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Research Report

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SWP Comment

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Sea Change in EU Trade Policy

Opportunities for diversification in the Indo-Pacific

Hanns Günther Hilpert

Europe's trade policy is heading for a sea change. But it is not Putin's war of aggression against Ukraine that is the main reason for this development. Rather, there are long-term influencing factors at work here: the WTO-centred multilateral trade order is visibly eroding. Protectionism is on the rise around the globe. World trade is growing only marginally or is even stagnating. Globalization is undergoing a transformation whose outcome is uncertain. And international trade is increasingly being instrumentalized for political purposes. In February 2021, the European Commission responded to these structural upheavals by announcing an "open, sustainable and assertive trade policy". However, there has so far been uneven progress towards implementing the objectives included in the new trade policy strategy. While the EU's intention to strengthen both Europe's assertiveness and the sustainability of trade is being realized through numerous new instruments and measures, its promise of openness and liberalization remains unfulfilled for the time being. In particular, the Indo-Pacific region beyond China would offer the German and European economies significant opportunities to tap new sources of raw materials and access reliable supplier networks and growing sales markets.

The EU's response to the political and structural trade challenges of the 21st century has been quite remarkable. The following stand out as important steps towards European strategic autonomy: the EU foreign investment screening mechanism (10/2020), the anti-coercion instrument (12/2021), the updated European industrial strategy focusing on climate neutrality and digital transformation (05/2021), the European chip bill (02/2022) and the European supply chain draft law (02/2022). These laws and measures provide European industries and businesses with some protection

against both unfair competition and non-European trading partners that seek to put political pressure on the EU. Thus, they are manifestations of an emphatically defensive orientation of trade and industrial policy. But beyond these measures to protect companies and consumers, trade policy must not lose sight of international competition and global markets. It is important that European companies also take an offensive approach to accessing new supply and sales markets and reducing their obvious vulnerabilities in doing business with China.



Opportunities for a liberal foreign-trade policy

It would be wrong to conclude from the experience of the current existential geopolitical risks in foreign trade with Russia and China that globalization and the international division of labour need to be rolled back. On the contrary, cross-border trade in goods, the movement of services and foreign direct investment have all paved the way in recent decades for enormous growth in prosperity worldwide and have contributed significantly to overcoming underdevelopment and reducing poverty in the Global South. The deepening of the division of labour has enabled participating businesses to make significant increases in productivity. It has stimulated innovation, led to greater product diversity and may well have dampened inflationary trends at the same time. The opportunities for individual economic returns and the prosperity gains for society as a whole are too huge to even consider the dismantling of foreign trade and globalization as a desirable option, let alone allow it to become a dominant global trend.

As an economy particularly strongly interconnected with the world economy, Germany has benefited more from globalization in recent years than other industrialized countries of a comparable size. For this reason, it should be very interested in a Europe whose foreign trade is open and liberal. Trade policy efforts to improve protection against unfair competition and strengthen the resilience of domestic industry and supply chains need therefore to be complemented by an active liberalization policy — for example, concluding free-trade and sectoral agreements with non-European trading partners.

In addition to the basic productivity and growth opportunities afforded by a liberal foreign-trade policy, the pursuit of an active trade policy can make tangible contributions to Europe's green and digital transformation; and it can reduce the geopolitical vulnerabilities of European companies:

- Elements of a climate-friendly industry and agriculture can be included in the

sustainability clauses and sector chapters of trade agreements. Political commitments to environmental protection or concrete measures to reduce CO₂ emissions can be made legally binding not just inside but also outside Europe. In addition, new markets for climate-friendly products and processes can be opened up.

- International cooperation is essential for the success of Europe's digital agenda. The governance and standardization of digital services and trade in digital goods must be tested, implemented and made binding in international practice. The EU's desire to have a say in the establishment of international rules, including with regard to data security, and in the creation of fair competitive opportunities for European companies by clamping down on regulatory protectionism demands an active digital trade policy — both bilateral and multilateral.

- Trade agreements open up access to sales markets and sources of supply and make it possible to limit economic and political risks through diversification. Companies with a broad international presence are generally better equipped to deal with unexpected events such as Covid-19, the Ukraine war and the recent Taiwan crisis. Production locations and purchasing and sales markets scattered over a wide area make it easier for German and European companies to reduce their vulnerability to a China that not only threatens economic competition but also poses foreign- and security-policy risks that are extremely difficult to predict. That is because neither decoupling from China nor reshoring or rigorous friend-shoring of supply chains can be a viable option for companies competing internationally. In a world in which the G7 account for about 10 per cent of the world's population and a good 30 per cent of world trade, a policy that sought to limit foreign trade to those countries with which Europe shares the same values would be unrealistic and self-destructive. While soberly weighing potential returns against geopolitical risks, European companies

must at the same time strive to diversify their sales markets and sources of supply and not restrict their choices of location for production facilities unless absolutely necessary.

Indo-Pacific – a key region

The Indo-Pacific, geographically defined as comprising the sub-regions of South, South-east and Northeast Asia as well as Oceania, is by far Europe's most important regional partner in foreign trade, accounting for 33 per cent (2021) of the EU's total non-European trade. The Indo-Pacific is also the fastest-growing region in the world; in 2021, it accounted for 44 per cent of global economic growth (based on purchasing power parity), with China alone accounting for 22 per cent. Realistically, the region's multi-decade growth trend can be expected to continue for some time, unless the Indo-Pacific economies are derailed by a disruptive military conflict. Given the market size and growth potential of this region, it is clear that the EU's regional trade policy should prioritize the Indo-Pacific. But besides economic considerations, there are also political arguments in favour of a shift towards this region, as the EU High Representative for Foreign Affairs and Security Policy made emphatically clear in September 2021 when he unveiled a European Indo-Pacific strategy. Europe's self-interest in maintaining peace and stability in Asia, in preserving a rules-based world order and in upholding and respecting democratic principles and human rights demands a stronger engagement and deeper cooperation with the countries of this region. Thus, for both economic and political reasons, it is imperative that the EU's trade policy priorities are directed towards the Indo-Pacific region. There can be no doubt that an offensive liberal trade policy is also appropriate with regard to other non-European regions of the world. However, it is precisely Europe's claim to be able to assert itself in an environment of geopolitical rivalries – a claim associated with the

guiding principle of “open strategic autonomy” – that requires an active trade policy engagement in precisely that macro-region which, by virtue of its size and dynamism, has established itself as the centre of gravity of world trade and the world economy.

European trade policy has tapped only part of the potential of the Indo-Pacific region. To date, free trade agreements have been concluded with just four important partner countries – Korea, Japan, Singapore and Vietnam. Unlike the US, Canada and Japan, the EU has not succeeded in networking with the region through multilateral trade agreements. The opportunity to expand and deepen trade and economic relations (for example, via ASEM) with the Indo-Pacific through a region-to-region agreement or interregional strategic cooperation has never been seriously considered. Nor did the negotiations for a free trade agreement with ASEAN, which began in 2007, go beyond preparatory consultations and the exchange of technical information; and in 2010, they were suspended by the EU because of the difficult and unpromising nature of the talks. Also, contrary to the political conviction of the High Representative – and in contrast with the course adopted by the US, Canada, Japan and the UK – the European Commission's Directorate-General for Trade has not made the Indo-Pacific the focus of its regional trade policy.

Regardless of any misjudgements or strategic failures in the past, the imperative of the present should be to exploit the economic potential of the Indo-Pacific through trade policy and to develop supply sources and production locations in the region outside China. In terms of foreign trade, the EU should be pursuing two main strategic goals. First, given the now dense tapestry of discriminatory bilateral and multilateral free-trade agreements, it should strive to enter and operate in the markets of the Indo-Pacific region on the same terms of access as its main competitors – for example, Japan, China, Korea and the US. However, non-discriminatory market access can be achieved only by concluding binding trade-policy agreements. Second, the EU

has a strategic interest in its own trade and regulatory standards being recognized and enforced in the Indo-Pacific. If the countries of the region are working on the further development of standards within the framework of the transregional alliances RCEP (Regional Comprehensive Economic Partnership), CPTPP (Comprehensive and Progressive Agreement for Trans-Pacific Partnership) and IPEF (Indo-Pacific Economic Framework) — separately from and probably in anticipation of corresponding multilateral agreements at WTO level — the EU should feel compelled to exercise influence, directly or indirectly.

And the opportunities for opening markets in the Indo-Pacific and reducing economic vulnerabilities through trade agreements are fundamentally good. Within the region, there remains a high level of interest in the European single market and European investments, not least because the Indo-Pacific states want to limit their economic dependence on China. The economic and political weight of Europe, the referential model character of the EU and its regulatory standards all speak in favour of the EU.

In order to optimally exploit the potential of the Indo-Pacific region, a three-pronged trade policy agenda is to be recommended. First, the existing trade agreements with Korea, Japan, Singapore and Vietnam must be expanded. A positive example here is the current efforts by Germany and the EU to reach a digital partnership agreement with Singapore, Japan and Korea. Second, the EU should seek integration with the multilateral trade-policy networks (RCEP, CPTPP, IPEF). Third, at the bilateral level, Europe's trade and investments should be liberalized through individual agreements with as many partner countries in the region as possible. The following analysis focuses on this third recommendation. It takes a closer look at the status of the ongoing negotiations about new EU trade and investment agreements with Australia, New Zealand, Indonesia and India and what the prospects for concluding such agreements are.

Australia and New Zealand – partners with shared values

Located on opposite sides of the planet, the EU and Australia/New Zealand have grown closer politically and economically in recent years, notwithstanding the UK's exit from the Union (Brexit) and historical reservations on the fifth continent about protectionism stemming from the Common Agricultural Policy. The mutual interest of defending the liberal world order, similar views about trade liberalization and multilateralism, and the same perception of global and regional threats have fostered this closeness. To put their good relations on a treaty footing, the EU and New Zealand concluded a partnership agreement in 2016 while Brussels and Australia reached a framework agreement in 2017. Australia and New Zealand rank 21st and 50th, respectively, among the Union's most important trading partners in terms of trade volume (€42.3 billion and €7.8 billion in 2021). At the same time, the Union is the third most-important trading partner of both Australia and New Zealand. In June 2018, the EU launched parallel negotiations on a free trade agreement with Australia and New Zealand; but despite broad agreement on democratic values and the closely aligned foreign policies of the negotiating parties, the talks were not an immediate success. While the parties' agricultural interests were too conflicting, Australian reservations about European regulatory and sustainability standards were too strong.

In the end, the negotiations with New Zealand, which proved easier than those with Australia, were successfully concluded in late June 2022. The two sides agreed on almost total tariff exemption, albeit with significant exceptions for agriculture. Imports of sensitive agricultural products (beef, lamb, powdered milk, butter and cheese) to Europe remain restricted by quotas, much to the chagrin of the New Zealand agricultural lobby. However, the following are envisaged: the liberalization of digital trade, movement of services and public procurement as well as improved

protection of intellectual property rights, in particular the recognition of the geographical indications for 163 European food products and for the complete list of European wines and other alcoholic beverages. The binding sustainability agreements in the areas of labour, environment, climate, agriculture, forestry, fisheries and, for the first time, gender equality are both innovative and far-reaching; either side can respond to violations of core labour standards or the Paris Climate Agreement by imposing sanctions if necessary. The next steps include a legal review of the draft texts and the translation of the treaty into the official EU languages. The treaty will then be submitted to the Council for approval. Finally, it will be signed by the two parties and ratified by the European and New Zealand parliaments. The European side expects bilateral trade in goods and services to expand significantly — by an estimated 30 per cent — as a result of the agreement.

Negotiations with Australia are well advanced, too, and, following a short interruption due to French disgruntlement over the AUCUS agreement, have now entered a decisive phase. While Australian reservations about European sustainability standards are likely to be fewer under the government of Anthony Albanese, which took office in May 2022, they have not yet been dispelled altogether. Since Australia has committed itself by law to a 43 per cent reduction in CO₂ emissions by 2030 and to CO₂ neutrality by 2050, the two sides are on the same page with regard to climate policy. But it remains to be seen whether Australia will be willing to commit bilaterally, as New Zealand has done, to climate-policy sustainability standards that are sanctions-based.

However, the main stumbling block remains agricultural trade. There are still gaping differences between the offensive interests of Australia with regard to exports of grain and, in particular, meat and dairy products and the countervailing protectionist interests of Europe, especially France, Ireland and Poland. At the same time, the European demand that the geographical

indications for European food, wine and other alcoholic beverages be recognized meets with strong reservations. It is very unlikely that Australia will agree to a treaty like that negotiated with New Zealand. Canberra's demands carry more weight owing to the country's larger import market but, above all, because of Europe's urgent need for reliable access to crucial energy resources and raw materials. Given the Australian-European confluence of interests in geopolitics and current convergence on climate policy issues, the two sides should be prepared to reach a compromise on agricultural trade. Agreement on a free trade treaty would be an important milestone for the further development of the political and economic relations between Australia and Europe.

Indonesia and ASEAN

Europe continues to underestimate Indonesia as a trade and economic partner. Indonesia ranks just 31st among the EU's most important trading partners in terms of trade volume (€24.7 billion in 2021) and thus lags even the ASEAN neighbouring countries of Vietnam, Singapore, Malaysia and Thailand. The world's fourth-largest country in terms of population and the seventh-largest in terms of economic output at purchasing power parity (2021), Indonesia has the potential to become Germany and Europe's most important foreign-trade partner in Southeast Asia. A positive development is that the EU's political relations with Indonesia have gradually improved since the end of the Suharto dictatorship (1998) and have been amicably anchored in a partnership and cooperation agreement since May 2014. Given their respective commitments to the preservation of democracy, human rights and pluralism and their shared advocacy of a rules-based international order, it can be said that Europe and Indonesia are in political unison. And it is interesting that the EU and Indonesia have chosen the same slogan to emphasize the internal cohesion of their region despite all

the diversity: “United in Diversity” / “Bhinneka Tunggal Ika”.

But compared with political ties, European-Indonesian foreign trade relations and trade policy still have a lot of catching up to do. Indeed, the launch of negotiations on a bilateral free trade agreement in July 2016 was long overdue, not least since both the EU and Indonesia have been seeking to diversify their trade and economic relations. However, the two sides have different expectations of the Indonesia-EU Comprehensive Economic Partnership Agreement (IEU-CEPA). For its part, the EU hopes the agreement will lead to non-discriminatory access to Southeast Asia’s largest market and a strategically important supplier of natural resources and metals — on the same terms as competitors from Japan, China, Korea and the US. Moreover, it sees the negotiations as offering a unique opportunity to counter the protectionist tendencies of Indonesian economic policy and enforce regulatory and sustainability standards. But Jakarta’s main goal is to develop and modernize the domestic economy. The government of the island-state hopes that improved access to the EU’s internal market and increased investor confidence in Indonesia as a business location will stimulate both domestic production and employment and increase the inflow of foreign direct investment. The country’s economic dependence on China and Japan could thereby be reduced somewhat.

It is due to this fundamental divergence of interests that after 11 rounds of negotiations — and despite agreement having been reached on many points at the technical level — the two sides remain far apart on the substantive issues of market access, trade rules and sustainability. On the one hand, the EU demands that Indonesia abolish the manifold constraints to foreign direct investment, lift export restrictions on raw materials, open its services and public procurement markets and end competition-distorting subsidies. On the other hand, it is precisely these regulations that Indonesia sees as legitimate instruments to promote its development and industrialization. So

far, the negotiations have not clarified whether and to what extent the above-mentioned measures are in any way conducive to promoting development or whether, on the contrary, they are protectionist and even inhibit development.

The main bone of contention in the negotiations, if not in European-Indonesian relations as a whole, is palm oil. For Indonesia, the world’s largest producer of this commodity, the EU remains the third most-important market (after China and the US). But within the Union, the cultivation of palm oil in the tropics and imports of the product to Europe meet with the dual resistance of biofuel suppliers, which feel threatened by shipments from Southeast Asia and accuse Indonesia of inadmissible subsidies and unfair competition, and civil society groups, which point to the violation of labour and human rights and the ecological damage caused by palm oil production. Against this background, the EU, in its Second Renewable Energy Directive, no longer recognizes palm oil as a biofuel energy resource unless the sustainability of production can be proved. Indonesia, for its part, considers this directive an inadmissible protectionist measure but at the same time is going to great lengths to make the domestic cultivation of palm oil more sustainable. Resolving this issue is likely to involve the two sides reaching agreement on and enforcing certified sustainability standards for palm oil production, similar to the provisions of the Comprehensive Economic Partnership Agreement (CEPA) that Indonesia has concluded with EFTA. For a compromise to be reached, Indonesia would have to guarantee the reliable implementation of those sustainability standards in a legally binding way, including through strict control and sanction mechanisms. And the European side would have to actively seek to sell the agreement to the domestic agricultural sector and civil society, as Switzerland did ahead of the referendum on the EFTA CEPA with Indonesia.

An IEU-CEPA would serve the trade, geo-strategic and environmental interests of both sides. Moreover, the successful conclu-

sion of a free trade agreement with Indonesia, the leading ASEAN power, could pave the way for the EU to reach an interregional treaty with the entire ASEAN community. There are already signs that negotiations on a free trade agreement with Thailand, Malaysia and the Philippines will resume.

India – fast-growing market

The EU and India have been strategic partners since 2004. They have concluded various cooperation agreements and meet annually for a bilateral summit. At the same time, they are committed to maintaining the liberal, rules-based international order and seek reassurance against the vagaries of China's rise. However, the EU and India, which are each other's third and tenth most-important trading partners, respectively, have so far failed to conclude a bilateral trade or investment agreement. In fact, India unilaterally terminated the existing bilateral investment treaties with 23 EU member states in 2017. Moreover, negotiations on a free trade agreement, which began in 2007, were suspended in 2013 owing to irreconcilable differences. The main sticking points were the EU's sweeping demands for tariff liberalization, the opening of India's services and agricultural markets, improved patent protection, and social and environmental sustainability, while India was insisting on recognition as a country with an adequate level of data security and wanted flexible work permits and visa regulations for Indian skilled workers. Although these issues remain unresolved, the EU and India resumed negotiations on a "balanced, ambitious, comprehensive and mutually beneficial" trade agreement in 2022 and launched separate consultations on a bilateral investment protection agreement and the protection of geographical indications of origin. A joint Trade and Technology Council is to provide consultative and coordinating support for bilateral cooperation.

There can be no doubt that closer trade ties are in the political and economic inter-

ests of both sides. As non-members of the multilateral trade alliances RCEP and CPTPP, both the EU and India are, to all intents and purposes, isolated outsiders in the Indo-Pacific economic area. A bilateral free trade agreement would not only benefit both actors economically but also enhance their political standing. After all, the EU and India are important and attractive trade and economic partners for each other – Europe as a provider of investment capital, technology, infrastructure and as a door opener to global sales markets, India as a huge market with enormous growth potential and as a promising alternative manufacturing location to China. India has a good chance of continuing to develop along the path of urbanization, industrialization and demographic transition and growing at a rate of 6–7 per cent annually for some time to come. But for these prospects to be realized, the subcontinent will have to implement difficult internal structural reforms and permit a degree of external economic opening. As regards the latter goal, there is some cause for optimism because India is currently changing the course of its foreign trade policy. Fearing a neo-colonial dependence on its big neighbour to the north, the country is resolutely pursuing a policy of decoupling from China. At the same time, it is actively seeking integration into international supply-chains while striving to attract capital and technology and gain market access. Moreover, it is prepared to liberalize. In the first half of this year, India became a partner in the Indo-Pacific Economic Framework (IPEF), a US initiative, and concluded a free trade agreement with the United Arab Emirates and Australia. And negotiations for similar treaties with the Gulf Cooperation Council, the UK, Israel and Canada are under way. It is likely that India will be prepared to make more concessions to the EU than to other trading partners. For this reason, there are pretty good prospects of the EU concluding a comprehensive and ambitious free trade agreement with India. However, it would be illusory to assume that Brussels could impose European regulatory and sustainability

standards on India in the same way as it has on New Zealand. India, like the EU, is a trade heavyweight and a confident negotiator. To conclude a deal of substance, the EU will probably have to make more compromises than it has done with other partner countries in the past. But it is likely to be worth its while to do so.

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