TO THE COMMISSIONER RESPONSIBLE FOR TRADE

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* You face three big challenges. Probably the most important is preserving the multilateral trading system, including by reforming the World Trade Organisation. Second, you must build stronger bilateral trade relations with key partners, such as the US, China and the United Kingdom. Third, you need to deal with issues such as e-commerce and climate change.

You should make contingency plans in case the WTO becomes dysfunctional or even ceases to exist. Meanwhile, you should pursue strong bilateral trade relationships with the hope that they can form the basis for a reformed WTO. Post-Brexit negotiations with the UK should also top your agenda.

The increasing role of services, investment and e-commerce will also require much of your attention, and you will have to reflect on trade and the goals of the Paris Agreement.

* PRESERVING THE MULTILATERAL SYSTEM
* BILATERAL TRADE RELATIONS
* E-COMMERCE AND CLIMATE CHANGE

1 STATE OF AFFAIRS

*INTERNATIONAL CHALLENGES

The European Union's trade policy, which has the goal of contributing *"in the common interest, to the harmonious development of world trade, the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers"*[1], has never faced such a difficult international environment.

EU trade policy has always been embedded within the international trading system embodied in the General Agreement on Tariffs and Trade and its successor the World Trade Organisation. When established in 1995, the WTO was given the authority to enforce trade rules through a quasi-judicial dispute-settlement mechanism, covering an increasingly large number of countries[2]. The scope of WTO rules has also been broadened beyond trade in goods to cover foreign direct investment in services and trade-related aspects of international property rights. Unfortunately, these successes have also brought with them conflicts between WTO members, with the result that the system has become partly dysfunctional and, most importantly, risks collapsing.

* WORLD TRADE ORGANISATION

A clear assessment of why the WTO has become dysfunctional should be your starting point as the new commissioner responsible for trade. Three main reasons can be identified. First, the increase in membership has brought about heterogeneity as more emerging countries joined the club. This is clearly shown by the lack of agreement on concluding the Doha round of trade liberalisation measures, which launched in 2001. Second, some new members, especially China but also Vietnam, are still state-led planned economies, a model the WTO rules have not been designed for. Third, under the Trump administration, the United States has clearly turned its back on the WTO as an institution that can solve the US's perceived trade problems.

While the EU has tried to play a constructive role in the Doha round, the lack of progress has pushed the EU to embark on a programme of bilateral trade deals with major trading partners. Between 2009 and 2013, the European Commission obtained mandates to start negotiations with the ASEAN countries[3], India, Canada, Japan and the United States. It also obtained a mandate to

* TRADE AGREEMENTS

negotiate a Comprehensive Agreement on Investment with China.

The EU-Canada Comprehensive Economic and Trade Agreement (CETA), the EU-Singapore Free Trade Agreement (EUSFTA), and the EU-Japan Economic Partnership Agreement (EUJEPA) will be fully operational by the time you take office. However, other bilateral negotiations remain unfinished or are pending: the EU-India talks were brought to a *de-facto* standstill in 2013 because of differences in objectives between the two parties; the EU-Vietnam trade agreement has been signed but awaits ratification at the time of writing; the EU-China investment agreement has made little progress, despite the 16 rounds of negotiations held up to April 2019; and the negotiations with the US on the Transatlantic Trade and Investment Partnership (TTIP) were frozen by President Trump a few days after he took office in January 2017.

* TRUMP ADMINISTRATION

President Trump's decision to halt the TTIP negotiations was a major setback for the EU, because, together with his support for Brexit, it sent a clear message that he considers the EU more as an irritant than as an economic partner. Along those lines, in 2018 President Trump adopted a series of decisions that further crippled the rules-based multilateral trading system. The first was the imposition of additional tariffs on imports of steel and aluminium, justified by national security concerns[4]. For the EU, the measures impacted €7 billon of exports (in 2018) to the US, and led to retaliation against EU imports from the US for an equivalent value. The Juncker-Trump meeting at the White House in July 2018 extracted a promise from President Trump to *"hold off on further tariffs"* against the EU. It also paved the way for revived negotiations on an EU-US trade free trade agreement, though much less ambitious than TTIP. In April 2019, the EU Council approved guidelines for the Commission to open negotiations with the United States on two agreements: a trade agreement limited to the elimination of tariffs for industrial goods, excluding agricultural products; and an agreement on conformity assessment that would have as its objective the removal of non-tariff barriers, by making it easier for companies to prove their products meet technical requirements both in the EU and the US.

* TARIFFS AND RETALIATION

President Trump also imposed tariffs on imports of products from China[5], following a determination by the US Department of Commerce that the Chinese government had engaged *"in unreasonable or discriminatory activities that harm American intellectual property rights, innovation, and technology"*. Like the EU, China has retaliated against the US, leading to further US counter measures. The EU has inevitably been affected by the US-China trade war both economically and politically. In addition to the impact on trade and investment flows, and the induced macroeconomic effects, the EU has felt the pressure from both China and the US to side with them in their mounting trade and political bilateral conflict. The EU has pushed for WTO reform as a way to reduce trade frictions and preserve the multilateral system. At the same time, the EU has hardened its position on China's industrial policy and its impact on global trade. More specifically, the Commission has urged China to change its behaviour with respect to industrial subsidies, intellectual property, innovation and technology transfer (European Commission/High Representative, 2019).

* WTO APPELLATE BODY

A further decision by President Trump that unsettled the global trading community in 2018 was the announcement that (continuing a policy initiated by President Obama) the US would block reappointments to the WTO's appeals panel, on the grounds that the appellate body took too long to reach decisions and tended to overreach. At the time of writing, the appellate body is down to only three members (out of seven) of which two will end their terms in December 2019. If the US administration continues to refuse new appointments, the WTO's dispute settlement mechanism will no longer be able to function.

No matter how difficult the external environment, that fact that the EU continues to be a large player in trade globally, even when compared to the US and China[6], gives it the ability to influence the course of global affairs.

This is especially true since for trade policy the EU speaks with one voice. But the strength of this voice also depends on the Commission's ability to assemble a majority in the Council and the European Parliament. Obtaining a negotiating mandate from the Council can be tricky, as was the case for the latest EU-US trade negotiations[7]. But the more difficult part is getting the approval of the Council and the European Parliament once negotiations are completed. Members of the 2014-2019 European Parliament were split into three groups: one consistently in favour of trade deals, one consistently opposed, and the third deciding on a case-by-case basis to be in favour, to oppose or to abstain. Because neither of the first two groups commanded a majority, members of the third group played a crucial role in determining the fate of trade agreements, which meant that lobbying was intense.

All these recent international and domestic developments suggest that you will face unprecedented challenges.

2 KEY CHALLENGES AND SOME PROPOSALS

* WTO REFORM

You face three key challenges. The first and probably most important one is preserving the multilateral trading system, including by reforming the WTO. The second is to build stronger bilateral trade relations with key partners, such as the US, China and the United Kingdom. The third is to deal with issues such as e-commerce and climate change.

2.1 Multilateralism at risk

The EU's overarching principle for trade has so far been to keep the multilateral trading system working by taking an active role in reform of the WTO. The Commission has already presented a concept paper for reform[8], mainly covering two of the three main missions of the WTO –rule setting and dispute settlement – while leaving aside further liberalisation. This is reasonable because there would be little room for additional liberalisation at a time when the existence of the WTO itself is under threat. This threat comes two sides: President Trump's profound disdain for multilateralism, and China's state-led system, which is not compatible with the liberal nature of the global trading system and might have weakened the WTO's foundations.

China has influenced the WTO's rule setting, which is intended to ensure a level playing field. In fact, it has become increasingly clear that the existing rules governing the WTO cannot adequately control the use of non-market measures designed to favour a

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Several emerging countries emulate China's economic model, implying that they might not support reform of the WTO oriented towards improving the level playing field

* CHINA'S ECONOMIC MODEL

specific trading partner (namely China) over others. To this end, the EU proposal for reform of the WTO focuses on measures including the notification of subsidies and disciplinary actions against market distorting actions by state-owned enterprises (SOEs). It should be acknowledged, though, that China's importance for global trade will increase as China's economy grows. This will be even more the case if we consider that several emerging countries emulate China's economic model, implying that some of them might not support a full-fledged reform of the WTO oriented towards improving the level playing field. This means that the EU will have increasingly difficult time in gaining acceptance for its proposal at least part of the emerging world. This is particularly the case if the US continues to disengage from the WTO.

2.2 Relations with key trading partners

There are three key trading partners that the EU can simply not obviate in its quest for relevant bilateral trade and investment relations, namely China, the US and the UK.

China

EU-China trade relations have evolved from the trust built by China's accession to the WTO to a much more cautious relationship. Still, given the large and increasing size of the Chinese market, engaging in negotiations with China to improve market access for European goods and, especially, services, should be one of the key tasks of the new Commission.

As for investment, the negotiations to conclude a bilateral investment agreement between China and the EU hinge on finding a workable solution to the structural economic differences between the two. One of the practical ways in which China's economic model influences the EU-China investment relationship, and the conclusion of negotiations, is the leading role of Chinese state-owned companies in China's outward foreign direct investment[9].

United States

* TRADE TENSIONS

It is hard to think of a more rapidly worsening trade relationship – besides the China-US relationship – than that between the US and the EU. One of the EU's key objectives is to reach a free-trade agreement with the US in industrial products, but the omens for such a deal are frankly not good. On the US side, there is clear dissatisfaction that the EU negotiating mandate explicitly excludes agricultural products, an area where the US generally enjoys a comparative advantage relative to the EU. On the EU side, there are also reasons to be dissatisfied. One is that the US continues to maintain additional tariffs on steel and aluminium products from the EU imposed in 2018. President Trump has even threatened to impose tariffs on cars from the EU and other countries.

United Kingdom

After Brexit, the United Kingdom will become one of the EU's key trading partners. A crucial task therefore will be to negotiate a trade deal between the EU and the UK. The EU's position is that it is willing to envisage many possibilities. It is willing to sign a customs union (CU) arrangement with the UK, which would imply the UK adopting the EU's common external trade policy, at least for goods. The EU, however, is not willing (nor legally able) to share decisions on its common external trade policy with the UK (or with any other non-EU country), which might at some stage lead to clashes between the UK and the EU over the EU policy, which the UK would be obliged to follow. The *quid pro quo*, however, would be that by staying in the EU's CU, the flow of goods between the EU and the UK would be greatly facilitated compared to a situation in which the UK would be outside the CU. If the UK decided to stay outside the CU, it would probably seek to negotiate an FTA with the EU that could be similar either to the CETA agreement with Canada or the FTA agreement with Norway, which is supplemented by an agreement that gives Norway full access to the EU's single market. Whichever option the UK chooses, difficult trade

* CUSTOMS UNION

> *Whichever option the UK chooses after Brexit, difficult trade negotiations will be required*

negotiations will be required. It would be important to try and speed up these negotiations to maintain trade relations between the EU and the UK that are as close, and as similar to the current state of affairs, as possible.

Finally, you will need to work closely with the Council and the European Parliament to ensure ratification of the bilateral agreements that your trade negotiators reach. It was already hard enough for the previous trade commissioner and it can only get harder with the new political configuration in the European Parliament.

2.3 Services, investment, e-commerce and climate change in trade negotiations

* SERVICES

There are a number of increasingly important aspects of trade, and even more so of investment, are not fully covered under WTO rules. This is particularly the case for trade in services and e-commerce. In addition, preventing dangerous climate change is becoming a key topic on which the EU could use bilateral trade deals as leverage.

For services, the WTO rulebook is insufficient and a widely agreed definition of services is needed. Currently, WTO rules are generally looser for services than for trade in goods, and are also less widely accepted by WTO members (via reservations or exclusions). The need for greater harmonisation of definitions and practices for trade in services has become increasingly evident in the realm of forced technology transfer. While provisions exist in the WTO rulebook, their scope of application is simply too limited.

In addition, there is a lack of underlying data. For example, while the largest components of EU services trade are research and development, management and consulting, technical and trade-related services, comparable statistics only cover tourism for most of the less-developed countries. Your first step should therefore be to further harmonise trade in services statistics. For services, WTO most-favoured-nation (MFN) principles cover tourism and, to some extent, infrastructure services, but much less so education and health services, while government-related services are virtually excluded, though the latter is becoming critical for fostering a level playing field for trade in services, which has been at the core of modern international economic transactions. In the realm of investment, one of the key issues is how to move beyond the trade-focused international dispute settlement system to a system that also covers investment issues.

* DIGITAL TRADE

The harmonisation of trade rules and dispute settlement is even further away for the newly-emerging digital trade. Regulating digital trade requires information on data flows, but control of data is increasingly being viewed as a key comparative advantage and, thus, not necessarily sharable. The reality is that if e-commerce data is not shared between different countries, the authenticity of the information is hard to verify, which could lead to a rapid increase in e-commerce-related trade disputes.

A final aspect is climate policy. The EU has taken the lead in fighting climate change but it needs to do much more to become carbon neutral by 2050. Assuming it takes the necessary measures to reach this objective, the issue of border carbon taxes will become relevant.

More generally, any bilateral trade deal signed by the EU in the future would definitively need to include chapters on services, investment, e-commerce and climate policy.

3 RECOMMENDATIONS

We make three recommendations.

First, WTO reform should be your key objective. The first-best scenario would be to convince both China and the United States to bring their bilateral discussions to Geneva and to engage in multilateral negotiations with the rest of the WTO membership to reform the WTO. However it must be admitted that the chances of succeeding in this endeavour are relatively small for the moment. You might need therefore to consider alternative approaches.

One approach would be to form an alliance. The EU would benefit from forming an alliance with key partners (including those with whom it has close bilateral partnerships, including Canada, Japan and Singapore) to uphold the principles of the multilateral trading system under the auspices of the WTO. It seems wise not to invite China and the US to this alliance in the first instance because the objectives of the participants should be fully aligned with those of the EU, namely preservation of the liberal trading system and rejection of unilateral action. In a second step, the alliance should put forward its proposals to the entire WTO membership, including China and the US, and work with them to create new rules that address fundamental issues, including the level playing field and the threats posed by state-led economies.

If this approach fails, you will be faced with two potential scenarios, both of which imply difficult choices for the EU.

* MAINTAINING THE SYSTEM

First, if the reason for the failure is the refusal of the US administration to engage in multilateral negotiations aimed at upholding the system's fundamental principles, you could aim to continue operating the system in the absence of the US, but with China. The difficulty in this would be that the EU would need to accommodate China and other emerging economies that choose to follow China's state-led economic model. Clearly, such accommodation could only take place for an agreed transition period. Otherwise, the WTO would lose its liberal nature and its appeal to the EU and other like-minded economies.

* CONTINGENCY PLANNING

In the second scenario, the WTO, or more generally the multilateral trading system, would become fully dysfunctional or even cease to exist. In this situation, we can identify two options for the EU, which could even be complementary. First would be to replicate the WTO rule setting outside of the WTO with as many partners as possible. How much Europe can push rules that are close to its current proposal for reform of the WTO will hinge on the ability to form a group of like-minded partners while being inclusive with respect to emerging economies in the second round of negotiations once the alliance has been formed. The elephant in the room is obviously China as we are assuming that the US would have no interest in a European initiative which replicates an institution that the US administration has decided to abandon or prevent from functioning. Replicating the WTO outside of the WTO would obviously not be an easy task.

Given the difficulties in pursuing a new multilateral trading system without the US, a second – more pragmatic but complementary – route, would be to launch new negotiations of bilateral trade agreements with countries relevant for the EU and willing to take this route.

Our advice is to treat these options as complementary since the former is more appealing but more difficult than the latter. The bilateral route is obviously a second best, but worth pursuing for a big trading bloc, such as the EU, which has more negotiating power than other smaller economies. Although safer, there are two clear drawbacks to pursuing both routes in parallel. The first is manpower to design and reach agreement on an inclusive new multilateral trading system, while still negotiating bilateral trade agreements. The second drawback is related to the EU itself, as starting negotiations with trading partners is becoming controversial among EU member states, as experienced in the recent EU-US case.

* BILATERAL AGREEMENTS

Our second recommendation deals with bilateral trade agreements. Here a distinction should be made between two groups of countries. China and the US fall into the first group. The second group includes like-minded countries with which the EU should pursue strong bilateral trade relationships with the hope that these relationships can also form the basis for a reformed WTO if and when the circumstances are right.

The bilateral relationship with the United States is obviously of paramount importance to the EU, but the chances of an EU-US free-trade agreement any time soon are not high. A realistic view of the EU's position on the EU-US FTA negotiation is that it must aim above all to keep the dialogue between the two partners alive, and to hope that continuing talks would signal a truce in terms of further trade measures, in particular in the automotive sector. We would caution you that President Trump, assuming he is re-elected, is likely to confront the EU with a one-sided trade negotiation under the threat of auto tariffs, and that threat will be more credible after a successful re-election and once other trade agreements are concluded and ratified. The EU needs to prepare for such a scenario.

Trade talks with China could serve as a basis to negotiate China's better adherence to WTO principles in a future reform of the system

*CHINA

The bilateral relationship with China is also crucially important to the EU. Here the negotiations need to focus on finalising the existing bilateral investment agreement. Given the prominence of the role of SOEs in such negotiations, talks could actually serve as a basis to negotiate China's better adherence to WTO principles in a future reform of the system.

As far as like-minded countries are concerned, the EU should concentrate on the G20 countries. By now the EU already has bilateral trade deals with many of these countries and it is negotiating with others including Australia. One country with which the EU has made little progress so far is India. You should devote some time and effort to exploring whether the negotiations with India should be relaunched, with a view to reaching an agreement before the end of your term.

* UNITED KINGDOM

The other obvious candidate among the like-minded countries for bilateral trade negotiations is the United Kingdom. Given the economic and political proximity between the EU and the UK, these negotiations should be top of your bilateral agenda.

Thirdly and finally, the increasing role of services, investment and e-commerce will require much more of your attention as the existing multilateral trading system covers them in a rather limited way (especially for e-commerce). Moreover, the increasing importance of climate change in the EU's policy objectives will result in trade policy being one of the levers the EU has to influence the behaviour of other trading partners in relation to environmental protection and, more specifically, adherence to the goals of the Paris Agreement. Assuming the EU adopts bold policies in order to become carbon neutral by 2050, you will have to reflect on whether and how the EU should introduce border carbon adjustment taxes in relation to countries that do not take the necessary domestic measures to comply with the Paris Agreement. On services and e-commerce, the scope of the multilateral rule book needs to be extended, for which widely agreed definitions and data sharing are clearly needed. This is especially true for government-related services and, in the investment realm, for forced technology transfer. Finally, improvements in the investment realm would clearly require establishment of an international dispute-settlement system covering investment. This is obviously also true for e-commerce. More generally, to be sufficiently comprehensive, any bilateral trade deal to be signed by the EU in the future would definitively need to focus on services, investment, e-commerce and, of course, climate policy.

NOTES

1 Article 206 Treaty on the Functioning of the European Union.

2 In 1994, the GATT had 127 members. Today the WTO has 164 members.

3 Association of Southeast Asian Nations: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.

4 National security concerns require the use of Section 232 of the 1962 US Trade Expansion Act which is very rare.

5 Section 301 of the US Trade Act of 1974 was used in clear violation of WTO rules.

6 The EU is one of the three world trade giants, together with the US and China. In 2017, the EU accounted for 16.2 percent of world trade (exports and imports combined) in goods and services, compared to 14.1 for the US and 12.8 percent for China. But obviously the share of China has been increasing, partly at the expense of the EU and the US.

7 The Council granted the mandate in April 2019 with 26 countries voting in favour; see https://www.consilium.europa.eu/en/press/press-releases/2019/04/15/trade-with-the-united-states-council-authorises-negotiations-on-elimination-of-tariffs-for-industrial-goods-and-on-conformity-assessment/.

8 Available at http://trade.ec.europa.eu/doclib/docs/2018/september/tradoc_157331.pdf.

9 Since 2014, more than half of the value of China's overseas M&A has been conducted by SOEs (MERICS, 2019).

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