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**Research Report**

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# The European Union's response to the trade crisis

Uri Dadush and Guntram Wolff

## Executive summary

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**THE GLOBAL TRADING** system, a source of prosperity, is under attack on various fronts. The causes run deep and require a strategic response from the European Union and from the main trading nations. The future of the system hinges on the answer to three questions, and the scenarios associated with them:

- Can the World Trade Organisation be reformed?
- Is the United States' scepticism about the system a new normal?
- Can China undertake reforms that would make its system more compatible with the WTO?

**THE POSSIBLE OUTCOMES** for the global trading system could be good or bad, depending on how each of these issues is resolved. Under a good set of scenarios, the EU should persist on its current course with some significant adjustments. We call this Plan A, which would aim to preserve the multilateral trading system. Under a bad set of scenarios, the EU will have to contend with a possible break-up of the multilateral trading system, requiring the formulation of a Plan B. The EU needs today to put in place its Plan B, not only to prepare for a far less favourable trading environment, but also to clarify the trade-offs implicit under Plan A. All major trading nations must recognise that the alternative to making compromises is not the status quo, but something much worse.

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# 1 Introduction

The European Union's economy has never been as closely integrated with the rest of the world as it is today. The share of extra-EU trade in the EU's GDP has increased from 15 percent in the mid-1980s to 24 percent today, while the share of intra-EU trade in total EU-trade has remained at around 63 percent over the same period (European Commission, 2018a). The EU is now the world's largest trading bloc, even if intra-EU trade is left out. The EU's economy depends on its stable trade relationships around the world.

**Table 1: International trade flows in 2017, € trillions**

	Exports	Imports	Total trade
China	1.9	1.4	3.3
US	1.3	2.0	3.3
EU total	5.2	5.1	10.4
EU intra	3.4	3.3	6.6
EU extra	1.9	1.9	3.7
World	15.5	15.7	

Source: Bruegel based on International Trade Centre (2019) and Eurostat (2019). Note: Total trade is the sum of exports and imports. Discrepancies between world exports and imports and intra-EU exports and imports are due to statistical issues. EU refers to the 28 members states of the European Union at time of writing.

But the world trading system, on which the EU's economic activity depends, is engulfed in an unprecedented crisis. How the EU responds will be critical not only in terms of the living standards of Europeans over the next decade and beyond, but also in terms of growth prospects and stability across the world.

In this Policy Contribution, we examine the root causes of the current problems, develop good and bad scenarios for what could happen next, and provide recommendations for how the EU should respond. We argue that the EU needs to redouble its efforts to preserve the multilateral trading system, which we call Plan A. We also argue that the EU must devote serious consideration to a Plan B, which would respond to a dark scenario in which the World Trade Organisation falters. Plan B is needed not only to prepare for the worst, but also because it helps clarify the trade-offs implicit in the policy choices under Plan A.

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# 2 The world trading system under attack

The trading system is under attack on three main fronts:

First, the inability of the WTO to make progress in critical areas such as services, agricultural subsidies, investment, the facilitation of global value chains and digital trade calls into question the value of the organisation and the sustainability of its legal framework.

**The US-China trade and geopolitical conflict undermines the stability of the multilateral trading system.**

Second, the United States is directly challenging the WTO's dispute settlement system by (at least up to the time of writing) blocking the replacement of members of the WTO Appellate Body <sup>1</sup>, which could cease functioning in 2019 <sup>2</sup>. The United States is also openly ignoring the spirit of WTO rules and engaging in managed trade. Countries that respond to the United States with retaliatory tariffs or by trying to make a deal are in danger of walking down the same path.

Third, China is accused of not playing by at least the spirit of the rules. In the WTO context, China is accused of systematic theft of intellectual property, forcing investors in China to share such property (forced technology transfers) and employing widespread and opaque subsidisation, especially of and by its state-owned enterprises (SOEs; see for example European Commission, 2018b). Lack of market access and the lack of reciprocity are further concerns (European Union Chamber of Commerce in China, 2018). Some prominent US observers believe that China's economic system is incompatible with membership of the WTO, not just because of the preceding concerns but also because of the opaque and weak rule of law. The United States also objects to China's *Made in China 2025* programme, which it considers a plan to dominate the industries of the future. The EU and Japan share many of the United States' concerns about China and are collaborating with the United States in proposing WTO rule changes. The US-China trade and geopolitical conflict undermines the stability of the multilateral trading system (see also García-Herrero, 2019).

These frictions have already done permanent damage to the system, since they have undermined the credibility of the WTO and are also encouraging countries that are so inclined to adopt protectionist measures and/or to weaken or reject proposals to strengthen the rules-based multilateral trade system <sup>3</sup>. For example, according to the *Global Trade Alert Report* (Evenett and Fritz, 2018), India and South Africa, which have two of the most protectionist trade regimes among the G20, adopted 926 and 230 discriminatory instruments respectively from 2008-18, and 98 and 19 respectively in 2018 <sup>4</sup>. India raised its applied tariffs on numerous products in 2018. Unfortunately, even if future US administrations revert to policies supportive of the WTO, the doubt will persist that the

1 Under the WTO's dispute settlement procedure, any member can bring a case against any other member for not living up to its commitments in a specific instance. After a period of consultations, and in the event the dispute is not resolved between the parties, the WTO membership appoints a panel of experts to decide whether the WTO member whose policy is being challenged is at fault. In case of a finding of fault, one or both parties to the dispute can appeal to the Appellate Body. The Appellate Body consists of seven permanent members, representative of the WTO membership, who serve four year terms. The Appellate Body can uphold, modify or reverse the panel's legal findings. A minimum of three Appellate Body members is required in order to adjudicate on a dispute. Because new appointments and reappointments have been blocked, the Appellate Body is at time of writing down to three members, of whom one will retire in late 2019.

2 US complaints include procedural concerns such as the speed of the process and the continued involvement in cases of appellate body members even after they leave office. More fundamentally, the US objects to the ostensible 'overreach' of the appellate body to adjudicate in ways that go beyond what was negotiated, and also to opine on issues that go beyond the case in question. At a Center for Strategic and International Studies (CSIS) event on 19 September 2017, US Trade Representative Robert Lighthizer said: "*the United States sees numerous examples where the dispute-settlement process over the years has really diminished what we bargained for or imposed obligations that we do not believe we agreed to. There have been a lot of cases in the dumping and countervailing-duty, the trade-remedies laws, where, in my opinion, the decisions are really indefensible, and even a lot of people who have much more free-trade orientation who read these question(s). And we've had tax laws that have been struck down. We've had other provisions where the WTO has taken - really, I think, took the position that they were going to strike down something they thought shouldn't happen rather than looking at these - the GATT agreement as a contract. So what we've tended to see is that Americans look at the WTO or any of these trade agreements and we say, OK, this is a contract and these are my rights. Others - Europeans, but others also - tend to think they're sort of evolving kinds of governance. And there's a very different idea between these two things. And I think sorting that out is what have to do.*"

3 The rejection of global governance systems appears to be an important feature of this administration; see for example Bolton (2000).

4 In comparison, the United States, Germany and China, the three largest trading nations, adopted 1661, 1249 and 452 discriminatory measures respectively from 2008-18.

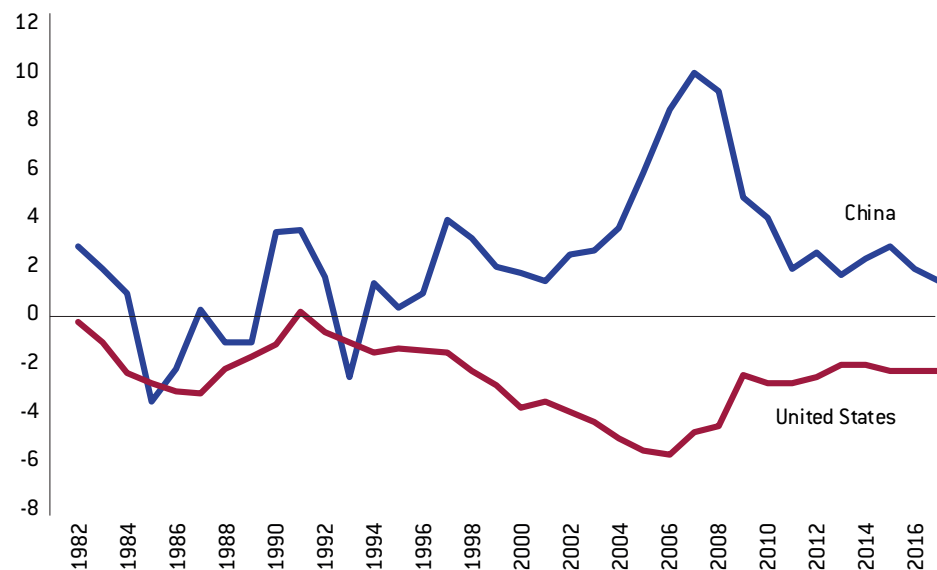
United States or another of the world's great powers will ignore or refute the system when it is opportune for their domestic politics. Less immediate, but equally important, are the concerns about China. While China formally sticks to the letter of the WTO framework, there is broad agreement in the EU and the US that state subsidisation and forced technology transfer are not satisfactorily addressed by the existing WTO agreement on subsidies and countervailing measures<sup>5</sup>.

### 3 Causes of the attack on the trading system

The causes of the current attack on the trading system run deep and require a strategic response.

The resistance to globalisation is probably in large part a result of the secular trend in skill-biased technological change which accounts for rising inequality, economic disruption and the stagnation of most incomes, a trend especially evident in advanced countries, but not only there. Globalisation also contributes to increased disruption and inequality directly because it creates demand for higher skills disproportionately and gives rise to many 'winner-takes-all' opportunities, especially for platform companies that can scale-up quickly and inexpensively. The disruption has been made worse by the rapid rise of China and the coming-on-stream of low-skilled workers across the developing world. Rightly or wrongly, large current account and bilateral imbalances (Figure 1) remain a source of tension, despite the narrowing of China's overall surplus and the United States' overall deficit in recent years (the latter is widening again despite higher tariffs in 2018).

**Figure 1: Current account balance as a share of domestic GDP**



Source: Bruegel based on World Bank [2018].

Even if economic factors are at the root, political factors – such as resurgent nationalism and fear in the United States that it is losing its primacy – also contribute to the disaffection with globalisation, and these political factors have a life of their own. Populist and nationalist leaders capitalise on the fear of globalisation to erect trade and investment barriers and to severely

5 For details and a concrete proposal on how to address this issue, see Mavroidis and Sapir (2019).

restrict immigration. Brexit, though a unique phenomenon, can be read as reflecting some of these concerns. However, both export and import interests have gained in political weight with the increase in trade. With raw materials, parts and machinery accounting for 75 percent of world trade (UNCTAD, 2017), companies worry about the viability of the global value chains on which they rely. Many people, especially young people, see their ability to buy foreign goods, invest and travel abroad as a natural right. For all these reasons, most large economies including the EU remain committed to increased openness in trade and foreign investment.

Economic analysis shows that protectionism is not the right answer to the problems. Rather, more attention should be paid to the plight of the most vulnerable. *Ex-ante* policies include investment in skills and infrastructure, or more generally in policies that improve competitiveness. *Ex-post* policies include measures to share the gains from global integration (Freytag *et al*, 2018). However, the national populists have typically refused such a course, preferring to blame foreigners and put up protectionist barriers. Meanwhile, mainstream politicians in Europe and elsewhere are hampered by budget constraints, or for other reasons do not pursue policies that enhance public investment and social welfare.

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## 4 A case for preserving the world trading system

The world trading system has been remarkably successful in promoting trade and must be preserved. The system rests on three main pillars: the WTO, preferential trade agreements and domestic institutions.

The WTO is a global public good that supports open and predictable trade based on reciprocity. It now includes 164 members, accounting for 98 percent of world trade, with another 22 members at various stages in the accession process. The WTO provides the bedrock of international trade law, as it is based on the principle of non-discrimination across nations. It is a true globally-operating multilateral framework with enforcement rights.

Under WTO rules, regional agreements are governed under the WTO's General Agreement on Tariffs and Trade (GATT) Article 24 (substantially all trade and tariff reductions). These preferential trade agreements now cover about one third to one half of world trade. Thanks to the formation of the European Union and its bilateral agreements with partners, EU members can count typically on 75 percent of their trade being covered by them (Ahearn 2011).

International commercial disputes are prevalently resolved in domestic, not international, courts. Domestic institutions – the rule of law – that affect or directly govern international trade are crucial and are being continuously reformed. Although some of these reforms have moved in the direction of trade restrictions (according to the *Global Trade Alert Report*, Evenett and Fritz, 2018), over the last 10 years G20 countries have adopted 9041 measures that discriminate in favour of domestic producers), for the most part, the trend over the last few decades has been in the direction of facilitating international trade and of complying with WTO disciplines.

The combined effect of multilateral, regional and domestic reforms on the freedom and predictability of trade has been remarkable. The Most-Favoured Nation (MFN) applied tariffs of low- and middle-income countries have declined by 70 percent since the mid-1980s (World Bank, 2017a). And about 85 percent of exports from the poorest countries now enter advanced countries duty-free (UN Committee for Development Policy, 2019). The effectively applied tariffs (which take account of all preferential agreements) have declined even more. Despite a hiatus in the wake of the global financial crisis, world trade now represents a far larger share of world GDP than it did twenty and thirty years ago.

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## 5 Crucial questions for the future of the world trading systems

The future of the trading system hinges on the answers to three related questions, and the scenarios related to them (see also Akman *et al*, 2019).

### Can the WTO be reformed?

**Good scenario:** in a good scenario, the WTO's negotiating arm would be revitalised, on the condition that the membership can agree to move forward on specific issues and to address them through plurilateral agreements<sup>6</sup>. These would involve members who represent a critical mass of trade and who would be willing to grant concessions to non-participants on an MFN basis. It is also possible that members accounting for a critical mass of trade could agree a plurilateral agreement that is not MFN in exchange for concessions in other areas, as happened with the Agreement on Government Procurement agreement which was approved under the Uruguay Round.

It is difficult to imagine that plurilateral agreements can be reached without the involvement of the major trading economies, underscoring the importance of the United States, China, the European Union and Japan, among others, resolving their present differences. An important part of that discussion, in our view, will be to find ways to improve the operation of the agreement on subsidies and countervailing measures, so that it effectively constrains WTO members, especially those where the rule of law and the judiciary do not operate as they do in the US and the EU. Such improvements would also go a long way towards responding to the concerns of the US about the WTO's judicial function.

**Bad scenario:** if the WTO negotiating arm is not revitalised, the institution will lose relevance and its judicial role will be undermined. Trade law, like any law, must evolve with the times to maintain its legitimacy, requiring a functioning rule-making system. Most urgent at the time of writing, the WTO Appellate Body requires at least three members and could cease being operational as of November 2019 if retiring members are not replaced. This would undermine the resolution of trade conflicts within a binding legal framework.

### Do the Trump Administration's trade policies constitute a new normal in the United States or are they are an aberration?

**Good scenario:** many of the concerns expressed by the current administration, especially those related to China, will persist. However, the tone and the methods deployed will change in the future. We do not believe that the United States' body politic is likely to abandon the WTO completely. Most American politicians and American businesses do not favour a lawless trading regime, even if they do not exclude a power-based approach to China's perceived infractions. Especially pressing today is the question of whether the United States will challenge the WTO dispute settlement system only on procedural grounds – in which case solutions might be found – or whether it has come to perceive it as an unacceptable infringement on its sovereignty. Again, our baseline belief is that it is likely that a future United States administration would accept procedural changes to the WTO dispute settlement system that address its concerns; however, we are less sure that the current administration is prepared to do so.

**Bad scenario:** rightly or wrongly, an important ruling by the WTO dispute settlement body against the US could lead the US to leave the organisation. Other countries would then

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<sup>6</sup> The rationale for plurilaterals is that it is easier for a subset of WTO members representing a 'critical mass' of nations to reach agreement on a single issue of importance to them, than for all WTO members to agree on a very wide set of issues. The 'everyone has to agree on everything' approach to WTO negotiations (single undertaking/consensus approach) has become extremely unwieldy with the increase in the number and diversity of WTO members and the increase in the number of issues that the WTO deals with.

need to face the reality of a WTO without the US. If the US reverts to a policy of isolation and protection – as it did for much of the nineteenth century and early twentieth century, a vast share of its exports and imports will no longer be covered by agreed rules. It is also possible that the US and other major trading nations will increasingly be tempted to ignore these rules if they cannot be updated in negotiations.

### **Is the Chinese system compatible with the WTO and if so, is China willing and able to implement the reforms needed to address the concerns of its main trading partners?**

**Good scenario:** China has derived great benefits from its membership of the WTO and more broadly from policies of closer integration into the global economy. Naturally, China should want the system preserved. However, there are clear instances of Chinese free-riding in relation to China's large SOE sector, various forms of state intervention that tilt the playing field, forced technology transfer, lack of market access and the lack of protection for intellectual property. These issues would be gradually addressed.

**Bad scenario:** China refuses or is unable to undertake the reforms to its state capitalist system that are required to create a more level playing field in international trade. Tensions with the US and its allies escalate, and countries are forced into the unwanted choice of siding with China or with the US. As in the scenario in which the US turns inwards, all aspects of international relations would become more complicated.

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## **6 What should the EU strategy be? Towards a Plan A and a Plan B**

In addressing the implications of these scenarios, the EU should act on the basis that globalisation will continue even if, or as, the trading system runs into severe difficulties and slows the process for a while.

To understand the persistence of globalisation, it is useful to keep in mind the three forces behind it. First, globalisation is an entirely spontaneous economic process driven by arbitrage (buy low, sell high) in the world markets for goods, services, capital and labour. Human beings will continue to engage in this arbitrage, which they do as naturally as they breathe.

Second, the arbitrage process in the four markets is greatly facilitated by improvements in transportation and information technologies, which reduce trade costs, including communication costs and face-to-face costs. These improvements have enabled a significant transformation in the international division of labour that began around 1990 in relation to industry, production processes and tasks. And now, we are experiencing a drastic reduction in matching costs for business-to-consumer and consumer-to-consumer transactions, which might trigger the development of massive services outsourcing. These changes are expected to continue and even accelerate, mainly because of further advances in information technologies.

Third, it is true that historically, policies, macroeconomic depression and international conflicts have interrupted globalisation in individual countries and regions in many instances, and, sometimes even across the world. However, history shows that a withdrawal from globalisation is not technologically or economically sustainable. Politically, countries that have withdrawn from globalisation have often also had to resort to repression. In shaping their long-term strategy, EU policymakers should assume that no country, even the largest such as the US or China, can isolate themselves from globalisation without incurring enormous costs.

EU policymakers need to redouble their efforts to ensure that the multilateral trading system is preserved – Plan A.

The main aim of Plan A would be to preserve the multilateral system, which is not only a fun-



damental interest of the EU but is arguably even more critical for small economies around the world. Plan A is quite close to the strategy that the EU has been pursuing in recent years but we also recommend some important adjustments that would increase the probability of success.

The EU is pursuing several objectives at present, and is doing so quite appropriately:

- The EU is striking bilateral and regional trade agreements, and engaging in domestic reforms that improve its international competitiveness and facilitate its integration into global value chains. The successful conclusion of trade agreements with Japan and Canada, and the ongoing finalisation of the agreement with Singapore, are in line with that strategy. These steps increase the competitive pressure on all other economies to remain within the present trading system, including within the WTO as the legal bedrock of the system. These are also steps that guard against the worst consequences of bad scenarios, should they materialise.
- EU members are pursuing measures that aid the adjustment of the most vulnerable to the proliferation of labour-saving technologies and to international trade involving low-wage economies. These policies require the pursuit of *ex-ante* and *ex-post* domestic policies that help ensure that global economic engagement does not increase inequality. The EU, with its comparatively strong welfare systems, is in a good position on these issues, even though it is costly and open to regulatory arbitrage. Its welfare systems and its training systems will need further adaptation – subjects that are beyond our scope here, but critical <sup>7</sup>.
- The EU endorses plurilateral approaches to WTO negotiations. It supports WTO reforms in critical areas such as the operation of global value chains (investment rules, intellectual property protection, trade facilitation, etc), digital trade, services and agriculture.
- The EU supports procedural changes to the WTO dispute settlement process to improve the speed and thoroughness of the system. While these changes need to take into account the concerns of the United States, the focus should be on making the system work better for all parties.
- The EU continues to make full use of the WTO dispute settlement process to deter unilateral measures. It should always be clear to the EU's partners that, in the event of their taking protectionist steps that affect the EU, such steps will backfire on them. More specifically, should the United States impose tariffs on automobile imports from its allies on national security grounds, the European Union should consider this action an emergency safeguard measure (not a legitimate national security measure) and retaliate as per the emergency safeguards agreement, as was done for steel and aluminium.
- The EU recognises that the United States, which has long been the lynchpin of the international trading system, is legitimately pushing for changes to some aspects of the current system, especially in relation to China. At the same time, the EU should insist that the US plays by WTO rules.

There are also major areas in which the EU can do more to increase the likelihood that the trading system will be preserved – ie that Plan A will succeed.

- As an integral part of Plan A, the EU should re-examine its own red lines. It should review its trade and macroeconomic policies with greater alacrity than is presently evident. This would include another look at the Common Agricultural Policy with a view to reducing subsidies, tariffs and non-tariff barriers <sup>8</sup>. It would also include reducing its applied tariffs in sectors such as textiles, automobiles and in various other cases where tariff peaks exist. Ideally, these measures would be implemented through MFN commitments under the WTO. Alternatively, they could be used as means to make progress on crucial bilateral

<sup>7</sup> See for example Darvas and Wolff (2016).

<sup>8</sup> In addition to responding to the demands of some advanced nations, agriculture reforms would encourage many developing nations to redouble their commitments to the WTO.

**The EU should re-examine its own red lines, reviewing its trade and macroeconomic policies with greater alacrity than is presently evident.**

**The EU cannot change China's state capitalist system, but should insist China adopt reforms that avoid the most blatant trade distortions.**

negotiations, such as those with the United States and with Mercosur.

- As part of these reforms, countries with very large current account surpluses should re-examine the appropriateness of their macroeconomic, taxation and structural policies. Large-surplus countries are right to affirm that neither global nor bilateral trade imbalances can be, nor should they be, effectively corrected through trade policy measures, but only through changes to macroeconomic and structural policies. But large-surplus countries should also show greater willingness to adopt such macroeconomic and structural reforms, which are ultimately also matters of self-interest for these countries.
- The EU needs a policy that reflects China's rising economic weight without – as appears to be happening in US-China relations – falling into the trap of geopolitical competition that might have ominous consequences. For all its remarkable progress, China remains on average a relatively poor country, with per capita income at PPP 21 percent lower than that of Bulgaria, the EU's poorest member (World Bank, 2017b). China's exports of goods and services per person in 2017 were only \$1,743, compared to \$6,800 for the United States, \$12,388 for France and \$21,000 for Germany (World Bank, 2017c, 2017d). Still, these averages mask the fact that some parts of China are now high-income regions and several Chinese firms are now at the cutting edge of technology and sophistication. The richer regions of China are comparable in size to some nations in Western Europe, and their economies directly compete with European industries.

China's rapid transition poses major governance challenges for its leaders. It should be clear that the EU cannot change China's state capitalist system. It should instead insist that China, which is by some measures already the world's largest economy and appears destined to become the largest trading nation by a wide margin, must rapidly adopt reforms that avoid the most blatant trade distortions – reforms that correspond to its new-found status.

China doing its fair share would include reducing its MFN applied tariffs and adoption of stringent rules on subsidisation in traded sectors, on protection of intellectual property and on the rights of foreign investors. The frameworks governing SOEs – in China and elsewhere – should minimize their distorting effect on international trade<sup>9</sup>. The best way to achieve these reforms would be through a multilateral effort in which China is a leading participant.

In shaping its trade relationship with China, the EU should be wary of generalisations and stereotypes and should focus instead on specific cases of infringement. For example, China's SOEs are far less productive and innovative than its private companies and, while their share of investment has risen in recent years, their share of profits and exports has declined sharply. In some export sectors, Chinese subsidies, where they exist, might even be positive for European consumers. On the other hand, such subsidisation schemes, even if they are bad for Chinese growth and good for European consumers, can represent unfair competition or dumping policies, which are harmful for European producers in some instances.

The EU should be especially vigilant in relation to China's protection of, and state support for, young industries where first-mover advantage and economies of scale determine long-term competitive positions. Here, strong responses are needed as long-term advantages could be gained by China that would risk loss of significant parts of the EU's value creation for a long period of time.

When it comes to forced technology transfer, European companies make the choice to invest in China and many are adept at deciding which technologies they expose and which they protect. But the Chinese policy of using market access as a lever to force technology transfer is problematic and needs to be addressed. In the medium term, though, the EU might not remain a net loser from the transfer of intellectual property, given that China is already the largest source of new patents and scientific articles and increasingly needs to protect its

<sup>9</sup> Also within China there is a debate on how to achieve a level playing field between SOEs and private companies. This discussion comes under the heading of 'competitive neutrality'. We are not in a position to assess how far the recent decisions will go. See, for example, <https://www.caixinglobal.com/2018-12-26/state-council-endorses-competitive-neutrality-101363735.html>.

own innovations. This provides some negotiating space for the EU in its relations with China.

All that said, in shaping its China policy, the EU should bear in mind that European consumers and firms derive large benefits from the rapidly expanding trade and investment links with China. China is a far less export-driven economy than it was just a few years ago and it now imports almost as much as it exports. Moreover, China, which in 2017 imported goods and services amounting to \$2.2 trillion, roughly 30 percent less than the United States, could under plausible assumptions<sup>10</sup> import 30 percent more than the United States in 2030. It is therefore in the EU's interest that China reforms and remains an important market for European companies.

China's size, its long history of state involvement and of state capitalism, and the considerable extent to which its different provinces can pursue independent policies, means that the reforms needed to eliminate these distortions are complex and will take time. The EU must strike a balance between exercising continuous pressure for change while avoiding falling into the trap of geopolitical rivalry.

Such a constructive approach towards China encourages change through the WTO and through bilateral negotiations. The China policy needs to be complemented by the strengthening and the build-up of domestic EU instruments that ensure a level-playing field within the EU. For example, the EU's state aid instruments need to evolve so that subsidised foreign companies entering the EU market cannot distort the market. While such measures need to be WTO-compatible, they cannot be based only on notifications to the WTO, as these are insufficiently accurate and timely.

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## 7 The risk of a collapse of the multilateral trading system is real and must be addressed systematically

Plan A might fail for a variety of reasons, in particular if the various bad scenarios materialise. The EU therefore must reflect on a Plan B. This Plan B is clearly not a desired outcome, but it would be careless not to reflect on what the world would look without a functioning WTO and with trade relations based on power relations. The risks are too high for the EU to ignore such an outcome.

In the worst-case scenario, the WTO could collapse quickly – ie over the next few years if the US refuses to replace members of the Appellate Body – or the organisation might gradually lose relevance over the next decade or two if its negotiating arm is not revitalised. In the latter case, the EU has more time to execute Plan B, but Plan B is still needed today.

If the United States refuses to replace the members of the Appellate Body, the EU, with China, Japan and others, could conceivably continue for a while to operate under present dispute settlement arrangements minus the United States, until a more permanent arrangement is found that engages the world's largest economy (or until a new US administration reverses course). It is also possible that the EU, China and several other parties could decide to resort to an alternative mechanism for dispute resolution within the WTO, ie arbitration under Article 15, a procedure that is purely voluntary and that the United States might or might not decide to accept.

However, none of the alternative arrangements are likely to be permanent. Unless the negotiating arm of the WTO is revitalised – which would almost certainly become more difficult if the US remains outside – the EU cannot discount the possibility that the days of

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<sup>10</sup> The assumptions are that China's real GDP grows at 6 percent a year from 2017 to 2030 and that the United States' real GDP grows at 2 percent per year, and that Chinese and US imports grow at the same rate as their respective GDPs.

**Under Plan B, the EU's greatest challenge would be to avoid that its trade with the US and China becomes disrupted by a series of unmanageable disputes.**

the WTO as we know it are numbered. Not only would the dispute settlement system have lost credibility and the negotiating arm ground to a halt, but the EU would have lost its most important ally in its effort to modernise the organization, move forward on the new issues and provide a counterweight to China's rising power. The day might then come when, even for the EU's multilateralists, the benefits of WTO membership might be more than offset by the constraints it imposes and the unwieldy nature of its negotiating procedures.

In those unfortunate circumstances, the essence of Plan B would be a wider set of bilateral and regional trade agreements. However, while under Plan A the purpose of these agreements is to support and complement the WTO, under Plan B the purpose of the EU's bilateral and regional agreements would be to replace the WTO to the greatest extent possible. That means that the EU must seek an even wider set of agreements that also include effective dispute settlement provisions. Already, individual EU members are covered by bilateral and regional agreements (the EU itself) for, on average, about 75 percent of their trade. Several new agreements are also being negotiated with Singapore, Vietnam, Mexico, Chile, Australia and New Zealand (European Council, 2019). Assuming the agreements hold, individual EU members would be protected to a significant degree from the worst consequences of a world without the WTO. Assuming NAFTA or some version of it survives, the US would also be protected to a degree, though less so than EU members. China is the least protected of the large traders, but is working towards more bilateral trade agreements, including through its Belt and Road Initiative.

Under Plan B, the EU's greatest challenge would be to avoid that its trade with its largest trading partners, the US and China, becomes continuously disrupted by a series of unmanageable disputes. While the EU could possibly rely on its size and influence to maintain some order in its trade with small nations, based on historical norms even in the absence of trade agreements, the same cannot be said of the US and China, with which the EU is quite evenly matched.

In fact, a distinct possibility under Plan B would be that the global trading system breaks down into three major blocs – with far reduced trade between those blocs and increased trade within them. The global economy would certainly suffer a major blow from such a scenario.

Under Plan B, bilateral negotiations with the US and China would therefore acquire far greater urgency. At present, the most important of these is the strained negotiation with the United States, a successful conclusion of which would almost certainly require a major redrawing of the EU's red lines (as mentioned). Further down the road, the initiation of a bilateral trade agreement with China would be just as critical. Current exploratory negotiations with China are limited to a bilateral investment treaty. As part of Plan B, the EU should immediately launch a study on what a trade agreement with China would entail. It could well turn out that such an agreement would be unviable, because the terms would be unacceptable either to the EU or to China, or to both.

The EU will also need to reach a comprehensive bilateral trade agreement with the United Kingdom, which is one of its most important trading partners, because the WTO framework would no longer be available. Here, its weight gives the EU considerable leeway in setting the terms of the agreement as the UK will be fully dependent on an agreement with the EU, by far its most important trading partner (46 percent of the UK's good exports go to the EU).

If the WTO falters, and if the EU was then unable to reach bilateral trade agreements with the United States and China, trade relations with the EU's most important partners could continue for a while to be based on inherited norms. A natural initial reference point would be the presently applied tariffs and rules of the WTO. It is conceivable that such disciplines could be maintained under bilateral interim deals and could be enforced under an agreed dispute settlement system, such as arbitration or such as already exists as provisions in many bilateral regional agreements.

As part of Plan B the EU should start to study how such a system could be made to work to minimise disruption. A system of this kind would be hugely inferior to the present WTO, but it could also offer some advantages of speed and flexibility. For example, remedies could be better articulated, including the possibility of financial compensation. And, the system would allow for the negotiation of partial rules or agreements in specific sectors, allowing for a process of continuous renewal.

From a global perspective, such arrangements would be clearly far inferior to the present multilateral system. However, this shortcoming could be mitigated to some degree by allowing for an open architecture under which third countries could negotiate to become part of one of the ‘mega-regional’ arrangements, of which there would naturally be three, EU-US, EU-China and China-US. Clearly, the most exposed to a collapse of the present system would be the middle and lesser powers, whose bilateral agreements cover little trade. For example, countries such as Brazil, India and South Africa – countries with a history of protectionism – would be more exposed than countries such as Chile, Mexico and Morocco.

The preparation of Plan B should not be done solely by experts working in isolation. It should instead involve consultations with a wide group of stakeholders. One notable consequence would be to sharpen the understanding of what a failure of Plan A might entail. It is important that everyone understands that the counterfactual to redrawing the EU’s, the US’s and China’s red lines might not be the status quo, but something far worse.

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## 8 Conclusions

The global trading system is currently severely challenged. The EU should pursue its current Plan A, while moving some of its red lines. Plan A consists of fostering more bilateral trade agreements and constructively but firmly engaging with China on reform of its economy while seeking to find solutions with the US. To make success more likely, the EU should reconsider some key issues, such as more forcefully addressing its internal and external imbalances and opening up its agricultural markets more readily in the context of WTO agreements or new bilateral agreements.

But equally importantly, the EU needs to prepare for a world in which the global multilateral trading system is damaged beyond repair. Studying this scenario more carefully will also help all involved players from the US, China and the EU to grasp the costs they might face. In this way, the chance of compromise might be increased.

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