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International trade under attack: what strategy for Europe?

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Executive summary

THE MULTILATERAL TRADING system is seriously threatened by the country which has been its main inspirer, the United States. The US position is focused on bilateral trade imbalances presumably resulting from unbalanced trade policies, but it is flawed. Not only does it make little sense given the existence of global value chains, but it also misses its target: what matters most are aggregate trade surpluses and deficits, which depend above all on the differential between domestic investment and savings, and little on trade policy.

THIS POLICY CONTRIBUTION first analyses the economic consequences of a full-scale trade war. Our estimates show that it would have a permanent effect of a similar magnitude on the GDP per capita of the three major global powers (the European Union, the United States and China) of around 3 percent to 4 percent of GDP, as big as the effect of the Great Recession of 2008-09. The impact would be much more damaging for small countries. By contrast, the EU is partly protected by the size of its internal market. In addition, the short-term effects would be even greater because of the negative supply and demand shock the global economy would be subjected to. For this reason, the EU must engage resolutely in a strategy of defence of trade multilateralism.

WE RECOMMEND COMBINING the adoption of firm and credible retaliatory measures in response to the current attacks with an offer of multilateral or plurilateral negotiations on legitimate issues: macroeconomic imbalances, institutional design of dispute settlement at the World Trade Organisation (WTO), reciprocity of commitments and updating of rules on subsidies, state-owned enterprises and intellectual property rights. However, considering how difficult plurilateral and multilateral negotiations with the US administration are, Europe needs a plan B. In the short term, this requires, for instance, coordinating a club of countries in order to identify and implement strategies to circumvent US blocking of the WTO at the Appellate Body level.

IN ADDITION, WE recommend pursuing an ambitious policy of trade agreements. The expected economic gains are modest. But trade agreements can play an additional role of insurance policies in case of full-scale trade war and can be used as leverage on other non-trade issues. Therefore, these agreements should change and address two main concerns about globalisation: environmental protection with the issue of global warming and problems related to tax evasion and optimisation.

WE THEREFORE RECOMMEND making the signing of trade agreements conditional on the adoption of the OECD's action plan to combat erosion of the tax base and the implementation of the Paris Climate Agreement. We put forward progressive monitoring and sanction measures to ensure effective implementation.

Globalisation, inequality and the rise of populism

Economists widely agree that international trade is an important source of benefits in terms of welfare. These benefits arise from better allocation of resources and greater economies of scale, and are reflected by lower production costs and prices and a greater variety of available products. There is a striking contrast with public opinion as several recent polls have shown (Printemps de l'Économie, 2018): 60 percent of French people have a negative opinion of globalisation and only 13 percent are favourable to deeper trade openness. The French are more critical of trade integration than the Germans: 75 percent of the French and 57 percent of Germans are favourable to greater protection against foreign competition. This fear of openness to international trade is part of a more general distrust: 47 percent of Americans and 36 percent of French people want more to be done to protect them from today's world (IPSOS, 2017). At the same time, 68 percent of the French and 55 percent of Germans consider that globalisation increases social inequality. Economists broadly share these concerns and point out that over the last thirty years, increasing globalisation in trade has increased competition between markets, often at the expense of certain categories of workers in developed countries.

Several empirical studies[1] have assessed the impact of increased imports from emerging and developing countries (mainly China) and the introduction of new technologies. While the increase in inequalities and the effects on wages and employment in developed countries can be partly attributed to the increase in imports from emerging and developing countries, these studies concluded, however, that technological change has played a more important role than trade. The studies[2] found that the regional employment areas most exposed to competition from Chinese imports – intensive in unskilled work – are those that have experienced the greatest decline in manufacturing jobs. In the case of the United States, however, the increases in manufacturing jobs from total exports are of the same order of magnitude as job losses brought about by imports from China, so the net effect on jobs produced by trade in goods and services is probably globally very limited (Feenstra *et al*, 2017).

'Increasing globalisation in trade has increased competition between markets, often at the expense of certain categories of workers in developed countries.'

Finding 1: The destruction of jobs in the manufacturing sector and the increase in inequality are partly but not primarily due to the increase in trade.

The estimates in this Policy Contribution confirm economists' view of international trade as a source of net benefits for countries that liberalise trade. Contrary to the view of the current US administration, trade is a positive-sum game. These benefits are, however, unevenly distributed and create losers. The criteria and the arrangements for transferring gains from the winners to the losers of globalisation need to be reconsidered: with the possible exception of the Scandinavian countries, industrialised countries have failed to redistribute the benefits of globalisation. In this regard, the exclusive competence given to the European Commission in matters of trade policy justifies the implementation of a European instrument seeking to mitigate the negative consequences of trade liberalisation. While this instrument already exists in the form of the European Globalisation Adjustment Fund, the tasks and resources assigned to it are manifestly insufficient[3]. It is certainly difficult to identify job losses specifically

1 WTO (2017) gives an overview of this literature; according to the cases studied, opening up to trade is alleged to be responsible for 20 percent of job losses.

2 This is in particular the case for the impact of Chinese imports on the US manufacturing sector; see Author *et al* (2013) and Malgouyres (2017).

3 Provided with a budget of €500 million per year when it was created in 2006, the resources of the European Globalisation Adjustment Fund were reduced to €150 million a year in the 2014-20 budget because of its under-use. For an analysis of the operation of the current system and proposals for reforms, see Claeys and Sapir (2018).

attributable to trade liberalisation, though it should not be an obstacle to European support for labour-market areas severely hit by unemployment. In addition, while trade globalisation requires resources, fiscal resources especially, to redistribute its benefits and effectively support the most vulnerable sections of society, financial globalisation, through the mobility of capital, of production and of the taxable base – in particular that of large corporate groups – makes this redistribution more difficult. In practice, along with competition and tax optimisation (or even tax evasion) it puts unprecedented pressure on our redistribution systems. Trade integration also acts as an incentive to tax competition as it facilitates the relocation of production in response to tax advantages. For this reason, the political sustainability of globalisation calls for trade liberalisation issues to be linked with tax competition issues. This sustainability is now being challenged in most advanced countries, which are confronted with movements of opinion in favour of greater protection. However, Guiso *et al* (2018) show that exposure to globalisation (as measured by the intensity of increased competition from Chinese imports) is not the only explanation for the rise in populism. In the countries mostly hit by the financial crises in the euro area (2008-13), economic insecurity and the perceived inability of governments to protect them effectively against such crises have added to globalisation as factors explaining the rise in populism (Guiso *et al*, 2018). There is also a parallel with the situation in the 1930s as recent work by economic historians shows that it was in countries that were unable (because of the gold standard) or unwilling to use monetary instruments to stimulate their economies that protectionist temptations were the strongest.

Finding 2. The rise of populism is not only or even primarily fuelled by trade openness but rather by the sense of economic insecurity and growing inequalities.

A repeated aim of the Trump administration is to reduce bilateral trade deficits (in particular with China and Germany). This focus on bilateral deficits and surpluses rather than aggregate trade deficits and surpluses is flawed. Bilateral imbalances are largely linked to the respective industrial structures or value chain mechanisms[4]. Since a country's trade balance is not determined by its trade policy but rather reflects its net savings, increasing trade protection has no impact on this balance, as the real exchange rate is adjusted, either by the nominal exchange rate or by inflation, if the savings imbalance persists. At the bilateral level, the argument is even more incongruous, given the poor economic sense of the bilateral balance in a context where supply chains are widely internationalised. However, the aggregate trade deficits and surpluses of large countries are a relevant issue since the global imbalances they generate might partly explain the 2008-09 crisis. But these imbalances have little to do with trade policies (tariffs and trade agreements). There is no empirical correlation between trade balance and customs duties[5]. The current account is impacted by macroeconomic factors, such as fiscal policy, exchange rates, asset prices and productivity. In order to prevent the protectionist and populist contagion, governments should thus not hesitate to use macroeconomic instruments to support the economy in the event of a crisis. While the macroeconomic response worked relatively well in 2009 at the G20 level, it was then defective, in particular in the euro area. We conclude from this that the debate on current imbalances should be shifted from bilateral trade issues to multilateral macroeconomic issues. While discussions on this subject can take place within the framework of the G7 or G20, the three main players are undoubtedly the USA, the EU (and in particular the euro area) and China (G3).

4 For example, Germany has an aggregate trade surplus (of €244.9 billion in 2017) and has bilateral deficits with a number of eastern European countries from which it imports intermediate goods. Gross bilateral deficits do not take into account the fact that the value of exported goods (eg from China to the US) represents not only the value added by Chinese companies but also the value of intermediate goods imported by China. This difference between gross bilateral deficit and added value is about 40 percent in the case of the United States/China.

5 There is no robust international relationship between the level of trade protection and trade balance. See, for example, Gagnon (2017) or Hufbauer and Zhiyao (2016).

Attacks on multilateralism and the uncomfortable position of the EU

Three decisions by the Trump administration constitute attacks on multilateral rules. The first, since 2017, concerned the blocking strategy on the appointment of new judges to the WTO Appellate Body, which could jeopardise the dispute resolution system. The Appellate Body, considered the 'crown jewel' of the WTO, is essential for the proper functioning of the international trading system, which relies on its ability to enforce the rules accepted by its members. The second decision (March 2018) was to invoke the national security argument to apply additional customs duties of 25 percent on steel imports and 10 percent on aluminium imports – which were implemented for the European Union on 1 June 2018 – amounting to $6.4 billion in total. In this context, the EU rightly believes that it is entitled to respond to unilateral US measures affecting the European Union, Canada and Japan. The fact that these countries are close allies invalidates the national defence argument. The EU adopted retaliatory measures amounting to €2.8 billion (which could be extended by 2020 in case of WTO approval). The rejection by the European authorities of a voluntary export restriction – which would go against WTO rules – in exchange for an exemption from US tariffs is also part of the defence of multilateralism and an approach based on the rule of law. The third decision (March 2018) was to introduce tariffs of 25 percent on $50 billion worth of imports from China, which the US administration accuses of infringements of intellectual property protection, threatening the US's innovation capacity; in June 2018, customs duties threats of 10 percent on $200 billion of imports were added.

These decisions, taken as a whole, generate trade tensions, which are in themselves a source of uncertainty. One of the strengths of the WTO rules system at the outset was to reduce uncertainty about future tariffs. The current unpredictability will have a non-negligible impact, similar to the increase of tariffs, not only on trade itself but also on investment. The EU will therefore be a victim of this unpredictability, but the cost in terms of investment can be limited if the EU continues to act as a force for stability based on compliance with rules. However, the EU is in a unique position between China, with which it shares a commitment to the multilateral rules system, and the United States, with which it has several common grievances in relation to China. These include steel (for which China has excess production capacity), intellectual property and the Chinese state's role in managing the economy. The 'Made in China' agenda is as much a concern for the European Union as the 'America First' agenda of the Trump administration.

Finding 3. The current trade tension is a source of uncertainty and unpredictability that will have a negative impact on trade and investment.

Avoiding a trade war

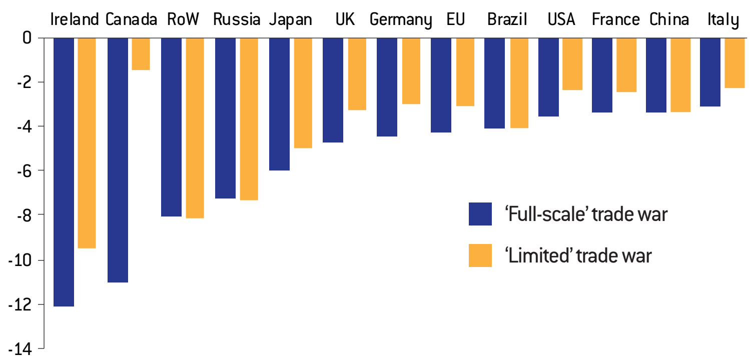
What would be the effects of a full-scale trade war?

The scenario of protectionist escalation at global level can no longer be ruled out. The global system based on non-aggression tariff commitments is fragile. The economic literature has shown that a large economy, by making use of its market power, can impose customs duties to its advantage to lower the price of its imports or to encourage the relocation of industries to its territory. However, the current US trade aggression is more a response to political sector-based rather than economic-based motives. Due to value chains, most economists believe that the imposition of tariffs, in particular on intermediate goods such as steel and aluminium, will be to the detriment of the US economy as a whole, even without retaliation. There could, however, be a series of retaliations and counter-retaliations. How much can world tariffs increase if we move from the current cooperative equilibrium to the non-cooperative equilibrium of a trade war? Two simulation studies indicate that tariffs would increase by 30 or 60 percentage points in trade war scenarios (Nicita *et al*, 2018; Ossa, 2014).

An estimate of the long-term impact of the most dramatic scenario was established with a 60 percentage points increase in tariffs on manufactured goods between the world's major countries (currently below 3 percent on average for the US and the EU) and restrictions on trade in services (Vicard, 2018). The European single market (post-Brexit) in this scenario remains intact and customs duties remain zero within the EU. Two scenarios are then considered: the first scenario, that of a full-scale trade war, where the new tariffs are applied everywhere except within the EU and the second scenario, involving a limited trade war, where the tariffs are not applied either within the EU or between countries that have signed bilateral trade agreements.

The methodology we use exploits the most recent developments in academic literature described as 'new quantitative trade models' (see Mayer *et al*, 2018). It can be broken down into two stages. The first involves estimating the impact of tariffs and various types of regional trade agreements on trade based on historical precedents (data on international trade between 1948 and 2016). This makes it possible to simulate the impact of a change in costs on all trade flows between two partners. This exercise takes diversion effects into account: for example, an increase in customs duties between the United States and the European Union destroys trade between them but increases France's trade with its European partners. The second stage involves translating this variation in a country's trade openness into an impact on its real income. These simulations reflect the long-term impact of a trade war after adjustments in jobs and wages have been made: they thus underestimate certain short- to medium-term effects.

The consequences of a global trade war, in % of GDP



Source: Vicard (2018). Note: RoW = rest of world.

The 'full-scale war' case shows that the permanent loss of GDP would be more than 4 percent for the EU and more than 3 percent for France (Figure 1), ie an annual average loss of €1,250 *per capita* in the EU and €1,125 per capita in France. These losses are the direct consequence of a sharp fall in trade. For example, France's trade outside the EU would fall by about 42 percent. The smaller and more open the countries are, the more they are affected with larger losses by the increase in production costs (through the destruction of value chains) and consumer prices and by the loss of markets. In a global trade war scenario, EU countries are partly protected by their membership of the European internal market. However, this fall of more than 3 percent in GDP for France should be compared to the loss of potential GDP that France suffered following the Great Recession of 2008-09, estimated to be 2.2 percent by Ollivaud and Turner (2015). This calls into question the US assertion that the EU and China would be the only losers in a trade war. A remarkable result of these simulations is that the losses of the three major trading powers (the United States, China and the EU) are roughly equivalent, namely around 3 percent for China and the United States and 4 percent for the EU. For other open countries, these losses are much higher (more than 10 percent for Ireland, Canada, Switzerland, Mexico and Korea). Moreover, the literature has documented the long-term negative dynamic effects of an increase in customs barriers on long-term growth, in particular through the emergence of an administered economy that is not conducive to innovation and to the proper allocation of production factors[6]. Models integrating this decrease in productivity growth deriving from protectionism result in much higher permanent losses (at least doubled) (Sampson, 2016).

Finding 4. A global trade war would have a permanent effect on the three major global powers (EU, United States and China), of similar magnitude to that of the Great Recession of 2008-09.

These estimates underestimate short- to medium-term effects since the macroeconomic and financial impact is not taken into account on this time scale. In the short- to medium-term, the sharp loss of purchasing power brought about by the increase in taxes worldwide should trigger a negative demand shock and a negative supply shock as well, because of the rise in the price of intermediate goods in global production chains. In addition, the fall in world trade would cause a major sectoral adjustment with large-scale job losses in exporting sectors that would not be able to be quickly offset by job creation in importing sectors, with a resulting sharp increase in unemployment. Several other mechanisms could have a negative impact: higher risk premiums in financial markets, increased uncertainty and possible tightening of monetary policy by central banks in response to inflationary pressures generated by tariffs[7]. The counter argument, however, is that the announcement of Brexit, which actually opened an era of uncertainty for the UK, did not, despite the recent slowdown in UK growth relative to its European partners, trigger the recession that some economists may have feared. Does this mean that the risks of a trade war, with uncertainties that go with them, are overestimated? We do not think so as, in the particular case of Brexit, the United Kingdom was able to benefit, at least in the short term, from a sharp depreciation of its currency, which dampened the shock. Since, in the event of a trade war, the shock would be global, exchange rate adjustments would reflect the relative effects on each country (smaller countries more affected than larger ones would see their currencies depreciate) but would not reduce the global shock itself.

Other scenarios of more limited trade wars – such as the United States against China or the United States against the EU – are also possible, even if they are more difficult to model. Assuming an additional tariff of 25 percent applied to all products traded between the United States and China, bilateral trade would be reduced by almost 60 percent, while Chinese exports to the EU would increase by 10 percent and European exports to the United States would increase by 7 percent (Bellora *et al*, 2018). However, if the US were to impose a number of anti-dumping measures against Chinese imports, this would create a more damaging redirection of flows to the EU[8]. Another scenario is that of a bilateral agreement to the detriment of the EU. Although vague and not at time of writing confirmed, the agreement of 20 May 2018 between China and the United States, through which China would commit to purchase more US goods, would have the same effect as the imposition of Chinese tariffs on imports of foreign goods other than from the United States. It is to be feared that this type of agreement

6 See, for example, Aghion *et al* (2018), Berthou *et al* (2016) and *et al* (2016).

7 For the first time in April 2018, the US Federal Reserve raised concerns in the 'Beige Book' about the possible imposition of tariffs on manufacturing imports.

8 US anti-dumping measures increase imports from the targeted countries to the EU by around 13 percent; see Skoglund (2018).

will proliferate, thereby fundamentally calling multilateralism into question.

Safeguarding multilateralism

Given the strategy of an aggressive attack on multilateralism by the current US administration in several domains such as trade (blocking of the Dispute Settlement Body, DSB and customs duties), environment (withdrawal from the Paris Agreement), and diplomacy (withdrawal from the Iranian Agreement), the EU definitely needs to implement a defence strategy. Retaliation in proportion to unjustified US protectionist measures, together with a complaint to the WTO, are the only short-term options. To be effective, such retaliation should be coordinated with countries with which the EU has trade agreements (such as Canada and Japan). The purpose of such retaliation is to increase the cost of a unilateral protectionist policy for the non-cooperative country, since the suspension of concessions (ie the increase in customs duties) for a partner that violates its commitments is one of the fundamental principles of the WTO dispute settlement system.

Recommendation 1. Make the protection of multilateralism the European Union's priority. In the short term, the European Union should coordinate with its main trading partners the adoption of firm, proportionate retaliation in response to attacks on multilateralism.

Furthermore, it is necessary to try to escape the political deadlock into which the US administration is pushing its partners by putting on the table a proposal for multilateral negotiations on macroeconomic imbalances and WTO rules to adjust them to new economic and social realities. In terms of the dispute settlement mechanism within the WTO, the EU could make an offer of negotiations to reform the current practice allowing DSB Appellate Body judges to continue the examination of cases for which they are responsible beyond the end of their mandates. However, it is not appropriate for the Appellate Body to challenge the power to interpret agreements. This is a demand by the United States so as not to encroach on the sovereignty of member states. This would jeopardise the system as a whole since the judges' interpretation is essential, given that no agreement is comprehensive or unambiguous.

The EU should also play a leading role in proposing discussions on rules at plurilateral level. Beyond the complaints on formal matters, several WTO members have complaints on the substance of rules, in particular when it comes to ensuring fair competition and taking the specific features of the Chinese economy into account. While the US trade deficit argument has no economic consistency, there remain two substantive issues on which serious negotiations are a priority: the reciprocity of commitments, given the differences in levels of development, and the updating of rules on subsidies and state-owned enterprises.

Differences in countries' revenue levels are currently only considered through special and differential treatment, based on the self-reported distinction between three categories: developed, developing and least-developed countries. While China, the world's largest exporter of goods, is still considered a developing country, rethinking is needed to make this differentiation more graduated by replacing, for example, self-declaration by a system based on objective criteria. As regards updating the rules, the fundamental problem is to ensure that they allow us to face competition from China on an equitable basis. In their current form, they are not suited to Chinese industrial policy, which massively favours strategic sectors through a combination of instruments (subsidies, input prices, credit and land allocations, trade relations with public or state-influenced companies)[9] that distort competition to the detriment of its partners bound by European and multilateral rules. The European photovoltaic panel sector, for example, was not able to withstand heavily subsidised Chinese competition. Updating the rules implies both defining and limiting the available instruments, the information relating to them and the responses that partners can make to protect themselves

9 See, for example, Wu (2016).

(in particular, anti-dumping and anti-subsidy measures). To overcome blockages associated with the consensus rule, plurilateral negotiations, bringing together a critical mass of member countries, are the most credible way forward. E-business, moreover, is another issue on which such an approach would be welcome, given the virtual absence of rules in this area.

Recommendation 2. At the European level, offer plurilateral negotiations to change the WTO's functioning and rules: operation of the DSB, reciprocity conditions given the differences in the level of development and rules relating to subsidies, state-owned companies and intellectual property rights.

In the event of persistent refusal or blocking by the current US administration of the negotiating offers put forward by the EU, which seems to be the most likely scenario currently, the EU should adopt an alternative short-term damage limitation strategy. The EU and its partners then need to identify and analyse all possible strategies for circumventing the US WTO blockage, and even to begin implementing them. For example, in order to circumvent the US blocking of the DSB in the short term, the EU could organise a club of countries excluding the US that would commit to not go to the Appellate Body in the event of appeals filed before the WTO.

Recommendation 3. If it is not possible to break the US blockage of the WTO, organise a club of countries to identify and implement a bypass strategies.

What role for trade agreements?

Following the failure of the Doha Round negotiations in July 2006, the major trading powers began to consider a shift in their trade policies towards bilateralism or regionalism. This was in particular the case for the European Commission which, while reasserting its commitment to the multilateral system, has considered it necessary to relaunch negotiations on new generation free trade agreements (FTAs)[10] with its main trading partners. This was done *"while ensuring that the new FTAs would be a stepping stone and not an obstacle to multilateral liberalisation"* (European Commission, 2006).

Trade agreements essentially institute a reduction in trade barriers between a limited number of partners. They are by their very nature discriminatory and thus constitute an exception to the fundamental principle of the multilateral system of non-discrimination towards trading partners, as allowed by GATT Article XXIV (subject to compliance with specific rules). In terms of economic efficiency, these preferential agreements represent a second-best situation combining a positive trade-creating effect (through the elimination of customs barriers between the countries signing an agreement) with a negative effect through the risk of trade diversion detrimental to the countries excluded from such a preferential agreement (which may ultimately also have a negative effect on the participating countries). Typically, the risk of trade diversion increases with the level of tariffs applied to non-preferential WTO partners: when these tariffs are low, the level of preference and therefore the level of discrimination is low. Positive effects prevail when trade agreements are of the 'deep' type, with agreements going beyond areas already covered by WTO rules.

10 The first of these agreements was entered into with South Korea and has been in effect since July 2011. Peru and Colombia followed on (joined by Ecuador in 2017), together with Canada, Singapore, Vietnam and Japan. Negotiations are still ongoing with MERCOSUR, Chile and Mexico, the latter two countries already having free trade agreements with the European Union dating from 2000 and 2002 respectively.

Who are the winners with trade agreements?

The economic impact of recent or future agreements can be estimated by analysing the effects of past trade agreements. This analysis is based on the same methodology used to estimate a trade war. The estimated benefits for the EU of an agreement with Japan would thus be 0.07 percent of GDP, assuming that this agreement corresponds to the 'average' of past agreements (Table 1 on the next page). This method is also applied to Switzerland and the United Kingdom (see the Annex), comparing the current situation with the theoretical case of these countries no longer having a preferential trade link with the EU. For the main possible agreements, the economic benefit for France is between 0.03 percent and 0.23 percent of GDP (between €10 and €79 *per capita*), ie of the same order of magnitude as for the EU as a whole. While these benefits may appear small, they are not very different from the benefits estimated by the OECD of other structural reforms in France (OECD, 2014). The size of the benefits varies from one EU country to another primarily in proportion to the intensity of their trade relations with the partner concerned, hence the higher figures for Ireland with the United States. The countries with the greatest benefits in proportion to their size are those that are relatively small and geographically close. Switzerland is the most extreme case. Its benefits from a trade agreement are thirty times greater than that of its partner (the EU). The large size of the EU therefore creates a significant asymmetry: even if in absolute terms the economic benefits to be expected from an agreement are often close between the EU and its partner[11], they are much higher as a proportion of GDP for the outside country than for the EU. The small country benefits strongly from access to a large market while the advantage of access to a small market is small for the EU[12]. The use of this bargaining power in past EU agreements is not obvious as regards tariffs, where the practice has been to dismantle them symmetrically, with the exception of a few sensitive agricultural products. Its use is clear, however, in the regulatory field within which the EU imposes its framework to a large extent in trade negotiations. For example, European Union trade agreements systematically include detailed articles on public procurement and geographical indications. Recent agreements (with the exception of that with Japan) also include the International Court System for Settlement of Investment Disputes.

The insurance dimension of trade agreements

The current context of protectionist tensions and threats to multilateralism is bringing about a profound change in the scope of trade agreements. While the multiplication of such agreements is likely to be at the expense of multilateralism, they may also represent, for the European Union, an insurance policy in the event of a full-scale trade war with the disappearance of the WTO. Such a trade war scenario in which tariff increases do not apply to partners[13] with which the EU has existing or ongoing trade agreements, has been tested. This insurance policy strategy is effective as it reduces trade war losses for the EU and its member states by one third (Figure 1). Similar results have been observed in recent empirical studies that show that trade agreements, by reducing uncertainty over future demand, act like an insurance policy for exporting companies. During the 2008-09 recession, exports thus fell less among countries that had signed a trade agreement (Carballo *et al*, 2015). In addition, preferential agreements signed by the EU have a negative impact on countries that are not included in the trade agreement: this is the case of the United States, which is harmed by the EU-Canada trade deal. These side effects of trade agreements are not what motivates countries to sign them but could also be interpreted as retaliatory measures against those who attack multilateralism.

11 In the case of the EU/Switzerland agreement, the benefit is around €19 billion for Switzerland and €17 billion for the European Union.

12 Asymmetry is also present in the future agreement with the United Kingdom, which at first sight gives significant negotiating power to the EU (see the Annex).

13 Canada, South Korea, Japan, Mexico, Norway, United Kingdom, Switzerland and Turkey.

Recommendation 4. The European Union should continue to negotiate trade agreements both for the conventional economic benefits they provide and also for the insurance policy role they can play in the event of a full-scale trade war.

However, these agreements need to be part of a new approach consistent with the EU's non-trade objectives such as environmental protection or tax cooperation.

Why include objectives other than trade objectives in trade agreements?

The primary objective of the European construction was, through the integration of economies, to prevent the return of the conflicts that had ravaged the continent. The current US offensive puts this political dimension of trade relations back at centre stage of the debate, since the attacks by the US administration go well beyond trade and challenge the transatlantic political relationship. The purely economic objective of international trade remains legitimate, of course, and the EU's primary objective should be to safeguard those benefits. What about the new trade agreements? As shown in our simulations, the pure economic benefits expected from trade agreements are now relatively modest except in three cases: a full-scale trade war where they can play an insurance policy role, the future agreement with the UK (Annex) and for small countries. Our position is therefore that beyond the conventional efficiency benefits, other dimensions of these agreements must be included. Two issues seem essential as they are at the heart of concerns about globalisation: the environment with the issue of global warming and taxation with the question of tax evasion and optimisation.

The introduction of some non-trade matters is not completely new. It is reflected both in the inclusion of chapters on social, environmental and, more generally, sustainable development issues in the European Union's trade agreements: the most recent agreements thus go well beyond areas already covered by WTO agreements ('deep' agreements).

Two main reasons can be given for including non-trade matters in agreements. They may primarily respond to a set of policy preferences (on environmental or fiscal issues). Trade as a

Table 1: Benefits associated with European Union trade agreements, as a % of GDP per capita

	Canada	Japan	Switzerland	US	Brazil	China	India	Russia
	Countries for which an agreement already exists				Countries for which there is no agreement*			
Non-EU countries								
Canada	0.41	0.00	0.00	– 0.06	0.00	– 0.01	0.00	0.00
Japan	0.00	0.23	0.00	– 0.01	0.00	– 0.01	0.00	0.00
Switzerland	– 0.01	– 0.01	3.16	– 0.06	– 0.01	– 0.03	0.00	– 0.02
United States	– 0.01	0.00	0.00	0.26	0.00	0.00	0.00	0.00
Brazil	0.00	0.00	0.00	– 0.01	0.32	0.00	0.00	0.00
China	0.00	0.00	0.00	– 0.01	0.00	0.22	0.00	0.00
India	0.00	0.00	0.00	0.00	0.00	– 0.01	0.26	0.00
Russia	0.00	0.00	0.00	– 0.02	0.00	– 0.02	0.00	1.22
EU and member states								
EU	0.03	0.07	0.11	0.26	0.04	0.28	0.04	0.12
Germany	0.03	0.10	0.19	0.31	0.04	0.44	0.04	0.14
Spain	0.02	0.04	0.05	0.14	0.05	0.17	0.03	0.05
France	0.03	0.05	0.08	0.23	0.03	0.20	0.04	0.04
Luxemburg	0.03	0.03	0.35	0.68	0.00	0.08	0.00	0.11
Italy	0.03	0.03	0.11	0.16	0.04	0.18	0.03	0.09
Ireland	0.13	0.16	0.20	1.48	0.06	0.27	0.03	0.11

Source: Vicard (2018). Note: * = the benefits shown are potential benefits.

lever can facilitate cooperation in these areas, and the more intense the trade the more effective the cooperation.

The steps taken to combat climate change provide a striking illustration of this: while the perfect example of the greenhouse effect externality makes international cooperation essential, this area offers little incentive for reluctant partners to cooperate. Indeed, it was reasoning based on the contrast between the negotiating capabilities in these two areas that led Nordhaus (2015) to propose using the threat of a tariff as a mechanism to encourage countries not included in a climate change agreement to join it.

On a more economic note, the second reason is the complementarity between trade policy and other areas of public policy intervention. Indeed, the adoption of demanding regulatory policies entailing additional costs compared to partner countries is likely to have trade consequences that are all the greater as trade barriers are low. This distorts comparative advantages which become more fiscal and environmental than productive. When it comes to putting a price on carbon emissions, the term leakage effects is used to refer to the loss of effectiveness of this type of policy associated with the relocation of some polluting production to countries where climate policies are less restrictive.

How is this done?

Implementation procedures must be chosen carefully. Firstly, it is preferable to focus on an approach based on minima and guarantees. This ensures consistency and sets limits, while preserving the freedom of action of partners. This has moreover long been the preferred approach on the social dimension of trade agreements, in particular based on requests for the application of International Labour Organisation agreements, or in the environmental field through related multilateral agreements, which now have to include the Paris Agreement.

Secondly, the objective of effectiveness calls for a combination of cooperation and enforceable commitments from the outset of agreements. These commitments may be a useful addition as long as they can be based on verifiable criteria, although this is most often difficult in social and environmental areas, where the margins for interpretation of commitments and their implementation are broad and difficult to measure. While some areas, such as taxation, are more suited to this, the European position remains weak because of its lack of internal coordination.

Thirdly, to make non-trade clauses enforceable, it is best to establish in agreements that non-compliance may give rise to a trade response, even in the absence of proof of trade damage. The clauses concerning the motor vehicle sector in the EU/Japan agreement provide a useful example in this respect: a special safeguard measure allows the EU to reintroduce tariffs in this sector if Japan does not fully comply with its regulatory commitments to remove non-tariff barriers. While these provisions remain in the strictly trade field, they are an example of the parallelism established in the agreement itself between tariff and non-tariff concessions. Another example is the Trans-Pacific Partnership Agreement, which explicitly linked US trade benefits to Vietnam's commitments on trade-union freedom and workers' rights. Traditionally, the settling of trade disputes has been based on the principle of suspensions of concessions (eg tariff increases) to compensate for damages suffered as a result of nonconforming practices of partners. These examples show that it is possible to move towards a new system in which suspensions of concessions could respond to the lack of compliance with non-trade commitments (not covered by the WTO), even if no direct economic damage results. This would greatly facilitate dispute resolution.

Fourthly, the Union must determine the desirable status for non-trade clauses. Should they be included in agreements or should trade preferences be made conditional on compliance with specific agreements (eg on sustainable development or tax cooperation)? Since trade agreements are part of a wider set of external actions and trade is a tool rather than an end in itself, linking them with other separate specific agreements would be more consistent than including multiple issues within trade agreements. However, complex legal and practical issues are involved, as was seen, for example, in the Schubert report (2017) proposing a bilateral climate agreement between the EU and Canada. Indeed, since the agreements include clauses related to investment, taxation or the environment, the member states must be associated with their adoption[14], as the EU strictly speaking loses its exclusive competence associated with trade.

Recommendation 5. Adjust trade agreements to ensure that trade goes beyond purely economic issues. Prefer an approach of minima and guarantees and combine cooperation and enforceable commitments through safeguard clauses or other explicit mechanisms.

Trade agreements and tax cooperation

Tax instruments other than customs duties may have an impact on trade terms. This may be the case for corporation tax, which is ultimately borne in part by consumers and workers in open economies[15]. A tax advantage that would specifically benefit an exporting sector can be considered as an export subsidy whose trade distorting effects can be compared to those of customs duties. To be sure, the WTO has a binding instrument regarding direct taxation with the agreement on subsidies and compensatory measures, which makes it possible to impose trade sanctions on countries that use taxation to give their companies a competitive advantage[16]. However, as this rule only applies to the strict area of trade and cannot be applied with regard to tax incentives for investment, the WTO rules need to be changed to better take into account the issue of subsidies.

In the tax area, however, states oscillate between defending their sovereignty and acting within a multilateral or regional framework to avoid the erosion of their tax bases and to protect themselves against unfair competition practices[17]. This is a primary difficulty for the European Union, where tax optimisation issues arise within the EU itself, with countries (often small ones) that are also the main beneficiaries of trade agreements and of the European integration itself. Moreover, due to the short distance, the initial regulatory situation and the presence of a trade agreement, the more trade is integrated between two markets the closer the link between trade and taxation. Companies are indeed more mobile in a more integrated area, ie it is easier to relocate in one market for tax attractiveness reasons and then re-export to another. This aspect must therefore be included in trade agreements with close partners, such as the United Kingdom (Annex). While there is now a standard article in the 'financial services' section of EU Union trade agreements that stipulates *"proper fiscal behaviour"* (steps taken to combat tax evasion, etc), it does not imply any binding legal commitment (as they are only 'best efforts' commitments) and is not present in all agreements. While it seems difficult to be very specific in the tax provisions associated with a trade agreement, compliance with the OECD codes of good practice and the BEPS (Base Erosion and Profit Shifting) action plan within a multilateral framework ought to be included as an integral part of future agreements[18].

14 As stipulated by the EU Court of Justice in its statement (2/15) of 16 May 2017 on the Free Trade Agreement between the European Union and Singapore.

15 See for example Simula and Trannoy (2009).

16 See, in particular, the dispute between the United States and the European Union relating to foreign sales corporations. The question of export subsidies should be raised again in connection with the recent US tax reform, which provides in particular for lower taxation of income derived from intangible assets when they originate abroad (Foreign Derived Intangible Income).

17 According to a recent estimate, up to 40 percent of profits of multinational corporations are transferred to low-tax countries; see Torslov *et al* (2018).

18 However, the idea put forward by some economists that trade sanctions can be used to force tax havens outside the European Union to change their practices does not seem realistic to us as these countries are only marginally dependent on international trade. For such countries, financial sanctions are likely to be much more effective.

Recommendation 6. Make the signing of trade agreements conditional on the adoption of the OECD's BEPS action plan to combat erosion of the tax base. Put in place gradual control and sanction measures to ensure its effective implementation.

The environmental dimension

The environment has a long history in EU agreements, through the pillars of cooperation and, since the agreement with South Korea, through the chapters on sustainable development. However, the importance of the subject and its links with trade issues calls for renewed efforts, all the more so as the climate has thus far been conspicuously absent from the agreements signed (Schubert, 2017).

Existing EU agreements that include a chapter on 'Trade and sustainable development' already implicitly imply compliance with the Paris Agreement through the commitment to comply with international multilateral climate treaties. It would be desirable for compliance with the Paris Agreement to become an explicit *sine qua non* condition of future EU trade agreements, as is already the case in the agreement with Japan and in the renewal of the agreement with Mexico. This would mean, on the one hand, that the EU makes it a prerequisite for the signing of trade agreements and, on the other, that it makes the full application of the agreements conditional upon compliance with the Paris Agreement. The benefit of certain trade preferences could be conditional on the proper implementation of the commitments in the Paris Agreement: the market access conditions (customs duties and preferential tariff quotas) would then be the most favourable when the partner fulfils its commitments, but would be less so (within the limits of the conditions under the most-favoured-nation clause) if they are not fulfilled. Such a mechanism would create a tangible incentive for both the partner and the EU to fulfil their commitments.

Recommendation 7. Make the ratification and implementation of the Paris Climate Agreement a prerequisite for signing a trade agreement with a partner. Make the full application of trade preferences conditional on compliance with climate commitments, in accordance with explicit provisions.

Faced with the aggressive attack on multilateralism by the current US administration, the EU must put in place a forceful strategy. It should take the lead in proposing multilateral negotiations on the WTO's functioning and rules in order to adapt them to the new economic and social realities. It should continue to negotiate trade agreements that act as insurance policies, while linking them to objectives other than trade.

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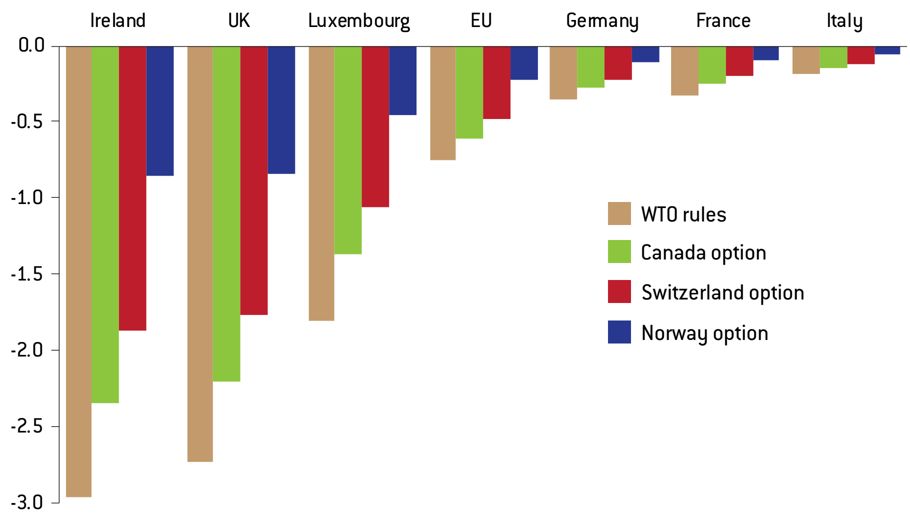
Annex: Which post-Brexit trade agreement with the UK?

Various scenarios for the European Union's trade relations with the United Kingdom have been simulated to estimate their long-term impact. The comparison is made against the current situation where the United Kingdom is still an EU member state:

- The absence of a formal agreement that would involve relations governed by the WTO's most-favoured-nation status;
- A standard trade agreement similar to the one signed with Canada;
- A deeper bilateral free trade agreement such as the one with Switzerland;
- A Norway-type Single Market access agreement.

Figure 2 shows that the more ambitious the simulated agreement is, the more limited the Brexit-related losses are. The impact on France of the absence of a preferential agreement with the United Kingdom (–0.3 percent of GDP *per capita*, or around more than €100 per person) is not negligible, but it is much smaller than for the United Kingdom itself (around –3 percent, or slightly more than €1,000 per person) or for small countries that are highly dependent on their relationship with the United Kingdom such as Ireland or Luxembourg (Vicard, 2018). For the European Union, the effect of a lack of agreement would lead to a 0.8 percent reduction in GDP *per capita* (or €260 per person).

Figure 2: Scenarios of the consequences of the future post-Brexit agreement, as a % of GDP *per capita*



Source: Vicard (2018).

These figures are fully in line with those obtained in other empirical studies (eg Dinghra *et al*, 2016; Mulabdic *et al*, 2017; Vandenbussche *et al*, 2017). In all cases, they conclude that the consequences of a 'hard' Brexit are three to four times greater than those of a more optimistic scenario.

The future trade agreement with the UK will be exceptional in many respects and could set a precedent for new type agreements, giving centre stage to fiscal, competitive, environmental and social issues. In this respect, the myriad of bilateral agreements with Switzerland, which are a product of history but which create a number of institutional problems (static agreements, very partial consideration of state aid, question of the dispute settlement body) clearly appears to the European Commission as a counter-model. The United Kingdom's geographical position and initial situation (as a member of the EU) are such that an agreement should probably lie between full access to the single market and a Canadian-style agreement.

However, the economic implications are different because of the UK's proximity. Unlike Canada, the UK could attract companies to its territory through an aggressive industrial and fiscal policy, and benefit from access, even imperfect, to the single market. The level of ambition in terms of integration of the agreement between the EU and the UK must thus be directly linked to the level of ambition of the mechanisms guaranteeing a level playing field* between the two partners; in particular as regards state aid** and a dispute settlement mechanism. However, there are a number of challenges. On the one hand, the European Union is faced with its own contradictions in these negotiations, since this level playing field has not been reached within the European Union on the issue of the taxation of corporate profits†, even if the use of state aid rules has enabled progress††. On the other hand, while the form this monitoring of the rules is to take is crucial, it has yet to be determined. For example, while the establishing of an independent domestic state aid monitoring authority would be welcome, it would not be sufficient in the event of disagreement as to what constitutes such aid. It is not clear whether the decisions taken by the Directorate-General for Competition on Apple's undue tax advantages in Ireland, for example, would also be taken by an independent British authority.

* An economic and legal environment that offers everyone an equal chance of success.

** The question of state aid monitoring is also being considered by the European Commission.

† However, the objective is not to converge towards a single rate of taxation on profits, since it is legitimate for small peripheral markets to compensate for a lower effective market potential with a tax rate which is itself lower.

†† In recent years, state aid regulation has been used to examine tax agreements negotiated by companies with certain governments including Ireland, Luxembourg and the Netherlands (see, for example, Apple, Starbucks, McDonald's or Amazon): such agreements not only create competitive distortions but also competition between states to attract the profits and jobs of large multinational groups.