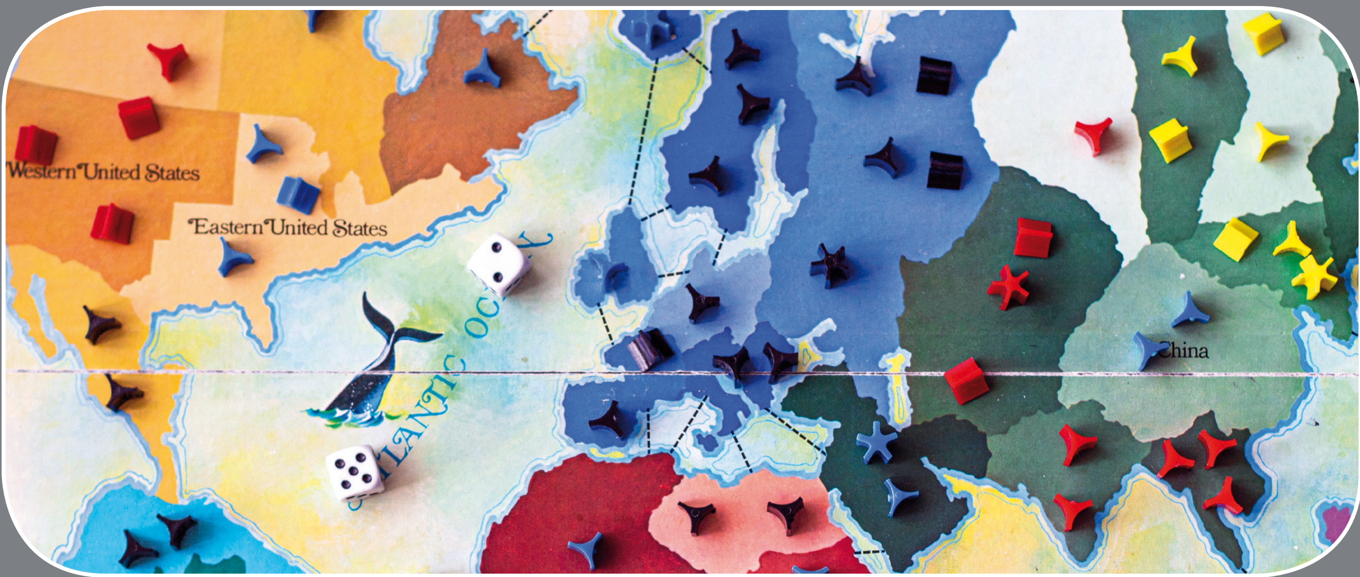
Foundation for
Family Businesses

European Trade Policy at the Service of Geopolitics?

Requirements for New Instruments from the Perspective of Family Businesses



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Contents

Summary of main results

1. Against the backdrop of geopolitical tensions with China and Russia and drawing on the experience gained during Donald Trump's US presidency, the EU is drafting **new rules for a common foreign trade policy**. The current French Presidency of the Council is seeking to prepare regulations on international procurement, protection against economic coercion and a carbon border adjustment mechanism as well as EU-wide supply chain legislation. These measures would change Europe's foreign trade policy fundamentally, politicising it and using it to achieve goals which go beyond foreign trade policy. Trade policy must not, and cannot, be a substitute for foreign policy. The EU must adjust its foreign trade policy actions to new geostrategic realities, but this must not lead to a widespread rise in protectionism. Otherwise, the benefits of the international division of labour enjoyed by family businesses, consumers and nations alike will be lost.
2. In recent years, we have seen an increase in both **trade barriers** and the uncertainty surrounding them. Foreign governments are not the only ones responsible for this state of affairs: Europe, too, has become more protectionist. As a result, value chains are shrinking, gains from specialisation are decreasing and per capita income is declining. The EU is employing foreign trade policy tools in its attempts to achieve **non-trade policy goals**, for example in human rights, environmental and foreign policy, with economic sanctions used as a substitute for other foreign policy measures. But family businesses rely on free and predictable access to international sales and procurement markets, and are especially affected by trade barriers.
3. Germany is more heavily dependent than other countries on participation in the international division of labour. **Real per capita income** in Germany is at least 40 percent above the hypothetical autarky level, which assumes no international trade – and is thus higher than in comparable countries. This figure underscores the great importance free global trade has for Germany. Germany's *Mittelstand* in particular, which is largely characterised by family businesses, is dependent on international markets for the sale of its highly specialised products and the efficient procurement of materials and input products. Internationalisation is a key element of its business model and is responsible for good wages and secure jobs both in urban areas and in rural regions.
4. Trade barriers are on the rise. A total of almost 1,700 new protectionist measures were introduced worldwide last year alone. This marks a new record. A small number of these barriers are tariff measures, while the major part consists in non-tariff obstacles to trade. Germany ranks behind China as the country that is most frequently subject to **discriminatory measures** – a fact that can be explained by the size and diversification of Germany's export economy. Another reason is the sharp rise in the number of trade obstacles faced by traditional German export industries, such as metal construction, mechanical engineering, means of transport and chemicals. It is also clear, however, that protectionist measures

are frequently used inside Germany as well. It would be incorrect to think of the EU as a benign trade policy player.

5. Rising protectionism is already leading to **losses in prosperity**. Between 2011 and 2019, per capita income in Germany was around 1.6 percent lower than it would have been had trade policy conditions remained unchanged.
6. Following the global economic and financial crisis, geopolitical tensions are once again on the rise. The number of economic sanctions has risen sharply: by a factor of 15 since 1950. Consequently, the number of trade sanctions has also grown notably, from 13 in 1950 to 80 in 2019. But since the 1970s, financial sanctions have been the most important category within economic sanctions, as evidenced by the recent measures imposed on Russia.
7. Germany is the western country which suffers most as a result of trade sanctions. In 2019, the damage inflicted on Germany as a result of the sanctions imposed on Russia and Iran came to around 8 billion dollars. Countries such as Japan, the USA and France are less impacted. Growing geostrategic rivalry, the deep crisis facing the World Trade Organization and widespread populism create a need for new defensive instruments to punish legal violations in a credible manner, to demand reciprocity effectively and to strengthen the stability of the global trade system. **But the goal must always be to keep markets open.** A decoupling of value chains does little to stabilise the domestic economy – and comes at a high economic cost.
8. Instead of building new barriers it is better to create incentive structures so that opportunistic behaviour which disadvantages others is unattractive from the outset. This includes **credible sanction mechanisms** like those that international trade law has always employed, such as the restriction of access to the European Single Market. Threats must be made promptly and unambiguously, and the relevant sanctions applied following clear rules. Mechanisms must be in place to ensure a fair distribution of internal costs, for example through an adequately endowed **compensation fund**.
9. The regulation on **protection from economic coercion** (*anti-coercion instrument*) currently being developed is designed to protect EU member states from illegal economic coercion by third countries through the threat of countermeasures by the Union. But threats and their implementation must be credible, prompt and rules-based for them to be effective, and precautions must be taken to protect against spiralling escalation.
10. The EU is preparing a new regulation (*International Procurement Instrument*) designed to encourage foreign governments to open up their public **procurement markets** by using the threat of closing its own market. Great caution is advisable to ensure that public procurement processes within the EU do not ultimately become more expensive while failing to achieve additional market access outside the EU.
11. The French Presidency of the Council is seeking to bring the negotiations about a **Carbon**

Border Adjustment Mechanism to a conclusion. The proposals in their existing form are, however, scarcely convincing. They offer little protection against the outsourcing of production outside the EU while at the same time running the risk of generating considerable red tape and international tensions. Whatever the case, the system needs to be placed within a more broadly defined international climate club.

12. Access to the **European Single Market** is the **highest value card** in the deck of the EU's foreign trade policy. For it to be employed to its fullest effect, the Single Market needs to be wide, deep and dynamic. Weak internal growth, the withdrawal of the United Kingdom, the failure of the framework agreement with Switzerland and the dysfunctional customs union with Turkey all serve to diminish its appeal. This is where the EU must focus its efforts.

A. Introduction

The French Council Presidency will materially change Europe's foreign trade policy.

On 1 January 2022, France took over the Presidency of the European Council for six months. It is expected that during this period, important waypoints will be decided which will result in material changes to European foreign trade policy. The EU seeks to defend and assert its interests more actively and to deploy appropriate trade policy tools to this end. The French government is in agreement with the EU Commission as regards this goal, and it is also enshrined in the coalition agreement of Germany's new coalition government. The war in Ukraine makes a reconfiguration of European trade policy all the more urgent.

Indeed, adjustments to a changed and unusual convergence of geostrategic factors are necessary. But a situation where this restricts the economic benefits of the international division of labour excessively must be prevented, since this would particularly burden the economic livelihoods of many family businesses in the manufacturing sector and those of their employees.

It is pursuing the goal of an open, sustainable and assertive trade policy.

France is a major driver of a proactive approach that is more strongly geared to geostrategic goals, while Germany has so far been more restrained. The French Presidency of the Council *"seeks to **bolster the contribution of trade policy to European prosperity and sovereignty,** drawing on the Communication form the Commission of 18 February 2021 on 'An Open, Sustainable and Assertive Trade Policy'."* This is the position of the official programme for the French Presidency of the Council of the European Union.[1]

France is seeking to take better account of the objectives of the Green Deal in the EU's trade policy imperatives and to make the fight against deforestation a trade policy goal. It intends to focus, in particular, on *"the **Carbon Border Adjustment Mechanism,** which will enable this transition to be implemented for all European industries while preserving the EU's competitiveness"*. By contrast, the German coalition agreement is substantially more restrained, agreeing to support "the introduction of a carbon border adjustment mechanism effective across Europe, or comparable effective instruments".

The French Council Presidency is also planning a European legal instrument governing the **due diligence requirement** of companies in their value chains, something which the German governing coalition also endorses. In this context, "mirror measures" are designed to ensure that imported products are subject to the manufacturing standards in force within the EU. Accordingly, reciprocity in trade will be increasingly sought; this corresponds to a demand in the German coalition agreement for a trade policy which counters protectionism and unfair trade practices. The French Council Presidency also seeks to push ahead with negotiations on the

1 https://presidence-francaise.consilium.europa.eu/media/qh4cg0qq/en_programme-pfue-v1-2.pdf

following EU autonomous instruments: the **Regulation on the international procurement instrument** and the **Regulation on the protection of the Union and its Member States from economic coercion** by third countries. Without being explicit about it, the German coalition government has also made clear its support for these two instruments, which seek to create more opportunities for German businesses, protect European interests better against unfair or coercive practices of third countries and ensure reciprocity in trade.

The programme reflects two trends which have been in evidence for some time: firstly, the increase in **geostrategic tensions** and the associated fears of exploitation by trading partners and, secondly, the EU's desire to implement its own **values** in environmental, peace and human rights policies to a greater extent on an international stage.

Both the French Council Presidency and the German coalition agreement stress the importance of cooperation with the USA. But this does not involve a dismantling of trade barriers as much as joint defensive measures directed primarily at China. In light of the conflict with Russia and China's ambiguous stance it makes even more sense for the transatlantic nations to pull together. Even without resuming the failed project of a transatlantic free trade agreement (TTIP), the EU-US Trade and Technology Council (TTC) can be used to remove numerous meaningless trade barriers. By contrast, in both documents there is little about the trade agreements currently being negotiated.

Trust in the international legal order, an idea popularly referred to as *law and order* in a domestic context, has taken a number of hits in recent years, spurred on by a variety of developments. First of all, the hope has gone unfulfilled that China would develop into a market-based democracy following its accession to the World Trade Organization (WTO) in 2001, as Korea and Japan did. With its state capitalist economic system, the country does not fit well into the liberal global trade system. Its subsidies, preferential treatment of domestic suppliers, strictly self-serving regulation, highly aggressive regional foreign trade policy and much more have meant that the EU and the USA perceive China to be an unfair partner. In addition, China's rapidly growing economic importance has also increased the country's geostrategic power. Many believe that "the West" is engaged in a **new competition between systems** (e.g. Fuest, 2018), a battle being fought without gloves.

What is more, Russia's brutal war of aggression in Ukraine clearly demonstrates the quite fundamental differences between the West and Russia when it comes to the political and the economic order in Europe. While the EU in recent decades has held the firm conviction that a country's ability to choose its own trade policy affiliations forms an inherent part of its sovereignty, Russia continues to think in terms of spheres of power. The EU's inability to recognise this in good time constitutes a tragic failure of European foreign and foreign trade policy. Because the Russian economy is relatively small compared to that of China (Russia's GDP is only around 10% of China's) and is not very dynamic, the current conflict with Russia should not prevent us from seeing where the actual challenge lies, namely, to find the right way to deal with China.

But other countries once considered defenders of the system, especially the USA, have distanced themselves from the current global trade order and thereby withdrawn protection previously offered to other beneficiaries of the multilateral approach. Assuming that the current system promotes China's ascent, the Obama administration refused to reappoint WTO appeals judges; under President Trump, the appellate body lost its ability to function. The associated weakening of international trade law is generating suspicion everywhere that countries might take opportunistic action to the disadvantage of their trading partners and that the countries whose rights have been violated in the process are not able to defend themselves effectively – and indeed, we have seen a substantial increase in the number of trade policy and other foreign trade policy interventions, as we have set out below. Germany also feels that it is under attack and needs to defend itself. Thus, the preamble of the coalition agreement concluded between the SPD, Bündnis 90/Die Grünen and the FDP states: *"In the international competition between systems we seek to ... defend our **values resolutely**"* (emphasis added by the author). In particular, it has become apparent in recent years that Beijing frequently interprets the World Trade Organization rules in a highly opportunistic manner – for example, the country holds fast to its status as a developing country and to the associated privileges and exemptions. Moreover, it puts pressure on EU members with foreign trade sanctions in order to push through changes in policy.

The geostrategic rivalry between the USA and China is a problem for the EU even beyond the collateral damage resulting from a weakened WTO: Europe could well be forced to bear the policies of one or the other conflict partner even though doing so runs counter to its own interests and it will have to suffer the consequences.

The erosion of trust in international law and its institutions has meant that countries must "take their fate into their own hands", as German Chancellor Angela Merkel demanded for Europe at the Council Summit in October 2017. This means, firstly, that the EU wants to arm itself better to fight trade policy encroachments by other countries; secondly, that it is seeking to do more itself to assert its own interests.

EU trade policy is increasingly deployed for foreign, security and environmental policy goals.

A second major development is the attempt by many countries to use foreign policy tools and, more generally, foreign trade policy tools, to achieve **non-trade policy goals** in human rights, environmental or traditional foreign policy. This phenomenon of the *weaponisation* of trade policy (Farrell and Newman, 2020) is not new, but has been in evidence much more frequently of late. Economic sanctions are used as a substitute for other foreign trade policy measures.[2] This is particularly important in the EU because the EU does not have a common foreign and security policy and thus no convincing military or diplomatic means to assert its interests abroad. Yet the projection of economic power to achieve a variety of different foreign policy goals is made more difficult in the EU by the fact that it does not have a long tradition of geostrategic reflection about the definition of its own interests and their assertion, nor are there any clear responsibilities and instruments.

In light of this, the European Union and its members have been busy for some time realigning the EU's **common foreign trade policy**. To this end, a review of the existing foreign trade policy rules was concluded in February 2021 and the results made public.[3] The Commission recommends gearing the EU's foreign trade policy more strongly to the goal of sustainability and, overall, a more self-confident ("more robust") approach. In future, the Commission aims for an *"open, sustainable and assertive"* trade policy. This means that although the goal of openness will not be abandoned, the pursuit of "green" goals and the defence of self-determination (sovereignty) will now be of equal value. The EU must be able to be "strategically autonomous": it must be able to implement its own political preferences in its domestic and foreign policies, and it must not be possible for third countries to coerce it to undertake other actions or tolerate practices which run counter to its own policies. The war in Ukraine has forced the realisation that, as part of this canon of objectives, the foreign trade policy additionally needs to make its contribution to ensuring peace in the European neighbourhood because no other tools are available for this purpose.

As part of the **reorientation of the EU's trade policy** a large number of political initiatives are currently under discussion. Even though they have advanced to different stages in the legislative process, their common goal is to equip the EU with instruments designed to help it assert its interests more effectively on an international stage. The EU is thus responding to the changed geopolitical situation. It also seeks to assert international agreements, such as the Paris Agreement, the General Declaration of Human Rights and various United Nations conventions ranging from the ILO core labour standards to the protection of biodiversity. Because such agreements do not themselves have an effective enforcement mechanism, trade policy measures can be deployed in order to sanction behaviour that deviates from them.

Generally speaking, it makes sense for the EU to adjust its foreign trade tools. The geostrategic situation has changed fundamentally, and the socio-political importance of **environmental concerns** has grown in light of the climate emergency. At the same time, a more offensive

2 This is particularly well presented in Blackwill and Harris (2016).

3 EU Commission (2021): https://trade.ec.europa.eu/doclib/docs/2021/february/tradoc_159438.pdf

foreign trade policy does also harbour great risks. It could become the playground for protectionists who enforce ever new speculative restrictions on competition and use ostensibly moral arguments in order to promote particular interests at the expense of the general public. This would reduce real incomes in the EU and weaken economic momentum. It is necessary, therefore, to check new instruments carefully for their effectiveness and susceptibility to abuse, and to weigh the possible alternatives carefully. The present study seeks to take steps in this direction.

A more offensive foreign trade policy must not lead to protectionism – the right tools are decisive.

It is clear that **family businesses** in the manufacturing sector, in particular, rely on access to international sales and procurement markets that is as free and predictable as possible. This is why trade barriers, uncertainty and trade policy conflicts affect them particularly strongly.[4]

Family businesses need free and predictable access to international sales and procurement markets.

The present study will start by discussing the benefits of the international division of labour and the threat posed by increasing protectionism. This will be followed by a brief historical outline of the development of the strategic basis of the EU's foreign trade policy and a discussion of a strategic foreign trade policy based on game theory. And finally, it will look at the new instruments currently being discussed at EU level and assess them from the perspective of family businesses.

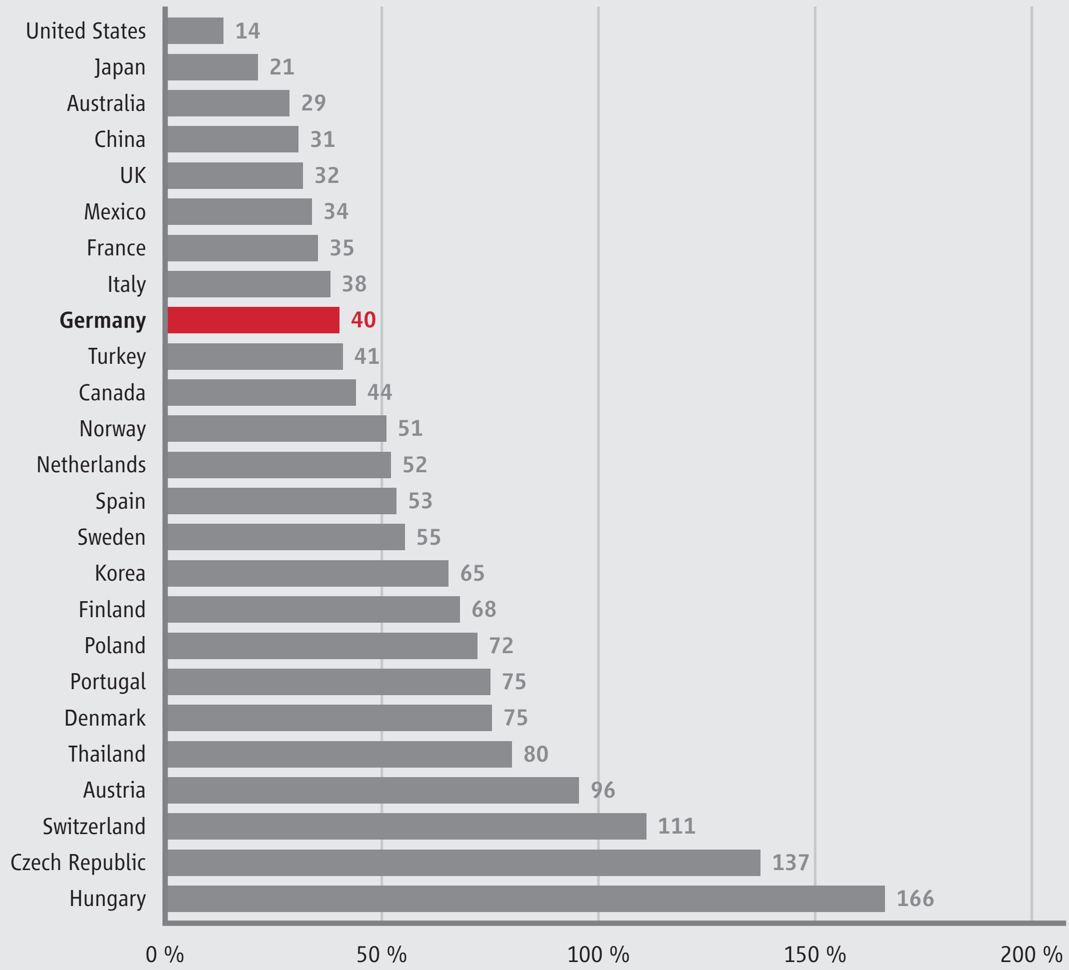
4 See Stiftung Familienunternehmen (ed., 2020) using the example of the EU-US trade war over steel and aluminium.

B. New protectionism: what is at stake

Germany is an open economy. As a country with very few raw materials, it is dependent on imports. Its industrial companies specialise in niche products for which its own market would be far too small. Although the European internal market partly offsets these disadvantages, in qualitative terms the same applies to Europe as to Germany itself. Moreover, access to the internal market is not barrier-free; there are still national regulations, cultural characteristics, language differences and, in some cases, different currencies to deal with.

The German economy and, in particular, industrial companies benefit to a major extent from international trade.

Figure 1: Real income gains due to international division of labour, in percent



Note: The figure shows the percentage by which real per capita incomes actually observed in 2011 are above counterfactually simulated autarky levels.

Sources: Ossa (2015), own presentation. Selected countries.

As the world's fourth largest economy, Germany itself has a large domestic market; nevertheless, in quantitative terms the real income gains as a result of the international division of labour are very significant. Figure 1 reproduces the results of a simulation by Ossa (2015). It shows how much the real per capita incomes actually observed for a selected group of countries in the base year 2011 would differ from those in a hypothetical autarky situation. Here, the trade costs are artificially inflated to such an extent that no trade at all occurs with other countries; but the technological conditions are kept at the 2011 level even though they are themselves the result of a relatively free global economy. For this reason, and also because this type of calculation is based on a sectoral analysis which cannot map the high import dependency at the product level, the figures reported are very conservative estimates. Nevertheless, it is clear that Germany's per capita income in the observed **status quo of 2011 is around 40.2 percent above the hypothetical autarky figure**. Using the size of its own market as a starting point, we would expect to see a substantially smaller figure for Germany, below those of the UK or France. Germany is thus more heavily dependent than other countries on participation in the international division of labour.

Germany is heavily dependent on the international division of labour.

Conversely, this means that a return to autarky would lead to Germany's pro capita income shrinking by around 29 percent. Based on the 2019 figures, this would be equivalent to a loss of some 12,000 euros per person per year. Total income in Germany would be around 996 billion euros lower per year.

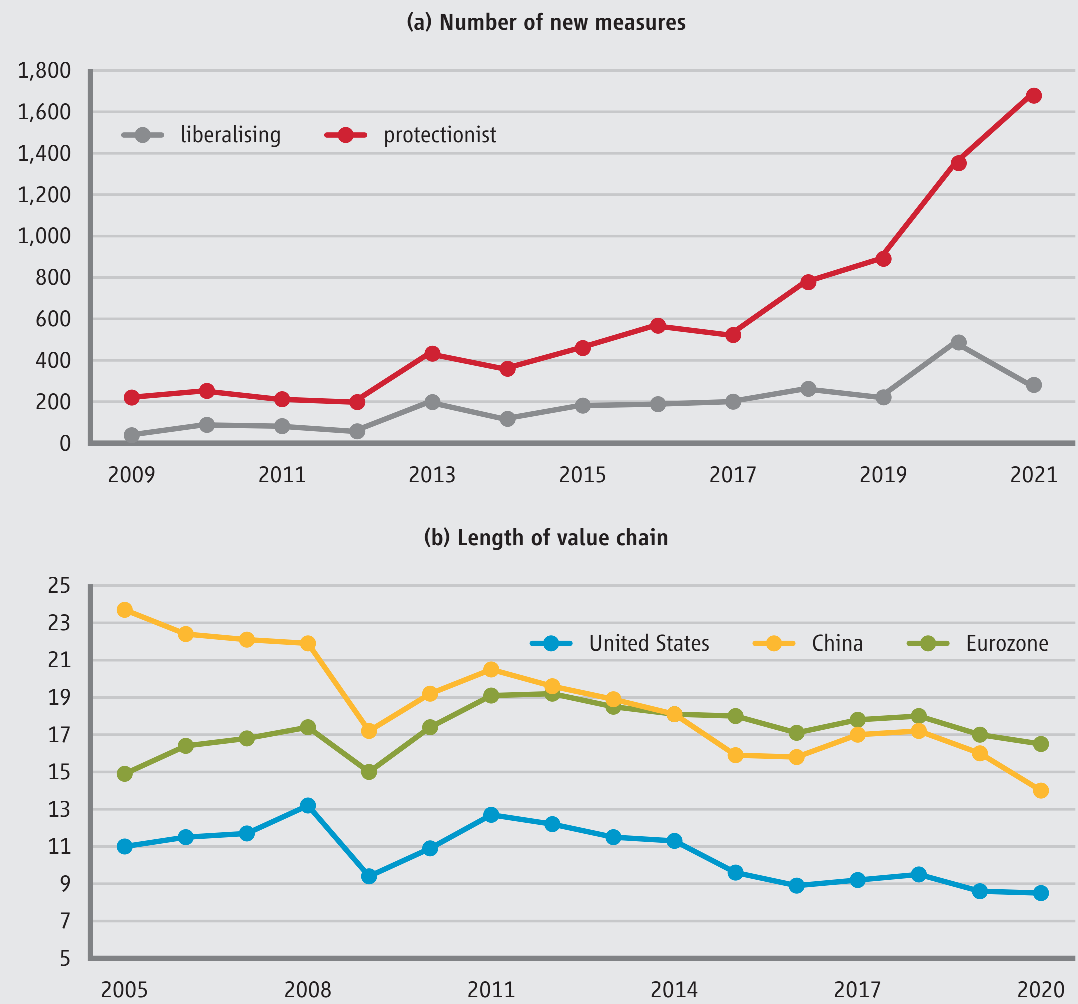
Autarky is an unlikely and extreme scenario. If trade outside Europe alone were to come to a standstill while trade within the EU were maintained, this would lead to income losses of slightly more than 500 billion euros per year or 6,000 euros per capita.

Trade in input and intermediate products along **value chains** appears to be under particular threat – at any rate, these were the products the US administration under President Trump focused on during the conflict with China. Eppinger et al (2021) estimate what would happen if prohibitively high barriers were created for the trade in such intermediate goods while final goods were traded as before: in Germany, the result would be losses in prosperity amounting to just under 12 percent. If the restrictions were limited to trade outside Europe, the losses would still come to 4 percent – at the lower limit of the true costs, as mentioned above.

Other EU countries will be affected to a substantially greater extent than Germany because of their small domestic markets. Even if the EU remained fully intact, an end to **the trade in intermediate goods** with partners outside Europe would be disastrous for countries such as Belgium, the Netherlands, Denmark and Austria, let alone the smaller countries, such as Malta, Luxembourg or the Baltic states.

Trade barriers are on the rise, and very clearly so. Figure 2 shows the sharp increase in new protectionist trade barriers since 2009. A total of almost 1,700 new protectionist measures were introduced worldwide in 2021. Since the launch of the Evenett and Fritz (2021) database, there have only been two years when the annual increase in protectionist measures was below that of the previous year.

Figure 2: New protectionism and the length of value chains



Note/source: figure 2 (a) shows the number of annual trade policy measures imposed as stored in the Global Trade Alert database (https://www.globaltradea- lert.org/). See Evenett and Fritz (2021) for the most recent report. Figure 2 (b) shows the length of the value chains as a percentage of imported value added in the value of gross exports of countries (Backward Participation in Global Value Chains, OECD Trade in Value Added; own estimates for 2019 and 2020).
Author's own calculation and presentation.

The barriers shown in the illustration concern imports and exports of goods and services. Only a small percentage is attributable to tariff measures; very frequently, they are non-tariff barriers which discriminate against foreign suppliers in comparison with domestic suppliers.

Free global trade is made increasingly difficult by trade barriers.

Figure 3 (a) illustrates that **Germany** is the country the most frequently the target of discriminatory measures after China. The reasons for this can be found in the size and degree of diversification of Germany's export industry but also in the fact that barriers have increased particularly sharply in traditional German export industries such as metal work, mechanical engineering, means of transport and chemicals.

The EU is a strong trade policy player.

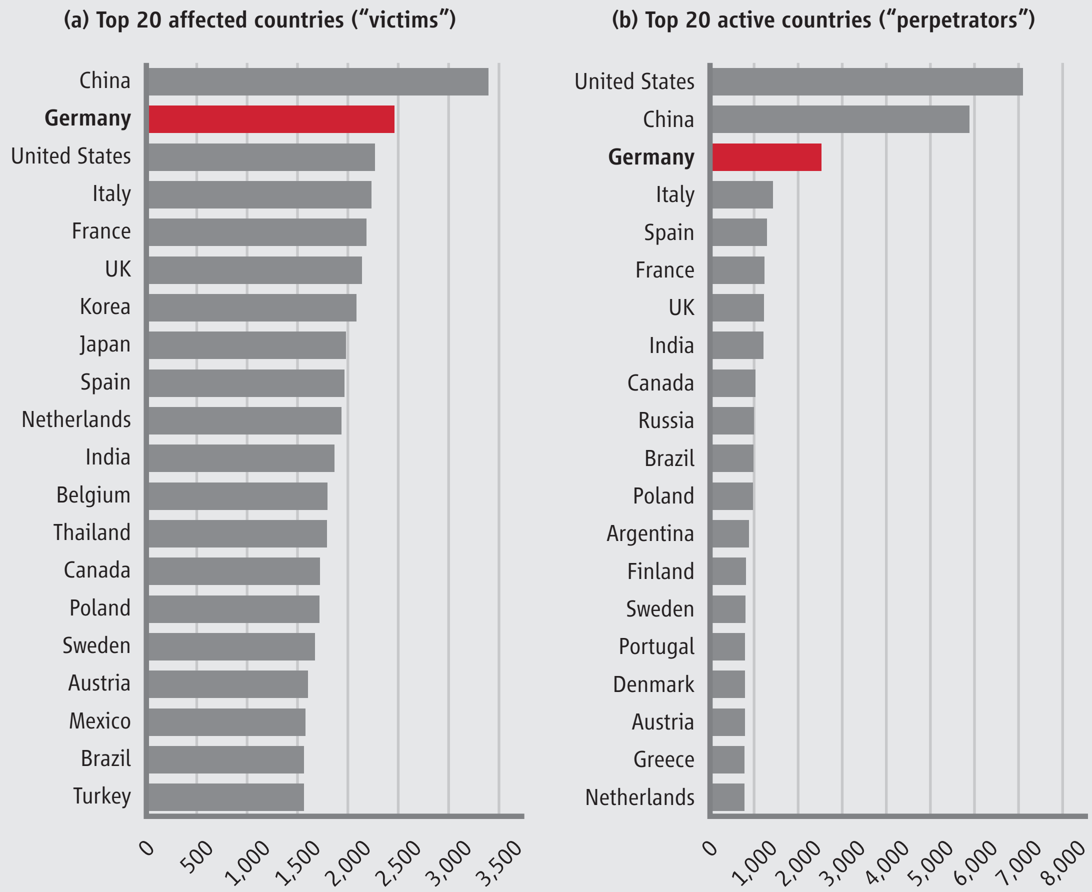
Figure 3 (b) shows that Germany is also often itself the source of protectionist measures. Although the country has delegated its trade policy powers to Brussels, its broad import base means that many bilateral relationships are also affected by EU measures. The USA and China are far ahead in the ranking. Nevertheless, it would be incorrect to **think of the EU as a benign trade policy player**. A more detailed presentation of the protectionist side of the EU's foreign trade policy is given in Felbermayr (2018).

Figure 2 (b) shows that the increasing protectionism seems to be correlated with a **decline in the length of value chains**.[5] We can see that China, since the start of the time series in 2005, has been increasingly reducing the share of imported input products in the production of its final export goods. Even before then, China launched a policy of import substitution and successfully pushed ahead with it – a feat in economic history achieved by few countries without suffering major macroeconomic damage. We are also already seeing a strong decoupling of China, driven forward by the People's Republic itself. Since the global economic and financial crisis of 2009 we have seen value chains contract, even in the eurozone and the USA.

But the rise in protectionism is already having an impact on prosperity in Germany: as Kinzius and Yalcin (2019) have demonstrated, the measures reported in the *Global Trade Alert* database do indeed reduce global trade, i.e. by an average of 12 percent for the goods in question.

5 As an approximation, the length of value chains is measured using the share of value creation of imported input products in the total value (gross value) of exports.

Figure 3: Number of harmful trade-policy interventions, 2008–2021



Note: author's own calculations and presentation. Cumulative figures 2008 to 2021.

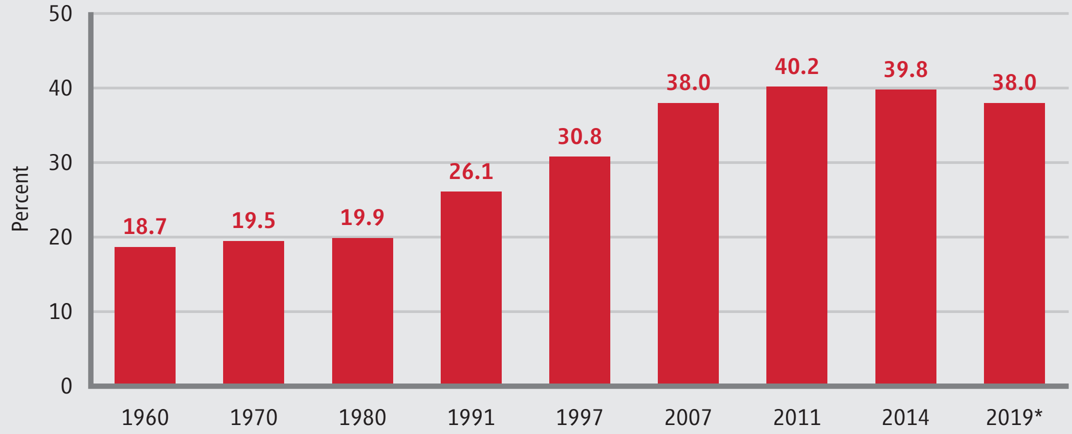
Source: Global Trade Alert database(https://www.globaltradealert.org/).

Figure 4 shows that the wealth gap between the observed status quo of the base year in question (1960 to 2019) and the hypothetical state of autarky has been shrinking since 2011. Felbermayr et al (2017) show the same result for the German Council of Economic Experts using a broad range of simulation models. The income losses were balanced out by the respectable autonomous growth of Germany's economy. Nevertheless, it is clear that owing to the growth in protectionist measures between 2011 and 2019, real **per capita income in 2019 was around 1.6 percent lower** than it would have been had trade policy conditions remained constant.[6] This means that without new protectionism, the per capita income in 2019 would be almost 670 euros higher than the actual reported figure of 41,801 euros.

Protectionism diminishes prosperity and reduces real per capita incomes.

6 In 2019, per capita income was 138% of the autarky level, compared to around 140.2% in 2011. The current figure is about 1.6% below the 2011 figure.

Figure 4: *Real income gains due to international division of labour in Germany over time, in percent*



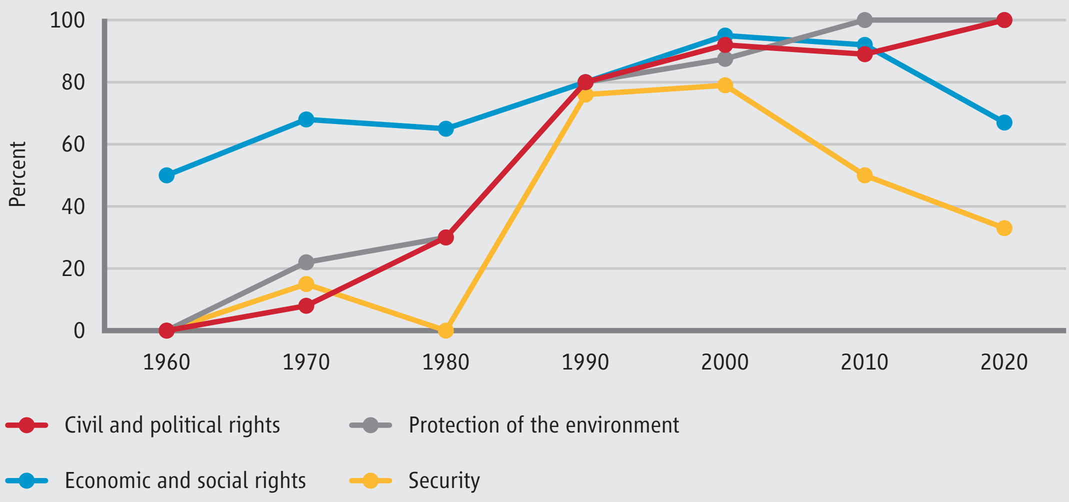
Note: status quo relative to hypothetical situation of autarky in Germany, various base years, Germany, in percent.
*Approximation on the basis of 2014 input/output tables.

Source: author's own calculations on the basis of Ossa (2015).

There are many reasons for the rise in protectionism. First of all, an **inequality** that is increasing, or is perceived as increasing, has eroded the trust of many voters in the market economy as a prosperity-creating institution. In addition, the high speed of technological, social and economic change has created winners and losers, and populist movements attribute this change to globalisation. Alongside such domestic policy motivations, there have also been foreign and security policy motives, and these tend to weigh more heavily. One important reason is the **loss of trust** in the multilateral trading system, which for a long time afforded a guarantee against opportunistic behaviour by trading partners. If this guarantee no longer appears to be working, countries attempt to protect themselves against the risk of exploitation. Very often, such protection takes the form of trade barriers which are designed to give priority to domestic value creation. This is not an entirely new development: countries have always used foreign trade policy for their own geostrategic interests. But geostrategic tensions have intensified in recent years; the *Pax Americana* as guarantee of the peaceful coexistence of countries and of free global trade is no longer credible. Finally, attempts to assert goals outside traditional trade policy by means of trade policy measures can also promote protectionism.

Figure 5 shows how the European Union is using its trade agreements to **pursue environmental policy, social policy or civil rights issues** to an ever-increasing extent. They now form part of virtually all new EU agreements and are also playing a growing role in determining how the Union generally acts in trade policy matters.

Figure 5: Share of EU trade agreements with non-trade goals, in percent



Source: Lechner (2020).

It is absolutely legitimate for the EU to pursue a broad range of different goals. However, the EU is hampered more than other players by the fact that it only has a limited number of tools at its disposal. For instance, it does not have a common foreign and security policy; its trade policy is the only power available to the EU. But if the number of independent targets exceeds the number of independently available instruments, it becomes highly likely that targets will be missed: conflicting targets are inevitable. This was demonstrated in 1950 by **Jan Tinbergen**, recipient of the first Nobel Prize in Economics. If the number of targets increases, the number of instruments also needs to increase for the targets to be achieved. For this reason, a reformed European foreign trade policy must prioritise the expansion of its toolbox.

A reformed foreign trade policy must expand the toolbox.

Figure 6 provides further proof of the increase in targets outside traditional trade policy. It shows that the number of **economic sanctions** has been steadily increasing over the past decades: since 1950 their number has risen almost 15-fold, as shown by the *Global Sanctions Data Base* of Kirilakha et al (2022). The figure does not include sanctions issued in the context of the World Trade Organization. Figure 6 (a) demonstrates that the motivations for imposing sanctions are very diverse: they extend from measures to punish human rights violations, to push for democratisation, to terminate or avert a war or a territorial dispute, and also include measures aimed at combating terrorism, destabilising an undesired regime or bringing about a change in policy.

Figure 6 (b) shows the types of sanctions used to achieve this. Traditional trade policy measures that prevailed in the 1950s now play a relatively less important role. Because sanction episodes have increased, however, the number of trade sanctions has not declined in absolute terms; instead, it has also risen sharply: from 13 in 1950 to more than 80 in 2019. Since the late 1970s financial sanctions have been the most important category: from this time, they have consistently accounted for around 30 percent of sanction measures. Travel restrictions have also grown in number over recent years. However, not surprisingly, the effect of trade sanctions on common trade is the greatest, especially if it comprises a broad range of goods (Felbermayr and Sandkamp, 2022).

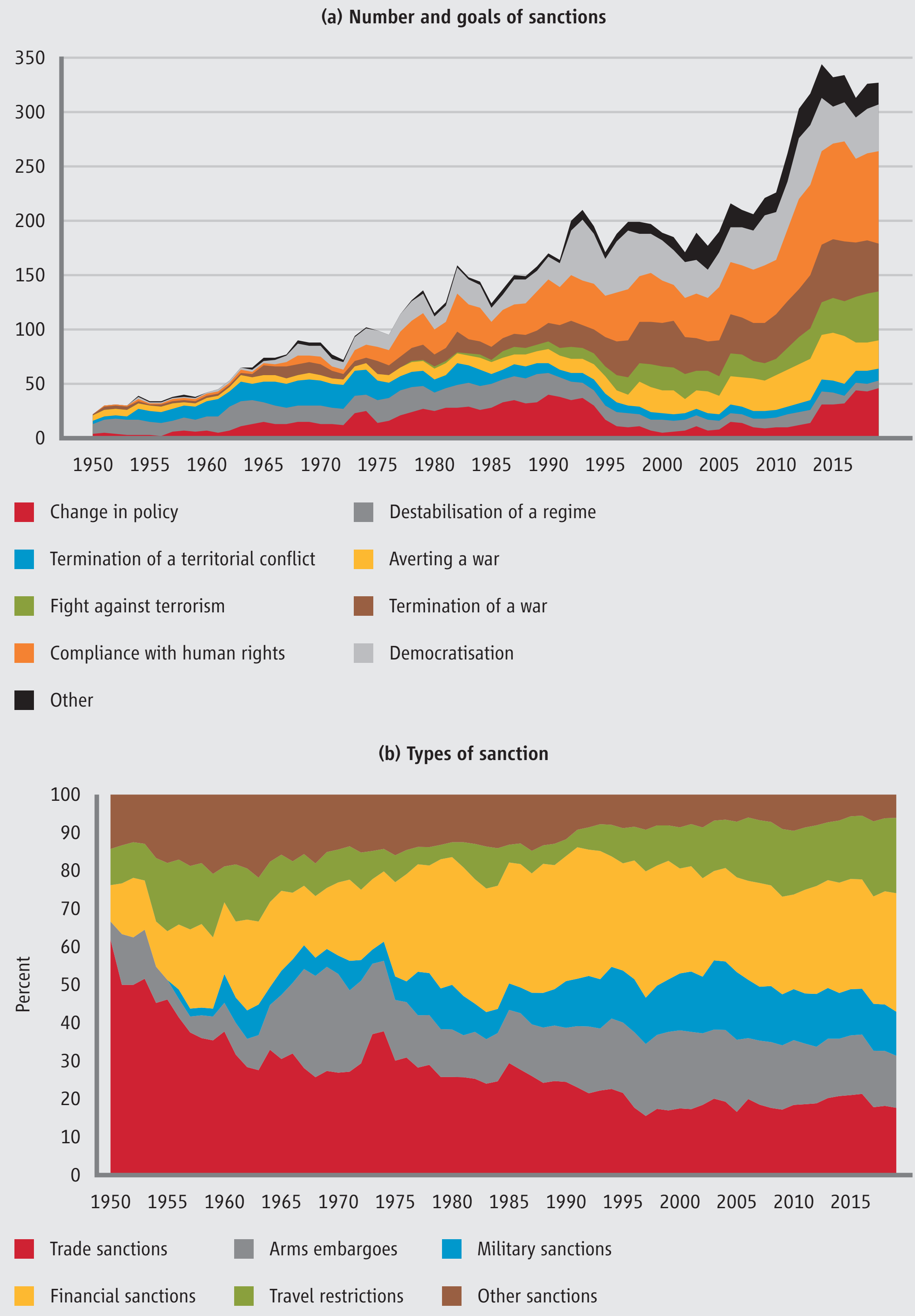
Germany suffers the most from trade sanctions.

At any rate, sanctions are of economic significance. Chowdhry et al (2020) used the sanction episodes in the *Global Sanctions Data Base* to simulate the real income losses resulting from the sanction regimes employed against Russia and Iran.[7] The results for selected countries are shown in figure 7. It becomes apparent that the burden resulting from the measures is very unevenly distributed. The country suffering the most from the trade sanctions in economic terms is Germany: in the base year 2019, the **damage came to around 8 billion US dollars**, equivalent to slightly more than 0.2 percent of GDP. But other countries, primarily smaller countries in close proximity to Russia (the Baltic republics, Finland, Slovakia, Bulgaria, but also the Netherlands, which is extremely open to trade) lose more as a percentage of GDP. By contrast, the USA loses hardly anything: the simulation study shows that the economic damage it suffers comes to less than 0.01 percent of GDP.

The new sanctions which the EU and its allies have imposed on Russia and Belarus will also have extremely heterogeneous effects. Initial analyses conducted by e.g. Felbermayr et al. (2022) show that the closer a country is to Russia, the higher the cost. Among the world's major economies the economic damage here too is likely to be greatest in Germany, although other countries in immediate proximity to Russia will probably be negatively affected to a greater extent in terms of their economic output.

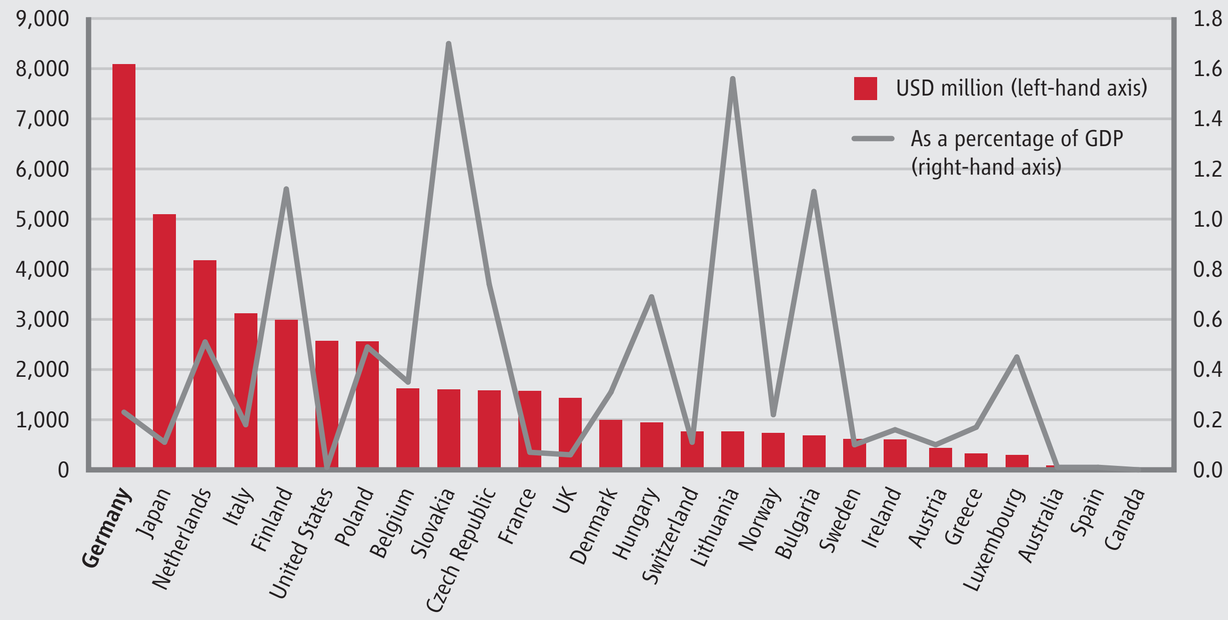
7 These two sanction regimes are by far the most important with regard to their effects on trade.

Figure 6: Economic sanctions – ever more frequent, ever more diverse



Source/note: Global Sanctions Database (https://www.globalsanctionsdatabase.com/);author's own calculation and presentation. Data does not comprise sanctions in line with WTO law. Limited double counting if a sanctions regime pursues a variety of goals.

Figure 7: Real income losses due to sanctions, in millions of US dollars and percent (base year 2019)



Sources: Chowdhry, Felbermayr et al (2020), on the basis of the Global Sanctions Database; author's own calculations and presentation.

Trade policy uncertainty and sanctions often hit family businesses.

What the analysis clearly shows is that trade policy sanctions can prove expensive in macroeconomic terms. If their number and intensity continues to rise, this harbours considerable risks for prosperity in Germany and elsewhere. Serious problems result not just from the actual introduction of sanction measures but also from the threat involving the introduction or intensification of an existing regime, often over a period of many years. In fact, trade policy uncertainty is primarily a problem for medium-sized exporters or importers, often family businesses, which do not possess the latitude necessary to expand their country portfolios in order to mitigate the effects of sanctions.

C. Reform of the EU foreign trade strategy

Foreign trade is largely the sole responsibility of the European Union, and decisions are taken by the Council with a qualified majority.[8] The EU Commission has executive powers, which means in this case that the policy areas in foreign trade – tariff policies, trade conflicts, trade agreements – are communitised where they relate to the trade in goods (the distribution of responsibilities is more complicated for the trade in services).

The European Union's foreign trade strategy has seen constant change over the years. Until 2006, there was a clear focus on deepening and widening the European Single Market, on **association agreements** to prepare the accession of new members and on neighbourhood agreements aimed at political and economic stabilisation. Moreover, at a multilateral level the EU was active in expanding and deepening the GATT (General Agreement on Tariffs and Trade) and, from 1995, the WTO (World Trade Organization). To illustrate, in November 2001 – almost exactly 20 years ago – China joined the WTO, with the EU making a significant contribution to the country's accession. Subsequently, growing disappointment about the lack of progress emerged within the WTO.

As a result, in 2006 the ***Global Europe Strategy*** was adopted, which to some extent marked a move away from multilateralism. The aim now was to pursue more bilateral agreements by means of which growth markets were to be opened up with the aim of securing and expanding employment in EU countries. Here, the EU deliberately focused its efforts on countries considered particularly promising on account of their market size and momentum: the USA, Canada, Japan, Korea, India, Mercosur, the ASEAN countries and others. It took a while for the negotiation mandates to be adopted by the member states, and the negotiation process itself proved to be of great difficulty in some countries. Nevertheless, modern and comprehensive free trade agreements were signed with a number of major countries, such as Korea (entry into force in 2015), Canada (provisional and partial entry into force in 2017) and Japan (entry into force in 2019).[9] Agreements are now in place with a number of ASEAN countries (Vietnam 2020, Singapore 2019) but not with others (Thailand, Malaysia, Philippines). Negotiations with the USA and India have been put on hold while negotiations with Indonesia are ongoing. Broadly speaking, these agreements can be described as successful: they have dismantled trade barriers and strengthened bilateral economic exchanges, with no major negative side-effects to report.

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8 Decisions require a double majority of 55% of member states (currently 15 out of 27 states) representing at least 65% of the population.

9 So far, Germany and other EU member states have not ratified the trade agreement with Canada owing to domestic policy concerns; the agreements with Singapore and Vietnam are structured as "EU-only" agreements and were thus able to enter fully into effect without requiring ratification by the national parliaments.

According to the philosophy underlying the *Global Europe Strategy*, trade policy should limit itself to allowing aggregated prosperity gains from trade; social policy should then redistribute these gains to ensure that they reach the largest possible number of people. Following the Great Depression the debate changed, and concerns about inequality gained in importance. This trend was further accelerated by widespread resistance to in-depth and comprehensive trade agreements, such as the planned TTIP agreement with the USA. And so, in 2015, the European Commission published its new ***Trade for All*** **strategy**, which gives more weight to the distribution of trade gains and to social and economic concerns.

The EU is facing the challenge of implementing its goals of openness, sustainability and strategic autonomy equally.

This trend has continued in recent years. Increasingly, EU trade policy mirrors an extended definition of EU interests, and there has been a move away from purely economic goals towards the maximisation of social goals comprising environmental, human rights, labour and social affairs. The European Commission completed a review of its trade policy in February 2021 and called for the implementation of an **"open, sustainable and assertive trade policy"** as the aim of its endeavours. In its new foreign trade doctrine, it specified its drive to achieve **"open strategic autonomy", which it announced a few months earlier**. This autonomy refers to the EU's ability to act sovereignly when choosing its strategic focal points while at the same time maintaining a close dialogue with its international partners. However, since this means the EU now pursues at least two, or more likely three, targets, including sustainability, conflicting targets can be expected. First of all, the difficult compromises between the targets of openness, sustainability and strategic autonomy must be made transparent in analytical terms. The conflict with Russia demonstrates just how urgent this is, and how unrealistic it appears to be to hope that the above-mentioned conflicting targets will simply vanish. In addition, ways have to be found to deal with them. If EU members want to retain their sovereignty, the EU must look after its strategic interests and demonstrate self-confidence.

Conflicting targets are to be expected.

The new regulations discussed below are a consequence of the new doctrine. Alongside foreign trade policy initiatives, however, changes can also be observed in EU industrial policy. This becomes clear if we look at the example of the ***European Chips Act*** advanced by Commissioner Thierry Breton. It concerns a package of measures which seeks to ensure that at least 20 percent of global semiconductor production will be located within the EU over the medium term. In order to implement this plan, the new Act will also include restrictions on foreign direct investment in the EU together with export controls. The USA has similar legislation. In a comparable way, there are plans at EU level to adjust the competition and state aid legislation in order to facilitate cross-border cooperation within the EU and to mobilise more public funds for strategic, industrial policy projects. Such an activist and interventionist industrial policy is a further hallmark of an EU economic policy that is becoming more interventionist and should be viewed particularly critically.

D. Some game theory basics

Trade policy tools have long been used in order to promote domestic economic prosperity, at times to the disadvantage of the trading partners (***beggar-thy-neighbour* policy**) and in order to influence the behaviour of foreign governments in both the economic and non-economic spheres.

Beggar-thy-neighbour policies are measures through which a government attempts to manipulate exchange relationships with its trading partners for its own benefit, thereby exploiting the foreign countries in question. For example, by imposing import duties or using subsidies it becomes more attractive for a market to be served with goods produced in the country rather than being served with export goods produced outside. Tariffs can thus be connected with location; large countries such as the USA and China, in particular, have the clear ability to deploy this tool with success, as economic history has demonstrated. Another way is by influencing relative prices: import goods are imported as cheaply as possible and export goods exported at as high a price as possible, allowing import tariffs, for example, to be used to curb demand from domestic customers for foreign goods. Foreign suppliers are actually moving down on a rising supply curve, so that the prices of goods fall before the tariff is imposed. The home country thus comes into the possession of import goods at lower prices because a portion of the tariff is effectively paid by the foreign suppliers while the total tariff income remains in the home country. This is also easier for major import countries to achieve than it is for smaller ones because major countries have considerable market clout. Conversely, when supply volumes become scarce in export sectors, major export nations are able to take advantage of their market clout as a seller and drive prices up. If the countries concerned have a large number of producers, the market would find its equilibrium without a strategic foreign trade policy; but with the state policy, unilateral advantages can be achieved. The literature here refers to **optimum tariffs** (Johnson, 1953).

The problem here, however, is that the trading partners are also able to manipulate their exchange relationships. In an equilibrium which sees all countries making such attempts, the resource transfer from abroad fails but the distorting effect of the tariffs remains. Thus, instead of gaining an advantage through supposedly clever manoeuvres, all the countries end up worse off. Here have an example of the game theory **prisoners' dilemma**: the individually rational strategy proves collectively disastrous and everyone loses.[10] And it is difficult to escape this non-cooperative equilibrium: a partner with high tariffs who lowers them unilaterally worsens its position as long as its trading partner doesn't also lower its tariffs. And a partner with low tariffs has an incentive to increase its own tariffs given the high foreign tariffs. Any promises

A selfish tariff strategy can lead to a prisoners' dilemma, the outcome of which is less than ideal for everyone.

10 A small part of the literature addresses the question whether trade wars can be won. In theory, it is conceivable that they can, in the case of a very large country; but empirically there is no evidence to support this possibility.

to lower one's own tariffs as soon as the trading partner has lowered its tariffs always run the risk of not being believed.

The World Trade Organization is a way to escape this harmful equilibrium. It provides a forum for repeated games in which countries maintain their interactions while adhering to certain rules. Sanctions are crucial in ensuring that system works. A partner who does not play cooperatively will be punished in the next period, as its trading partner will also play non-cooperatively, i.e. by making access to its own market more difficult as a sanction. This means that, compared to a cooperative equilibrium, the benefits of non-cooperative strategies are reduced. If the future is of sufficient importance to political decision-makers, then cooperation becomes more likely because any possible future losses unfold their effect in the present. But this only works if the trading partners actually adopt a sanction strategy when a country doesn't play ball. Thus **credibility** becomes a crucial factor. Furthermore, where major countries deviate from rules, it is important for the others to be able to form coalitions. In these areas, the World Trade Organization has developed important principles and structures, but they have suffered a massive loss of credibility in recent years.

Credible sanctions provide incentives for cooperation.

As a general rule, however, even large countries or blocs might, using the strategy of penalising a deviation from the rules, create incentives for all countries to abide by the rules because a deviation creates more costs than benefits. Sanctions whose use is credible will not be deployed in a cooperative game. They are important for achieving a cooperative equilibrium, but they do not play a role in the cooperative equilibrium itself. Game theory thus refers to "off-equilibrium strategies". These mechanisms are the **core of the economic theory underlying GATT and the WTO**, see Bagwell and Staiger (2004).

Threats of sanctions only have an effect if they are credible, otherwise they are nothing but cheap talk. In pure theory, threats do not have to be put into practice, because no uncooperative behaviour occurs. In realistic constellations with incomplete information or players who are not fully rational, however, deviations from the rule may occur despite the threat apparatus. Then, the threat needs to be carried out even though to do so entails short-term economic costs. If the sanctions announced fail to materialise, this confirms the impression that the threats are not serious. The ingredient which is supposed to ensure a cooperative equilibrium is thus lost.

For threats to be credible, there must be strong and rapid mechanisms in place that allow rule violations to be identified and penalties to be determined and imposed. Where possible, this should be **rules-based** and largely automatic so that the forces which are disadvantaged by the measures in the home country are not able to build up an effective political resistance. At the same time, these domestic losers of a sanction regime must also be considered, for example by ensuring a **compensation fund** is in place. If a trade policy opponent has to assume that the potential losers of a sanction will be compensated, then that opponent cannot expect the potential losers to resist the sanction – something which would obviously be in the trade opponent's favour. The threat therefore does not become credible until internal **compensation mechanisms** are in place. This is all the more true if the matter escalates.

The available instruments range from import duties (tariffs), export subsidies or taxes, volume restrictions on imports and exports and trade protection instruments such as anti-dumping tariffs through to licence requirements or provisions on domestic minimum added value content. Disciplines in relation to such instruments were developed multilaterally at varying levels of depth and breadth as part of the WTO's General Agreement on Tariffs and Trade (GATT) or using bilateral and regional free trade agreements (FTAs).

There is a distinction to be made between **positive and negative sanctions**. The former attempt to reward cooperative behaviour, for example by granting trade concessions or market access. This is what the EU's preferential agreements do by offering developing countries largely tariff-free access to the EU market; in return, they require these countries to ratify and observe international conventions. The terms are in the process of being tightened: in future, for the EU to grant tariff preferences, 31 international conventions will need to be ratified, as opposed to the present 27. Free trade agreements also increasingly include an obligation to sign and comply with other agreements which are often not directly related to trade policy. There are growing voices calling for sanctions to be attached to these obligations. A coded way of referring to this, for example in the German coalition agreement, is through dispute settlement mechanisms, with sanctions as the final step. By contrast, negative sanctions aim to ensure rule-compliant behaviour through explicit penalties.

Positive, negative and unconventional sanctions can prove highly effective in asserting existing rules.

At issue, however, is more than compliance with trade policy rules, and the goal is not always to increase gross domestic product or employment. Outside trade policy, economic sanctions are increasingly being used as a substitute for more conventional, i.e. military, forms of intervention (*war by other means*, Blackwill and Harris, 2016). All told, we can say that the tools used are increasingly of an unconventional nature, i.e. they do not originate from traditional foreign trade law. They are often highly non-transparent and are described as *murky protectionism* in the literature (Caldera et al, 2020; Evenett and Fritz, 2015). As described in section B, their scope extends to discriminatory regulatory provisions, travel bans, the freezing of assets and other financial sanctions, the keeping of black lists of companies (known as *entity lists*), through to propaganda means (such as calls to boycott goods or services from specific countries).

Usually, the aim is to force governments, consumers or businesses in other countries to adopt behaviour they would not display at their own initiative (*coercion*). The end goal may be to push through compliance with existing rules of international law or to force a partner into specific opportunistic behaviour that is outside international law.

The threat of opportunistic behaviour by trading partners can result in countries not wishing to risk participation in the international division of labour, which typically involves specialisation, because they fear being exploited by the trading partner as soon as certain goods are no longer produced domestically but are rather imported. This fear is key in the current debate about **strategic dependencies** and in calls to relocate the manufacture of major import goods to the EU. The concerns aired in this debate are felt by many and must be taken seriously. If they cannot be dispelled, there is a risk of losing the prosperity gains that result from the international division of labour. In recent years we have seen a significant increase in harmful trade policy uncertainty because countries deploy traditional trade tools more often in order to pursue a variety of foreign policy goals which may differ greatly in nature.

Foreign governments can cut the EU off from major imports or threaten to do so in order to force through advantages for themselves. However, they can also pursue the same goal by refusing or impeding access to their markets. To counter concerns about both problems, the EU could promote the diversification of the portfolio of supplier countries, for example through the **signing of free trade agreements**. It could promote the international role of the euro as means of payment in order to become independent from US dollar-denominated payment systems. To prevent the threat of import restrictions, the EU could create strategic reserves of essential goods or strengthen incentives for stockpiling by businesses. By contrast, a general decoupling from global trade would be expensive in macroeconomic terms, as evidenced by the relevant simulations.

New trade barriers may not be allowed to arise.

In summary, therefore, we can say that if the World Trade Organization is no longer able to safeguard international law itself, the individual players will have to arm themselves better. To maintain cooperation it is necessary to be able to respond credibly to non-cooperative behaviour through sanctions. But for this the EU will need new instruments, and designing them well is difficult, since the aim must be that there is no escalation beyond the level of a simple threat wherever possible and that no new trade barriers are created. In any event, a decoupling from the global economy would be an expensive business, and the gains in terms of security and stability would be highly questionable.

E. Evaluation of the EU's new trade policy instruments

Because there is no international law enforcement agency, agreements between countries have to be designed in such a way that the incentives for countries to deviate from the agreed rules are minimised in all eventualities. As described above, even in the traditional areas of application of WTO law the credible threat to respond to breaches of the rules by imposing *tit-for-tat* sanctions is of existential importance for the stability of the international trade order (Bagwell and Staiger, 2004). In other areas, and particularly where no relevant international legal orders exist and the aim is to impose *good behaviour*, the EU must invest in increasing the credibility of its sanctions mechanisms. To date, the options extend to the events codified in WTO law; but this is no longer sufficient for the reasons outlined above.

The EU must increase the credibility of its sanction mechanisms.

The EU must create the legal conditions necessary to improve its ability to act. This requires, for example, the faster and more effective establishment of transparency in foreign trade policy processes, the acceleration of decision-making processes and the creation of a compensation fund to deal with collateral damage. Above all, the EU must create the legal conditions for threatening and implementing retaliatory measures as part of a new ***anti-coercion instrument***.

I. Regulation on the protection from economic coercion

Time and again, members of the EU come under pressure from the governments of third countries seeking to prescribe specific actions under the threat of economic consequences.

One example of such attempts to exert influence is a current **dispute between China and Lithuania**. Following Lithuania's decision to allow Taiwan to establish a representation in its capital Vilnius, Lithuania has been put under massive pressure by the People's Republic of China using economic measures. Thus Beijing is attempting to coerce European exporters to refrain from using input and intermediate products from Lithuania if they want to continue exporting to China.[11] The issue was discussed in the EU Council in December 2021 but it does not feature in the minutes because the EU apparently has difficulties documenting the evidence for the Chinese measures in a legally watertight manner. The French trade minister Franck Riester has quoted the case as proof that the planned anti-coercion instrument should become ready for use as quickly as possible. He is planning to push ahead decisively with the legislative process in the first half of 2022 during the French Presidency of the Council.

11 According to a Reuters report dated 17 December 2021, for example, German automotive supplier Continental is affected (https://www.reuters.com/world/china/exclusive-china-asks-germanys-continental-cut-out-lithuania-sources-2021-12-17/).

Another example often quoted in this context is the **dispute between Australia and China** regarding the origin of coronavirus.[12] In this context, Beijing has limited 10 percent of imports from Australia in a total of 13 critical sectors, including wine, barley, beef, coal and grapes, claiming its actions are in accordance with WTO law. Australia's exporters are accused of dumping measures; moreover, Beijing has classified some food as unsafe. Canberra considers these arguments to be a pretext and the case is now pending before the World Trade Organization.[13] As the example shows, measures introduced with the intention of exerting coercion can be justified using WTO law and disguised as defensive measures in this way. Even if the country thus attacked defends itself in front of the WTO or other bodies and is vindicated, and the active country has to reverse the measures, economic damage may still have occurred and coercion been applied. Timing plays an important role in this context.

Against the backdrop of the cases discussed, representatives of the Federation of German Industries (Bundesverband der Deutschen Industrie, BDI) are now publicly backing the instrument.[14]

The **USA** has repeatedly attempted to bring about policy changes by threatening European countries with trade policy sanctions, for example, in order to dissuade France from introducing the planned digital tax.

The new Regulation on the protection from economic coercion (*anti-coercion instrument*) is designed to supplement the existing ***blocking statute***. This Regulation has been in existence since 1996 to protect EU citizens and businesses from the extraterritorial use of legislation adopted by a third country. The EU considers the application of such legislation to be illegal. The Regulation revokes the effect in the EU of specific foreign court rulings as listed in the Annex (e.g. US legislation in relation to sanctions against Cuba and Iran) and grants EU citizens the opportunity to claim damages in court for losses suffered by the extraterritorial use of the specified foreign legislation. It even bans EU citizens from complying with requirements or prohibitions on the basis of that foreign legislation, with some exemptions being granted. However, these measures have not stopped other countries, particularly the USA, from the extraterritorial application of their legislation in the past, and because EU companies do not want to risk the loss of access to the US market under any circumstances, they comply with the US rules. Thus the new *anti-coercion instrument* is designed to enable the EU to issue credible

12 For example, the Chairman of the International Committee in the EU Parliament, Bernd Lange, in a guest contribution in Borderlex dated 7 December 2021 (https://borderlex.net/2021/12/07/comment-how-to-make-the-eus-anti-coercion-instrument-work/).

13 https://www.reuters.com/business/wto-panel-examine-australia-china-wine-dispute-trade-source-2021-10-26/

14 For example, Wolfgang Niedermark at an event held by the European Council for Foreign Relations in Brussels in December 2021.

threats of reciprocal sanctions so that no extraterritorial application of the legislation adopted by third countries is threatened or occurs in the first place.

A central motivation for the new EU legislation is the fact that the **appellate body in the WTO's dispute resolution mechanism** has been blocked since 11 December 2019 because the USA is still refusing to agree to the reappointment of new judges. Together with 15 other WTO members, the EU has created a substitute called *Multiparty Interim Appeal Arbitration* (MPIA). However, countries which have not joined the MPIA Agreement can now block the further enforcement of WTO law if they have lost a legal dispute in the first instance by an appeal *'into the void'*. For this reason, the EU revised the *Enforcement Regulation* in February 2021, which enables the EU Commission to take countermeasures without a WTO decision having been taken.

These countermeasures are further extended through the proposed *anti-coercion instrument*, which empowers the EU to speak the **new language of power**. If the multilateral settlement of disputes can no longer be relied upon, an additional tool is required which attempts to ensure the assertion of law at a bilateral level by imposing trade policy countermeasures, for example in the form of import tariffs, volume restrictions and export and import licences for goods and services, and measures in international capital movements, in finance or in connection with intellectual property etc. The primary goal is **deterrence**. It should be clear, however, that such measures are really only used as an *ultima ratio* and only in response to the violation of international law, not in response to security policy threats which are virtually impossible to determine objectively. Beforehand, the parties need to undergo a process of bilateral or multilateral dispute resolution, with or without mediation.

Trade policy countermeasures are primarily designed to act as a deterrent.

It is also important to ensure that the process is, to some degree, **automatic** so that no difficult consultations with an uncertain outcome are required between the EU members and the institutions before the Commission is able to take measures. Thus it has been proposed that a qualified majority of member states should be required to halt measures by the EU Commission. Finally, it is important for the EU to coordinate with other WTO members whenever possible. This maximises the pressure on the country which breaks the rules.

Interestingly, this new instrument is based on Article 207 TFEU, i.e. on the common trade policy, even though it deals with intrinsically geopolitical issues of security and foreign policy which are not actually the sole responsibility of the EU. The aim is that it be deployed whenever a third country makes any attempt at exercising coercion, such events not being typically dealt with in WTO law. Even the Commission's proposals do not go beyond a vague description of the specific events that could activate the instrument. Triggers may include formal or informal measures by third countries aimed at exerting coercion; or may include covert measures or measures based on a state-orchestrated boycott of EU products. To this end, qualitative assessments will be required which will have to be taken on the basis of evidence that is as extensive as possible; quantitative threshold values which trigger the use of the instrument are hard to imagine. It will also be possible to punish extraterritorial sanctions with the new instrument even though the *blocking statute* is intended for these cases.

Consequently, the EU Commission proposes the use of a **comitology** to come to quick decisions in a delegated legal act. It is envisaged that the EU Commission will, in coordination with the member states, transpose the Regulation itself into applicable law, which would undoubtedly accelerate the process. But there is a risk that the EU, through the new instrument, will in fact claim foreign and security policy powers for itself which have no basis in any of its agreements or treaties.

Fast responses and credibility call the unanimity principle into question.

If the EU members and institutions must first clarify the domestic European division of responsibilities in disputes with third countries, they will lose valuable time and credibility. It is therefore important as a supplementary measure that the principle of unanimity in foreign and security policy issues is softened. Moreover, it might be the case that trade policy measures are not coordinated with other policy areas, thereby diminishing the instrument's effectiveness.

Finally, there is a risk that unilateral measures taken by the EU will lead to bilateral escalation and that a coordinated international response is more unlikely even though it would ultimately have a greater chance of success. In point of fact, the increasing number of sanctions observed empirically (Felbermayr and Sandkamp, 2022; see section B) is problematic because it shows that many implied or explicit **threats were not successful** and that a greater number of conflicts escalates.

Governments the world over are developing legislation designed to counter the possibility of foreign sanctions. China did this just recently, and the European anti-coercion instrument is another important example. Such developments have the potential to stabilise the world order by strengthening deterrence and creating an equilibrium of terror. At the same time, however, they may also destabilise the global order by leading to a sanctions race with its increasing fragmentation of the global economy. To avoid such costly results for the economy (Eppinger et al, 2021), it will be important to keep the communication channels open for all parties and to ensure a commitment to basic rules such as transparency and predictability on a multilateral level.

It is also urgently advisable for the EU to maintain continuous dialogue in the OECD or WTO with like-minded countries in order to achieve a **maximum degree of coordination**, and in the Commission Proposal, this is set out as a recommendation. However, it is important that an internationally coordinated approach is, in fact, adopted, and it may make sense to dispense with unilateral measures if no coordination with other countries can be achieved.

At any rate, many questions remain open. The most important include (i) the definition of trigger events (that is, of the circumstances under which the EU can or must take action); (ii) the definition of the countermeasures to be applied; and (iii) the form which an adequate proportionality check might take, in which the expected impact of the number of available options – of which there are usually many – is described and quantified. The latter question is of great importance: it does not help the EU if the new instrument damages the rules-based trading system even further because it is located outside the WTO and it is not supervised by an international organisation. Other countries, for example Japan, have already raised concerns on this point. Finally, it is not yet clear how the new instrument is supposed to interact with other EU instruments such as the *blocking statute* and the *International Procurement Instrument* (more details below). German politicians and the public should quickly take an interest in these issues.

The effects of the new trade tool must be checked to see whether they are proportionate.

II. Reciprocity and the Regulation on international procurement

Efforts to draft a Regulation on international procurement (*International Procurement Instrument*) have been ongoing for the past nine years, with France and Italy as particularly active proponents of such an instrument. These efforts, however, have been rebuffed to date by the UK and Sweden, but also by Germany. The regulation seeks to find ways to get foreign governments to admit European suppliers to public procurement and to treat them fairly, as the EU does with third-country suppliers (at least on paper). In other words, at issue is primarily the creation of **reciprocity**. And, as in section E.I, the failure of multilateral efforts is the starting point: in recent years, the World Trade Organization WTO has not been able to widen membership of the WTO's *Global Procurement Agreement* (GPA). The initiative can be seen in a similar way as a response to the EU's failure in bilateral negotiations.

Foreign governments should allow European suppliers access to procurement.

The problem is that the EU is not able to offer its negotiation partners much because its own market is already very open; for this reason, previous attempts to persuade third countries to open their markets have failed. Even far-reaching free trade agreements with the EU, including those with friendly states such as Canada, extend to only some aspects of the partner countries' procurement. And yet, according to the OECD, public procurement accounts for at least **10 percent of global gross domestic product**.[15] Family businesses, whether as suppliers of

15 https://www.oecd-ilibrary.org/sites/18dc0c2d-en/index.html?itemId=/content/component/18dc0c2d-en#sect-79

products or services or as a provider of construction services, could benefit to a substantial degree from the opening of markets.

The EU wants to be able to exclude foreign suppliers from public procurement markets in order to create reciprocity.

Should foreign suppliers' access to the EU's public procurement markets be restricted if the home countries of foreign providers do not allow EU producers in their procurement? This is exactly the direction of the EU's thoughts on the new Regulation,

which is aimed at the governments of states which have not signed up to the **WTO's Global Procurement Agreement**. In the case of Europe, China is particularly worth a mention: it refused to even enter into negotiations with the EU about the Comprehensive Agreement on Investment (CAI) governing public procurement which was concluded in December 2020 (but not ratified). Russia is also of importance. Both countries are home to businesses which regularly tender for EU infrastructure projects. But members of the WTO Agreement could also come under the scope of the new instrument if their concessions within the above-mentioned agreement do not correspond to those made by the EU. Suppliers from the US might be affected in this way; the tightening of the *Buy American Act* by the current US administration has widened the existing chasm.

If a bid is received from a country which does not allow EU companies access to the public procurement market, then, according to the drafts of the new regulation, the Commission will enter into negotiations with the country in question to persuade it to open up its own market. If this proves unsuccessful, a **calculatory price premium** is to be added to the bid received from this country. The Commission has suggested 20 percent; members of the EU Parliament are, however, demanding prohibitive premiums as a result of which the bid would be directly excluded from the bidding procedure. The European government that wanted to procure goods or services would thus have to pay a higher price unless the foreign provider wins the bid despite being disadvantaged in the calculation.

That being the case, how much time should the Commission be given to negotiate with a third country, particularly since a specific, perhaps urgent, procurement project of an EU member might be concerned? Here, there will need to be **exceptions**. Furthermore, exceptions for the member states will need to be allowed for reasons of environmental, security or health policy, or for strategic reasons. However, exceptions anticipated by the negotiating partners and actually granted by the Regulation destroy the negotiating power of the EU Commission *ex ante*. Consequently, they will need to be at least approved by the EU Commission; only in this way can negotiating power be built up. Either way, there is the question of **competence or jurisdiction**. The member states whose procurement procedures are concerned will want to have a say if the bids of foreign suppliers are to be inflated artificially or if foreign providers are to be excluded altogether from the bidding procedure.

Another contentious issue is the determination of **threshold values** above which the new Regulation will apply. Limits of 10 million euros for infrastructure projects and five million euros for the procurement of goods and services are under discussion. Exceptions are planned for developing countries. However, it would be better not to exempt countries but rather to provide exceptions for small and medium-sized businesses.

Some EU parliamentarians would like to see an obligation for foreign providers to comply with labour and environmental standards to avoid their exclusion from the bidding process. This corresponds to a demand that goes even further and is often made by French representatives. Paris is seeking to enshrine **mirror clauses** in free trade agreements; they would require exporters to comply with EU environmental and labour law standards which are guided by EU rules. This would amount to a dramatic move away from the EU's current practice and from international trade law as a whole. At present, the rule is that trade policy measures should be geared not towards production processes but towards the characteristics of the imported goods. Plans call for it to be possible to return dangerous goods at the border, while goods which do not themselves constitute a danger but were produced abroad under poor conditions cannot be returned. This is an important distinction which leaves it to the discretion of poor countries to make a judgement about the production standards applicable in their country.

Additional questions arise alongside these fundamental problems. For example, the definition of public demand is not a trivial one. Are outsourced companies, such as rail companies or energy utilities in public ownership, public purchasers? How should public-private partnerships be treated? What should be done with bidding consortia consisting of companies from different countries where some countries grant reciprocal market access to companies from the EU while others don't? How should foreign suppliers who become domiciled in the EU be treated?

Even though a generally applicable instrument is to be created, it is clear that the new **Regulation is directed against China**. Chinese firms have repeatedly executed large public projects in the EU, and providers from the EU have complained about this. Chinese companies have provided construction services for railways in Hungary and Poland worth at least 2.5 billion US dollars over the past ten years, a further 2 billion US dollars were generated from the construction of coal-fired power stations in Romania and Poland, and 4 billion in the telecommunications sector in Italy and Denmark. And this list is not exhaustive.

Finally, one possible criticism lies in the fact that any increase in the cost of public procurement measures is **at the expense of public sector budgets**. Although it is worth striving for an opening up of the public procurement markets in third countries, the disadvantages of reduced competition in terms of costs and quality in the procurement system of EU states may be considerable. This is a serious issue, especially in view of the significant rise in construction prices.

III. Anti-subsidy instrument

The EU wants to act against distortions of competition through foreign subsidies.

With the anti-subsidy instrument, the EU is putting together a package of measures designed to protect European businesses from "unfair" competition from rivals who benefit from implicit or explicit financial help – subsidies – abroad. Here, again, the problem is that the WTO instruments are not good enough. Its *Agreement on Subsidies and Countervailing Measures*, for instance, does not do justice to reality, is considered difficult to implement and is thus rarely used.

The European Commission has presented a proposal for a regulation which will grant it fresh powers to investigate alleged distortions of competition in the EU by companies which receive subsidies.[16]

Following the example of the existing provisions for state aid, merger control, antitrust law and public procurement, the proposal provides for the creation of three new regulatory instruments.

Firstly, a **notification-based instrument** would be created for mergers and takeovers supported by foreign subsidies. It would be used for transactions where the target company is based in the EU and generates sales of at least 500 million euros in the EU. Furthermore, the companies involved must have received a financial contribution from non-EU governments totalling more than 50 million euros over the past three years.

Secondly, an instrument would be created to investigate whether foreign providers received subsidies from their home countries enabling them to submit **"unduly advantageous"** bids for public tenders in the EU. This is considered to apply to public sector bids in the EU with an estimated order value of at least 250 million euros.

Thirdly, and finally, a general investigation tool would be created enabling the Commission to investigate alleged **competition-distorting effects** of foreign subsidies in any market situation, including mergers and public bids below the thresholds mentioned above.

The Commission would be endowed with far-reaching investigative powers similar to those used in antitrust investigations, and would be able to adopt commitment decisions or impose remedial action; it could also block mergers or the award of public contracts.

16 https://ec.europa.eu/commission/presscorner/detail/en/ip_21_1982

These plans by the Commission are extremely problematic in foreign policy terms and could, at least in part, be viewed as extraterritorial regulation. The question to be asked is why, in fact, the EU should defend itself against subsidised products or services from abroad. Here, too, the new geostrategic situation makes a crucial difference: if subsidies are granted in order to gain market power, then the concern is justified.

IV. Carbon Border Adjustment Mechanism

The French Presidency of the Council wants to make maximum progress in the creation of a Carbon Border Adjustment Mechanism. This is not the place for a comprehensive discussion of this topic; for this please see a recent expert opinion by the Scientific Advisory Board of the German Federal Ministry for Economic Affairs (the author of this study took a leading role in supervising the expert opinion). In this study we have developed the **idea of a climate club** – a model that is not only sensible in order to promote an internationally coordinated climate policy, but also valuable when it comes to a large number of other global governance issues.

According to the mechanism being prepared by the Commission, goods imported in the areas of steel, aluminium, cement, fertiliser and electric power will be subjected to European emissions trading. To this end, a separate market will be established so that existing trade is not disrupted. Because the carbon content of the imported goods is unknown, lump-sum values will initially be used. Suppliers from third countries can submit proof that they fall below these lump-sum values; the number of certificates required for import will then be reduced accordingly. This measure is designed to ensure conformity with WTO law. By contrast, exports are not due to be included in the adjustment system: in contrast to sales tax, for example, no exemption of exports will take place.

This construct is presumably compatible with WTO law, but it has considerable drawbacks, as a result of which the targets associated with its introduction will not be achieved. For one, the design of the mechanism will make it possible to set high prices for carbon emissions within the EU without adversely affecting the competitiveness of the domestic industry. By not including exports, this target will not be reached on the foreign markets; especially if, as has been decided, the free allocation of emission certificates is ended. Furthermore, on the import side no more than slight relief for the domestic industry is to be expected. First of all, only direct emissions are analysed while emissions in built-in input products are not taken into account. This is an important issue in mechanical engineering, vehicle construction, metals technology and many other areas. Secondly, many producers from abroad may well be able to provide proof of very low carbon emissions. The cleanest products are exported to the EU; the dirtier products remain in the countries of origin or are exported to other states. **Carbon**

Carbon border adjustment can only generate approximate competition neutrality.

border adjustment will thus have more of a symbolic value and it will generate only approximate competition neutrality.

At the moment, discussions are ongoing as to which countries can be excluded from the border adjustment mechanism altogether. Should there be **exceptions** only for countries with their own explicit carbon pricing or also for countries which operate an ambitious climate policy using other instruments? Another topic of discussion is whether there should be an exception made for developing countries, as provided for in international climate policy since the Rio Protocol. It would be better to provide for supporting measures instead of exceptions. But, the fewer exceptions are made, the more likely we are to see trade policy disruptions by dissatisfied trading partners.

The EU Parliament is ramping up the pressure and wants to end the free allocation of certificates earlier than planned, i.e. in 2028 instead of 2035 as proposed by the Commission. In return, the plan is for the border adjustment to come into effect earlier: it is due to be introduced gradually from 2025, rather than 2028. The EU Parliament also wants to see a broader application, one that takes into account organic chemicals, hydrogen, and polymer compounds in addition to direct emissions such as those from the generation of electricity. Yet the latter risk entailing **a lot of red tape** and generating huge implementation problems. Finally, there is also the as yet unanswered question of who should monitor the border adjustment system. Petty state thinking in 27 different member states should be avoided; instead, a uniform central approach is needed.

V. Supply chain legislation

The project of European supply chain legislation is controversial.

Another project which both the French Council Presidency and the German governing coalition have listed among their priorities is the introduction of EU-wide corporate supply chain due diligence legislation. However, the Commission's presentation has been delayed; it would seem that there is considerable resistance to this project in many member states. It has been argued that supply chain legislation could be seen as discriminatory and that it cannot remedy the actual problems – child labour triggered by poverty, poor working conditions etc. The legal problem of discrimination can be eliminated if the rules also apply within the EU. It will not prove easy, however, to eliminate the economic problem, i.e. that the burden imposed on importing companies with new obligations to provide evidence and financial risks may lead to a withdrawal from poor countries, which forces local suppliers out of western supply chains and pushes employees into the informal sector. See Felbermayr and Sandkamp (2022).

VI. Further measures by the EU

The royal road to curbing the erosion of the international rule of law consists in negotiating modern and incentive-compatible international law agreements which regulate the use of opportunistic instruments and discipline their abuse. For this reason it is important that the EU continues its agenda of negotiating and implementing ambitious trade agreements with countries the world over at all levels – multilateral, plurilateral and bilateral – and does not limit it narrowly to classic trade policy instruments, and that it monitors compliance with the provisions and sanctions non-compliance. Thus it is to be welcomed that the EU has now introduced the role of ***Chief Trade Enforcement Officer*** with the rank of Deputy Director General who coordinates the monitoring tasks and reports on the results. Where mismanagement is identified, a dialogue needs to be started, if necessary in order to correct the legal basis, while further sanctions remain an *ultima ratio*.

Ambitious trade agreements are the royal road.

Alongside measures to punish economic policy behaviour by foreign powers that is against the rules or otherwise opportunistic, the EU should invest in the **functioning of the Single Market** – which remains, in its attractiveness, the most effective instrument for creating incentives for cooperative behaviour by the partner countries. The simple reason is that all implementation mechanisms are based on refusing access to this Single Market. Thus the wider, deeper and more dynamic this market is, the greater the likelihood that the EU and its members will continue to shape the global economic and political order in their interest.

An attractive Single Market remains the most effective trade policy tool.

Trade agreements also extend the reach of EU provisions. The further European regulation is applied on an international level, the less likely it is that competing provisions by other economic powers which are not ideal for EU companies will prevail. Major trading powers such as the EU could create incentives for trading partners to adjust their rules and regulations to EU standards because deviations would be economically expensive for exporters. This **"Brussels effect"** (Bradford, 2020) is an important tool for informal influence which is heavily dependent on the size, momentum and general attractiveness of the EU Single Market and the quality of its own provisions.

F. Conclusions

The EU must adjust its foreign policy actions to the new geostrategic realities. No one would dispute this. But whether it should use the narrow set of trade policy instruments at its disposal in the service of ever new tasks – ranging from the assertion of European values in social and labour policy, in environmental and climate protection through to traditional issues of diplomacy – is a different question. The more targets have to be pursued with the small number of available tools, the fewer will ultimately be achieved. It is therefore important for the EU to expand its **toolbox**.

The most important step, however, will probably be to pack a more powerful punch and become more credible when it comes to its common foreign and security policy. To achieve this, the principle of unanimity will need to be abandoned. This step could ease trade policy and allow the EU to devote itself more to its actual tasks: to create and maintain structures which promote cooperative behaviour – and thus allow **open markets** on which prosperity can be generated and secured through the division of labour. Under such conditions, family businesses, especially in the manufacturing industry, are able to provide valuable value-added input for Germany and Europe.

The EU's new foreign trade policy is a response to the failure of multilateral approaches. While this is both understandable and necessary, the successful implementation of a multilateral strategy is better than a solo effort on Europe's part. Alongside the development of the instruments discussed here, the EU must therefore continue to push resolutely ahead with the multilateral (in actual fact, omnilateral) approach and join forces with like-minded partner countries. The **club idea** cannot replace a failing WTO, but it is nevertheless far superior to a unilateral approach.

The EU must make sure it hits on the right mix of defensive and offensive policies. The more demanding it becomes in its trade policy, the more foreign governments are likely to lose interest in cooperating with the EU. As a result, the Union would not just deteriorate, it would go from bad to worse.

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