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The future of EU trade policy and strategies in a militarised environment

Institute for International Trade

The future of EU trade policy and strategies in a militarised environment

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Abbreviations

AB	Appellate Body
BRICS	Brazil, Russia, India, China, South Africa
CBAM	Carbon Border Adjustment Mechanism
COVID 19	Corona Virus Disease 2019
DSM	Dispute Settlement Mechanism
ESG	Environmental, Social, Governance
ETS	Emissions Trading Scheme
EU	European Union
FTAs	Free Trade Agreements
GDP	Gross Domestic Product
G7	Group of 7
G20	Group of 20
MNCs	Multinational Corporations
OSA	Open Strategic Autonomy
IPE	International Political Economy
NATO	North Atlantic Treaty Organization
OECD	Organization for Economic Cooperation and Development
SOEs	State-owned Enterprises
US	United States
VAT	Value-added Tax
WTO	World Trade Organization

Executive summary

China's spectacular economic rise in recent decades has changed much, so when the proverbial elephant squeezes into a crowded room, others have to make way.

Furthermore, given its divergent economic model China is challenging the global economic order in ways that previous Asian competitors never did. Moreover, China's political model is so divergent that fears of systemic rivalry between western-oriented and democratic economies and China, as well as authoritarian economies, are rising sharply.

It is no surprise, therefore, that EU trade policies have been undergoing significant revisions in recent year, driven substantially by concerns about how to work with China to secure EU prosperity. It is also evident that the European Union's (EU) relative position in the world economy, and global geopolitics, has been in decline for some time. In addition, EU members face sustained geopolitical pressure from their large, bellicose Eastern neighbour and former Cold War competitor, Russia. Economic and political relations with Russia have also deteriorated in recent years, so that the EU, along with other Western democracies, faces increasing hostility from authoritarian powers one of which has the capabilities to pose a systemic challenge.

These developments pre-date Russia's brutal invasion of Ukraine. The war has

sharply reminded EU members that hard power still matters, and soft power only gets you so far in a world now rapidly spiralling downwards into systemic competition. Yet before the invasion the EU's strategic community had already been jolted into action by their main patron, the United States (US), in the form of President Donald Trump who seemed determined to scapegoat what he saw as EU allies free-riding on the US security footprint whilst competing unfairly in the US market place to displace his voting base, principally rural and working-class voters. This had given rise to a growing movement in EU policy circles to build more "strategic autonomy" from their main security guarantor. This policy stance resonated with the EU's own emerging spectrum of populist politicians, many of whom advocate decreased exposure to the global economy as well as evincing increasing scepticism towards the EU project itself.

Considered together these shifting economic and political trends gave birth to a consolidated EU trade policy framework dubbed "open strategic autonomy". In this paper we review this framework's meanings, origins, and broad contours to the Russian-Ukraine war, and then consider the war's impact on the framework. We conclude that the move towards open strategic autonomy has been sharply, and at once, accelerated and consolidated. This sets the scene for a dive into the EU's enduring, and emerging, economic policy imperatives and how those relate to its trade policy settings as broadly captured under open strategic autonomy. Overall, we find reasons to be concerned that open strategic autonomy may shift the EU away from deepening the single market in key respects. In the concluding section we draw out some high-level conclusions and implications.



Open Strategic Autonomy: origins and framings

In this section we first clarify the meanings of Open Strategic Autonomy (OSA) in relation to trade policy, as set out by the European Commission's Directorate General for Trade in recent documents.

We then analyse those framings by drawing on 3 recent reports on the topic, distilling what we take to be the policy's key features and drivers, as well as lines of evolution, in the pre-Ukraine war environment. This sets the scene for a brief exposition of various lines of impact the war has imposed, most notably on the European Union, and its member states' strategic policy settings; and speculate on how these in turn interact with Open Strategic Autonomy. The last part is the most challenging component of this analysis given that at the time of writing the war's outcome was far from determined.

What is Open Strategic Autonomy?

In its factsheet explaining the policy, the European Commission observes (European Commission, n.d):

The term 'strategic autonomy' comes from defence/ military planning and refers to the EU's ability to chart its own course in line with its interests and values. This does not mean going it alone, but rather accepting and managing our interdependence in the best possible way. The addition of 'openness' shows that the EU will be open to trade and will promote stable rules in order to be strong economically and have geopolitical influence.

What led the European Commission to develop this policy stance? Introducing its 2021 Trade Policy Review (European Commission, 2021, 5), the Commission cited a constellation of driving factors:

- Deteriorating geopolitics and the associated rise of unilateralism on the part of major powers;
- the EU's domestic economic policy imperatives, being anchored in the green and digital transitions;
- the emergence of new growth poles that challenge the EU's economic position, some with different economic models, and notably China;
- a cluster of challenges presented by globalization of value chains, including polarization of marginal communities, growing inequalities, and lack of level playing fields; and

- the need to respond to the economic policy challenges posed by COVID 19.

Section 2 (European Commission, 2021) sets out the trade policy arenas impacted by these dynamics. The factsheet (European Commission, n.d) succinctly sets out three contours:

1. Openness to trade and investment;
2. An emphasis on sustainability, and associated responsibility to lead internationally "to shape a greener and fairer world, reinforcing existing alliances and engaging with a range of partners"; and
3. Resistance to unfair and coercive trade practices, through cooperation where possible.

It then rhetorically asks whether OSA means reshoring production by EU multinational corporations (MNCs), responding that it does not but value chains will be reviewed to identify "strategic dependencies in the most sensitive industrial ecosystems".

Finally, 4 broad policy anchors are set out:

1. Reform of the World Trade Organization (WTO) and support for multilateral sustainability initiatives, as well as "the green and digital transformations, and global solutions";
2. Rebuilding transatlantic partnership and diversifying dialogue partners to address common global challenges;
3. Building benefits for EU companies and workers by enforcing trade agreements and "levelling the playing field"; and



4. Adopting an anti-coercion instrument to defend against non-EU countries' coercive trade practices.

Pulling this together the fact sheet offers a telling catch-phrase to define the intent behind OSA: “[It] means cooperating multilaterally wherever we can, acting autonomously wherever we must.” In other words, a decisive shift towards unilateralism to protect EU values and economic policy priorities, while consciously externalising those values and policy preferences through trade agreements and the WTO. The Trade Policy’s chapter 3 (European Commission, 2021, PP 13-25) sets out 16 precise “Headline actions” that give expression to OSA in the trade policy arena.

What to make of Open Strategic Autonomy Prior to the Russia-Ukraine War?

In a broader review of how various countries and regions are managing globalization in the current global context Young and Ulgen (2022) describe the evolving EU trade policy as “Competitive Globalism”. By this they mean the EU

has shifted from a stance of viewing globalization as generally beneficial – to the world as well as the EU – towards one in which the EU must increasingly struggle to gain relative advantage over other states, necessitating a shift from cooperation to competition.

This shift predates the advent of the Trump Administration, and can be located in factors such as the rise of the BRICs¹ (O’Neil, 2001) as major competitors, and the many challenges thrown up by the global financial crisis and its aftermath (Draper, 2020). In addition to the drivers of the shift towards OSA as identified in the Commission’s documents, Young and Ulgen (2022) add the strengthening of globalization-sceptic populist political forces within EU member states. Clearly the same factors were weighing on US voters’ minds when they elected Donald Trump to the US Presidency, itself a major jolt to Europeans sense of their place in the world in relation to the trustworthiness, as well as commitment, of their major security guarantor. The COVID 19 pandemic posed further serious challenges to all countries. Given that throughout the tumultuous past two

decades the developed world’s relative economic position has been in decline, it is not surprising that an EU course correction has been building, with the metaphorical dam seeming to burst in the last 3 to 4 years, in the Europeans case.

This shift has not been uncontested. Tobias (2022, 68) notes that – as with many national governments – there is a tension between the economic departments favouring openness and those tasked with managing vulnerabilities. These tensions culminated in the Commission’s Trade Policy Review, as discussed above, but also a plethora of related policy instruments or what Tobias (2022, 68) terms the “autonomous policy toolbox”. In Table 1 Tobias sets out 4 “policy baskets”:

1. Tackle Economic Distortions;
2. Defend Against Economic Coercion;
3. Link Values and Sustainability; and
4. Critical Infrastructure and Supply Resilience.

He then allocates 17 specific and recent policies to these 4 baskets. Clearly the Commission has been busy.

Overall, Young and Ulgen see the shift as defensive, anchored in “the weaknesses and frustrations of European societies”, and do not discern a long-term strategy behind it (Young and Ulgen, 2022, 61). They also characterise this approach as “geo-economic”, even “mercantilist”. Tobias (2022) concurs with the geoeconomic label while seeking to trace its intellectual lineages and appropriateness to the EU’s global position. Drawing on international political economy (IPE) literature, and particularly the work of Robert Gilpin (Gilpin, 1978), he notes that throughout history states have balanced economic interdependence with sovereignty. While most would recognise that economic interdependence yields a range of economic benefits, some forms also create dependencies that generate vulnerabilities. This dilemma was first codified by Hirschmann (1945), who pointed to the particular dilemmas faced by smaller and/or less powerful states in their economic relations with larger ones, in which power relations are asymmetric.

¹ Brazil, Russia, India, and China. Jim O’Neill’s original conception was anchored in economics and focused on market opportunities, but also inspired the Multilateral grouping now known as BRICS, now including South Africa, which is an important developing country response to the G7.

Viewed through Hirschmann's prism the rise of China is particularly challenging given its increasing recourse to economic coercion to achieve political goals. Of course, China is not unique in this; the United States has increasingly resorted to economic coercion instruments as its relative economic power has declined, notably financial sanctions but more recently the trade coercion imposed by the Trump Administration on China, as well as Europe and other trading partners. Indeed, recourse to "aggressive unilateralism" (Bhagwati and Patrick, 1991) first came to prominence in the 1980s during the Reagan Administration, with Japan being the key target then. The point being that the EU now finds itself – on the trade and investment fronts – squeezed between two major powers increasingly resorting to unilateral coercion measures to achieve their political ends. As Tobias (2022, 67) notes, this dynamic necessitated a shift in the EU's balancing strategies - from openness towards managing vulnerabilities.

Before the Ukraine war this shift centred on the economic and military rise of a revisionist China. Hence the EU identified China (European Commission, 2019) as simultaneously partner, competitor, and strategic rival. As a partner the geoeconomic challenge was framed as working with China to solve common global economic problems, notably climate change but also buttressing the rules-based trading system. Given divergent normative preferences pertaining to, in particular, the markets/state balance, the underlying issue is where the limits to such coordination lie. Given those normative divergences, as competitor the challenge was identified as curtailing unfair competition in the EU's own internal market, and in third country markets. The former led to the tightening of trade enforcement and establishment of an investment screening mechanism at EU level – both of which could be applied to countries other than China. In other words, to impose stronger conditionality on access to EU markets, leveraging the single market as a strategic tool. This had a companion common market thrust in the desire to invest in strategic technologies to compete with China – and the US – to control key industries of the future and reduce dependence on potentially untrustworthy or unreliable external powers, thereby securing future

standards of living. Industrial policy for the new age, in other words, and represented in particular by the recently established semiconductor subsidies fund.

At the same time, although of far less strategic consequence, the United Kingdom withdrew from the EU thus diminishing the EU's (questionable) foreign policy authority - arguably for both. In some OSA formulations – advocated by France in particular – a more integrated, self-reliant military capable of taking geopolitical actions on the global stage was the primary goal – requiring commensurate industrial capacities anchored on national champions and supportive institutional infrastructures. Others, notably Germany, preferred the North Atlantic Treaty Organization (NATO) umbrella and perhaps not the deeper institutional coordination plus budgetary outlays which the more bullish OSA conceptions pointed to.

Overall, as young and Ulgen (2022) frame it, the trajectory was towards the competition/rivalry end of the spectrum particularly as the contradictions between openness and autonomy became apparent. Notably, the EU Parliament's sanctioning of Chinese officials and institutions for systematic human rights abuses in Xinjiang, the Chinese retaliatory sanctions this engendered, and the subsequent derailing of the EU-China Comprehensive Agreement on Investment highlighted the risks of pursuing OSA as set out above. Subsequent Chinese actions to punish Lithuania for allowing Taiwan to open a "Representative Office" in Vilnius compounded the general downward drift in bilateral relations, with Chinese "wolf warrior" diplomacy and aggression against India, Australia, and Southeast Asian countries aggravating the situation. These trends also culminated in the launch of various EU member states' "Indo-Pacific" strategies, and a counterpart EU version, signalling clearly to China that its relations with Europe were deteriorating, and that increased coordination with the US – and other US allies – to compete with China in Asia was in the cards.

Still, the risk that the EU will turn inwards, as the US has, remains. Countering this, the EC emphasises commitment to the rules-based order, multilateralism, and in particular the WTO, as well as free trade agreements with strategic partners –

particularly in the Indo-Pacific. It could also be argued that increasing conditional access to EU markets provides leverage for opening markets abroad. Furthermore, the EU's internal market is being leveraged by doubling down on the EU's regulatory power through the "Brussels effect" (Bradford, 2019), or externalising EU normative and regulatory preferences across a range of issues, most notably industrial subsidies, the role of state-owned enterprises in the economy, and a broadly conceived sustainability agenda (environment, labour and human rights). This is framed as "levelling the playing field"; on the face of it not protectionist but a pursuit of equity, and reciprocity. While these policies do variably impose costs on trading partners, it is too simple to dismiss them as protectionist given that they reflect EU norms, and often where global regulation needs to go. In this light Bradford (2019) argues that the "Brussels effect" is sometimes used to establish first mover advantage in emerging international regulatory domains where institutional voids (Khanna and Palepu, 2005) exist and are exploited by potentially unscrupulous actors.

In concluding this section, it is clear that the forces pressing on the EU, both domestic and international, pre-dating COVID 19 and particularly after its advent, required a shift in EU trade policies towards more conditional engagement with globalization. Analysts' opinions differ as to whether, as Tobias (2022, 75) frames it, autonomy outweighs openness. He thinks not (yet), whereas Young and Ulgen – with their characterization of current EU trade policies as "mercantilist", seem to think it does. Importantly, their analyses were written before the Ukraine war broke out.

The new geo-economic environment

The brutal Russian invasion of Ukraine has crystallised European, and EU, strategic thinking and action in ways that no-one could have foreseen. Clearly, the first major war in Europe since the Second World War has fundamentally changed the geopolitical environment. Moreover, the war's outcome is undecided at the time of writing, and may not be known for quite some time – analysts' opinions on the scenarios are divided. Not surprisingly, European responses to this are still unfolding.

In what follows we briefly contextualise the EU's institutional responses to the war. Then the wider strategic canvas is tackled, since it will shape the EU's responses going forward. This sets the scene for the final section, in which we analyse possible trajectories for OSA.

EU institutional responses to the war

The relative speed and extent of the EU's responses to the conflict have surprised many. They have broadly followed three lines:

1. Imposition of a plethora of sanctions on the Russian economy, institutions, and key individuals;
2. Mobilisation of funds to support the Ukrainian economy; and
3. Mobilisation of funds to support purchases of advanced weaponry required by the Ukrainian military to take the fight to the Russian army, marking the first-time general revenues have been used for this purpose (Politico, 2022). Member states have also supplied weaponry to Ukraine.

Through these actions the EU's emergence as an institutionalised geopolitical actor has been cemented. In particular, the heightened role of the EU Commission's executive leadership and Council in influencing strategic decision-making taken ultimately by EU member states, has been notable. Of course, key member states have played pivotal roles, notably France given that the war erupted in the course of the French presidency of the EU. These developments are captured in the release by the European External Action Service (2022) of the EU's Strategic Compass, which brings EU defence planning into line with NATO's new Strategic Concept, discussed below (Borrel, 2022).

But limits to that influence are evident, and may intensify if the war drags on. In the short to medium term European militaries are not prepared to quickly ramp up defence production and exports to Ukraine, and face difficult trade-offs between doing so, maintaining and improving their own defence postures,

and in some cases servicing export contracts (Bergmann, 2022). Hence, as Bergmann (2022) observes, the EU has a crucial role to play in mobilising medium term financial and industrial commitments while public support for Ukraine remains relatively high. This would support the Strategic Autonomy objective, to the extent that it reduces European defence capability dependencies (Borrell, 2022). Furthermore, member states have differing appetites for sustained confrontation with Russia. Evidently, Russia is mobilising those differences by exploiting European reliance on its energy supplies, particularly of natural gas. Hungary's spoiling role as the Russian trojan horse appears particularly problematic. Furthermore, still, the more states like Hungary seek to block broader EU consensus, the more likely it is to lead to institutional reforms, for example over how decisions are taken – with a view to ameliorating member states' vetos. European Unity is likely to endure for this year at least. And much depends on how the wider geopolitical environment evolves.

The wider strategic picture

It is interesting what difference a year makes. On August 30th, 2021, the US withdrew from Afghanistan, seemingly without adequately informing its NATO allies, and a shambolic exit ensued. European States and leaders were dismayed, with some regarding the withdrawal as a betrayal, and posed questions about the future of US leadership of the Western alliance and democracies. Importantly, this came against the backdrop of the Trump Administration's sustained haranguing of European countries, and the NATO alliance itself. In this light, "Strategic Autonomy" took on renewed urgency. No doubt Russian President Putin made the same judgement, deeming the US leadership weak and EU states disunited and this emboldened him to pursue the course of invasion, calculating that the likely responses would be manageable.

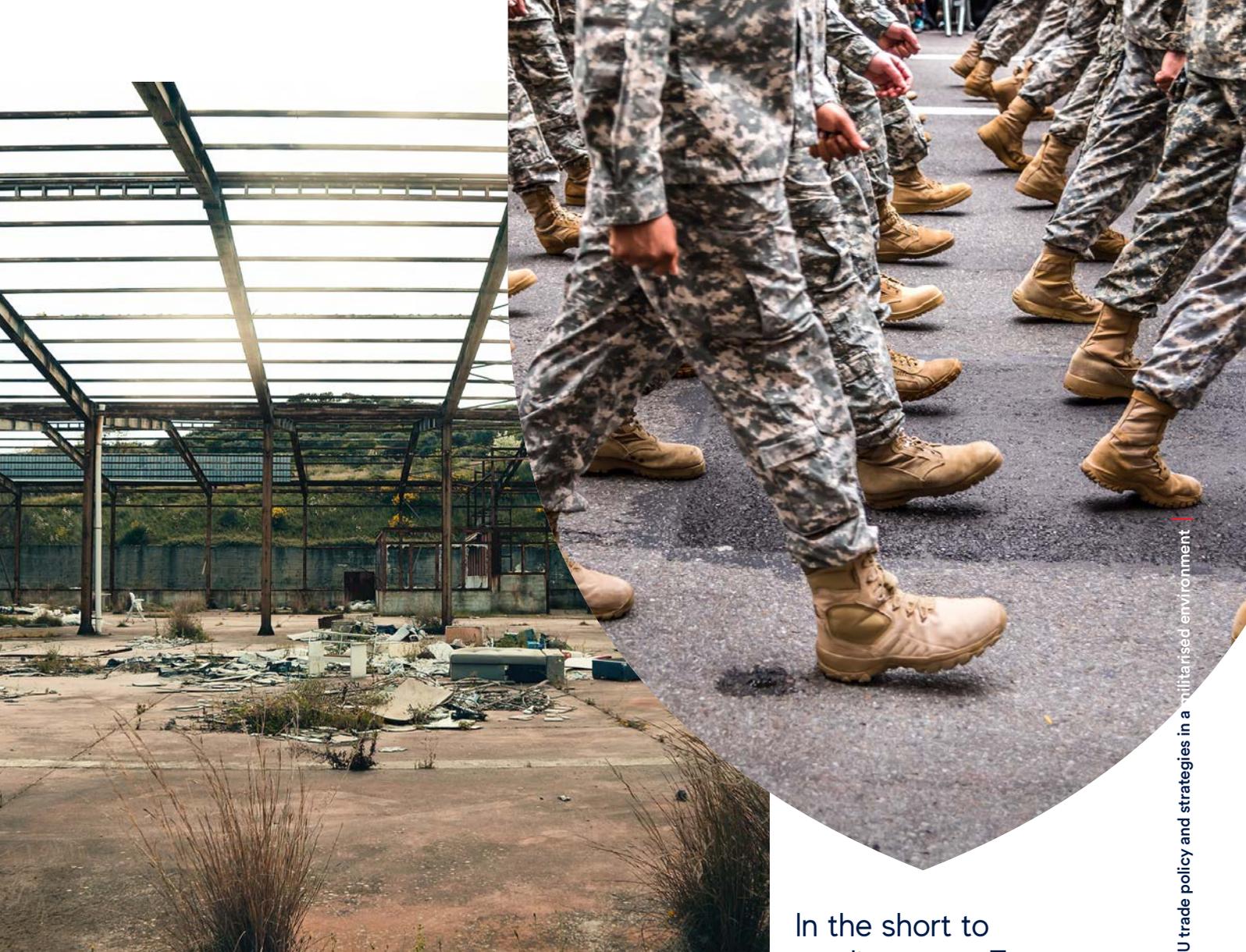
Arguably the standout feature of the aftermath of the Russian invasion has been US mobilization of a comprehensive



Western democracies' response, including the EU. This had three key dimensions. First, the resurgence of NATO, particularly its support for Ukraine and the impending admission of two historically neutral countries, Finland and Sweden. At its 2022 Summit in Madrid NATO (2022) adopted a new Strategic Concept that identified Russia as the primary threat to global security and the rules-based order, but also identified China as a comprehensive threat to that order and indicated that NATO will increasingly become involved in the Indo-Pacific. This recognises the evolving, if complex challenge that Russia-China coordination poses. In advance of the Summit 15 European states made commitments to

² A Heads of State forum comprising: Canada, France, Germany, Italy, Japan, the United Kingdom and the US. The EU is a "non-enumerated member".

³ A Heads of State forum comprising: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Republic of Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey, the United Kingdom, the United States, and the EU.



In the short to medium term European militaries are not prepared to quickly ramp up defence production and exports...

raise defence expenditures (IISS, 2022), and these pledges, taken together with the institutionalized actions described in the previous section, offer the prospect of Europe and the EU taking more responsibility for European defence. Bergmann (2022) notes that if the EU is able to mobilise a large-scale joint defence procurement effort this would sharply increase efficiencies, reduce costs, and increase the inter-operability of European weapons systems. That would provide more scope for the US to adjust its force posture and focus on the Indo-Pacific, and the larger challenge represented by China, thus ensuring the maximum effectiveness of NATO's Strategic Concept.

Second, Western allies rallied to punish Russia— notwithstanding the economic pain inflicted upon themselves and especially in Europe – by implementing a comprehensive, and evolving, sanctions regime.

Third, at the heart of this renewed dynamism amongst Western allies the G7, including the EU Commission President, has found a new relevance for itself (Freytag and Draper, 2022). This could lead to a G7 renaissance, albeit with new limits to the group's influence and authority given that the economic dominance those economies enjoyed when the group was first founded has eroded significantly. Moreover, the resurgence of the Western alliance,

including its expansion into Asia to confront China, risks polarising the world into competing blocs. The most prominent emerging divide is between “authoritarian” and “democratic” states. Given that many developing countries do not want to pick sides this poses substantial risks to multilateralism and global governance more generally. The G20 is a cogent example of this, and at the time of writing geopolitical tensions threaten to derail the Bali Summit in Indonesia at a time of acute

⁴ Gabuev is Senior Fellow at the Carnegie Endowment for International Peace, and was until recently based in Moscow.

⁵ Australia, Japan, New Zealand, and South Korea. All four are US security treaty allies.

international economic stress. Emerging markets and poor countries suffering from multiple macroeconomic shocks require G20 coordination more than ever (Financial Times, 2022) but are unlikely to experience it.

Still, hard questions remain. One concerns Russia's trajectory, and what that might mean for European States' major defence commitments in the medium term, noting that NATO's Strategic Concept has a ten-year time horizon. Amongst a range of possible scenarios, perhaps the most likely one is that Russia becomes, in effect, a Eurasian Iran – an energy and commodities exporter with an autocratic, pariah regime but significant destabilisation capacity (Gabuev, 2022). The Russia-China relationship is also a key determinant. As Gabuev notes, since the Russian invasion of Ukraine and for a variety of reasons the bilateral balance

of power has swung in China's favour, making NATO's announced strategic shift to an Indo-Pacific focus all the more relevant. The presence at the 2022 NATO Summit of 4 Heads of State of Asia-Pacific democracies brought home the message that NATO is now actively concerned about the Indo-Pacific. However, per Leonard's (2021) memorable phrase, we are now living in the "Age of Unpeace" in which state to state conflicts remain unlikely, but states remain permanently in conflict owing to the plethora of connections amongst them, principally in the digital realm but also via supply chains and trade flows. Russia and China together have enormous capacity to destabilise NATO members should they so wish.

In addition, there are abiding questions over the EU's commitments to the Indo-Pacific given the continued uncertainty

over Russia's long-term future, and how that may lock down European focus and resources at a time of significant budgetary constraints. To the extent that the Russian military endures and threatens Europe, EU members will remain overwhelmingly focused on their eastern neighbour. Furthermore, many observers ask how long will western, particularly European, unity to confront Russia last? And, finally, what is the medium-term evolution of US strategic and foreign policies in relation to US domestic politics? Would a future Republican President withdraw US commitments to favour domestic constituencies in an updated version of "America First"? And if so, where would that leave Europe in its relations with China? The last question highlights the fact that NATO members have divergent views on how to deal with China over the medium to long term. These uncertainties place a question mark over NATO's Strategic Concept, and particularly its implementation. Much will depend on unity of purpose in relation to underlying domestic political consensus in a host of states.

Large imponderables indeed, but for the remaining term of the Biden Presidency at least OSA's military and strategic aspect has undoubtedly been strengthened.

Intensification of Open Strategic Autonomy

Clearly the Ukraine crisis has put to rest doubts about whether OSA was an appropriate European response to changing global geo-economic conditions. While the sanctions regime established to punish Russia is in essence resort to economic coercion by the EU to achieve political ends, and as such does not fit neatly into the 4 "policy baskets" identified by Tobias, they do go in the direction of defending against economic coercion in the sense that they will reduce European states' vulnerability to dependencies on Russia. Furthermore, the evident sense of Western crisis will impel Western economies to make



⁶ Dual-use technology controls – export restrictions and investment screening; critical minerals; anti-coercion extending to sanctions regimes; and etc.

⁷ Joint Statement of the Russian Federation and the People's Republic of China on the International Relations Entering a New Era and the Global Sustainable Development, February 4, 2022. Nb: the link to this statement on the Kremlin's website is not secure.

the world safer for them, partly by locking in alliances using various means including trade agreements, but also by externalising their normative preferences. Therefore, it is likely that the EU's "level playing field" agenda will intensify, and access to the EU market be made more sharply conditional on exporters signing up to it. The added geopolitical framing of "democracies" being in systemic conflict with "autocracies" will place many emerging and developing countries under increasing pressure to choose sides; a position they generally do not want to be in and will resist.

A pressure point derives from the fact that the EU model of integration is *sui generis*, and needs to be recognised by EU leaders as such (Draper, 2010; Leonard, 2022). As Leonard notes, many leaders of developing countries regard the Ukraine crisis as a European one, and may not share Europeans' collective normative outrage at Russian transgressions. Therefore, when the EU externalises its normative preferences via trade measures, notably its sustainability toolbox, it will encounter resistance given widely diverging institutional starting points (Draper, 2010).

Furthermore, it is unclear how, over the long-term, western democracies will manage their increasing systemic competition with authoritarian countries while retaining open markets at home – never mind abroad. On the one hand, Western democracies understandably do not want to find themselves in a position of reliance on powers that will mobilise trade as a weapon against them – ironically as the West is doing now to Russia. The same applies to investments into dual-use technology sectors by state-owned enterprises (SOEs) from authoritarian countries. On the other hand, maintaining open international markets is the cornerstone on which the liberal international economic order is built. The more western democracies restrict access to their domestic markets on the grounds of countering authoritarianism or divergent normative preferences, the more their citizenries will seize upon these actions, which in turn will be mobilized by populist politicians. More

intervention at home is likely to also lead in illiberal political directions (Bauer, 2000). The end result may be that western democracies become increasingly akin to the very authoritarian powers they seek to constrain. This is the heart of the OSA dilemma.

So, what is the appropriate balance? Australia, widely regarded as the "canary in the coalmine" regarding western democracies managing China's rise, offers an interesting case-study. Over the last 5 years or so investment screening has been tightened, laws to combat foreign political influence rolled out, and export diversification pursued through a doubling down on various trade agreements, from traditional free trade agreements to critical minerals partnerships. Tightening and loosening go hand in hand, in a significant recalibration of market access conditions and opportunities. Europe's OSA is on a similar course. However, while we can trace the same arc in the US its pendulum has swung further, some might say worryingly so, in the direction of regression from open markets.

Overall, the emerging story is one of intensification of the pre-existing OSA framing through a doubling down on levelling the playing field and trade defence, notably the military and military-related. Furthermore, China's "no-limits" partnership with Russia, notwithstanding inherent limits to that partnership (Kireeva, 2022), will lead to a hardening of the EU's own unilateral instincts and unleashing of the "Brussels effect" (Bradford, 2019)

when it comes to "levelling the playing field" in the trade domain, and particularly vis a China. Those tensions are already manifesting in a range of arenas, notably industrial subsidies, as discussed above. That will generate negative reactions from China whose government will test European unity. The EU will also increasingly look to find accommodations with the US, building on two emerging frameworks in the Transatlantic Innovation Council, and G7 discussions over establishing a "climate club". The EU will also look to lock in other potential allies in a position to provide key goods to reduce reliance on Russia and China, such as Australia which is a major source of critical minerals and energy. On the institutional terrain these developments are very likely to mean an increasing recourse to the OECD to formulate core economic policies of global interest, with the G7 – perhaps expanded to a G10 (or more) group of democracies by taking in Asia-Pacific states such as Australia - acting as the "caucus group". That is likely to mean bypassing the G20, if not abandoning it altogether, and decreasing relevance of the WTO. This sobering picture entails the EU, and Western democracies, cooperating less with the developing world to solve global problems, in favour of more rich country coordination. While this scenario is perhaps unavoidable, it does not look desirable.



The EU's trade policy and strategies in the "Roaring Twenties Reloaded"

From the very beginning of the EU's history, its trade policies have served as an incomplete substitute for an EU foreign policy on which member states so far have failed to find a commonly agreed upon format.

These policies were institutionally framed by different layers of multilateral, regional, and bilateral approaches which depended on the depth of relations, the income level of partner countries and the preferences of the EU and the partner countries to conclude a shallow or deep relationship. This offered third countries a selection of agreements on trade liberalization, economic and financial co-operation, aid, and more recently, on sustainability in economic transactions.

The underlying principle of these relations has always been a mercantilist one: reciprocity adjusted to the level of development of the partner countries. Where this principle was given up or only

waived, for instance, in the aid-substitute of unilateral trade preferences like the Generalized System of Preferences (GSP) or the Everything but Arms Initiative for very poor countries, the waiver was bound to strict limits and reviews targeted to the phasing out of the preferences (graduation), also in compliance with General Agreement on Tariffs and Trade (GATT) regulations.

Thus, for the EU, opening third country markets to EU goods and services through insistence on reciprocity was always part of its understanding of trade as a handmaiden for furthering economic prosperity for all negotiating parties through trade.

Yet, both the direction and extent of EU economic prosperity in general will be fundamentally determined by five major drivers of economic and technological change in the world. Trade policies will serve as a tool to mitigate or even withstand potentially negative effects of these drivers on EU prosperity.

The demographics, de-carbonization, digitalization and resilience challenges

first, there is a demographic driver. The EU population is continuously aging. Between 2019 and 2050 the median age in the EU is projected to increase by 4.5 years to 48.2 years. (Eurostat, 2020b)

This process goes hand in hand with decreasing productivity growth, changes in demand structures from goods to services, and bottlenecks on the supply side of labour markets (Eurostat, 2020a).

To overcome such barriers to more prosperity would require policymakers to focus on

- the completion of the single market for services as this market is by far less completed than the goods,
- the liberalization of external trade in services, both measures aimed to intensify competition in the service market, and
- to facilitate the inflow of people from outside the EU to ease labour market bottlenecks

Second, there is the ecological transformation towards de-carbonization through process innovations making existing production less material resource-intensive and through product innovation substituting energy-intensive products for less energy-intensive products.

Here, enhancing trade policies can support such transformation indirectly as freer trade will push economic growth, accelerate technology transfer towards resource saving, open markets for less material resource-intensive imports, both intermediate and finished goods and facilitate the access to markets where EU exports can contribute to lower the



ecological footprint. Concrete but also controversially discussed proposals in this direction exist already through the intended carbon border adjustment mechanism (CBAM) of the EU to be launched in 2026 and the idea of a climate club initially suggested by William Nordhaus in 2015 (Nordhaus 2015).

Third, there is the digitalization challenge which will profoundly shape external economic relations. The EU must be aware that the rise of digital trade exposes

- its companies to hard tests in software and hardware competitiveness,
- its regulatory bodies to the task of establishing and implementing multilaterally agreed upon rules of data security and privacy
- its fiscal authorities to prevent the erosion of the tax base as the normal VAT export tax refunding/VAT import tax collection is difficult to enforce in digital trade.

Fourth, there is the claim of the EU to enforce sustainability criteria for ESG (environment, social, governance) in all aspects of external economic relations, ranging from ESG criteria in the corporate bond purchases programs of the European Central Bank to due diligence legislation of EU member states (France, Germany) and of the EU in supply chains to protect labour rights, environmental-friendly production, and good governance. In particular the proposal of the EU

Commission covering direct and indirect suppliers along the whole supply chain will strongly impact on the direction of trade flows eventually causing trade diversion in favour of suppliers which offer similar working conditions as the EU countries.

Fifth, there is the geopolitically driven resilience aspect. Ideally, secure access to supply chains is especially relevant for EU companies which traditionally act on the downstream side of production with strong backward linkages to non-EU countries. This access should be free of threats of coercion and sufficiently diversified in order to prevent the emergence of monopolists in critical inputs.

What do these five challenges mean for EU trade policies targeted to defend prosperity in the EU?

Above all, the overarching prerequisite for a powerful trade policy is to complete the single market. This holds because the degree of completion decides on the degree of concessions offered to third countries. The lower the degree of completion the lower the concessions offered as external trade liberalization can never exceed the level of intra-EU liberalization. The most deficient sector in the completion process comprises services which in future will very likely be the most expansive sector relative to goods.

A 2022 study commissioned by the European Parliament (Saulnier, 2022) concludes that in spite of substantial progress made in completing the internal market for services “the share of services in intra-EU trade still represents less than one third of the comparable figure in an integrated continental economy of similar size, the US” (Saulnier,2022:4). Excessive red tape and the complexity of administrative procedures including guidelines for mutual recognition are mentioned by 80% of EU service providers as the most important barriers to EU internal trade in services. The total benefit of removing barriers to internal trade in services are estimated in this study to about at least 2% of EU gross domestic product (GDP).

It thus comes as no surprise that the lack of completing the single market for services is a major bottleneck for the EU in bilateral free trade agreements and multilateral trade negotiations in Geneva at the WTO, notwithstanding the fact that from the very beginning of the WTO, the General Agreement on Trade in Services could never rise to the importance of the GATT as a door opener for trade.

Next, the de-carbonization process in the EU targeted for climate neutrality in 2050 requires a supporting hand from the trade policy side. To settle the so-called leakage problem, the unhindered import of goods produced under more environmentally damaging conditions in third countries than under EU regulations, the EU has proposed its own CBAM to be introduced in 2026 (Council of the European Union, 2021).

This would require that until 2026 the EU would have phased out its own subsidization scheme for carbon-intensive production called free allocation of emission allowances under the EU ETS. Only then, the EU would have a fair yardstick for using the CBAM to equilibrate the carbon price for selected

domestic and imported goods like steel and cement and for imposing adjustment levies on imports of these goods if the origin countries would not have introduced own emission reduction schemes or ETS deemed equivalent for the EU.

In 2022, it seems unlikely that trading partners of the EU will have introduced EU-equivalent ETS schemes. Hence, in the absence of such schemes, should the EU advance unilaterally in 2026 by measuring the carbon content of imports with its own scheme that would probably lead to serious trade policy conflicts with trading partners, including the US and China. Beyond that prospective, it is possible that the unforeseeable consequences of the Russian invasion in Ukraine, the steeply rising energy prices and the risks of a deep recession would induce the EU to postpone its scheme in order to continue the free allocation of emission allowances to its own industries and to avoid a conflict with its most important security partner, the US. Postponement would save time to enable other countries to introduce own ETS schemes, to advance to mutual recognition of minimum standards for emission reduction and to come to plurilateral agreements under the WTO rules-based system. Such agreements would help to come closer to the suggestion of William Nordhaus (2015) of forming climate clubs among like-minded countries. Such clubs would aim to harmonize national emission trading schemes leading to an international price for carbon emissions.

Third, for the EU to defend its interests in the digitalization of trade, it is essential to host companies commanding a sizable share in hardware and software markets in the IT sector. This is a prerequisite for anchoring rules for digital trade in bilateral and multilateral trade negotiations which would serve EU principles of data security, privacy, intellectual property rights protection, and defence of the tax base. Yet, as digital trade is strongly connected to services trade, the EU lacks a level playing field basis of negotiations with the two IT giants, the US and China, partly because its internal services trade as mentioned above is not yet fully covered by the common market, and partly because its market power compared to the US and China in the information technology sector is still deficient (Köhler-Suzuki, 2020).

To cope with the handicap of a splintered internal market, first stages in intra-EU online trade have been achieved by introducing a so-called one-stop-shop procedure in July 2021 for facilitating VAT taxation of e-commerce. Furthermore, in its bilateral trade agreements, the EU gives rules for digital trade an ever more important place while within the WTO the EU is active in negotiations on global rules for e-commerce.

Fourth, to establish stricter rules for ESG in trade in its trade policies, in particular in supply chains of its companies, exposes the EU to a number of possible trade-offs. Higher ESG conditions in trade through due diligence laws imposed upon their companies can backfire on the competitiveness of these companies if costs of control and enforcement rise and if competitors from outside the EU free ride by lack of from similar laws in their country. Moreover, setting higher ESG standards unilaterally against developing countries can be interpreted either as disguised protectionism to be reviewed in the WTO Dispute Settlement Mechanism (DSM); or, it could be understood as a means to split labour markets in these countries into a non-affected part, especially informal labour markets, and an affected part which will see increases in production costs. It remains open to question whether targets such as banning child labour will be achieved by due diligence laws if labour supply shifts from the formal to the informal part or if other circumvention tactics are applied. It is thus possible that comparative costs advantages will be eroded and goals of development policies be missed. Should parts of the supply chains move back to near Europe or inside the EU, EU consumers could incur real income losses and EU producers incur options to source in the cheapest markets. A study of the Kiel Institute thus proposes alternatives such as negative list for companies banned from supply chains because of proven violation of internationally agreed upon rules of fair worker treatment and protection of the environment (Felbermayr et al, 2022).

Fifth, repeatedly the EU has been targeted by the US (under the Trump Administration) and by China for “divide and rule” practices in order to weaken a common voice of the EU in international trade fora (Chirathivat, Langhammer, 2020). The most prominent case also

being submitted to the WTO DSM refers to Lithuanian suppliers of input being allegedly discriminated against by China because of the decision of Lithuania to open a Taiwan Office in its capital Vilnius. To act against such practices against individual EU member countries the EU introduced an ultima ratio anti-coercion law should WTO procedures remain ineffective. This law would be one way to strengthen the resilience of supply chains against outside pressure.

A brief summary of five trade policy responses of the EU to these five challenges does not yet allow for a clear answer to the question whether the EU is already well prepared to defend its prosperity under a power-based trading order replacing a rules-based order. In fact, the jury is still out as the EU just starts to identify its power base against a number of barriers which require compromises between dovish (more de-centralized) and hawkish (more centralized) positions among member states.

One such barrier is the incompleteness of the single market just in the sector which – due for demographic and technological reasons – will matter most for the prosperity of the EU in future: services. The EU’s negotiations potential in service trade is capped by its success to further liberalise the internal market for services. Put it differently, the more the single market in services would approach completion, the higher would be the bargaining power of the EU in multilateral negotiations on service trade. Yet, so far this process is very slow.

A second reason is its ambivalence in seeing China simultaneously as a trading partner, competitor and systemic rival. While the EU Council and the Commission still keep the EU-China agreement on investment as a fleet in being and stress the partnership aspect, the EU Parliament is very much determined to block the ratification process unless China departs from its refusal to commit to a universal interpretation of human rights. For the Parliament, defending human rights are an important aspect to resilience in supply chains, more sustainability and good governance; all three anchored in the common due diligence initiative of the EU. The hostility of both China and Russia to the US and the closer security alliance of the EU with the US after the Russian

invasion in the Ukraine, has destroyed any vision of an equidistant trade relationship between the EU/ China and the EU/US. In fact, never in the recent past of trade relations has the EU been closer to the US as in 2022 after February 24.

Implications for the EU's trade policy

Traditionally, this policy was very much determined by the GATT/WTO reciprocity (tit for tat) principle. Except for very poor countries, no concession was offered without receiving counter- concessions from partner countries, preferably at similar value. The so-called "principle supplier" rule meant to negotiate only with those partner countries offering an export market of similar size as the EU market and condemned small developing countries to the role of bystanders. They received the gains from bilateral negotiations between the large partner markets multilaterally via the most-favoured-nation clause. The aim was a mercantilist one: to increase exports at the "cost" of alleviating imports.

A weaponized world characterized by the conflict between democracies and autocracies and vulnerable supply chains is a game changer in the mercantilist understanding of a trading order. Democracies like the EU tend to produce on the downstream side of the supply chain while autocracies hold the command on essential inputs and mostly produce on the upstream side. Fossil and mineral resources, in particular, are mostly in the hands of autocracies with China as the leading natural resource producer. Edenhofer (2022) reports that the share of natural resource rents in GDP in 2019 was found to be four times higher in autocracies (almost 10%) than in democracies. Traditionally, upstream commodities do not face high tariff barriers in downstream democracies. They often enter downstream markets duty-free. This is why these products so far did not play a significant role in trade policies. This will drastically change once measures on the exporter's side determine the volume and the direction of trade flows.

Trade policies for hardening the budget constraints of autocracies using their commodities as a weapon and for pursuing climate policies, the EU can go two ways. First, the EU can conclude agreements with like-minded

democratically governed countries to form coalitions or clubs in which the target of sustainability with its three facets of environment, social, and governance is given measurable dimensions. In the long run, such agreements would aim at a complete ETS within the members of the coalition.

Second, in strategic resources like oil, gas and green metals it can contribute to formation of demand cartels. These cartels would impose import tariffs on gas and oil imports from those autocratic suppliers weaponizing their resources. This would help to shift the costs of the tariff to the exporter's side. Such tariffs would reduce domestic demand and thus lower emissions, lower the dependence on imports from autocratic suppliers, accelerate the process of ecological transformation and enlarge the budgetary options of income support for those tax payers who suffer most from higher oil and gas prices.

For both ways, existing bilateral free trade agreements (FTAs) of the EU with democracies offer the best starting point as many of the FTAs already include elements of political cooperation and commitments on climate policies and protection of worker's rights to anchor sustainability targets in trade relations. Among these FTAs, those with Canada, Japan and South Korea figure prominently. Should agreements with Australia and New Zealand be concluded, they would

join the club of like-minded democracies. The two ways have one aspect in common. They see safe and fair access to sourcing markets as a priority over access to export markets. Furthermore, they differentiate between the intentions of autocratically and democratically governed sourcing markets. The former are allegedly suspected to use their resources as a weapon.

Should safe and fair access to sourcing markets be prioritized over access to export markets FTA members would be well advised to step down from the reciprocity mantra. Instead, they should first analyse in which products important sourcing markets have interests to enter markets of FTA members but are facing access hurdles. These could be for instance products processing agricultural commodities. Given that a number of FTA members in democracies impose relatively high access barriers to agricultural imports (Japan, South Korea but also the EU), these FTA partners should unilaterally offer entry concessions just in these sensitive products in order to win the trust of sourcing markets (many of them under autocratic rule) for closer cooperation with the FTAs of democracies. Yet, removing trade barriers faced by sourcing markets on the demand side is necessary but often not sufficient. Many sourcing markets are lower-income countries which lack the technological means to meet EU ESG standards of



sustainability. Here, facilitating the transfer of technology via supply chains between EU firms and their suppliers would remove an essential barrier on the supply side which cannot be simply substituted for by concession of the demand side. The meagre success of the Generalized System of Preferences for lower-income countries witnesses the importance of supply-side barriers once sourcing markets are heading for the diversification of their export mix and for keeping more local content in the supply chain within their economies. In brief, unilateral preferences are mostly seen by the donor countries as development aid and cannot compensate for supply-side barriers in sourcing markets.

The EU and WTO Reforms

Finally, responses to the challenges facing the EU in the next decade should find their footprint in the EU proposals to reform the WTO in a phase of deep crisis. In the past, the EU pursued a modernization of the WTO under three headings: rule-making, regular work and transparency, and dispute settlement (EU 2018). With respect to rule-making, the EU saw:

- An opening of the WTO to negotiations on individual issues relevant for interested member states under WTO auspices as a necessary process which eventually can lead to plurilateral or even multilateral agreements;
- Clarification of the role of SOEs as public bodies, tighter disciplines on the use of trade-distorting industrial subsidies, and strengthened requirements for notifying subsidies as key issues of improving rule-making; and
- Reconciliation of targets like development promotion, enhancing sustainability, and protecting intellectual property rights with border-free trade as a promising process towards more consistency in rule-making.

The EU's proposals to further regular work on transparency concentrated on better notification compliance, strengthening the trade policy review mechanism, streamlining responses to complaints of member states regarding market access, and giving teeth to sanctions if non-compliance with commitments was wilfully and repeatedly pursued by member states. Furthermore, a monitoring process was suggested once new

issues are brought up by member states taking the form of targeted proposals for advancing WTO rules.

Concerning the Appellate Body (AB) blockade by the US, the EU suggested an all-encompassing discussion process among all member states to redefine the task of the AB relative to the Dispute Settlement Body in the context of US complaints about "overreach" and trade defence measures. This discussion should have been targeted to modify articles in the Dispute Settlement Understanding as the legal procedure in the DSM.

With geopolitical uncertainties on the rise, a closer political understanding between the Biden administration and the EU, and increasing distance of the EU from a Chinese view on a leading position in a new world economic order, proposals of the EU and the US on WTO reforms seem to have narrowed. This refers in particular to more bindingly defining and containing the competences of the AB, the special free-riding status of developing countries called "special and differential treatment", and a closer monitoring of trade-distorting subsidies enjoyed by the public sector in general and SOEs in particular.

In its 2021 suggestions of reforming the WTO (EU 2021), the EU follows this trend. More sustainability in terms of workers' rights, environmental protection, and good governance is given greater weight than in the past. The same holds true for the importance of digital trade to be submitted under WTO rules. Yet, as the following citation underlines, in 2021 the EU had still underplayed the shift from a rules-based to a power-based system:

A stable trading environment with the WTO at its centre is more essential than ever to address the challenges before us, starting with the economic recovery from the pandemic. The context is challenging in an organisation that seems to have lost its sense of common purpose. But the EU has a fundamental strategic interest in ensuring the effectiveness of the WTO. Not only is trade vital for our economy; promoting rules-based international cooperation is the very essence of the European project. The EU must therefore play a leading role in creating momentum for meaningful WTO reform (ibid: 8).

It does not become evident from the reform proposals of the EU which concrete challenges the EU had meant. It goes without saying that in 2021 a military

confrontation between Russia and NATO as it emerged in 2022 after the Russian invasion in Ukraine war not yet on the radar screen of the EU Commission. Nor could the flood of trade sanctions sometimes, but not always, legitimized with Article 21 GATT (protection of national security) be predicted. To defuse the possibly lethal effect sanctions on trade invoked through Article 21, any revision of the EU reform proposals in the light of the military events in 2022 should focus on a clear analysis of the nexus between national security and trade and on proposals to allow for lawfully applied trade measures.

Instead, in 2021 the EU saw a major challenge in the recovery from the pandemic by fading out trade barriers, such as export restrictions for essential pharmaceuticals. While overcoming the negative effects of the pandemic on rules discipline is doubtlessly important in the short run, the longer lasting challenge for the EU is to mitigate the risk of being cut off from important commodities as a result of hostile political strategies. That could happen because of export restrictions of suppliers which are officially legitimized by reasons such as defending income stability of domestic consumers or protecting the environment but where in fact the political target of using commodities as a weapon prevails.

This is a challenge which addresses major risks which the EU in future will face as a downstream producer being dependent on safe access to products like green metals which are relevant for the success of an ecological transformation. Such access risks also comprise information technology products and technology which the EU as an ageing and ever more service-oriented economy badly needs for digitalizing its economy and where Asian and US suppliers are still leading ahead of EU competitors.

In total, so far EU proposals to reform the WTO display a familiar "wish list syndrome": each issue raised in the proposals seems equally important. The transition to a power-based order would require the opposite: Focusing on the essentials based on an assessment how the EU economy is likely to develop within the next decade and how a reform of the WTO could contribute to further prosperity and social cohesion for its citizens.

Concluding thoughts and speculations

Open Strategic Autonomy was initially defined in relation to the US whose commitment to Europe was wavering in the Trump years.

But the US-EU embrace in the wake of the Russia-Ukraine war, combined with the EU Parliament's path of confrontation with China over human rights, means that in the US-EU-China triangle the EU is hewing ever closer to the US now.

This is leading inexorably towards Manichean characterizations of current geopolitical tensions as “democracies vs autocracies”, which risk compromising key parts of EU supply chains in relation to sourcing raw materials especially. Critical minerals pacts amongst democracies will alleviate these constraints, but perhaps the long-term solution is to be less ideological and picky in choosing whom to trade with. Indeed, the Russia-Ukraine war's impact on global oil prices and inflation offers a salutary reminder of the limits to sanctions strategies, as demonstrated recently through US President Biden's Saudi Arabia trip in which he met with the very Saudi leader he had vowed not to during his election campaign. In this regard, remarks by the EU's Director General for Trade, Sabine Weyand (CSIS, 2022), about the need to avoid creating a “gated community of liberal democracies” bear serious consideration and points to inherent limits to “friend-shoring”, “critical minerals” sourcing from like-minded countries, etc. That said, establishing import cartels of democratic countries imposing duties on strategic commodities imported from autocratic countries seeking to mobilize democracies' vulnerabilities could offer a counterweight, assuming these

could be successfully established given participants' incentives to undercut each other and non-participants' abilities to free-ride.

Turning to specific trade policy terrains, it is instructive to note that the 5 key challenges we set out above include demographics and services, neither of which are covered under OSA as constituting key challenges. The EU has made significant strides in the direction of promoting autonomy and harnessing the “Brussels effect”, including in the digital governance arena concerning privacy rules. But services will matter most to its digital future and its single market integration to be driven in future by the Digital Services Act (DSA) and the Digital Markets Act (DMA (both politically agreed upon in Spring 2022) has still a long way to go towards completion. Furthermore, CBAM introduces the prospect of serious trade conflict with the EU's major trading partners, the US and China, that are also the powers targeted by OSA. At least two questions arise in relation to this. First, is the Brussels effect likely to induce changes in the directions favoured by the EU? And second, will those two retaliate, and potentially mobilize EU vulnerabilities in its trade with them? The latter possibility highlights the importance of the anti-coercion law, as well as the importance of the EU working with like-minded countries to create bandwagons of convergent regulation – such as the proposed climate club(s). Nonetheless, the future seems destined to

contain serious trade challenges from the EU's main trading partners in relation to its preferred regulatory models.

Finally, in relation to WTO reforms, and as set out above, there is more work to do. Most pressingly, the EU occupies a precarious position in relation to export controls, bearing in mind that it has used such controls to coerce Russia in particular to change its course on Ukraine but also fears resources suppliers doing the same to the EU. During the pandemic the EU made extensive use of export controls and is therefore in a difficult position to seek reform to their recourse in the WTO, but reforms are required if the EU is not to become a victim itself. Furthermore, the EU's appropriate focus on reforming special and differential treatment being accorded to developing countries (IIT, 2021) risks alienating developing countries whose support may be required vis a vis the unfolding system conflict – for example to reform export controls. There is also an urgent need to prioritize WTO reforms that resonate with the EU's long term economic priorities as set out earlier, rather than engaging in development of wish lists.

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