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Protectionism on the Rise? New Challenges for EU Trade Policy*

KEY MESSAGES

- **We review the EU's trade policy trajectory up to now, situating it within the international context. We then examine new challenges, particularly concerning the resilience of international supply chains and the geopolitical implications of economic interdependencies**
- **Almost 80 percent of all EU imports take place under the most favored nation (MFN) tariff regime. This number illustrates the central importance of the WTO and the multilateral trading system for the EU's external trade**
- **The EU is one of the world leaders in terms of the number of trade agreements: according to the WTO, the EU has 45 trade agreements with 77 countries, which (excluding the EU) account for over 21 percent of the world's GDP. However, recent negotiation and ratification processes have often proved lengthy**
- **The event of Brexit and the resulting increase in bureaucratic hurdles illustrate that the extent of economic integration among EU member states is neither self-evident nor irreversible**
- **Instead of aiming for a Europeanization of supply chains and an increase in protectionism, the goal of European trade policy should be the systematic identification and management of critical dependencies. The diversification of trade relations is essential in this context**

In the spring of 2021, the European Commission released a new version of its trade policy review (European Commission 2021). At the heart of these guidelines is the concept of "open strategic autonomy" as the goal of European trade policy. At first glance, this goal appears to present conflicting interests that are not easily reconcilable: on the one hand, trade openness to international trade may imply a partial renunciation of economic autonomy; on the other hand, achieving strategic autonomy from autocratic regimes like Russia or China might only be achieved by scaling back trade relations.

Undoubtedly, the European Union faces a delicate balancing act while implementing its new trade policy agenda amid challenging global economic and geopolitical circumstances. In this essay, we assess the current state of Europe's trade policy. We review the EU's trade policy trajectory up to now, situating it within the international context. Moreover, we examine the new challenges that European trade policy is facing, particularly concerning the resilience of international supply chains and the geopolitical implications of economic interdependencies.

IMPORTANCE OF THE MULTILATERAL TRADING SYSTEM FOR THE EU

How open is the EU to international trade? A good starting point to answer this question is EU customs policy. EU member states have formed a customs union with a common external tariff against imports from non-EU countries since 1968. As can be seen in Figure 1, around 70 percent of EU imports did not incur a tariff in 2022. This is largely because the EU has set the MFN tariff rate at zero for many products. The MFN tariff is the rate of duty that the EU applies to all other World Trade Organization (WTO) member countries in accordance with the most favored nation (MFN) principle. Overall, almost 80 percent of all EU imports take place under such MFN conditions. This applies to trade flows with major economies such as China, the US, and India, which illustrates the continued central importance of the multilateral trading system for the EU's external trade.

WTO DEADLOCK: IMBALANCE BETWEEN MEMBER STATES

However, since the conclusion of the Uruguay Round and the establishment of the WTO in 1995, there has been no significant multilateral reduction in MFN tariffs. One of the reasons for the stalemate in negotiations is the fact that tariff rates in advanced economies are already very low, while tariffs in many developing countries are still relatively high. While the average applied MFN tariff rate is 13.3 percent in Argentina, 18.1 percent in India, and 11.1 percent in Brazil, it is only 3.3 percent in the US, 3.9 percent in Japan, and 5.1 percent in the EU.[1] The large tariff differential complicates negotiations at the multilateral level, as industrialized countries have less leeway to reduce their own tariffs when negotiating tariff reductions with emerging economies.

A closer look at the applied tariffs, however, also reveals considerable heterogeneity between individual product groups for the EU. The high tariffs applied in the agricultural sector are particularly striking. MFN

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[1] See WTO/ITC/UNCTAD (2023). Figures refer to simple, non-trade-weighted averages for 2022.

tariffs applied to agricultural products are on average 11.4 percent, while the average import tariffs for industrial goods are around 4.1 percent.[2] Particularly high tariffs are imposed on imports of dairy products (38.4 percent), sugars and confectionery (24.6 percent), and beverages and tobacco (19.0 percent). By contrast, for product groups such as machinery or minerals and metals, the average MFN tariff rate applied is around 2 percent. These figures point to a strongly protectionist EU trade policy in the agricultural sector and show that the EU could take further steps toward trade liberalization on its import tariffs.

Moreover, imbalances among WTO members go beyond tariffs. For example, subsidies and export-related measures account for over 60 percent of all protectionist measures imposed worldwide (Evenett 2019) and are a growing cause of trade tensions. In principle, subsidies can have an employment-stabilizing effect, for example in times of crisis. However, they often lead to so-called "market-share stealing" strategies, which make market access more difficult for other companies. To avoid market distortions caused by state subsidies, international cooperation is fundamentally important: if such efforts are not coordinated internationally, the subsidized sectors could be the main beneficiaries, as companies can use this as an opportunity for "subsidy shopping" in different countries: companies pick the highest state subsidy offer, with high costs for the countries involved. The EU has also recently adopted a new Foreign Subsidies Regulation (FSR) to be able to take unilateral action against distortions in the EU's internal market caused by foreign subsidies. An important question in this context is which specific instruments and rules are necessary to create a fair competitive environment without promoting protectionist particular interests. The same question also applies to other trade defense instruments, such as anti-dumping measures. These examples highlight the importance of multilateral cooperation within the WTO system that goes far beyond tariffs and encompasses a multi-layered agenda.

THE EU AS A PIONEER IN TRADE AGREEMENTS

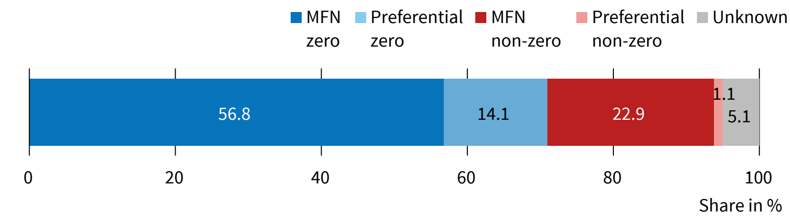
An important development in trade policy since the fall of the Iron Curtain has been the rapid growth of trade agreements. In the first ten years after the establishment of the WTO alone, the number of trade agreements more than tripled from 58 to 188 (Maggi 2014). This number has continued to rise in recent years, with for example the Regional Comprehensive Economic Partnership (RCEP), currently the largest free trade area in the world, signed in November 2020.[3]

[2] Op. cit.

[3] RCEP, in which the ten ASEAN countries, China, Japan, South Korea, as well as Australia and New Zealand participate, comprises 28 percent of world economic output, 28 percent of world trade, and 29 percent of the world population (Flach et al. 2021).

Figure 1

Extra-EU Imports by Tariff Regime (2022)



Source: Eurostat.

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The EU is one of the world leaders in terms of the number of trade agreements signed: according to the WTO, the EU has ratified 45 trade agreements with 77 countries, which (excluding the EU) account for over 21 percent of the world's gross domestic product (GDP).[4] Among them are several small countries and island states that have signed trade agreements with the EU in the last ten years, such as Botswana, El Salvador, and St. Lucia, but also larger economies, such as Canada, Singapore, South Korea, Vietnam, and the United Kingdom after the event of Brexit. Modern trade agreements have become much more comprehensive over time, as they include not only customs agreements but also other regulations such as the harmonization of product safety and hygiene standards, approval procedures, the recognition of geographical designations of origin, and access to local services markets. Far-reaching trade agreements play a particularly central role for trade in services by reducing non-tariff trade barriers. Economic studies show that they have a greater impact on trade in services than on trade in goods (Dhingra et al. 2023). However, the conclusion of deeper trade agreements is often accompanied by an increased use of unilateral trade protection instruments, which in turn leads to an increase in trade barriers. For example, technical barriers to trade and antidumping measures are often used for classic protectionist motives (Vandenbussche and Zanardi 2008; Nes and Schaefer 2020).

Despite the EU's success in the number of FTAs by international standards, however, the EU's recent negotiation and ratification processes have often proved lengthy, as exemplified by the negotiations on the EU-Mercosur Association Agreement or the EU-West Africa Economic Partnership Agreement. At the same time, in other world regions, new economic link-

[4] Own calculations based on European Commission and WTO data on trade agreements as well as World Bank data on GDP.

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ages are emerging at a rapid pace: one example is the RCEP agreement, which is not deep in terms of trade policy but will nevertheless increase economic integration within the Asia-Pacific region (Flach and Teti 2020). This should be a warning signal for the EU to take a more pragmatic approach to negotiations on free trade agreements and to strive for swift conclusions in current negotiations.

TRADE AGREEMENTS AND RULES OF ORIGIN

Particularly in comparison with multilateral trade liberalization, free trade agreements, despite their name, are not unreservedly conducive to trade. First, bilateral trade agreements benefit mainly the signatory countries, whereas other WTO member states are left comparatively worse off, as their relative market access deteriorates as a result. Due to lower trade costs within the agreement, trade shifts in favor of the respective contracting parties. Second, the actual utilization of trade agreements by firms can also be low, because it is often associated with high bureaucratic hurdles, which are an obstacle in particular for small and medium-sized enterprises (SMEs). Rules of origin are one example. If the preferential tariff rates of a trade agreement are to be used, exporters must usually provide rules of origin that prove domestic production. This is to exclude the possibility that goods previously imported from third countries also benefit from the advantages of a trade agreement. Each trade agreement has its own rules of origin that must be followed in order to obtain preferential market access. Because of the costs associated with rules of origin, they make trade agreements more difficult to use and thus reduce their trade-liberalizing character.

The Trade and Cooperation Agreement (TCA), which was signed between the EU and the UK after Brexit and came into force in January 2021, illustrates the bureaucratic hurdles that rules of origin can create. Under the TCA, all tariffs on trade in goods were basically set at zero percent. However, this preferential market access is conditional on traded products meeting rules of origin. Such rules make market access more difficult, especially for SMEs, because rules of origin usually involve fixed costs that can be potentially prohibitive for SMEs. However, the bureaucratic burden also increases significantly for large EU companies integrated into cross-border supply chains with the UK: for example, if a company in the UK wants to export goods to the EU whose production used inputs from third countries, it is possible that this product will no longer comply with the relevant rules of origin. Instead of zero tariffs, positive MFN tariffs would then be due, if applicable. Hence, despite the far-reaching trade liberalization under the TCA in the form of zero tariffs, considerable trade barriers have been created in the wake of Brexit, which negatively affect trade between the EU and the UK. The fact that positive MFN tariffs were paid on around 16 percent of imports from the UK in 2021 (Eurostat 2022) illustrates their significance.

TRADE INTEGRATION INTERNALLY AND EXTERNALLY

Brexit marks a turning point in the European integration process, demonstrating that the level of economic integration among EU member states is neither irreversible nor should be taken for granted. The creation of the European single market, which guarantees the free movement of goods, services, capital, and people, has dramatically lowered national trade barriers and contributed to enormous economic interdependencies among EU member states. For example, Head and Mayer (2021) show that the level of EU economic integration in subsectors such as trade in goods is comparable to integration among the 50 US states. Based on a gravity model, they also find empirical evidence that the reduction of trade costs within the EU has been accompanied by a parallel reduction of trade barriers vis-à-vis countries outside the EU.

Several statistical indicators also show that the EU's economic linkages with the global economy have continued to grow in recent years. Even if trade flows between individual EU member states are excluded, the EU is the world's largest exporter as well as importer of goods and services, ahead of the US and China. The importance of foreign markets has increased almost continuously for the EU as a whole: whereas in 1995 around 10 percent of the total value added of the current 27 EU member states depended on demand outside the EU27, this figure rose steadily to 17 percent in 2019 (OECD 2022). For the US and China, on the other hand, the importance of foreign demand is much lower, with a share of 9.2 percent and 13.9 percent, respectively, and has even been declining in recent years. Similarly, imported intermediate inputs play an important role for the European economy. For example, 16.5 percent of EU exports alone are based on value added from countries outside the EU.

MORE RESILIENT SUPPLY CHAINS THROUGH PROTECTIONIST POLICIES?

The EU's trade policy is currently under greater scrutiny than ever before. The massive supply-chain and transportation disruptions during the Covid-19 pandemic have raised doubts about the reliability of international production networks. Moreover, the war against the Ukraine and geoeconomic uncertainty have come increasingly into the public focus. Given this context, the calls for nationalization or Europeanization of supply chains and the economic decoupling from autocratic regimes have gained momentum. Consequently, the question arises whether the EU should pursue a more protectionist policy to enhance supply chain resilience and mitigate geoeconomic vulnerabilities.

In principle, a large-scale Europeanization of supply chains would come at the cost of considerable economic losses. A simulation study by the ifo Institute shows that shifting value chains back to the EU, Turkey, and North Africa (nearshoring) would lead to considerable long-term decline in the EU's gross domestic product (Dorn et al. 2020).

At the same time, there is doubt about the extent to which a widespread nationalization of supply chains back to the EU would result in more resilient supply chains. From an economic standpoint, international trade works rather as an insurance against country-specific shocks, and hence it allows companies and economies to reduce local risks. If supply disruptions occur at home or abroad, well-diversified trade relations with a variety of countries and regions make it possible to cushion them at least to some extent. A large-scale nearshoring strategy, on the other hand, could lead to greater regional concentration of supply chain risks. For example, several economic studies using various shock scenarios show that economic stability does in general not increase with reshoring and nearshoring, but rather decreases, as the diversification of risks is more limited.[5]

POLICY OUTLOOK

It is questionable to what extent a more protectionist EU policy would lead to a more resilient European economy. A central objective of European trade policy should be to identify foreign trade dependencies and systematically manage the economic and political risks associated with it.

The existence of supply chain risks has been demonstrated not least by the coronavirus pandemic and the economic consequences of the Russian invasion of Ukraine. Critical economic dependencies from China have also recently come increasingly into the public spotlight. For example, a study by the European Commission (2020) shows that around 65 percent of all raw materials required for the production of electric motors are sourced from China. In order to identify such critical economic dependencies at an early stage and increase supply chain transparency, further political efforts are needed, as is an improved exchange of information between the government and the private sector. For example, supply chain stress tests for critical goods organized at the European level could contribute to the identification of potential weaknesses and strategic vulnerabilities in European foreign trade (Simchi-Levi and Simchi-Levi 2020).

The diversification of trade relations is essential for the reduction of critical dependencies and for the design of resilient supply chains. Particularly in this area, European trade policy plays a crucial role. As shown at the beginning, a large part of European trade is still conducted within the framework of the most-favored-nation principle of the WTO. Despite the political hurdles, the EU should continue to work hard to support an ambitious WTO reform, as a strong multilateral trade order provides the best conditions for well-diversified external economic relations. In addition, the objective of EU trade policy should revolve around advancing the current network of regional trade agreements, thereby improving access for European firms to foreign markets and strengthening bilateral cooperation with partner countries around the world. Here, both the negotiation processes and the ratification and implementation of trade agreements must be significantly accelerated in the future.

[5] That the negative impact of the pandemic on the global economy would have been even greater with nationalized supply chains than in a world with global supply chains is shown by Barthélémy et al. 2022). Another relevant simulation study is D'Aguanno et al. (2021).

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