

# EU TRADE POLICY AMID THE CHINA-US CLASH: CAUGHT IN THE CROSS-FIRE?

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China's rapid rise and unique economic system, and the United States' increasingly disruptive trade policy, threaten the global rules-based trade and economic system. The European Union has so far been comparatively spared from the US-China trade war, but must nevertheless safeguard its critical interests by adopting an independent, proactive stance. The EU does not currently have to make a general choice between China or the US, and like many other jurisdictions around the world it should aim to defend its continuing ability to not make such a general choice, even as this stance will generate tensions with both. The April 2019 China-EU summit illustrated the credibility of this approach, and the objectives stated in the summit conclusions should be delivered.

The EU, even more than the US or China, has a strategic interest in preserving the global rules-based order embodied by the World Trade Organisation. It must steer WTO reform, working closely with aligned third countries such as Japan. The EU should expand its outreach beyond its immediate negotiating counterparts in both the US and China, and work in particular to ensure its (EU- and member-state level) leading officials better understand China. While strengthening its instruments to address new challenges, such as the screening of foreign direct investment for security purposes, the EU must also resist the temptations of protectionism and economic nationalism.

In support of these objectives, the EU should prepare for difficult decisions, which might involve revising some of its red lines in international trade negotiations. Conversely, the EU should stand firm on principles such as refusing one-sided agreements and rejecting abusive recourse to national security arguments in trade policies.



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## **1 INTRODUCTION**

This paper addresses the questions:

1. What risks face the EU with regard to China's strategic aims in trade policy and how can the EU respond?
2. The US effort to isolate China poses particular risks for Europe. How can the EU counter such efforts with the aim of forging its own distinct trade policy?
3. How should the EU move forward with reform of the World Trade Organization (WTO) in light of differing demands and aims of trading blocs like China and the US?

Based on an overview of the main concerns over China's trade policies and practices and a description of the US trade policy stance and actions vis-à-vis China, the paper identifies the consequences for the EU of those measures and provides a set of recommendations to inform the EU's response to the China-US confrontation. The paper does not provide a full analysis of the rapidly evolving global trade landscape or quantitative estimates of the economic impact of key policy actions. While policies in areas other than trade are relevant to craft a full EU positioning in a new trade context, they are not the subject of this paper.

The analysis is based on our observation of the shifts in the relevant jurisdictions' trade policy stances and actions and their impact on the global trading system, a review of recent publicly available articles and materials, and conversations with lead experts and policymakers. We included developments up to 15 June 2019.

The paper has four sections. Section 2 sets the scene. Section 3 describes the China-US trade confrontation, in particular the concerns associated with China's model of state capitalism and the main elements of the US trade policy stance towards China. Section 4 considers the implications of the China-US conflict on the EU and the global trading system. The final section concludes with suggestions to inform a revised EU trade policy and influence the trade policy environment.

## **2 THE CHANGING TRADE POLICY LANDSCAPE**

### ***2.1 Background***

For the past 70 years, international trade has been governed by a set of rules based on non-discrimination, transparency, and binding and enforceable commitments on tariffs and other policy instruments, which have brought greater certainty, stability and increased market openness. At the heart of the system, the WTO – and before it, the General Agreement on Tariffs and Trade (GATT) – ensures that trade flows as smoothly, predictably and freely as possible. This global framework of trade rules has helped create an unprecedented extent of prosperity across the world.

Even as the past situation should not be idealised, risks to the global rules-based system have accumulated in the past few years and accelerated since early 2018. With trade spats, new technologies and geopolitical competition reshaping the global economy, the trade and investment policy landscape is rapidly changing. Overall, managed trade has been gaining traction, rules have increasingly fragmented in competing spheres of influence, and global trade governance has weakened.

The US and China are the most visible protagonists of these high-stakes conflicts, but underlying systemic issues amplify the impact beyond the two countries. Current frictions are undermining confidence in the world economy. Global trade, investment and output remain under threat from policy

uncertainty; failure to resolve differences would not only increase costs for producers and consumers but also lower business investment, disrupt supply chains, and slow productivity growth (IMF, 2019), all while eroding the rules-based global trading system.

Current trade spats layer on technological rivalry (González, 2018) and geostrategic considerations, ranging from the military advantage that dominance in some of the emerging technologies may bring about (Ciuriak, 2018) to increasing cybersecurity-related trade conflicts at the global level (Madnick *et al*, 2019). Moreover, a redistribution of global economic might has given rise to a new era of great power rivalry and systemic competition (Bergsten, 2018) with increasing use of economic tools to achieve strategic goals and the assertiveness of some governments in trying to unilaterally reduce or manage their exposure to the interdependence underlying the global economy (Roberts *et al*, 2018). A widespread view is that current frictions run much deeper than the trade confrontations and have more to do with control over technologies such as artificial intelligence, key inputs such as energy sources for electric vehicles, and command over connectivity, both physical and digital (Choer Moraes, 2018).

Amid these deep frictions sits the EU, the largest and most open trading bloc in the world, for whom the US and China represent about one-third of its total merchandise trade – 17.1 percent with the US and 15.4 percent with China in 2018 (European Commission, 2019). The three of them together account for almost half of global trade in goods. When services trade and investment flows are taken into consideration, their combined economic might and strong inter-relationships are even more pronounced. Clearly, the EU cannot be a passive bystander in the China-US confrontations. It is directly affected by Beijing's policies and practices, by Washington's approach towards China and by the consequences of these conflicts on the multilateral trading system. In a world driven by power politics, the EU risks both diminished influence and commercial damage.

## ***2.2 China's rise, 'America First' and upcoming challenges for the EU***

China's rapid rise, state-dominated economic system and sheer size have brought heightened attention to its industrial and trade policies, some of which either break or evade multilateral rules and distort the level-playing field for its competitors. While one may question the uniqueness of China's trade policies or the extent of its non-compliance with trade rules (Beinart, 2019), they have undeniably strained the global trading system. Concerns were first centered on the challenges faced by foreign firms competing in the Chinese market, but they now extend to competition with Chinese firms in developed and third-country markets, and expanding Chinese investments and acquisitions of advanced technologies – all of which also intertwine with strategic considerations.

Even though China's actions are putting stress on the global system, Beijing has repeatedly expressed its interest in upholding the WTO and the global architecture as it stands. The system has underpinned China's fast economic development, providing predictability and a rules-based system of adjudication of disputes. That general preference, nevertheless, comes into friction with China's own state-directed and only partly market-driven domestic economic model. The corresponding trade-offs are the object of intense policy debates and political tugs-of-war inside the Chinese governance apparatus, even though these are typically hard to observe and analyse from the outside.

Since early 2018, the US 'America First' stance has put China at the center of its trade policy agenda. Through a combination of increased tariffs, quotas, revised investment screening mechanisms, export controls and other domestic measures, bilateral China-US negotiations, the trilateral (EU-Japan-US) process to address non-market economy systemic distortions, selective recourse to the WTO, and negotiations of trade agreements with other partners, the US is ostensibly looking to reform China's policies, modify the relationship and set new rules and enforcement mechanisms. Beyond recalibrating and resetting the trade relationship under a revised framework, influential voices within

the US national security establishment favor 'decoupling' the US and other Western countries from the Chinese economy. Senior levels of the US government have appeared to support such a vision (Pence, 2018).

In dealing with China, the current US administration has opted mostly for a go-it-alone approach. Traditional trade allies like the EU not only have seen little US appetite for consultation and cooperation with them but also have actually been hit by increased tariffs on steel and aluminum with the threat of more to come in the auto sector. Likewise, the US has shown no restraint in defying WTO rules when they get in its way, as in the case of the national security tariffs on metals. Instead of working with others to leverage the system to address concerns with China via litigation and reform of trade rules, the US actions may have already significantly undermined global trade governance.

In this fluid trade landscape, the outcome of two short-term processes are important for the EU. First, will the US and China reach an agreement in 2019 and if so, what would it look like? In early May 2019, there appeared a reasonable chance that a deal with some specific market access and structural reform commitments might have been struck, even though the precise content of it was still mostly unknown (Beattie, 2019). However, not only was the agreement not reached but also the conflict was further escalated (see section 3.2.2) (Bown and Zhang, 2019a).

At this stage, any outcome is impossible to predict. Should a bilateral deal be reached, the EU and other third countries might free ride on some aspects of a bilateral deal, depending on its content. In the same vein, it could potentially pave the way for the conclusion of the China-EU Investment Agreement (see section 4.2). But a China-US agreement would most surely also create new problems with trade-diverting and negative terms-of-trade effects resulting from managed trade. A China-US deal might also spell additional problems for the multilateral trading system, if based on discriminatory arrangements and power-based enforcement mechanisms. While a bilateral accord could ease some of the trade pressures at the global level, at least for a while, in a calmer China-US trade scenario, the EU could well become in full force the next target of US trade actions. On the other hand, lack of agreement could result in even more tariffs, as has been already announced, and a full-blown trade war that would worsen the business environment, disrupt supply chains and slow productivity growth, all while further weakening the rules-based order. Should trade tensions continue and trigger a reduction in investor confidence, a World Bank study estimates they would reduce global income by 1.7 percent (or US\$1.4 trillion), with losses across all regions (Constantinescu *et al*, 2019).

The second critical question for the EU is: will the US impose national security tariffs on cars? In mid-May 2019, President Trump announced that while imports of autos and auto parts threaten US national security, he would refrain from levying tariffs by up to six months as bilateral negotiations with the EU and Japan take place (Cohen-Setton, 2019; Leonard and Donnan, 2019). While this provides a respite to current tensions, the issue is far from settled. If national security tariffs on vehicles were to be imposed at any point, political dynamics would make EU trade cooperation with the US even more challenging than it already is.

The EU-US relationship could be further clouded by the imposition of tit-for-tat tariffs on each other's products as both parties could move in the following months to retaliate, as a result of the latest WTO ruling in the Airbus-Boeing dispute (Swanson, 2019a). The US list of targeted EU products amounts to \$21 billion worth of European exports and covers a wide spectrum, from aircrafts and dairy products to wine and hunting knives (USTR, 2019e); the equivalent EU list is equally broad (European Commission, 2019b). For now, though, they have both indicated they will await the WTO's decision on the authorised maximum value of trade that could be hit. In any case, these trade differences would layer on top of diverging strategic views across the Atlantic, eg on the use by European countries of Huawei equipment in next-generation 5G networks (Yun Chee, 2019), the goals and effects of China's

Belt and Road Initiative (BRI) [Brattberg and Soula, 2018], the re-establishment of sanctions on Iran [Jacques Delors Institute, 2018] and the strengthened extra-territorial application of US law as regards Cuba [Cleary Gottlieb, 2019].

Amid the uncertainty and instability, the EU is faced with the need to adjust its stance to respond to China's trade policy strategic aims, to counter the risks to the EU-US bilateral relationship of the US efforts to isolate China, and to preserve and reform the WTO, all while finding its own voice and maintaining its commitment to an open, fair and rules-based global trading system.

### **3 THE CHINA-US TRADE CONFRONTATION**

#### ***3.1 Overview of concerns over China's trade regime***

The role of the Chinese government and the Communist Party of China in the allocation of resources in China's economy is at the core of the US and other countries' concerns over China (USTR, 2019). Despite reforms undertaken as a result of China's WTO accession in 2001, the Party-state's involvement in the economy remains pervasive. According to the WTO, for example, as of early 2018 the state retained a majority share in all but one of the 100 largest publicly listed companies (WTO, 2018). Expectations that WTO accession reforms would pave the way for a more market-driven economy have faltered and instead, the view that China is in the process of consolidating a state-dominated economic model that enters into systemic competition with liberal market economies has gained traction [BDI, 2019].

Industrial and trade policies are critical instruments to implement China's strengthened state planning in pursuit of strategic autonomy and/or global leadership in high-tech sectors such as new information technology, numerical control tools and robotics, aerospace equipment, ocean engineering equipment and high-tech ships, railway equipment, energy saving and new energy vehicles, new materials, biomedicine and medical devices, agriculture machinery and power equipment, as embedded in *Made in China 2025*, the *13<sup>th</sup> Five-Year Plan (2016-2020)* and other official documents. The Office of the United States Trade Representative (USTR) asserts that China's pursuit of industrial policies limits market access for imported goods, foreign manufacturers and foreign service suppliers, while offering substantial guidance, subsidies and regulatory support to Chinese state-owned enterprises (SOEs) and other industries not only in China but also abroad (USTR, 2019a). Alleged misappropriation of foreign technologies, through forced technology transfer and intellectual property infringement, is of particular concern. China's scale and its large share of global trade further compound the problem, leading to competitive pressures, excess capacity and distorted markets (USTR, 2019) and more generally, increasing the risk for the global economy of negative spillovers from these distortions [European Commission, 2019a].

Asymmetry in market access between China and most advanced economies is also a source of tension. While China has benefited until recently from relatively open markets in most advanced economies, foreign firms encounter higher tariffs, non-tariff barriers, investment and services trade restrictions, discrimination in public procurement and others limitations in the Chinese market [BDI, 2019; European Union Chamber of Commerce in China, 2019]. China's rapid ascent has led to calls for a more balanced relationship, with greater reciprocity, non-discrimination and openness of its system, commensurate with its increasing status as a leading global power [European Commission, 2019].

Concerns also extend to the digital front, in at least two dimensions. First, China's regulatory policies in the digital economy, including on information security, provision of cloud services, cross-border data restriction and data localisation requirements, among others, limit how foreign companies can do business in China (USTR, 2018). And second, increased Chinese foreign investment in critical sectors,

including in systems and digital infrastructure, such as 5G networks, is associated with security concerns (European Commission, 2019).

China has taken some measures to defuse tensions, eg by reinforcing and centralising its intellectual property law enforcement apparatus, and by unilaterally reducing tariffs in late 2018. These initiatives, however, have received very limited if any recognition in the US debate.

### **3.2 US trade policy towards China**

#### 3.2.1 Context and objectives

The US trade policy towards China is embedded in what may be termed the ‘Trump doctrine’ on international trade, which in turn is part of a broader economic nationalist ideology that permeates the current administration. This doctrine is based on four strands, all at variance with generally accepted economic analysis: it overlooks the gains from trade, disregarding the benefits of specialisation; it focuses on the trade deficit, as if that was the result of trade agreements rather than savings and investment trends at home and abroad; it ignores the changing nature of trade in general and global value chains in particular; and it disdains the need for cooperation in international affairs in favor of the pursuit of a politically defined self-interest (Nordhaus, 2018). Under this view, trade policy intersects with the national security strategy, as trade is a critical means for nations to assert their influence in a new era of great power competition with strategic rivals (Pence, 2018) and because national security in a broad sense is considered to include economic security.

The main premise invoked for the current US trade policy agenda is that the Trump administration inherited a flawed trade system, with outdated and imbalanced trade agreements, a failing multilateral trading system that had largely broken down over negotiation paralysis and judicial activism, and unfair trade practices that have harmed US workers and businesses and led to wage stagnation and job losses in the manufacturing sector (USTR, 2019b). In this context, while not the only culprit, China is singled out. According to official documents, the main objectives of the US trade policy towards China – some of which are also applicable to other trading partners – include defending US companies and workers from unfair trading practices, restoring balance to the trade relationship, making China assume the costs of its non-market economy system and encouraging it to make fundamental structural changes (USTR, 2019).

Some of the trade concerns regarding China predate the Trump administration. The narrative has evolved in a way that today may command support from both sides of the aisle in Congress (Lighthizer, 2019), as well as in much of the US business community (US Chamber of Commerce, 2018). Even so, several objectives of the US trade policy widely touted by President Trump and his officials, in particular reducing bilateral trade deficits and bringing manufacturing back to the US, are broadly misguided. Of special concern is the related question of ‘decoupling’, that is, whether the US aims at disentangling its economic relationship with China through supply chain diversification, to reduce economic dependency and strategic vulnerability and contain China (Lamy, 2018). Decoupling would bring huge costs for the US economy and significant consequences for third countries, some of which are highly integrated with China, even more than with the US (Dollar *et al*, 2019). There is some emerging evidence that companies around the world are moving to reduce their dependence on Chinese factories, even if they may not bring their plants to the US (Bradsher, 2019). Whether decoupling actually gains ground will depend very much on how Washington’s current trade tactics play out.

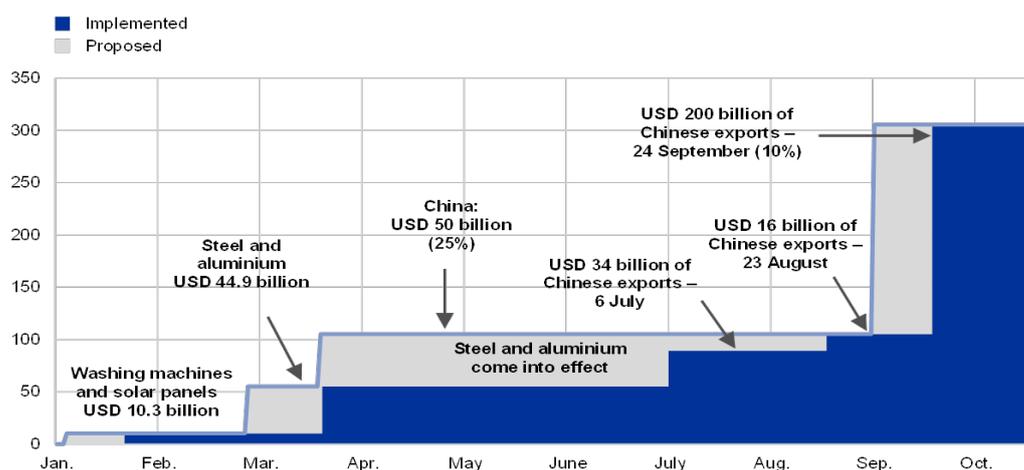
### 3.2.2 Ongoing actions

The US trade policy agenda vis-à-vis China is being implemented through a combination of unilateral instruments and bilateral negotiations that aims at bringing China to the negotiating table to extract a number of specific and structural concessions, ranging from increased purchases of US goods to changes in laws and policies addressing areas of concern. Recourse to cooperation with other partners or to the WTO is more the exception than the norm; moreover, key US allies and the global trading system it once founded are under threat by the adoption of unilateral trade measures, presumably directed at least in part to ratchet up the pressure on China and/or as part of a broader protectionist stance that casts doubts on underlying US trade policy objectives. Negotiation of trade agreements with other partners also complement in one way or another the actions directed at China.

- *Increased tariffs and other unilateral measures*

Increased tariffs have come to the forefront of the US trade policy. They are based on long-dormant trade statutes, namely i) Section 201 of the Trade Act of 1974, which authorises the president to restrict temporarily imports that are found to cause or threaten serious injury to domestic industry (so-called ‘safeguard’ action); ii) Section 232 of the Trade Expansion Act of 1962, which provides the president with the ability to impose restrictions on imports that are being imported in such quantities or under such circumstances as to threaten to impair the national security (‘national security clause’); and iii) Section 301 of the Trade Act of 1974, by which the US may (unilaterally) enforce US rights under trade agreements and respond to policies and practices it considers unjustifiable and that burden or restrict US commerce (known as the ‘reciprocity’ provision, which has rarely been invoked after the establishment of the WTO) (Congressional Research Service, 2019). Main actions include increased tariffs on solar panels and washing machines, adopted under Section 201; steel and aluminum imports from Canada, the EU, Mexico, South Korea and other partners, justified under the national security clause; and increased duties on Chinese imports, based on Section 301 (Figure 1).

**Figure 1. Timeline of tariffs proposed and implemented in 2018**

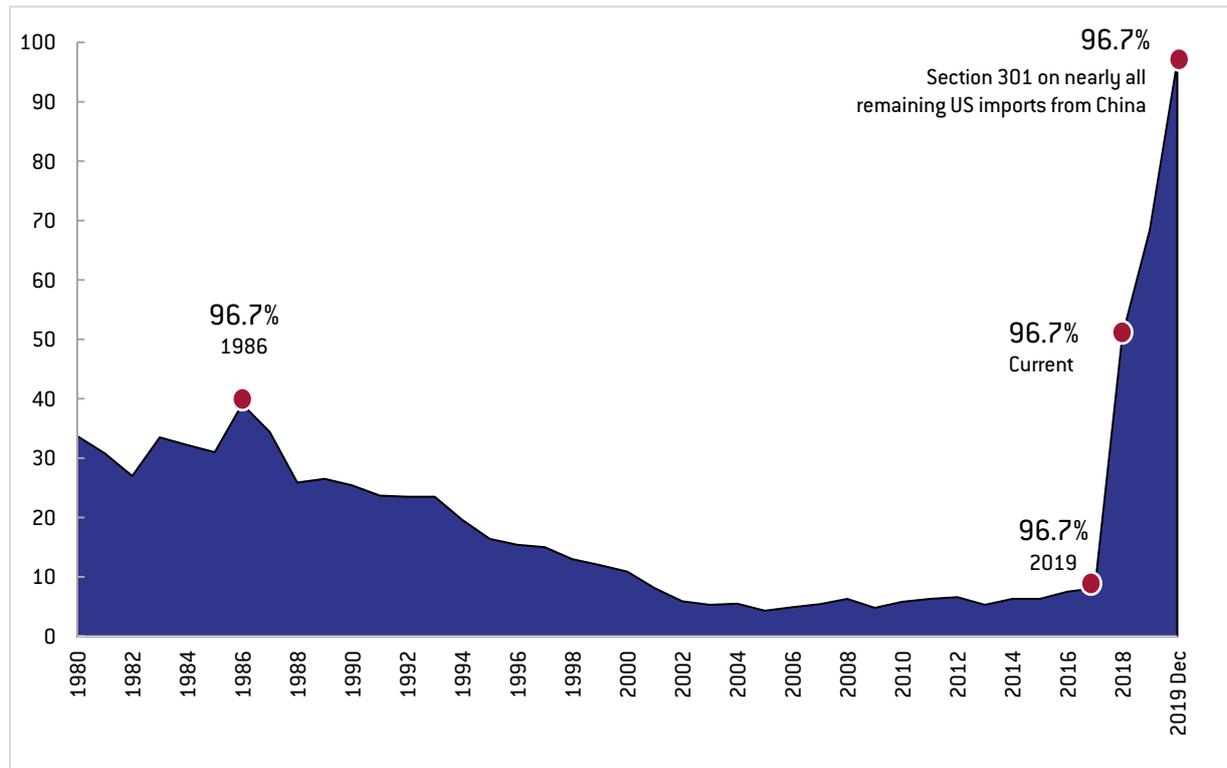


Source: European Central Bank (2019).

In a detailed exercise to measure US trade protection in 2018, Chad Bown and Eva Zhang found that in total, the five sets of tariffs adopted by President Trump covered \$303.7 billion, or 12.6 percent, of the total goods imported by the US in 2017. When adding other special duties, many imposed by prior administrations, the volume of US imports covered increases to 14.9 percent (Bown and Zhang, 2019). China is the top country hit by this accumulation of US special tariffs. Overall, over 50 percent of US

imports from China had become subject to special US trade protection by the end of 2018 (Figure 2). Should President Trump follow through with his current threat to impose tariffs on the rest of US imports from China, special trade protection would raise to 96.7 percent, an unprecedented level in US history. It would also bring average tariff rates on imports from China from 3.1 percent in 2017 to 27.8 percent, a level not far from the average level of duties the US imposed under the infamous Smoot-Hawley Tariff Act of 1930 (Bown and Zhang, 2019a). Conversely, China has hit some \$60 billion of its US imports with increased 5 percent and 10 percent tariffs; announced additional tariff hikes would raise the tariffs for most of those products to 25 percent (Bradsher, 2019).

**Figure 2. Share of US goods imports from China covered by special trade protection**



Source: Bown and Zhang (2019a). Note: the figure shows the share of US goods imports from China covered by special forms of tariff and non-tariff protection in effect each year.

One additional action looms on the horizon. Under a separate national security investigation, President Trump is to decide whether to hike tariffs on \$350 billion of US imports of cars, trucks and parts from Canada, Mexico, the EU, Japan and South Korea. While the decision was made that imports pose a threat to national security, action was delayed in May 2019 by up to six months to avoid negatively impacting bilateral negotiations with the EU and Japan and further antagonising allies in the ramp-up of the China-US trade war (Cohen-Setton, 2019; Leonard and Donnan, 2019). As regards the EU, in a July 2018 meeting between President Trump and European Commission President Juncker, agreement to work on issues of common interest put a temporary halt to this threat, unless either party terminates the negotiations (European Commission, 2018).

It is not clear what is the US objective in raising all these duties. Political statements suggest tariff increases are being used as a bargaining chip for a variety of purposes: to reduce bilateral trade deficits, achieve increased leverage to negotiate new agreements, bring manufacturing back to the US or punish countries that enter into certain behaviors (Lawrence, 2018). In addition to increasing uncertainty, unnerving investors, rattling markets, disrupting supply chains, and alarming farmers and consumers, these duties are in excess of what the US is authorised to apply under WTO rules and are

unlikely to fall under any of its exceptions, thus posing an important challenge to the system. Most of these special tariffs have been met with actions by US trade partners, including application of retaliatory tariffs and submission to WTO litigation (Bown and Kolb, 2019) – though smaller partners opted for negotiating exemptions via export restraints.

Managed trade is complemented by other policies, in particular in the areas of investment screening and export controls, the combination of which also point to decoupling the US from the Chinese economy (Lee, 2018). Strengthened revised investment screening mechanisms by the Committee on Foreign Investment in the United States (CFIUS) are discouraging the acquisition of US firms in sectors deemed sensitive from the national security perspective. Expanded export controls to address concerns regarding the release of critical technologies to end uses, end users and destinations of concern are part of the mix as well (Akin Gump, 2018).

- *Bilateral China-US negotiations*

In December 2018 the US and China agreed to start negotiations with the aim of addressing some of the US concerns regarding China's trade and industrial policies and halting further tariff increases. The US originally set a deadline on March 1, 2019 to conclude negotiations, with 10 percent tariffs on approximately \$200 billion increasing to 25 percent in the absence of a deal. In late February, citing progress in the conversations, the US extended the deadline, with no new date announced. While President Trump had suggested the parties would know by May whether they would be able to conclude a deal (Wong and Koty, 2019), the failure of the May 9-10 negotiations – and the tariffs and threats thereof that have followed – have further increased uncertainty.

By late April, US and Chinese negotiators had reportedly made progress on several agreements spanning some 150 pages (Swanson, 2019; Swanson, 2019a). While details of the negotiations are unclear, a number of issues had been under discussion. First, some 'good faith' concessions from China, like resuming purchases of American soybeans or reclassifying all variants of fentanyl (a synthetic opioid whose use the US aims to restrict) as a controlled substance. Second, long-term goods purchases, with China reportedly offering to increase imports of US goods, including agricultural products, natural gas and semiconductors, to reduce the trade deficit by 2024. Third, structural reforms, the most concrete of which is the rewriting of a Chinese foreign investment law that would facilitate various modifications of the current regime, including a prohibition on forced technology transfer, protection of intellectual property rights of foreign investors, and national treatment of foreign investors. Fourth, industrial subsidies to SOEs, regulations, business licensing, standards and others, with reportedly vague commitments under consideration. Fifth, prevention of currency manipulation. And sixth, enforcement mechanisms, with discussions around the establishment of enforcement offices in each country and a three-level process with the possibility of automatic tariff increases in certain cases. President Trump had announced that, even if a deal were to be reached, the US would not lift the Section 301 tariffs on some \$250 billion of China imports to ensure compliance (Swanson, 2019; Lincicome *et al*, 2019; Swanson and Rappeport, 2019; and Palmer, 2019). According to the US, China's backtracking from earlier commitments resulted in the suspension of negotiations on May 9-10 (Liptak and Collins, 2019); as per the Chinese side, the blame lies with the US (Cheng, 2019).

President Trump has indicated he will meet with President Xi in June, in the context of the G20 meeting in Japan. In addition to the removal of all additional tariffs, China has indicated it needs the figures for purchases of US goods to remain realistic and the text to be balanced (Kilcoyne, 2019). At this stage, it is unclear whether an agreement is feasible. While several economic dynamics in both the US and China are pushing the two governments in this direction, much of the US security establishment is not keen on further interdependence of the two economies (Rajah, 2018). There is a tension on the US side between the objective to favor quick purchases of goods versus aiming at structural reforms. Even

if agreement is reached, it is not clear what form it may take. It is even more difficult to anticipate the content and impact of the potential outcome of the bilateral conversations. In every trade negotiation, the devil is in the details -and in this case too, the specifics are critical. Both within the US and China, they will be thoroughly scrutinised. That will also be the case of their trading partners, who will be on the look-out for potential negative spillovers or WTO inconsistencies. Of particular concern is whether the world's two largest economies will agree to settle disputes between themselves as this would sideline the WTO (Luce, 2019).

In any case, even if there were to be a truce to the trade confrontations, given the complexity of the issues at stake, frictions between the US and China will almost certainly continue to be a standard feature of the global trade landscape for years to come. This is all the more natural considering China's economy is as large as that of the US (in purchasing power terms, and soon also in dollar terms) and is expected to contribute more than three times the US to global economic growth in the next ten years (Garcia Herrero, 2019). This points to the need for a solid and effective broader framework to underpin that relationship.

- *The trilateral EU-Japan-US process*

In late 2017-early 2018, the EU, Japan and the US have endeavoured to address their concerns with the systemic non-market-oriented policies and practices of third countries that lead to severe overcapacity, create unfair competitive conditions for workers and businesses, hinder the development and use of innovative technologies, and undermine the proper functioning of international trade, including where existing rules are not effective. Measures would include information exchange, engagement, enforcement and rule-making (USTR, 2017; USTR, 2018a).

The three governments have held conversations and exchanged information on non-market policies and practices and market-oriented conditions. In the area of industrial subsidies and SOEs, progress has reportedly been made on text-based work in areas like improved subsidy notifications by governments, provision of industrial subsidies through SOEs, more effective coverage of the most trade-distortive subsidies, and enhanced remedies to address adverse effects of the most egregious subsidies (USTR, 2019f). The three parties have also emphasised a commitment to continue working together to maintain the effectiveness of existing WTO disputes, including through ongoing WTO disputes, even though on the face of it this stands at odds with otherwise US actions. Another area of concern of the trilateral group is forced technology transfer policies and practices of third countries, including through the use of joint venture requirements, foreign equity limitations, administrative review and licensing processes, among others (USTR, 2018a; 2018b and 2018c).

In the WTO context, the three partners have signaled strengthened collaboration, in particular through the submission of a joint transparency and notification proposal in end-2018, which they will continue to promote (WTO, 2018b). They have confirmed their agreement to work towards strengthening the regular committee activities. They have also reiterated their call on larger WTO members claiming developing country status, a category that includes China but also Brazil, India and others, to undertake full commitments in current and future negotiations (USTR, 2019c). Finally, they have confirmed the importance of cooperating in digital trade facilitation and also on achieving a high-standard agreement on WTO negotiations on e-commerce with as many WTO members as possible.

The trilateral process can be a useful mechanism to foster cooperation between the three jurisdictions and to potentially influence China's willingness to move forward on these issues. For it to be effective, however, it would need to engage China and other trading partners in a potential negotiation on industrial subsidies and SOEs. Until there is some kind of outcome on the China-US trade war, it seems unlikely that China would be willing to entertain this prospect.

- *The WTO*

The current US administration has made relatively limited use of the WTO to support its trade policy strategy vis-à-vis China, at least partly because it considers the WTO not well-equipped to handle the challenges posed by China's state-led economic system (Shea, 2018). First, in addition to increasing tariffs, the US activated the dispute settlement mechanism to counter China's alleged discriminatory technology licensing requirements (WTO, 2018a). The EU followed suit with a similar case against China (WTO, 2018e). Second, the US requested a WTO panel to examine the legality of the retaliatory measures imposed by China – and others – against US Section 232 tariffs (WTO, 2019). The US has also made some submissions to reform the WTO which relate primarily, though not exclusively, to China. These include the proposals to strengthen transparency and notification requirements in collaboration with other members (WTO, 2018b) and to establish criteria to limit certain developing countries from availing themselves of special and differential treatment (S&DT) in ongoing and future negotiations (WTO, 2019a).

Observers indicate that instead of relying on unilateral tariffs, the US could have worked with other countries to further leverage the WTO dispute settlement mechanism to discipline China's trade practices including on general intellectual property protection and enforcement, trade secrets protection, forced technology transfer, and subsidies; China's good compliance record at the WTO would have supported such an approach. Likewise, current gaps in the rules could be addressed through dialogue and negotiations (Bacchus *et al*, 2018; Hillman, 2018a).

The US not only has failed to fully exploit the potential of the WTO in addressing some of its concerns over China's trade practices and policies but also is at the epicenter of the organisation's most fundamental crisis since entering into force in 1995. Two sets of actions are the most critical: the justification of the increased tariffs on steel and aluminum under the GATT national security exception; and the attack on the WTO's Appellate Body.

In the first case (national security exception), the WTO's forthcoming ruling on the matter is a lose-lose proposition – if the decision upholds the US position on the national security exception, others would feel free to follow suit with their own protectionist measures; should the ruling limit the US ability to protect its national security interests, it could be perceived as an unacceptable infringement on its sovereignty and in extreme, could lead to the US withdrawal from the WTO (Swanson and Ewing, 2018). In referring to the limits imposed to the national security exception in the first-ever WTO ruling on the matter – on measures adopted by Russia against Ukraine in the context of the Crimea dispute – the US referred to the decision as 'seriously flawed' (Miles, 2019).

In the second case (Appellate Body), the US has been blocking the nomination of Appellate Body members to allegedly force changes in what it perceives to be the procedural and systemic shortcomings of the system, in particular the Appellate Body's 'overreaching' interpretations in trade defense and other areas (Payosova *et al*, 2018). By end-2019, when there will only be one judge left, an appeal by any party to a dispute would effectively block the adoption of a panel report, rendering the mechanism inoperative and returning the world trading system to a power-based free-for-all arrangement (Payosova *et al*, 2018). Proposals by the EU and others to address some of the US concerns with the Appellate Body have been rejected by the US under the view that the solution is for the Appellate Body to conform to existing rules (Hillman, 2018) – an evidently inconsistent position, as a non-performing Appellate Body, as it could soon be, cannot demonstrate conformity with those rules. The underlying question is whether the US is seeking to change the features of the dispute settlement system and if so, in which direction – eg is it looking to suspend, negotiate and reboot; does it want to get rid of an appeal process altogether; or is the objective something else. The answer to this underlying question is entirely unclear.

While members explore options to keep the dispute settlement system running despite the apparent forthcoming Appellate Body paralysis, restoring the dispute settlement function no longer depends solely on members reaching an accommodation on the essential features and operation of the system, but on a new bargain that updates the balance of rights and obligations that resulted from the Uruguay Round to address some of the most pressing concerns with China. It would also require solving the critical WTO cases on the national security tariffs and on the non-market economy status of China for purposes of the methodologies used by the EU and the US to apply antidumping duties – another critical issue on which the WTO will rule in 2019 (WTO, 2018c; 2018d). In an interim report leaked to the press, the WTO panel allegedly sided with the EU on the issue of China’s non-market economy status (Baschuk, 2019). If confirmed, the report would potentially set a precedent for the China-US case, which could then help ease one important source of tension within the system.

- *Negotiation of trade agreements with other partners*

In addition to its China-centered trade actions, the US is pursuing other initiatives that may have a bearing on China. Of particular relevance are the renegotiation of the North American Free Trade Agreement (NAFTA), which resulted in the United States-Mexico-Canada Agreement (USMCA), and the proposed negotiation of bilateral trade agreements with Japan, the EU, and possibly the United Kingdom<sup>1</sup>. Were all these agreements to be concluded and approved – neither of which is an easy task nor should be taken for granted – the US would have bilateral frameworks to govern merchandise trade with 10 out of 15 of its main trading partner countries (including five EU27 member states, and South Korea), collectively accounting for well over half of its total trade, to be compared with 15.7 percent for China (US Census Bureau, 2019). US agreements with Japan and the EU, by virtue of the size of their economies – and depending on the content of the accords – could support a vision of disentanglement from China.

- The USMCA

Viewed one way, the USMCA is a modernisation and updating of the NAFTA, without many implications for third countries. Viewed another way, some of its new provisions, for instance, on intellectual property, digital trade or currency manipulation, will influence future global trade rule-making. Yet from the perspective of complementing or consolidating the US strategy towards China, two areas of the USMCA are particularly relevant. First, the agreement tightens rules of origin in the automotive sector (among others). While under NAFTA, 62.5 percent of car and truck components must be manufactured in the US, Mexico or Canada to receive duty-free treatment, under the USMCA this threshold is raised to 75 percent. This – and other related rules – will impact sourcing patterns for components, including from China and other countries. It will also erode the competitiveness of US carmakers, which could further incentivise the adoption of national security tariffs on imports of autos and auto parts (Schott, 2019). While increased tariffs in this area would be targeted at Germany and Japan as lead automobile exporters, the measure would still hit China given the integration of the automotive value chain.

From the Chinese perspective, the most controversial part of USMCA is article 32.10 – sometimes called the ‘anti-China’ provision. This article commits any country in the agreement to inform the other two if it intends to start free trade negotiations with a non-market economy, and allow them to review the full text of the agreement. If the other countries examine a potential agreement and decide it will impact trade among them, they are authorised to terminate the trilateral USMCA with six months’ notice and replace it with a bilateral agreement. While Canada and Mexico have tried to minimise the relevance of this last-minute request from the US in the negotiating process, it is widely seen as

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<sup>1</sup> As potential trade negotiations with the UK are subject to the uncertain outcome of the ongoing Brexit process, this paper only refers to the negotiations with Japan and the EU.

another step in the process of isolating China and disrupting its ability to forge new trade agreements of its own (Ciuriak, 2018). A related concern for China, the EU, Japan and other trading partners is whether the US will try to replicate this provision in other agreements. Initial indications are that it will. In its summary of specific objectives for the forthcoming negotiations with the EU and Japan, the USTR indicates it will seek a mechanism to ensure transparency and take appropriate action if the counterpart negotiates a free trade agreement with a non-market economy (USTR, 2019d; 2018d).

The approval of the USMCA requires a majority vote in both US congressional bodies. While the legislative process has been activated, approval is unlikely before the second semester of 2019 and it could well go into 2020. In a Democrat-controlled House of Representatives, the agreement is already encountering political challenges. President Trump's threat to impose tariffs on Mexican goods for Mexico's alleged inaction in curbing illegal immigration from Central American countries, made in late May 2019 then withdrawn in early June following Mexican reassurances, is further complicating the prospects of USMCA approval (Swanson, 2019c).

- Potential bilateral trade agreements with Japan and the EU

In accordance with US domestic legislation, the administration has notified Congress of its intent to enter into separate trade agreement negotiations with Japan and the EU and has submitted the statement of specific negotiating objectives it intends to pursue with each trading partner (USTR, 2019d; 2018d). It is now authorised to begin formal negotiations.

In the case of Japan, the discussions started in mid-April 2019. As in other cases, improving the trade balance and reducing the bilateral deficit is the main US objective. Three issues are likely to take center-stage in the negotiations. First, the auto sector: in addition to enhanced regulatory compatibility – which it will likely pursue in other areas – USTR is looking at obtaining what it refers to as fair and more equitable trade in the automotive sector, including by addressing what it considers are non-tariff barriers that stifle auto exports and maybe even a quota to cap Japan's exports to the US (Reinsch and Caporal, 2019). Second, agriculture: US farm exports have been losing market share in Asia as a result of both the trade confrontation with China and the entry into force in Japan of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) (Goodman, 2019) – an 'early harvest' of concessions seems to be of interest to the US. And third, rules to secure against currency manipulations – an issue high on the bilateral agenda (Reinsch and Caporal, 2019). From the Japanese perspective, lifting of the steel and aluminum tariffs and no imposition of national security tariffs on cars are critical points in the negotiation.

It is too early to tell how these negotiations may evolve. The potential scope and structure of an agreement remain unclear. One important point to note is that USTR intends to pursue negotiations with Japan in stages, beginning with a rapid, limited scope agreement – which is in line with the leaders' initial joint statement (Joint Statement of the US and Japan, 2018). This not only would represent a departure from the traditional US comprehensive approach towards trade agreements but also may be inconsistent with the WTO. From the Japanese perspective, there is a positive angle to it as a limited first-stage agreement would address immediate threats of unilateral US action, while allowing Japan to remain focused in the long run on CPTPP, in the hope the US might someday rejoin. Also, were the US to accept agriculture market access concessions comparable to those originally negotiated under the Trans-Pacific Partnership (TPP), this could facilitate a more expedited process (Hirsh, 2019). It is not clear, however, that this first stage could be successful if it basically comprises a one-sided deal, with concessions coming only from Japan (Hirsh, 2019). In any case, the outcome on the 'anti-China' provision is an open question.

As with Japan, the main apparent objective of the US in negotiating with the EU is to improve the trade balance and reduce the bilateral deficit, which in turn goes back to the auto sector. Among other objectives, a key goal of the US is comprehensive market access for US agricultural goods in the EU. Brussels comes to the table with a different view. In the Council mandate, the Commission is authorised to begin negotiations with the US for an agreement on the elimination of tariffs for industrial goods (Council of the EU, 2019) and for a separate agreement on conformity assessment (Council of the EU, 2019a). While indicating that guidelines originally issued in the case of the Transatlantic Trade and Investment Partnership (TTIP) are not applicable to this case, the directives for the agreement on industrial goods state the objective to increase trade between both parties as a result of increased market access due to reciprocal tariff elimination. The scope of the agreement is industrial goods, with the specific exclusion of the agricultural sector. Additionally, the agreement is to include an effective and binding dispute settlement mechanism to ensure observance of mutually agreed rules as well as a provision to allow Brussels to unilaterally suspend the application of substantially equivalent concessions or obligations if the US adopts against the EU any measures under Section 232, Section 301 or under any other similar US law (Council of the EU, 2019b).

By any account, there is a fundamental mismatch in the negotiating objectives of both parties, in particular on the scope of the agreement. The EU is trying to entice the US with the promise of an industrial win-win negotiation that would deliver reciprocal increases in exports of 8-9 percent and could be concluded by 1 November, before the current Commission's term comes to an end (Brunsden, 2019). President Trump, however, threatened to levy tariffs on EU auto imports unless Brussels agrees to put its barriers on US agricultural goods on the table (Washington Trade Daily, 2019). This may take a while to get sorted out. An eventual revision of the EU red line to discuss agriculture would require a new mandate and more time and effort to negotiate (Tran, 2019; Hufbauer and Lu, 2019; Dadush and Wolff, 2019).

While most private sector participants in the US support negotiations with the EU, positions on specific topics are not necessarily fully aligned with the government's views. For example, the US Chamber of Commerce supports the US government's objectives of addressing non-science-based restrictions on agricultural trade and preventing restrictions on the free flow of data, but opposes the continuation of the steel and aluminum tariffs and increased tariffs on EU auto and auto parts, 'grey area' measures such as voluntary export restraints and rules on currency manipulation (US Chamber of Commerce, 2018). As expected, the American Farm Bureau Federation's main objective is to include all agricultural products and policies in the negotiations (American Farm Bureau Federation, 2018).

An additional point to mention is that there is a shared perception in the US that if Brexit were to materialise, the US would lose a major supporter on a number of important trade and regulatory issues in its relationship with the EU, where the UK's approach mirrors that of the US closely (Eizenstat, 2018). This could potentially add another element of complexity to the US-EU bilateral negotiations.

#### **4 THE EU AMID THE CHINA-US CLASH: CAUGHT IN THE CROSSFIRE AND A TARGET IN ITSELF**

##### ***4.1 Shared grievances with the US, but a different approach to China***

In the past months, the EU has been rethinking its trade and investment policy towards China. While recognising that China's increased participation in the global economy has opened and will continue to represent new significant opportunities for European companies, the EU and its member states have become increasingly critical in their pronouncements about China. The European Parliament has played a significant role in developing this renewed policy stance, and will presumably continue to do so following its renewal in the May 2019 election. From describing China as primarily a strategic partner and a source of growth and jobs, the EU has moved to a more nuanced and occasionally

hawkish framing of its approach to China (Legrain, 2019). An important recent EU strategy paper states that *“China is, simultaneously, a cooperation partner with whom the EU has closely aligned objectives, a negotiating partner with whom the EU needs to find a balance of interests, an economic competitor in pursuit of technological leadership, and a systemic rival promoting alternative models of governance”* (European Commission, 2019a). Strategic political concerns, including over China’s growing economic presence in Europe and potential influence on EU policy making, also underline this change (Morelli, 2019).

Ostensibly, the shift in the EU’s position stems from the concern that China has failed to reciprocate market access and maintain a level playing field; thus the need for a new EU approach, where Europe becomes “more strategic in planning its technological and industrial future, and far less naïve with regard to unfair competition from other countries” (European Political Strategy Centre, 2019). For example, one area of worry relates to China’s apparent pursuit of unique standards and technical regulations in a number of sectors, including autos, telecommunications equipment, Internet protocols, wireless local area networks, software encryption, mobile phone batteries and others, a strategy that shields domestic firms from competition and can potentially create significant barriers to access the Chinese markets (USTR, 2017a). In addition, the new stance may be motivated by increased defensiveness on the part of European businesses that are feeling more competitive pressure than in the past from their Chinese peers; and by a willingness to align as much as possible with the US, thus limiting the scope for transatlantic conflict.

In line with these views, the Commission advocates for greater balance and reciprocity in the trade and investment relationship, which can be achieved through WTO reform, bilateral negotiations and domestic measures. On the latter, the EU, including the European Parliament as an active participant, has taken important decisions in support of strengthening the EU trade defense instruments against dumped and subsidised imports, as well as a new EU-level coordination process aimed at improved (national) scrutiny of direct investments coming from third countries on the grounds of security or public order. Current debates indicate other potential areas for reform are export controls for dual-use and critical technologies, data security and privacy rules, procurement rules and competition policy (European Commission, 2019a).

While the overall thrust of this change has the appearance of partial alignment with the US policy stance, the recent China-EU summit (9 April 2019) confirms a different strategy to address the issues: economic cooperation, dialogue and negotiation instead of the use of unilateral measures outside of the WTO (Herszenhorn and von der Burchard, 2019). Aside from committing themselves to building their economic relationship on openness, non-discrimination and fair competition, three points in the joint statement stand out because of their relevance in potentially addressing some of the most critical concerns over China’s policies. First, the two sides agreed to making decisive progress on market access commitments in 2019 so as to achieve an ambitious China-EU Comprehensive Investment Agreement in 2020. Second, they reaffirmed their joint commitment to cooperate on WTO reform and agreed to intensified discussions with the aim of strengthening international rules on industrial subsidies, building on the work developed in a joint China-EU working group. And third, they also agreed to continue to work to resolve the WTO Appellate Body crisis and build convergence on other areas of WTO reform. Both parties also agreed to conclude the negotiations of a China-EU agreement on geographical indications. In addition, there is some reference to other topics that are part of the set of contentious issues with China, with different levels of engagement or commitment, including increased Chinese efforts to join the WTO Government Procurement Agreement, strengthened intellectual property protection and enforcement, compliance with WTO rules, and no forced transfer of technology. One topic conspicuous by its absence in the joint statement is any reference to China’s continued claim to developing country status and differentiated treatment in the WTO – an issue of

contention (EU-China Joint Statement 2019). After the meeting, EU Council President Tusk stressed the parties had set the direction for the China-EU partnership based on 'reciprocity' (Tusk, 2019) – code for having China play by the same rules.

The China-EU summit represents a win for the EU – and China – in that it consolidates an alternative approach to that of the US in dealing with Beijing. The critical question is now whether economic cooperation, combined with the toughened EU rhetoric, will work to produce results. It is in the interest of both parties that it does, as they need each other as a matter of strategic balance. But it will not happen automatically. Close attention to monitoring progress and implementation will be required. There are some in-built mechanisms in the joint statement in this direction, which are a first step. Chief in importance is the need to conclude the negotiation of the China-EU Comprehensive Investment Agreement negotiations, started in 2013 and going into their 21<sup>st</sup> round, as they represent the greatest opportunity to address the concern for increased reciprocity and market access for EU companies in the Chinese market and potential discrimination against EU investors in China from preferential (subsidised) treatment of Chinese competitors (and the related situation of investment by these firms in European countries). The recent adoption of both China's new Foreign Investment Law and of the EU Investment Screening Mechanism may provide further clarity on the scope for trade-offs. It is also of relevance to produce results on potential rules on industrial subsidies as substantive alignment between the EU and the US on this matter would in effect significantly contribute to a potential broader understanding. And finally, shared views between China and the EU on how to address the Appellate Body crisis – working with other WTO members – will be critical to navigate a likely halt of the system.

#### ***4.2 The fallout for the EU from China-US confrontations and the EU's turn***

While European companies could gain from substituting Chinese exports to the US market and vice versa (Garcia Herrero, 2019), the resulting uncertainty, value chain disruption and systemic consequences of the US unilateral imposition of tariffs outside of the WTO spell trouble for the EU and the world (European Central Bank, 2019). Moreover, as time has shown, Washington's aggressive quest for re-balancing is not limited to China – the EU is also a target in itself and there is no reason at this point to believe that the EU will be spared any of the negative measures or tactics applied on China. Thus, the EU has both a direct and indirect stake in the current China-US negotiations halting the confrontation.

Aside from the question of whether Washington and Beijing will soon reach a point where they will decide to conclude negotiations and claim victory, the fallout for the EU from a potential deal would come in the form of substantive, systemic and strategic considerations. The first point is related to the content of the agreement, and there are two sides to it. On the one hand, the EU may benefit from any Chinese commitment to structural reform on industrial subsidies, SOEs, forced technology transfer or intellectual property protection and from increased market access in financial and other services, effectively free-riding on the bilateral China-US negotiations. On the other hand, if the agreement were to include a pledge by China to increase its purchases of American products – under the misguided aim of reducing the bilateral trade deficit – this could potentially come at the expense of EU and other countries' products, who may compete with the US in the Chinese market.

In addition to commercial considerations, managed trade is also worrisome from a systemic perspective in that if it were to proliferate, it would fundamentally call multilateralism – which is based on rules and not outcomes – into question. In the same vein, should a China-US agreement include enforcement mechanisms based on unilateral assessments, which could then result in the automatic or unilateral imposition of tariffs, this will also erode the rules-based trading system. Any such mechanism would just become "a framework for the indefinite exercise of power politics, with the US

repeatedly clobbering China with tariffs whenever it considers China to be acting unreasonably” (Beattie, 2019).

From the strategic perspective, a China-US deal could potentially ease some of the trade frictions among the largest players and, depending on the content of the agreement, may even open the opportunity to cooperate at the multilateral level, even if on a limited basis. But it may also be that having found temporary trade peace with China, the US would next turn to the EU in full force – possibly after negotiating with Japan as well. While a fallout from a China-US deal, the unhappiness of the US with the current distribution of costs and benefits in the EU-US relationship points to a high probability of confrontation before the end of the current presidential term. President Trump himself has said that the advantage the EU has taken of the US on trade for many years will soon stop (Blenkinsop, 2019). His main instrument to force negotiations continues to be the threat of tariffs on autos and auto parts, which hangs in the air. In addition, further strain on the transatlantic partnership is coming from the early publication by the US of the list of products that could be targeted with increased tariffs as a result of what would be a WTO-authorized tit-for-tat in the long-running Airbus-Boeing case (Swanson, 2019a).

One alternative for the EU to respond to potential national security tariffs in the auto sector is by filing a WTO case against the action and adopting ‘rebalancing’ measures under the WTO safeguards process, in a similar way as it did in the steel and aluminum case (Chase *et al*, 2018). An EU-US trade agreement could be a better option to try to halt the tariffs, resolve trade differences and minimise the costs of a US-EU trade war on both parties and the global economy. Moreover, negotiations of such an agreement are at the heart of the EU-US July 2018 trade truce. Failure to move in this direction could bring in the increased tariffs. But for that, the current fundamental differences over the scope of negotiations will need to be solved.

#### **4.3 The WTO under increased duress**

The China-US confrontation has brought heightened tension to the WTO, compounding longer-term challenges facing the organisation in its negotiating, dispute settlement and monitoring functions. The US increase in tariffs in disregard of the system’s core rules erodes both the organisation’s legitimacy and its ability to reduce uncertainty, while certain of China’s policies and practices have revealed the limits of the current norms to discipline some of the most pressing concerns over its economic system. The US direct attacks on the organisation, under the argument that it is stacked against US interests, further put the system at risk. Whether the continued existence of a WTO that includes China is in the long-term US strategic interest is no longer a matter of consensus (Ciuriak, 2018).

A recent brief to inform trade and investment discussions in the G20 (Akman *et al*, 2019) identifies three critical questions for the future of the multilateral trading system, namely: can the WTO be reformed so that its negotiating arm can make progress on the most crucial issues? Do current US trade policies constitute a new normal in the US or do they reflect a temporary phase? And, is a state capitalist system compatible with the WTO and if so, can the reforms needed to address the concerns of China’s main trading partners be implemented? While the future of multilateralism depends on actions taken at different levels, the China-US confrontation has brought to the forefront the stark reality that, without reform, the future of the WTO has become grim. It may slowly fall into irrelevance, or face a disruptive US withdrawal, or possibly both. In all such scenarios, increased power politics would lead to greater trade frictions, unpredictability and risks to the global economy.

Bergsten (2018) argues that during a period of transition in global leadership, as the US has abdicated its traditional international role and China’s rise poses challenges to the international economic order, others must keep the system afloat. If so, the role of the EU in guiding WTO modernisation to preserve

the rules-based nature of the system is particularly critical. It is in its own interest, both as the largest and most open trading bloc and a great economic power without matching security or defense capabilities, who has always relied on rules-based orders (Legrain, 2019; Pisani-Ferry, 2019). While the EU cannot sustain a strong multilateral system on its own (Demertzis *et al*, 2019), it is in a unique position to work with a range of partners, in different settings and configurations. With the exception of Japan, there is no major player with whom the EU could work in tandem on all issues of WTO reform. But as ongoing efforts show, there are opportunities for cooperation and coalition-building with the US on groundwork for new disciplines on industrial subsidies and SOEs, with China on dispute settlement reform, and with other players – large and small – on these and a host of different issues.

As the guardian of the system at a time of distress, the EU should aim at brokering a change in stance from China and other larger emerging economies, such as Brazil, India, Indonesia and others, on the need for greater reciprocity of concessions as a critical element to succeed in WTO reform (Gonzalez, 2019). This would of course serve not only the EU interest but also the interest of others. Low-key diplomacy should clearly convey the view that the system is under real threat and that, if it were to break down, some of the emerging countries, which do not have the protection of bilateral trade agreements with the major powers, would be very exposed (Dadush and Wolff, 2019). While there will certainly be different responses to such a message, it may well find a receptive audience, for instance, in Latin American countries, where large agricultural exporters stand to lose from a weakened multilateral trading system.

EU leadership is key not only on the active front to promote WTO reform but also on the defensive front to activate the dispute settlement mechanism with the aim of enforcing the application of the rules and keeping protectionism at bay. The EU has asked the WTO to rule on important matters, most notably against China on certain measures on the transfer of technology and against the US on the national security tariffs on steel and aluminum; a case on increased tariffs on cars should follow were the US to move in this direction. Several scholars have argued for a ‘big, bold, comprehensive’ case in the WTO against China, where the US and a broad coalition of countries at different levels of development would submit a case on systemic concerns stemming from China’s economic system (Hillman, 2018; Bacchus *et al*, 2018). Hillman argues that such a case could include claims of violation of China’s specific accession commitments in areas such as technology transfer, discriminatory licensing requirements, outbound investment, theft of trade secrets and intellectual property, investment restrictions, subsidies, export restraints, standards, and services trade in addition to an ‘exceptional’ WTO claim of non-violation nullification and impairment of the legitimate expectations that the US and others had when China joined the system (Hillman, 2018a). The aim of creating such a broad coalition clearly stands at odds with the current US administration’s behavior, but could become more relevant in changed circumstances and should be kept in mind by the EU as a possible future option. In particular, should unilateral actions and bilateral negotiations fall short in promoting structural reforms in China, the WTO dispute settlement system could provide an alternative avenue to achieve the objective, at least partially. Also, depending on the outcome of the US 2020 presidential election, new authorities could be more inclined to strengthen collaboration with allies and work within the system to address challenges associated with China.

## **5 THE WAY FORWARD: SUGGESTIONS FOR AN EU TRADE POLICY TO COUNTER THE CHINA-US CONFRONTATION AND KEEP THE SYSTEM AFLOAT**

### ***5.1 Leading from strength***

The global trade policy landscape has been severely disrupted. While in the midst of great turbulence, with several forces moving in different directions and uncertainty as to the final outcome and duration of the turmoil, the environment has clearly worsened. For the EU, the risk of conflict with the US is

higher now than it was a year ago, as is the danger the WTO's dispute settlement system will come to a halt. While the pressure on the EU is greater, there is a silver lining in taking advantage of a rebalancing of responsibility away from the US to gain in responsibility itself (Chase *et al*, 2018).

The EU's long-standing principled and values-driven commitment to the rules-based order is a source of strength to be leveraged, as is its economic might as a trading bloc. This needs to be supported by internal strength. The high turnout in the May 2019 European Parliament election has illustrated the legitimacy of EU institutions. Now, the challenge is to achieve a solid, unified EU trade and investment position, manifested both at the European Council and the European Parliament. This will be critical for a united external front to prevail. Conversely, the greater the divide between Member States and EU institutions, the lesser the EU's ability to be effective vis-à-vis the US or China.

At this time of distress, the EU trade policy is to be based on two principal, inter-related objectives: sustain an open rules-based multilateral trading system, while protecting itself from the direct and indirect upshots of the China-US confrontation and, more broadly, from US unilateralism and from the misalignment between China's economic model and the global rules. In addressing short-term challenges, the EU must act strongly and decisively, but based on principle (Demertzis *et al*, 2017) – staying away as much as possible from opportunistic and/or power-driven considerations. It must resist calls to undermine the multilateral system's core, even while flexible formats or alternatives are to be explored. But it is also vital for the EU to keep an eye on the long term. Second-best options may be required should the system break down, but the fundamental commitment to openness and rules must, and in the present circumstances can, be preserved. In crafting and refining a strategy for the current circumstances, November 2020 will mark a critical point, as the results of elections in the US will determine whether and how there will be adjustments to US trade policies and tactics, which in turn will impact how the EU and other countries adapt.

It is also essential that the EU ensures that its defense of, respectively, the global trading system and the global environment, including the fight against climate change, go hand in hand. On substance, there is broad alignment between these two policy objectives, but the political legacies in several member states imply that significant debate will be needed to achieve such consistency. In playing an instrumental role to make operational the Paris Agreement, the EU has displayed leadership and commitment in support of multilateral solutions to address the important global challenge of climate change. Trade policy and trade agreements may also facilitate cooperation in this area and one view advocates for a strengthened relation between both realms of public policy, including in the context of trade agreements (Jean *et al*, 2018). Given the complexity of current circumstances, the EU should continue to defend action against climate change, and combine this critical concern with its trade policy as much as circumstances allow.

Needless to say, for all its relevance in the current context, trade policy cannot carry all the weight in providing a conducive environment for European firms and workers to compete in the global economy and to protect against the downsides of globalisation. Domestic policies, including macroeconomic, taxation and structural policies, among others, are to play their part.

## **5.2 A multidimensional approach**

A range of options are available for the EU to pursue its objectives, the pertinence of which may be more or less appropriate depending on how events unfold. There is in particular a time dimension that is critical in shaping the EU position. These recommendations are centered on the short term but with an eye on the long term – that is, they focus on what the EU could do now to achieve its trade policy objectives, while keeping the options open should circumstances change. The EU is already acting on a number of these points, and doing so quite appropriately (Dadush and Wolff, 2019).

- **EU domestic tools should be further strengthened to respond to current challenges but protectionist forces must be kept at bay.** Beyond recent efforts towards more consistency in FDI screening, the EU should envisage a fully harmonised legal framework for such processes, even if it leaves the individual assessments and decisions primarily at the national level, as long as a credible EU-level risk assessment capability does not exist (Röller and Véron, 2008). This should be coordinated with trading partners and allies to the extent possible. Recent changes to protect against unfair trade practices may be complemented with measures already under consideration in the areas of competition, state aid, public procurement and others (European Commission, 2019a). But initiatives advocating aggressive industrial strategies, through restrictions of non-EU imports of intermediate goods or the weakening of competition policy rules to promote national champions, would undermine the EU's legitimacy to counter others' policies and must thus be resisted (Zettelmeyer, 2019). The European Parliament's continued active involvement will be critical in shaping these responses.
- **The EU must redouble its outreach efforts both in the US and China to expand and deepen its impact.** A sustained effort is required to underscore the EU's position in the US beyond the federal government, in particular to reignite support to the transatlantic partnership in US business, society, and Congress. In the case of China, greater investments are required to strengthen EU's understanding of and presence in China. At all levels – heads of EU institutions, Parliament, trade negotiators, business associations and think tanks, among others – the EU would benefit from strengthening ties with its Chinese counterparts to build increased understanding and stronger partnerships for the future.
- With a renewed framework to deal with China recently agreed, **the EU (and China) must now act to make rapid tangible progress and achieve results.** In this context, the single most important bilateral action would be the conclusion, as agreed, of the negotiations on the China-EU Comprehensive Investment Agreement by 2020. While the complexity of issues at stake is not to be underestimated, a combination of strong disciplines with adequate transition periods for ambitious market opening commitments could pave the way. A hands-on process to ensure continuous follow-up, coupled with high-level political attention, provides the best option to sustain progress. In a similar vein, while working in tandem with the US and Japan in the trilateral process, the EU should seek progress with China on strengthened rules for industrial subsidies that could potentially provide the basis for a WTO plurilateral negotiation. In particular, the EU should press upon China that failure to deliver on the commitment in this area weakens the China-EU partnership at a time when it is as important as ever. Continued progress on reconciling views on WTO reform is also critical.
- While the decision on the timing and outcome of the China-US bilateral negotiations is outside of the EU's influence, **the EU shall continue to impress on the US the importance of a multilateral or at least plurilateral effort to address concerns on China's policies and practices** as a group approach could be useful in promoting implementation (Cutler, 2019). While the EU and other countries could potentially benefit from structural reforms to be agreed at a bilateral level, **the EU should stand ready to examine a potential China-US deal in light of WTO disciplines and to work with other countries in countering any potential violation to WTO rules** resulting from efforts to manage trade outcomes.
- **The EU could promote the progressive expansion of the membership in the EU-Japan-US trilateral process** working on industrial subsidies, forced technology transfer, strengthened intellectual property and other issues to other countries that share similar concerns, such as Australia, Canada, Mexico, New Zealand, Singapore, South Korea and Switzerland (Cutler, 2019). While preserving the aim for high standards, this would help pave the way for eventually moving the discussions to the WTO for potential plurilateral agreements. One important first step in this direction has been the joint submission by the trilateral group and other partners of a proposal for WTO notification reform (WTO, 2018b).

- ***The EU must strengthen the conditions for EU-US trade negotiations to deliver on market access, standards and regulatory coordination, and solve trade frictions.*** Past experience and current circumstances on both sides of the Atlantic, point to the wisdom of avoiding protracted, all-encompassing negotiations, *à la* TTIP, at least for now. In this regard, a negotiation focused on tariffs only – a transatlantic zero agreement, ‘TAZA’ (Chase *et al*, 2018) – could prove an achievable objective. The EU negotiating mandate, however, limits the scope of the negotiations to industrial goods. While that would be politically challenging, it may require revision, possibly to include agricultural products (Dadush and Wolff, 2019), both to engage the US in the discussion and for the agreement to be consistent with WTO requirements to include ‘substantially all trade’ in negotiation of preferential trade agreements. In the same vein, if the renegotiation of NAFTA and bilateral negotiations with China are to provide a clue, it may be the case that negotiations will have to take place in an unfavorable context of tit-for-tat tariff increases. If so, one priority for the EU will be to avoid lopsided negotiations, with no commitments on the US side. This should be a true red line.
- ***A firm EU response to the US potential imposition of national security tariffs on auto and auto parts should include the filing of a WTO claim against the action and EU ‘rebalancing’ tariffs on US imports, as per the WTO safeguards process,*** as in the case of the steel and aluminum tariffs. The EU may opt to selectively target a smaller volume of trade to minimise the negative impact on the EU and the global economy, but also to prevent unnecessary escalation. Retaliation should nevertheless be large enough to have an impact and remain credible (Chase *et al*, 2018). ***All efforts should be made to avoid retaliatory tariffs in the context of the Airbus-Boeing case becoming a fixture in the EU-US trade landscape.*** While the parties await in the coming months authorisation from the WTO on the exact amount of authorised retaliation, the magnitudes at stake could prove very damaging for both parties and the global economy. Again, one major objective of EU-US trade negotiations should be to de-escalate and solve these conflicts.
- ***The EU should continue to play its key role in fostering WTO reform, actively pursuing WTO litigation to counter protectionism and rule-breaking, and strengthening monitoring, all in cooperation with other countries.*** The EU holds a special role in sustaining the multilateral trading system in the current context and in particular, for trying to deactivate the potential demise of the system as a result of increased trade frictions. While it will not be easy to find cooperation with the US on WTO reform or to persuade China on some of the key elements for the reform to succeed, including the need for differentiation and greater reciprocity, the EU must persist in trying to engage both members. It is also well placed to exercise leadership among middle-sized powers and developing countries alike to build a large coalition in support of the system. The concern of almost all (non-US) WTO members is understandably focused on solving the Appellate Body crisis, but that crisis cannot be sorted out in the absence of negotiations of new rules. This should encompass initiating the negotiation of plurilateral agreements, with the participation of China, on issues such as subsidies, forced technology transfer, notifications and other areas of concern. It should also aim at producing results in the area of fisheries’ subsidies, as well as in recently launched negotiations, including in the area of e-commerce. The EU should aim at having, by the time of the next WTO Ministerial Conference in mid-2020, a set of plurilateral agreements on issues such as industrial subsidies, technology and intellectual property, among others, ready for ‘reciprocal concessions’ (Bown, 2019). As with other participants in the process, the EU should be ready to bring value to the table, for example, with concessions in the area of agriculture subsidies. At the time it might also be possible to negotiate a way out of the Appellate Body impasse. On the latter, the objective should be to preserve the Appellate Body itself and the binding nature of its decisions. Until that time, an interim solution will be required. A draft EU proposal would provide a legal alternative to the current process by establishing an interim appeal arbitration procedure for WTO members to voluntarily arbitrate their WTO dispute rulings (Lester, 2019). This would keep the system alive along the lines of a ‘WTO minus one’ format (Lamy, 2018a). Another option is for

countries to agree reciprocally in advance not to appeal the WTO panel report during the crisis (Charnovitz, 2019; Payosova *et al*, 2018).

- ***Closer EU-Japan coordination on several fronts is in the interest of both partners and could enhance opportunities to maximise impact.*** Building on their strengthened relationship resulting from the path-breaking EU-Japan Economic Partnership Agreement, the EU and Japan are well aligned on a number of substantive topics. The recent EU-Japan summit showcased the commonality of views among the two partners (EU-Japan Summit Joint Statement, 2019). Clearly, they are both subject to the perils of aggressive US unilateralism, certainly in the case of autos and auto parts, with each of them poised to enter into separate bilateral negotiations with the US. A closer, discreet but intense dialogue and coordination at a detailed level would serve both countries well and could help to promote greater convergence across both the Atlantic and the Pacific. Any moves by the US to prevent this coordination should be firmly resisted.
- ***Keep the political level engaged on concerns associated with the China-US confrontations in all relevant international fora,*** including the G20, the OECD Council Ministerial, the IMF and World Bank spring and annual meetings, and others, to leverage finance ministers and other key actors in the global economy.
- ***Deepen and expand the already solid network of EU bilateral and regional agreements, with effective dispute settlement provisions, while looking for increased market access.*** With recent entry into force of agreements with Canada and Japan, some 75 percent of EU members' trade is covered under preferential accords (Dadush and Wolff, 2019). Negotiations under way with Australia, New Zealand and others would further expand this number, as would the conclusion of protracted negotiations with Argentina, Brazil, Uruguay and Paraguay (Mercosur). In addition to increased market access, these agreements would act as insurance policies to protect EU trade in case of disruption of the global system (Jean, 2019). If the world were to break into major trade blocs, this part of the plan would be particularly relevant. In the field of public procurement, amid a steady increase of protectionist measures globally, removing barriers in foreign markets would open up new opportunities (European Political Strategy Centre, 2019).
- ***In the face of greater complications of a potential system breakdown, priority should be given to minimising the risk of trade disruption with major partners, while maintaining the commitment to openness and rules, albeit in a less-than-multilateral trade context.*** Things would become more complicated should the multilateral trading order start to really break down. In this case, the EU would be relatively protected vis-à-vis a number of trading partners under its preferential trade agreements. It would face, however, greater risk from trade with its largest partners, the US and China, becoming continuously disrupted by a set of unmanageable disputes. Bilateral negotiations with these countries would thus acquire far greater urgency.<sup>1</sup> In this context, priority should also be given to minimise disruptions across different agreements, providing for open architectures that would allow for the negotiated accession of third countries (Dadush and Wolff, 2019). One option to explore in this very challenging scenario would be potential EU membership in CPTPP. The EU has already agreements in place, under negotiation or awaiting entry into force with all CPTPP members, except Brunei, and while agriculture would likely be a sticking point, ongoing negotiations with Australia and New Zealand could pave the way (Cutler *et al*, 2019). If open to all interested countries, including China, CPTPP could lay the foundation for an alternative system to emerge.

To conclude, the prospects for the EU – and the rest of the world – in the current trade policy landscape are challenging. They are not written in stone, however. In the US, a more confrontational attitude towards China has settled in and frictions will continue to put into question the global trade

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<sup>1</sup> An agreement with the UK would of course also be important, if the UK eventually exits the Internal Market and/or the European customs union.

environment. This is not the case in the EU. Meanwhile, the transatlantic alliance enjoys wide support in both political and economic circles on both sides of the ocean. The Trump administration's most extreme trade policies vis-à-vis the EU, like the potential imposition of national security tariffs on the auto sector, do not have the support of any known member of Congress, nor of the US business community. The EU can thus hope for a future improvement from the current dark outlook. Options that are now closed could emerge as the circumstances vary. EU policymakers should keep this in mind.

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