THE ISSUE

The United States is the European Union's most important trade and bilateral investment partner, which has, until now, supported a multilateral trade system and European integration and has provided a security guarantee to the countries of the EU. But like other advanced economies, the US's relative weight in the global economy has declined. The new US administration seems intent on replacing multilateralism with bilateral deals. In trade, it aims to secure new trade deals in order to reduce bilateral trade deficits and to protect, in particular, the US manufacturing sector. In climate policy, the US commitment to the Paris Agreement is being questioned. In defence, the security umbrella appears less certain than previously. The overall promise behind this change of direction is to put ‘America first’ and deliver better results for US citizens.

POLICY CHALLENGE

The EU is a relatively open economy and has benefited from the multilateral system. If the US does change from its previous course, the EU should respond with a four-part strategy: (1) Collaborate with partners around the world in defence of the World Trade Organisation; (2) Establish deeper economic relations with China and other partners; in particular, the EU should accelerate discussions on the Bilateral Investment Treaty with China while safeguarding its interests and favouring public courts for dispute settlement; (3) Reform EU trade governance and address internal imbalances, to increase the EU’s external credibility. Moreover, strengthening Europe’s social model would provide a response to protectionist temptations; (4) Prepare tools that could be deployed bilaterally against the US, including WTO-compatible anti-subsidy measures and possible tax measures.
INTRODUCTION

From Europe’s perspective, the world in 2017 looks very different to how it looked just one year ago. But despite significant upsets resulting from elections and/or referendums, not all of the changes that are taking place are breaks from previously-trodden paths. Some are continuations of previous trends that have now become more visible or more entrenched.

One major trend, which started some 20 years ago, is the diminishing relative economic importance of advanced countries. This trend became evident around 2010, when advanced countries started to account for less than half of global GDP in purchasing power terms.

This reduction in economic importance is associated with so-called diminished giant syndrome, otherwise known as the curse of declinism. Previous world hegemons pursue “myopic and self-indulgent...’what’s in it for us’ economic policies in the world arena”, which end up undermining their roles as world leaders¹.

In the case of the United States this trend emerged during the Clinton administration (1993-2001), when the question of “what’s in it for us?” first arose in terms of “regaining competitiveness”. Donald Trump’s victory in November 2016 seems to have made this principle into the underpinning of all the new administration’s policies.

Other advanced economies have also seen their shares in global trade and income decline, leading to calls for protectionism. The European Union remains unsure about its role in the world, not least in terms of its security and its ability to do new trade deals. Brexit will diminish the EU’s size and possibly its trade and security influence.

By contrast, China’s position in the world has strengthened during the last 20-25 years. President Xi Jinping’s speech in Davos in January 2017² was more like that of a ‘growing giant’ and reminiscent of presidents’ speeches calling for an open global economic system during the heyday of US hegemony.

However, Trump’s election also marks a break from trends in terms of the US’s world role in defence, trade and spreading of cultural values. Importantly, the current administration does not only aim to reduce the US’s role as an anchor of the global multilateral system, it may be on course to openly challenge it, either by threatening to withdraw from it unilaterally or by imposing protectionist measures, such as high tariffs. Culturally, the US may draw back from liberal values. Meanwhile, the US’s military commitment to NATO is being questioned. The underlying rationale of “what’s in it for us?” is well captured by President Trump’s ‘America first’ rhetoric.

In this paper, we consider what the EU’s strategic reaction should be to US diminishing giant policies, and the EU’s role in a world of declining hegemons and shifting balances. We start by exploring the geopolitical reasons for the new US administration’s ‘America first’ orientation. We then discuss the central elements of the emerging US policies and possible consequences for Europe. Lastly, we discuss how Europe should respond, how it could sustain a multilateral system and what partnerships it could build.

Our focus is on the economic aspects but cultural and security aspects also play central roles in the broader picture.

WHAT LAYS BEHIND TRUMP’S ‘AMERICA FIRST’ APPROACH?

Since the second world war, the US has played a clear leadership role in building, supporting and policing the global system. This sense of responsibility for maintaining the world order was supported by a view that it was beneficial to the US.

This view is not shared by the newly elected US president. On the contrary, President Trump argues that the rules-based multilateral system has not benefitted US citizens, and in fact has hurt them. While this view was not necessarily shared by the majority of Americans in the election, it was shared by a sufficient number to make a difference.

There are two versions of this argument. The first is that the multilateral system has benefitted foreign countries

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at America’s expense. The second is that the possible benefits that the US might have enjoyed, deriving for instance from the dollar’s exorbitant privilege, accrue to Wall Street at the expense of Main Street – the multilateral system is seen as having favoured the financial sector at the expense of the manufacturing jobs that ‘ordinary’ folk lost.

Supporting and protecting the multilateral system was politically easy for the US when it was considerably richer than the rest. However, as the level of income in the rest of the world increased, the US began to see other countries as competitors. China’s economic advance is a case in point. Chinese growth and its emergence as a major trading partner for the US have led to the belief that it is now a competitor and threatens US economic interests. The Trump administration’s view of Mexico and even Europe also fits this narrative³.

The United States has experienced a long period during which real wages for most American citizens have not increased. The sense of unfairness has been reinforced by a welfare system in which healthcare expenditure has risen rapidly, leaving many citizens without protection⁴. Trump’s central argument to address these woes and to “make America great again” is to turn away from globalisation, while rejecting the notion of building a welfare state.

Trade, in particular in manufactured goods, is very much at the heart of Trump’s zero-sum view of international relations, and contrasts with the typical view of economists of trade as a positive-sum game. Trump blames trade for the real wage stagnation observed primarily in manufacturing and intends to bring manufacturing jobs back to the US because they are supposedly highly paid⁵. A major theme of the presidential campaign was therefore about introducing protectionist measures to correct a system, which in the view of many Trump supporters led to the US trade deficit⁶.

But high manufacturing employment shares do not necessarily correlate with trade surpluses. Japan, Germany (countries with persistent trade surpluses) and Italy (broadly in trade balance over time) currently have similar manufacturing shares in employment. Employment share differences rather suggest differences in specialisation. Moreover, there is little difference in wage levels in manufacturing and services in the US⁷.

Nevertheless, it is correct that the trade balance at the margin can matter for the relative size of the manufacturing sector. If an economy is at full employment and increases its net exports, its tradable sector (or manufacturing sector) would increase. Manufacturing therefore has a zero-sum dimension, but this operates at the margin and cannot explain the long-term decline in employment in manufacturing.

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3. This zero-sum view of economic relations is not new. It was already part of the ‘diminished giants’ narrative in the 1990s when the US viewed Japan, rather than China, as the emerging threat. But it has certainly taken on a new dimension with Trump’s insistence on ‘America first’.

4. The recent introduction of Obamacare apparently was not enough to change the sentiment.


6. Ibid.

One way Republicans in the House of Representatives have put forward to improve the US trade balance is through a ‘destination-based cash-flow tax’ (DBCFT). This would impose a 20 percent tax on all imports, while providing a special tax exemption for income generated from exports. Such an approach to taxation is known as ‘border adjustment’.

The DBCFT would be levied on producers not consumers, and would act as a penalty on imports and as a subsidy for exports. Unlike a value added tax, it would therefore discriminate against foreign producers, and would (depending on its precise formulation) be incompatible with World Trade Organisation rules. A levy on imports and a subsidy for exports would both increase the value of the dollar. A more expensive dollar would then counteract the benefits of this tax in terms of promoting exports and reducing imports. Whether the tax and the rise in the value of the dollar would totally offset one another remains a point of empirical debate because exchange rates are also affected by other factors. DBCFT would generate significant tax revenues in countries with a trade deficit, like the US, while countries with trade surpluses would lose tax revenues.

Beyond taxes, President Trump appears also to see bilateral, rather than regional or multilateral, trade deals as the instrument of choice for promoting US interests. Bilateral deals, in his view, could maximise US leverage in negotiations. In particular, they are seen as the right approach to reduce trade deficits that supposedly destroy jobs. The figure on the front page of this Policy Brief shows that the US has a trade deficit with most countries, certainly in goods and in particular in manufacturing. The biggest deficit is with China, followed by the EU and Mexico/ Japan. The trade deficit with EU countries is particularly high with Germany.

However, the deficits are much smaller when measured on a value added basis. CONSEQUENCES OF ‘AMERICA FIRST’ FOR GLOBAL TRADE AND INVESTMENT

The new US administration’s attempts to back-pedal on multilateral trade arrangements will have profound implications for global trade and investment because of interlinkages between the US and its partners (see Tables 1 to 3).

As far as goods trade is concerned, the top five sources of US imports are, in descending order, China, the EU27 (the EU without the UK), Canada, Mexico and Japan. On the export side, the top five destinations are Canada, the EU27, Mexico, China and Japan.

For the EU27, the US is the number one destination for exports, just before China, and the number two source of imports, just behind China.

The close relationship between the EU27 and the US is even more intense for trade in services, where the EU27 and the US are each other’s largest export destination and import source.

The close interconnectedness between the EU27 and the US is even more important as far as foreign direct investment stocks are concerned. Table 3 shows that 44 percent of US’s FDI comes from the EU27, and 31 percent of the EU27 FDI comes from the US.

The EU reaction to possible US trade measures will depend on the size of the measures and their effects on the EU economy (as well as on geostrategic considerations to which we will return later). There are preliminary attempts to measure the effects of such actions but the real effects will not be understood before US plans become clearer and the rest of world decides how to react.

HOW CAN THE EU DEFEND A MULTILATERAL SYSTEM?

Trump’s America first policy threatens to upset the global trading system and even put the WTO in danger. This will naturally precipitate reactions from other global players, and in particular the EU and China.

The EU has a strong economic and political interest in preventing the demise of the multilateral trading system.
Openness, measured as exports relative to a country’s GDP, is far greater in the EU (43.8 percent) than China (22.1 percent) or the US (12.6 percent). The rules-based system allows all players, including the weaker ones, to trade with each other based on high and comparable standards that have to be followed by all. Protectionism would reduce EU and global welfare, hurt global growth and could mean lower standards and unfair competition. In particular, in the EU with its strong trade relationships around the world, many jobs could be at stake.

However, though the EU is the largest trading bloc in the world, it cannot sustain a strong multilateral system on its own. The EU’s inability to replace the US as a global hegemon is partly for internal reasons (the state of the economy, a weak defence and security policy) and partly for external reasons (the world balance has changed with the increasing economic relevance of China and other

| Table 1: Bilateral imports (goods) in 2015 for selected partners, (US$ billion) |
|-----------------|-----|-----|-----|-----|-----|-----|
| From US | EU27 | UK | China | Japan | Mexico | Canada |
| US | . | 249.4 | 58.1 | 150.5 | 68.3 | 187.3 | 223.2 |
| EU27 | 376.5 | . | 340.0 | 190.4 | 64.8 | 41.4 | 40.9 |
| UK | 58.7 | 188.5 | . | 18.9 | 6.5 | 2.3 | 7.2 |
| China | 502.6 | 366.3 | 63.0 | . | 160.6 | 70.0 | 51.4 |
| Japan | 134.8 | 72.3 | 10.2 | 143.1 | . | 17.4 | 11.6 |
| Mexico | 297.5 | 21.2 | 2.1 | 10.1 | 4.8 | . | 24.4 |
| Canada | 301.0 | 18.7 | 10.7 | 26.3 | 9.2 | 9.9 | . |
| World | 2306.8 | 1978.8 | 630.3 | 1681.7 | 625.6 | 395.2 | 419.2 |

Source: Bruegel based on UN Comtrade data (available here: https://comtrade.un.org/data/). Note: Bilateral trade relies on import statistics, which are considered more accurate given the customs system in place to collect tariff revenues.

| Table 2: Bilateral imports (services) in 2014 for selected partners, (US$ billion) |
|-----------------|-----|-----|-----|-----|-----|-----|
| From US | EU27 | UK | China | Japan | Mexico | Canada |
| US | . | 214.1 | 38.5 | n.a. | 57.9 | n.a. | 62.0 |
| EU27 | 119.0 | . | 105.6 | n.a. | 23.2 | n.a. | 13.3 |
| UK | 49.8 | 160.0 | . | n.a. | 12.6 | n.a. | 5.8 |
| China | 14.4 | 28.7 | 1.7 | . | 11.9 | n.a. | 2.1 |
| Japan | 31.2 | 15.9 | 4.3 | n.a. | . | n.a. | 2.0 |
| Mexico | 19.5 | 4.2 | 0.9 | n.a. | 0.3 | . | 2.4 |
| Canada | 30.1 | 12.4 | 2.8 | n.a. | 2.1 | n.a. | . |
| World | 477.4 | 849.3 | 214.9 | 452.8 | 192.1 | 33.5 | 110.3 |

Source: Bruegel based on ITC Trade Map and OECD Statistics on International Trade in Services by partner country. Both sources follow the Extended Balance of Payments Services Classification (EBOPS 2010). Note: data on EU27 estimated by subtracting UK imports from all the bilateral import flows of EU28. In particular, EU27 (EU without the UK) total imports are equal to [EU28 total imports â€“ UK total imports from ExtraEU28 + EU27 imports from UK].

| Table 3: FDI stocks 2015, $ billions |
|-----------------|-----|-----|-----|-----|-----|-----|
| From US | EU27 | UK | China* | Japan | Mexico | Canada |
| US | . | 2156.3 | 433 | 116.6 | 51.6 | 222 | 280 |
| EU27 | 1382.3 | . | 679.9 | 257.9 | 58.4 | 184.1 | 150 |
| UK | 484 | 1248.6 | . | 42.3 | 13.2 | 20.5 | 24.8 |
| China* | 25.9 | 97.1 | 20.6 | . | 8.4 | 3.8 | 26.7 |
| Japan | 411 | 115.3 | 67.7 | 180.7 | . | 13.4 | 15.9 |
| Mexico | 16.6 | 43.4 | n.a. | 0.1 | 0 | . | 1 |
| Canada | 269 | 214.3 | 34.4 | 15.8 | 1.2 | 28.1 | . |
| World | 3130 | 6833.6 | 1550 | 2580 | 171 | 509 | 555 |

Source: CDIS (Coordinated Direct Investment Survey), IMF. Note: * including Hong Kong.

At the same time, all three leading global trade players have expanded the number of regional trade agreements. The world therefore is evolving from a multilateral system centred around the US into a more multipolar system resting on the three strong trading poles of China, the EU and the US, each with several bilateral and regional trading arrangements. This has been criticised as already undermining existing multilateral frameworks.13

This raises two questions: whether the poles of the system are collectively interested in supporting at least the core of the existing multilateral system, and whether the EU and China are willing and able to jointly support the multilateral system as the US steps back from its central role.

While the EU and China each clearly has an interest in supporting the multilateral trading system, it is an open question whether they can act in a coordinated manner as the EU and the US have done in the past. This is not a trivial question because the European and Chinese economic systems are much more different from each other than the European and American economic systems. Nevertheless, in certain areas, such as support for the WTO, EU-China collaboration should be relatively straightforward. The EU should also seek other partners for collaboration in support of the WTO.

**STEPPING UP TRADE RELATIONS WITH PARTNERS**

Strategically, the EU should continue its bilateral trade and investment negotiations with other partners. The bilateral deals should be designed as stepping stones rather than obstacles to the multilateral system, including in investment matters, where the ultimate goal could be an expansion of the WTO into a ‘WITO’ (to include investment).

An obvious objective is to complete on-going bilateral investment treaty (BIT) negotiations with China. But the EU differs most from China in terms of the role of state-owned enterprises (SOEs) in manufacturing. It is natural, therefore, that the role of SOEs is at the heart of the BIT negotiations that both the EU and the US are pursuing China. An additional priority is bridging the gap between different approaches to state aid and competition policy.

Moreover, the two parties should agree to use a public court system for the settlement of their bilateral investment disputes (as has been done in the EU-Canada Comprehensive Economic and Trade Agreement, CETA), rather than the investor-state dispute settlement (ISDS) system favoured by the US. They should agree, like in CETA, that the ultimate goal should be the creation of a multilateral investment framework. The BIT itself should ensure reciprocity in investment conditions.14 Only after an EU-China BIT has been agreed, say by 2020, should the two partners start negotiations on a bilateral investment and trade agreement.

The aim of the EU-China bilateral deal should be to improve market access and set high environmental, corporate governance, consumer safety and workers’ rights standards. It should ensure fair competition and reciprocity. A deal that would materially lower standards in the EU is not in its interest and should therefore be rejected.

The EU should seek new and complete bilateral deals also with other countries, including Japan, India and the Mercosur bloc. Again the aim must be to ensure high standards for EU citizens because otherwise support for such deals will be lacking. And the aim should be to do the deals in a way that strengthens rather than weakens the global system. In trade and investment matters, the EU has an opportunity not only to uphold but even strengthen the global system according to the EU’s high standards and values.

**THE EU NEEDS TO STEP UP INTERNALLY TO BECOME MORE CREDIBLE EXTERNALLY**

For the EU to assume a bigger role in safeguarding multilateralism and in forming new, and deepening old, alliances, a number of reforms would be re-

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13. On the importance of structuring bilateral deals in a way that they do not undermine the multilateral trading system, see this 2006 speech by Pascal Lamy: https://www.wto.org/english/news_e/sppl_e/sppl46_e.htm.

required. We see three main areas in which reforms would increase the credibility of Europe’s claim to a bigger global role.

First, addressing distributional concerns domestically is a prerequisite for entering new trade arrangements. Europe’s social model is a major factor in reducing inequality and is rightly thought of as softening the impact of rapid change on citizens in an age of globalisation and technological change. But many EU countries still need to reform their social systems to deliver inclusive growth and better social protection. The EU’s role should primarily be to empower its members to achieve desired levels of redistribution by effectively combatting tax evasion and social fraud that relate to the single market.

Second, the governance of EU trade and investment policy has become cumbersome. The recent difficulties in signing CETA have increased partners’ doubts about the EU’s ability to deliver. We consider it imperative that the EU institutions regain citizens’ trust so that they can negotiate trade agreements on citizens’ behalf. This requires more transparency in negotiations. It will also be important to ensure greater EU legitimacy, including through a reformed European Parliament.

Third, the EU as a large open economy cannot sustainably run large current account surpluses. The large surpluses, and in particular Germany’s surplus, are a result of imbalances in the euro area that need to be resolved irrespective of the global environment. Strengthening domestic demand in Germany is pivotal. Structural reforms at the national level, for example by addressing the debt overhang and remaining banking problems in other countries, would further boost demand. Such actions in surplus and former deficit countries will help speed up the normalisation of European Central Bank policy and strengthen the euro, thereby also helping to address the large euro-area surplus.

WHAT BILATERAL ACTIONS SHOULD THE EU TAKE?

While future EU reforms can set new trends in motion in terms of the new global economic order, there remains the question of how to respond to a potentially antagonistic US administration.

At a higher level, Europe’s possible responses range from pure antagonism and retaliation, to staying the course and building alliances with other countries.

Then there are more specific questions: what is the worst-case scenario in terms of US trade and investment discrimination and over what time horizons should the EU prepare to react? What are the implications beyond the purely economic relations, in terms of defence and cultural values?

In our view, the underlying objective of the EU’s response to unilateral measures by the US should be to sustain the multilateral trading system. The aim should be to react strongly and decisively but based on principles. The aims would be to wait until future US administrations change course and abandon unilateral actions, and to prevent an unnecessary escalation that would be damaging to all: the EU, the US and the rest of the world.

In the event that the US terminates the North American Free Trade Agreement and imposes tariffs on imports from Mexico that are above the US most-favoured nation (MFN) tariffs, it would amount to a violation of the US’s WTO obligations. The EU and other WTO members would be affected directly because they have foreign direct investments in Mexico to serve the US market (see Table 3). The EU and other WTO members would be affected directly because they have foreign direct investments in Mexico to serve the US market (see Table 3).

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In case the US introduces a form of DBCFT that is clearly in violation of WTO rules, the EU should carefully consider, again in collaboration with other WTO members, stronger measures. There is for example the possibility to adopt reciprocal measures on corporate taxation that would only be directed against the US. An alternative would be to use anti-subsidy measures against...
US exports to the EU or even to third countries. The latter is entirely within the EU’s remit and one of the WTO legal instruments at the European Commission’s disposal.

CONCLUDING REMARKS

It remains an open question to what extent Trump and his presidency are an acceleration of a trend or a real break from past US policies. In either case, but particularly in case of a strong break, the EU should rethink its global position. The US will remain the EU’s most natural partner in economic, cultural and probably military terms. But if differences grow significantly during the term of the current US administration, not least because of different social models, the EU needs to stand ready to defend its interests.

The EU should prioritise measures that help to sustain the multilateral trading system. It should be firm in its response to the US, based on the principle of multilateralism. Building coalitions with as many players as possible, but especially large ones like China, will be important to defend the system. The EU could also support smaller partner countries in their WTO complaints against potential unilateral trade measures.

Strengthening the collaboration between the EU and China, two large global players with a clear interest in and support for multilateralism, would seem particularly relevant for trade and investment. But the EU and China could also work closely together on environmental and climate matters to ensure that other countries do not drop their commitments under the Paris Agreement on climate change, should the US drop theirs.

But beyond China, the EU would benefit from forging alliances with other countries. Promoting multilateralism would protect smaller countries that naturally rely on established frameworks, and would help for keeping to existing agreements. This is of crucial importance for issues such as upholding commitments to the Paris Agreement or combating tax evasion and fraud at the global level.

Maintaining domestic support for trade in the EU depends on ensuring that trade and financial flows do not undermine environmental standards and countries’ capacities to deliver adequate social systems. To the extent that multilateralism helps the latter, it also helps support the pursuit of free trade.

The EU itself needs to reform. Real or perceived, the EU’s credibility in trade matters has suffered and needs to be restored. Moreover, the EU and in particular the euro area, must address their internal imbalances by reducing external trade surpluses and strengthening domestic growth.

Also important is what relationship the EU should foster with the United Kingdom once it leaves the EU. The arrival of President Trump has arguably increased the need for the two sides to reduce the Brexit-related damage that both could suffer. Such an agreement should preserve Europe’s ability to weigh in on world affairs, at a time when European values of liberal democracy and social market economy are threatened. In particular, the EU and the UK should be natural partners in supporting the multilateral system in areas such as trade, climate and financial regulation.

Finally, the EU remains a weaker player than its size suggests, not only because of its internal divisions but also because of its dependence on the security guarantee that the US provides and its dependence on energy imports. How and whether the EU and its member states address these two concerns is a crucial subject that goes beyond the scope of this paper.