EUROPEAN TRADE FINANCE

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BOSONE *ET AL* EXPLORE THE IMPACT OF GEOPOLITICAL TENSIONS ON TRADE FLOWS

CONOR MCCAFFREY AND NICLAS POITIERS ASSESS the EU'S EXPOSURE TO HOSTILE COUNTRIES

BRUNO CASELLA, RICHARD BOLWIJN AND FRANCESCO CASALENA HIGHLIGHT TEN FDI TRENDS

A EUROPEAN PERSPECTIVE ON TRADE FINANCE

Foreword

Welcome to the Summer 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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Instruments of economic security

Geopolitical and economic developments have raised concerns about the EU's exposure to hostile countries. Conor McCaffrey and Niclas Poitiers assess the nature of this threat and outline lessons that can be drawn

1 Introduction

Recent years have seen rising concern over the 'weaponisation of interdependence', ie. the exploitation of economic links for geopolitical purposes (Farrell and Newman, 2019). There has been a significant shift in the prevailing narrative on both sides of the Atlantic, from seeing economic interdependence as leverage to achieve political liberalisation, to a geopolitical view that sees it as a liability that exposes Western economies to foreign influence[1]. The relationship between the United States and China has soured and China's accession to the World Trade Organisation may now be seen as a mistake[2].

Meanwhile, Russia's invasion of Ukraine is portrayed as glaring example of a failed Western strategy of *Wandel durch Handel* (change through trade). Rather than reducing tensions, economic interdependence instead left some parts of Europe significantly dependent on Russia at the time of the invasion, arguably strengthening Russia's hand.

However, a strategy of economic decoupling, undoing decades of globalisation and therefore vastly reducing the gains from trade, seems neither feasible nor desirable (Aiyar *et al* 2023). There is a new consensus among the G7 countries that the 'de-risking' of economic relationships with revisionist countries is a more feasible strategy[3].

The central idea is to diversify supply chains and build a 'high fence' around a 'small yard'[4], to protect vital economic sectors from foreign interference without jeopardising the economic benefits of globalisation. Put simply, the aim of this strategy is to reduce risks without starting all-out trade wars and undermining the rules-based economic order.

Many of the solutions put forward as part of this strategy include significant government intervention. While additional state support in certain areas, in particular for green industries, could have positive outcomes, this approach is not without risks. State support can backfire unless accompanied by strong governance.

This risk is exacerbated in the case of the European Union because the cohesion of its single market is threatened when discipline on state aid given by member states is eroded (Kleimann *et al* 2023). Therefore, it is important to have a thorough understanding of the problems that 'economic security' measures aim to solve, in order to judge the trade-offs involved in the proposed solutions.

To support the development of such an understanding, we attempt to derive a nuanced view of the economic risks that arise from economic interdependence with China in particular[5]. Based on this view, we assess the

The rise in global geopolitical tensions has coincided with deeper economic integration of EU and non-democratic countries, and an increase in the market concentration of EU imports

appropriateness of EU instruments aimed at improving economic security. We conclude that the EU has made significant steps forward in terms of ex-ante instruments, though many of them need more European coordination to avoid risks for the single market.

However, credible ex-post instruments are lacking. We see the need for a new ex-post instrument that shares the costs from economic coercion and helps countries and firms respond. Such instruments have to be underwritten by member states, and therefore the credibility of any European economic-security instrument depends crucially on a closely coordinated foreign policy.

2 What is economic security?

Despite its prominence in recent debates, the term 'economic security' is only vaguely, if at all, defined. The term has been used in varying contexts, and at times has been employed as a catch-all for policies aimed at mitigating all kinds of economic shocks, as well as a wide range of 'national/physical security' measures. This conflation of different types of risk can unsurprisingly lead to poorly targeted government interventions.

We employ a narrow definition that is centred around the notion of economic 'de-risking' from shocks, and not the use of economic measures to pursue national security objectives. We focus in particular on risks surrounding 'economic coercion' – the politically motivated disruption of supply chains and targeting of economic interdependencies.

Examples of such coercion include sanctions and trade embargoes, the weaponisation of energy markets following the Russian invasion of Ukraine, and Chinese economic coercion against Japan, South Korea, Lithuania and Australia.

In these cases, a hostile government targeted vulnerable economic sectors with the aim of inflicting economic and political damage. We assess instruments and strategies that are aimed at mitigating and limiting the risks from such deliberate and targeted economic shocks. It is noteworthy that these types of shock are not only a concern for strategic imports. Recent cases of economic coercion have actually targeted exports more than imports.

While threats to economic security can come from a range of sources, such as climate-related shocks or natural disasters, we focus on improving resilience against economic coercion for two reasons. First, the policy lessons are equally applicable to other supply-chain disruptions. Second, economic coercion includes an additional factor (the behaviour of hostile governments) not present in 'accidental' shocks.

This additional factor necessitates additional policy responses to affect other countries' incentives. As such, policies designed to address threats arising from economic coercion should also address wider risks to economic security.

We also focus on foreign-trade shocks and not domestic shocks, which can have similar implications and are part of some broader definitions of economic security. We are concerned with the interaction between economic outcomes and foreign policy, which is less of a concern with shocks of domestic origin and so the relevant policy instruments differ.

We deliberately abstract from policies that are framed as part of 'economic security' (eg. in the European Commission's Economic Security Strategy; European Commission, 2023a), but are not 'economic' in either nature or objective. With the exception of the very rare cases in which technical complexity creates monopolistic power and therefore the potential for future economic coercion[6], measures aimed at preventing technology transfers are hard to justify on economic security grounds alone.

While maintaining European technological leadership in certain cutting-edge sectors is clearly desirable, it fails to meet the definition of economic security as articulated here. Other justifications – such as maintaining an edge in dual-use technologies for defence reasons – are thus generally necessary to justify measures that restrict technology transfers.

The distinction between 'economic' security risks and national security is important for two reasons. First, economic-efficiency arguments become less important when considering policies with direct national security implications. Economic analysis can help identify the most efficient way to achieve a desired outcome, but cannot ascertain whether a policy is necessary for defence purposes.

Second, separating economic security from national security has legal implications. WTO rules give countries the ability to react to policies that harm their economic interests (eg. with countervailing duties and rebalancing of tariffs) and to call panels to adjudicate on whether rules were broken.

The WTO framework also includes exemptions for measures pertaining national security[7]. The principle that states can intervene in markets to ensure their national security in ways that would be otherwise prohibited is generally recognised. However, there has been considerable debate about the wide-ranging usage of these exemptions by the United States (see Maruyama and Wolff, 2023).

In several cases, the US has justified policies that arguably primarily have protectionist aims with such national-security exemptions (for a discussion of the role of transatlantic relations see Box 1).

The EU and the US have converged on a shared paradigm of 'de-risking', a notion that was first embraced by European Commission President Ursula von der Leyen in March 2023[13]. It is noteworthy that the EU and US have come from opposite directions to arrive at similar strategies.

Box 1. Economic security and the transatlantic relationship

While there have been regular trade conflicts between the EU and the US (such as a long running dispute on subsidies for Airbus and Boeing), these were concerned primarily with protectionist measures and support for national champions.

However, during the Trump Administration, new conflicts arose that were framed explicitly around security. While not directly comparable to the current economic security debate relating to Russia and China, certain aspects of the European discourse can be traced back to these origins.

The retreat of the United States from the Iran nuclear deal (the Joint Comprehensive Plan of Action, or JCPOA) was a leading cause of the European desire for a more autonomous foreign policy.

Even though the EU believed it to be in its interest to keep trading with Iran, the US threatened European companies with secondary sanctions if they did so (see Leonard *et al* 2019). This did not affect European 'economic security' per se, but it did advance a discourse on how to harden European trade flows against foreign interference.

In 2018, the Trump Administration put tariffs on EU steel and aluminium exports, justified by national security concerns (Department of Commerce, 2018), launching a transatlantic trade conflict with a vague notion of national security at its centre.

Since President Biden took office, the EU and the US have managed to resolve major trade conflicts. The Airbus-Boeing trade dispute was suspended[8], an agreement on transfers of personal data found[9] and the trade and technology council established[10] with the aim of preventing future conflicts through intergovernmental consultations.

The US tariffs on European steel and aluminum justified by 'national security' have been put under a moratorium, though a permanent solution has not yet been reached (Dadush, 2021). There are ongoing efforts to enhance economic security in the G7[11] and to cooperate on common concerns, such as those surrounding critical raw materials[12].

However, should political dynamics change again after the 2024 US presidential election, transatlantic relations could be tested once again and new EU-US trade disputes could arise.

In the US, the emphasis in 'economic security' has primarily been on security, representing a 'securitisation' of economic policy. Major economic policies have been announced by National Security Advisor Jake Sullivan, rather than by economic policymakers.

Many actions considered to fall under the umbrella of economic security, such as the US CHIPS and Science Act[14] or outbound investment screening[15], have been explicitly justified on national-security grounds. This stands in contrast to the European context, with the European Commission hitherto primarily concerned with economic policies and without a strong national-security mandate.

The 'Geopolitical Commission' of President von der Leyen[16] is trying to use its economic powers to assert itself as a player in foreign policy. Yet its economic-security strategy includes many measures that are not directly related to economic considerations and mirror US policies (European Commission, 2023a).

3 A brave new world of economic interdependence

The idea of using economic linkages to achieve political goals is by no means new (see Mulder, 2022). Since the end of the Second World War, outright economic sanctions have mostly been used by the US and its allies against emerging-market developing countries (Hufbauer, 2007). Even before the Russian invasion of Ukraine, there was a surge in the number of sanctions imposed by Western countries (Felbermayr *et al* 2020).

However, while sanctions have historically been mostly used by Western countries, economic coercion is by no means an exclusive to the West. The examples of such measures targeting Western countries range from the oil embargo during the Yom Kippur War in 1973 (Hansen, 2023) to import restrictions on Norwegian salmon by China after the 2014 Nobel Peace Prize for Liu Xiaobo (Harrell *et al* 2018).

Given the dominance of Western economies in finance and technology, the types of economic linkage targeted by non-Western economies have historically often been access to raw materials. However, recent decades have seen a remarkable shift in the goods that are available for use in economic coercion against the West.

Figure 1 shows the breakdown of the main categories of EU imports by the political systems of source countries, as defined by Freedom House. While raw materials were long primarily imported from non-free countries, as recently as 2001 only 10 percent of imports of intermediate inputs came from such countries. By 2019 this share had increased to almost 40 percent.

As a result, EU industry imports many more intermediate goods from countries with authoritarian political systems. Intermediate imports are often more specialised and differentiated, limiting their substitutability compared to commodities. This thus represents a new type of risk. Meanwhile, advanced technologies are increasingly dependent on specialised materials as critical inputs, meaning raw materials have also become more susceptible to economic coercion (Le Mouel and Poitiers, 2023).

One additional and often overlooked source of European vulnerability is export dependency. China in particular has become an increasingly important market for Western exports (Figure 6), with approximately 10 percent of German passenger car exports in 2022 going there, for example[17].

As will be shown, this means that import bans are also available as a means for China to put political pressure on Western governments. As Baqaee *et al* (2024) showed, the potential economic costs of sudden trade disruptions with China for a country like Germany are significant (they assess that the effect of a total cessation of trade with China for Germany would be 'severe but not devastating').

Figure 1. EU import sources by political system

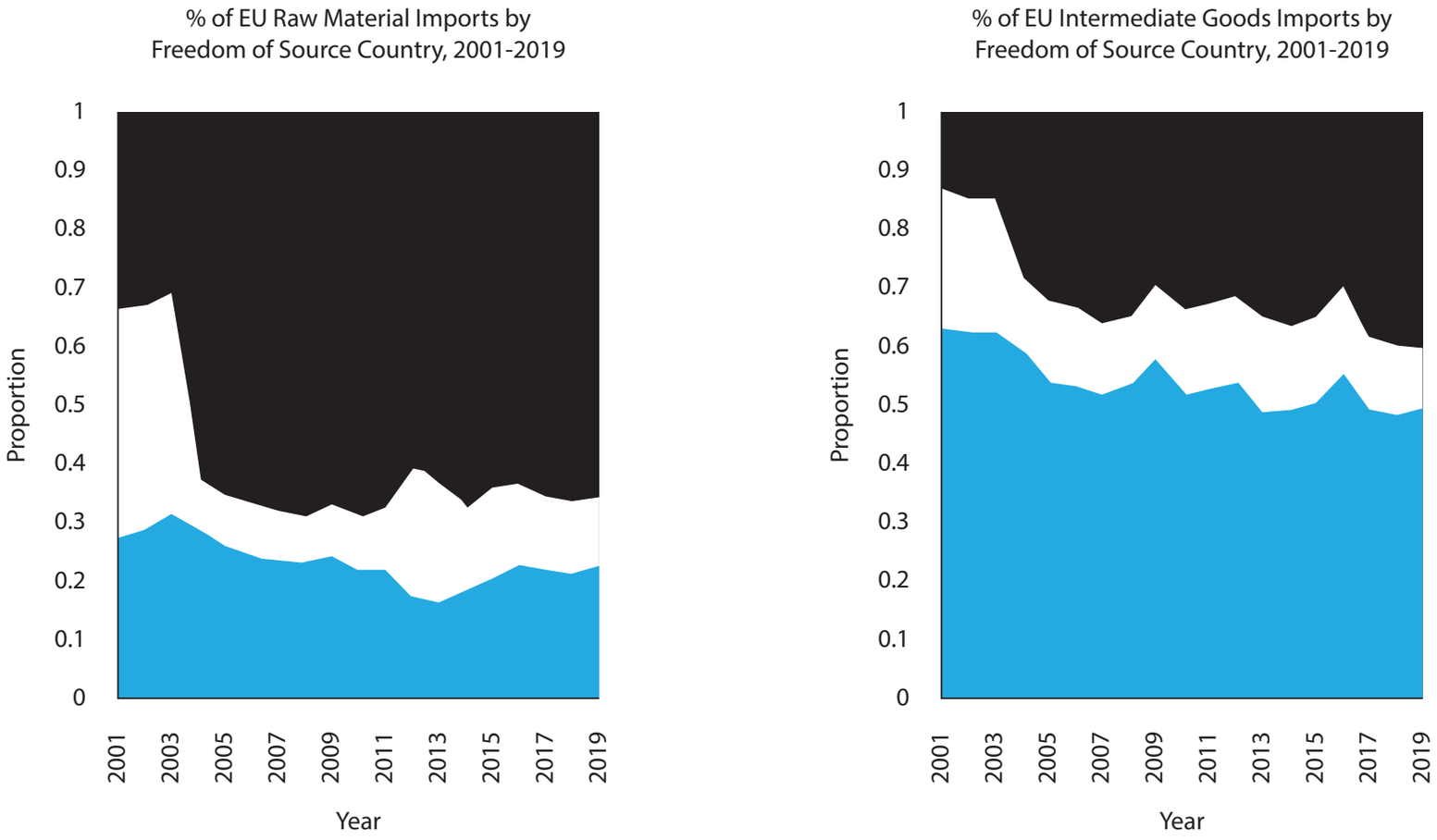
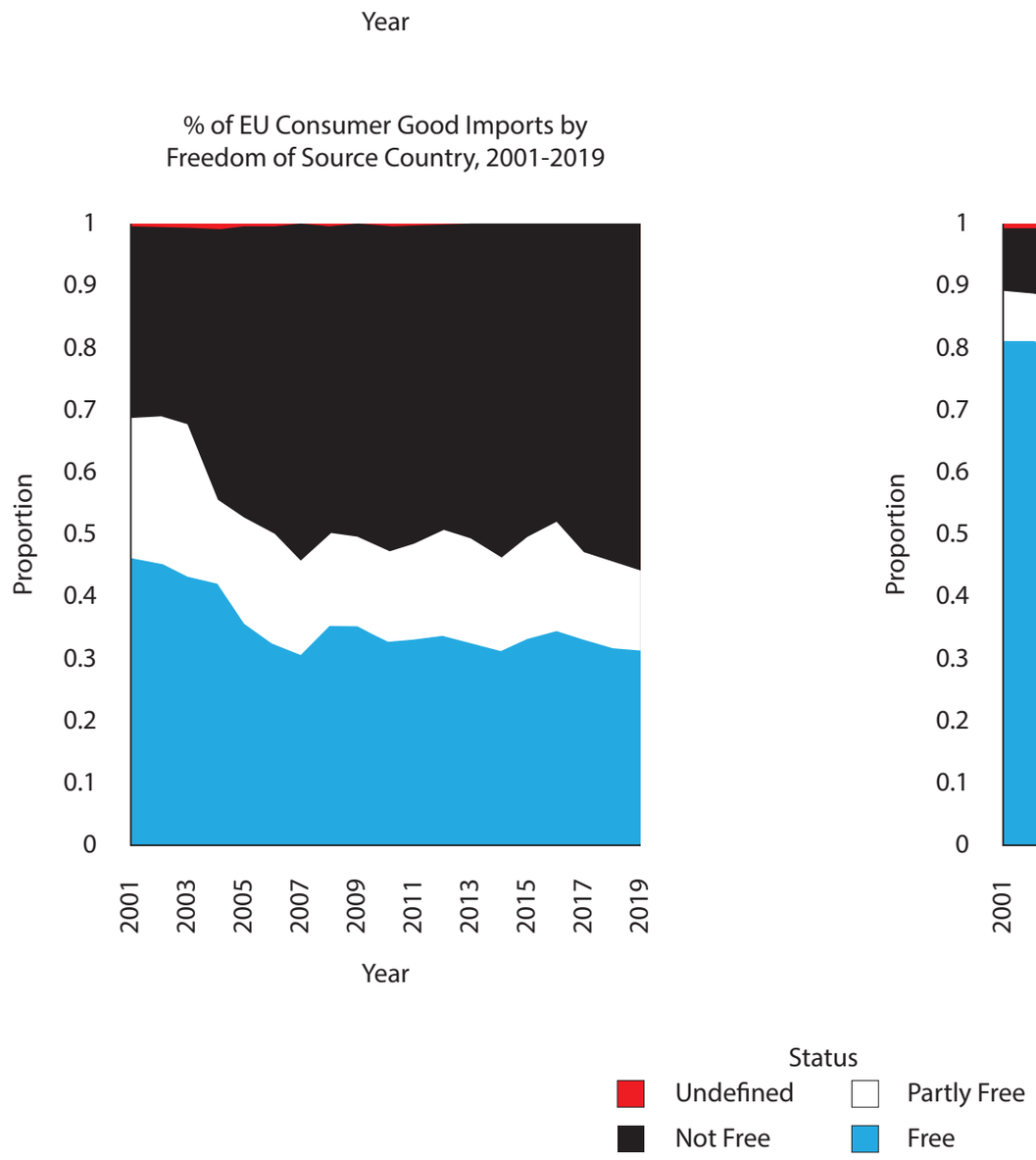
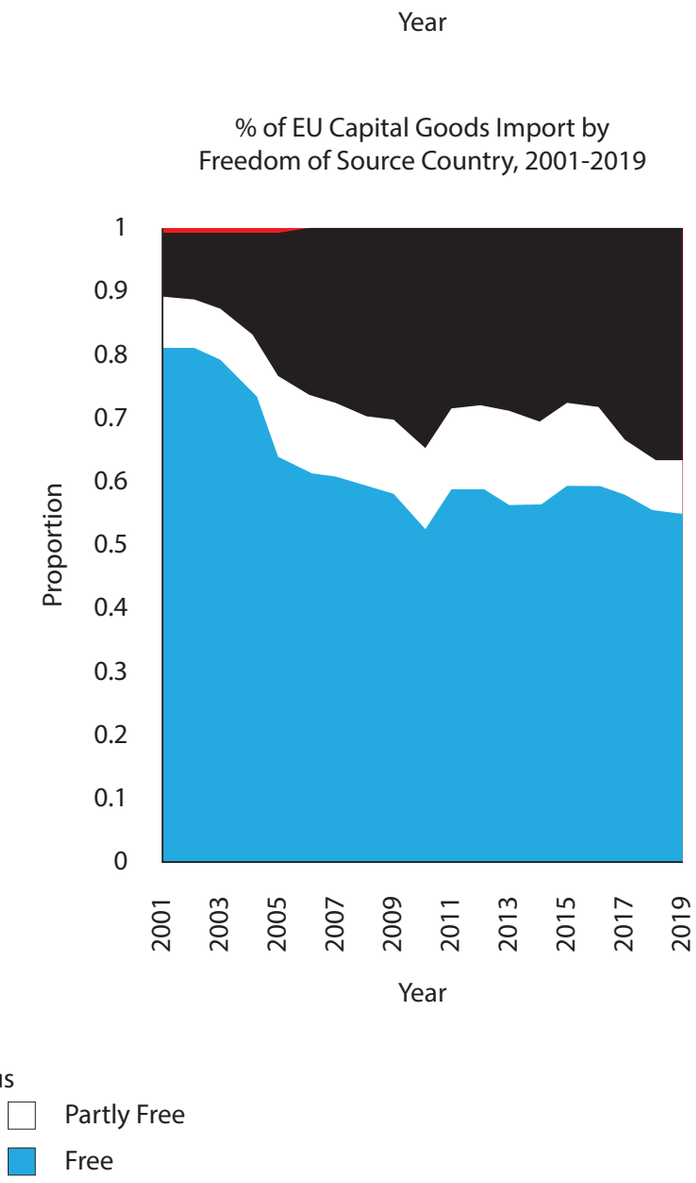


Figure 1. EU import sources by political system cont.





Source: Bruegel basted on Eurostat, UNCTAD & Freedom House.

4 The threat of economic coercion

Economic coercion comes in many shapes and forms. Adachi et al (2022) tallied Chinese coercive methods since 2012 (Figure 2). Many measures targeted individual firms, while trade restrictions have been the most common form used to target countries. Within these trade restrictions, import restrictions (China blocking the imports of goods from foreign markets) have been used more often than export restrictions[18].

Unlike Western sanctions that follow formal legal procedures and can be challenged in courts, measures taken by China are often informal. Documentation detailing measures can be difficult to find, and targeted entities might thus find it difficult to challenge measures even when avenues to do so might exist (Hackenbroich *et al* 2022).

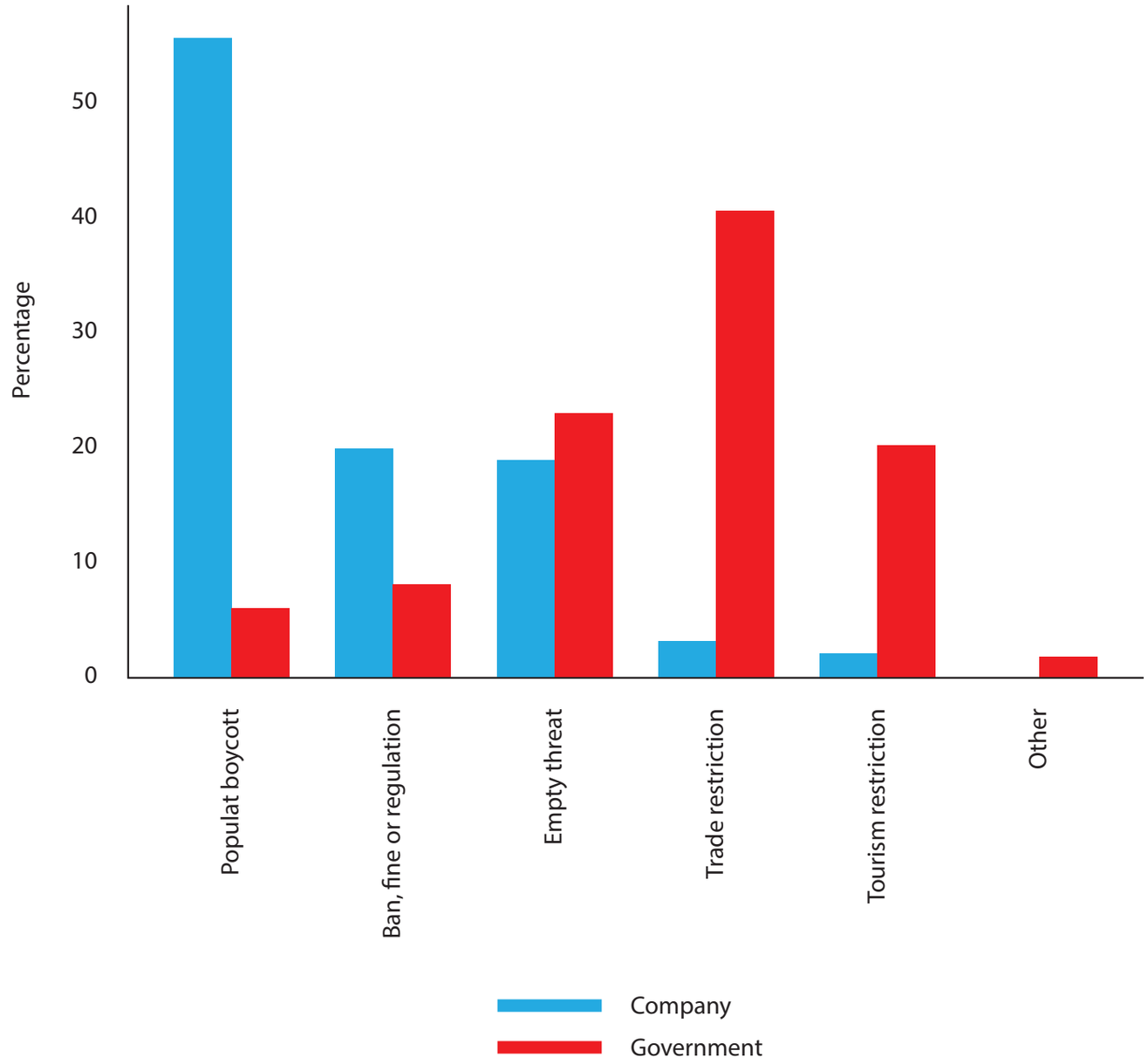
A particularly problematic example is popular boycotts against certain foreign brands, individuals or firms. While sometimes genuine, these movements to encourage firms and consumers to punish certain firms are often stoked by state-controlled media and on social media[19]. They represent the most common form of economic coercion used by China against firms, and are particularly difficult to attribute to undue state intervention.

The experiences of trade wars and Western sanctions against Russia provide some insights into what types of goods are vulnerable to economic coercion. In episodes such as the China-US trade war that began in 2018, trade diversion has been a major feature, limiting the effects of trade restrictive measures (Fajgelbaum *et al* 2023).

Similarly, sanction circumvention and alternative sourcing pose major challenges for the effectiveness of Western sanctions against Russia (Babina *et al* 2023).

The effectiveness of any type of coercive economic measure depends on the market power of a country or coalition. If alternatives are widely available, a targeted economy can easily switch its sources of imports for a product.

Figure 2. Forms of Chinese economic coercion



Source: Adachi et al (2022).

Similarly, if alternative export markets exist, a bilateral trade relationship cannot easily be weaponised. This rules out most commodities from being used or targeted effectively for economic coercion, as they have many sources and markets. Even where a high degree of market concentration is found, this does not necessarily imply high monopolistic power.

The contestability of a market also depends on barriers to entry for newcomers. Many of the products for which there is a high degree of market concentration are low-tech products, such as artificial flowers and electric blankets (Mejean and Rousseaux, 2024).

If the dominant producers would limit exports of these products, it would be rather easy for new companies to enter the market. This was the case for rare gases (neon, krypton and xenon), the supply of which was disrupted by the Russian invasion of Ukraine (Georgitzikis and D'Elia, 2022). Their prices spiked after the outbreak of the war, but came down rather quickly as new producers entered the market[20].

Furthermore, there might exist close subsitutes that might not be employed presently but could become commercially viable if the supply chain of the incumbent technology is disrupted. Examples of this dynamic have been documented during trade embargoes (Mulder, 2022). However, it can be difficult to assess the feasibility of such substitution before an actual disruption occurs.

An economy can have monopolistic power for several reasons. First, a natural resource might only exist in a few countries, giving them effective control over where the supply goes. Second, infrastructure bottlenecks might create monopolistic power in segregated markets.

This was the case for Russian pipeline gas in the wake of the invasion of Ukraine: a lack of liquified natural gas (LNG) capacity in central Europe allowed Russia to hike prices in European gas markets.

Third, economies of scale or industrial policy can lead to dominance on certain markets, as is the case of China in the solar panel industry (García Herrero *et al* 2023). Fourth, advanced technological capacities might give monopoly power. An example for this would be ASML in the chip industry (Poitiers and Weil, 2021; Kleinhans and Baisakova, 2020).

The 'contestability' of a market is also important. Only if a monopoly market can be maintained over time can it be exploited over extended periods without the risk of losing future markets.

In 2022, there was considerable concern over the supply of certain gases that were primarily produced via a Russian-Ukrainian supply chain. However, alternative sources were brought online relatively quickly, preventing lasting shortages (Darvas *et al* 2023).

To induce harm that is macroeconomically significant, the impact of a bilateral flow needs to have a material impact on the overall export or import performance of the targeted economy. For certain goods, in the fields of health, defence or clean energy, for instance, disruptions to imports may be highly damaging on have some non-economic outcome, with prominent examples being personal protective equipment and vaccines during the COVID-19 pandemic.

In highly diversified advanced economies such as the EU, the capacity to induce truly significant shocks, either macroeconomic or otherwise, is limited to a very small number of strategic goods. However, in many cases of economic coercion, the harm is market- and industry-specific rather than macroeconomic.

Though few individual products are of such importance that they can affect the economy as a whole, targeted measures can easily harm politically important constituencies, and thus exert political pressure on policymakers.

In the following, we consider two recent cases of economic coercion that illustrate how economic interdependence can be weaponised: the measures taken by China against Australia and Lithuania since 2020.

4.1 Australia: a tale of two sectors

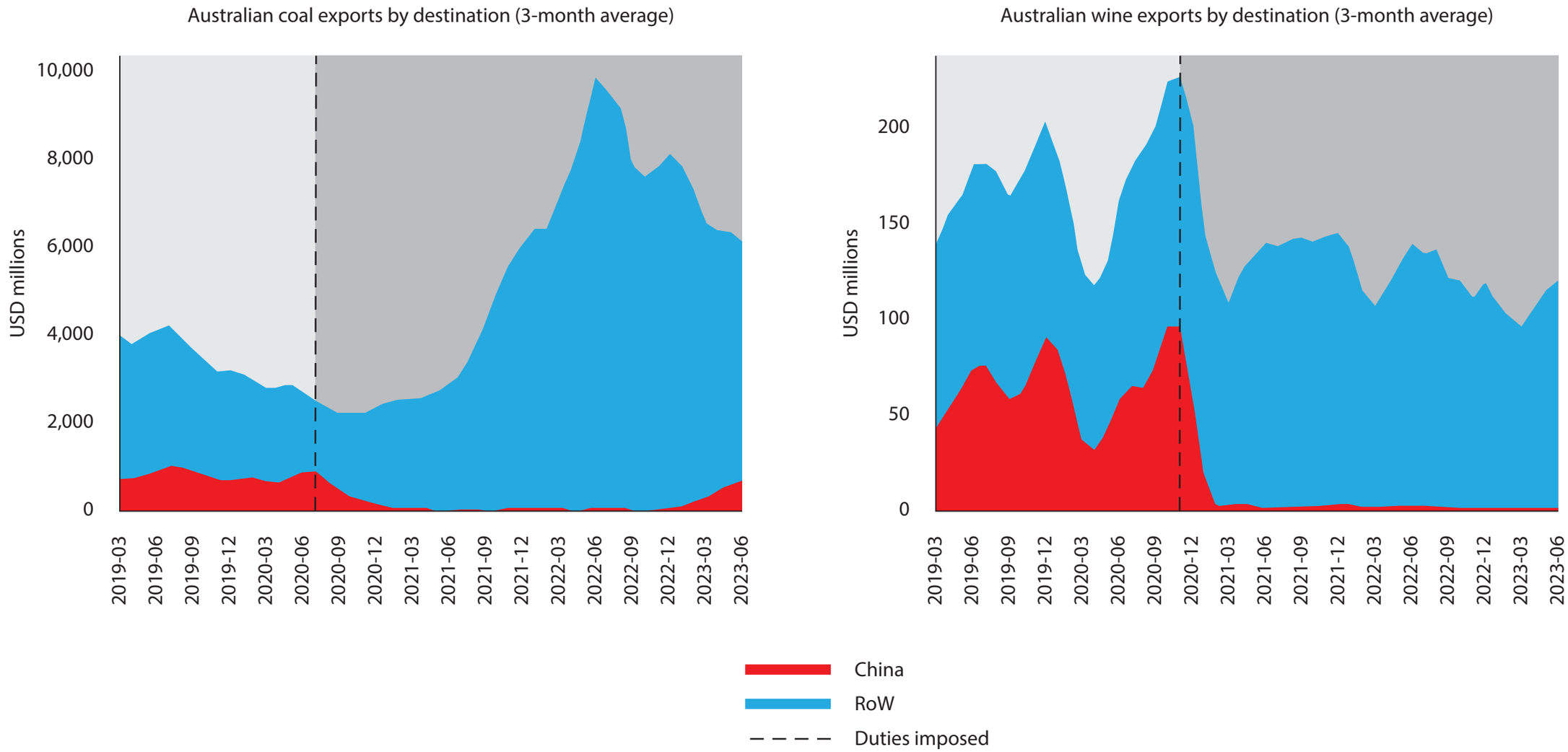
In mid-2020, following then-Australian Prime Minister Scott Morrison's calls to open an investigation into the origins of the COVID-19 pandemic[21], China began a campaign of economic coercion against Australia that only began to be eased in early 2023.

It targeted Australian exporters and introduced *"discriminatory tariffs on wine and barley"* and *"informal and WTO-illegal bans on coal, beef, lobster, cotton, wood, nickel and copper concentrates"* (Urden 2023a)[22]. As a result, China's share of Australian exports fell from its mid-2021 peak of almost 45 percent to less than 30 percent by the end of 2022[23].

The Australian economy as a whole successfully navigated the coercive measures introduced by China. The value of Australian exports rose between 2020 and the end of 2022, largely driven by energy exports to Asian markets other than China.

There was however important variation in the impacts on the various targeted sectors. For the coal sector, the decline in exports to China was more than offset by higher exports to the rest of the world, in particular to Asian countries that were also indirectly affected by China's actions (Figure 3, Panel A)[24].

Figure 3. Chinese economic coercion against Australia



Source: Bruegel based on Australian Bureau of Statistics (left) and UN COMTRADE (right).

Significant export diversification, coupled with high coal prices following the Russian invasion of Ukraine, meant that Australian coal exporters enjoyed surging import revenues over the period of the unofficial embargo.

This makes for a stark contrast with Australian wine exporters. Because of a 2015 free trade agreement[25], Australian wine exporters had been at an advantage in China compared to many other wine-exporting countries, making China an important export destination.

However, following the imposition of countervailing duties as high as 218 percent in late 2020, wine exports to China collapsed from approximately 38 percent of total Australian wine exports in 2019 to zero since 2022. Unlike coal, the industry failed to expand into other markets.

Consequently, monthly Australian wine exports in June 2023 were down over 40 percent from their October 2020 peak. Chinese duties, coupled with a strong harvest, led to a significant oversupply of Australian wine[26], depressing prices and adversely impacting the industry[27].

The two industries detailed here are representative of the broader range of targeted industries. Some, such as barley, succeeded in diversifying away from Chinese buyers (to Saudi Arabia) and saw their exports grow over the period in question. Lobster and wood exporters on the other hand failed to move into new markets and suffered the same fate as their counterparts in the wine industry (Buckland *et al* 2023).

4.2 Lithuania: much ado about nothing?

The trade restrictions introduced by China against Lithuania in 2021 marked the most serious incident of Chinese economic coercion against an EU member.

The relationship between the two countries had been particularly fraught since the formation of a new Lithuanian government in 2020[28], but broke down entirely in mid-2021 when the Lithuanian authorities announced that they would allow a Taiwanese representative office to be opened in Vilnius[29].

After two years of an essential trade ban (detailed below), the Lithuanian government reported in November 2023 that 'most' Chinese trade measures had been lifted[30].

Given the opacity of China's actions, it is difficult to disentangle precisely which measures were implemented and when. However, the European Commission (2022) detailed that the original measures enacted included disruption to logistics networks (leading to more expensive and delayed freight deliveries), difficulty obtaining trade credit insurance for imports, and general disruption to supply chains containing Chinese components.

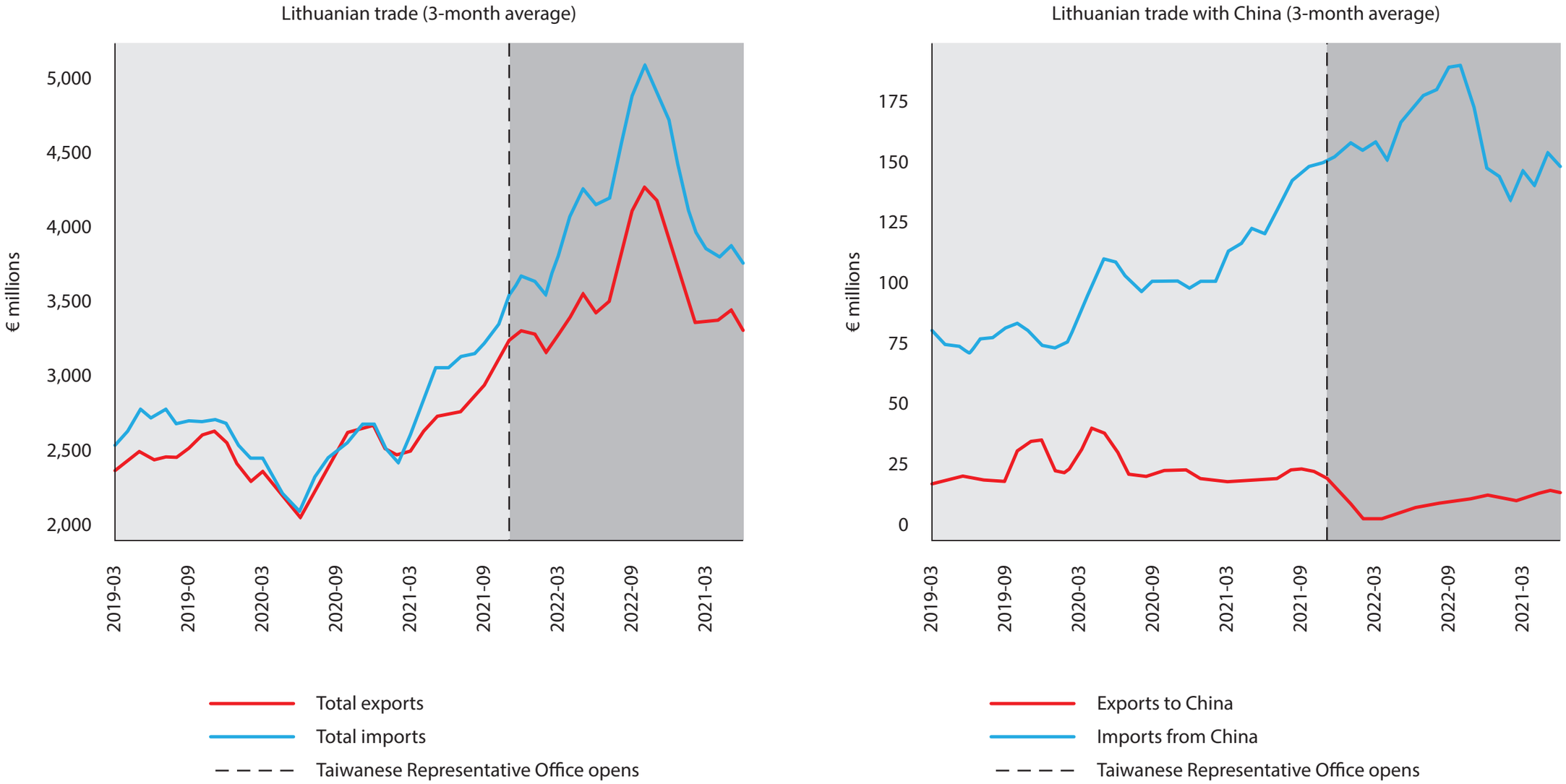
These measures were escalated following the actual opening of the Taiwanese office in November 2021, to go beyond direct trade between the two nations. They also targeted Lithuanian participation in global supply chains, with products from other European countries containing Lithuanian components being threatened with rejection by Chinese customs authorities.

Official import bans on certain products were introduced in 2022, with China relying once again on spurious justifications, such as a 'lack of documentation'[31].

Lithuanian exports to China fell by two-thirds between 2020 and 2022, but imports from China grew by the same amount over the period in question, which reinforces the idea that China most often targets countries' exports.

Neither Lithuanian total exports nor total imports were significantly impacted, which is unsurprising given that China made up just 1% and 4% of Lithuania's 2020 exports and imports respectively[32].

Figure 4. Lithuanian exports and imports to the world (left) and to China (right), 3-month average in € millions



Source: Bruegel based on Eurostat.

Box 2. Lithuanian support scheme

In April 2022, the European Commission approved under EU state aid rules a Lithuanian loan scheme designed *"to support and facilitate access to finance by companies affected by the exceptional circumstances resulting from China's discriminatory trade restrictions on Lithuania"* (European Commission, 2022). This was approved to last until the end of 2027 or the end of the trade restrictions, whichever came first. However, because of a lack of uptake, the scheme was wound down in 2023[35].

Administered by INVEGA, the Lithuanian national promotional institution, the scheme was capped at a maximum of €130 million overall, and at €5 million per firm. Access was limited to Lithuanian firms for which the *"proportion of either imports from or exports to China represents at least 25% of the beneficiary's total imports or exports in 2021"*, and that were unable to receive financing on the market (which had to be proven by rejections from three financial institutions). The loans had to be used: (i) to source inputs from different sources, (ii) to explore the possibility of entering new markets or (iii) to use *"the time to undertake such efforts."*

Estimates at the time of approval were that there were 130 potential beneficiaries, with this expected to increase to up to 500 as Chinese restrictions persisted and grew. However, only three firms, each an SME, made use of the support offered. The total amount of loans granted was €4.22 million, just 3 percent of the maximum amount permitted.

However, as in the case of Australia, certain sectors were negatively affected by the measures, with two of the three firms claiming assistance under a national support scheme (Box 2) operating in the solar PV industry[33].

Several observations can be made on the joint experiences of Australia and Lithuania of Chinese economic coercion[34]. First, exports to China were targeted more strongly than imports. Second, despite significant trade restrictions from one of the world's largest economies, neither country suffered macroeconomically. Third, targeted industries can emerge unscathed without government intervention, largely through successful diversification.

As Australian coal and barley exports showed, commodities are particularly poor targets for economic coercion as global markets provide alternative buyers. However, it also shows that even if the wider economy can withstand coercion, certain sectors can be strongly impacted.

The markets where Chinese coercion had the greatest effects (wine, lobsters and wood in Australia) are macroeconomically insignificant, yet their targeting affected some constituencies. In other words, the inflicted damage was political rather than macroeconomic.

5 Where is the EU exposed to economic coercion?

As monopolistic power is a necessity for economic coercion, potential vulnerabilities can be identified by looking at market concentration. The Herfindahl-Hirschman index (HHI) provides an index that measures market concentration. It is used widely not only for assessing competition cases, but also in defining economic security risks (European Commission, 2021a; Jaravel and Mejean, 2021; Welslau and Zachmann, 2023).

The HHI has a value between 0 and 1. The lower the value, the more competitive a market. In competition policy, any market with a value above 0.25 is considered indicative of a high degree of market concentration, and any market with a concentration above 0.6 is considered 'monopolistic' (US Department of Justice, 2010).

While these measures might not apply one-to-one to import vulnerabilities, they provide a yardstick of how concentrated import markets are.

Figure 5 plots the distribution of HHI values of EU imports by product category for 2001 and 2019[36]. For easier comparison, estimated distributions for both years are displayed in the right panel. We highlight goods with an HHI above 0.6 as monopolistic and thus problematic.

This is a conservative choice, compared to the threshold values used in other analyses (an HHI of 0.4 in the case of the European Commission). However, this analysis is meant to illustrate the evolution of EU import markets and we abstract from the second stage of import concentration analysis, justifying a more restrictive approach[37].

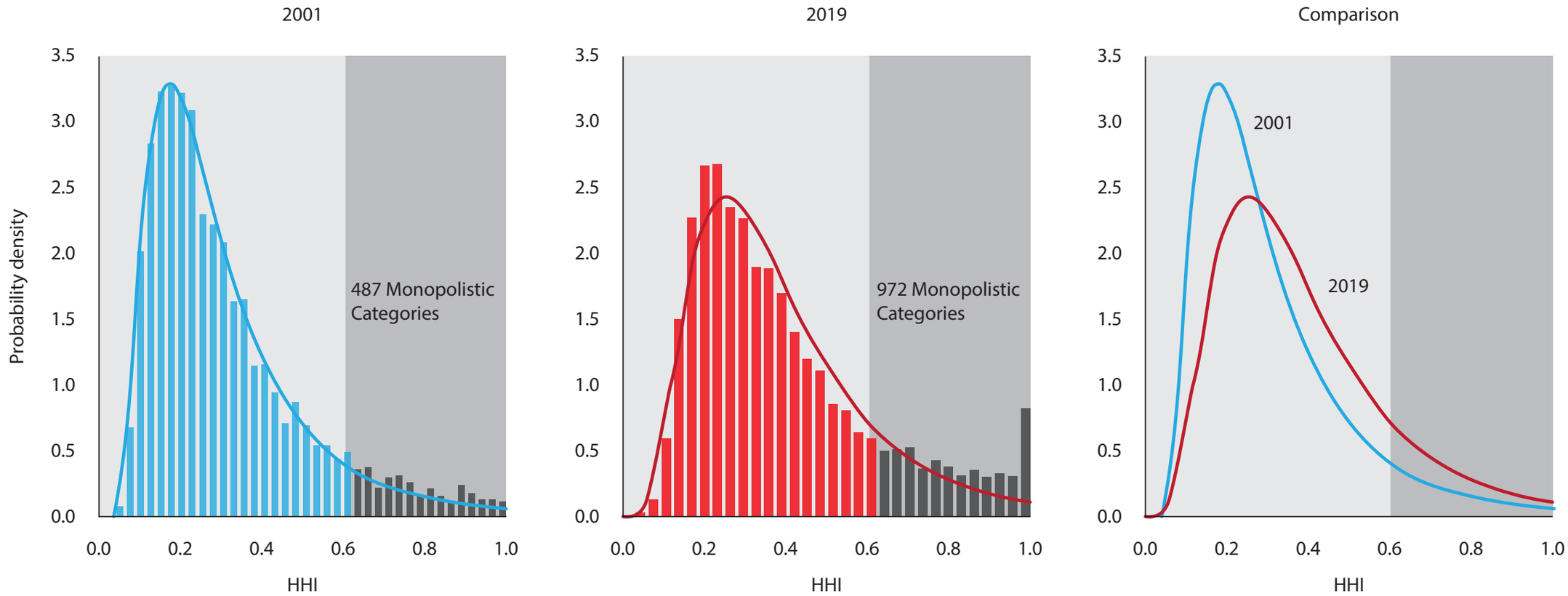
Between 2001 and 2019, the distribution of EU import market concentration shifted considerably to the right. While in 2001, 487 products had concentrations considered 'monopolistic', in 2019, 972 products fell into this category.

Table 1 provides for the EU a breakdown of the types of product that were in highly concentrated markets in both 2001 and 2019. In both periods, most of the products in highly concentrated markets were manufactured goods.

For instance, in 2019, 626 products were manufactured goods, but they accounted for only 11 percent of the value of manufactured goods imports into the EU. This was more than double the 5 percent of the import value of manufactured goods falling into the 'problematic' category in 2001.

For non-fuel raw materials, 22 percent of products were in monopolistic markets in 2019. While the share of value of non-fuel raw materials in monopolistic markets did not change significantly over the time period in question, many more of the highly concentrated goods categories were classified as 'critical raw materials' in 2019 than in 2001.

Figure 5. Evolution of concentration of EU imports



Source: Bruegel based on Eurostat.

Similarly, many more of the highly concentrated manufactured goods imports are 'high tech' goods, with the share increasing from 25 percent to 43 percent. A significant part of the increase can be directly attributed to China. It was the main source country for 20 percent of the highly concentrated import categories in 2001, with this share more than doubling to 49 percent in 2019.

Meanwhile, the share of the US in concentrated EU imports roughly halved in almost all categories (for an analysis of the trends, see Welslau and Zachmann, 2023).

Overall, EU imports of both raw materials and manufactured goods were much more concentrated in 2019 than in 2001. This shows that a high degree of market concentration is not merely a feature of a few goods categories that might have been supported through strategic Chinese industrial policy, but rather the effect of an increase in market concentration across the entire spectrum of imports.

Therefore, a strategy to limit import concentration cannot be focused only on strategic imports, as potential targets for import bans are plentiful and new ones are likely to arise in an overall concentrated market environment. An effective diversification strategy should therefore aim to lower the degree of market concentration more generally.

It is also important to note that import dependencies alone are not necessarily concerning. Among the categories of goods for which Mejean and Rousseaux (2024) found the EU to be reliant on highly concentrated import markets are, for instance, artificial flowers and camping flasks.

While shocks in the countries of origin would likely lead to EU import disruptions in these sectors, it seems implausible that these shocks would cause social welfare losses significant enough to warrant government intervention.

Table 1. Breakdown of highly concentrated import markets

	Year	# Products	Products	Value	Products HT/CRM	Value HT/CRM	Products China	Products US
Raw materials								
Total	2001	71	15%	4%	7%	4%	13%	21%
	2019	110	22%	2%	6%	18%	16%	11%
Non fuels	2001	66	15%	7%	8%	8%	14%	20%
	2019	101	22%	9%	7%	21%	17%	11%
Manufactured goods								
Total	2001	348	9%	5%	11%	25%	120%	37%
	2019	626	15%	11%	10%	43%	49%	19%

Note: HT = high tech goods according to classification by the United States Census Bureau.; CRM = critical raw materials as defined by the European Commission.
Source: Bruegel based on Eurostat.

There are important precedents for the weaponisation of import vulnerabilities. These include the Chinese threat to ban exports of certain critical raw materials during a 2010 trade dispute with Japan[38], and recent export restrictions on critical minerals[39].

However, most cases of economic coercion by China have either directly targeted companies operating on its markets or exports to China. This stands in contrast to the almost exclusive focus of economic security on risks stemming from Western imports from China.

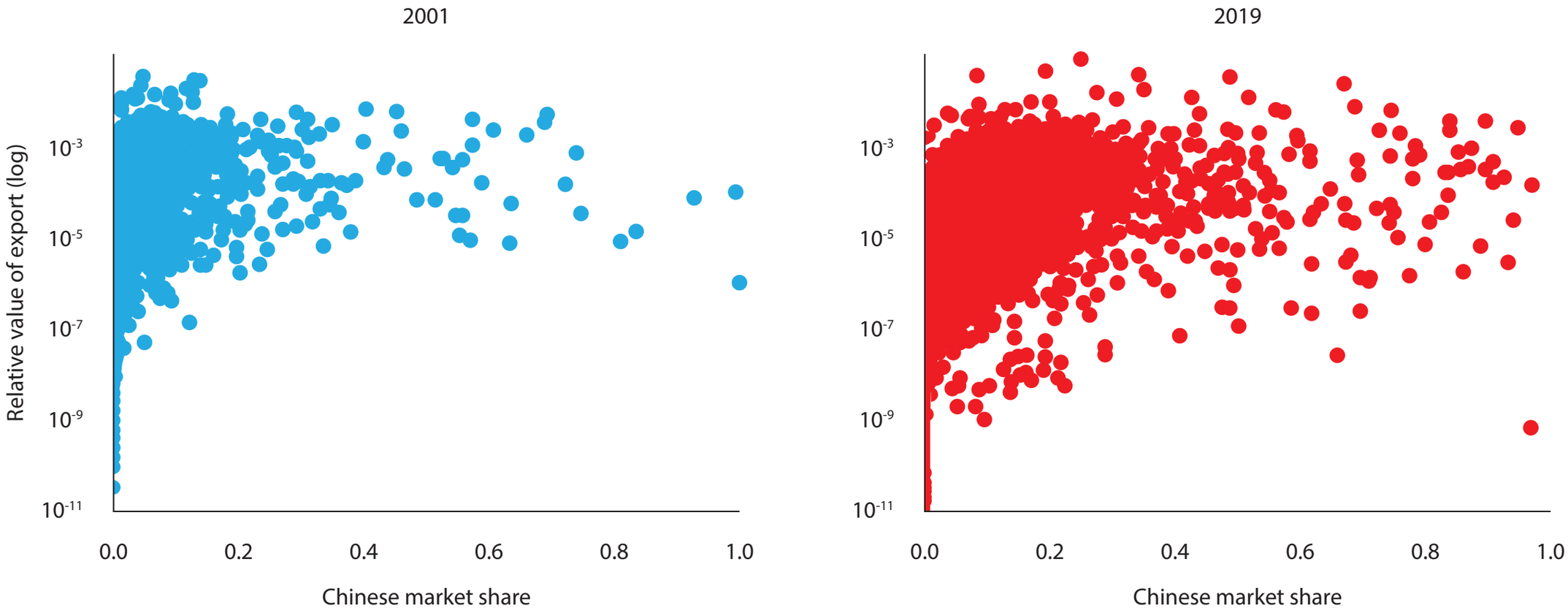
As Adachi *et al* (2022) showed and the Australian and Lithuanian cases illustrate, imports from China are not typically the primary vulnerability for economic coercion. Instead, these past experiences have shown that China tends to weaponise access to its domestic market for foreign exporters.

Given that a market must be sufficiently large to have monopolistic power as an export destination, China is virtually the only country of concern to the EU for this type of risk[40]. While other countries can also harm EU export interests, they are unlikely to be sufficiently large to inflict significant damage.

Therefore, we use in Figure 6 Chinese market shares as proxy for export vulnerabilities instead of the HHI index. The economic importance of an export is measured by its relative value (it's share of total exports to China). A product in the lower left corner is of relatively low value and is not exported a lot to China, whereas a product in the upper right corner is of high value with most of it being exported to China.

Overall, a large shift to the right is evident. In other words, there is now a much larger number of products where a Chinese embargo on EU exports would inflict significant harm, increasing the number of potential targets for Chinese restrictions.

Figure 6. Concentration of EU export markets



Source: Bruegel based on Eurostat.

As in the case of the increasing import concentration, the increase in Chinese market shares in exports represents a structural shift rather than something that is product-specific. A focused strategy on the most exposed exports might limit some potential harm in the short term, but the number of potential targets is so high that broader diversification is necessary and overarching policy instruments are required.

6 Instruments of economic security

The increased exposure of the EU to economic security risks has rightly drawn the attention of policymakers. Various initiatives have been proposed with the aim of increasing the resilience of the European economy against such risks. Given the different types of threat, these initiatives rightly include a wide range of instruments[41].

Table 2 provides an overview of the policy instruments relevant to the economic-security debate, including both those announced under the auspices of economic security but that are in fact more pertinent to national security, and policies relevant to addressing economic security risks that have not yet been put forward.

We distinguish them depending on the nature of the threat (eg. whether it targets exports or imports)[42] and the intended timing of implementation (pre-emptive, ex-post or both, which we term 'overarching'). It is noteworthy that many of these policies have the potential to improve the resilience of the European economy in areas beyond responding to economic security threats.

As mentioned, Table 2 includes a number of policies mentioned in the Commission's Economic Security Strategy but that are arguably more concerned with non-economic risks. The downsides to many cyber-attacks or research interference are not primarily economic in nature.

Table 2. Instruments of economic security

Vulnerability	Threat	Ex-ante instruments	Ex-post instruments	Overarching instrument
Economic security				
High export concentration	**Targeted trade embargoes**	**Diversification** - Free/Preferential Trade Agreements (FTAs/PTAs) - Secondary instruments, eg. export credit agencies, development policies, 'clubs', TTCs, Global Gateway	**Bespoke national support** eg. state aid-sanctioned scheme in Lithuania	**Anti-coercion instrument** - Introduction of proportionate retaliatory measures **Internal Market Emergency and Resiliance Act** - Monitoring, stockpiling, joint procurement and potential 'priority rated orders'.
		Diversification - FTAs/PTAs - Secondary instruments (see above)		
High import concentration	**Disruption of supply of crtical components**	**Increase domestic production** - Industrial policy - Strenthening the single market	**Missing:** EU support	
		Ensure a level playing field - Foreign Subsidy Regulation - Trade defence instruments		

National security	**'Critical' competitive advantages** ('Narrow yard with high fences')*	**Loss of technological advantage in dual use goods and the control over their production**	**Boost industry** - Industrial policy
			Prevent leakages - Export controls* - Outbound investment screening* - Toolkit on Tackling Foreign R&I Interference*
			Ensure a level playing field - Foreign Subsidy Regulation - Trade defence instruments
	Not otherwise classified		**Protecting infrastructure** - Cyber Resilience Act* - NIS2 Directive*
			FDI Screening*
			EU Standardisation Strategy*

*Note: Includes current/proposed EU policy measures, as well as those we believe are missing. * denotes policies or ambitions put forward under the umbrella of economic security that generally fall outside of our definition[43].*
Source: Bruegel.

The Commission has declared certain technologies to be of particular concern because of *"the enabling and transformative nature of the technology; the risk of civil and military fusion; and the risk of misuse of the technology for human rights violations"* (European Commission, 2023d).

The latter two criteria are not relevant in terms of our narrow definition of economic security. The former, which the Commission defines as assessing the technology's *"potential and relevance for driving significant increases of performance and efficiency and/or radical changes for sectors, capabilities, etc"*, could fall under the remit of economic security only in sectors where high degrees of technological complexity create monopolies, as described earlier.

In the following, we discuss the role of some instruments in more details, as part of four complementary strategies to enhance economic security: mapping of vulnerabilities; diversification of imports and exports; industrial policy and technology security in strategic sectors; and ex-post policies to help redress political damage.

6.1 Mapping vulnerabilities

The first step of responding to economic security concerns is to identify risks. Global value chains are enormously complex and not all dependencies are direct (Qiu *et al* 2023). Coercive measures can go beyond direct bilateral trade, as was the case with China's actions against Lithuania.

As such, a detailed understanding of the EU's dependencies on other countries for both exports and imports is necessary. This would allow authorities to identify potential vulnerabilities ahead of shocks, and assist affected firms, in particular SMEs, to diversify their supply chains and mitigate the risk in question.

Hackenbroich *et al* (2022) argued that there may be scope for an EU body to carry out detailed data analysis for this purpose.

Monitoring supply chains by requesting, and in some instances requiring, firms in strategic sectors to disclose information on their suppliers, stocks and productive capacities is a key, and controversial[44], component of the proposed EU Internal Market Emergency and Resilience Act[45].

Similarly, the European Chips Act entails mapping and monitoring the semiconductor supply chain to assess ex-ante risks of potential import disruptions[46]. Depending on the importance of a sector, a balance has to be found between the administrative burden on firms and the benefits from further insights. For instance, informational requirements should be higher on those sectors flagged by Mejean and Rousseaux's method (2024) as being at risk.

However, awareness of risks alone does not directly lead to mitigation measures; economic incentives have to align as well. While over 95 percent of firms surveyed in the EIB Investment Survey (European Investment Bank, 2023) had experienced some form of disruption to international trade, less than half of them had changed or were planning to change their sourcing strategies.

Even when potential downsides are large enough to warrant a change in sourcing, there might not be readily available alternatives. This leads us to the next strategy.

6.2 Diversification

Since monopolistic power is a necessary condition for effective economic coercion, trade diversification is the most effective strategy to reduce vulnerabilities, as it can lead to more competition across a wide range of imports and exports.

While precise results change depending on the criteria used to determine dependence, there has been significant churning in the products in which the EU has been overly import dependent (Vicard and Wibaux, 2023).

Failing to further comprehensively diversify both imports and exports will likely lead to more goods falling into the concerning range of high export or import concentration. Otherwise, in focusing on individual goods in structurally concentrated markets, policymakers will be constantly racing to address different areas of concern.

To achieve greater diversification, a combination of policy tools offers the most promising avenue. First and foremost, free and preferential trade agreements (FTAs/PTAs) open new markets for both exporters and importers.

The EU has made progress in broadening its level of trade covered under PTAs. As of 2020, half of extra-EU exports were covered by reciprocal PTAs, up 8 percentage points from 2010 as trade agreements with Canada, Japan and Korea came into force (Dadush and Dominguez Prost, 2023)[47].

The December 2023 agreements[48] between the EU and Chile, an important exporter of some CRMs, to enhance and modernise their existing FTA, also shows how these agreements are not static, and should be updated if needed to reflect the increased focus on economic security.

However, mainly because of domestic political pressure, the EU has struggled to conclude trade agreements with major trading partners such as the Mercosur countries, while even negotiations with close allies like Australia have proven difficult[49].

Besides the difficulty of ratifying FTAs, there are other limits to relying on FTAs for diversification. Many of the products for which the EU has problematic import dependencies do not have significant tariffs precisely because there is no European industry that would justify protective measures.

Where Most Favoured Nation (MFN) tariffs offered to all WTO members are already very low, the EU cannot offer significantly better market access through an FTA compared to the access that, for instance, China has. This is the case for CRMs, many of which have no tariffs at all applied to them (Le Mouel and Poitiers, 2023).

Therefore, a diversification strategy must complement FTAs with external financial instruments[50]. The European Commission aims to harmonise and streamline European development assistance under the umbrella of the Global Gateway.

Beyond its primary objective of promoting economic development globally, this initiative has as a stated goal to support the EU by *"strengthening the resilience of its supply chains, and to opening up more trade opportunities for the EU economy"* (European Commission, 2021b, p.2).

To an extent, this is indeed already happening. In October 2023 the EU signed Memoranda of Understanding under the Global Gateway framework with both the Democratic Republic of Congo and Zambia to deepen cooperation around the development of resilient value chains for critical raw materials, which could help to improve import diversification[51].

More should be done in this area, such as potentially investing in infrastructure in northern Africa to further diversify European energy imports (as argued by Rizzi and Varvelli, 2023).

Export credit agencies (ECAs) should play an important role in this strategy, including the potential creation of a European export credit agency. ECAs are state-owned or publicly financed bodies that are used to support exports by providing a range of financing instruments (primarily insurance and guarantees, but also loans) at below market rates to de-risk trade.

Going beyond facilitating direct exports, they can also be used to support investments in third countries which, if targeted appropriately, can ultimately improve diversification of supply. A European ECA could compliment the 24 national ECAs (European Commission, 2023c)[52]. The support in question is significant, with EU ECAs in 2021 insuring projects amounting to approximately €90 billion (Schlögl *et al* 2023).

The ECAs' funding could be boosted and applied strategically to support the objective of economic security. It will not be commercially viable in a high-wage economy to produce many of the products for which the EU is reliant on imports from China. Some raw materials do not exist in Europe, or local resistance to their extraction could be too high.

In such cases, ECAs can play a critical role in promoting investments in alternative sourcing in partner countries (Le Mouel and Poitiers, 2023). Export-promotion offices could also be useful to help firms identified as being overly reliant on a particular export market to identify and access new markets.

The Enterprise Europe Network (EEN), a Single Market Programme-funded umbrella of national SME support organisations (including chambers of commerce and government agencies) already offers assistance to SMEs in the areas of 'resilience' and 'internationalisation'. This role, however, could be boosted, with awareness of the network at just 9 percent among SMEs[53].

6.3 Targeted industrial policy and interventions

For sectors that combine a high degree of dependency with a high degree of economic importance, diversification might not be enough to safeguard economic security. There are very few sectors from which macroeconomically significant impacts might arise because of supply chain shocks.

As noted, concerns beyond economic outcomes, such as defence and health, may justify such policies in other areas, but this group should also be limited. Three types of strategies are possible: (i) maintaining strategic reserves; (ii) growing domestic production; or (iii) improving productive capacities in third countries.

In some cases, stockpiling a certain buffer level will often be the most cost-effective option, but it is not always feasible. Certain goods (like medicines) might spoil, and in certain fast-moving sectors (for instance PVs), technology quickly becomes obsolete. As such, this should play only a limited role.

The global trend thus far has been to prioritise boosting domestic supply via industrial policy. Examples include the European Chips Act and the Net Zero Industry Act in the EU, the Inflation Reduction Act and CHIPS and Science Act in the US, and the K-Chips Act in Korea.

However, competing policies have led to costly subsidy races even among likeminded partners, and heavy-handed reshoring policies can have unintended consequences. Javorcik *et al* (2022) estimated that friend-shoring could generate global real GDP losses as high as 4.6 percent.

Reshoring drug production to avoid shortages could lead to prices increasing by up to 30 percent (Galdin, 2023). Import restrictions have likely contributed to shortages of infant formula in the US[54].

Meanwhile, producing green technology in Europe would lead to much higher decarbonisation costs, slowing the green transition and Europe's attempts to diversify away from Russian hydrocarbons. In the EU, the emphasis on national state aid also poses risks to the single market (see Kleimann *et al* 2023; Tagliapietra *et al* 2023)[55].

In the instances in which increasing domestic production is justified, a bespoke strategy should be designed for the sector in question that aims to minimise distortions and leverage the comparative advantages of the EU in that area.

For instance, McWilliams *et al* (2024) argued that an EU industrial policy for the solar panel industry should focus on recycling and innovation, not import substitution. Given the different abilities of EU countries to support their domestic industries, a 'Europeanisation' of state-aid tools such as the Important Projects of Common European Interests (IPCEIs) will be indispensable if single market fragmentation is to be avoided.

Currently, IPCEIs and similar policies, such as the European Chips Act and funding for clean tech through the Temporary Crisis and Transition Framework, rely on national funding. While they have to be part of a common European framework, individual projects are chosen via opaque processes by EU countries based on (sometimes competing) national interests. Project selection should rather be based on more thorough, transparent methodologies (Poitiers and Weil, 2022).

Internationalising industrial policy provides a very promising avenue to increasing the security of supply while simultaneously minimising protectionism, though international policy coordination will be challenging. Variations of this approach include critical raw materials (CRM) 'clubs' and the establishment of clean-tech partnerships to leverage different countries' relative comparative advantages, as proposed by García-Herrero *et al* (2023).

Beyond growing domestic production, technology security measures (such as export controls or outbound investment screening) to prevent diffusion in the aforementioned key sectors at risk of complexity-driven monopolisation, must also be complemented by policies that reinforce and strengthen existing advantages, through support for R&D, skilled immigration and via bespoke industrial policies.

In addition, policymakers must be aware of the risk of reciprocity in these measures (as was the case with China in 2023[56]) and should therefore be judicious in their application.

In sum, there may be cases in which the risks associated with supply disruption warrant application of industrial policy to promote alternative supply chains, either in the EU or in other countries, or the imposition of technology security measures.

However, policymakers should not pretend that this is a cost-free approach, and need to weigh losing the gains from trade against the potential welfare losses from supply chain disruptions. If they opt for industrial policy, how exactly they choose to design this approach, in particular to minimise any protectionist elements, is critically important.

6.4 Ex-post instruments

While some goods and industries are of such strategic importance that they warrant state intervention, as discussed above, it would be prohibitively expensive to do so for all smaller industries that are exposed to economic security risks (think for instance again of the artificial flower industry identified by Mejean and Rousseaux, 2024).

Therefore, ex-ante policies alone will not suffice. Ex-post policies can help deter targeted attacks against such industries and can soften their impact when they do occur. The first instrument in this regard is the Internal Market Emergency and Resilience Act.

In cases of severe supply chain disruptions or the risk thereof, this law allows the EU to impose reporting obligations and build-up strategic stockpiles and, in case of crisis, it lists the potential ways in which the EU can intervene in supply chains (Ragonnaud, 2024).

However, the primary ex-post EU instrument to this end is the new Anti-Coercion Instrument (ACI, Regulation (EU) 2023/2675), a wide- ranging trade defence instrument intended to be applied in retaliation in cases of economic coercion against an EU country. To quote the Commission, *"the primary objective of the ACI is deterrence"*[57], and it will therefore be considered a success if it is never used. However, if triggered, the retaliatory measure could apply in virtually all areas of economic policy.

This instrument should be complemented with another instrument that helps share the burden of economic coercion. This would entail providing affected firms with financial and perhaps logistical support to enable them to find new markets for their exports or imports.

The logic behind supporting firms is twofold: it removes the ability of adversaries to target groups and inflict political damage on European countries, which they could try to leverage to change policy, and it supports firms that will likely have suffered a serious shock to their business model through no fault of their own.

While in most cases the economic damage from economic coercion will be small enough that national government could finance support for affected workers and firms, there would be several benefits from setting up an EU-wide tool.

EU solidarity assistance would reinforce the signal that an attack against one country is an attack against all and would disincentivise divide-and-rule strategies on the part of third countries[58].

It would also potentially allow firms in other countries that are indirectly affected by the coercive measures (eg. German firms that export to China but use Lithuanian components, in the case of sanctions against Lithuania) to be supported without the need for new state-aid schemes to be approved in each country.

Such a measure to fortify the joint EU response will become more important as other European countries, such as Czechia, pursue foreign policy akin to that of Lithuania (McVicar, 2023).

The challenge of this proposed instrument is that it introduces the potential for moral hazard. If firms believe that the EU will bail them out in the event of supply chain disruption, they may choose to deepen their exposure to geopolitical risks, rather than diversifying, increasing their potential exposure to economic coercion.

Similarly, countries themselves could feel emboldened to pursue foreign policy beyond the EU consensus, safe in the knowledge that their firms will be supported by other member states[59].

Therefore, any new ex-post instrument should be accompanied by new incentives for companies to diversify their supply chains and customer bases to limit potential abuse through moral hazard, as well as further progress on common foreign policy.

Part of this could be accomplished through the nature of the support itself. For instance, limiting support to capped, concessional loans with strict terms of use would reduce any perverse incentives to double down on critical imports from China.

Eligibility requirements should also be used to minimise these risks: receiving state aid could be made conditional on previously having fulfilled certain reporting obligations, having conducted risks assessments ('supply chain stress testing') or on companies insuring themselves against certain economic security risks in private markets[60].

There could be some symbiosis with the supply chain monitoring detailed previously, with firms operating in dependent sectors required to demonstrate diversification efforts before being deemed eligible for support, for example.

Overall, there is a need to strike a balance in both the nature of the instrument and the eligibility: too generous and lenient and there is the risk of moral hazard; too frugal and restrictive and the instrument could become pointless, unable to adequately support those negatively impacted and therefore failing to negate the political pressure points[61].

For the success of both the deterrence value of the ACI and any EU-wide support scheme, a common or at least strongly coordinated foreign policy is a prerequisite. All EU countries should have to underwrite the potential backlash against a forceful application of the ACI and be willing to pay for EU assistance for affected companies, even if they did not necessarily agree with the action that provoked the coercion in question.

As detailed in Hackenbroich *et al* (2022), when considering their responses, countries must weigh up both the underlying policy and the value of preserving EU solidarity and unity against coercion, which will likely be successful if it succeeds in dividing member states.

With Lithuania, this was not the case, as other EU countries appeared unwilling to pay a price for a foreign policy action taken by Lithuania alone. Despite public proclamations of outrage by other EU countries, there was neither material support nor immediate retaliation against China for what even the Commission described as 'discriminatory trade measures'[62].

In contrast to the US, which promised a $600 million export credit agreement to Lithuania[63], and Taiwan, which established both a loan and investment fund focused on Central and Eastern Europe of approximately €190 million and €1 billion respectively[64], the only response from the EU was to allow Lithuania to provide state aid from its own finances (Box 2) and to file a complaint to the WTO[65].

This failed to send a message of European unity, nor did it create a precedent that could serve as deterrence against future economic coercion.

Therefore, it is unlikely that any additional support scheme could be introduced in the absence of further progress on aligning foreign policy.

7 Conclusion

The rise in global geopolitical tensions has coincided with deeper economic integration of EU and non-democratic countries, and an increase in the market concentration of EU imports. While the EU benefits from this trade in many ways, the links have also created economic security risks beyond traditional trade wars.

To counter these risks, the EU should invest in a deeper understanding of its supply chains and pursue targeted industrial policies in a small number of carefully selected industries of strategic importance.

However, the depth of exposure to economic coercion and other shocks stems from structurally more concentrated imports and exports. Unless the EU manages to diversify its trading relationships, many products will remain exposed.

While it is difficult to inflict macroeconomically-relevant harm through economic coercion alone, there are many products over which pressure could be applied on politically important constituencies.

Therefore, the EU should invest in ex-post policies that mitigate economic harm where it occurs. Such policies, taken together with deterrence through the threat of defensive measures under the ACI, would disincentivise the use of economic coercion against the EU.

However, for ex-post policies to be effective, a more common foreign policy is necessary, as otherwise common burden-sharing and unified responses are not credible. ■

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Endnotes

1. Jean Pisani-Ferry, 'The Geopolitical Conquest of Economics', Project Syndicate, 30 September 2021.

2. For a discussion see Hillman (2022).

3. The G7 wants "coordinate our approach to economic resilience and economic security that is based on diversifying and deepening partnerships and de-risking, not de-coupling". See G7 Hiroshima Leaders' Communiqué of 20 May 2023.

4. "Many of you have heard the term 'small yard, high fence' when it comes to protecting critical technologies. The concept has been citied at think tanks and universities and conferences for years. We are now implementing it." Remarks by National Security Advisor Jake Sullivan on the Biden-Harris Administration's National Security Strategy on 13 October 2022.

5. We focus predominantly on China because of the documented potential exposure of EU firms to Chinese shocks; see for instance the survey results reported in Attinasi et al (2023). See Box 1 for a discussion of the US.

6. Given the potential for technological advantages to give monopolistic powers to semiconductor firms, coupled with the immense capacity for economic coercion in this sector, we believe that the 2023 export controls introduced by the Netherlands on advanced semiconductor manufacturing equipment are one of the very few instances in which technological defence measures can be justified by economic security arguments; for an English translation of the justification given by the Dutch government, see: https://csis-website-prod.s3.amazonaws.com/s3fs-public/2023-07/230721_CSISTranslations_Dutch_Export.pdf.

7. Article XXI of the General Agreement on Tariffs and Trade.

8. J Brunsden, S Fleming, A Williams and J Politi, 'EU and US end Airbus-Boeing trade dispute after 17 years', Financial Times, 15 June 2021.

9. See European Commission Questions and Answers of 10 July 2023, 'EU-US Data Privacy Framework'.

10. See https://commission.europa.eu/strategy-and-policy/priorities-2019-2024/stronger-europe-world/eu-us-trade-and-technology-council_en.

11. See The White House, 'G7 Leaders' Statement on Economic Resilience and Economic Security', 20 May 2023.

12. See The White House, 'Joint Statement by President Biden and President von der Leyen', 10 March 2023.
13. See European Commission, 'Speech by President von der Leyen on EU-China relations to the Mercator Institute for China Studies and the European Policy Centre', 30 March 2023.
14. See The White House, 'FACT SHEET: CHIPS and Science Act Will Lower Costs, Create Jobs, Strengthen Supply Chains, and Counter China', 9 August 2022.
15. "It's important to recognize this is a national security action, not an economic one … This executive order protects our national security interests … Again, I want to be clear: This is a national security action, not an economic one." The White House, 'Background Press Call by Senior Administration Officials Previewing Executive Order on Addressing U.S. Investments in Certain National Security Technologies and Products in Countries of Concern', 10 August 2023.
16. See European Commission press release of 10 September 2019, 'The von der Leyen Commission: for a Union that strives for more'.
17. See German Association of the Automotive Industry, https://www.vda.de/en/news/facts-and-figures/annual-figures/exports.
18. "Beijing frequently restricts trade by targeting imports of agricultural goods or commodities. Only on rare occasions has it employed or threatened to employ export restrictions, as was the case with rare earths to Japan in 2010" (Adachi et al 2022).
19. See Lim and Ferguson (2019) for a discussion of the use of boycotts by China during the dispute with South Korea regarding the THADD missile defence programme.
20. The Economist, 'How rare-gas supply adapted to Russia's war', 30 March 2023.
21. Some analysis has also pointed to Australia deciding to exclude Huawei from 5G infrastructure as a cause for the Chinese response; see Hackenbroich et al (2022).
22. The justifications given for these different de-facto import embargoes were both imaginative and spurious. For instance, mandatory testing for traces of heavy metal was introduced for the import of crustaceans, with the testing period long enough that live lobster exports could not survive the process (Buckland et al 2023).

23. The value of Australian exports to China did grow slightly over this period, because of an increase in the price of iron ores, a key input into the Chinese economy and overwhelmingly the largest component of Australian exports to China- averaging over 50 percent of monthly bilateral exports in 2019.
24. As detailed by Urden (2023b): "China started buying coal from Indonesia, which then cut its sales to India and elsewhere. India boosted its purchases of Australian coal that had previously gone to China". Japan and Korea also massively increased their purchases of Australian coal over this period. This also coincided with energy shortages following the Russian invasion of Ukraine, which meant that coal prices increased significantly.
25. See Casey Hall and Xiaoyu Yin, 'China's wine market ready to welcome likely return of Aussie wine as ties improve', Reuters, 3 November 2023.
26. Reports estimate it at two billion litres, see for example Rabobank news release, '"Swimming in wine" – navigating oversupply in Australia's wine industry'.
27. UN Comtrade data shows that Australian wine imports actually increased steadily each year between 2019 and 2022, which seems to suggest limits on the wine industries' ability to diversify into the domestic market.
28. For instance, in May 2021, Lithuania became the first country to withdraw from the China-CEEC initiative.
29. The standard practice to avoid Chinese disapproval has been to allow institutions that represent the city of Taipei, not Taiwan. For more details on the actions undertaken by Lithuania, see Andrijuaskas (2022).
30. See Foreign Minister Gabrielius Landsbergis' comments in Milda Seputyte and Natalia Drozdiak, 'Lithuania Says Businesses Remain Wary on China Trade', Bloomberg, 28 November 2023.
31. Dominique Patton and Andrias Sytas, 'China suspends Lithuanian beef, dairy, beer imports as Taiwan row grows', Reuters, 10 February 2022.
32. The decrease in Lithuanian imports and exports visible from late 2022 onwards was accounted for largely by the economic slowdown in trading partners and was unrelated to the Chinese actions.
33. This is unsurprising given the well-documented dominance of China in this supply chain.
34. The experiences also match those of South Korea during the THAAD dispute of 2016-17 (Lim and Ferguson, 2019).

35. Gabija Sabaliauskaitė, '„Invega“ stabdo paskolas nukentėjusiems nuo Kinijos veiksmų: iš 130 mln. Eur paskolų suteikta už 3 mln. Eur', Verslo žinios, 6 February 2022.
36. We focus on individual goods categories rather than market values, as harm to an individual industry might come even from a low value if an indispensable import is affected.
37. See Mejean and Rousseaux (2024) for both a more detailed discussion of how to identify dependencies and a more comprehensive data exercise.
38. For a discussion, see Le Mouel and Poitiers (2023).
39. Mai Nguyen and Eric Onstad, 'China's rare earths dominance in focus after it limits germanium and gallium exports', Reuters, 21 December 2023.
40. For a discussion of the role of security concerns with regards to the US, see Box 1.
41. Due to capacity constraints, we do not consider here general policy measures to improve the single market, even if these measures could improve the competitiveness of European firms, thus likely contributing to the economic security of the EU. For a discussion on these measures, see Kleimann et al (2023).
42. Some have attempted to argue that potentially losing current comparative advantages in critical technologies constitute a threat to economic security, given that it may result in future import dependencies. In our view, this is currently too many degrees removed to fall under economic security concerns.
43. As discussed previously, there are some rare instances involving technology-induced monopoly that legitimise the use of technology security tools to maintain economic security.
44. See Sultan et al (2023), for example.
45. Formerly called the Single Market Emergency Instrument (SMEI).
46. See European Commission, 'European Chips Act: Monitoring and crisis response', undated.
47. If intra-EU trade is also included, the average of EU countries' exports covered by reciprocal PTAs was 81 percent.
48. For more information on the Advanced Framework Agreement and Interim Trade Agreement, see European Commission press release of 13 December 2023, 'EU and Chile sign modern and ambitious trade and political agreements'.

49. Negotiations between the EU and the Mercosur states on a deal began in 2000 and only concluded with an agreement in June 2019. Five years later, EU ratification is still awaited. The October 2023 breakdown in EU-Australian trade agreement negotiations also fails to bode well for the prospect of new deals on the horizon.
50. Article 5 of Regulation (EU) 2021/947 establishing the Neighbourhood, Development and International Cooperation Instrument (NDICI, the EU's primary international development tool) states that the EU should "seek to promote increased synergies and complementarities" between trade policy and sustainable development". See https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX%3A32021R0947.
51. European Commission press release of 26 October 2023, 'Global Gateway: EU signs strategic partnerships on critical raw materials value chains with DRC and Zambia and advances cooperation with US and other key partners to develop the "Lobito Corridor"'.
52. The Commission has raised concerns that national ECAs "do not follow overarching EU interest and policies… and can be also in competition with one another" (European Commission 2023b, p.7). It also argued that better coordination between national ECAs and EU and national development finance agencies could lead to better outcomes across a range of policy areas, including the sourcing of CRMs and "the trade aspects of EU geopolitical strategies" (European Commission, 2023b, p. 39).
53. Source: Flash Eurobarometer 537 (2023); Firms would likely be more aware of their local branches of the EEN, such as national export promotion offices.
54. Gabriella Beaumont-Smith, 'Rock-a-Bye Trade Restrictions on Baby Formula', Cato at Liberty, 10 May 2022.
55. This already at a time when concerns are growing over single market fragmentation due to the relaxing of state aid rules following Russia's invasion of Ukraine; see Théo Bourgery-Gonse, 'EU subsidy race is on – and Germany is winning it', Euractiv, 12 September 2023.
56. See Reuters, 'China export curbs choke off shipments of gallium, germanium for second month', 20 October 2023.
57. European Commission, 'Questions & Answers regarding the Anti-Coercion Instrument', undated.

58. This was a feature of Chinese measures against Lithuania, as it sought to pressure German industry to intervene. See for instance Andrius Sytas and John O'Donnell, 'German big business piles pressure on Lithuania in China row', Reuters, 21 January 2022.
59. This same moral hazard applies to the ACI, as discussed in Hackenbroich et al (2022).
60. To reduce the administrative burden, we would propose limiting these additional requirements to larger firms, with SMEs covered regardless.
61. The lack of uptake of the Lithuanian support scheme warrants consideration.
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Why Europe must safeguard its global currency status

Amid geopolitical shifts Piero Cipollone argues Europe needs to further develop the infrastructure for making crossborder payments in euro with key partners

For the last quarter of a century, the euro has been a key global currency, second only to the dollar. It has demonstrated its resilience despite the coronavirus pandemic, Russia's war in Ukraine and the tragic conflict in the Middle East. The euro's estimated share of international currency use stands at over 19 per cent, a level that has remained broadly stable over the past five years.

Nevertheless, the currency's place on the global stage cannot be taken for granted, as a recent report by the European Central Bank on the international role of the euro shows. More reforms are needed.

China's increasingly large role in global trade is encouraging use of its currency. By 2023, the renminbi's share of China's trade invoicing had risen to around one-quarter for goods and one-third for services. It is racing with the euro to become the second most used currency for trade finance[1].

History shows that the evolution of global currencies is deeply intertwined with that of the global geopolitical order. In an increasingly multipolar world, there are signs that the fragmentation of the global monetary system is no longer a remote possibility.

To diversify and protect against geopolitical risks, central banks — led by China's — are accumulating gold at the fastest pace seen since the second world war. And anecdotal evidence suggests that some countries are exploring ways of using their own currencies more in international trade transactions instead of those of countries sanctioning Russia.

Yet nowhere else are the risks of global monetary system fragmentation more visible than in international payments. At a time when we should be integrating payment systems to reduce their complexity and cost to users, some nations are deliberately creating separate platforms as alternatives to existing global infrastructures.

For example, China, Iran and Russia have created their own crossborder payment messaging systems, while BRICS members have started to discuss a 'bridge' platform for linking digital payments and settlement. These developments could potentially disrupt the smooth flow of capital and reduce the efficiency of the global financial system.

Given these shifts, there are compelling economic and political reasons for seeking to preserve the euro's global currency status. This status brings tangible benefits to European citizens, such as low borrowing costs in international capital markets and protection from exchange rate volatility.

By bolstering safety, liquidity and connectivity, we can ensure that the euro continues to strengthen as a cornerstone of the global monetary system

Moreover, in a fragmented geopolitical landscape, the euro's international currency status provides strategic autonomy by shielding Europeans from external financial pressures.

Internally, the euro's appeal to foreign investors hinges on maintaining confidence in its stability, supported by well-anchored expectations of price stability and sound economic policies. And its appeal depends on the size and liquidity of the market for safe euro-denominated debt securities and the resilience of the underlying market infrastructures, particularly as a haven in times of stress.

A majority of official reserve managers have expressed an interest in increasing their euro holdings but note that the currency's attractiveness is hampered by a lack of highly-rated assets and centrally-issued debt[2].

So building a stable, technically resilient, and deeper market for internationally accepted euro debt securities is essential. To be a reliable haven in times of stress, this market could be supported by a robust and flexible supply of common instruments[3].

Providing a broader pool of euro-denominated safe assets, which would act as a European risk-free benchmark, would also be crucial to deepening euro-denominated capital markets. That is why building a genuine European capital markets union must go hand in hand with efforts to further strengthen the fiscal dimension of the EU economic and monetary union.

Externally, Europe needs to further develop the infrastructure for making crossborder payments in euro with key partners. This could, for example, involve interlinking the euro area's Target Instant Payment Settlement system with fast payment systems in other jurisdictions, either through bilateral links or by connecting to a common, multilateral platform.

Such steps could strengthen the trade and financial relations with key partners, including emerging economies, especially where legislation on combatting money laundering and terrorist financing is fully aligned with the international standards established by the Financial Action Task Force. They could also pave the way for central bank digital currencies to be used to make crossborder payments in the future.

Robert Mundell — the late international economist whose Nobel Prize-winning work was so influential for the creation of Europe's single currency — once said of the euro: *"In all the aspects in which it was expected economically to make an improvement, it has performed spectacularly."*[4]

By bolstering safety, liquidity and connectivity, we can ensure that the euro continues to strengthen as a cornerstone of the global monetary system. ■

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How to de-risk

How should the EU 'de-risk' its external economic relationships without foregoing the benefits of trade? Jean Pisani-Ferry, Beatrice Weder di Mauro and Jeromin Zettelmeyer discuss

Executive summary

Pandemic-related supply disruptions, the energy crisis provoked by Russia's invasion of Ukraine and economic coercion by China have put economic security high on the European Union policy agenda. The question is how exactly the EU should 'de-risk' its external economic relationships without foregoing the benefits of trade. The standard answer is that it should identify product-level trade dependencies, mainly on the import side, and reduce them, mainly through diversification of suppliers, while otherwise maintaining maximum trade integration.

This Policy Brief argues that this answer falls short. First, product-level dependencies cannot be identified reliably even with sophisticated analysis and data. As a result, both 'missed dependencies' and 'false positives' are inevitable. Second, external shocks and coercion could be propagated through exports, productive assets held abroad and financial channels as much as through imports.

The analysis has five main implications:

1. Import de-risking should focus on a few product categories for which the costs of supply interruptions would be unquestionably large. This reduces false positives.

2. De-risking and/or buffers to deal with exports and financial coercion require more attention.

3. De-risking must be complemented by raising resilience against all shocks, whatever their origin. This requires a deeper and broader European single market.

4. De-risking and resilience must be complemented by deterrence.

5. A sufficiently high probability of chronic trade conflict – or one very large conflict – may justify reducing overall integration with a large trading partner, on both the export and import sides.

EU economic security policies have been right to emphasise the reduction of import dependence on chips and critical raw materials, and the creation of a powerful legal instrument to deter coercion (the Anti-Coercion Instrument). In most other respects, there is room for improvement.

Economic risks relate increasingly not just to crises or shocks, but to deliberate economic coercion by foreign governments

1 Introduction

Over a period of just fifteen years, Europe has been confronted with a financial shock that originated in the United States, a pandemic shock that originated in China but could have come from anywhere, and an energy shock provoked by Russia's invasion of Ukraine. These events have prompted a re-examination of efficiency/security trade-offs that arise as a result of international integration, and particularly as a result of specialisation in international trade and the vulnerabilities of global supply chains.

Economists and policymakers have long worried about similar trade-offs. At the most fundamental level, such trade-offs arise from the standard tension between growth and economic crises: higher growth is often accompanied by greater instability. For example, regulation of financial and product markets may prevent or mitigate financial or environmental hazards at the cost of dampening entry and growth of firms. Similarly, in open economies, trade and financial integration may be good for growth, but can expose economies to imported shocks.

The most recent set of concerns – as exemplified, for example, by a series of European Commission (2021, 2022) papers and an associated legislative agenda (see section 4, and McCaffrey and Poitiers, 2024) – differs from these standard preoccupations in two respects.

First, economic risks relate increasingly not just to crises or shocks, but to deliberate economic coercion by foreign governments or even non-governmental entities (such as criminal groups). This is probably the reason why the term 'security' – as opposed to 'stability' or 'resilience' – has become popular to describe the mitigation of economic, rather than just national security threats (we discuss the difference in section 2).

One reason to be concerned with economic coercion is that China, an increasingly powerful and authoritarian country, has been applying coercion regularly in response to political actions by trade partners (for example,

Australia's call for investigations into the origin of the COVID-19 pandemic and Lithuania's decision to let Taiwan open a representative office in Vilnius[1]).

But the concern is not just about China: the policies of President Trump between 2017 and 2020 showed that even one's closest ally can be tempted to leverage its market power and its control of the technical and financial infrastructures of globalisation. The possibility of a second Trump term is now prompting a reflection on the need for Europe to prepare for such a risk (Gonzales Laya *et al* 2024).

Second, recent concerns have focused mostly on trade-related rather than financial vulnerabilities. This reflects the fact that trade-related vulnerabilities have become more prominent as a result of specialisation and the vulnerability of global supply chains that maximise efficiency, but at the cost of creating hidden fragilities.

But the prominence of trade concerns may also reflect a rather myopic reasoning, as the last two or three external shocks that Europe (and, to a lesser extent, the US) has suffered have been trade-related: supply chain disruptions related to COVID-19 and energy price shocks following the Russian invasion of Ukraine.

In line with this concern, we focus mostly on trade-related external economic security. This should not be taken to imply that Europe does not need to worry about financial security. But unlike trade-related security, financial risks continue to be mostly of the financial-stability variety, linked to shocks and financial vulnerabilities rather than coercion. To the extent that financial coercion is a serious concern, it is linked to one main potential source: the United States if President Trump returns (see section 2). In contrast, trade-related external security risks are ubiquitous.

In this Policy Brief we seek to answer two critical questions. First, how should trade-related vulnerabilities be identified, and what trade relationships make Europe particularly vulnerable to shocks and coercion? Second,

how can these vulnerabilities be reduced while minimising the costs of 'de-risking' and reducing the chances of unintended consequences? Four such potential costs come to mind:

- Foregoing some of the gains from trade specialisation and trade openness. This could weigh on European growth and competitiveness, which depend on export specialisation and on importing raw materials and intermediate inputs more cheaply than they could be produced at home (if at all). It could also make it harder to attain emission reduction objectives, by raising the cost of the transition to renewable energy sources. In turn, this could exacerbate social and political divisions related to climate action.

- Becoming more vulnerable to domestic shocks including natural disasters, epidemics and home-grown financial crises – and more generally, to any shock whose consequences would be mitigated by international trade and/or capital flows.

- Damaging international cooperation. This could include European Union cooperation with China on vital matters of common interest, such as climate-change mitigation, as well as respect for the rules of the multilateral trading system. Notwithstanding the damage that the World Trade Organization has suffered over the last decade, these rules continue to be largely respected (Mavroidis and Sapir, 2024).

  An aggressive 'de-risking' of European trade relationships through trade policy tools and subsidies could trigger protectionist reactions from trading partners, particularly if measures violate WTO rules. It could also become an excuse for protectionists in the EU, who might use economic-security arguments to further special interests.

- Damaging cohesion within the EU. EU countries differ in their trade structures and their dependence on specific export and import markets. As a result, attempts to de-risk trade may have net benefits for some

and net costs for others. If de-risking becomes a source of division, it may be counterproductive, as internal divisions in the EU are partly what an adversary – whether China, Russia or President Trump – might try to exploit (and indeed, divisions are what these three powers have tried to exploit in the past).

The remainder of this paper summarises as best we can the answers to these questions, drawing on a set of papers collected in Pisani-Ferry *et al* (2024). Section 2 defines what we mean by economic security, and what risks we should be worrying about. Section 3 discusses how these risks should be addressed in principle. What trade relationships require de-risking? Section 4 discusses the instruments. How can protection be built that preserves the benefits of trade? A concluding section summarises the main lessons.

2 Defining risks to economic security

As noted by Bown (2024), economic security remains an emerging concept. At its most abstract level, it can be defined as both preventing bad economic outcomes and making sure that should risks materialise, the damage they cause is minimised. Societies care both about raising expected welfare and about reducing its volatility. Economic security is concerned with the latter.

Defined in this broad way, economic security has been a standard concern of policy- makers for centuries – and not just of economic policymakers, since economic harm can be inflicted by 'non-economic' shocks, including political disruption and wars. The use of state intervention to address these concerns, including industrial policy and trade policy, is similarly nothing new (Kelly and O'Rourke, 2024).

The question, then, is how the concept of 'economic security' differs from those of 'economic crisis prevention' or 'national security'. To the extent that the perceived nature of the risk and risk propagation has changed, it is important to understand how it has changed, to avoid duplication, and to prevent overreaction to perceived new risks when the old risks and risk propagation channels might still be there.

Economists concerned with crisis prevention and mitigation typically focus on risks and vulnerabilities related to the financial system or the structure of production. For example, credit cycles can expose countries to financial crises, which are propagated internationally. Dependence on commodity exports or imports exposes economies to swings in international prices and to disruption to domestic production that relies on commodity imports.

Military and security experts worry about a different type of threat: harm that is inflicted purposely by outside actors, normally nation states, but also terrorist or criminal organisations. Murphy and Topel (2013) widened the definition of national security to include all 'substantial threats' to the safety and welfare of a nation's citizens, eg. including national catastrophes and public health threats.

Defined this broadly, national security would include preparedness and mitigation against any harmful acts conducted by foreign governments or non-governmental organisations with military or non-military means, including economic sanctions, and threats related to physical and information infrastructure.

The recent usage of the term 'economic security' is at the intersection of non-financial economic crises and national security in the broad sense defined by Murphy and Topel[2]. Specifically, it focuses on harm inflicted through international economic relationships – and particularly trade relationships – whether these reflect exogenous shocks (such as COVID-19-related trade disruption) or deliberate actions by foreign governments or non-governmental organisations (Bown, 2024; McCaffrey and Poitiers, 2024; European Commission, 2021, 2022).

These risks are particularly relevant today because of the combination of economic integration through trade and FDI, specialisation, long supply chains and actors willing to engage in coercion through these channels.

It is in this sense that the term 'economic security' will be used in the remainder of this paper. In this definition, achieving economic security involves the prevention and mitigation of:

- Disruption to critical imports, whether accidental or deliberate;

- Economic coercion through restrictions or boycotts on specific exports, along the lines of actions taken by China against Australia; or through pressures on foreign companies even when they produce locally (for example, threats of depriving them from access to the domestic market, restrictions on profit repatriation, or expropriation);

- A broad disruption of global trade at a scale with macroeconomic impact, for example, as a result of geopolitical conflict leading to economic sanctions or a protracted tariff war with a major trading partner. Events that could trigger such scenarios include a Chinese attack on Taiwan, or the re-election of President Trump triggering a sharp deterioration of the political relationship between the US and the EU.

It is important to emphasise that this a narrow – perhaps inappropriately narrow – definition of economic security, for two reasons. First, it disregards the possibility of economic disruptions as a result of domestic shocks, which historically have been a major source of economic crises (Table 1).

Hence, a better term for the type of economic-security risks we discuss would be 'external economic security'. This terminology reminds us that there could be trade-offs not just between economic security and economic growth, but also between external economic security and security from domestic shocks. International integration may increase exposure to the former but offers protection against the latter.

Table 1. Varieties of welfare threats and propagation mechanisms

		Origin		
		Domestic shock	External shock	Deliberate action
Propagation	Trade and investment	Economic	External economic crises	security risks
	Financial			National
	Disease	Epidemics/pandemics		security risks
	Military			
	Other			

Note: The columns in Table 1 define the origin of a bad event – an exogenous shock originating at home or abroad (pro- duction disruption, natural catastrophe, transportation or infrastructure disruption, confidence shock) or a deliberate action by a foreign government or a non-governmental entity. The rows define the propagation channel: economic activity related to trade or finance, disease, military action or other (for example, through IT infrastructure).
Source: Bruegel.

Second, the narrow definition largely ignores external economic security risks through financial channels. However, international finance – including the international payments system and the confiscation of financial assets located in foreign jurisdictions – is an obvious instrument of economic coercion and economic sanctions, as shown by G7 sanctions against Russia since its full-scale invasion of Ukraine.

The main reason why financial risks do not feature prominently in the recent literature on European economic security is that Europe is much less likely to be on the receiving end of such sanctions, given the control exerted by the US and its allies over international finance.

But this could rapidly change if President Trump is re-elected in the United States and decides to use financial coercion against Europe for whatever reason (for example, to force Europe to align its foreign or commercial policies with those of the United States, as was the case when the US threatened EU firms with 'secondary sanctions' for violating US-imposed sanctions on Iran).

A broader analysis of European economic security should take into account such financial economic risks and how to mitigate them. For now, the remainder of this paper focuses on trade and investment-related risks.

These are particularly relevant for the relationship with China, but could also become relevant in the event of a return of President Trump and a revival of US tariffs against Europe, whether imposed for mercantilist or political reasons.

3 What to de-risk

Firms have incentives to avoid becoming dependent on one or a small number of suppliers or customers, particularly when those suppliers or customers are vulnerable to high risks out- side their control, including politically motivated interference.

Yet, as Mejean and Rousseaux (2024) have pointed out, the firms' private interest in security may not be enough to take care of the collective EU security interest. Firms often fail to realise the extent to which suppliers or customers are themselves subject to risks, simply because they do not know the entire value chain.

Firms also do not internalise the potential costs of supplier or customer dependency on the entire value chain, and ultimately the welfare of citizens. If a supplier relationship rep- resents a critical link in that chain, the social costs of that link failing may far exceed the private costs to the firm. This argument, which is broadly consistent with the evidence presented by Bown (2024), can justify policy-led de-risking.

But what areas of trade require de-risking? How can policymakers tell when trade dependencies are excessive, in the sense that the economic security risks of trade outweigh its benefits, both for efficiency and growth and as protection against domestic disruption? The ideal way to answer this question would be through a firm-level model of trade and supply relationships, both across borders and within the EU.

The model would 'know' who trades with whom, how specific inputs enter each stage of production, and to whom firms sell. It would also have information about the ease of switching suppliers if a supplier fails or sharply raises its prices. Such a model could be used to stress test European economies in relation to specific supply chain or customer risks.

Where large effects are found, it would be used to identify trading relationships worth de-risking. Unfortunately, such a model does not exist and may never exist because of data limitations. We are therefore constrained by the available information and should make the best of it.

3.1 Critical goods and the risk of import disruption

Suppose we were mainly interested in risks related to import disruption. This would be the case if exports are either well diversified or go mainly to countries that one would not consider to be major sources of shocks.

In that case, the following approach might be a close substitute for the perfect model. Using the most disaggregated data possible, one should identify products for which:

1. A large share of EU consumption relies on imported inputs;

2. Foreign supply of these goods is highly concentrated;

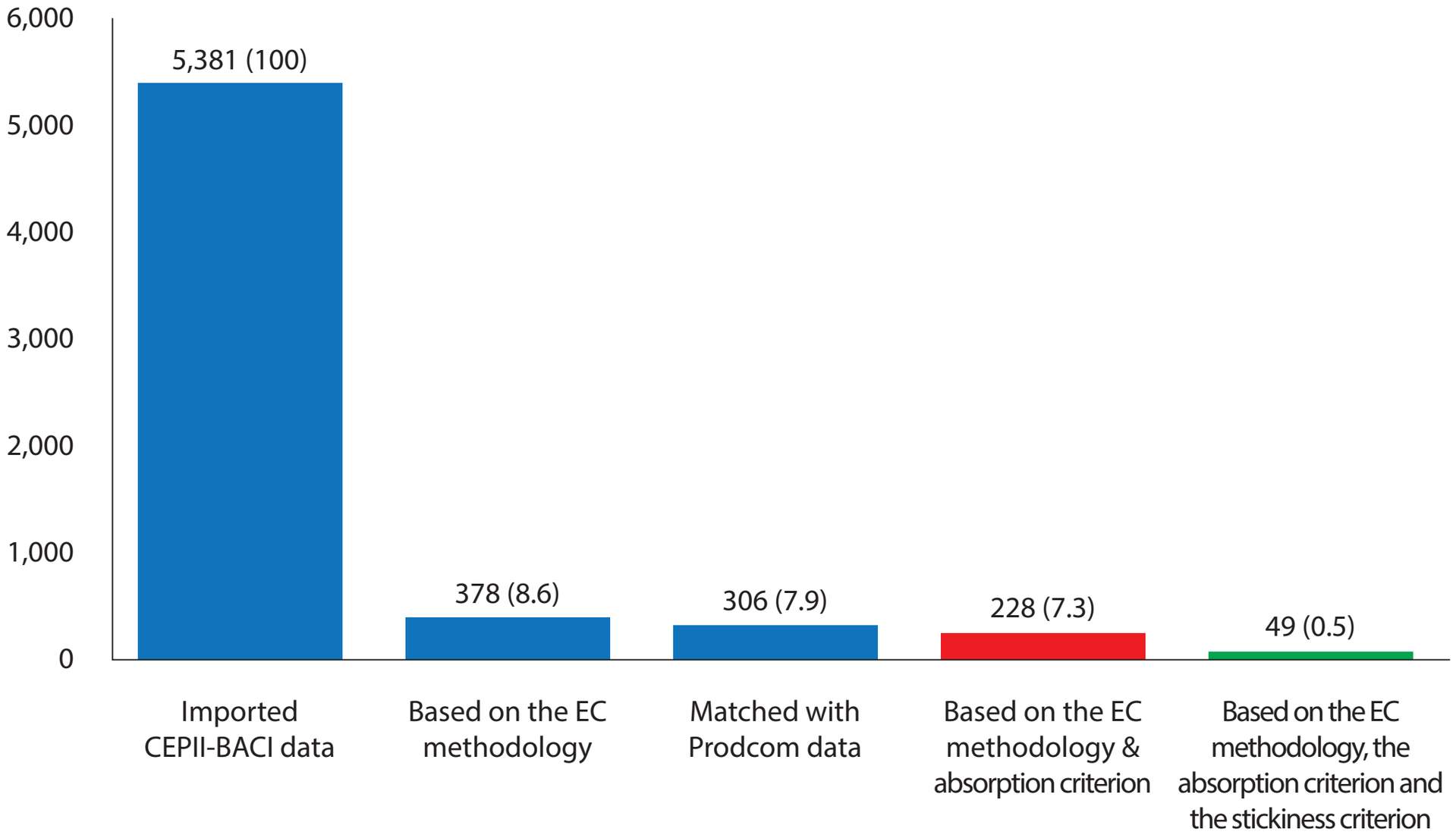
3. Finding alternative suppliers in the event of a disruption is difficult, and

4. Disruption to supply would have high economic costs. Unlike criterion 3, this criterion reflects the substitutability of products in either consumption or production, as opposed to the substitutability of supplier relationships.

Products that meet all four criteria would be prime candidates for de-risking. This approach, which builds on work undertaken by the European Commission (2021), approximately describes the approach taken in Mejean and Rousseaux (2024). Their main innovation relative to the work of the Commission and other authors is step 3, which they implement by eliminating products for which 'relationship stickiness' – the typical duration of firm-supplier relationships – drops below a specific threshold.

For example, if the stickiness threshold is set at the sample median, the number of products for which the EU should consider itself import-dependent drops from 378 to just 105, and to just 49 if the 75 percent least relationship-sticky products are eliminated (Figure 1). Focusing only on upstream intermediate products – for which an export ban would affect many supply chains and hence have high economic costs – would reduce the list further, to just 21 products. For 12 of these, the main supplier is China.

Figure 1. Number of products for which the EU is import dependent



Note: The figure shows the numbers of products for which the EU is import-dependent according to various methodologies, starting with that of the European Commission (2021) (second blue bar) and adding the criteria proposed by Mejean and Rousseaux, based on the ratio of imports over domestic absorption (red bar) and the degree of product stickiness (green bar). Numbers in brackets refer to percentage of value of EU imports.
Source: Mejean and Rousseaux (2024).

To these, Mejean and Rousseaux (2024) suggested adding a small number of 'critical goods' that, if insufficiently supplied, 'can result in human losses and other severe non-economic consequences'. These would include between two and 19 pharmaceutical products, depending on where the substitutability cut-off is set, as well as inputs to the green transition.

Interestingly, most of these inputs – including most critical raw materials, which have been among the main justifications for the drive to de-risk imports, particularly from China – currently fail one or several of Mejean's and Rousseaux's dependency tests.

While highly relationship-sticky, batteries and their components, hydrogen technologies, rare earth metals and solar panels fail the concentration test, and most components of solar panels fail both the concentration test and the relationship-stickiness test.

Yet, Mejean and Rousseaux urged caution with respect to these products, on the grounds that demand for them is developing so fast that the structure of EU imports during 2015-2019, on which concentration indices and import needs are based, may be a poor proxy for trade dependencies in the future.

Mejean and Rousseaux's work represents the most exhaustive analysis so far to identify dependencies on the basis of ranking critical imports with respect to concentration and relationship substitutability, and deciding on thresholds above or below which concentration is deemed too high or substitutability too low. Precisely because it is more thorough and comprehensive than previous attempts in this literature, Mejean and Rousseaux (2024) illustrates the intrinsic limitations of this approach.

- We have so far no systematic way of telling which imports are genuinely critical. Focusing on upstream products and pharmaceuticals may miss other products (such as computer chips), the accidental scarcity

of which would cause large economic or non-economic losses. Meanwhile, some upstream products and pharmaceuticals might not be critical if they can be substituted by other products.

The European Commission's (2021) approach of designating whole 'ecosystems' (sectors, such as health, energy, digital, electronics and aerospace) as critical, seems even more problematic, both because many products in these sectors are not in fact critical and because products outside these sectors that may well be critical could be missed (for example, most of Mejean and Rousseaux's upstream products).

- As both Mejean and Rousseaux (2024) and Bown (2024) emphasised, data limitations imply that import dependence measures do not reflect indirect exposure. If the EU has an import exposure to a country that is itself import dependent on China for this product (or an important intermediate input), then direct import dependence on China might significantly understate total import dependence.

- The final lists can be very sensitive to how the cut-offs are set, which is somewhat arbitrary. For example, whether relationship substitutability thresholds are set at the twenty-fifth, fiftieth or seventy-fifth percentile adds or subtracts large shares of products from the sample.

- Supplier relationships in normal times tend to be relatively long (25 and 19 months, respectively, for the seventy-fifth and fiftieth percentiles in Mejean and Rousseaux's sample). This implies that unless replacement duration is significantly shorter in a crisis, an import interruption could be very damaging even for products that are relatively non-relationship-sticky in normal times.

  But the impact of a forced interruption on the replacement period could go both ways. Firms seeking to replace suppliers under duress would have incentives to do so much faster than in normal times. However,

finding new suppliers when many other firms are trying to do so could take longer and/or result in price jumps for scarce supplies, which could be very damaging.

3.2 Risk from export disruptions and from decoupling

Another problem is that an approach focused on reducing dependence on critical imports does not consider disruptions to exports, which could equally have a macroeconomic impact if they were highly concentrated in any one destination country.

For example, 20 percent of EU exports got to the US, 13 percent to the United Kingdom and 9 percent to China; while 41 percent of UK exports go to the EU, 21 percent to the US and 5 percent to China. Furthermore, just as import dependency numbers ignore indirect exposures, so do export shares. For example, direct UK export dependency to China is only 5 percent, but the UK's indirect exposure via the EU alone could be larger if UK products are part of the value chains of goods ultimately destined for the Chinese market.

While demand shocks via exports are a standard risk of trade integration, geopolitical conflict can take this risk to an entirely new level. First, hitting the exports of specific industries through import bans, high tariffs or social-media campaigns can be a form of geopolitical coercion. As reported by Bown (2024) and McCaffrey and Poitiers (2024), there are numerous examples of Chinese coercion of this type.

This type of coercion is typically not macroeconomically critical, but may seek to exploit the lobbying power of groups that are hurt, as well as internal divisions (in the case of the EU, this may include divisions across member states). Second, deliberate economic sanctions can of course have a much greater impact than swings in export demand triggered by normal economic fluctuations, or even than an economic crisis in a trading partner.

Baqaee *et al* (2024) simulated the impact of a decoupling from China in a trade model with 43 countries and 56 sectors, in the form of a complete stop in trade between a 'Friends' bloc comprising the G7 countries, Spain, the Netherlands and an artificial country comprising the rest of the EU, and a 'Rivals' bloc including China and Russia, on the assumption that trade continues both within these blocs and with the rest of the world.

As might be expected, the short-term effects are substantial, with German output calculated to decline by 3-5 percent of GDP. At the same time, the simulations suggest that the cost of a complete decoupling from China would be relatively low if done slowly over time: around 1.25 percent of GDP for Germany and Japan, while the US and the remaining European countries would suffer in the range of 0.47 percent to 0.69 percent of GDP.

The intuition behind this result is that the welfare costs of an end to trade integration between China and the 'Friends' group are mitigated by the fact that the Friends continue to trade with each other and with the 'Neutrals', and that these groups are sufficiently large and diverse to preserve most of the gains from trade.

3.3 Putting it all together

Combining the insights of Baqaee *et al* (2024) and Mejean and Rousseaux (2024) with the assumption that external economic risks include not only exogenous shocks to trade but also coercion, and possibly a wider trade disruption involving China, leads to the following conclusions.

First, there is a strong case for de-risking concentrated exposures to critical imports, by either diversifying supply or making preparations to mitigate disruption. However, identifying such products turns out to be very difficult, mainly because it is hard to assess the criticality of products, ie. the welfare losses inflicted by a shortage or price spike. While we know that some products are critical – chips, energy, some pharmaceuticals, some minerals and some upstream inputs – we do not know what other products are critical.

A good way to start is by de-risking the products known to be critical. Because we don't know how long it would take to find new suppliers in a crisis, or how price sensitive these imports might be to a loss of the main supply source, products known to be critical should be de-risked even if their relation- ship stickiness in normal times is fairly low.

The identification of such products obviously needs to take into account the costs as well as the benefits of de-risking. Take the example of solar panels and their components, often cited as a prime de-risking candidate because of their importance in the green transition and China's overwhelming global market share (63 percent, according to Mejean and Rousseaux, 2024).

However, the short-term economic costs to the EU of a complete stop in solar panel imports from China would be tiny (hitting mostly installation services, while leaving the solar capacity unchanged). Unlike imported gas from Russia, disruption to solar panel imports from China would have no direct impact on the energy supply, although it would affect the increase in installed energy capacity and would raise the cost of replacing panels that become obsolete.

Hence, the main benefit of de-risking Chinese solar panel imports would be insuring against a (possible) disruption to the energy transition to renewables, which could sharply raise solar-panel prices. This needs to be weighed against the certain price impact of a decision to diversify away from Chinese solar imports and purchase panels from more expensive sources, which will slow the green transition.

Second, the de-risking of trade dependencies cannot be the only layer of protection against import disruption, because it will never be possible to identify and de-risk all critical products. Beyond trade de-risking, it is hence essential to strengthen the resilience of European economies against import shocks, whatever their source. This is

an argument for a better-functioning and more flexible single market, and for the broadening of international trade relationships through free-trade agreements with friendly countries.

Third, it is important to de-risk export dependencies as well as import dependencies. For specific products, this could be done in three ways: by deterring coercion (as the EU's new anti-coercion instrument, discussed in the next section, attempts to do); by offering EU producers incentives to diversify export destinations, particularly to reduce concentrated exposures to China; and through insurance mechanisms that reduce ex post the impact of export disruptions to specific products.

The latter must of be designed in a way that avoids moral hazard, ie. does not encourage concentrated exposures ex ante. We return to possible instruments for export diversification and ex-post protection in the next section.

Fourth, there is a role for deterring coercion, rather than just reducing vulnerability to it. This is because de-risking of export and import dependencies will never be complete – and should not be complete, given that de-risking needs to be weighed against the benefits of trade specialisation and continuation of trade with China and other countries that may use coercion.

Fifth, there is the question of whether the EU should reduce its overall trade integration with China to soften the blow of sudden trade disruption triggered by a geopolitical confrontation. According to Baqaee *et al* (2024), the cost of a gradual reduction in trade integration with China would be small for most EU countries, even if trade integration is reduced all the way to zero.

Even for Germany, where the cost of complete decoupling from China would not be small, the cost of a partial reduction of trade integration – for example, reducing export and import shares by one third – would be small if

pursued gradually. On this basis, policy measures to encourage a pre-emptive reduction in trade integration would be justified if all three of the following conditions are met:

1. The probability of a very costly sudden trade disruption is considered to be sufficiently high, and

2. Firm-level diversification of trade is not, by itself, sufficient to engineer this pre-emptive de-risking;

3. Targeted (ie. firm- or sector-level) export diversification efforts do not have a substantial impact in terms of reducing aggregate import dependency.

There is significant uncertainty around each of these points. With regard to points two and three, Bown (2024) found that trade diversion triggered by US tariffs on China and Chinese retaliation has further increased EU trade integration with China. With fresh US legislation directed against Chinese imports, such as the Inflation Reduction Act, this effect might continue.

At the same time, the combination of a heightened sense of the risks created by concentrated exposure to China and the structural slowing of the Chinese economy might push in the other direction. Furthermore, targeted de-risking efforts may have an aggregate impact, particularly if they reduce concentrated exposures to China in major sectors for the EU economy, such as the car industry.

Finally, it is important to highlight two trade-related economic-security concerns that are the intellectual cousins of the risks identified and quantified by Baqaee *et al* (2024) and Mejean and Rousseaux (2024), but are not directly discussed in those papers.

The first is the obvious risk, already mentioned in section 2, of a broad disruption to European trade with the United States in the event of a return of Donald Trump to the US presidency[3]. Given the much larger share of US imports and exports in European trade, this could hit Europe even harder than a disruption to trade with China.

While Baqaee *et al* (2024) did not directly simulate such a shock, this is suggested by their 'EU autarky' scenario, which has substantial costs even in the long run, ie. even when phased-in slowly (a permanent consumption loss of 9 percent of GDP). It follows that de-risking the trade relationship with the US by reducing trade integration might makes sense only if an even more catastrophic sudden decoupling from the US is viewed as likely.

However, a disruption to trade with the US would likely take the form of a (limited) tariff war rather than a trade embargo. This argues against a pre-emptive reduction in trade with the US. Instead, the EU must be politically prepared to fight a trade war with the US, if and when a returning President Trump decides to start such a war.

A second related concern is that exposures to China and other countries that might engage in coercion against EU firms could take the form of asset expropriation – in particular, expropriation of production sites. By removing an important source of foreign revenue and profits, this could impact EU firms in much the same way as an import prohibition.

However, the risk would show up ex ante in the form of a concentration of profit sources, rather than concentrated exports, and the remedy could involve diversification of production sites and profit centres, rather than diversification of exports, as along with increases in capital buffers.

Summing up, our analysis results in five main calls for European policy action:

1. Reduce import dependency for critical products;

2. Diversify foreign revenue sources and/or strengthen firm resilience against potential disruption to foreign demand, asset expropriations or payment controls impeding profit repatriation;

3. Deepen the EU single market and make it more flexible;

4. Deter economic coercion of any kind, whether through imports or exports, or through other means such as expropriation;

5. Possibly, limit overall trade dependency (and particularly export dependency) on China, at the aggregate level.

Achieving these objectives requires policies that are effective, that balance costs and benefits, and that minimise risks of unintended consequences. We next examine what such policy might look like concretely, starting with those the European Commission has already started implementing.

4 How to de-risk

As the outbreak of COVID-19 revealed dangerous vulnerabilities and called for a reassessment of the EU's international economic relations, rising pressure from the US under the Trump presidency and the increasingly aggressive behaviour of the Chinese government focused the attention of European policymakers on the threat of economic coercion and prompted a redefinition of the toolkit with which they could respond.

The EU took a series of major initiatives to strengthen its economic resilience and to equip itself to better counter malicious behaviour by economic partners (Box 1).

Box 1. Additions to the European external economic security policy toolkit

The EU has adopted or is discussing a series of new initiatives, which complement standard trade defence instruments[4] (anti-dumping or anti-subsidy duties consistent with the World Trade Organisation Agreement on Subsidies and Countervailing Measures, for which the EU has developed procedures that are in the process of being strengthened):

The Foreign Subsidies Regulation[5] (FSR, in force since July 2023) introduced new tools to tackle foreign subsidies that cause distortions and undermine the level playing field in the areas of mergers and acquisitions and procurement (see Anderson, 2020).

The European Chips Act[6] (in force since September 2023) is intended to bolster Europe's competitiveness and resilience in the semiconductor sector by supporting large-scale manufacturing projects via somewhat more permissible subsidy rules compared to a conventional Important Projects of Common European Interest (IPCEIs, investment projects involving crossborder collaboration and state aid from several EU countries). It also entails measures aimed at mapping and monitoring the semiconductor supply chain to assess ex-ante risks of potential import disruption but also and envisions broader powers for the Commission to act in a crisis, including as common purchasing body (see Poitiers and Weil, 2022).

The Net Zero Industry Act (NZIA)[7] and related parts of the Temporary Crisis and Transition Framework[8] (TCTF) are intended to strengthen the European ecosystem of clean-tech manufacturing. The NZIA includes measures intended to accelerate permitting, while the TCTF allows member states to provide subsidies to clean tech manufacturing projects which can match subsidies of third countries under certain conditions (see Tagliapietra *et al* 2023).

The Critical Raw Materials Act[9] (CRMA) aims to tackle the issue of highly concentrated imports of certain raw materials that are of strategic importance. It seeks to boost domestic mining, refining and recycling of such raw materials through accelerated permitting procedures as well as measures related supply chain monitoring, stockpiling and improving the recyclability of CRMs (see Le Mouel and Poitiers, 2023).

The Health Emergency Preparedness and Response Authority (HERA)[10] that was launched in September 2021 has as part of its mission to improve the resilience and availability of medical supplies. It aims to achieve this mission by identifying key supply chain bottlenecks and addressing them through measures such as coordinated stockpiling and joint procurement.

The Anti-Coercion Instrument (ACI, in force since December 2023) is intended to provide to the EU a wide range of possible countermeasures when a third country exercises coercion. It gives the EU extensive powers to deploy countermeasures in response to an act of foreign coercion, including the imposition of tariffs, restrictions on trade, services and intellectual property rights, and restrictions on access to foreign direct investment and public procurement.

The Internal Market Emergency and Resilience Act[11] (IMERA, formerly Single Market Emergency Instrument, on which agreement was reached between the Parliament and the Council in February 2024) aims at ensuring continued access to critical goods and services. Although primarily intended to respond to COVID-type emergencies, it also covers disruptions to the single market triggered by conflicts, such as the war in Ukraine.

Commission initiatives on inward and outward investment screening and the coordination of export controls were proposed in January 2024. The coordination mechanism for inbound investment screening is in place since 2020, but it mainly commits member states to put an investment screening into place. The 2024 economic security package includes an update of this scheme, but remains vague on the prospect of outbound investment screening.

Limitations notwithstanding, the EU has assembled an impressive package that expresses a change of attitude. Considerable effort has gone into addressing critical import dependencies, giving the European Commission powers to deter coercion (the Anti-Coercion Instrument, application of which must be triggered by a majority in the Council), and preventing a breakdown of the single market in an emergency (Internal Market Emergency and Resilience Act, IMERA). However, these efforts fall well short of meeting the policy objectives listed at the end of section 3.

First, and most obviously, export dependencies have been largely neglected. Aside from the intention to negotiate additional trade agreements with friendly nations, there is no instrument to encourage export diversification and/or reduce concentrated export dependence on China.

Second, instruments to address import dependencies remain imperfect and incomplete:

- While the European Chips Act, Critical Raw Materials Act (CRMA) and Health Emergency Preparedness and Response Authority have plausible economic-security justifications, the Net Zero Industry Act covers a broad swathe of goods that mostly fail to meet the definition of critical good proposed in section 3[12].

  Many other goods that might be critical, such as the upstream products with high import concentration identified by Mejean and Rousseaux (2024), remain outside the scope of any of these acts. There is no framework for identifying goods that may be genuinely critical, but are not part of any of the four identified product categories.

- EU-level instruments to reduce dependency on these goods are for the most part weak. EU-level funding for industrial policy directed at expanding EU capacity is small (Chips Act) or non-existent (CRMA). Trade policy

instruments rely mainly on increasing market or investment access for EU companies via new or expanded trade agreements.

The main channel through which these acts operate is by giving EU countries greater leeway to subsidise investment in the areas covered by these acts. While this may lead to occasional successes (investment in a critical area that would otherwise not have happened), there is no governance structure to ensure that critical dependencies are reduced in a timely way.

Furthermore, the approach mostly benefits EU countries that have the fiscal resources to provide large subsidies, and large incumbents, which have the clout and scale to lobby for subsidies and participate in IPCEI consortia.

Third, the Commission has so far missed the opportunity to rally members states behind the push to increase resilience by deepening the single market. This would help the EU resist external shocks and coercion – whatever the source and the channel – by allowing faster re-direction of trade and supply.

Banking and capital markets union would raise economic security both by funding new productive capacity and by improving automatic risk-sharing, better risk sharing across intra-EU borders would in turn make the EU more cohesive, and would make it harder to exploit internal divisions.

A more systematic attempt to strengthen economic security could involve the following elements.

1. A process for identifying and regularly reviewing critical import dependencies, based on the criteria developed in section 2, and better data (Mejean and Rousseaux, 2024; Bown, 2024). Better data may require

Table 2. Economic security objectives and available instruments

Objective	Available Instruments	Problems
Reduce import dependency for critical products	Important Projects of European Interest (IPCEIs) European Chips Act Critical Raw Materials Act Net Zero Industry Act and related sections of the Temorary Crisis and Transition Framework for State Aid Health Emergency Preparedness and Response Authority (HERA)	Imperfect match between critical products and targetted products. Lack of cost-benefit analysis Weak EU-level instruments Weak governance - actions and funding rely mostly on member states and lobbying by large firms
Diversify concentrated export exposures at the firm level	None, except for intention to negotiate additional free trade agreements with 'friends'	Lack of instruments leaves EU vulnerable to coercion
Deepen the single market and make it more flexible	Internal Market Emergency and Resilience ACT (IMERA)	No economic security-motivated deepening agenda
Deter economic coercion	Anti-Coercion Instrument	Council majority required to allow the Commission to deploy ACI powers
Limit overall trade dependency on China's market	None, except for intention to negotiate additional free trade agreements with 'friends'	Economic cost of sudden decoupling may deter appropriate action by the EU

Source: Bruegel.

more systematic due diligence on the part of European firms in relation to their supply chains, from an economic-security perspective.

2. Stronger governance and better funding for a competition-friendly EU-level industrial policy. This could involve:

> i. An institution similar to the US Advanced Research Projects Agencies (ARPA) to develop technology in areas that are identified as critical (Tagliapietra et al, 2023; Pinkus *et al* 2024).
>
> ii. Where the technology exists already, allocation of production or investment subsidies through auctions (along the lines of auction mechanisms that are currently used to tender renewable energy capacity).

These mechanisms would not necessarily require large funding. US ARPA budgets are relatively modest (in the single digit billon range), while the auction process could be co-funded by EU countries, along the lines of the 'Auctions as a Service' concept proposed by the Euro- pean Commission in relation to climate goals (European Commission, 2023).

3. The use of WTO-consistent trade instruments to incentivise import and export diversification. These could include:

> i. On the import side: countervailing duties, justified by the presence of a foreign subsidy, that are focused on an area in which there is a critical import dependency on the country that is responsible for the subsidy;

ii. On the export side, a duty levied on EU exports to countries for which export exposure is considered excessive. The latter could be politically difficult, but would be fully consistent with WTO rules[13].

4. As an alternative to export taxes, requiring exporters that are highly dependent on a specific export destination to buy publicly provided political risk insurance that would defray the costs of ex-post public support in the event of coercion (and would discourage exports to the destination in question).

5. Incentivising European firms that are highly dependent on production and profits in foreign jurisdictions to diversify production, structure their operations or hold capital to enable them to survive an expropriation (or controls that impede profit repatriation).

6. To further increase the deterrence value of the ACI, allowing the Commission to trigger retaliation under the ACI without requiring confirmation by a majority of member states.

7. Preparing for economic coercion through financial channels rather than just trade channels. While European firms have not recently been at the receiving end of such coercion, this may change if Donald Trump returns to the White House.

8. Invigorating the single market for economic security rather than just for efficiency reasons. ■

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Endnotes

1. See, for example, The Economist, 'China punishes Australia for promoting an inquiry into covid-19', 21 May 2020; and Andy Bounds, 'Lithuania complains of trade 'sanctions' by China after Taiwan dispute', Financial Times, 3 December 2021.

2. The European Commission (2023) uses a definition which also includes "risks related to physical and cyber security of critical infrastructure" and "risks related to technology security and technology leakage". We would classify this as part of national security (within the 'other' category in Table 1) rather than economic security.

3. Trump has announced that he would implement a 10 percent across-the-board tariff. This would affect EU exports significantly, in addition to US importers. See Charlie Savage, Jonathan Swan and Maggie Haberman, 'A New Tax on Imports and a Split From China: Trump's 2025 Trade Agenda', New York Times, 26 December 2023.

4. See European Commission, 'Trade defence', undated.

5. See European Commission, 'The Foreign Subsidies Regulation in a nutshell', undated.

6. See European Commission, 'European Chips Act', undated.

7. See European Commission, 'Net-Zero Industry Act', undated.

8. See European Commission, 'Temporary Crisis and Transition Framework', undated.

9. See European Commission, 'Critical Raw Materials Act', undated.

10. See European Commission, 'Health Emergency Preparedness and Response (HERA)', undated.

11. Final compromise text agreed in February 2024 available at https://data.consilium.europa.eu/doc/document/ST-6336-2024-INIT/en/pdf.

12. Namely, photovoltaic and solar thermal, onshore wind and offshore renewables, batteries and storage, heat pumps and geothermal energy, electrolysers and fuel cells, sustainable biogas and biomethane, carbon capture and storage (CCS) and grid technologies.

13. Article XI of the 1994 General Agreement on Tariffs and Trade prohibits quantitative export restrictions (with certain exceptions) but permits "duties, taxes or other charges". See https://www.wto.org/english/res_e/publications_e/ai17_e/gatt1994_art11_oth.pdf.

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Global economic fracturing and shifting investment patterns

There is a risk of economic deglobalisation. Bruno Casella, Richard Bolwijn and Francesco Casalena highlight ten FDI trends and their development implications

The trends stemming from technological advances, policy shifts, and the sustainability imperative, along with the effects of the trade tensions starting in late 2017 and the shock of the COVID pandemic, have sparked a debate on the risk of a reversal of economic globalisation (Fajgelbaum *et al* 2020, Antràs 2020, Zhan *et al* 2020, Kukharskyy *et al* 2021, Baldwin 2022a, 2022b, 2022c, 2022d).

The subsequent shocks of conflicts and political fragmentation have brought to the fore the heightened pressure towards global economic fracturing and the decoupling of global value chain (GVC) links between the US and other developed economies and the Chinese economy, with implications for many other countries and regions (Campos *et al* 2023, Aiyar *et al* 2023, Javorcik *et al* 2023).

So far, this debate has mainly focused on the trade perspective (Aiyar *et al* 2023 is an exception). The objective of this study is to explore the investment angle, offering a comprehensive reference for policymakers and analysts on the main trends reshaping the global FDI landscape amidst global economic fracturing. Given the intertwined nature of trade and FDI in the global production landscape dominated by GVCs, it also aims to build a much-needed bridge between connected narratives in the FDI and trade areas.

The underlying analysis owes credit to, and is directionally consistent with, previous studies investigating specific aspects of the FDI trends, particularly various recent editions of UNCTAD's World Investment Reports (eg. UNCTAD 2017, 2020, 2021). However, to date, a fully integrated diagnostic covering both short- and long-term perspectives, as well as the sectoral, geographical, and bilateral dimensions of FDI patterns, has been lacking.

This column highlights ten empirical FDI trends, grouped into three overarching themes: the triple divergence, the rise of economic fracturing and the implications for sustainability and development (UNCTAD 2024). These trends

fundamentally alter the development paradigm based on promoting investment in manufacturing and export-led growth, as will be discussed in the concluding part.

Triple divergence

Over the past two decades, FDI patterns have adapted to the transformative shifts reshaping economic globalisation in three key aspects.

Since the escalation of the trade war – with an acceleration after the outbreak of the pandemic and the recent geopolitical crisis – escalating international tensions are turning divergence into fracturing

1. Divergence between trends in FDI and GVCs and trends in GDP and trade. Historically closely intertwined under the common shaping force of GVCs, global trends in FDI and GVCs and in GDP and trade have been growing apart since the 2010s. While global GDP and trade have continued to grow steadily, crossborder investment and GVCs are coping with a long-term stagnation (FDI trend #1).

2. Divergence in FDI trends between services and manufacturing. FDI's long-term stagnation is characterised by starkly divergent trajectories between rapidly growing investment in services (FDI trend #2) and shrinking investment in manufacturing activities (FDI trend #3) (Figure 1).

The transition from manufacturing to services is part of a broader change in the role of FDI in global value creation, whereas crossborder investment is moving from the centre to the two ends of the smile curve (FDI trend #4). This major shift is involving developed and developing economies alike, blurring the traditional boundaries in terms of their FDI sectoral footprints (FDI trend #5).

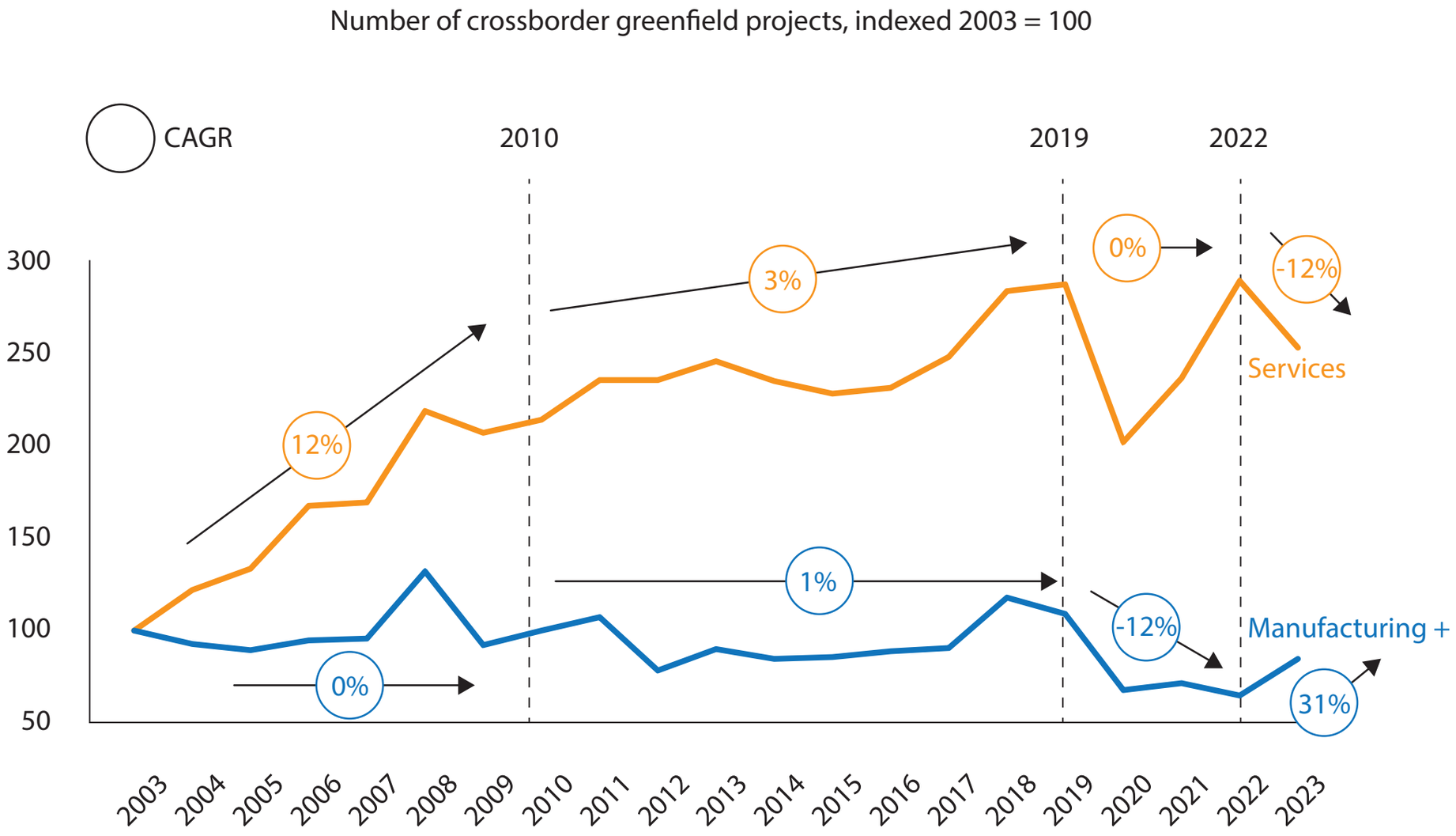
3. Divergence in FDI trends between China and the rest of the world. Chinese share in crossborder greenfield projects has been consistently declining for two decades, with an acceleration after the pandemic.

Despite a waning interest from multinational corporations in initiating new investment projects in China, the country continues to maintain a dominant position in global manufacturing and trade. Far from downsizing, 'Global Factory China' is changing its operational model from globally integrated to more domestically focused production networks, while still maintaining its leadership in global trade (FDI trend #6).

From divergence to fracturing

Since the escalation of the trade war – with an acceleration after the outbreak of the pandemic and the recent geopolitical crisis – escalating international tensions are turning divergence into fracturing, leading

Figure 1. Diverging FDI trends in manufacturing and services



Note: CAGR: Compound Annual Growth Rate. The sectoral analysis is based on the variable 'Business Activity' from fDi Markets. 'Manufacturing+' includes 'Manufacturing' and 'Other non-services' activities. The latter group comprises the following categories: construction, electricity, extraction and infrastructure.
Source: UNCTAD, based on information from the Financial Times Ltd, fDi Markets (www.fDimarkets.com).

to the disruption of historical investment patterns. Fracturing is associated with heightened uncertainty and unpredictability in the FDI landscape, and limited possibilities for countries to strategically benefit from diversification (FDI trend #7).

The fracturing process is characterised by the rising importance of geopolitics. Overall, between 2013 and 2022, the share of FDI projects between geopolitically distant countries decreased by 10 percentage points, from 23% to 13% (figure 2). Geopolitical motivations are thus emerging as primary drivers of investment decisions, at times overriding traditional FDI determinants (FDI trend #8).

Sustainability push, but marginalisation of developing countries

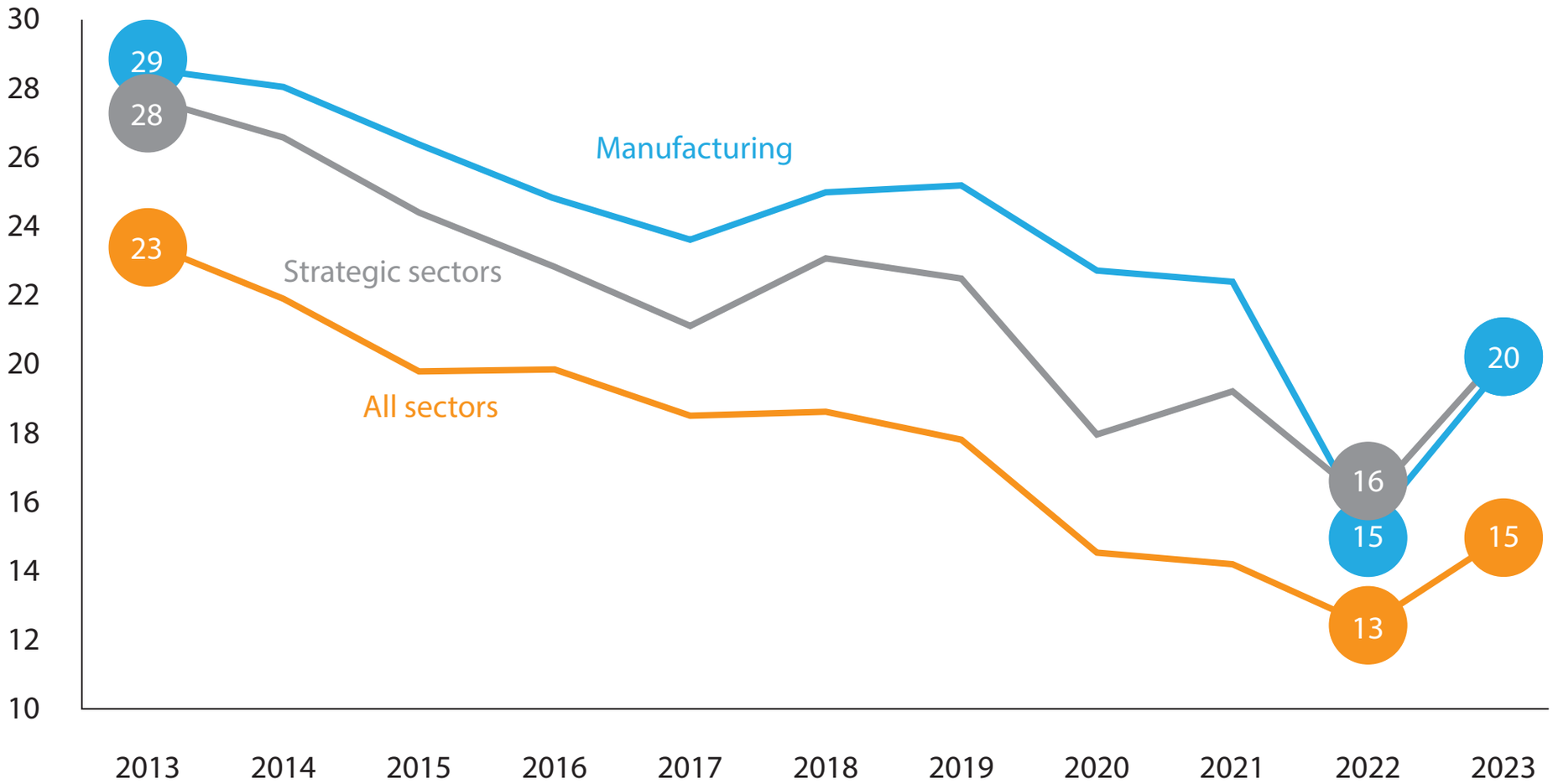
Amid long-term stagnation of manufacturing investment across all industries, the number of crossborder greenfield projects in renewable energy generation (environmental technologies) as well as in the manufacturing of batteries and electric vehicles (EVs) has steadily increased (Figure 3).

The sustainability imperative and the drive to stimulate investment in the Sustainable Development Goals (SDGs) have opened new opportunities for investment in industrial development (FDI trend #9). However, these new opportunities can only compensate in part for the lack of FDI growth in other industrial sectors that are critical for GVC development strategies.

Historical shifts and economic fracturing are leading to a decrease in the share of FDI in smaller developing countries and least developed countries. This trend exacerbates their marginalisation and vulnerability, as FDI becomes increasingly concentrated in developed and emerging economies (FDI trend #10).

Figure 2. Declining share of FDI between geopolitically distant countries

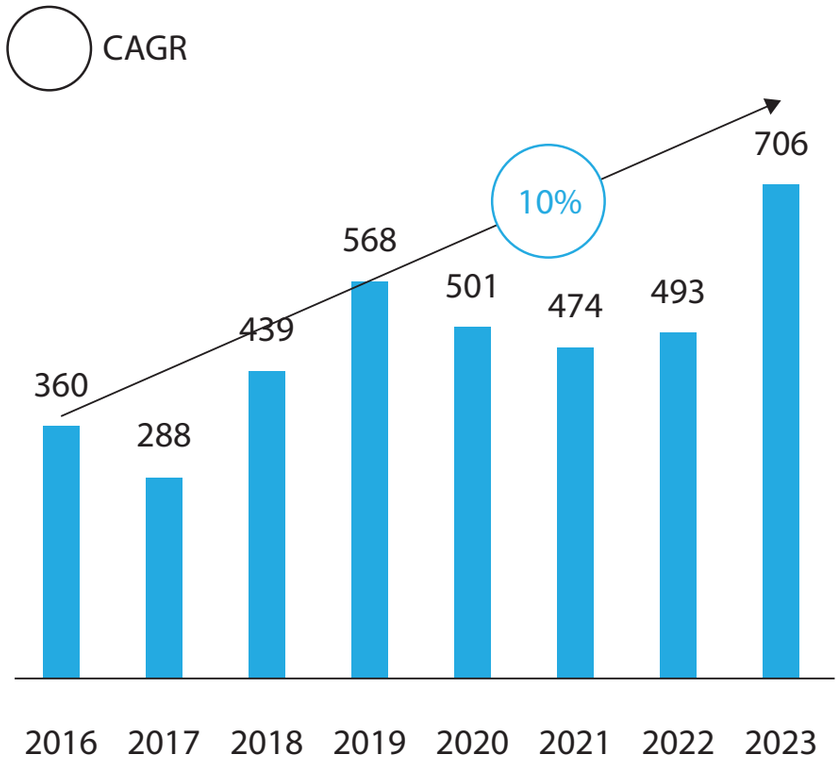
Crossborder greenfield projects between geopolitically distant countries as a share of total, per cent



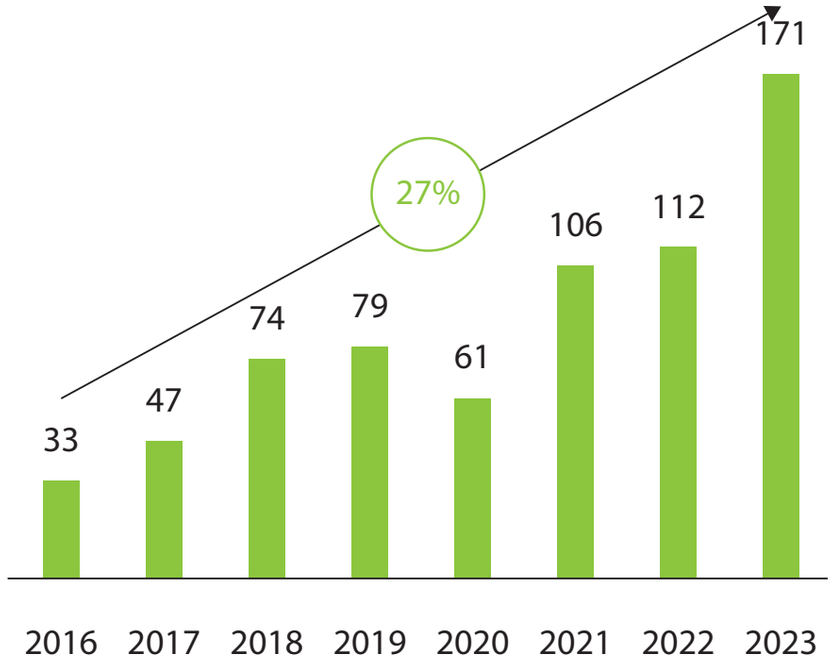
Note: The classification 'Strategic sectors' follows IMF (2023). Assessment of geopolitical alignment is based on United Nations voting patterns (Bailey et al 2017). The findings remain robust under alternative definitions of geopolitical groupings.
Source: UNCTAD, based on information from the Financial Times Ltd, fDi Markets (www.fDimarkets.com).

Figure 3. Growth of green FDI

Number of crossborder greenfield projects in environmental technologies



Number of crossborder greenfield projects in manufacturing of batteries and electric vehicles



Note: CAGR: Compound Annual Growth Rate.
Source: UNCTAD, based on information from the Financial Times Ltd, fDi Markets (www.fDimarkets.com).

Conclusions: rethinking the FDI-GVC-development nexus

Based on a diagnostic of ten trends in foreign direct investment, in this column we put forward three major implications for developing countries and their development and industrialisation strategies.

First, the long-term stagnation of investment in GVCs and the sectoral shifts in investment patterns fundamentally alter the development paradigm based on promoting investment in manufacturing and export-led growth. These shifts affect the prospects for developing countries to increase their GVC participation and to gradually upgrade to higher value-added industrial activities.

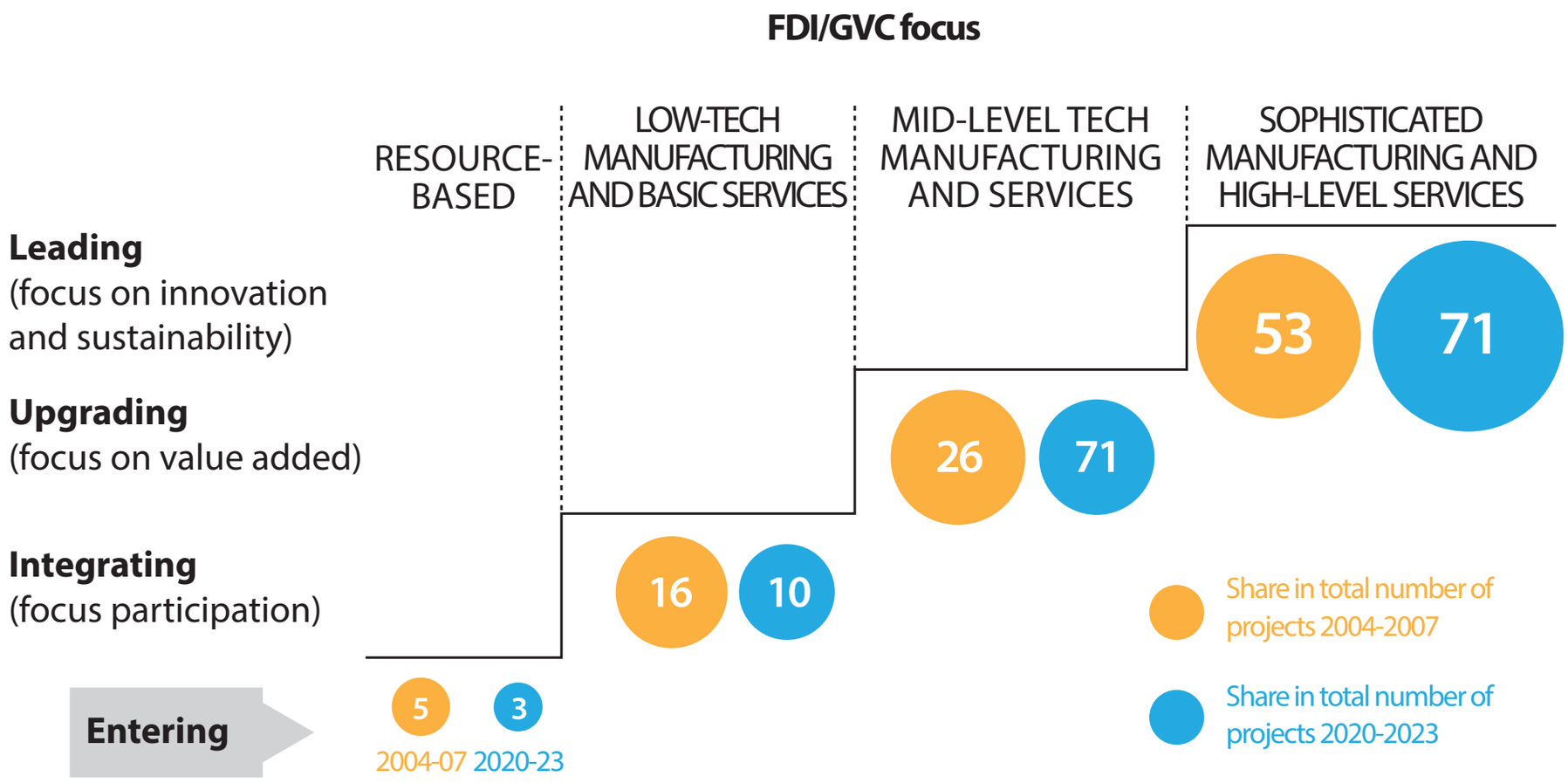
The GVC development ladder – a concept developed in UNCTAD's *World Investment Report 2013* (UNCTAD 2013) – is becoming harder to climb as the least developed countries face declining manufacturing investment and a shrinking pool of efficiency-seeking, lower value-added projects to leverage for GVC participation (Figure 4).

Second, changes in the patterns of sources and destinations of investment due to global economic fracturing, de-risking, and resilience trends can bring opportunities for some countries, but are a challenge for most. They not only reinforce the effects of the long-term trends but also introduce new complexity into international production and increased uncertainty for both investors and investment policymakers as geopolitical considerations become more important FDI determinants.

Third, the ongoing marginalisation of countries at the lower levels of the GVC development ladder, combined with diminishing opportunities in traditional GVC-intensive industries, requires investment policymakers in these countries to intensify their search for investment promotion opportunities in sectors that are less reliant on GVCs.

Figure 4. The GVC development ladder: Shifting FDI weights

Distribution of crossborder greenfield projects across stages of the GVC-development ladder, per cent



Note: The classification of projects along the ladder is based on fDi Markets variables 'Business Activity' and 'Cluster' and Lall's technological classification (Lall 2000, Sturgeon and Gereffi 2009).
Source: UNCTAD, building on the concept developed in UNCTAD World Investment Report 2013 (pages 179-181); project shares based on information from the Financial Times Ltd, fDi Markets (www.fDimarkets.com).

This includes industries where growth is driven by policy factors other than those influencing the general trend in GVCs. Notably, the promotion of investment in environmental technologies and sustainable energy serves as a notable example, albeit not the only one (UNCTAD 2023). ■

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How geopolitics is changing trade

There has been a rise in trade restrictions. Costanza Bosone, Ernest Dautović, Michael Fidora and Giovanni Stamato explore the impact of geopolitical tensions on trade flows

Since the global financial crisis, trade has been growing more slowly than GDP, ushering in an era of 'slowbalisation' (Antràs 2021). As suggested by Baldwin (2022) and Goldberg and Reed (2023), among others, such a slowdown could be read as a natural development in global trade following its earlier fast growth.

Yet, a surge in trade restriction measures has been evident since the tariff war between the US and China (see Fajgelbaum and Khandelwal 2022) and geopolitical concerns have been heightened in the wake of Russia's invasion of Ukraine, with growing debate about the need for protectionism, near-shoring, or friend-shoring.

The impact of geopolitical distance on international trade

Rising trade tensions amid heightened uncertainty have sparked a growing literature on the implications of fragmentation of trade across geopolitical lines (Aiyar *et al* 2023, Attinasi *et al* 2023, Campos *et al* 2023, Goes and Bekker 2022).

In Bosone *et al* (2024), we present new evidence and quantify the timing and impact of geopolitical tensions in shaping trade flows over the last decade. To do so, we use the latest developments in trade gravity models. We find that geopolitics starts to significantly affect global trade only after 2018, which, timewise, is in line with the tariff war between the US and China, followed by the Russian invasion of Ukraine.

Furthermore, the analysis sheds light on the heterogeneity of the effect of geopolitical distance by groups of countries: we find compelling evidence of friend-shoring, while our estimates do not reveal the presence of near-shoring. Finally, we show that geopolitical considerations are shaping European Union trade, with a particular focus on strategic goods.

In this study, geopolitics is proxied by the geopolitical distance between country pairs (Bailey *et al* 2017). As an illustration, Figure 1 (Panel A) plots the evolution over time of the geopolitical distance between four country pairs: US-China, US-France, Germany-China, and Germany-France. This chart shows a consistently higher distance from China for both the US and Germany, as well as a further increase in that distance over recent years.

Our findings point to a redistribution of global trade flows driven by geopolitical forces, reflected in the increasing importance of geopolitical distance as a barrier to trade

Geopolitical distance is then included in a standard gravity model with a full set of fixed effects, which allow us to control for unobservable factors affecting trade. We also control for international border effects and bilateral time-varying trade cost variables, such as tariffs and a trade agreement indicator.

This approach minimises the possibility that the index of geopolitical distance captures the role of other factors that could drive trade flows. We then estimate a set of time-varying elasticities of trade flows with respect to geopolitical distance to track the evolution of the role of geopolitics from 2012 to 2022.

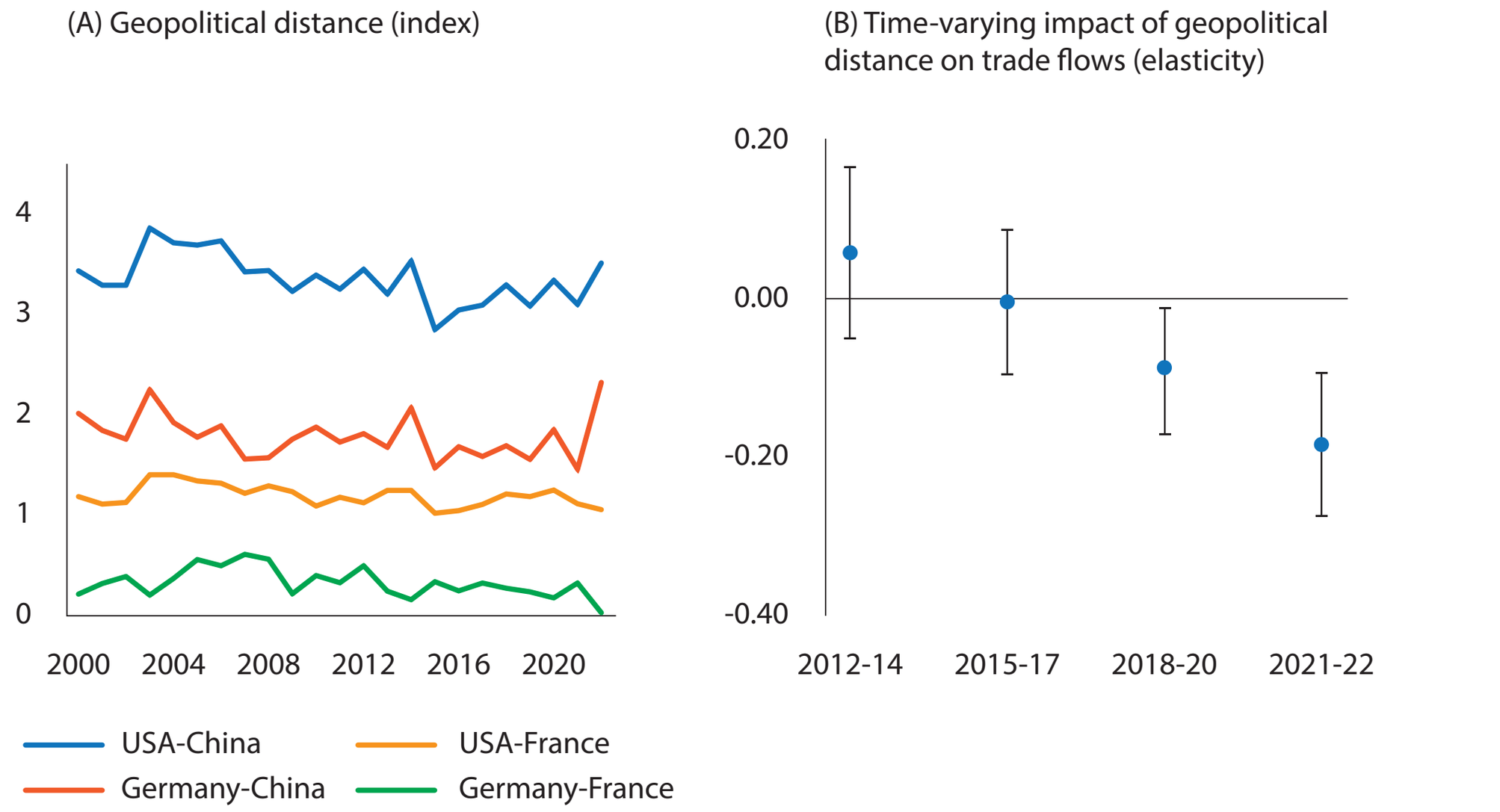
To the best of our knowledge, we cover the latest horizon on similar studies on geopolitical tensions and trade. To rule out the potential bias deriving from the use of energy flows as political leverage by opposing countries, we use manufacturing goods excluding energy as the dependent variable. We present our results based on three-year averages of data.

Our estimates reveal that geopolitical distance became a significant driver of trade flows only since 2018, and its impact has steadily increased over time (Figure 1, Panel B). The fall in the elasticity of geopolitical distance is mostly driven by deteriorating geopolitical relations, most notably between the US and China and more generally between the West and the East.

These reflect the effect of increased trade restrictions in key strategic sectors associated to the COVID-19 pandemic crisis, economic sanctions imposed to Russia, and the rise of import substituting industrial policies.

The impact of geopolitical distance is also economically significant: a 10% increase in geopolitical distance (like the observed increase in the USA-China distance since 2018, in Figure 1) is found to decrease bilateral trade flows by about 2%. In Bosone and Stamato (forthcoming), we show that these results are robust to several specifications and to an instrumental variable approach.

Figure 1. Evolution of geopolitical distance between selected country pairs and its estimated impact on bilateral trade flows



Notes: Panel A: geopolitical distance is based on the ideal point distance proposed by Bailey et al (2017), which measures countries' disagreements in their voting behaviour in the UN General Assembly. Higher values mean higher geopolitical distance. Panel B: Dots are the coefficient of geopolitical distance, represented by the logarithm of the ideal point distance interacted with a time dummy, using 3-year averages of data and based on a gravity model estimated for 67 countries from 2012 to 2022. Whiskers represent 95% confidence bands. The dependent variable is nominal trade in manufacturing goods, excluding energy. Estimation performed using the PPML estimator. The estimation accounts for bilateral time-varying controls, exporter/importer-year fixed effects, and pair fixed effects.
Sources: TDM, IMF, Bailey et al (2017), Egger and Larch (2008), WITS, Eurostat, and ECB calculations.

Friend-shoring or near-shoring?

Recent narratives surrounding trade and economic interdependence increasingly argue for localisation of supply chains through near-shoring and strengthening production networks with like-minded countries through friend-shoring (Yellen 2022).

To offer quantitative evidence on these trends, we first regress bilateral trade flows on a set of four dummy variables that identify the four quartiles of the distribution of geopolitical distance across country pairs. To capture the effect of growing geopolitical tensions on trade, each dummy is equal to 1 for trade within the same quartile from 2018 and zero otherwise.

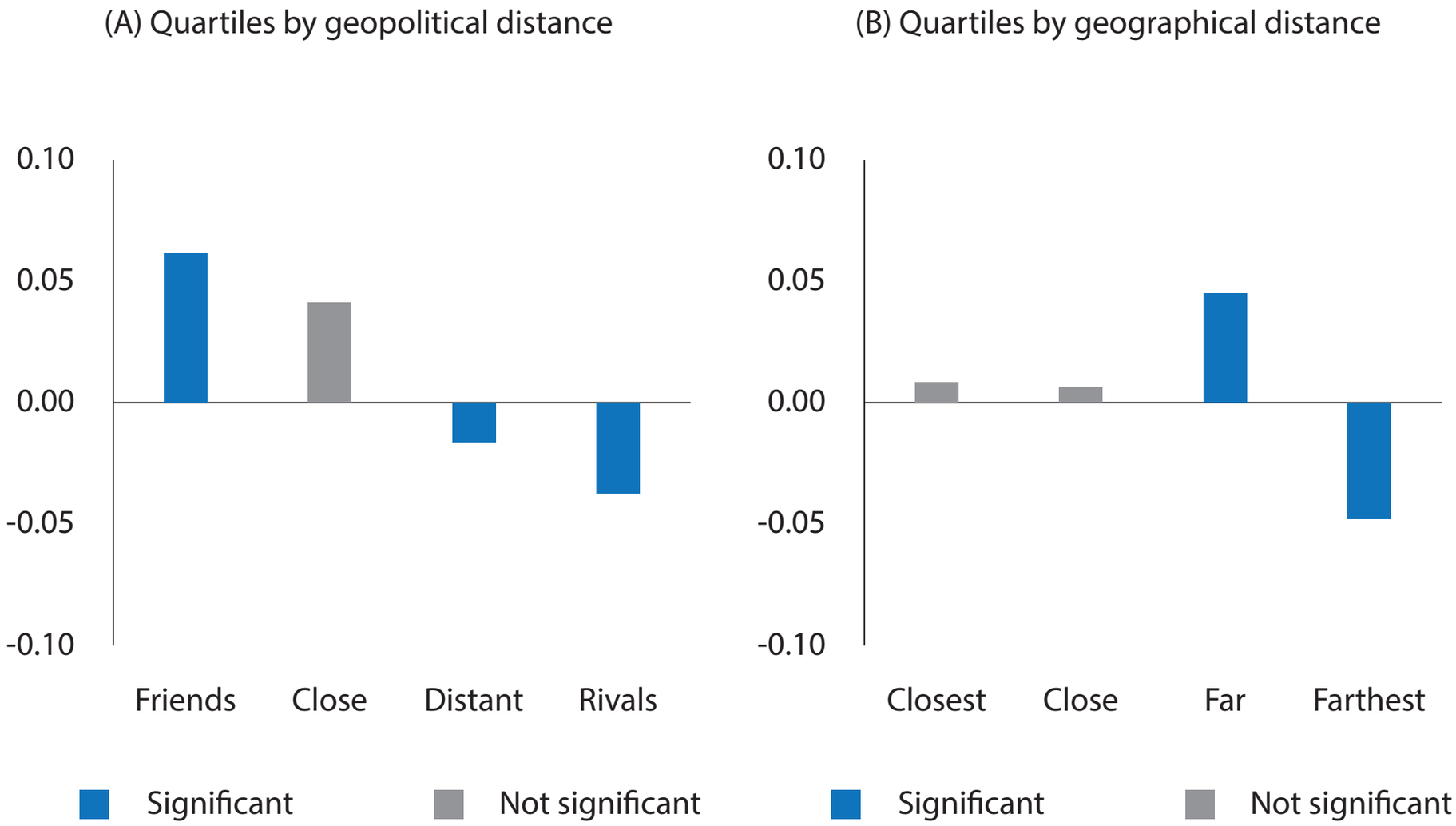
We find compelling evidence of friend-shoring. Trade between geopolitically aligned countries increased by 6% since 2018 compared to the 2012–2017 period. Meanwhile, trade between rivals decreased by 4% (Figure 2, Panel A). In contrast, our estimates do not reveal the presence of near-shoring trends (Figure 2, Panel B).

Instead, we find a significant increase in trade between *far*-country pairs, offset by a relatively similar decline in trade between the *farthest*-country pairs. Overall, shifts toward geographically close partners are less pronounced than toward geopolitically aligned partners.

Evidence of de-risking in EU trade

The trade impact of geopolitical distance on the EU is isolated by interacting geopolitical distance with a dummy for EU imports. We find that EU aggregate imports are not significantly affected by geopolitical considerations (Figure 3, Panel A).

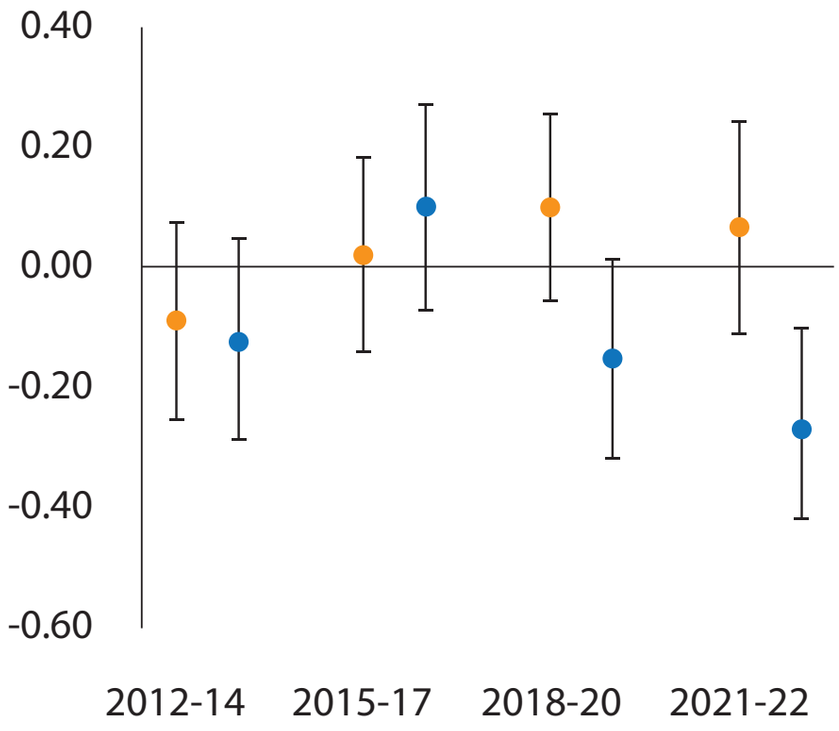
Figure 2. Impact of trading within groups since 2018 (semi-elasticities)



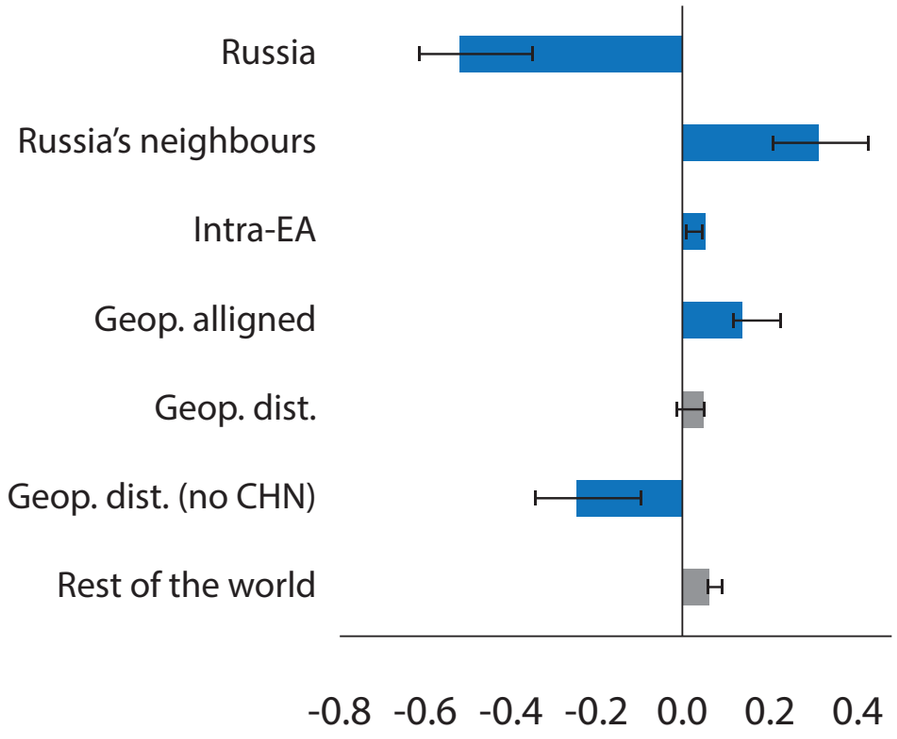
Notes: Estimates in both panels are obtained by PPML on the sample period 2012–2022 using consecutive years. Please refer to Figure 1 for details on estimation. The effects on each group are identified based on a dummy for quartiles of the distribution of geopolitical distance (panel A) and on a dummy for quartiles of the distribution of geographic distance (panel B) across country pairs. The dummy becomes 1 in case of trade between country pairs belonging to the same quartile since 2018.
Sources: TDM, IMF, Bailey et al (2017), Egger and Larch (2008), WITS, Eurostat, CEPII, and ECB calculations.

Figure 3. Impact of geopolitical distance on EU imports and of the Ukraine war on euro area exports

(A) Time-varying impact of geopolitical distance on EU imports (elasticity)



(B) Impact of the Ukraine war on euro area exports (semi-elasticity)



Strategic products
Aggregate imports

Significant
Not significant

Notes: Estimates in both panels are obtained by PPML on the sample period 2012–2022. Panel A: Dots represent the coefficient of geopolitical distance interacted with a time dummy and with a dummy for EU imports, using 3-year averages of data. Lines represent 95% confidence bands. Panel B: The sample includes quarterly data over 2012–2022 for 67 exporters and 118 importers. Effects on the level of euro area exports are identified by a dummy variable for dates after Russia's invasion of Ukraine. Trading partners are Russia; Russia's neighbours Armenia, Kazakhstan, the Kyrgyz Republic, and Georgia; geopolitical friends, distant, and neutral countries are respectively those countries that voted against or in favour of Russia or abstained on both fundamental UN resolutions on 7 April and 11 October 2022. The whiskers represent minimum and maximum coefficients estimated across several robustness checks.
Sources: TDM, IMF, Bailey et al (2017), Egger and Larch (2008), WITS, Eurostat, European Commission, and ECB calculations.

This result is robust to alternative specifications and may reflect the EU's high degree of global supply chain integration, the fact that production structures are highly inflexible to changes in prices, at least in the short term, and that such rigidities increase when countries are deeply integrated into global supply chains (Bayoumi *et al* 2019).

Nonetheless, we find evidence of de-risking in strategic sectors[1]. When we use trade in strategic products as the dependent variable, we find that geopolitical distance significantly reduces EU imports (Figure 3, Panel A).

We conduct an event analysis to explore the implications of Russia's invasion of Ukraine on euro area exports. We find that the war has reduced euro area exports to Russia by more than half (Figure 3, Panel B), but trade flows to Russia's neighbours have picked up, possibly due to a reordering of the supply chain.

Euro area exports with geopolitically aligned countries are estimated to have been about 13% higher following the war, compared with the counterfactual scenario of no war. We find no signs of euro area trade reorientation away from China, possibly reflecting China's market power in key industries.

However, when China is excluded from the geopolitically distant countries, the impact of Russia's invasion of Ukraine on euro area exports becomes strongly significant and negative.

Concluding remarks

Our findings point to a redistribution of global trade flows driven by geopolitical forces, reflected in the increasing importance of geopolitical distance as a barrier to trade.

In this column we review recent findings on geopolitics in trade and their impact since 2018, the emergence of friend-shoring rather than near-shoring, and the interactions of strategic sectors with geopolitics in Europe.

In sum, we bring evidence of new forces that now drive global trade – forces that are no longer guided by profit-oriented strategies alone but also by geopolitical alignment. ■

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Endnote

1. We follow the definition given by the European Commission and define strategic products as military equipment, raw materials, battery packs, high-tech, medical goods, and all those goods which are particularly relevant for security, public health, and the green and digital transitions.

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How the Ukraine war changed the global sanctions landscape

The sanctions imposed have created significant uncertainty and complex compliance challenges. Brent Connor, John Pearson, Henrietta Worthington and Jaime Rosenberg write that compliance processes need to be in order

The sanctions measures introduced in response to Russia's invasion of Ukraine have been unprecedented. Since the invasion on 24 February 2022, nations and regions including the EU, UK, US, Australia, Canada, Japan, New Zealand and others have worked together to develop a complex toolbox of measures with the aim of *"cutting off funding for Putin's illegal war from every angle."*

The global response is notable for many reasons, including the speed of implementation, the aligned approach and the novel sanctions introduced. The coordinated actions have also had a significant impact on businesses that are affected by the measures.

Indeed, the speed and expansive nature of the sanctions regimes imposed in response to the Russian invasion, whilst lauded by many, has created significant uncertainty and complex compliance challenges for businesses.

Compliance challenges and effects – speed and breadth of sanctions

To date, the EU has introduced thirteen packages of sanctions against Russia. The bloc was able to act extremely quickly in spite of the number of member states required to agree on measures, which has slowed down the implementation of such regimes in the past.

The nature of the situation meant that the sanctioning jurisdictions introduced wave after wave of sanctions, in addition to amendments and derogations to the existing sanctions. Consequently, many companies were left rushing to understand and adopt the measures within the tight timeframes imposed for implementation.

Similarly, the US has implemented an extensive array of sanctions and export controls. These measures have included 'primary sanctions' that require compliance by US persons, and secondary sanctions that bar entities regardless of location from doing business with individuals and entities designated on the US lists.

Unlike many regulatory requirements which provide extended grace periods for companies to implement necessary amendments to their internal processes, many of the sanctions restrictions came into immediate effect or provided expedited grace periods.

A consequence of the swift way the regimes have been introduced is companies failing to understand their obligations and of certain measures having unintended consequences. As a result, regulators have seemingly

It is clear that we have entered a new era of sanctions: the global response to the Russian invasion of Ukraine prompted the G7 and its allies to apply significant pressure on Russia via sanctions and to develop previously untested measures

found themselves on the backfoot publishing clarifications, derogations and extended guidance to help companies navigate through the requirements.

For instance, the UK's publication of its legal services restrictions caused a stir in the legal community prompting the UK's Law Society to issue a briefing to Parliament stating that the restrictions imposed by the regulation would actually *"negatively impact the ability of solicitors to support businesses to comply with the complex web of sanctions legislation and enable them to cut ties effectively with Russia"* (emphasis added). Ultimately, a general licence was issued to permit the provision of legal services in relation to sanctions imposed by any jurisdiction.

However, the perceived 'trial and error' approach has also had positive effects and has led to an increased information flow between the private sector and regulators. This approach has allowed regulators to better understand how regulations impact specific industry sectors and to work more collaboratively in their development of new measures.

Sanctioning jurisdictions continue to publish guidance, and expanded guidance by sector, with FAQ sections in a way that has not been seen previously, particularly in the EU and the UK. The US has issued 100 new FAQ documents including defining terms, and has processed hundreds of requests for licences and interpretive guidance.

The aim of the guidance is to help businesses avoid compliance pitfalls. In practice, transactions parties are placing significantly more weight on the guidance than they did prior to 2022.

In addition to expanding guidance tools, the US has issued a business advisory *"to help ensure that businesses, individuals, and organisations have the information necessary to inform their considerations regarding the range of*

heightened risks associated with doing business in or engaging in transactions involving the Russian Federation or Russia-occupied territories of Ukraine."

This includes activities that involve the Russian military-industrial base that were not explicitly addressed by sanctions, export controls or other trade restrictions providing clarity for US entities to comply with the extensive new sanctions.

Why new measures pose fresh challenges

Over two years on from the invasion, it is clear that despite the wide-ranging measures introduced, there is still significant leakage or diversion of goods to Russia. This has led to a focus on anti-circumvention and the introduction of novel sanctions measures. In particular, the UK and EU are concerned with monitoring how high priority items are still able to reach Russia.

From a US perspective, although comprehensive sanctions are not a new concept to US regulators (considering the US sanctions programmes including Cuba, Iran, and North Korea), the US government has not issued a comprehensive sanctions programme against Russia to date because of its concern of entangling Western allies that are still purchasing Russian oil and gas.

The US Russia sanctions programme is consequently extremely complex because it is not comprehensive, with the US's fragmented approach targeting some sectors of the Russian economy, but not others.

It has become clear that sanctions restrictions have forced companies and individuals to seek alternative routes to transfer goods to Russia, thereby undermining the impact of the restrictive measures. Indeed, exports of high priority items to Russia's neighbours have increased enormously, and have an increased risk of re-export to Russia.

Recent waves of sanctions have therefore focused on anti-circumvention measures to try and identify how circumvention is taking place, including increased notification obligations on parties. For example, the EU's recent introduction of a 'No Russia' clause requiring for EU exporters to contractually prohibit the re-export of certain sensitive goods to Russia.

This requirement was specifically introduced *"to combat the circumvention of EU export bans"* and the EU hopes that the notification of any breaches will assist in identifying how high priority items continue to be channelled to Russia.

Alignment between sanctioning jurisdictions

Whilst the G7 nations have moved together on their approach to sanctions for some time now, the Russian sanctions were significant in the unified global approach: nations are increasingly moving in lockstep to implement regimes, multiplying the impact of economic measures.

Despite the overall cohesive approach adopted by the G7 countries in response to the Russian invasion, the surfeit of new sanctions has created significant compliance challenges for international companies and companies that do business overseas as there are inherent underlying differences between the aligned regimes.

Enforcement

When navigating the fragmented sanctions landscape, in practice many companies facing multiple regimes have made the commercial decision to prioritise the US requirements, usually on the basis of perceived appetite for enforcement.

Historically, the US has been the most aggressive in implementing and enforcing economic sanctions and export controls. In 2023 alone, the Office of Foreign Assets Control (OFAC) enforced 17 penalties against entities who violated US sanctions totalling USD 1,541,380,594.08 in fines.

It enforced four penalties totalling USD 8,085,195.86 in fines under its Russian sanctions regime in 2023. OFAC's continued enforcement demonstrates the US commitment to compliance and protecting the US financial system from bad actors. With the release of numerous compliance guidance, OFAC is committed to working with the private sector to further promote the understanding of, and compliance with, sanctions requirements.

In contrast to the US, in the UK, no fines have been issued to date as a result of breaches of the Russian sanctions regime, which has led the Chair of the Foreign Affairs Committee to query whether it's *time "to ask difficult questions about the efficacy of [the Office of the Superintendent of Financial Institutions (OFSI)]'s enforcement capacity."*

Since it was given the right to impose monetary penalties in 2017, OFSI has issued 10 fines totalling £22 million. However, it is coming under increasing pressure to use its fining powers. In May 2024, OFSI updated its sanctions enforcement and monetary penalties guidance, summarising how it deals with breaches.

In the EU, enforcement is the responsibility of each member state and has therefore been patchy. However, the EU, like the UK, has shown its appetite to increase enforcement across the bloc. In March 2024, the EU approved rules aimed at harmonising enforcement through a new EU Directive that entered into force on 19 May 2024.

The new rules criminalise sanctions violations and introduce a common definition of, and minimum penalties for, sanctions violations. The EU has also emphasised the importance of ensuring that judges are *"able to issue dissuasive fines"* signalling that the bloc may be moving towards a US style enforcement approach.

Increasing use of thematic sanctions

The scope of thematic sanctions has evolved hugely since the US enacted the Global Magnitsky Human Rights Accountability Act in 2016. Thematic sanctions regimes now encompass chemical weapons and non-proliferation, corruption, cyber-attacks, human rights, narcotics and terrorism.

Thematic sanctions regimes give the sanctioning jurisdiction the authority to impose targeted sanctions on individuals or companies anywhere in the world who have been involved in the specified act (eg. human rights abuses or drug trafficking). Globally, there were 1,044 thematic sanctions designations made in 2023, which is nearly double the previous year.

The increase in the use of thematic sanctions creates compliance issues similar to those addressed previously in the context of Russian sanctions, including, for example, issues of breadth, novel measures and coordination in approach. A recent example of a novel thematic sanctions measure is the US's proposed Fentanyl Eradication and Narcotics Deterrence Off Fentanyl Act (or the FEND Off Fentanyl Act).

If signed into law, the FEND Off Fentanyl Act will provide a framework for the US to sanction individuals and entities responsible for trafficking fentanyl and other illicit opioids.

Recently, OFAC and OFSI coordinated to implement sanctions under a thematic sanctions regime (namely the cyber-attacks framework). The US and UK's aligned actions targeted a company and individuals tied to the China state-affiliated hacking group named Advanced Persistent Threat Group 31 (APT31) as a result of its *"malicious cyber campaigns targeting democratic institutions and parliamentarians."*

The UK revealed that it is highly likely that the group hacked the UK Electoral Commission between 2021 and 2022, and that they attempted reconnaissance activity against UK parliamentarians in 2021. The US identified malicious cyber activity by the group targeting certain critical infrastructure sectors over a period from 2010 to 2020.

The sheer breadth of the sanctions has increased hugely, and the number of designations has grown exponentially as a result. The nature of thematic sanctions provides that any bad actor across the globe can become subject to sanctions. Consequently, companies can no longer afford to just avoid dealing with high-risk jurisdictions, but rather must ensure that they heighten their due diligence practices.

It is clear that we have entered a new era of sanctions: the global response to the Russian invasion of Ukraine prompted the G7 and its allies to apply significant pressure on Russia via sanctions and to develop previously untested measures.

More information is flowing to sanctioning authorities that will allow them to develop their regimes further. Businesses will need to stay vigilant, ensure their compliance processes are in order and adapt to any further changes. ■

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Understanding the the WTO e-commerce moratorium

The WTO e-commerce moratorium has been renewed. Andrea Andrenelli and Javier López González explore the different issues around the moratorium debate

The last two decades have seen momentous shifts in globalisation as a result of digital transformation (Baldwin 2019, Winters and Borchert 2021, Savona 2020). During this time, the WTO moratorium on applying customs duties on electronic transmissions, the only WTO provision that applies explicitly to digital trade, has underpinned a stable, predictable, and duty-free environment for digital trade to thrive (IMF *et al* 2023).

At the last WTO Ministerial Conference, after difficult negotiations, the moratorium was renewed, and WTO members agreed to continue discussions on its *scope*, *definition*, and *impact*.

What is the e-commerce moratorium and why is it controversial?

The WTO e-commerce moratorium is a commitment to continue the current practice of not applying customs duties (ie. tariffs) on electronic transmissions. However, since 'electronic transmissions' were never defined, there is room for interpretation about the precise scope of the commitment.

Recently, several WTO members have raised questions about the opportunity costs of the moratorium[1]. Chief among their concerns is the potential loss of 'policy space' in the context of rapid technological change and potential losses in customs revenue due to the 'dematerialisation' of goods trade. For these WTO members, the lack of clarity on issues of scope and definition makes it difficult to understand the potential value, or opportunity cost of the moratorium.

In a recent paper (Andrenelli and López-González 2023), we review regional trade agreement provisions related to the electronic transmissions, provide new estimates of the potential foregone revenue implications of the moratorium, and explore some of the potential impacts of not renewing the moratorium on trade and competitiveness.

What can we learn from regional trade agreements about the scope and definition of the moratorium?
Some WTO members question whether the moratorium applies to the 'content' of the transmission (that is, the actual movies or e-books downloaded) or its 'carrier medium' (the bits and bytes that carry the content)[2]. Questions have also been raised about whether the Moratorium affects the ability of countries to apply other, internal, taxes beyond customs duties, or if the Moratorium erodes other commitments made in the WTO.

Our analysis suggests that the potential foregone revenue costs of the Moratorium are small and that its lapse would come at the expense of wider gains in the economy

Much can be learnt about the potential scope of the moratorium by looking at how countries have approached customs duties on electronic transmissions in their trade agreements. Analysis using the Trade Agreement Provisions on Electronic Commerce and Data (TAPED) database (Burri *et al* 2022) shows that, of the 105 regional trade agreements (RTAs) with an e-commerce chapter (by end of 2022), 100 included a provision on the non-imposition of customs duties on electronic transmissions (NICDET provision for short). More detailed analysis of these provisions reveals that (Figure 1):

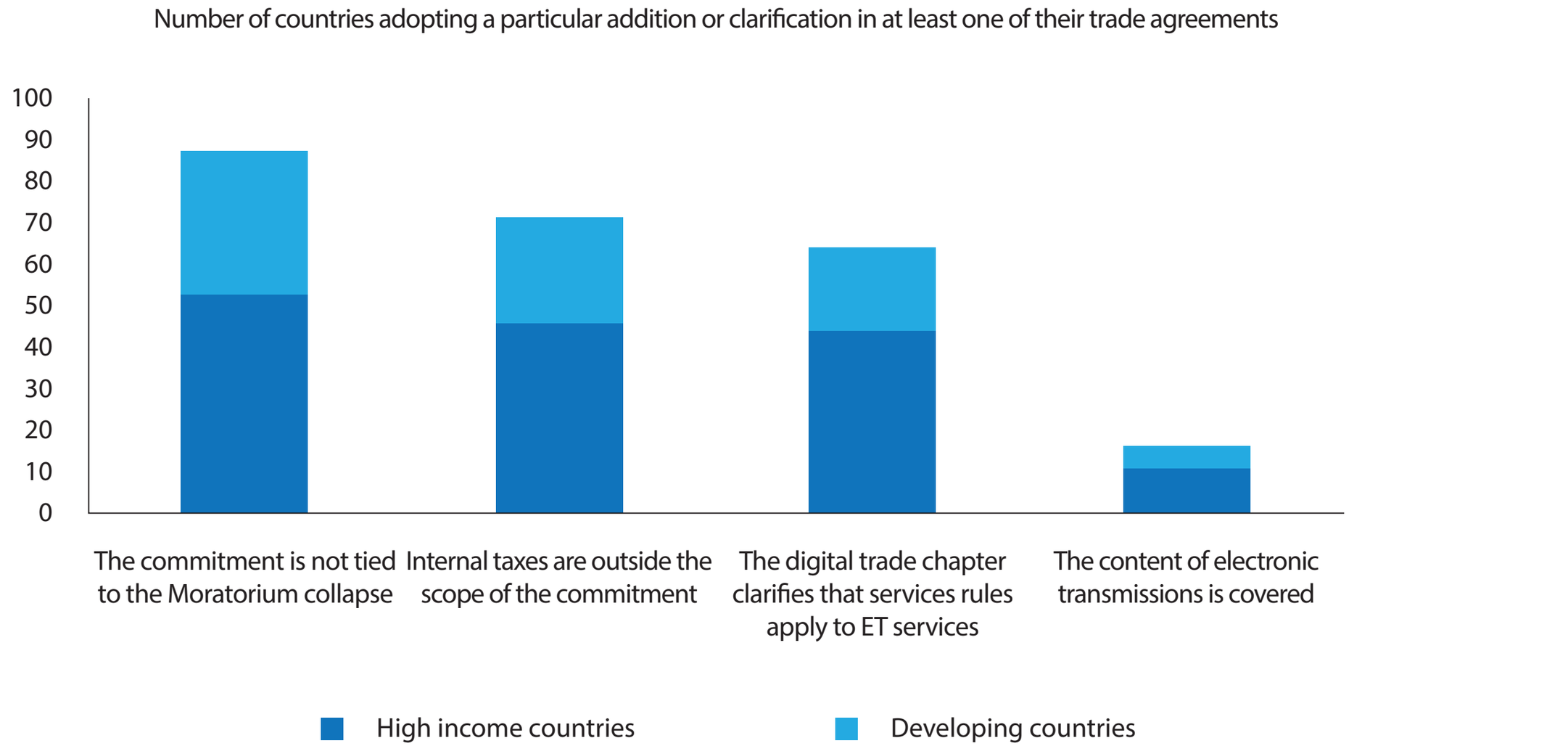
- The majority of NICDET commitments, 88%, are not tied to the e-commerce moratorium. Specifically, 54 high income and 33 developing countries would continue not imposing customs duties on electronic transmissions, at least on a reciprocal basis, even if the moratorium were to lapse.

- The majority of NICDET provisions clarify that internal taxation is outside the scope of commitments. Most countries do not see the commitment as having implications for applying other forms of taxation, including value added taxes (VAT) or goods and services taxes (GST).

- Digital trade chapters generally reaffirm that measures related to electronic delivery fall within the scope of obligations and exceptions related to services (eg. the General Agreement on Trade in Services (GATS) or regional trade agreement commitments and flexibilities remain). This suggests that the moratorium is unlikely to restrict 'policy space' beyond the non-imposition of tariffs.

- Since 2015, members have started to clarify that NICDET commitments apply to the content of electronic transmissions. There are no trade agreements clarifying that NICDET provisions apply to the 'carrier medium'.

Figure 1. Non-imposition of customs duties on electronic transmissions (NICDET) commitments in regional trade agreements can provide useful guidance on the interpretation of the potential scope and definition of the moratorium



Note: Income group classification based on the 2022-2023 World Bank classification, where developing countries refers to lower-middle-income and upper-middle-income countries.
Source: Andrenelli and López-González (2023).

Some countries define electronic transmissions as 'digital products' which include computer programmes, text, video, images, sound recordings, and other products that are digitally encoded. Others clarify that 'deliveries by electronic means shall be considered as the provision of services'. Others just use the term 'electronic transmissions', without any further clarifications.

However, differences in definitions have not prevented the conclusion of NICDET provisions between countries with different definitions[3]. While for some the lack of a precise definition might be considered a challenge, for others it is a way of enabling a variety of views to coexist.

What are the potential fiscal implications of the moratorium?

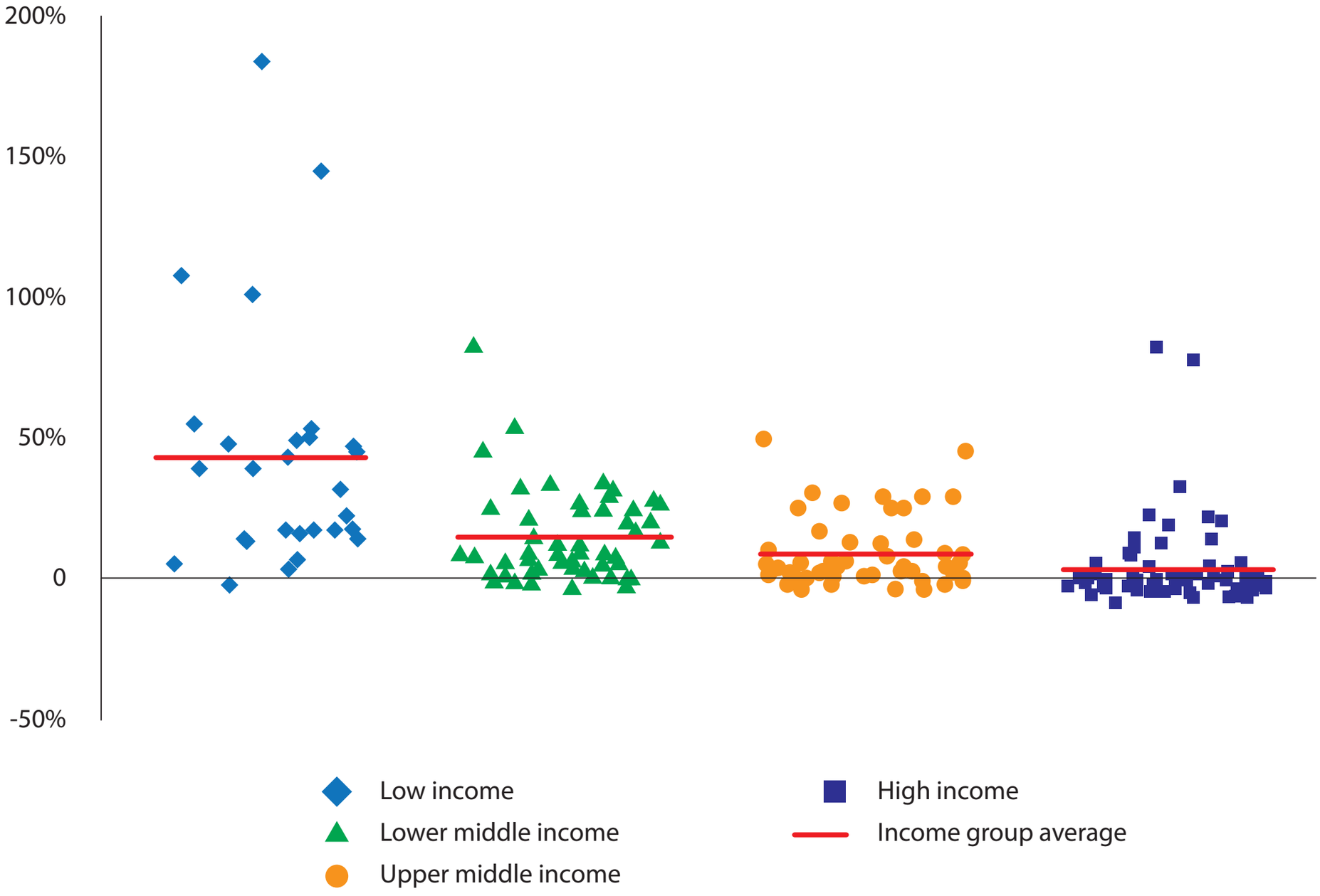
Some WTO members worry that not imposing customs duties on electronic transmissions may lead to foregone customs revenue. That is, a country importing a movie via an electronic transmission foregoes the tariff revenue associated with its import via a physical carrier medium, such as through a DVD. They argue that the rapid pace of digitalisation increases the scale of the problem, especially for developing countries, which tend to charge higher tariffs on these items.

However, imports of 'digitisable goods', which are physical goods that can be digitised and subsequently sent across borders digitally (e.g. CDs, books, calendars, videotapes), have generally been growing over the last decade, especially in developing countries (Figure 2), continuing to generate tariff revenue.

Accurately assessing the potential foregone revenue implications of the moratorium is not easy given uncertainties about scope and definition. However, we argue that existing empirical studies (Banga 2022, 2019) have not addressed three important issues that bias current estimates upwards.

Figure 2. Imports of digitisable goods have been growing, particularly in low-income countries

Average yearly change in physical imports of digitisable goods in 2008-2019, by income group



Note: Markers represent individual countries. Based on 206 countries and territories. Red lines show the income group average. The horizontal axis line indicates 0% average growth. Calculations based on BACI data.
Source: Andrenelli and López-González (2023).

The first is that existing commitments and practices, such as NICDET provisions or other preferences granted in regional trade agreements, limit the ability of countries to raise tariffs on digitisable goods and electronic transmissions, even in the absence of the e-commerce moratorium.

The second is that not all trade that can be electronically transmitted will be (as seen above, imports of digitisable goods have actually been increasing for many countries). The third is that assessments need to consider the potential offsetting effects of VATs/GSTs applied on growing digital imports.

We find that the foregone customs revenue that can be attributed to the moratorium is small – on average 0.68% of total customs revenue or 0.1% of overall government revenue. Given higher tariffs and lower levels of commitments, impacts are on average higher for low-income countries (0.33% of government revenue), and lower for high income country (0.01%).

That said, for 77 of 106 countries analysed, standard VAT/GST taxes applied on digital services imports which are 'born digital' completely offset the customs revenue effects of the moratorium[4].

These findings underscore the potential to find fiscal solutions, based on consumption taxes, to collect revenue on immaterial imports based on widely adopted and internationally accepted standards (OECD 2017). These taxes are efficient and have a demonstrated capacity of increasing tax revenues (Hanappi *et al* 2024).

In addition, since single rates tend to apply, there is no need to spend resources identifying how to classify products into detailed nomenclatures or to determine their origin. These taxes also target final, instead of intermediate consumption, which, as we will show below, is important.

What benefits are at stake with the potential lapse of the e-commerce moratorium?

We find that tariffs on electronic transmissions have the potential to hit low-income country trade most. If existing tariffs on digitisable goods were to be applied to digital services (which is where electronic transmissions are measured in existing trade statistics) imports of low-income countries would fall by 32% and exports would fall by 2.5%.

This is because more than 80% of digital services exports of low-income countries are to middle income countries which have more scope to increase tariffs. For middle-income countries, losses would be of 6% and 0.4% and for high-income countries of 0.04% and 0.5%, respectively.

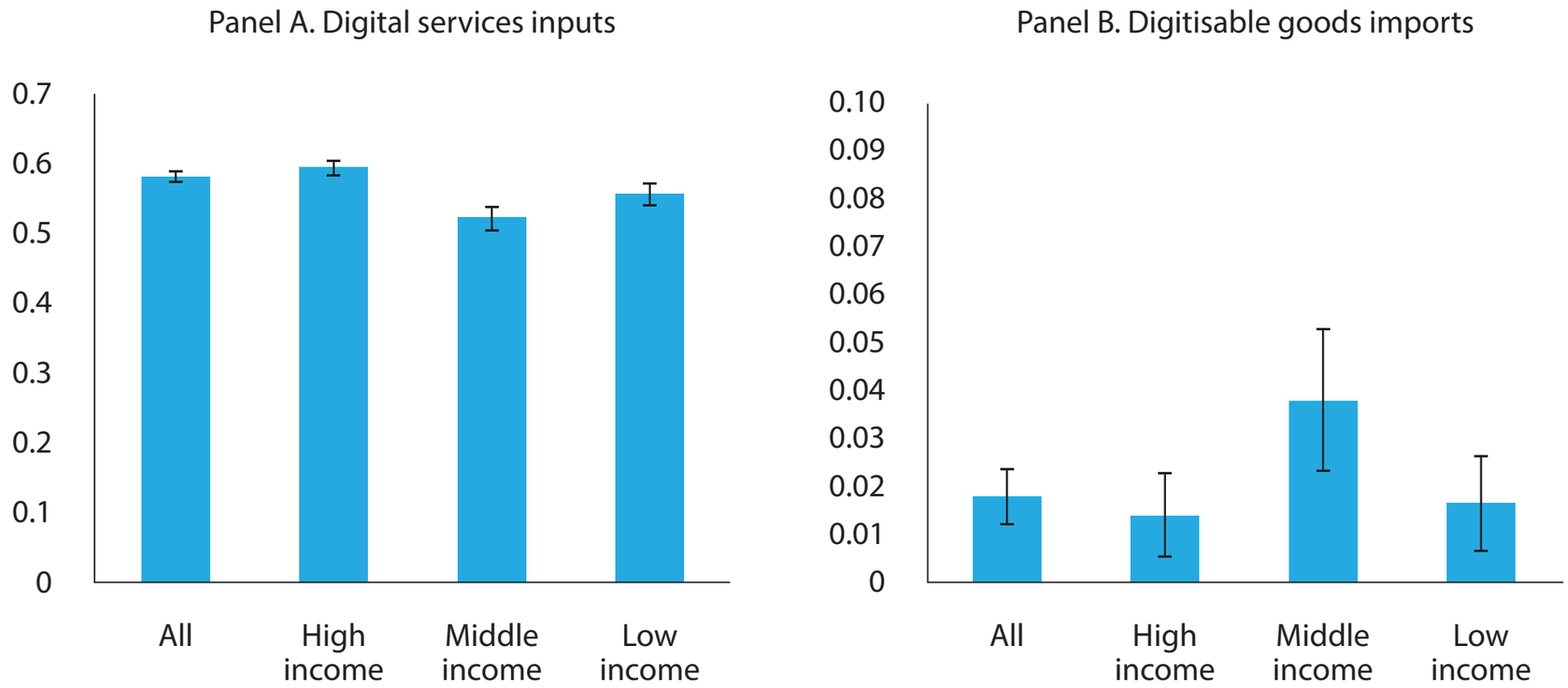
Evidence also shows that the use of foreign digital inputs and digitisable goods contributes to domestic competitiveness, measured as changes in the domestic value added in final consumption (Figure 3). This suggests that trade cost increases arising from the termination of the Moratorium would lead to losses in domestic competitiveness. Therefore, there is a self-interest argument for maintaining a duty-free environment for electronic transmissions.

The impact of greater barriers on electronic transmissions is also likely to be asymmetric, affecting small and medium-sized enterprises (SMEs) most. Analysis using the World Bank Enterprise Survey (WBES) suggests that being able to deliver trade digitally is associated with higher propensities to export of smaller firms and not larger ones.

Since SMEs generally have a lower propensity to export than larger firms, the ability to deliver products digitally may be an important mechanism to reach foreign markets, and this channel may be affected by the Moratorium lapse.

Figure 3. Digital inputs are key determinants of domestic competitiveness

Figures show the impact of increasing use of foreign digital inputs by one standard deviation on domestic value added



Note: Standardised regression coefficients capturing impact of increasing digital services inputs and digitisable goods imports on domestic value added with confidence intervals (95%). Calculations based on data from TRAINS and ITPDE.
Source: Andrenelli and López-González (2023).

There is a strong economic case for keeping electronic transmissions free from tariffs

Overall, our analysis suggests that the potential foregone revenue costs of the Moratorium are small and that its lapse would come at the expense of wider gains in the economy. ■

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Endnotes

1. See WTO Communications WT/GC/W/747, WT/GC/W/798 and WT/GC/W/833.

2. See WTO Communication WT/GC/W/859

3. For example, the EU-Canada agreement relies on flexible language, calling these "a delivery transmitted by electronic means", to bridge existing differences.

4. 'Born digital' trade is proxied using data on trade in computer, audio-visual, and information services imports. The intuition is that this captures growth in trade that might not have been previously delivered via physical carrier media. For instance, the is no physical goods equivalent of cloud computing services.

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The rocky road to EU accession

The Western Balkan countries are moving towards European Union accession. Armin Steinbach examines the obstacles and lessons from the Eastern Partnership

Executive summary

Th e Western Balkan countries and the countries of the Eastern Partnership are moving towards European Union accession at different speeds. We explore whether and how the variable speed towards EU accession can be traced to different legal regimes governing European integration: Stabilisation and Association Agreements (SAA) for the Western Balkan countries, and Deep and Comprehensive Free Trade Agreements (DCFTA) for the countries of the Eastern Partnership (EaP).

We find that DCFTAs apply more lenient conditionality to intra-regional cooperation. They subject non-tariff barriers to a more explicit regime than the Western Balkan SAAs. The DCFTAs also off er a more rigid and comprehensive approach to the approximation of laws than the SAAs, and the DCFTAs are more inclusive with regard to the role of civil society.

However, there is no indication that the differences in legal governance have translated into stronger economic performance in the EaP countries or greater integration with the EU, compared to the Western Balkans.

The Western Balkan countries remain significantly more integrated than the EaP countries with the EU in trade terms, while convergence with the EU has been stagnating both for the Western Balkan and the EaP countries. Economic shortcomings in the Western Balkan still need to be addressed.

Conditionality attached to both integration into the EU single market and EU funding should be nuanced; the eradication of non-tariff barriers should be prioritised both inter-regionally and intra-regionally between Western Balkan countries; the need for stronger EU investment in the region is reinforced by geopolitical concerns about

Chinese investments coming without EU-type conditionality attached; and governance should give a stronger role to civil society.

In order to address the shortcomings in SAAs, a pragmatic solution is to use the existing governance framework under the SAAs.

The importance of EU single market membership to West Balkan economic prospects cannot be overstated

1 Introduction

Until the Russian invasion of Ukraine, the European Union pursued a two-track approach to its south-eastern and eastern European neighbours. The EU accession prospects of the Western Balkan (WB) states (Albania, Bosnia and Herzegovina, North Macedonia, Montenegro, Kosovo and Serbia) were more promising than those of their eastern counterparts – in particular Georgia, Moldova and Ukraine – which were associated with the EU through its Eastern Partnership (EaP).

Georgia, Moldova and Ukraine declared they wanted to join the EU in the mid-2000s, but for a long time the EU preferred alternative models: first the European Neighbourhood Policy (in 2004) and then the EaP (in 2009). But though the EU pursued an integration model in relation to the EaP that did not aim at EU accession, Russia's war against Ukraine triggered a change to this two-track approach.

Suddenly, the process, at least with Ukraine, Geogia and Moldova (which are the reference point of comparison with the WB in this paper), turned into an accession process, ushering in the initiation of accession negotiations with Ukraine and Moldova in December 2023.

The three eastern European states had practically no waiting time before being accepted as candidate countries right after application (Box 1). This contrasts with the Western Balkans, with either, as for North Macedonia, a decade of waiting for the opening of accession negotiations because of resistance from some EU member states or, as for Serbia, a decade of dragging negotiations because of democratic backsliding.

As the progress report in Box 1 shows, given that WB applications to accede to the EU date back as far as 2004, the accession process has advanced much more slowly than for the EaP countries that applied only in 2022.

Yet, new impetus has spilled over to the WB, as the EU opened accession talks with Albania and North Macedonia in July 2023 and with Bosnia and Herzegovina in March 2024, while Kosovo officially submitted its membership application in 2022.

The new 'reversed order' of accession, with Ukraine seemingly outpacing the WB since 2022, adds to a dissatisfaction with the WB accession process that has long been growing. Among WB countries, the dominant perception was that the EU promise of WB membership was not credible, while the EU felt persistently concerned about the lack of *"genuine domestic reforms"* and remaining political rifts in the region (Dabrowski, 2022).

Ukraine's rapid move towards accession raises the question – notwithstanding the political accelerator for Ukrainian accession arising from the Russian assault – whether there are lessons to be learned from the new 'front runners'[1].

With the relationship between the EU and Ukraine, Georgia, and Moldova now governed by a different set of agreements and governance, this paper explores possible differences between the relationships the two blocs have with the EU.

It has been argued – but not analysed in depth – that the Deep and Comprehensive Free Trade Agreements (DCFTA) led to Ukraine, Georgia and Moldova being better integrated with the EU in terms of their access to its markets, than the Stabilisation and Association Agreements (SAAs) did for WB countries (Blockmans, 2018). The DCFTAs form part of the countries' Association Agreements with the EU and supplement and deepen their integration into the EU internal market.

Our analysis explores more deeply the comparison between the two groups of agreements. Clearly, we consider the pre-war situation and as such exclude that war-related geopolitical factors changed the accession pace of EaP countries, and of Ukraine in particular.

Specifically, we seek to better understand the differences in regimes and access to the EU internal market. First, we systematically assess and compare the substantive, procedural and institutional differences between the eastern European AA/DCFTAs and the WB SAAs with respect to their potential in offering access to the EU internal market.

Despite large similarities between the agreements, we find considerable differences in legal governance related to conditionality, non-tariff barriers of trade, trade in services, foreign direct investment (FDI) and the approximation of laws. We extend the comparative analysis to shortcomings in the governance and implementation process of the relevant SAAs and working plans.

Second, in view of the differences, we explore the extent to which they may have had an impact on economic performance in terms of convergence with the EU, trade in goods and services, non-tariff barriers, FDI and what measures should be implemented to overcome the existing shortcomings.

These could be implemented either by modifying the WB SAAs or through modifications to the level of technical implementation. We caution against claiming a causal effect in terms of the differences in legal governance leading to Ukraine to obtain the status of accession negotiations so rapidly (geopolitical reasons are likely to trump the modest performance of Ukraine, for example).

Our analysis comes at a critical time. Political sentiment in some WB countries, particularly Serbia and North Macedonia, blames the EU for slow accession, while democratic backsliding and authoritarian regimes in the WB is leading to China and Russia, as underpinned by an influx of Chinese FDI (Figure 7), to be seen as alternatives to moving closer to the EU, with the EU portrayed as just one among the external players in the region (Vulović, 2023).

The new Growth Plan (European Commission, 2023a) and the draft Reform and Growth Facility for the Western Balkans (European Commission, 2023b) seek to revive WB integration. While additional funding for the region will be made available, the new proposal brings a demanding degree of conditionality, increasing the pressure for domestic reforms (in line with the EU Copenhagen, or accession, criteria), and setting additional intra-regional integration as cumbersome preconditions, both for internal market access and funding eligibility.

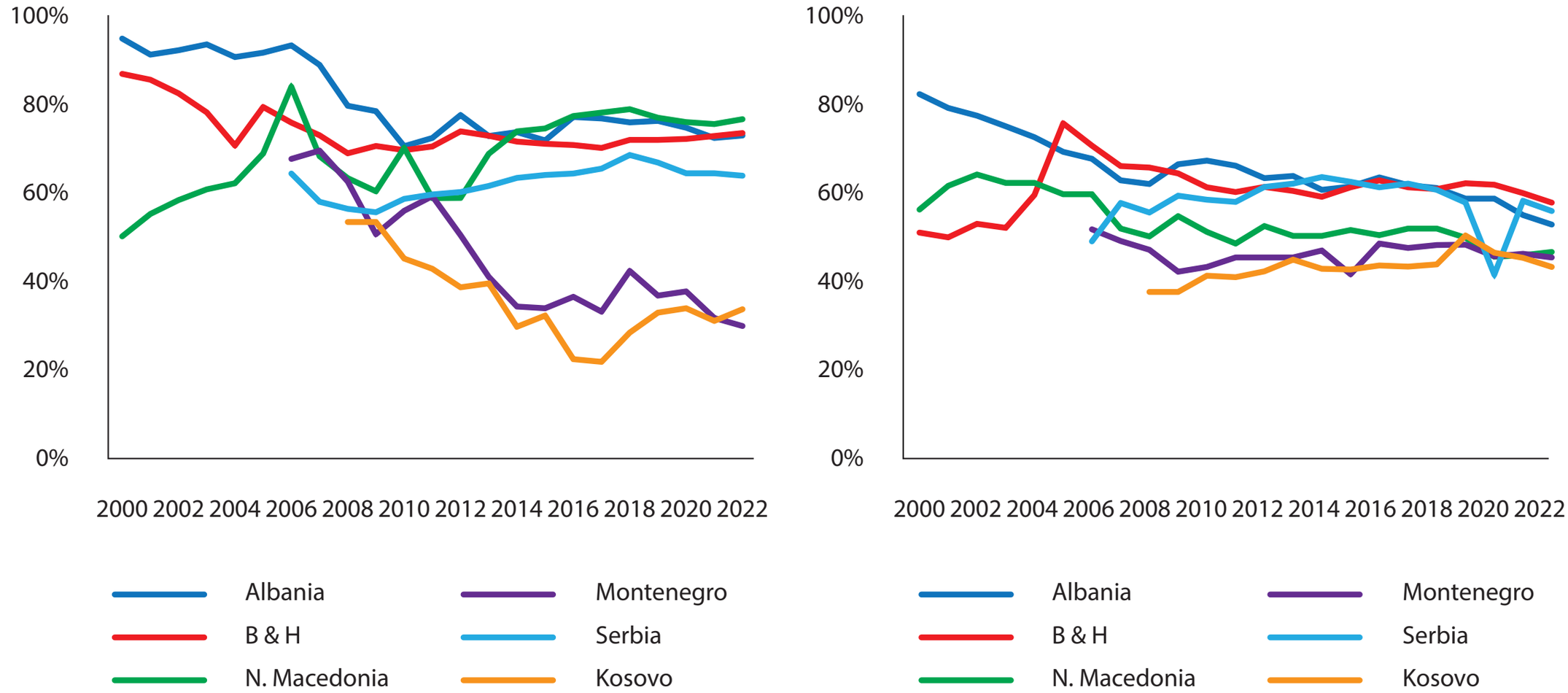
Yet, the current negotiations of a roadmap for Ukraine's accession to the EU may offer a new momentum for the WB states to integrate further into the EU single market, by underlining the mutual benefits. The new geopolitical reality enhances the significance of the EU's enlargement policy, but for it to materialise, it requires modification of the current regime governing market access, financial investment and governance.

We focus on access to the single market both from the perspective of substantive market access and governance of the implementation. The EU is the key trading partner of the Western Balkans, with WB goods exports to, and imports from, the EU in 2022 amounting to €37 billion and €48 billion respectively (equating to simple averages of approximately 59 percent and 49 percent of their respective trade totals; Figure 1). Services trade between the two is also significant, with exports to and imports from the EU amounting to approximately €8.5 billion and €7.5 billion respectively for the same year (Figure 6)[2].

However, the WB share of exports to and imports from the EU27 has been constant in average over the last twenty years. Since the sequential entry into force of SAAs since 2004 there has not been a significant increase in trade integration with the EU. In turn, the share of the EU as an export destination for EaP goods has on average increased (Figure 1b).

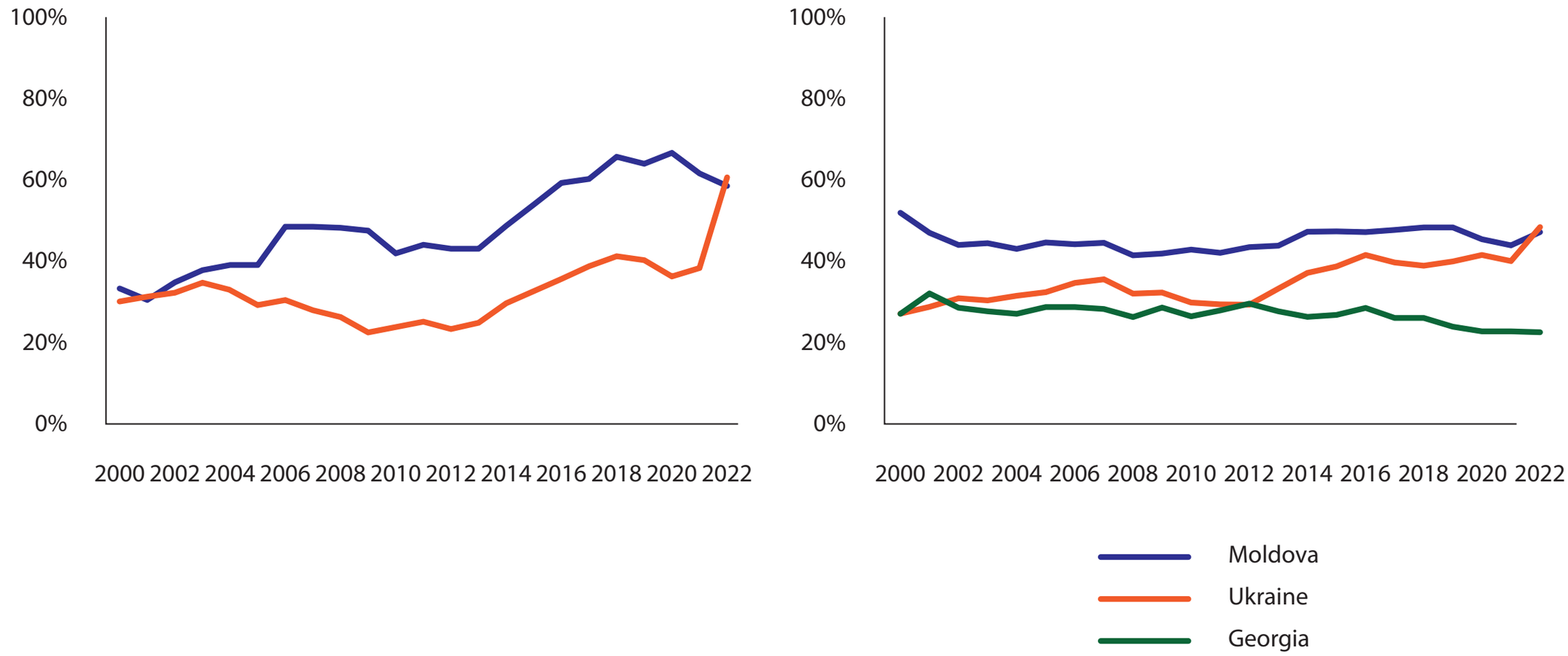
At the same time, the rate of convergence of the Western Balkans countries was described in the new Growth Plan as *"not satisfactory"* and *"holding back their progress on the EU track"* (European Commission, 2023, p.1).

Figure 1a. The EU as an export destination (left) and import source (right) for WB goods (% of total exports and imports respectively)



Source: Bruegel based on IMF Direction of Trade Statistics.

Figure 1b. The EU as an export destination (left) and import source (right) for EaP goods (% of total exports and imports respectively)



Source: Bruegel based on IMF Direction of Trade Statistics.

As illustrated in Figure 2, both regions have struggled with GDP per capita convergence to the EU27 average, recording moderate gains between 2011 and 2021. WB countries had higher initial GDP per capita level than the EaP countries (by approximately 10 percentage points of average EU27 GDP) but caught up less quickly up to 2021. In 2022, Ukraine and Moldova recorded reversals of their previous growth trends, because of Russian aggression against Ukraine.

The stagnating share of the EU27 in trade with the WB, and the moderate pace of convergence, provide the economic motivation for our analysis and for exploration of a possible connection to the legal regime set out in the SAAs.

Based on our comparative legal and institutional analysis, we identify a number of differences between the agreements the EU concluded with the eastern European countries and the WB. Yet while differences in the legal governance of DCFTAs and SAAs would suggest WB economic underperformance compared to the EaP, because of a legal framework limiting WB integration into EU internal market in comparative perspective with the DCFTAs, this is not supported by the available economic evidence.

While these differences are significant deficiencies and should be addressed, we hasten to say that there is no compelling evidence that remaining shortcomings can causally been traced to the different legal treatments.

In any case, taking the DCFTAs as an example, the remaining constraints in the SAAs and in the new Growth Plan should be lifted to untap further potential for WB convergence with the EU internal market.

Figure 2a. GDP per capita in PPP (percent, EU27 = 100)

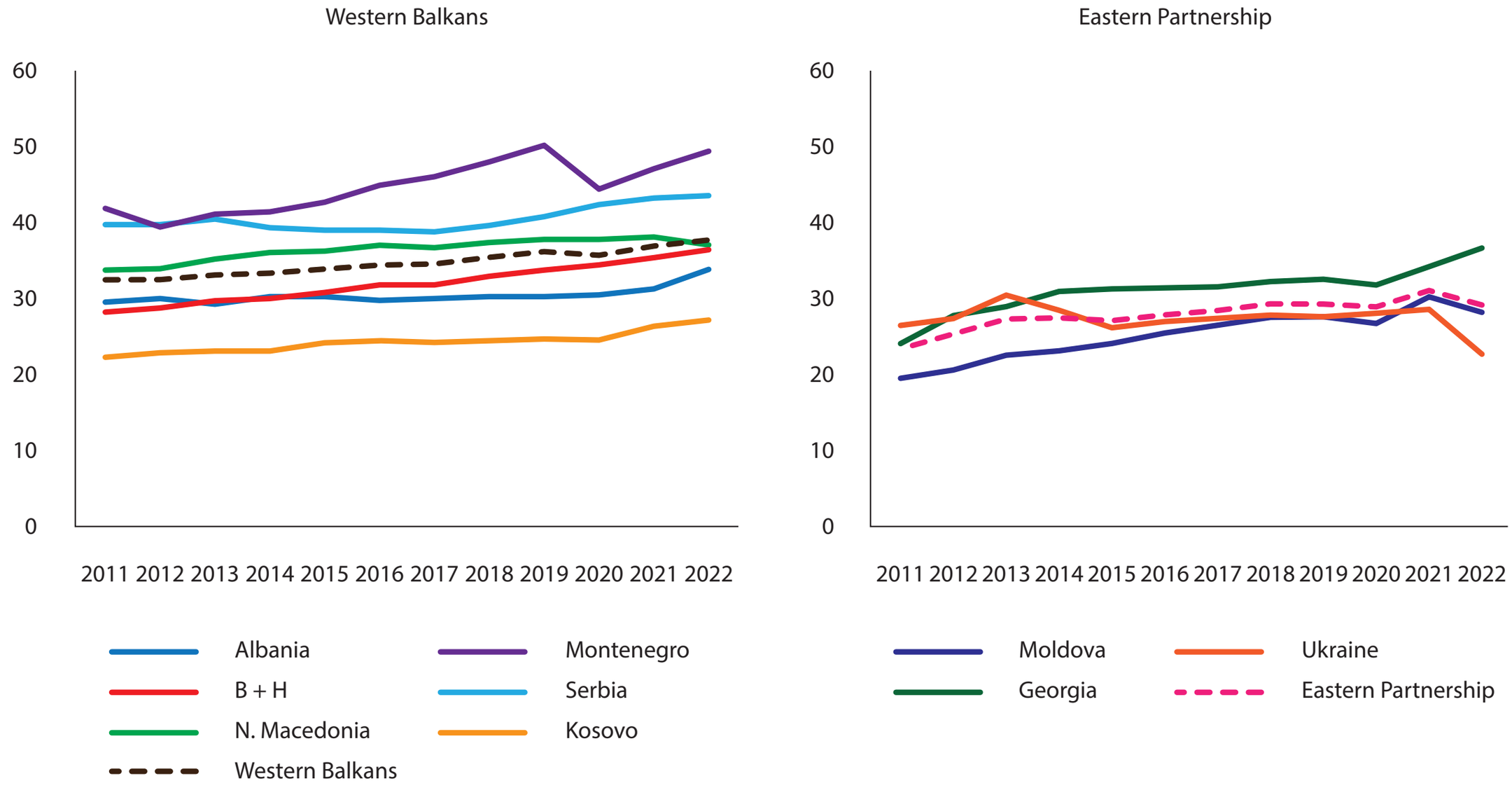
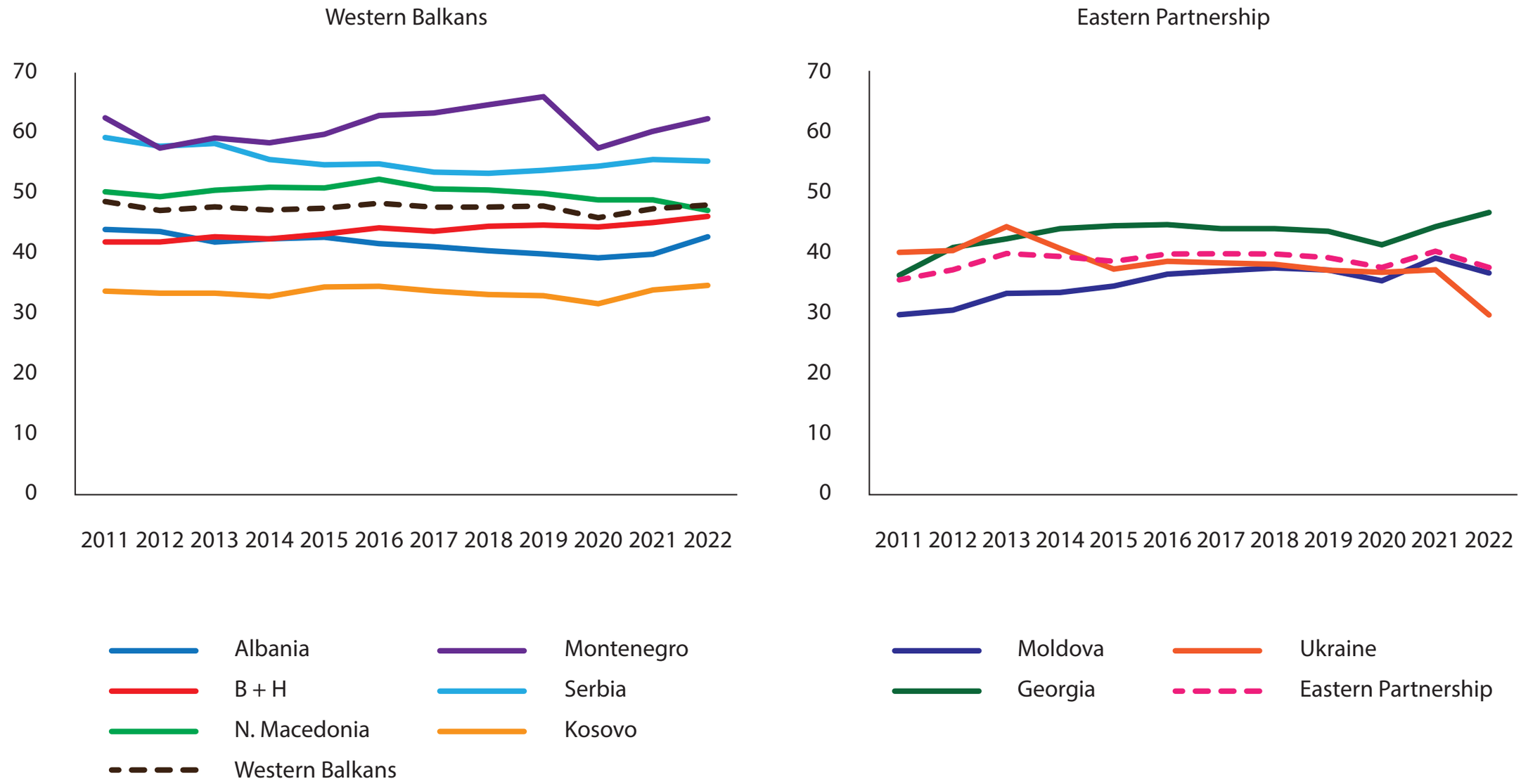


Figure 2b. GDP per capita in PPP (percent, 10 central and eastern European countries = 100)



Note: The Western Balkans and Eastern Partnerships dashed lines are simple averages. For an insight into convergence in the regions in general, a weighted approach to account for population may be more appropriate. However, the relevant metric for accession is the convergence of the countries in question, not the regions as a whole. These averages are only included for ease of comparison.
Source: Bruegel based on World Bank World Development Indicators.

Box 1. The nature and state of play of the Accession talks[3]

The EU accession process involves five main steps[4]. First, a country must apply to the Council of the EU to become a member. Article 49 of the Treaty on the European Union (TEU) stipulates that any European country that respects and commits to the values of the EU as expressed in Article 2 TEU can apply, and this is the stage that Kosovo is currently at.

The second step is a positive assessment of the Commission recommending the granting the candidate status. Third, candidate status is approved based on a unanimous decision of the European Council, which is what happened for Georgia for instance in December 2023. However, this does not necessarily mean that formal negotiations have been opened.

The fourth step is the accession negotiations, which begin with a detailed examination (screening) carried out by the Commission, together with the candidate country, of each policy field (chapter), to determine how well the country is prepared. This initial screening exercise of the EU's acquis serves to identify levels of preparedness in each policy field (which Albania and North Macedonia completed in 2023).

If completed satisfactorily, negotiations ensue focusing on six different thematic clusters, each consisting of various chapters; these negotiations take place at intergovernmental conferences (Montenegro, for instance, has opened negotiations on all chapters and closed three).

Fifth and finally, the process concludes when all chapters have been closed and an accession treaty is approved unanimously by the European Council and receives the consent of the European Parliament. Each EU country must also ratify the treaty according to its constitutional procedures (Dabrowski, 2014).

Country	Stage of process (early 2024)	State of play	Next step(s)
Western Balkans			
Albania	Applied for membership in 2009; candidate country since 2014; accession negotiations began in 2022[5].	The screening meetings (ie. prior to accession negotiations entailing analytical examination of the EU acquis) were completed in November 2023.	First negotiation cluster will begin once the roadmaps identifying rule of law and public administration reforms are assessed and approved[6].
Bosnia and Herzegovina	Applied for membership in 2016; candidate country since 2022; accession negotiations opened in March 2024.	The Commission noted positive steps towards meeting key priorities and opening negotiations following the awarding of candidate country status, but recent rule of law developments have proved a barrier.	Preparation of the negotiating framework.

Kosovo	Applied for membership in 2022; currently a potential candidate country[7].	The European Reform Agenda was adopted in 2016 and updated in 2021 between the Commission and Kosovo to guide the implementation of SAA reforms. Due to a lack of de-escalatory measures regarding rising tensions with Serbia, the EU froze various cooperation and funding mechanisms in 2023 (European Commission, 2023d).	The frozen measures are temporary and will be reversed if and when authorities take satisfactory de-escalatory steps and implement commitments related to Serbia. The next steps of the accession process are unclear.
Montenegro	Applied for membership in 2008; candidate country since 2010; accession negotiations began in 2012.	Since 2012, all negotiating chapters have been opened, with three closed. The enlargement methodology was revised in 2021 to place more emphasis on fundamental reforms and reinvigorate the process.	Further progress on the rule of law chapters is necessary before any others are provisionally closed.

North Macedonia	Applied for membership in 2004; candidate country since 2005; accession negotiations began in 2022.	The screening meetings were concluded in December 2023.	First negotiation cluster will begin once the roadmaps identifying rule of law and public administration reforms are assessed and approved[8].
Serbia	Applied for membership in 2009; candidate country since 2012; accession negotiations began in 2014.	Since 2014, 22 negotiating chapters have been opened, with two closed. The enlargement methodology was revised in 2021 to place more emphasis on fundamental reforms and reinvigorate the process.	The rate of progress in the rule of law chapters and in the normalisation of relations and de-escalation with Kosovo dictate the pace of negotiations.
Eastern Partnership			
Georgia	Applied for membership in 2022; candidate country since December 2023; accession negotiations yet to begin.	Due to progress on the 12 identified priorities since the application was made, candidate country status was granted on the understanding that nine steps would be taken.	Progress must continue on the nine steps detailed in the November 2023 Communication[9] on enlargement.

Moldova	Applied for membership in March 2022; candidate country since June 2022; Council decided to open accession negotiations in December 2023.	In the June 2022 Commission Opinion (European Commission, 2022a) on Moldova's application recommended to grant candidate status on the understanding that nine steps were taken. As of November 2023, six of the nine steps were completed.	Accession negotiation framework will be adopted once the three recommendations in the November 2023 Communication[10] on enlargement are completed. Screening began in January 2024[11].
Ukraine	Applied for membership in March 2022; candidate country since June 2022; Council decided to open accession negotiations in December 2023.	June 2022 Commission Opinion (European Commission, 2022b) on Ukraine's application recommended to grant candidate status on the understanding that nine steps were taken. As of November 2023, six of the nine steps were completed.	Accession negotiation framework will be adopted once the four recommendations in the November 2023 Communication[12] on enlargement are completed. Screening began in January 2024.

2 Comparing DCFTAs and the Western Balkan SAAs in terms of EU market integration

This section highlights differences between the legal regimes governing market access for the eastern European countries of Ukraine, Moldova and Georgia (on basis of DCFTAs) and the applicable framework under the Western Balkan SAAs. Differences are explored in relation to five benchmarks: conditionality, non-tariff barriers to trade, trade in services, movement of capital and the approximation of laws.

Annex I provides a comprehensive comparative assessment of the relevant agreements and the applicable rules, while this section discusses some of the marked differences. What facilitates the comparison (while highlighting the stark differences between the regimes) is a large degree of homogeneity in agreements within each group – within DCFTAs and Western Balkan SAAs. For the purpose of making comparisons, the Serbia SAA[13] will be the reference point for the WB SAAs, while the Ukraine AA/DCFTA[14] is referred to to exemplify the agreements the EU concluded with the eastern European partners.

2.1 Regional integration as conditionality

One core distinguishing feature between the DCFTA and the WB SAAs is the degree of conditionality attached to intra-regional integration as a precondition for further access to the EU internal market.

Most recently, this emphasis has been reiterated in the draft New Growth Plan, which, as an extension of the WB SAAs, makes single market access conditional not only on political and economic domestic structural reforms, but on the progress made in intra-regional market integration.

The Serbia SAA emphasises regional cooperation by requiring the WB country to *"enhance its cooperation"* and to *"implement fully the CEFTA"* (Article 14 Serbia SAA) – the Central European Free Trade Agreement governing trade relations between the WB states.

The Serbia SAA further requires the conclusion of additional bilateral conventions with WB countries that foster political dialogue, establish free trade, cooperation in justice affairs and provide free market access more globally (Article 15 Serbia SAA).

This conditionality has been constantly upheld in the EU's policy on the WBs, with the most recent draft Growth Plan tying access to EU internal market benefits and the release of funds under the draft Reform and Growth Facility (the financial assistance vehicle of the plan) (European Commission, 2023b) to a wide set of reforms.

This extends not only to traditional conditionality securing the Copenhagen criteria, including democracy, rule of law and human rights (which apply to WB and EaP countries alike). In the case of WB, the political conditionality also extends to requiring Serbia and Kosovo to normalise their relations and comply with the relevant agreements governing reconciliation, and to negotiate the Comprehensive Agreement on normalisation of relations (European Commission, 2023b, Article 5).

Importantly and in addition, the EU requests economic intra-regional integration as precondition and conditionality attached to access to the EU single market. For example, the Commission envisages making access to EU financial support through its draft Reform and Growth Facility (European Commission, 2023b) conditional ex ante on the implementation of the Common Regional Market Action Plan.

This Plan is the outcome of the Common Regional Market Initiative of the WB countries, which builds on the CEFTA framework (and thus connects to the conditionality embedded in the SAA). The Plan requires, inter alia, the development of a regional digital market, which requires investment in broadband internet access, 5G and digital services.

The Plan also foresees expansion of green lanes at the border to cut waiting times. Hence, the extended conditionality regime allows the EU to make internal market access and access to funding conditional on WB ex-ante investment in these areas.

This conditionality contrasts with the absence of mandatory regional cooperation under the DCFTAs. The agreements are silent on this type of intra-regional conditionality. Specifically, the Ukraine-DCFTA provides for *"regional stability"*, stipulating a vague obligation for Ukraine, Moldova and Georgia to *"intensify their joint efforts to promote stability, security and democratic development in their common neighbourhood"* (Article 9 DCFTA Ukraine).

The main conditionality in the Ukraine-DCFTA is the approximation of the relevant EU law by Ukraine along with the Copenhagen criteria, which must be respected by all EU aspirants. However, the DCFTAs lack the intra-regional layer of conditionality that the EU, in relation to the WB, has increasingly insisted on.

Not only are the DCFTAs lenient on regional integration as a requirement, the question is also whether the EU's persistent insistence on regional economic cooperation is an adequate requirement. Intra-regional conditionality is plausible if it seeks to alleviate political rifts between Serbia and Kosovo, and societal tension and political blockages in decision-making (European Commission, 2023a; Ghodsi *et al* 2022). But the economic intra-regional conditionality referred to above appears much more ambivalent.

On one side, creating a common regional market for goods, services and labour within the Western Balkans offers opportunities for increased trade – according to one estimate[15], regional economic integration in the Western Balkans could generate up to 2.5 percent of GDP growth, should the level of integration reach the level of that of the European Free Trade Association (EFTA), while it could even generate up to 7 percent should it reach the EU's level of integration.

The most ambitious initiative negotiated in this regard is the creation of the Common Regional Market[16] as an outcome of the Berlin Process, launched in 2020[17]. It foresees WB intra-regional freedoms of goods, services, capital and people, including aspects relating to digital, investment, innovation and industry policy.

On the other side, barriers to intra-regional economic integration lie in the lacking physical infrastructure and persistent inequality in the WB. In particular, lack of public investment in roads, digital infrastructure, railways and energy have been identified as limiting factors (Ghodsi *et al* 2022).

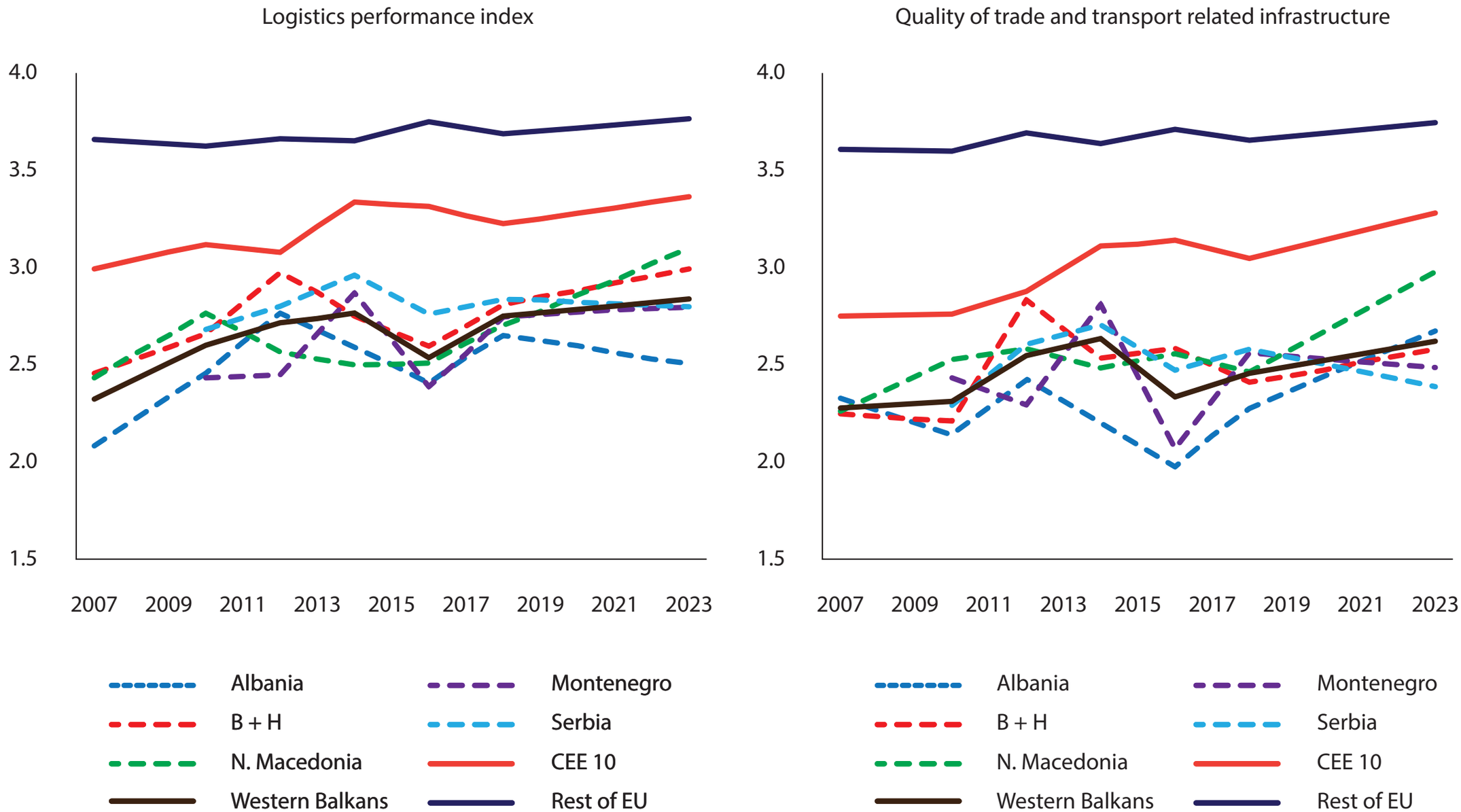
The Commission itself noted in its November 2023 Communication on enlargement that *"there is a strong need to upgrade infrastructure; investments should be… consistent with the priorities agreed with the EU"* (European Commission, 2023c, p.11).

Panel B of Figure 3 highlights the limited progress achieved on improving the trade-related intra-regional infrastructure and in closing the gap with the EU, using the broader logistics performance index[18] (Figure 3, Panel A), similarly showing low levels of convergence.

Even the central and eastern European EU members (a more adequate group for comparison with WB countries) seem to have been more successful in improving trade-related infrastructure by reducing the gap with other EU members. However, convergence has not been better across the same indicators for the EaP countries (see Annex 4).

The connection to conditionality is that with limited public investment in infrastructure identified as one persistent barrier to regional integration in the WB[20], the EU should not implement ex-ante conditionality on WB public

Figure 3. Logistics and trade-related infrastructure



Note: Data is available for 2007, 2010, 2012, 2014, 2016, 2018 and 2023. Data for Serbia, Montenegro and Georgia unavailable for 2007. Data for Albania is unavailable for 2014. Data for Kosovo unavailable throughout. WBs is a simple average of the relevant countries. CEE 10 and Rest of EU refer to the simple averages of the central and eastern European countries that joined the EU in the 2000s[19] and the other 17 EU countries, respectively. See Annex 4 for the same exercise for EAP countries.
Source: Bruegel based on World Bank Logistics Performance Index.

investments in digital infrastructure or crossborder trade facilities, as set out in the Common Regional Market Action Plan (eg. lanes at borders or customs procedures).

The EU should fund these 'win-win' investments, which are beneficial to the WB and the EU alike, rather than blocking EU internal market access because of the lack of these investments. This concerns in particular crossborder infrastructure and networks that are often underfinanced because of a mismatch between costs and benefits and that are, under EU internal market standards, typically eligible for funding. WB infrastructure should be prioritised accordingly. Conditionality attached to these kinds of projects is not a sensible approach.

In fact, intra-regional crossborder transport infrastructure has significant positive spillovers, such as the potential to reduce income disparities across the EU and its neighbouring regions.

In this regard, it is positive that the draft Growth Plan implies revising the trans-European transport framework (TEN-T), in order to include a new corridor crossing the Western Balkan region (Western-East Mediterranean corridor), and the EU's recent Economic and Investment Plan for the Western Balkans offers financing of rail transport[21].

However, conditionality of the new Growth Plan should be relaxed for these infrastructure projects more generally and the involvement of European Investment Bank and the European Bank for Reconstruction and Development funding in the investment should be further facilitated (Ghodsi *et al* 2022).

Finally, conditionality should also be rethought in light of geopolitical rivalry. EU conditionality contrasts with Chinese investment in the region without strings attached, which makes Chinese FDI more attractive.

Again, the legal comparison of WB SAAs with the DCFTAs shows that the latter offer a more explicit acknowledgement of internal market integration. The Ukraine AA is explicit about its objective of bringing Ukraine into the EU internal market (Article I (d) of the Ukraine-DCFTA), while such an explicit recognition of this objective is absent from the Serbia SAA, in which language is limited to *"gradually develop a free trade area between the Community and Serbia"* (Article 1 (f) Serbia SAA).

While more assertive language in the agreements does not guarantee more favourable economic outcomes, specifying the objective in the agreement can bind the institutions under the SAA to work towards that goal.

2.2 Trade in goods and non-tariff barriers

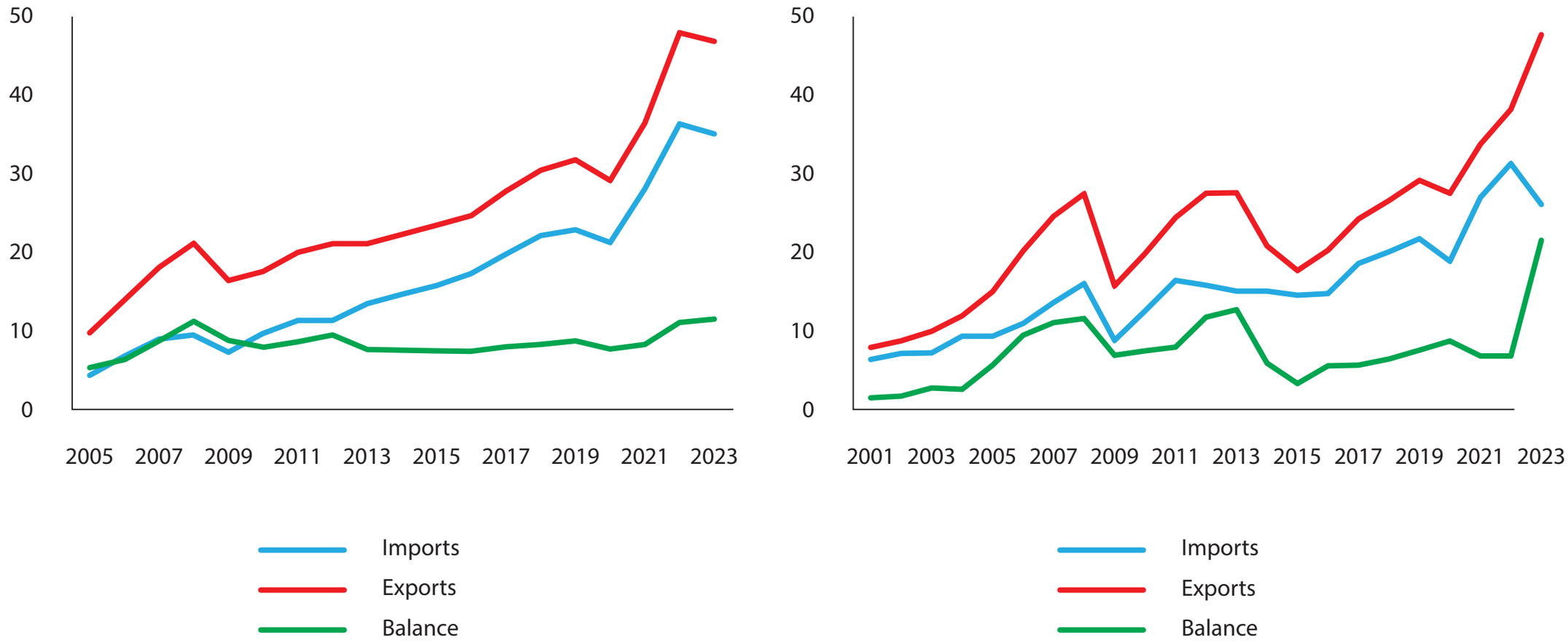
The EU-Ukraine association agreement has been praised by European Commission officials as *"the most ambitious Agreement that the EU has ever developed with any partner"*[22].

Indeed, by integrating the DCFTA into the Association Agreement, the integration of Ukraine, Georgia and Moldova into the EU has been propelled through wide-reaching market access and regulatory approximation, ushering in increased trade with the EU.

How do the agreements facilitate market integration? The WB SAAs have eliminated tariff barriers with the EU to a great extent, and trade with the region has grown by almost 130 percent over the past 10 years.

Figure 5 confirms that trade between the EU and WB has grown in absolute terms (though did not further increase the already high levels in relative terms, Figure 1), and there is no indication of being outpaced by the Eastern Partnership countries. Yet, non-tariff barriers (NTBs) remain significant – both barriers with the EU and within the Western Balkans region.

Figure 4. EU27 trade in goods with WBs (left) and EaP countries (right), € billions



Note: See Annex 2 for data disaggregated by country.
Source: Bruegel based on Eurostat (DS-018995).

NTBs can generally be associated with technical regulations, customs procedures, licensing requirements and other regulatory obstacles, all of which limit trade through increased costs, delays and administrative burdens.

For example, the waiting and processing time only at crossing points in CEFTA states generates between €250 million and €300 million in costs annually (World Bank, 2015). While reliable data on the scope of NTBs is limited, some proxies indicate their presence.

For instance, World Bank Trading Across Barriers data points to higher costs, both financial and in terms of time taken, associated with border and documentary compliance for importing goods to the Western Balkan countries, than to the EU or high-income OECD countries (Annex 5). While the same data limitations make it difficult to identify non-tariff barriers in EaP countries, the consensus is that they also pose challenges to trade in these countries.

Comparative legal analysis of the treatment of NTBs reveals a more detailed legal regime in the Ukraine DCFTA in three respects. First, the Serbia SAA does not foresee a non-discrimination rule regarding non-tariff measures, while the Ukraine DCFTA established a national treatment rule (Article 34).

It has been argued that the current legal reference to freedom of goods in the SSA should be interpreted in line with EU law and would thus suffice to ban non-tariff barriers (Sretić, 2023).

Second, the Ukraine DCFTA explicitly addresses technical barriers to trade (TBTs), in particular the *"adoption and application of technical regulations, standards, and conformity assessment procedures"* (Article 53).

Again, the Serbia-SAA is silent on the treatment of technical barriers to trade. The CEFTA addresses TBTs and provides for a governance structure to minimise them (Article 13). There have been further attempts to address

NTBs in the WB intra-regional integration process. For example, the Common Regional Market (CRM) has established green lanes at borders within the region.

Through better exchange of customs data before goods arrive at crossing points, the transit times for goods have greatly reduced (European Commission, 2023a). The draft Growth Plan, while requesting alignment with EU standards, does not foresee a regime to address further eradication of NTBs.

Yet overall the lack of salience of TBTs in the SAAs does not correspond to the significance of this source of impediment to market integration. Estimates suggest that a three-hour reduction in waiting times is the equivalent of a 2 percent reduction in tariffs (Del Mar Gomez *et al* 2023).

The OECD has considered the trade reducing effects of being outside the single market associated with TBTs and sanitary and phytosanitary measures (SPS) measures, suggesting these costs amount to 50 percent of the ad-valorem equivalent of measures on goods imported into the European Union from third countries (RCSPI, 2023). We infer that NTBs remain under-addressed at the level of the SAA agreements between WB countries and the EU.

Reducing NTBs is pivotal. Slow customs procedures are often the result of lacking infrastructure. For example, electronic payment of duties and charges and pre-arrival processing are essential infrastructure elements, lacking in all CEFTA economies. Serbia and Montenegro are reported not to offer the option of paying the fees for exports online (GIZ, 2022).

As argued above in relation to crossborder infrastructure and networks, infrastructure facilitating customs procedures should qualify for EU funding without (or with limited) conditionality, because the positive intra-regional economic effects are significant. The EU should allocate financial resources to the modernisation of such

facilities, in particular infrastructure that facilitates the payment of duties, taxes and other fees for the importation process.

In addition, mutual recognition also helps to reduce waiting times caused by scanning procedures and sample testing. The EU has created separate lanes with WB countries, and the same practice should be applied between WB countries (GIZ, 2022).

Again, where EU funding could facilitate this, there should be unconditional support for expanding joint crossing point facilities and establishment of separate lanes.

Likewise, concerning intra-regional commerce with 'mutual recognition' having proved itself as a motor for fostering intra-EU trade, WB countries should pursue recognition of conformity assessments procedures across the CEFTA region. The CEFTA provides the framework for this both in the field of SPS measures and NTBs more generally, but the available legal space under the agreement for eradicating NTBs (Articles 12, 13 CEFTA) should be exploited further.

In particular, Article 13 para. 4 CEFTA paves the way for WB countries to implement *"mutual recognition of conformity assessment procedures"*, offering a powerful tool for eliminating non-tariff barriers.

Finally, the EU should see advantages for itself not only in liberalising access to the internal market but also in outbound investment into the WB region. Access to the EU internal market and EU-financed crossborder infrastructure would reduce WB dependence on geopolitically risky partners.

For example, given Serbia's persistent dependence on Russian energy supplies, the EU should integrate the WB into its energy internal market by fostering the construction of electricity and gas connections – in the EU's own best interest and without conditionality.

At a time when economic security is becoming so important, helping to integrate the WBs into the supply chain could be very useful and help reduce dependencies. The Trans-Balkan electricity corridor is a good example[23], but further energy-oriented EU investments efforts could be directed to financing solar-energy capacity in the Western Balkans or wind and hydropower projects (Ghodsi *et al* 2022).

The EU can also do more to provide loan guarantees and investment incentives for private firms to invest in infrastructure in the region, in addition to tying this to reform and green agenda benchmarks. With EIB and ERBD expanding targeted loan guarantees to firms investing in these areas, the investment potential would be increased (Ghodsi *et al* 2022).

The draft Growth Facility aims at accelerating the green transition towards decarbonisation and to boost innovation, particularly for SMEs and in support of the green transition, yet no reference is made in the draft Facility to technological and industrial support to that end.

Energy-related infrastructure is an important policy field in view of the politically controversial energy dependence of WB countries on Russia (in particular Serbia). However, the CEFTA agreement is silent on issues of infrastructure, energy or gas supplies, leaving untapped a natural area of cooperation.

While integration into Europe's energy markets is part of the goals under the Serbia SAA (Article 109), there is no provision for translating these goals into substantive market access and specific cooperation obligations.

By contrast, the Ukraine DCFTA offers a comprehensive and substantive regime on energy, covering, inter alia, prohibition of trade-restrictive measures and striving for the emergence of energy markets (Article 338).

As long as there is no integration into EU energy markets in the WB, trade in energy will be constrained significantly by insufficient investment in transmission infrastructure and production capacity. China and Russia are likely to fill a void left by the EU, using state-driven investments in essential infrastructure in the WB (Stanicek, 2022).

Against this background, a proposal worth exploring on the level of implementation is to integrate the Western Balkans fully into the EU emissions trading system (ETS), which would accelerate the energy transition in the WB and be a significant new source of funding (Egenhofer, 2023).

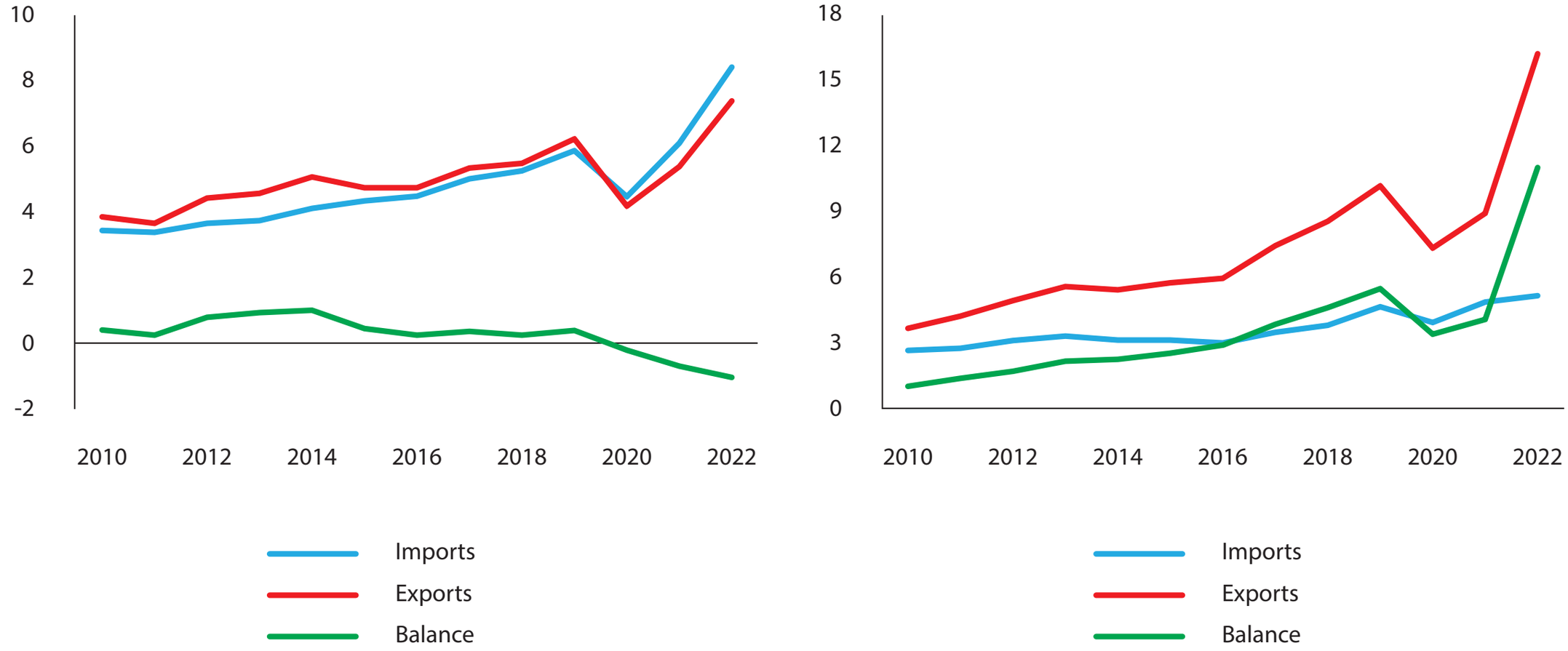
2.3 Freedom of services

From a comparative perspective, data on trade in services shown in Figure 6 indicates that WB services trade with the EU has grown less quickly than goods trade (compare with Figure 4). Also, EU services exports have grown more quickly with the EaP than with the WB, though from a very low basis.

One reason for this may be associated with the shortcomings in unleashing the potential of services, which can be illustrated by the inferior treatment of services in the Western Balkans SAAs compared to the Ukraine DCFTA. The EU-Ukraine DCFTA establishes a non-discrimination standard for Ukrainian services provided in the EU.

Specifically, these services must be granted *"treatment no less favourable"* than EU domestic services (Articles 93, 94). While this does not apply to all services, it extends to an extensive list of services. Consequently, the available evidence on Georgia supports the idea that its services sector has been expanded, with exports more than doubling in size since the entry into force of the DCFTA between 2014 and 2019 (Akhvlediani *et al* 2022).

Figure 5. EU27 trade in services with the Western Balkans (left) and EaP (right), € billions



Note: Data for Kosovo is not available. Data is presented from the perspective of the EU. See Annex 2 for data disaggregated by country.
Source: Bruegel based on Eurostat (bop_its6_det).

The Serbia SAA does not stipulate a no-discrimination principle similar to the Ukraine DCFTA. The Serbia SAA provides that the EU may not take measures that are *"significantly more restrictive"* than the situation before the Serbia SAA. It also provides procedurally for the EU and the WB to engage in *"steps to allow progressively the supply of services."*

Yet, this procedural potential has not so far been exploited, while substantive law liberalisation of services remains weak compared to the non-discrimination rule under the DCFTAs. Even the CEFTA does not provide unconditional liberalisation of services on intra-regional level.

The legal comparison points at the absence of rules providing for substantive discrimination prohibitions and the lack of regulatory harmonisation. This contrasts with the non-discrimination clearly spelled out in the agreement on trade in goods. Regulatory harmonisation (or mutual recognition) would be particularly beneficial in core service areas of the region, such as travel and transportation (RCSPI, 2023).

2.4 Capital movement

The EU accounts for approximately 60 percent of the current FDI stock in the Western Balkans[24], but there is no indication that FDI is treated more favourably in either the Western Balkan or the countries of Eastern Partnership.

The rules laid down in the relevant agreements indicate a high degree of capital movement freedom. Established through a ban on discrimination, capital movement is guaranteed both in the WB (Article 63 Serbia SAA) and in the Ukraine (Article 145 Ukraine DCFTA). Both types of agreements explicitly extend the free movement of capital to direct investments.

However, specific relevant sectors enjoy less-favourable treatment in the WB. For the financial sector, for example, DCFTA agreements offer an elaborate regime to promote the access of European investment in the Eastern partnership countries.

Access is granted to payment systems (Article 132 Ukraine DCFTA), regulatory approximation is required (Article 133) and bans on discrimination exist (Article 128). By contrast, the WB SAAs emphasise that financial services are subject to significant restrictions (Articles 54, 56 Serbia SAA).

Figure 6 shows that, much like for trade, EU FDI in the two regions is mainly into Serbia and Ukraine respectively (however, see Annex 3 for a breakdown of EU FDI into the various countries as a share of their GDP)[25].

The evidence suggests that FDI could be driven, more than the other freedoms we have discussed, not only by the openness of market access but by factors beyond the absence of barriers to moving capital. This is also evidenced by the experience of Bulgaria and Romania.

Both saw a one-time surge in FDI after accession to the EU, but have remained at pre-accession levels since. Rather, factors associated with state-driven investment and geopolitical competition have significant effects on FDI in the WB. The EU has historically been the dominant investor in the WB (See Annex 3).

In any case, a legal regime that secures non-discriminatory treatment of capital movement does not offer a complete picture on possible vulnerabilities related to FDI. This is so because state-funded, non-EU foreign investment increasingly outcompetes EU private investment. Some research points to a growing Chinese investment footprint in the region, especially in Serbia (Vulović, 2023; Bykova *et al* 2022), which seems to be driven

Figure 6a. EU27 FDI stock in the Western Balkans (€ billions)

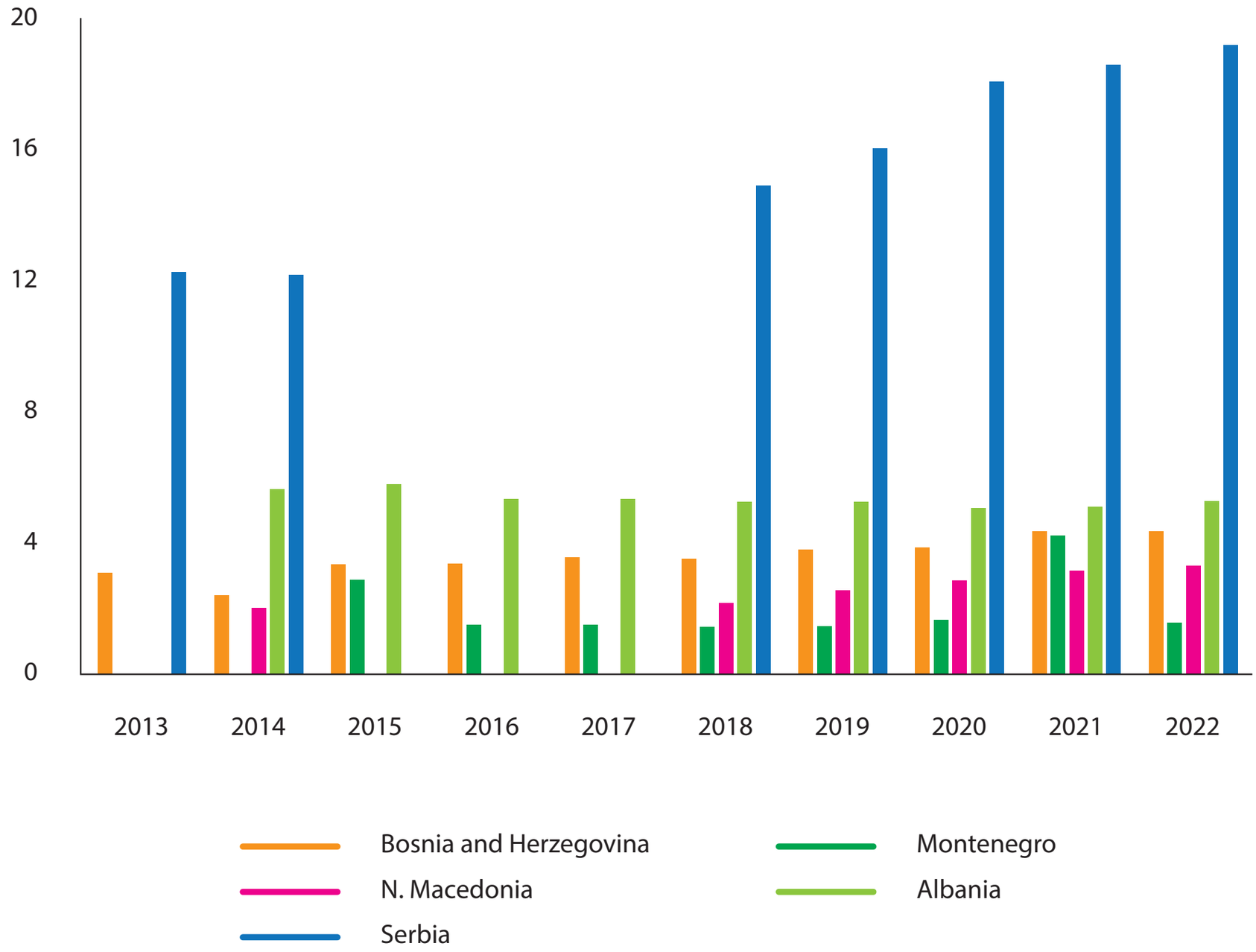
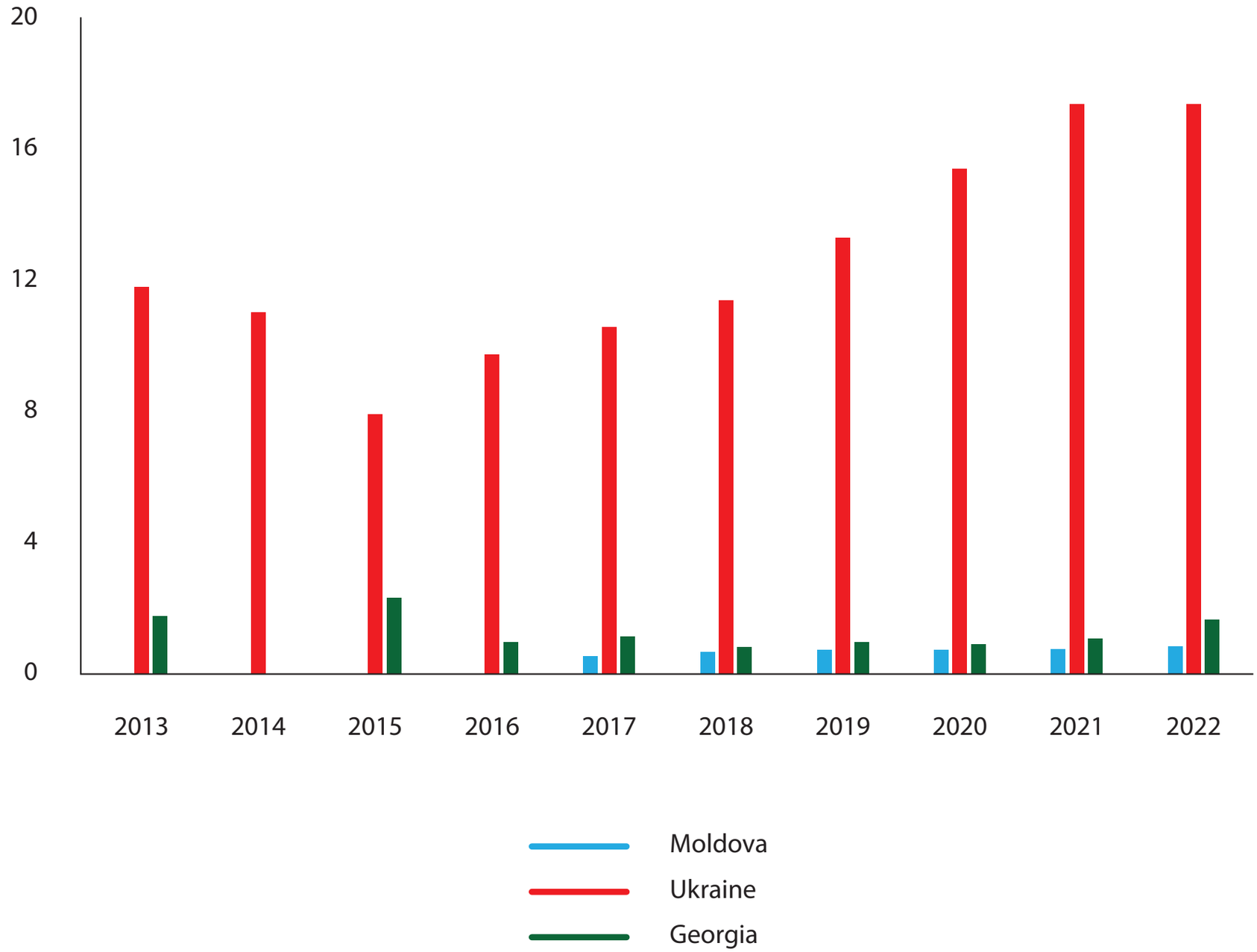
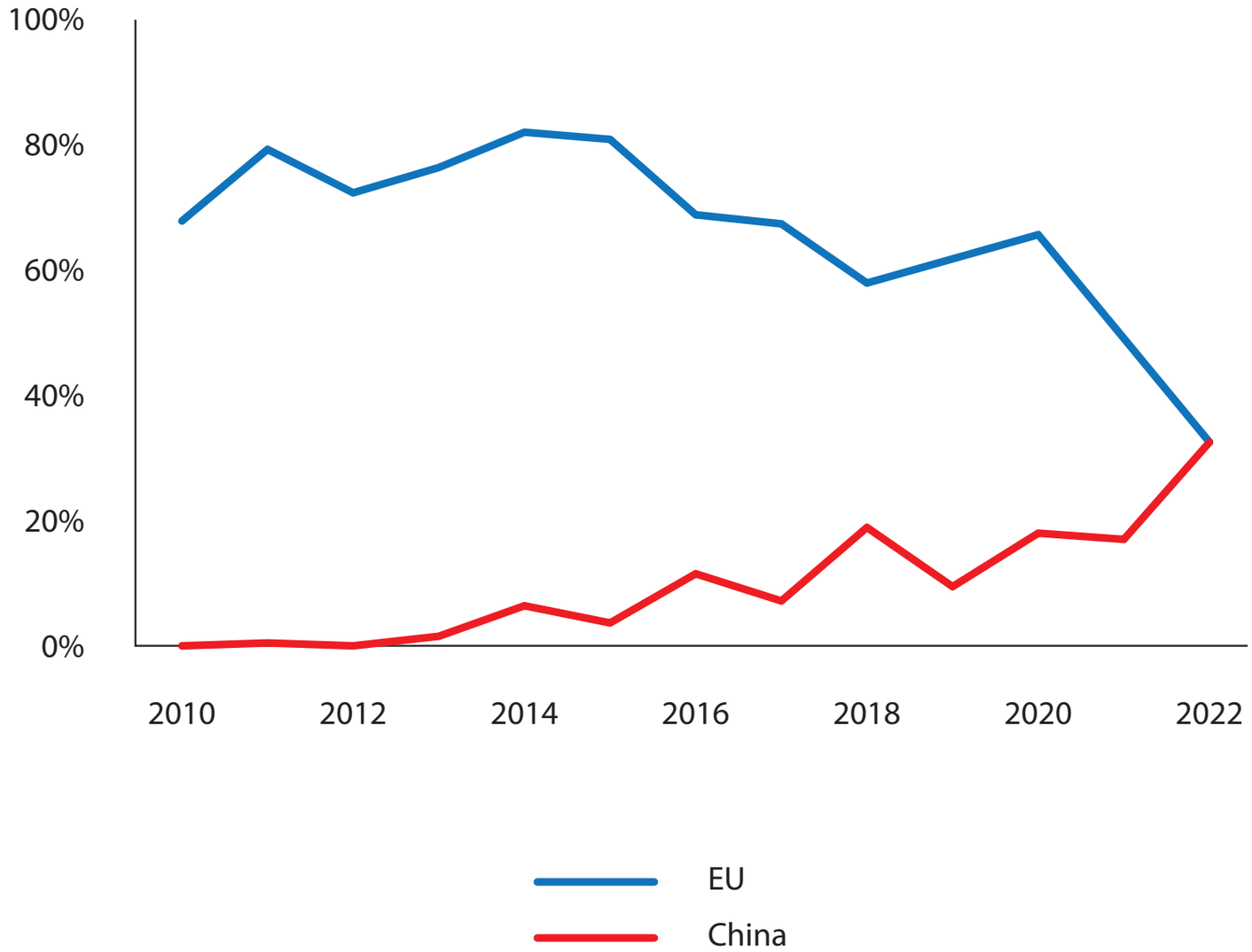


Figure 6b: EU27 FDI stock in the EaP (€ billions)



Note: The lack of data in some years is due to data not being reported by Eurostat for confidentiality purposes.
Source: Bruegel based on Eurostat (bop_fdi6_geo).

Figure 7. Share of net FDI flows to Serbia, 2010-2022



Note: The variable reported is the share of the EU27 and China net FDI in overall net FDI in Serbia. Net FDI is calculated as the difference between assets (Serbian residents' investments abroad) and liabilities (non-residents' investments in Serbia). Over this period there was consistently a larger inflow of investment into Serbia than outflow. This figure shows the share of that net inflow of FDI that comes from the EU27 and China.
Source: Bruegel based on National Bank of Serbia[26].

by state-owned investors or by state-guaranteed finance linked to contract guarantees for Chinese companies (Ghodsi *et al* 2022).

Indeed, this increase in Chinese investment in Serbia is supported by China's growing share in net FDI flows to Serbia (Figure 7).

Dependence on countries perceived (from a European perspective) as geopolitical rivals increases the WB's vulnerability to geopolitical turmoil. A high EU share of FDI in turn should align EU and WB interests.

Furthermore, from the EU perspective, FDI in WB is self-serving, as one element of a 'de-risking' strategy, put in place by incentivising European firms to shift production closer to home, with the Western Balkan as one region in which geopolitical competition takes place.

As mentioned above, the ERBD and EIB can play an important role in promoting EU FDI in the region and in maintaining the FDI-based ties between the EU and WB, thus sidelining investment from geopolitical rivals. Through these institutions, the EU should develop and enhance the capital market in the region, in particular by stimulating investment by smaller firms in the region (Ghodsi *et al* 2022).

Both EU outbound investment promotion and inbound investment control can play roles here. Outbound EU investment to WB has positive implications (both for the EU and WB countries) beyond market opportunities and should be promoted through available incentivising instruments, while WB inbound investment control becomes increasingly important in light of the state-driven and strategic investment of China and Russia in the region.

The existing EU inbound investment control regime should be treated as relevant acquis that should enjoy priority in implementation in the WB. This would help to identify (and divert) state-driven acquisitions that could ultimately increase WB dependence and vulnerability.

Within the WB bloc, this implies that EU and WB countries must develop regional guidance on screening mechanisms that respond to FDI in line with the EU investment control regime.

2.5 Approximation of laws

Another comparative imbalance between the WB and eastern European countries are their variable commitments on the approximation of laws. While the EU generally makes the adoption of the acquis an ex-ante precondition for access to the internal market, there are significant differences in how this obligation is put in place substantively and in governance structure.

Approximation of laws forms an essential element of the SAAs, which provide for seamless access to the internal market for goods originating from WB countries based on a sufficient alignment of national rules with the Union acquis.

Specifically, the WB SAAs *"recognize the importance of the approximation to that of the Community"* (Article 72 Serbia-SAA) and they provide for a governance structure that aims at promoting the approximation process.

What is missing beyond this general obligation is a more detailed enumeration of specific legal texts to be adopted and by when. Likewise, CEFTA provides a governance structure on *"harmonization of technical regulations and standards"* in the field of TBTs (Article 13 of CEFTA) but remains silent on substantive obligations and concrete legal texts.

This contrasts with the extensive approach on the approximation of laws under the DCFTA agreements, which specify the approximation of laws for individual policy areas (rather than one single encompassing global obligation).

In the DCFTAs, the agreements are much more explicit, with the listing of hundreds of directives and regulations that the Eastern partnership countries are required to implement.

Take public procurement as a specific example. The Georgia DCFTA provides for a gradual approximation of public procurement legislation in Georgia with the Union public procurement acquis based on the specific EU procurement law (Article 141 Georgia DCFTA), and it requires further approximation with the Union's public procurement acquis (Article 146 Georgia DCFTA).

In essence, while the WB SAAs rely on a procedural framework to pursue approximation of law (through cooperation), the DCFTA agreements, in addition to a procedural framework, specify substantively the specific approximation obligation.

Evaluation of the Georgian experience shows that the gradual approximation to EU norms in public procurement improved the already reformed system (Akhvlediani *et al* 2022).

The higher degree of specificity in terms of the obligation to approximate the laws is also a result of a continuous practice of amending the SAAs. The Ukraine SAA has been modified and extended by new or revised Annexes to the SAA around ten times since 2018, while the Serbia AA has been amended in the same time period only once.

One reason for this difference could lie in the more compelling approximation ambition in the EaP SAAs. For example, the Ukraine SAA contains special approximation provisions for the areas of sanitary and phytosanitary and animal welfare legislation, as well as for telecommunications – these specific approximation obligations have been used to amend and further develop the Ukraine SAA. In turn, the Serbia SAA is limited to a general approximation provision but largely lacks more specific obligations.

3 Comparative assessment of governance deficiencies

While integration into the internal market is primarily an issue of substantive requirements on market access, governance is essential in implementing effectively the commitments under the agreements.

The governance structure common to SAAs typically involves an SAA Council as political body, with high-level representatives of both the EU and the country in question, tasked to supervise and evaluate the integration process. A Stabilisation and Association Committee composed of high-level civil servants supports and prepares the work of the SAA Council. Sub-committees involving civil servants meet at technical level throughout the year to discuss and monitor progress on specific subject areas covered by the SAA.

There is also a joint SA Parliamentary Committee, involving members of the national parliament and of the European Parliament, from across the political spectrum. These joint institutional structures manage the process by jointly overseeing the implementation of the SAA.

3.1 Political dialogue and civil society

With the WB as a region characterised by multiple historical and contemporaneous internal political tensions (Domi, 2023), the political dialogue as a reconciliatory and inclusive element for integration of the WB into the EU single market is key when it comes to effective implementation of the agreements.

The EaP countries and the WB have established structures of political dialogue that serve to address political and technical issues impeding implementation and deepening cooperation. Dialogue can take place at different political and technical levels between the EU and the region (Annex 1).

Building on the general governance institutions mentioned above, a number of additional formats subsequent to the initial governance under the SAAs have been initiated. Intra-regional governance is put in place through the Regional Common Council (RCC) Secretariat under the Regional Common Market initiative, in cooperation with the CEFTA Secretariat.

The different institutions perform different functions, either inter-regionally to foster convergence with the EU, or intra-regionally between WB countries.

A core difference and shortcoming of the WB structures, compared to the relationship between the EU and the EaP countries, is the absence of civil-society involvement in the framework of implementing the agreements.

Civil society plays an important role in various ways: civil society is a carrier of expertise feeding into implementation of commitments; civil society is key in identifying and eliminating barriers to trade; it collects relevant information to provide to the bodies engaging in trade facilitation or rules approximation.

Civil society also has an important and disciplining surveillance function over governmental decision-making. Also, civil society is one of the groups affected by democratic backsliding in some of the WB countries, undermining the ability of civil society to monitor government action.

The sufficient integration of civil society into the governance structure of the SAA (and the EU Growth Plan) can thus be likened to the Copenhagen Criteria for EU accession, for which involvement of civil society without political and administrative pressures is indispensable.

In that respect, the Ukraine DCFTA establishes a comprehensive structure for political dialogue involving civil society. The EU and the DCFTA countries are obliged *"to involve civil society in the implementation of the agreement"*, to encourage mutual exchanges of experiences and multiple other forms of connecting civil society among each other, as well as with decision-makers (Articles 443, 444, SAA Ukraine). It even creates policy-specific civil-society exchanges, such as for trade and sustainability issues (Article 299, SAA Ukraine).

By contrast, the relevant agreements involving the WB are silent on the role of civil society. The WB SAAs do not assign a task to civil society, nor has CEFTA integrated civil society into the implementation process, nor does the Working Programme of the Common Regional Market[27] identify civil society as a relevant contributor to the implementation process.

In addition and likewise, the EU does not seem to attach much value either to civil-society involvement. Its draft Growth Plan foresees a role for civil society only at the evaluation stage, and only as one of many stakeholders (Article 25 of draft Growth and Resilience Facility).

The limited role of civil society in implementing the WB SAA is insufficient and forgoes benefits, both from the perspective of relevant expertise as well as a source of legitimacy and acceptance.

Again, Georgia can be referred to as a positive example in this respect. The Georgia SAA established a Civil Society Platform, which enables civil-society organisations from both sides to monitor the implementation process and prepare their recommendations to the relevant authorities.

Specifically, the Georgian National Platform of the Eastern Partnership Civil Society Forum was established in 2015 as a consultative body under the Association Agreement. It brings together up to 200 organisations, among them civil-society organisations, employee organisations, trade unions and associations.

Not only does this platform perform a bottom-up process of providing insight, but it also assures the monitoring of the AA/DCFTA's implementation by producing recommendations to the Association Council and the relevant authorities of both parties (Akhvlediani *et al* 2022).

3.2 The DCFTA Trio format as role model?

There is no shortage of political bodies created under the agreements and involved in the process. Association Agreements, CEFTA, the Common Regional Market Initiative – bodies abound, yet they remain deficient. CEFTA's governance structure lacks the enforcement capacity that other trade agreements with similar scope of ambition have.

CEFTA is designed in intergovernmental fashion, it has not created institutions endowed with competences to make legislative proposals, nor does it exercise adequate supervision over the implementation of the agreement.

While the CEFTA Secretariat is largely limited to providing technical and administrative support to the CEFTA Joint Committee and Bodies, the latter are plagued by the need to decide by consensus and are riddled by political controversies over the representation of Kosovo (RCSPI, 2023).

To some extent, the Common Regional Market initiative sought to create the missing element. The RCC Secretariat created under this framework (including countries such as Turkey and Greece) coordinates and monitors the Action Plan in close cooperation and consultation with CEFTA Secretariat.

While dialogue, reconciliation and cooperation characterise the work of the RCC, its success is limited because of the participation of countries beyond the WB, including the geopolitical rival Turkey, which limits the possibility for this governance framework to focus on the specific concerns of the WB countries in relation to the EU.

Drawing from the experience of the EaP countries, there is a need for a political framework dedicated to the joint WB endeavour for EU accession. The 'new frontrunners' – Ukraine, Georgia and Moldova – motivated but disappointed about the slow accession process, created an Associated Trio format in 2021 to push harder to *"enhance their political association and economic integration with the EU"*, in line with their European aspirations[28].

The Trio format was complementary to the multiple other formats and bodies established under the Eastern Partnership, but it was complementary in a productive way by offering an agenda for the dialogues between the 'Association Trio' and the European Commission, in addition to the DCFTA-related issues, one that deepened cooperation in areas including transport, energy and green economy, even if the Trio has its own shortcomings and the war in Ukraine has hampered the effectiveness of this institution.

Taking the Trio format of the DGFCA countries as role model, it is worth exploring an equivalent body as a complementary element to the multiple existing formats and bodies of the Western Balkan. While WB states maintain their individual agreements with the EU, there is no sufficiently visible format that focuses on the joint WB concerns in pursuing EU accession.

Just as the Trio format of DGFCA countries established ad-hoc trilateral consultations to discuss specific issues in the framework of their integration with the EU, a similar institutionalisation could promote the concerns of the WB beyond the SAAs and the Growth Plan framework.

Such a framework could establish 'Trio' coordinators within the Ministries of Foreign Affairs, and coordinate meetings at expert, senior official and, when appropriate, ministerial levels.

The Open Balkan Initiative (OBI) could be a first step in this direction. Intended to intensify the economic integration between three WB countries (Albania, North Macedonia and Serbia), this initiative could grow further to become a representative body that represents WB interests in relation to the EU.

The initial motivation for the OBI arose from fatigue with the sluggish EU integration process, but it could become a productive forum by accelerating intra-regional economic integration, political cooperation in the areas of infrastructure and transport, and the fight against organised crime and terrorism (Semenov, 2022).

There is the potential that the EU finds a counterpart able to speak with one voice for WB countries. Yet, in its current setup, the OBI is not able to compensate for one of the core deficiencies of the cooperation frameworks under CEFTA and the Common Regional Market, which is the absence of an independent institution tasked with overseeing and implementing agreements, and which ensures consistent implementation across countries and alignment with the EU acquis (RCSPI, 2023).

4 Conclusions

The importance of EU single market membership to WB economic prospects cannot be overstated. This analysis sought to highlight differences between WB SAAs and DCFTAs and lessons to learn from the DCFTA process. It showed that the DCFTAs apply a more lenient approach to intra-regional cooperation.

Also, the DCFTAs subject non-tariff barriers to a more explicit regime than WB SAAs; rules governing trade in services incorporate a stronger non-discrimination standard; and the DCFTAs offer a more rigid and comprehensive

approach to the approximation of laws than the WB countries. It is the latter point in particular that underscores the different integration models underpinning the WB SAAs and the DCFTAs.

The WB SAAs were initially concluded with the prospect of addressing the adoption of the acquis during the subsequent accession negotiations (which then turned out to be delayed), rendering SAAs in some aspects less ambitious.

In turn, conclusion of the DCFTAs with the EaP countries was seen as a substitute for EU accession, which explains the (in parts) greater degree of trade liberalisation in the EaP countries than in the WB, and the more assertive stance of these agreements in particular on approximation issues.

There is no indication that the differences in legal governance have translated into a stronger economic performance in the EaP countries compared to the WB. From a comparative perspective, the analysis suggests that dubbing Ukraine and other EaP countries as the 'new frontrunners' appears premature if not misleading. Rather, they can be dubbed 'quickstarters', reflecting their rapid pace in moving from application status to candidate status and accession negotiations.

The WB remains significantly more integrated in trade with the EU than the EaP countries, while convergence with the EU has been stagnating both for the WB and the EaP. While not underperforming compared to the EaP countries, economic deficiencies in the WB nevertheless exist and should be addressed.

Conditionality attached to both internal market and EU funding should be nuanced; above all, in relation to economic intra-regional integration, it should not impede the necessary investments. The eradication of non-tariff barriers should enjoy priority both inter-regionally with the EU and intra-regionally between WB countries.

The EU's levers for promoting investment in the region should be further enhanced, a demand that is further reinforced by geopolitical concerns about Chinese investments coming without EU-type conditionality attached, and thus creating a tempting alternative for WB countries that have been increasingly disappointed with the slow progress in EU accession.

The question is whether and how the identified shortcomings in the agreements should be addressed. One avenue is to seek amendments of the SAAs and adjust according to the shortcomings identified in this analysis, which implies bargaining with the EU on amending the SAAs on a country-by-country basis. Such a formal amendment approach is likely to undermine the negotiation stage of EU accession (into which five out of six WB states have entered).

Amending the SAAs with a view to aligning them with the DCFTAs would in the WB region be perceived as a (disappointing) substitute for EU accession. An alternative would be to seek an agreement that is complementary to the existing ones, concluded between WB countries (negotiating in unity) on the one side and the EU on the other side.

This approach would be in line with the above exploration of a joint body as a counterparty to the EU. However, the existing and persistent intra-regional political tensions make a sufficiently homogenous stance, as a precondition for crafting a joint agreement, an unlikely prospect.

A third and more pragmatic solution would be to use the existing framework to the greatest extent possible. For example, regulation of trade in services gives leeway to the SAA Council to *"take the measures necessary to progressively"* liberalise the supply of services (Article 59 Serbia SAA). In addition, the SAA Council has sufficiently

wide procedural leeway to widen the scope of interaction with civil society and to create space for civil society in the implementation of the SAAs (Article 120 Serbia SAA).

In turn, the EU is more flexible in unilaterally adjusting its policies on the WB. It could nuance the conditionality embedded in its draft Growth Plan and the draft Growth Facility, and it can extend its tools to foster investment in the regional infrastructure, and thus contribute to stronger convergence by the region. ■

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Endnotes

1. Lisa O'Carroll, 'As Ukraine and others queue to join, is EU ready for enlargement?' The Guardian, 31 August 2023.

2. Services data is missing for Kosovo.

3. Based primarily on European Commission (2023c) and the latest relevant Reports and Conclusions from the European Commission and Council, available for each country; other sources referenced as appropriate.

4. For more details, see 'Treaty on European Union — Joining the EU'.

5. Despite Council agreement to begin negotiations with Albania and North Macedonia in March 2020, the process only began for each country in July 2022.

6. See European Commission news article of 8 December 2023, 'Screening meetings completed as part of screening process with Albania and North Macedonia'.

7. Meaning that it "should be offered official candidate status when it is ready"; see https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/steps-towards-joining_en.

8. See footnote 6.

9. See point 16 in European Commission (2023c).

10. See point 15 in European Commission (2023c).

11. Based on media reports; see for instance Alexandra Brzozowski, 'EU Commission to start screening process for Ukraine, Moldova after 'surprise' delay', Euractiv, 17 January 2024.

12. See point 14 in European Commission (2023c).

13. See 'Stabilisation and Association Agreement with Serbia'.

14. See Association Agreement between the EU and Ukraine.

15. See Majlinda Bregu, Secretary General of the Regional Cooperation Council, speaking at the 10th Belgrade Security Forum, 22 October 2020.

16. See 'The Western Balkans Common Regional Market – a catalyst for deeper regional economic integration and a stepping stone towards EU Single Market'.

17. See https://www.berlinprocess.de/.
18. Which also includes factors such as the efficiency of the clearing process and the ability to track and trace consignments. For more details see https://lpi.worldbank.org/.
19. Bulgaria, Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia.
20. As well as political tensions and institutional factors, for example.
21. See European Commission news article of 13 December 2023, 'European Commission announces additional €680 million investment package for the Western Balkans under the Economic and Investment Plan'.
22. Christian Danielsson, Director-General for Neighbourhood and Enlargement Negotiations, speaking on 3 March 2020. See Strategeast, 'EU welcomes Ukraine's progress in implementing the Association Agreement and the Deep and Comprehensive Free Trade Area', 4 March 2020.
23. See EU Projects in Serbia, 'The Trans-Balkan electricity corridor'.
24. See Council of the EU, 'The EU: main investor, donor and trade partner for the Western Balkans'.
25. FDI data is problematic, given the opacity of the ultimate investor behind the FDI in question. To address these concerns, in Annex 3 we build on the work of Damgaard et al (2019), who used firm-level data to estimate the "ultimate investor economy" in FDI data.
26. See 'Foreign direct investments, by country, 2010-2022 (BPM6)'.
27. Available from: https://neighbourhood-enlargement.ec.europa.eu/enlargement-policy/policy-highlights/common-regional-market_en.
28. See Ministry of Foreign Affairs of Ukraine, 'Association Trio: Memorandum of Understanding between the Ministry of Foreign Affairs of Ukraine, Ministry of Foreign Affairs of Georgia and the Ministry of Foreign Affairs and European Integration of the Republic of Moldova', 17 May 2021.
29. Source and notes are consistent for each figure in this section.
30. Eurostat does not provide services data for Kosovo.

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Annex 1. Legal comparisonAnnex 2. Trade data

Country (Date of entry into force)	Association Agreement/Deep and Comprehensive Free Trade Area Agreements Ukraine (Association Agreement since 2014, DCFTA since 2016)	Associate Agreement Serbia (2013)	Observed differences between DCFTA and SAA
Regional Cooperation Requirements (ie. necessity to integrate primarily regionally)	Chapter 27 - promote regional understanding; support and strengthen involvement of local and regional-level authorities in crossborder and regional cooperation; strive to develop crossborder and regional elements in various areas; regular dialogue on this matter.	Title III, Art 14: "Serbia shall actively promote regional cooperation. The Community assistance programmes may support projects having a regional or crossborder dimension through its technical assistance programmes.… implement fully the CEFTA"; Art 15: "Serbia shall start negotiations with the countries which have already signed an SAA with a view to concluding bilateral conventions on regional cooperation", main elements: political dialogue, free trade areas, various economic freedoms and cooperation in areas such as justice, freedom and security. "Readiness by Serbia to conclude such conventions will be a condition for the further development of the relations between Serbia and the EU"; Art 16: Pursue regional cooperation with the other States concerned by the SA process;	The language seems stronger for SAAs-matches what Windisch said in his intervention "no access to the single market on any of the 7 pillars will be granted before there is integration on the common regional market."

		Art 17: "Foster its cooperation and conclude a convention on regional cooperation with any country candidate for EU accession in any of the fields of cooperation covered by this Agreement… should aim to gradually align bilateral relations… with the relevant part of the relations between the Community… and that country". Should also start negotiations with Turkey on establishing a free trade area.	
Political dialogue structure (institutional exchange, high level, lower level etc.)	Arts 460-468: Highest level is Summit level, to take place in principle once a year; political and policy dialogue at ministerial to take place at least once a year within the newly established Association Council; Parliamentary Association Committee established. Article 5: As well as the above, there will be regular dialogue at Foreign Minister, Political Directors, Political and Security Committee and expert levels.	Title II, Art 10-13: Political dialogue to be further developed between the parties to support the rapprochement between the EU and Serbia and increase convergence on international issues and security and stability; in addition to the institutions described below dialogue can occur directly between officials representing the Council Presidency or HRVP and those representing Serbia Art 119-125: Stabilisation and Association Council, made up of members of the European Council and Commission and the Government of Serbia, is established and shall meet at regular intervals and when required; the Council is to be supported by an SA Committee; Stabilisation and Association Parliamentary Committee established, consisting of members of the European Parliament and the Parliament of Serbia, to allow them to meet and exchange views.	Slight differences: DCFTAs seem to mandate ministerial meetings, whereas SAAs talk about senior officials.

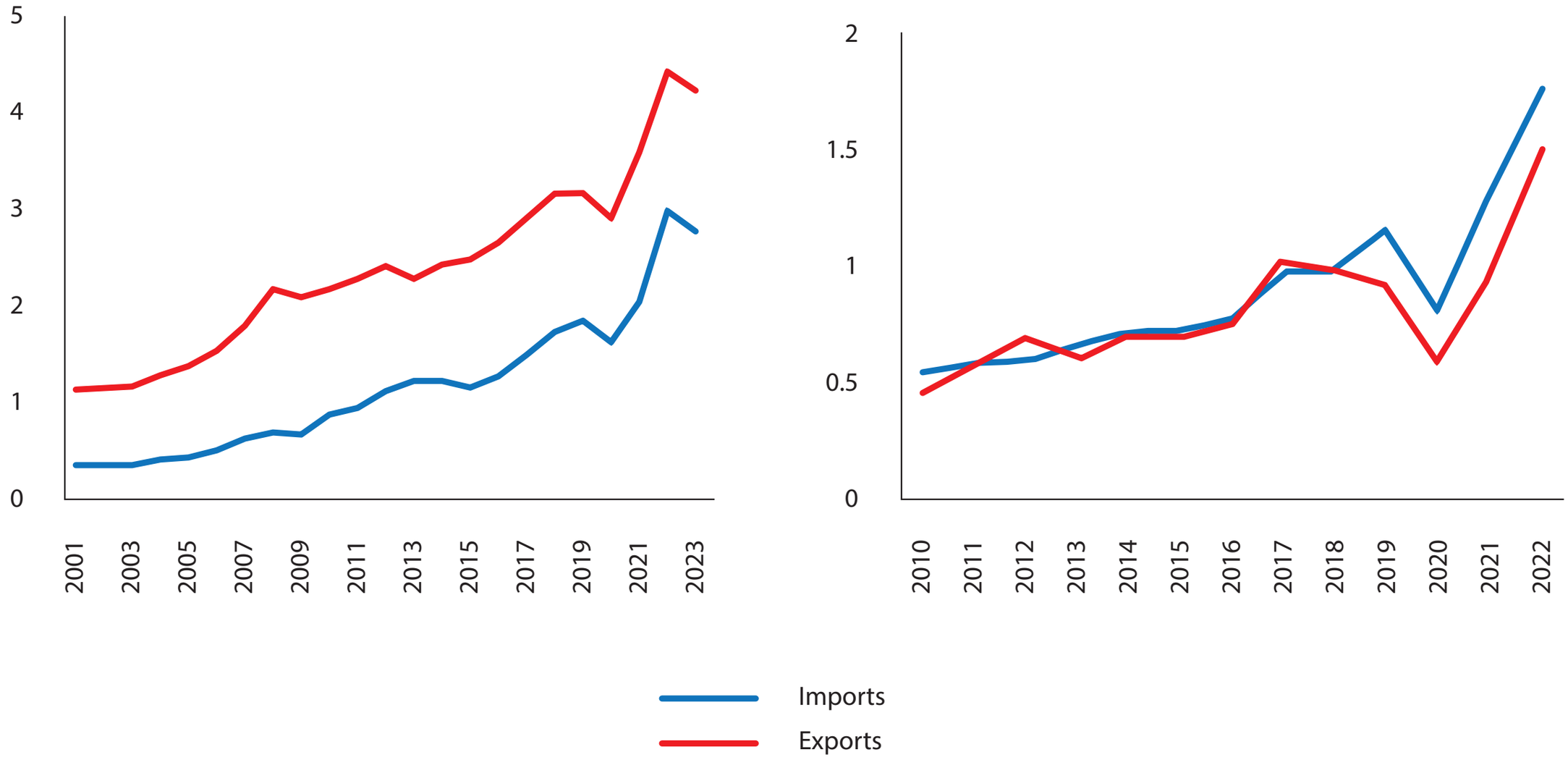
Political dialogue: involvement of civil society	Arts 443 and 444: Promoting dialogue and cooperation between civil society groups in both regions. Arts 469 and 470: Parties will promote regular meetings as representatives of their civil societies; Civil Society Platform established to allow for an exchange of views and to meet with and make recommendations to the Association Council.	No	More of a reference to civil society in the DCFTAs.
Freedom/liberalization of trade in goods	Art 29: Sets out schedule for reduction/elimination of custom duties.	Title IV, Art 18: "shall gradually establish a bilateral free trade area over a period lasting a maximum of six years"; controversial legal interpretation, see Sretic (2023), pg 6-7.	Not significant.
Trade in services	Art 94: In the sectors where market access commitments are inscribed in Annexes… each Party shall grant to services and service suppliers of the other Party… treatment no less favourable than that it accords to its own like service and services suppliers.	Art 59: Liberalisation process-parties undertake to take the necessary steps to allow progressively the supply of services by firms/nationals of the other party, with a review after four years; temporary movement of key personnel allowed to support this; Art 60: "The Parties shall not take any measures or actions which render the conditions for the supply of services by Community and Serbia nationals or companies which are established in a Party other than that of the person for whom the services are intended significantly more restrictive as compared to the situation existing on the day preceding the day of entry into force of this Agreement."	Different form of no discrimination (time vs nationality).

		Art 61: Provisions on transport services specifically.	
Freedom of workers	Art 97-102: Limited freedom of movement for certain classes of workers.	Art 49: Non-discrimination rules. Art 50: Bilateral agreements on access to employment for Serbians should be preserved, improved and possibly expanded to other member states. Art 51: Rules shall be laid down for the coordination of social security systems for Serbian workers, legally employed in the territory of a member state and vice versa.	Not significant.
Freedom of establishment	Art 88: Treatment no less favourable than that accorded to its own legal persons… or to any third-country legal person… whichever is the better;	Art 53: "no less favourable than that accorded to its own companies or to any third country company, whichever is the better."	Not significant.
Freedom of capital	Art 145: Shall "ensure the free movement of capital relating to direct investments made in accordance with the laws of the host country, to investments … and to the liquidation or repatriation of such invested capitals and of any profit stemming therefro". Portfolio investments, financial loans, credits related to commercial transactions also covered. "Ukraine undertakes to complete the liberalisation of transactions on the capital and financial account of balance	Art 63: "With regard to transactions on the capital and financial account of balance of payments, from the entry into force of this Agreement, the Parties shall ensure the free movement of capital relating to direct investments made in companies formed in accordance with the laws of the host country and investments made in accordance with the provisions of Chapter II of Title V, and the liquidation or repatriation of these investments and of any profit stemming there from."	Not significant.

	of payments equivalent to the liberalisation in the EU Party prior to the granting of internal market treatment in the area of financial services… A positive assessment of the Ukrainian legislation on capital movements, its implementation and continued enforcement… is a necessary precondition of any decision by the Trade Committee to grant internal market treatment with respect to financial services." Discussions to take place 5 years after the entry into force to see what still needs to be done.	Free movement of capital relating to credits related to commercial transactions/provision of services, portfolio investment and financial loans and credits are also covered. Serbia should authorise and liberalise the purchase of its real estate by EU nationals so that they ultimately receive the same treatment as Serbians. After four years the SA Council will determine what remains to be done to apply full EU rules on freedom of capital.	
Provisions on non-tariff barriers	Art 34-35: Each Party shall accord national treatment to the goods of the other Party in accordance with Article III of GATT 1994, including its interpretative notes… No Party shall adopt or maintain any prohibition or restriction or any measure having an equivalent effect on the import of any good of the other Party or on the export or sale for export of any good; Art 53-58: Reference cooperation and previous agreement on technical barriers to trade.	Title IV: No explicit mention in trade in goods (though legally controversial, Sretic 2023).	No explicit mention of non-tariff barriers in the SAAs, but the Sretic piece seems to argue they are implicit?

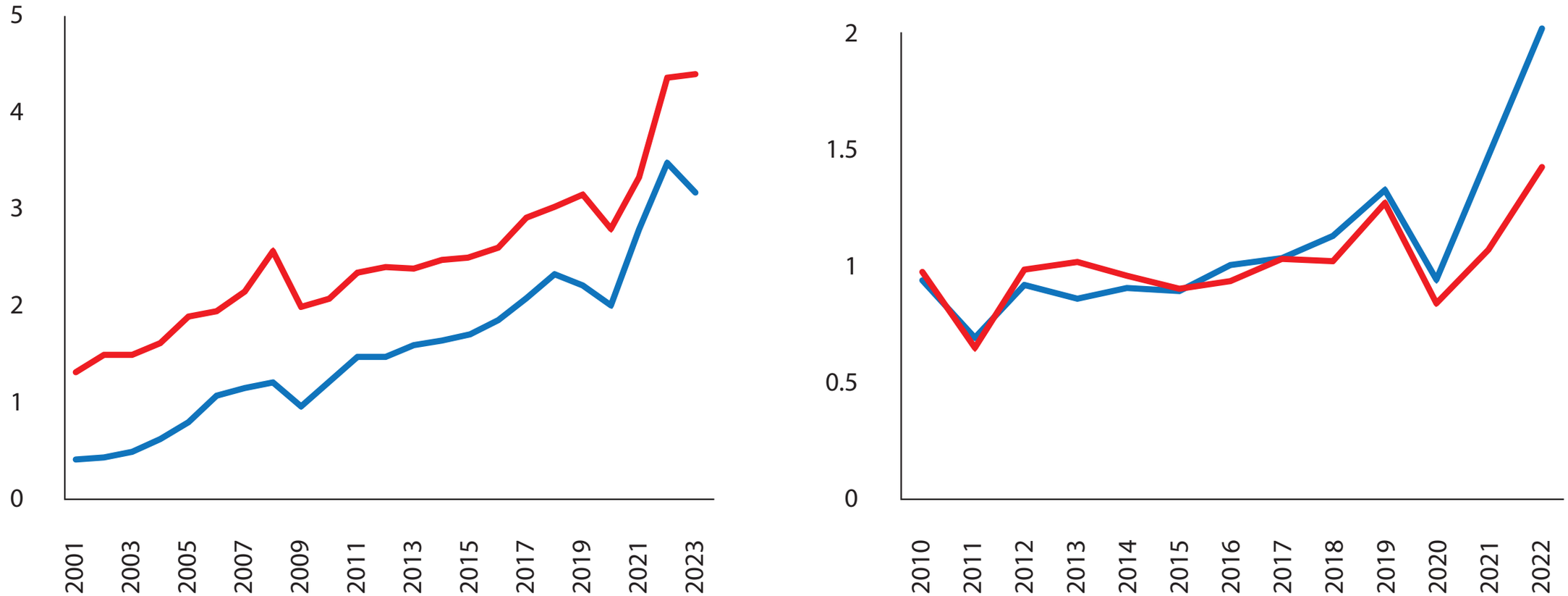
Annex 2. Trade data

EU27 goods (left) and services (right) trade with Albania (€ billions)

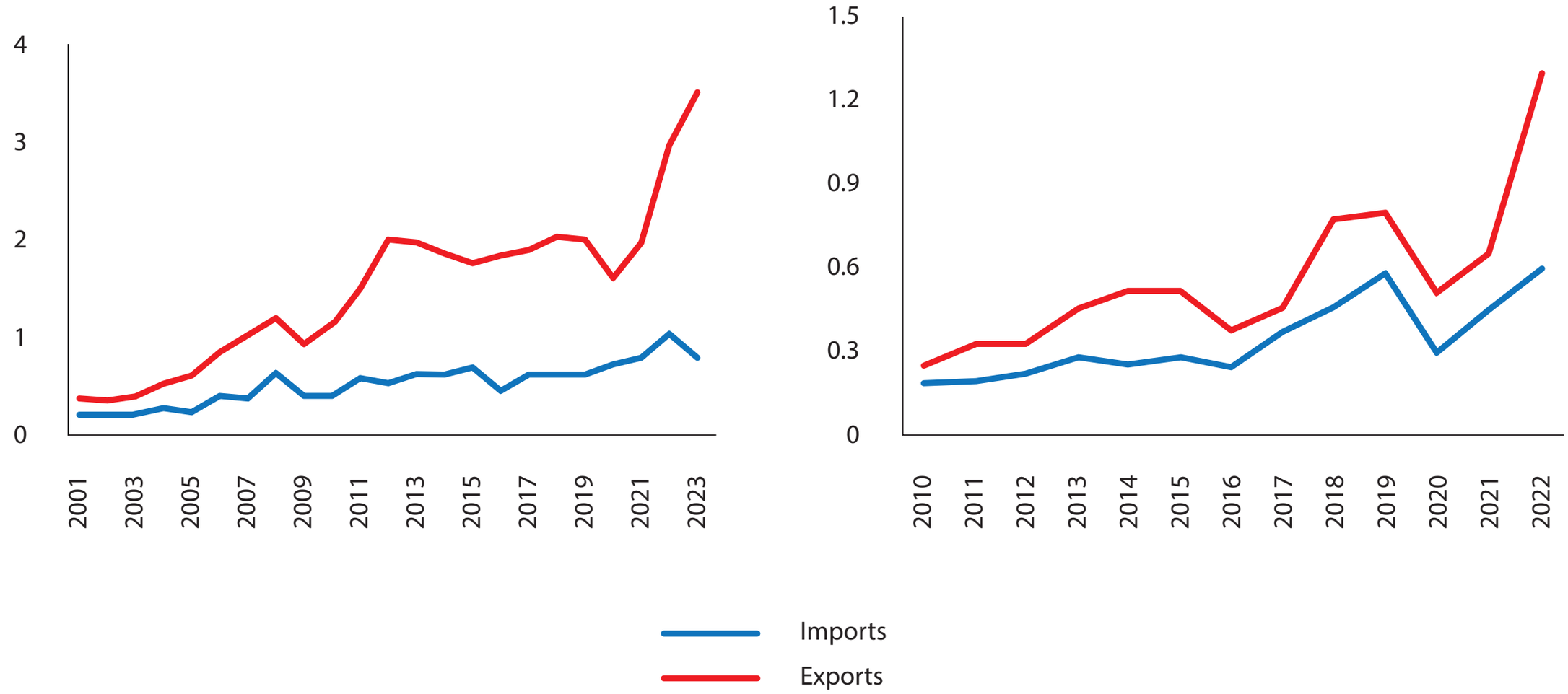


Note: Exports refer to EU exports to Albania and imports the reverse[29].
Source: Bruegel based on Eurostat (DS-018995).

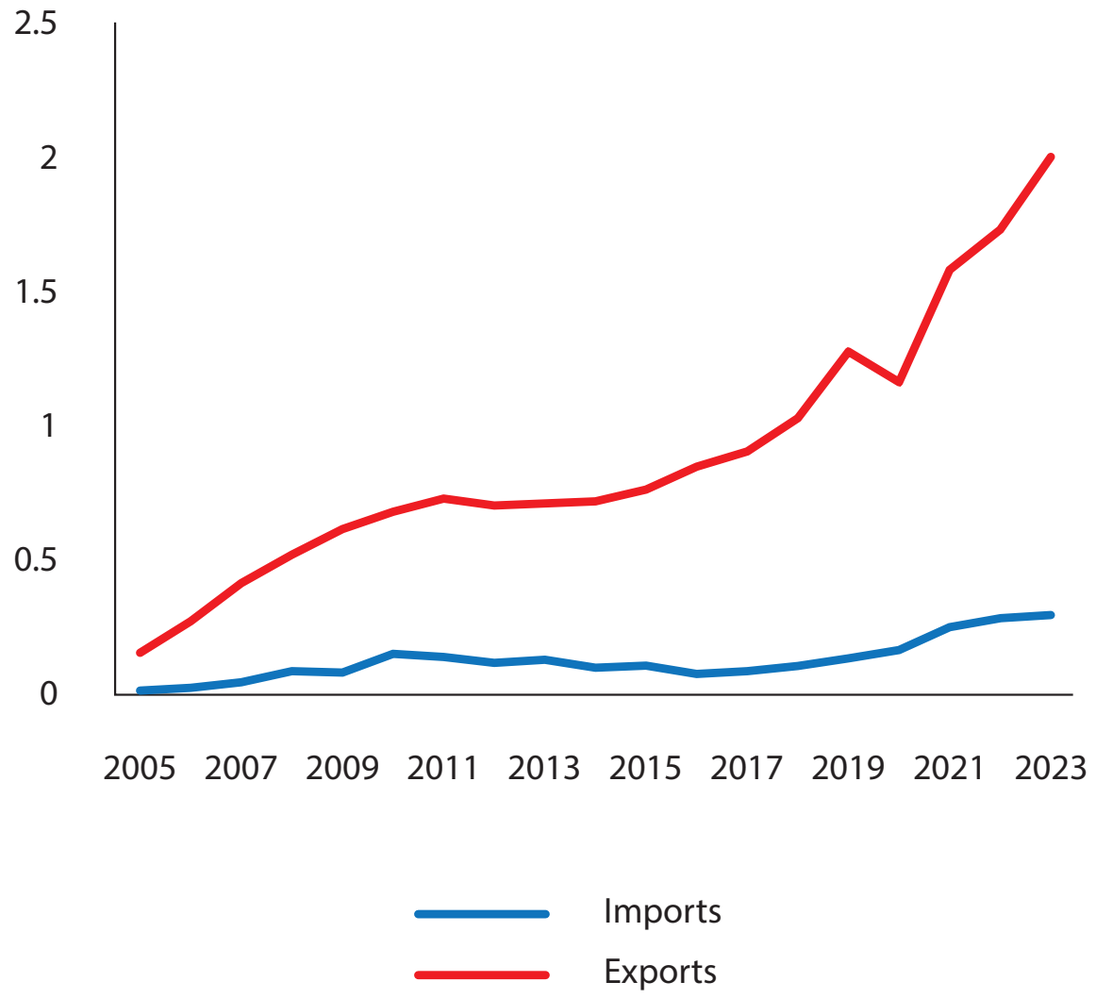
EU27 goods (left) and services (right) trade with Bosnia and Herzegovina (€ billions)



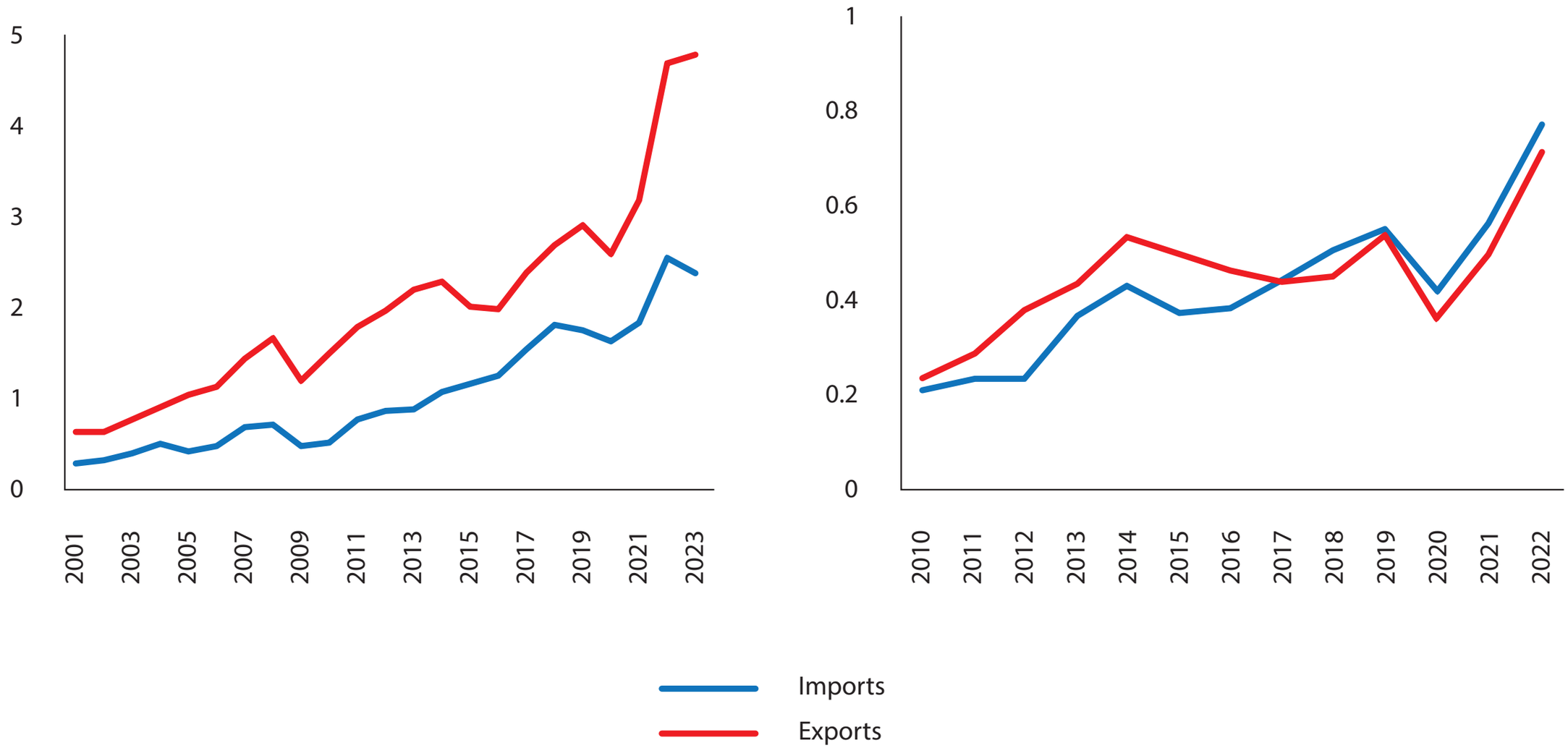
EU27 goods (left) and services (right) trade with Georgia (€ billions)



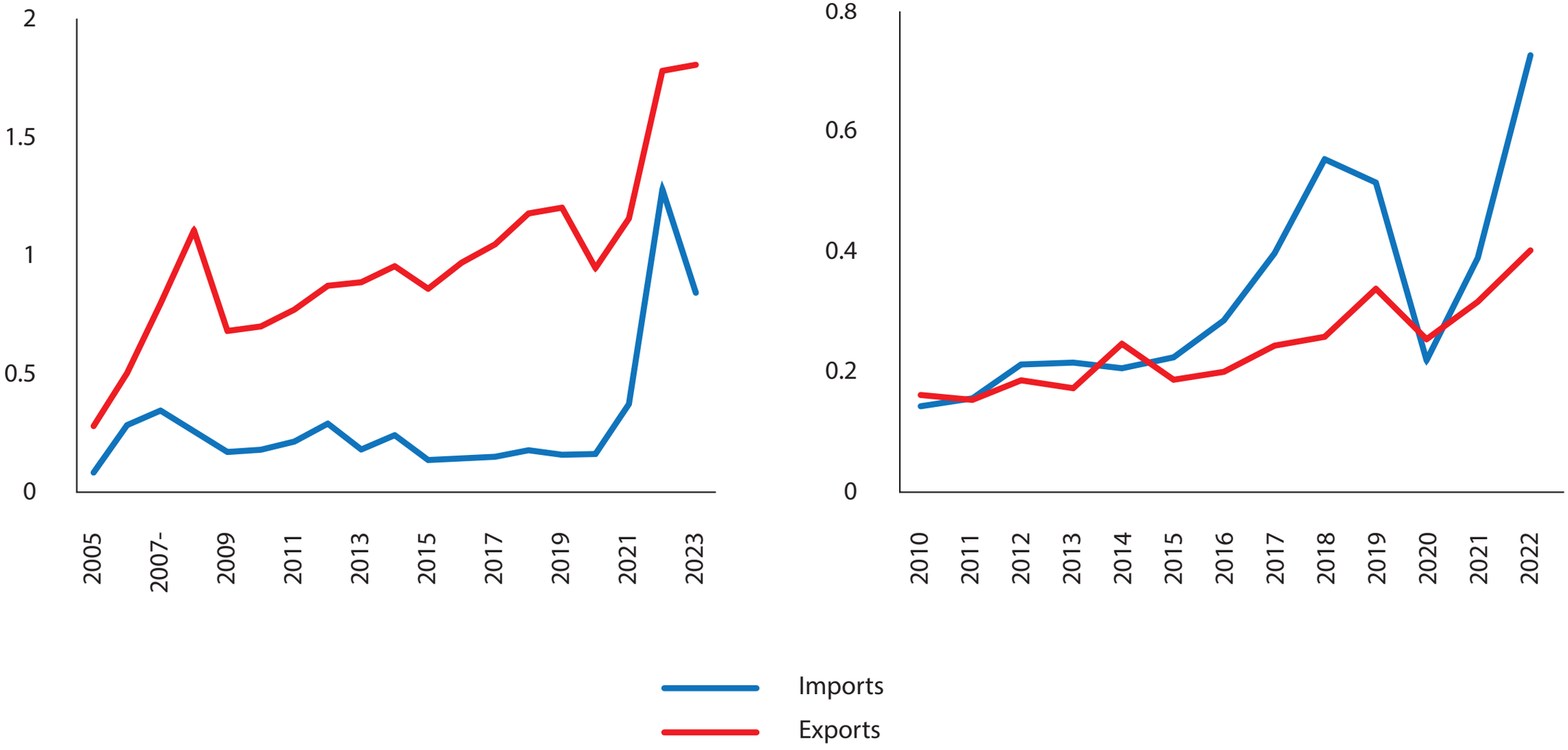
EU27 goods[30] trade with Kosovo (€ billions)



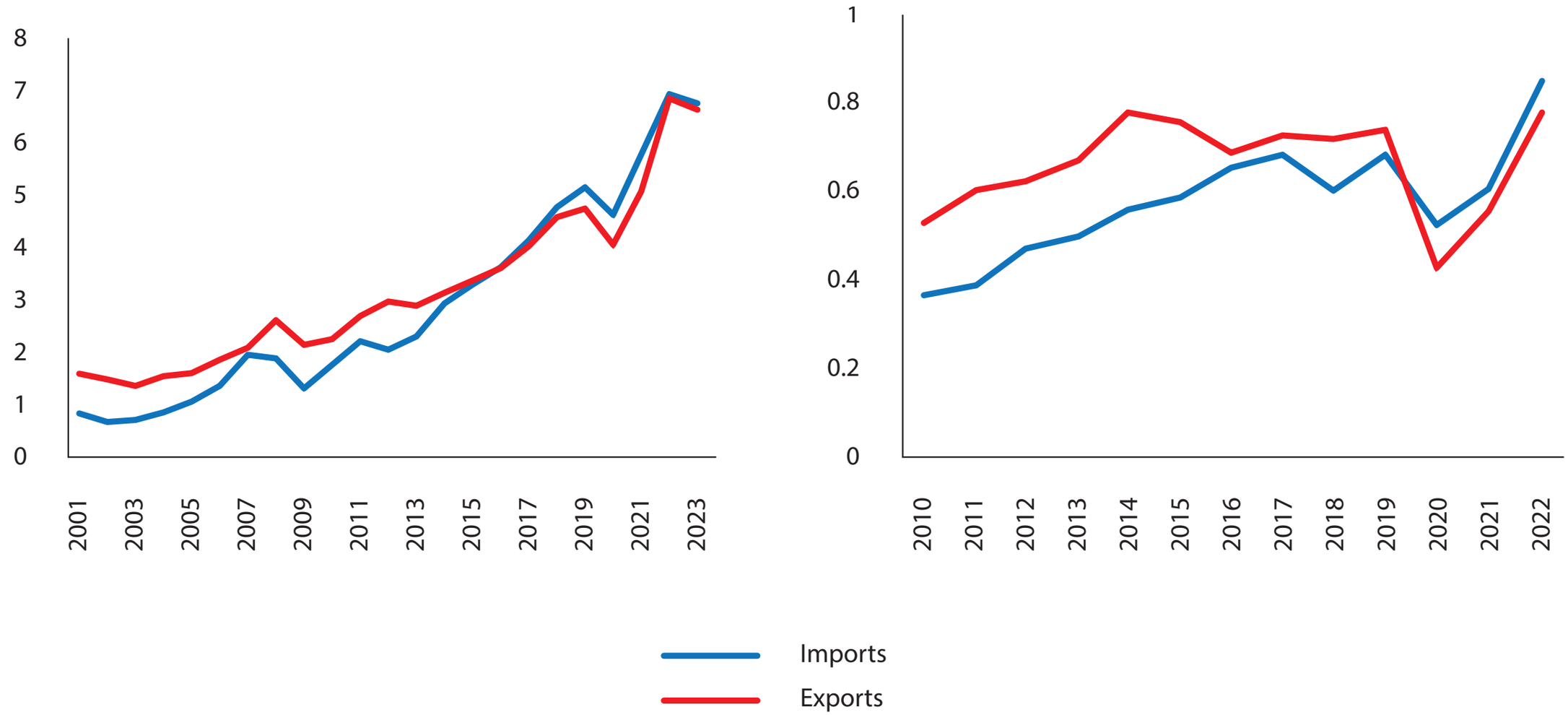
EU27 goods (left) and services (right) trade with Moldova (€ billions)



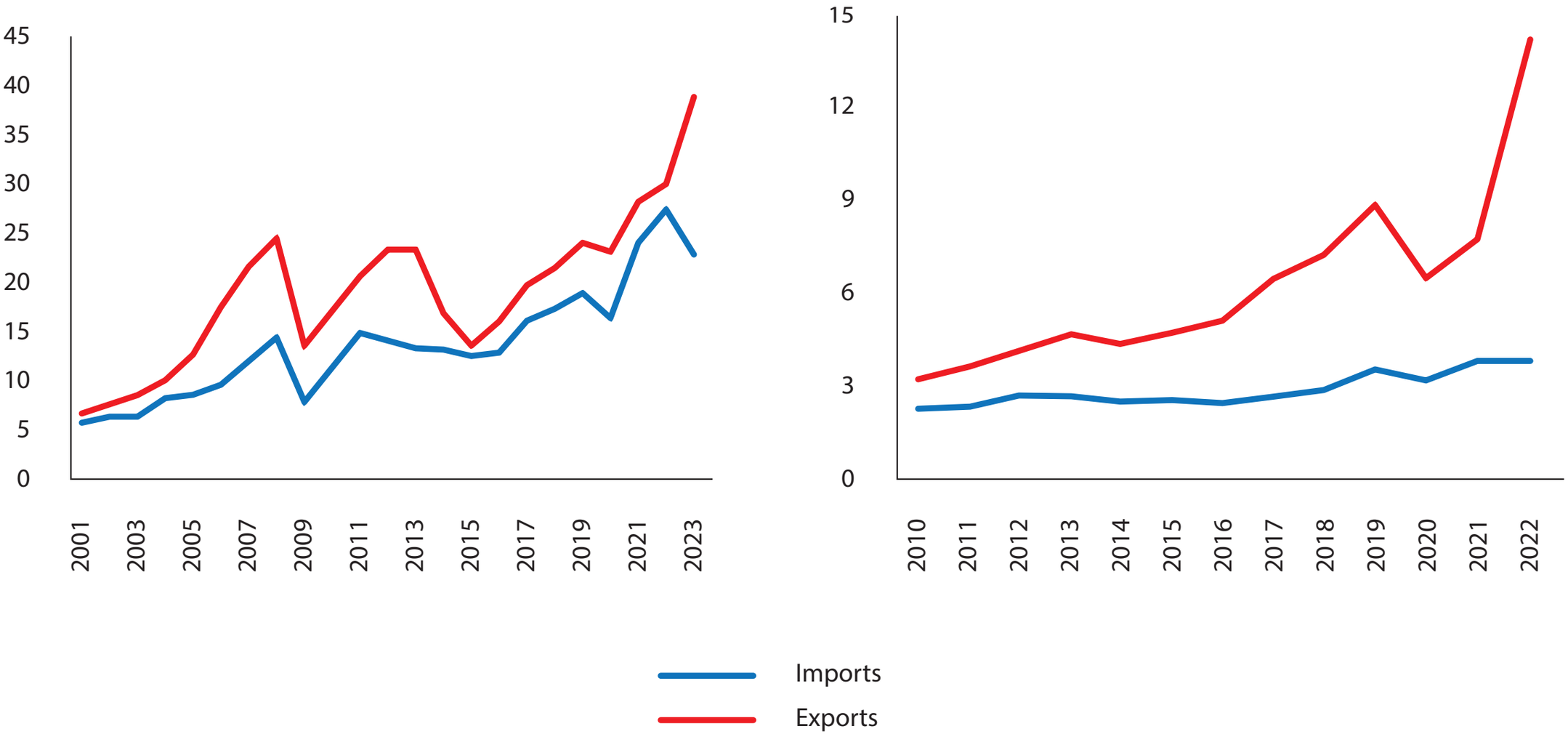
EU27 goods (left) and services (right) trade with Montenegro (€ billions)



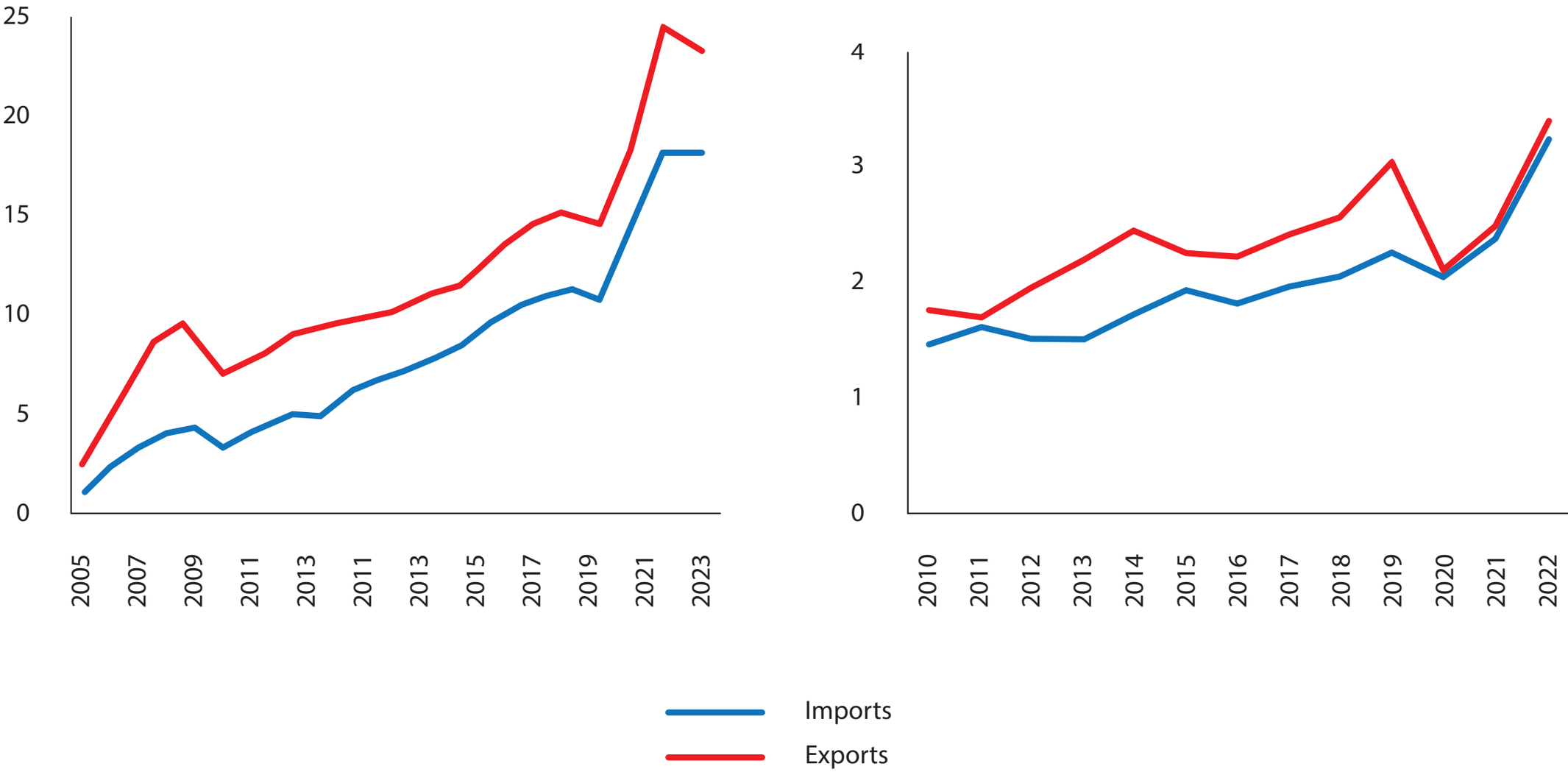
EU27 goods (left) and services (right) trade with North Macedonia (€ billions)



EU27 goods (left) and services (right) trade with Ukraine (€ billions)



EU27 goods (left) and services (right) trade with Serbia (€ billions)



Annex 3. FDI data

Figure 3.1. EU FDI stock as a share of national GDP, Western Balkans

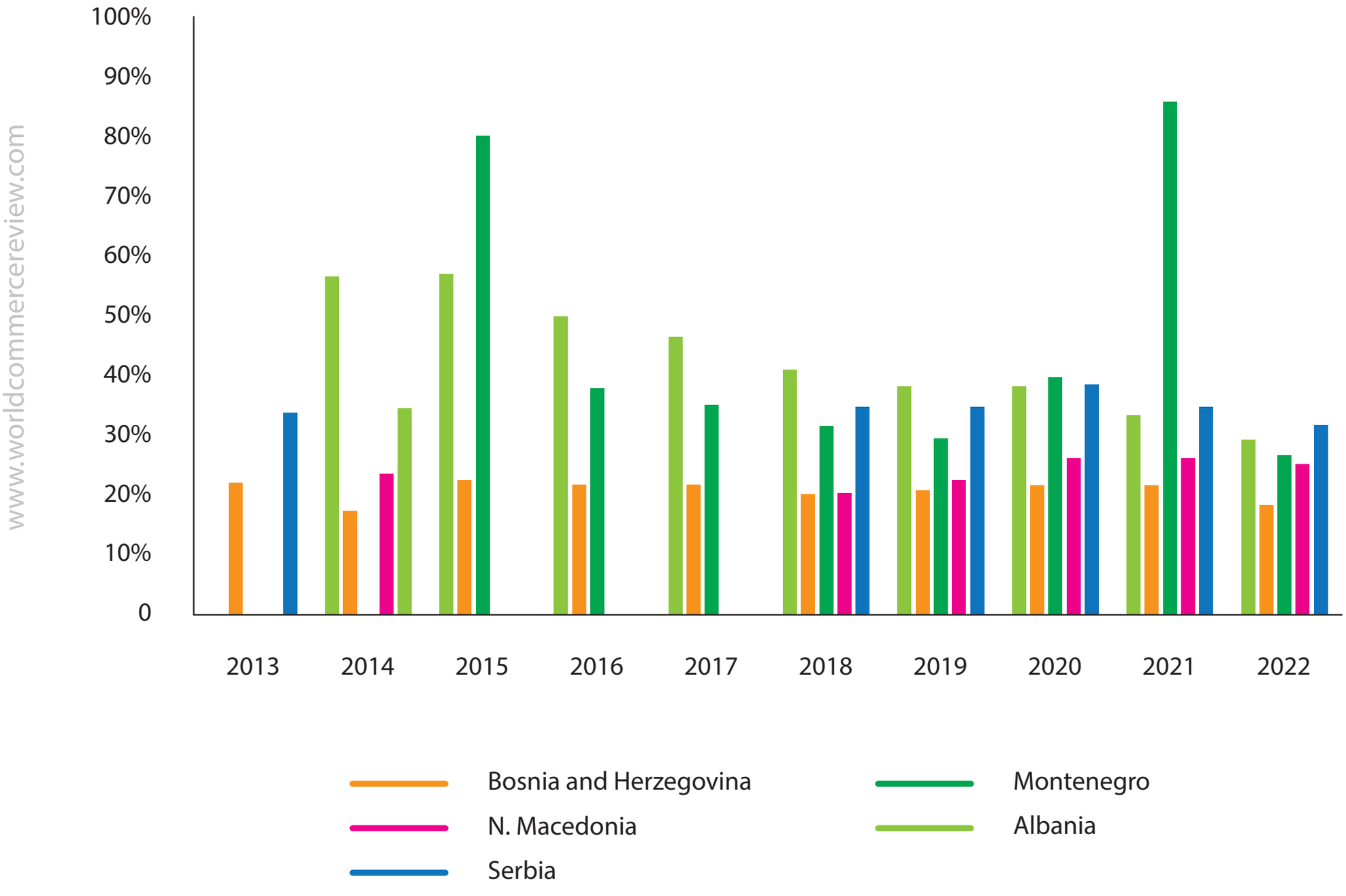
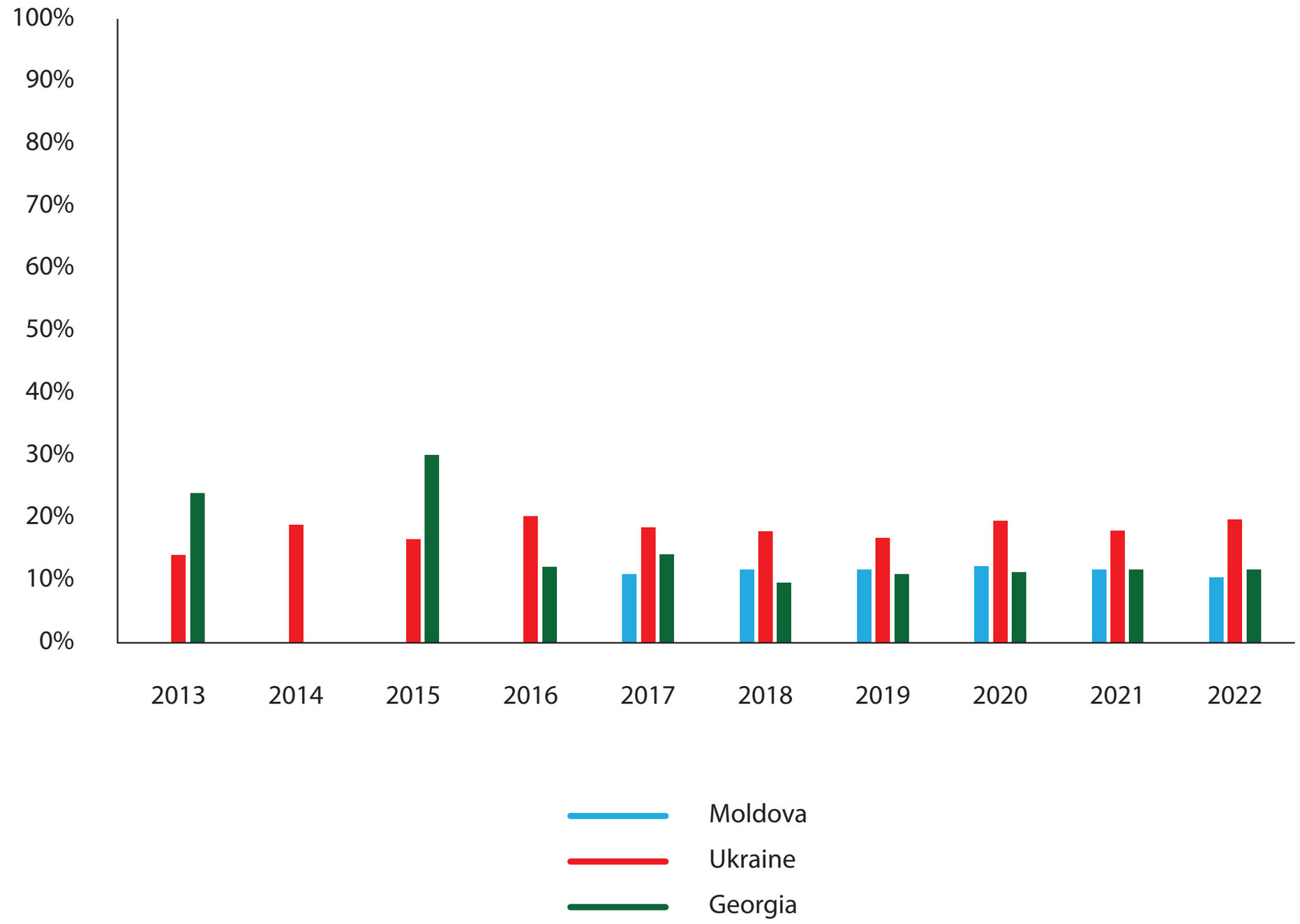


Figure 3.2. EU FDI stock as a share of national GDP, EaP



Source: Bruegel based on Eurostat, World Bank and OECD.

Reporting of FDI data must acknowledge that FDI statistics often mask the true origin of the investment in question, a phenomenon that is exacerbated in the case of the EU given the prominence of certain member states in global tax avoidance (Darvas *et al* 2023). Damgaard *et al* (2019) built a dataset for 2013-2017 that estimated FDI by what they term the *"ultimate investor economy"* (UIE). Over this period, the simple average for the WBs of FDI with the EU as UIE was 45 percent, higher than that of the EaP countries, but lower than the level of trade integration at the same time (the simple average for the EU as a share of total exports for the same period was 59 percent, Table 3.1). An average of 74 percent of the FDI reported as being from the EU across the WB countries actually had the EU as UIE, ranging from 90 percent in North Macedonia to just 50 percent in Montenegro (Table 3.2)

Table 3.1. Share of FDI with the EU as the ultimate investor economy in total reported FDI stock into the WB and EAP countries

Country	2013	2014	2015	2016	2017	2013-2017
Western Balkans						
Albania	43.7%	63.7%	65.0%	53.3%	45.4%	53.5%
B + H	49.7%	50.8%	54.0%	46.6%	47.3%	49.6%
Kosovo	19.0%	21.3%	20.8%	20.3%	20.7%	20.4%
Montenegro	30.6%	32.4%	21.3%	21.9%	21.9%	25.7%
North Macedonia	70.0%	73.0%	68.7%	60.0%	57.3%	65.6%
Serbia	58.8%	57.4%	51.2%	50.9%	45.0%	52.3%
EaP						
Georgia	14.9%	13.3%	10.9%	8.4%	7.5%	10.7%
Moldova	49.0%	48.3%	47.6%	50.6%	52.4%	49.6%
Ukraine	40.6%	34.8%	41.2%	35.1%	40.4%	38.7%

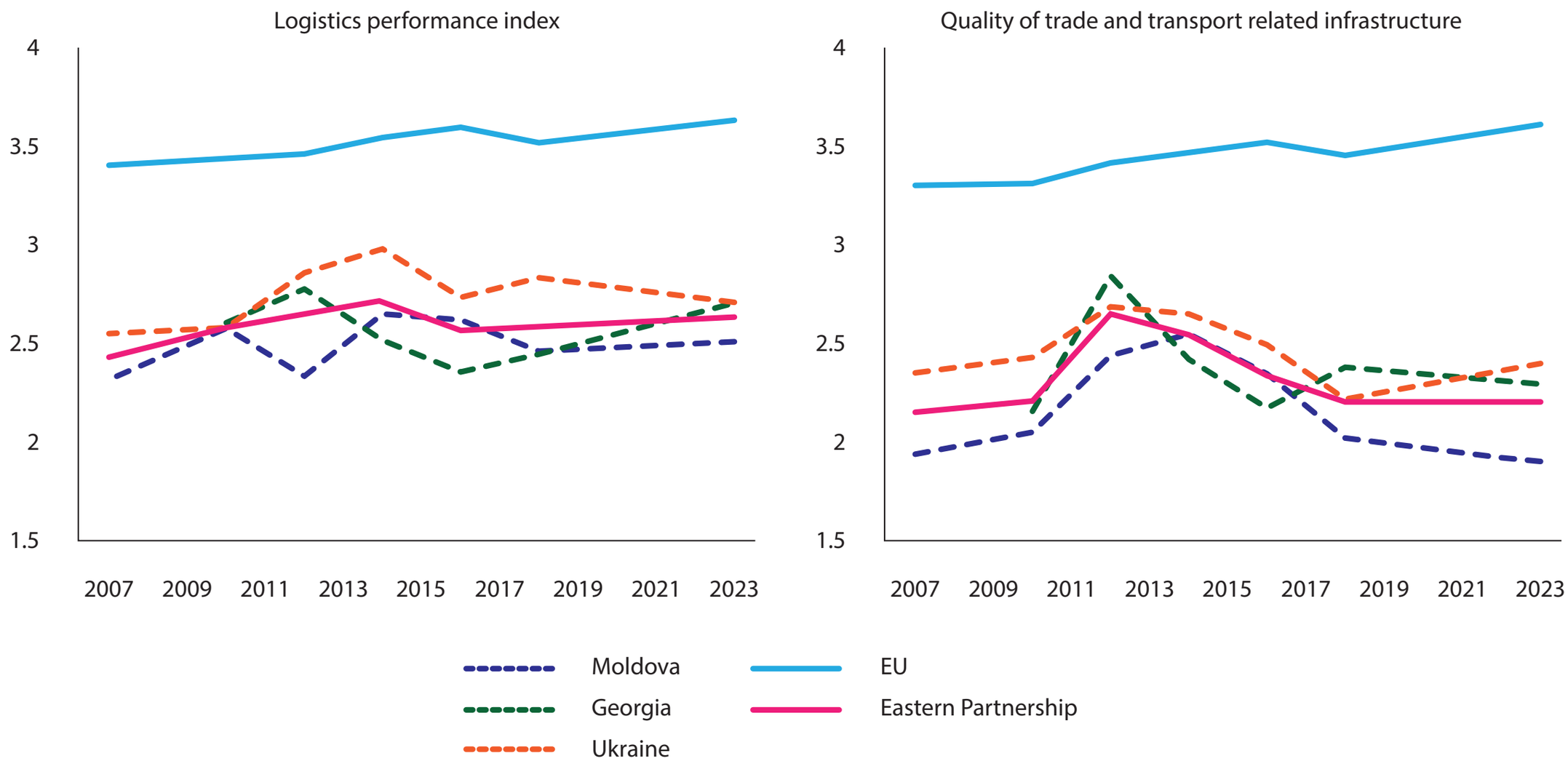
Source: Bruegel based on Damgaard et al (2019) and Darvas et al (2023).

Table 3.2. FDI stock with the EU as the ultimate investor economy as a share of the reported EU FDI stock in each country

Country	2013	2014	2015	2016	2017	2013-2017
Western Balkans						
Albania	91.3%	91.9%	93.0%	90.1%	81.3%	88.9%
B + H	84.7%	88.3%	92.9%	77.5%	76.8%	83.8%
Kosovo	65.6%	69.8%	67.5%	69.9%	66.3%	67.7%
Montenegro	51.1%	54.5%	48.6%	52.0%	46.8%	50.8%
North Macedonia	85.9%	93.5%	90.8%	90.8%	88.1%	89.7%
Serbia	70.5%	70.4%	64.6%	64.8%	58.5%	65.6%
EaP						
Georgia	49.1%	41.6%	35.0%	27.8%	26.6%	35.2%
Moldova	82.0%	81.5%	81.5%	83.4%	82.3%	82.1%
Ukraine	55.2%	49.1%	58.4%	51.8%	60.8%	54.7%

Source: Bruegel based on Damgaard et al (2019) and Darvas et al (2023).

Annex 4. Logistics and trade-related infrastructure for EaP



Source: Bruegel based on World Bank Logistical Performance Index.

Annex 5. Non-tariff barriers

Figure 5.1. Difference in compliance costs of international trade between the Western Balkans and OECD high income countries (left) and the EU (right), $

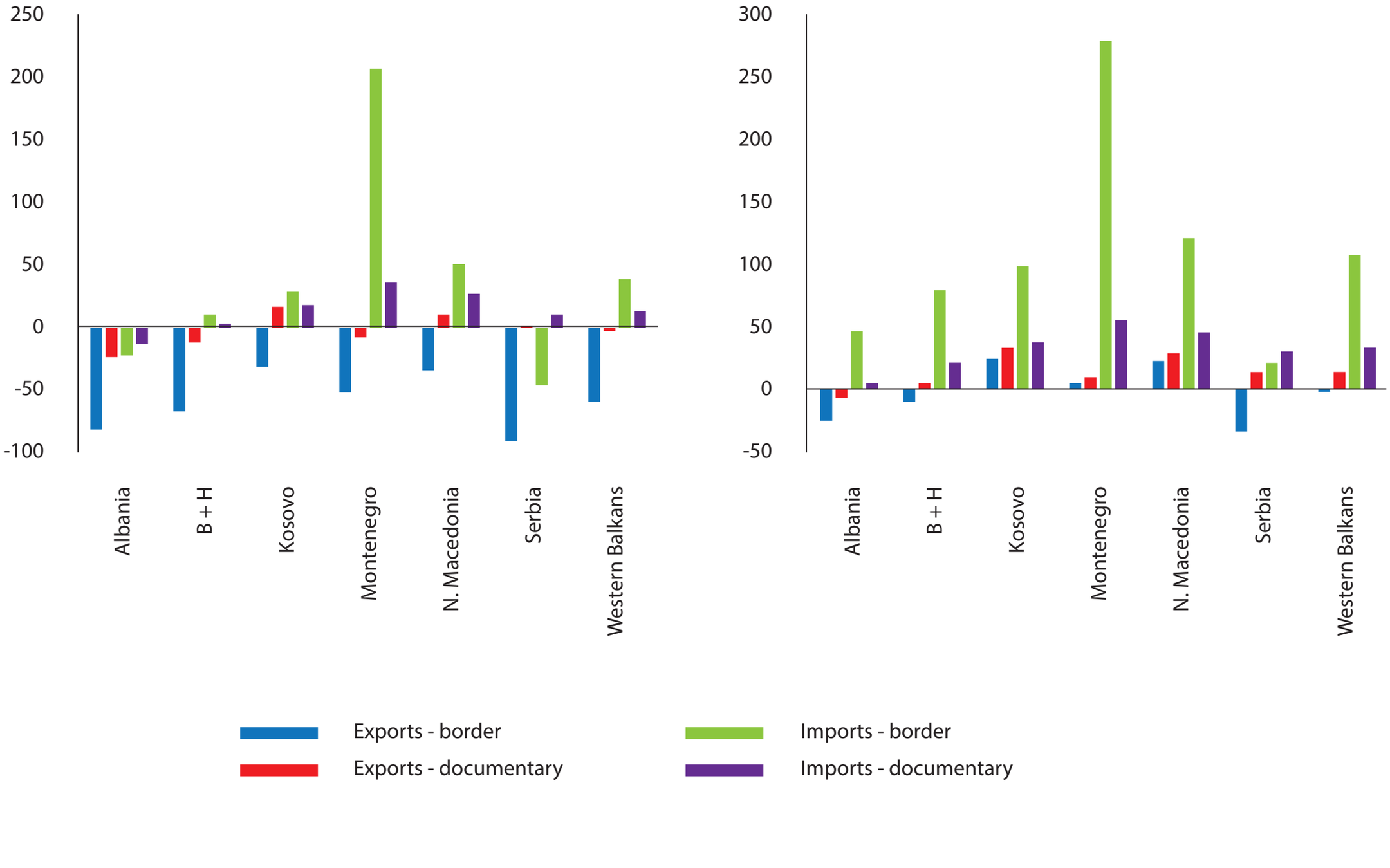
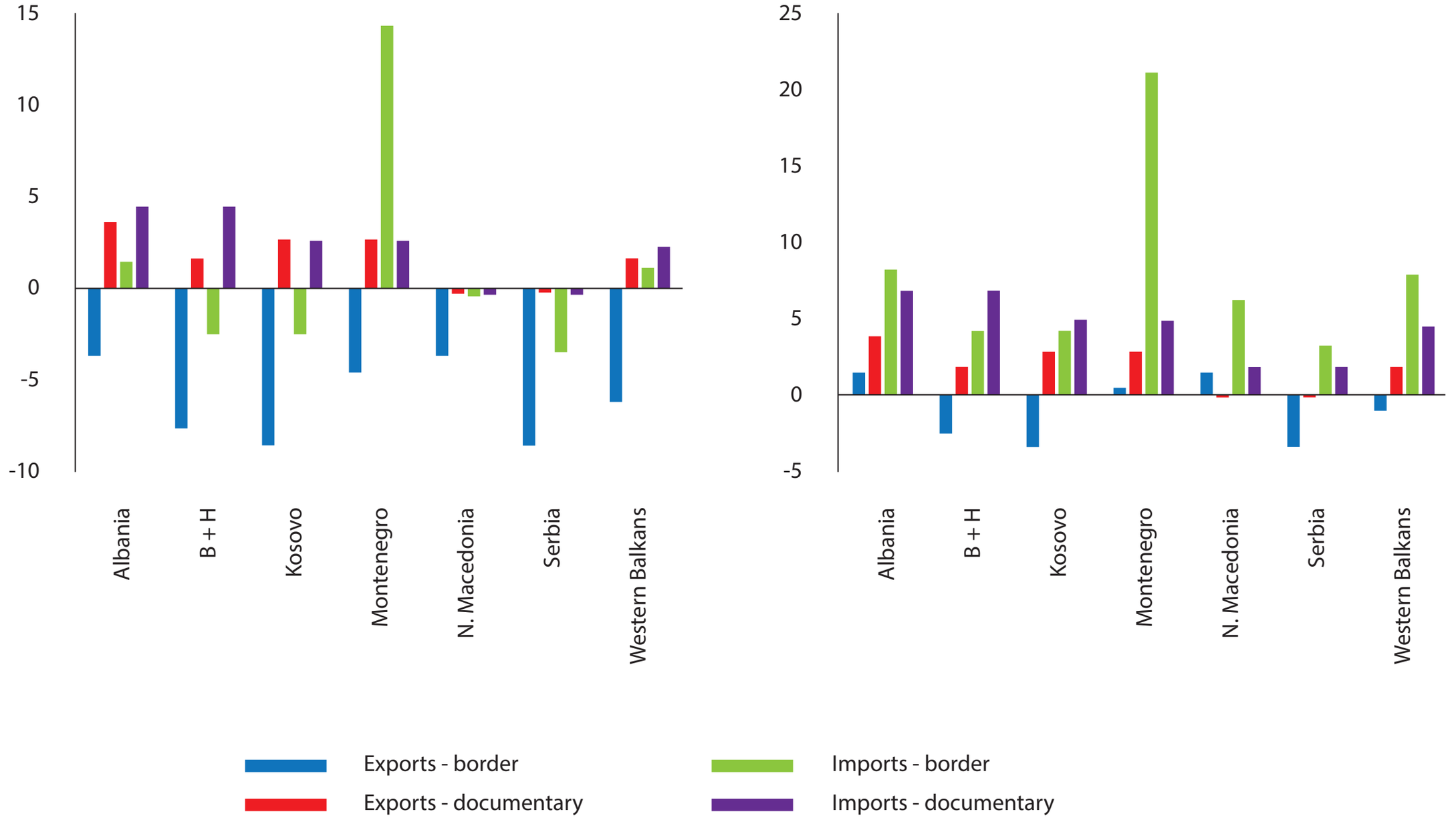
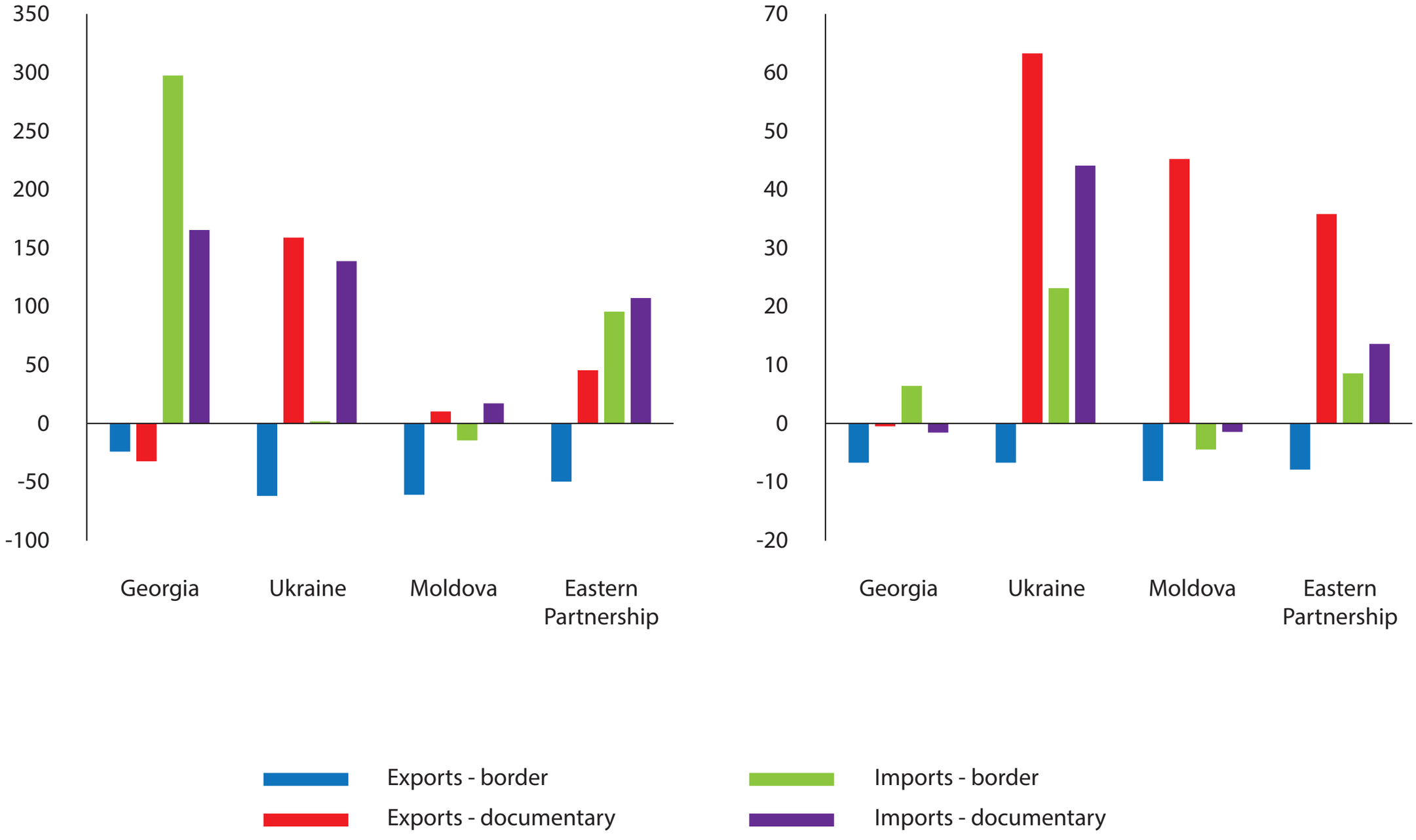


Figure 5.2. Difference in time compliance of international trade between the Western Balkans and OECD high-income countries (left) and the EU (right), hours



Note: WBs refers to a simple average of the six WB countries. EU refers to the simple average of the EU27 countries.
Source: The World Bank 'Trading across Borders'.

Figure 5.3. Difference in compliance costs of international trade between the EaP and OECD high-income countries in $ (left) and hours (right)



Note: WBs refers to a simple average of the six WB countries. EU refers to the simple average of the EU27 countries.
Source: The World Bank 'Trading across Borders'.