Policy Paper

Falling into Pieces. The EU in the Puzzle of Global Trade

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In Brief

The international events of the last three years showed a number of signals suggesting that the "golden age" of economic globalization – started at the end of Cold-war - might have come to an end. Also as a consequence of the Covid-19 pandemic in 2020 and the outbreak of the war in Ukraine in 2022, it seems that globalization is slowing down affecting trade flows and undermining economic growth potential. In fact, despite in 2021 global trade in goods reached an all-time record value of $ 28.5 trillion, latest forecasts from the World Trade Organization (WTO) cut growth in the volume of trade in goods for 2022 from 4.7% to 3.5%, with things getting even worse in 2023 as trade flows would increase by a lackluster 1%. Moreover, current geopolitical tensions and a new "trade war" between the United States and China are putting the resilience of Global Value Chains (GVCs) to the test, potentially increasing the attractiveness of re-shoring, near-shoring and friend-shoring practices. All this in a context where the functioning and effectiveness of the WTO have been at a standstill for several years already.

Where does the European Union fit within this intricated picture? The EU is by far the largest trader in the world, before China and the United States, and it is also the top trading partner for 80 countries, being involved in more than 40 Free Trade Agreements that include more than 70 countries. While pursuing a trade liberalization agenda, the EU has become increasingly wary of the importance to preserve its own economic and security interests: this is why its external policy – including trade – is currently inspired to the 'mantra' of strategic autonomy. A key concept that basically implies that critical supply chains – those ones that are crucial to carry the green and digital transitions forward - should be secured and regionalized, starting from the EU's interests rather than prioritizing specific areas or regions as trade partners. In fact, the EU is lagging behind China and the US with respect to the control of key inputs (such as critical minerals and raw materials) and the manufacturing of semiconductors.

Are there ways to ensure that globalization can still survive (and thrive), and with it the role of the EU as a key trade player? What could be done to preserve the EU's central role in GVCs and as a broker of FTAs? In this Policy Paper, we argue that:

- Globalization will not end but it will rather face a process of "fragmentegration", which is a scenario in which actors will react to supply shocks by looking for new trade partners and ways of integrating their economies;
- The WTO no longer looks fit for purpose and is in need for a deep reform, which should be also consist of new tools aimed at establishing a level playing field in areas such as digital trade (e-commerce

but also regulation of personal data) and "green" trade (for instance by identifying an agreement towards the establishment of a Carbon Border Adjustment Mechanism);

- The EU could exploit its comparative advantage as a "global standard setter" and look for broader consensus with other WTO members, rather than following an alternative route that would lead to a more isolated position and a protectionist attitude.
- Moreover, the EU should better equip itself to face geoeconomic competition from other key players in order not to lose the race for global technology leadership, that will mark the coming years, and to enhance resilience in its critical supply chains. As empirical data show, the EU has a competitive advantage in many manufacturing sectors, mostly thanks to its integration in GVCs.

This paper is divided into two parts: the first – **"What's at stake"** – analyses current and future economic risks if economic globalization falls into pieces. The second part – **"Exploring options"** – offers a broad overview of key reform proposals by leading experts and our take on them.

Keeping the EU at the core of world trade system

How to rescue globalization and free trade?

1. First best

Multilateral reform
(Towards a "WTO 2.0")

2. Second best

Exploiting free
trade agreements

Levaraging on the EU assets:
• "Brussels effect" (standard setting)
• Competitive advantage in manufacturing GVCs

What's at stake?

Towards the End of Globalization?

$28.5 tn

World trade all-time record reached in 2021

THE EU IN THE INTERNATIONAL TRADE CONTEXT: A MODEL AT RISK?

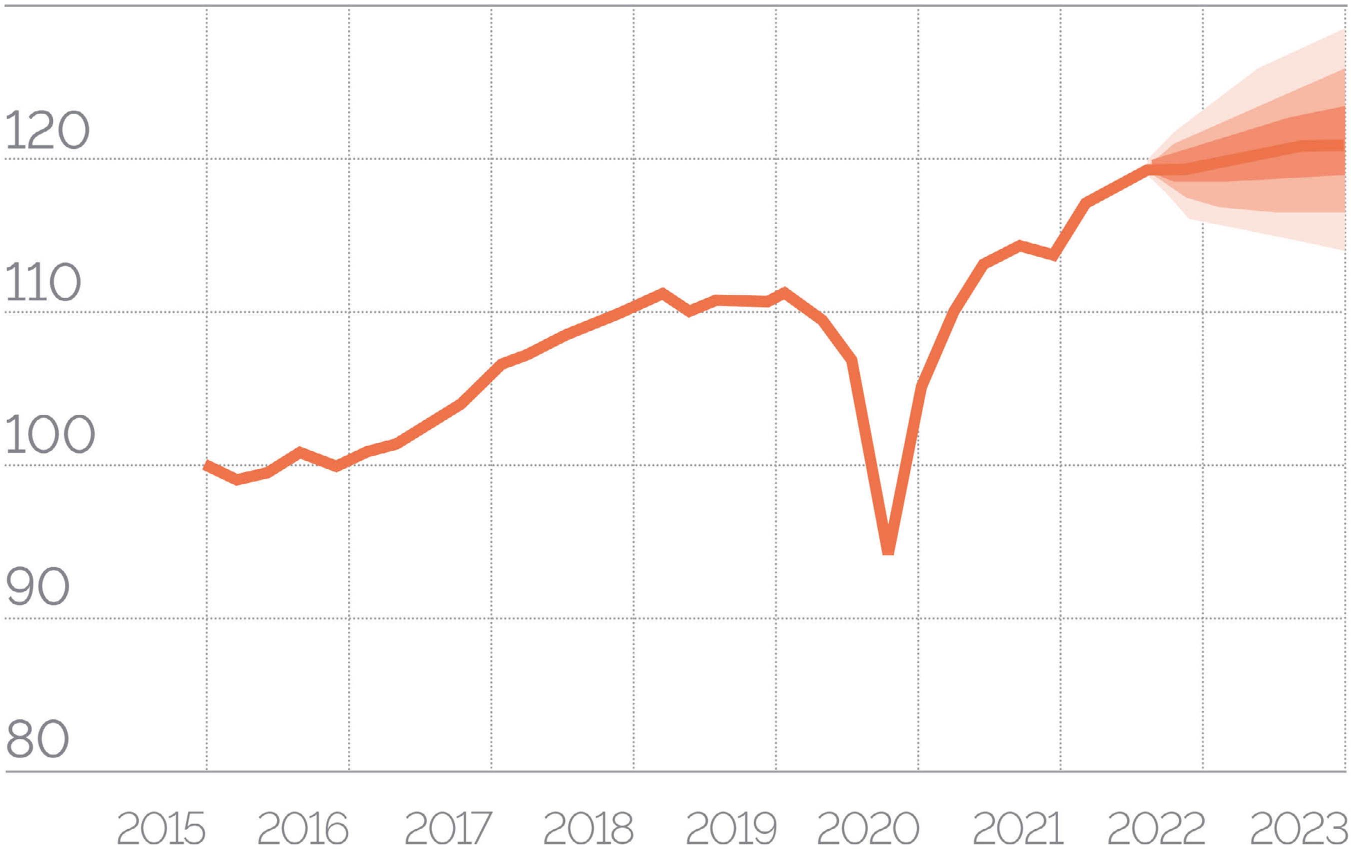
The end of Cold-war paved the way for the "golden age" of economic globalization: since the 1990s, international trade flourished thanks to enhanced economic openness and a boost to multilateral negotiations following the establishment of the World Trade Organization (WTO) in 1995. Fast-forward to 2022, we realize that the world we were used to know has quite changed. Also as a consequence of the pandemic and the war in Ukraine, globalization is slowing down, affecting trade flows and reducing economic growth. Where does the EU fit within this picture?

Europe Facing the Risk of a Global Trade Slowdown

In 2021, global trade reached an all-time record of $ 28.5 trillion (+25% on 2020 and +13% on pre-pandemic period.[1] Prospects for 2022 looked extremely positive at the beginning of the year, but the consequences of Russia's invasion of Ukraine have contributed to frame a darker picture. Latest forecasts from the WTO cut growth in the volume of trade in goods for 2022 from 4.7% to 3.5%, with things getting even worse in 2023 as trade flows would increase by a lackluster 1%.[2] A slowdown that will negatively affect Europe, a very active participant to global markets: European exports look set to grow by only 0.8% and imports even to shrink by -0.7% (probably also as a consequence of reduced energy imports from Russia).

International Trade slowing down

Growth of international trade in goods, 2015-23 (2015=100, Q3 2022-2023 = forecasts)

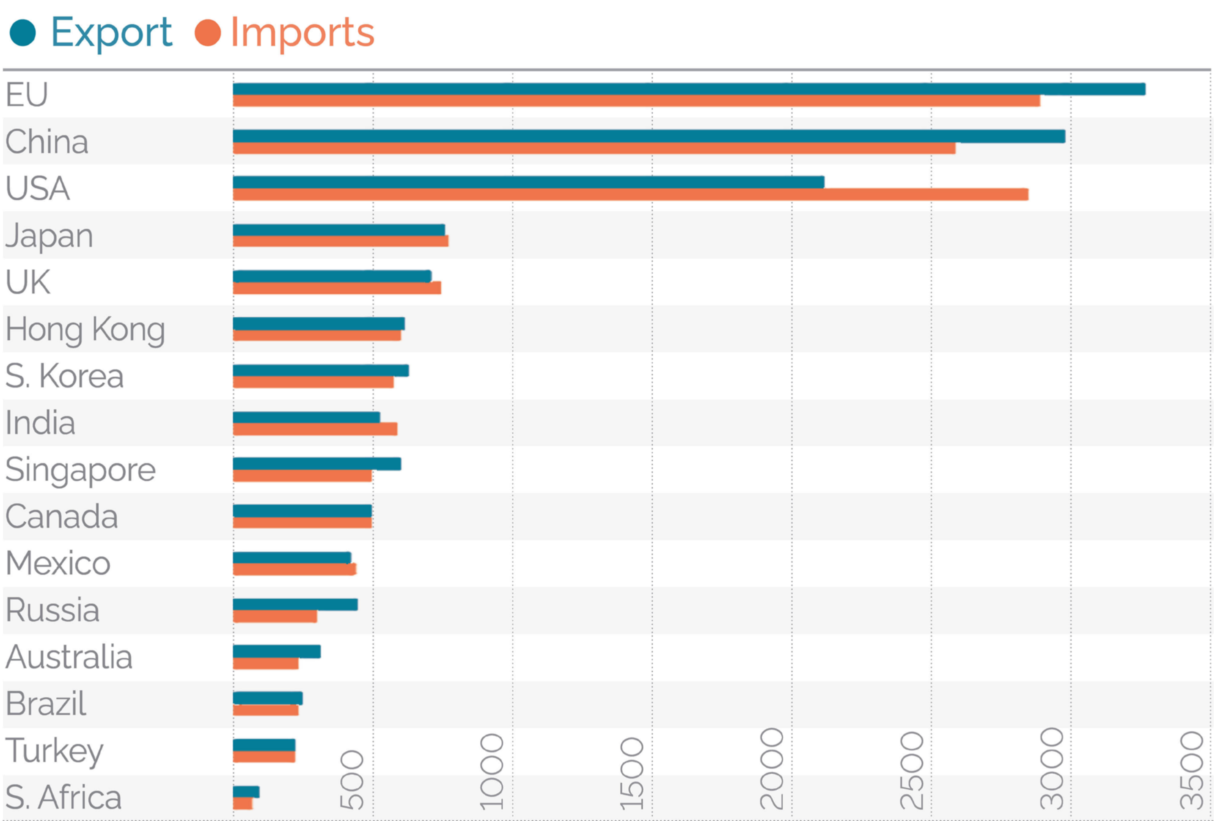


Source:World Trade Organization

The EU is the largest economy and the largest market in the world, with an average GDP per head of €25,000 for its 440 million consumers. Given its economic size and relevance, the EU, considered as a unique entity (instead of a 27-Member States organization) and including intra-EU trade, is also by far the largest trader in the world, before China and the United States (see Fig. 2).

The EU's world trade leadership

Value of international trade in goods and services, selected countries, 2021 (€ billion)



Source:World Trade Organization

- 6%

The decline of EU exports in 2020, less than the world average

200%

Increase of trade between 2002 and 2021 for Member States that joined the EU in 2004

Unsurprisingly, the recently much discussed slowdown in world trade has involved the EU as well, even if less than other areas. EU exports grew at a rate slightly higher that the world average between 2000 and 2008, but they declined to about 4% since 2010. How to explain this slowdown? There are many reasons both at the world and the European level, from the more inward-oriented China's policies to the declining impact of the ITC transformation. Basically, most experts agree that what we are observing now is a normalization of trade trends, after a period of so-called "hyper-globalization".[3]

Lately, trade patterns have also become more volatile. After the sharp decline in world trade in 2020 because of the Covid pandemic and generalized lockdowns (-7% in value for world exports and -6% for EU exports), trade flows bounced back in 2021. However, with the uncertainty created especially in European markets by Russia's invasion of Ukraine and the ongoing conflict, the WTO recently revised downward its forecast for 2022 and 2023. Such a reduction in trade growth is associated to growth slows in the major trading economies for different reasons. In Europe, high energy prices stemming from the Russia-Ukraine war are already taking their toll on household spending and have raised manufacturing costs. In the United States, monetary policy tightening will hit interest-sensitive spending in areas such as housing, motor vehicles and fixed investment. China continues to grapple with COVID-19 outbreaks and production disruptions paired with weak external demand. Finally, growing import bills for fuels, food and fertilizers could lead to food insecurity and debt distress in developing countries, affecting also their imports.

Against today's complicated backdrop, it is possible that in the future European trade could expand further, as the potential is not exhausted. Within the EU, there are countries (like Italy and Spain, for example) that are still increasing their degree of openness and integration within the global economy. Within the EU, trade grew dramatically in most of the Member States that joined the EU in 2004 or more recently. These countries experienced growth rates of more than 200 % in total trade between 2002 and 2021. For this group, such an increase may, at least in part, be explained by their process of integration into both global markets and (in particular) the European single market. Other Member States (such as the Netherlands, Spain, Germany, Austria, Portugal, Greece, Belgium, Sweden) recorded trade growth rates between 100 % and 200 % over the same time span. Another evidence that trade remains key for the EU economy, even if the period of "hyper-globalization" is over.

As mentioned, the relevance of trade for the EU is not only due to a deeply integrated Single Market, but also considering extra-EU trade. The EU is the top trading partner for 80 countries, a much larger number than the ones having the US as the top trading partner. Because of long historical ties, many of the EU trade partners are developing countries: fuels excluded, the EU imports more from developing countries than the USA, Canada, Japan and China put together. This means that on the one hand, the EU benefits from a high diversification of markets and suppliers, but on the other, it is also more exposed to both positive and negative world shocks.

WTO: Still Up to the Task?

Given the EU's openness and integration with the rest of the world, an orderly international trade system is very important for the European economy. In fact, the EU has always been a strong supporter of the WTO. Over almost three decades, the WTO has helped reduce barriers to trade in both goods and services and created a dispute resolution system that according to most observers reduced the threat of trade wars.

As many multilateral negotiations within the WTO stalled, WTO talks have continued through what are known as plurilateral negotiations, or agreements among subsets of WTO members. Plurilateral deals are easier to negotiate, as they are narrower in focus and not all members are bound by their terms. However, even if plurilateral agreements are important to help improving trade liberalization in some areas and especially to maintain an open negotiation channel within the WTO, the lack of achievements in the main multilateral setting for a decade or more has considerably weakened the role of the WTO and the institution is under considerable pressure. Negotiations on a comprehensive development agenda have foundered due to disagreements over agricultural subsidies and intellectual property rights, areas where the positions of advanced and developing countries seem quite difficult to reconcile, while members have increasingly turned to separate bilateral and regional free trade agreements to advance their trade interests. Criticisms of the organization vary from farmers and labor groups accusing the WTO of focusing too narrowly on corporate interests, to environmentalists worrying about deregulation, and different countries' policymakers alleging that the institution has failed to handle other countries' abuses.

In particular, the WTO has been recently criticized by one of its main former supporters, the USA. Former U.S. President Trump criticized the WTO for what he saw as its weakness in confronting China's trade abuses and constraints on U.S. sovereignty. His administration intentionally crippled the organization's appeals body by delaying the appointment of some judges, ensuring that its decisions cannot be enforced and placing the future of global trade rules into doubt. President Biden's administration has emphasized the U.S. commitment to the organization but has largely continued its predecessor's approach, maintaining the block on new appointments, and reiterating its frustrations with the dispute settlement process. With the appellate body paralyzed, countries can effectively ignore adverse rulings while their appeal is pending indefinitely. A group of about two dozen countries, as well as the EU, have set up an alternative arbitration system to settle disputes in the interim.

Even if looking for alternatives, the EU has a fundamental strategic interest in ensuring the effectiveness of the WTO. Not only is trade vital for the European economy; promoting rules-based international cooperation is the very essence of the European project. The EU is therefore pushing for meaningful WTO reform that allows revitalizing the organization, and it is trying to play a leading role in shaping the future set of international trade rules,: not an easy task as the USA attempts to maintain a key role in the trading system and China's growth is tilting eastward the world equilibrium.

EU Free Trade Agreements: Enough is Enough?

In a context where the multilateral rules become weaker, preferential trade agreements (PTAs) have proliferated and currently involve nearly all countries of the world. And the EU makes no exception to this trend: over the last years it increased the number of PTAs, also in the attempt to apply at least toward selected partner countries the set of rules that the EU considers most important for having smooth and fair international trade.

The European Union negotiates free trade deals on behalf of all its member states in view of its "exclusive competence" to conclude trade agreements. Even so, member states' governments control every step of the process, via the Council of the European Union, whose members are national ministers from each national government, in order to represent the interest of all member states in the negotiations. Before negotiations start, member states' governments through the Council of Ministers approve the negotiating mandate, which can be updated if necessary during the negotiations. Upon conclusion of negotiations, member states' governments decide whether the agreement should be signed. After approval from the European Parliament and (in case the agreement covers areas other than trade such as investment protection) upon ratification in each member state parliament, member states' governments decide whether the agreement should be concluded and enter into effect. This procedure can result in a very long time to conclude some negotiations and implementing the agreements.

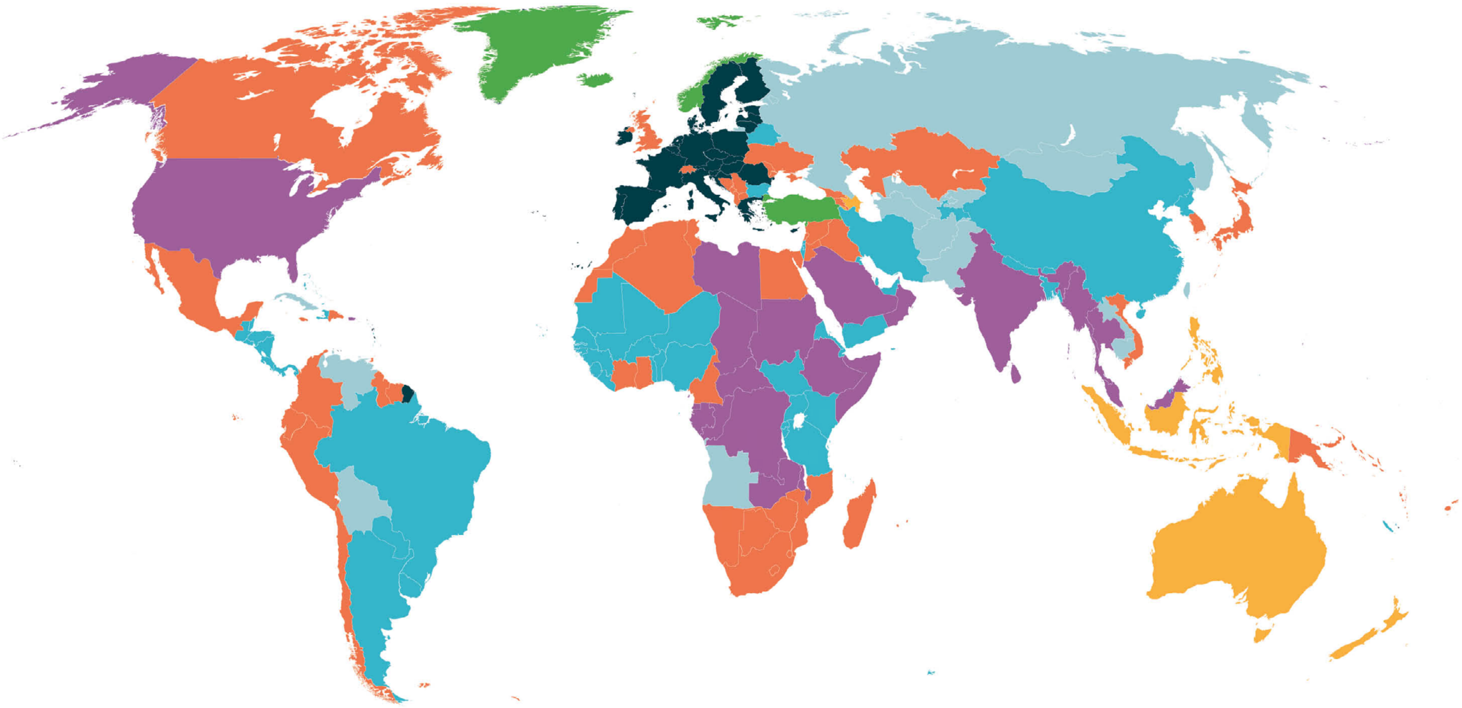
The set of concluded trade agreements involving the EU is very large (see Figure 3). There are currently 41 agreements in place between the EU and 72 countries.[5] In the past years, special attention was devoted to East Asia, and different free trade agreements with South Korea, Singapore and Japan signed between 2015 and 2019 manifest such interest. But Asia is not the only area of interest: for example, an important agreement with Canada entered into force (provisionally, as some parts still needed ratification) in 2017 – the so-called Comprehensive Economic and Trade Agreement (CETA).[6]

41

Number of FTAs signed by the EU with 72 countries

The EU's free trade agreements network

Partners with FTAs signed with the EU, and relative status



- European Union
- Customs Union, EEA & OCT
- In place
- Adoption/ratification on going
- Being negotiated
- On Hold
- No Agreement

Fonte: European Commission

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These are all so-called "deep" or "new generation" trade agreements, meaning that they include clauses that go well beyond the simple removal of tariffs or other restrictions to trade applied at the borders. These agreements include clauses on competition, environmental impact or consumers' protection in relation to trade, because as mentioned the EU would like to apply the same principles that rule the Single Market also to the economic relations with other countries. A clear example of this approach is given by the EU-Republic of Korea free trade agreement (FTA), provisionally applied since July 2011: this agreement went further than any of the EU's previous FTAs in lifting trade barriers, and was also the EU's first trade deal with an Asian country. It was also the first trade deal to include a chapter on Trade and Sustainable Development, reaffirming the commitment of the EU and Korea to contribute to sustainable development by integrating labour and environmental (including climate) protection in a bilateral trade relationship. Since the entry into force of the EU-Korea free trade agreement on 1 July 2011, bilateral trade and investment have expanded by a remarkable 71% in a decade.[7]

Another similar example is the EU-Singapore trade and investment protection agreements signed in October 2018. This is also very comprehensive, as it extends beyond trade to rules on foreign direct investment protection, notoriously difficult to deal with. The trade agreement entered into force in November 2019, but the investment protection agreement will enter into force after it has been ratified by all EU Member States (as of February 2022, 12 Member States have ratified it).

While the proliferation of preferential trade agreements can potentially expand EU trade, as observed in many cases, the risk is to reduce the transparency of the system of rules, as different procedures are applied toward different partners, making trade more complex for many firms, especially in the case of small exporters, increasing trade costs and fragmenting the world markets. So, it seems the EU is in the middle of a trade off between standstill of the multilateral trade system and the risk of economic fragmentation.

10%

Weight of China on the EU's total exports

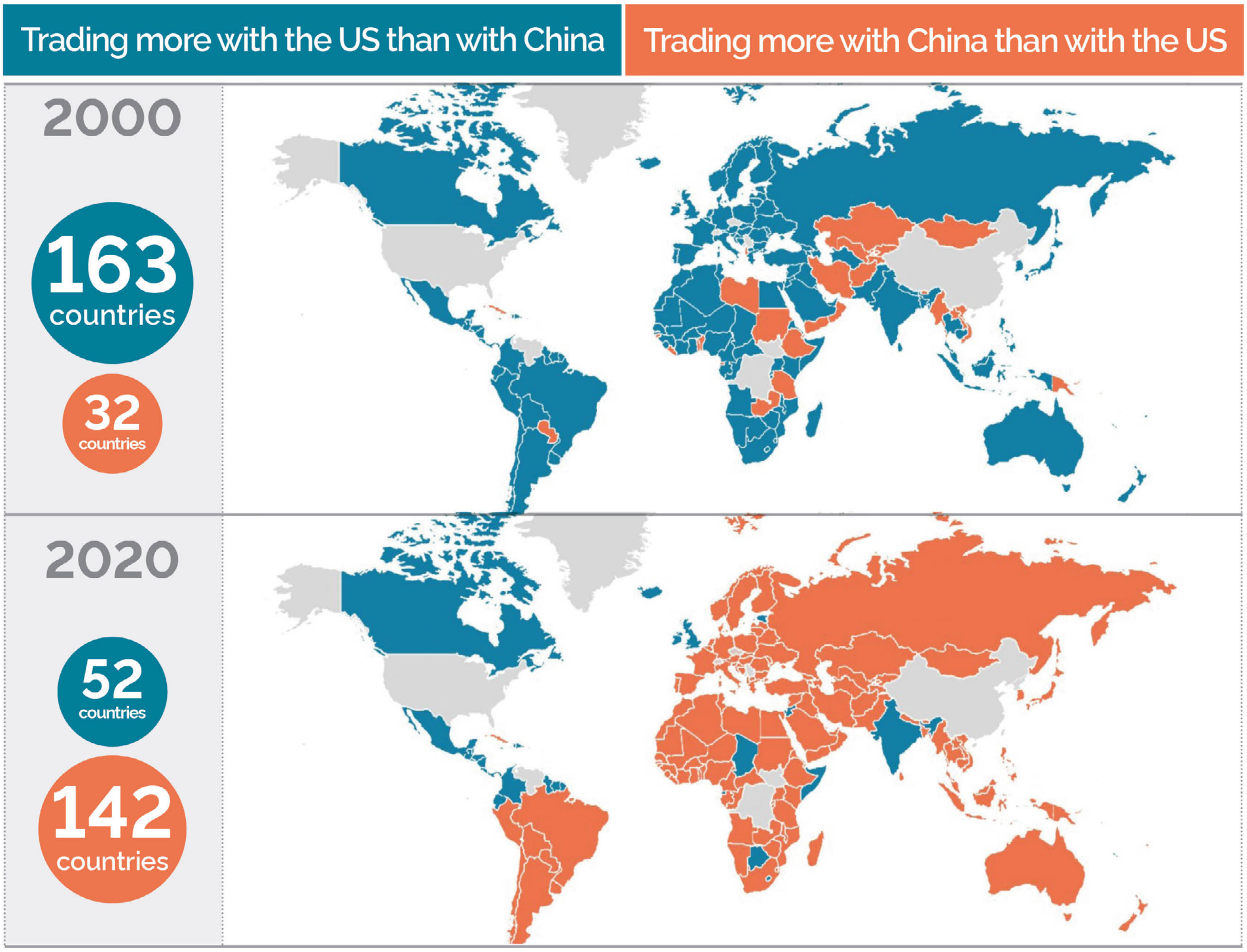
THE EU FACING A GLOBALIZATION IN CRISIS

Regionalization as the New EU Buzzword?

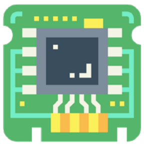
In the previous section it was discussed how the current slowdown in international trade might affect also the EU's exporting performance. But the consequences of this downward trend could go much further. Geopolitical frictions, skyrocketing energy and commodity prices, and disruptions along supply chains are questioning the future of globalization (at least as we used to know it). Can these trends help to widen and accelerate the mutual decoupling between China and the West (meaning the EU and the United States)? From the EU perspective, the economic partnership with China still seems crucial as Beijing is worth over 10% of exports and 22% of imports, making respectively for the third export destination and the first import provider.[8] These figures help to have an immediate idea of how costly an economic decoupling from China would be, at least in the short term; all the more so since China is the main shareholder in the global supply of critical minerals and rare earths, which are (and will be) increasingly crucial to propel both the digital and green transitions. Beijing's influence at this respect is telling as it holds 35% of the global refining capacity of nickel, between 50-70% of lithium and cobalt, more than 90% of rare earths.[9] Moreover, until recently the EU seemed keen to further deepen its ties with China having signed an ambitious bilateral agreement to promote investments (the so-called Comprehensive Agreement on Investment – CAI). But its ratification was then put on ice by the European Parliament: a move explained by concerns on human rights' violations in Xinjiang, but that is likely to hide more substantial economic reasons due to China's alleged unfair competition towards foreign companies.[10]

At the same time, it is no mystery that pressures to reduce dependence on China are rising in the West, both in the United States and in the EU. In terms of industrial and trade policies, all major players are trying to secure and strengthen semi-conductor supply chains. On one hand, China aspires to reach technological leadership and made the first move: the Made in China 2025 plan – aiming to reduce technological dependence from abroad by 30% - was launched in 2015.[11] The West reacted by launching its own plans: the US launched the CHIPS and Science Act in July 2022 with a $53 billion funding to strengthen the US semiconductor industry. Moreover, the restrictions to the exports of semiconductors to China, introduced in October by the US Department

China overtook the US as main global trade power



Source: Knoema, Eurostat



€15bn

Resources made available by the EU through the European Chips Act

of Commerce, are very close to what can be called an "economic war declaration" as they are aimed at accelerating technology decoupling.[12] And the EU did its part too: in January 2022, the European Commission launched the European Chips Act, putting 15 billion euros on the table from now to 2030 to generate 43 billion in additional investments and double the global market share between now and 2030 (from 10% to 20%). But it is doubtful whether EU's resources committed so far would be enough to eventually prevail in the global race for technology leadership.[13]

The quest for technology leadership is likely to accelerate existing trends that will reshape the geography of global value chains, through an expected increase of re-shoring, near-shoring, and friend-shoring practices. Apart from the growing narrative on the repatriation of foreign investment, how committed is the EU at this respect? These words are on everyone's lips, but how real is a scenario where global value chains are replaced by shorter, regional ones? We should look at data on investment and at policies aimed at creating regional supply chains. In terms of data, there is a caveat: at present, availability is still relatively limited and it is not easy to have extremely up-to-date figures. In the US, over the period 2010-21 repatriation of foreign investment (50% from Asia) involved more than 9000 companies, leading to the (estimated) creation on US territory of more than 800k jobs.[14] In the EU, according to the European Reshoring Monitor (initiative led by the EC) between 2015 and 2018 there were 253 projects of reshoring, with Italy and France on top of the ranking (mostly from China and Far East and in manufacturing sectors). It is still early to tell, but according to this trend it might be possible to estimate a repatriation equal to 10% of foreign production.[15]

Strategic Autonomy as the New Mantra: What About Free Trade?

It seems that the term "strategic autonomy" has become the new "mantra" for the EU. It originally comes from defence/military planning and refers to the EU's ability to chart its own course in line with its interests and values. The concept was used for the first time in December 2013 by the Foreign Affairs Council of the EU in reference to security and defence, at a time when the debate on the EU's external role as a foreign policy and defence power was beginning to frame. The concept kept evolving in the following years as the geopolitical context was becoming increasingly hostile, with the EU's scope and projection ability diminished by Brexit, and pressures arising from Trump's protectionist stance in the US and China's expansionist attitude through the pursuit of its Belt and Road Initiative.[16] Then, the economic shock induced by the pandemic in 2020 highlighted vulnerabilities along supply chains, starting from sanitary items and then extending to other manufacturing sectors because of the many "bottlenecks" that originated along global value chains (particularly from Asia towards Europe). This contributed to widen the conceptual framework of "strategic autonomy" also to other policy domains, in particular trade and industrial policy. Alongside this concept, "enhancing resilience" became another catchphrase quite popular in Brussels. In fact, in June 2020, High Representative for External Action Josep Borrell and European Commissioner for the Internal Market Thierry Breton published an opinion piece, making the case 'for a united, resilient and sovereign Europe', in which they linked the pandemic supply shortages to the need for the EU to become more resilient and independent.[17] This signalled the forthcoming extension of "strategic autonomy" to trade policy, which occurred in February 2021 with the publication of the latest EU Trade Policy Review that explicitly called for an "open, strategic autonomy" in the trade domain. What should this consist of? Basically, Europe's trade policy should be built around three main pillars – resilience and competitiveness, sustainability and equity, assertiveness and rules-based cooperation – to be pursued through the implementation of six key actions: reform the World Trade Organization, support green transition and promote sustainable supply chains, support digital transition and trade in services, strengthen the EU's position as a global rule maker and standard setter, reinforce the economic partnerships with EU neighbors, strengthen the focus on the implementation of existing free trade agreements.[18] And what does this mean in practice? It basically implies that critical supply chains – those ones that are crucial to carry the green and digital transitions forward -should be secured and regionalized, using the EU's interests as a starting point rather instead of prioritizing specific areas or regions as trade partners.[19] This applies to both China and the US (as a legacy of the tense relationship during the Trump presidency), although political and economic ties with the latter have become again much closer during the Biden administration, as it has been shown by the launch of the Trade and Technology Council.[20] All in all, the Trade Policy Review contains a number of interesting elements, which seek to map out the themes and axes of international trade in the years to come and to identify the appropriate tools for the EU to pursue its objectives by exercising leadership without having to 'follow closely stronger competitors, both economically and politically (the United States and, above all, China). But for such a 'proactive' and not merely 'reactive' approach to materialize, it would be necessary to reactivate multilateral trade governance in order to identify shared rules of the game. Only in the framework of a system truly based on shared rules Brussels could really maintain its competitive advantage as 'rule maker', exploiting the so-called "Brussels effect",[21] and become an increasingly attractive market, based on a virtuous balance between economic growth, innovation, environmental and social sustainability.[22]

The EU in Global Supply Chains: Doomed to Dependency?

If free trade agreements are the skeletal of globalization, Global Value Chains (GVCs) are the arteries that pump blood into today's globalized trade system. Production processes are structured in several stages which often take place in more than one countries. The example of the manufacturing process of an iPhone is probably the best case in point to explain the degree of fragmentation of these processes; but most manufacturing industries rely on this architecture, since more than 50% of world trade takes place along GVCs.[23]

50%

Share of world trade relying on Global Value Chains (GVCs).

As a consequence of the central position occupied within the global network of FTAs, the EU is also a key player in terms of GVCs positioning. How? The participation of the EU in GVCs is significantly higher than in the United States and China,[24] meaning that European countries rely both on backward linkages (in terms of inputs characterized by lower value added) and forward linkages (the final stages where value added is higher) of GVCs: typically, this is the case of manufacturing "powerhouses" like Germany and Italy as well as other smaller economies which are strongly connected to Germany on a more regional (rather than global) scale. Box 1 reveals that, on one hand, the EU holds a relevant position in terms of global competitiveness in many manufacturing sectors, occupying final stages in many crucial GVCs; on the other hand, its key role is also explained by the high degree of interconnectedness of EU manufacturing industries within GVCs.

The Covid-19 pandemic has had an impact on these profound economic linkages, highlighting and deepening concerns about the EU's dependence on global supply chains, from personal protection equipments to high-tech products based on semiconductors. These concerns have contributed to boost the pursuit of an "open strategic autonomy" and to declinate this concept also with respect to trade and industrial policies (see previous paragraph). The involvement in continental GVCs was already on the rise before the pandemic: 23 countries out of 27 registered an increase in the role of foreign affiliates in gross value added creation, and a simultaneous expansion in their role in international trade in the year between 2005 and 2015.[25] But redrafting the map of value chains, from a less global to a more regional scale, requires greater attention in order to preserve the strengths of EU manufacturing industries in view of the increasing competitive dynamics *vis-à-vis* other major economic blocks.[26]

BOX 1

THE EU'S POSITIONING IN GVCS: BETTER OR WORSE THAN OTHER COMPETITORS?

Luca Salvatici and Ilaria Fusacchia

The improved availability of value-added trade data allows us to picture what European Union (EU) sectors are more competitive within global value chains (GVCs). Rather than focusing on particular sectors or examples, we determine the distribution of competitiveness in relation to the sectors' distribution in terms of backward and forward participation to the GVCs. Results reveal significant differences across sectors. Specifically, we identify the EU competitiveness by considering domestic production factors and inputs used in the production (thus excluding the contribution of foreign intermediates) and defining revealed comparative advantage (RCA) in terms of value-added (VA). The RCA index is essentially a normalized value-added export share (a country's value-added exports in some sector as a fraction of national value-added exports, divided by the world exports in that sector as a fraction of total exports). When the RCA index exceeds unity, comparative advantage is 'revealed' for the country in that particular sector. To measure EU sector integration, we use the GVC participation indexes and depict EU involvement in GVC both as a buyer of inputs from abroad to produce its exports (backward linkages) and as a seller of domestic value-added used in other countries' exports (forward linkages).

The Global Trade Analysis Project Data Base provides comprehensive and balanced data on consumption, production, trade and trade policies (Aguiar et al. 2019). The most recent version of the Data Base refers to the year 2017, includes 65 commodities and covers 140 countries (representing more than 98% of world GDP) and 18 aggregate regions. Given our focus on goods, we maintain all the processed food and manufacturing sectors included in the Data Base (Table 1). To catch the complexity of international linkages within GVCs, we distinguish final and intermediate products within bilateral trade flows.

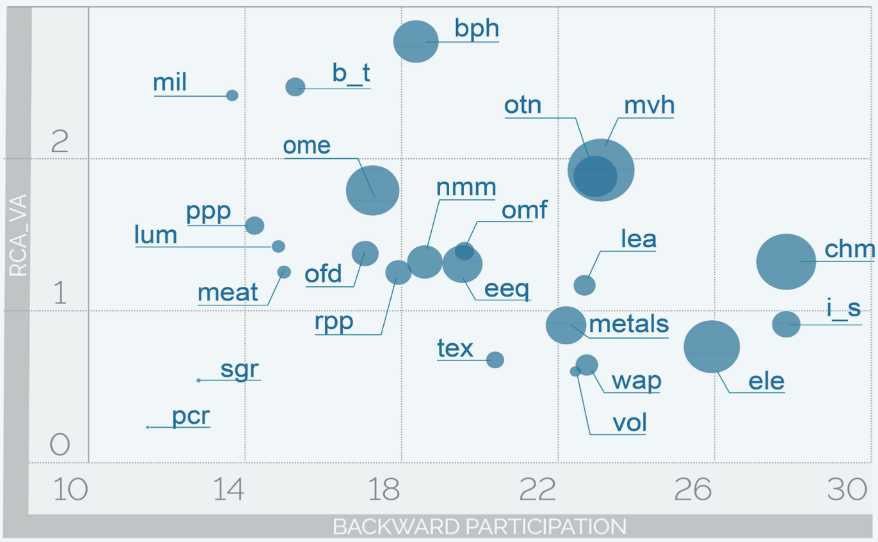
TABLE 1. SECTOR LIST

Bovine meat products (meat)
Vegetable oils and fats (vol)
Dairy products (mil)
Processed rice (pcr)
Sugar (sgr)
Food products nec (ofd)
Beverages and tobacco products (b_t)
Textiles (tex)
Wearing apparel (wap)
Leather products (lea)
Wood products (lum)
Paper products, publishing (ppp)
Chemical products (chm)
Basic pharmaceutical products (bph)
Rubber and plastic products (rpp)
Mineral products nec (nmm)
Ferrous metals (i_s)
Metals nec (metals)
Computer, electronic and optic (ele)
Electrical equipment (eeq)
Machinery and equipment nec (ome)
Motor vehicles and parts (mvh)
Transport equipment nec (otn)
Manufactures nec (omf)
Other sectors

Source: GTAP Data Base

Comparative Advantages and backward participation

EU industrial sectors, backward participation (horizontal axis), and revealed comparative advantage related to value added (vertical axis)



Source: Authors' elaborations based on Global Trade Analysis Project Database

In Figure 1, we analyze the global production linkages of the EU and assess the positioning of the key manufacturing sectors in terms of the Revealed Comparative Advantages based on the domestic VA (RCA_VA) and the backward GVC participation index, measured as the share of foreign value added that is included in the total export value of a country.

The results indicate that the EU has a comparative advantage in 16 sectors. The index values for these sectors are above 1, and this suggests a revealed comparative advantage in the value-added export of these products. Basic pharmaceuticals products register the highest value, but the most relevant sectors in terms of exports, as signaled by the size of the bubble, are Motor vehicles and Chemicals.

Comparing the overall distributions of RCA in terms of value-added across countries reveals that the EU specialization is quite different from those of countries such as China, India, Brazil or Russia since the correlation index assumes negative values. On the other hand, there is a positive correlation with countries such as Japan, Korea and the US, even if the value never exceeds 0.4.

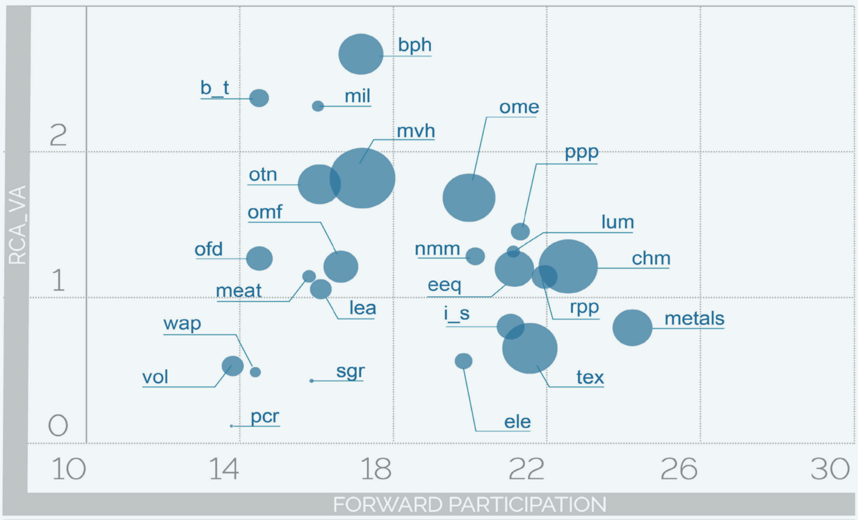
Overall, the EU backward integration value (19.7, the blue vertical line in Figure 1) is lower, as expected, than those of smaller countries such as the UK, South Korea or Canada. On the other hand, it is in line with that of China and higher than the US. Comparing the overall distributions, the sector values are positively correlated for all countries except Russia. Accordingly, even if the backward integration intensity varies, the sector ranking is similar across countries.

Some of the most relevant EU exporting sectors, such as Motor vehicles, Transport equipment and Chemicals, show the highest levels of backward integration. The relevance of foreign inputs is broader than sectors where the EU is relatively more competitive since industries, such as Electrical equipment and Metals, show high levels of backward integration and RCA index values lower than 1.

In Figure 2, the Revealed Comparative Advantages are related to the forward GVC participation. The forward GVC participation index is measured as the share of a country's value-added arising from its exports included in other countries' exports. It is worth recalling that at the industry level, for the forward participation indicator, the value added in the exports of partner countries from intermediates sourced from each industry only includes the value added that is transferred through direct linkages: e.g., Metals' value added embodied in other sectors' exports that are subsequently used to produce exports in other countries would not count towards Metals' forward indicator.

Comparative Advantages and forward participation

EU industrial sectors, forward participation (horizontal axis), and revealed comparative advantage related to value added (vertical axis)



Source: Authors' elaborations based on Global Trade Analysis Project Database

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THE EU IN A TRADE JIGSAW: FROM DEPENDENCY TO AUTONOMY

In the first part of this Policy Paper it was shown that the EU is a sort of "cornerstone" of the international trade system, both in terms of trade flows (volumes and values) and of the architecture (FTAs and inclusion in GVCs). Over the last three decades, in view of increasing interdependence among main economic blocks (namely the EU, US and China), globalization had become the dominant paradigm. But increasing economic competition (especially in high-technology sectors and those ones involving concerns of national interest), on top of the two major economic shocks – Covid and the war in Ukraine – that increased international fragmentation, are questioning the survival of this paradigm, questioning the future of the EU as an economic power.

The EU is seeking to pursue a trade policy based on "open strategic autonomy", meaning that it aims to reshape globalization trying to protect its economic security while preserving its global export shares through a mercantilist approach. But can this "competitive globalism"[27] succeed in an increasingly competitive scenario, where other key players hold crucial assets in terms of financial resources (like the US through the supremacy of the dollar) or commodities (like China that controls the global supply of critical minerals and rare earths), and where the rules of the game are increasingly undermined because of the prolonged standstill of the WTO? The purpose of the second part will be to explore viable policy options to escape this dilemma and find ways to keep and strengthen the EU's position as a trade leader.

Exploring Options

Is globalization really about to fall into pieces? Or are there ways to ensure it can still survive (and thrive), and with it the role of the EU as a key trade player? Rekindling multilateral trade negotiations would certainly be an ideal solution to address ongoing fragmentation, but geopolitical tensions and disagreements among States make this option less likely to achieve in a short-term perspective. So, what else could be done to preserve the EU's central role in GVCs and as a broker of FTAs?

2001

China enters the WTO, representing the biggest achievement of the organization

FIRST BEST: REVIVING MULTILATERAL TRADE

The WTO has been at the cornerstone of the architecture of multilateral trade. The Geneva-based organization was established in 1994 on the basis of the pre-existing General Agreement on Tariffs and Trade (GATT), and it got involved not only in the regulation of exchange of goods, but also of services (through the General Agreement on Trade in Services – GATS) and on the treatment of intellectual property rights (through the TRIPS agreement, its third normative pillar). At first, it seemed that the WTO was working well and reached its "zenith" in 2001, when China was finally admitted into the organization thanks also to tireless negotiation efforts by the US which managed to close (only temporarily) a long-lasting economic "schism": a cleavage between the two countries that affected also the rest of the globalized world economy.[28] Unfortunately, for a number of reasons this "multilateralist momentum" soon faded away, so much that the latest remarkable progress marked by the institution was the conclusion of the Trade Facilitation Agreement in 2015, a relatively minor advance aimed at reducing red-tape and simplifying exporting/importing procedures for developing countries so to help them include in the multilateral trade system.[29] Then, WTO entered a phase of prolonged standstill when the US – during the Trump administration – vetoed the reappointing of members of the Trade Appellate Body, which is crucial to ensure the functioning of the organization. This was paralleled also by a very negative moment for the trading relationship between the United States and the European Union as a consequence of retaliatory measures triggered by Washington in view of the dispute Airbus-Boeing, a case of alleged unfair competition.

June 2022

The WTO 12th Ministerial Conference is held in Geneva, with small steps ahead for multilateral trade governance

This led to a tariff escalation which was averted only in 2021 after the new Democratic administration led by Joe Biden took power. However, this situation did not open up a new phase of multilateral negotiations: the modest progress reached during the latest Ministerial Conference (MC12) in June 2022 cannot be considered as a major step forward. In fact, new areas which are increasingly crucial for international trade – such as digitalization and sustainability – remain largely unregulated. This somehow frustrated the EU's expectations because of its pioneering role within these two areas. In other words, a successful WTO reform that would preserve the EU's role as a key player in international trade would rely on the following elements:

- First and foremost, framing the boundaries of WTO action: widening too much its remit risks being counterproductive and eventually weakening its effectiveness;
- Avoiding to embed values in the trading system: the EU's objective of forcing its trading partners follow its rules and values brings can bring retaliation and further trade disputes. A more cautious approach would be based on promoting EU rules and standards (so-called "Brussels effect") rather than raising too much the bar on values that not all other players are prepared to abide by;
- Pursuing level playing field in areas which are crucial to preserve EU's global economic competitiveness. For the EU, the "primary focus of any WTO reform should be to modernise rules on competitive neutrality", i.e. level the playing field regarding subsidies, state-owned enterprises (SOEs), forced technology transfer and domestic regulations. (see Box 2).

BOX 2

HELPING THE WTO MOVE FORWARD IN POST-MC12: A ROLE FOR THE EU

M. Sait Akman

Almost everyone agree that the WTO is living an "existential crisis", as its functions are becoming progressively less efficient with respect to bringing new rules, adjudicating trade disputes and monitoring derailed policies of its members. It is losing its centricity in governing world trade as the "first best". The MC12 was completed with modest outcomes revealing that the WTO is still producing multilateral results, but far from satisfying the need of reinvigorating the functioning of the institution.

Most trade policy actions and negotiations take place in other venues among "like-minded" countries. Many priority issues are regulated in regional initiatives (e.g. CPTPP, RCEP, USMCA, IPEF, TTC), however global problems like pandemic, food security and climate change still need multilateral response. Regionals can bring deeper rules and regulations among narrower groups but multilateralism is the only way to prevent fragmentation and to benefit optimal use of world's resources for the prosperity of all.

The EU has been a strong defender of multilateralism. It submitted several proposals for reforming the WTO system (including the so-called Ottawa Group). However, earlier calls for reform including those of the EU have not produced any concrete result in major areas of friction largely because the problem was not simply relevant to institutional stagnation in the WTO, but the difficulty of reducing gaps in trading powers' positions and their trade strategies amidst global developments.

On its part, the EU's response has been to design a new trade strategy to address economic recovery in post-global financial (and more recently COVID-19) crisis, resilience of global value chains, imbalances in commitments of its trading partners sustainability issues like climate change, and digitisation in international trade. Accordingly, the trade policy is expected to support EU's geopolitical goals with an updated trade rulebook in many new areas and to reinforce its trade agreements by making better use of trade defense instruments. For the EU, the "primary focus of any WTO reform should be to modernise rules on competitive neutrality", i.e. level the playing field regarding subsidies, state-owned enterprises (SOEs), forced technology transfer and domestic regulations (European Commission, 2021: 11).1 A normative aspect is also evident in its trade strategy linking trade to values through an expansive agenda such as environment, labour regulations, good governance, human rights issues to influence its trading partners through its own norms and policies.

WTO members, in MC12 document committed to undertake necessary WTO reform and asked the General Council to launch a process on the matter, and review the progress until the next Ministerial Conference. Things are not yet clear about the process while concerns over negotiations in outstanding and new issues, transparency disciplines, and dispute settlement system remain. In putting the WTO back on track in post-MC12, the following elements can be highlighted:

FRAMING THE BOUNDARIES OF THE WTO FIRST, BEFORE REFORMING IT

The dynamic nature of global economy and developments make contours of trade policy difficult to define. Many global problems need macroeconomic, social, and other policy solutions but also trade policy interventions. Hence, several cross-cutting issues are becoming part of new generation trade agreements. The centricity of WTO in global trade governance will be further challenged unless many of these issues are multilateralized under its rulebook. However, a clear demarcation is vital to save the WTO from a work overload. The WTO reform process must consider the fact that initiating and completing negotiations in issues (like labour markets, environment, corporate governance, antitrust, and taxation) largely regulated under competing domestic models is extremely challenging and more flexible methods of decision-making will be necessary. Equally important is to keep trade policy governance confined to matters that require direct trade policy intervention. The EU and many advanced economies must consider developing countries need "non-trade remedies" (contrary to trade remedy measures) like capacity building, financing, training and other domestic regulations to solve their market failures.

EMBEDDING THE VALUES IN TRADING SYSTEM

All member of the WTO as sovereign nations can have their own regulations and safeguard their domestic choices. Universal values are hard to define, and members should refrain from imposing their own regulations, norms and values on others. Trade rules and practices should not be used as trade sanctions and barriers to force others change their policies.2 Imposing a regulatory environment from above will not work.

The new trade strategy of the EU emphasizes its openness and the need for sustainability. However, its is also "assertive" and the EU's new trade defensive policy instruments seek remedies. They aim at providing an enforcement mechanism in the form of an "aggressive unilateralism" recalling the US trade policy. The objective of forcing its trading partners follow its rules and values brings can bring retaliation and further trade disputes.3 The trading nations, including the EU must refrain from a power-based approach which is quite the opposite of a rules-based system and does not help revival of multilateralism.

RE-ASSESSING THE DEVELOPMENT ISSUE IN WTO REFORM

An important objective of the WTO is to ensure developing countries benefit from trade commensurate with their economic development needs. Special and differential treatment (SDT) has been a major device to help developing countries secure such gains. This procedure is now challenged because it does not define the "development" and "the developmental needs" and many emerging economies continue to benefit from such privileges. Identification of needs is not an easy process, while bringing metrics to measure the development (the US attempted once) and re-categorising members (proposed by Norway on behalf of Ottawa Group) is fiercely refuted by many developing members with some exceptions only (e.g. Brazil, Taiwan and South Korea announced to give up their status). However, the current practices of lump sum exemptions will not help the WTO, but mitigate its credibility further as a venue for future talks. The EU's offer of instituting a "graduation mechanism" needs further clarification in the reform process to be taken up by the General Council, but a blanket denial of SDT through graduation may not work. A "tailor-made approach" which is supplemented by the elimination of indefinite transition periods, carefully crafted rules in each agreement, and a rollback mechanism in which developing members waive or reduce the implementation of some of their practices that fulfilled their developmental objectives, can be contemplated.

CONSIDERING COMPLEMENTARY NEGOTIATION OPTIONS TO MULTILATERALISM

The willingness, capacity and interests of members differentiate and can even lead to hostage-taking in multilateral talks. The current stalemate in consensus-based decision-making in the WTO is driving many members towards new cooperation ways to regulate many areas. They join plurilaterals to circumvent difficulties faced in initiating multilateral negotiations. JSIs (Joint statement Initiatives) on domestic regulation of subsidies, investment facilitation and e-commerce advanced and many other initiatives such as environmental goods and plastics are in the pipeline. Some leading developing countries find them controversial because plurilaterals methods can fragment the WTO rulebook instead of restoring it. However, incorporation of plurilaterals agreements -possessing transparent, inclusive and development-friendly mechanisms into the WTO system can revitalise WTO's negotiating function. To encourage wider participation of developing countries: capacity-building measures need to be assessed;4 and a "hierarchical framework" of stages can be proposed with limited obligations initially towards gradual full membership with some flexibilities (Kher, 2022 et.al.),5 even though it is still difficult to overcome deep reluctance by some (e.g. India) which opt-for "issue-linkages" in trade negotiations.

The above-mentioned elements along with robust proposals to revitalise the dispute settlement system and to provide a clear mandate for improving WTO's institutional and executive functions need further discussion in the post-MC12 process. However, much depends on the decision and willingness of members to revive the system to the benefit of all, or witness its demise.

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SECOND BEST: MAKING GOOD USE OF REGIONALIZATION

Currently, there are more than 330 Preferential Trade Agreements (PTAs) in force at global level.[32] The European Union is part of 44 PTAs involving around 70 countries worldwide.[33] It seems that negotiating PTAs has become an inevitable option to bypass the longstanding standstill at WTO level. The EU has clearly been a champion in advancing trade liberalization through PTAs; however, the use of such "second best" instruments should be made so as not to further enhance geopolitical and economic fragmentation (particularly at such a critical time for international relations) but to enhance trade openness in a context of compatibility and possibly complementarity with WTO rules. What does this mean in practice? Basically, that such agreements should not be intended as "exclusive clubs" but should be left open to potential accession by other States and, even more importantly, that these act as a sort of "stepping stones" to include new issues at multilateral level. In fact, more and more often "modern" PTAs are increasingly less focused on tariffs reduction (or not only on this aspect, as it used to be in the past) but on harmonization of administrative rules and technical standards and are also pioneering the role of rule-setters with respect to new areas such as digitalization and environment sustainability (see BOX 3). Thanks to its overarching role as standard setter, the EU would be best-placed to exploit its so-called "Brussels effect" and pursue the widening and progressive incorporation of such rules and standards also at the multilateral level. One case in point could be represented by the forthcoming introduction of a Carbon Border Adjustment Mechanism (CBAM), an innovative tool aimed at tackling carbon leakage that is set to be enforced (although in a phasing-in fashion) by the EU from 2023. In order to avoid the controversial aspects of CBAM (in particular the ones related to the accusations of "disguised" protectionism), its design should be probably fine-tuned at WTO level in a way that it is more inclusive and not harmful of Least Developed Countries.[34] In other words, the EU's first mover advantage should be exploited so that Europe does not fall into a "fortress scenario" but rather it encourages the adoption of high standards by establishing a race-to-the-top scheme.

330

Number of Preferential Trade Agreements in force at global level.

BOX 4

A LOOK AT EU RTAS: HOW TO MAKE THEM COMPATIBLE WITH THE WTO SYSTEM

Claudia Schmucker

RThe multilateral forum of the WTO is still the best option for creating global trade rules. However, due to a lack of progress on the multilateral level, free trade agreements (FTAs) are often seen as the second-best option to negotiate new rules and market access. But the ongoing trend towards regional and bilateral FTAs also poses risks for the multilateral trading system: The preferential agreements are the major exception to the WTO's most-favoured nation rule (MFN) and discriminate against other trading partners. As such they include the danger of becoming economic fortresses leading to trade diversion. In order to make good use of regionalization, the EU needs to adhere to three conditions in its regional and bilateral agreements.

MAKE SURE FTAS ARE WTO-COMPATIBLE

Under WTO rules, FTAs are allowed as an exception to the general MFN treatment, if they respect certain principles listed in GATT Article XXIV and GATS Article V. These articles state that FTAs have to cover "substantially all trade," and that the tariffs and trade provisions, which are established in the agreement, are not higher or more restrictive in aggregate than the provisions prior to the conclusion of the agreement. However, these conditions are quite vague and open to a wide range of interpretation.

The EU as a leading global player in trade needs to make sure that the negotiated agreements are undoubtedly in accordance with WTO rules. It needs to act as a role model in this regard. Since the Global Europe strategy (2007), the EU has negotiated a wide range of ambitious trade agreements, which cover a variety of sectors and provisions. As such, they are clearly in line with WTO rules. However, in this regard, a transatlantic agreement on the elimination of industrial tariffs only, which was proposed by the EU during the Trump era, should be seen with concern. Even though it would probably obey with the letter of the WTO rules, but it would go against the spirit of it.

KEEP FTAS OPEN TO MINIMIZE DISCRIMINATION

In addition, in order to minimize the negative effects of discrimination and trade diversion, the EU should try to keep the FTAs as open as possible. This means first of all low rules of origin, which are also compatible with other FTAs. But the EU could also start to think about opening up its FTAs to other interested partners, who are willing to adhere to the high EU standards.

USE FTAS AS STEPPING-STONES FOR NEW ISSUES AT THE MULTILATERAL LEVEL

EU trade agreements go way beyond traditional market access agreements and include provisions on trade in goods and services, technical barriers to trade, sanitary and phytosanitary measures, customs and trade facilitation, subsidies, investment, digital trade, competition policy, SOEs, government procurement, SMEs, and the protection of intellectual property rights (IPR).

These agreements contain a number of provisions, which go beyond the multilateral rules of the WTO. A Bruegel study (2009) divided these provisions into two categories: WTO plus (WTO+) commitments, which deepen already existing WTO rules, and WTO extra (WTOx) commitments, which deal with new issues, which are not covered by WTO rules. EU FTAs cover both areas: They include a deepening of existing WTO rules e.g. regarding tariff reductions, subsidies, or IPR rules (WTO+) and they contain new rules, particularly with regard to new issues such as digital trade, environmental and labour standards, the so called TSD chapters (WTOx).

WTO rules largely date back to 1995 and have not adapted to modern trade realities. New topics such as digital trade, and a sustainability agenda are lacking until today, despite the urgency to develop rules in this regard. By including new WTOx rules with a variety of trading partners with different levels of development (including emerging market economies such as Singapore or developing countries such as Vietnam), EU FTAs can form a good basis for plurilateral or multilateral rules at a later stage. As such they can be used as a stepping-stone for future multilateralization.

In order for this to be successful, the EU needs to stay actively engaged in the ongoing multilateral and plurilateral discussions at the WTO. It needs to incorporate its experience into the discussions and find coalitions on these new norms and standards. The wide net of existing FTAs partners already form a good basis for that. As such, based on the experiences of its ambitious FTAs, the EU can actively shape globalization and global rules on issues, which are urgently needed.

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OUR TAKE

The current geopolitical context, characterized by the war in Ukraine and other frictions among key economic powers (China, the European Union and the US) will certainly contribute to redefine globalization, at least as we used to know it. Tensions aimed at shortening key value chains – particularly those with higher technology intensity and that are crucial for industrial sectors where States hold strategic interests – are likely to increase in the coming years. This does not mean that globalization is doomed to end, but rather that it will change aspect: interdependence is still – and will remain – too high to "destroy" economic integration along GVCs. The likeliest option is that the global economy will face a process of "fragmentegration", which is not the same as disintegration but is a scenario in which actors will react to supply shocks by looking for new trade partners and ways of integrating their economies.

Unfortunately, the WTO no longer looks fit for purpose. After a prolonged standstill, the Geneva-based organization does not seem able to make considerable progress on multilateral trade negotiations. Moreover, international trade is increasingly characterized by new issues, such as digitalization and environment sustainability, which currently remain largely unregulated. Therefore, the WTO is in need for a deep reform, which should be also consist of new tools aimed at establishing a level playing field in areas such as digital trade (e-commerce but also regulation of personal data) and "green" trade (for instance by identifying an agreement towards the establishment of a CABM).

The European Union is definitely in the position to contribute to the reform of the multilateral trade environment, thus paving the way to a sort of "WTO 2.0". Thanks to early adoption of high standards both in terms of digital regulation and sustainability, Brussels could exploit its comparative advantage as a "global standard setter" and look for broader consensus with other WTO members, rather than following an alternative route that would lead to a more isolated position and a protectionist attitude. Particularly over the past decade, the EU has substantially enjoyed the benefits of free trade and open markets and should continue to pursue such an environment. At the same time, the EU should better equip itself to face geoeconomic competition from other key players in order not to lose the race for global technology leadership, that will mark the coming years, and to enhance resilience in its critical supply chains. As empirical data show, the EU has a competitive advantage in many manufacturing sectors, mostly thanks to its integration in GVCs. This is a privileged position that should not be wasted in the future by the EU through a renewed ambition to remain at the core of trade liberalization processes, be them on a multilateral (first best) or regional/plurilateral basis (second best).

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