

## **THE RISKS OF POLITICIZATION OF TRADE**

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## Introduction

If we exemplify the evolution of the European Union (EU) along two dimensions – widening (the number of member States) and deepening (the number of common policies) – the trend is clear despite some steps back, such as Brexit for the widening and border controls within Schengen<sup>1</sup> for the deepening. As far as the Single Market is concerned, the positive trend of deepening is the clear path as quantified by the European Index of Regional Institutional Integration<sup>2</sup> and qualified by the recent proposals in policy areas that have been traditionally considered in the realm of national sovereignty such as health policy<sup>3</sup>, taxation<sup>4</sup> and labor law<sup>5</sup>.

The policy of free and fair trade promoted by the EU within its borders has been consistent, in principle, with the policy promoted abroad<sup>6</sup>. The EU is, in fact, an active proponent of bilateral and multilateral agreements with the aim of reducing tariffs and non-tariff barriers as well as opening capital flow. Moreover, with its set of common rules and its economic weight (16.7% of the World GDP<sup>7</sup>), the Single Market has influenced, *de-facto*, legislation and businesses' policies abroad, a phenomenon known as the 'Brussels effect'<sup>8</sup>: non-EU jurisdictions and firms voluntarily follow EU rules to reduce the cost of running separate compliance regimes.

Along with EU's legal activism, infrastructure and technological development have reduced the cost of transport and communication thus favoring cross-border business. Trade used to flow around obstacles and its stream set the beat of just-in-time production: parts delivered to factories right as they are required were keeping inventories thin and cheap. The

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<sup>1</sup> Countries of the Schengen Area have largely abolished internal border checks. However, in 2015 and 2016 Austria, Denmark, France, Germany, Norway, Poland, and Sweden temporarily reintroduced border controls in response to unexpected influx of migrants.

<sup>2</sup> Ettore Dorrucci, Demosthenes Ioannou, Francesco Paolo Mongelli, and Alessio Terzi, "The four unions "PIE" on the Monetary Union "CHERRY": a new index of European Institutional Integration", ECB Occasional Paper Series No 160 (February 2015): 37. ([link](#)).

<sup>3</sup> On 16 September 2021 the European Commission proposed a regulation on a framework of measures for ensuring the supply of crisis-relevant medical countermeasures in the event of a public health emergency at Union level.

<sup>4</sup> On 22 December 2021 the European Commission proposed a Directive ensuring a minimum effective tax rate for the global activities of large multinational groups.

<sup>5</sup> On 7 June 2022 the European Parliament and the EU Member States reached the political agreement on the Directive on adequate minimum wages proposed by the European Commission in October 2020.

<sup>6</sup> Art. 3 par. 5 of the Treaty on European Union.

<sup>7</sup> The figure refers to EU-27, IMF World Economic Outlook, April 2022. ([link](#))

<sup>8</sup> Anu Bradford, "The Brussels effect", *Northwestern University Law Review*, Vol. 107, No. 1, 2012; Anu Bradford, *The Brussels effect: How the European Union Rules the World*, (New York, NY: Oxford University Press, 2020).

fragmentation of value chains and offshoring reduced the cost of manufacturing and boosted profits and globalization became a buzzword. Trade has allowed countries to specialize<sup>9</sup> according to their respective comparative advantage as predicted by David Ricardo in his theory<sup>10</sup>.

When China joined the World Trade Organization (WTO), the institution promoting a market-based model on global scale, many believed in Francis Fukuyama's prophecy<sup>11</sup>: the triumph of liberal democracy after the collapse of the Soviet Union and the end of the Cold War. Free trade on a 'flat' world<sup>12</sup> was not utopia anymore and in a foreseeable future, trading across continents would be as smooth as trading within any country. The triumph of globalization found confirmation with the response by the G20 to the global financial and economic crisis of 2007-2008<sup>13</sup>: United States, EU, China and Russia, among others, worked together to avoid the Great Depression-styled protectionism and trade wars that many people thought would follow such a crisis.

## **When global trade stops being an open tap**

The path towards a frictionless global trade (and its welcomed efficiencies) has been punctuated by some discontinuities either of unintended (*e.g.*, the earthquakes in Taiwan in 1999 and in Japan in 2011) or of intended nature (*e.g.*, Brexit and protectionism during Donald Trump Presidency of the U.S.). As far as the latter is concerned, to some<sup>14</sup> it is evident that those policy decisions are the consequences of effective specialization. Developed economies focused on high-value-added services (*e.g.*, research and development, design, advertising, and finance)<sup>15</sup> and abandoned 'labor-intensive and resource-intensive' and 'low-skill and

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<sup>9</sup> For the EU see Francesco Paolo Mongelli, Elisa Reinhold and Georgios Papadopoulos "What's so special about specialization in the euro area? Early evidence of changing economic structures", ECB Occasional Paper Series No 168 (February 2016) ([link](#)). For an assessment of global specialization see McKinsey Global Institute, "Risk, resilience, and rebalancing in global value chains", Report, 6 August 2020 ([link](#)).

<sup>10</sup> David Ricardo, *On the Principles of Political Economy and Taxation*. (England: John Murray, 1817).

<sup>11</sup> Francis Fukuyama, *The End of History and the Last Man* (New York: The Free Press: 1992).

<sup>12</sup> Thomas L. Friedman, *The world is flat: A brief history of the twenty-first century*. (New York, NY: Farrar, Straus and Giroux, 2005).

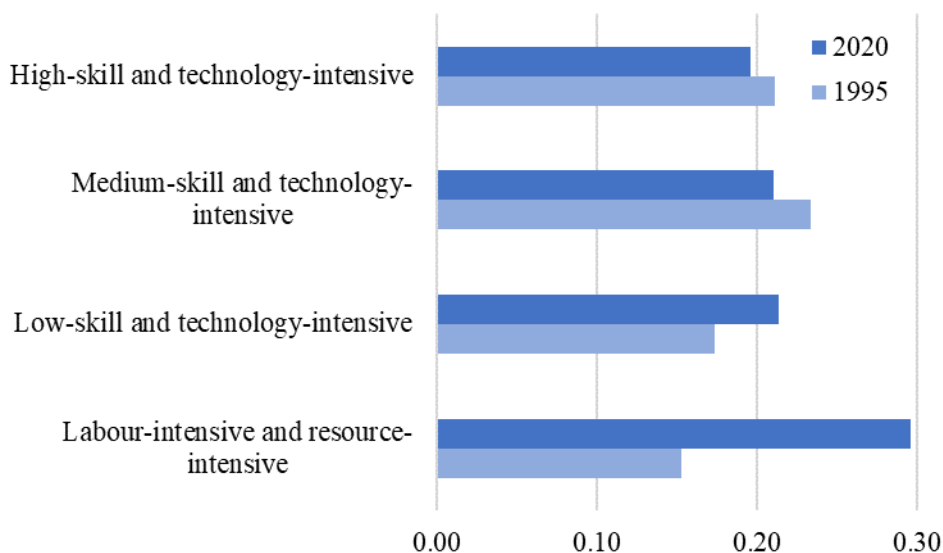
<sup>13</sup> G20 Special Leaders Summit on the Financial Situation, Washington DC, November 14-15, 2008 ([link](#))

<sup>14</sup> See for example: Italo Colantone and Pietro Stanig, "Global Competition and Brexit", *American Political Science Review*, Vol. 112, Issue 2, May 2018 pp. 201 – 218 ([link](#)); Joseph E. Stiglitz, "Trump and Globalization", *Journal of Policy Modeling*, 2018, vol. 40, issue 3, 515-528 ([link](#))

<sup>15</sup> Raghuram G. Rajan, "Just Say No to "Friend-Shoring", Project Syndicate, 3 June 2022 ([link](#)).

technology-intensive’ production in favor of developing economies thus increasing market concentration<sup>16</sup> (Figure 1).

**Figure 1 – Market concentration of export**



Source: UNCTAD

But nothing has been as disruptive for global trade as the unintended consequences of the Covid-19 pandemic and Russia’s intended invasion of Ukraine in February 2022. With the Covid-19 almost every country learned how critical some products can be for national security. Once the label used for weapons, innovative technology, network infrastructure and utilities like water, ‘critical’ was attributed to cheap gowns, gloves, face masks and eyewear. These products were imported from countries that experienced lockdowns and when export was not restricted it was nevertheless jeopardized by logistics disruption. This is the very moment when global value chains and the just-in-time model unveiled their weakness: slashed inventories left minimal margin for error in an unexpected event that made error very expensive.

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<sup>16</sup> Market concentration measures, for each product, the degree of export market concentration by country of origin. It tells us if a large share of commodity exports is accounted for by a small number of countries or, on the contrary, if exports are well distributed among many countries.

In response to shortages, firms have considered increasing the resilience of their value chains by stockpiling critical supplies (the ‘just-in-case’ model<sup>17</sup>) and geographically diversifying and/or shortening chains. The wave of off-shoring that made the value chains global has backwashed thus making firms and policymakers cherish the benefits of re-shoring (returning the manufacturing of goods back to the firm’s original country) and near-shoring (moving the manufacturing of goods to the firm’s original region as, for example, EU firms with the Western Balkans<sup>18</sup>).

## The political geography of trade

Among the alternatives to the off-shoring, once the awareness that trade may be disrupted was sufficiently apparent, U.S. Treasury Secretary Janet L. Yellen<sup>19</sup> called for ‘friend-shoring’, *i.e.*, the reshaping of trade relationships oriented around “trusted partners” to secure market access. This strategy has been already mentioned in 2020<sup>20</sup> as “ally-shoring” during the Covid-19 pandemic and it has gained currency due to the negative export shock caused by Russia’s invasion of Ukraine, also as a consequence of sanctions imposed by importing countries. As suggested by the proponents of ally-shoring, “the U.S. can lead an alliance of economies where robust trade, investment and financial and social benefits are tied to an endorsement of democratic norms of openness, transparency, free expression and rule of law”<sup>21</sup>.

Even if like-mindedness may increase the probability of cooperation among countries during emergencies, Covid-19 revealed that when national security is at stake even countries linked by strong ties as the ones in the EU can introduce export restrictions affecting other members<sup>22</sup>. The real issue is that the economic weight of democracies<sup>23</sup> – those countries that

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<sup>17</sup> Peter Atwater, "The troubling parallels between supply chains and securitisation", Financial Times, 31 August 2021 ([link](#)).

<sup>18</sup> Zuzana Zavarová, “Global Value Chains in the Post-pandemic World: How can the Western Balkans Foster the Potential of Nearshoring?”, Wiener Institut für Internationale Wirtschaftsvergleiche (WIIW), Policy Notes and Reports 58 (March 2022).

<sup>19</sup> Remarks by Secretary of the Treasury Janet L. Yellen on Way Forward for the Global Economy, 13 April 2022 ([link](#)).

<sup>20</sup> Elaine Dezenski and John Austin, "Re-Forge Strategic Alliances and Check China Abroad, Rebuild Economy at Home", Newsweek, 7 December 2020 ([link](#)).

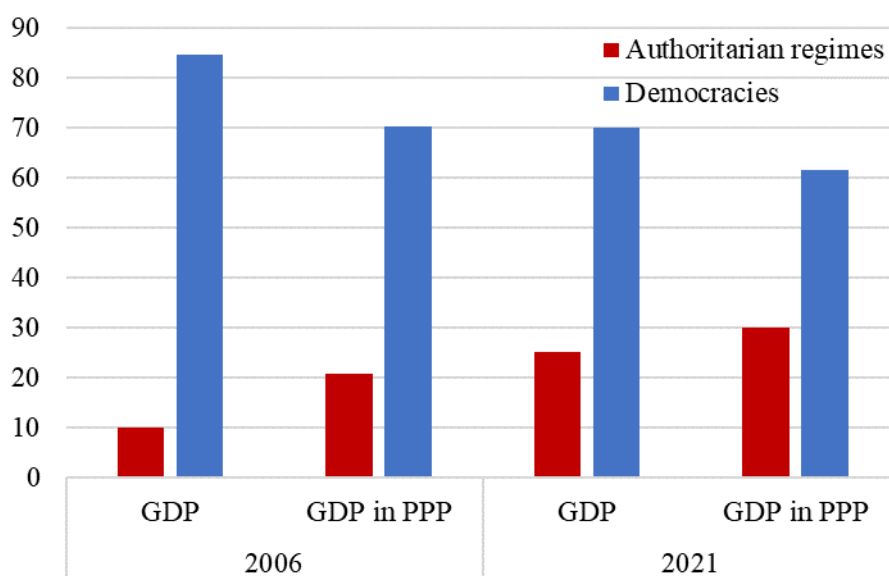
<sup>21</sup> Ibid.

<sup>22</sup> See for example, Stefano Riela and Peter Zamborsky, "Screening of Foreign Acquisitions and Trade in Critical Goods", Asia-Pacific Journal of EU Studies, 2020, Vol. 18, No. 3, 55-83 ([link](#)).

<sup>23</sup> The Economist Intelligence Unit (EIU)’s index of democracy is based on the ratings for 60 indicators, grouped into five categories: electoral process and pluralism; civil liberties; the functioning of government; political participation; and political culture. Each category has a rating on a 0 to 10 scale, and the overall Index is the

fulfil the criteria for an ally-shoring - has dropped during the last 15 years in favour of authoritarian regimes (Figure 2).

**Figure 2 – Economic weight of countries according to EIU democracy index**  
 (% World GDP)<sup>24</sup>



*Source: Author’s calculation based on IMF and EIU data*

If democracies decide to push friend/ally-shoring, this will increase the price of products in a context in which inflation rates are experiencing peaks never seen since 1980s (Figure 3). It is true that trade disruptions, especially the ones during the Covid-19 pandemic and its long tail, have had an impact on prices. However, lockdowns and delay in container shipping are less structural than a redesign of a value chain whose effects might last longer. All those reorientations of value chains would essentially be inflationary since they move links

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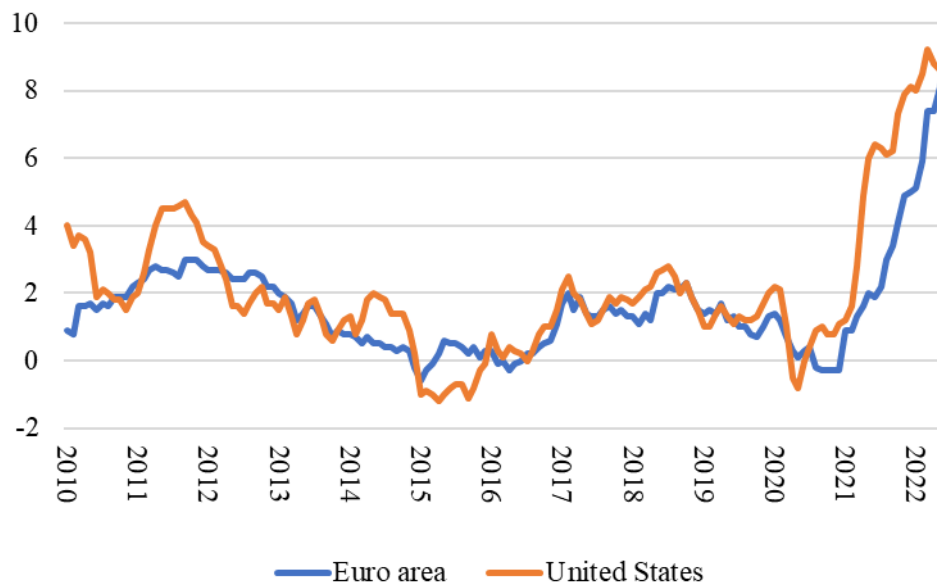
simple average of the five category indexes. “Full democracies” score greater than 8; “flawed democracies” score greater than 6, and less than or equal to 8; authoritarian regimes score less than or equal to 4. According to EIU, in “authoritarian regimes” state political pluralism is absent or heavily circumscribed. Many countries in this category are outright dictatorships. Some formal institutions of democracy may exist, but these have little substance. Elections, if they do occur, are not free and fair. There is disregard for abuses and infringements of civil liberties. Media are typically state-owned or controlled by groups connected to the ruling regime. There is repression of criticism of the government and pervasive censorship. There is no independent judiciary.

<sup>24</sup> Purchasing power parity (PPP) is the rate at which the currency of one country would have to be converted into that of another country to buy the same amount of goods and services in each country.

away from wherever it is cheapest to do so and over-ordering to stockpile is expensive due to its impact on working capital.

Manufacturing goods in developed economies, that are in general democracies, is relatively more expensive than in developing economies. Moreover, by limiting the geographical reach of firms to friends and allies, this will reduce the opportunity to exploit economies of scale thus increasing the cost of production.

**Figure 3 – Inflation rate (All-items HICP, annual % change)**



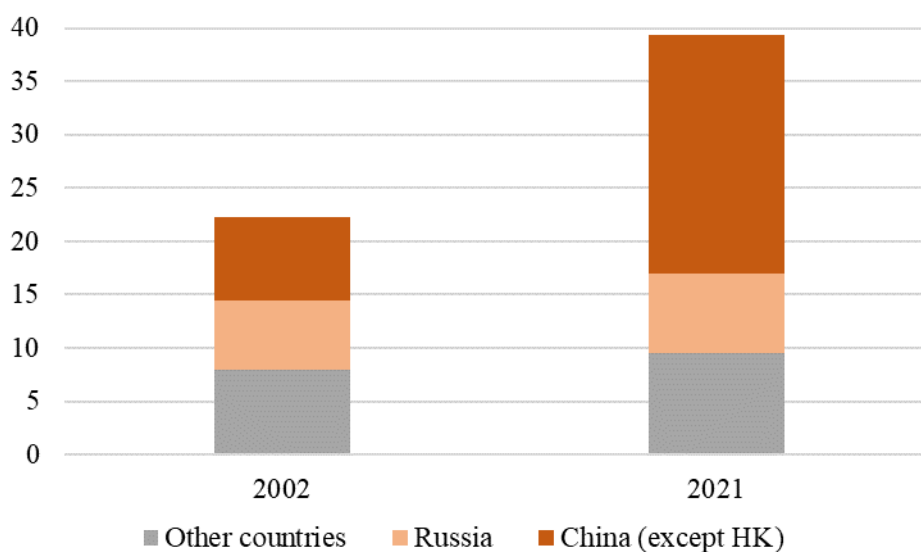
*Source: Eurostat*

## **Europe’s broad understanding of friendship**

In the previous section we mentioned why a strategy inspired by friend/ally-shoring does not come cheap. Especially for the EU, where the relative value of import coming from authoritarian regimes, has increased (Figure 4). The cost of reducing this dependence on unfriendly sources has become evident with Russia's aggression against Ukraine. Europe is highly dependent on Russian energy: import that has increased due to lower domestic production combined with stable demand. To cut using Russian natural gas, the EU has

launched a strategy named REPowerEU<sup>25</sup> that encompasses energy savings, diversification of energy supplies, and accelerated roll-out of renewable energy to replace fossil fuels in homes, industry and power generation. At the same time, European countries that are the most dependent on Russian gas are searching for immediate alternatives: Italy and Germany have cut deals respectively with Algeria and Qatar<sup>26</sup>, two suppliers that are as authoritarian as Russia. But the EU has another ‘unfriendly’ dependence. China, another authoritarian regime according to the EIU, is the first producer of 19 out of 30 raw materials identified as critical by the European Commission<sup>27</sup> and it has a market share at least equal to 80% in rare earth elements<sup>28</sup>, magnesium, bismuth, gallium and germanium. Those materials are essential to the functioning and integrity of a wide range of industrial ecosystems and to deliver the Green Deal<sup>29</sup>, *i.e.* the set of policies fit for reducing net greenhouse gas emissions by at least 55% by 2030 compared to 1990 levels.

**Figure 4 – EU’s imports from authoritarian regimes (% extra-EU imports)**



Source: Eurostat

<sup>25</sup> European Commission, "REPowerEU Plan", COM (2022) 230 final, 18 May 2022 ([link](#))

<sup>26</sup> The Associated Press, "Europe’s push to cut Russian gas faces a race against winter", 18 May 2022 ([link](#)).

<sup>27</sup> European Commission, “Critical Raw Materials Resilience: Charting a Path towards greater Security and Sustainability”, COM (2020) 474 final, 3 September 2020 ([link](#))

<sup>28</sup> Rare earth elements are a group of 17 specialty metals used in various high-tech applications including, smartphones, wind turbines, MRIs, hard disk drives, LEDs, electric motors.

<sup>29</sup> European Commission, "The European Green Deal", COM (2019) 640 final, 11 December 2019 ([link](#))



## Conclusion

The redesign of economic integration using a politically inspired pen comes with a cost even for the ‘big’ democracies. The advantages that come with size - such as more efficiency (thanks to economies of scale), more autonomy (thanks to a more diversified economy), more bargaining power (thanks to a larger market) – are shrinking as showed in Figure 2. Moreover, even the most democratic country cannot use its political capital to shape, to its advantage, the geological allocation of some critical raw materials that are under the earth's crust. A value chain, like any other chain, is as strong as its weakest link.

If a Brussels effect has been successful in levelling business legislation up to advanced economies’ standards, that has been not enough to export a moral code and to push political regimes towards democracies’ standards. The economic weight of authoritarian regimes has increased in contrast to Fukuyama’s prophecy and China is not a liberal democracy yet after more than two decades in the WTO. Truth be told, Fukuyama expected the triumph of liberal democracies in long run. But the short run could still be punctuated by setbacks that limit the desirability of any global trade fragmented along political lines also because a true and a long-lasting alliances and friendship are rare.