

EUROPEAN TRADE FINANCE

AUTUMN 2023

MAINTAINING MULTILATERAL
TRADE COOPERATION IS
CONSIDERED BY HOEKMANN
ET AL

FINTECH HAS A MAJOR ROLE
IN ENABLING GLOBAL TRADE.
GRAHAM BRIGHT CONSIDERS
THE KEY FACTORS

DI SANO, GUNNELLA AND
LEBASTARD ASK IF WE
ARE HEADING TOWARDS
DEGLOBALISATION

A EUROPEAN PERSPECTIVE ON TRADE FINANCE

Foreword

W

elcome to the Autumn edition of ETF, a *World Commerce Review* supplement. This publication has been prepared in response to readership demand for an overview of trade finance from a European perspective.

In these turbulent and unique times issues such as geopolitical tensions, macroeconomic volatility, trade digitalisation, sustainability and shifting supply chains will be examined in forthcoming editions, with the most respected authors providing the reader with the most comprehensive information available.

Our brief is to provide all the data necessary for the readership to make their own informed decisions. All editorials are independent, and content is unaffected by advertising or other commercial considerations. Authors are not endorsing any commercial or other content within the publication. ■

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Digital trade is good for growth: can it also solve our ESG challenges?

Digital trade is good for growth. Pamela Mar argues that digitalising trade could enable SMEs to be future ready, environmentally, and socially conscious businesses

The world expects a lot from SMEs (small and medium sized enterprises). These businesses account for between 70% and 90% of job creation in most economies (OECD and developing economies respectively), and their importance will only increase given the demographics in the developing world.

In Africa, for instance, one billion people will need jobs by 2050, almost 400 million more jobs than exist today. SMEs are the first step in formal employment for many unskilled workers, offering them skills and a way out of poverty. SMEs also provide essential services to poor and rural residents, contributing to social and economic stability, particularly where governing institutions may be weak.

Increasingly, SMEs are being called upon to play their part in the fight against climate change. 60% of the world's CO₂ emissions occur in global value chains largely comprising SMEs, in particular for consumer products and light industrial goods.

SMEs are the source of most Scope 3 emissions (ie. emissions generated along the company's value chain) for many large companies, which in many cases are 90% of a firm's total footprint. Put simply, the world will not meet its net zero imperative without massive action on the part of SMEs.

Alas, SMEs face myriad challenges to simply stay afloat: [one survey](#) reported that 80% of SMEs in Africa will fail within their first five years. While this is just one statistic, anecdotal evidence shows that many of the challenges facing SMEs are deeply set, persisting despite development aid, foreign investment, training support, and even periods of high growth.

The [International Finance Corporate estimates](#) that 40% of SMEs in developing countries have unmet financing needs totalling \$5.2 trillion. Surveys by organisations such as [We Mean Business](#) show that SME climate action is

hindered by a lack of financial resources, lack of capacity and technical know-how, and a lack of physical tools and technologies needed to drive their net zero programmes.

SMEs typically have a low capital base and fewer operating reserves even in the best of times. So, asking them to step up – whether for jobs or climate – particularly in an economic downturn, requires a new approach.

This is where digital trade could play a big role.

A digital trade environment, with its transparent rules and uniform standards could significantly level the playing field for SMEs across borders

The digitalisation of trade and supply chain processes is well known to be an economic opportunity with almost unparalleled upside from a growth perspective: it is good for business because it cuts costs, increases speed and transparency, and produces valuable data that can be used inside the supply chain and especially in financing.

For governments, digital trade is a potential growth driver and an accelerator of crossborder trade. It saves time and labour at the border, while offering transparency and traceability that make compliance easier and less corruptible.

And yet digital trade is difficult: physical systems must be converted; standards must be created and adopted; legal frameworks must be upgraded to acknowledge electronic records and forms; IT systems and networks must be connected; people must be trained to do things in new ways.

Digital trade does not just affect customs and border departments: in many cases a commitment to digital trade may involve over 20 government departments and agencies, including trade, finance, science, tax, interior, and so on.

Notwithstanding the complexity, there is a palpable sense of progress globally on the issue: over half the G7 (by GDP) is on its way towards a regulatory environment that legalises, and enables, digital trade. In the UK, the recent passage of the Electronic Trade Documents Act has the potential to kick-start trade transformation far beyond its borders because of the use of English law in many jurisdictions globally.

Digital trade has been recommended in a number of multilateral fora such as the G7, G20, APEC, the Commonwealth and others. Digital trade and economy agreements are being pursued by several major trading economies such as the EU, Korea, Australia, and Singapore. At least half a dozen other members of the G20 are making concrete steps towards legislation to support digital trade.

Drawing upon years of groundwork on trade standards by public bodies such as UNECE/UNCEFACT and the World Customs Organization, industry is making headway on digital standards for all key trade documents to be 'translated' into interoperable data by the end of 2023 in an effort led by the International Chamber of Commerce's Digital Standards Initiative (DSI).

Convergence toward key data standards will enable interoperability of data across networks and trade platforms, which will address a key barrier faced by SMEs seeking to trade internationally.

Today, trade platforms which facilitate data sharing do exist, but many are closed, meaning that data sharing can only take place between approved members. All companies within a supply chain – sometimes 10-15 different enterprises – must be on the platform so that the supply chain can transact digitally. At the same time, companies along a supply chain may have several customers, each using a different trade platform.

Multiple memberships and platforms become complex when these different platforms each uses their own data formats and data sets, meaning that for every instance, data must be reconfigured, reformatted, or recut entirely if taxonomies and standards differ.

SMEs, being lean by design, will more acutely feel such an administrative burden, while large companies can simply add administrative staff. The more platforms write their own rules, the more SMEs are disadvantaged. Add the complexity of different crossborder regulations, and it is no surprise that most SMEs do not trade internationally, and of those that do, most only manage to trade in one other market.

In other words, a digital trade environment, with its transparent rules and uniform standards could significantly level the playing field for SMEs across borders.

This is exactly what the evidence about paperless trade, customs single windows and digital aspects of [trade facilitation](#) shows: the implementation of these key measures not only boosts growth but is particularly empowering for SMEs.

Beyond this, initial work on digitalising trade documents by ICC offers hope in addressing financing hurdles faced by SMEs. Put simply, a consolidated dataset derived from digitalising seven key trade documents could address a significant portion of a bank's data needs for a typical trade finance transaction.

In essence, the supply chain dataset could function as the vaunted 'single source of truth' provided it uses globally interoperable standards, is secured by technologies of trust, and anchored by the use of verifiable digital identity.

The bank would not need to mount its own effort to ascertain this same information, potentially lowering the cost of financing, thus reducing the administrative burden which prevents many large banks from serving more SMEs.

This core supply chain dataset can also be applied to environmental data needs that must be met on the road to net zero. Virtually all of the critical data required to calculate Scope 3 – from raw material specs, quantities and product codes, shipment modalities, and ports of call – can be found within this core dataset, for obvious reasons.

Trade documents which summarise key terms of trade, enable goods to flow from partner to partner within global supply chains. The problem today is that in the analogue supply chain, data is manually gathered from different players and then passed along using spreadsheets, email, or other methods. It is rarely automated, prone to errors, and cannot be analysed in aggregate without a lot of effort and time.

As a result, the calculation of a Scope 3 footprint today is very painstaking across the supply chain, which is impractical for large or complex supply chains or for companies running thousands of products.

The alternative is to rely on a combination of big data or scoping of a part of a supply chain followed by extrapolating outward. And yet, the use of big data has already been [challenged by European governments](#) who realise, quite rightly, that such tactics are imperfect.

So, while climate activists may rejoice that Scope 3 emissions will eventually be disclosable (and subject to third party verification) under the recently released ISSB and European Corporate Sustainability Disclosure guidelines, it is openly known that most current methodologies for gathering such data are unfit for purpose, at least for many consumer-oriented supply chains.

Trade data from digitalised supply chains can provide the crucial bridge needed to close the gap. Indeed, the systems for sourcing and delivering such data are essentially the same whether for supply chain transactions or supply chain environmental impact calculations.

Moreover, secure, verified datasets sourced from key trade documents are by nature auditable; they will have passed multiple borders, customs authorities, and regulatory bodies. If financing can flow on this basis, so can climate data.

For companies in which sustainability still relies on the same practices – survey, upload, audit, monitoring – that have been used for years by social compliance programmes, the push for auditable, automated environmental data from the supply chain may seem like an impossible task. It need not be.

Of course, it is one thing to say that digital trade can help deliver the data needed to understand supply chain environmental impact, and another to say that mitigation actions are actually occurring. But providing transparency on the problem is a crucial first step.

And for small enterprises serving dozens of customers, digital supply chain practices – delivering standardised approaches to data, interoperability across platforms, and digital identity and credentials – hold the potential to drive the shift from an enterprise overwhelmed by data and the complexity of competing demands, to a future ready, environmentally, and socially conscious business. ■

Pamela Mar is the Managing Director of the Digital Standards Initiative at the International Chamber of Commerce

Enabling digital trade

A central image of a globe with a network overlay of white dots and lines, set against a dark blue background with a nebula-like pattern.

World Commerce Review interview Dr Graham Bright, a leading thinker on the digitalisation of trade, about the challenges that need solving



Tell us about Euro Exim Bank?

Founded in 2017, the bank is headquartered in St. Lucia, West Indies, regulated, supervised and authorised by the Financial Services Regulatory Authority. EEB also have a representative office in London.

From humble beginnings with a core team of 10, now, with a network of sales agents and partners in 190+ countries, we serve import and export businesses. EEB are one of the fastest growing and widest reach trade institutions anywhere across the globe.

EEB provides financial services to facilitate international trade, through issuance of key instruments for both buyers wishing to arrange imports, sellers to guarantee payment, and contractors wishing to bid for major infrastructure projects. Our clients are registered corporates based in active markets such as Asia, India, Middle East and Africa.

What is the main advantage of partnering with Euro Exim Bank?

In our extremely dynamic business sector, demand for new products and critical raw materials has changed the way that companies and countries are looking at new supply chains.

Globalisation is inevitable. The world is becoming increasingly connected, driving the need for faster and more efficient crossborder payments

From previously untapped markets, hit by lack of trust, low liquidity, expensive and compromised supply of fiat currency, withdrawal of major bank services and fragile infrastructure, the need is greater than ever for a specialist trade finance bank. Recognising our economic rates, fast issuance and local contacts in both developed markets and disintermediated emerging jurisdictions, EEB is a natural partner.

With free trade agreement opportunities and new partnerships, community events, and a growing network of agents and partners, EEB are ideally positioned to support and serve the ever-growing volumes of world trade.

What key services can EEB provide to the customer?

In addition to the issuance of stands trade instruments such as letters of credit and standby letters of credit, along with performance bonds and bank guarantees, the bank can also provide bank comfort letters, proof of funds and advanced guarantees.

In addition, the bank is providing services to corporate clients wishing to boost their balance sheets through bond issuance. Here we work in identifying companies looking to raise capital on USD markets by working on initial feasibility studies and introducing them to fund providers.

What sectors and geographical areas does Euro Exim Bank cover?

Our sales network now covers over 190 countries, and this gives us a unique global perspective which keeping contacts local.

Our clients deal in all manner of goods, from food to machinery, batteries to garments, and we have had dealings with clients on six continents.

Most business comes from Asia, Africa and India, and we are seeing more interest for critical raw materials, from Africa and South America fuelled by international free trade agreements and insatiable worldwide demand for metals.

What digital technologies does Euro Exim Bank employ?

As members of the ICC and as an active participant in the UK APPG All Party Parliamentary Group on trade, EEB are very aware of new technologies that will improve speed, accuracy and connectivity, in a long-awaited move from bureaucratic paper (mainly unchanged since the 1800s) to digital processes.

Specifically in the UK, The Electronic Trade Documents Act is a ground-breaking piece of law facilitating removal of legal barriers to digitalising commercial trade documents where information can flow more easily between the public and private sectors and across jurisdictions with trading partners. Our IT teams are purposefully embedding the recommendations and practical solutions offered by this legislation.

Our home-built trade platform also incorporates machine learning and blockchain capabilities, both of which technologies have improved internal processes, however, with all use of commercial blockchains is yet to see true benefits to end users, especially in geographically challenging countries.

Other technologies used include the transmission of standardised authenticated financial messaging via SWIFT, where we relay our instruments to banks securely for safe and verified delivery to ultimate beneficiary banks.

What plans for the future does Euro Exim Bank envisage?

Within 5 years, to be the largest, fastest growing, most trusted, truly global, reliable and innovative trade finance institution on the planet where our culture is driven by an obsession with excellence, integrity and an entrepreneurial spirit that recognizes and rewards vision and hard work.

Through partnerships, acquisition, and with a focus on adding value for our customers and making the necessary investments, we hope to ensure long-term success.

By offering services simply, efficiently and effectively, we will take advantage of opportunities in technology, ESG and supply chain dynamics to further establish ourselves as a global leader in the financial services industry, sustaining and accelerating our growth.

How do you see the future for crossborder payments?

This market is huge with C2C payments worth US\$800 billion in 2022, and B2B crossborder payments set to exceed US\$150 trillion by 2026. Banks have been the traditional de-facto providers of such services, managing international payments, which are essential to support the free flow of goods and services.

But change is coming, through emergence of fintech players looking to challenge the status quo. Their USP's? Faster, more efficient, cheaper, less error prone services, cloud based, secured and ready now.

Real-time payments systems make it possible to send and receive cross-border payments instantly, where formerly, the problem was the time it takes to reach the recipient and complete a transaction.

By reducing the number of intermediaries and not being hampered by operating schedules and time zones, or even currency exchange, real-time payments are the way forward.

Central Bank Digital Currencies (CBDCs), digital versions of fiat currencies, will increasingly be used for real-time settlements between central banks. Whilst take up has been slow, more countries are showing interest and working on pilots. Once these proofs of concept filters down to domestic banks, and accepted by local companies, we may see a situation of 'currency flight', a lessening dependency on the US Dollar as the primary currency of trade.

Technologies such as blockchains can provide a secure and transparent way to transfer money with efficiency and compliance, as all transactions are immutably and securely recorded on a distributed ledger, allowing instant secure transfer between two parties, even disintermediating banks.

Globalisation is inevitable. The world is becoming increasingly connected, driving the need for faster and more efficient crossborder payments.

We are already seeing a proliferation of alternative finance providers, fintech driven payment start-ups and interest from tech giants wanting to extend their market share as traders to full blown banking services supported by invoicing, identity and cross-border data management.

As these companies are not encumbered by the constraints of ever-changing financial regulations as applicable to traditional banks, they are uniquely positioned to rapidly innovate, offer new cost-effective solutions and ultimately take market share.

How will fintech enhance global trade?

The opportunities and economies of fintech in trade are significant.

Firstly, automating the process across the entire instrument lifecycle encompassing the full ecosystem, still consisting of siloed operations and disparate participants. Then, the accuracy and clarity of data, with early verification, identifying risk, enabling risk mitigation and lower contingent liability.

Also, connectivity, with easier communication and provision of new online banking services, for example, embracing digital and crypto currencies to reduce fx requirements, with real time transfer.

The latest iteration of fintech driven trade will be assisted through peer-to-peer (P2P) lending networks giving access to competitive funding for all sizes of companies.

This innovative mechanism may help smaller companies remove trade barriers, increase liquidity, and reduce administrative burden where they have traditionally been disadvantaged through small deal size, expensive FX and bureaucratic process.

Conclusion

Whilst trade remains vital to global economies, there are still deep-rooted challenges to be solved.

By employing technologies such as blockchain, real-time inter and digital currency payments through P2P networks and alternative funding options from non-regulated financial institutions, the trade landscape is undergoing rapid change.

Nirvana for trade is inclusivity, collaboration, affordability, security, digitisation, settlement finality and transparency, enabling all players regardless of geography, currency, culture, and tariffs to compete on the global stage effectively and economically, without being disadvantaged financially, exploited and bypassed. Fintech can only assist in this lofty ambition. ■

Dr Graham Bright is the Head - Compliance and Operations, at Euro Exim Bank



Tax for climate finance should start with shipping

Pascal Saint-Amans argues that emissions from international shipping are the most realistic target for taxes to pay for climate spending in developing countries

The Bridgetown initiative, a climate finance plan for developing countries launched by Barbados prime minister Mia Mottley in 2022, inspired the [Summit for a New Global Financial Pact](#), held in Paris on 22-23 June. The more than 40 leaders in attendance, including German Chancellor Scholtz, Chinese Premier Li Qiang and Brazilian President Lula, revived discussions on financing the energy transition in the South together with the fight against poverty.

They [confirmed](#) the reallocation of \$100 billion of International Monetary Fund Special Drawing Rights and agreed on the need for multilateral development bank reform to mobilise more public and private funds. There was also agreement on the need to work further on international tax.

What could sound like a vague commitment on tax might actually deliver a concrete outcome if a few conditions are met. To all economists, carbon taxation is the first-best candidate for an international tax to finance the energy transition. With only 40% of global carbon emissions priced, at an average worldwide price below €5 per tonne, a global carbon tax is long overdue.

However, the political economy of the reform makes it impossible in the current circumstances (France's *gilets jaunes* movement is the poster child of the opposition to carbon pricing). The Paris summit also floated briefly the idea of moving carbon taxation upstream to the point of fossil-fuel production, before rejecting it as a no-go.

One carbon tax might work, however. It was discussed in preparation for the summit but not mentioned explicitly in the outcome statement: a tax on carbon emissions from the shipping industry. Countries should give it a chance for three reasons.

First, global shipping is a crossborder activity that has both benefited from and contributed to globalisation, and is a significant contributor to overall emissions, representing almost 3% of global emissions, while all of Africa contributes 4%.

Second, this industry currently pays no tax on its carbon emissions. The fuel is completely tax free. No excise duties, no carbon tax. Moreover, shipping companies are not subject to regular corporate income tax anywhere in the world at a time when their profits have reached unprecedented levels.

The design should ensure impact even if not all countries implement. The 15% global minimum tax does not require all countries to implement; rather only a critical mass is required for it to have an impact

Third, very little progress has been made on improving the carbon efficiency of shipping fuel and shipping is in fact falling behind its own commitments. The International Maritime Organisation's net zero ambitions are not aligned with the Paris Agreement, and negotiations at the IMO on the path towards carbon neutrality by 2050 are stalled.

If properly orchestrated, global agreement on an international tax can happen, as shown by the deal reached by 137 countries in October 2021 establishing an effective 15% global minimum tax (even though the shipping industry is the only one carved out from this agreement). A tax on carbon emissions from shipping could follow the same path, with a few essential steps.

There should be a top-down approach, in the form of a message from leaders to their delegates at the IMO to empower them to deliver meaningful progress. The Paris [statement of outcomes](#) could have been more explicit but it is not too late. The design should ensure impact even if not all countries implement.

The 15% global minimum tax does not require all countries to implement; rather only a critical mass is required for it to have an impact. This pushes the slow movers, so that it is not just the first movers that accrue the revenues.

A first step has already been taken with the European Union including shipping emissions in its emissions trading system (ETS). In 2026, half of the emissions related to shipping to and from Europe will be in scope of the ETS.

The EU should seek allies to build a critical mass of countries, or of subnational governments where the large ports are located. It might be easier to convince the states of New York and California, than negotiating with the US as a whole.

Negotiations at the IMO will soon resume. The EU coalition to build out taxation of shipping emissions should start with small island states, like the Marshall Islands, under threat of disappearance because of rising sea levels. Together, they could open up a new route for international taxation. ■

Pascal Saint-Amans is a Non-Resident Fellow at Bruegel

This article was first published on [Bruegel](#).

Deglobalisation: risk or reality?



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Globalisation is said to be on the retreat. Martina Di Sano, Vanessa Gunnella and Laura Lebastard examine the data to see if we are heading towards deglobalisation

The increasing integration of more and more economies into international trade and production has shaped the modern world – both as a driver of growth and sometimes as a source of instability. This globalisation now appears to be at a tipping point. Its vulnerabilities and disadvantages have triggered a rethink. Many companies that used to source their inputs from around the world now face tough times and are being forced to adapt.

The reasons for this are clear. For example, many customers in Europe had to wait several months for a new car as critical parts, like microchips from Asia, became scarce in 2021. And Russia's war in Ukraine has laid bare the euro area's dependence on energy and critical raw materials from just a few suppliers.

Are we merely seeing a reshuffling of supply and production chains? Or is this a paradigm shift and the start of a new trend towards deglobalisation?

Let's take a step back and look at the ways firms can make their production and supply chains secure and resilient. They can establish stockpiles of resources that can serve as buffers in the face of unexpected disruptions. They can broaden the range of countries from which they acquire the resources they need to produce goods and services.

They can also go even further and relocate production back home or to neighbouring countries – known as reshoring and nearshoring respectively. All of these options have distinct implications for the integration of global trade.

For instance, reshoring, which can prompt deglobalisation, entails benefits and costs. It can benefit firms and consumers if it provides better control of production processes. Reshoring can also reduce the negative effects that disruption in one country can have in others.

But reshoring is also likely to have drawbacks. Less geographical diversification leaves a country more vulnerable to domestic shocks¹. The deglobalising effects of reshoring can also reduce international trade and crossborder investment, while making it harder to transfer productivity gains from one country to another.

All this can reduce prosperity, especially in the small, open economies that benefit most from international trade. Transferring production back from overseas can eliminate previous gains from international comparative advantages and increase domestic production costs².

After decades of being both hero and villain, globalisation is said to be on the retreat. There is a common perception that companies are diversifying supply chains and relocating business closer to home

The past decade has been characterised by a trend towards nearshoring. Yet, trade data provide no clear evidence that recent events – eg. pandemic and war – have accelerated this trend. The data also do not indicate reshoring of production chains to Europe.

Chart 1 shows that in the past decade the share of intermediate goods imported from within the EU increased³. This mirrors the long-term global trend of producing goods closer to their final markets, which has benefited central and eastern European countries⁴.

This shift has reversed in the wake of the pandemic as the share of both intermediate and strategic goods imported from the EU decreased. And it is the result of comparatively smooth global supply chain conditions and cheaper input costs outside the EU⁵.

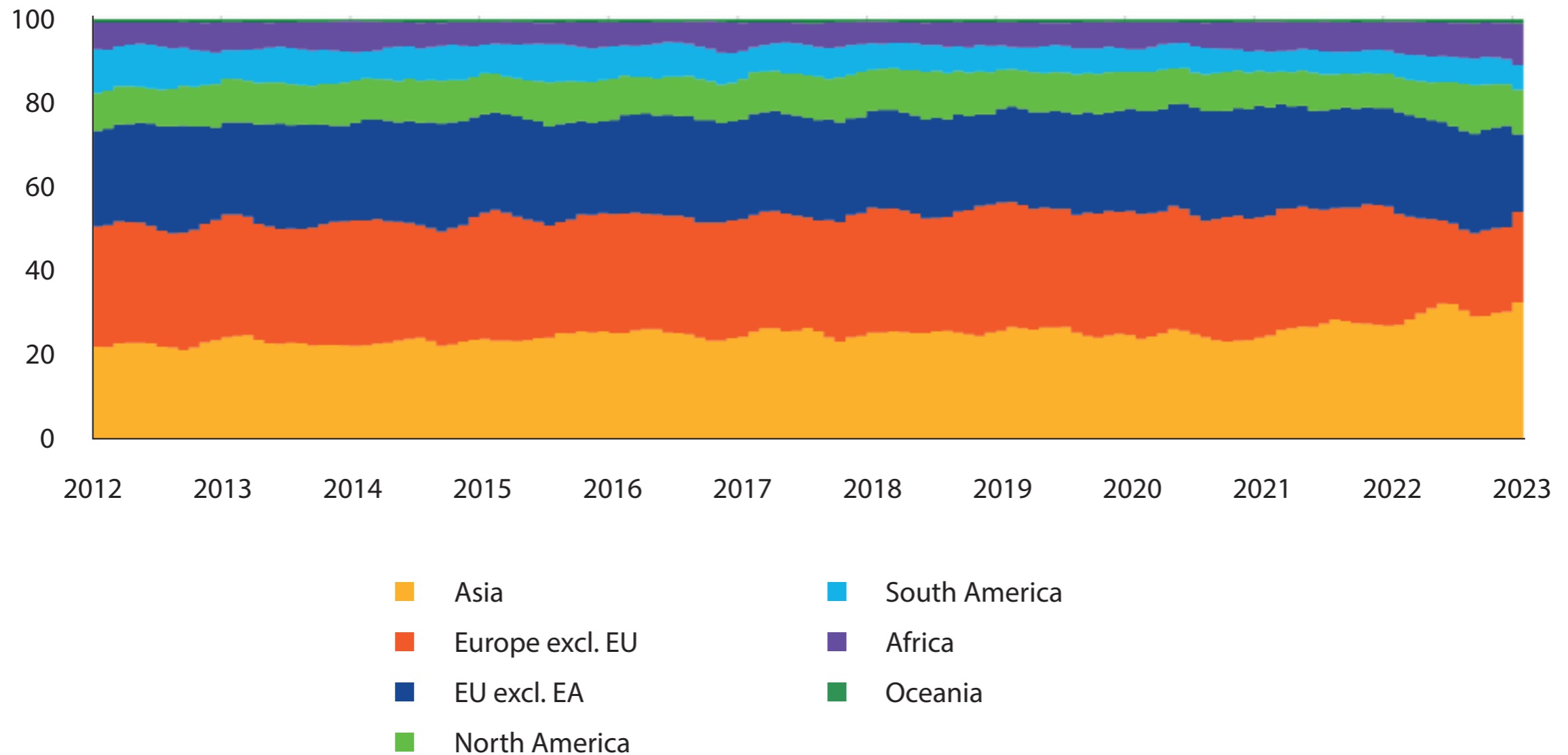
Overall trade in intermediate goods (a reliable indicator of global production chains) has remained high. The share of trading partners from outside the EU accounted for about 40% of total imports of intermediate goods (including those between euro area countries) in 2022.

The figure for strategic goods was even higher, at 65%, with Asia as the major sourcing region owing to its leading role as an exporter of electronics⁶. Analysis shows that there is no change in the pattern of euro area imports of intermediate goods from within the EU compared to those from outside the EU⁷.

These data support survey and anecdotal evidence that there has been no strong response in terms of reshoring within the EU. Companies are instead pursuing other strategies, including diversifying suppliers (eg. via the increase of sourcing countries) and building up strategic inventories⁸.

Chart 1. Euro area imports of intermediate goods by region (shares of total imports, deflated)

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Notes: The definition of intermediate goods is based on classification by Broad Economic Categories (fifth revision). Europe excluding EU includes Russia. The latest observations are for March 2023.

Sources: Eurostat and ECB staff calculations.

This limited empirical evidence for deglobalisation may reflect the fact that there are a number of forces that are still actively pushing for globalisation. Technological progress may make it easier to reshore the production of strategic goods and technologies, such as semiconductors. But doing so still requires large investments and time⁹.

Factors such as labour shortages resulting from emigration, population aging and skills shortfalls may make EU countries less attractive for reshoring. While other cost considerations, such as rising labour or energy costs, and regulatory differences, such as stricter environmental standards, might have encouraged firms to locate production abroad¹⁰.

Advancements in digital technologies also make it easier to trade services across borders, making relocating business processes internationally (offshoring) even simpler.

Another explanation for the absence of reshoring in euro area trade data is that the effects of reshoring may take longer to reveal themselves.

While trade data do not yet show deglobalisation of production chains, policies in many parts of the world now prioritise domestic or geopolitical objectives over efficiency. Strategic industries such as semiconductors or pharmaceuticals, for example, may see a reshoring of supply chains as a result of government policies.

This analysis, relying on past aggregate data and trade behaviour, is by definition backward-looking. While there may already be changes at company level, structural changes in trade patterns may take time to unfold, since relocating production is costly and complex. This will require further analysis and the use of firm-level data or surveys of firms' future plans.

To conclude, recent geopolitical changes raise questions about whether we are witnessing structural changes in the global economy that may shift towards deglobalisation. Even though there is no strong evidence from recent euro area trade patterns, the risk of global trade fragmentation is real and its consequences could be severe for both producers and consumers.

If firms restructure their production chains to source inputs from countries that are geographically closer, rather than those that are more efficient, their production costs could experience an increase that would eventually be reflected in the final prices charged to consumers.

However, the impact on import prices would depend on the actual scale of the shift towards closer sourcing countries. We must watch this closely to understand its implications for Europe. ■

Martina Di Sano is a Research Analyst, Vanessa Gunnella is a Senior Economist, and Laura Lebastard is an Economist, all with the Euro Area External Sector at the European Central Bank

Endnotes

1. See Attinasi, M, Boeckelmann, L and Meunier, B (2023), *“Friend-shoring global value chains: a model-based assessment”*, Economic Bulletin, Issue 2, ECB; Espitia, A, Mattoo, A, Rocha, N, Ruta, M, and Winkler, D (2021), *“Pandemic trade: COVID-19, Remote Work and Global Value Chains”*, Policy Research Working Papers, No 9508, World Bank; and OECD (2021), *“Global value chains: Efficiency and risks in the context of COVID-19”* Policy Responses to Coronavirus (COVID-19).
2. For quantifications, see Aiyar, S, Chen, J, Ebeke, CH, Garcia-Saltos, R, Gudmundsson, T, Ilyina, A, Kangur, A, Kunaratskul, T, Rodriguez, SL, Ruta, M, Schulze, T, Soderberg, G and Trevino, JP (2023), *“Goeconomic Fragmentation and the Future of Multilateralism”*, Staff Discussion Notes, No 2023/001, IMF and Javorcik, BS, Kitzmueller, L, Schweiger, H and Yildirim, A (2022), *“Economic Costs of Friend-Shoring”*, Working Papers, No 274, European Bank for Reconstruction and Development.
3. This trend is also true when including countries within 5,000 km of the EU.
4. See Cigna, S, Gunnella, V and Quaglietti, L (2022), *“Global value chains: measurement, trends and drivers”*, Occasional Paper Series, No 289, ECB.
5. See Frohm, E, Gunella, V, Mancini, M and Schuler, T (2021), *“The impact of supply bottlenecks on trade”*, Economic Bulletin, Issue 6, ECB and Chiacchio, F, De Santis, RA, Gunella, V and Lebastard, L (2023), *“How have higher energy prices affected industrial production and imports?”*, Economic Bulletin, Issue 1, ECB.
6. Strategic goods are defined in line with the *European Commission Staff Working Document on strategic dependencies and capacities*. The Commission identifies strategic dependencies related to specific imported inputs “in the most sensitive ecosystems where the EU can be considered highly dependent on imports from third countries” based on three indicators: (1) concentration, measured by the Herfindahl-Hirschman Index and the market share of the extra-EU supplying countries; (2) demand importance, calculated as the share of extra-EU imports in total EU imports; and (3) substitutability, calculated as the ratio of extra-EU imports to total EU exports.

7. The econometric specification is the following:

$$\ln \text{import}_{ijst} = \sum_{k=12}^{24} \beta_k \text{Time dummy}_{kt} \times \text{EU dummy}_j + FE_{ijs} + FE_{it} + \epsilon_{it}$$


where the dependent variable is the natural logarithm of imports from country j to the euro area country i in sector s at time t . The treatment group consists of EU countries. On top of importer-exporter-sector fixed effects, importer-time fixed effects are included to control for euro area country-specific developments, including supply bottlenecks. The results are robust when changing the treatment group to ‘friend’ countries (defined as countries which voted in favour of sanctions against Russia – UN General Assembly Resolution ES-11/3), EU and bordering countries, EU and countries closer than 5000 km, and democracies.

8. See Seong J, White O, Woetzel J, Smit S, Devesa T, Birshan M and Samandari H (2022), [“Global Flows: The Ties that Bind in an Interconnected World”](#), Discussion Papers, McKinsey Global Institute, McKinsey & Company and European Investment Bank (2022) [“European Union Overview”](#), EIB Investment Survey.

9. See International Relations Workstream on Open Strategic Autonomy (2023), [“The EU’s Open Strategic Autonomy from a central banking perspective”](#), ECB, forthcoming.

10. For a look at how companies find an advantage in producing high-carbon inputs outside the EU, see Böning, J, Di Nino, V and Folger, T (2023), [“Stop carbon leakage at the border”](#), The ECB Blog, ECB.

The views expressed in each blog entry are those of the author(s) and do not necessarily represent the views of the European Central Bank and the Eurosystem. This article is based on an [ECB Blog](#).



Multilateral trade cooperation

Trade and investment policy is increasingly becoming politicised. Bernard Hoekman, Petros Mavroidis and Douglas Nelson present pragmatic suggestions to sustain multilateral trade cooperation

Global trade and investment are increasingly affected by unilateral policies motivated by both economic and non-economic objectives such as safeguarding national and economic security, combatting climate change, and promoting social values. This column introduces a new book that summarises extant multilateral disciplines on use of trade policies motivated by non-economic objectives, documents the rising use of such measures, and presents pragmatic suggestions to sustain multilateral trade cooperation in a world characterised by rising geopolitical and geo-economic rivalry and existential threats.

The global value chains that have been a driver of globalisation are being buffeted by exogenous shocks and unilateral policy interventions that increase political risk, uncertainty, and associated risk premia, potentially distorting trade and investment decisions (Kitzmüller *et al* 2022, Attinasi *et al* 2023) and adversely affecting prospects for developing countries to attain sustainable development goals.

In a new [study](#) (Hoekman *et al* 2023) we call on states to clarify underlying objectives, assess the effectiveness of adopted policies, and consider their spillover effects. We argue that insofar as national security motivates trade intervention, adjudication is undesirable and likely to be ineffective.

Dialogue centred on the use of so-called specific trade concerns, already used in some WTO agreements, offers a better approach. The creation of platforms where WTO members, supported by relevant international organisations, can discuss the need for using trade to pursue non-economic goals, jointly assess the economic effects of interventions, and identify approaches that reduce inefficiencies and negative spillovers can inform reform efforts to help members realise non-economic objectives (NEOs) while continuing to benefit from international specialisation.

Plurilateral initiatives are a pragmatic path forward for like-minded states to pursue shared NEOs. Embedding such initiatives in the WTO offers both participants and nonparticipants a means to reduce the prospect of club-based cooperation – an inevitable corollary of a multipolar world economy – undermining the multilateral trade order.

The sustained higher rates of economic growth in major developing economies that has been a source of adjustment pressures in OECD member countries combined with increasing geo-economic rivalry with China is driving a resurgence in state intervention in the original core members of the GATT

Trade and investment policy is increasingly becoming politicised. One reason is that in the context of low formal border protection, global value chains (GVCs) create demand by participating firms for disciplines on domestic regulatory policies that affect operating costs, explaining why 'behind-the-border' policies have come to be included in deep trade agreements (Fernandes *et al* 2023).

In contrast to tariffs, because many of the policies constitute domestic regulation, they are more politically sensitive, affecting a much larger set of domestic interests. Another reason is that governments have become more concerned with non NEOs: environmental sustainability, public health, labour standards, human rights, and many others.

Often the pursuit of NEOs involves policies that target GVC-based production and exchange, reflected in regulatory instruments seeking to make supply chains more resilient to shocks, to prohibit or disincentivise the use of specific inputs or production processes, to reduce national dependence on certain sources of supply (Arjona *et al* 2023), or to require due diligence and third-party auditing of international supply chain operations.

A third reason is the 'backlash against globalisation' reflected in rejection of the so-called 'neoliberal' national economic policies and multilateral institutions that supported international integration.

While evidence for significant decoupling is still limited (Freund *et al* 2023) the sustained higher rates of economic growth in major developing economies that has been a source of adjustment pressures in OECD member countries combined with increasing geo-economic rivalry with China is driving a resurgence in state intervention in the original core members of the GATT.

To date, the focus of greater recourse to unilateral intervention in trade and investment by large trade powers has mainly been to support domestic economic activity in priority sectors. Instruments to do so have mostly involved subsidies of different types, complemented by trade and investment measures motivated by safeguarding competitive neutrality and NEOs such as national security, environmental sustainability, and protection of human rights.

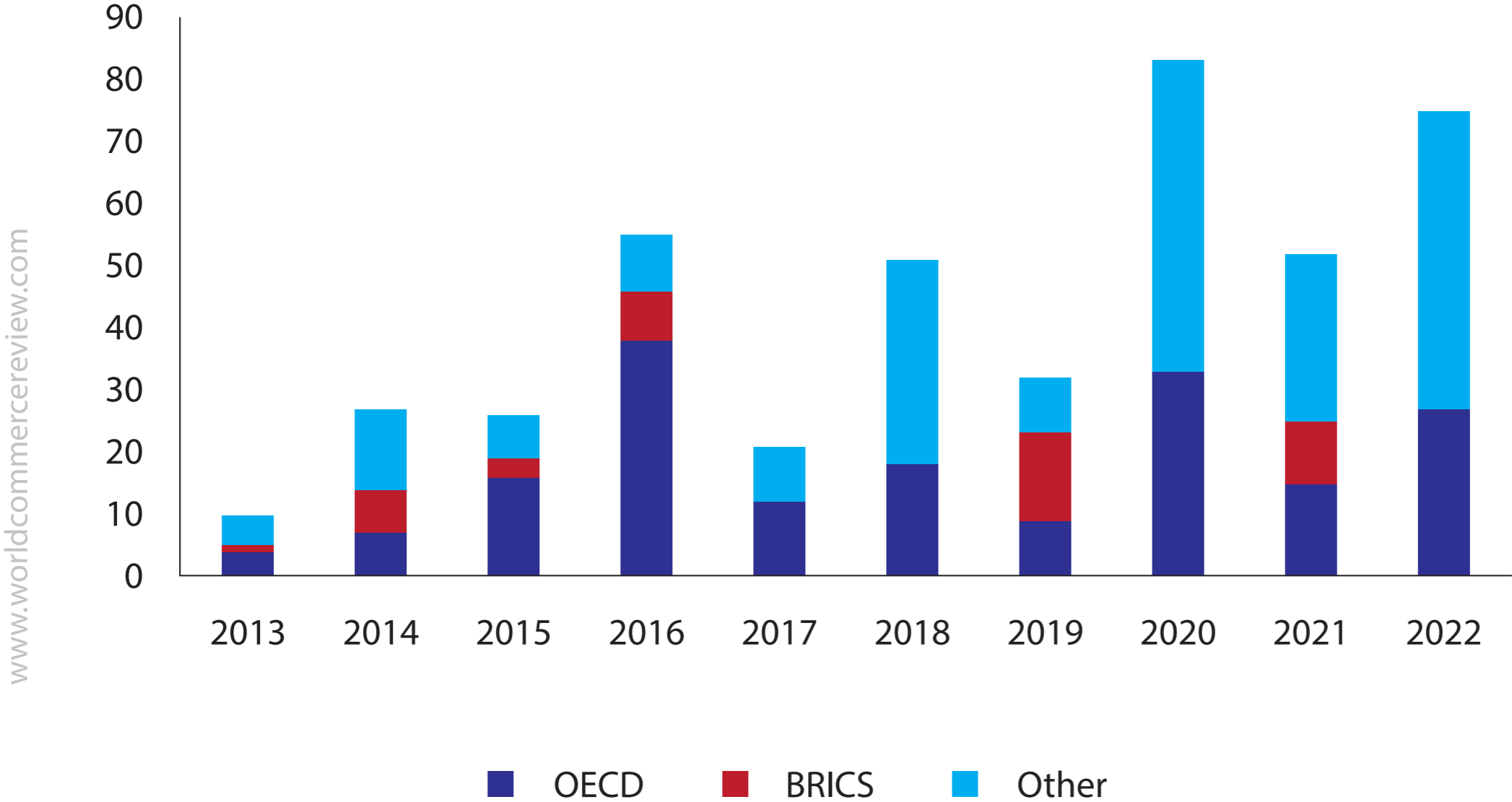
The pursuit of unilateral measures to attain or protect NEOs increases political risk perceptions and policy uncertainty, inducing lead firms that operate GVCs to re-think their international investment and commercial partnership strategies.

The trends are clear in notifications to the WTO of quantitative trade restrictions. Whereas in the past these tended to fall mostly under the general exceptions provision of the WTO (eg. to protect the environment), the number of such measures motivated by essential security considerations has been rising steadily (Figure 1).

A search of the Global Trade Alert database, an independent trade policy monitoring initiative that provides much more extensive information on the use of trade-related policy instruments than the WTO reveals that among trade interventions motivated by NEOs, security-related keywords have become the most prevalent type of noneconomic objective mentioned in the underlying documentation describing the purpose of a trade measure (Figure 2).

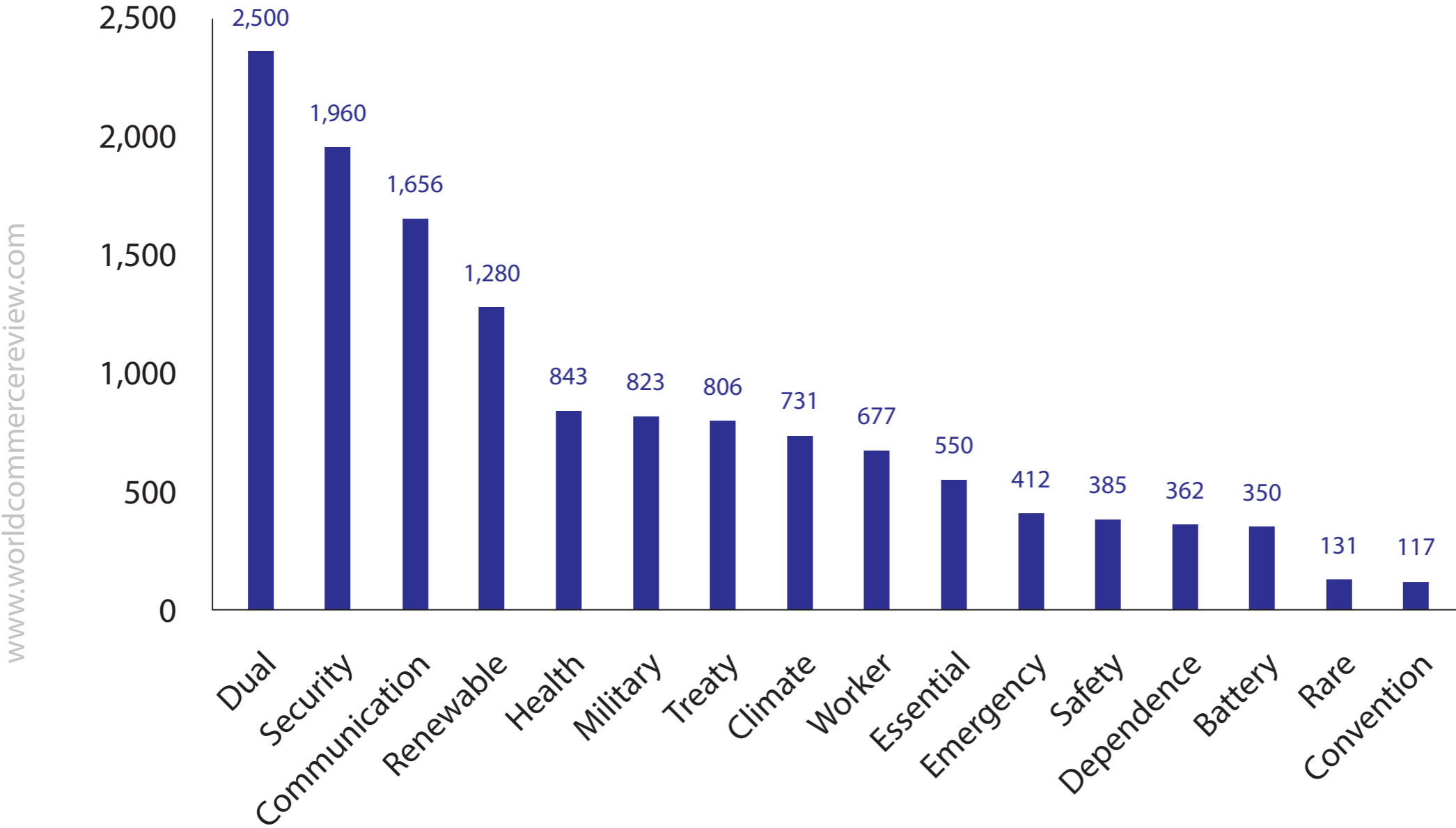
As a result of the complexities of NEOs and the way they interact with each other, the design and implementation of trade policy has become much more intricate. A corollary of the increasingly multifaceted trade policy environment is that international trade cooperation to reduce crossborder policy spillovers no longer works as well as it used to when the agenda centred on reciprocal reduction of border barriers on a non-discriminatory basis.

Figure 1. Notifications of quantitative trade restrictions mentioning 'essential interests', 2013-2022



Source: WTO quantitative restrictions database

Figure 2. Number of times a NEO-related keyword appears in GTA measures, 2009-2022



Source: Global Trade Alert database.

Instead, strategic autonomy, economic security and other NEOs motivate calls for collaboration among countries with similar values and political-economic systems – ie. clubs of like-minded states ('friends'). Arguably the greatest threat to the liberal trade order is the increasing rejection of the basic values of that regime.

The emergence of anti-liberal political movements of the left and right in many high-income countries is spilling over to a critique of the rules-based multilateral trading system. An essential part of both the left and right critiques of democratic capitalism is an explicit rejection of global liberal policies and institutions.

If the exceptions provisions included in the WTO are used in bad faith, this is actively destructive of multilateral trade regime. For the rules to function there must be general acceptance of norms of good behaviour. When countries use public morals or values as a cover for simple protectionist policy, they are violating those norms.

Our new study considers implications of these developments for the global trade regime and multilateral trade cooperation. The current rules and institutions of the world trading system are not built to deal with the structural changes affecting the global economy.

The erosion of trust among the large economic powers that has resulted from (perceived) increased willingness to 'weaponise' trade policy is a major constraint to launching negotiations on new rules of the game.

Our premise is that for the WTO to remain relevant in the 21st century, the membership must recognise the way that international trade increasingly is linked to system competition, cooperation, and contestation over NEOs for which trade is seen as instrumental to policy success.

Efforts to create new 'guardrails' to safeguard the rules-based trade order and international economic activity (globalisation) should centre on frameworks to guide initiatives by governments to attain NEOs such as making supply chains more resilient or safeguarding national policy autonomy.

We argue a central feature of multilateral cooperation should be to establish processes in which states can engage in deliberation and dialogue with a view to identifying shared NEOs and reducing negative spillovers of associated policies on GVCs and globalisation more broadly.

Both empirical research and historical experience demonstrate that a world in which mutually agreed rules no longer apply to all trading nations, especially the large powers, is one that can only have detrimental consequences for all countries (eg. Yotov *et al* 2019, Aiyar and Ilyina 2023, Campos *et al* 2023).

The opportunity cost of non-cooperative policies is greatly increased because the world confronts major, existential, threats and collective action problems.

Systemic differences and geopolitical rivalry need not preclude cooperation to attenuate and/or manage policy spillovers. The Biden administration has made clear that it is not interested in negotiating traditional preferential trade agreements (PTAs) that centre on reciprocal reduction of tariffs and nontariff barriers on substantially all trade.

Instead, the US is pursuing issue-specific cooperation and frameworks to coordinate policies – for example, agreeing on good regulatory practices towards the digital economy, export controls, foreign direct investment, and GVCs. Recent examples include the EU-US Trade and Technology Council and the Indo-Pacific Economic Framework for Prosperity.

Such arrangements have implications for the trading system insofar as they act as frameworks for cooperation among states to jointly condition trade and investment on shared values through, for example, production requirements relating to labour, human rights, and/or environmental sustainability.

If associated regulatory cooperation arrangements are open to any country interested in participating, with benefits extended conditional on implementing agreed regulatory standards or principles independent of national political systems and governance, they can support a process of gradual multilateralisation. If instead they are designed to be exclusive arrangements, they will foster greater fragmentation of the world trade system.

As we argue throughout, cooperation must be rooted in an understanding of the objectives of the participants and the way their interests are related to the domestic and international commitments of the states involved.

WTO reforms are not needed for discussions among members on NEOs, but there must be political willingness to go beyond the 'bread and butter' of the WTO: negotiating disciplines on trade policy without consideration of the rationale for using specific trade instruments.

WTO members that condition access to their market on satisfying specific production requirements motivated by a NEO have an interest in others doing so as well. In many cases, states may share a NEO, providing scope for dialogue and discussion about the policy instruments.

Cooperation can take the form of agreement to act in a concerted manner, but it is arguably better to put in place a framework that encourages states to use WTO-sanctioned clubs. This is in all WTO members' interest.

Greater scrutiny, transparency and discussion of the rationale, and analysis of the effects of trade-NEO issue linkages that are pursued by groups of countries would both benefit the jurisdictions pursuing such policies as well as those that do not join them but may be affected.

There is much to be gained from cooperating on NEOs of broadly common interest. Alliances (clubs) have long been a form of cooperation among states and are likely to figure more in the future as vehicles to support deeper integration among like-minded states.

We argue that WTO reform discussions should include a focus on developing a multilateral framework to guide the use of trade and industrial policy by groups of like-minded economies motivated by NEOs. This would benefit members of potential clubs to design and implement policies that are efficient. It would also benefit non-members by reducing potential negative spillovers and adverse effects on the trading system.

Basic features of any such framework should centre on using the WTO as a forum to increase transparency and support policy dialogue and peer review of the use of trade policy instruments. ■

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How deep trade agreements shape non-trade outcomes

Trade agreements include disciplines aimed at achieving non-trade objectives. Ana Margarida Fernandes, Nadia Rocha and Michele Ruta investigate how non-trade disciplines in PTAs affect non-trade outcomes

Trade agreements increasingly include disciplines aimed at achieving non-trade objectives: promoting foreign direct investment, technology transfers, and workers' movement, but also improving labour conditions and environmental quality and achieving other broader social goals.

This column introduces a new eBook that investigates whether these disciplines actually achieve their intended goals. The evidence shows some successes, such as in the area of FDI, technology transfers, and the environment, but also the limits of regulating non-trade policy areas in trade agreements, especially with regards to social outcomes such as child labour.

Preferential trade agreements (PTAs) have been a key policy tool in shaping trade relations in the past 30 years. Their number has increased, from less than 50 in 1990 to 350 today. Their scope has also widened over time, with many PTAs becoming 'deep' as they cover more policy areas and require more stringent commitments (Mattoo *et al* 2020).

Since the classic work by Baier and Bergstrand (2007), a vast body of empirical literature has analysed the impact of PTAs on trade with members and non-members (for reviews, see Freund and Ornelas 2010 and Limao 2016). More recent work has focused on the distinctive role of deep trade agreements in promoting trade and on how these effects result from specific provisions in PTAs (for a recent collection of studies, see Fernandes *et al* 2021).

A new [CEPR-World Bank eBook](#) (Fernandes *et al* 2023) brings together new research on the impact of trade agreements on a broad range of non-trade outcomes. These include diverse areas such as foreign direct investment (FDI), innovation, policy stability, labour standards, environmental quality, and political rights.

Of course, the increase in trade brought about by trade agreements has an impact per se – positive or negative – on non-trade outcomes. For instance, having access to larger markets can help promote a surge in FDI in member countries.

Trade agreements include disciplines aimed at achieving non-trade objectives: promoting FDI, technology transfers, and workers' movement, but also improving labour conditions and environmental quality and achieving other broader social goals

More open trade, in the absence of appropriate domestic policies, can lead to faster depletion of natural resources such as forests. But do non-trade policy areas in PTAs directly influence non-trade outcomes?

The chapters in this eBook build on the detailed information from the World Bank's Deep Trade Agreements Database, introduced by Mattoo *et al* (2020), to analyse if and how non-trade disciplines in PTAs affect non-trade outcomes.

Indeed, the inclusion of provisions that deal with non-trade objectives is increasingly a salient characteristic of PTAs, especially those signed by advanced economies such as the EU and the US with developing countries.

Underlying this transformation in the content of trade agreements are multiple reasons, ranging from the changing nature of trade with the growing importance of global value chains to the changing politics of trade, with issues like the protection of labour rights and the environment increasingly seen as central in the ratification process of PTAs.

Whatever the reasons for non-trade disciplines in PTAs, there is little understanding about their effects – ie. whether these non-trade provisions actually achieve the intended goals¹. The research in this eBook helps fill this important gap. In this column, we present the highlights of this analysis.

The evolution of non-trade disciplines in PTAs

Preferential trade agreements increasingly include different types of non-trade provisions. First, PTAs pursue economic integration, that is, free (or freer) movement of goods, services, capital, ideas, and people.

As such, PTAs cover policy areas such as investment, intellectual property rights protection, and visas and asylum that aim at regulating FDI, technology diffusion, and migration flows.

Second, policy areas such as labour and environmental regulation aim at improving social welfare or protecting rights that could be impacted by market integration, by regulating the behaviour of exporters.

For illustrative purposes, Figure 1 shows how the coverage of these five policy areas in PTAs has evolved – pointing to a large increase over time². Figure 2 illustrates the wide heterogeneity in the coverage of non-trade policy areas in PTAs and their enforceability. Disciplines on intellectual property rights, investment, and the environment tend to be more frequent than disciplines regulating labour market conditions and migration.

For example, in the period 2010–2021, 66% of PTAs included investment disciplines, compared to 37% covering migration. Interestingly, the most dynamic areas are environment and labour market regulation: PTAs including disciplines in these areas more than doubled between the period before the 1990s and the period 2010–2021. More than 60% of new agreements that entered into force in the latter period included these disciplines.

Finally, there is also heterogeneity in terms of the legal enforceability³ of the policy areas regulating non-trade outcomes. While 66% and 45% of new agreements covering intellectual property rights and investment, respectively, are also enforceable, fewer than 10% of agreements covering environment and labour market regulations are legally enforceable.

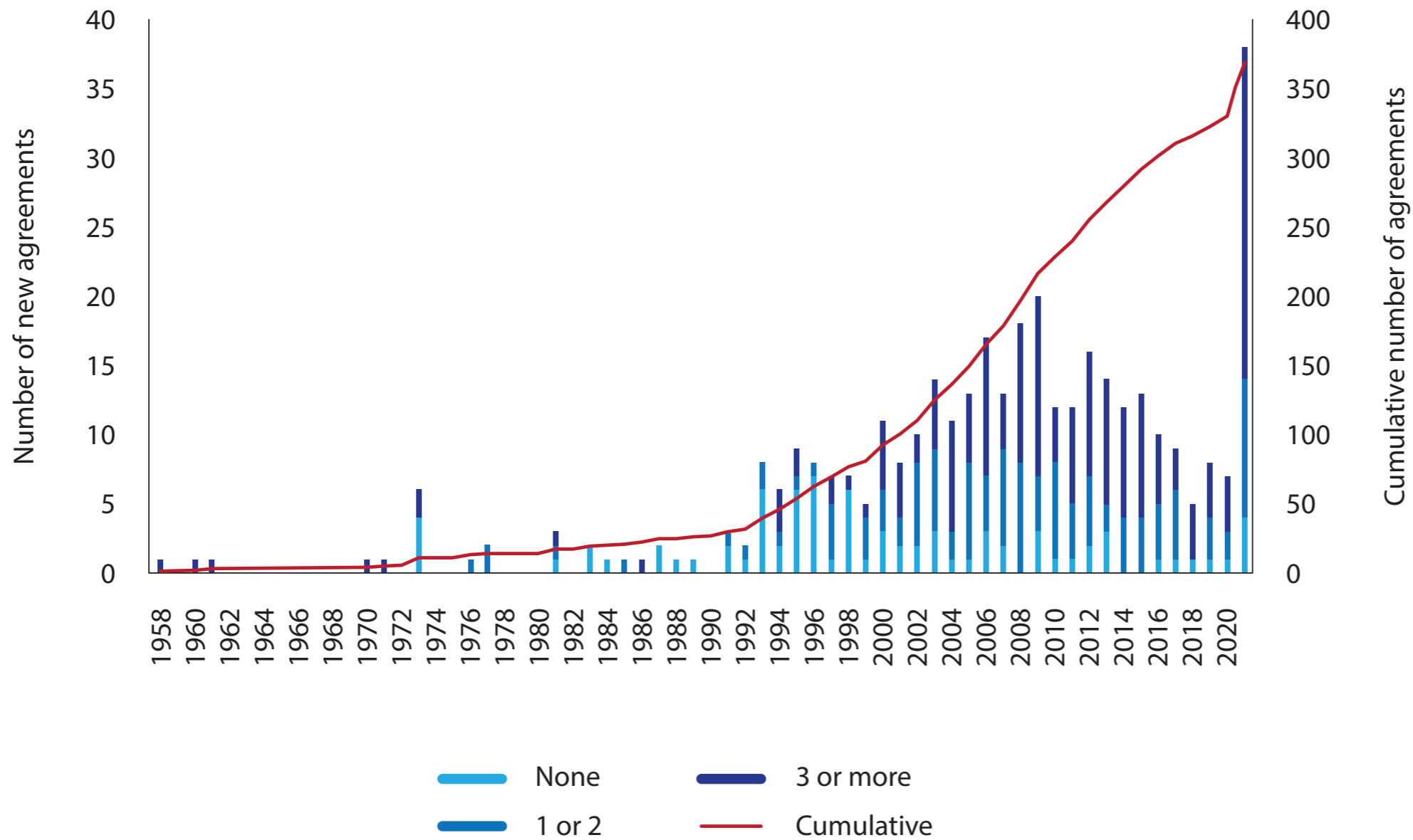
We turn next to the effects on non-trade outcomes of non-trade disciplines in PTAs. The analysis leads to four main findings.

Intended and unintended consequences

Non-trade provisions in trade agreements promote integration beyond trade. Through decreases in trade and migration costs, PTAs promote movement of capital and people across members, along with trade flows. Indeed, sizeable benefits for FDI flows from trade agreements arise only when investment provisions are included.

Figure 1. Evolution of non-trade disciplines over time.

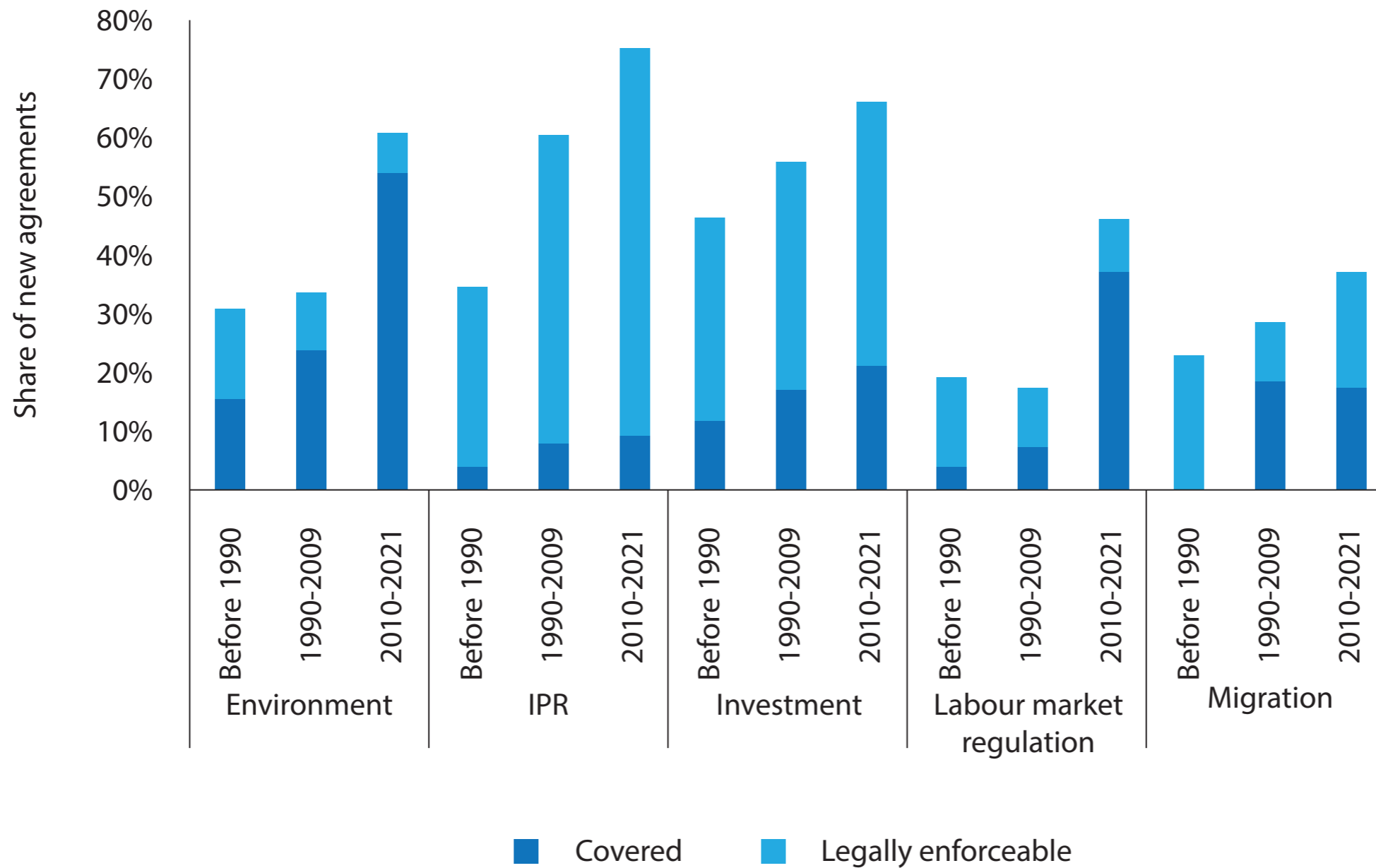
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Note: the figure shows the number of new PTAs that include different numbers of provisions (none, 1-2, 3 or more) in the 5 policy areas: environment, intellectual property rights, investment, labour market regulation, and migration.

Source: Authors' calculations based on Hofmann et al (2017).

Figure 2. Evolution over time in coverage and legal enforceability of non-trade disciplines in PTAs.



Source: Authors' calculations based on Hofmann et al (2017).

At a more granular level, PTAs – namely, those including investment, movement of capital, intellectual property rights, and competition policy provisions – foster crossborder firm ownership linkages (especially vertical) across countries. And the inclusion of visa provisions in PTAs stimulates bilateral migration stocks, especially of low-skilled immigrants.

Intellectual property rights (IPR) provisions in PTAs tend to improve and harmonise IPR standards, reduce patent application costs, and strengthen protection for patent holders, thus encouraging greater crossborder patenting activity among members.

Non-trade provisions in PTAs in areas that aim to enhance welfare by regulating the behaviour of exporters can also be effective. In particular, environmental disciplines are found to help shape environmental outcomes. The inclusion of binding environmental provisions in PTAs limits their nefarious impact on deforestation.

Signing a PTA generally supports the aims of international environment agreements like the Montreal Protocol, which limits trade in ozone-depleting substances (ODS) goods with non-member countries, by increasing the likelihood of member countries ratifying its amendments.

But the effects are shown to be much stronger if the trade agreement includes ODS-related provisions. The rationale for such impacts is the introduction of enforcement measures for non-compliance in PTAs with ODS-related provisions.

But non-trade provisions in PTAs in areas of labour and civil or political rights are not always effective and can have unintended consequences. Non-trade provisions in PTAs in areas of labour and civil or political rights do not

significantly improve indicators on labour rights, workers' protection, democracy, and political rights in member countries⁴. Binding labour provisions in EU PTAs actually result in a deterioration of worker protection.

A study of the impact of child labour standards in PTAs similarly finds that simple bans have a perverse effect on child labour outcomes. PTAs without child labour provisions reduce child employment and increase child school enrolment but, paradoxically, trade agreements with child labour provisions do the opposite.

The rationale for this result is that child labour bans can lead to a decline in child wages and a decline in the income of poorer households, requiring them to actually increase the supply of child labour.

Design matters for non-trade outcomes

The design of non-trade provisions matters for non-trade outcomes. First, in some cases there is a minimum set, or core, of disciplines that are needed for the realisation of underlying non-trade policy objectives. For instance, not all PTAs with IPR provisions encourage more technology transfer through patent flows among members.

PTAs that involve only some legally enforceable IPR provisions, and thus ensure a weaker protection to patent applicants, do not stimulate further bilateral patenting among members. The PTAs that are most effective in promoting patent flows are those that include a 'strong' protection that goes beyond the standards established by the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS).

Second, and related to the above point, there are trade-offs in the complexity of non-trade disciplines. Overly complex provisions can have adverse consequences. For example, an increase in investment provisions related to transparency and regulations is shown to actually decrease FDI given the large compliance costs they impose.

But in other cases, it is the simplicity of the provisions that can be problematic. The child labour bans discussed above are a case in point. The rule is simple, direct, and easily understood by relevant constituents in advanced economies. But it does not account for the incentives that are faced by the poor households in developing countries that are affected by the measure.

Rather than simple bans, labour clauses in PTAs should encourage active education policies that favour the poor, such as direct payments to households for school attendance.

A third element is the legal enforceability of non-trade disciplines. A key element of the effects of PTAs is that they change current and expected policies. The reduction in policy uncertainty brought about by legally binding disciplines is critical to understand the impact of PTAs on trade and non-trade outcomes.

For example, whether environmental provisions are subject to formal dispute settlement mechanisms or non-enforceable matters for environmental outcomes. PTAs with non-binding environmental provisions lead to a significant deterioration in several indicators of environmental quality: CO₂ emissions, ozone exposure, protected biological diversity, and sustainable nitrogen management in agricultural production.

These adverse effects point to the pressure put on the environment by the increase in production and trade associated with the signing of a PTA and suggest that non-binding environmental provisions in PTAs fail to ameliorate those pressures.

Heterogenous effects

The effects of non-trade provisions in PTAs can be heterogeneous, depending on the countries involved and the power relations among members. PTAs affect FDI very asymmetrically across countries, with China and the US

benefitting most in terms of their outward FDI while East Asian and Latin American countries with a large number of PTAs (such as Chile, Peru, Singapore and Thailand) benefit most in terms of inward FDI.

When origin and destination countries belong to different income groups, PTAs with visa provisions are stronger in fostering bilateral migration, but weaker effects are observed when destination countries have a large share of votes for parties at the extreme right of the political spectrum.

PTAs including strongly enforceable IPR provisions encourage patent applications from non-members to developing country members, suggesting the stronger IPR standards in the PTAs make these countries more attractive locations to protect and deploy new products.

In all these cases, it appears that PTA disciplines can help fill a gap in national legislations – if the discipline is properly designed and the right political economy conditions are present.

The role of complementarities

The effects of PTAs with non-trade provisions on non-trade outcomes depend on the overall content of the PTA as well as on other policies in place in member countries. There are complementarities between investment provisions and provisions on labour markets, exports, taxes, public procurement, and state-owned enterprises in fostering significantly FDI between PTA members. There is also a complementarity between IPR provisions and provisions on investment in PTAs in stimulating crossborder patenting.

Complementary policy instruments may play a role in making PTAs with non-binding non-trade provisions more effective in improving non-trade outcomes. One such instrument, official development assistance, may influence whether non-trade provisions are implemented.

High-income PTA members – the major proponents of non-trade provisions – allocate more aid to countries that agree to soft (non-binding) provisions in the areas of environment and human and civil rights. Non-binding non-trade provisions may thus act as focal points for cooperation among countries on an issue area.

Conclusions

Trade agreements increasingly include disciplines aimed at achieving non-trade objectives: promoting FDI, technology transfers, and workers' movement, but also improving labour conditions and environmental quality and achieving other broader social goals. Do these provisions actually achieve their intended goals?

The research presented in this eBook provides a first empirical assessment of the effectiveness of non-trade disciplines in PTAs. The evidence points to some successes, such as in the area of FDI, technology transfers, and the environment, but also to the limits of regulating non-trade policy areas in trade agreements, as in the case of the perverse effects of child labour bans on children's employment and school enrolment.

As governments' trade policy agendas in the post-COVID, post-Ukraine war world expand to consider new and wider non-trade objectives, from supply chain resilience to national security, we hope that the early work presented in this eBook will provide a solid ground to ask new questions and build new research in this area. ■

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Endnotes

1. Of course, a first-order question is the economic rationale (or lack of it) for including non-trade policy disciplines in PTAs. The arguments, in favour and against, are revisited in one of the chapters of this eBook.
2. The surge in the number of agreements since 2020 is mainly driven by the PTAs signed by the UK after Brexit to replace its trade agreements with third countries signed as a member of the EU.
3. A policy area is considered legally enforceable if the language is sufficiently precise from a legal point of view and if the agreement foresees a dispute settlement mechanism to resolve disagreement.
4. Note that that the EU and the US do not include enforceable non-trade provisions dealing with civil and human rights in their PTAs, so this greatly reduces the strength of the potential impacts of such provisions.

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Deep trade agreements and firms' exports

Matteo Neri-Lainé, Gianluca Orefice and Michele Ruta discuss the effect of deep trade agreements in integrating developing countries' economies

Deep trade agreements are widely used by governments in developing countries to boost their firms' exports. This column combines data on firm-level exports for a large set of developing countries with detailed information on the content of trade agreements to investigate these effects.

It shows that deep trade agreements boost overall firm exports, but this effect is driven by larger and more productive firms that are connected to global value chains. Smaller and less connected firms are on average hurt. This selection effect has important implications for welfare.

Many developing countries have signed deep regional trade agreements (RTAs) during the last two decades with the aim of better integrating their economies and improving the export performance of firms (Hofmann *et al* 2017, Mattoo *et al* 2020).

While a large body of literature focuses on aggregate trade flows (eg. Baier *et al* 2019, Orefice and Rocha 2011, Mattoo *et al* 2022, Dhingra *et al* 2021, Fernandes *et al* 2021), there is little understanding of how deep trade agreements impact on firms.

Our recent research (Neri-Lainé *et al* 2023) shows that, in line with the new trade theory, the effect of deep trade agreements depends on the firms' characteristics. Large firms and firms involved in global value chains (GVCs) benefit the most from the enforcement of deep trade agreement, while small firms suffer the increased competition at destination (pro-competitive effect) and may exit from the export market (selection effect).

These effects have important implications for the welfare of signatory countries that were neglected by the existing literature on the consequences of deep trade agreements.

Firm-level effects of deeper trade agreements

We empirically investigate the effect of deep trade agreements on the export performance of heterogeneous firms. The analysis combines firm-level export data for 31 developing countries for the period 2000-2020 from the World Bank Exporter Dynamics Database (Fernandes *et al* 2016) with detailed information on the content of more than 300 RTAs from the World Bank Deep Trade Agreements database (Hofmann *et al* 2017).

The negative impact on the export performance of small firms that have lower productivity and are not integrated in global value chains signals the presence of a costly adjustment process which calls for appropriate domestic policies to complement deep integration

We adapt the standard gravity model for trade (Head and Mayer 2014) to firm-level analysis in which we include a variable capturing the depth of RTAs.

Namely, we construct several proxies of RTAs' depth based on the policy areas covered by the agreements and their legal enforceability: (1) total number of provisions (independently of their legal enforceability); (2) number of legally enforceable provisions (ie. whose implementation is supported by strong legal language and by the availability of a dispute settlement mechanism) – our preferred measure; (3) number of provisions covered by the current mandate of the WTO (WTO+); (4) number of provisions not covered by the current mandate of the WTO (WTO-X); and (5) number of provisions directly related to trade enhancing factors.

We apply a standard difference in difference approach controlling for any firm-year, destination-year, and origin-destination specific factor affecting the export performances of firms. We identify the effect of the deep trade agreements based on the *change* in the depth of RTAs between origin and destination country (ie. newly signed PTAs or amendment of pre-existing ones).

Specifically, we compare a given firm's exports towards destinations having experienced changes in RTA depth with those towards destinations that had no change in RTA depth (conditional on any firm-and destination-specific shock).

Baseline results, using the number of legally enforceable provisions in RTAs as a proxy for their depth, show that one additional legally enforceable policy area in RTAs increases firms' exports by 0.3%, on average. Moving from *shallow* RTAs (ie. agreements with only tariff cuts) to deep RTAs (ie. in the 75th percentile of RTA depth) corresponds to a 3.6% rise in firms' exports.

Different firms, different effects

The average effect of deep RTAs on the export performance of firms hides significant heterogeneity depending on firms' characteristics. Figure 1 summarises the effect of deep RTAs by firm type: (1) GVC versus non-GVC firms (respectively squares and circles in Figure 1), and (2) large versus small firms (respectively squares and circles in Figure 1).

In line with models of trade with heterogeneous firms and pricing behaviour (Atkeson and Burstein, 2008), we show that large and highly productive firms benefit while small and less productive firms suffer from deep RTAs.

On average, including an additional legally enforceable provision in RTAs stimulates large firms' exports by 0.4–0.6% and reduces small firms' exports by 0.5–0.6%. Furthermore, firms participating in global value chains, ie. firms that export and import to/from the same country benefit the most from the RTAs.

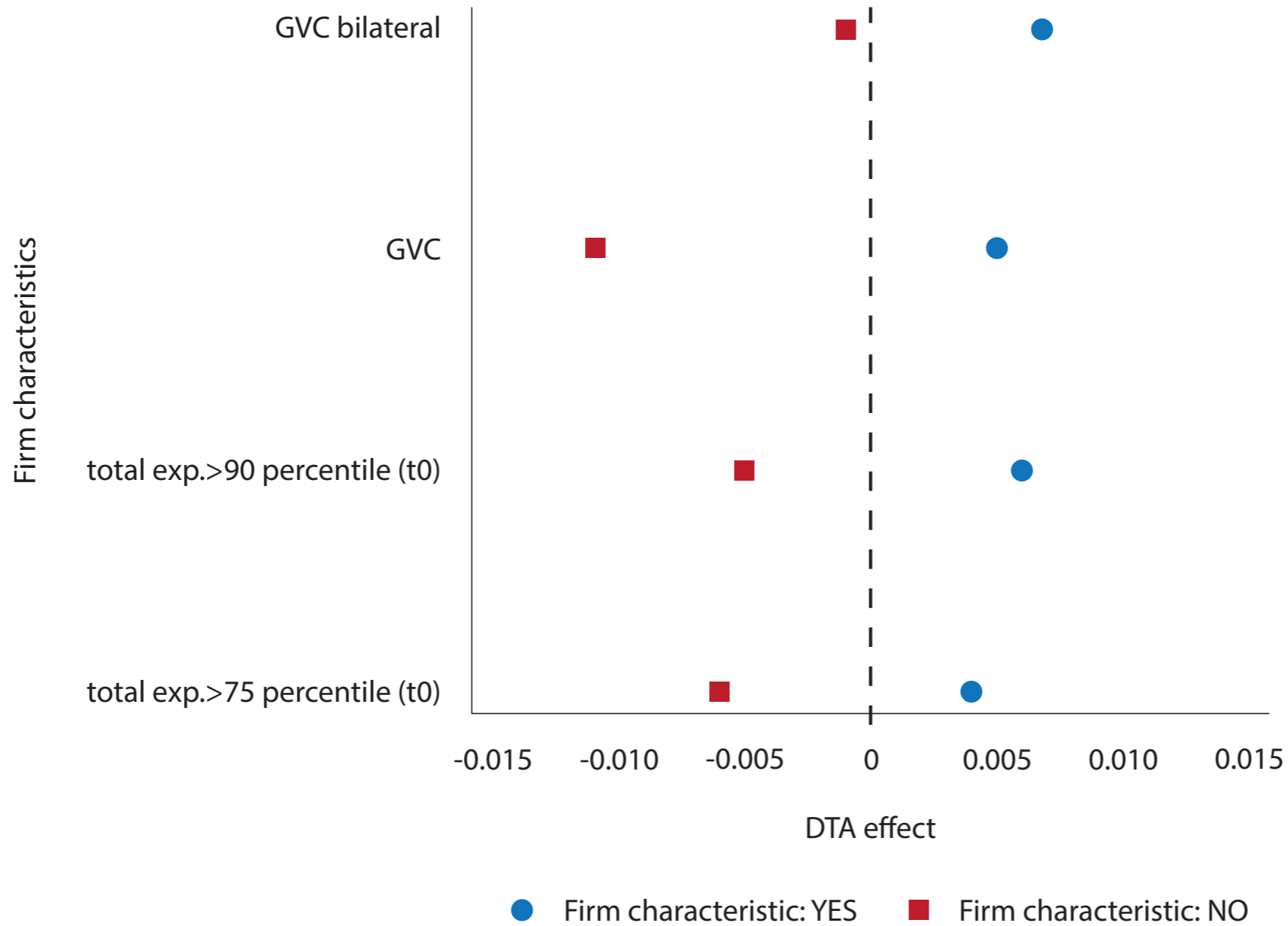
The *pro-competitive* effect identified in our research highlights the importance of using firm-level data to understand the welfare implications of RTAs. Specifically, by improving the export performance of larger, more productive, and better-connected firms and reducing that of smaller, less productive, and less connected firms, deep trade agreements generate a reallocation of resources from the latter group to the former.

This leads to an overall increase in the average productivity of firms in the exporting country and a decrease in the average price for imported varieties in the importing country (a welfare gain for developing countries signing the trade agreement).

However, this reallocation of resources also entails adjustment costs as small firms exit export markets due to the increased competition at destination.

Figure 1. The heterogeneous trade effect of deep PTAs by firm characteristics

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Note: Heterogeneity variables are estimated separately. Regressions includes firm-year, destination-year and origin-destination fixed effects. We control for tariffs. Standard errors are clustered by origin-destination-year.

Dynamic effects

We also analyse the dynamic effect of deep trade agreements on firms' exports using an event study approach. In Figure 2 we show the effect of RTA depth on treated firms (ie. firms exporting towards destination with a change in RTA depth) around the year of the change in RTA depth (t_0 in Figure 2). Regression includes firm-year, destination-year, and origin-destination fixed effects; the reference year is $t=-3$.

Two important messages emerge from the event study. First, before the change in RTA depth, *treated* and *untreated* firms (ie. respectively those that experienced and did not experience a change in the depth of RTAs at destination) do not differ in their export performance.

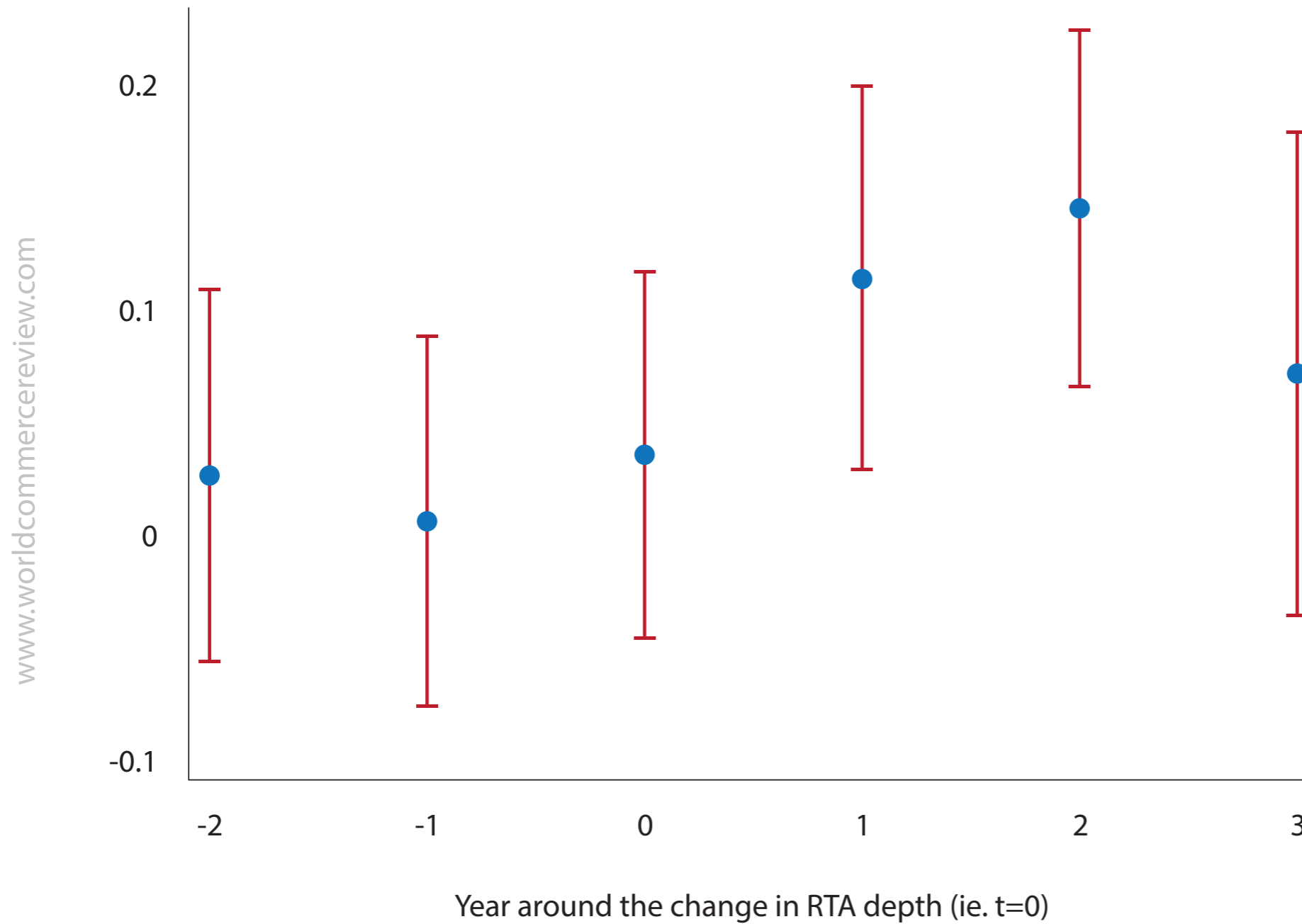
The absence of a pre-trend corroborates the causal interpretation of our earlier findings. Second, after the change in the depth of RTAs, treated firms export more into destinations that have signed a deep RTA with the country of origin.

This a positive effect vanishes after three years, which could reflect the increasing number of deep RTAs in the world (and the consequent reduction in market access towards other destinations) and the enforcement of non-discriminatory provisions in RTAs that de facto reduce trade costs for exporters in non-member countries.

The increasing number of preferential trade agreements in the world (Hofmann *et al* 2017) gives preferential market access towards a wider set of destinations, makes the existing trade agreements less 'unique' and hence reduces their effectiveness in boosting bilateral trade.

Also, non-discriminatory provisions in deep trade agreements apply to non-signatory countries. This makes exporters from third countries benefit from deep trade agreements, reducing the preferential nature of RTAs and hence eroding the advantage of firms in signatory countries (Lee *et al* 2023).

Figure 2. Firm exports event study



Note: Figure plots event time dummies for targeted firms relative to untargeted firms. Regression includes firm-year, destination-year and origin-destination fixed effects. Standard errors are clustered by origin-destination-year. Error bars show 90% confidence intervals.

Final remarks

Our paper uncovers important welfare and policy implications of deep trade agreements signed by developing countries. By reallocating resources toward larger, more productive, and better-connected firms, the pro-competitive selection effect of deep RTAs is expected to improve member countries' welfare.

Yet, the negative impact on the export performance of small firms that have lower productivity and are not integrated in global value chains signals the presence of a costly adjustment process which calls for appropriate domestic policies to complement deep integration. ■

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The Russian war economy: macroeconomic performance

The Russian economy has performed better than many expected since the war in Ukraine started. Marek Dabrowski argues that the financial burden will be felt for some time

When Russia started its full-scale invasion of Ukraine on 24 February 2022, the United States, European Union, several other G7 economies and their allies responded with an unprecedented package of economic, financial, diplomatic and other sanctions, which were continuously amended in the subsequent months¹.

Many expected that the economic price for Russia of the aggression and sanctions would be immediate and painful². The European Bank for Reconstruction and Development in March 2022 (EBRD, 2022) forecasted a real GDP decline of 10 percent in 2022, while the International Monetary Fund in April 2022 (IMF, 2022) projected a decrease of 8.5 percent.

Also, according to the IMF (2022), Russia's inflation would amount to 24 percent in December 2022 and the unemployment rate to 9.3 percent of the total labour force. Even the Bank of Russia at the end of April 2022 expected a real GDP decline of 8-10 percent in 2022³.

But the actual figures for 2022 were better (Table 1). According to the IMF, Russia's real GDP declined by 2.1 percent in 2022. The Federal State Statistics Service (Rosstat) agreed⁴. The largest GDP decline was recorded in the second quarter of 2022, by 4.5 percent compared to the second quarter of 2021⁵. In the subsequent quarters, GDP has recovered slowly but steadily.

There were no significant changes in the sectoral structure of gross value added compared to 2021, except for mineral production, the share of which increased from 13.1 percent in 2021 to 14 percent in 2022.

The volume of goods and services exports decreased by 8.7 percent year-on-year, while imports diminished even more (by 15 percent y/y). A smaller decline in GDP means the Russian economy became more closed to the external world.

Table 1. Russia: selected macroeconomic indicators, 2018-2023

Item	2018	2019	2020	2021	2022	2023
GDP, constant prices, % change	2.80	2.20	-2.70	5.60	-2.10	0.70
Total investment, % of GDP	21.90	22.70	23.50	23.20	22.70	23.20
Gross national savings, % of GDP	28.90	26.50	25.80	29.90	33.00	26.90
Unemployment rate, % of total labour force	4.80	4.60	5.80	4.80	3.90	3.60
Inflation, end of period, CPI, %	4.30	3.00	4.90	8.40	12.40	6.30
GG revenue, % of GDP	35.50	35.70	35.20	35.60	34.30	31.20
GG total expenditure, % of GDP	32.60	33.80	39.20	34.80	36.60	37.40
GG net lending/borrowing, % of GDP	2.90	1.90	-4.00	0.80	-2.20	-6.20
GG gross debt, % of GDP	13.60	13.70	19.20	16.50	19.60	24.90
Volume of imports of goods and services, % change	2.70	2.80	-11.80	16.70	-15.00	8.30
Volume of exports of goods and services, % change	5.10	-3.30	-4.40	0.60	-8.70	0.20
Current account balance, USD billion	115.70	65.70	35.40	122.30	227.40	75.10
Current account balance, % of GDP	7.00	3.90	2.40	6.70	10.30	3.60

Note: Red font indicates IMF staff estimates and forecasts.

Source: IMF World Economic Outlook database, April 2023.

The unemployment rate reached the lowest level in the post-Soviet era, 3.9 percent (Table 1). Mobilisation of more than 300,000 men to the army from September 2022, and emigration of 300,000-600,000 people in 2022, led to a reduction in the labour force of 1.0-1.5 percent year-on-year (Abramov *et al* 2023). As a result, the labour market situation became more tense for employers.

While the economic burden of the war and decoupling with the EU and other advanced economies will harm the growth prospects of the Russian economy in the medium-to-long term, they have not been lethal yet

The real disposable money income of the population in 2022 decreased by 1 percent compared to 2021, ie. less than during the previous crisis episodes (2008-2009, 2014-2015, 2020).

Better-than-expected results in 2022 can be attributed to several factors including conservative monetary and fiscal policies before February 2022 (Dabrowski, 2023), a well-calibrated monetary and fiscal policy reaction to the new situation, high global hydrocarbon prices and late and incomplete geographical adoption of oil sanctions.

Macroeconomic management

The beginning of the aggression against Ukraine and the first wave of financial sanctions which immobilised approximately half of Russia's international reserves (around \$300 billion) and which cut off part of the Russian banking sector from the SWIFT⁶, generated a mass capital outflow.

The ruble plummeted to the lowest level in its history (120 RUB for \$1) on 11 March 2022 (Figure 1). The Russian government and the Bank of Russia introduced capital and current account transaction restrictions to stop the panic (Astrov *et al* 2022). Simultaneously, the Bank of Russia hiked its key policy interest rate to 20 percent (Figure 2).

These measures helped to stabilise the situation in the forex market. The official exchange rate of the ruble recovered very quickly (Figure 1) to 51 rubles to the dollar at the end of June 2022. The market exchange rate also strengthened, although it was less favourable than the official rate because of convertibility restrictions.

Quick stabilisation of the ruble allowed for the arresting of the potential inflationary impact of exchange-rate depreciation. According to IMF estimates, annual inflation increased to 12.4 percent in December 2023 (Table 1).

Looking at the monthly figures of the Bank of Russia (which differ from the IMF estimates), 12-month inflation peaked at 17.8 percent in April 2022 (as a result of the ruble depreciation in February and March 2022)⁷. Then it decreased gradually to 11.9 percent in December 2022 and a record-low level of 2.3 percent in April 2023.

The stabilisation of exchange rates also allowed for a gradual decrease in the Bank of Russia's interest rate (Figure 2) and a relaxation of convertibility restrictions, especially for Russian residents and non-residents of the so-called friendly countries (those that have not adopted sanctions against Russia).

However, convertibility restrictions did not stop capital outflows in 2022. Although the Bank of Russia has discontinued publication of net private capital flows statistics, some trends can be deduced from the available balance-of-payments statistics⁸. The net capital outflow in 2022 amounted to \$230.3 billion, of which \$26.9 billion can be attributed to direct investment, \$23.2 billion to portfolio investment, and \$190.9 to other investments (but 72.6 percent of this amount left Russia in the first half of 2022).

A negative capital account balance was also indirectly confirmed by the decreasing international reserves of the Bank of Russia (Figure 3).

Hydrocarbon boom and its macroeconomic consequences

Another factor contributing to better-than-expected results in 2022 was high hydrocarbon prices. Oil prices have increased since April 2020, when they reached their COVID-19-related bottom (below \$20 per barrel). In June 2021, they crossed \$60 per barrel.

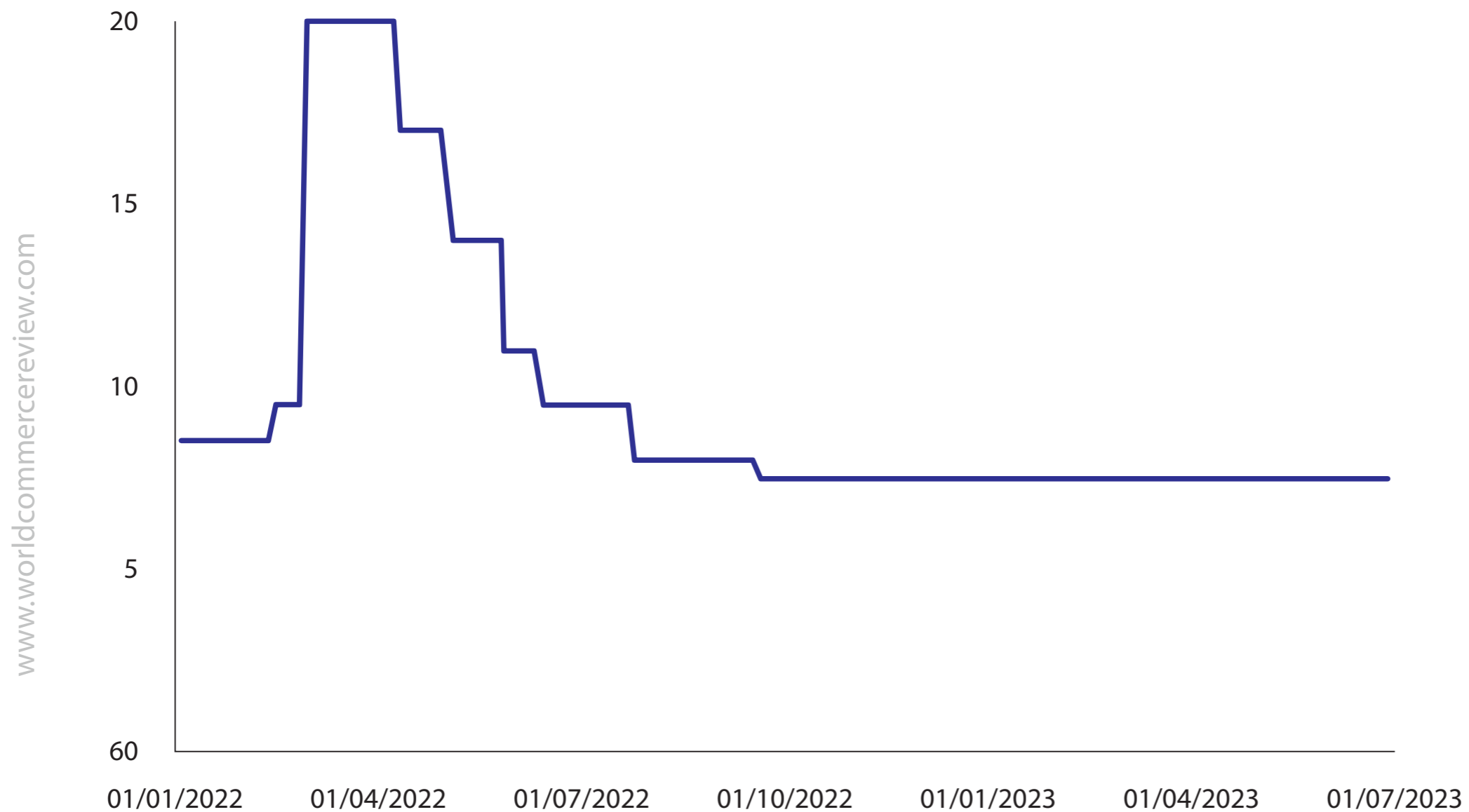
The post-pandemic global recovery and overheating of the world economy pushed oil prices further up. The Russian invasion of Ukraine added to this trend due to a higher perception of security risks and expectations of the

Figure 1. Exchange rate set by the Bank of Russia, RUB/1 USD, 01.01.2022 – 28.06.2023



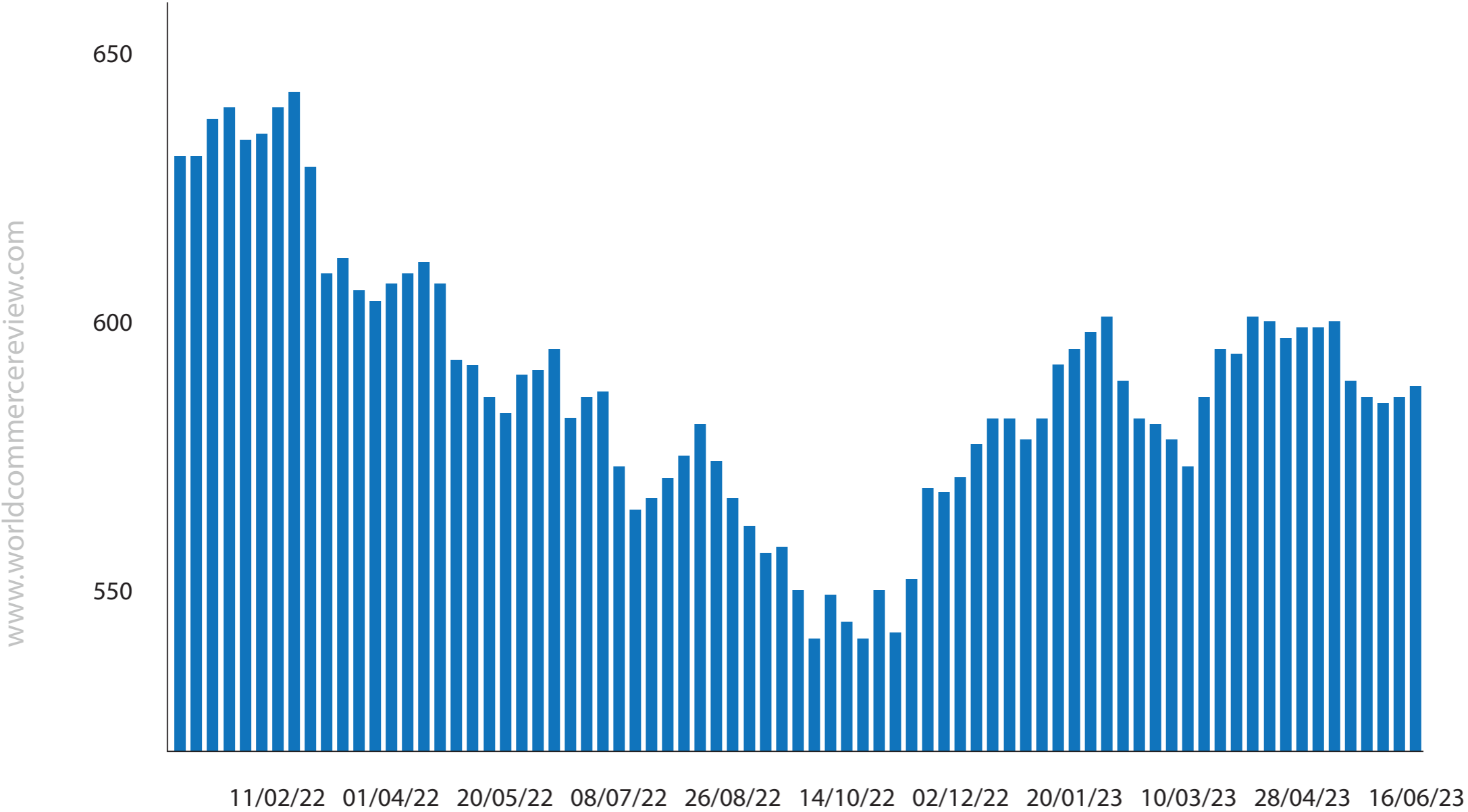
Source: Bank of Russia.

Figure 2: Key policy interest rate of the Bank of Russia, in %, 01.01.2022 – 28.06.2023



Source: Bank of Russia.

Figure 3. Bank of Russia's international reserves, USD billion, 31.12.2021 – 16.06.2023



Source: Bank of Russia.

Western sanctions against Russia. Unsurprisingly, Brent oil prices peaked on 28 February 2022 (over \$110 per barrel) and again (close to \$120) on 8 June 2022.

Russia benefited from this situation. The record high current account surplus in 2022 (Table 1), particularly in the year's first half, resulted primarily from favourable oil prices. Drastic import reductions (see above) also had an impact, partly neutralising the negative effect of freezing half of the Russian international reserves.

The increase in natural gas prices, another essential Russian export item, was even more rapid (Figure 5). However, Russia drastically reduced the volume of exported natural gas to the EU as a retaliatory measure for its support to Ukraine⁹.

The attempts to redirect natural gas exports to Asia brought only partial results because of the limited capacity of gas pipelines and LNG exports. Therefore, it was a self-inflicted wound caused by Russia's counter-sanctions policy.

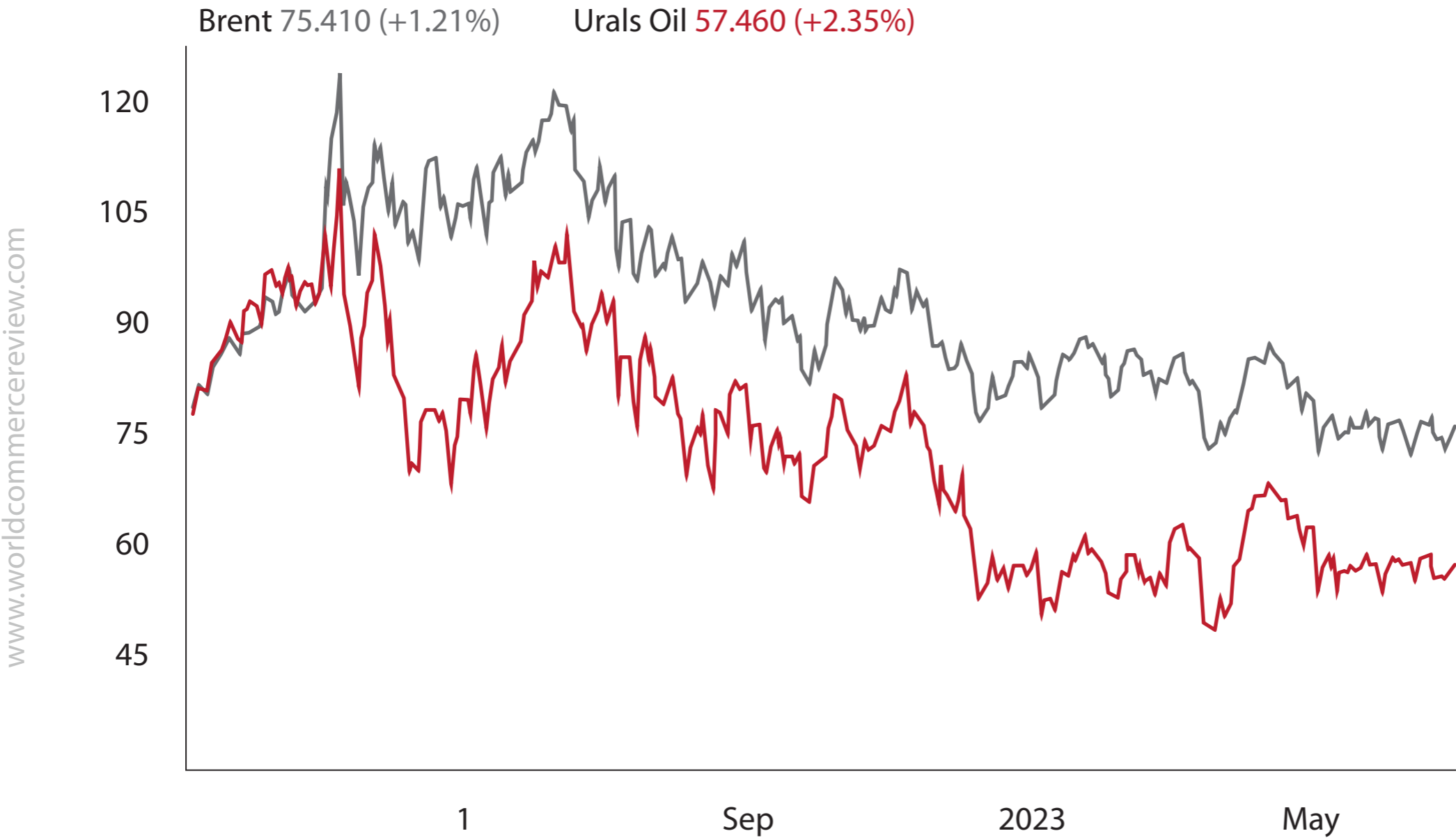
Late and incomplete sanctions

Macroeconomically, the most critical sanctions against Russia concerned its access to the global oil market. The United States banned imports of Russian oil immediately after the beginning of the Russian aggression.

However, this ban had a limited economic impact due to the small volumes of Russian crude imported by the US. The EU, a much bigger importer, banned imports of Russian crude oil transported by sea routes only from 5 December 2022, and refined oil products from 5 February 2023.

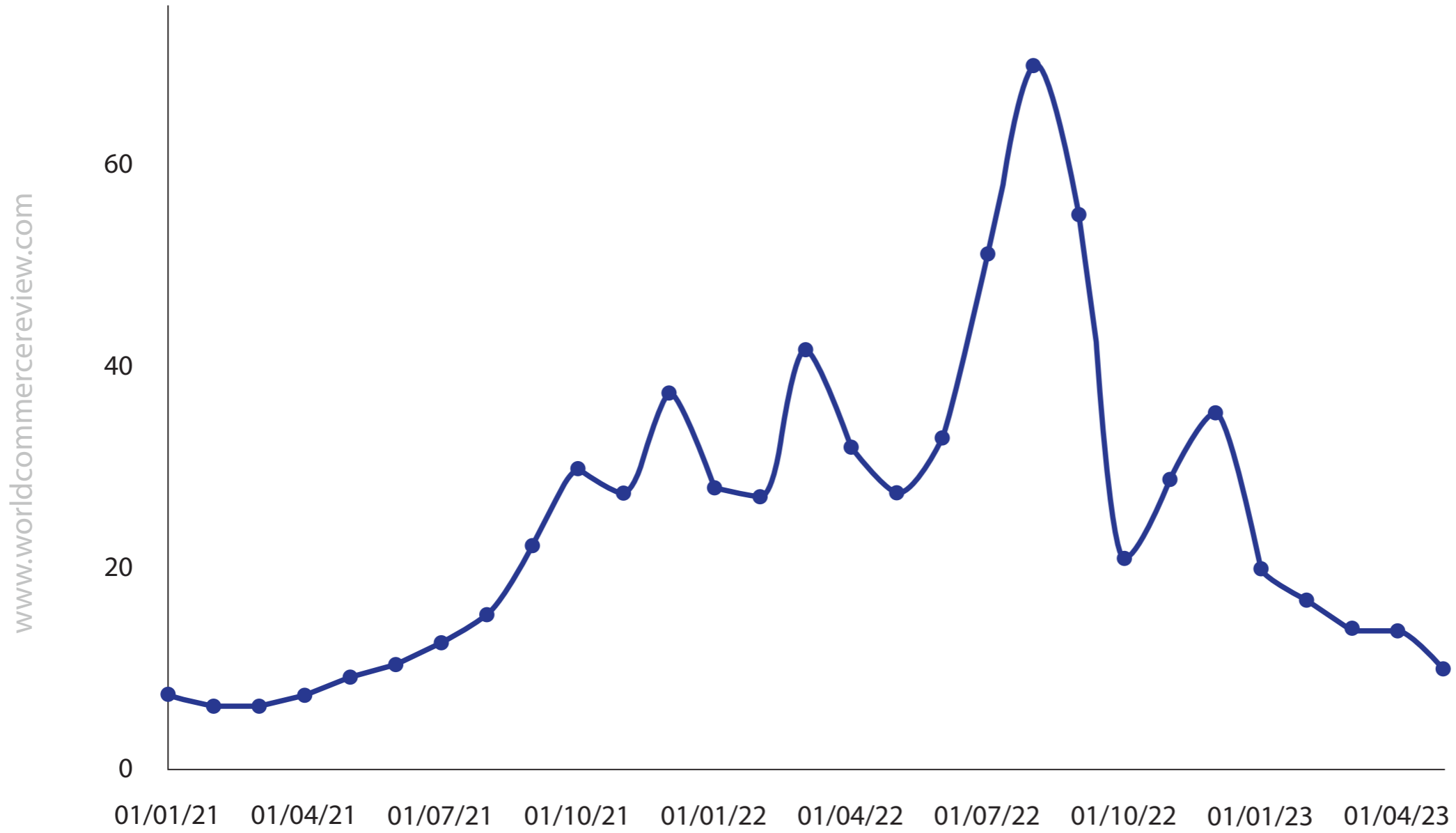
Furthermore, several large emerging-market economies (for example, China, India, Indonesia, Turkey, Brazil and South Africa) did not join Western sanctions against Russia at all, including sanctions related to oil imports. Therefore, Russia can easily circumvent oil sanctions by just redirection of oil export destinations.

Figure 4. Brent and Urals oil prices, in \$ per barrel, 01 January 2022 to 30 June 2023



Source: Trading Economics.

Figure 5. Global price of natural gas, EU, USD per million metric British Thermal Unit, monthly, not seasonally adjusted



Source: IMF Primary Commodity Prices, retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/PNGASEUUSD>, 2 July 2023.

The OPEC+ cartel and its leader Saudi Arabia were reluctant to expand oil-export quotas during the highest oil prices and cut them when global oil prices started declining.

Despite the geographical incomplete nature of sanctions and their late introduction, there has been a discount in the range of \$15 to \$30 per barrel for the Urals oil price (as compared to Brent), a phenomenon not observed before the full-scale war started. It limited the balance-of-payments surplus and federal budget proceeds from the oil exports. However, this discount has diminished since May 2023, which can suggest erosion of sanctions.

A more difficult 2023

Russia's surprisingly good macroeconomic situation in 2022 has started to deteriorate in 2023, especially on the fiscal front. While in 2022 general government deficit (net borrowing) amounted to a moderate 2.2 percent of GDP, in 2023, it may amount to 6.2 percent of GDP (Table 1).

Russian finance ministry preliminary fiscal data for the first half of 2023¹⁰ confirms a deteriorating trend driven by declining global oil and natural gas prices and increasing costs of the war. Compared to the same period in 2022, federal budget revenue decreased by 11.7 percent.

Hydrocarbon revenue declined by 47 percent, while non-hydrocarbon revenue increased by 17.8 percent. Federal expenditure increased by 19.5 percent, of which state procurement (which most likely includes purchases of military hardware and other army supplies) increased by 50.6 percent.

Still, Russia has relatively low public debt (Table 1), but its access to the international debt market has been closed by sanctions. The two remaining sources of deficit financing are the National Welfare Fund (NFW), which cumulated part of oil- and gas-related revenue in the surplus years along with Treasury bonds purchased mainly by state-

owned banks. On 1 June 2023, the total NFW assets amounted to \$153 billion (8.2 percent of the forecasted GDP in 2023)¹¹.

However, the liquid assets were slightly more than half of this amount. Part of the NFW assets was immobilised due to Western sanctions (together with the Bank of Russia's international reserves); another part was invested earlier in the shares of Russian companies such as Sberbank and Aeroflot. Most of the liquid assets are held now in Chinese yuan and gold.

Deteriorating terms of trade are also seen in the balance of payments statistics. While a current account balance remains positive, its surplus is much smaller than in 2022 (Table 1).

It has impacted the ruble's exchange rate, which has depreciated since October 2022 (Figure 1). At the beginning of July 2023, it exceeded 90 ruble to the dollar. A weaker ruble may boost inflation from the current low level.

The short-term prospects (the next 12 months) for the federal budget and balance of payments will depend on oil prices that Russian exporters can effectively obtain in the international (mainly Asian) markets.

Conclusions

While the economic burden of the war and decoupling with the EU and other advanced economies will harm the growth prospects of the Russian economy in the medium-to-long term (Ribakova, 2023), adding to other negative factors including shrinking population and its ageing, the poor business climate and increasing government interventionism, they have not been lethal yet.

Russia has avoided macroeconomic and financial destabilisation, minimised output losses and retained resources to continue its aggression against Ukraine.

Better-than-expected macroeconomic performance in 2022 and the first half of 2023 can be attributed to the situation on the global hydrocarbon market, favourable macroeconomic performance before the war, well-calibrated macroeconomic policy and regulatory response to sanctions, and the geographical incompleteness of those sanctions.

Russia also took several preparatory steps ahead of the confrontation with the West in 2014-2022, including building an independent payment system, import substitution, developing trade relations with China and conducting conservative macroeconomic policies (Dabrowski and Avdasheva, 2023) that increased the resilience of the Russian economy to Western sanctions.

On the other hand, Russian counter-sanctions against 'unfriendly' countries, especially those stopping natural gas exports to Europe, were self-damaging while missing their geopolitical goal of weaken the support for Ukraine provided by the EU and G7 countries. ■

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Endnotes

1. For a summary see Richard Martin, *'Sanctions against Russia – a timeline'*, S&P Global Market Intelligence, 5 July 2023.
2. See for example Brian O'Toole, Daniel Fried and Edward Fishman, *'For Biden, wreaking havoc on Russia's economy is the least bad option'*, New Atlanticist, 8 February 2022.
3. See http://www.cbr.ru/collection/collection/file/40964/forecast_220429.pdf
4. See https://rosstat.gov.ru/storage/mediabank/VVP_god_s_1995-2022.xls. We use data published by Rosstat, Bank of Russia, Russia's finance ministry and the IMF, along with independent estimates. So far, official Russian statistics, although less detailed than those before February 2022, remains broadly in line with independent and external estimates. Instances of data discrepancy or information gaps are noted in the text.
5. See https://rosstat.gov.ru/storage/mediabank/VDS_kvartal_OKVED2_s2011.xlsx
6. Véron and Kirschenbaum (2022). In the subsequent sanction packages, the number of sanctioned banks increased.
7. See http://www.cbr.ru/hd_base/infl/
8. See http://www.cbr.ru/vfs/eng/statistics/credit_statistics/bop/bal_of_payments_ap_e.xlsx
9. See the *Bruegel European natural gas imports tracker*.
10. See (in Russian) https://minfin.gov.ru/ru/press-center/?id_4=38583-predvaritelnaya_otsenka_ispolneniya_federalnogo_byudzheta_za_yanvar-iyun_2023_goda
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