidemics and global changes in demographic, technological and environmental (in particular climate change) developments. The latter three are well recognised as megatrends The rising frequency of epidemics has been noted as a megatrend in the wake of the COVID-19 pandemic. Whether this tendency will continue and whether this should be considered as a megatrend is still subject to debate.

1 e.g. UNCTAD (2019) p.5.

FIGURE 2.1 LONG-RUN EVOLUTION OF THE GLOBAL OPENNESS RATIO, 1830-2014



Source: Federico & Tena-Junguito (2016).

2.1 RISING EPIDEMIC FREQUENCY

During the COVID-19 epidemic, the policy actions of Asian countries like South Korea, Singapore and Taiwan received much praise as they turned out to be able to contain the spread of the virus much more rapidly and more effectively.[2] One explanation for the efficient management of the epidemic is that these countries had been strongly affected by the SARS outbreak from 2002-2004. SARS was not the only epidemic to emerge in the early 2000s: MERS, H1N1, H1N5, swine flu, bird flu, Ebola and other infectious diseases emerged during this same period.

2.1.1 Epidemics as a 'New' Megatrend

Epidemiological research suggests that the frequency of epidemics is increasing.[3] An excellent overview is provided by Jones et al. (2008) and is represented in Figure 2.2, which demonstrates how the frequency of epidemic events has increased. This is linked to population growth, increases in the density of human population, latitude (places nearer to the equator are more likely to experience epidemic events) as well as the growth in agricultural activity associated to wildlife habitat destruction.[4]

2 Hille & White (2020).
3 c.f. Jones et al. (2008), Morens et al. (2004), Smolinski et al. (2003), Binder et al. (1999) and Weiss & McMichael (2004).
4 Based on Jones et al. (2008).

Based on these criteria, it is also possible to make predictions about the likelihood of a new epidemic event emerging from a particular place. This is presented in the maps in Figure 2.3. Areas with heightened risk are South/East Asia, India, Central/Western Africa and Central/Western Europe. These predictions fit in with the emergence of COVID-19 but also Ebola in the course of the last decade.

As urbanisation (higher population density) and habitat destruction are drivers of these epidemic events, it is likely that their frequency will continue to increase in the future. The UN expects the proportion of the world's population living in urban areas to increase from 55% in 2018 to 68% in 2050. 90% of this increase is expected to take place in Asia and Africa.[5] Agricultural production needs to double by 2050 to be able to meet increasing demand for food, feed and biofuel. This expansion cannot be achieved through productivity increases alone; the area used for agricultural production will need to expand. The area available for expansion consists mostly of 'forests and other ecosystems with little disturbance'.[6]

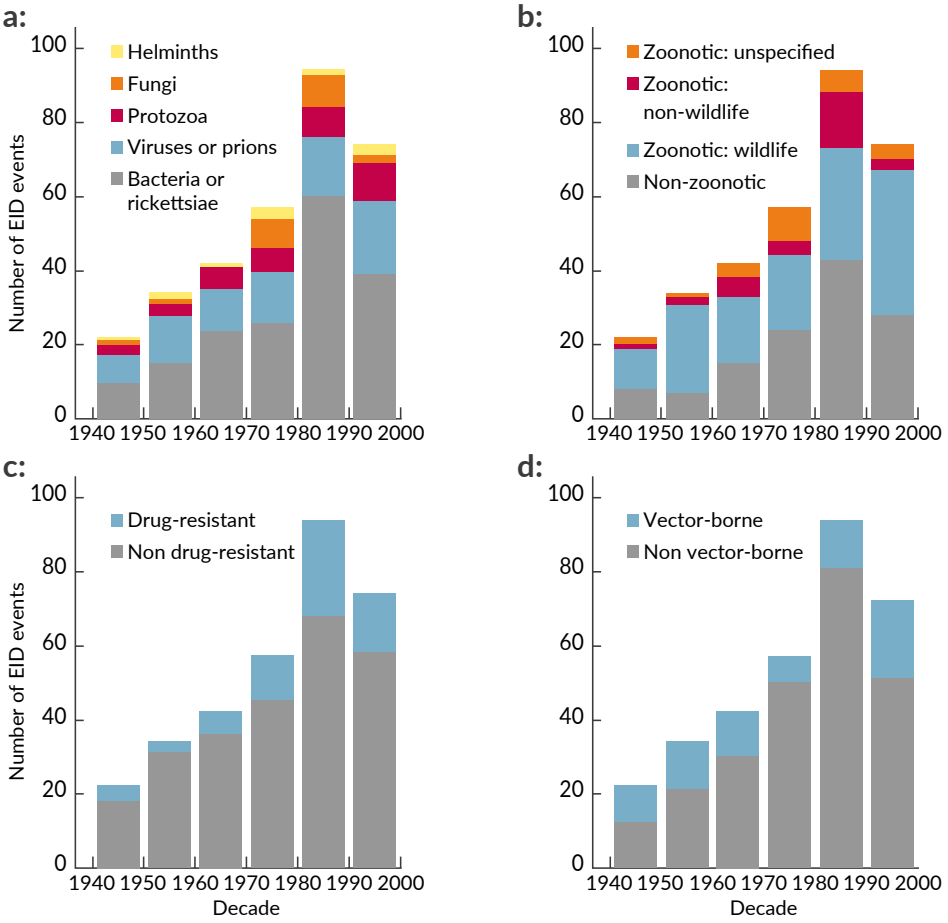
Taken together, these observations give little ground for optimism. COVID-19 is likely to be only the latest and so far most dramatic episode of a series of emerging epidemic events. It might therefore be justified to speak of epidemics as a new megatrend. However, there is scope for mitigating the impact of epidemics. As the examples of South Korea, Taiwan and Singapore show, with appropriate healthcare and monitoring systems in place, one can limit the spread of a disease early on and thus reduce the economic impact.[7] Given the immense economic costs of COVID-19 containment measures, countries will be investing in their capacity to contain the spread of epidemics.

2.1.2 Implications for Trade and the Economy

Nevertheless, if epidemics are a new megatrend, this is likely to have significant repercussions on the way trade is conducted, supply chains are designed and – perhaps most importantly – how availability of critical medical equipment and pharmaceuticals can be ensured. Policymakers will increasingly think about how to make an economy epidemic-proof, in the sense that they will encourage measures that allow the economy to operate as normally as possible despite an epidemic and be less exposed to importing epidemic-related shocks from abroad.

5 United Nations - Department of Economic and Social Affairs (2018).
6 United Nations Environment Programme (2019), p.209.
7 Jack (2020.

FIGURE 2.2 NUMBER OF EMERGING INFECTIOUS DISEASES (EID) PER DECADE



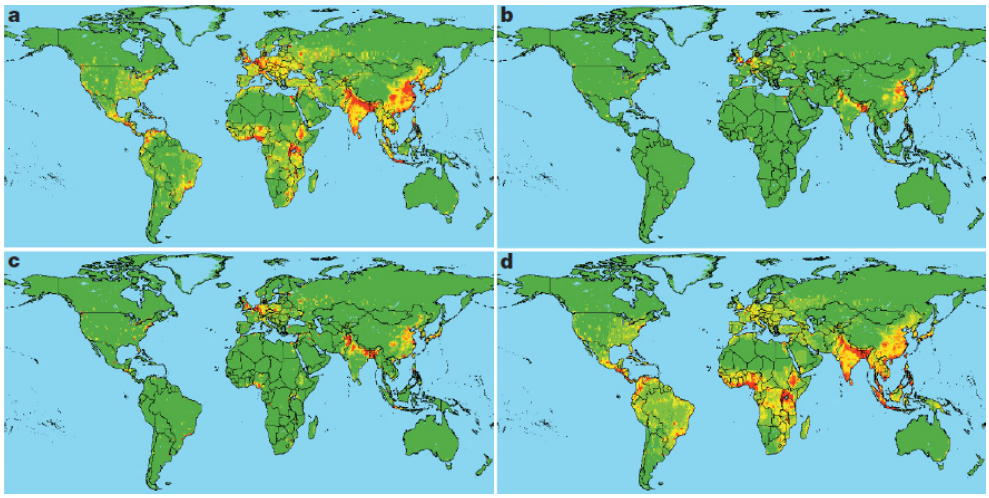
Note: EID (defined as the temporal origin of an EID, represented by the original case or cluster of cases that represents a disease emerging in the human population) are plotted with respect to a) pathogen type, b) transmission type, c) drug resistance and d) transmission mode.

Source: Jones et al. (2008).

Increasing the ability of an economy to remain resilient in the case of an epidemic shock can be facilitated only through various measures. As already discussed above, measures to limit the spread of an epidemic early on play an important role. Similarly, increasing the capacity of healthcare systems is critical. If healthcare systems are less likely to be overwhelmed by an epidemic, lockdown measures can be less severe which means less economic contraction. Further, a high degree of automation and digitalisation allows many economic activities to continue even in the case of a strong lockdown.

These measures do not help much with the trade-related aspects of a pandemic. Here, two problems are pressing: First, what role can trade play in ensuring the supply of critical medical goods and second, how can an economy build resilience into supply chains facing disruptions from epidemics elsewhere?

FIGURE 2.3 GLOBAL DISTRIBUTION OF RELATIVE RISK OF AN EID EVENT



Note: Maps are derived for EID events caused by a) zoonotic pathogens from wildlife, b) zoonotic pathogens from non-wildlife, c) drug-resistant pathogens and d) vector-borne pathogens.

Source: Jones et al. (2008).

The Role of Trade in Health Crisis Mitigation

Let me first turn to the role of trade in health crisis mitigation. COVID-19 is the only recent epidemic to spread worldwide and to hit almost all countries simultaneously. Previous epidemics, such as SARS, MERS or Ebola, had a much more regional impact. In case of an epidemic hitting asymmetrically, trade policy is actually a suitable tool to mitigate the impact. If the epidemic disrupts the production of critical goods in one place, these goods can typically be imported from elsewhere. This requires of course that no export restrictions are in place and that production capacity is available to compensate for shortfalls elsewhere and possible higher-than-usual demand due to the health crisis.

Since export restrictions aggravated the COVID-19 crisis and barely contributed to its mitigation, would it be possible to find a credible and reliable way of preventing similar measures being put in place in the event of a future pandemic or similar crisis? In fact, Article XI of the GATT already broadly prohibits export restrictions, although there are exemptions that allow a temporary introduction for essential products in times of crisis. An agreement to tighten these rules would strengthen the position of importing countries that otherwise find themselves at the mercy of exporting countries. But even if such an agreement could be reached, it would not be credible. The usual enforcement of rules at the WTO through the dispute resolution mechanism would be too lengthy and even if it ruled in favour of an importing nation, that would not mean that it would afterwards receive the sorely required imports. While such an agreement would send a positive signal and would give importer nations a stronger normative basis, nothing that would force exporter nations to eschew bans is conceivable.

The repatriation of the production of critical goods reduces vulnerability to export bans. But if a specific region/country is hit by an epidemic that disrupts production, then no improvements are gained from previous repatriations to that specific country or region. The region/country would still be dependent on importing the critical goods. There is also a question as to how such output could be maintained in normal times. The fact that production of specific goods is not taking place in a specific place is likely to be due to the fact that they can be produced more efficiently elsewhere and production would not be economically viable. In order to make the production of these goods viable, they would have to be made competitive artificially. This could happen through a protective tariff or through a production subsidy. Both create market distortions and are costly to consumers and are therefore not desirable policies.

An alternative to repatriation of supply chains would be increased stockpiling of critical products. The problem here is that is it not known which kinds of goods become critical in fighting a specific epidemic. While personal protective equipment is almost certain to be constantly required, the next epidemic might not come with any need of respirators such as COVID-19 but might require different types of technical equipment. Therefore, stockpiling works for a limited range of products that can be expected to be needed in the case of a health crisis, but it is unlikely to be a sufficient measure to solve the problem of supply shortages.

A problem similar to export bans on medical goods emerged in 2007-2009 when prices for agricultural commodities rose sharply. This caused several countries to impose export bans on agricultural products which could endanger food security. As a response, the Agricultural Market Information System (AMIS) was set up. This institution serves as a platform to monitor price developments in the agricultural sector and to coordinate a policy response if food security is endangered.[8] A similar approach could be used for the production of critical medical and pharmaceutical goods. Such a system would add value by generating transparency over production capacity. It would monitor where producers are, what kind of goods they can make available and how output could be increased if additional demand arose. Such a system reduces uncertainty and hence might help prevent governments rushing to impose export restrictions in a panic. It also helps policymakers to take appropriate action to increase production capacity.

Minimising Adverse Effects of Health Emergencies in GVC Partners

These measures can help to reduce the incentives to introduce export restrictions that in real terms make it more difficult to deal with a widespread health challenge. A different problem is to ensure that disruptions in the supply chains for non-critical

8 Agricultural Market Information System (2011).

goods are mitigated. Here, the priority is not to deal with a health emergency but to minimise economic disruption. The latter can come from two sources, either upstream or downstream.

Upstream would mean that production is disrupted somewhere in the supply chain before it arrives at a given country. Downstream means production activities – and eventually consumption – disrupted after the production step undertaken in a given country. Upstream disruptions are harder to deal with. If no or fewer intermediate goods arrive, it is hard to maintain the desired level of production. Downstream disruptions arise if production steps following the one performed in a given country are impossible, or finished goods cannot be purchased by consumers. Again, repatriation of supply chains is unlikely to fix the problem as it would make production in its entirety susceptible to country risk. It only works if the country to which the entire supply chain has relocated remains unaffected by epidemics or other negative events.

Maybe a lesson can be drawn from engineering: in airplanes, critical systems are built in two or three times, so if the primary system fails, the airplane can rely on the remaining ones and retain functionality. Translated into trade policy, this example would indicate that supply chain diversification is a better strategy. If every production step happens not only in one but ideally two or more places, an epidemic that prevents production in one place cannot shut down production completely. For example, in car production, parts could as a rule be sourced from two (or more) different suppliers, assembly could take place in more than one location, etc. This would of course be a complicated and costly strategy. In downstream disruptions, the same principle could apply. Whether such a strategy is economically viable, given the complexity and costs is another question.

In addition, stockpiling of final and intermediary goods could resurface as some kind of buffer. Just-in-time production has largely reduced the use of warehouses in which goods needed for production are housed. As a result, if supply of production parts fails to take place as scheduled, production comes to a halt. When more production parts are inventoried, this creates a buffer which allows production to continue if supply of goods is momentarily disrupted. Again, this comes at a cost but creates a more reliable production system.

A further idea could be to encourage more flexible production, i.e. production that can be swiftly shifted from one good to another. In particular, versatile production technologies such as 3D-printing could serve as buffer technology if a specific good in the value chain is missing. This might, however, not be generally possible and contemporary 3D-printing is often less efficient than other production technologies.

Epidemics as a new megatrend pose considerable challenges to producers and to global collaboration. Producers will be forced to monitor risks and think of suitable risk management strategy. In order to deal with critical supply chains, international

monitoring efforts of production capacity could be a promising way forward, especially if combined with more public stockpiling and tighter disciplines on the imposing of export bans.

The EU as a trade policy actor has a critical role to play. As it is a strong manufacturer of medical and pharmaceutical supplies, many countries' healthcare systems depend on EU exports.[9] While EU officials are now wondering whether they need to repatriate critical production capabilities, for example for personal protective equipment (PPE) or specific medicines such as paracetamol, it would not be in the EU's interest to spark a global race to repatriate production. Instead, the EU should show leadership by introducing multilateral initiatives, such as an AMIS for medical goods, that restore trust in the EU as a supplier of critical medical goods. This would mean that the EU lives up to its commitments to multilateralism and plays a crucial and constructive role. Such an initiative should be complemented with encouraging improved risk management in the production of goods in general, along the lines of supply chain diversification and creating safety buffers but not a blunt and counterproductive policy of repatriating entire supply chains.

2.2 CHANGING DEMOGRAPHIC WEIGHTS

A megatrend likely to shape the future of the planet dramatically is demographic change. In developed economies, birth rates lowered substantially in the second half of the 20th century. As a result, populations are growing very slowly, if not declining, and they are ageing rapidly. On the other hand, most of the developing world still has very high birth rates, leading to rapidly rising population numbers and a very young population.

These changes have significant effects on the economy as a whole and on trade policy. They affect market size, both in absolute terms but also relative to other markets. They change consumption patterns and economic dynamics in general, as older people tend to have different consumption, saving and investment patterns than younger people. There is also the hypothesis that younger societies are more innovative and more willing to embrace technological change. Therefore, the implications of global demographic change on economies and trade relations might be substantial. I will first turn to providing an overview of the overall changes in global demography and projected sizes of the economy before turning to more microeconomic factors.

2.2.1 Population, Market Size and Bargaining Power

In international trade relations, market size, population and purchasing power matter because they are important determinants of economic attractiveness. The attractiveness of a market is directly linked to its bargaining power.[10] This matters for bilateral,

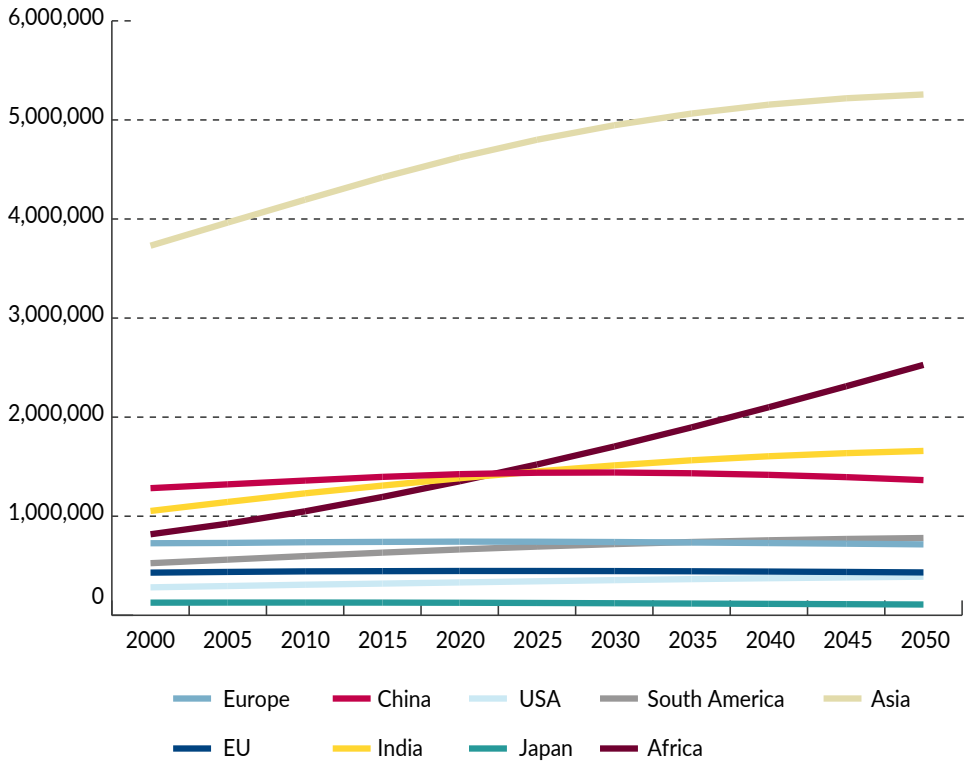
9 Blanc (2015).
10 Schneider (2005).

multilateral and plurilateral trade negotiations. A country with a large market can ask for more concessions from a potential trading partner that wants to obtain preferential market access than a country with only a small market.

Population matters, because of its obvious link to the number of consumers. However, since consumption patterns change with age, the demographic composition of the population influences demand in real terms. Purchasing power matters as well. A populous but poor country is not generally an attractive export destination. The ability of the population to purchase goods in significant volumes matters for the attractiveness of the market.

Figures 2.4 to 2.7 and Table 2.1 provide an overview of how these key fundamentals are going to change in the coming decades. To begin with, Figure 2.4 shows population developments in key countries or world regions. The most remarkable observation in this chart is the dramatic population rise in Africa. In Asia, which remains the world's most populous continent, India is overtaking China as the most populous country, as China's population is beginning to enter a phase of decline. The EU's population numbers are mostly stable, Japan is seeing a slight decline while the United States and South America continue to grow.

FIGURE 2.4 POPULATION PER GLOBAL REGION/COUNTRY



Source: United Nations - Department of Economic and Social Affairs (2018).

These figures change slightly when looking at them in terms of share of global population, which is presented in Table 2.1. Europe accounted for 12% of the world's population in 2000 and in 2050 will only contribute 7%. For the EU, respective figures are 7% in 2000 and 4% in 2050. In 2020, the EU's share remains 6%. China will also see its share of the world population reduce. It will fall from 21% in 2000 to 14% in 2050. The United States will remain mostly stable with 5% in 2000 and 4% in 2050. In relation to the world's population, India will also remain roughly stable – 17% in in both 2000 and in 2050 but rises slightly in the meantime. The big rise occurs in Africa: while Africa accounted only for 13% in 2000 it will double to 26% in 2050.

But population size alone is an insufficient determinant of trade power. The next charts (Figure 2.5 to 2.7) try to approximate market size and dynamics as well as purchasing power. So let us first turn to the long term projections of GDP growth that are presented in Figure 2.5. The EU and the United States are both slated to continue to grow – with a slight growth advantage for the United States – while Japan is expected to stagnate in the main. The big growth regions remain China and India where GDP is expected to almost double. Brazil and South Africa are also expected to experience strong growth although starting from a lower base.

To approximate purchasing power, it makes sense to look at GDP per capita. If GDP growth is only driven by population increase and the population is mostly poor, then this growth is not going to translate into significantly higher living standards and consumption. Looking at GDP in per capita terms gives a different flavour. The United States remains the richest among the large players in the world economy and the EU will retain second place. China and India grow considerably but from a lower starting point. The emerging markets of Brazil and South Africa are expected to make progress in per capita terms. Nigeria, Africa's largest economy, is seeing a stagnation of its GDP per capita.[11] Figure 2.7 summarises growth dynamics for GDP and GDP per capita for the economies presented here.

What is also striking is how the structure of age groups is changing across the globe. This is presented in Figure 2.8. It used to be a constant that the largest age group is that of the under 25s – at least in a global perspective. This is no longer true; the largest age group is now the 25-64 year old population. Also, the share of those aged 65 and older is rising. Africa remains the continent with the lowest median age but on almost all the other continents the median age is rising quickly and with it the share of older people in the population.

What does this imply for trade policy, in particular when it comes to bargaining power? The United States is going to remain a strong trade power; its population remains stable and continues to develop in prosperity. This is slightly less true for the EU. While individual purchasing power remains high, its declining share of the global population

11 Looking very closely it is actually a decline compared to 2018..

makes it relatively less attractive compared to other more dynamic markets. Further, as older citizens tend to consume and invest less, this might also have a negative impact on Europe's attractiveness as a market destination. China and India will gain in importance as their huge markets become increasingly prosperous. This is also true for other emerging markets for which Brazil and South Africa here feature as a proxy. The high growth rates of Africa's economies have to be taken with a pinch of salt. It is possible, as in the case of the Nigeria, that the economic gains are mostly eaten up by demographic dynamics and are not necessarily linked to increased consumption.

TABLE 2.1 COUNTRY/REGION POPULATION AS SHARE OF WORLD POPULATION

Country/ Region	2000	2005	2010	2015	2015	2020	2025	2035	2040	2045	2050
Europe	12	11	11	10	10	9	9	8	8	8	7
EU	7	7	6	6	6	5	5	5	5	5	4
China	21	20	20	19	18	18	17	16	15	15	14
India	17	17	18	18	18	18	18	18	17	17	17
USA	5	5	4	4	4	4	4	4	4	4	4
Japan	2	2	2	2	2	2	1	1	1	1	1
South America	9	9	9	9	9	8	8	8	8	8	8
Africa	13	14	15	16	17	19	20	21	23	24	26
Asia	61	61	60	60	59	59	58	57	56	55	54

Source: own calculation based on United Nations - Department of Economic and Social Affairs (2018).

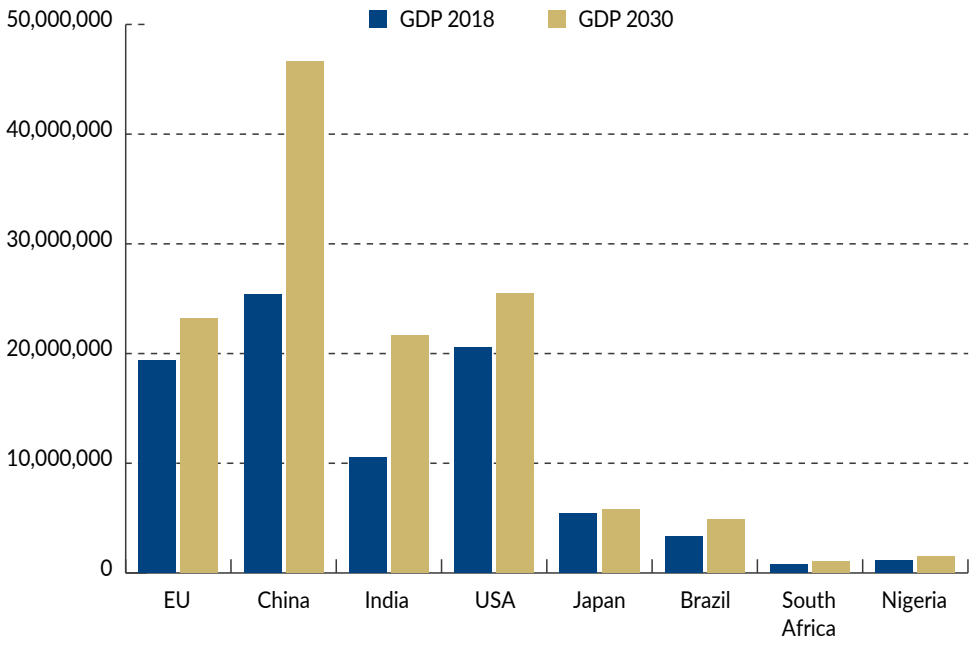
2.2.2 Demographic Dynamics and Economic Activity

Demographic development is not only of interest with regards to market size and purchasing power. Demographic developments can also change consumption and investment patterns, influence productivity developments and innovative capability. These developments deserve to be taken into account as well when thinking about the challenges of trade policy linked to demography.

Bertelsmann Stiftung (2019) has analysed these dynamics and projects their development for the large European economies, the United States and Japan. For productivity it finds that most economies in the study will experience a productivity growth at around 1%, which is lower than in the past but still higher than that of Italy and Spain. This is linked to the adoption of information and communication technology (ICT). Here, the United States is forecast to lead the group of countries observed, followed by Japan,

France and Germany. Italy and Spain are again lagging behind. It also analyses current account dynamics, which is interesting as this is linked to investment abroad. It finds that the German current account surplus is going to remain large but decline slightly over time, from above 6% in 2020 to a little below 4% in 2050. Japan's current account is expected to be mostly in balance while that of the United States gradually worsens further from its deficit of 4% in 2020. Italy and Spain maintain a small current account surplus while France exhibits a small deficit. The current account perspective is relevant because surpluses can be interpreted as a credit to the world, associated with investment abroad. Deficits on the other hand need to be financed externally. While the study does not provide data for the EU as a whole, with Germany and Italy as two large European economies will be looking for investment opportunities. The United States will continue to require credit from the rest of the world in order to finance its current account deficit. Sustaining a large deficit over a long period of time can be difficult but the positive market dynamics of the United States is a positive sign that this could be feasible.

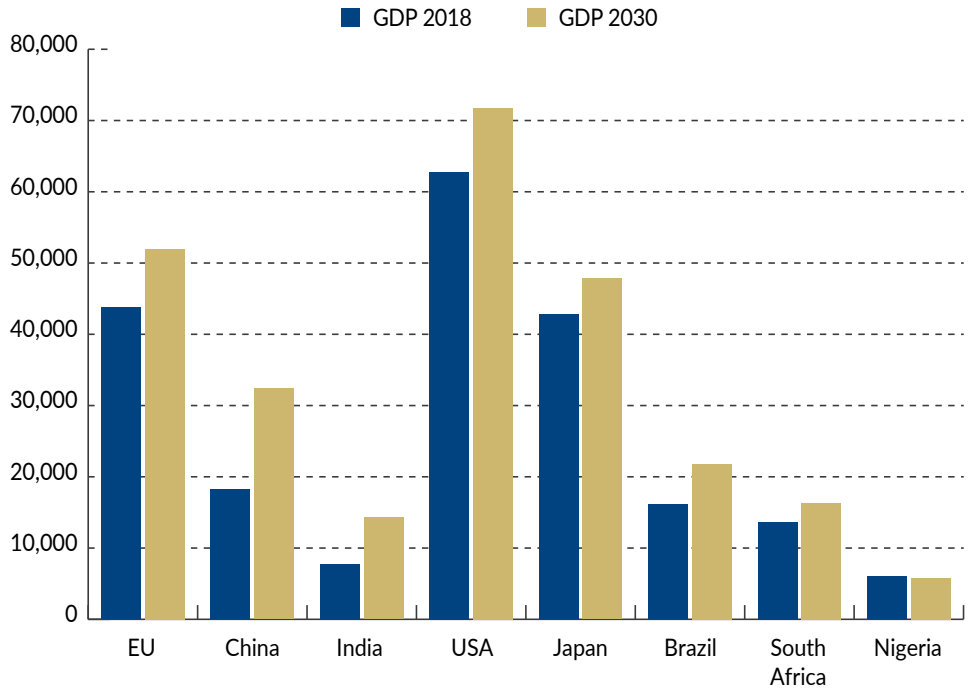
FIGURE 2.5 GDP IN 2018 AND PROJECTED GDP FOR 2030 (IN MILLION USD, BASE YEAR: 2010)



Source: Henry & Pomeroy (2018).

How people choose to allocate their resources, between consumption, investment and savings, changes with their age. Typically, younger people invest and consume more, while older people tend to exhibit a higher propensity to save.

FIGURE 2.6 GDP PER CAPITA IN 2018 AND PROJECTION FOR 2030

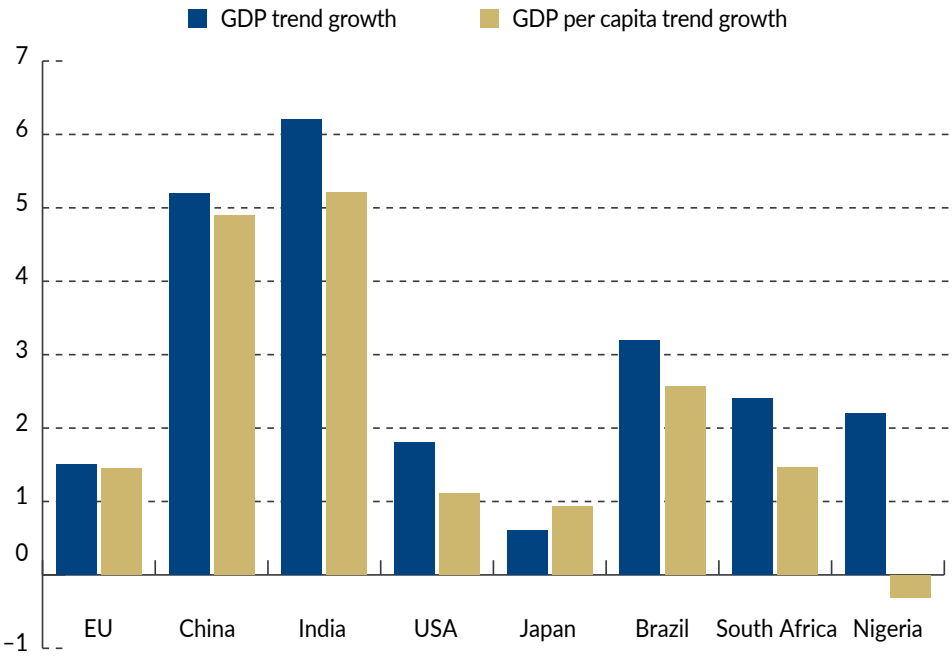


Source: own calculations based on United Nations - Department of Economic and Social Affairs (2018) and Henry & Pomeroy (2018).

When a society is ageing, these microeconomic factors have macroeconomic consequences. For example, a society where older people save a lot in order to live off savings during their retirement, monetary policy decisions aimed at making investment and consumption more attractive are only effective to a limited degree.[12] It is pretty safe to assume that economies with a relatively high median age exhibit less dynamic growth. Microeconomic changes do not stop here. The age of a certain group of professionals can also have an effect: Japan used to have a relatively high level of protection for its agricultural sector. However, given that the average age of Japanese farmers is above 60, this can be seen as a driver of Japan's willingness to liberalise agricultural trade in the TPP and EUJEPA negotiations. This anecdote illustrates that demographic change might have an effect on the political economy of trade negotiations.

12 Leahy & Thapar (2019).

FIGURE 2.7 COMPOUND ANNUAL GROWTH RATE (CAGR) BETWEEN 2018 AND 2030 (IN PERCENT)

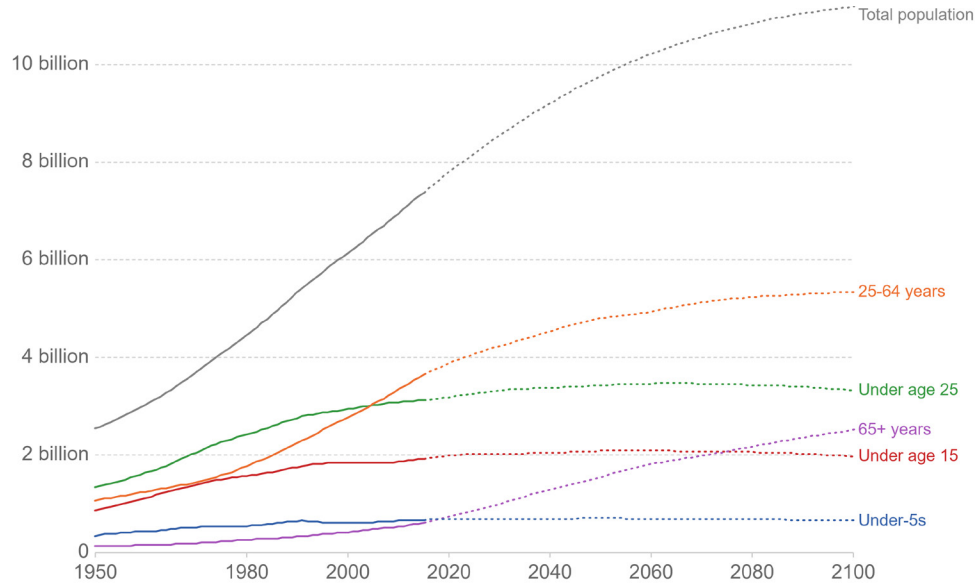


Source: Henry & Pomeroy (2018).

Unfortunately, there is little research on how demographic change influences innovative capabilities, which might be another important microeconomic factor. A theoretical growth model postulates that ageing economies will exhibit lower innovative potential. This is due to the fact that investments in human capital – which drive the ability to innovate – are less profitable for older workers than for younger ones, as the latter will be able to use their obtained human capital for longer.[13] Logically, if there are fewer young and more old workers set to retire in the near future, an employer has less incentive to invest in his staff. This hypothesis seems to be supported by empirical evidence collected by Irmen & Litina (2016). Theoretically, it would be possible to argue that if investment in human capital is concentrated on the younger workers, they might become even more productive. Additionally, their human capital can be further augmented by artificial intelligence and other forms of automation. Whether these news trends are capable of overcoming the demographic drag on the economy and on innovation is not conclusively answered by research.

13 Canton et al. (2002.

FIGURE 2.8 POPULATION BY AGE BRACKET



Note: Historical population estimates (from 1950 to 2015) and projections through to 2100 based on UN medium fertility scernarios. This is shown for various age brackets and total population.

Source: UN, cited after Ritchie & Roser (2019).

Summing up this section, the picture is mixed. On the one hand, there is no need to be particularly gloomy about the effects of demographic change on Europe: While it seems that the more dynamic markets will be elsewhere in the future, the EU is going to remain a large and attractive market which will ensure that it can use the power of its trade policy in international relations. The citizens of the EU will continue to dispose of substantial purchasing power. But on the other hand, competition with emerging markets will increase. China will remain a large and influential market, although India can be expected to emerge as a strong rival. However, there are clues that point to the EU lagging behind in the future when it comes to its innovative potential and productivity developments. There is a real danger that Europe might lose its competitive edge *vis-à-vis* the rest of the world.

2.3 TECHNOLOGY, DATA AND INTERNATIONAL COMPETITION

Technology is one of the fundamental enablers of globalisation. This is particularly true for transport and communication technology. In particular the latter has been a fundamental driver of the emergence of GVCs.[14] Technological change has gained in pace in recent years and the digital transformation is changing the way business is conducted all over the world.

14 Baldwin (2016).

This section will focus on two areas of technical change: First, the digitalisation of business models and the concomitant developments and second, the implications of increased automation for GVCs and comparative advantages. Before I turn to these points, I would like to devote some space to technological progress and innovative capability in general.

Economic growth can come either from increases in factor contents of production – generally speaking more capital and labour will yield higher output or it comes from increases in efficiency, i.e. more is being produced with the same factor employment. These efficiency gains typically come from investment in human capital, aimed at enhancing the ability of people to innovate and to invent.

Europe's demographic development implies that the production factor labour is going to decline over time. To compensate for the associated loss in production, a higher level of productivity would be required. The big question for Europe's future is how to continue to grow while the working age population is shrinking. Innovation leading to greater productivity is, therefore, a high policy priority.

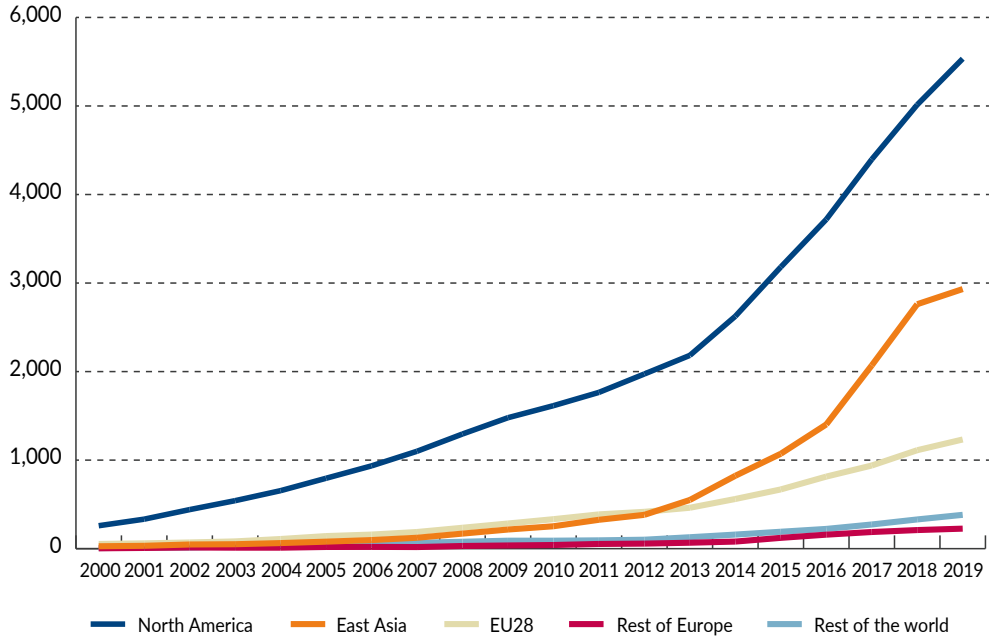
One way to approximate innovative capacity is by looking at patents. Raw patent data is often confusing, as the number of patents per country does not allow much by the way of analysing the economic viability or technological significance of these patents. It is not easy to distinguish a technological breakthrough from an absurd niche product when using raw patent data. A different approach has been employed by a recent study which tries to isolate 'cutting-edge patents' for 58 sectors that do have a significant research and economic effect and makes international comparisons.[15]

The main results of this study are summarised by Figure 2.9. North America, in particular the United States, is clearly the innovation leader in the world. East Asia is rising fast, with China being the main driver. The EU28 has been overtaken by Asia and occupies third place. However, the growth rate of patents structurally changed for North America and East Asia around 2012-2013 while the EU's rate of innovation has remained stable. As a result, in relative terms, the EU28 is falling behind. This is further accentuated by Brexit, as the UK has contributed considerably to the EU's research output.

It is also worthwhile digging a little deeper and exploring in which areas the EU is actually an innovation leader and where it is a laggard. Table 2.2 below compares the top ten research areas (approximated by percentage of world cutting-edge patents) for the three largest players. The United States is particularly strong in digital areas as well as cutting edge medical research. For China, too, digital innovations play a significant role. The EU27 is relatively strong in green technology, food and some medical research but digital innovation areas do not figure here.

15 Breitinger et al. (2020). The innovation of this paper is that it only counts patents that are registered in several countries and which are being widely cited by other patents.

FIGURE 2.9 NUMBER OF CUTTING-EDGE PATENTS BY GEOGRAPHIC REGION



Source: Breitinger et al. (2020).

TABLE 2.2 TOP 10 RESEARCH INNOVATION AREAS (APPROXIMATED BY PERCENTAGE OF WORLD CUTTING-EDGE PATENTS IN THIS RESEARCH AREA) IN 2019.

Rank	USA		China		EU27	
1	Quantum Computing	56.5	Fertilizer	61.7	Wind	50.0
2	Rational Drug Discovery	53.9	Water Treatment	36.1	Additive Manufacturing	27.8
3	Cloud Computing	52.5	Blockchain	33.5	Air and Spacetech	26.1
4	Fintech/ Payments	51.6	Recycling	26.5	Biotech Green	25.5
5	Precision Medicine	51.3	Construction	25.3	Biofuels/Biomass	25.0
6	Defence	50.8	Biocides	25.1	Precision Farming	24.8
7	Big Data	50.5	Waste Management	23.6	Functional Food	24.3
8	Digital Meditech	49.2	Drones	22.6	Biocides	24.2
9	Authentification/ Identification	47.5	Smart Grid	19.4	Diseases	24.1
10	Gene technology	46.0	Big Data	19.2	Gene technology	24.1

Source: Breitinger et al. (2020).

As can be seen from these numbers, Europe is in danger of lagging behind in innovative potential. Apart from strengthening research through a more robust science policy, industrial policy can be a tool to ensure that Europe retains a competitive edge in certain strategic sectors. While industrial policy provokes some severe criticism, the question of how to embrace industrial policy effectively has been much researched and ranks high on the policy agenda. The reasons for engaging in industrial policy are essentially threefold: First, to break path dependency in innovation. Often, new research areas develop very slowly, as structures and financing favour research and development activities in well established areas. Second, other international players – such as the United States and China – are engaging extensively in industrial policy, while the EU as a whole has been by and large reluctant to make large-scale use of industrial policy measures. Third, the private sector is often incapable of realising path-breaking innovation; as a matter of fact, the state and publicly funded research has played an important role in many historically important innovations. The state frequently has an important role to play in correcting market failures that inhibit technological progress. For these reasons, a strand of literature is calling for an industrial policy that targets sectors expected to generate growth spillovers in the future but are not yet developing at a fast pace.

Philippe Aghion has published extensively on policies that foster innovation and growth.[16] He is a strong advocate of sectoral industrial policy. Such an industrial policy would break path dependency and correct market failures and generate substantial growth spillovers. The essential mechanism is that the state intervenes through subsidies, concessional credit, privileged access to public tenders or trade protection for certain sectors. This will make these sectors more profitable and encourage investment in them. Most importantly, such policies increase competition within these sectors in which firms will best differentiate themselves through innovation. Aghion argues strongly against picking national champions as this would clearly be inconsistent with his approach of inducing innovation through competition. Quite the contrary, sectoral industrial policy yields, according to Aghion, the best results if applied in a decentralised way. Aghion calls for EU competition policy to be less legalistic and generally less sceptical of state-aid but to take a more pragmatic and flexible approach.[17]

More recently, Marianna Mazzucato's research has also received a great degree of attention.[18] She, too, is calling for a greater role of the state in promoting innovation. Rather than focusing on a level playing field, governance should aim at tilting the playing field in a way that facilitates the successful accomplishment of *mission-orientated projects*, such as a flight to the moon or combatting climate change. Mazzucato establishes a set of criteria that are crucial for the success of such mission-orientated programmes: First, a mission ought to be clearly defined, including processes of monitoring and accountability. Second, a mission should not comprise a single research project but a portfolio of projects

16 An excellent summary of his research is provided by Aghion et al. (2011).
17 Aghion et al. (2011), p.7.
18 e.g. Mazzucato (2018) for a concise summary.

which together help to accomplish the mission. Third, a mission should bring together actors and sectors across the entire economy, including both the public and the private realm. Fourth, such missions require joined-up policymaking, i.e. concrete policy instruments at all levels of government are employed to facilitate the mission and the division of labour among policy actors is defined such that responsibilities are strategically allocated. Mazzucato's ideas are different from Aghion's in the sense that he focusses on specific sectors that the state should support, which is sometimes referred to as 'vertical industrial policy'. Instead, Mazzucato proposes a mix of vertical and horizontal elements: while there is a focus on a specific task, which can be interpreted as a vertical element, other relevant sectors across the horizontal spectrum of the whole economy are employed to provide the ecosystem that delivers the mission.

With the calls for an industrial policy becoming more urgent in the EU, it is important to keep this research in mind. The European Commission has recently published a new industrial strategy, aimed at strengthening EU competitiveness and innovative capacity.[19] This strategy lists four specific focus areas – or missions, to borrow Mazzucato's terminology:

- **Support the EU's Green Deal:** As discussed above, the Green Deal is one of the key projects of the von der Leyen Commission, aimed at making Europe a net carbon neutral continent by 2050. An ambition linked to this strategy is to 'create lead markets in clean technologies and ensure than our industry is a global frontrunner'.[20] Through regulatory policies but also financial support, the EU hopes to achieve a first mover advantage. State-aid rules will be reviewed in order to facilitate this, as well as a review of the EU's overall competition policy.[21]

- **Support the EU's digital transformation:** The digital aspect of the industrial strategy focuses on continuing to deepen the Digital Single Market (DSM) in order to help scale up digital business models. In addition, it aims at enhancing the EU's 'industrial capacity in critical digital infrastructure [...] the successful rollout of highly secured and state-of-the-art 5G network will be a major enabler for future digital services and be at the heart of the industrial data wave'.[22]

- **Support the EU's sovereignty:** Finally, several provisions are aimed at ensuring the EU's autonomy. This includes stronger FDI screening, safeguarding the EU's digital infrastructures, strategically develop the EU's defense and space sectors and implement a new EU pharmaceutical strategy in response to COVID-19.[23]

19 European Commission (2020a).
20 European Commission (2020a), p.3.
21 European Commission (2020a), p.5.
22 European Commission (2020a), p.4.
23 European Commission (2020a), p.13-14.

While the industrial strategy is not very explicit about the exact measures to be undertaken, it shows that the EU has realised the need to improve its competitive edge in key areas. Comparing the industrial strategy with the analysis provided by Breitinger et al. (2020), it makes sense in particular to strengthen Europe's performance in the digital area, both in terms of innovations but also of facilitating business models. In particular, strengthening the DSM could remove barriers that digital business models in the EU face so far. While this is not easy to implement as the remaining barriers originate mostly in member state legislation (e.g. in the area of copyright) it could unleash considerable growth potential for digital business models.[24] The focus on green industries in order to support the Green Deal also makes sense, in particular since the demand for clean technologies is likely to rise further in the near future. To what extent an additional industrial strategy is needed to develop or defend the EU's competitive edge in this area is not easy to say, given that the EU is already a world leader here.

In particular, the support for the EU's digital transition is badly needed and should be a policy priority. Digitalisation is a key feature of defending EU global competitiveness. The next section will discuss how digitalisation is affecting all kinds of business models, including traditionally more analogue ones and why data is particularly relevant to future economic success.

2.3.1 Flows of Data and Digital Business Models

It has become a commonplace to emphasise the importance that the digital transformation has for businesses and competitiveness. In 2000, the five companies with the biggest market capitalisation were General Electric, Cisco Systems, Exxon Mobil, Pfizer and Microsoft – two digital companies figuring among the top five.[25] Twenty years later, the top five are Apple, Microsoft, Amazon, Alphabet (Google) and Facebook, no company without a predominantly digital business model among them.[26] Digital businesses are no longer a niche growth market, but rather increasingly the centre of gravity of the economy, as this list highlights. What is also worth considering is that among the top ten companies by market capitalisation, not a single one is European – eight are from the United States, and two are from China.

There are reasons why Europe, with regards to digitalisation, is a laggard not a leader. These concern not only the emergence of new, digital business models as embodied by Amazon, Facebook or Google. They also concern the digitalisation of more traditional business models in which Europe's economy retains its backbone. What is holding Europe back, is not a lack of entrepreneurship, it is rather an environment that is not sufficiently conducive to allowing new business models to growth fast.[27] Among the reasons that are frequently cited for the lack of European digital leaders, three come up most often:

24 Marcus et al. (2019).
25 Financial Times, March 31, 2001.
26 As of July 1, 2020.
27 Zabrazna et al. (2017).

• **Market fragmentation:** Scalability – i.e. the ability to scale up a business model quickly – is a key feature of digital business models. Having access to a large market is therefore crucial. The EU market could in theory be large, but it is too fragmented to best harness this advantage. The problem is that businesses active in one EU member state incur legal costs whenever they start to operate in a different EU market as they need to adjust to a different legal framework. Linguistic fragmentation also entails further costs. A digital start-up in the United States does not face similar constraints, with immediate access to 330 million consumers and without any significant legal barriers. In the EU, such a start-up cannot expand beyond its home market without having to deal with extra barriers plus the associated costs – which can be substantial. For example, Zabrazna et al. (2017) estimates that the legal costs alone of operating in an additional EU market amount to 5,000 Euros which for start-ups and SMEs can constitute a significant barrier.

• **Venture capital:** In order to get a start-up off the ground and develop it quickly, the availability of venture capital plays an important role. Again, Europe lags behind the United States and China.[28] It is easy to see the connection between the availability of finance for start-ups and their ability to grow quickly. Especially in digital business models, where the number of network participants or the access to large amount of data can be critical for success, growing quickly can obviously give rise to a competitive advantage.

• **Digital divide:** A digital divide exists not only in Europe but also in other countries, including the United States and China. However, it seems that this divide is more pronounced in Europe. This might have something to do with Europe's demographic structure and the willingness to experiment with new technologies. The digital divide causes problems both on the supply and the demand sides. Companies are slow to use new digital technologies internally or in their retail operations, while consumers are relatively slow to embrace e-commerce. The increased use of digital technologies during the COVID-19 pandemic may have generated a learning effect that has reduced the digital divide and helped the adoption of digital technologies. To what extent this effect is long lasting, however, remains to be seen.

Digitalisation as a Driver of Competitiveness

Addressing these points through adequate policies is not easy. The EU's DSM strategy was geared at removing market barriers for digital business models between EU member states. According to EU Commission estimates, the completion of the DSM could generate a GDP increase of up to 415 billion euros – roughly four times that of TTIP

28 Reliable data on venture capital is difficult to find and often dated. While different data sources define and measure venture capital differently and hence produce different numbers, the general picture is consistent: The United States leads strongly over the EU, also China seems to have stronger than the EU although weaker than the United States. According to European Investment Bank (2019), venture capital in the United States amounted to a little over 0.3% of GDP whereas the EU 28 average was just below 0.05% of GDP.

or equivalent to the GDP of Poland, so quite a significant amount.[29] While the DSM strategy is generally viewed as successful in reaching its objectives, it has not eliminated all legal barriers among EU member states. The remaining elements, such as different copyright laws in member states, are deemed too politically contentious. Nevertheless, it is crucial for the EU to continue to make progress in completing of the DSM, as this will not only yield direct growth results, but also provide a better ecosystem for European business models to grow. One could argue that creating the right market conditions for European digital start-ups could be a promising version of industrial policy promoting Europe's digital capabilities.

This also applies to the 'digital divide'. The twin deadlock of insufficient digital skills in companies and among consumers needs to be overcome. As long as consumers lack the digital knowhow to make the most of their purchase choices and hence there is little demand for digital business models, companies have little incentive to build up such capabilities and will remain in path dependency. A good overview of where the EU is lagging behind international competitors in digital businesses, in particular in the services sector, is provided by van der Marel et al. (2017). Besides a knowledge gap, this has to do with poor digital infrastructure in many EU member states. As a result, the EU as a whole does not match its potential in the trade with digital services, while the United States, as well as some other advanced economies, outperform it substantially.[30]

The uptake of digital business models matters beyond services trade performance. Digitalised businesses can scale their activities up more swiftly, they are more productive and they are – as the COVID-19 pandemic has shown – more resilient. If the EU is falling behind its international competitors in keeping up with the digital transformation, this is bound to have a negative effect on productivity and international competitiveness.

Arguably, COVID-19 might turn out to be a game changer in the EU's digital transformation. Owing to the lockdown measures, most of the physical economy was brought to a standstill. Companies implemented digital ways of getting business done quickly, enabling their employees to continue to work from home. Similarly, shops began to set up the infrastructure to sell their goods online and consumers turned to this offer more than before because shopping online was simply the only way to procure certain products. The lockdown economy might have had a lasting positive effect on the digitalisation of European businesses and in changing the habits of consumers.

Free Trade and Free Flow of Data

Technology, in particular communications technology, has always been an important driver of globalisation. Digitalisation is no different. As discussed in the previous section, digital business models are quickly scalable. In addition, digitalisation provides new

29 European Commission (2017)
30 van der Marel et al. (2017).

business prospects for the global tradability of services and even goods. When thinking about free trade, we still mostly think about the unhindered movement of goods and services around the globe. But in a digitalised world, the free movement of data becomes a third component.

The amount of data around the globe has grown exponentially over the last few decades, dwarfing growth rates in other forms of global flows. By now, the largest share of data flowing internationally is from machine to machine, indicating the relevance of data flows for businesses. Most of the data flows occur between the North American and Europe, but those between North America and Asia, North America and Latin America and between Europe and the Middle East are also particularly dense.[31]

Digitalisation has drastic consequences for business models, of which three appear particularly relevant:

- **Platform economy:** Digitalisation is leading to the emergence of platforms as an intermediary between seller and buyer. Amazon is the most obvious example, but a plethora of platforms exist that service almost any niche imaginable – from hotel booking to internet and telephone contracts, etc. A platform economy has several advantages: It reduces information costs for consumers as they can easily find the right product to match their demands and budget. It is also an advantage for producers as they can more easily retail their products to a larger potential community of consumers without having to build a retail infrastructure for themselves. As a result, the entry barriers for firms to market their products internationally are lowering, offering new opportunities to small and medium-sized enterprises. However, the reality is not always quite as rosy as the theoretical potential of platforms. The sorting of search results and the availability of a large amount of data gives platform providers huge powers over buyers and sellers. They can price discriminate buyers and boost or hinder different sellers. If, as in the case of Amazon, they also market their own goods, not only those of sellers, they may not only skew the market place in their favour but also engage in markets where outside sellers are very successful. Because of these downsides, there is a growing need to regulate platforms to prevent them from tampering with the basic competitive dynamics of the economy. India, for example, has introduced a law that a platform cannot offer its own products on the same website as that of competitors. A company has to decide whether to be a neutral platform or retail their own goods. From an international perspective, platformisation is generally helpful in facilitating international trade and SME involvement. However, the rules governing platforms and for example their responsibility for consumer protection, counterfeit products,

31 Manyika et al. (2016).

etc. diverge greatly, which is why this is an area where more international regulatory cooperation is required. One initiative – the WTO e-commerce initiative – will be described in greater detail below.

• **Services trade, 'servicification' and productivity:** For a long time, it was assumed that services are not very readily tradable. While this remains true for certain services (few people travel to get their hair cut or cut that of their clients), it is much less true for others, such as accounting, legal advice, research and design, etc. These services are tradable because technological advances, in particular cheap communications and exchange of data, have rendered them possible as an international business operation. To some extent, this was already adumbrated in our discussion of the Trade for all strategy, which placed an emphasis on improving the international framework for trade in services. Facilitating services trade has been on the agenda for many years and many FTAs have tried to improve the tradability of services. No substantial progress has been made in the multilateral policy area since the General Agreement on Trade in Services (GATS). Yet services trade matters immensely, since developed economies mentioned above all specialise much more in the provision of services rather than the manufacturing of goods and the removal of obstacles to the tradability of services is deemed to provide substantial welfare gains.[32] The importance of services trade continues to grow with many traditional manufacturing companies beginning to adopt 'servification' strategies, i.e. rather than offering a product, offering the service that can be performed with this product. The possibilities include automobile manufacturers that now aim at providing mobility services, where the sale of the car is just one element. Finally, services and macroeconomic productivity developments are closely linked. As services make up a large share of the value-added in developed economies, productivity developments in the services sector matter immensely for aggregate productivity. But productivity gains are difficult to achieve in the services sector: a hairdresser cannot do much to improve his productivity, nor can a lawyer easily manage to service more clients at one and the same time. But digitalisation is changing this for some services professions. The lawyer can actually raise his/her productivity through support from some legal tech, digital office organisation, etc. Research shows that service sectors that more readily adopt digitalisation also exhibit stronger productivity gains.[33]

• **Smart production and IoT**: Finally, digitalisation also changes the way manufacturing is carried out. Not only is production increasingly automated, it is also increasingly networked within companies and beyond. Machines are capable of communicating with each other and differentiating every product that comes down the assembly line according to the customer's specifications, a development known as the Internet of Things (IoT). Production plants are capable of monitoring stocks

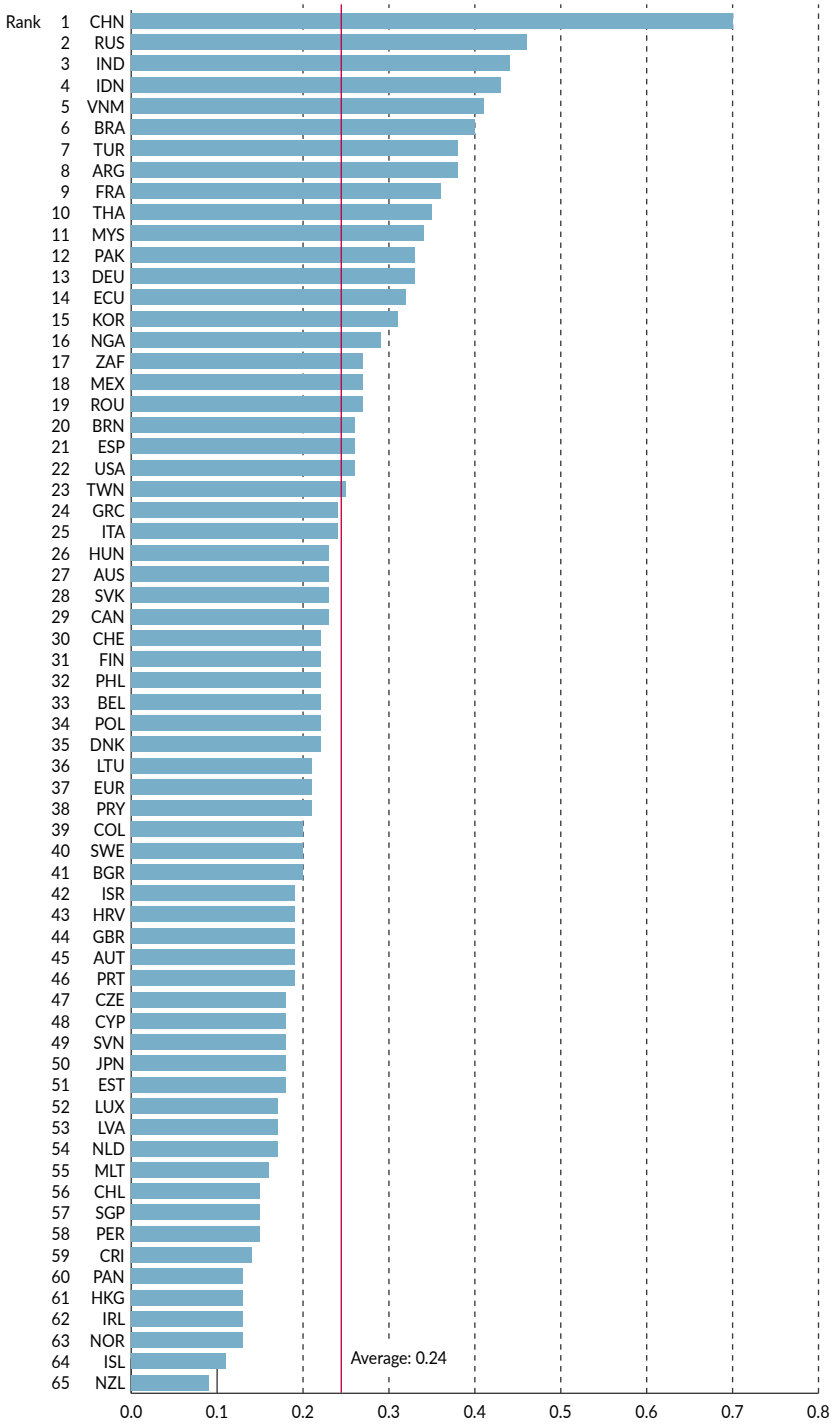
32 Francois & Hoekman (2010).
33 van der Marel et al. (2020).

and ordering intermediates as orders come in so they are available for production when needed – sometimes without the involvement of a human being. The high degree of automation diminishes the importance of labour costs when determining the production site. Instead, especially taken together with the networking element, it becomes crucial that supply chains are capable of delivering in time and reliably. Production is also increasingly customised and less standardised.

These changes triggered by digitalisation have significant repercussions for the way globalisation and trade is designed. For example, the question of free movement of data is becoming increasingly relevant. Compiling an index based on over a hundred individual variables, the Digital Trade Restrictiveness Index (DTRI) approximates the restrictions to digital trade.[34] As the DTRI shows, obstacles to digital trade are significant in many countries in the world. Figure 2.10 provides an overview. According to the DTRI, the most restrictive countries in the world are China, Russia, India, Indonesia and Vietnam. It is perhaps not surprising to find countries with few political freedoms, such as China, Russia and Vietnam in this list. But why India and Indonesia appear as particularly restrictive and why Germany and France also rank relatively high needs further explanation. The high scores are in fact driven by different measures. In the case of China, it is its particularly strong restrictions in public procurement, foreign investment, intellectual property rights (IPRs), competition policy, intermediary liability, content access and standards.[35] Russia has particularly strict rules on data localisation and data retention and a series of policies that impose high costs on companies as well as restrictions on cross-border movement of ICT professionals.[36] For India, the restrictions stem from requirements in public procurement and standard setting, high tariffs on digital goods, the use of trade defence measures on digital products, burdensome barriers in the fields of taxation and subsidies, foreign investment, and IPRs.[37] France and Germany are not in the top five, but they are above average in their digital restrictiveness – France ranks ninth and Germany eleventh. Looking at the subcomponents of the DTRI, both countries rank high in similar areas: establishment restrictions and restrictions on data, i.e. there are restrictions on digital trade for companies which do not have a legal presence in either country and there are limits in place on the use and transfer of data. On the other hand, the least restrictive countries when it comes to data flows are New Zealand, Iceland, Norway, Ireland, and Hong Kong.

34 Ferracane et al. (2018).
35 Ferracane et al. (2018), p.8.
36 Ferracane et al. (2018), p.8.
37 Ferracane et al. (2018), p.8.

FIGURE 2.10 DIGITAL TRADE RESTRICTIVENESS SCORES BY COUNTRY



Source: Ferracane et al. (2018).

There are legitimate reasons to restrict the free flow of data. One particularly salient example is to safeguard privacy and protect sensitive data. For example, many countries have restrictions on the transfer of health data outside of their jurisdiction, as this information is particularly sensitive. Other restrictions that can easily be justified are for national security. While restrictions are justifiable in the case of highly personal and sensitive data, they are not necessary for all types of data and can constitute a heavy burden on companies and the cross-border use of digital technology. An example is data localisation requirements which matter for trade because they are costly, in particular for SMEs, as setting up a server in every jurisdiction that they would like to trade with is cumbersome. The same applies to provisions to set up a legal entity in countries in which a firm wishes to be commercially active; this too can be a considerable burden for SMEs.

Data localisation requirements are particularly burdensome but they are not the only restriction with a strong impact on digital trade. Not surprisingly, dealing with obstacles to cross-border digital business has gained in importance in bilateral FTA negotiations. The first FTA to feature a commitment to 'endeavour to refrain from imposing or maintaining unnecessary barriers to electronic information flows across borders' was the United States-Korea Free Trade Agreement (KORUS) in 2011.[38] More ambitious provisions were found in the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), which features a specific chapter (Chapter 14) on e-commerce covering the following issues:[39]

- no customs duties, fees or other charges on digital products
- application of the non-discrimination principle to e-commerce
- avoidance of unnecessary regulatory burdens on electronic transmissions
- facilitating electronic certification and signatures
- facilitating the use of cloud computing services
- protection of personal information
- customer protection, including means for customer redress and building consumer confidence
- no data localisation requirements
- interconnection charge sharing
- addressing unsolicited commercial electronic messages
- cooperation among the members of the CPTPP to share experiences, e.g. in exchanging information, assisting SMEs, encouraging self-regulation, etc.

38 cited after Singh et al. (2016), p.9.
39 Singh et al. (2016), p.10.

- general prohibition of source code revelation requirements (with limited exceptions)
- mutual recognition of technical standard certification among CPTPP members
- e-commerce provisions being subject to dispute settlement

Because of this forward-looking and ambitious agenda, CPTPP is for many a reference when it comes to the governance of e-commerce. The EU has incorporated e-commerce issues in its bilateral trade negotiations as well. Most recently, the EU-Japan Economic Partnership Agreement (EUJEPA) features a chapter on 'Trade in services, investment liberalisation and electronic commerce'. The main provisions are going in a similar direction as the CPTPP's, as they keep electronic transmissions duty free and electronic signatures and contracts are recognised, while source codes may not be required to be transferred or accessed. Futhermore, the EU recognises Japan's data protection regime as equivalent, so free flow of data is permitted.[40] The EU is negotiating similar equivalence recognition agreements with a series of countries in order to facilitate cross-border data flows that respect the strict European data protection regime. This is particularly important since the EU's data protection regulation, the General Data Protection Regulation or GDPR goes beyond the regulations of many other countries and – what's more – applies extra-territorially. This means that an Indian company handling data gathered in the EU and belonging to EU citizens must apply the GDPR, even if this data is located in India. Of course, this practice of the EU has not been without criticism but it has also helped to concentrate attention more strongly on the issue of data protection worldwide.

With regards to the regulation of e-commerce, negotiations are underway for a plurilateral agreement under the auspices of the WTO. This initiative was launched at the WTO's Ministerial Conference in Buenos Aires in December 2017 and since then 84 WTO members have joined the negotiations. Negotiations are currently divided into six focus groups:[41]

- Focus Group A 'Enabling digital trade/e-commerce' – covers basic issues such as electronic signatures and contracts, spam, etc.
- Focus Group B 'Openness and digital trade/e-commerce' – covers more complicated issues such as data flows, non-discrimination in digital content, liability and access to internet and data
- Focus Group C 'Trust' – focuses on consumer protection, privacy and business trust
- Focus Group D 'Cross-cutting issues' – deals with issues such as transparency, cybersecurity, capacity building, cooperation, domestic regulation and other legal issues

40 Chowdry et al. (2018).
41 Based on Dreyer (2020).

- Focus Group E 'Telecommunications'
- Focus Group F 'Market access'

Given the very different conceptions of the big players – the United States, the EU, China and India – in this plurilateral, it is far from certain whether these negotiations can produce a wide-ranging agreement. It is quite possible that a fairly limited agreement will emerge that establishes some common ground on legal issues such as electronic signatures and contracts, liability and consumer protection. Making significant advances in removing the current trends towards digital protectionism seems much less likely.

At the same time, discussions are taking place at the WTO on extending a moratorium on import duties on electronic transmissions. At the time of writing, it is not yet clear whether another extension can be achieved, as in particular India and South Africa show little interest in extending it. This is possibly significant as tariffs on electronic transmission would add an additional and particularly vexing element to digital trade protectionism.

More generally, while there is hope that the e-commerce initiative at the WTO as well as bilateral treaties among trading nations render digital trade easier and remove some barriers, it is questionable whether there is substantial policy space for progress. On the one hand, gains from curbing digital protectionism could be large. Many firms in almost all areas of business would benefit from greater market access and lower associated costs. On the other hand, an infant industry argument is frequently made. There is a worry that more advanced businesses will dominate the market and less competitive domestic rivals would have to leave the market. This logic is behind the controversy on ending the e-commerce moratorium as well in the finer points of the e-commerce negotiations.

The risk that the current negotiations will lead to relatively modest gains in easing digital trade is real. Digital protectionism seems to be on the rise and coincides with stricter non-economic control of the internet and its contents. A particularly negative scenario would be that of a 'splinternet', i.e. a scenario where the internet landscape is broken up into 'parallel internets that would be run as distinct, private and autonomous universes'.[42] With regards to China, this is of course already a reality. Russia is also moving in such a direction. Such a splintered network would be bad news for export orientated economies and for GVCs which rely on swift and free flowing information and data.

42 The term 'splinternet' was first coined by Crews (2001), where the above definition can be found.

Big Data and Artificial Intelligence

The utility of the free flow of data is particularly linked to new ways of analysing data and using this to optimise business models. The phrase that 'data is the new oil' has become a commonplace. The reason why that is the case is because availability of data allows for providing a more targeted supply to the customer's needs. For example, if fed with good data on a customer's preferences, retail platforms can suggest products that fit the customer's preferences first. It is also possible to design products that suit the customer's preferences – for example, car makers use data on usage of their cars to find out about a customer's usage pattern. Artificial intelligence is crucial for interpreting large amounts of data, detecting preferences and optimising product use. The larger the data source, the better the analysis. The better the analysis, the greater the advantage over competitors. The perfect example of this is Google's search engine: since it has become the go-to search engine, it has access to a huge amount of data on producers, consumers and their preferences. This allows it to improve search results and to present them according to the consumer's taste. Any new search engine aiming to rival Google doesn't only have to overcome the fact that Google is by far the best known search engine, it will also struggle to provide similarly good results given that is has much less data (none, to begin with), on consumers and their preferences. Why use a new search engine when Google works well?[43]

Because of this technological trend, the size of the available data can be a determinant of competitiveness. If data cannot be transferred across borders or there are otherwise restrictions on interpreting it, this can be a competitive disadvantage. The policy challenge therefore is to make sure that EU companies have access to a large pool of data that they can use to optimise their business models. This access needs to be balanced with protection of the consumer's privacy and the permissible types of data analysis and customer discrimination. While analysis of preferences can help customers by being offered better goods, it can also be used against them, for example by adjusting prices to his purchasing power. The regulatory challenge is to permit the advantages of big data to play out while safeguarding the interests of consumers. This requires setting rules across borders and a level playing field, in order to prevent less regulated competitors turning this into a predatory advantage. This last case will be a policy challenge that's hard to address.

2.3.2 Automation and the Global Division of Labour

According to Ricardian trade theory, the relative prices of production factors play an important part in determining where something is produced. Countries specialise in the production of the good in which they have a comparative advantage. In Ricardo's classic example, England is more efficient at producing both goods – in this thought

43 e.g. Kubina et al. (2015).

experiment, wine and cloth – than the other country in his two-country model, Portugal. The production of cloth is more resource intensive and if England has to produce both goods, it can produce less cloth because some resources also need to be dedicated to the production of wine. If England only produces cloth and Portugal produces only wine and then they trade, both countries end up with larger quantities of cloth and wine than they would under autarky.[44]

The logic of the theory of comparative advantage is very powerful and goes a long way towards explaining globalisation. The pattern that emerged through the 1980s and 1990s is that manufacturing which was very labour intensive was shifted to places where labour was much cheaper and high-income countries specialised in the businesses that were capital (or human capital) intensive, like research and design, services, etc. Attracting manufacturing through cheap labour was the dominant development model of the 1990s and the 2000s, most obvious in the case of China but also successfully applied elsewhere.

Manufacturing, Automation and Labour

Production is becoming increasingly automated. This simple fact might upset the logic behind the global division of labour and development models. If production can take place with a high degree of automation, then labour costs are no longer the factor that determines its location. There is no longer a need to produce in a low wage country.

Instead, other factors are becoming more important in determining the location of production. The time it takes to reach the consumer is frequently mentioned as a more and more relevant factor. For companies it is increasingly important to be able to deliver their goods to the consumers within a short time-frame. One example of this is the fashion industry, where trends are short-lived and the time from design to retail is getting shorter. If a dress for the European market were produced in Asia, it would spend 2-3 weeks on a ship before reaching the market – which may be too long. Another, possibly more relevant, example is that of highly customised goods. Consumers increasingly demand goods that are adjusted to their personal preferences. A frequently cited example is Adidas's smart factory, where sneakers are 3D-printed according to the customer's specification. In such a case, customers do not wish to wait ages for their purchase. Therefore, Adidas located this smart factory in Germany, so as to service the European market more quickly.[45] The point here is that the place of production will move closer to the place of consumption. This could possibly mean the return of some industrial production to Europe and North America, but does not mean that production for the important Asian markets will not continue in Asia.

44 Samuelson (2001).
45 Adidas eventually decided to close the factory in Germany without clearly stating the reasons for this decision. One possibility might be that demand turned out to be less strong than expected..

In order for a location to be attractive for automated industrial production, not only the time to market matters, other factors play a role. As automated production is closely linked to suppliers through IoT connections, the availability of excellent digital and physical infrastructure is important. Digital infrastructure matters, so that the exchange of data between different manufacturing sites up and down the production chain can work smoothly and reliably. Physical infrastructure is important, because goods must be shipped from one production location to another swiftly and on time.

Another factor that might have a bearing on production is energy prices. Automated production can be fairly energy intensive, so prices for this factor matters. But it is more than just the price of electricity. If the EU implements a CBAT, the carbon content of the energy will matter as well. This point will be developed more fully in the next section. Countries that are able to provide clean energy at favourable prices, and which find themselves close to consumption hubs, will clearly have an advantage.

A New Development Model: Services?

The flipside of automation is that the Chinese model of development is no longer viable for many developing countries. The advantage of having an abundance of cheap labour no longer attracts industrial production – and with it the investment, knowledge spillovers and incentives for efficient governance than come with it. This is possibly very damaging. If this engine of development fails, the question is which other mechanisms can continue to provide rapidly growing populations with livelihoods and prospects of a better life?

The digital revolution may possibly allow a services-driven development model. In particular, simple services that can be provided online might offer a possibility for many to enter business with developed markets. This could, for example, be video editing, web design, customer services, etc.

A prerequisite for such a development model to work is, first, that data can flow relatively freely. Second, developing countries need to have an adequate digital infrastructure in place. And finally, people must have the means to avail themselves of the (digital) tools they need to perform these services, such as computers, etc.

The EU should support such a development model. First, it will help European businesses to have such supporting services performed in a low wage environment. But the utility of this model goes beyond this. If there is no development perspective for low- and middle-income economies in Europe's neighbourhood, this might have undesirable political consequences for the EU. In particular, working with Africa to find tools to facilitate trade in services, notably through digital channels, should be an element of the EU's future trade strategy.

This section has tried to sketch out the main technological trends. The main take away is that trade policy should support the technological transition and help European producers gain a competitive edge. This means that the EU should endeavour – as now – to allow

free data flows and to eliminate unnecessary barriers to digital trade while ensuring an adequate level of data protection. The latter is not just in the interests of European consumers but might also give European data-intensive businesses a competitive edge with non-European consumers alert to data protection issues.

Europe should support automated and IoT-powered production within its boundaries and its neighbourhood. Similarly, it should continue to work to facilitate the cross-border delivery of services, in particular digital services, in order to help create a services-driven development model and harness the economic benefits of such a business model.

2.4 CLIMATE CHANGE, SUSTAINABILITY AND TRADE POLICY IMPLICATIONS

The megatrend of climate change and rising concern about sustainability and environmental issues have been with us for a long time. Nevertheless, this megatrend is going to be increasingly policy relevant in the upcoming decade and beyond. One reason for this is that the window of opportunity to limit global warming is closing rapidly, another – linked to the first – is that demand for and acceptance of 'green' policies are rising.[46] This is true not only for Europe but also beyond. Yet Ursula von der Leyen's plans for a European Green Deal aimed at making the EU the first net carbon-neutral continent by 2050 show the increasing relevance and teeth of 'green' policies. This is true for policymaking far beyond the remit of trade policy but it also has strong relevance for the way trade policy is currently conduced. While environmental and sustainability concerns go far beyond climate change and de-carbonisation, this section will focus on these developments as they have particularly wide-ranging implications for trade policy.

In the Paris Agreement, signatories agreed to limit global warming to 1.5 °C.[47] Not much time is left to achieve this target. Figure 2.11 shows that the warming of 1.5°C compared to pre-industrial times will be reached at a point between the early 2030s and the 2050s. This forecast rests on carbon emission pathways as outlined in subfigure b), where a worldwide net zero is reached either in 2040 (blue) or 2055 (grey) – where both cases seem fairly optimistic given the progress made in actual carbon reductions so far.

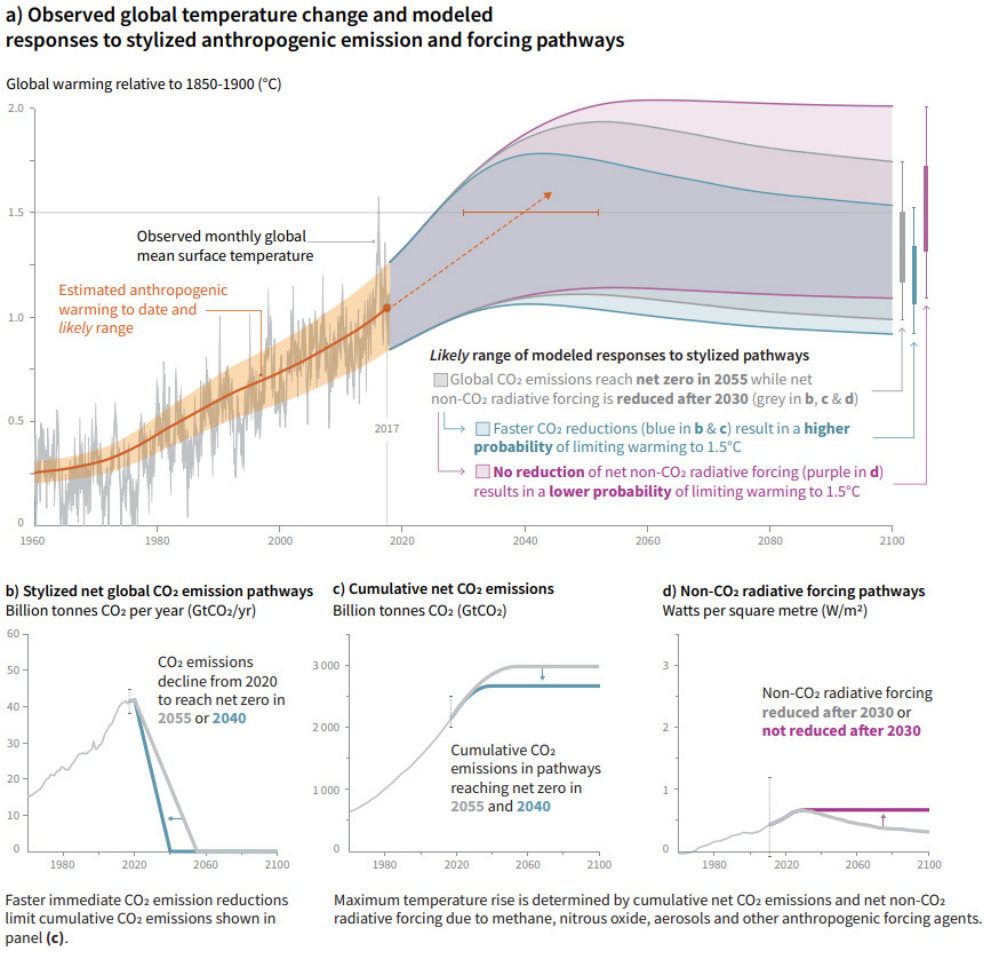
As it is likely that the effects of global warming will become more and more visible over the next decade, the political demand for green policies is likely to increase. This is crucial, because in order to meet the target of the Paris Agreement, significant emission reductions are necessary – to achieve a global net zero at around 2050, CO_2 emissions need to decline by 45% from 2010 levels.[48] This 'would require rapid and far-reaching

46 Arregui Coka & Rausch (2020).
47 United Nations (2015).
48 IPCC (2018), p.12.

transitions in energy, land, urban and infrastructure (including transport and buildings), and industrial systems (*high confidence*). These systems transitions are unprecedented in terms of scale, but not necessarily in terms of speed, [...]'.[49]

The Green Deal is the EU's policy strategy to meet its commitments under the Paris Agreement. It's aims will be outlined in the section below. Before we do so, it makes sense to observe what other large trading nations – and carbon-emitting countries – are doing with regards to their carbon emissions and climate change mitigation policy. An overview of global annual CO2 emissions per country is provided in Figure 2.12

FIGURE 2.11 GLOBAL TEMPERATURE CHANGE FOR DIFFERENT CO2 EMISSION PATHWAYS



Note: Cumulative emissions of CO_2 and future non-CO_2 radiative forcing determine the probability of limiting warming to 1.5°C

Source: IPCC (2018).

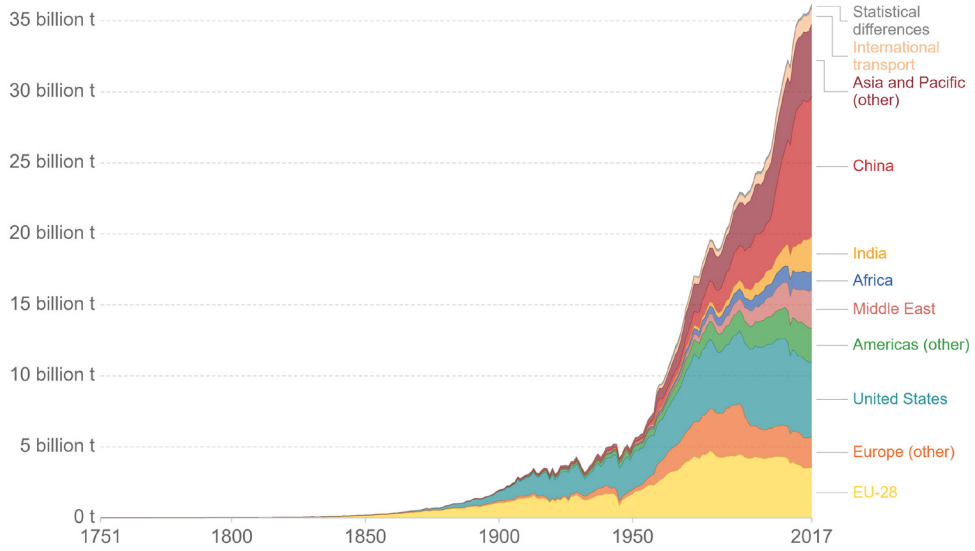
49 IPCC (2018), p.15.

The largest emitter of CO_2 is China, closely followed by the United States, the European Union and other Asian and Pacific countries. From a historical perspective, the United States and the EU member states have been the largest emitters. Emissions in the emerging world (India, Middle East, non-US Americas and Africa) are rising but are still relatively small globally. The brunt of the emission reduction therefore rests on the big emitters, China, the United States and the EU, with other players having to step up their efforts as their development progresses.[50]

China is a signatory of the Paris Climate Agreement. Yet according to the Climate Action Tracker, its policies are inconsistent with the 1.5 ◦C target and China's Nationally Determined Contribution (NDC) is judged as 'highly insufficient'.[51] This means that if all other countries in the world pursued a similar level of ambition, global temperatures would rise 3-4°C. While between 2014 and 2016 it appeared that China's carbon emissions were flattening, in more recent years carbon emissions have started to rise again, by 2.3% in 2018 and 4% in the first half of 2019. This is to a large extent driven by China's greater fossil fuel consumption, including the expansion of its coal powered energy production facilities. Paradoxically, China is simultaneously the world's largest consumer of coal and the largest developer of renewable energy.[52] Also, China is setting up an emissions trading system which is expected to become operational in the course of 2020. President Xi Jinping announced in September 2020, that China will aim at achieving carbon neutrality in 2060 and reach peak carbon before 2030.[53] China has not, however, announced any details on how it will achieve these objectives.

50 Collier (2015).
51 Climate Action Tracker (2020), China country profile.
52 Climate Action Tracker (2020), China country profile.
53 Normile (2020).

FIGURE 2.12 ANNUAL CO_2 EMISSIONS PER COUNTRY



Note: The difference between the global estimate and the sum of national totals is labelled 'Statistical differences'. OurWorldInData/co2-and-other-greenhouse-gas-emissions.

Source: Data from The Global Carbon Project, obtained through Ritchie & Roser (2017).

As for the United States, the second largest emitter of CO2, the picture is even less positive. Originally a signatory of the Paris Agreement, the Trump Administration withdrew from it on November 4th, 2019 – the withdrawal will become effective exactly one year later, on the day after the presidential elections. According to the Climate Action Tracker (2020) (CAT), US climate policy is considered 'critically insufficient', i.e. if every other country pursued similar ambitions, global temperatures would rise by more than 4°C. This classification also factors in, however, that the United States is no longer part of the Paris Agreement and has no political commitment to any specific target. If judged only by the current observed emissions, the United States would fall in the category of 'insufficient', i.e. linked to a global temperature rise of 2-3°C. While the Trump administration has considerably weakened domestic climate mitigation policies and sought to undermine the ability of the federal states to pursue their own standards, it still looks as if the United States is going to overachieve the emission goals stated in the Clean Power Plan, due to the decline of coal and the increased use of gas and renewable energy. Nevertheless, emissions are falling at a lower rate than the nationally determined contribution (NDCs) that the United States committed to under the Obama administration.[54] For the future of US climate policy, the outcome of the 2020

54 Climate Action Tracker (2020), US country profile.

presidential elections will be crucial. While a re-election of Donald Trump would mean current policies would continue, the democratic candidate Joe Biden has pledged a more ambitious policy aimed at a net zero by 2050.[55]

The CAT evaluates the European Union's climate policy as 'insufficient', i.e. linked to a 2-3°C increase in world temperature. This assessment precedes the Green Deal which came after the latest update of the CAT.[56] The EU has been reducing its emissions over time, and is expected to achieve a 40% reduction of CO_2 emissions in 2030 compared to 1990s levels, which would correspond to its NDC. However, more ambitious goals are deemed possible by the Climate Action Tracker (2020).[57] [58]

2.4.1 The Green Deal and Trade Policy Implications

The Green Deal

The European Green Deal fits into the efforts of the EU to step up its level of ambition in terms of carbon emissions and sustainability.[59] Elements of this strategy have been discussed before but here it seems appropriate to discuss the Green Deal in general.

The Communication from the European Commission lists ten central actions for the Green Deal:

- **Climate ambition:** The central objective of the Green Deal is to achieve net carbon neutrality for the EU by 2050. This principle is enshrined in a new European Climate Law. Also, the targets for emission reductions by 2030 are to be toughened. To make this happen, the ETS remit is to be expanded and the Energy Taxation Directive revised. Various industrial standards are also planned to be made more stringent in support of the climate neutrality ambition. Furthermore, the above-mentioned CBAT is listed as a policy action in this block and is scheduled for 2021.

- **Clean, affordable and secure energy:** Besides a strategy on offshore wind, the EU aims at boosting the renovation of buildings with the goal of making them more energy efficient and developing a strategy for smart sector integration.

- **Industrial strategy for a clean and circular economy:** The basic tenets of the EU's industrial strategy have already been discussed in the section addressing technological change. In particular, the aim is to provide incentives for switching to clean technologies and to foster innovation. In addition, the circular economy should be further developed with an action plan on batteries and waste management.

55 Biden (2020).
56 The next update including an appraisal of the Green Deal is expected for September/October 2020.
57 Climate Action Tracker (2020), EU country profile.
58 For completeness, according to the CAT, the climate policies of Bhutan, Costa Rica, Ethiopia, India, Kenya and the Philippines are deemed to be consistent with the 2°C target, while Morocco and the Gambia are consistent with the 1.5°C target.
59 European Commission (2019b).

• **Sustainable and smart mobility:** To reduce transport's contributions to carbon emissions, the Commission proposes supporting the roll-out and adoption of alternative fuel infrastructure and vehicles, to toughen standards on combustion engine vehicles and to make more efficient use of public transport.

• **Greening the Common Agricultural Policy (CAP):** The farm to fork strategy is particularly important in this regard. This aims at reducing the use of chemical pesticides, fertilisers and antibiotics in agriculture.

• **Preserving and protecting biodiversity:** This aims at addressing the causes of the loss of biodiversity and making forests more climate resilient. This includes measures to support deforestation-free value chains.

• **Towards a zero-pollution ambition for a toxic-free environment:** Pollution through channels other than carbon emissions should also be reduced, in particular when it comes to the use of chemicals and large industrial installations as a whole.

• **Mainstreaming sustainability in all EU policies:** To make the Green Deal a success, it is important that all of its elements are linked to various other EU policies. This goes from integrating SDGs into the European Semester, i.e. the coordination of national budgets. At the same time, state-aid rules with regards to subsidies for green activity/technology should be revised and a Just Transition Fund introduced that would help regions particularly negatively impacted by the shift to a carbon-neutral economy to adapt (in particular coal producing regions).

• **The EU as a global leader:** The EU should aim at becoming a global leader in climate and biodiversity negotiations and at strengthening international cooperation in these areas. Part of this effort is to 'induce partners to act and ensure comparability of action and policies'.[60]

• **Working together – a European Climate Pact:** To ensure societal support, the Climate Pact is designed to raise awareness and to build understanding of climate change, to encourage people and organisations to commit to concrete actions and to provide opportunities for communication, learning and networking.

The core element is that the negative externalities of carbon-using production are priced accurately for producers. This is done through the ETS which should be strengthened by the Green Deal. In addition, member states should also increase the price for carbon emissions which are not covered by the ETS. Since the beginning of 2019, the price for the emission of a ton of CO_2 in the EU'S ETS has been between EUR 20-25. There seems to be a consensus that the price should be higher in order to reflect the true cost of carbon emissions.[61] Claeys et al. (2019) argue that, if one is to address the distributional

60 European Commission (2019b), Annex, p.4.

61 There is a controversy on the actual level of the price. Research has suggested that a range of $ 68-85 might be realistic. Cf. Tol (2009), Nocera & Tonin (2014) and Poelhekke (2019).

consequences of carbon pricing, it would be preferable to avoid a single price for carbon across the economy but to differentiate between sectors.[62] In any case, as becomes evident from the comparison of current prices and possible future price ranges, it is reasonable to expect carbon emission prices to rise substantially.

That is why a CBAT is a logical extension to the Green Deal package. Otherwise, there would be a temptation for producers to shift production from the EU to other locations with cheaper carbon prices and export the goods from there back to the EU rather than make them there. A CBAT would be set in such a way that there is no substantial price difference between a final good produced in the EU and an imported good with a similar carbon content.

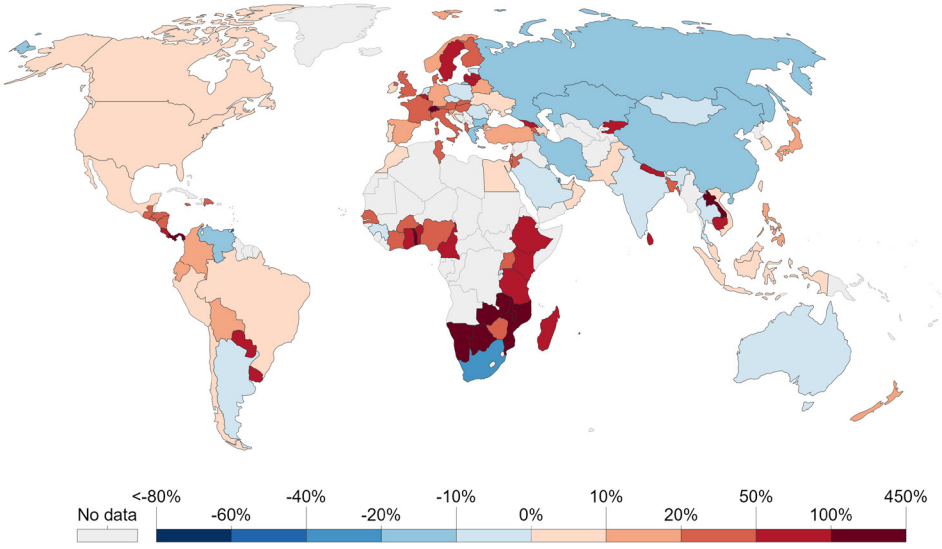
Trade Policy Implications

Carbon pricing is the central mechanism that will drive the Green Deal. Companies that emit CO_2 will need to buy emission rights. The price for these rights will gradually increase as the volume of emission rights is reduced in order to comply with the emission reduction pathway. While there will be subsidies for green technologies in place aimed at helping individuals and companies to switch to more efficient production tools, the price for CO_2 emission will rise.

Carbon prices will initially increase incrementally, so will the CBAT. Nevertheless, the introduction of a CBAT is likely to cause considerable dismay among trading partners, especially those that export a lot of carbon to the EU. An overview of net carbon exporters and importers is provided in Figure 2.13. Countries in red import more CO_2 than they export. As carbon prices rise, it will become more expensive for these countries to import carbon intensive goods. This will be the case for most European countries. At the same time, carbon net exporters will be hit by a tariff on their exports. This will particularly affect China and Russia, but also India, Australia, South Africa and Argentina. While the United States is also a net carbon importer, the Trump administration has already expressed its opposition to the EU introducing a CBAT.[63] Figure 2.13 might not capture the whole picture by focusing on the net balance of carbon trade. Developed economies in particular tend to trade with each other to a large degree in intermediates which have of course been produced by using carbon-based energy. As these intermediates are traded in both directions, both trading partners would be an exporter and an importer of carbon at the same time. Such GVCs trade might suffer from the introduction of the CBAT, as intermediates can be sourced at cheaper costs from countries with less extensive carbon pricing.

62 Claeys et al. (2019), p.3.
63 Bade & Palmer (2020).

FIGURE 2.13 CO_2 EMISSIONS EMBEDDED IN TRADE (2016)



Note: Share of carbon dioxide (CO_2) emissions embedded in trade, measured as emissions or imported as the percentage of domestic production emissions. Countries shown in red are net importers of CO_2 emissions, they import more CO_2 embedded in goods that they export. Countries in blue are net exporters of CO_2, they export more CO_2 embedded in goods than they import.

Source: Data from The Global Carbon Project, obtained through Ritchie & Roser (2017).

The dismay about the plans for a CBAT is not only occasioned by the tariff costs involved. It is also deemed to be a fairly difficult policy to administer. If it is to meet its goal of equalising the price of production in the EU and abroad, it has to take into account not only the carbon content of an imported good but the carbon used in its production. Therefore, companies will be required to document the carbon intensity of different production steps which in the case of complex GVCs can be quite difficult. It's also a procedure that is more burdensome on SMEs than large trading companies.[64] Lowe (2019) recommends that the EU undertake active efforts to ease the administrative burden, in particular on SMEs, by investing some of the tariff revenues in third-party certification.

Another issue is that the EU emphasises in all publications is that the CBAT should be introduced in such a manner that it is WTO compatible. There is disagreement among legal scholars to what extent CBATs can be compatible with the WTO rulebook.[65] A discussion of the precise legal argument would go beyond the purpose of this text. At the core of the question is whether the EU would be allowed to treat products of the same type, say bicycles, differently, depending on the carbon intensity of their production. The rulebook does not allow discrimination between 'like' products, so one argument is that

64 Lowe (2019)
65 For example, Green (2005) argues that a CBAT on carbon emissions in production is not compatible, on the other hand Pauwelyn (2013) argues that this is indeed compatible with WTO law.

there can be just one single tariff for bicycles. As this question remains unresolved, it is almost certain that if the EU introduced a CBAT, it would be challenged in the WTO's dispute resolution mechanism. Therefore, the EU would operate at best in a legally uncertain environment or – in the worst case – face significant 'retaliation' from trading partners.

At the same time, the question of the competitiveness of EU products in foreign markets also remains open. Even if other countries levy no special taxes on goods produced in the EU, the goods risk being more expensive because carbon pricing in the EU is likely to be higher than in other countries. EU companies could circumvent this disadvantage by producing goods for foreign markets outside the EU. This possibility would, however, not be open to all producers as the building of an additional production plant is a costly process. It also runs counter to the intuition of a CBAT that is designed to prevent exactly such leakage. One – not entirely unproblematic – policy option would be to create a series of FTAs with locations that have cheap and clean energy, such as Morocco. If production is moved to such locations, there would be less carbon emissions – since the energy used is clean – and hence the environmental objective of the CBAT would not be undermined. At the same time, the incidence of the CBAT would be limited. Finally, since energy in such places is also cheap, competitiveness would not be undermined.

The political challenges around the introduction of a CBAT could be resolved if such a tax were to become mainstream. The smaller the price difference among CO_2 emission rights in different countries, the smaller the incidence of the CBAT. The EU should therefore actively engage other countries to follow its example of an ambitious climate change mitigation policy. The ideal would of course be to bring the issue of carbon pricing to the WTO and develop a multilateral system for the trading of CO_2 emission rights, which would then make the introduction of a CBAT redundant. If there is only one global CO_2 price, there is simply no need for pricing carbon content again at the border. The Paris Agreement explicitly allows the possibility for countries to merge their ETSs.[66] Given the different levels of ambition in various countries in the world when it comes to carbon reduction, it is unlikely that a multilateral agreement by consensus is possible.

Alternatively, this could be pursued through the plurilateral or bilateral route. In the same way that the EU is now party of plurilateral initiatives within the WTO, this could be done for a limited group of WTO members that wish to take ambitious climate action. But this would only make sense if the largest emitters were part of this initiative, as the benefits of such an agreement would be made available to all WTO member countries on a most-favoured nation (MFN) basis. An alternative route could be to include provisions on carbon pricing in the EU's FTAs, thus making sure that at least these preferential trade flows are not hurt by the introduction of a CBAT. In any case, the EU will have to use a lot of political capital to gain acceptance for its own CBAT, let alone any wider

66 United Nations (2015), Article 6.

application within the WTO system. Yet if the EU, China and maybe the United States (under a different administration), pursue ambitious climate goals, there could be a window of opportunity to establish such a system.

While the CBAT is the feature of the Green Deal that has the most wide-ranging implications for trade policy, it is not the only one. Issues evolving around the right to regulate and dealing with subsidies given out as part of the Green Deal are also likely to have repercussions in the trade policy world. As regards the right to regulate and to set standards, different opinions exist as to what extent this clashes with the WTO principle of non-discrimination of foreign goods.[67] Here, it would be helpful to seek a clarification within the WTO that the right to regulate with a view to achieve sustainability goals and climate change mitigation objectives are not limited by the principle of non-discrimination.

The existing WTO disciplines on industrial subsidies are not in conflict with the type of subsidies that are envisaged as part of the green deal, at least to the extent that such subsidies are now known. There is an increasing interest among WTO members in developing more far-reaching disciplines for industrial subsidies in order to address their competitive effects. This may have repercussions for the implementation of the Green Deal although it is currently too early to say this with any certainty. It is an issue that policymakers should pay attention to.

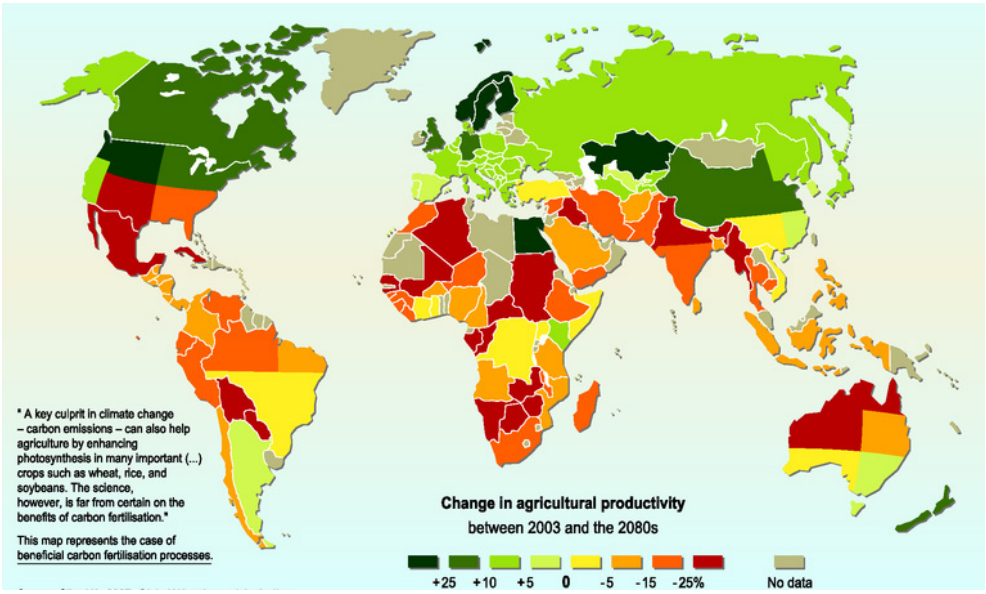
2.4.2 Implications of Climate Change for EU Trade Policy beyond the Green Deal

Climate change has implications for trade policy beyond the Green Deal. This is true not only for the EU but also for other trade policy players. Perhaps the most important point is to think about the implications of climate change for food security and the role of agricultural trade. Other issues include the trade in 'environmental goods' and its role in facilitating clean development, sustainability in the production of raw materials, etc.

In the section on demographic developments, I have already described that agricultural production needs to expand and become more efficient if it is to provide food for the world's rising population. This task is rendered considerably more difficult by climate change. Figure 2.14 shows that agriculture in the global south is likely to be less productive than it was at the beginning of the century. This is particularly worrying since, Africa and South-East Asia, the world regions with the largest population growth, are going to be impacted.

67 Green (2005).

FIGURE 2.14 IMPACT OF CLIMATE CHANGE ON AGRICULTURAL YIELDS



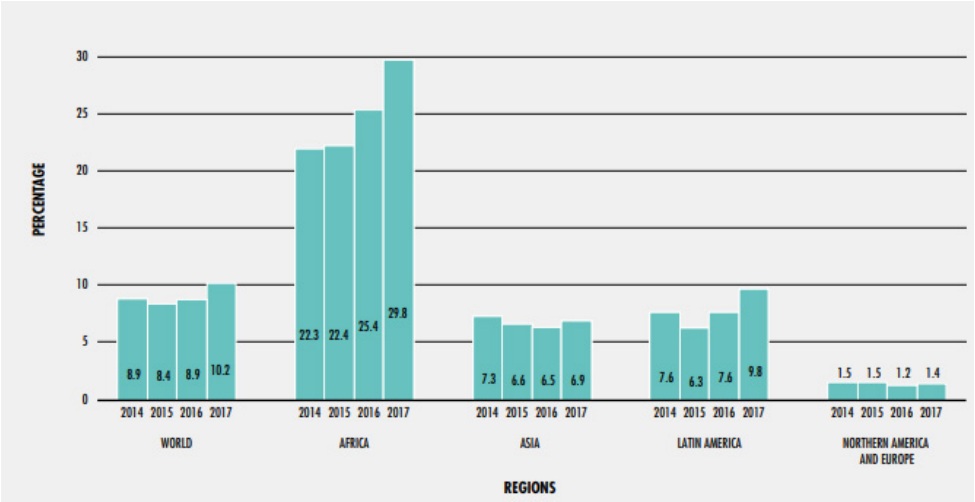
Source: Cline (2007).

This problem is not something that will materialise slowly – we are already seeing it. Data from the FAO already shows that the number of undernourished people in the world has been increasing since 2014 – both as absolute numbers or as a share of the population.[68] This development is more pronounced in countries prone to droughts, where, since 2012, undernourishment has increased by 45.6%. Figure 2.15 further illustrates this point, referencing the evolution of food insecurity in global regions.

For the EU, food security and undernourishment are not internal issues. But the EU will need a strategy to address this as a global problem. What solutions are there to deal with food insecurity in places where not enough food can be produced locally or where production is too unreliable? To some degree, countries can mitigate the situation themselves, through a combination of shifting agricultural production to more climate-resilient crops (where possible) and through increasing public stockpiling. The latter is problematic, because if this goes beyond previously agreed limits, it might be viewed as a price-distorting state intervention that could be challenged in the WTO. This issue has been the subject of negotiations at the WTO and in the light of the difficult situation around food security, a 'peace clause' was put in place which was reconfirmed in 2014. This implies that public stockholding of agricultural goods would not be legally challenged, even if it leads to price distortions. The EU should support finding solutions that allow public stockholding and create legal certainty in order to help mitigate the food security problem.

68 FAO et al. (2018).

FIGURE 2.15 EVOLUTION OF FOOD INSECURITY BY GLOBAL REGION



Note: Severe food insecurity is highger in 2017 than it was in 2014 in every region except Northern America and Europe, with notable increases in Africa and Latin America.

Source: FAO et al. (2018).

CHAPTER 3

Trade Policy and Political Megatrends

The non-political megatrends of epidemics and of demographic, technological and climate change have a considerable bearing on trade policy. Nevertheless, they are not the only forces fundamentally changing the face of globalisation. More than at any point since the inception of the liberal trading order is trade policy dominated by decidedly political trends.

Political trends are different from non-political trends in the sense that they are the result of the meeting of opposing political forces. They are rarely unidirectional. Instead, they are a product of an antagonism between two or more political players or political poles. Perhaps the most important political megatrend for trade policy is the increased competition between the United States and China. This is a conflict of geostrategic nature but it is played out to a large extent within the geoeconomic arena. The competition for influence and the resulting polarisation between China, the United States and their respective allies will shape trade policymaking well beyond the Sino-American bilateral relationship.

This conflict has prompted greater competition between two different conceptions of the role of trade. The 'embedded liberalism' that motivates the institutional set-up of the liberal globalisation is under growing pressure from a stronger geoeconomic globalisation where trade is viewed from the angle of 'weaponised interdependence'. The US-China battle is the most prominent example of this trend but not the only one, which is why this deserves to be discussed beyond the narrow focus on US-China relations.

Another antagonism that is defining the future of trade policy is the governance of the economy in general. The multilateral institutions of the Bretton Woods system and the GATT/WTO system have been complemented by regional organisations. Where multilateralism is not delivering the expected results, these regional organisations have been able to move forward. With their increased role and relevance, the question is however to what extent multilateralism is in competition with regional organisations or how far do the different levels of governance complement each other.

Not all political trends are rooted in relations and rivalries between states. In fact, one of the most defining antagonisms of our time is the erosion of a broad societal consensus to embrace trade and openness and sharp contrast between pro-globalisation and protectionist forces. How this conflict plays out and how it is resolved has severe repercussions for the future of trade policy.

Finally, the EU as a trade policy actor is marked by long-standing controversy over the division of power between the European institutions, primarily between the Commission, and the member states. In particular, in an increasingly geoeconomic world, where trade becomes less of a technocratic and more of a political issue, the success of the EU as a trade policy actor could lie in its ability to find a new balance of power that enables it to address the challenges it faces in the right manner.

The remainder of this chapter will tackle each of these defining antagonisms one by one and tease out the implications for EU trade policy.

3.1 'WEAPONISED INTERDEPENDENCE' VS. 'EMBEDDED LIBERALISM'

This chapter could begin either with the geoeconomic competition as embodied in the conflict between the 'embedded liberalism' and 'weaponised interdependence' or with what is the next section, the growing antagonism between the United States and China. Without the latter, the former would not possess the disruptive potential that it has – while remaining valid as a trend beyond the competition of the two big powers. But without the fear of weaponised interdependence, the rivalry between two global powers would play out in a completely different way. The two antagonisms taken together have a markedly disruptive potential that is stronger than either of these trends on its own.

3.1.1 Embedded liberalism and the multilateral trading system

The concept of embedded liberalism was first coined by Ruggie (1982). He used this term to distinguish the post-war set-up of international economic governance from that of the interwar years or that preceding the first world war. Ruggie recognises that there is a tension between the aims of putting in place an international liberal regime that allows free trade and the free flow of capital and a domestic economic regime that allows the state to intervene in the economy – as various countries had done in the 1930s to counter the effects of the Great Depression. This tension arises from spill-over effects of the latter that makes it politically impossible for free trade to dominate the way it did in the pre-WWI laissez-faire economy. Embedded liberalism is an attempt to reconcile the two objectives of domestic stability and international openness.

Ruggie writes that '*this was the essence of the embedded liberalism compromise: unlike the economic nationalism of the thirties, it would be multilateral in character; unlike the liberalism of the gold standard and free trade, its multilateralism would be predicated upon domestic interventionism*'.[1] The term 'domestic interventionism' here means that the government can take necessary steps domestically to ensure social stability – for example through a welfare state or macroeconomic management of the business cycle.

1 Ruggie (1982), p.393.

An important feature of embedded liberalism is that the parties to the system share a common vision of its purpose in their policymaking, not just a functional form of cooperation under a hegemon.

Ruggie's argument has been used to characterise the GATT/WTO system, in the sense that it aims at a kind of compromise between domestic ability to stabilise and the ability to trade goods internationally. Ruggie himself observes that the trading regime of the early 1980s allows for a kind of liberalism that limits domestic disruptions. He comments on the emergence of intra-industry trade: '*As a result, national export structures are becoming ever more alike. On reflection, however, this outcome should not cause surprise. For governments to pursue domestic stabilisation, it is quite safe to liberalise this kind of trade. Adjustment costs are low. It poses none of the vulnerabilities that a true Ricardian specialisation among sectors would pose. Whatever political vulnerabilities might arise from it, they are all more or less shared by all parties to it, so that it is unlikely to lead to a contest for political advantage among them. And all that while it offers gains from trade. In contrast, there has been no progress in liberalising agricultural trade. Furthermore, where trade in industrial products is based on a more classical notion of comparative advantage, as it is with imports from the so-called newly industrialising countries, the trade regime has encountered difficulty*'.[2]

One has to recognise the prescience in these observations. The trading system for a long time was based on a shared normative purpose embedded in an institution that he describes as multilateral but that in the 1980s did not yet have the near-universal membership that it has today.[3] The changing economic weights that arose within it, as a consequence of China's economic rise in particular but also that of India, Brazil, and Russia, changed the nature of the organisation.

The difficulties highlighted in liberalising trade in agriculture persist to this day. While some progress has been made, the difficulties around finding common rules for agriculture were key reasons for the failure of the DDA. The emergence of new economic players entailed social adjustment costs that were more significant than in previous trade liberalisations. As I will argue in the section discussing the tension between protectionist populism and globalism, the resulting questioning of the ability of the state to provide stability has undermined the social consensus on increased globalisation.

Finally, one might dispute whether the membership of the WTO is still united by a common sense of purpose. The sense that gradual trade liberalisation plus domestic stability support the purpose of welfare and development has been gradually eroded. The primary objective of trade is – in many cases – no longer just the pursuit of prosperity.

2 Ruggie (1982), p.402-403.
3 At the end of 1982, the year of publication of Ruggie's essay, the GATT had 86 signatories.

Trade as an instrument to achieve geostrategic aims has risen in importance, calling into question whether the foundations for Ruggie's idea of embedded liberalism are still in place.

How does China and its emergence as an economic and political power fit into Ruggie's framework? On the one hand, one might argue that China as a policy actor committed to gradual liberalisation of trade and its readiness to engage in domestic stabilisation fits his description of the motivations fostered by the trade regime quite well. On the other hand, the fact that China's domestic economy is not a market economy, the influence of state is so strong, and in many ways discriminates against foreign investors and trading partners might enable one to equate China with the economic nationalism that Ruggie criticises. While China is a member of the multilateral institutions, it is often accused of failing to engage seriously with criticisms of its national economic policy and being slow to find solutions for domestic policies that cause international spill-overs. China cannot be easily identified either as disruptor or as disciple of embedded liberalism. However, its increased economic nationalism under Xi, the discrimination against foreign investors and trading partners and its increasingly geoeconomic agenda, have all tilted the balance towards its characterisation as a disruptor of the global governance system and the embedded liberalism it rests on.

The basic idea of embedded liberalism remains a powerful one. The notion of using multilateral institutions to find ways to reconcile the legitimate aims of domestic stability and trade for the purpose of welfare gains still has considerable force. While one might argue about how far consensus on the purpose of trade may have eroded, there is still a lot of consensus within the current system. Embedded liberalism is not dead. Liberal globalisation is still a force to be reckoned with. But it is increasingly under pressure from a globalisation of a different kind, a geoeconomic globalisation characterised by the concept of weaponised interdependence.

3.1.2 The emergence of weaponised interdependence

Ruggie recognised that fostering international trade leads to rising interdependence among the participants of this system. As shown in the quote above, he did not believe that this would be used *'for a contest for political advantage among them'*[4] because vulnerabilities are shared. Interdependencies can be used to hurt another party, but only at the price of hurting yourself in the process, which is why it would be unlikely that such interdependencies would be exploited to gain a political advantage.

The concept of weaponised interdependence – first developed by Farrell & Newman (2019) – questions this belief. It starts from the realisation that economic interdependencies are indeed exploited for political purposes. Their analysis is rooted in network theory: Actors

4 Ruggie (1982), p.403.

and critical pieces of infrastructure form hubs or nodes of varying degrees of centrality. Over time, the centrality of a specific node reinforces itself. Spokes are connected to such hubs and depend on them because of their centrality.

Hubs therefore have power over the spokes connected to them and this is derived from two sources:

1. **Panopticon effect:** The more central an actor, the more it has an information advantage over less central actors. It can use the privileged position of the hub to track the actions of peripheral actors dependent on the hub. The opposite is often not true: peripheral actors have little ability to find out about the actions of more central actors.
2. **Chokepoint effect:** Privileged, central actors can limit or penalise the use of hubs by more peripheral actors, thus giving them a strong gatekeeping power.

Farrell & Newman (2019) use two examples to illustrate this. First, they refer to the power of oil-producing economies which have repeatedly used their oil exports to achieve political goals. Second, they refer to the more recent example of Western sanctions against Iran prior to the negotiation of the Joint Comprehensive Plan of Action (JCPOA) in which Tehran agreed to refrain from building nuclear weapons. When the United States eventually left the JCPOA and it reinstated sanctions, these were not only sanctions against Iranian entities but would also apply to any third-country company doing business with sanctioned Iranian companies. A very effective tool among the different sanctions deployed was to cut off the access of Iranian banks to the SWIFT system, used for international transfers. The latter effectively illustrates the use of a central node to exert pressure on a peripheral actor. This is another example of how interdependencies (in this case the importance of the US market for many companies) are deployed for a geostrategic purpose.

In Ruggie's perspective, interdependence would not be weaponised because interdependencies were symmetric. The emergence of asymmetric interdependencies – where it is possible to hurt an external player disproportionately more than oneself – allows for these to become weaponised. Such asymmetric interdependencies are particularly substantial – according to Farrell & Newman (2019) – in international finance and in digital connections. The example above of the use of the SWIFT infrastructure illustrates the importance of being able to control financial flows. In the internet infrastructure, two nodes are particularly important: overseas cables and the Internet Corporation for Assigned Names and Numbers (ICANN) administration. Overseas cables are obvious nodes, as they are relatively few in number but traffic for many peripheral actors flows through them. The ICANN serves as an institution to govern the internet. It can be considered a node, because the US government has a veto right within it. Futhermore, various digital networks and platforms – Amazon, Google, Alibaba, Facebook, etc. – constitute nodes with powerful influence.

The United States, the EU and China have strong control over several such nodes. For example, the afore-mentioned SWIFT system is based in the European Union.

These actors therefore have a stronger ability to weaponise interdependence with others if they so wish – whether the EU would wish to weaponise SWIFT is a different question, it might be wiser not to do this as it might lead to the emergence of competing payment systems and thus erode the EU's chokepoint power.

An interesting account of the Chinese perspective on interdependence can be found in Gewirtz (2020). The leadership of the Chinese Communist Party has long been conscious of the different implications of interdependencies for China and these dependencies have been taken account in developing and reorientating China's growth strategy. In internal documents, interdependencies have been described as:

1. An engine of economic growth and technological development
2. A source of risk due to China's dependencies and vulnerabilities; and
3. A source of leverage over other countries due to their own dependencies and vulnerabilities.[5]

While the leadership was willing to accept interdependence so as to harness the benefits of 1), it sought to minimise vulnerabilties subject to this objective. This has changed under Xi Jinping, where the emphasis has shifted to thinking of interdependence more in terms of 2) and 3). As a result, China is now focusing more on increasing resilience by relying to a larger extent on domestic production and capabilities, as shown by the *Made in China 2025* strategy.[6] It is also increasingly thinking about using interdependencies as a tool for coercing other countries.[7]

Examples for the use of weaponised interdependence are manifold, not just from China, the United States and European players. Harnessing asymmetries in economic relations is an effective way to obtain political objectives. However, weaponising interdependence can turn out to be a self-defeating strategy. If interdependencies are increasingly exploited for political purposes, vulnerable policy actors will aim at reducing them, even if this comes at an economic cost. As a result, interdependencies are undermined and can no longer be used as a tool of geoeconomic strategy. Of course, this logic only applies to actors which can effectively reduce interdependencies, which is the case of large, developed nations but less so of small developing ones. It also implies that weaponised interdependence is most effective when applied either without prior warning or against smaller actors unable to reduce their dependency. The trust in trading partners not to exploit interdependencies has diminished recently, especially in the light of the US-China conflict. Worries that

5 Gewirtz (2020), p.2.
6 Gewirtz (2020), p.4.
7 Gewirtz (2020), p.4 and p.6, also Rosenberg et al. (2020), p.22-34.

China might exploit interdependencies with Western trading nations are grounded much less in an acute threat to do so but in an abstract worry and reduced trust that they may (or may not) start using to them.

The fact that the United States, the EU and China have used interdependencies to obtain political aims has now sparked the fear of weaponised interdependence. Within all three large trade policy actors, there is a domestic debate taking place on how to reduce interdependencies and vulnerabilities. Weaponised interdependence has undermined the spirit of embedded liberalism that allowed the emergence of a close-knit international trade network and sophisticated GVCs. If risk management is becoming more and more a priority, this means reducing one's reliance on any one actor.

For the time being, weaponised interdependence and embedded liberalism are competing forces shaping the global trading system. It is not impossible that because of weaponised interdependence, embedded liberalism will ultimately see a resurgence as it can potentially provide assurances against trade policy as a tool of grand national strategy. But it is equally possible that the disregard of multilateral rules in the pursuit of weaponised interdependence fatally damages the liberal institutions.

3.2 US-CHINA GEOECONOMIC COMPETITION

Big power competition is nothing new in geopolitics. It was possible to forge the liberal international trading system despite the sharp antagonism between the United States and the Soviet Union and their respective allies. Before that, the first wave of globalisation occurred exactly at a moment when the British Empire and Germany were strong geopolitical antagonists and the United States rivalled Britain's economic power. Such rivalries can articulate themselves through the spheres of geopolitics – i.e. in the classic sense of the confrontation via diplomacy and possibly armed conflict – and/or geoeconomics – i.e. through the deployment of economic 'weaponry' – to reach their respective strategic goals.[8]

While big power competition through geoeconomic means is not a new phenomenon, it has resurged recently. The Cold War was predominantly a geopolitical rivalry. The economic dependencies between the United States and the Soviet Union were too small to play a significant part in this context. This is different when it comes to China and almost any other country in the world. The economic dependencies are significant. Pursuing geostrategic goals through geoeconomic means is therefore a tempting strategy. This is one reason for increased use of geoeconomics in Grand Strategy. The other is that – at least in the Western countries – the social acceptance of geopolitics is decreasing. For example, strong guarantees for Taiwan or Hong Kong would not be supported by a large majority: only a small proportion of the population of the United States or EU member

8 This definition is based on Baracuhy (2018).

states would be willing to go to war if China annexed those territories. The sympathy for the use of geoeconomic 'weaponry' would be much higher. Geoeconomic 'weaponry' can be many things and it is not easy to provide an exhaustive list, but sanctions, trade privileges, investments, tariffs, development aid, etc. are important examples of the geoeconomic arsenal. According to Scholvin & Wigell (2018) non-Western actors such as Brazil, India and China have historically used geoeconomics more than military means to achieve their strategic objectives.

The Western nations have not perceived China as a geostrategic rival for a long time. Instead, the expectation in the 1990s and the 2000s was that China would become a more 'normal' market economy with a smaller role for the state and might also open up politically.[9] With its economic liberalisation, China was first and foremost seen as an attractive business destination. As a result, the economic relations of the United States but also the EU and other players with China deepened considerably. Today, China is the EU's second largest export destination and the main source of imports. The picture is similar for the United States: The EU is its top trading partner from an export perspective, followed by Canada, Mexico and then China. When looking at imports into the United States, China ranks number one, followed by the EU. Of course, the flipside of this picture is that China is also closely linked to the EU and the United States through trade. For China, the United States and the EU are the first and second most important export destinations. Its imports come from the EU and the United States primarily, but also to a substantial degree from South Korea, Japan and Taiwan.

These close interlinkages are perceived as problematic, because there is the fear that China might 'weaponise' this interdependence that has grown up over time.[10] But that is not the only concern when it comes to trade relations with China. Other issues viewed as perceived as problematic (not just by the United States) is the large role of the state in the economy, through SOEs and through subsidies, the weak protection of IPR, insufficient reciprocity when it comes to market access and investments and China's status as a 'developing country' in the WTO. None of these issues are new and many of them were already on the table when China negotiated its accession to the WTO, but they have dominated the trade policy agenda more than in recent years.

3.2.1 Trade Policy Concerns Regarding China

To what extent the trade war between the United States and China is genuinely motivated by trade policy concerns or whether these concerns mostly serve as a pretext for a geostrategically motivated confrontation is debatable. Whatever the answer, the aforementioned elements of China's trade policy have been criticised not only by the United States but also the EU for a long time, including from the time of Chinese accession negotiations to the WTO. Indeed, a frequent criticism now is that the United States and

9 e.g. Lardy (2001).
10 e.g. Palmer & Bermingham (2019).

the other trading power should have asked more from China in its accession protocol than they did – although the negotiations were already proving difficult at the time. As frustration is growing about China's failure to engage with these contentious issues, they deserve some attention in this context.

The Role of SOEs

One of the most contentious issues is the involvement of the state in the Chinese economy. When China acceded to the WTO, the general expectation in the West was that it would become a market economy. This did not happen. To this day, state-owned enterprises (SOEs) continue to make up a sizable share of the Chinese economy. That alone may not be ground for concern, given that SOEs are also not uncommon in Europe and other parts of the world, without this causing major headaches for the global trading system.

Several problems are, nevertheless, linked to the high degree of state involvement in China. SOEs make up a significant part of the economy – 40% of assets and 20% of employment – but are also generally known to be less productive than the private sector, slower to adjust to market developments and overly indebted.[11] As SOEs are not required to adjust or shut down in the face of low productivity and even losses, they cause severe competitive distortions that have a negative effect on the Chinese and to some extent the world economy. The presence of SOEs in many sectors makes it more difficult for more efficient private companies to enter these markets and it might even happen that SOEs crowd out more productive private firms completely. Another frequent complaint is a lack of transparency: it is often unclear what constitutes an SOE as ownership structures can be opaque. A company that looks like a private entity might in fact be linked to the state. This doesn't always have to be the central government, it can also be a province or local entity.

Yet the Chinese government is resisting the reform of SOEs and this is also a subject of debate within China.[12] To some extent, this is motivated by a domestic political economy problem, as SOEs account for a relatively large share of employment and reforming them might lead to rising unemployment. In the same vein, some policymakers in China prefer the stabilising function that SOEs provide for the economy over further increases in productivity. Another motivation that strengthens SOEs is that they play an important role in safeguarding China in strategically important sectors such as defence, energy, telecoms, aviation and railway systems.

The competitive distortions have not remained limited to the Chinese market. They are also felt internationally, for example in the steel sector where there is persistent overcapacity due to steel producing Chinese SOEs.[13] As a result, there has been repeated resortion to antidumping measures against China, not only in steel. China insisted that

11 World Economic Forum (2019).
12 Kratz (2013).
13 OECD (2018).

it be considered a market economy 15 years after it joined the WTO, as foreseen by its accession protocol. However, when the EU and the United States failed to grant China this status, it started a lawsuit before the WTO's dispute settlement body – only to halt it in 2019, allegedly because the panel was clearly not going to support China's claim of being a 'market economy'.[14] This means that the United States and the EU can continue to apply anti-dumping measures against China.

Market Access and Investment

Another frequently raised criticism *vis-à-vis* China is that market access for companies and investors is not equal that granted by its Western trading partners. Many areas of the economy are still not accessible for foreign companies or only under strong restrictions. Since 2018, China has been operating a nationwide negative list approach, i.e. each sector for which bans or restrictions are in place is now listed. This list is revised annually. The 2019 version of the list indicates 131 items, out of which five are blanket bans – neither foreign nor domestic private investors are allowed to operate in these sectors. This is 20 items shorter than the 2018 edition.[15] For those items listed, companies have to respect restrictions on their activity, such as the frequently cited obligation to form a joint venture with a Chinese investor. A frequent complaint is that China is moving at snail's pace to improve market access, despite its lip-service to continued liberalisation.[16] Levelling the playing field and ensuring that the conditions that US and EU investors encounter in China are more comparable to those found by Chinese investors in the EU or the United States is becoming a policy objective that is pursued by the United States and EU with increased urgency. For example, improved market access has been one of the concessions reached through the 'Phase One' deal between the United States and China.

The Role of Intellectual Property Protection

China is also accused of not sufficiently respecting intellectual property rights (IPR). Complaints about counterfeit goods and/or software piracy have been made for a long time, but recently forced technology transfer has become an increasing concern. According to the US-China Business Council (2015), 59% of US firms were worried about transferring technology to China. Generally, three ways in which technology transfer can take place are mentioned: through the legal obligation to enter a joint venture with a Chinese company, through the process of obtaining regulatory approval for starting a business or making an investment and finally, new regulations that require the hand-over of technology, especially in IT, to ascertain that they are 'secure and controllable'.[17]

14 Miles (2019).
15 Zhang (2019).
16 e.g. American Chamber of Commerce in Shanghai (2017).
17 Hufbauer & Lu (2017).

Complaints are frequent, both in the EU and in the United States. The EU has made higher respect for its IPR an ingredient of its negotiations with China on a bilateral investment treaty; similarly the United States has included some provision in the 'Phase One' deal. But even if a common agreement is reached, enforceability is difficult since the burden of proof that a certain technology has indeed been stolen is difficult to provide. Even if that were possible, businesses might be reticent, as they fear retaliation by China.

'Development' Status

Within the WTO, developing countries enjoy certain privileges referred to as 'Special and Differential Treatment' (SDT). In particular, this means that developing countries are exempt from certain treaty obligations or enjoy longer transition periods. Any country can self-identify within the WTO as a developing country as no formal definition exists. While this is controversial in itself, so is the fact that China self-identifies as a developing country despite its rapid economic growth over recent decades. The Chinese side would argue that in per- capita terms, many Chinese are still too poor to be considered developed. In particular the current US administration has been very critical of this Chinese policy to the point of putting forward a proposal which would make 'developing' status contingent on meeting certain criteria.

Currency Manipulation

The final allegation is that China is manipulating its currency in order to gain a competitive advantage. This accusation is levelled by the current US administration and the US treasury is undertaking an investigation into the matter. While this criticism was more widely shared in the early 2000s, today few others make this complaint. The EU eschews similar allegations while the IMF does not assess the Chinese exchange rate as being manipulated.[18]

3.2.2 The US and China in Geopolitical and Geoeconomic Competition

The trade policy controversies listed above rose on the international policy agenda as China's spectacular economic success continued over time. With increased economic weight also came a stronger role as a foreign policy actor, first in a regional context and gradually on the international stage. The United States could not and did not ignore China's rise and its implications for the regional power balance in Asia. Over time, the United States became increasingly assertive towards China and its regional ambitions.

18 International Monetary Fund (2019).

Pivot to Asia

A particularly momentous move was the US 'pivot to Asia' that Hillary Clinton, as secretary of state, announced in an influential essay in 2011.[19] She argued there that with the winding down the presence of US troops in Iraq and Afghanistan, the America's military and diplomatic capabilities should increasingly be dedicated to Asia, along six lines of action: strengthening bilateral security alliances; deepening working relationships with emerging powers, including with China; engaging with regional and multilateral institutions; expanding trade and investment; forging a broad-based military presence and advancing democratic and human rights. These ambitions are clearly meant to reassure America's traditional allies and to discourage Chinese territorial ambitions. Yet, as regards China, the language of the essay is not predominantly confrontational: while it does state clearly areas of disagreement, including in the trade policy issues listed above, the tone it takes is one of wanting to address these areas through cooperation and collaboration.

An important element of the economic strategy of the US pivot to Asia was the Trans-Pacific Partnership (TPP). Negotiations among a smaller group of countries had been going on since 2005, building on earlier inspirations but they changed track in 2010, when the United States and other countries joined the negotiations. TPP was now slated to become a highly ambitious, modern trade agreement, on the one hand an answer to the frustrating DDA talks and, on the other, an answer to China's economic rise.[20] Negotiations among Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United States and Vietnam were successfully concluded in 2015. President Barack Obama signed the agreement in 2016 but it was never ratified by the US Congress and Obama's successor Donald Trump 'withdrew' from the TPP when he assumed office in 2017. The remaining eleven signatories eventually went ahead and the Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) – largely based on the originally negotiated TPP[21] entered into force on December 30, 2018. The CPTPP is kept deliberately open for the United States to join in at a later date. Also a UK membership is under discussion.

The CPTPP is an innovative and interesting agreement in many ways – not all of which are relevant for the discussion of US-China relations which is the primary objective of this subsection. China is indeed the elephant in the room of the TPP as well as the CPTPP. The agreement works in particular as a tool to strengthen a normative vision about the rules of trade and economic policy as shared among the signatories to this agreement. This includes restrictions on the role of SOEs in the economy, but also provisions about market access, investment and IPR. With the CPTPP in place, these rules take hold not only the signatory countries but also to a certain degree in non-member countries – in

19 Clinton (2011).
20 An excellent description of the TPP's history and the content of the CPTPP can be found in Elms (2019).
21 The CPTPP is identical to the TPP, except for the entry into force provision, a few modifications to Chapter 30 and the suspension of 20 commitments.

order to facilitate their trade with CPTPP member countries, to avoid trade diversion or to prepare a future membership.[22] For the United States, it was an important ambition to include strong SOE-related rules within the CPTPP, in order to gain leverage against Chinese SOEs. In the CPTPP, there are indeed rules on SOEs aimed at establishing a more level playing field, for example by forbidding governments to provide non-commercial assistance for SOEs.[23] However, these are fewer in number than in subsequent US trade deals, such as the US-Mexico-Canada Agreement (USMCA) and were deemed insufficient by US observers even at the time of debating TPP ratification.[24]

What does the TPP imply for China's trade policy and its own ambitions to create a regional trading block, through the Regional Comprehensive Economic Partnership (RCEP)? Since the CPTPP does not really pose a threat to China and its commercial policy, there is no need to take immediate action. The hope of some strategists was that the economic potential of the full TPP – including the United States – would be so tempting for the Chinese that they would undergo substantial economic reform in order to be able to become a member.[25] While other countries have showed interest in joining the CPTPP, China has not undertaken any serious steps towards membership although the option remains under discussion.

Belt and Road Initiative

Instead, China is pursuing its own trade policy agenda, which is linked to its ambitions to extend its influence. One important project is the RCEP, already briefly introduced above, a trade agreement under negotiation between the ASEAN countries, Australia, China, Japan, New Zealand and South Korea. Until recently, India was part of these negotiations. This initiative began in 2011. Perhaps more significant from a geopolitical perspective is China's Belt and Road Initiative (BRI) project, dating back to 2013. The BRI is a global development strategy involving a series of investment and infrastructure projects. The most important elements are the 'road', a land-based route connecting China with other countries along the historic Silk Road (including some European countries) but also north and south of it and the 'belt', a maritime route around South Asia and parts of Africa. China is investing substantially in these connections and offers credit to countries willing to participate. China has currently spent almost 200bn USD linked to the BRI, analysts expect costs for the total life cycle of the BRI to reach 1.2-1.3tr USD.[26]

22 Elms (2019), p.18.
23 CPTPP, Chapter 17.
24 e.g. Scissors (2015).
25 e.g. Chunding & Whalley (2016).
26 Chatzky & McBride (2020).

The BRI has come under criticism for several reasons. The United States geopolitical establishment in particular views the initiative predominantly as a tool to extend influence and military reach.[27] Another frequently voiced concern is that the credit is used as a tool to trick poor countries into expensive infrastructure projects and make them dependent on Chinese financial support.[28]

The question of the nature of BRI is an interesting and unresolved one. It can be interpreted as a mainly economic project, an exercise in the expansion of soft power or as an infrastructure project with possible military use. Officially, China underlines its peaceful nature.[29] It has also been interpreted as a defensive tool against increasing US assertiveness in the region, implying that the mistrust between the United States and China is the primary driver of the project.[30] Finally, another reading is that this is an offensive tool to exploit network centrality and make the spokes more dependent on the hubs, as discussed in the section on geoeconomics.[31] The former Australian Prime Minister and China specialist, Kevin Rudd, commented that 'if the pillars of strategic analysis are capabilities, intentions and actions, it is clear from all three that China is no longer a status quo power'.[32] Regardless of the correct interpretation of the motivation behind the BRI, it is a tool that can be used in multiple ways and has thus caused concern among many observers in the geoeconomic and security policy field.

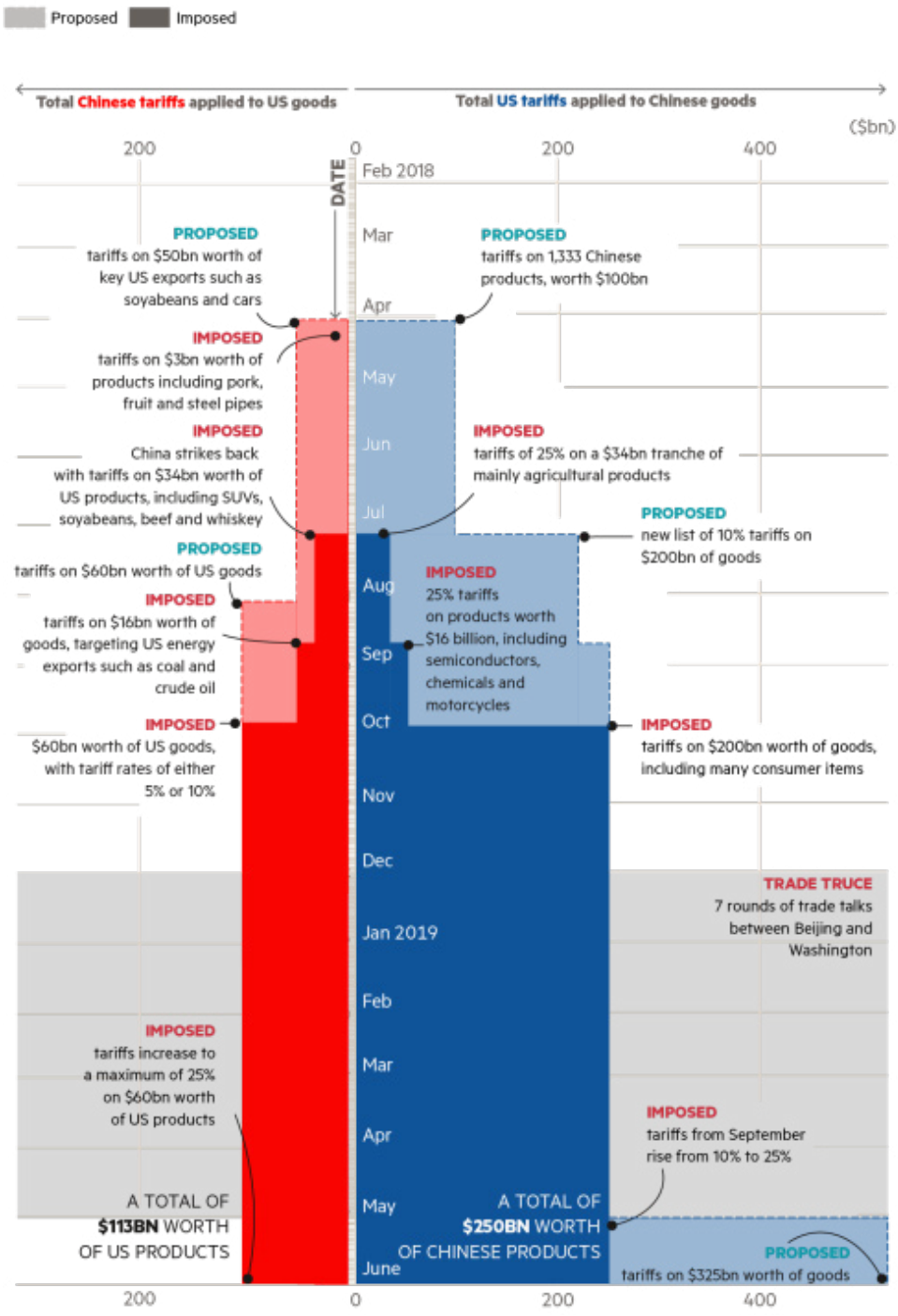
The US-China Trade War

While the Obama administration pursued a strategy that was defined on the one hand by asserting the US interests in Asia but also by an openness for cooperation with China in multilateral institutions and on a series of foreign policy issues, the Trump administration adopted a much more confrontational course. His first trade policy action was however to withdraw the United States from the TPP which had become very unpopular in domestic policy and which he had attacked vigorously in his campaign.[33]

Regarding China, the tone of Trump and his trade policy advisors swiftly became much more confrontational.[34] President Trump focusses in particular on the trade balance of the United States with other countries and took aim at the US deficit with China. In March 2018, he began what over multiple rounds of escalation turned into a fully-fledged trade war with China (an overview is presented in Figure 3.1).[35]

27 Ali (2020), p.23.
28 e.g. Horn et al. (2019). According to their research, China is now the largest creditor to developing countries while the conditions of the debt are often non-transparent and contain collaterals such as mining rights, privileged repayment of Chinese debt, etc. China is also not a member of the Paris Club in which creditor countries to developing nations coordinate their policies.
29 Ali (2020), p.23.
30 Ali (2020), p.319.
31 e.g. Beeson (2018).
32 Rudd (2018).
33 Palmer (2016).
34 Bermingham (2020).
35 This timeline is based on Council of Foreign Relations (2020).

FIGURE 3.1 EVOLUTION OF THE US-CHINA TRADE WAR



Politi et al. (2019).

At first, the United States imposed additional tariffs on Chinese imports worth 50bn USD in response to what he views as violation of IPR. China responded with retaliatory measures in April. On July 6, 2018 further tariffs were imposed on an additional USD 34bn of Chinese imports. Again, this was met by Chinese retaliation.

In December 2018 the conflict escalated further, as Canada arrested the CFO, Meng Wanzhou, of the Chinese telecommunications company Huawei at the request of US authorities. She was accused of helping Huawei circumvent US sanctions against Iran. This step is significant because in addition to escalating tit-for-tat tariff increases, a single company is targeted by US policymaking. This carried on with the United States banning Huawei – on grounds of alleged risk of espionage or sabotage – from being used by US federal agencies. The Trump administration also launched an aggressive campaign against Huawei, warning other countries not to use this company in their critical telecommunications infrastructure, in particular in the 5G networks being rolled out. Similarly, the US administration more recently also attacked the popular app TikTok, owned by a Chinese company, because it is allegedly acquiring too much data on US citizens. The WeChat app, ubiquitous in China, is now also banned in the United States. All of these are examples that in addition to trade policy action against China as a whole, the United States is targeting specific Chinese companies that it views as a security risk.

In the meantime, talks took place between China and the United States to find a solution for the tariff war. As they broke down in May 2019, the United States implemented further tariffs on Chinese imports worth 200bn USD, again met by Chinese retaliation on 60bn USD worth of US exports to China. A further round of tariff increases followed in August, shortly before the United States officially labelled China a currency manipulator.

On the margins of the G20 summit in Buenos Aires in 2019, Trump and Xi held talks and agreed to stop the escalation of the trade war and to conclude a trade deal. This deal was later labelled the 'Phase One' deal,[36] which was signed in January 2020. It contains commitments from the Chinese to purchase more US goods, to step up intellectual property provisions and to improve market access. The deal does not contain any provisions on subsidies. Most of the tariffs remain in place but the United States has dropped its accusation of China being a currency manipulator.

In the course of the COVID-19 crisis, relations between the United States and China began to deteriorate once again. At the time of writing, no further tariffs have been imposed, although additional restrictions on the use of US technology in Chinese products, in particular Huawei mobile phones, has been introduced.[37]

36 Originally, a sequence of treaties was planned between the US and China. In practice, the name 'Phase One' deal is potentially a misnomer as neither the Chinese nor the US side are currently envisaging further talks at the current time.
37 As of June 23, 2019.

The escalation of the trade war and the increasing confrontation between China and the United States have undermined the ability of the two countries to work together constructively in other areas of economic policymaking. Concerns about China are now more widely shared in US policymaking circles. It is not only the Trump administration that is becoming increasingly confrontational with China. While Trump's policies are controversial even within the United States and a different administration would use different strategic tools, the view of China as a competitor that requires to be met with tough policies has won bipartisan consent.[38] It is, therefore, unlikely that if the elections in November 2019 lead to a new administration, US-China relations would resort to the status quo ante pre-Trump.

3.2.3 The EU and the US-China Conflict

The EU did not join in the aggressive moves of the Trump administration against China. The EU, however, does share many of the concerns about Chinese trade policy practices. It has engaged China at various levels to address these issues through negotiations. These negotiations or consultations are still ongoing. They are now taking place at the WTO, where the EU is increasingly calling for a level playing field and at a bilateral level, in particular in the negotiations about an investment treaty (Comprehensive Agreement on Investment, CAI) between the two. In addition, there is a consultation group, known as the 'trilateral', where the United States, Japan and the EU coordinate their positions with regards to Chinese trade practices. The Trilateral and the CAI negotiations will be discussed in more detail in this section.

The Trilateral

The Trilateral was launched on the margins of the 11th WTO Ministerial Conference in Buenos Aires at the end of 2017, as an initiative between the United States, the EU and Japan to coordinate their positions with regards to Chinese trade practices. Negotiations have been ongoing since.

In January 2020, a joint statement on industrial subsidies and technology transfer was released, calling for a strengthening of WTO rules. They view the current disciplines on subsidies in the WTO Agreement on Subsidies and Countervailing Measures (ASCM) as insufficient and call for the prohibition of unlimited guarantees, subsidies to an insolvent or ailing enterprise, subsidies to enterprises unable to obtain long-term financing through commercial channels and some types of direct forgiveness of debt. Tougher disciplines on subsidies should also come with sanctions in case a country is opaque about the subsidies that it gives out – a nod to the problem of delivering notifications to the WTO on subsidies being handed out. They also call for a revision of the WTO definition of what constitutes a public body.[39]

38 Leung & Depp (2019).
39 Kajiyama et al. (2020), p.1.

On forced technology transfer, they also call for a toughening of the rules. Voluntary, market-based technology transfer is supported and welcomed by the three parties. For enforced transfers, they wish to negotiate tougher WTO rules which can include measures such as export controls, an investment review for national security purposes, respective enforcement tools among others.[40]

The issues covered in the statement cover only part of the controversial Chinese trade policy practices. Nor are the suggested provisions spelled out in detail. This could be a sign that finding common ground between the participating countries has not been an easy task. The statement was meant as a precursor for negotiations to take place before and at the 12th Ministerial Conference, originally scheduled for June 2020 but delayed to 2021 because of COVID-19. Negotiations in the Trilateral continue.

The CAI Negotiations

Bilateral investment treaties (BITs) are fairly common in international relations. Some EU member states already have such an agreement with China but not the EU as a whole. The intention of the CAI would be to replace these BITs with a more ambitious agreement that would cover all EU member states. Unlike with typical BITs, which contain assurances about protection and non-discrimination against foreign investment, the EU hopes that it can address some of the trade policy concerns regarding China through this more ambitious instrument. More concretely, the EU is pursuing the following objectives:[41]

- Provide new opportunities and improved conditions for access to the EU and Chinese markets for Chinese and EU investors. China only allows investment in limited sectors, others are barred off. In most sectors in which investment is allowed, it maintains a joint venture requirement, i.e. foreign investors need to share ownership with a Chinese investor – this is often viewed as contributing to the theft of intellectual property and know how.
- Address key challenges of the regulatory environment, including those related to transparency, licensing and authorisation procedures.
- Establish guarantees regarding the treatment of EU investors in China and Chinese investors in the EU, including protection against unfair and inequitable treatment, unlawful discrimination and unhindered transfer of capital and payments linked to an investment.
- Ensure a level playing field by pursuing, inter alia, non-discrimination as a general principle subject to a limited number of clearly defined standards.

40 Kajiyama et al. (2020), p.2.
41 Based on European Parliament (2020).

- Support to sustainable development initiatives by encouraging responsible investment and promoting core environmental and labour standards.
- Allow for the effective enforcement of commitments through investment dispute settlement mechanisms available to contracting parties and to investors.

Negotiations started as early as 2013, with the scope of the planned agreement settled between the EU and China in 2016. In 2018, China tabled an offer that the EU-side considered insufficient as it did not go much beyond WTO (GATS) commitments. At the end of 2019, both countries agreed to aim at ending the negotiations within 12 months. The German EU presidency had hoped that the conclusion could be reached in time for the EU-China summit planned for the second half of 2020. However, at the end of the 28th negotiation round in April 2020, no breakthrough had been announced. Allegedly, negotiations went better at the peaks of the US-China confrontation and less well once de-escalation settled in.[42]

The CAI is an example of the different strategies adopted by the EU and by the United States to deal with trade policy concerns regarding China. While different US administrations have gradually increased the pressure on China and adopted a negotiation strategy based more on sticks than on carrots, the EU has been trying a more conciliatory approach. While the carrot that the EU has to offer is not particularly large – as Chinese investors already have a mostly unrestricted access to the European market – the EU is asking for China to see sense and make concessions on a number of its policies. We do not yet know for sure which approach will be more successful. The EU negotiations with China on the CAI are certainly lengthy but at least so far not excessively so. Some other complicated trade negotiations have been going on for longer. What is more important is that this evidences that China is willing to address concerns of other trade policy players through negotiations and not strong pressure.

The Phase One Deal the Trump administration obtained from China under great pressure, including measures that harmed the United States, certainly marked progress over the status quo, although not as far-reaching on issues such as market access, intellectual property protection and enforcement mechanisms as some had hoped.

Another route that the United States and EU might try with regards to Chinese trade policy is to bring the issues of concern to the WTO and negotiate in a multilateral (or at least plurilateral context). Such an approach would have the additional benefit of involving a broad coalition of countries worldwide sharing the EU and US concerns. Arguably, it would also be easier for China to make concessions in a multilateral context as this would be more face-saving in the sense that it would not appear to be giving in to pressure from the Trump administration alone. Whether such a multilateral negotiation would be speedy enough to deliver results is another question.

42 Fleming & Brunsden (2020).

The most important point of this section is that the big power controversy between the United States and China is unlikely to go away anytime soon, regardless of the outcome of the US elections in November 2020. This rivalry will persist much longer. The US power play will not stop with regards to China, its allies will be asked to play their role, as they were in the Huawei case. The EU has largely refrained from putting pressure on China, not only with regards to trade policy concerns but also political developments. It is likely that the United States will ask the EU to get more involved *vis-à-vis* China. The EU needs to figure out how it wants to balance its commercial interests in China with its ambition to play a stronger geopolitical role and its relationship to the United States. This is not an easy trilemma to solve.

3.3 PROTECTIONIST POPULISM VS. GLOBALISM

The emergence of China and other formerly developing countries has changed the face of globalisation. Specialisation of production was much more radically Ricardian than in times when most trade (in goods) took place between countries of comparable development levels. This more radical globalisation with the offshoring of many labour-intensive tasks, the emergence of GVCs, deeper competition but also more business opportunities has not been met with universal support. Quite the opposite, in particular in the developed world, support for open trade and embracing globalisation is in many cases weaker than it used to be.

The election of Donald Trump as President of the United States is the most visible demonstration of the rise of a new protectionism. Protectionism or a new mercantilism is on the rise in many developed nations. This is undermining not only the liberal trade policies of individual countries, like the United States, it risks undermining Ruggie's 'embedded liberalism' and the rules-based, free trading system in general.[43]

The consequence is an increasingly stark contrast between those advocating globalisation and those who want to reduce exposure to the rest of the world. Those in favour of harnessing the potential of trade to generate welfare have sometimes been labelled 'globalists', in contrast to the 'protectionist populists'. To some extent, this is a controversy between winners and losers of globalisation but that is not the only explanation. Other factors, such as identity, also play a role.[44] According to Tabellini (2019), the conflict between protectionist populism and globalism is gradually replacing the traditional left/right framework of politics as the defining conflict of the 21st century. It opposes more nationalist and socially conservative sentiments to a more cosmopolitan and socially progressive perspective.

43 Ruggie (1982).
44 Noury & Roland (2020).

As the Trump years have shown, this conflict has consequences for trade policy and economic policy in general. If a country wishes to maintain a liberal trading regime, it needs to find ways to shore up any domestic consensus on engaging in trade activities. This is becoming more difficult in a more polarised environment in which trade policy increasingly commands political attention. Trade has become more politicised. A new trade strategy needs to reflect on how to build a domestic consensus on open trade. This should be flanked by other economic policies that will be briefly sketched below.

3.3.1 Polarisation of Societies and the Consensus on Trade

Trade economics has established that while trade is overall welfare-enhancing, it has polarising effects on the domestic welfare distribution.[45] In other words: Most people gain from trade but some lose. A common suggestion is that an optimal strategy would be to use some of the gains from trade to compensate the losers and then everyone would be better off. Recent research, however, shows that inequality within countries is rising which is partly attributed to increasing globalisation.[46] Hence, such redistributive mechanisms are not working well enough. The result is more polarised societies and concomitantly a diminishing consensus on trade.

What is causing the backlash against globalisation? Several hypotheses have been suggested: increasing polarisation due to the uneven distribution of the positive and negative consequences of globalisation, an increasingly limited ability of the nation state to act and possibly a concern about the weakening of national identity.

The increasing polarisation caused by globalisation and its consequences have already been sketched out in the introductory paragraph to this section. Trade brings with it gains, in the form of access to more and cheaper goods by consumers and increased export possibilities for producers. It also means more competition. In general, this is a desirable effect because it forces companies to modernise and enhance their efficiency in order to remain competitive against foreign rivals. In some areas it is impossible for companies to achieve sufficient competitiveness. A good illustration of this is the decline of textile production in developed economies. This was in fact so much cheaper in the developing world that only small niches of the textiles industry survived within developed economies once protection through tariffs was withdrawn. This is just an example that illustrates efficiency-enhancing specialisation. It is not problematic, so long as the people employed in textile production enjoy the opportunity to switch to employment in expanding sectors – to be no longer the losers from trade, but join the winning side. There is now ample research showing that incomes globally are increasingly polarised.[47]

45 e.g. Ohlin (1967) for a theoretical motivation the overall gains of trade and Stolper & Samuelson (1941) for the polarising welfare effects. A more recent empirical investigation on the gains of globalisation is available in Weiß et al. (2018) and Bertelsmann Stiftung (2020).

46 Lang & Mendes Tavares (2018).

47 Excellent research on this has been undertaken for example by Milanovic (2018). How rising import competition, in particular from China, has negative effects concentrated in specific locations and industries is shown in Autor et al. (2013)..

There is an increasing perception that switching to the winning side is becoming harder and a rising anxiety about negative side-effects of globalisation. The increasing polarisation of society is a prominent concern. In a recent survey by Arregui Coka & Rausch (2020), which covered both developed and developing nations, the views of respondents on globalisation and its effects were nuanced and mostly in line with economists' predictions – for example, they valued the access to cheaper and more plentiful goods, the economic opportunities coming with globalisation, etc. When it comes to the effects of globalisation on society, they believed that it contributes to social polarisation as it is benefitting large companies more than small ones, more people in cities rather than those in rural areas, the young more than the old, the rich more than the poor.[48] The share of people viewing globalisation as a force for good decreased considerably between the 2018 and the 2020 edition of this survey.[49]

The unequal distribution of the gains of globalisation is problematic going beyond concerns about social cohesion. Populism is essentially a form of politics that gives up on welfare maximisation. While traditional political parties compete on the ground of different strategies to enhance well-being, their policies aim at making society as a whole better off. They make different offers as to which groups will benefit most from their policies but do not abandon the aim of overall welfare improvement. Populist parties are not pursuing welfare maximising policies. At best, they aim at improving the welfare of their constituency while damaging the welfare of other groups. But in many cases, they are not even certain that their proposed policies are beneficial for their own electorate. Trump's trade policy is a good illustration in point: his trade war was costly for the United States as a whole, as well as on trading partners. The trade war with China, the tariff increases on various goods or the renegotiation of some US trade agreements have not even benefitted his base.[50] Traditional rational voter models cannot explain how and why Trump could be elected with such a policy vector. One possible explanation comes from Tabellini (2019), who argues that in parts of the electorate which feel they have insufficiently benefitted from specific policies, there is a large acceptance of risk, as they feel things cannot get much worse. As a result, they are willing to try policies unlikely to benefit them but may still be better than more of the conventional policies that they feel of no benefit to themselves. The result of polarisation can be a less rational form of politics that is in fact detrimental to overall welfare.

Another hypothesis about the populist backlash is the increasing frustration about how globalisation limits the ability of the nation state to act. This can come either through outright international legal provisions that rule out certain actions or from fears that certain actions might harm international competitiveness and therefore do not constitute a viable path even if they are not formally outlawed. The EU as well as many other

48 Arregui Coka & Rausch (2020), p.18.
49 Arregui Coka & Rausch (2020), p.10 and Bluth (2018), p.6 and p.9.
50 Gertz (2020). Interestingly, Arregui Coka & Rausch (2020) find that among US Americans, 37% believe that Trump's trade policy has been beneficial while 39% believe it has not been beneficial..

countries have entered obligations through the WTO or bilateral commitments to refrain from certain trade policy actions. Such rules are in place for good reason as they prevent countries from putting in place policies that benefit their own economy to the detriment of others and thus help the stability of the system. A case in point would be the TTIP negotiations, where worries about the ability to block genetically modified food produced in the United States from entering the EU were a major motivation for opponents.[51] As Arregui Coka & Rausch (2020) show, there is a limited willingness of people to engage in international cooperation in rulemaking. While overall 62% believe that the WTO is an important organisation, more people are in favour of maintaining the ability of the state to set trade policy rules independently rather than subscribing to a binding set of rules.

Finally, there is the hypothesis that globalisation has undermined national identity and that populism as a backlash against globalisation is triggered by a determination to reaffirm that national identity. This argument usually relates less to trade and more to other dimensions of globalisation, in particular migration, which is highly controversial in many countries.

An element that contributes to the erosion of the social consensus on openness for trade, which is one not directly linked to populism nor addressed by the measures outlined to far – is the perception that trade is often characterised by a blatant disregard for agreed social values and norms. The opposition to TTIP or to the EU-Mercosur trade agreement was to a large extent driven by a perception that these deals run counter to widely shared societal norms. In the case of TTIP, a widespread fear was that agricultural standards would be undermined, together with labour standards. In the Mercosur trade deal, concerns whether this would be conducive to eco-sustainability were particularly prominent. What these two examples illustrate is that societies in EU member states are no longer satisfied if the pursuit of trade policy is simply prosperity.

This is a development that trade policymakers must take seriously. The appointment of an EU Trade Enforcement Officer who will make sure that trade partners respect the obligations they entered into with the EU is an important step in this regard. It proves that trade does not ignore issues of normative importance, as some critics have sometimes alleged. In fact, it may help to give trade agreements a stronger normative power.

A deeper reflection on how trade can become a stronger force contributing to better norms, standards and good governance is a logical consequence. How can normative influence be brought to bear in the most efficient way? It makes sense to evaluate which norms have the most positive effects. It may also be worthwhile helping less developed trade partners to create the necessary administrative capabilities for enforcing any obligations that they enter into.

51 Bluth (2016).

While there is a risk that potential trading partners will now find trade negotiations with the EU even more cumbersome, this is a risk worth taking in shoring up domestic support for trade and openness. EU policymakers should actively monitor the trade policy consequences of a stronger normative influence. If the EU accordingly finds it harder to conclude new trade deals while countries that have less stringent demands on their trading partners are capable of enlarging their network, this can pose problems for EU competitiveness – and it would not help the normative agenda either. If in practice a trade-off between normative influence and competitiveness emerges, the EU should think of how to address this challenge, such as longer phasing-in periods, more active capacity building, etc.

The increased doubts about the positive effects of trade along with the polarisation in views on globalisation and support for free trade is problematic for trade policy. If consensus that trade is worth embracing is eroding, it will be much more difficult to implement effective trade policies and to harness the welfare potential of trade.

3.3.2 Globalisation and Social Cohesion

What policy options exist to address some of the root causes of populism? The core is to address the distributional effects of trade policy more effectively. The question then is how to address them most appropriately. The US Trade Representative, Robert Lighthizer, has argued that trade policy should perform this function by repatriating parts of the value chain and restoring industrial employment.[52]

I argue that this is primarily the task of social cohesion policies, not of trade policy. The welfare state allows one to keep the advantages of an open economy while addressing the downsides. Thus, it is able to support the social consensus on open trade that is so important. A well-developed welfare state is not only a redistributive mechanism it also provides insurance against economic shocks and facilitates the transition from one sector to another through retraining programmes. The link between a strong welfare state and the social consensus on open trade has been made for example by Lindbeck (1977). Empirical evidence shows that in fact trade openness and the development of the welfare state used to be closely associated.[53] The support for trade and globalisation is also higher in countries with strong welfare states. But this link has weakened over time: While Cameron (1978) finds a strong and positive correlation between openness and the size of the welfare state, Rodrik (1998) and Bluth (2017) show that this relationship has disappeared over time.

As discussed in more detail in Bluth (2017), the welfare state is important in the context of globalisation, as it provides insurance against shocks imported from abroad, redistributes unequal gains from globalisation, can play an important role in stabilising the economy

52 Lighthizer (2020).
53 Cameron (1978).

during a crisis and help parts of the workforce to transition from less competitive to more competitive sectors. With an increased frequency of economic crisis, these functions of the welfare state become increasingly important. But the welfare state has been unable to keep up with globalisation.

If one is to deal with the backlash against globalisation, reinforcing the welfare state is essential. Even more so, as the effects of automation and climate action in many cases resemble those of the offshoring of labour intensive work and could create a similar backlash. This is not an easy task, as there are strong fiscal constraints on expanding the welfare state. Much of this strengthening will hence have to come from efficiency gains rather than any increase in dedicated resources. So, it makes sense to focus on specific regions in which impacted industries are clustered as well as on retraining and education.

An illustration of a programme that has a promising design is the EU's Globalisation Adjustment Fund (EGF). This programme targets regions specifically hurt by the relocation of economic activity. It aims at facilitating transition and building up new sectors. While evaluations of this programme have been positive, a legitimate criticism is that the financial resources dedicated to it are too small to allow it to have a significant impact.[54]

If the antagonism between pro- and anti-globalisation forces is becoming the defining element of political discourse in the same way as left/right antagonism was for the 20th century, this makes trade policy much more complicated. Trade policy is highly technocratic and complex. This complexity clashes with the simplifications and stark policy choices that come with politicisation. If the pursuit of welfare gains is to remain the principal function of trade policy, it is vital that one shifts the debate from an antagonism between globalism and protectionism towards a serious discussion about how the social imbalances that globalisation has created within countries can be addressed most effectively. While it is possible to design a trade policy that minimises the erosion of social cohesion, such a policy would only be possible at the expense of overall welfare. Trade policy should be dedicated to welfare generation, and more effective tools, such as a stronger welfare state, should be used to address distributional questions and to foster social cohesion.

3.4 SOVEREIGNTY VS. MULTILATERALISM

Trade policy must also respond to the emerging antagonism between the reaffirmation of national sovereignty and coordination of policymaking at the supranational or intergovernmental level, which often results in rules that constrain the nation state's set of policy options. As discussed in the section covering 'embedded liberalism', the Bretton Woods system was created out of distrust of uncoordinated domestic-focused

54 Claeys & Sapir (2018).

policymaking because of experiences in the interwar period. Since the inception of the Bretton Woods system, international cooperation has known only one direction: it expanded in scope and in depth. This trend is coming to a halt. Instead of calls for international policy coordination, calls for sovereignty and a reaffirmation of national decision making are dominant.

Perhaps the most striking example is comparing the response to the COVID-19 crisis to that of the GFC. In the GFC, governments coordinated closely in the G20 and quickly formulated a stimulus programme to relaunch the global economy and while agreeing to refrain from protectionist measures or privileging domestically produced goods within this programme. None of this can be seen in the COVID-19 crisis. Nor is there any strong and meaningful joint initiative of the G20 economies – or another global forum – to relaunch the economy, let alone effective action to prevent protectionist or domestic-privileging trade policy actions.[55]

This is only the most visible example of the state of international cooperation. International policy coordination and cooperation is not advancing anywhere. At best it remains stagnant. The IMF and the World Bank, for example, remain strong international institutions, capable of decisive policy action.[56] Yet the IMF has been accused of a pro-European bias in the European debt crisis and overly harsh conditionality in its adjustment programmes. At the same time, China has overtaken the World Bank as the largest lender to developing countries.[57] The condition of other international organisations is much worse: The WTO is losing credibility as a forum for effective trade policy rulemaking. The role of the UNFCC Conference of Parties (COP) in climate governance has been damaged by the announced withdrawal of the United States and from the lack of commitment of many parties. The WHO has found itself embroiled in severe criticism for its management of the COVID-19 crisis. This list could easily be expanded.

The main reason why international policy cooperation is faltering is the lack of leadership and the dispersion of power. The Bretton Woods institutions were very much led by the United States, even after the breakdown of the system of fixed exchange rates in the 1970s. Even in the GFC, US leadership was very much present and helped to formulate an international policy response. Under Donald Trump, the United States retreated from international leadership and did little to shore up the institutions in which previous US administrations had invested so much political capital.

No other power has stepped forward to fill the leadership gap – and it is far from certain if any of the other large players would have the political clout of the United States. The European Union has shown important initiatives in some areas, for example in the WTO, by trying to find solutions or workarounds for the Appellate Body crisis. Within the WTO

55 An excellent account of the GFC and the policy response at the global, European and national level is provided by Tooze (2018).

56 One might even go as far and argue that they have been strengthened in the COVID-19 crisis as an expansion of their resources was decided early on.

57 Horn et al. (2019).

system, coalitions of members, such as the Ottawa Group, have also taken initiatives in certain areas.[58] In the absence of big power leadership, coalitions can act as a surrogate in driving business forward and preparing the ground for more favourable political conditions.

What would happen if the United States – possibly under a different administration returned to international policy cooperation? It is unlikely that the situation would be comparable to that preceding the Trump administration. That is partly to do with the fact that the United States is losing economic weight *vis-à-vis* emerging economies, most importantly China. It has also lost credibility and political capital with its allies due to the actions of the Trump administration. Critical, however, is that any commitment of the United States to international policy cooperation cannot be reliable in the long run. This has to do with a domestic political economy that is not unique to the United States but particularly pronounced there: the extreme polarisation between the political camps and what they stand for. The antagonism between sovereignty and multilateralism is the logical continuation in the international sphere of the protectionism vs. globalism antagonism in domestic politics. The calls for greater resort to unilateral action – not only in trade but virtually any policy area – are particularly strong in the United States and will not go away with a change of administration. Even under an administration committed to multilateral/plurilateral policy cooperation, the specific constraints imposed by the domestic political economy would persist. This has two implications: First, an administration can only show commitment to international policy cooperation if it can prove that it works – otherwise domestic political competition will force it to move more in the direction of unilateral action. The second implication is that even if international policy cooperation can be pursued successfully, it may well be that a future US administration will revert to prioritising sovereignty and unilateral action instead, as a matter of political preference. As a consequence, the United States will not be as reliable a long term international leader as in the past. The United States will likely switch its international leadership on and off, depending on the policy preferences of the administration and the dynamics of the domestic political economy.

This situation is not unique to the United States; similar political economy conditions will be likely in several countries in the world. In the United States, it will be the most consequential because of the strong leadership role that the United States used to have internationally and the weight of its economy. But other players, too, will move to and from between an emphasis on national sovereignty and international policy cooperation. The EU is not immune to these kinds of political dynamics. Brexit is an extreme example of the consequences of a rebalancing between sovereignty and international cooperation. But the EU as a whole has proven itself more stable than other players: while protectionist

58 The Ottawa Group brings together Australia, Brazil, Canada, Chile, the European Union, Japan, Kenya, South Korea, Mexico, New Zealand, Norway, Singapore and Switzerland. The group has fostered discussions on the reform of the WTO. This initiative serves here as an example that groups of smaller, likeminded countries try to assume leadership in certain areas.

tendencies exist at member state level as well as in the European institutions, they haven't dominated the political discourse as in other countries. This is partly because the – in international comparison – well developed European welfare states cushion some of the negative effects of globalisation and automation but also because multiple checks and balances exist between EU institutions and member states which makes it difficult for protectionist policies to dominate. This stability and the international reliability that comes with it can be an asset of the EU in future.

3.4.1 A More Affirmative Policy Response

The antagonism between sovereignty and multilateralism has implications for how international policy cooperation will be pursued. As mentioned before, one criticism of international policy cooperation that feeds into populist protectionism is that it is too slow and its rules sometimes too constraining or hard to reform once they have become inadequate. Especially among the long-standing trade policy concerns *vis-à-vis* China, the inability of international policy cooperation to deliver solutions and the populist backlash are a case in point.[59]

There is a first-best and a second-best response to that problem. The first-best solution is improved ways of putting in place international cooperation and is discussed in more detail in the next subsection. As such measures alone are not going to solve the underlying issues, it is likely that we will also see greater use of the second-best solution: a more affirmative unilateral policy response.

If protectionist populism is continuing to be a menace to mainstream political parties in many countries, then proving the ability of the state to act and to regulate is a must. As a result, patience with international policy cooperation will be shorter. International negotiations are likely to be carried out in a more robust way, with temporary national decisions regardless of ongoing negotiations or threats of unilateral action if agreement cannot be found. The consequence may very well be more difficult negotiations and more grandstanding to domestic audiences.

Beyond posturing, this has implications for policymaking. Trade policy negotiations tend to take place over long timespans. In the GATT system, the Tokyo Round took six years to complete and the Uruguay Round eight years. With bilateral negotiations of the EU, CETA took five years to negotiate, the EUJEPA a little over four years and TTIP was suspended after a little over three years of active talking.[60] This is acceptable in cases – such as FTA negotiations – where both parties agree in principle on a positive policy agenda and only the right balance has to be teased out and technical difficulties resolved. It is less acceptable in cases where the substance is removing an imbalance, causing a

59 Again, important to bear in mind the studies by Autor et al. (2013) as well as follow up studies that show similar results for countries beyond the United States, including the UK and several EU countries.

60 Note that the timespans provided here are for actual negotiations. The timespans before provisional or full application can be considerably longer.

severe disruption in at least one of the trading partners. Where a partner's discriminatory trade policy is causing significant economic disruption, the patience of the EU cannot be unlimited.

The EU should continue to engage in international policy cooperation and to shore up support for doing so. Globalisation may change in character but it will not disappear. As long as the world is closely interconnected, cooperation is indispensable for finding effective solutions for common challenges. This is particularly true for any kind of problem that is too large for one player to solve alone: climate change is a case in point, but also the response to an economic crisis or a pandemic.

3.4.2 A More Flexible and Efficient System of International Cooperation

While the need to prove the ability of the state to act remains important, the more promising route to achieve results is to change the way international policy cooperation is carried out in trade policy. This concerns in particular the WTO system, where too many veto players with very diverse interests prevent the system from being modernised and moving forward. Currently, the WTO operates by consensus, which is obviously a difficult enterprise with 164 member countries.

There are basically two possibilities for taking the system forward: one is through increased use of voting and a departure from the consensus principle. This option is permitted within the rulebook although not actually practiced.[61] Here the problem of veto players would be overcome by stripping the individual members of their veto power. The other possibility is to operate increasingly on the basis of plurilateral cooperation, i.e. only a subset of the membership would proceed and not everyone need be party to an agreement for it to enter into force. Consensus would still be required but only among those members who engage in this plurilateral cooperation. The number of veto players is reduced but those who are part of the agreement retain their veto power.

The reason why the WTO operates by consensus even if voting is formally allowed is because the member states fear that riding roughshod over the concerns of others will undermine support for the institution as a whole. Also, any member state might find itself on the losing side in an important vote, a position that is uncomfortable for many policymakers. Voting would increase the risk of a backlash against international policy cooperation. Operating by consensus on the other hand provides an insurance that the concerns of any member state will not be completely ignored. Therefore, a complete departure from the consensus principle and an increased resort to voting is neither likely nor desirable. A possible exception might be cases in which there is virtual consensus with only a few members objecting. In such cases, recourse to voting might be considered, as some observers have suggested, in efforts to resolve the Appellate Body impasse.[62]

61 GATT Article XXV.5.
62 Vidigal (2019).

Since such voting would likely only be politically viable in a small number of cases, it makes more sense to turn to the other promising route: cooperation among subsets of the membership.[63]

The advantage of proceeding in this way is that the sovereignty – or veto power – of the participating countries remains intact. Nothing will be done unless a party to an agreement consents to it happening. However, the system is still more likely to advance, because the subsets of the membership are smaller – hence have fewer veto players – and possibly more homogeneous, i.e. more likely to have converging interests. The idea for such cooperation has been advanced by Hoekman (2018) and subsequently fleshed out in greater detail in Hoekman & Sabel (2020). A cooperation of this kind would not only be plurilateral, it would also be open in the sense that other WTO members who are not original signatories are free to join later on. The agreement between the parties would also apply on an MFN-basis, i.e. that non-members can take advantage of the agreed substance in their dealings with members of such an initiative. The advantage of these two features is that this prevents too strong a fragmentation of the multilateral trading system. The application on an MFN-basis is also a limitation. As free riding is possible, such cooperation will mostly take place in areas where the effects of free riding are limited and only if all the major players are on board. A variant of such a system could therefore be a plurilateral cooperation on a discriminatory basis, although it would be difficult to ground this in the WTO as such cooperation is not foreseen by the treaties.

This more flexible route to WTO trade policymaking is now being tried with the joint statement initiatives (JSI) in e-commerce, investment facilitation, fisheries subsidies and domestic regulation. None of these initiatives has been brought to a successful conclusion yet. They have, however, had an invigorating effect and drawn new attention to policymaking at the WTO. Further initiatives on this basis, for example on subsidies or carbon pricing, could theoretically be envisaged. The proof that such negotiations do indeed allow one to shift the trade-off between scope of application and speed/likelihood of conclusion favourably is still out there. Once the viability of such an approach has been proven, it makes sense for an actor like the EU to engage more in proceeding in such plurilateral open way.

Next to making international policy cooperation in trade more flexible and overcoming deadlocks, another strand worthwhile exploring is to make it more efficient. Efficiency gains can be found in a number of ways. For example, with regards to the controversy on the effects of industrial subsidies, Wolfe (2020b) has suggested engaging in a thorough analysis of how far different types of subsidy truly entail competition-distorting effects. The basic idea behind this is that in earlier negotiations about agricultural subsidies, it was much easier to agree on disciplines once the economic effects of different types of

63 If voting took place in the WTO, every country would have one vote. Other international organisations where voting is more common sometimes have other voting mechanisms. In the IMF for example, voting shares reflect a member countries' quota. In theory, it would be possible to devise a system, where voting is weighted by trade share or some other metric. However, even in that case, the downsides of voting outlined above would persist.

subsidies were clearly established, along with information about which trade policy actor made use of them and how far. It might make sense to mainstream this approach, not only with regards to subsidies but various controversial policies in trade policy in general. As member states typically find it hard to agree to embark on such a fact finding mission, the WTO Secretariat should be granted the right of initiative in such areas.

Another way forward is to use little tweaks in the way WTO committees currently work in order to make the agenda more forward looking and ambitious.[64] Further, a regular 'Trade Policy Review of the System' in which an independent evaluator scrutinises the policymaking processes at the WTO seems a promising way to enhance the body's efficiency.[65]

Ideally, such a process of WTO reform would enjoy buy-in from the highest political level. With such a commitment from the main players, it would be easier to give such a process momentum. Garcia Bercero (2020) suggested that a formal WTO reform agenda should be launched through a joint effort by the political leaders of the main trading powers. Such a step would be more than a symbolic gesture, it would reaffirm the importance of the WTO.

If the flexibility and efficiency of international policymaking cooperation is enhanced, this should entail a return of important players to the system. If results can be obtained through cooperation and these prove to be more effective than unilateral measures, investing political capital is a sensible strategy. It might also reduce the preference for unilateralism and desire for the reaffirmation of sovereignty if cooperation proves a more effective remedy for policy concerns. Associated with this is a kind of Catch-22 problem: In order to be effective, global governance needs buy-in from important actors. Without political buy-in from said actors, it is unfortunately almost impossible to improve the efficiency of the system. Global leadership can make a difference. The EU does not have the strength that the United States would bring to the table, but it is an important, credible and reliable actor. If the EU can assume leadership in some areas, possibly in coalition with like-minded countries, it can bring innovations to international policy cooperation and help improve the system.

3.5 THE EU AS AN INCOMPLETE ACTOR

In the previous sections of this chapter, I have described political megatrends that have strong repercussions on the nature of trade policy and global governance. An underlying feature is that these policy fields are likely to be more politicised and even more likely to be incorporated into geostrategic policymaking. For the EU this is a challenge, because the EU is currently not fit to be a fully-fledged geostrategic actor. While trade policy has been shifted to the European level, the member states remain the chief actors in geopolitical

64 Some ideas have been presented in Wolfe (2020a).
65 For details of this proposal, refer to Wolfe (2018) and Hoekman (2018.

and many geoeconomic areas. In that sense the final antagonism to be discussed in this chapter is that between EU and member state institutions, where the challenge is to find an appropriate mix of competencies between them.[66]

3.5.1 The EU as Trade Policy and as Foreign Policy Actor

A geostrategic actor should be coherent and unambiguous in its relations. Coherent implies that different elements of foreign policy – trade, security, development, etc. – serve the same overarching strategic objectives. Unambiguous means that different actors send the same message with regards to their foreign policy intentions, that there are no internal divisions about the aims being pursued – or if there are, they are not visible to other foreign policy actors. If a foreign policy actor sends an ambiguous signal, other actors can exploit this ambiguity and use the internal divisions to confuse policymaking and/or apply a 'divide and rule' tactic.

For the entirety of its foreign policy areas, the EU does not meet these two criteria, which is why I characterise it as an incomplete foreign policy actor. The Lisbon Treaty (TFEU) delegates the executive authority for some foreign policy areas to the Commission but retains it within the member states in other policy areas. The External Action of the EU brings together the Common Foreign and Security Policy (CFSP), the Common Security and Defence Policy (CSDP) plus the areas of the pre-accession process of the EU candidate countries, the European Neighbourhood Policy (ENP), foreign trade and development policy. For the policy areas outside the CFSP and the CSDP, the executive is the Commission. The CFSP as well as the CSDP are organised in an intergovernmental way, i.e. the executive authority remains with the member states which decide on CFSP/CSDP matters (as a rule) through unanimity. The High Representative/Vice President is often, by and large, a coordinator between the different EU member states, with the aim of putting together a common position.[67] In the other areas, qualified majority voting (QMV) is the rule.

As a consequence, the European Union is not always coherent or unambiguous in its foreign policy. One could argue that it is sufficient that foreign policy is carried out by member states and that the EU should serve primarily as a platform for coordination. Member states have of course established domestic mechanisms in place to design and implement coherent foreign policies. But the individual member states – while not exactly powerless – do not have the political weight that a more unified EU foreign policy actor could contribute. So, often, the EU sends ambiguous signals in its foreign policy interactions and the policies of its member states often lack coherence.

66 This is of course not an antagonism of comparably stark nature as those previously discussed, yet the transfer of power from the member state to European level is never without controversy.

67 Based on Auswärtiges Amt website and European Union (2009).

For those policy areas where executive authority lies with the European Commission, the coherence and unambiguity criteria are generally met. A good example is the Brexit negotiations, in which the British side had originally hoped to be able to exploit differences in policy positions between the member states. However, the Commission exclusively managed the negotiations and no side-negotiations with member states took place. Nor did member states visibly diverge from the official and jointly agreed position.

A contrary example is the relations of the EU with China's BRI: Some member states have signed a memorandum of understanding with China while others have not. There is no common position with regards to this important policy initiative.

These two examples also show that it is sometimes hard to draw clearly defined boundaries for those policy fields that are under EU authority and those that remain with the member states. For example, while it is up to the member states to decide whether or not to join the BRI, de facto, this has implications for their involvement in trade and investment with China. This difficulty in defining clear boundaries is also found elsewhere. For example, some member states carry out a variety of policies that have bearing on their trade policy performance, such as domestic industrial policy – also experiencing a revival – along with export financing, government guarantees and support for participation in public tenders of third countries, etc. The list is long. Much of this may be unproblematic in practice but, at least potentially, it could contribute to an erosion of the coherence and unambiguity of EU policies.

A clear downside of intergovernmental policymaking in CFSP and CSDP is that if unanimity does not exist from the outset, building a consensus can be time-consuming and often means agreeing only on the smallest common denominator. This limits the possibilities of the Union as a foreign policy actor where swift decision making and the capability to take a decisive task are often essential to achieve policy outcomes and to be perceived as a meaningful policy actor.[68]

As discussed in Chapter 1, Commission President Ursula von der Leyen has labelled her Commission the 'geopolitical' Commission, which implies among other things a stronger role for the European Union in foreign policy and streamlined decision-making mechanisms – such as QMV in foreign policy – to enable it to play this role. Whether the member states are willing to transfer more competencies in this important area to the European level is not clear. On the one hand, there are growing calls from the member states for the EU to become a more complete foreign policy actor.[69] On the other hand, concrete policy proposals to this end are not currently under discussion.

As a result, it seems likely that von der Leyen will have – at least for the time being – to articulate the geopolitical character of her Commission through the policy areas in which she and her commissioners do have executive power. The policy areas of accession and the

68 Weiss et al. (2017).
69 e.g. Macron (2019).

neighbourhood policy as well as development have a significant geopolitical character. With regards to other big powers and the geoeconomic nature of big power competition in today's world, trade policy will have to play an important role in making the EU a geopolitical, or perhaps more to the point, geoeconomic actor.

3.5.2 The Geopolitical EU in a Geopolitical World

The increasingly geoeconomic nature of globalisation and big power competition is as big a challenge for the European Union as an institution as it is for its member states. The EU could potentially become a foreign policy actor with considerable weight, if the institutional setup of foreign and security policy were changed in such a way that the EU Commission or the European External Action Service (EEAS) can act more like an executive. Such a step would, however, require more than just a reform of decision making mechanisms, it would also have to provide the European institutions with the means to carry out foreign and security policy.

As it does not seem likely that such steps will be taken in the foreseeable time, it is worth thinking about the best ways that the EU can increase its geopolitical and geoeconomic leverage with the means currently at its disposal. It also means talking about effective ways to compensate for the current institutional shortcomings and make the EU a credible foreign policy actor.

Let me first turn to the policy areas in which the Commission can act with executive power, in particular pre-accession negotiations, the ENP, development and trade. It would be over-ambitious for this text to aim to provide a coherent strategy for each of these areas. But it does seem that the EU is facing geostrategic competition in these areas and is unable to deal with this challenge very effectively. In the ENP, Russia has successfully undermined some EU policies directed towards its Eastern neighbours. In the Balkans, where most of the EU's accession candidate countries lie, China is becoming increasingly active. While the EU and its member states disburse more development aid to BRI countries, the results are less visible than those that China achieves with its BRI strategy.[70] What these examples show is that the EU needs to become a more effective geostrategic actor and find ways to react more effectively other players' activities in areas of strategic interest. Geoeconomic tools can play an important role in this strategy. Since the Commission has an executive role in these areas, the lack of adequate decision making mechanisms is not the main reason for the lack of achievements here.

The question of how the EU can address its institutional shortcomings as a foreign policy actor is perhaps more pressing. Institutional reform would be the most promising avenue, but this does not seem to be likely in the short term. If this is indeed the case, then the challenge becomes how the EU can achieve more coherence and less ambiguity in its foreign policy. If a proper solution is not in sight, which workarounds could be explored?

70 Taube & Hmaidi (2019).

What is required is something that focusses minds in the member states and provides direction for a commonly pursued policy. This could be an alliance or close coordination with another likeminded and powerful player – which could be only the United States. Pursuing a common geoeconomic strategy with the United States would make sense in principle, as most trade policy concerns are shared by the EU and the United States. They also have a similar normative conception of how the global trading system should work and both are concerned with China bending the rules in its favour. The United States also has the power to whip some EU member states into line, which is something that even leading EU member states or the Commission do not have. This option will be explored further in the next chapter. Obviously, this is not a project that could sensibly be undertaken under the current US administration but its prospects might improve under a future one.

Currently, the EU seems determined to position itself as an independent actor in global geostrategic competition. This is a risky enterprise, given that especially *vis-à-vis* China, the EU struggles to find a coherent position among its member states.[71] The EU may find itself in a position where urgent and decisive foreign policy action is required but unable to make the decision. Since the weakness of EU foreign policy decision-making is known to foreign actors, there is an increased risk that this weakness could be exploited. With a more streamlined foreign policy decision-making mechanism, the EU's chances of being a more independent actor would improve but the question remains whether even in such a case, it might be better to leverage bargaining power through an alliance.

Another option for the EU could be to consciously refrain from geoeconomics of any kind. This would not only resonate with the abilities that its current institutional setup confers upon the Union but it would also correspond to its liberal DNA. An EU that is deliberately neutral in big power competition and clearly states an interest in market-based economic relations alone might be an attractive trading partner, as other powers will not have to worry whether the EU is going to use geoeconomic tools against them. This can give the EU a competitive edge *vis-à-vis* other economic players. However, it also leaves the EU exposed to the dangers of all neutral powers: Neutrality only provides protection as long as it is recognised by other parties. If neutrality is not respected by other parties, neutral players are particularly vulnerable. Therefore, it is also questionable whether geoeconomic neutrality is the best course of action for the EU.

The plethora of political megatrends and complicated interlinkages between domestic politics in the EU's partner countries and their foreign policy pose considerable challenges for the EU. The world is becoming more geostrategic and relations between large foreign policy players more confrontational. The use of geoeconomic tools plays an important role in this new type of big power competition. Given its size, the EU should be a strong and relevant player. But it can only perform this role partially, since the division of power between the EU institutions and the member states themselves leaves crucial foreign policy powers with the member states.

71 e.g. Lungu (2020).

CHAPTER 4

Elements of an EU Trade Strategy Fit for Global Megatrends

This final chapter is meant to bring all the loose ends from the previous chapters together. Along with the discussion of different megatrends and the challenges they pose for the European Union, I have sketched out different options available to the EU to respond to these challenges. This is now the place where I develop a suggestion as to how these different options can be put together in a coherent way.

To do this, I will first return to the question of which strategic objectives the EU should pursue in its trade policy. Second come some reflections on the role of risk management in EU's trade policy. Third, I deal with the questions that ended the previous chapter: how should the EU position itself in an increasingly geoeconomic/geopolitical world and what kind of relations the EU should seek with other important trade policy players.

4.1 WHICH OBJECTIVES SHOULD THE EU PRIORITISE?

The reflection on trade policy in this book began with the objectives that trade policy should pursue. In Chapter 1, I identified prosperity, resilience, competitiveness, sustainability, normative influence and diplomacy as potential objectives of trade policy. In my analysis, I concluded that the current EU trade strategy, *Trade for all*, predominantly pursues the objective of prosperity. While other objectives, such as sustainability or competitiveness appear, they are clearly of minor importance when compared to the overall objective of prosperity.

Since 2015, when *Trade for all* was published, the world has changed considerably. In particular, geoeconomic globalisation has become a serious rival to the liberal globalisation that has marked Western democracies for several decades. This is perhaps the most important change in the trade environment, but it is far from the only one. The consequence has to be a rethinking of how trade policy is accomplished and which objectives ought to be prioritised.

Putting trade policy at the service of increasing prosperity should still be a priority. It should not be forgotten that many European countries have a 'business model' in which trade plays an important role. It is also impossible to generate a social consensus on engaging in trade and remaining an open economy if trade is not economically beneficial and these benefits are not widespread. Trade is also an engine for resilience and competitiveness, contributing to making European companies more innovative, competitive and diversified. Finally, if trade does not prioritise prosperity, there will be less incentive to engage in trade activities which would reduce the leverage that trade has

in the other fields discussed above: sustainability, normative influence and diplomacy. Therefore, prosperity should be accorded the top priority as an objective also in any new trade strategy.

However, the changing nature of globalisation means that the manner in which prosperity and economic opportunity are pursued change too. An underlying feature derived from the political and non-political megatrends discussed above is that uncertainty is rising. This means that while the search for efficiency is still an important element of the pursuit of prosperity, it has to be complemented by an increased effort to contain the various risks from which uncertainty arises.

That implies boosting the importance of resilience, or the ability to weather and recover quickly from shocks. Trade can increase exposure to shocks but it can also provide means to recover from them and to limit exposure single-source ones. How the EU can inject a systematic approach to risk management into its trade strategy will be the subject of the next section.

Given the rising importance of geoeconomics, the EU cannot stay out of this game. That means that the objectives of normative influence and diplomacy also gain in importance, in particular in the context of a 'geopolitical Commission'. Some might argue that rising risks and geoeconomics should be met with a strategy aimed at sovereignty or self-sufficiency. The idea is that vulnerabilities from outside would be drastically reduced. I would caution against such an approach. Self-sufficiency or politically-induced reshoring is bad risk management and a bad economic strategy. It would leave firms completely exposed to domestic risks while reducing its ability to balance them with engagement in foreign markets. An emphasis of sovereignty risks going in a similar direction. If it means that interdependencies are to be reduced because of a fear that they might be weaponised, beware of other countries doing the same. Interdependencies are vulnerabilities but since they work two-directionally, they are also an assurance of non-aggression, as long as they are more or less symmetric. Symmetric interdependencies are in fact the best guarantee of geoeconomic stability. In addition, it is possible to harness the positive effects of international economic integration. Strategies around self-sufficiency or sovereignty risk de facto becoming strategies of neo-mercantilism which will invariably generate a backlash from trading partners. This would destabilise trade relations and the prosperity objective. The EU needs to be aware that its actions have consequences for the global trading system.

Normative influence is not only important in a geoeconomic perspective. It is also important in a domestic policy perspective. If citizens feel that trade is eroding the normative fundament of societies, this will make it more difficult to defend trade in policy debates at home. So, it is important that FTAs and other trade agreements reflect a credible commitment to social norms.

Competitiveness and sustainability as responses to non-political megatrends are equally important and urgent. The EU urgently needs to improve its ability to compete, in particular in areas related to digitalisation and artificial intelligence, where other actors currently appear in the lead. The window of opportunity in this area might be closing fast. This is certainly true for sustainability, in particular the reaction to climate change and the increased urgency to act if temperature rises are to be contained to 2°C. In both, competitiveness and sustainability, the trade policy implications are potentially very profound and far-reaching. There is a risk that these objectives of sustainability and competitiveness will slip down the list of priorities as prosperity and geoeconomic pressures might be felt more acutely by policymakers. Allowing them to slide would, however, repeat a mistake made too often in the past. Now, there is a window of opportunity to change this, and it should be used.

The result is that the new trade strategy will have to respond to many more objectives than the old one. This is not a result of lack of rigour or inability to prioritise. It reflects the fact that the world has become more complex and trade needs to respond to multiple objectives. For policymakers, this is a challenging environment as they need to reflect in their actions how to kill several birds with one stone.

4.2 HOW SHOULD THE EU STRIKE A BALANCE BETWEEN RISK MANAGEMENT AND EMBRACING GLOBALISATION?

The realisation that the search for economic efficiency has not been complemented adequately by risk management is sinking in with policymakers. A senior EU official recently used the phrase 'from just-in-time to just-in-case'.[1] As is often the case when a balance between risk management and efficiency gains has to be found, the question is what the right trade-off between the two conflicting objectives is.

The COVID-19 shock has made EU policymakers realise that the EU is dependent on too few suppliers with difficult credentials for some critical goods. Examples include PPE from China, antibiotics, also from China, or paracetamol from India.[2] If a specific good or task is supplied only from one country – or in some cases maybe even a single firm – that implies a vulnerability to a series of risks.

The question that policymakers should think about is how the highest levels of economic efficiency – and linked to that prosperity – can be reached while keeping the risk at acceptable levels. Options range from a diversification of risk combined with increased stockpiling, to a reshoring of production and building up domestic capabilities. Some risks are best dealt with by designing appropriate supply chains, others might be better reigned in through political guarantees and coordination.

1 This was said at an event under Chatham House rules in mid-May 2020.
2 Cerulus (2020).

In order to better understand the options any EU trade strategy should pursue, it makes sense to recapitulate the sources of risks that previous chapters have identified:

- **Climate change risk:** Climate change is adding considerably to the risks of production chain disruption and does so in several ways. The first is the immediate risk stemming from rising temperatures and the increasing frequency of extreme weather events. These may disrupt production in one specific location, although the likelihood of such events is higher in certain global regions. Added to that is the consequence of policy action to combat climate change, which may have disruptive effects on supply chains, for example through the introduction of a CBAT by the EU or by other trade policy actors.

- **Epidemic risk:** The risk of an outbreak of a regional epidemic or global pandemic is rising. As governments improve their capabilities to respond to such health challenges, it might be possible to contain such outbreaks regionally. The risk of global repercussions cannot, however, be excluded, especially when supply chains turn out to be insufficiently resilient to production shortages at some steps along the production chain.

- **Geoeconomic risk:** As various actors begin to exploit their economic leverage over other players, such a 'weaponisation' of asymmetric interdependencies, comes with the risk that production chains or financial flows might be disrupted. This can happen either in a direct confrontation with a geoeconomic competitor, or as a kind of 'collateral damage', if geoeconomic confrontation happens upstream in the production chain. This type of risk is very specific: geoeconomic warfare is most effective if it is least expected – which might induce some actors to overlook this kind of risk while others might overstate it.

- **Political risk:** As the consensus on embracing globalisation erodes in many countries, the risk of a protectionist backlash increases. This makes trade relations in general less stable and reliable. It may also complicate policymaking in multilateral and plurilateral formats.

All these risks point in a similar direction: Avoid dependency on one single trading partner or region. Ideally, diversify supply chains across several global regions, thus allowing them to continue to operate if one production strand fails. As the EU is not immune to any of the risks listed above, this includes it. While it might be sensible (in some cases) to have local production capabilities, these should not make up for the entirety of production where possible. In addition to spreading production and production capabilities around several global regions, it makes sense to engage in increased efforts to create transparency. Today, in many cases producers do not know sufficiently well what is happening a few tiers up in the supply chain and what kind of dependency risks might be present there. There is clearly scope for improvement at relatively low costs.

So far, I haven't discussed the role of technology and to what extent technological risks are present and determine the location of production. To some extent, technological risks fall in the category of geoeconomic risk. At least in theory, a technologically dominant actor – which would not even have to be a state – could exploit technological dependencies. It is not possible to reduce this risk through regional diversification. To some extent, one could diversify risk across different technology providers, for example in cloud computing. But given the tendency in many digital areas for natural monopolies to emerge, even this diversification strategy may often prove impossible. Two possibilities exist: First, to develop something similar to technological sovereignty, i.e. to use industrial policy to make sure that the knowhow contained in certain types of technology is available in the EU and that there are domestic actors that can provide certain critical services. The second is to think about dependencies in terms of a 'balance of fear': monitor and develop interdependencies, so that they are symmetric with main actors. If then, for example, a technological hub considered exploiting its dominance, it must fear retaliation through another hub on which it is dependent. Since both players would lose from such a confrontation, they would coexist peacefully instead of weaponising their interdependence.

Thinking about risk management is something that the EU will have to do more seriously in future. Most of the risk management of supply chains will in truth take place in firms. The risk is that since supply chain developments are very costly, firms will return to pre-COVID-19 complacency. Policymakers should incentivise firms to think about risk management of their supply chains, in particular firms that perform crucial public services or have substantial economic heft. Trade policy should think of ways to support firms in their risk management efforts, for example through increasing the networks of FTAs or helping with monitoring risk along the supply chains and with putting in system a place of global risk management and mutual support. Such a system would have a monitoring function like the AMIS system for agricultural commodities, a permanent dialogue bringing together key stakeholders and possibly involving negotiations on disciplines for export bans.

4.3 HOW CAN THE EU BECOME A MORE COMPLETE GEOECONOMIC ACTOR?

As I have laid out in the previous chapters, globalisation will become more geoeconomic in character. Countries increasingly use economic tools to pursue geostrategic goals. The EU will not be able to ignore this trend, in fact, the label of the 'geopolitical Commission' suggests that the EU is embracing the opportunity to become a stronger geostrategic actor.

However, the EU's decision making mechanisms in foreign policy make it difficult for the Union to deliver a decisive, meaningful, coherent and unambiguous foreign policy *vis-à-vis* other global powers. The EU is capable of exercising and also increasing its use

of geoeconomic power in those fields where it holds executive power, specifically in trade, pre-accession, development and ENP. This is however not enough for the Union to be a player on equal footing with other global powers.

For the EU, this means that it should think hard about two issues for the time being: First, what sort of defensive strategy would make the EU less vulnerable to geoeconomic pressure. This includes defensive capabilities, strategic use of dependencies, including the strategic increase or reduction of such dependencies with specific actors (actors will be discussed in greater detail in the next section). The second issue is to rethink decision-making mechanisms, ensuring that the Union is capable of decisive action. This is particularly relevant for the EU's defensive arsenal, as a dissuasive threat is not credible if decision making-mechanisms can be disabled through divide-and-rule tactics. If the EU wishes to use geoeconomic tools offensively, for example in its neighbourhood policy, the current decision-making mechanisms also require overhaul to render them more effective.

The incompleteness of the EU as a geoeconomic actor is a disadvantage in particular if the EU wishes to play a strong role. Whether the EU should seek to do this, is another question. The more geoeconomic the EU becomes, the more it risks weakening the liberal trading system on which it relies. The EU should, therefore, prioritise its abilities to take defensive action but affirm its commitment to economic stability and its role as a reliable trade policy actor. For such a role, the incompleteness of the EU is not a hindrance. Incompleteness is also not a problem as long as alliances or alignments help to achieve coherence and unambiguity in EU decision-making mechanisms.

Nevertheless, in the long term, the EU might pursue a more ambitious foreign policy strategy. This is a particular necessity if the EU wishes to enact a foreign policy which is much more independent and self-reliant than its current model.

4.4 SHOULD THE EU SEEK GEOECONOMIC ALLIANCES?

I have suggested that as long as the EU is an incomplete geostrategic actor, it might be dangerous to establish the Union as an independent foreign policy actor. This is especially true since the economic and political weight of the 'West' is decreasing and its norms and institutions might be challenged more often. For both reasons, I believe it would be better for the EU to seek alliances in a geoeconomic world.

First, let me clarify what I understand by the concept of geoeconomic alliance. This can mean for example an FTA which is concluded with a geoeconomic objective and which de facto serves as an economic non-aggression pact. But a geoeconomic alliance does not necessarily have to take this form. One can also imagine that a pair or a group of countries could agree on joint retaliation if attacked through economic means by a third country. Such as defensive mechanism would work in a similar way as a strategic alliance in which a group of country pledges mutual retaliation against military aggression against one

of them. This would allow smaller actors to defend themselves against large players exploiting their dominance and weaponising their dependence. It could also apply in cases where an FTA is difficult to conclude, or it could be an additional element in future FTAs.[3]

With whom should the EU seek such an alliance? The most important nation for the EU to seek an alliance with is the United States. This is not currently popular thinking, to a large extent due to the Trump administration, its attitude to the EU and its bullying of allied nations. With Trump still in power, it would indeed be impossible to forge an alliance. Under a different administration, it might be more apparent that the interests of the United States and EU are to a large extent aligned and both can gain from a closer coordination of their trade and foreign policy efforts. A specific advantage of an alliance with the United States is that its leverage over EU member states would help to address some of the shortcomings that arise from the incompleteness of the EU as a foreign policy actor. I will discuss the advantages and disadvantages of seeking an alliance with the United States in closer detail in a dedicated subsection below.

In addition, the EU could also seek defensive geoeconomic alliances with other players. These could be mid-sized or small economic players that share a similar normative conception of how to conduct trade policy and would not gain any advantage from an increased pursuit of geoeconomic power politics. One advantage of an alliance is obvious – it makes conflict with the allied player much less likely and helps with resolving any conflicts through negotiation rather than open confrontation.

4.4.1 China: How to Deal with the Elephant in the Room

Why would the EU need an alliance in the first place? Much of this has to do with China, which in many ways has become the elephant in the room. It is an important trading nation and also a confident international political player. While China is an important market, in particular for European companies, the EU and other trading nations have long accused China of distorting the playing field in its favour – with only minor concessions to date. More important than these level playing field concerns are, however, worries that China might use its increasing economic might to pursue its geostrategic ambitions in Asia and beyond.

Assessing China's role and subsequently the risk associated of dealing with it accurately is very difficult. This stems from the fact that China supports the multilateral trading system and has largely complied with dispute settlement cases which it lost. China imposing export bans in the wake of the COVID-19 crisis raised some concerns in the

3 So far, such a system of pooled defensive mechanisms has not been fleshed out, this might be an interesting avenue for future research.

trade community, but this practice was not that different from that of many other actors. Yet China has used its economic power against other nations, mostly in its neighbourhood but also to a lesser degree beyond.[4]

One could therefore be tempted by the conclusion that China is behaving differently in its economic relations with Western countries than in its geopolitical relations with its neighbours. This does not stop with China's interference in Hong Kong and Taiwan; it continues with its expansion in the South China Sea, territorial conflict with India and its geopolitical assertiveness *vis-à-vis* some BRI member countries. For a long time, many observers believed that China would compartmentalise regional geopolitical ambitions and international economic relations. China would have the incentive of not disrupting trade relations as its economic success to a large degree depends on its integration within the world economy.[5]

I have previously expressed the expectation that China will graduate over time and become a pillar of the international trading system. An emerging market focused on economic development and poverty reduction might implement some policies that tilt the playing field in its favour. But as China is graduating, becoming a larger, more technology- and service-driven economy and seeing – in a long-term perspective – its share of world population and economic weight decline or stagnate, I believed China would recognise that a multilateral rules-based trading order is a reassurance, helping its economic stability and helping it deal with newly emerging powers, such as India, which by mid-century might become a serious challenger to China, both regionally and internationally. With this increased value of the rules-based system for China, it would in turn invest political capital in this system, align its domestic politics and possibly become an advocate of a level playing field itself. China would seek stability, not disruption. This could still happen. But under the leadership of Xi Jinping, China has moved in a different direction: its economy is becoming increasingly state-driven, it has done little to address concerns about a level playing field or other controversial trade practices – instead it has become an increasingly nationalistic and affirmative geopolitical actor, not shying away from interfering in the policymaking of the EU and other players.[6]

Another school of thought about China can be summarised by the famous quote from Deng Xiaoping: 'Hide your strength, bide your time'.[7] According to this thinking, China does not seek confrontation early on but aims at changing the power balance quietly and then deploys its power once it is ready to do so.

4 e.g. Medcalf (2017).
5 Huang (2020).
6 e.g. there have been reports of China meddling into the wording of a protest letter by the EEAS regarding Hong Kong's security law. Stolton (2020).
7 Quoted after Harshaw (2018).

Kissinger (2011) uses the image of the two popular strategic board games in the West and in China to illustrate this thinking: chess and go. While chess is a confrontational game by design, in go, one player tries to encircle the other until he achieves dominance. China's increasing geopolitical and geoeconomic assertiveness would then be a sign that China feels increasingly ready to use its power and no longer hide it.

What should the EU do regarding its trade policy *vis-à-vis* China? Which school should it follow? How should it balance normative and geopolitical interests in its neighbourhood and economic interests in China? The answer is not simple. The EU has so far tried to settle its economic policy controversies with China through amicable channels and avoided confrontation. Arguably, this has achieved little. The alternative confrontational approach by the United States has accomplished some concessions but at a large cost.

As discussed above, there are many reasons for the EU to diversify its supply chains (upstream and downstream) and sales markets and concern about geoeconomic force is only one of them. To some extent, this has already happened before COVID-19, as production is shifted to destinations with lower labour costs and/or more reliable access to the US market. Diversification means building up additional supply chains and thus reducing dependency on production being done in China. As long as economic activity is sufficiently diversified, EU companies can continue to remain present in China and harness its economic opportunities.

The EU should be more vigilant with regards to FDI from China. As discussed in Jungbluth (2018), Chinese firms use FDI specifically to support the country's industrial development policy. The increased screening procedures and veto powers for mergers and acquisitions help to control this and the subsequent dependencies. While Chinese FDI can be unproblematic in some cases, it can be used for technology transfer or the creation of dependencies in strategic areas. If the CAI negotiations don't yield tangible results in the near future, the EU might consider toughening its approach to China.

With regards to the level playing field concerns and other trade policy issues, the EU should seek a close coordination with likeminded countries, including the United States, and use a mix of sticks and carrots to develop sustainable solutions for these concerns within the WTO. Such a strategy should involve more pressure than baits but allow China to make concessions in a face-saving way. This is important not only in order to improve the chance of a deal being sustainable but also to be able to accommodate any possible change in the balance of political forces in China, if a future administration becomes more cooperative perhaps.

Finally, a trade and investment policy has to square with a larger China policy. An appeasement strategy might serve the EU's economic interests but might backfire politically and economically in the long run. The EU needs a strategy on how to deal with China, Chinese interference inside the EU and in its immediate neighbourhood. The priority should be to reduce dependencies on China and thus political and economic leverage of China over Europe. As dependencies shrink, the EU will be able to access

a larger set of strategic options regarding China, which can be pursued together with other economic and political actors for greater efficiency. Yet the EU should be careful to remain capable of working with China in areas where this is of common interest. The Chinese announcement of working towards a carbon neutral Chinese economy would be such a case in point: as China and the EU will face similar challenges as a result of decarbonisation, they might foster international cooperation to achieve these aims.

4.4.2 The United States: Ally or Alienated?

Europe's share in the world economy and in global population is declining, and with this will come a loss of political influence. New, emerging powers might find that the system built by the United States and the EU after WWII works for them too and assume leadership in it. Or they might decide that this system reflects and favours the positions of old powers and that pursuing their interests outside these institutions suits them better.

In any case, the EU will need alliances to compensate for its declining political and economic weight. To some degree, the FTAs with Japan, Canada, South Korea and possibly the United Kingdom and Mercosur can constitute the basis of such alliances in a geoeconomic world. The deep FTAs that the EU currently has with these countries mean not only an economic pact of non-aggression; the large degree of regulatory cooperation also implies that both actors do not engage in fundamental normative competition. From there, it is not such a large step to defending together the normative conceptions held *vis-à-vis* any normative challengers.

Yet even though these FTAs bring together fairly large economies and trading nations, they involve neither the United States nor China, the largest economies in the world. As China does not share the same normative broad vision of how a market economy should function, it is unlikely to be a potential trade policy ally of the EU – not to mention broader policy disagreements. As far as the United States is concerned, the common ground with the EU is larger than the areas of disagreement. This is particularly true in view of concerns about China's economic policy.

To what extent a closer cooperation might be possible under a different administration and over the longer run is a different question. The TTIP negotiations aspired to building not only a closer trade integration but also (especially seen in conjunction with TPP) but a larger trade policy alliance sharing similar normative conceptions. But even under the Obama administration, the TTIP negotiations were not easy. While the negative public opinion in the EU has certainly been a major political stumbling block, the negotiations have not been able to dissolve substantial disagreements in some areas, for example public procurement, agriculture, geographical indications, differences in SPS regulations, some areas of services trade, standards and conformity assessment and investor state dispute settlement.[8] Whether they would have been resolved had the negotiations had more time,

8 Executive Office of the President of the United States & European Commission (2017).

is uncertain. Equally uncertain is whether these issues could be resolved if negotiations were taken up again with a future administration. Societal resistance against TTIP in Europe would likely resurface.

While the rationale for a deep FTA between the EU and the United States remains strong, perhaps collaboration on other trade-related issues is more promising and pressing. There are the two interrelated questions of how to deal with trade policy concerns regarding China, in particular level playing field concerns, and China's rising geoeconomic influence. While both countries are part of the Trilateral, differences on how they should pursue their policies *vis-à-vis* China have impeded closer collaboration, in particular the EU did not support America's aggressive approach towards China. If both countries could converge more on substance and on the strategy of pursuing their interests, that might give them more leverage.

Another issue on which the EU and the United States should collaborate on is bringing green issues into the multilateral trading system. The United States rejects EU plans for a CBAT for now. Whether this would change under a future administration, we can only speculate. However, policies similar to the Green Deal feature prominently in Biden's manifesto and enjoy wide-spread support within the Democrats. In implementing these policies, the United States will face similar problems as the EU and may consider a CBAT in order to prevent leakage. If the EU and the United States could agree on this issue, this would be a game changer for the international trading system and the success for the battle against climate change.

Both the EU and the United States benefit enormously from being members of the WTO. The organisation is suffering from the United States having not only given up its leadership but also in some areas actively undermining it. If both countries could collaborate more strongly in reinvigorating and modernising the WTO, this would also help to strengthen the global trading system.

Finally, a closer alignment with the United States would help the EU overcome its incomplete foreign policy setup. This is nothing new in principle but given the divergence during the Trump administration is in urgent need of being reinvigorated. The geopolitical alliance of the majority of EU member states with the United States is well established and remains the bedrock of the Western security architecture. Provided that the EU and the United States shared enough common ground on the substance of designing a strategy to defend themselves and their allies against geoeconomic aggressions from third countries, closer collaboration could be very beneficial in this area as well. Reflecting on a way to link geopolitical alliances, such as NATO, with tools of geoeconomic defense is an additional avenue worth exploring.

Above, I have argued that the polarisation of the United States makes its internal politics unstable. It is likely that US politics will oscillate between an affirmation of national sovereignty and working together with its allies. This poses a dilemma for the EU if it is willing to engage with the United States in a close alliance. How can the EU pursue

common goals with the United States over longer periods, if US politics is so unstable? It is anyway unclear what form this collaboration might take. It could be a looser kind of collaboration, where the two countries develop joint positions on issues of common interest. It could be based on another attempt to establish an FTA or it could be a new type of agreement that would sketch out elements of a joint geoeconomic strategy. I would argue that it makes sense to pursue a close kind of collaboration, including principles and objectives laid down in some kind of agreement (not necessarily an FTA). This would give both countries leverage in global affairs, and it might exercise discipline on unstable domestic politics.

4.4.3 The EU and Emerging Markets

For the same reason that the EU's share in the global economy is likely to decline, it makes sense for the EU to continue its network of FTAs while it still retains comparatively strong bargaining power. The expansion of the network should focus on fast growing emerging markets. To some extent, the EU is already pursuing this strategy, as its recent FTAs with Vietnam and Mercosur, ongoing negotiation with Indonesia and other ASEAN economies, and talks with India (among others) show.

The EU should continue and expand this strategy. Particularly in relations with India, there may be a potential to accelerate the talks. India is simultaneously badly hit by COVID-19 and experiencing hostilities with China. This might imply that it is looking to reduce its dependency on China, find more reliable trading partners that can also bring substantial investment to India and thereby help with rebuilding their economy after the COVID-19 shock. The country is rapidly growing both in terms of population as well as in terms of economic growth, which makes it an interesting market. Furthermore, India is likely to be hit particularly strongly by climate change, making food security a top concern – an area where the EU's more reliable agriculture production could be helpful.[9] For the EU, India would likely be an interesting destination for deepened services trade. While India is currently known to be a difficult country to negotiate trade agreements with, this might change in future.[10] As a minimum, the EU should regularly affirm its willingness to engage in closer trade relations and to give life to the FTA negotiations.[11]

A delicate question is what the EU should do about Russia. Russia has reacted aggressively to the EU's opening up towards countries that it considers to be in its traditional sphere of influence, in particular in the case of Georgia and Ukraine. Sanctions against Russia are still in place. Therefore Russia is not a priority country for any enhanced trade relations. It is possible to imagine a world where this might change. Russia might eventually realise that China is interfering with its sphere of interest more aggressively than the EU ever has.

9 India will likely be reluctant to open its agricultural markets because of the social implications. However, some specific arrangement that might help Indian governments deal with shortages and price shocks could be option worth exploring.
10 Puri (2017).
11 Politically potentially problematic is the increased religious discrimination in India. This might have a negative impact on future EU-India relations and make also a trade deal more difficult to achieve.

A stick and carrot strategy that incentivises Russia to give up its hostile stance might be worth conceiving. If this helps to create greater peace in the Eastern neighbourhood and along EU borders, much is already gained. Closer cooperation with the Eurasian Economic Area could be envisaged as part of this strategy. The ball, however, lies in Russia's court, it would be misplaced for the EU to reward Russia for its past aggressive behaviour.

The subject of EU-Africa relations could both be part of the emerging markets' as well as the neighbourhood subsection. While from a trade policy perspective it might be a worthwhile long-term project to develop a continent-to-continent FTA with the CFTA, initial steps will probably be with individual countries. Their geographic location might determine whether such negotiations are predominantly trade relations or whether other issues typical of relations to ENP will also feature. As far as predominantly trade-orientated relationship are concerned, the EU should consider building stronger ties with the African continent's largest economies, Nigeria and South Africa. In addition, the EU could consider developing a 'connectivity' strategy with the continent as a whole, helping to develop better connections between African nations, thus helping the development of the CFTA but also ensuring good connections to the EU. This would help African development, help the EU to gain access to raw materials and – perhaps more important – allow the possibility of the establishment of supply chains ultimately servicing EU markets in Africa.

Africa, especially North Africa, is an attractive location for supply chains, because it is geographically close to Europe and disposes of relatively cheap and clean energy or could develop it. At the same time, labour is relatively cheap. This will become increasingly relevant, once the prices of CO_2 increase and a CBAT is implemented. Therefore, for the EU it makes sense to develop closer trade and investment ties with North African nations and help build much needed infrastructure.

4.5 THE EU IN INTERNATIONAL ECONOMIC ORGANISATIONS

Global collaboration in economic policy – beyond trade – is currently weaker than at any point before since the inception of the Bretton Woods system. This is a worrying trend because at the same time the need for collaboration and coordination was never higher, given the strong degree of economic interdependency. The reason for this is a lack of leadership from the United States on the one hand and on the other hand a dispersion of power among the other powers in the system that make it difficult for any other power to assume leadership instead. Hopefully, the next US administration will return to global economic governance and take up the leadership role once more.

If it does, the EU should seek close cooperation with the United States to rebuild global economic governance. If it doesn't, the EU will have to increase the role it currently plays by exercising leadership and bringing together coalitions of players that collectively seek to advance global economic policymaking.

This does not only mean trade policymaking at the WTO. As the GFC has shown, global collaboration in economic policymaking, can make a real difference and help the recovery. The fact that we are not seeing action on a comparable scale, although the challenges presented by COVID-19 are arguably even larger, is worrying.

4.5.1 Make Multilateral Trade Governance More Flexible and Efficient

Besides collaboration on policies in fora such as the G20 and increasing the role of the IMF and the World Bank in the crisis management of the COVID-19 fallout, getting trade governance back on track will be an essential element of the mix of policies enabling economic recovery.

To help ensure that the right policies are put in place, the mode of rulemaking at the WTO needs to change. Overall, the organisation needs to become more flexible and more efficient. Flexibility can come from advancing in smaller subsets of the membership through open plurilateral cooperation. This will break the impasse of too many veto players without departing completely from the consensus principle. At the same time, new forms of collaboration can be explored that make negotiations in old and new formats more efficient and forward looking.

Once these conditions are met, the WTO should be able to see negotiations advance in crucial areas and achieve new successes. This covers the JSIs where progress is imperative to prove the viability of new forms of collaboration. However, in light of COVID-19 interventions and the effects of different recovery packages, other items have risen in importance on the policy agenda, such as industrial subsidies and how to deal with CBATs and other green issues in the world trading system.

4.5.2 Enlarge the Scope of Multilateral Policymaking

Dealing with these new priorities cannot wait until the negotiations on the existing JSIs are completed. On industrial subsidies, negotiations might be particularly fruitful in the current climate, as virtually every government has engaged in subsidies on a large scale to stabilise the economy in light of COVID-19. At the same time, public finances are likely to be under strain in many places. This arguably creates good conditions to negotiate disciplines on industrial subsidies because no player has the resources to enter a subsidies 'arms race'. At the same time, the involvement of so many actors in subsidies means that concessions can be made across the board.

Also related to COVID-19 is putting in place a system to prevent panic-driven export bans in any future pandemic. For that, a monitoring system for critical goods, in particular in medicine and pharmaceuticals, should be put in place, similar to the AMIS system in agriculture. This should be a multilateral forum where policy actions in the event of visible shortages can be debated and coordinated.

Finally, trade will have to respond to the green agenda of many important players. This should be done in a way that the trading system remains inclusive and conducive to development. A suitable solution could be a plurilateral where the largest polluters agree on either a joint carbon-pricing mechanism or at least enter commitments to increase national carbon pricing. This would make a CBAT redundant, achieve similar green objectives and be less disruptive for trade and exporters.

4.6 TECHNOLOGY AND COMPETITIVE EDGE

The EU needs to step up its efforts to remain at the forefront of technology. As I have discussed above, data-driven business models and AI in particular might increasingly determine firm competitiveness. The EU is currently lagging behind in the scaling up of digital business models as well as in leading technological research in areas related to data science.

First and foremost, for the EU that implies that it has to improve its research performance and business application in this area. The industrial strategy points in the right direction. However, some of the EU's relatively poor performance might be due to the fragmentation of the Single Market for digital firms which is likely to be an impediment to the scalability of digital business models. The EU needs to carefully investigate where internal regulatory barriers have a substantial negative effect on the growth of digital businesses models and look for ways to reach regulatory policy goals with lighter touch measures.

To boost the development of digital business models and the digitalisation of existing business models, the EU should be ambitious in ensuring that the scalability of such models is supported by FTAs and through multilateral arrangements, such as the e-commerce talks in the WTO.

At the same time, the EU needs to carefully investigate in which areas it depends on the digital business models and capabilities of other players. As networks lend themselves particularly well to weaponised interdependence, the EU needs to understand its vulnerabilities and identify a strategy based on a combination of the creation of own capabilities and the diversification of different suppliers to make itself less vulnerable.

4.7 SOCIAL CONSENSUS ON TRADE AND GLOBALISATION

Trade policy is of huge importance for the EU's business model. The importance of trade is likely to increase if companies look for more active consumer markets outside the EU, when ageing in the EU leads to a slowing down of domestic consumption. For the EU, it is therefore vital to remain a capable and reliable trade policy actor.

This requires the social consensus on embracing trade and globalisation to be strengthened. Only if a large share of the population in the EU member states agrees that engaging in trade is beneficial, will it be possible to succeed in developing a globalisation strategy

This has an internal dimension because, if trade policy is controversial and politicised, it will be much harder to get political support for bilateral and multilateral trade policy action. It also has an external dimension because, without a broad-based societal consensus, the EU might become a less reliable trade policy player as political pressures may lead to the non-ratification of FTAs and other trade agreements or to withdrawal from them.

Shoring up the domestic consensus on trade and globalisation has much to do with distributing gains more broadly and helping those that are negatively affected by structural change driven by trade or technology. This requires a more effective and possibly larger welfare state at national level and/or further assistance from the EU level. But trade policy should also contribute to shoring up the consensus on trade. That means that trade should not be seen as favouring large enterprises disproportionately, nor should there be any doubt that it might undermine social norms, such as environmental and labour standards.

Conclusion

As stated in the introduction, the aim of this book is to map out the challenges that lie ahead for EU trade policymaking, and to sketch a rough path. Turning this map into a more precise and detailed blueprint constitutes a busy research agenda for the next years. Nevertheless, the general direction that the EU should take is clear enough.

Luckily, this new general direction does not imply a complete turnaround. The EU is by and large doing the right things and setting the right policy objectives. Some of the current debates overshoot their target, such as that on strategic autonomy, but may still be helpful in bringing about a more balanced policy position.

The environment in which trade policy will be made in future will be much riskier than today's. Climate change, the threat of epidemics, weaponised interdependence and an unstable domestic political consensus on trade result in far more unstable ties to trading partners. Finding a suitable way to deal with these risks is going to be the core challenge of the new trade strategy. I argue that the right approach is to foster risk management of supply chains and networks, not reshoring. This can be done through diversification and stockpiling, through monitoring global production capabilities and demand needs, especially for critical goods and services.

The response of the EU to geoeconomic globalisation should be to invest political capital in rules-based economic governance. Especially given that the EU is an actor of declining economic weight and yet with a strong outward orientation, it does depend on liberal institutions, such as the WTO. The EU should not do anything – intentionally or not – to undermine this order, as it will invariably weaken its own position. Yet the EU cannot ignore the increasingly geoeconomic nature of globalisation. The response to this is creating defensive capabilities, trade policy instruments and decision making

mechanisms, so as to deter potential aggression through economic means. It should, however, be careful to underline that such measures are defensive in nature and will not be used against trading partners unless they attack first.

Another area in which the EU needs to act is in improving its technological competitiveness. Much of this is beyond the scope of outward-orientated trade policy: removing internal barriers for digital businesses to grow and scale up is vital here. From an international perspective, the EU should not succumb to digital protectionism as this would hurt its traditional competitive industries. The exception is areas in which indigenous technological capabilities are essential if it is to avoid falling prey to geoeconomic dependencies.

The EU should do what it can to shore up the domestic consensus on embracing openness and trade as an opportunity. This means providing insurance against negative shocks from outside that inflict more brutal damage in open economies. It also means ensuring that EU trade policy respects the values that the citizens demand and expect from it. The creation of a trade enforcement officer has been a step in the right direction in this regard.

Finally, among these many policy areas and objectives, it is important not to lose sight of the core of trade policy: to help citizens and businesses generate more prosperity. That is not to say that everything else should be sacrificed in the search for profit and wellbeing. Quite the contrary: prosperity generated through trade can only be sustainable if it rests on rules and values. The EU should knit these closely into its trade policy. Of central importance for the EU is that it is seen as a trustworthy, reliable and fair trading partner. That is what trade strategy should aspire to. The EU cannot afford to be naive and ignore geoeconomic threats. But it is still possible to stand up for the values of rules-based trade without succumbing to the threats of geoeconomic rivals.

Abbreviations and Acronyms

AI	Artificial Intelligence
ASCM	Agreement on Subsidies and Countervailing Measures
ASEAN	Association of Southeast Asian Nations
AMIS	Agricultural Market Information System
BIT	Bilateral Investment Treaty
BRI	Belt and Road Initiative
CAI	Comprehensive Agreement on Investment
CAP	Common Agricultural Policy
CBAT	Carbon Border Adjustment Tax
CETA	Comprehensive Economic and Trade Agreement
CFSP	Common Foreign and Security Policy
CFTA	Continental Free Trade Area
CO2	Carbondioxide
COP	Conference of the Parties
CPTPPP	Comprehensive and Progressive Trans-Pacific Partnership
CSDP	Common Security and Defence Policy
DCFTA	Deep and Comprehensive Free Trade Agreement
DDA	Doha Development Agenda
DSM	Digital Single Market
DTRI	Digital Trade Restrictiveness Index
EEAS	European External Action Service
EID	Emerging Infectious Disease
EGF	European Globalisation Adjustment Fund
ENP	European Neighbourhood Policy
ETS	Emission Trading Scheme
EU	European Union
EUJEPA	EU-Japan Economic Partnership Agreement
FAO	Food and Agriculture Organization of the United Nations
FDI	Foreign Direct Investment
FTA	Free Trade Agreement
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GDPR	General Data Protection Regulation
GFC	Great Financial Crisis 2008/2009
GTA	Global Trade Alert
GVC	Global Value Chain
ICANN	Internet Corporation for Assigned Names and Numbers
ICT	Information and Communication Technology
IFAD	International Fund for Agricultural Development
IMF	International Monetary Fund
IoT	Internet of Things
IPCC	International Panel on Climate Change
IPR	Intellectual Property Rights
ITO	International Trade Organization
JSI	Joint Statement Initiative
KORUS	United States-Korea Free Trade Agreement
MERS	Middle-East Respiratory Syndrome
MFN	Most Favoured Nation
NDC	Nationally Determined Contribution

NGO	Non-Government Organisation
NTB	Non-Tariff Barrier to Trade
OPA	Open Plurilateral Agreement
PPE	Personal Protective Equipment
QMV	Qualified Majority Voting
RCEP	Regional Comprehensive Economic Partnership
SARS	Severe Acute Respiratory Syndrome
SDG	Sustainable Development Goal
SDT	Special and Differential Treatment
SME	Small and Medium-Sized Enterprises
SOE	State-Owned Enterprise
SPS	Sanitary and Phyto-Sanitary
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TFEU	Treaty on the Functioning of the European Union
TPP	Trans-Pacific Partnership
TTIP	Transatlantic Trade and Investment Partnership
UN	United Nations
UNEP	United Nations Environmental Programme
UNICEF	United Nations Children's Fund
WFP	United Nations World Food Programme
WHO	World Heath Organization
WTO	World Trade Organization

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The nature of globalisation is changing – and fast. The globalisation that we see today differs substantially from the globalisation that we witnessed just a few years ago. We no longer live in a world where our chief concern is to enhance economic growth and prosperity. Geoeconomic considerations have risen in importance. But they are not the only objective to be satisfied. In fact, globalisation and trade need to respond to a multitude of challenges that emerge from political as well as non-political trends. Climate change, demographic change, technological change, an increased frequency of epidemics but also protectionist populism, a weakening of international cooperation – these are the forces that will shape globalisation for the foreseeable future.

This book maps out a broad strategy for EU trade policymaking to help navigate these shifting challenges for the future. The message of the book is that if geopolitics is increasingly being pursued by economic means, the EU needs to overhaul and revamp its trade strategy in order to respond to this new objective. Its future trade strategy should follow value-driven trade policy, as well as efforts to restore the rules-based trading order, risk management and the development of defensive geoeconomic capabilities.

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