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# The Good, the Bad and the Ugly: Taking Stock of Europe's New Trade Policy Strategy

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## EXECUTIVE SUMMARY

This Policy Brief takes stock of the EU Trade Policy Review – the Commission's proposed strategy for trade. Despite appearances, the Review doesn't come close to its billing as a strategy for the new geopolitics of trade. In fact, the Review is weak on key geopolitical developments and rather gives the impression that the EU doesn't have an ambition to shape outcomes. Obviously, the Review is anchored in Europe's general economic climate: defensiveness on globalization, competition and digitalization. It follows that Europe is getting increasingly detached from world developments.

There are several good parts in the Review. The Commission wants to revive and reform the World Trade Organisation, and it's clear about what factors that have made the Geneva-based trade body dysfunctional. The Review also acknowledges that the EU will seek a closer alliance with the United States and use that for constructive purposes. Finally, it is welcome that the Commission proposes some new instruments for dealing with market distortions caused by foreign subsidies and protectionism in government procurement. All these initiatives can achieve good outcomes. However, they all require that Europe makes changes in its own policies and positions.

The bad parts in the Review are Europe's weak agenda for getting better market access in the growth regions in the world and its continued passivity on matters related to China. Europe's main trade-policy challenge in the next decade is to ensure that businesses and consumers in Europe get better integrated with a world-market dynamism that predominantly will come from the Asian region. Absent a realistic and medium-term strategy for dealing with challenges connected to the rise of China, Europe will have difficulties getting the EU-China Comprehensive Agreement on Investment approved. Europe needs an actionable agenda for addressing bilateral frictions with China and problems that occur outside bilateral trade.

Finally, the ugly part of the trade strategy are all the commercial policies in the EU – with strong effects on trade – that aren't recognized or only casually mentioned in the Review. The latter category includes the ambition to introduce an autonomous carbon border tax on imports. Such a policy comes at a high political and economic cost, and the measure's effect on reducing global carbon emissions is at best very negligible.

## INTRODUCTION

In this paper, I will take stock of the EU Trade Policy Review released by the European Commission in late February.[1] I have organized my thoughts in three sections and each segment – the good, the bad and the ugly – should be self-explanatory. It should also be said that the aim is to consider the broad themes and views in the Review, not the small print. Inevitably, this paper will encompass the broader politics of commerce in Europe and include some trade policies that are difficult to sight in the Review. The conclusion is that the EU deserves a better trade strategy.

## THE NEW GEOPOLITICS OF TRADE

There is one general theme to start with because of its obscure treatment in the Review: trade and geopolitics.[2] Ursula von der Leyen's Commission has branded itself as a "geopolitical Commission" and the Trade Policy Review is one of the first strategy documents that reveals how this Commission thinks about Europe's position in the world and what it wants to achieve in international affairs. Obviously, the Review has also been billed by the Commission as an effort to anchor its trade strategy in the new geopolitics of trade. This all makes sense: the world is changing and Europe has ideas to promote and interests to defend. So how does the Trade Policy Review compare with the stated geopolitical orientation of the Commission?

An initial point is that the Commission isn't exactly overburdening the reader with geopolitics and, in the EU's analysis, how changing geopolitics inform trade-policy choices today. There is actually surprisingly little of it in the Review. The Commission makes some efforts to speak the language of power – getting other countries to do what Europe wants them to do – but it neglects some of the most fundamental geopolitical developments. The Commission pays little attention to developments in Europe's own geographic proximity – which is, after all, the starting point for geopolitics. Relations to the UK are covered in one vapid sentence.[3] The treatment of Turkey and Switzerland is equally parsimonious. Israel and the Gulf seem to have fallen off the map. Talks about Deep and Comprehensive Free Trade Agreements (DCTFA) with selected Northern African countries are mentioned, but it's difficult to suppress the suspicion that the Commission is quite pessimistic about these talks.[4] Eastern Partnership countries, especially those who have already signed a Deep and Comprehensive Free Trade Agreement with the EU, are brought up in the Review, but predominantly as targets for the EU's regulatory regime – an invitation that isn't responded to with enthusiasm. However, other countries in the South Caucasus are absent – just as all of Central Asia. And Russia? No, nothing.

It is true that a trade strategy cannot tick off all countries in the world. It is also true that the Commission has to prioritise pressing issues: the need-to-haves, not the nice-to-haves. But it is notable, in the first place, that Europe's surrounding regions get so little attention. And that gets all the more puzzling when we take into account that many important geopolitical developments actually happen in the EU's neighborhood. In fact, one can say without much exaggeration that many neighbors to the EU are gradually moving out of Europe's economic slipstream. There are growing frictions in trade relations with Europe's neighboring north, east and south. Many

[1] European Commission, 2021, Trade Policy Review – An Open, Sustainable and Assertive Trade Policy. COM (2021) 66 final.

[2] This introductory section was inspired by Christian Bluth, 2021, ***Europe's Trade Strategy for the Age of Geoeconomic Globalisation.*** London: CEPR. One of the megatrends covered by Dr. Bluth – demography – is absent in this paper but I will return to it in the forthcoming paper ***Achtung Europa!***

[3] "The EU looks forward to working closely with the United Kingdom to use the full potential of the Trade and Cooperation Agreement".

[4] Which isn't surprising considering that talks with Morocco and have been going on for eight years and with Tunisia for six years. Generally, the Review comes out in favour of a better and more integrated approach to relations with African countries and the African Union.

of these frictions aren't caused by the EU. But it is for the EU to make a decision if it wants a stronger geopolitical role in its region. The answer in the Trade Policy Review seems to be No.

Nor does the geopolitical orientation get a lot more visible if we move from pure geography to broader geopolitical themes – or geopolitical flashpoints – and the role that EU trade policy could play for their management. Rather, it's remarkable how conspicuously absent many of these themes are in Europe's thinking about its economic statecraft and external economic policy. For instance, the Trade Policy Review says nothing about growing shifts in energy production and supply – a huge issue for the new geopolitics of trade and competition. China's Belt-and-Road initiative is absent: again, a pretty big matter in both geopolitics and trade. The economics of the Abrahams accords, and how these accords have consequences for economic integration in the region and the outside world, aren't recognised. And the broader global geopolitical shifts? We aren't provided with much guidance about how the Commission thinks about Europe's international trade policy as part of an integrated policy on geopolitical shifts in the Asian region. Does it aspire to have a role in the shaping of trade openness and rules, or broader economic alliances, in in the Asia-Pacific region? Trade policy is part and parcel of that region's unfolding geopolitical development and, if the Trade Policy Review is something to go by, the EU seems to be sitting this one out.

The major geopolitical dimensions in the Review are the commitments to revive the World Trade Organisation (WTO) – which follows one of this Commission's six strategic priorities[5] – and give priority to improving relations with the United States. Both ambitions are good. But they alone don't add up to a geopolitical orientation. In the first place, many of the major geopolitical issues that Europe are confronted with are outside the realm of the WTO. Even if we would charge our view of the WTO's future with some Panglossian optimism, the expectation would still be that Geneva isn't going to deliver all that much in new trade governance. Moreover, there is already a significant divergence between American and European approaches to geopolitical threats. Germany, for instance, has decided to make itself (and Europe) more dependent on Russian energy through the Nordstream II pipeline: the US disagrees with that position. The divergence between European and American trade-policy attitudes towards China shouldn't be exaggerated but it is clear that the two have made different calls on how to address trade and investment frictions with China. The US is caught in the centrifugal force of the Pacific region's economic rise, with all the opportunities and problems that come with it. Europe isn't – or doesn't want to be. Obviously, this limits the usefulness of the Transatlantic relation for both sides.

Observers of European Union politics have a riposte: "move along, nothing new to see here". Europe is acutely aware of new geopolitical tensions but there isn't an EU policy because EU member states are split and there is no common ground for a stronger geopolitical orientation.[6] There is a good deal of truth in that observation. It is difficult to let geopolitics infuse trade policy when some countries view Russia as a territorial threat while others want to defrost relations with the Kremlin. Or take the debate around making the investment-screening mechanism more consequential for warding off foreign state-supported investors that could use the investment to pressure Europe. Strangely, some countries are putting their power behind that argument while at the same time supporting Gazprom to get a larger stake in Europe's energy supply.

However, one other explanation needs to be added. Europe has a defensive attitude to new global developments and, while that attitude is sometimes understandable, notable member states increasingly want to shield from and not manage these developments. The Trade Policy Review

[5] The European Commission's priorities for international affairs are presented here: https://ec.europa.eu/info/strategy/priorities-2019-2024/stronger-europe-world-0_en

[6] Fredrik Erixon, 2015, *How Trade and Security became Europe's Unhappy Couple.* Carnegie Endowment. Accessed at https://carnegieeurope.eu/2015/03/24/how-trade-and-security-became-europe-s-unhappy-couple-pub-59475

makes a number of good general points about the benefits of economic openness, but it isn't divorced from the general direction of economic policy in this Commission. The von der Leyen Commission is the first one in ages that isn't putting European competitiveness front and centre in its political programme: after the Lisbon agenda came the Europe 2020 programme but now there is nothing. Remarkably, there is no real priority given to deepening the single market and freeing up exchange within the EU – despite obvious and long-term trends of the single market getting less relevant for economic development in Europe. Without powerful policy agendas to improve competitiveness and deepen the single market, EU trade policy becomes more about protection than liberalisation. Europe gets defensive.

The Commission is instead reviving industrial policy – and it does it with a rhetoric that comes close to a cartoonish version of French-style economic dirigisme. Additionally, it is putting forward new regulations of AI, data, digital markets and services, capital markets, corporate governance, commercial regulations, corporate tax and more that are extraordinarily heavy-handed. Much of this is presented as necessary policies to protect Europe against an unfriendly world. There is a lot of talk about cutting Europe's dependence on other regions.[7] Many EU and European leaders argue that the EU should now embrace economic and technological sovereignty. Fortunately, the Trade Policy Review spares the reader from Europe's muscular attempts to punch trading partners in their face. However, the current mood in Brussels and many national capitals is that Europe is a regulatory superpower that can improve its relative competitiveness vis-à-vis the rest of the world by regulating Europe harder and forcing other countries to adopt European-style regulations. The Review can only go so far outside the realm of this Commission's economic understanding. If Europe's internal policies are substantially increasingly the role of the state in markets, it's external policies will inevitably go in the same direction: it will introduce new barriers to exchange, not take away existing ones.

## THE GOOD

There are several good observations and initiatives in the EU Trade Policy Review.[8] Its Annex reinforces some of these initiatives, especially in matters related to the WTO. So let's start there.

### *World Trade Organisation: Initiative and Realism*

It's welcome that the Commission highlights the importance of the WTO and the case for WTO reform. The Trade Policy Review includes clear statements about the benefits to Europe of global trade and multilateral trade policy, and makes the right analysis about the dysfunctional state of the WTO and its judicial, negotiation and deliberative functions. Unlike the typically bland WTO statements that have been coming out of G20 summits in the past decade – and the type of purist WTO idealism that European leaders usually have been promoting – this communication isn't shy about the problems in the WTO. It also provides a diagnosis, saying that a "key driver of the crisis is that China's accession to the WTO has not led to its transformation into a market economy".[9] It points to problems with Special and Differential Treatment (SDT), or how a number of countries that are now middle or high-income should be able to take on obligations that are similar to those of mature developed economies. A new method of defining the

[7] Fredrik Erixon, 2020, *Work for Others, not Yourself: Globalisation, Protectionism and Europe's Quest for Strategic Autonomy.* ECIPE Policy Brief No. 7/2020. Oscar Guinea and Fredrik Erixon, 2019, *Standing up for Competition: Market Concentration, Regulation and Europe's Quest for a New Industrial Policy.* ECIPE Occasional Paper No. 1/2019.

[8] It should be mentioned that the Commission brings up plans for getting Western Balkans closer to the EU. More should be done on this front because of the strategic importance of these countries. First, these countries have a strong mining sector producing critical raw materials for the green transition and digitalisation. Second, absent more direct EU leadership they have developed geopolitically awkward relations with China and Russia.

[9] European Commission, 2021, *Annex to the Trade Policy Review.* COM (2021) 66 final, page 2.

development dimension is clearly called for: self-declaration, the current way, leads to unequal trade obligations for similar types of economies.[10] Moreover, the Review highlights the significant discrepancies that exist in traditional market access between countries. All of this leads to a situation of unfair trading conditions and saps the institution of energy: too many countries only think they have defensive interests to protect in negotiations.

There is much truth in these observations, even if they don't give a full account of all factors behind the WTO's depreciation. For the WTO to reclaim some of its relevance, members need to be prepared to liberalise their trade and countries that have a systemic importance for the entire global economy, like China, will need to do more than others. Rich countries also share the blame for the WTO slipping into oblivion, but for almost 20 years now an important explanation to why a good part of the WTO membership has been unwilling to open up is that they have feared the Chinese juggernaut. For the WTO to get its vitality back, China will have to show it's ready to open up its markets and allow for more of market-based competition and stronger disciplines on state interference in markets. It's not a sufficient condition, but it's a necessary one.

In the Review, the EU proposes that new negotiation initiatives in the WTO should focus on sustainable development and the digital economy, and that rules should be sharpened to reduce the scope for state subsidies and State-owned Enterprises (SOEs). These are good initiatives. The Commission wants to restore the old negotiation over freeing up trade in green goods and makes other constructive proposals for taking away government interventions that drive carbon emissions, like fossil fuel subsidies. Taking account of various trade restrictions during the pandemic, the Commission also proposes – following its own concept paper from last summer[11] – a new initiative on trade and health. Ambitions, however, aren't overly spirited and there is a good degree of realism behind these proposals. In most cases, the Commission calls for moderate expectations.

The analysis is sincere and initiatives connect with obvious problems where better WTO rules can play a role to improve European and global outcomes. While it is doubtful that the EU actually would go along with all these initiatives – and generally abstain from taking own measures that directly would hurt the WTO and undermine efforts to bring it back to life (more of this later) – the Review's proposals are important because they also provide some much-needed direction in Europe's own thinking about its trade openness. The reality is that EU trade policy flounders without the strong WTO anchor: new opportunities in Geneva could help bring more attention to trade policy in this Commission and among big member states. The WTO connects immediately with the identity of the European project as a rules-based order and as soon as the EU steps outside that order, the political accord for freer trade becomes less stable.

[10] James Bacchus & Inu Manuk, 2020, *The Development Dimension: What to Do about Differential Treatment in Trade.* Policy Analysis No. 887, Cato Institute.

[11] European Commission, 2020, Trade in Healthcare Products. A Concept Paper. 11 June 2020, accessed at https://trade.ec.europa.eu/doclib/docs/2020/june/tradoc_158776.pdf

### *Stronger Alliance with the United States*

The Trade Policy Review boldly states that "the transatlantic relationship is the biggest and most economically significant partnership in the world."[12] It says that, with the new US administration, there are opportunities to work together with the US on a host of issues, including WTO reform. It concludes that the EU will "give priority to strengthening the partnership with the US."[13] EU initiatives to pause the tit-for-tat compensatory tariffs that came out of the aircraft subsidy disputes in the WTO are a first step.

Seeking a closer relation to the US is a good priority. There is, to start with, a geopolitical argument for it: the US remains an indispensable ally for security and peace in Europe. Moreover, Europe would benefit if the Biden administration took a less protectionist direction and started to engage with the world in trade policy, and closer transatlantic ties could be a step in that direction. But perhaps the most important reason for closer relation with the US is that it would be a power multiplier: with America engaged and the two parties aligned, the EU can better reach its ambitions in international affairs. Just like Europe, America's commitment to an open global economy is partly challenged by unfair terms of global competition. It is more concerned than Europe about systemic competition from China. China hasn't made up its mind if its strategic interests are better served by a collapsing or reinvigorated liberal trade order. As a consequence, the US is in some doubt if it is in its strategic interest to revive the liberal trade order. A stronger Transatlantic relation could help push America closer to the European view.

If Europe is true to its ambitions of arresting climate change and spurring digitalisation, it will need the support of the United States. The climate change agenda is already unleashing geopolitical tensions that Europe alone cannot manage: they will only grow bigger as Europe and others wean themselves of energy sources, goods and production technology that are carbon intensive.[14] Moreover, as a good part of Europe struggles with demographic challenges and shrinking labour forces, and have created an inhospitable regulatory climate for innovation and entrepreneurship in digital sectors, Europe will become a lot more dependent on foreign digital creation and diffusion. Closer relation with the US will provide Europe with a better choice of access to digital technologies and businesses.

There is, of course, a price to be paid for stronger cooperation with the US – or, for that matter, with any other partner. If America seeks much more confrontation with China and redoubles efforts to ward off foreign competition to Uncle Sam, that price may be too high for Europe. In a more likely scenario, however, a closer relation with America means that Europe will have to moderate some of its own policies and that European nations can't go off on a tangent with commercial policies that clearly runs counter to core US security interests. Europe should offer that bid. Ambitions of deepening transatlantic relations just rings hollow if Europe isn't prepared to moderately change some of its data policies to allow for a resurrected Privacy Shield and accept that relations with Russia cannot be deepened. Talks with America on digital trade or trade and sustainable development will go nowhere if Europe isn't prepared to negotiate and change some of its policies. It is a good ambition to seek closer relations to the US; now the EU needs to show that it is prepared to invest in it.

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[12] European Commission, 2021, Trade Policy Review – An Open, Sustainable and Assertive Trade Policy. COM (2021) 66 final, page 9.

[13] European Commission, 2021, Trade Policy Review – An Open, Sustainable and Assertive Trade Policy. COM (2021) 66 final, page 10.

[14] See Daniel Yergin, 2020, ***The New Map: Energy, Climate and the Clash of Nations.*** Penguin Press. For shorter analyses, see for example Helen Thompson, 2021, "The Geopolitical Fight to come over Green Energy". ***Engelsberg Ideas,*** March 5. Accessed at https://engelsbergideas.com/essays/the-geopolitical-fight-to-come-over-green-energy/. Another recent contribution in this discussion is David Wallace-Wells, 2020, ***After Alarmism – The War on Climate Denial has been Won. And that's not the Only Good News.*** New Yorker, January. Accessed at https://nymag.com/intelligencer/article/climate-change-after-pandemic.html

### *New Disciplines on Foreign State Interventions in Markets*

A final area that deserves attention is the Commission's ambitions to improve European contingent policies by addressing foreign subsidization of goods and services that distort the single market and unfair restrictions on European firms participating in foreign public procurement.[15] In the Review, they are part of a broader list of initiatives, that also includes other parts such as the FDI Screening Regulation and the Export Control Regulation.[16]

In my view, initiatives to tackle foreign subsidization and closed procurement markets should be part of package that improves the day-to-day work of the Commission to help European firms to access foreign markets and reduce unfair competition. So these initiatives deserve support – but support that comes with qualifications. Addressing foreign subsidization and procurement distortions form part of what the Commission calls "assertive" trade policy. The Review goes to some length to flag that there is a new tune in Brussels and that it will become better at defending the rights and interests of European companies. Fine. But the selling of these initiatives signals a lot more assertiveness than the Commission actually proposes. The language is also stoking negative reactions from member states and trading partners, and some of these policy conflicts are unnecessary. Many of these initiatives – like the International Procurement Initiative (IPI) – draws the abstract support of many member states, including the free-trade leaning north who has pushed against initiatives like the international procurement instrument. Still, these countries have blocked the IPI and it would be useful for the Commission to take on some of their principal reservations.

A first issue concerns methodology and how the EU will decide to activate new instruments. There are cautionary tales from the use of other contingent measures (antidumping[17] and countervailing duties[18], for example) and obvious differences between member states in their lobbying for how such instruments should be used. Related to that are issues about power balances. If there should be stronger EU measures to deal with these issues, they cannot be turned into policies that are used only when they fit France and Germany – and that aren't used when France and Germany protest against their activation. The problem, as so often these days, isn't about the abstract benefits and costs of stronger EU integration: it's about whether the EU can agree on a policy that divorces policy execution from Berlin and Paris. If the activation of the IPI would carry retaliation risks of denied contracts for Airbus and sales for German car producers, the two capitals wouldn't accept that IPI would deny tendering rights for a foreign firm. If measures against the foreign subsidization of goods in the EU market would include measures against Huawei and Gazprom, at least one of these capitals would balk.

A second issue is the need to distance instruments away from the ideology of reciprocity, which has guided supporters of especially the IPI. The desire on the part of key member states like France and Italy have been to have an instrument that lead to reciprocity: if you don't open your market to me, I close my market for you. Some Commissioners are also dancing to that tune. The problem is that there is no forward agenda in the actual use of this policy: the context is entirely about closing the EU market and it doesn't concern actual examples of problems for European firms getting access to foreign procurement markets, or being exposed to clearly distortive tender conditions. Tenders from foreign firms in countries that have not signed the

[15] See for example European Commission, 2020, *White Paper on Levelling the Playing Field as Regards Foreign Subsidies.* COM (2020) 253 final.

[16] The possibility of a new anti-coercion instrument, which is currently under consultation, could also be mentioned.

[17] Brian Hindley, 2009, *Cause-of-Injury Analysis in European Antidumping Actions.* ECIPE Working Paper No. 5/2009.

[18] Simon Evenett et. al., 2020, "The European Union's New Move Against China: Countervailing Chinese Outward Foreign Direct Investment", *Global Trade and Customs Journal.* Vol. 15:9, pages 413-422.

Government Procurement Agreement (GPA) in the WTO or that don't have other relevant agreements with the EU could in principle be excluded from a procurement contract in the EU. But the first intention of the activation should be to have that foreign firm participating in the tender and the condition should be that this firm's host government take a reciprocal action.

A final qualification is that these policy ambitions have a European context that requires attention. The EU is no beacon of public procurement openness – when we move from nominal to effective policies.[19] On subsidization, there is a great deal of distortions in European markets that come from state intervention or state ownership of European firms. State intervention in the economy has increased for several decades and the politics of commerce are getting ever more obscure: for instance, EU rules are routinely sidelined in big mergers and acquisitions by governments who believe they are capable of organizing firms and markets to their favour. So while there is a good case for the EU to be assertive on foreign distortions, the risk is that new tools will be used in a way that leads to double standards and that will provoke negative reactions from other countries.

## THE BAD

Some parts of the EU Trade Policy Review deserve criticism. I will bring up two concerns with the policy intentions that are outlined in the Review: poor strategies for connecting the EU with world-market growth and passivity about trade challenges related to China.

### *Few Proposals for how to Connect with Growing Markets in the World*

In my view, the main flaw of the EU Trade Policy Review is its weak ambitions to negotiate better market access with growth economies in the world. If trade policy is defined as negotiations with other countries to improve market access, there is surprisingly little of it in the Review. Obviously, this is also reflected in the general attitude to trade from the Commission and many member states. The key point of relevance in the Trade Policy Review when it comes to better market access to growth regions and markets says that the Commission will "seek to consolidate the EU's partnerships with key growth regions – in the Asia Pacific and Latin America – by creating conditions to conclude negotiations and ratify outstanding bilateral agreements."[20] Yes, this is how far the strategy goes. In fact, there is so little of outward-oriented market-access thinking in the Review that it's fair to ask: do we have a trade policy anymore?

It isn't just the Review. Trade politics in Europe are getting increasingly charged. There is one major Free Trade Agreement up for ratification – with Mercosur. It has just been kicked into the long grass because of member state opposition. The EU-China Comprehensive Agreement on Investment, which was politically blessed by major leaders just before the New Year, has an uncertain future. In fact, many observers think it was dead on arrival – and since the New Year, political frictions in EU-China relations have increased. Currently there are trade negotiations with Australia and New Zealand: both countries are likely to sign agreements with the EU in the foreseeable future. There are existing mandates for negotiating with other countries, including high-growth countries in Southeast Asia. The old FTA

[19] Patrick Messerlin, 2015, *How Open are Public Procurement Markets?* EUI Working Papers RSCAS 2015/89. Estimates suggest that about 5 percent of procurement in the EU is awarded to a foreign contractor. See European Commission, 2017, *European Semester Thematic Factsheet: Public Procurement.* Accessed at https://ec.europa.eu/info/sites/info/files/file_import/european-semester_thematic-factsheet_public-procurement_en_0.pdf

[20] European Commission, 2021, *Trade Policy Review – An Open, Sustainable and Assertive Trade Policy.* COM (2021) 66 final, page 22.

with Chile is up for modernization. There are talks about talks with other countries such as India. But this is about how far as current FTA-based market-access strategies go.[21]

The absence of an agenda to negotiate better market access is in a way surprising. The Review starts off by a good dose of economic realism: the EU may be a global economic power, but 85 percent of all GDP growth in the world will by 2024 happen outside the EU.[22] Obviously, growth in the world economy has moved from the Atlantic towards the Pacific. Already now, a policy for the European economy to recover from the Covid-19 slump will have to look at better trade opportunities with a growing world economy. In a few decades, the centre of gravity for the global economy will be located between China and India.[23] If Europe's choice is to avoid deeper engagement with the new growth regions, it will have a negative impact on Europe's prosperity. Making sure that Europe's economy gets strong impulses from the economic dynamism in Asia is probably our most important trade-policy objective. Moreover, if it really is Europe's intentions to have the ability to "make its own choices and shape the world around it through leadership and engagement" – to quote the definition of "open strategic autonomy" in the Review – there will have to be a lot more trade-policy engagement from the EU with growth economies.[24] If the current strategy of little integration holds, other countries will make these choices for Europe in the not-so-distant future.

Europe's current international economic policy moves in the direction of detachment. In the Review, the European Commission sets out an argument for the EU to export its regulations and condition market access to compliance with Europe's non-commercial regulatory regime: that combination won't produce more international integration. In areas of digital trade – and, more broadly, the digital transformation – the Review takes a defensive approach and disregards that Europe is a successful trade power in digitally-enabled services with great interests in avoiding a regulatory development that chokes services trade and the "servicification" of industrial trade. Indeed, in matters of innovative technology, the industrial Internet, and services (e.g. transport, telecom and financial services) Europe has strong interest in an outward-oriented approach that also takes down non-standard forms of services-market barriers, such as regulatory protectionism. There is very little in the Review that reflects these offensive interests and that recognizes the importance for Europe to keep its markets open if it wants to sell more abroad in sectors of strong competitive advantages. The Commission calls for an agenda at the WTO where digital standards and regulatory approaches should be agreed – knowing, of course, that this isn't on the cards. There can, at best, be some smaller accords with a smaller group of WTO members. It says that once these rules have been agreed, it can consider liberalizing trade in services that go beyond e-commerce. Frankly, if this is Europe's market-access policy in digital and digitally-enabled trade for the next few years, the European economy is going to be deprived of a lot of progress.

### *Passivity on Challenges Related to China*

Obviously, the European Commission is as cognizant as everybody else about the frictions related to the rise of China and the challenges of having Beijing accepting the norms of market economics and the rules of the liberal economic order. A few years ago, the EU labelled China an "economic competitor" and a "systemic rival", and the EU Trade Policy Review (including the

[21] See also European Commission, 2021, *Overview of FTA and other Trade Negotiations. Updated March 2021.* Accessed at https://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf

[22] European Commission, 2021, *Trade Policy Review – An Open, Sustainable and Assertive Trade Policy.* COM (2021) 66 final, page 4.

[23] A study from 2011 suggested this point to be reached by 2050. Since then, growth in Asia has surprised positively while growth in Europe has been weaker than expected. See Danny Quah, 2011, "The Global Economy's Shifting Centre of Gravity". *Global Policy Journal,* vol. 2:1, page 3-9.

[24] European Commission, 2021, *Trade Policy Review – An Open, Sustainable and Assertive Trade Policy.* COM (2021) 66 final, page 5.

Annex) is set in that context.[25] It says that Europe has values and interests to defend in relations to China. It also says that the priority is to build a fairer and rules-based relationship with China, "ensuring that China takes up greater obligations in international trade" while "dealing with the negative spillovers caused by its state-capitalist economic system."[26]

These are good ambitions. It is also right of the EU to seek this outcome both by trying to reinvigorate the WTO and negotiating bilaterally with China, such as in the context of the EU-China Agreement on Investment (CAI). There were some commentary around the time of the political declaration of the CAI suggesting that the EU had been naïve in negotiating with China and, in the process, breaking ranks with the US. This is nonsense. The EU has interests to defend and the approach taken by America towards China hasn't exactly generated better outcomes – for the US economy or the global economy. The problem isn't that Europe is trying to shape its own policy for China; the problem is that Europe remains too passive about China and how Beijing is re-shaping the economics and politics of trade and exchange in many parts of the world.

There are two problems with the China policy laid out in the Review and in other strategy documents from the EU. The first is that the challenge from China manifests itself in trade flows and distortions outside the direct EU-China relation, and that European leadership requires a broader response. The "systemic rivalry" with China, to use that term, is that an increasing number of economies get into China's economic slipstream and adjust their view of the world to fit with preferences in Beijing. China is the top trading partner for an increasing number of countries in the world – inside and outside the Asian region. For Europe to address the long-term challenges arising from China's economic rise, it has to become a better partner and friend of countries in Asia as well as in Africa, Latin America and the Gulf that cannot defend its economic interest in relation with steamrolling China. It needs to become better at offering other countries a route to more trade that doesn't mean having to kowtow to Beijing.

Obviously, Europe cannot sign substantive bilateral agreements with all of them, and that isn't the point. But Europe can do a lot more to shape outcomes that are better for Europe as well as for other countries. For instance, ratifying the trade deal with Mercosur would add muscles to Europe's broader systemic defence of the liberal economic order. Reviving the trade negotiations with India, Indonesia and Malaysia would be high up the list of any European agenda aspiring to long-term and consequential international leadership. A joint accord with the United States and India in strategic sectors (e.g. energy, digital and pharmaceuticals) should be considered. Taking the EU into a stronger partnership with the CPTPP is another way forward that would signal ambition. There are many options that would combine new economic opportunities for European businesses and new pathways to success for other countries that don't include a surrender to the politico-commercial norms of China.

So the point is this: the challenges with the rise of China is about far more than bilateral relations and what happens at the WTO. Moreover, bilateral negotiations on trade and regulation frictions between the EU and China won't lead to much as long as Europe is detaching itself from the world. If the European Union is pausing from deeper economic relations with (non-China) Asia and Latin America, and accepts to be bossed around by autocrats in Ankara, Beijing and Moscow, China won't have much interest in liberalizing more for Europe. Countries often move towards liberalization because of fear and greed. None of these motivations power China's approach to Europe today.

[25] European Commission and HR/VP, 2019, *EU-China – A Strategic Outlook.* JOIN (2019) 5 final

[26] European Commission, 2021, *Trade Policy Review – An Open, Sustainable and Assertive Trade Policy.* COM (2021) 66 final, page 10.

The second problem is that the EU is everywhere and nowhere when it comes to bilateral frictions with China. While there are good reasons to have the CAI with China, it's obvious that the EU was the sole demandeur in these talks and couldn't extract much market access from bilateral give-and-get negotiations. The agreement isn't as worthless as some critics have argued: there are some meaningful provisions on market access, forced technology transfer, and state-owned enterprises (SOEs). But in political terms, the EU had to sell itself pretty cheaply in the CAI and will therefore find it difficult to get the necessary support in member states and the European Parliament to ratify this deal. There is only a slim chance that the deal ever will be approved.

Bedeviling the complex politics of CAI ratification is uncertainty about the future – or, rather, what comes next in Europe's China strategy. No one in high office seems to have an idea about whether the EU wants to negotiate more with China. So is the current agreement with China it or will Brussels seek to follow CAI up with other negotiations? The Review doesn't add anything to help observers of EU trade policy to understand Europe's medium-term strategy for trade with China. Ratifying CAI is for the short term; getting better market access and rules in China through the WTO is, at best, for the long term. But what is the thinking for the medium term – for the next 5 years?

Inevitably, expectations about the future will inform choices now because trade politics about China are discounting future developments. If, for instance, the Commission would lay out strategies for addressing subsidies in China – an area missing in the CAI[27] – the agreement with China would be seen in different light. The same goes for dealing with fundamental labour rights issues – like forced labour in Chinese detention camps. But if there isn't a medium-term plan for more market-access and rules negotiations with China, which seems to be the case, the usefulness of CAI can be challenged. After all, the economic benefits are small and the political costs of approving it could be high for many EU countries. A similar verdict can be found in other China-related trade areas. For instance, many of the new initiatives to add more power in contingent trade policy is a form of China policy, and that includes the new anti-coercion instrument that is being developed. They aim to make the trade relation to China more reciprocal. But if these policies are the only change that can expected in the foreseeable future, their political usefulness can be doubted for many EU countries. Support for these initiatives – as for the CAI itself – would likely increase if the EU had a strategy for the next step of negotiations with China.

## THE UGLY

After "the good" and "the bad", let's finally turn to "the ugly" – to follow the title of Sergio Leone's classic spaghetti western movie. In my view, the ugly parts of the EU Trade Policy Review are Europe's signature plans in commercial policy that either aren't recognized in the Review or that are just casually mentioned. The first category includes new strategies for industrial policy in Europe.[28] It isn't just Europe that is crafting a new and muscular industrial policy that includes more state subsidies and regulatory privileges; the US is also moving in that direction.[29] Initiatives in Europe and elsewhere will have consequences for openness to trade and the rules of fair competition. These results go against what the Commission declares in the Review: it's ambition to improve disciplines on state subsidies and other state interventions that distort competition. So which policy intention has primacy over the other?

[27] Gary Clyde Hufbauer, 2021, *EU-China Investment Accord Fails to Resolve Subsidy Disputes.* Peterson Institute Trade and Investment Policy Watch, March 10.

[28] The export authorization programme for vaccines could also be mentioned, given its consequences for one of the key WTO initiatives by the EU – on trade and healthcare products.

[29] Scott Lincicome, 2021, *Manufactured Crisis: "Deindustrialization", Free Markets and National Security.* Cato Policy Analysis No. 907. James Pethokoukis, 2021, *Will Biden's Embrace of Industrial Policy Pay Off?* AEI Ideas, January 15. This direction of industrial policy in the US started already under the Trump administration. See Gary Clyde Hufbauer and Euijin Jung, 2020, Industrial Policy Makes a Comeback. *East Asia Forum,* 16 August 2020.

The second group includes what the Commission euphemistically calls a Carbon Border Adjustment Mechanism (CBAM), and it is this instrument that will be discussed in this chapter.[30] The Review only has this to say about CBAM: "In addition, autonomous measures are supporting the objective to ensure that trade is sustainable, responsible and coherent with our overall objectives and values. The Carbon Border Adjustment Mechanism (CBAM) is a case in point. The Commission is working on a proposal for a CBAM in order to avoid the effectiveness of its own climate policies being undermined by carbon leakage."[31]

This is remarkable. All sides in the debate about the design, legitimacy and legality of a CBAM probably could agree that an autonomous carbon border tax on imports will have huge consequences for Europe's trade and trade relationships. It will surely lead to trade conflicts; it doesn't require much imagination to see that other countries will react very negatively and question Europe's multilateral character. These trade conflicts could potentially become very severe and undermine every other ambition that is outlined in the Review. It is therefore reasonable to ask from a Review that it would lay out a longer motivation of the policy and an analysis of how it will go about introducing this measure without hurting Europe's trade interests. An autonomous carbon border tax is explosive stuff in international trade policy. The Commission seems to think it's nothing to write home about.

My view is this: if the EU wants to introduce a CBAM, it should first negotiate with other countries about its design and, more generally, what "competitiveness measures" that should and shouldn't be allowed when countries are ramping up their policies to reduce carbon emissions. This latter part is hugely important for avoiding climate change policies (regulations, subsidies, trade) to fundamentally undermine a rules-based trade order. It is strongly inadvisable to introduce a CBAM autonomously without a political accord with other and affected countries. There are five strong reasons against that course of action.

First, there will be legal disputes about CBAM that the EU very possibly will lose. Other countries will question the WTO compatibility of a CBAM and file multiple complaints. The exact content of the disputes will depend upon the CBAM design and its effects on various countries. However, it is likely that other governments will claim – with reference to core GATT rules and WTO jurisprudence – that CBAM is a tax or charge on imports that is discriminating like products and/or discriminating between countries. Unless the Commission can miraculously design a CBAM that won't include a lot of arbitrary methods determining which products to tax and at what level to tax them, that claim seems obvious. Moreover, other countries will argue that CBAM won't pass GATT Article XX – the general exception clause – and its chapeau requirements for environmental measures that are discriminatory. Others make a different call and say that CBAM could pass because of the exceptions allowed under Article XX. That is possible: a policy like CBAM has never been adjudicated in the WTO. However, it requires an intentional and teleological – not to say political – reading of GATT rules and WTO jurisprudence to arrive to that conclusion.

[30] I say "euphemistically" because it isn't going to be a border adjustment mechanism that the Commission will introduce. A system of border tax adjustment adds a tax on imports and reimburses the tax on export: it ensures trade neutrality. But what the Commission will propose isn't going to reimburse any domestic carbon cost when a producer exports. It's a one sided tax on imports that will be introduced. This is also what the Commission President, Ursula von der Leyen, outlined in the political guidelines for this Commission. There it was rightly called a "Carbon Border Tax". See Ursula von der Leyen, 2019, A Union that Strives for More: My Agenda for Europe. Political Guidelines for the Next European Commission 2019-2024. Accessed at https://ec.europa.eu/info/sites/info/files/political-guidelines-next-commission_en_0.pdf

[31] European Commission, 2021, Trade Policy Review – An Open, Sustainable and Assertive Trade Policy. COM (2021) 66 final, page 14.

Second, and related to the first point, countries will not just go after CBAM but are likely to also include the Emission Trading System (ETS) in the EU. Why? A CBAM in the EU will most likely be connected to the ETS and the requirement for EU producers to buy ETS allowances for their carbon emissions. But the ETS also allocates allowances for free and has done so since its inception: hence, European installations emitting a lot of carbon don't pay for all their carbon allowances. They are receiving an indirect subsidy. Furthermore, during the three past phases of the ETS, firms have also been allowed to sell their free ETS permits if they didn't need them – leading to a subsidy of these firms that clearly is open to challenge under WTO rules.

In the ETS regulation between 2013 and 2020, says the European Commission, 57% of all allowances where auctioned and the rest could be allocated for free.[32] The explicit motivation for the free allocation was, logically, that the EU didn't want to raise costs for producers that were exposed to potential carbon leakage. In phase 4 of the ETS, between 2021 and 2030, there will still be free allocations: in addition to the already set free allocations, the Commission has reserved a buffer of 450 million allowances so that "Europe's industrial competitiveness [can] be safeguarded".[33] It will still be allowed for EU member states to take compensatory actions, within state-aid rules, to firms for indirect carbon costs. The EU Innovation Fund will also use revenues from ETS permits to subsidise industries to reduce their carbon costs through technology. All these subsidies are actionable under WTO.

Furthermore, the EU has just agreed on the revised benchmarks for the system of free allocations to installations.[34] This is a highly technical area, but it is important for Europe's relation to other countries in the WTO. And it relates to a critical question: how can correct levels of carbon leakage be evidenced without using competitiveness benchmarks? For leakage to happen, current or future production needs to shift from Europe to territories with lower carbon costs. But all extra costs for carbon in Europe don't lead to a shift in current production from Europe to other parts of the world: in fact, only a small part of increased carbon costs have that effect.[35] Some estimates suggest that there is no evidence at all of carbon leakage from the ETS when trade flows of embodied carbon is modelled.[36] Just as with other mandated cost increases for firms (e.g. compliance with other environmental regulations), firms will manage them differently depending on competitiveness and the technological capacity for greenhouse gas efficiency. Some firms will do very little about their capital and technological structure; other firms will address these carbon efficiency problems as parts of their overall capital strategy and improve their efficiency.[37] In fact, the annexes to the updated methodology still show there is a significant difference among Europe's installations in their greenhouse gas efficiency. The effect of increasing carbon cost for one installation isn't the same as for the other, meaning that the potential size of leakage is surely

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[32] See https://ec.europa.eu/clima/policies/ets/allowances_en#tab-0-0

[33] European Commission, 2017, Questions and answers on the provisional agreement to revise the EU Emissions Trading System (EU ETS). Accessed at https://ec.europa.eu/clima/sites/default/files/ets/revision/docs/high_level_qa_en.pdf

[34] European Commission, Implementing Regulation (EU) 2021/447. Accessed at https://eur-lex.europa.eu/eli/reg_impl/2021/447. See also on benchmarks and competitiveness methodologies European Commission, 2015, Ex-post investigation of cost pass-through in the EU ETS. Accessed at https://ec.europa.eu/clima/sites/default/files/ets/allowances/docs/ex-post_investigation_of_cost_en.pdf

[35] Antoine Dechezleprêtre et. al., 2019, ***Searching for Carbon Leakage in Multinational Companies.*** Centre for Climate Change Economics and Policy Working Paper No. 187.

[36] See for example Helene Naegele and Aleksandar Zaklan, 2019, "Does the EU ETS Cause Carbon Leakage in European Manufacturing?", ***Journal of Environmental Economics and Management,*** vol. 93, pages 125-147.

[37] Over the lifetime of the ETS, there has been very many simulations suggesting significant carbon leakage from heavy industries like steel and cement. Ex-post studies, however, has shown most of them to be wrong. See for instance Julia Reinaud, 2008, ***Issues Behind Competitiveness and Carbon Leakage: Focus on Heavy Industry.*** International Energy Agency, and Jane Ellis, Daniel Nachtigall and Frank Venmans, 2019, ***Carbon Pricing and Competitiveness: Are they at Odds?*** OECD Environment Working Paper No. 152.

a factor of firm-specific and not just cost-specific effects.[38] These firm-specific effects could be amplified by the market structure, especially the market share held by firms that can reallocate their supply across carious factories around the world. Hence, the linkage between increasing carbon costs and carbon leakage is far more complex than presumed. As a consequence, a carbon border tax in the EU could have the effect of indirectly subsidising some firms in the EU that are perfectly competitive without the protective tax.

All of the above is problematic for the EU in a trade dispute because there are inherent subsidies in the ETS system that other countries will justifiably attack. But not just that, they will also make a direct link between the free allocations and CBAM: isn't a strong intention of CBAM, just like the free allocations, to avoid negative effects on EU firm competitiveness? No, it isn't the only intention, but it's perfectly obvious that it is one of them and that EU leaders aren't shy about putting that intention to the public.[39] Therefore, the result of the likely multiple WTO disputes could be that the EU will be in the wrong for more measures than just CBAM. Since the EU isn't likely to repeal any of these policies, other countries will be authorized to take compensatory measures against the EU. And the size of these compensatory measures could potentially be very substantial.

Third, some countries aren't going to wait for complaints to work their way through the full WTO system: they will retaliate directly or take measures that counteract the carbon border tax. The end result is that the total economic effects of CBAM will exceed the specific effects of EU carbon taxes. Retaliatory measures can take many forms: they can target like-for-like products or go after other products that have economic and political importance but are not directly related to the actual dispute.[40] Since retaliatory measures are actionable, the EU is likely to respond by challenging them at the WTO. However, the end result is likely to be a decline in total trade and in total EU exports. That also has consequences for total carbon emissions in the world since EU exports overall have a lower carbon intensity than world production. In a static world, it is better for the climate if other countries buy their goods from Europe than elsewhere.[41] Other governments can also agree to compensate their firms for the EU carbon tax, directly or indirectly, leading to growing subsidies of fossil fuels. But they will say that, under the Paris Agreement, they have already taken on a package of measures to reduce their carbon emissions that the EU has approved, and the EU is trying to change that with CBAM. In conclusion, there are big risks of ugly trade actions and disputes.

Fourth, it is by no means likely that other countries will be incentivized to improve their own policies for carbon reductions if the EU autonomously introduce a carbon border tax. Let's take an example based on some observers' suggestion that the EU is likely to start CBAM by introducing carbon taxes only on imports from heavy industries like cement, steel, glass and aluminum. For some countries, the EU is a very important export market of these goods; for other countries, it isn't. For countries in that latter category, it wouldn't make financial sense to lower their own carbon pollution in order to avoid paying a carbon border tax in the EU. From the viewpoint of the EU share of their total exports, very few exporters would find it rational to take additional carbon measures raising the cost of all their exports.

[38] Shon Ferguson and Mark Sanctuary, 2014, *Firm Productivity and Carbon Leakage: A Study of Swedish Manufacturing Firms.* IFN Working Paper No. 1035.

[39] Camilla Hodgson, 2021, "EU Rebuffs US Concerns over Carbon Border Tax Threat", *Financial Times,* March 31, 20201. Accessed at https://www.ft.com/content/d31ec6c9-453a-4705-b47b-1c9e46de817a

[40] For instance, the EU's retaliatory action against the US steel and aluminum tariffs partly targeted US products from swing states or Republican states in the US.

[41] Hana Nielsen and Astrid Kander, 2020, "Trade in the Carbon-Constrained Future: Exploiting the Comparative Carbon Advantage of Swedish Trade", *Energies,* vol. 13:14.

However, that group gets even smaller if we take this market-share logic a step further. Very few substantial exporters of these goods to Europe have European sales that are such a big part of their total sales (not just exports) that it is rational for them to increase the carbon cost for all their producers and all their production. China and the United States, for instance, have a significant share of their production done for their own markets. It's basically only Turkey and a few other countries in Europe's neighborhood that have a sales-dependency on Europe that is sufficient for CBAM to motivate them to take additional measures to reduce carbon emissions that would reflect Europe's new carbon-cost development. Hence, the effect on climate change from heavy-industry production destined for the EU in the handful of countries we are talking about is negligible and to the extent they cannot sell to the EU anymore, they will sell that output to other countries.

That takes us to the fifth and last point for why the EU should not autonomously introduce a carbon border tax. Most sectors are fungible in international markets and production that is no longer competitive on the European market will be sold on the world market. The effect is that, with CBAM, world output will go up and world-market prices will go down, potentially leading to more consumption of the product. Since the EU represents only a marginal part of the growth of the world market in sectors likely to be subject to a carbon border tax in the EU, the carbon-intensive production that the EU wants to disincentivize will find other customers. The conclusion is that while a carbon border tax have the effect of protecting domestic-market competitiveness for EU firms, it probably doesn't change the carbon-intensity of global consumption. There are solid climate-change motivations for combining an increase in carbon costs with some forms of border adjustment, but the positive effect of global carbon emissions will primarily materialize if the EU moves in tandem with other big markets.

## CONCLUSION

The European Union has reasons to think twice about its trade-policy strategy. The Trade Policy Review has some good parts but, on the whole, it's inadequate and doesn't set the EU up for current global economic opportunities and challenges. It's too influenced by a pessimistic understanding of the world and the capabilities of the EU to constructively shape outcomes that are good for European interests and prosperity. It deals too much with abstract concepts that have little association with actual problems on the ground and that just masquerade as policies dealing with the big economic shifts in the world economy and Europe's economic dynamism. The headline mission of current trade-policy thinking – open strategic autonomy – is at risk of becoming a misnomer. The Review sets out a strategy that is neither open nor strategic. A Europe that is detaching itself from the world will also have less effective autonomy.

The EU can do better than this. In addition to the good parts – for example, reviving and reforming the WTO and seeking a closer alliance with the US – and other ideas drafted previously in the paper, the EU could:

- Set out a geopolitical trade agenda that starts with Europe's role in its neighboring regions. The EU should have its own ambition for keeping the United Kingdom close and not letting the Brexit whims of London define what the EU wants to achieve. Similarly, if the EU keeps a shortchanging approach to Switzerland and a other European neighbours, it will reduce the geopolitical power of the EU. Rather, be constructive and generous. The EU would also benefit, in power and prosperity, from a lot more giving a lot more market-access to neighbouring regions in its East and South. There's also a geopolitical agenda for more distant regions. That agenda starts by ratifying the trade agreement with Mercosur and finding ways to build stronger economic alliances in the Asia-Pacific region.

- Outline and execute a much stronger strategy for better market access to key growth markets in the world. That includes taking trade and other commercial-policy initiatives with the CPTPP or single economies in the region, and specific deals on key sectors with countries that won't sign up to a full trade deal on Europe's current conditions. The EU could work more flexibly with initiatives that aim to protect key economic interests in world trade – e.g. technology and intellectual property – and that would secure better market-access conditions for key growth sectors in the EU.

- Propose better trade initiatives that free up trade in technology, digital trade and digitally-enabled trade – including better market openness in Europe. Secure free cross-border data flows with the US – a resurrection of the Privacy Shield. Update the network of existing FTAs with stronger provisions on technology, data and digitally-enabled services. Propose trust-building mechanisms for judicial data exchange with selected countries.

- Outline a strategy for future market-access negotiations with China as part of a broader package of policies dealing with the frictions that have emerged from China's economic rise. Improve and clarify new contingent trade instruments dealing with foreign subsidies and procurement distortions: seek a reciprocal market opening, not a reciprocal market closure. Propose initiatives, for the stronger alliance with the US and other allies, on subsidies and competitive neutrality that will increase the cost for China of keeping to status quo.

- Use the time up to the new COP-meeting in Glasgow to develop meaningful proposals on trade and climate change, including subsidies to fossil fuels and subsidies to fossil-free energy and production. Propose meaningful systems of carbon border adjustment mechanisms that include other key markets. Avoid unilateral measures with dubious consequences on total carbon emissions that could undermine all other efforts on trade and that would force the EU to spend most of its trade focus on litigation.

- And, finally, develop a policy for a deepening of the single market and improved competitiveness. A Europe that is detached from the world because it fears growing competition will not be able to shape outcomes.