ESPAS *Ideas* Paper Series

ESPAS European Strategy and Policy Analysis System

# The Future of International Trade and Investment

ESPAS European Strategy and Policy Analysis System

AN INTER-INSTITUTIONAL EU PROJECT



**Acknowledgements**

The ESPAS Ideas Papers have benefited from valuable feedback received from colleagues from across all EU institutions who participated in a series of ESPAS Ideas events throughout 2018.

# The Future of International Trade and Investment


## SUMMARY

This paper examines current trends, uncertainties and wild cards in relation to international trade and investment. It then considers implications for the European Union.

The European Union's interest remains clear: a rules-based order is better than a transactional or winner-takes-all approach to international trade. But it is wise to plan for the worst, while hoping for the best.

The future of international trade and investment may lie somewhere between the extremes of the status quo and a reversion to protectionism. This would involve a thorough revision and rebalancing of multilateral norms, to take account of major global changes on many fronts. The EU has traditionally been a leading player in the creation of international institutions and norms. But the days when Europe could dictate the global agenda are over. Europe's role will be increasingly a matter of seeking to influence events, rather than asserting dominance. In the coming decades, internal unity and a strong sense of purpose will be all the more important.


In this Briefing



Author: Eamonn Noonan

# Introduction

The world faces two opposing scenarios for international trade and investment. One is the continuation of the present relatively open and multilateral landscape - a rules-bound order with a strong focus on legal instruments and institutions. The other is a shift to a less open, and less multilateral, framework, with a focus on transactional relationships. Defenders of the present order see higher trade as advantageous for all - a win-win relationship. Fear of the displacement effect of imports has driven support for a mercantilist, zero-sum viewpoint, in which a win for one side must entail a loss for the other.

The EU has been a strong supporter of multilateralism, and has been a major beneficiary of the existence of international rules in the post-war era. The European Commission stresses 'the EU's commitment to a fair, international, rules-based order based on high standards through cooperation and strengthening of multilateral institutions.'[1] Article 206 of the Treaty on the Functioning of the European Union (TFEU) states that common commercial policy should, among other things, contribute to 'the progressive abolition of restrictions on international trade and on foreign direct investment, and the lowering of customs and other barriers.'

This paper examines in turn trends, uncertainties and wild cards in relation to international trade and investment. It then considers options for the European Union. The timeline is the period from now until 2030. It suggests that a scenario of robust reform of the present rules-based order has advantages over both the strict preservation of the status quo and a revolutionary departure from it.

# Trends

International trade and investment is not just a matter of economics and finance. It also involves geopolitics, social affairs and environmental issues. It follows that many global trends impact the future of trade and investment, including megatrends from demographics and digitalisation to climate change and global power shifts. The following is a brief account of selected trends, looking especially for areas that are new or potentially problematic for the EU in the coming decades.

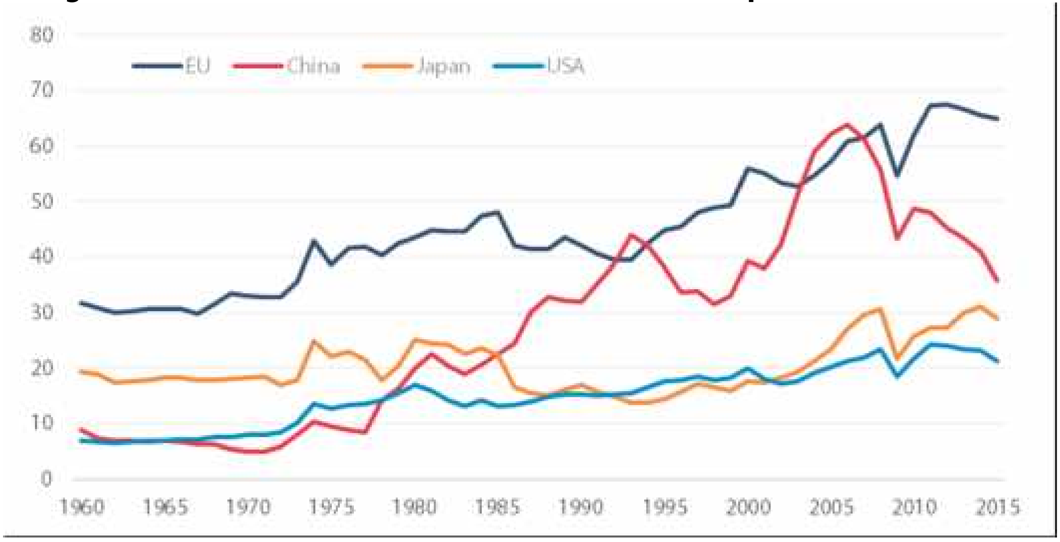
In this paper, a **trend** is something that is happening gradually, or a measure that has been changing steadily. An **uncertainty** is an event or development that has a reasonable chance of happening. A **wild card** is something that is very unlikely, but would have a big effect if it happened.

## China as a supporter of globalisation

China has expressed strong support for globalisation, notably through President Xi's speech at Davos in 2017.[2] It has good reason to take this position. Export-led growth has driven its economic transformation. China's trade in goods is now equivalent to 30% of a vastly increased GDP. This is a higher proportion than the US or Japan, though less than the EU (Figure 1).

China faces serious constraints in the coming years, including overcapacity in heavy industry and an ageing population. It is also planning to become less reliant on exports. Yet a reversal of its commitment to a trading system that has brought huge gains seems unlikely. Internal limitations may mean that exports will continue to be highly important; the Belt and Road Initiative is seen in part as a strategy to deal with over-capacity in heavy industries.

**Figure 1: Merchandise trade as % of GDP; EU, China, Japan, USA, 1960-2015**




Data source: World Bank.

The support China expressed for globalisation was widely welcomed - not least because of a stark contrast with the positions taken by the Trump administration. But it should not be misunderstood as support for the rules-based international order in its present form. China may attribute its economic growth to access to foreign markets, which is not the same thing as the multilateral system in itself. The dominance of state-owned enterprises remains a serious challenge to free competition. State subsidies and requirements on foreign firms to transfer technology are also problematic. A test of Chinese thinking will be the extent to which it opens its domestic market. A key indicator of its true intentions will be its record on entering into binding agreements - and then abiding by their terms.

## Increasing international economic interdependence

In the past, a number of EU external agreements focused narrowly on trade. The case of the EU-Canada Comprehensive Economic and Trade Agreement (CETA) is emblematic of a trend towards a broader approach. The spread of Free Trade Agreements (FTAs) reflected the belief that free trade in goods and services was of mutual benefit. The creation of *trade and investment* agreements reflects greater acceptance of the view that the free flow of capital also creates win-win opportunities.

The increased ambition of external deals has made the path to ratification more complicated on the EU side, not least in view of the European Court of Justice opinion on a proposed free trade agreement with Singapore.[3]

The inclusion of investment is a reminder that international economic relations cannot be boiled down to the simple arithmetic of a trade surplus or a trade deficit. But it brings with it other thorny questions. One is investment protection. The Investor State Dispute Settlement (ISDS) model is now widely seen as too favourable to private interests. In response, the European Commission has negotiated bilateral investment court systems in recent agreements (with Canada, Singapore, Vietnam and Mexico). It has also promoted a Multilateral Investment Court (MIC). It remains to be seen whether this new approach will become the global norm.

Inward investment is increasingly subject to scrutiny from the perspective of strategic and national security interests. When is it appropriate to prevent Foreign Direct Investment (FDI), or to exclude investments from specific foreign countries? What businesses or sectors should be kept in the control of national investors? New EU rules on screening FDI are already on the table. Greater international tension may strain the present consensus in favour of free flow of capital; traditionally, this has been weaker than the consensus in favour of free trade.

## Greater influence of emerging economies

The distribution of global population shows that the US and Europe cannot expect to dominate world affairs in perpetuity. In population terms, Europe plus the Middle East equals the Americas plus Australia. It also equals Africa. Each of these three has one quarter of the population of Asia (Figure 2).

**Figure 2: Seven equal areas of population**

Source: Max Roser.

The seven largest emerging economies (E7) are advancing as a counterweight to the G7. Some suggest that the E7 economies together will be twice the size of the G7 economies by 2040, and that China and India together will have 35% of world GDP by 2050. China will be close to the combined economic weight of the US and the EU27.[4]

G7: Canada, France, Germany, Italy, Japan, United Kingdom, United States.

E7: China, India, Brazil, Mexico, Russia, Indonesia, Turkey.

The EU has a keen interest in cultivating relations with the emerging countries. Pressure will grow for a Global New Deal; Europe's ability to shape this will largely depend on the state of its relations with both established and rising economic powers.

# Uncertainties

## Populist opposition to globalisation

The key uncertainty about the future path of trade policy is whether voters will elect governments committed to greater protectionism. In the US, the swing states in the 2016 presidential election were in the rust belt. They opted for the candidate with a more protectionist profile. The UK decision on Brexit, which takes the UK out of the world's largest trading block, also reflected greater sympathy for economic nationalism. In several countries, populist parties with a protectionist leaning have made electoral gains; the new government in Italy has threatened not to ratify CETA. If this electoral trend continues, there is a clear risk that trade liberalisation will stall and that trade barriers will rise. The May 2019 European Parliament elections will reveal more about how voter sentiment in Europe is shifting.

A recent analysis of voting patterns in Europe concludes that 'at the district level, a stronger import shock leads to: (1) an increase in support for nationalist parties; (2) a general shift to the right in the electorate; and (3) an increase in support for radical right parties.'[5] Economic insecurity drives support for protectionist parties. If it continues or increases, the political push towards trade restrictions will have greater impact. Economic recovery would work in the opposite direction.

There are large differences between the degree to which European regions can manage globalisation. Very generally, the north and west appear more resilient, while the most vulnerable regions are in the south and the east. This opens the prospect of division between EU Member States, and the possible emergence of a minority group of states which are openly sceptical to international trade. Genuine progress on cohesion and convergence strategies would mitigate this risk.

## Digitalisation and trade: a double-edged sword

Technological change will continue to have a huge impact in the coming decades, and will present both risks and opportunities. The upside includes efficiency gains from speeding up and streamlining administrative procedures. This links to the trade facilitation agenda, which offers the prospect of considerable cost savings and thus greater capacity for investment. Small and medium-sized enterprises (SMEs) could also gain, if market entry barriers are reduced. Connectivity, red tape and logistics affect small business disproportionally, especially outside urban centres. Technological fixes could level the playing field.[6]

Digitalisation also generates new problems. One is the possibility that jobs in the service sector will migrate from advanced economies to emerging and developing economies, in a repeat of the pattern seen in manufacturing industry. This is not a foregone conclusion. Some technological innovations favour such a trend, but others do not. The implications of tele-robotics, telepresence and remote intelligence (RI) are far from clear.[7]

The rapid growth of e-commerce, and the emergence of data as a commodity in its own right, illustrate the complex relationship between digitalisation and trade. The creation of ground rules for moving data across international borders is already a bone of contention, not least between the US and the EU. Increasing digital connectivity around the world is itself a major trend, and is more likely to intensify than to decline. This calls forth the need to develop norms, laws and an institutional framework to prevent predatory or hostile behaviour. Discussions on regulation of e-commerce continue at the WTO, but progress is slow.[8]

The creation of an international digital order could draw on a central lesson of the post-war international trade order: a multilateral and agreed framework has distinct advantages, compared both to a centrally imposed one, and to a web of unconnected bilateral agreements.

## The effort to improve standards

The effort to make trade fair as well as free faces many obstacles. Progress is neither inevitable nor impossible. The EU has a declared ambition to improve standards. Recent EU trade agreements include Trade and Sustainable Development (TSD) chapters, with a view to improving compliance with labour and environmental standards.[9]

The path to equitable and effective international standards is long and winding. European countries seems to accord greater weight to the rights of individuals when setting boundaries for corporate behaviour, than does the US, for example. Under what conditions are countries willing to depart from deeply embedded national norms, and to accept internationally agreed standards?

Traditionally, market access has been a lever to encourage movement on standards. Some believe that a model based on assertive dialogue with partners can deliver substantial change. Others see a need for sticks as well as carrots, and argue that a model including sanctions would be more effective. The form sanctions should take is also debated. A more fundamental choice lies between building enforcement mechanisms through bilateral agreements, on the one hand, and reinforcing multilateral instruments, on the other.[10]

The international trade policy environment does not stand still. Adjustments are constantly under negotiation, and the long struggle for often marginal progress can create fatigue and pessimism. A key point to bear in mind is that the sustained improvement of standards, and their enforcement, can arrest the political impetus towards protectionism. Advanced economies have legitimate concerns about imports from countries that do not have or do not apply relevant standards. Action on fair trade is likely to gain in importance if it is seen as an alternative to the adoption of trade barriers.

# Wild cards

## Atlantic rapprochement

The present US administration has proved to be a difficult partner, not least for its traditional allies. On international trade and investment, it has flagged its intention to look first to US interests - and to define those interests narrowly. US-EU trade relations are thus framed as a matter of competition and rivalry, rather than a matter of mutually beneficial exchange. On some subjects, the common interests of the US and the EU still come to the fore; an example is the December 2017 joint statement (with Japan) on the need for a level playing field in global trade.[11] Suppose the present difficulties were overcome, ushering in a transatlantic rapprochement. The EU-US relationship is under-institutionalised;[12] there could be an effort to remedy this. A relaunch of a new and improved TTIP could enter the realm of the possible.

Although unlikely, rapprochement has a rationale. The US and the EU are better placed to influence the parameters of international trade and investment if they act together. There is also an incentive to do so sooner rather than later. They will be less able to be the norm-setters as their combined share of global economic power continues to fall. Their negotiating power, individually and collectively, will decline over time relative to Asia and the emerging economies. In a scenario of a large-scale reorganisation of the international institutional framework, for example, today's advanced economies may risk becoming norm-takers, unless they cooperate on the basis of their shared interests.

## Trade war

A sustained trade war between the US and China would have a major and negative impact on global trade and investment. The economic costs of a trade war are well known. It raises import prices in the short term, and slows economic growth in the long term. Retaliation by trading partners means that workers in export-oriented sectors get laid off. Meanwhile, protected domestic industries, in the absence of competition, have less need to innovate. Over time, this tends to lead to a loss of quality in the local product.

A US-China trade war could have yet more serious consequences. It could see the world dividing into rival and conflicting camps and the arrival of a new cold war.[13] This carries within it a greater risk of a hot war, with potentially catastrophic consequences. One body of opinion in the US feels that China exploited its membership of the World Trade Organization to steal millions of US jobs; this sentiment contributed to the result of the 2016 election. There are examples through history of clashes between dominant powers and emerging rivals; this has been called the Thucydides Trap.[14] A specific concern is that China may take the lead in Artificial Intelligence, causing a new Sputnik moment. The present volatility of US external policy raises the possibility of serious conflict with China, whether intentional or accidental.

## Renewed multilateralism

A swing back towards multilateralism is another unlikely but potentially high impact development. The EU has a long wishlist of reforms to WTO rules, not least to strengthen its surveillance role.[15] The International Labour Organization (ILO) could be empowered to enforce compliance with international labour standards, based on terms written into bilateral and multilateral trade deals. A world environmental organisation could monitor compliance of traded goods and services with international environmental and sustainability standards. Another high impact and low probability event would be the liberalisation of agricultural trade. Failure to agree on reducing barriers to trade in agriculture contributed to the failure of the WTO's Doha Round; the signs are that agreement will remain elusive.

# Implications for the European Union

The Reflection Paper on Harnessing Globalisation sets out the Commission's recipe for a successful trade and investment policy. Externally, the approach is to endeavour to make international rules fairer and to work for even-handed enforcement. Internally, the plan involves competitiveness; regional resilience; and robust social and educational policies.

## The external dimension

The EU's room to manoeuvre externally is constrained by the strategic choices made by trading partners, as well as by major trends and uncertainties outlined above. Trade defence has come to the fore recently,[16] and will probably have a more prominent place in the trade policy mix in the coming years. WTO rules make provision for response to unfair competition and undue import restrictions. Foreign access to EU procurement tenders may become dependent on reciprocal access for EU companies abroad.[17] A stronger focus on safeguarding strategic sectors is also likely. The case can be made that smart globalisation is a better option than naive globalisation.

'Investment defence' will become more important, in response to concerns about the political dimension of inward investment. Outside of the finance sector, a very small proportion of EU enterprises are foreign-controlled.[18] This has, however, become a sensitive political issue, and is related to larger questions about the growing global influence of China. The Commission has put forward proposals for a common European regime for investment screening,[19] and this has an obvious appeal, as compared to 27 different national regimes. This is a test case for the EU's ability to overcome much publicised divisions among its Member States; success in establishing a common standard would show that the forces binding the Member States together remain strong.

On the international stage, internal EU unity increases the likelihood of favourable outcomes; division risks worse outcomes. The impact of Brexit may be felt more on the EU's relative weight in international talks than on policy positions on trade matters. The departure of the UK removes a traditional proponent of multilateralism, but the UK's absence may open the way to deeper cooperation and more cohesion in a wider range of policy areas.

**Key questions in the external domain**

How committed is China to the rules-based international order?

What circumstances could lead to a US-EU rapprochement?

Will the WTO be successfully reformed?

Will improved environmental, labour and public health standards be written in to trade agreements?

What criteria will be used to restrict inward investment (FDI)?

What positive and negative impacts can be expected from digitalisation?

## The internal dimension

Internally, there are obstacles to the consolidation of a cohesive EU approach. Responsibility for relevant policy areas is distributed across different levels of government. The EU level has lead responsibility for trade agreements, the promotion of regulatory standards, trade defence, and product and food safety. It has a significant role in providing funding for transition support. The individual Member States take the lead on education and training, active labour market policies (ALMP), social support and infrastructure. The regional level also has a key role on infrastructure, as well as on smart specialisation and the effective use of regional funds. Many salient points are decided at national or indeed regional level, and this will not change in the foreseeable future. Coordination between different levels, and between individual Member States, is essential.

Policy priorities may vary from country to country. Some may choose to focus principally on competitiveness and cost cutting, and to back away from social protection initiatives. Some may feel constrained to cut programmes that are needed to allow people to prepare for new opportunities - thus compounding the damage of an economic downturn.

In response to greater scepticism about globalisation, the World Trade Organization has urged a policy mix that balances employment protection, compensation, and transition assistance.[20] This should include:

- more funding for adjustment;
- work on education and skills;
- supportive social policies; and
- active and passive labour market policies.

The WTO also concludes that it is better to make adjustments early, rather than after crisis hits; and that programmes should be tailored to a country's specific circumstances.

New approaches on education and skills are clearly desirable, but they cannot solve the problem on their own. The same can be said of active labour market measures. In both of these domains, a strong evidence base is a sensible requirement before redirecting resources on a large scale into private, for profit programmes. Yet the evidence base on the effectiveness of adjustment initiatives still has large gaps. Until this is remedied, the prudent option is to step up investment in public services, with close monitoring of their effectiveness. Embedding future-proofing strategies into existing social and education services has advantages of synergy. This may also prove more resistant to rent seeking than a strategy of dispersed and small-scale branded interventions.

The World Trade Organization has pointed out the need to think even more broadly about adjusting to new realities: 'Governments can take measures to address possible adverse distributional consequences of technological change and increased trade competition.'[21] This is a reminder that digitalisation may disrupt traditional employment patterns as much or even more than globalisation did in the past decades. The OECD also emphasises that redistributive policies have a role to play.[22] The example of northern Europe suggests that adjustment is more likely to succeed in jurisdictions with stronger redistributive policies.

The importance of wealth distribution for the grand bargain in favour of open international trade has often been overlooked. Awareness of this connection adds urgency to efforts to improve tax transparency and tax fairness. Offshoring profits erodes tax revenues at a time when additional resources are needed for adjustment policies. Greater investment in regional, educational and labour market transformation may well be crucial for maintaining the policy consensus in favour of open trade. The scope to do this may well depend on a return to redistributive principles.

**Key questions in the internal domain**

Can the EU maintain a united front on trade and investment policy?

Can it arrive at common analysis and common understanding of the fundamentals, as part of establishing a unified front?

Will lack of convergence increase the risk of disunity at EU level?

*Are effective cohesion policies a necessary part of a trade policy package?*

Will increased inequality undermine political support for a multilateral trade policy?

*Can enhanced redistributive policies fix this?*

*What role has increased funding for targeted public services?*

What trade-offs are involved, between countries, regions and sectors? How can these be managed?

# Concluding remarks

The European Union's interest remains clear: a rules-based order is better than a transactional or winner-takes-all approach to international trade. But it is wise to plan for the worst, even while hoping for the best. Areas to watch include the following:

- The EU may find it necessary to adopt defensive measures in the short run, in order to maintain the integrity of international rules and institutions.
- Fairness will be a central focus of trade policy debate in the coming decades. The adoption of public health, environmental and labour standards can improve the resilience of the rules-based order.
- There are both economic and social reasons to ensure that the benefits of trade and investment are more widely distributed than at present.
- The EU needs to be prepared for 'hockey stick' curves. This kind of exponential pattern is becoming typical at the frontier of technology: changes can happen very rapidly and on a very large scale.

The future of international trade and investment may lie somewhere between the extremes of the status quo and a reversion to protectionism. This would involve a thorough revision and rebalancing of multilateral norms, to take account of major global changes on many fronts. The EU has traditionally been a leading player in the creation of international institutions and norms. But the days when Europe could dictate the global agenda are over. Europe's role will be increasingly a matter of seeking to influence events, rather than asserting dominance. In the coming decades, internal unity and a strong sense of common purpose will be all the more important.

## FURTHER READING

European Commission, Trade for all. Towards a more responsible trade and investment policy, 2015

European Commission, Reflection paper on harnessing globalisation, 2017

Harte, R., Multilateralism in international trade. WTO achievements and challenges, EPRS, European Parliament, December 2017

Noonan, E., Between multilateralism and protectionism: Prospects for International Trade, in Rechard, D., ed., Global Trendometer. Essays on medium- and long-term global trends, EPRS, European Parliament, 2017

# ENDNOTES

[1] European Commission, Trade and Sustainable Development chapters in EU Free Trade Agreements (FTAs), non-paper, 11 July 2017, p. 1

[2] Financial Times, Xi Jingping delivers robust defence of globalisation at Davos, 17 January 2017

[3] European Court of Justice, Press Release, 16 May 2017

[4] PWC, The long view: How will-the-global economic order change by 2050?, 2017

[5] Colantone, I., and Stanig, P., *The Trade Origins of Economic Nationalism: Import Competition and Voting Behavior in Western Europe*, 2017

[6] World Economic Forum (WEF), Global Enabling Trade Report 2016

[7] Baldwin, R., *The Great Convergence. Information technology and the new globalization*. Cambridge, Mass.: Belknap Press, 2016

[8] World Trade Organization, New initiatives on e-commerce, 13 December 2017

[9] European Commission, Feedback and way forward on improving the implementation and enforcement of Trade and Sustainable Development chapters in EU Free Trade Agreements, 2018

[10] European Commission, Trade and Sustainable Development chapters in EU Free Trade Agreements (FTAs), non-paper, 11 July 2017

[11] Reuters, US, EU, Japan slam market distortion in swipe at China, 12 December 2017

[12] Fahey, E., ed., *Institutionalisation beyond the nation state. Transatlantic Relations: Data, Privacy and Trade Law*. Berlin: Springer, 2018

[13] Atlantic Council, Global Risks 2035: The search for a new normal, 2016

[14] Allison, G., The Thucydides Trap, Foreign Policy, 9 June 2017

[15] European Council, Conclusions, 28 June 2018, p. 7

[16] Grieger, G., Modernising trade defence instruments, EPRS, European Parliament, May 2018

[17] Harte, R., International procurement Instrument, EPRS, European Parliament, December 2017

[18] Eurostat, Globalisation patterns in EU trade and investment, 2017, p. 180

[19] Grieger, G., EU framework for FDI screening, EPRS, European Parliament, 12 July 2018

[20] World Trade Organization (WTO), *World Trade Report 2017*

[21] Ibid., p. 11

[22] OECD, Bridging the gap: Inclusive growth 2017 update report, 2017

# PHOTO CREDITS

Kano Naizen - Kobe City Museum / Public domain