

# The European Union's response to the trade crisis

by Guntram Wolff and Uri Dadush

## Executive summary

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The global trading system, a source of prosperity, is under attack on various fronts. The causes run deep and require a strategic response from the European Union and from the main trading nations. The future of the system hinges on the answer to three questions, and the scenarios associated with them:

- Can the World Trade Organisation be reformed?
- Is the United States' scepticism about the system a new normal?
- Can China undertake reforms that would make its system more compatible with the WTO?

The possible endgame for the global trading system could be good or bad, depending on how each of these issues is resolved. Under a good set of scenarios, the EU should persist on its current course with some significant adjustments. We call this Plan A, which would aim to preserve the multilateral trading system. Under a bad set of scenarios, the EU will have to contend with a possible break-up of the multilateral trading system, requiring the formulation of a Plan B. The EU needs today to put in place its Plan B, not only to prepare for a far less favourable trading environment, but also to clarify the trade-offs implicit under Plan A. All major trading nations must recognise that the alternative to making compromises is not the status quo, but something much worse.



Second, the United States is directly challenging the WTO's dispute settlement system by (at least up to the time of writing) blocking the replacement of members of the WTO Appellate Body <sup>1</sup>, which could cease functioning in 2019 <sup>2</sup>. The United States is also openly ignoring the spirit of WTO rules and engaging in managed trade. Countries that respond to the United States with retaliatory tariffs or by trying to make a deal are in danger of walking down the same path.

Third, China is accused of not playing by at least the spirit of the rules. In the WTO context, China is accused of systematic theft of intellectual property, forcing investors in

United States or another of the world's great powers will ignore or refute the system when it is opportune for their domestic politics. Less immediate, but equally important, are the concerns about China. While China formally sticks to the letter of the WTO framework, there is broad agreement in the EU and the US that state subsidisation and forced technology transfer are not satisfactorily addressed by the existing WTO agreement on subsidies and countervailing measures<sup>5</sup>.

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## 3 Causes of the attack on the trading system

The causes of the current attack on the trading system run deep and require a strategic response. The resistance to globalisation is probably in large part a result of the secular trend in skill-biased technological change which accounts for rising inequality, economic disruption and the stagnation of most incomes, a trend especially evident in advanced countries, but not only there. Globalisation also contributes to increased disruption and inequality directly because it creates demand for higher skills disproportionately and gives rise to many 'winner-takes-all' opportunities, especially for platform companies that can scale-up quickly and inexpensively. The disruption has been made worse by the rapid rise of China and the

restrict immigration. Brexit, though a unique phenomenon, can be read as reflecting some of these concerns. However, both export and import interests have gained in political weight with the increase in trade. With raw materials, parts and machinery accounting for 75 percent of world trade (UNCTAD, 2017), companies worry about the viability of the global value chains on which they rely. Many people, especially young people, see their ability to buy foreign goods, invest and travel abroad as a natural right. For all these reasons, most large economies including the EU remain committed to increased openness in trade and foreign investment.

Economic analysis shows that protectionism is not the right answer to the problems. Rather, more attention should be paid to the plight of the most vulnerable. *Ex-ante* policies include investment in skills and infrastructure, or more generally in policies that improve competitiveness. *Ex-post* policies include measures to share the gains from global integration (Freytag *et al*, 2018). However, the national populists have typically refused such a course, preferring to blame foreigners and put up protectionist barriers. Meanwhile, mainstream politicians in Europe and elsewhere are hampered by budget constraints, or for other reasons do not pursue policies that enhance public investment and social welfare.

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## 4 A case for preserving the world trading system

The world trading system has been remarkably successful in promoting trade and must be preserved. The system rests on three main pillars: the WTO, preferential trade agreements and domestic institutions.

The WTO is a global public good that supports open and predictable trade based on reciprocity. It now includes 164 members, accounting for 98 percent of world trade, with another 22 members at various stages in the accession process. The WTO provides the bedrock of international trade law, as it is based on the principle of non-discrimination across nations. It is a true globally-operating multilateral framework with enforcement rights.

Under WTO rules, regional agreements are governed under the WTO's General Agreement on Tariffs and Trade (GATT) Article 24 (substantially all trade and tariff reductions). These preferential trade agreements now cover about one third to one half of world trade. Thanks to the formation of the European Union and its bilateral agreements with partners, EU members can count typically on 75 percent of their trade being covered by them (Ahearn 2011).

International commercial disputes are prevalently resolved in domestic, not international, courts. Domestic institutions – the rule of law – that affect or directly govern international trade are crucial and are being continuously reformed. Although some of these reforms have moved in the direction of trade restrictions (according to the *Global Trade Alert Report*, Evenett and Fritz, 2018), over the last 10 years G20 countries have adopted 9041 measures that discriminate in favour of domestic producers), for the most part, the trend over the last few decades has been in the direction of facilitating international trade and of complying with WTO disciplines.

The combined effect of multilateral, regional and domestic reforms on the freedom and

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## 5 Crucial questions for the future of the world trading systems

The future of the trading system hinges on the answers to three related questions, and the scenarios related to them (see also Akman *et al*, 2019).

### Can the WTO be reformed?

**Good scenario:** in a good scenario, the WTO's negotiating arm would be revitalised, on the condition that the membership can agree to move forward on specific issues and to address them through plurilateral agreements<sup>6</sup>. These would involve members who represent a critical mass of trade and who would be willing to grant concessions to non-participants on an MFN basis. It is also possible that members accounting for a critical mass of trade could agree a plurilateral agreement that is not MFN in exchange for concessions in other areas, as happened with the Agreement on Government Procurement agreement which was approved under the Uruguay Round.

It is difficult to imagine that plurilateral agreements can be reached without the involvement of the major trading economies, underscoring the importance of the United States, China, the European Union and Japan, among others, resolving their present differences. An important part of that discussion, in our view, will be to find ways to improve the operation of the agreement on subsidies and countervailing measures, so that it effectively constrains WTO members, especially those where the rule of law and the judiciary do not operate as they do in the US and the EU. Such improvements would also go a long way towards responding to the concerns of the US about the WTO's judicial function.

**Bad scenario:** if the WTO negotiating arm is not revitalised, the institution will lose relevance and its judicial role will be undermined. Trade law, like any law, must evolve with the times to maintain its legitimacy, requiring a functioning rule-making system. Most urgent at the time of writing, the WTO Appellate Body requires at least three members and could cease being operational as of November 2019 if retiring members are not replaced. This would undermine the resolution of trade conflicts within a binding legal framework.

### Do the Trump Administration's trade policies constitute a new normal in the United States or are they an aberration?

**Good scenario:** many of the concerns expressed by the current administration, especiallyvi7 (udiciik)5.m7

need to face the reality of a WTO without the US. If the US reverts to a policy of isolation and protection – as it did for much of the nineteenth century and early twentieth century, a vast share of its exports and imports will no longer be covered by agreed rules. It is also possible that the US and other major trading nations will increasingly be tempted to ignore these rules if they cannot be updated in negotiations.

### Is the Chinese system compatible with the WTO and if so, is China willing and able to implement the reforms needed to address the concerns of its main trading partners?

**Good scenario:** China has derived great benefits from its membership of the WTO and more broadly from policies of closer integration into the global economy. Naturally, China should want the system preserved. However, there are clear instances of Chinese free-riding in relation to China's large SOE sector, various forms of state intervention that tilt the playing field, forced technology transfer, lack of market access and the lack of protection for intellectual property. These issues would be gradually addressed.

**Bad scenario:** China refuses or is unable to undertake the reforms to its state capitalist system that are required to create a more level playing field in international trade. Tensions with the US and its allies escalate, and countries are forced into the unwanted choice of siding with China or with the US. As in the scenario in which the US turns inwards, all aspects of international relations would become more complicated.

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## 6 What should the EU strategy be? Towards a Plan A and a Plan B

In addressing the implications of these scenarios, the EU should act on the basis that globalisation will continue even if, or as, the trading system runs into severe difficulties and slows the process for a while.

To understand the persistence of globalisation, it is useful to keep in mind the three forces behind it. First, globalisation is an entirely spontaneous economic process driven by arbitrage (buy low, sell high) in the world markets for goods, services, capital and labour. Human beings will continue to engage in this arbitrage, which they do as naturally as they breathe.

Second, the arbitrage process in the four markets is greatly facilitated by improvements in transportation and information technologies, which reduce trade costs, including communication costs and face-to-face costs. These improvements have enabled a significant transformation in the international division of labour that began around 1990 in relation to industry, production processes and tasks. And now, we are experiencing a drastic reduction in matching costs for business-to-consumer and consumer-to-consumer transactions, which might trigger the development of massive services outsourcing. These changes are expected to continue and even accelerate, mainly because of further advances in information technologies.

Third, it is true that historically, policies, macroeconomic depression and international conflicts have interrupted globalisation in individual countries and regions in many instances, and, sometimes even across the world. However, history shows that a withdrawal from globalisation is not technologically or economically sustainable. Politically, countries that have withdrawn from globalisation have often also had to resort to repression. In shaping their long-term strategy, EU policymakers should assume that no country, even the largest such as the US or China, can isolate themselves from globalisation without incurring enormous costs.

EU policymakers need to redouble their efforts to ensure that the multilateral trading system is preserved – Plan A.

The main aim of Plan A would be to preserve the multilateral system, which is not only a fun-





negotiations, such as those with the United States and with Mercosur.

- As part of these reforms, countries with very large current account surpluses should re-examine the appropriateness of their macroeconomic, taxation and structural policies. Large-surplus countries are right to affirm that neither global nor bilateral trade imbalances can be, nor should they be, effectively corrected through trade policy measures, but only through changes to macroeconomic and structural policies. But large-surplus countries should also show greater willingness to adopt such macroeconomic and structural reforms, which are ultimately also matters of self-interest for these countries.
- The EU needs a policy that reflects China's rising economic weight without – as appears to be happening in US-China relations – falling into the trap of geopolitical competition that might have ominous consequences. For all its remarkable progress, China remains on average a relatively poor country, with per capita income at PPP 21 percent lower than

own innovations. This provides some negotiating space for the EU in its relations with China.

All that said, in shaping its China policy, the EU should bear in mind that European consumers and firms derive large benefits from the rapidly expanding trade and investment links with China. China is a far less export-driven economy than it was just a few years ago and it now imports almost as much as it exports. Moreover, China, which in 2017 imported goods and services amounting to \$2.2 trillion, roughly 30 percent less than the United States, could under plausible assumptions<sup>10</sup> import 30 percent more than the United States in 2030. It is therefore in the EU's interest that China reforms and remains an important market for European companies.

China's size, its long history of state involvement and of state capitalism, and the considerable extent to which its different provinces can pursue independent policies, means that the reforms needed to eliminate these distortions are complex and will take time. The EU must strike a balance between exercising continuous pressure for change while avoiding falling into the trap of geopolitical rivalry.

Such a constructive approach towards China encourages change through the WTO and through bilateral negotiations. The China policy needs to be complemented by the strengthening and the build-up of domestic EU instruments that ensure a level-playing field within the EU. For example, the EU's state aid instruments need to evolve so that subsidised foreign companies entering the EU market cannot distort the market. While such measures need to be WTO-compatible, they cannot be based only on notifications to the WTO, as these are insufficiently accurate and timely.

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## 7 The risk of a collapse of the multilateral trading system is real and must be addressed systematically

Plan A might fail for a variety of reasons, in particular if the various bad scenarios materialise. The EU therefore must reflect on a Plan B. This Plan B is clearly not a desired outcome, but it would be careless not to reflect on what the world would look without a functioning WTO and with trade relations based on power relations. The risks are too high for the EU to ignore such an outcome.

In the worst-case scenario, the WTO could collapse quickly – i.e. over the next few years if the US refuses to replace members of the Appellate Body – or the organisation might gradually lose relevance over the next decade or two if its negotiating arm is not revitalised. In the latter case, the EU has more time to execute Plan B, but Plan B is still needed today.

If the United States refuses to replace the members of the Appellate Body, the EU, with China, Japan and others, could conceivably continue for a while to operate under present dispute settlement arrangements minus the United States, until a more permanent arrangement is found that engages the world's largest economy (or until a new US administration reverses course). It is also possible that the EU, China and several other parties could decide to resort to an alternative mechanism for dispute resolution within the WTO, i.e. arbitration under Article 15, a procedure that is purely voluntary and that the United States might or might not decide to accept.

However, none of the alternative arrangements are likely to be permanent. Unless the negotiating arm of the WTO is revitalised – which would almost certainly become more difficult if the US remains outside – the EU cannot discount the possibility that the days of

<sup>10</sup> The World Trade Organization's *World Trade Review* (2018) estimates that the United States' imports from China will reach 30 percent of total US imports by 2030. See [https://www.wto.org/press/pr/2018/20180401\\_wtr.htm](https://www.wto.org/press/pr/2018/20180401_wtr.htm).





