TO THE COMMISSIONER FOR TRADE

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Your challenges are to promote the benefits of the multilateral trade agenda and respond to the rise of regionalism worldwide, and to assess the future of EU trade policy in the new era of global interconnectedness centred around global value chains

STATE OF AFFAIRS

The global trade landscape has undergone marked changes in the last decade. The European Union remains the world's largest trader; in 2013, the EU accounted for nearly one-sixth of global (excluding intra-EU) merchandise trade (exports 15.3 percent, imports 14.8 percent). However, in 2013 China (exports 14.7 percent, imports 12.9 percent) for the first time became the world's second largest merchandise trader, pushing the United States (exports 10.5 percent, imports 15.4 percent) to the third position.

According to the World Trade Organisation (WTO), in addition to creating a downward shift in the level of global trade[1], the global recession of 2008-09 might also have reduced its average growth rate. Pre-crisis global trade grew at an average annual rate of 6.0 percent from 1990-2008, a figure attained only once since the onset of the crisis. Looking ahead, if GDP forecasts hold true, the WTO expects a broad-based but modest upturn in global trade growth in 2014, much of which is expected to be generated by emerging markets, in particular in Asia.

In 2013, the US was still EU's largest merchandise trade (exports plus imports) partner (with a 14.2 percent share), followed by China (12.6 percent) and Russia (9.6 percent)[2]. However, bilateral EU-US trade has

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become less significant for the EU in recent times; transatlantic trade accounted for 24.2 percent of extra-EU trade in 2000. On the other hand, EU trade with Asian emerging economies (and in particular China) has increased significantly; China accounted for 12.6 percent of the EU's merchandise trade in 2013 (exports 8.6 percent, imports 16.7 percent), up from 5.2 percent in 2000. In general, there has been a relative decline in EU trade with developed economies, while with emerging economies, there has been a relative increase.

The situation was both the same and different as far as trade in services is concerned. The EU is again the largest trader, but its share of services is far bigger than its share of merchandise trade, accounting for well over one fifth of global trade (exports 25.0 percent, imports 19.9 percent). The US comes second (exports 18.8 percent, imports 12.7 percent), while China is a distant third (exports 5.9 percent, imports 9.8 percent). However, on both the export and import sides, growth in European services trade turned sharply negative in 2012 before rebounding into positive territory in 2013, indicating very high volatility.

Global trade trends

The most notable features of the last decade from a trade policy perspective have been: (a) the rapid increase in regional trade agreements (RTAs) worldwide[3]; (b) the lack of progress in the Doha Round of trade negotiations; (c) and yet, the remarkable resilience of the multilateral trading system, with relatively little increase in global protectionism. While the progress in WTO-led negotiations on trade liberalisation leaves much to be desired, the WTO's rules and governance mechanism have rather successfully resisted protectionist pressures at a time of extreme global economic weakness and even persistent recessionary conditions, unparalleled since the 1930s.

Revival of regionalism

A recent development in the world's major trading nations is the revival of preference for regionalism, with negotiations for three new mega-regional trade agreements taking place in different parts of the globe: the Trans-Pacific Partnership (TPP), the Transatlantic Trade and Investment Partnership (TTIP) and the Regional Comprehensive Economic Partnership (RCEP). EU trade policy under your predecessor took a significant pro-regional turn. The EU today has trade agreements with nearly 50 partners, and discussions are ongoing with several large partners, including the US, Japan and India. Of course the EU is not alone in this: the preference for regionalism is prevalent in the US too, where companies and policymakers have openly prioritised the TPP and TTIP mega-regionals over WTO trade negotiations. In the Asia-Pacific region, the Association of Southeast Asian Nations (ASEAN) is leading regional economic integration by consolidating its ASEAN+1 agreements into a larger ASEAN+6 (China, India, Japan, Korea, Australia and New Zealand), or RCEP, agreement. Additionally, at the Asia-Pacific Economic Cooperation (APEC) meeting of trade ministers in mid-May 2014, China aggressively pushed the idea of a new free-trade zone in the region, despite objections from the US, Japan and some other TPP members.

In addition, within the WTO system, the preference for plurilateral, rather than multilateral, negotiations is on the rise in key sectors such as services and environmental goods, given the inability of the full WTO membership to come to an agreement on the Doha market access negotiations after nearly 13 years. Some view this failure of the WTO as an outcome of the massive shifts in the world economy that have challenged twentieth century power configurations and enhanced responsiveness to special domestic interests; as a result, WTO negotiations deteriorated into repeated declarations of unchanging positions.

Global value chains

An added challenge for trade policy arises from the increasingly important role that global value chains (GVCs) play today in determining production location, trade and investment flows across the world, and in setting trade rules and product and operational standards (including private standards) to suit the specific needs of the globalised production and distribution systems.

Your first challenge is to save multilateralism and the World Trade Organisation

It is in this context that you must focus on shaping trade and investment policies in order to ensure sustainable trade and investment growth, and ultimately production and employment creation, safeguarding the interests of business and consumers within the EU and in the rest of the world.

CHALLENGES

Reinforcing multilateralism

Your first challenge is to save multilateralism and the WTO, and to balance the costs and benefits of multilateralism in the face of regionalism. After more than a decade of negotiations on the Doha trade round, the interim agreement reached in Bali in December 2013 remained narrowly focused on trade facilitation, and will most likely need time before it yields some of the gains it promised. This slow pace of multilateral trade liberalisation negotiations has encouraged a focus on the less cumbersome regional trade agreements.

A decline in multilateral economic governance will have adverse effects for the EU's trade prospects, not least the potential demise of the familiar rules-based multilateral order and its implications for dealing with large emerging economy powerhouses that might prefer to settle matters through unilateral action or, at best, bilateral deals. The latter often tend to be both arbitrary and unequal in the negotiating status of the participants, in contravention to the fairness and legitimacy that WTO-led multilateralism provides. Thus, crafting an appropriate trade strategy to manage this shift is as important as creating the right narrative to address the sensitivities of the unequal gains from globalisation, and the perceived benefits from regional agreements that bring together less disparate trade partners.

Furthermore, geopolitical developments have made multilateral forums and organisations increasingly important, even if they are more difficult to manage. Sustained economic growth and prosperity calls for stability in global systems, and a major challenge for you will be to manage geopolitical rivalries and reintegrate rivals into a common global system.

TTIP

A second related challenge will be to respond to the rise of regionalism worldwide, and its implications for the large emerging markets and for EU trade with them. TTIP is a potential game-changer for the EU, and a closer trans-Atlantic engagement can help soften the impact of the shifts in global power structures, and can even act constructively on global common interests. More importantly, this is the most complex and highest-profile dossier that you have inherited, and you must somehow bring it to a satisfactory conclusion. Your challenge will be to recalibrate expectations of reaching a very deep and comprehensive TTIP agreement in a relatively short time period (by 2015!), especially given that the lack of a trade negotiating fast-track mandate with the US President makes it difficult for the EU negotiators to make credible and deal-making offers because of the threat of the deal being unravelled by the US Congress. The current politico-economic conditions on both sides of the Atlantic mean there are poor prospects for a rapid conclusion of TTIP. Meanwhile, the large emerging Asian markets have become systemically critical for the EU given their: (a) increasing importance as significant trade partners, both as export destinations and source of critical intermediate inputs to European goods and services; (b) rise in significance as final consumers of EU products; and (c) key nodal status in the presently largely Asia-Pacific centred GVC production system.

India and China

Sceptics of the current regionalism initiatives in fact doubt the ability of these mega-regional agreements to integrate large emerging market trading partners at a later date, when they were not party to the negotiations setting the initial rules. Also, it has been argued that it is difficult now to imagine large emerging economies like India and China queuing up to join the new developed country-led RTAs any time soon. China's and India's recent decisions to join the plurilateral negotiations on information technology products, services, government procurement and environmental goods clearly indicate that these two Asian emerging economies are participating in these western initiatives based primarily on their domestic economic imperatives rather than the fear of being left out of global systems/markets. It is however clear that in the long run, an integrated global trade governance regime will have to include these high-growth zones and large consumer markets, both from the legitimacy perspective and because of the economic imperatives.

Clearly, much will depend on the credible threat of economically meaningful discriminatory outcomes that the new mega-regionals can actually create within a definite timeline (ie ability to negotiate and implement ambitious agreements before the WTO Doha agreement is signed). The on-going TTIP negotiations can potentially emerge as a threat to the WTO-led trading system, by firmly shifting global rule- and standard-setting (including those regarding dispute settlement) to the two sides of the Atlantic, though this will obviously depend on the timeline of the TTIP negotiations and the depth of the realised ambition. Additionally, you will need to address the challenge of new environment, health and labour regulations likely to be enshrined into the new-age RTAs; these are essentially domestic policies but often act as *de-facto* trade barriers for both imports and exports.

Even the investment agreement negotiations have turned pro-regional in recent times (in preference to bilateral and multilateral agreements) as more and more countries are negotiating investment agreements as part of their larger trade agreements or as standalone international investment agreements. However, a challenge in the context of the current international investment agreements stem from the contours of the international investor arbitration (investor-state dispute settlement, ISDS) processes that often also impinge on domestic policies of sovereign states, in particular the national investment policies geared towards new development strategies (productive capacity building and sustainable development). There has been rising scepticism and resistance in both developed and developing countries against the ISDS mechanism, an issue that the EU will also need to resolve in the interests of promoting trade and investment while retaining adequate national-interest policy space.

Global value chains

Your third challenge arises from the new nature of globalisation that is dominated by the GVCs. Heightened global interconnectedness linked to rising GVC production and trade has challenged the ability of national governments to adopt protectionist policies. The high and

Global interconnectedness has challenged governments' ability to adopt protectionist policies

rising import content of domestic output and exports have increased the cost of protection and resistance from business and consumers to proposed trade defence measures. Clearly, it is no longer a simple case of black-and-white economic relationships, in which one is either a friend or an enemy. The economic needs and compulsions of nations, both large and small, have become more complex and interdependent as a result of GVCs. As a result, the environment for sovereign policy-making has changed, and the role of trade and investment rules in this regime of global supply chains will necessarily differ from those in the past, and might even lead to changes in future global trade and investment relationships. This development calls for a nuanced assessment of what trade policy the EU can and should adopt in the years to come.

RECOMMENDATIONS

The challenges outlined above necessitate some priority measures. First, globalisation (in particular the GVC-centred variety of our age) is best served by multilateral rules, irrespective of the many short-term economic benefits that regional trade agreements offer. Regional agreements are also almost always less welfare enhancing when compared to multilateral rules. Given the relatively greater overall benefits, it is therefore imperative that you act as the champion of multilateralism at EU and global levels. In that vein, the EU should continue to lead the Doha negotiations, and make necessary commitments to ensure a balanced outcome in all the pillars of the Doha Development Agenda negotiations, in both the traditional and new trade issues. Unlike in the Uruguay Round, the EU has not been a major dissenting voice in the Doha negotiations, and the clashes in the WTO have largely been between the US and the large emerging economies. This gives you an opportunity to act as a power broker. The EU can and should act to help push the Doha Round to a conclusion, and make the necessary compromises befitting the world's

Doha

largest trader. Interestingly, with the recent Common Agricultural Policy reforms, the EU has carved an advantageous position from which to lead the agriculture subsidy negotiations in the WTO. Constructively engaging trade partners at the WTO will further help the EU to reduce its costly trade protection in agriculture, in addition to garnering market access in some large, growing emerging markets, which are already or will shortly turn into net agricultural importers. In attempting to bring a rapid closure to the current WTO Round, which is necessary before one can start a new and future-focused WTO Round, the EU should lead in ensuring that the new trade rules continue to enshrine the core WTO principles of inclusiveness and flexibility. To that end, while encouraging the WTO to continue to adopt the more nimbler mode of negotiating plurilateral agreements in new areas with a critical-mass group of interested parties (as in the Tokyo Round), you should strive to ensure that these plurilateral agreements remain open to all interested parties that may wish to join at a later date.

Accommodating emerging economies

The second set of recommendations pertains to reconciling regionalism with the shift in economic weight to emerging economies, and, in particular, accommodating peacefully the increasing power of high-growth emerging markets and large consumer blocs, in addition to maximising the potential gains from the TTIP. It is important that the new EU trade policy is cognisant of the new growth markets given the flagging consumer base in the EU, which might require an appreciation that very stringent regulatory regimes can create economic fortresses that compromise the ability of European firms to competitively price their products in the high-growth emerging markets. The most dynamic of the emerging markets, China, has seen its middle class grow from 18 million people in 2000 to nearly 500 million in 2014, earning, on average, \$9,000 to \$34,000 per year. However, averages hide the fact that it is the third-tier cities in China with incomes at the lower end of the middle-class spectrum that will be the main drivers of growth in the years to come. The story is the same for India, and even Brazil, albeit at different levels of *per-capita* income. Global European firms are naturally rushing to adjust, and an appropriate policy nudge can further benefit businesses and help them identify the most suitable product portfolios.

TTIP

With respect to the EU's bilateral and regional initiatives in trade and investment, in particular the TTIP, your focus should be to conclude an ambitious agreement, with as much regulatory coherence and mutual recognition in the key export sectors as is feasible without compromising consumer interests. China's accession to the WTO twinned with increased possibilities for slicing up manufacturing production processes boosted the relocation of low- and even medium-value-added intermediate goods production from the EU to lower-cost Asia, in particular China. Arguably, today's trans-Atlantic trade in final goods incorporates inputs from many third countries. However, had the two partners agreed to tear down regulatory barriers earlier on, the savings from the costs of meeting multiple regulations would probably have helped to offset (at least in part) the huge labour cost savings from relocating to China, thereby moderating the rapid relocation of manufacturing units and manufacturing employment away from the EU. Thus, eliminating unnecessary regulatory costs through TTIP as a competitiveness boosting measure should be viewed also in terms of protecting labour interests, as much as it promotes business interests.

Furthermore, TTIP is important to the EU not only because of the common challenges that the two economies face from global economic rebalancing and the rise of the emerging markets, but also because of the high inter-dependence of the two partners in each other's trade basket. The US accounts for 20 percent of EU exports and 20 percent of EU imports (excluding intra-EU trade), while the EU accounts for 28 percent of US exports and 24 percent of US imports. However, measured in value-added terms trans-Atlantic trade flows are even more important than when measured in gross terms. In 2009, the US received 23 percent of total EU exports and provided 21 percent of EU imports on a value-added basis, while the EU accounted for 29 percent of US exports and 27 percent of US imports. The services share in US value-added exports was 52 percent and that of the EU 56 percent in 2009. The higher value-added trade-based interdependence also argues in favour of an ambitious agenda. Deep reduction of non-tariff measures that regulate the production and trade of goods and services should be central to this effort.

The non-economic imperatives of regional and multilateral trade policy and engagement should not be under-estimated when design-

You should strive to avoid TTIP becoming viewed as a 'west against the rest' strategy

ing your overall trade strategy. It is an open secret that the US uses trade and investment policies as instruments of its broader foreign policy. In that vein, the geopolitical merits of the TTIP agreement should not be ignored. Notwithstanding the infrastructure, licensing and other legislative challenges that exist on both sides of the Atlantic, the possibility of importing natural gas from the US (even as a temporary measure) under the TTIP to reduce the EU's dependence on gas imports from Russia should not be treated lightly[4].

That being said, the EU should also strive to avoid TTIP becoming viewed as a 'west against the rest' strategy – a risk not only in the EU and the US, but also in third countries. The twenty-first century is bound to see a relative decline of the west and a return to a situation in which Asia plays an economic (and political) role more commensurate with its demographic weight, a situation that prevailed until the middle of the nineteenth century. The trick here is to avoid falling into the trap of thinking that TTIP will help the EU and the US retain their twentieth century positions as uncontested global economic leaders. TTIP must be a strategy to project ourselves into the future, not the past. To that end, you must ensure that TTIP remains open and inclusive, and is also designed to foster structural reforms within the EU to equip it better to face the challenges of the twenty-first century. In terms of scope and timing, reaching by 2017 an agreement consisting of the elimination of tariffs and a framework for future regulatory cooperation, should be seen as a realistic and satisfactory outcome.

Managing globalisation

Finally, in view of rising economic interconnectedness and the role of GVC networks, effectively managing globalisation is not going to be easy, even for the world's largest trader. Rising internal conflicts and the dichotomy in the motivations and actions of the different groups of stakeholders can lead to domestic resistance to proposed trade policy measures, as demonstrated in the EU-China solar panel anti-dumping case. Similarly, the diverse pressures of incentivising foreign investment in the EU without compromising on the ability to embark on national-interest policy reforms and legislation, which is at the heart of the ISDS debate in the context of the TTIP negotiation, is going to be a challenge. The trick will be to marry the external trade strategy with the right narrative that reflects citizens' concerns and sensitivities. You must therefore enhance both transparency and stakeholder engagement in the EU external trade policy process, and also reinforce the dialogue with the European Parliament. Furthermore, your overall external trade strategy should also make a realistic assessment of the limits of trade policy. Inclusion of non-trade regulatory issues in trade agreements (such as environment, labour) is often mandated by interest-group demands and national policy imperatives. However, the WTO's experience has been that these tend to slow down the negotiation process (which could lead to loss of opportunities in other sectors) while also causing issue overload. A smarter way could be to focus trade policy (and trade agreements) on core trade-related issues, while using complementary policies to address the legitimate non-trade concerns. Rather than treating trade policy as the most critical policy game in town and including all economic issues in trade agreements, negotiating the non-trade policy issues separately but simultaneously with the trade negotiations would be useful in speeding up the trade negotiations while linking non-trade concerns with the progress of trade negotiations.

NOTES

01 EU PRESIDENTS

1. 'Strategic agenda for the Union in times of change', European Council conclusions, 26-27 June 2014.

2. Also, the President of the European Parliament should accept that national parliaments use the subsidiarity review more often.

04 COMPETITION

1. The antitrust definition of a market is conventionally based on tests that identify the boundaries of a market by measuring the degree of competition that different products exert on each other. If two products are very good substitutes – such that a significant proportion of demand and/or of supply would shift to one product if the price of the other is changed – then the products are considered to belong to the same market.

2. All figures quotes are up to April 2014.

3. See Mario Monti (2010) *A new strategy for the single market*, report to the president of the European Commission José Manuel Barroso, available at http://ec.europa.eu/bepa/pdf/monti_report_final_10_05_2010_en.pdf.

05 SINGLE MARKET

1. The European House – *Ambrosetti, 2014 European Business Leaders Survey*, June.

2. Eyal Dvir and Georg Strasser (2014) 'Does Marketing Widen Borders? Cross-Country Price Dispersion in the European Car Market', mimeo, available at http://fmwww.bc.edu/EC-P/wp831.pdf.

3. Trade integration of goods (or services) as a share of GDP is defined as the average of imports and exports of goods (or services) divided by GDP.

4. See for instance the series of reports accompanying the 2007 Single Market Review exercise http://ec.europa.eu/citizens_agenda/single_market_review/index_en.htm

5. Some initial steps towards a framework for implementing a market monitoring exercise in the Commission were already developed in 2008, laid down in Commission Staff Working Document SEC(2008) 3074.

06 DIGITAL AGENDA

1. Sources: Domo.com: onesecond.designly.com/; and Intel: http://www.intel.com/content/www/us/en/communications/internet-minute-infographic.html.

2. Scott Marcus, J., I. Godlovitch, P. Nooren, D. Elixmann, B. van der Ende, and J. Cave (2013) *Entertainment x.0 to boost broadband deployment*, ISBN: 978-92-823-4760-7.

08 MIGRATION

1. This memo is written to a European Commissioner responsible for EU mobility, international migration, border management and asylum. In the past, these competences were divided between DG Home, DG Justice and DG Employment. A few points raised in this memo cut across other portfolios (European External Action Service, DG Development and Cooperation). The author would like to thank Elizabeth Collett, Robert Holzmann, Khalid Koser and André Sapir for their helpful comments.

09 TRADE

1. Global trade in goods fell by 12.2 percent in 2009, by far the largest decline since 1950.

2. The direction of trade and ordering of trade partners varies for exports and imports. In 2013, the EU28's top three import sources were (in descending order) China, Russia and the US, while the top three export destinations were the US, Switzerland and China. All the data in this Memo excludes intra-EU trade.

3. As of 31 January 2014, 435 physical RTAs (counting goods, services and accessions together) were notified to the GATT/WTO, of which 248 are currently in force. The overall number of RTAs in force has increased steadily since the 1990s, a trend likely to be buttressed by the many RTAs currently under negotiation.

4. US domestic law permits targeted energy exports only to countries with which the US has free-trade agreements.

10 ENERGY

1. That is, it should discuss the schemes to remunerate electricity, the roll-out of renewables, networks, demand response, capacity, system services, etc, and assign the responsibility for the development and operation of networks, renewables, etc.

2. There is some legal issue with delegating powers from the Council and the Commission to community agencies ('Meroni Doctrine') that has been widely discussed in the context of the institutions of the 'banking union'.