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European trade policy in a changing international environment

Enrique Feás & Federico Steinberg

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Trade is a fundamental part of the identity of the European Union (EU). The integration of the community began with trade and it is trade that has paved the way for political integration. The EU is home to just 7% of the world's population but the largest exporter and importer, responsible for one-third of global trade (more than the US and China). Around 30 million (one in seven) of its workers depend directly or indirectly on exports to the rest of the world. This figure has risen by almost 50% since 1995, with European companies strongly integrated in global production chains, especially in the service sector.

Yet the EU faces an uncomfortable truth: the international trade system is gradually moving away from the model that prevailed during the second half of the 20th century. The multilateral rules-based framework, the technological prowess of many European businesses and a solid transatlantic relationship all allowed EU countries to prosper throughout this period. However, the resurgence of nationalism and geostrategic rivalry among major powers, above all the US and China, has made international relations less cordial and cooperative than those that would suit a 'herbivore' power like the EU, jeopardising the sustainability of the so-called liberal international order. The technological revolution is also rapidly transforming the nature of global trade, implying difficult adjustments for businesses and societies. Finally, support for economic globalisation is undergoing a crisis of legitimacy –both in Europe and in other advanced countries– with potentially serious consequences for prosperity and standards of living.

This report highlights the importance of internal cohesion within the EU, of increasing the legitimacy of an open economy among the public and of acting as a single bloc to lead the reform of the multilateral rules-based order. At the same time, the EU must also continue to build on its network of preferential trade agreements to be prepared for a collapse –currently a possibility– of the multilateral system embodied by the World Trade Organisation (WTO) and the disintegration of the global economy into blocs under a neoimperialist logic.

The EU is the only actor able to lead a coalition of like-minded countries in a reform of the WTO that seeks to find minimums acceptable to both China and the US. Despite acknowledging the need for a reform of the multilateral framework, these two powers are currently locked in a dangerous trade and technology war with no clear end in sight and in which the EU must remain neutral. Given the gulf between their positions, an agreement seems impossible without other players who can bring them together and it may even be necessary to wait until Trump departs the

White House. Any reform must focus on the rules governing subsidies, intellectual property, technology transfers, the treatment of public companies, export rates, the defence of competition in international trade and the facilitation of investment. However, arguably the most urgent task of all is to reform the dispute resolution mechanism, the jewel in the WTO crown, which is currently blocked by the US.

The EU has recently signed major preferential and bilateral agreements with countries including Canada, Japan, Singapore, Mexico, Vietnam and Mercosur. However, the agreements need to be implemented as soon as possible and progress with the main emerging countries in Asia and Africa must be accelerated. The EU trade agenda also includes completing the bilateral agreement with the US (provided negotiations are ambitious and not just confined to a few matters of interest to the US) and resuming negotiations with India. The EU has been in talks with China on investment for years but a deeper free trade agreement with the country will only be possible when it agrees to play by the same rules as others. This means ending subsidies to companies with practices that lack transparency and stopping discrimination against European companies and the theft of intellectual property.

The EU must not set vetoes or preconditions for these agreements and must defend its values and interests, especially on human and labour rights and environmental sustainability, flexibly and without recurring to threats. It must also work to change the controversial Investor-State Dispute Settlement (ISDS) system, replacing it with a model based on an international investment court, which it is already promoting in some of its preferential trade agreements.

This assertive role on the international stage must be complemented by activities to increase the legitimacy of trade agreements in the public opinion. The EU has already made significant progress in promoting transparency and European values. However, it still needs to advance with the crucial tasks of protecting and empowering those who lose out from openness to trade and ensuring a level playing field for financial globalisation. While the European Commission negotiates trade policy for the EU as a whole, the impact of opening up the bloc's economy often varies across countries and even regions due to the different structures of the economies and welfare states of the different EU Member States. Without a broad federal budget at the EU level to allow *ex post* redistribution among countries and with less effective policies for unemployment and training in the relatively poorer countries, trade liberalisation has the potential to aggravate inequality in the EU. Resources must be increased at the EU level through a reform of the European Globalisation Adjustment Fund (including an increased budget), which has to date been limited, underused and ineffective.

However, the debate on EU fiscal instruments for the internal redistribution of income and mitigating the growing economic inequality that is partly caused by trade and financial openness must also take into account the role of financial globalisation and the challenges of collecting taxes in the most internationalised sectors in recent years. It is clear that for trade in goods, there is a level playing field that, despite its limitations, guarantees competition. Yet the same cannot be said of finance. Moreover, this situation is undermining the legitimacy of globalisation and will continue to do so unless measures are taken to address this problem. To address these issues, unanimity needs to be replaced by qualified majority voting for fiscal matters and the EU must be more assertive in tackling corporate tax evasion by transnational companies through appropriate tax base harmonisation at the EU level. Aside from setting a minimum rate to prevent a race to the bottom, it is not necessary to harmonise rates, given the different fiscal traditions in EU Member States. However, when taxing the profits of businesses, their tax residence, the treatment of income from intellectual property, withholdings (especially for transactions involving tax havens), transfer prices to other group companies and other more complex aspects related to technology (eg, the concept of permanent establishment or place of supply for digital services) must be standardised throughout the EU. A level playing field for the free circulation of capital means countries must compete solely on administrative facilities, the ability to provide a fast and efficient legal system and the quality of complementary resources, such as human capital.

In short, trade policy cannot be conducted in isolation. It is intimately linked to other European sectoral policies, such as regulation of the single market for goods and services, the defence of competition, industrial policy, the internationalisation of the euro and regulation of the global financial system and its effects on global governance and inequality. These are issues on which Member States are too small for their voice to be heard in a world of large powers but in which the EU as a whole can be a major player. Recent examples include the national security implications of Chinese suppliers of 5G technology in EU countries, how dollar hegemony makes European companies more vulnerable to US sanctions and the extent to which 'European champions' are needed for artificial intelligence and big data. It is not a matter of denying the risks of the EU being fully dependent on third countries in certain strategic sectors. In the telecommunications sector, there are a number of factors that make it desirable for the bloc to have its own technology and for large European companies to be able to supply the market. Air transport is another example, which is why the creation of Airbus was a good idea. However, this must not be confused with the need to create 'European champions' in all cases and in all sectors, since there are highly segmented markets or markets where foreign dependency does not exist or is not dangerous. Competition is not just another aspect of the market, it is an inherent feature that can only be sacrificed under rare and carefully considered circumstances. Similarly, size and productivity are a two-way street: while size favours economies of scale, empirical evidence shows it is often productivity that facilitates size, not the other way round. Creating large European companies does not necessarily translate into competitive ones.

Nonetheless, in a world increasingly characterised by its complexity, geopolitical instability and threats to cooperation, it seems reasonable to promote further EU integration and ensure the public better understands its policies. The world will become more Asian and less European, more Indo-Pacific and less Atlantic. This phenomenon will be accompanied by recurrent spasms of nationalism that will further weaken the structures of global economic governance. Faced with this scenario, the only option for the EU is to increase its strategic autonomy, strengthen its powerful foreign economic policy instruments –of which trade policy is just one– and continue to pursue, in the words of the Treaty of Rome, 'ever closer union'. Should it fail to do so, its countries –all too small to individually play a significant role in a world of large powers– will gradually be consigned to irrelevance, declining prosperity and eventual submission to one of the new empires that will dominate the international geopolitics of the 21st century.

INTRODUCTION

INTRODUCTION

International trade and governance has undergone major changes in recent years. The nature of international exchanges has changed, with the structure of international trade now based on value chains that denationalise the classical concept of comparative advantage and create new winners and losers. Technological progress has also enabled a significant rise in trade in services, which is set to accelerate further. All this has redefined classical patterns of trade and investment, resulting in a new geography of exchange in which emerging countries, and above all China, play an increasingly important role in a world that is more Asian and less European.

Alongside the impact of technological change on jobs, increasing inequality in advanced countries and the challenges of regulating financial globalisation and making multinational companies –especially technology companies– pay their fair share of taxes, these transformations have led to a growing rejection of globalisation and free trade organisations in the EU and elsewhere. At the same time, Trump's rise to power and the ensuing trade wars, Brexit and an increasingly assertive China seeking to subvert international rules are rapidly eroding the multilateral frameworks of governance that underpin international trade and under which the EU has been so comfortable.

The EU is faces need to address both internal and external challenges in its trade policy at the same time. Internally, it must increase cohesion (and finally move beyond Brexit, whose end result still remains uncertain) and restore the legitimacy of openness to trade. This means increasing and improving compensation and empowerment for those who lose out from an open economy, giving meaning to the phrase 'the Europe that protects'. Externally, it must learn to navigate an increasingly hostile geopolitical environment in which the trade and technology war between China and the US shows no signs of abating. The EU is currently the only power that can lead the reform of the paralysed World Trade Organisation (WTO), which is facing a crisis on two fronts: the aggressive unilateralism of the US, on the one hand, and China's anti-competitive practices, on the other. However, if the multilateral system collapses –an outcome that is unlikely but not impossible– the EU must be prepared for a world of trade blocs and preferential agreements, one in which the rules of global trade are absent. To achieve this, it needs to continue developing a network of preferential agreements that advance its offensive trade interests and values, ranging from respect for liberal democracy through to human and labour rights and environmental sustainability.

Finally, the EU must realise that, in a world of increasing geo-economic rivalry between leading powers who are locked in a technology race to lead in the fourth industrial revolution, trade policy can no longer be formulated or conducted in isolation. As an instrument of foreign economic policy, it must be closely linked to strengthening the single market, the defence of competition, industrial and technology policy, internationalisation of the euro and the regulation of the global financial system and its effects on global governance and inequality. This requires the EU to have a comprehensive strategic vision that encompasses all levels of integration –from fiscal all the way to defence– to continue to pursue the 'ever closer union' of the Treaty of Rome.

This report is structured in five parts. Chapter 1 analyses the evolution and current situation of globalisation, characterised by the development of value chains and the global and regional concentration of production. It also covers the role of trade in services, financial flows and the major change created by new players, mainly China and India.

Increasingly complex global trade and specialisation of production constitute huge barriers to trade liberalisation, as we shall see in Chapter 2. Trade agreements must account for increasingly complex factors, fight increasingly subtle protectionist measures and deal with the inclusion of thorny issues such as labour rights and the environment. It should thus come as no surprise that the multilateral approach, conceived for a less specialised world, has been replaced by a regional preferential system between countries that share similar economic visions and structures. As a consequence the main multilateral organisation, the WTO, has lost standing and it is unclear as to whether the best way forward is reform or a new model.

In this context, Chapter 3 analyses EU trade policy in perspective, dealing with its objectives, instruments and how it has responded to new challenges, such as the settlement of investment disputes. Trade policy is not merely an economic instrument: it is a set of geostrategic tools that form part of a coherent approach that seeks to assimilate the change from multilateralism to a preferential system and resist the temptation to retreat from globalisation.

Chapter 4 examines the issues surrounding the legitimacy of EU trade policy, which has been challenged in terms of the authority or mandate of its actors, the economic and social justice of its results (with the need to compensate and empower those who lose out), the different criteria applied to financial globalisation (allowing bets against countries and the erosion of the public resources of those that renounce unfair tax competition) and the asymmetry of its instruments (the need for a level playing field where respect for the dignity of work and the environment are an intrinsic part of trade agreements).

In this context, Chapter 5 then sets out the major challenges facing the EU in the global trade system, including the resurgence of protectionism and Trump's trade and technology war, a critical analysis of the challenge technology poses as a key part of remaining competitive in the 21st century (exemplified by the current war for industrial supremacy between the US and China) and the occasionally misguided strategies of the EU to avoid being left behind. Regardless, the EU is the only player that can restore the banner of international cooperation and lead a reform of the international trade system to ensure a globalisation that is controlled and regulated but whose core principles remain intact. Our report concludes with a summary of the main conclusions and recommendations to allow EU trade policy to address the challenges of our times.

EVOLUTION OF TRADE GLOBALISATION

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The world's economic history is not linear. Its progress has been marked by a number of revolutions: the agricultural revolution around 10,000 BC, the industrial revolution, driven by the development of the steam engine, electricity and the combustion engine at the start of the 19th century, and the IT and communications revolution at the end of the 20th century. The fourth industrial revolution of robotics and artificial intelligence is just beginning.

The industrial revolution allowed mass production and the export of surpluses to other countries, facilitating unprecedented exchanges beyond the scope of nation states. Driven by steam engines, freight speed and capacity began to increase, accelerating the flow of exchanges between different parts of the world, a process aided by the stability of the gold standard between 1872 and 1914 and the force of the British Empire. The interwar period, marked by the start of the UK's decline and in which the US had yet to come to prominence, saw the rise of nationalism, protectionism and competitive devaluation.

After the war, the lessons learnt underpinned the creation of an ambitious institutional framework of rules-based economic and trade cooperation. The approval of the General Agreement on Tariffs and Trade (GATT) allowed the first experience of global governance of international trade based on a general principle of non-discrimination between both countries and goods. Non-discrimination between countries meant that tariff advantages and reductions between states had to be extended to the other parties of the agreement (most-favoured-nation principle). For goods it meant that, once inside a country, foreign-origin products had to be treated the same as national ones ('national treatment'). GATT negotiation rounds were conducted every few years until the 1970s. Following the Tokyo Round in 1973, they became longer and more complicated, like trade itself.

Table 1. GATT/WTO rounds

Year	Rounds	Issues covered	Countries
1947	Geneva	Tariffs	23
1949	Annecy	Tariffs	13
1951	Torquay	Tariffs	38
1956	Geneva	Tariffs	26
1960-61	Geneva (Dillon round)	Tariffs	26
1964-67	Geneva (Kennedy round)	Tariffs, anti-dumping	62
1973-79	Geneva (Tokyo round)	Tariffs, non-tariff measures, legal framework agreements	102
1986-94	Geneva (Uruguay round)	Tariffs, non-tariff measures, rules, services, intellectual property, dispute settlement, textiles, agriculture, creation of WTO, etc	123
2001-	Doha	Tariffs, non-tariff measures, agriculture, labour standards, environment, competition, investment, transparency, patents, etc	159

Source: WTO.

The liberalisation processes facilitated by the successive GATT rounds provided an enormous boost to trade. They considerably reduced average levels of tariff protection, especially for manufacturing and among wealthy countries, and allowed the development and improvement of logistics and transport systems. This included both air cargo and the optimisation of port loading and unloading systems, with increasingly sophisticated containers, during the Second World War and the decades that followed.

The 1970s also marked the start of the expansion of IT and telecommunications technology. The exponential growth in computing power and communications facilitated a major technological revolution, leading to a rapid acceleration in globalisation in just a few decades. Technology, international coordination and ease of transport in a more open world allowed the optimisation of production on a global scale. This meant some industrial jobs being transferred to other countries with lower costs or shifting to national service sectors, which saw strong growth. The technological revolution also revolutionised services, which became the heart of developed economies.

Table 2. Technological revolutions and globalisation

Technological revolutions	Approximate start date	Key technologies	Population displacement	Time to globalisation of the effects
Agricultural revolution	10,000 BC	Agricultural techniques	From hunting to agriculture	Millennia
Industrial revolution (I and II)	1759 1870	Steam engine Electricity and combustion engine	From agriculture to industry	Over a century (from 1820)
Technological revolution (in services)	1970	IT and communications technology	From industry to services (or industry abroad)	20 years
Robotics revolution	2000	Robotics and artificial intelligence	From services to services abroad	Instant

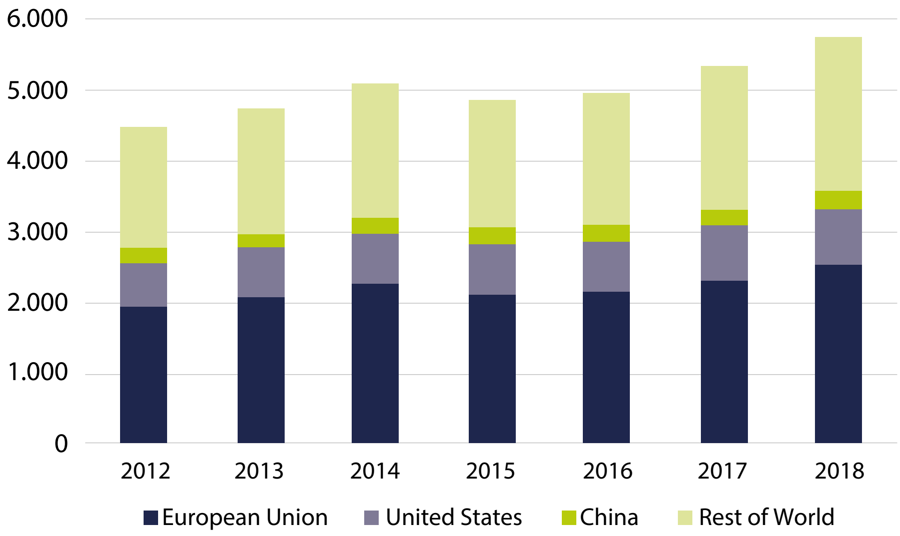
Source: the authors from Baldwin (2019).

The 21st century has seen unimaginable developments in technology, far surpassing the achievements of the 1990s and constituting a new revolution in its own right: the revolution of robotics and artificial intelligence. The key difference is that while industrial automation and technology replaced physical work in the industrial sector, this fourth revolution has the potential to replace not just physical work in the service sector (eg, through telepresence) but also some intellectual work, particularly repetitive tasks and calculations. Moreover, the effects on globalisation will not be measured in centuries or even decades: they will be immediate. As such, as we shall see below, trade rivalry goes hand-in-hand with technological rivalry.

1. The new globalisation: value chains, regional factors and trade in services

Globalisation, especially since the development of IT and communications technology in the 1990s, has caused the disaggregation of global goods production into what are known as global value chains in which the products produced and exported by any given country include components from many others.[1] However, this has not benefited everyone: the costs of the movement of people (understood as part of non-tradable services) and the need for some form of coordinated and physical management at the destination (a manager cannot be present in many different countries) means this outsourcing is not spread across the globe but is polarised in certain regions or 'global factories', the majority in Asia.[2] At the same time, one of the most characteristic features of trade expansion in recent decades has been the surge in the importance of trade in services. In 2018, global services exports totalled US$5.8 trillion, making up 23% of all exports of goods and services. These figures, however, mask a different reality, one in which services play a much more important role than the statistics reflect.

Figure 1. Service exports (US$ million)

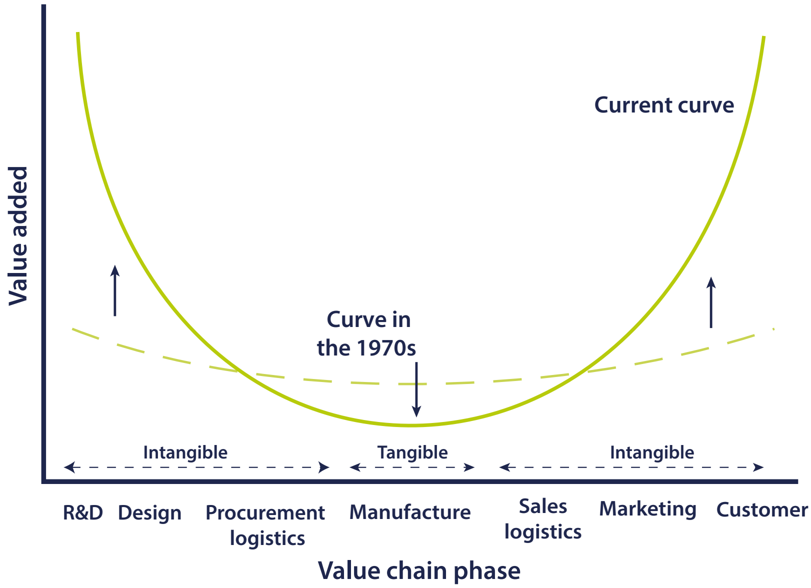


Source: WTO and the authors.

1 Baldwin (2016).
2 The I6, or 'Industrial 6' countries of China, India, Indonesia, South Korea and Thailand, in addition to Poland, are described by Baldwin (2016) and have absorbed all the shift away from the G7.

The main reason for this is that technology and the distribution of value chains have increasingly concentrated added value in global production in the pre- and post-assembly phases. In the 1960s, all phases of production tended to be concentrated in the same location (specific countries) and physical manufacture and assembly made up the bulk of added value (and thus the remuneration of factors). Technology, the complexity of products and the ability to distribute the different phases of production to maximise their efficiency have concentrated added value on the pre- and post-manufacture phases, relegating manufacturing itself to the status of the most tangible but least relevant part of the production process. The result is the smiling curve, which reflects the relationship between the phase of the value chain and added value (or profitability).[3]

Figure 2. Smiling curve



Source: the authors from OECD (2013), based on Shih (1992), Dedrick & Kramer (1999) and Baldwin (1992).

3 The term ‘smiling curve’ is attributed to the founder of the computer company Acer, Stan Shih. It is used to describe how the development of IT caused profitability from the basic manufacture and assembly process to fall.

These high-value-added phases are mostly services: R&D, product design and procurement logistics (pre-production) and sales logistics, marketing and customer service (post-production). This change has various implications. The first is that it radically alters the concept of manufacturing, which is no longer associated with a single country. Under this new paradigm, an order for an Apple iPhone conceived and designed in the US implies an order with Foxconn in China to import more than 17 components manufactured in Japan, Taiwan, South Korea, Germany and the US itself (which only manufactures the memory chip, the audio codec and the Bluetooth-wireless module), assembly by Foxconn and shipping via a complex logistics system, in addition to the activation of software and aftersales services.[4]

Secondly, the concept of industry itself becomes obsolete. This is not because industry is no longer a source of jobs or added value, or because the smiling curve applies to every sector (eg, metals, which conserve a significant part of the value added in manufacturing).[5] Instead, in a world of global value chains, in which every aspect of production is globally segregated and performed where it is most efficient, industry can no longer be regarded as a monolithic structure. It has become a complex assembly of dispersed elements in which services, which are incorporated into goods or as accessories, and whose sectoral boundaries are hard to define, can be just as important as goods.[6]

Thirdly, the unequal distribution of added value makes the headquarters of technology-intensive companies much more important than their production plants. For example, in the case of the iPhone, the services generated in the US make up more than 60% of added value, compared with less than 5% in China.[7]

Fourthly, it means that trade statistics are less accurate. In contrast to GDP figures for national accounts, which only measure added value (value of production minus the value of intermediate consumption), trade statistics like those of the WTO measure the value of all products that cross borders, regardless of whether they are raw materials or finished products.[8] The foreign components of a car manufactured in a given country are recorded as imports when they enter the country and again as part of the value of the exported car when they leave. This means that as production becomes more disaggregated, multiple accounting increases and the concepts of origin and value are diluted. Since what leaves a country may bear little relation to what was generated there, the 'origin' of a product becomes a mere statistical convention, and with it concepts such as the bilateral trade deficit. This is one

4 Xing (2017).
5 Sepälä & Kenney (2013).
6 It remains to be seen if robotics and the development and reduction in costs of 3D printing will result in a new concentration of the value chain, since it will be possible to produce many components cheaply with hardly any labour costs (Baldwin, 2019).
7 Xing & Detert (2010).
8 Maurer & Degain (2010).

of the traditional difficulties in correctly estimating intra-firm services (between companies belonging to the same group), both in terms of volume and prices.[9]

Fifthly, statistics for services are undervalued, since the services incorporated into a product are recorded as part of the value chain for goods. The WTO currently classifies trade in services using the four modes shown in Table 3.

Table 3. Modes of supply of services trade

Mode	Description	Example
Cross-border trade (Mode 1)	Services that cross borders	Legal advice emailed to a client in another country
Consumption abroad (Mode 2)	Movement of people to receive a service	A client travels from another country to receive advice from a lawyer
Commercial presence (Mode 3)	Movement of companies through a permanent establishment to provide a service	A lawyer opens an office in another country to advise clients there
Presence of natural persons (Mode 4)	Movement of people to provide a service	A lawyer travelling to another country to advise a client

Source: WTO.

These modes can be summarised as the flow of services, the flow of their consumers and the flow of the factors for their provision (capital and labour). Current statistics on trade in services (compiled based on the 6th edition of the International Monetary Fund *Balance of Payments and International Investment Position Manual*) only disaggregate cross-border supply and consumption abroad (Modes 1 and 2) but not the movement of the factors linked to the provision of services (Modes 3 and 4). These four modes are complemented by a fifth: services incorporated or 'embedded' in exported goods, which some authors have suggested should be classified as Mode 5.[10] Analyses by the WTO and the OECD based on the joint database of Trade in Value Added (TiVA) show that the contribution of services to the added value of exports (49% at the global level, 54% in OECD countries and 59% in Spain) is far higher than the share of services in total trade (23% for the world and 31% in Spain).

9 For a review of the literature, see Durán Lima and Ventura-Dias (2003).
10 Cernat & Kutlina-Dimitrova (2014).

The sixth point to be made is that taking Mode 5 services into account would have a number of benefits, such as resolving one of the paradoxes created by the liberalisation of trade in services through the General Agreement on Trade in Services (GATS). The fact that the agreement is limited to the four traditional modes allows an absurd situation in which the sale of software (exempt from tariffs under GATS) is subject to barriers when incorporated in a mobile phone or laptop computer. It is estimated that Mode 5 services could be responsible for €414 billion in exports and 8 million jobs in the EU.[11]

Finally, the seventh point to be made is that the importance of embedded services in exported products means the role of small and medium enterprises (SMEs) in international trade is also under-reported. SMEs are the main producers of services, making it highly likely that the high concentration of goods exports among a small number of large companies is misleading. This has significant implications for trade policy, since it means free trade agreements would benefit SMEs more than is commonly believed, while protectionism causes them more harm.

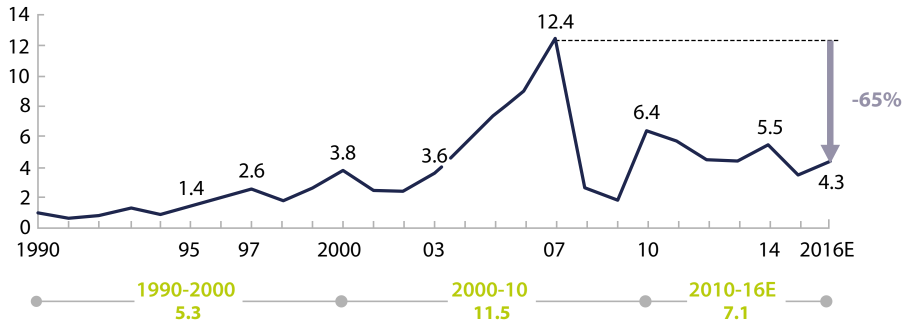
2. Capital flows and investment

International capital flows are the flipside of trade in goods and services. The IMF defines three types of international capital flows: foreign direct investment (FDI), which covers the creation of foreign companies or the purchase of shares to take control of a company, in addition to the reinvestment of profits and funding flows between affiliated companies; portfolio investment, which covers the acquisition of shares, public and private debt securities and investment instruments; and financial derivatives and other capital (generally short-term), such as loans and concessional loans, financial leasing and purchases of deposits.

Global capital flows (the gross total of FDI, portfolio investment and other capital) totalled over US$6 trillion in 2017 (4.5% of global GDP). However, this figure was severely affected by the financial crisis: having risen from an average of 5.3% of global GDP during the period 1990-2000 to 11.5% for 2000-10 (peaking at a historical record of US$12.4 trillion in 2007), it subsequently fell to 7.1% for 2010-17.

11 Cernat & Sousa (2015).

Figure 3. Global capital flows 1990-2016



Source: McKinsey Global Institute (2017).

Over the last 12 years, direct investment has totalled around US$2 trillion (with a slightly higher figure of US$2.5 trillion for balance of payments purposes). There have been large fluctuations in both portfolio investment and other capital, which plummeted from US$6 trillion in 2007 to almost zero in 2013. Similar to services, there are also difficulties when it comes to estimating direct investment flows (comprising new or greenfield investment, the acquisition of existing companies, reinvestment of profits, parent-subsidiary loans and real-estate investment). This is due to the traditional separation between investment and portfolio flows: direct investment aims to obtain control of companies while the goal of portfolio investment is profitability. The fifth edition of the International Monetary Fund *Balance of Payments Manual* classes flows as direct investment when they acquire a minimum of 10% of ordinary shares; otherwise, they are classed as portfolio investment. The 10% threshold is practical but arbitrary, since it fails to recognise the increasing complexity of capital flows, which can facilitate corporate control with much lower levels of capital or speculative investments with much higher numbers. Nor does it correctly capture the use of conduit companies.[12]

Moreover, even though, in accounting terms, the financial balance is the reflection of the current account and capital balance (ie, the difference between national savings and investment, and thus an expression of spending decisions), the level of capital movements reached in recent decades makes it impossible to claim that the financial balance merely is the *consequence* of spending decisions. It has also come to be a cause. Financial innovation, marked by the exponential growth in financial products, has made it possible to effectively facilitate or restrict spending

12 See Duce (2003) for a summary of the method for calculating FDI, or UK Parliament (2019) for some of the current issues with measurement.

decisions. This means it is no longer possible –as may have been the case decades ago, or as may still be the case in small and less-developed countries– to talk of a causality between real activity and finance, since we are now dealing with a double causality.

A study by McKinsey in 2017 concluded that, following the bursting of the financial bubble at the end of 2007 and the Great Recession that followed, global financial integration has developed more solid foundations, with increased risk aversion and a fall in foreign assets held by Eurozone banks (down 45% since the start of the crisis). Another sign of stability is the diversification of cross-border capital flows, with a reduction in lending (down 66%) while maintaining FDI (the least volatile type of capital flow). FDI and portfolio investment together now make up 69% of cross-border capital flows, compared with 36% in 2007.[13] Another sign of increasing stability is the reduction net financial account and capital imbalances (1.7% of global GDP compared with 2.5% in 2007), with improved distribution of deficits and surpluses, both in the US, China, and –albeit with a few exceptions, such as Germany and the Netherlands– the Eurozone. Developing countries have once again become capital importers. However, this situation is not necessarily structural: some stock markets and property markets are already stressed again and there have been major fluctuations in gross capital flows in one-third of developing countries and two-thirds of advanced economies since 2010 (especially lending).

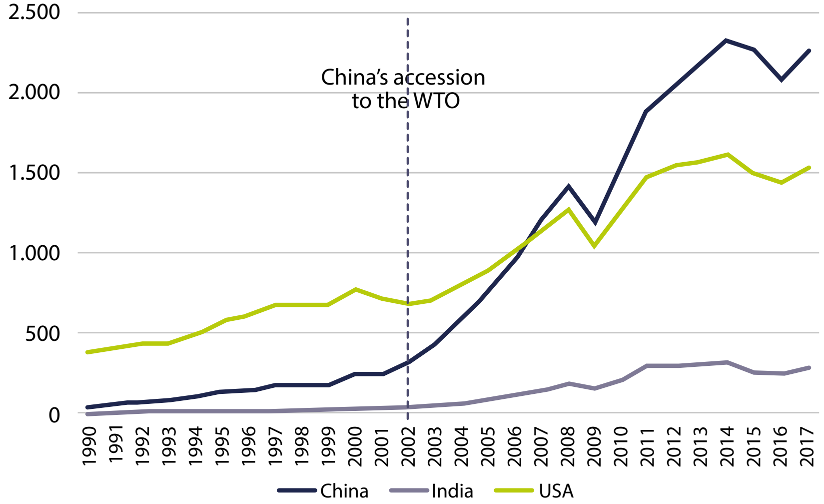
3. China, India and new actors in international trade

Industrial relocation since the 1990s has also brought about a structural change to trade. Two Asian countries –China and India– have absorbed the majority of the benefits, becoming global centres of production. Both were large, poor and overpopulated countries and their spectacular emergence from poverty and progressive incorporation to a global middle class has significantly improved global development indicators. India was a highly protectionist country but has been part of GATT since its inception. China gained GATT observer status from 1986 and only began adhering to its systems in December 2001, seven years after the creation of the WTO.

Even though India has significantly benefited from globalisation, it has been China that has taken fullest advantage. In just six years, Chinese exports have soared from US$266 billion to US$1.22 trillion, overtaking the US for the first time. By 2017, Chinese exports stood at US$2.26 trillion (compared to US$1.54 trillion for the US). During the same period (2001-17), nominal GDP per capita increased by a factor of 8.6 (from US$1,000 to US$8,600) and by a factor of 3.75 when adjusted for purchasing power (from US$4,000-US$15,000).

13 McKinsey Global Institute (2017).

Figure 4. Imports from the US, India and China (1990-2017)
(US$ billion)



Source: WTO and the authors.

The incorporation of China and India in international markets –and the effect on some of their neighbours, especially in the case of China– has resulted in an objective reduction in global poverty. The proportion of people living in extreme poverty fell from 36% of the world's population in 1990 to just 10% in 2015. Much of this reduction can be attributed to the Asian countries. In parallel, China and India's rise as global 'factories' has allowed the rest of the world to benefit from cheap consumer goods, helping improve real incomes. This process has been accompanied by the deindustrialisation of developed countries, which was driven by both technological improvement and relocation, and which many developed countries have not been able to assimilate.

Nonetheless, beyond the fact that India's development process lags China by decades, there are significant differences between the two countries when it comes to trade. While China is strongly oriented toward foreign trade, has developed a solid industrial base and major trade partnerships and is highly connected to the rest of the world through trade and finance, India's economy is much more closed and has been unable to replicate the boom in industrial jobs while its elites, similar to Brazil, tend to be more protectionist. As well as being viewed with greater concern than India by advanced countries (especially, as we shall see, the US), this means that China's rise has also resulted in polarised relationships with other emerging countries. There are countries whose productive structures are highly complementary to those of China, such as exporters of raw materials and food (mainly in Latin America and Africa), who benefit from the dynamism of the Chinese economy. However, there are also countries with similar productive structures to the Asian giant (low and medium value-added manufacturing), such as Mexico, Turkey and certain Maghreb countries, who see the rise of the Asian giant as a threat. As China's economy grows, it becomes harder to talk of a coherent block of emerging countries in the WTO, as was the case in 2001 at the start of the Doha Round, when India and Brazil led the coalition of developing countries in the G20.

4. The winners and losers of globalisation

While globalisation has benefited humanity as a whole, like in any process involving competition, there are winners and losers. These have varied depending on the features of the major waves of globalisation. In the decades following the Second World War, countries that were able to use their comparative advantage prospered. Highly-skilled workers and the industrial sectors in advanced countries were the main beneficiaries, giving rise to a golden era of capitalism for the North Atlantic, especially in European countries (and Japan). From the 1990s, as industrial production became disaggregated into global value chains, specialisation began to be defined by companies, not states, and their productivity multiplied. While there were winners and losers in all countries and across all sectors, it was industrial workers in developing countries like India and China that benefited most, allowing them to emerge from poverty.[14] In developed countries, less qualified workers felt the effects of deindustrialisation while, generally speaking, skilled workers benefited in both groups of countries.

Globalisation has not ended and the current revolution, defined by automation and robotics, has the potential to affect all sectors, including services, which have traditionally been shielded from international competition due to their human component and difficulties for their international trade, and all kinds of skilled workers. Artificial intelligence will make all workers vulnerable, although it will also create many new employment opportunities. The problem is that if the service sector no longer acts as an escape valve, the distribution of the winners and losers may be more drastic: there may be countries where there are only losers and where the state is not in a position to help them.

Anti-globalisation movements are not a new phenomenon. These expressions of civil society's rejection to hyperglobalisation came to the fore in December 1999, during the so-called WTO Millennium Round in Seattle (US), with protests by unions, anti-capitalist organisations, ecologists and other groups that contributed to the

14 Lakner & Milanovic (2016) is one of the best analyses of the evolution of global inequality in recent decades.

break-down of the talks. The following year, the protests also managed to break up the IMF and World Bank summit in Prague. Since then, there have been other protests, with varying repercussions, including the ones that have taken place since the Great Recession, in both the US and Europe.

While globalisation has benefited humanity as a whole, like in any process involving competition, there are winners and losers. These have varied depending on the features of the major waves of globalisation.

There has been a persistent debate on the limits of globalisation in economic and political circles since the publication of Rodrik's influential analysis of its winners and losers.[15] However, this debate has different contours. In the market for goods, it is focused on two issues. The first is the diminishing marginal returns of trade liberalisation. The issue here is the extent to which the benefits of flows and growth outweigh the losses for SMEs after eliminating the main tariff barriers to trade. In other words, whether there is a threshold at which the costs of redistribution associated with trade liberalisation outweigh the overall benefits. The second is the disproportional weight of large multinational companies, not just in terms of economies of scale but also in terms of market power and their ability to influence governments. The claim that trade agreements are conducted 'for multinationals' is highly questionable. However, it is less far-fetched to argue that globalisation without rules to fully ensure free competition at the international level (as we have noted, the WTO has failed in this respect) makes it much easier to exercise power over the market. A second consequence of this is that multinational companies can use lobbying to ensure the issues that most affect their interests are given the greatest weight in trade deals.[16]

Another issue, this time related to the financial sector, is the over-financialisation of the economy or the excessive weight of this sector and financial markets in proportion to the real economy. Here, there are powerful arguments for increased control over financial flows, whose volume has meant they are no longer merely a means to channel and ensure free-flowing markets for goods and services but can now tilt their balances. It is not merely the fact that when investment credit flows reach excessive levels, they cease to be the result of the difference between savings and investment decisions and become their cause (some studies have concluded that, in contrast to trade liberalisation, financial liberalisation does not have clear positive effects on development).[17] It is also about the potential of currency and financial derivatives markets to knock apparently stable economies off balance.

15 Rodrik (1997).
16 Rodrik (2017a).
17 For example, Prasad *et al.* (2003).

Some authors have explained the empirical evidence by suggesting that financial markets may simply act as amplifiers of effects: in periods of stability, they help reduce volatility and risk management but also have the potential to exacerbate it in periods of instability.[18] The Great Recession is a good example of the irrationality of financial markets, recalling the phrase traditionally attributed to Keynes: markets can remain irrational for longer than one can remain solvent.[19]

Finally, the costs of globalisation cannot be debated in isolation from the importance of the capacity of states to compensate and empower those who lose out. On the one hand, it must be acknowledged that countries' social policies must facilitate the transition of their populations during major structural changes. 'Markets' must not be blamed for what is often no more than governments neglecting those who lose out. On the other hand, it is equally important to emphasise that reducing global inequality is also compatible with higher internal inequality in countries (eg, the US, although this is not the only example). It is impossible to correctly manage globalisation without addressing inequality, an aspect that is now a core part of the analysis conducted by multilateral institutions. However, the capacity to compensate those who lose out is limited by three factors: the high levels of debt in many developed countries, the growing capacity of some businesses and individuals to evade their tax responsibilities and the existence of countries that stand to lose out from the coming expansion of the automation and robotics revolution.

In recent years, especially after the 2008 crisis, all these factors have led to an increase in voices that are critical of globalisation, free trade, trade and investment agreements, and the role of multinationals, especially in advanced countries. As such, despite free trade continuing to enjoy majority support in the EU, some agreements, such as the abandoned Transatlantic Trade and Investment Partnership (TTIP) with the US, have been widely rejected by certain countries, while public opinion in general has tended to regard the processes of opening up the economy with more scepticism than in previous decades.

18 Cordella & Ospino Rojas (2017).
19 The phrase appears to have been popularised by Gary A. Shilling in an article for *Forbes* in 1993 (vol. 151, nr 4, p. 236).

TRADE AGREEMENTS AND REGULATIONS IN A COMPLEX WORLD

TRADE AGREEMENTS AND REGULATIONS IN A COMPLEX WORLD

1. Economic complexity and trade liberalisation

The global economy and, by implication, trade is becoming increasingly complex. This makes trade liberalisation and signing trade agreements increasingly difficult. In the 1950s, when trade was essentially confined to goods and protected by tariffs, the only real service being tourism, promoting liberalisation and trade expansion was relatively simple. The difficulties were political, since in technical terms, it was simply a case of reducing the value of the tariff applied to foreign products or converting other forms of protection like quotas into tariffs that could then be reduced.

However, as tariffs were eliminated, four things occurred. First, the marginal benefit of tariff reductions tended to diminish: in terms of promoting trade and production, a reduction from 50% to 25% is not the same as a reduction from 10% to 5%. Secondly, once tariffs had been reduced, protectionism adopted more subtle forms, such as regulations only applicable to foreign products. These are now referred to as non-tariff barriers and are less easy to recognise, making them harder to denounce and eliminate. Thirdly, investment became closely linked to trade. Finally, the effect of the growing trade in services made trade liberalisation much more complex, since there are no tariffs for services and protection against foreign competition is based on regulatory and operational aspects, which have a more direct effect on the regulatory sovereignty of countries. Allowing a foreign car to enter a country at a lower price is not the same as allowing a foreign national to practice as a doctor: the former involves border trade barriers while the latter involves behind-the-border ones.

While non-tariff barriers are not easily eliminated, in some areas attempts have been made to regulate them to prevent the arbitrary use of sanitary and phytosanitary measures (Agreement on the Application of Sanitary and Phytosanitary Measures, or the SPS Agreement), ensure respect for intellectual property rights linked to trade (Agreement on Trade-Related Aspects of Intellectual Property Rights, or the TRIPS Agreement), avoid discriminatory technical regulations on products (Agreement on Technical Barriers to Trade, or the TBT Agreement) and other aspects such as valuation at customs, safeguard measures and measures for unfair competition through export subsidies.[20] As a consequence, liberalisation became

20 It is also necessary to take into account that non-tariff barriers arise due to the different regulatory traditions in different countries or trade blocs. These become especially important when tariffs are lowered.

The complexity of trade flows and the spectacular advance of trade in developing countries creates a need to address many different issues, both economic and moral, which have not formed part of governance of globalisation through the WTO.

full of nuances, asymmetries and lacunae. For example, despite being necessary, the protection of intellectual property rights linked to trade, incorporated through the TRIPS Agreement in 1994 after the apparent failure of the World Intellectual Property Organisation (WIPO) to guarantee them, clearly benefited countries that generate patents, almost all of which are in the developed world. Similarly, the technical complexity of regulatory processes increased the influence of large companies in advising governments in negotiations. Finally, a number of important trade-related aspects were never seriously addressed, such as intervention in currency markets to keep currencies artificially undervalued (a strategy used by countries like China and Japan), the defence of competition and the risks of liberalising the capital market, especially in the short term.[21]

The second half of the 20th century also saw a dramatic reduction in restrictions on the establishment of foreign companies. This provided access to protected markets and lower production costs, while permitting destination countries to adopt foreign technology, increase local employment (especially in non-energy sectors) and increase export capacity, which, by definition, is the goal of multinationals. It was precisely this intrinsic link to FDI that created the need for regulation at the national, bilateral and multilateral levels to address the aspects of trade related to investment. The 20th century saw the proliferation of bilateral investment agreements, arbitration mechanisms in third countries and multilateral regulatory aspects, such as the Agreement on Trade-Related Investment Measures (TRIMs). In 1998, the OECD promoted the creation of a multilateral agreement on investment but this was rejected by developing and some developed countries.

In terms of trade in services, the impossibility of harmonising the different global regulations, which were closely linked to social preferences and historic traditions, soon became clear. Their liberalisation did not take place until the Uruguay Round (when the WTO was created). Moreover, they only became subject to multilateral negotiations with the approval of GATS in 2000, an attempt to liberalise all service sectors except those regarded as essentially public, such as education and health (which are seldom provided under pure market conditions), public procurement (subject to a plurilateral agreement that only applies to its members and not the other WTO countries) and air transport rights.

21 For a detailed analysis of these asymmetries and lacunae, see Rodrik (2017a).

This increased complexity made multilateral liberalisation increasingly challenging. The result was a proliferation of regional preferential agreements (eg, the EU, EFTA, Mercosur and NAFTA), which are compatible with the WTO when they affect all sectors of a given region, and these in turn developed into forms of integration. Bilateral and regional agreements (ie, preferential, because they discriminate against certain countries), gradually replaced multilateral ones. The outcome was what Bhagwati eloquently describes as the ‘Spaghetti bowl effect’, which does not necessarily achieve optimum efficiency at the global level.[22]

A similar phenomenon has occurred with services. GATS is proving extremely hard to implement, since, as a WTO agreement, the most-favoured-nation clause applies, meaning any concessions must be extended to all members. However, as we have seen, liberalising services is highly complex on account of its implications for national sovereignty. This explains why trade in services has been promoted via parallel agreements to GATS. Negotiations for the Trade in Services Agreement (TiSA) began in 2013, at the initiative of the US (before the arrival of Trump) and conceived as a preferential agreement under article V of GATS (the equivalent of article XXIV of GATT). However, the negotiations were blocked by Trump and the US has sadly abdicated from leadership. The stalling of TiSA has led many countries to explore alternative approaches, such as a plurilateral agreement on ecommerce (a form of multilateral treaty signed on the margins of the system) to establish specific rules, which was proposed at the World Economic Forum in Davos in January 2019. However, making progress in this area remains challenging, given the diversity of interests and the concerns of the actors involved. The result is that the most dynamic part of international trade lacks a multilateral regulatory framework and is not covered by the WTO dispute settlement mechanism.

2. New issues linked to trade

At the same time, the complexity of trade flows and the spectacular advance of trade in developing countries creates a need to address many different issues, both economic and moral, which have not formed part of governance of globalisation through the WTO. On the one hand, growing concerns have emerged about the lack of specific measures to address problems of competition, such as international price fixing agreements (eg, Organisation of Petroleum Exporting Countries, or OPEC), active industrial policies to promote national champions and the power of multinationals to negotiate agreements with weak governments in need of direct investment.

On the other, the precarious labour conditions of many developing countries (low wages, long hours, child labour and the absence of social security and benefits)

22 Bhagwati (1995).

and a lack of respect for environmental or intellectual property regulations were no longer matters of moral concern but also raised issues of economic competitiveness. Is it fair to accept that the precariousness of the labour market and low environmental standards give companies in developing countries an advantage or should 'fair' trade that guarantees the protection of workers' rights and respect for the environment be demanded to create similar conditions for all companies and ensure a level playing field? This complex debate is focused on three main issues. The first is jurisdiction: is trade or the WTO the right place to address labour rights or environmental law, given that there are other international bodies in the United Nations system responsible for these issues? Should this not be done by these organisations and should the governments of developing countries not be responsible for protecting their populations? The second issue relates to historical development: it is easy for developed countries to insist on minimum labour and environmental conditions in the 21st century, while forgetting that they have undergone a process of evolution in which social rights and environmental requirements have been the consequence, not the cause, of development. Imposing high costs on developing countries further hinders their competitiveness, pushing up the price of their exports and strangling their development. The third issue is a technical and moral one: it is easy to say that child labour is unacceptable; however, what about low wages, which are traditionally the main source of initial competitiveness for countries emerging from poverty?

While the debate has not yet been resolved, the reality is that labour standards and the environment have become essential aspects of trade agreements, both in the WTO and in bilateral agreements. There can be no level playing field without making at least some attempt to address them. Moreover, the problems of climate change mean more and more voices, especially in the EU, are demanding the incorporation of environmental provisions in trade agreements to accelerate the reduction of polluting emissions.

3. The WTO crisis

Looking back, it is clear that GATT and the WTO have been excellent at removing tariff protections for the trade in goods. However, we must question the extent to which the WTO has been able to address the growing complexity of trade in new areas (services and investment), sophisticated new forms of protection (subsidies and technical barriers to trade), new issues linked to trade (intellectual property, development, labour and environmental standards) and arbitration in dispute resolution.

On these issues, despite its many achievements and all the progress that has been made, it is simply impossible to claim that the WTO has successfully adapted. The liberalisation of services has been too slow. At present, 23 WTO countries (including the EU), which together make up 70% of global trade in this sector, are negotiating TiSA (based on GATS) from the proposals submitted by the participants.[23] The agreement seeks to open up markets and improve regulations for the provision of licences, financial services, telecommunications, ecommerce, maritime transport and the temporary movement of workers for the provision of services. The initiative is being negotiated by a group of like-minded countries, leaving the door open to other participants. The negotiations have stalled since Trump's arrival in the White House, although the difficulties to making progress in crucial areas like ecommerce have been evident for a long time.

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The US has also fiercely criticised –not without justification– the operation of the WTO in areas including the Agreement on Subsidies and Countervailing Measures (SCM Agreement), which has proved ineffective due to under-reporting by many countries (China is one of the biggest culprits). Moreover, it has criticised the delays and interpretations of the Dispute Settlement Body –blocking the appointment of judges to its Appellate Body– and the lack of adherence to its arbitrations. It has also raised the difficulty of enforcing intellectual property rights and the absurdity of countries being able to classify themselves as 'developing', with all the advantages this entails, instead of this status being determined by objective criteria. The WTO has been unable to prevent the abuse of the national security clause (which has been used by the Trump Administration to levy tariffs on steel and aluminium imports since 2018), implement a minimal outline of a competition policy on the international stage and ensure proper treatment of public multinationals.

Globalisation takes place on many different fronts and without a common rule book. Moreover, the rule of consensus used for reaching decisions at the heart of the WTO is becoming a guarantee of stalemate in addressing crucial issues for the governance of globalisation.[24] WTO reform is essential. The problem is whether it is possible in a world in which key figures are retreating from multilateralism, not just overtly, like the US, but also more subtly, such as when EU leaders talk about

23 Australia, Canada, Chile, Colombia, Costa Rica, Hong Kong, Iceland, Israel, Japan, Liechtenstein, Mauritius, Mexico, Norway, New Zealand, Pakistan, Panama, Peru, South Korea, Switzerland, Taiwan, Turkey, the US and the EU.

24 Consensus is defined as a process whereby a text is only accepted when there are no formal objections from any of the participants (although reservations are permitted). In contrast, unanimity is a form of voting that requires all members to vote in favour or abstain to allow approval. See written question P-3526/03 to the European Council (https://bit.ly/2MkVCLM).

'reforming trade policy and competition policy' to create 'national champions', ensure 'European preference' and avoid Chinese competition. In hindsight, it is clear that China's incorporation into the WTO did not take place with sufficient guarantees of minimum rules to ensure a level playing field. Europe and the OECD countries are now watching China provide unrestricted financing to its companies in Africa (in breach of the OECD consensus), make huge subsidies available to companies at home, use public energy companies in the national interest, expel foreign entities from markets after stealing their intellectual property and benefit from 'developing country' status while sending rockets to the Moon. Even though the trade war initiated by the US may be a bad idea, this does not mean its criticism of the operation of multilateral governance and the role of China is unfounded. The problem, as we shall see below, is that the partial agreement of the diagnosis has not translated into multilateral solutions but into isolationist strategies.

At its heart, the WTO crisis is nothing more than a reflection of the difficulty of making multilateral bodies work when decisions are adopted by unanimity in increasingly complex and multipolar economic systems with opposing strategic interests and increasingly sophisticated trade and protectionism. The potential of other multilateral organisations must be leveraged. For example, it may be necessary to reconsider the role of WIPO in determining the recommended scope for the protection of patents (crucial for developed countries in areas such as pharmaceuticals).[25] Similarly, as we shall see below, the United Nations Commission on International Trade Law (UNCITRAL) is working on a potential reform of the investment arbitration mechanism, with the cooperation of other international institutions, including the EU. The reality is that ISDS mechanisms currently form part of a large number of bilateral trade and investment treaties like the recently renegotiated North American Free Trade Agreement (NAFTA) and the Trans-Pacific Partnership (TPP) but with wide-ranging jurisdictions, sometimes under the rules of the International Centre for Settlement of Investment Disputes (ICSID) and on other occasions under international arbitration courts with different rules.[26] Moreover, when it comes to the environment, undoubtedly the most pressing area of concern, both the Paris Agreement on climate change and the United Nations Environment Programme (UNEP) seem to be falling short in their efforts to fight global warming. This has resulted in growing demands from large swathes of the European public to establish tariffs on imports from producer countries with low environmental standards. One thing is certain, however, in an increasingly integrated world, solutions cannot be bilateral; issues must be addressed at the multilateral level.

25 Rodrik (2017a) argues that intellectual property has suffered what is known as 'forum shifting', in this case from WIPO to WTO.
26 For example, the London Court of International Arbitration, the International Chamber of Commerce, the Hong Kong International Arbitration Centre and the UNCITRAL Arbitration Rules.

EU TRADE POLICY IN PERSPECTIVE

EU TRADE POLICY IN PERSPECTIVE

The history of the EU is the history of an integration process, first trade and then economic. Despite mistakes along the way, the process has largely been a success. Its historic development means that, somewhat unsurprisingly, the EU has always had a clear focus on trade. Despite the bloc making up just 7% of the world's population, it is the biggest exporter and importer of goods and services, representing one-third of global trade, ahead of the US and China. It is also the biggest investor and recipient of foreign investment.

1. Objectives, elements and types of agreements

From its own experience, the EU knows that trade is one of the most powerful tools for the development of countries. Moreover, this tool can also serve European interests and the interest of its trading partners. This is why trade agreements have always been an essential part of its relations with third countries, regardless of the objective.

Generally speaking, the EU's bilateral economic agreements pursue one of three objectives:

- In some cases, they seek to align the laws of countries that are candidates for membership of the EU or countries that wish to have a close relationship with the bloc but without becoming Member States. This is a technical requirement, since the EU is, and has been since its inception, a customs union. Any country that wishes to join must eliminate tariffs and harmonise its trade laws. However, the EU is also a single market, which means members are obliged to adopt EU law, guaranteeing the free circulation not only of goods but also of services and factors of production (capital and people).

- On other occasions, the objective is to support the development and access to the European market of countries that share borders with the EU as part of the European Neighbourhood Policy. In these cases, the goal is to foster economic development and promote democracy while ensuring the collateral objectives of controlling migration flows and security.

- Finally, a third objective is simply to facilitate trade and general economic cooperation with other parts of the world, including both developed and developing countries.

To achieve these goals, the EU includes different elements in its agreements. These elements include guidelines to facilitate bilateral relations, reductions or eliminations of tariffs on goods, reductions on non-tariff barriers through harmonising customs, technical and sanitary and phytosanitary regulations, the defence of intellectual property, competition measures, the liberalisation of services, direct investment, portfolio investment, dispute resolution mechanisms and commitments to adopt European social, political and cultural values such as labour or environmental standards.

Table 4. Types of EU trade agreements

Level of integration	Components	Name of agreement	Examples
Low	General framework for bilateral economic relations (without tariff reductions)	Partnership Agreements (PA) or Partnership and Cooperation Agreements (PCA) [Comprehensive (C) or Enhanced (E)]	Former USSR, Central and South-East Asia
Medium-low	Reduction or elimination of tariffs, occasionally aspects of services and investment, labour and environmental rights	• Economic Partnership Agreements (EPA) • Euro-Mediterranean Association Agreements (EMAA) • With a specific name	• ACP countries, former USSR • Euro-Mediterranean countries • TTIP, CETA, EU–Japan EPA, Singapore, Vietnam
Medium-high	Reduction or elimination of tariffs, services, investment and political, social, cultural and security agreements	• Deep and Comprehensive Free Trade Area (DCFTA) • Association Agreement (AA)	• Ukraine • Mercosur, Balkans
High	Customs unions (elimination of tariffs and common external tariff)	Customs Union (CU)	Turkey, Andorra, San Marino (uses the euro)
Very high	Access to single market	With specific name	European Economic Area (EEA), Switzerland

Source: the authors.

2. Scope of powers: the problem with investment dispute settlement agreements

A particularly important and controversial issue is the scope of powers in EU trade negotiations. Following on from the Treaty of Lisbon, which extended the European Commission's powers on trade and investment, the Commission requested an opinion from the European Court of Justice (ECJ) on the distribution of powers based on the signing of the Free Trade Agreement with Singapore. The ECJ ruled that apart from purely trade issues, the Commission has exclusive powers to negotiate aspects of access to the market, including transport services, public procurement, the generation of renewable energy, intellectual and industrial property rights and sustainable development.[27] In contrast, investment remains a power shared with Member States. The Commission has exclusive power over FDI but not portfolio investment or the ISDS mechanism, since it 'removes disputes from the jurisdiction of the courts of the Member States'.[28] Since then, any agreement that includes investor protection mechanisms must be ratified by national parliaments before taking force.

This matter is closely linked to the debate on the effectiveness and legitimacy of ISDS systems. On the one hand, as the ECJ notes, the settlement of disputes between investors and states removes powers from national courts, directly affecting their sovereignty. On the other, investors need certainty that disputes with foreign governments will be handled both impartially and in abstraction from the country's political situation 'to ensure that the international nature of the obligation is not lost in the interpretation applied by the domestic courts', no matter how sophisticated they may be.[29] This is the main reason behind the European initiative to create a Multilateral Investment Court (MIC), a permanent court comprising a Tribunal of First Instance and an Appeal Body made up of experts in international law and trade and investment, with the intention that countries signing bilateral investment treaties with the EU can voluntarily opt for its jurisdiction.

27 ECJ Opinion 2/15 of 16 May 2017 on the EU–Singapore FTA.
28 In the ECJ opinion, portfolio investment is understood as investment made 'without any intention to influence the management and control of the undertaking'.
29 Brown (2018), p. 9.

Box 1. The proposal for a multilateral investment court

In March 2018, the European Council authorised the European Commission to negotiate a convention to establish a multilateral court for the settlement of investment disputes on behalf of the EU and published the negotiating directives.

The aim is to establish a permanent body for the settlement of disputes arising from current and future investment treaties. The body will replace bilateral investment courts in EU trade agreements and community investment agreements.

The Council mandate is a response to what it regards as the legitimate concerns of the public regarding the current investor-state dispute settlement (ISDS) system, incorporating some of the fundamental aspects of national and international investment arbitration courts.

The specific features of the court will depend on the result of the negotiations, which are taking place under the United Nations Commission on International Trade Law (UNCITRAL) framework. However, the EU is proposing a system based on the following principals: the court must be a permanent international institution; adjudicators must be tenured experts who receive permanent remuneration and their impartiality and independence must be guaranteed; legal proceedings must be transparent; the court must allow rulings to be appealed; effective compliance with the decisions of the court must be guaranteed; the court must hear disputes arising in the context of current and future investment treaties in countries that submit to its jurisdiction.

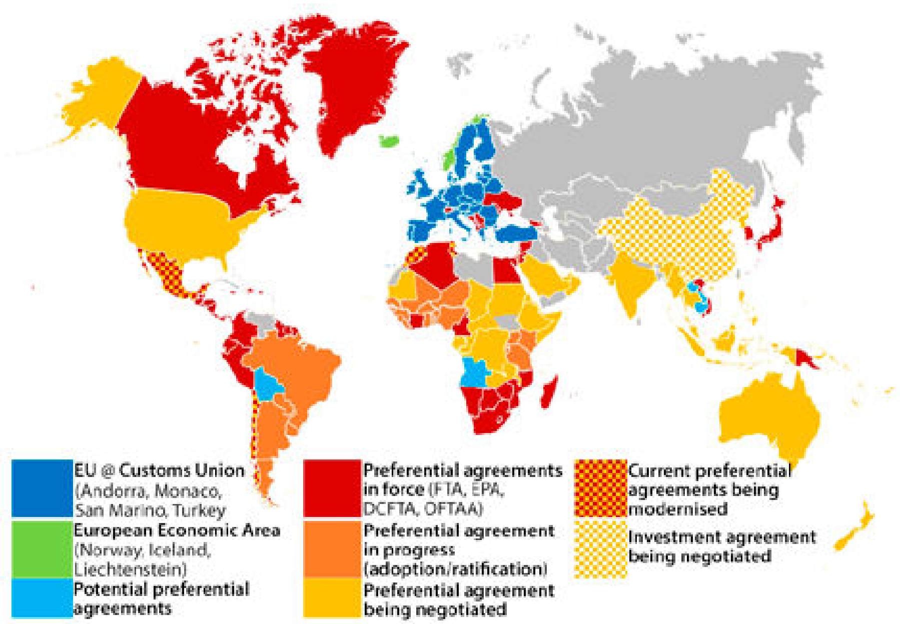
The ISDS mechanism in the EU's trade agreement with Canada (CETA) uses this model. However, it remains to be seen whether the EU will succeed in making it the standard for trade agreements, given the difficulty of bringing together different legal traditions and, perhaps more importantly, given that the US has traditionally preferred continuity of the current ISDS system.

3. Overview of EU trade agreements

At the end of 2018, the EU had 116 trade agreements that were either in force or being updated and negotiated with third countries[30]

30 European Parliament (2018). The Commission regularly updates the list of the status of trade negotiations at https://bit.ly/QAr3S3.

Figure 5. EU trade agreements



Source: the authors based on data from the European Commission.

A first group of agreements is designed for European or quasi-European countries whose size or specific economic or political features mean they do not wish to be part of the EU.

- These are the countries of the European Economic Area (EEA), the EU agreement with a subset of the European Free Trade Association (EFTA) countries, specifically Norway, Iceland and Liechtenstein. These countries have the highest level of integration: full access to the single market and application of freedom of movement of goods, services, people and capital. The only exceptions are farming and fishing products (the latter being one of the reasons Norway did not join the EU) and the possibility of a safeguard that allows immigration control under exceptional circumstances. In return for this access, all these countries fully accept EU law and make financial contributions to a number of the EU cohesion policies. Disputes are resolved by the EFTA Court, which, despite having a certain level of autonomy, is in practice required to harmonise legal practice with the ECJ. In the case of Brexit, the softest option would have involved the UK associating with the EU under a special *ad hoc* formula for this type of agreement.

- The position of Switzerland is extremely close to this group: as a member of EFTA, it should have signed the EEA agreement but chose to remain outside to avoid obligations related to services. What makes Switzerland different from the other EEA countries is that it has had to sign hundreds of bilateral treaties to access the European single market. This has been extremely costly in terms of time and administration, hence why the EU would never accept a post-Brexit relationship with the UK based on the Swiss model. The EFTA Court does not have jurisdiction over disputes with the EU, meaning these must be resolved in complex bilateral diplomatic committees. In practice, this has meant the failure to make further progress with integration and makes Switzerland an exception that would be hard to replicate as opposed to a model for relations with the EU.

- Turkey was a long-standing candidate for membership of the EU until a few years ago and has a customs union with the bloc for industrial products. The EU also has a customs union with a number of small countries and economies closely linked to Europe, including Andorra, the Faroe Islands, Monaco and San Marino.

The European Neighbourhood Policy for bordering states currently covers a total of 16 countries, which can be subdivided into three groups:[31]

- Central and eastern European countries that are candidates for membership of the EU. This was the case with Poland and the Baltic States (Estonia, Latvia and Lithuania) and the former Yugoslavia (Slovenia). This leaves Albania, Bosnia-Herzegovina, Kosovo, Macedonia, Montenegro and Serbia.

- Euro-Mediterranean countries in the Mediterranean basin, with which close economic and political cooperation is pursued to promote their development and democratisation and prevent migrant flows. These are the Euro-Mediterranean Association Agreements, which have been signed with Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine and Tunisia. Agreements with Libya and Syria are currently blocked due to the political situation in these countries. These agreements have so far made slow progress, largely due to the political uncertainty in the region.

- Countries of the former Soviet Union, which are different from the Baltic States and which the EU would like to see closely linked to the EU economy. The integration of these countries is moderate, except in the case of Ukraine,

31 Algeria, Armenia, Azerbaijan, Belarus, Egypt, Georgia, Israel, Jordan, Lebanon, Libya, Moldova, Morocco, Palestine, Syria, Tunisia and Ukraine. Thirteen of these countries are full participants, while Algeria is negotiating its plan of action. A further three (Belarus, Syria and Libya) are outside the scope of most of the strategies due to their political situation. Russia participates in cooperation activities related to the Neighbourhood Policy but is not explicitly part of the policy.

with which a DCFTA has been established. There are also Association Agreements with Georgia and Maldova and a Comprehensive Economic Partnership Agreement (CEPA) with Armenia to replace the current PCA is pending ratification. Finally, a PCA with Belarus and Turkmenistan and an EPCA with Kazakhstan have been signed and are awaiting ratification.

For large OECD countries the EU seeks to establish the most extensive possible free trade agreements with access to specific services markets and generally with investment protection mechanisms.

For large OECD countries the EU seeks to establish the most extensive possible free trade agreements with access to specific services markets and generally with investment protection mechanisms. This category includes the Comprehensive Economic and Trade Agreement with Canada (CETA) and the agreements with Japan, Singapore and South Korea. A highly limited free trade agreement is also being negotiated with the US. The agreement falls short of the ambitious TTIP and will only cover tariffs on industrial products. There are also smaller agreements with Australia and New Zealand. In the event of a hard Brexit, this is the type of agreement the UK will have with the EU, although it will be necessary to find a solution to the issue of the border between Northern Ireland and the Republic of Ireland.

In the case of Latin America, the goal is to sign free trade agreements that are as broad as possible, albeit less ambitious than those with other OECD countries. A good example is the agreement reached with the Mercosur bloc (Argentina, Brazil, Paraguay and Uruguay) in July 2019. This is the EU's most ambitious deal in terms of market size and has been completed after 20 years of negotiations (see Box 2). There is also a trade and partnership agreement with the Andean countries and with Chile, and the agreement with Mexico has recently been updated. Finally, an EPA is being negotiated with the Caribbean Forum (CARIFORUM).

Box 2. The EU-Mercosur agreement

On 29 June 2019, after nearly 20 years of negotiations, the EU and Mercosur countries (Argentina, Brazil, Paraguay and Uruguay) reached an agreement to sign a Partnership Agreement with a major trade component and various political aspects.

The agreement will see Mercosur liberalise 91% of its trade with the EU (72% within 10 years) in highly protected sectors such as cars (previously subject to a 35% tariff) and their components (14%-18%), machinery (14%-20%), chemicals (18%), pharmaceuticals (14%) and textiles and footwear (35%). The liberalisation measures also apply to agriculture and food products in sectors including chocolate and confectionery (20%), wine (27%) and spirits and soft drinks (up to 35%), as well as the dairy sector (with some exceptions). Quotas for dairy and cheese exports will also be increased and their Designations of Origin will be protected.

For its part, the EU will liberalise trade with Mercosur, while maintaining quotas on certain sensitive agricultural products. Customs procedures will be streamlined, quality and labelling rules will be harmonised and cooperation on sanitary and phytosanitary measures will be strengthened, guaranteeing the same food security rules as the EU.

The agreement also covers the services market, guaranteeing more openness and better legal security for European companies, in addition to the commitment of the parties to effectively implement the Paris Agreement, ensure the sustainable management and conservation of forests, respect labour rights and promote responsible corporate behaviour, adopt a more sustainable approach to agriculture and –as part of the political dialogue– protect the rights of indigenous communities. Civil society has an active role in analysing the implementation of the agreement, including human, social and environmental rights. The agreement also provides a new forum to work closely together on a more sustainable approach to agriculture and protects the right of the EU and Mercosur to regulate in the public interest and organise public services as they deem fit.

The agreement will require approval by the European Parliament and probably the Member States, although the trade part can be brought into force early. Not only is it important in terms of the size of the market (773 million people with a combined GDP of €19 trillion) but also in terms of the high initial level of protection measures. European companies stand to save over €4 billion in tariffs, more than four times the savings from the agreement with Japan and almost seven times those of the agreement with Canada. The deal sends a powerful message at a time of rising protectionism in the US and represents closer trade and political ties between the EU and with the hitherto often-overlooked region of Latin America.

In Sub-Saharan Africa, European trade policy has focused on opening up access for its industrial products (and to a lesser extent, its agricultural ones). An agreement is currently being negotiated with Cameroon, Madagascar, Mauritius, Seychelles and

Zimbabwe, and another with Côte D'Ivoire and the Southern African Development Community (SADC). There is also a free trade agreement with South Africa.

There are also two special initiatives for developing countries: the first is the Partnership Agreements with the developing countries of the African, Caribbean and Pacific Group of States (ACP), former European colonies;[32] the second is the Everything but Arms (EBA) initiative, which allows exports of all products except arms to the EU without tariffs or quotas for the least-developed countries (33 countries in Africa, nine in Asia, four in Oceania and one in America).[33]

Finally, the EU has begun negotiations with some of the most dynamic countries in Asia. Having abandoned the strategy for a joint agreement with the Association of South-East Asian Nations (ASEAN), the EU has concluded individual trade and investment agreements with Vietnam and Singapore and continues to negotiate with Indonesia. Negotiations with the Philippines, Thailand and Malaysia are currently suspended for political reasons. Negotiations for an ambitious agreement with India were opened in 2007 but were suspended in 2013 due to incompatible levels of ambition. For the time being, only investment liberalisation is being discussed with China (see Box 7).

4. From multilateral to preferential and back again

For decades, the EU's trade negotiation strategy was characterised by a firm commitment to the multilateral trade system, led by the EU and the US, which defined the rules of globalisation in a framework that was also able to project their interests and values. In fact, with the creation of the WTO, following the Uruguay Round in 1994, the EU was comfortable in the multilateral framework,

32 There are 79 ACP countries: Angola, Antigua and Barbuda, Bahamas, Barbados, Belize, Benin, Botswana, Burkina Faso, Burundi, Cabo Verde, Cameroon, Central African Republic, Chad, Comoros, Congo, Cook Islands, Côte D'Ivoire, Cuba, Democratic Republic of the Congo, Djibouti, Dominica, Dominican Republic, Equatorial Guinea, Eritrea, Ethiopia, Fiji, Gabon, Gambia, Ghana, Grenada, Guinea, Guinea-Bissau, Guyana, Haiti, Jamaica, Kenya, Kiribati, Lesotho, Liberia, Madagascar, Malawi, Mali, Marshall Islands, Mauritania, Mauritius, Micronesia, Mozambique, Namibia, Nauru, Niger, Nigeria, Niue, Palau, Papua New Guinea, Rwanda, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Samoa, Sao Tome and Principe, Senegal, Seychelles, Sierra Leone, Somalia, Solomon Islands, South Africa, Sudan, Suriname, Swaziland, Tanzania, Timor Leste, Togo, Tonga, Trinidad and Tobago, Tuvalu, Uganda, Vanuatu, Zambia, Zimbabwe.

33 Of the 47 least-developed countries, 33 are in Africa: Angola, Benin, Burkina Faso, Burundi, Central African Republic, Chad, Comoros, Congo, Djibouti, Eritrea, Ethiopia, Gambia, Guinea, Guinea Bissau, Lesotho, Liberia, Madagascar, Malawi, Mali, Mauritania, Mozambique, Niger, Rwanda, São Tomé and Principe, Senegal, Sierra Leone, Somalia, South Sudan, Sudan, Togo, Tanzania, Uganda and Zambia; nine are in Asia: Afghanistan, Bangladesh, Bhutan, Cambodia, Laos, Myanmar, Nepal, Timor Leste and Yemen; four are in Oceania: Kiribati, Solomon Islands, Tuvalu, Vanuatu; and one is in America: Haiti.

which allowed it to maintain an offensive position on what were known as 'new trade agenda' issues while conserving its protectionist position on agriculture.[34] Following the WTO ministerial conference in Cancun in 2003, which revealed the new and powerful role of emerging powers in the WTO system, and the difficulties concluding the Doha Round, the EU continued to advocate multilateralism while the US began to explore preferential agreements, both in Latin America and Asia.

During this period and well into the first decade of the 21st century, the EU continued to support the WTO system, doing everything possible –albeit unsuccessfully– to conclude the Doha Round, even offering concessions on agriculture and accepting to eliminate the most controversial 'new issues' from the agenda. It also sought to use its influence over trade policy to shape globalisation in line with European values. It was a period marked by optimism toward integration and confidence in being able to export the multilateral governance established by the EU to the rest of the world. This period, characterised by its accommodating stance on emerging powers, was superseded by the 'Global Europe' trade strategy in 2006, marked by entrenchment, less flexible positions and a more confrontational trade strategy. This marked the onset of a loss of confidence in the WTO, in parallel to the opening or reactivation of negotiations on preferential trade agreements with a wide group of advanced and emerging countries.

The EU's shift from multilateralism to preferential agreements arguably came too late due to its reluctance to accept the global shift from cooperation to geo-economic rivalry, which has made completion of the Doha Round all-but impossible. It also has to be understood in the context of the rapid change in the dynamics of international trade and the political economy of liberalisation, as outlined above, which rendered the WTO ineffective in advancing the EU's most offensive interests (and also those of other major powers). This process culminated in a new approach to EU trade policy in the Trade for All strategy of 2015 (see Box 3). The strategy sought to respond to public concerns about the negative effects of trade liberalisation, while promoting a series of new preferential trade agreements.

34 New trade agenda issues included rules on investor protection, public procurement, policies for the defence of competition, trade facilitation measures and labour and environmental standards in trade agreements. See Steinberg (2007) for a detailed analysis.

Box 3. Trade for All: the European Commission trade and investment strategy for 2015

The Trade for All strategy aims to adapt EU trade activity to a reality dominated by globalisation and increasingly high public expectations of transparency and respect for European values when it comes to trade policy. It also aims to ensure that the benefits reach the various actors and are more evenly distributed.

The Commission emphasises the importance of international trade for the activity of the EU, considering measures such as facilitating ecommerce and the trade in services, increased openness to FDI and supporting the mobility of workers, paying special attention to the phenomenon of migration, whose potential can be exploited through training programmes.

The approach is based on trade liberalisation, advocating the reduction of protectionist measures through Free Trade Agreements (FTAs), which also serve to facilitate trade cooperation among countries while protecting the interests of the EU. However, more open markets can pose risks to workers and SMEs, which have fewer resources for internationalisation. There are provisions to promote more continuous education for the former group, together with the creation of sustainable jobs through the European Globalisation Adjustment Fund (EGF). For the latter group, measures to improve access to information on foreign markets and any obstacles and applicable regulations will be key to taking full advantage of the opportunities of FTAs.

The growing demands of consumers for environmental and social standards and human rights in international trade means transparency and protecting basic values are at the heart of the Commission's strategy. It aims to strengthen the role of the European Parliament in trade negotiations and open up the debate to civil society. This means addressing issues of general interest to the public and raising the profile of the process as a whole.

The Commission's new strategy responds to many of the concerns surrounding the TTIP negotiation. This is clearly reflected in the section on values, which begins by stating the EU's commitment not to accept lower environmental, social or labour protection standards as part of new FTAs. One of the most widely debated issues stemming from the negotiations for this agreement is the desire for a global reform of the investment regime, which is regarded as lacking transparency and in need of independent arbitrators, as well as increasing the participation of states in regulating this area.

> The trade agenda is also projected as a useful tool for social development by promoting an ethical approach to trade relations. There are an increasing number of international initiatives and standards that advocate giving more weight to these dimensions. Examples include the 2030 Agenda for Sustainable Development, the OECD Guidelines for Multinational Enterprises and the inclusion of sustainable development clauses in FTAs. The Commission is committed to ensuring compliance with these rules through instruments such as the revamped Generalised System of Preferences scheme (GSP+), which awards preferential trade agreements with the EU to non-members who work to comply with certain international standards on human rights, governance and the environment.

However, as we shall see below, Trump's rise to power in the US and his attacks on the WTO have led the EU to renew its support for multilateralism while expanding its network of preferential agreements.

THE LEGITIMACY OF EU TRADE POLICY

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In recent years, leaving aside minority groups that have always been opposed to free trade, European public opinion has begun to pay greater attention to international trade negotiations, even criticising them and questioning their legitimacy. In the past, these agreements were much less politicised. They were primarily focused on reducing tariffs and thus had a limited impact on national regulations and sovereignty. Agreements were concluded after long technical conversations and, generally speaking, there legitimacy stemmed from their positive results, allowing their content to go largely unchallenged by the public.[35] However, this is no longer the case. Both TTIP and CETA were widely covered by the media, even appearing on popular TV programmes and prompting significant demonstrations in the streets (particularly TTIP).[36] There is increased public demand for transparency in negotiating these types of next-generation agreements, given that they address issues that more directly affect sovereignty and the European social model and values, alongside the realisation that the distribution of the benefits of trade liberalisation has been more unequal than was imagined and the fact that new technologies have facilitated access to much more information (albeit not always accurate). In this context, it seems relevant to review the criticisms of both trade agreements and the negotiation processes undertaken by the EU to ascertain which are valid and suggest mechanisms to increase their legitimacy. These will need to address the process, their results and the impact on third countries.

35 In countries like the US, trade policy has tended to form part of the political debate and election campaigns. However, in the EU, this only occurs under exceptional circumstances and almost never in Spain. There is a broad consensus on the advantage of trade integration in general and in Europe in particular, which appears to be shared by the majority of the electorate.
36 For example, this edition of the Spanish TV programme *El Intermedio*: https://bit.ly/2JqDKyD.

1. The legitimacy of actors and procedures: criticism of EU trade negotiations

Before addressing the issue of legitimacy, it should be noted that, in general, the public are not well informed when it comes to the debate on trade deals. This is understandable since the issues being discussed are highly technical and the effects of any agreements are uncertain and hard to predict. This means that those both for and against trade agreements –especially in negotiations with superpowers like the US and China, or countries whose standards and wages are clearly much lower than in the EU (eg, emerging countries)– adopt positions largely based on ideological considerations that oversimplify the reality. By means of example, supporting an agreement with the US would be classed as 'right-wing' because it favours the interests of multinationals, while opposing it would be classed as 'left-wing' because it protects the rights of workers from unchecked North American capitalism. However, this logic ignores the fact that the agreement could generate growth and employment, which the left does not disapprove of, or that, notwithstanding its problems, transatlantic capitalism may be more effective in allowing the defence of workers rights than the Chinese model, which appears to be gaining traction.

This makes such a simplified schema ineffective for understanding the opportunities and risks, both economic and geopolitical, associated with any agreements. Nonetheless, it is important to understand that the perception of international trade in EU societies has changed, resulting in increasing interest –and concern– when it comes to trade deals. As former Director-General of the WTO Pascal Lamy notes, the interest in and fear of new trade agreements responds to a new logic of the political economy of trade liberalisation.[37] In the past, interested above all in raising its material standards of living, the public, especially in the EU, saw trade liberalisation, which was largely confined to tariff reductions, as a means to access a wider range of products at lower prices. While people understood that opening up markets created conflicts in the distribution of gains, with winners and losers, they generally believed consumers gained from liberalisation. From this perspective, producers who wished to continue to enjoy a protected and captive market, free from international competition, were the losers.

As such, under the 'old logic' of trade, as described by Adam Smith in 1776 in the *Wealth of Nations*, consumers tended to favour free exchange and businesses were protectionist. However, in increasingly wealthy and advanced societies like those of the EU, which are increasingly concerned with post-materialist values, citizens understand that liberalisation can challenge principles they hold dear as consumers and subject them to certain risks, which are no longer outweighed by the desire to access cheap goods and services. They fear that trade liberalisation, when

37 Lamy (2015).

extended to non-tariff barriers and regulatory standards, could undermine food security and rights associated with the EU welfare state. In other words, they fear that if agreements fail to respect certain regulatory principles that they value above economic efficiency, the technocratic logic of trade openness will override aspects, such as the precautionary principle, under which the state has a duty to protect the public from certain risks (including those associated with free trade), and allow the interests of investors to be defended in special courts separate from those used by the public and to undermine privacy.

Discontent with trade liberalisation can also be explained by the fact that it has generated more losers than initially expected, particularly in the developed world. Moreover, many of those who lose out lack access to adequate compensatory mechanisms.

This explains why, the 'new logic' of trade means many citizens, especially those who speak out to oppose agreements, are more protectionist than under the old logic, while producers, which are now organised in transnational networks of global supply chains, tend to favour free exchange. These characterisations of the attitudes of 'consumers' and 'producers' are clearly generalisations that omit a number of important nuances. However, for the purposes of analysis, the distinction between 'new' and 'old' trade is key to understanding the rejection of certain trade deals.[38]

Discontent with trade liberalisation can also be explained by the fact that it has generated more losers than initially expected, particularly in the developed world. Moreover, many of those who lose out lack access to adequate compensatory mechanisms. Despite abundant empirical evidence that technological change has had a bigger impact than trade liberalisation on unemployment and increasing inequality, since it is not normal –or reasonable– to oppose technological change, free trade is used as a scapegoat. Agreements such as TTIP have become flashpoints for many sectors of the public to express their economic or social frustrations. As we shall see further on, there are strong grounds to justify rethinking the policies available for compensating and empowering those who lose out from free trade. However, these must be implemented at the EU level, in the same way as the EU is responsible for negotiating trade agreements on behalf of all Member States.

38 While the Eurobarometer shows that the majority of the public in the EU favours free trade, there is much less support for the free trade agreement between the EU and the US, undoubtedly the most controversial to date.

If we examine the specific details of recent criticism of trade deals, one of the biggest complaints has been the lack of transparency of their negotiation, conclusion and ratification, with the absence of public debate and democratic oversight. No negotiations, whether on trade or other issues, take place in full transparency. A space free from light and permanent written records is required to create a trusted space for the parties and it is in nobody's interests to reveal their red lines, since this would weaken their position. While this has been the case for all EU trade deals, it has also been the case with the negotiations to end the violence in Northern Ireland and curtail the Iranian nuclear programme.

Yet this is not to say that the level of transparency should not be as high as possible. In democratic societies, with the new tools technology provides for the public, it is unacceptable to hide the impact of an agreement of this nature. An informed debate between those in favour and those against is essential, as is avoiding falling prey to stereotypes grounded in the naive conviction of the boundless advantages of free trade or the fear that trade liberalisation could jeopardise the European social model.

While the European Commission has arguably been slow to react to demands for transparency, there is unprecedented transparency of both negotiating mandates and the texts negotiated (albeit respecting the necessary conditions of bilateral confidentiality), as well as in debates on recent EU trade agreements, for which the Commission negotiating mandates have were published. On the other hand, given the technical complexity of agreements, transparency does not necessarily mean that the public correctly understands the consequences and implications of the texts or escapes the influence of biased or ideological opinions.

Secondly, there is criticism of the lack of democratic oversight of agreements. Populists argue that the technocrats have usurped the people's sovereignty, rendering these agreements illegitimate. However, it is important to remember that the EU has a complex system of checks and balances to ensure the legitimacy of its actions, despite not functioning as an Athenian democracy (and nor do its Member States). The president of the Commission, who is responsible for negotiations, is expressly approved by the European, in whose elections all citizens are entitled to vote. Similarly, all officials are appointed after strict processes, including hearings and parliamentary votes. To initiate trade negotiations (or the Brexit process, whose negotiations have the same structure), the Commission must first receive a mandate from the Council, an inter-governmental institution comprising the heads of state of all EU members. It must then negotiate based on the red lines set by the Council. Moreover, during the process, it now provides members of the European Parliament and officials of the Member States who request it with full access to the details of the negotiation. All this makes it among the most transparent processes in the world. If an agreement is reached, there is another round of democratic oversight for its ratification in the Parliament. Furthermore, if the agreement extends to noncommunity powers, it must be ratified by all national parliaments, and even certain regions of federal states (eg, the Belgian region of Wallonia's ratification of CETA). This last step can even involve a referendum in any of the Member States. It is clearly impractical to subject every step of a negotiation to a public debate or referendum and the claim that EU trade negotiations lack procedural legitimacy simply does not stand up to scrutiny, even though the procedures are certainly more complex than those of traditional nation states. By definition, any representative democracy implies the transfer of sovereignty from the public to the nation state and, in this case, from the nation state to a supranational organisation. Provided the transfer is legal and there is appropriate governance, with checks and balances in place, the supranational entity can act legitimately in the interests of all the Member States and their citizens.

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Thirdly, there are those who claim that trade agreements only benefit multinational companies. While such companies may be the biggest exporters, it is precisely their size that makes them most resistant to changes in rules. Notwithstanding some studies that show multinational companies benefit disproportionately from trade liberalisation,[39] SMEs also enjoy significant benefits, not only directly (there are 600,000 SMEs in Europe that export outside the EU)[40] but also indirectly, through the production of intermediate goods for the exports of large companies and the provision of services to manufacture these goods. These services that are 'embedded' in goods (eg, research and design for technology products and automotive components) are much more important than often thought. Some estimates have shown that their liberalisation can generate hundreds of billions of euros.[41] Not only would a drop in trade negatively affect manufacturers of goods and raw materials, it would also hurt service providers, many of which are SMEs.

The fourth criticism is that many trade agreements entail ISDS mechanisms that bypass national courts. This is exacerbated by the relative ease with which large

39 Baccini *et al.* (2017)
40 Cernat *et al.* (2014b).
41 Antimiani & Cernat (2017).

multinationals with vast resources can litigate compared to many developing countries and SMEs. Although these *ad hoc* systems can be justified in the case of countries with weak legal frameworks, some of these criticisms are well founded.[42] Following the ECJ clarification that the Commission cannot negotiate such systems on its own, the EU has decided to pursue a new strategy. On the one hand, it has decided not to include these mechanisms in the main negotiations of certain new trade agreements (eg, Japan) and instead address them after the basic trade agreement has been approved. On the other, the Commission has shown its willingness to listen to criticisms of ISDS courts (defended above all by the US) and has devised a new dispute settlement solution with stronger guarantees. This mechanism has been approved by the ECJ and forms part of CETA.[43] Going forward, there will be a need to assess its effectiveness and the extent to which it could be the first step toward a multilateral investment court, which the Commission would like to see become the new global standard for dispute settlement (see Box 1).

If there is one thing trade agreements have seldom done, it is to lower the guarantees and rights of European consumers and workers. For consumers, this is because agreements often raise the levels of protection to the highest common denominator. For workers, leaving aside the competition created by agreements (and which, logically, threatens less competitive companies), European agreements have tended to do precisely the opposite: improve working conditions in third countries, with demands for human rights, the prohibition of child labour and environmental sustainability, among many other aspects.[44] In fact, part of the obstacles to progress in negotiations on ecommerce under TiSA are the Commission's concerns about data privacy. Civil society is responsible for informing itself of the implications of agreements, ensuring the effectiveness of safeguards and debating any grey areas. However, it must also be aware that outright opposition to trade harms the interests of many workers and SMEs and that the Commission will never negotiate –as a matter of logic or of powers– lower guarantees of protections for consumers and workers.[45] It is quite another matter as to whether there are specific groups (generally on the fringes of the political system) that do not trust the Commission's

42 It is often argued that greater protection of investor rights and more streamlined systems for settling disputes will result in higher levels of FDI. However, this can result in discrimination in favour of investors, which received privileged treatment compared to members of the public, an unacceptable situation that may not be necessary for trade agreements between countries where the separation of powers and the rule of law operate correctly.
43 ECJ Opinion 1/17 of 30 April 2019 found the ISDS mechanism in CETA compatible with EU law because the courts that are created do not have 'any jurisdiction to interpret or apply EU law other than that relating to the provisions of that agreement' and cannot 'call into question the level of protection of public interest'. It also approved the guarantees of the Council and the Commission to ensure SMEs can access this mechanism and prevent it being restricted to companies with more resources.
44 Some have argued that the EU must do more in this respect. See, for example, Harrison *et al.* (2018) for a critical analysis of how labour standards are handled in European trade agreements.
45 A good example is the collapse of the TTIP negotiations in 2016, precisely because the EU was not willing to lower its agricultural standards to meet the demands of US negotiators.

trade negotiators to adequately defend the interests of the public or who, quite simply, hold nationalist, protectionist and anti-establishment beliefs that put them at odds with EU initiatives other than as indicated by objective data.

2. Legitimacy of results: supporting those who lose out from open economies

We have seen that many criticisms of the procedures for approving EU trade agreements are misguided. We have also seen how the Commission has recently taken measures to better explain the content of agreements and to increase their transparency and procedural legitimacy. There is, however, another obstacle to their legitimacy: the 'losers' of globalisation, especially trade liberalisation, feel increasingly neglected by the authorities. Strictly speaking, this is not a problem with trade itself. There has been a rise in public discontent fuelled by the so-called hyperglobalisation of the last 30 years (especially the financial aspect), growing tax evasion by multinational companies and the platforms of the new economy (which make it harder to fund policies for redistribution and equal opportunities at the national level), the spectre of job losses from technological change and, finally, inequality (the result of all these forces combined). Trade agreements are sometimes criticised as a symbol of globalisation, when in many cases other factors, such as the crisis facing the welfare state and the growing concentration of wealth in the hands of certain elites bear a greater share of the blame.

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When trade is highly liberalised (as is the case with non-agricultural goods in the EU), increased openness may result in smaller marginal increases in standards of living overall and significant redistributive effects.[46] This should come as no surprise. Models of international trade, such as the Stolper-Samuelson theorem, clearly show that openness creates winners and losers.

46 Rodrik (2018).

In 2006, the EU created the European Globalisation Adjustment Fund, which supports people who have lost out from trade liberalisation, to mitigate this problem by establishing a compensatory mechanism at the same level at which trade liberalisation decisions are made.

While the income of some groups falls in absolute terms, the total gains for the winners outweigh the total losses for the losers, meaning the country as a whole has benefited from openness. The problem is that those who lose out, who were previously able to rely on a generous welfare to protect them if they temporarily became part of the group left behind by liberalisation, are now seeing the reduction of social protection nets together with a lack of mechanisms, such as new public programmes, to help them adjust to the new economic reality.

In the case of the EU, this is compounded by the fact that trade policy is negotiated by the Commission for all Member States while protections and welfare state coverage vary between countries and regions, meaning the impact of opening up markets is often unequal. Depending on the economic structure of individual states, some sectors of relatively poorer Member States may suffer from trade agreements while sectors in wealthier ones may reap most of the benefits of liberalisation. In the absence of a broad federal budget at the EU level to allow *ex post* compensation among countries and given the weaker policies to support the unemployed and provide training in relatively poorer countries, trade liberalisation has the potential to exacerbate inequality in the EU.[47]

In 2006, the EU created the European Globalisation Adjustment Fund, which supports people who have lost out from trade liberalisation, to mitigate this problem by establishing a compensatory mechanism at the same level at which trade liberalisation decisions are made. The problem, as Claeys & Sapir note,[48] is that the use of the fund was limited and determining the extent to which job losses have been caused by trade liberalisation is not an easy task. Moreover, the fund was not big enough (€500 million), its impact limited and the number of beneficiaries small (140,000 workers between 2007 and 2016). These were mainly workers from relatively large companies when arguably the fund should have focused on SMEs in greater need of support. As such, the budget for 2021-27 should make increased provisions for funding, facilitate access and raise awareness of its availability, especially in less wealthy regions. This will help improve the legitimacy of trade

47 When the EU decided to move toward the single market, which is essentially a huge liberalisation and integration agreement, it established the Cohesion Fund to 'compensate' regions that lose out to indirectly alleviate this problem.
48 Claeys & Sapir (2018).

policy in terms of results. The winners of open economies will see openness positively while those who lose out (much fewer) will be less inclined to reject liberalisation insofar as they receive appropriate compensation.

However, the debate on EU fiscal instruments for the internal redistribution of income and mitigating the growing economic inequality partly caused by trade and financial openness must also take into account the role of financial globalisation and the difficulties collecting taxes in the most internationalised sectors in recent years. There is clearly a conflict between the free circulation of goods under conditions of fair competition and the free circulation of capital under conditions of unfair competition due to the existence of tax havens and regulations that facilitate tax avoidance. This means there is a need to strengthen the capacity of states to increase tax collection from those who are increasingly able to avoid it, both by increasing tax bases and by fighting the use of financial engineering and new technology to evade taxes. While this challenge can be addressed at the national level, action is most effective at the global level. The EU could spearhead initiatives in this area as it has done in the past on issues such as climate change.

The fact that the losers of trade liberalisation can be victims of competition from companies in countries with lower labour or environmental standards has also raised issues of legitimacy that must be addressed. While EU citizens tend to be less concerned than their US counterparts about competition from countries with low wages (probably because of the welfare state, which, despite its decline, continues to be much broader and more generous in Europe), there is growing concern at the loss of industrial and manufacturing jobs to new emerging countries, particularly China. The public appears to be comfortable with the EU protecting its values through its foreign policy (of which trade policy is part) in areas such as human and labour rights, economic development in the poorest countries and –above all and to a growing extent– environmental sustainability. These aspects were explicitly included in its 'Trade for All' strategy in 2015. We shall deal with the issue of China in the following section. For now let us focus on the contradiction between a protectionist agricultural policy and defending the economic development of countries that are exporters of agricultural products or demanding higher labour standards from emerging countries when it is precisely low wages that make their exports competitive.

For the time being, the EU has squared the circle by opening its markets to exports from the least-developed countries through initiatives such as EBA, rightly arguing that the poorest countries are often net importers of food (meaning they are not penalised by the EU's agricultural protectionism) and reforming the Common Agricultural Policy to produce less distortion on international markets. However, there is growing pressure, especially from members of the public that support anti-establishment parties, to protect EU jobs from competition from emerging countries. All this makes it necessary to strike a new balance between trade

We need a harmonisation of the rules for determining the corporate tax bases and the prohibition of corporate structures unrelated to the activities of the business and whose sole purpose is to shift tax bases.

openness and social protection, spelling out just what Macron's concept of a 'Europe that protects' really means.

3. How to increase the legitimacy of financial globalisation

Trade globalisation has external effects: if goods and services are allowed to flow freely inside a market, it is also necessary to ensure a level playing field for trade. This means that the rules of trade must be expanded with another series of complementary rules to prevent unfair competition. Trade requires the guarantee of competition, which means preventing trade from creating monopolies or oligopolies that allow abuse of dominant positions. It also means outlawing mechanisms that create unfair advantages, such as state aid and subsidies for companies, to avoid this support determining the winners of trade. Finally, it means preventing a race to the bottom in areas that are not strictly covered by trade but are directly related, such as labour and environmental standards, so that competitiveness does not come from a lack of protection of workers or the environment.

The EU has always acknowledged the need for rules to ensure a level playing field for the trade in goods and has established rules to promote competition, prohibit state aid and ensure minimum labour and environmental standards, both within the EU (since the Treaty of Rome) and in trade policy agreements with third countries. Yet it can be argued that the same level playing field for the free circulation of goods does not exist for capital. In other words, it is a question of whether there is a suitable level playing field for financial globalisation. The answer is quite possibly no. During the last few decades, the free circulation of capital, especially the freedom of FDI and intragroup financial flows, has been overshadowed by unfair competition at the fiscal level. In contrast to the situation for goods, the intimate connection between taxation and national sovereignty has prevented the minimum harmonisation needed to avoid unfair competition in the circulation of capital.

The Commission has always been fully aware that the fiscal autonomy of Member States creates a distortion and has tried to address this by promoting a high level of harmonisation at the European level. However, this has not been easy. It was only at the start of the 1990s, after the creation of the single market, that steps were taken to harmonise value-added tax (VAT) regulations to prevent indirect taxes becoming a source of unfair competition among Member States. The principle of taxation in the destination country (exports from one EU country to another are exempt from VAT and the importer pays the national tax) avoids border settlements and a race to the bottom in VAT rates. However, since the 1990s, the free circulation of capital and freedom of establishment, together with the development of IT and communications technology and value chains, saw businesses restructure their production, plants and logistics centres to benefit from lower direct taxes, such as corporate tax, which is not harmonised. In theory, in terms of the free circulation of capital, a lower rate of corporate tax is the same as lower prices for the free circulation of goods. However, this is not true if profits are not clearly allocated. Determining where a good is consumed and thus where it should be taxed is relatively simple. However, determining the point of added value for businesses is no mean feat when dealing with complex corporate structures with high levels of intragroup financing and the payment of usage rights and 'royalties'. The situation is even more complex for technology companies, whose costs are hard to estimate (eg, software has a high manufacture cost but the marginal cost of sales is almost zero). In other words, if corporate tax bases are clearly determined in the different countries, it will be hard to challenge the different rates applicable in different jurisdictions, just like the different rates of VAT in different states, subject to certain minimum thresholds. The problem of unfair competition arises when technology and legal divergence in corporate affairs makes it possible to shift tax bases between countries, regardless of where profits are generated.

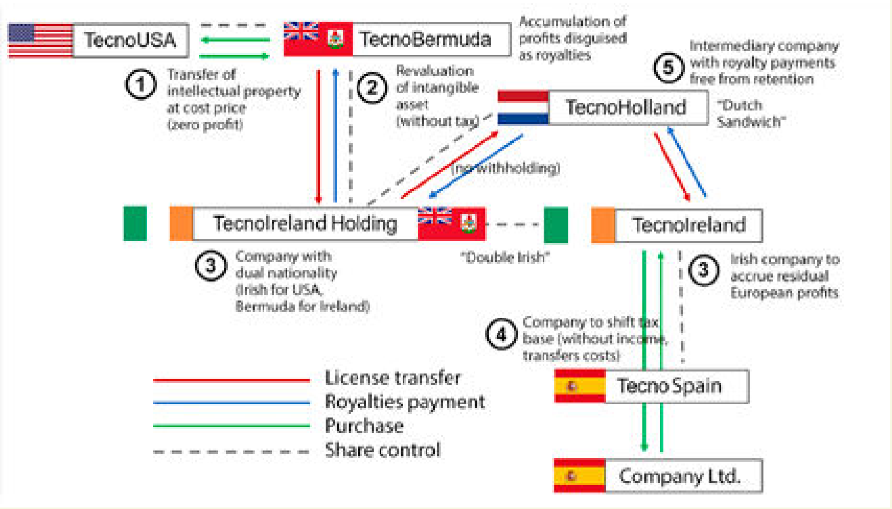
The solution to this problem is clear: minimum harmonisation of the rules for determining the corporate tax bases and the prohibition of corporate structures unrelated to the activities of the business and whose sole purpose is to shift tax bases. The 'Double Irish' and the 'Dutch Sandwich' (Box 4) are clear examples of lax corporate regulations at the expense of the common good. In 2013, the OECD launched its Base Erosion and Profit Shifting (BEPS) project to combat this type of tax evasion at the international level. The OECD estimates that BEPS affects between 4% and 10% of corporate tax receipts, equivalent to between US$100 billion and US$240 billion a year.[49] The OECD/G20 BEPS framework published in 2015 contains measures to address the problem, although the interests of certain countries hinder their application.[50]

49 OECD (2018).

50 Minimum standard to prevent 'treaty shopping'; review of regulations on the transfer of intragroup tax advantages; focus on the purpose of transactions not their legal form; evaluation of preferential special regimes introduced by governments and tax standards applied to intellectual property; and national legislative measures to tackle BEPS.

Box 4. A recipe for tax evasion: the 'Double Irish' and the 'Dutch sandwich'

In recent decades, many companies, especially EU and US technology companies, have taken advantage of the flexibility of Irish and Dutch legislation to shift their tax bases from business generated in Europe to tax havens. The mechanism works as follows. A technology company (let us assume it is American) creates a company in a tax haven like Bermuda and transfers its intellectual property (eg, a piece of software) at cost price. The company in Bermuda then revalues this intangible asset on its balance sheet –without paying taxes– to reduce the profit obtained when it is licensed. To evade the US tax authorities, two companies are created in Ireland (the 'Double Irish'): the first is a holding company (a subsidiary of the company in Bermuda), legally established in Ireland and, as such, Irish in the eyes of the US tax authorities, despite being 'managed and controlled' from Bermuda; the second is a second 'real' subsidiary of this holding company, which is also established in Ireland and thus meets the Irish government's requirements for the holding company to be accepted as resident in Bermuda. The result is that the holding company in Ireland is in a no man's land: from the point of view of the Irish authorities it is in Bermuda, while for the US authorities it is Irish. It operates in the EU through its subsidiary (the second part of the 'Double Irish') using successive software licences paid via royalties (to avoid making profits). The bulk of the profits (disguised as royalties) accrue to the Irish holding company (which consolidates with its parent in Bermuda), while its subsidiary obtains residual profits from its European operations declared at the low local rate of tax.



Source: the authors.

There is only one leak in the process: the payment of royalties within the 'Double Irish', since Ireland withholds 20% of royalties paid to a tax haven (recall the parent in Ireland is resident in Bermuda). To avoid this, an intermediary company is set up in the Netherlands (the 'Dutch Sandwich') to take advantage of the fact that the Netherlands do not levy a withholding tax on royalties. This time, the Irish holding company licences its software through the Dutch company, which licenses it to the second Irish company, such that the royalties return with no retention (from Ireland to the Netherlands, as they are both EU Member States; the Netherlands to the Irish parent, because the Netherlands do not levy a withholding tax). Moreover, given that the second Irish company can shift the tax base of the business it generates in the various EU countries, transferring all costs to subsidiaries, it is easy to understand why large technology companies pay less than 1% tax on profits in Europe and how 60% of royalties paid from the Netherlands end up in Bermuda.[51] The scheme is not just limited to technology companies: famous European football players have also used the 'Double Irish' system to manage their image rights.

However, these loopholes are being closed down. From 2021, Ireland will no longer allow use of the 'Double Irish' scheme and the Netherlands will implement a withholding tax on royalties. This is not to say that new tax avoidance schemes (eg, the 'Single Malt', which replaces the 'sandwich') will not spring up in their wake. In other European countries, opaque bilateral agreements are still being signed with multinational companies, complemented by convoluted financial products (such as fake insurance and pension plans used to hide deposits). It is important to note that the veneer of legality of these schemes in fact conceals outright fraud, including the arbitrary fixing of costs, the use of company structures or financial products that are not genuine and camouflaging profits as costs (royalties).

In a strictly European context, direct taxation decisions, foreign policy and treaty reform are the only areas in which unanimity is required. In practice, this gives veto power to the countries that benefit most from unfair practices, a list that includes Cyprus, the Netherlands, Hungary, Ireland, Luxembourg and Malta. While the Commission avoids directly labelling Member States as 'tax havens', its country reports always use the same euphemism to describe their actions: 'some indicators suggest that [this country's] tax rules are used by multinationals engaged in aggressive tax planning structures'.[52] So far, the Commission's attempts to relax the stringent criteria for unanimity on tax matters –a proposal was included in the Commission's letter of intent to the Parliament and the Council in September 2018 and in its Work Programme for 2019– have been unsuccessful.

51 Lejour *et al.* (2019).
52 European Commission (2019). This description appears in the reports for Cyprus, the Netherlands, Hungary, Ireland, Luxembourg and Malta. In 2018, it also appeared in the reports for Belgium and Estonia.

Nonetheless, the issue is cause for concern among the public: in a 2018 Eurobarometer, three out of four European citizens believed the fight against tax fraud should be one of the main areas of action for the EU and 57% believed the EU was not doing enough to fight tax fraud.[53] It is hard to justify globalisation when the world of finance plays by its own national rules. Members of the public are unhappy that large companies benefit from globalisation but do not contribute to the costs by paying their taxes.

4. Legitimacy of instruments: the necessary link between trade and labour and environmental rights

As we have already noted, the admission of developing countries with large populations like India (1995) and China (2001) to the WTO raised new issues related to trade, such as labour rights and the environment. On the one hand, using a single instrument to pursue multiple objectives is complicated: the Tinbergen rule states that to achieve a given number of policy objectives the authorities require at least the same number of independent policy instruments. Attempting to include labour and environmental requirements in trade agreements is hard. We have also seen how the globalisation of trade and finance requires a shared minimum rulebook. However, aspects that are clear in countries with similar levels of development (eg, the OECD countries) are much less so when comparing developed countries that have emerged from a period of lower social and environmental guarantees to developing countries where this is not the case. Can the same standards for labour and the environment in developed countries be required from developing ones? Moreover, given that these are absolute rights of human progress and not related to the relative progress of countries, should developing countries be compensated for the loss of competitiveness entailed by these requirements?

The debate on such complex matters must clearly take place in a multilateral context and require coordination with the international bodies responsible for these matters.[54] On issues with so many externalities in terms of human rights and environmental sustainability, it is clear that an optimum global solution cannot be reached acting alone. In the EU, the public are increasingly demanding that the fight against climate change is linked to trade deals

53 European Parliament (2018).
54 See Rodrik (2017b) for a discussion of these issues.

THE EU AND THE FUTURE OF THE INTERNATIONAL TRADE SYSTEM

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The global rules-based trade system led by the US, which has been in place since the Second World War and has significantly benefited EU countries, is in crisis. Its multilateral nature and the centrality of the WTO are seriously under threat from the new reality of global trade, which requires much deeper agreements that tend to be preferential in nature, and growing and reckless protectionism, the clearest example being the 'trade wars' of the US.[55] More generally, however, the paradigm of multilateral cooperation is being replaced by geo-economic rivalry and the escalating tensions between China and the US, which the EU is watching with growing concern.

In this context, it is crucial that the EU defines a new foreign economic policy strategy in which trade policy plays a key role. However reluctant, Europeans must assume that international trade relations have permanently become less cooperative and less transparent. Regardless of who wins the White House in 2020, the EU's transatlantic ally will not resume leadership of the global liberal order and China will become an increasingly powerful strategic rival, creating challenges that European countries will only be able to address by working together and speaking with a single voice. In a world of rapidly changing technology and geopolitics, EU trade policy must not be made in isolation from the defence of competition, industrial policy, the internationalisation of the euro, technology policy, the development of artificial intelligence by European companies and the regulation of global finance and its effects on global governance and inequality. In this changing world, the EU needs to move beyond its mission of 'defending the multilateral order'. There is a danger that it could see its standing increasingly weakened in a world with more and more 'carnivore' powers that seek to circumvent or redefine the rules in the best case and in the worst undermine them altogether.

Today, both the US and China appear to have clear strategies. The former believes the multilateral system is obsolete: the Trump Administration regards it as useless for pursuing its interests, at least as it currently stands, and the US has sought to rewrite its trade agreements bilaterally, threatening those who do not meet its demands with tariffs. At the same time, it seeks to undermine the WTO on two fronts: first, by blocking the appointment of judges for the dispute settlement

55 See Crowley (2019).

Appellate Body and, secondly, by violating the spirit of multilateral rules, using the excuse of national security to impose tariffs. For its part, China wants the status quo of recent decades to remain unchanged. It wants the WTO to continue to keep international markets open to its exports while allowing the country a flexible interpretation of regulations to maintain its model of state capitalism where public aid, businesses loans and the ineffective protection of foreign intellectual property go unchecked. A trade and technology war, which some are interpreting as the start of a new cold war, has already begun as a consequence of the irreconcilable ambitions of the two superpowers.

Closer to the European position, a number of major –albeit smaller– countries, including Japan, Canada, Australia, South Korea and the Latin American countries, have expressed both concern over the escalation in tariffs and their interest in preserving the multilateral system. However, it remains to be seen if the EU can lead this coalition of countries (with whom it has negotiated or is negotiating preferential agreements) and secure WTO reform. This is a challenging task, given the incompatible preferences of China and the US on multilateral agreements. In short, imperialism and nationalism are on the rise and the rules-based order and primacy of international law, with which the EU was so comfortable, are being undermined, all of which suggests a challenging future.

1. Trump's new protectionism and the threat of economic disintegration

Trade disputes are not a new phenomenon. In recent decades, however, they have been channelled and resolved through the international mechanisms of GATT/WTO and both the rules and the system have gone unquestioned. We know the rapid growth of China and other emerging countries in Asia has partly been fuelled by maintaining an artificially suppressed exchange rate, despite fierce criticism from the US and Europe. The WTO has been unable to conclude the Doha Round and seems increasingly trapped in a 20th-century agenda focused on the liberalisation of agricultural and manufacturing trade, rendering it unfit to address the trade challenges of the 21st century. This situation has encouraged the negotiation of major preferential agreements that are deeper and more flexible. At the same time, the severity of the recession that followed the global financial crisis in 2008 reduced support for free trade in the West. However, the Trump presidency, which began in 2017, has upended the multilateral trade system with its trade wars (see Box 6). On the other side of the Atlantic, the Brexit vote in 2016 has also acted as a wake-up call to those who believe economic and trade integration is clearly positive.

To navigate these increasingly turbulent waters, the EU needs to understand that liberal institutions are in decline. The Trump strategy is based on four simple ideas.

The first is that multilateralism has allowed the rest of the world to take advantage of the US and must therefore be changed in the best-case scenario and be dispensed with altogether in the worst. The second is that bilateral trade deficits are harmful and must therefore be eliminated, a perspective that goes hand-in-hand with Trump's tendency to regard the countries with which the US has a trade deficit as rivals or enemies. The third is that the US must use its power to negotiate more favourable bilateral trade agreements and that it will ultimately succeed in doing so because other countries stand to lose more from trade wars and, as such, will give in. Fourthly, there is the idea that this neo-mercantilism should help re-industrialise the country and create jobs. In short, Trump is a nationalist who feels more comfortable in a world of major powers without rules and who perceives international relations as a zero-sum game. In his worldview, instead of being a geopolitical ally, the EU has become a trade rival.

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It does not matter that none of these ideas will increase prosperity. The doctrine of mercantilism, which can be summarised by the formula that exports are good and imports are bad, failed to improve living standards or stabilise international relations, unlike the subsequent opening-up of trade under multilateral rules. A trade deficit is not good or bad in its own right. If a country spends more than it produces but spending involves investment designed to increase future growth, there should be no problem. Similarly, the idea that a US trade deficit with Mexico, China or Germany could be easily reduced by imposing tariffs, and that this would create industrial jobs in the US, is deceptive. A country's current account balance is determined by the (im)balance between national savings and investment, not by tariff barriers (if savings are higher than investment, there is a current account deficit, and vice versa). Putting up barriers to trade with a country like China without increasing national savings will only cause this deficit to reappear in the bilateral trade balance with other countries whose imports are not subject to tariffs (eg, Vietnam).

Research by Autor shows there are certain regions of the US where Chinese imports have caused the loss of manufacturing jobs and that industrial workers who have lost jobs have not been able to find new ones in other sectors and, moreover, have tended to vote for Trump.[56] However, the reality is that the decline

56 See Autor *et al.* (2013) and (2016).

There is no doubt that the EU Member States and emerging countries have benefited from the liberal economic order and openness promoted by the US. However, the main reason it created and maintained this order was geopolitical. It served to check the advance of communism in Western Europe at the start of the Cold War.

in industry has affected all advanced countries, despite higher productivity allowing industrial production to increase, while resulting in less jobs. In fact, automation plays a bigger role than trade when it comes to explaining the loss of industrial jobs. In this context, protectionism will not help to recover industrial jobs in the US, since most low-paid activities that now take place in Mexico or China would almost certainly be automated over the coming years if repatriated. This is not to say that the long-term unemployed who formerly worked in industry should not be supported (both in the US and in Europe), especially in depressed regions that have suffered from deindustrialisation and need more support. However, protectionism is not the answer: social policies to help those who lose out from openness to trade are needed, precisely the opposite of what the Republican Administration is doing and precisely where the EU must redouble its efforts.

Finally, the idea that the GATT/WTO system established by the US after the Second World War has allowed other countries to take advantage of its good intentions is an exaggeration to say the least. There is no doubt that the EU Member States and emerging countries have benefited from the liberal economic order and openness promoted by the US. However, the main reason it created and maintained this order was geopolitical. It served to check the advance of communism in Western Europe at the start of the Cold War and accommodate emerging powers as part of an international order in which the US remained the main hegemonic power. Somewhat ironically, the main objective of TPP, the first victim of Trump's protectionism, was to contain the geopolitical rise of China in Asia.

Moreover, both the Trump trade ideology and other examples of sovereignism, especially Brexit, conveniently overlook the fact that trade protectionism is not symmetric: slowing down a process of trade liberalisation is not the same as imposing new restrictions on already liberalised trade. Economic disintegration has enormous costs, which often go unnoticed. This is because of the profound structural changes liberalisation causes in systems of production, changes that are amplified by the aforementioned value chains. More liberalisation in a specific area of trade means more diluted production and increased flow in the trade of intermediate goods and accessory services. Tariffs are designed for productive structures grouped in countries and based on final goods, whereas in value chain structures both production and exports are highly dependent on imported intermediate products. For example, two-thirds of EU imports are raw materials, intermediate products and components needed by manufacturers as part of their production processes.

As such, there are diminishing returns from increasing the cost of imports, either through tariffs or exchange rates. Moreover, obstructing imports also harms production and national exports, together with the associated services. It is precisely services, which make up 70% of the GDP of developed economies and whose trade has become more dynamic in recent decades, that are often left out of protection systems designed for physical goods.[57] The major dependence of production systems on trade also translates into more jobs from trade-related activity. It is estimated that over 30 million workers in the EU (one in seven) directly or indirectly depend on exports to the rest of the world, an increase of 50% since 1995. FDI, which is closely associated with trade and trade agreements, is also a source of employment in the EU: in 2012, US and Japanese multinationals employed 4.2 million people in the bloc.[58] In short, reductions in trade actively harm employment.

2. The Chinese question

Beyond the negative consequences of trade disintegration and protectionism, the malaise afflicting the liberal order cannot be understood in isolation from China's role in trade in recent decades and the fears aroused by its ambitions. The Asian giant has made spectacular progress since embarking on opening up its economy at the end of the 1970s. It is now the world's second biggest economy (first by purchasing power parity), the largest global exporter and has the world's second-highest budgets for both for R&D and defence.

Despite taking advantage of global markets to develop exports, the key to its economic success has been internal economic reforms, above all a model of state capitalism increasingly at odds with multilateral rules. While the Chinese economy remained small, government subsidies for companies, violations of property rights in its territory and the low penetration of exports from wealthy countries in the Chinese market were tolerated by advanced economies, as was previously the case with Japan and South Korea. However, as the Chinese economy grew, these practices became problematic, implying the absence of a level playing field and giving Chinese companies an advantage. Moreover, China was not an ally of the NATO countries.

57 McKinsey Global Institute (2019).
58 European Commission (2016), p. 5.

China's economic growth became more and more intense but, despite reforms, its economic model did not converge with the West.

When China joined the WTO in 2001, the dominant narrative in the US and Europe was that, over time, as part of the multilateral system, its economic model would converge and fall into line with the prevailing model of liberal capitalism in the West. The US and Europe expected a win-win situation: the juicy Chinese market would open up, its consumers (increasingly wealthy) would buy more Western products, companies in advanced countries would continue investing in the enormous Asian market, taking advantage of the high returns and its cheap labour to secure continued access to cheap consumer goods in advanced countries. The most optimistic voices even claimed that economic growth and socialisation in international institutions would lead to China becoming a liberal democracy that would integrate into the governance structures of globalisation like others. They were the times in which Fukuyama's theory of the end of history went unchallenged.[59] As this would be a long process, in the protocol for China's accession to the WTO, it was specified that the country could be classed as a non-market economy for 15 years. This would allow other countries to use anti-dumping clauses or countermeasures to compensate subsidies for Chinese companies with greater flexibility in the event of an avalanche of Chinese products causing serious disruptions to markets.

The process did not turn out as Washington and Brussels envisaged. China's economic growth became more and more intense but, despite reforms, its economic model did not converge with the West. Its production system continued to be based on hybrid public-private conglomerates that enjoyed unfettered access to credit under a financial system controlled by the State and the Communist Party. Chinese companies were soon able to add value to their products. This forced the foreign companies who wanted to operate in its market to share its technology with local partners, only to be expelled after their products and processes had been copied. Moreover, for all intents and purposes, the Chinese market remained closed to many exports from advanced countries (above all services, where advanced economies had a comparative advantage), while foreign companies suffered from increasing obstacles and discrimination to operate in China. In short, a complete absence of reciprocity. Finally, the Chinese authorities kept their currency's exchange rate artificially undervalued for years, giving exports a competitive advantage and allowing its central bank to build up enormous reserves.

59 Fukuyama (1992).

Box 5. US complaints against Chinese behaviour

In 2018, the US Trade Representative produced a report for Congress setting out China's principal infractions in the WTO system.[60] These can be summarised as:

1. **Export control:** China promotes its exports but also controls them. Many countries have complained to the WTO about unlawful restrictions on exports (quotas, licences, minimum prices, export rights or quantity of raw material inputs), evidenced by the multiple complaints submitted by the US and other members.
2. **Import control:** China places major restrictions on imports, especially in areas like technology, where the registration of foreign agricultural biotechnology products are systematically blocked while Chinese companies build their own capacity
3. **Restrictions on foreign payment systems:** China prevents the use of foreign payment systems, in breach of a commitment made in 2006. There is still no foreign electronic payment services company (eg, Visa, MasterCard, American Express) in the country, despite US complaints to the WTO dispute settlement body.
4. **Aid for public companies:** China provides import and export subsidies in sectors such as automotive, textiles, advanced materials, medical products and agriculture, despite explicit prohibitions in the WTO Agreement.
5. **Technology transfer and theft and disregarding intellectual property:** China has promoted the forced transfer of technology by foreign companies and allowing its theft. The US Trade Representative investigated China's forced technology transfer under Section 301 of the Trade Act and concluded China: (1) forces technology transfer through administrative blackmail; (2) uses discriminatory regulations to prevent the use of foreign licences; (3) uses public funds to acquire high-tech foreign companies so as to transfer their knowledge to China in line with industrial policy objectives; and (4) obtains confidential trade information and intellectual property through cybertheft.

All this has allowed China to climb the value-added ladder and reach the technological frontier much faster than imagined. Despite being a lower-middle-income country, which classifies itself as developing in the WTO, and despite remaining the world's factory, China also has areas at the cutting edge of innovation, in addition to major technology, financial and energy firms. What makes understanding and dealing with China so hard is that it contains many different countries and economies, all the way from cutting-edge high-tech sectors through to areas that remain trapped in poverty and can thus continue to compete on low wages. Moreover, China has much lower labour and environmental standards than Europe, coupled with firm and astute state control that is apt at amending regulations to meet the needs of an economic strategy aligned with long-term political objectives. These objectives

60 USTR (2018).

are none other than to make China the hegemonic global power by 2050, after a century of expansion to make up for the previous ‘Century of Humiliation’.[61]

To achieve its aims, China has strengthened the leadership of Xi Jinping and it has proposed moving toward China three centres of gravity:

1. The industrial, through its ‘Made in China 2025’ strategy, it aims to lead the fourth industrial revolution by restructuring its industry and promoting the most advanced sectors in the world, including robotics, biotechnology and artificial intelligence, to achieve global technological leadership.

2. The commercial, through the creation of a new Silk Road (originally the ‘One Belt, One Road’ initiative, recently rebranded the ‘Belt and Road Initiative’) to provide a network of land and maritime economic corridors connecting China, Asia, the Middle East, Europe and Africa to promote trade. This will be complemented by cooperation proposals in a range of other areas, as well as the Silk Road Fund, a US$40-billion investment fund.

3. The multilateral, through the creation of the Asian Infrastructure Investment Bank (AIIB) in 2015, a financial institution to promote development, equipped with capital of US$100 billion to fund infrastructure in Asia as an alternative (or complement) to the Washington-consensus institutions operating in the region, such as the Asian Development Bank and the World Bank and including 87 countries (most European countries but not the US and Japan).

It would suit China to maintain the status quo in international economic relations for another two decades. This would allow it to continue building its power and wealth, address internal economic imbalances, particularly inequality and environmental problems, strengthen its position as a regional power and make progress toward the internationalisation of its currency. To do so, it must continue to benefit from WTO guarantees to maintain access to the rest of the world’s markets while exploiting regulatory grey areas. This would allow it to circumvent multilateral rules (without explicitly failing to comply with them) when it is advantageous to do so and maintain –and, if possible, export– its model of state capitalism. Despite the problems it creates for the EU and the US, China is not necessarily violating WTO rules. The problem is that these rules were not designed for the Chinese economic model, which affords Chinese companies a competitive advantage while complying with the letter –if not the spirit– of the law.

61 The Chinese refer to the period between 1839 (the start of the Opium Wars) and 1949 (after the Sino-Japanese War) as ‘100 years of national humiliation’. The period was marked by the imperialism and domination of Western powers over China, particularly the UK, France and the US, alongside Japan.

Many EU countries have strong economic and trade ties with China and until recently the EU defined the country as an essential strategic partner for addressing the main issues of the global agenda in a multilateral order. However, since 2019, the EU has reclassified China as an 'economic competitor seeking technological leadership' and a 'systemic rival that promotes alternative models of governance'. While the EU may not share the thesis of a new cold war that is gaining traction in the US, it is increasingly concerned about the Asian giant's attitude undermining EU economies and leaving its citizens unprotected. Not all EU countries share this outlook: France and Germany have been the most vocal in promoting an EU policy for the supervision of foreign investment, alongside a more active European industrial policy that supports European champions in key sectors. In contrast, traditionally more liberal countries, such as the UK (whose voice has been all-but absent since the Brexit referendum), the Netherlands and the Nordic countries are more reluctant to increase the political role of the EU to tackle the Chinese threat. Finally, southern and eastern countries seem more willing to continue under the current relationship insofar as Chinese investment helps stimulate their economies.[62] This lack of coherence allows China to benefit from individual relationships with each of the EU countries, clearly a losing strategy for Europeans.

While the EU continues to believe in multilateralism and takes a liberal view of international relations based on the mutual benefits of exchange and cooperation, it agrees with the US that China must modify certain trade practices to ensure a level playing field.

In short, while the EU continues to believe in multilateralism and takes a liberal view of international relations based on the mutual benefits of exchange and cooperation, it agrees with the US that China must modify certain trade practices to ensure a level playing field. However, it believes this can be achieved through dialogue, cooperation and WTO reform, without resorting to the threats of the Trump Administration, whose volatility and arbitrariness make it seem an unreliable partner, thus undermining the chances of making progress on other agreements.

62 See Esteban & Otero-Iglesias (2019).

Box 6. Trump's trade wars

In 2017, the businessman Donald Trump was elected President of the US, a country where protectionism has always enjoyed some degree of popularity ('Buy American' provisions date back a long time), albeit within a framework of respect for international rules. In contrast, Trump came to power openly promising a trade war. He swiftly withdrew from the TPP negotiations (which continued without the US), began renegotiations of NAFTA and the US agreement with South Korea, initiated negotiations for a bilateral agreement with Japan and suspended the TTIP negotiations, threatening a pitched battle with the EU (postponed after floating the idea of a limited free trade agreement). Most significantly, he has embarked on a tariff race with China, which has evolved into an all-out trade and technology war.

His goal has been to rewrite US trade agreements bilaterally, outside the WTO, in order to reduce or eliminate large bilateral trade deficits. Moreover, through his 'America First' platform, he has sought to bolster his public support in the run-up to the 2020 presidential election. Aware that the negative impact of tariffs is not instantaneous and that the US is currently enjoying an extremely strong economy, Trump has sought to portray himself to voters as someone who can modify the 'bad' trade deals of his predecessors. His negotiating tactic has been strike first then negotiate, applying tariffs before sitting down at the table and threatening to increase them if countries do not bend to his demands. He has also sought to justify tariffs based on grounds of national security in flagrant disregard for the rules-based spirit of the WTO, while undermining its dispute settlement system by blocking the appointment of judges to its Appellate Body in an attemp to force other countries that wish to preserve the multilateral system to accept his demands.

So far, this strategy has been effective with smaller countries. Both Canada and Mexico have accepted a reform of NAFTA, which will be rebranded the US-Mexico-Canada Agreement (USMCA), dropping the words 'free' and 'trade' from the title. South Korea and Japan have followed suit in their bilateral agreements. All these countries, fearing the consequences of their companies losing access to the US market, have preferred to bend to Trump. However, in practice, the changes to the agreements have been largely cosmetic, despite Trump seeking to portray them as radical.

In contrast, the EU and China, whose markets are of a comparable size to the US, are different. First, in responding to the protectionist measures of the Trump Administration for steel and aluminium with equivalent tariffs, the EU has shown it will not be intimidated. It has remained open to a trade negotiation with the US but on the condition that it covers all areas of trade (similar to TTIP), not just agriculture and manufacturing, as requested by the US. It remains to be seen how the situation will evolve. However, for the time being, the EU is standing its ground and has announced that if the US applies tariffs to its cars (as Trump has threatened), it will not give in and is not scared of escalation.

However, in the case of China, there is no doubt we are seeing a major trade war, with a significant technological dimension. The initial tariffs imposed by the US on Chinese products and the Asian giant's response in 2018 have seen barriers erected to US$360 billion of trade, an order of magnitude far beyond other trade conflicts. The protectionist measures initially forced China to negotiate but dialogue has broken down. China was willing to cede ground but was unwilling to go as far as altering its model of production, which was the ultimate goal of the US (and would also have suited the EU). At the end of May 2019, the US doubled down on its approach, imposing new tariffs to which China responded in kind. All this has taken place outside the WTO framework, which was designed to resolve conflicts and avoid trade wars.

Trump has escalated the conflict with a technology war whose main aspects have been the decision to prohibit all IT and communications transactions with companies under the control or jurisdiction of a 'foreign adversary' deemed to be a 'national security threat' by the Secretary of Commerce and the inclusion of Huawei on the blacklist of entities with which trade is prohibited without prior authorisation. In contrast to the tariff war, this time China cannot give way, since the issue cuts to the heart of its quest for technological and industrial supremacy in the 21st century. As such, it has reacted much more aggressively, regarding the measure as a strategic attack.

A similar logic lay behind the decision to apply a 5% tariff (increasing to 25%), on all products from Mexico to apply pressure to curb illegal immigration. Aside from the complexity of its objectives, the measure has been interpreted by the Mexican government –already badly bruised by the obligation under USMCA to improve Mexican collective bargaining to create upward pressure on wages– as a direct attack on its sovereignty. An indirect effect of this collateral war is that it jeopardises ratification of the USMCA agreement.

The technology war and the immigration tariff have two things in common. First, they have strayed from the objectives of bilateral trade and have begun to affect non-trade issues in a dangerous way. Secondly, they aggravate alarming nationalist tendencies in both China and Mexico. Talking about tariffs means talking about money. However, talking about technology touches on industrial supremacy and talking about immigration means people, rights and national legislative sovereignty. This shift in Trump's trade war has the potential for serious repercussions on the global economy.

Table 5. US-China tariff war

Announcement	Finalisation	In force	Origin	Destination	Products	Tariff	US$ billion
03/IV/2018	15/VI/2018	06/VII/2018	US	China	List 1 (818 products)	25%	34
03/IV/2018	15/VI/2018	23/VIII/2018	US	China	List 2 (279 products)	25%	16
04/IV/2018	16/VI/2018	06/VII/2018	China	US	List 1 (545 products)	25%	34
04/IV/2018	16/VI/2018	23/VIII/2018	China	US	List 2 (333 products)	25%	16
10/VII/2018	17/IX/2018	24/IX/2018	US	China	List 3 (6,000 products)	10%	200
03/VIII/2018	18/IX/2018	24/IX/2018	China	US	List 3 (5,207 products)	5%-10%	60
05/V/2019	10/V/2019	10/V/2019	US	China	Revised list 3 (tariff increase)	25%	200
13/V/2019	01/VI/2019	01/VI/2019	China	US	Revised list 3 (tariff increase)	5%-10%-20%-25%	16

Value of Chinese exports affected: US$250 billion
Value of US exports affected US$110 billion

Notes:

US Lists: List 1: Aircraft parts, batteries, LCD televisions, medical equipment, satellites, arms. List 2: Iron and steel products, electrical machinery, rail products, instruments and apparatus. List 3: Consumer products, chemicals and construction products, textiles, tools, food and agricultural products, commercial electronics devices and vehicle and automotive parts.

Chinese lists: List 1: Agricultural, automotive and aquatic products. List 2: Copper scrap, fuel, buses and medical equipment. List 3: 25% on 2,493 products (agricultural, food and textile products, chemicals, metal products, machinery); 20% on 1,078 products (foods, paperboard, chemicals, works of art); 10% on 974 products (agricultural products, chemicals, glassware); and 5% on 662 products (chemicals, machinery, medical equipment). Revised list 3: Beef, lamb, pork, vegetables, juice, cooking oil, tea, coffee, refrigerators, and furniture, among many others.

Source: the authors.

3. The EU and trade competitiveness in the 21st century

The trade war between the US and China must be seen as part of a more general struggle for industrial and technological supremacy in the 21st century. This was made clear by Vice President Mike Pence a major speech delivered at the Hudson Institute: 'Now, through the "Made in China 2025" plan, the Communist Party has set its sights on controlling 90 percent of the world's most advanced industries, including robotics, biotechnology, and artificial intelligence. To win the commanding heights of the 21st century economy, Beijing has directed its bureaucrats and businesses to obtain American intellectual property – the foundation of our economic leadership– by any means necessary'.[63] In other words: whoever dominates technology in the 21st century will dominate the global economy.

The trade war between the US and China must be seen as part of a more general struggle for industrial and technological supremacy in the 21st century.

The battle to set the standard for 5G wireless Internet technology is a good example of the importance the two countries attribute to technological supremacy: on the one hand, the US is seeking to use its enormous financial power to prevent the Chinese company Huawei, one of the world's five manufacturers of 5G telecommunications equipment, from dominating the Western market, both in the US and Europe. This strategy has been justified by citing a security risk to Western communications posed by a Chinese standard for the key technology behind the Internet of Things. Huawei, the US Administration argues, would struggle to resist pressure from the Chinese government to allow spying over its networks in the event of a conflict. The clarity of the US strategy, which has prohibited the use of Huawei in the US, contrasts with the insecurity of the EU, which, despite having two European manufacturers of 5G technology (in contrast to the US, which has none), has been unable to agree a common strategy, with some EU countries reluctant to accept Chinese technology and others willing to embrace it.

The fourth industrial revolution of robotics and artificial intelligence is already under way and the EU is lagging behind. Levels of investment in artificial intelligence, the development of technology platforms, numbers of patents and tech startups and other indicators of innovation show the EU behind the US and China.[64] The EU structure of a group of sovereign states slows down decision-making, as the Commission itself has acknowledged.[65] This is clearly a risk, since countries that are unable to compete on technology in the 21st century will be unable to compete at all.

Some voices in the EU have floated the idea of reforming European trade and competition policy to ensure the future competitiveness of EU companies. There is even talk of the need to promote 'European champions', large companies that can compete under the same conditions as the big US and Chinese conglomerates.

63 Available at https://bit.ly/2OCjmww.
64 Hidalgo (2019).
65 European Commission (2018).

While this debate is relevant, it is also dangerous. The Commission's refusal to green-light the merger between the two biggest rail companies in the EU (the French company Alstom and the German company Siemens) showed that national and European interests are often mixed. It was not so much that the EU blocked the creation of a 'European champion' but rather the foreseeable abuse of the company's dominant position in two sectors in which China has yet to flex its competitive muscles in Europe: high-speed rail and signalling.[66] Yet it can be argued that it is not size that determines productivity but productivity that determines size.[67] It is possible, however, that in certain sectors that lack a 'European champion' and where there is a clear risk of a non-EU company controlling the market (5G and technology platforms are good examples, with additional security issues), there are reasonable grounds to support the creation of such companies to overcome the intrinsic difficulties. While Airbus is a good example of success in this area, the idea of creating a European 'Google' seems unlikely and less still if promoted by the public sector. In other cases, steps must be taken to prevent the unjustified creation of European giants (whose size does not necessarily translate into competitiveness) stymieing European competition, which would clearly be negative for consumers, and perhaps also implicit support for German or French companies. European competition policy has always been fiercely independent of political power and the criticism it has received is evidence of this. Any reform of both competition or trade policy with the overarching objective of creating European giants is risky enough to warrant extreme caution.

This does not, however, prevent the EU adopting measures to stop countries that do not show reciprocity from taking advantage of its openness. The recently approved regulation on controlling FDI in the EU seeks to address this problem by establishing an information and cooperation mechanism for Member States and the Commission to ensure the protection of investment in strategic sectors and technologies is transparent and fair.[68]

4. The role of the EU in the international trade system

The EU must face up to an uncomfortable truth: the international trade system is gradually moving away from the model that prevailed throughout the second half of

66 Feás (2019).

67 See, for example, Moral-Benito (2016).

68 Regulation (EU) 2019/452 of the European Parliament and of the Council of 19 March 2019 establishing a framework for the screening of foreign direct investments into the Union applies to infrastructure including energy, transport, communications, space and finance, technologies including semiconductors, artificial intelligence and robotics, and other sectors proposed by the Parliament, including water, health, defence, communications and media, biotechnology and food security. In addition to authorisations for Member States (with no veto power for the Commission), the regulation allows the Commission to control FDI with the potential to affect projects or programmes in the EU interest.

the 20th century, when the system of multilateral rules, the technological prowess of many European businesses and a solid transatlantic relationship created comfortable conditions for EU countries. The return to nationalism and geostrategic rivalry among major powers implies less cordial and cooperative international relations than a 'herbivore' power such as the EU would like. In this context, the EU requires internal cohesion to act as a uniform block and must work toward laying new foundations for the multilateral rules-based order. Yet it must also prepare for the worst-case scenario by developing a strategy to ensure its relevance in a much more economically fragmented and geopolitically hostile world without effective multilateral institutions.

Public support for the EU has risen in recent years and Trump's protectionist stance seems to have increased its support for free trade in Europe, or has at least reinforced perceptions of the advantages of an open and rules-based international economic system.

From an internal point of view, the rise of nationalism and protectionism in 21st-century Europe jeopardises the bloc's openness to trade. The threat of countries such as the UK seeking to leave the bloc is clearly an economic risk: its departure will strip the EU of stature, power and influence on the international stage and similar attitudes could be replicated in other Member States. For the time being, the external threat (Brexit and Trump) has served more as a vaccination to prevent contagion. However, the outcome in the event of a proliferation of governments within the EU seeking to reorient its traditional openness and apply the brakes to trade expansion poses major questions.

For the time being, this remains unlikely. Public support for the EU has risen in recent years and Trump's protectionist stance seems to have increased its support for free trade in Europe, or has at least reinforced perceptions of the advantages of an open and rules-based international economic system. Assuming that internal cohesion, which is essential to maintain a strong external position, holds, the EU must develop a dual strategy, strengthening and leading reform of the WTO system, on the one hand, while working on deeper and more ambitious preferential trade agreements, on the other. It must also develop a new industrial policy strategy to prevent it falling behind in the technology race.

It is highly possible that the new reality of international trade, based on global supply chains and increasingly reliant on services, requires deeper trade deals than those possible under the mulitilateral system. This means the EU must continue to build on its preferential agreements, as has been the case. However, WTO rules must be preserved as a lowest common denominator and a guarantee

> *The priority should be reaching a minimum consensus acceptable to both China and the US in order to allow reform of the WTO in such a way that restores legitimacy to its decisions and ensure there is no incentive to any country to circumvent its rules like at present.*

of the 'relative' openness of markets, as well as for providing mechanisms to monitor the trade policies of all countries and settle any disputes that arise. Basic multilateral rules are a necessary but not sufficient condition for the minimum acceptable functioning of trade and financial globalisation. This makes it beneficial to preserve the multilateral system, which, as we have seen, is under threat, both directly from the US and indirectly from the Chinese policies that have provoked the wrath of the Trump Administration. The EU, as we have seen, is the only power able to lead WTO reform.

International institutions do not normally die, they simply fade into irrelevance and are replaced by others or a return to survival of the fittest. As we have explained in this report, the WTO system is facing multiple threats. On the one hand, there is the risk that its dispute settlement system, which has worked so well until now, is rendered inoperative by the Trump Administration blocking the appointment of judges to its Appellate Body. On the other, the US has used the national security clause to justify its tariffs on steel and aluminium, and perhaps also on cars in flagrant breach of the spirit of the rules. Importing cars or steel from Canada, Germany or Mexico is far from a security threat to the US. This attitude places the WTO in a catch-22 situation: if it authorises the US tariffs under the Article XXI provision for exceptional cases, other countries will follow suit and use security as a justification to close their markets; however, if it fails to authorise the tariffs, there is a danger of the world's biggest economy abandoning the organisation altogether. The crisis facing the WTO is compounded by the immense difficulty of reaching agreements among its 164 member countries on areas of trade that require regulation (eg, ecommerce and the growing list of services) or successfully updating rules on aspects such as investment arbitration and subsidies, which are particularly important for China. In all these cases, plurilateral agreements within the WTO have met with limited success.

In this context, the priority should be reaching a minimum consensus acceptable to both China and the US in order to allow reform of the organisation in such a way that restores legitimacy to its decisions and ensure there is no incentive to any country to circumvent its rules like at present. Reform must be focused on subsidy rules (particularly in the industrial sector), intellectual property and technology transfer, the treatment of public companies, export rates, the defence of competition in international trade (eg, the continued tolerance of the OPEC cartel) and regulations on services and facilitating investment. It is also important to improve transparency (eg, notifications), the effectiveness of committees and permanently rethink fundamental aspects of the institution, such as the paralysing rule of consensus, the absurd preferential common treatment of developing countries, instead of on a case-by-case basis, and permanently clarify the dangerous national security clause, in addition to interpretation of the rules for the dispute settlement Appellate Body, more generally.[69]

In parallel to providing leadership in the multinational sphere the EU must also continue to push for preferential agreements.

Given the current outlook, instead of pursuing a new foundation, which is certain to lead to frustration, it would be more effective for a small group of major trade powers to take the lead through an agreement other countries can subsequently adhere to. The EU, working together with Japan, Canada, South Korea and Australia, appears to be the only power placed to lead such a reform, which would involve finding minimum agreements acceptable to both the US and China. China has shown a willingness to make concessions if the liberal and open nature of the multilateral trade regime, which has benefited it greatly, is preserved. The key point is the extent to which it is willing to change its harmful practices to guarantee a level playing field without advantages for certain actors. Leaving Trump's bravado to one side, the US also appears to understand the need for a minimum framework of multilateral rules. As such, it may be willing to accept certain reforms although it also looks set to continue down the road of economic isolation albeit without necessarily dismantling globalisation. The goal would be to see the practices that are most harmful to the multilateral order abandoned, such as aggressive unilateralism, blocking the WTO appeal mechanism and the use of economic sanctions for geopolitical ends, as in the case of Iran and Cuba. It is important to note that we are not talking about an ideal agreement that would resolve the geostrategic tension between China and the US: since such an agreement would be impossible; instead, we are talking about agreeing a framework of rules acceptable to everyone and that provides stability for international economic relations for decades to come.

In parallel to providing leadership in the multinational sphere, the EU must also continue to push for preferential agreements. Firstly, because by forging alliances and reaching consensuses, negotiations can contribute to progress toward a multilateral solution. Secondly, because a healthy network of agreements is an essential part of being prepared to withstand a collapse of the multilateral system and the fragmentation of the global economy into blocs, an outcome that

69 The EU proposal for the modernisation of the WTO in 2018 is available on the European Commission website (2018b). For the time being, limited progress appears to have been made in trilateral meetings between the EU, the US and Japan. The problem is that the US attitude is not constructive and China continues to prefer bilateral dialogue with the US to end the trade war between the two countries, ruling out any role for the EU.

is possible but can be avoided. In establishing these agreements, the EU must not seek vetoes or preconditions and must defend its values and interests at the negotiating table, without threats and showing flexibility. For example, France's proposal not to negotiate preferential agreements with countries that have failed to ratify the Paris Agreement on climate change is dramatic but impractical, as is imposing a tariff on imports from countries with lower environmental standards. Given the current balance of power, these measures may discourage some major players to negotiate, choosing to continue their harmful environmental practices instead. As the recent Mercosur agreement shows, it is more fruitful to negotiate reductions in emissions and respect for international climate conventions as part of broader trade packages and, above all, without recurring to Trump-style ultimatums that erode trust.

While the EU has reaped the rewards of intensifying the negotiation of such agreements in recent years, progress must be speeded up with the most important emerging countries in Asia and Africa, as well as in reaching bilateral agreements with the US and India.

Box 7. A free-trade agreement between the EU and China?

China is the only major economic power with whom the EU is not negotiating a bilateral free trade agreement. This situation will persist as long as China refuses to play by the same rules as others. China and the EU have close economic relations, which are governed by WTO rules. Negotiations for a bilateral investment agreement have also been taking place since 2013, with talks focused on facilitating investment flows in both directions, increasing transparency, preventing discrimination against and protecting the rights of foreign investors, and making progress in labour and environmental matters linked to FDI. This dialogue makes sense from an EU perspective, since European investment in China faces many more hurdles than Chinese investment in the EU. Yet there is a clear lack of reciprocity in this area, since Chinese investment in the EU has increased exponentially in recent years. This has resulted in the approval of an EU supervision mechanism to monitor the extent to which foreign investment can pose an internal threat (something the US has been doing for decades). Only if the trade agreement is signed and China complies, and if there is also a reform of the WTO in which China accepts to change certain anti-competitive practices, will talk of a free trade agreement between the EU and China be possible, not before. The present bilateral balance of trade is clearly advantageous to China, not only because of the high level of Chinese manufacturing exports to Europe but also because the former blocks many service exports from the latter, precisely the area in which the EU has a comparative advantage. As long as this situation persists, it would be meaningless to sign an agreement that would be detrimental to the EU's interests. European companies have shown they have nothing to fear if fair competition, clear rules and reciprocity are guaranteed. However, a level playing field –so far absent in the case of China– is required.

In all these cases, the objective is to sign comprehensive agreements that take into account the offensive interests of the EU while accepting concessions in areas where it has defensive interests, such as agriculture. The CETA mechanism for settling investment disputes should become the EU model for these types of preferential agreements, with the ultimate aim of converting this into a multilateral mechanism through future WTO reform, or at least making it a standard used for settling disputes. China's acceptance of this European model will be crucial and it would consign the wounded ISDS to obsolescence in the medium term.

The ultimate goal for the EU would be to lead a critical mass of like-minded countries to protect the trade system from the damage inflicted by the US and the dubious practices of China. This will be challenging, given that trade works through global supply chains that include thousands of US companies and given the dollar's status as the global reserve currency. However, the EU has no choice. Not only do protectionism and nationalism threaten global trade, they threaten the sustainability of the liberal order, whose collapse could spell the death of the EU, an institution praised by less hostile US Presidents as 'a historic necessity', 'a moral success story', 'the best ally in peace and prosperity' and 'one of the greatest achievements in the history of humanity'.

CONCLUSIONS AND RECOMMENDATIONS

CONCLUSIONS AND RECOMMENDATIONS

In a world in which the reality of global trade and its governance is undergoing rapid change, this report has analysed why the EU must reformulate its trade strategy at various levels and better integrate it with its other policies. The main recommendations for action are set out below.

Internal strengthening and increasing the legitimacy of economic openness

- The EU must increase the integration of aspects not strictly related to trade in its trade policy. Technology, industry, tax, geopolitics and the internationalisation of the euro must be considered alongside trade policy to develop a strategic and coordinated vision of EU foreign policy. This is the only way a more cohesive and assertive EU can aspire to play a relevant role in the emerging world of major powers. This means establishing a procedure for cooperation between the European Commissioner for Trade, the High Representative of the Union for Foreign Affairs and Security Policy and other relevant commissioners.

- For the coordination of different policies, it is imperative to avoid clashes between trade policy, industrial policy and competition policy. The EU's openness exposes European companies to international competition in a framework in which not everyone –especially China– plays by the rules. It is also lagging behind the US, China, Japan and South Korea in technological development, the battleground for global competition in the 21st century. Coordinating the industrial policies of many different Member States is complex and in terms of patent development, the number of start-ups, the development of technology platforms, the use of robots and investment in artificial intelligence, the figures for the EU are less than encouraging. On the one hand, size matters, and it is important to have large European companies able to compete in international markets. On the other, competition is an essential aspect of the operation of the market, a public good that cannot be sacrificed lightly in pursuit of 'European champions', even though this may be justified at certain points in time and in certain sectors with non-segmented markets where there is a clear threat of foreign dominance and where external dependence is particularly undesirable. It is up to the EU to clearly define the sectors and the conditions for supporting 'European champions', always carefully weighing up the negative effects on consumer's surplus as some political leaders have remarked, it is not about changing policies on competition and tax but about using them correctly. This is compatible with the demand for protective measures for investment and public procurement when justified by the lack of reciprocity or a level playing field. Competition policy is not a recent development but, like trade policy, is closely linked to the creation of the EU single market. Without competition there can be no market and without a market the efficient allocation of resources is impossible.

- The EU must improve the public legitimacy of economic openness. It must do so both in terms of the results (the balance between the winners and losers of liberalisation in European countries) and by ensuring the shared values of EU citizens on labour and environmental rights, consumer protection and privacy can be 'exported' through trade agreements. Despite its varying impact on different Member States and regions, trade policy is negotiated at the EU level, making it essential to improve the economic circumstances and standards of living of those who lose out from liberalisation through centralised EU fiscal instruments. The European Globalisation Adjustment Fund should be reformed to increase its resources and make it more flexible, opening it up to more individuals and companies (especially SMEs). However, the debate on increasing resources and spending at the EU level cannot take place in isolation from the debate on the need for fiscal integration or the need to speed up and increase the economic convergence of the regions of the EU unevenly impacted by trade liberalisation. This means tackling the legitimacy of financial globalisation.

- The increased and justified perception that globalisation lacks legitimacy comes from its financial dimension, creating a need to guarantee a level playing field for the movement of capital, as is the case (notwithstanding the imperfections) for trade. A minimum corporate tax rate is required to prevent a race to the bottom and key areas of taxation should be harmonised, such as the fiscal residence of companies and other aspects that determine their tax base, including the treatment of intellectual property revenues, witholding taxes (especially for transactions involving tax havens), transfer prices between intragroup companies and other more complex aspects related to technology (eg, the concept of permanent establishment or place of supply for digital services), to ensure that competition to attract companies does not depend on loopholes or secret agreements but instead more efficient institutions and human capital.

- It will be hard to legitimise financial globalisation in Europe without preventing countries that use other Member States to reduce tax bases blocking such measures. Although there is political and social pressure for the progressive disappearance of tax havens, they should be prohibited altogether, especially those within the EU that allow 'aggressive tax planning structures'. To do so, it is imperative to reform the EU decision-making process, replacing the requirement for unanimity with qualified majority voting, if not in all areas, at least for harmonisation and tackling abuses to prevent fraud and evasion. If this solution –the preferred solution of the Commission and some Member States like Spain– is not possible, an alternative would be to develop a fiscal Europe at different speeds, with fiscal integration among a group of countries and the isolation of others. Introducing taxes on a proxy measure of profits (eg, the so-called 'Google tax') runs the risk of creating additional distortions and should only be considered as a last resort.

Increasing the EU's influence in the international trade system

- The EU must continue to support the multilateral system of the WTO and actively work for its reform to prevent it collapsing or becoming irrelevant. The reform of the dispute settlement Appellate Body is particularly urgent to avoid paralysis. The EU should aspire to lead a coalition of like-minded countries to agree guidelines for WTO reform that can eventually be adopted by the US and China. Taking the lead in the TiSA negotiations could be a good way to set an example and encourage positive behaviour. The EU must also understand that progress via plurilateral agreements within the WTO is increasingly probable (ie, at different speeds and with variable geometries). While this may be unsatisfactory to certain countries, not including all members could be a practical and operational solution (a 'second best') to ensure the relevance of the institution and prevent its paralysis. The EU, which is already advancing at different speeds, has no reason to prevent the WTO from doing likewise.

- In terms of the trade and technology war, the EU must remain within the rules of the WTO system and stay neutral in the geopolitical conflict between the US and China. It must respond in kind and proportionally to the protectionism of the Trump Administration, within the multilateral framework, avoiding the example set by smaller and more vulnerable countries that have given in to US pressure. This will allow it to uphold its values and promote its regulatory power, while showing a clear difference in negotiating style compared with the US (and China), helping it to project a position of leadership.

- In parallel to defending and promoting reform of the multilateral system and plurilateral agreements, the EU must continue to build a healthy network of preferential agreements. These two strategies are not incompatible. Preferential agreements will allow the EU to ensure continuity of an open global economic system, promote the insertion of European companies in new value chains for the trade in services (which normally require deeper agreements than possible at the multilateral level), promote its values (from respect for liberal democracy through to human rights and environmental sustainability) and build partnerships that will prove useful in the event of a collapse in the multilateral system and the disintegration of the global economy into blocs based around the US and China as part of a neoimperialist logic.

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