EUROPEAN TRADE FINANCE

WINTER 2025

The EU must speed up its integration amid mounting geopolitical turmoil, Christine Lagarde warns

Ignacio García Bercero and Niclas Poitiers consider the next steps for European economic security

Andrew Bailey reflects on the reforms made to the financial system since the 2008 financial crisis

A EUROPEAN PERSPECTIVE ON TRADE FINANCE

Foreword

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Welcome to the Winter 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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Trade wars and central banks: lessons from 2025

Christine Lagarde states we can take comfort in having overcome a large inflation shock after the pandemic, and in how the economy has coped so far with an upheaval in trade relations, but warns we must remain alert to possible new shocks that may still lie ahead

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The idea that economics cannot be separated from geopolitics is hardly new. During the early 1990s, as the Soviet Union collapsed, Finland lost more than 10% of its GDP when trade with its eastern neighbour suddenly evaporated[1]. Few countries know better the costs of ignoring geopolitical realities.

Today, the rest of Europe is facing a similar reckoning. We find ourselves in a new world – one where policymakers can no longer confine themselves to traditional economic and financial variables. Now, we must factor 'geoeconomics' into our analyses. The term was coined in 1990 by Edward Luttwak, who described geoeconomics as *"the admixture of the logic of conflict with the methods of commerce."* It is not protectionism in the old sense of sheltering vulnerable industries. Instead, it is trade deployed as a tool of power, a strategy of influence and dominance.

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This approach has been around for some time, most visibly during the US-China trade disputes that unfolded during the first Trump Administration. The unjustified war in Ukraine and the sanctions that followed have also reshaped the European landscape. But 2025 marks the first year in which Europe itself has been on the receiving end.

We currently face the highest tariffs since the days of Smoot-Hawley in the 1930s, imposed by our largest trading partner. Global trade is being reshaped as other countries respond to tariffs directed at them. And in the span of just a few months, we have seen a surge in trade uncertainty and sharp swings in exchange rates. So now is a good time to take stock of what we have learned so far, and what this implies for monetary policy.

Trade wars: expectations versus reality

A year ago, most would have assumed that US tariffs rising from 1.5% to 13% would trigger a major adverse shock to the euro area economy. Indeed, most trade models judged the imposition of tariffs to be, on net, negative for euro area growth and likely positive for inflation, at least in the short run.

This was broadly our internal assessment in December of last year, albeit surrounded by considerable uncertainty. Three channels were usually seen as decisive in producing such an outcome. First, retaliation. Reciprocal tariffs were expected to raise import costs and reverberate through supply chains. In most models, this retaliation channel was by far the largest driver of higher short-term inflation[2].

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This is an unusual time to be a monetary policymaker. We can take comfort in having overcome a large inflation shock after the pandemic, and in how the economy has coped so far with an upheaval in trade relations. And yet, we must remain alert to the possibility that not all the consequences are visible today – and that new shocks may still lie ahead

Second, the exchange rate. Tariffs were expected to trigger a depreciation of the euro against the dollar – driven by expectations of higher US rates and a smaller US trade deficit – thereby amplifying imported inflation[3].

Third, uncertainty. Elevated trade policy uncertainty was expected to weigh heavily on business investment and growth, often more than the direct effect of tariffs on exports themselves. This was expected to be the largest negative force on growth. Yet some of these assumptions have not been borne out. This is because the tariffs were not an isolated economic event, but a symptom of a broader geopolitical shift – one that triggered political economy dynamics beyond the reach of standard models.

Start with retaliation. In Europe and globally, it has so far been limited. In response to the US tariffs on steel and aluminium, the EU announced counter-tariffs on around €26 billion worth of American goods, but suspended them once a deal was struck in July. Pressure from major industrial groups to avoid a prolonged cycle of tit-for-tat measures, as well as concerns about jeopardising US support for the war in Ukraine, ultimately outweighed pure economic calculus.

As a result, we have not yet seen significant supply chain disruption. Global supply chain pressures remain contained, and in the euro area, bottleneck indicators are close to historical averages. If anything, rather than blocked supply chains, the euro area is facing rising imports. The euro area's trade deficit with China has risen by around 10% this year, although this was driven more by weaker Chinese demand than by diverted trade flows.

The exchange rate has also not behaved as expected. Rather than depreciating, the euro has appreciated substantially. Since the start of this year, it has risen by 13% against the US dollar, while the nominal effective exchange rate has increased by 6.5% and the real effective exchange rate[4] by 5%.

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This reflects the fact that the imposition of US tariffs coincided with a broader re-evaluation of the country's position in the global financial system. Investors began to question whether the US dollar would continue to warrant its status as the ultimate safe-haven currency – another political-economy factor that narrow, tariff-focused models excluded by assumption.

The international role of the euro has helped insulate us from the resulting exchange rate volatility, with 52% of our imports invoiced in our own currency. But many key imports, especially commodities, are still priced in dollars. The euro's appreciation has therefore contained imported inflation from supply chains, while at the same time placing an additional drag on growth.

The effects of uncertainty have been more in line with expectations. The expected cumulative impact of tariffs and uncertainty on growth is around 0.7 percentage points between 2025 and 2027, compared with our projections last December. Still, these effects have not been as strong as we anticipated. For example, only about a quarter of the downward revision for next year, compared with December last year, is due to uncertainty.

This is partly because trade policy uncertainty fell faster than we expected once the deal with the United States was concluded. It is also because the euro area has taken internal measures to boost growth that have helped counter external weakness.

In particular, governments in Europe have committed to the largest increase in rearmament in decades, with some reversing years of underinvestment. Government investment is now expected to add 0.25 percentage points to growth[5] between 2025 and 2027, offsetting around one-third of the trade shock[6].

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The EU has also pushed ahead with new trade agreements, which will support growth. The Mercosur and Mexico deals now being adopted cover more than 3% of extra-euro area goods exports, while agreements currently under negotiation account for a further 6%[7]. This is another example of a response that models could not capture beforehand: trade pressures have led European governments to re-evaluate their broader trade and security relationships, prompting an endogenous investment response.

All in all, with no retaliation and an appreciating exchange rate, tariffs have had little inflationary impact so far, with their adverse effects mainly limited to growth. Those effects, however, have been relatively moderate thanks to the domestic response.

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Evaluating the balance of risks

In an environment of high uncertainty, understanding the nature of shocks is a precondition for getting the baseline projection right. But capturing the balance of risks is just as crucial, so that we are prepared for a situation in which the baseline may prove obsolete and can act pre-emptively, if necessary.

This was a key conclusion of our recent strategy review: to emphasise more risks and uncertainty in our decisions, not just central projections. Initially, we viewed the risks to growth from US tariffs as tilted to the downside. This assessment was informed by extensive scenario analysis, including escalation scenarios and possible offsetting forces – notably the growth impact of a sustained increase in defence and infrastructure spending.

Overall, these scenarios have consistently shown that the most salient risks – those that could push growth furthest from its current path – lie on the downside rather than the upside.

For example, ECB staff find that severe escalation in trade tensions could lower growth cumulatively by about 1 percentage point over the projection horizon[8]. The potential boost from higher defence spending would not be sufficient to offset this, even if all countries were to deliver fully on their NATO commitments.

This tilt in the risk balance remains in place today. But at our last meeting, we judged risks to growth to be more balanced, because the likelihood of major tariff-related downside risks materialising had fallen owing to the new trade deal.

Meanwhile, we judged inflation risks to be two-sided, with plausible scenarios that could push inflation off track in either direction. But as new information has come in, the range of risks on both sides has also narrowed. In particular, the absence of significant EU retaliation has reduced the risk that higher import tariffs might drive inflation above the baseline. Our scenario analysis also points to inflation risks that remain well contained.

If trade tensions were to reignite, staff project only moderately lower inflation in 2027, reflecting weaker growth. Higher spending on defence equipment, by contrast, would only modestly raise inflation, given its relatively small weight in the consumption basket.

Staff have also examined scenarios that would affect prices more directly: on the downside, Chinese export prices being lowered further as a strategic response to tariffs; and on the upside, more pronounced bottlenecks in global supply chains.

In both cases, however, the impact would be limited under reasonable assumptions, with inflation in 2027 differing by only 0.1-0.2 percentage points[9].

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Policy implications

So what does this imply for our monetary policy? I have said that we are in a good place. This was largely a reference to the fading of the large inflation shock we faced in recent years, which is now essentially over in the euro area.

But there are also three additional reasons why it applies to the current situation. First, because trade shocks are not creating new inflationary pressures, we are not confronted with the classic policy trade-off where the central bank faces stalling growth and rising inflation. This has already allowed us to cut policy rates by 100 basis points since December – cushioning the impact while keeping medium-term inflation on track.

Second, insofar as we can model the future, the risks to inflation appear quite contained in both directions.

Third, with policy rates now at 2%, we are well placed to respond if the risks to inflation shift, or if new shocks emerge that threaten our target.

At the same time, we are navigating a far more difficult environment than before – beset by war, tariffs and uncertainty – which we must also factor into our policy. If we consider the 'known knowns', the risks appear well bounded.

But there are also 'known unknowns' – above all, how euro area companies will adapt to this new setting. Firms are still running down inventories and absorbing the shock in margins, so the full effects of US tariffs have yet to become clear[10].

Finally, there are the 'unknown unknowns': in a world of geoeconomics, new trade and geopolitical shocks will remain a constant feature of our environment.

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How these forces play out will have unavoidable effects on monetary policy – not only through their impact on growth, but also on potential growth. If firms interpret the new environment as a lasting confidence shock, we could see investment shift out of the euro area[11]. Preliminary staff analysis suggests that, all else being equal, tariffs are likely to weigh negatively on potential growth.

Lower potential growth would, in turn, put downward pressure on real rates and reduce the policy space available. But other paths are possible if governments act decisively and give firms new reasons to be confident.

One factor often overlooked in the tariff debate is that our internal market is far more important for trade than the global market. Staff analysis shows that an increase of just 2% in intra-euro area trade would be enough to offset the loss of exports to the United States caused by higher tariffs[12].

This is a compelling reason to implement the reforms identified in recent reports from Mario Draghi and Enrico Letta, in particular simplifying burdensome regulation, completing the Single Market and building a genuine European capital market. The same reforms would also help European companies adopt artificial intelligence more rapidly[13]. This would result in a positive shock for potential growth, helping to balance the negative forces coming from abroad.

In short, nothing about our future is fate – and there is no room for complacency by any party. For our part, we cannot pre-commit to any future rate path, whether one of action or inaction. We must remain agile, and ready to respond to the data as they come in.

Conclusion
This is an unusual time to be a monetary policymaker. We can take comfort in having overcome a large inflation shock after the pandemic, and in how the economy has coped so far with an upheaval in trade relations. And yet,

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we must remain alert to the possibility that not all the consequences are visible today – and that new shocks may still lie ahead.

As we look to the future, we do so mindful of Finland's long tradition of *sisu* – courage and inner strength in the face of uncertainty. *Sisu* is not a show of fleeting bravery, but rather a fierce determination and perseverance to continue fighting even when times get tough. We are in a good place today, but that place is not fixed. Our task is to sustain it with agility, humility and a firm grounding in the data. ■

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Christine Lagarde is President of the European Central Bank

Endnotes

1. Analysis finds that the trade shock alone can explain between 4.7 and 5.9 percentage points of the loss in GDP. See Gulan, A (2021), "Can large trade shocks cause crises? The case of the Finnish-Soviet trade collapse", Blogs – Bank of Finland Bulletin, Bank of Finland, 5 May.

2. Gnocato, N et al (2025), "Tariffs across the supply chain", VoxEU Column, CEPR, 30 May.

3. Jouvanceau, V, Darracq Pariès, M, Dieppe, A and Kockerols, T (2025), "Trade wars and global spillovers. A quantitative assessment with ECB-global", Working Paper Series, No 3117, ECB, Frankfurt am Main, September.

4. Deflated by consumer price inflation.

5. This estimate also includes wages, government consumption and transfers.

6. Government investment as a ratio to GDP is expected to be cumulatively almost 0.6 percentage points higher over the period from 2025 to 2027 than projected in December last year.

7. With South Korea, India, Australia, Malaysia, Thailand, Indonesia and the Philippines.

8. European Central Bank (2025), "Eurosystem staff macroeconomic projections for the euro area, June 2025", Frankfurt am Main, June.

9. European Central Bank (2025), "Eurosystem staff macroeconomic projections for the euro area, September 2025", Frankfurt am Main, September.

10. Organisation for Economic Cooperation and Development (2025), OECD Economic Outlook Interim Report September 2025: Finding the Right Balance in Uncertain Times, OECD Publishing, Paris, September.

11. European Central Bank (2025), "The outlook for euro area business investment – findings from an ECB survey of large firms", Economic Bulletin, Issue 4.

12. The United States accounts for 10% of total euro area exports, and the new tariffs are expected to reduce euro area exports to the United States by approximately 9%, translating to a 0.9% decline in overall euro area exports – roughly €66 billion. Making up for this shortfall in direct trade would require a 2% increase in intra-euro area trade.

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13. European Investment Bank (2025), Investment Report 2024/2025: Innovation, integration and simplification in Europe, March.

This article is based on a keynote speech delivered at the Bank of Finland's 4th International Monetary Policy Conference, Helsinki, 30 September 2025.

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Challenges to financial stability

Andrew Bailey reflects on the reforms made to the financial system since the 2008 financial crisis. He addresses the challenges these reforms face in an ever-changing world and says the regulatory system of the future must be constantly assessed and adapted as needed

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I am going to focus on a number of key questions. What has been achieved in the time since the crisis? What appears to be the challenge today to these achievements? And where do we go from here? There have been times in recent years when we might have treated these questions as matters of more academic speculation, that's not so today. They are real questions up for debate and challenge.

What has been achieved in the field of financial stability since the financial crisis? Answer – a lot. Yes, today's world is a highly uncertain and unpredictable place sadly. We have experienced very large shocks – a pandemic, the longest war in Europe since 1945, I could go on.

But we have come through, so far at least, without a crisis of financial stability of the sort that has been seen in the past. Likewise, we have not had a major and lasting recession during these recent shocks.

But, this all reminds us that bad things happen in the world, and they can affect financial stability, this is always possible. That said, we start with a financial system that is much more resilient, which is a much better place to be. We have a banking system that after a long-haul post-crisis appears to be sustainably earning its cost of capital in terms of returns. This is reflected in market pricing, with market price-to-book value more consistently above unity.

Another lens through which to look at this point is to examine arrears and loan losses across the recent period of economic shocks. The evidence points to resilience here – such losses have been low by historical standards. Of course, this benefits banks and their shareholders, but it also helps consumers as customers and economies generally. Customers get better outcomes and particularly when they avoid having their business closed, losing their job, or having their home repossessed.

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The benefits of financial stability are real and tangible. Yes, but they may not be perceived as such. One of the challenges of financial stability is that it is a state of being in which success comes when things don't happen, and don't go wrong. It is therefore susceptible to the problem of 'out of sight, out of mind', in other words under-appreciated.

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We must enable safe innovation and development of the financial system, otherwise competitiveness is an issue and it will undermine achieving the goal of financial stability. This enablement needs however to happen within a system that is grounded in the core ideas and principles

But, I am conscious that this story alone leaves open the charge that we have achieved the so-called stability of the graveyard. Nothing moves, there are no big dramas, because the system is moribund. Not true, is my response. The financial system has evolved and continues to do so.

The record of the last 15 years indicates that the financial system has played its part in supporting economies through a series of severe shocks, and has acted to absorb rather than amplify these shocks. I would emphasise here that financial stability is not an end in itself. Rather, the goal is to support economic activity, a point I will come back to later.

When we look at the developments of the last 15 years or so we should also recognise how the financial system has changed, and it certainly has. I am not going to give an extensive review of the changes, but rather pick out a small number of key points and seek to explain their broader significance.

The first major change that we have seen is a rebalancing of the overall scale of global financial intermediation with an increase in the non-bank sector relative to banks. The non-bank sector is not, of course, homogenous, a point I will come back to. I think it is worth drawing out a number of closely related points that underline this shift in balance between banks and non-banks.

The first is one that, I think, was clear during the financial crisis, and provides a backdrop to the changes that were to come. It is that the financial crisis was severely exacerbated by the concentration of assets and exposures on the balance sheets of banks which were too volatile and hard to value in a stress, and thus created too much uncertainty around the stability and ultimately solvency of banks.

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One of the eternal questions that gets posed during such a stress is whether for banks it is a solvency or liquidity event? The presumption is that the latter is ok in the sense of manageable while preserving going concern, while the former is not. But the problem is that we only know the answer to this question ex-post. Illiquidity is a symptom which tends to point towards doubt around future solvency, but does not answer the question conclusively, either ex-ante or contemporaneously.

The question is better put as whether there is sufficient uncertainty around future solvency to cause stress through illiquidity. The answer to this question in many, if not all, problem cases during the crisis was yes. From that answer, it is a logical step to conclude – as we did – that the tools of liquidity assistance available to central banks – let's call them the traditional Bagehot tools – should be reinforced and supplemented by tools of resolution, and this rightly became an important part of the post-crisis agenda for national authorities and the FSB, an agenda that Klaas has played a major part in leading.

We have made huge progress on the resolution agenda. Alongside that, we have also made huge progress on the Basel agenda for reforming the prudential regulation of banks. At this point, I must make the - obvious I hope but it has to be made anyway – comment that we must finish off implementation.

Linking this back to the re-balancing of the bank and non-bank financial sectors, these developments help to explain why the re-balance has been a sensible and logical development. It has been a foundation reducing the probability of crisis in the banking system.

But, some of the argument for this was apparent at the time of the crisis, and some was less apparent. I think what has become more obvious over the last 15 years is why this change matters for financial stability, and what it tells us about the future.

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For me at least, this is where the concept of the singleness of money, and trust in money, comes in, and how it underpins the regulation of banks. Put simply, why were some assets problematic for banks in the crisis, and why did it matter?

The distinctive feature of banks is that their liabilities are typically substantially in the form of money deposits. In the regulatory world, it is deposit taking that is unique to banks. Most of the stock of money in our systems is commercial bank deposits.

These deposits underpin the functions of money – its role as store of value, unit of account and means of exchange or payment. The critical property of money is trust in its nominal value.

Put simply, a Pound or euro in my account has the same value as a Pound or euro in another account, and thus when we make payments we do not have to worry about variable nominal value. This is a key foundation of financial stability, and thus of public trust. In the crisis it was the uncertainty about the future solvency of banks that undermined this trust and thus ended financial stability itself.

The underlying issue here was increasing doubts on whether the liabilities of banks did satisfy the properties of the singleness of money. So, a key objective of the post crisis reforms has been to rebuild confidence in the singleness of, and trust in, money.

However, if I stopped the account here, it would fall into the trap of adapting an old-fashioned view of banks that they are only deposit-takers and not involved in activities which get loosely called investment banking. In what I regard as one of the best books on financial crises, Gary Gorton described the 2008 crisis in the US as a run on repo, prime broker balances, and asset-backed commercial paper[1].

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At first sight, this appears critically to muddy the distinction between banks and non-banks. Can we be confident we know where the boundary lies? The lessons here are that the critical feature of banks is the singleness of money and the public's trust in the assured nominal value of their money.

Moreover, since banks are ultimately single entities, their reputation and that trust depends on confidence in their balance sheets as a whole (which is not, of course, to ignore that their capital structures must involve loss-bearing in both going and gone concern states). In other words, we must be very focused on the money system in our economies and its stability.

That said, our economies rely on financial risk taking, and that is essential to support investment and growth. To achieve this, it's crucial in large parts of the non-bank system that there is not assured nominal value for the liabilities so that risky investment proceeds. It is critical that we maintain this distinction between banks and non-banks, and it is well understood by the public.

I will, however, add two important qualifications. First, banks must of course take risks – that should not need to be said, but just in case. The point is that the risks must be managed to preserve the assured value of money. Most non-banks do not need to do this. But, second, some non-banks do write liability contracts which contain promises of future value of one sort or another. Insurance is a very good example of this.

My key point here is that over the last fifteen years post crisis, the distinction between banks and non-banks and the importance of the money system has become better understood and defined. It is not new at all, but it has been important to define it under today's conditions. Failure to do so was a major flaw that led to the financial crisis.

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There has to be a 'however' though, and this brings in the second of the three big changes in financial intermediation that we have seen since the financial crisis. The 'however' is that it would be a mistake to think that the greater scale of non-bank finance, and the distinction between money and non-money liabilities has led to a comprehensive separation of these two parts of finance. The two are as inter-connected as ever, but in ways that have changed. And this is absolutely key to understanding financial stability today and the risks to it.

Let me use a prominent example. There has been a major change in the nature of trading in most major government debt markets, resulting in a much expanded non-bank presence and often much more leverage attached to newer trading strategies. But the banking system remains the ultimate source of liquidity for these activities. Banks' activities in prime brokerage have expanded substantially and rapidly. The financing is typically secured and margined to protect against risk. Often, this relies on another of the major post-crisis developments, namely the expansion of central clearing.

These developments are consistent with the post-crisis direction of policymaking, to strengthen infrastructures like clearing houses, put them at the heart of the system, and thereby manage and reduce the risk of serious systemic stress which threatens financial stability. There is a good case that these developments have to date worked.

However, rather like the overall growth of non-bank finance, we should not be surprised that a stronger infrastructure has led to the growth, for instance, of more leveraged trading activities. Our job as authorities is to understand these developments and assess and if necessary tackle any vulnerabilities that they may give rise to.

I would describe developments such as the growth of leveraged trading as putting the post-crisis financial system to work. We may or may not like all of them, and they give rise to new risks, but we shouldn't be surprised that the system responds and evolves.

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Another example of post-crisis developments in non-bank finance is private assets – private equity and private credit. These may fall into a somewhat different behavioural category, namely there may be aspects of public markets which encourage going private. Our job is to assess the consequences for financial stability purposes.

It is not to presume that such developments are per se bad, but rather to ask questions and assess them with rigour and be transparent with our conclusions. In the lead up to the crisis, there was a different culture, more of an absence and at times disapproval of such scrutiny, and the consequences were regrettable.

A third big change in financial intermediation post-crisis that I would highlight is the growth of cryptoassets. I'm not convinced that the cause of this was a response to post-crisis regulation. It seems to me to be more an outcome of technological advances. But it falls into the category of new areas that require thorough assessment of possible vulnerabilities and their financial stability implications.

I don't regard crypto as a homogenous world, and the distinction between investments and money helps with understanding the distinction. Crypto of the Bitcoin variety falls into the risky investment category, whereas stablecoins used for retail and wholesale payments, rather than just to support crypto trading, fall into the money category, or should do. Understanding the implications of this distinction is important for designing the approach to regulation.

But I will go further than that and say it should enable better stablecoins to emerge than would do in a world in which the distinction was not understood and followed up.

This point takes me to the last important theme I want to cover. Today, we face a growing challenge to the post-crisis system of financial regulation. It comes with a number of descriptions and reasons. One is an old point made

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by Hyman Minksy, that as time passes memories of a financial crisis fade and this leads to a questioning of the continuing need for the responses.

This creates the risk of history showing signs of repeating itself, remembering back for instance to the strength of the deregulation argument before the financial crisis. Those of us who are veterans of dealing with the financial crisis, don't tend to forget, but I can see evidence in today's world of the truth of Minsky's observation.

But I don't think the Minsky theory is the end of the story. Another argument made is what gets described as the need for regulatory simplification. I think a reasonable interpretation of this argument is that it is perhaps natural that the response to an event as big as the financial crisis becomes over-complicated, and the passage of time exposes the need to stand back and take a hard look at whether some parts of the response are too complicated, or excessive.

There is truth in this, and we should take up the challenge and respond – and we are doing so. But again I don't think this is the full story on the reasons for the growing challenge to financial regulation.

A third argument I detect concerns the distributional effects of the regulatory changes and comes in a few forms. The first is that the response to the financial crisis has changed the financial system and has thereby gone too far to create winners and losers. A second form of this argument is that the post-crisis regulatory system is inflexible and does not allow innovation.

These are important arguments about competitiveness that we need to assess carefully. Brushing them off will not do. Again, where there is truth in the argument, we should respond.

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The fourth argument I can see in many ways is the most fundamental namely that the regulatory system is impeding growth in economies. This is a very important challenge, for the simple reason that the potential growth rate of many developed economies has slowed markedly since the financial crisis, and particularly the growth of productivity. And since productivity is a main determinant of the growth of living standards, the evidence of a very flat growth in GDP per capita underlines the importance of this point.

So, we have four challenges to the state of financial regulation, all of which amount in different ways to saying that we have overdone it post-crisis. In my remaining time, I probably can't do each or any of them proper justice, but this debate is now so central to what we are doing that it has to be taken on and given due consideration.

I will start with the Minsky passage of time point. First of all, I think Minsky was right, and current events are illustrating his point. As I mentioned earlier, success in financial stability is when nothing happens, and not much has happened relative to the scale and nature of the shocks we have had – COVID, Ukraine etc.

It is convenient to think, nothing has happened, job done with regulation, I rest my case for the benefits. But meanwhile, the argument is growing that since nothing much has happened, we must be overdoing it on regulation.

The answer to all of this is that it rightly pushes us to ground the case for regulation and keep doing so, because 'out of sight, out of mind' does not lead to good long-run outcomes. Moreover, since the world constantly changes, it is a mistake to freeze the regulatory system because it appears to have worked in the recent period of time.

Here I think it is important to set out the specific outcomes we seek in the financial system when we say we are aiming for financial stability. What I have in mind here are outcomes as follows:

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- First, we want a system where confidence in banking is maintained in the face of economic shocks and where resolution regimes enable the continuity of financial services if a bank fails.
- Second, we want to maintain the singleness of money, including where new types of non-bank that have grown up in the crypto world seek to issue money for real-world payments purposed.
- Third, we want robust market and payments infrastructure that operates without interruption and recovers quickly from rare disruptions.
- Fourth, we want financing from banks and non-banks to the real economy that is sustainable through the economic cycle and avoids excess supply of debt followed by debt overhang.

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These are big building block outcomes that we have to articulate, otherwise the debate on regulation is dangerously ungrounded.

Let me turn to the second challenge, the point on simplification. Regulation probably does go in cycles, and we should recognise this and respond. Post-crisis it was straightforward to advance a cost-benefit case for increasing regulation, and this happened. By the way, in my experience governments were very much part of this process, it wasn't just central banks and regulators.

But pro-cyclical regulation is not a good or stable state of the world, and we should recognise this. There is little doubt that in some areas we collect too much data. There is also a growing risk that because of this, as the pro-cyclical tide turns, we are inhibited from collecting necessary data in new areas of risk.

So, we must, and I think are, responding positively to the simplification challenge. Another case of simplification is the adoption of a simpler capital regime for small deposit takers, in the UK the so-called 'Strong and Simple' regime.

The third challenge is the competitiveness one. As I mentioned, this comes in several forms – you have skewed competitiveness by regulating, and you have prevented innovation by doing so. These are basically the same argument taking on different forms. Here, too, we must respond, and we have to ground the response in the core building block arguments.

The danger here, to be frank, is that arguments that are interest based – and I don't say this in a critical way, it's a matter of fact – swamp the fundamental ideas based grounding of financial regulation. We have seen this before – its another form of the Minsky argument.

It is the case that post-crisis regulation did intentionally change the competitive balance of banks and non-banks, for the reasons that we had ended up pre-crisis with an unstable and dangerous banking system which had lost the anchor of the singleness of money. That anchor could only be put back in place with massive state intervention at an unacceptable cost to taxpayers.

Today, I would argue that the financial system is not only more stable, but also generally earning returns which meet basic commercial objectives. It is up to firms then to increase their returns further, nothing is wrong with that. But there is a point in the third challenge.

We must enable safe innovation and development of the financial system, otherwise competitiveness is an issue and it will undermine achieving the goal of financial stability. This enablement needs however to happen within a system that is grounded in the core ideas and principles. Yes, I'm back to points like the singleness of money again.

The fourth challenge, the growth issue, is crucial. We face a huge challenge on this front. However, I push back at the line of argument that post-crisis financial regulation caused the fall in productivity growth, by restricting business investment in the economy. I think it is a rather different line of argument.

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Big shifts in productivity growth over history have been shaped by advances in so-called general purpose technology – things like the steam engine, electricity etc. We had such an advance before the financial crisis, through ICT and the internet. Over time, the contribution of these advances to economic growth does run out – that's as distinct from their contribution to the level of economic activity. I think this is more what we have seen post-crisis, but the timing is coincidentally awkward for separating out causes.

All of that said, we need a financial system that is ready and able to finance the next general purpose technology advance, which I would guess is AI. This is the important question today. In my view this must be a stable financial system, grounded in the core areas and principles of financial stability, but one that must be set up to support growth.

To finish, all of these four challenges have a point to them. We cannot behave as if the case for financial stability can ignore them. That said, if the baby is thrown out with the bath water so to speak, and financial stability is relegated in terms of its importance, we won't achieve our objectives. There is no trade-off between financial stability and objectives like growth and competitiveness.

But nor is our system perfect in every respect and fit for an ever-changing world. Our system must be constantly assessed and adapted as needed. But that process must be grounded in the core principles and ideas of financial stability. ■

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Endnote

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I would like to thank Nathanaël Benjamin, Sarah Breeden, Karen Jude and Sam Woods for their comments and help in the preparation of this speech. This article is based on the speech by given at the Klaas Knot Farewell Symposium, 03 October 2025.

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A threat to financial stability

Stablecoins have emerged as a major innovation with broad implications for payments and international finance. Richard Portes explores the risks such stablecoins pose to financial stability and measures that could contain these risks

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The multi-issuer model for cryptoasset stablecoins poses significant financial stability risks and regulatory challenges for the EU. In such a model, an Electronic Money Token (EMT) — a stablecoin — is jointly issued by both an EU-regulated institution and one or more third-country entities. This arrangement was not foreseen and not explicitly regulated under the EU legislation governing stablecoins, the Markets in Crypto-Assets Regulation (MiCAR), applicable from mid-2024.

There are thus substantial ambiguities which issuers can exploit. These stablecoins – deemed fungible across jurisdictions – facilitate regulatory arbitrage, fragment reserve management, and potentially expose EU issuers and their banking partners to systemic stress, redemption runs, and contagion. Hence regulatory reforms are needed urgently. The urgency is heightened by the passage of the American stablecoin-enabling GENIUS Act in July 2025.

In this column, we provide a framework for understanding and mitigating the multi-issuer stablecoin (MISC) loophole — a gap which, if left unaddressed, could have far-reaching consequences for EU financial stability and investor protection. We advocate prompt legal and supervisory adaptation to ensure MiCAR meets the realities of a globalised crypto-finance landscape.

We first explain the model and the regulatory background, then provide a technical and legal risk assessment. We highlight the need for a robust EU-level regulatory and supervisory response, bespoke prudential standards, explicit crossborder arrangements, and greater harmonisation at the global level.

The multi-issuer model and its risks

Stablecoins are supposed to maintain a stable value, pegged to an official currency or a basket of assets. They are meant to be backed by reserves in the form of high-quality liquid assets (EU and US requirements are somewhat different). The design is not entirely robust: there are multiple instances in which key stablecoins have 'broken' their

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pegs under stress; and there is significant everyday volatility for the major stablecoins, USDT and USDC, around the $1 peg.

A multi-issuer arrangement arises when a stablecoin is issued in multiple jurisdictions by different legal entities with the same controlling interest — for example, a European subsidiary and a US parent or affiliate issuing 'the same' token. These tokens are treated by the issuer and the holders as interchangeable (fungible), regardless of the regulatory framework.

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The multi-issuer model introduces critical vulnerabilities into the EU financial system, undermines MiCAR's single-market protections, and exposes EU issuers to liabilities and operational risks beyond their control

For intra-EU issuance, joint liability is clear and fully subject to rules under MiCAR. In a crossborder framework, with issuance in the EU and a third country, the fungibility of tokens muddles accountability, as an EU entity may be responsible for redemptions originally claimed from a non-EU affiliate, over which it has neither legal nor operational control (Figure 1). But there is no explicit provision in MiCAR for third-country crossborder co-issuance, although issuers market multi-issuer stablecoin tokens as fully fungible, regardless of the original jurisdiction.

This model poses significant prudential and regulatory issues. First, the reserves backing the stablecoin are fragmented. When the same stablecoin is issued by both EU and non-EU entities, reserve assets are split and managed under different regulatory regimes, with no guarantee the reserves held in the third country will be available for attempted redemptions in the EU in stress episodes.

EU law requires prompt, cost-free redemption at par by EU issuers. But the third-country issuer may apply fees or delays. And in a crisis, the third-country authorities might 'ringfence' (withhold) locally held reserves, jeopardising redemptions in the EU.

This national ringfencing of liquidity was observed within the EU itself during the crises of autumn 2008 and spring 2020, despite the supposedly ironclad legal prohibition of capital flow barriers within the EU.

The multi-issuer stablecoin model therefore raises major macroprudential issues. First, there would be clear incentives to run in a stress episode. Regulatory arbitrage enables stablecoin holders to redeem preferentially in the jurisdiction offering the most favourable terms, likely the EU. This increases the likelihood of a run, especially if holders (correctly) perceive the inadequacy of EU-held reserves to meet redemptions.

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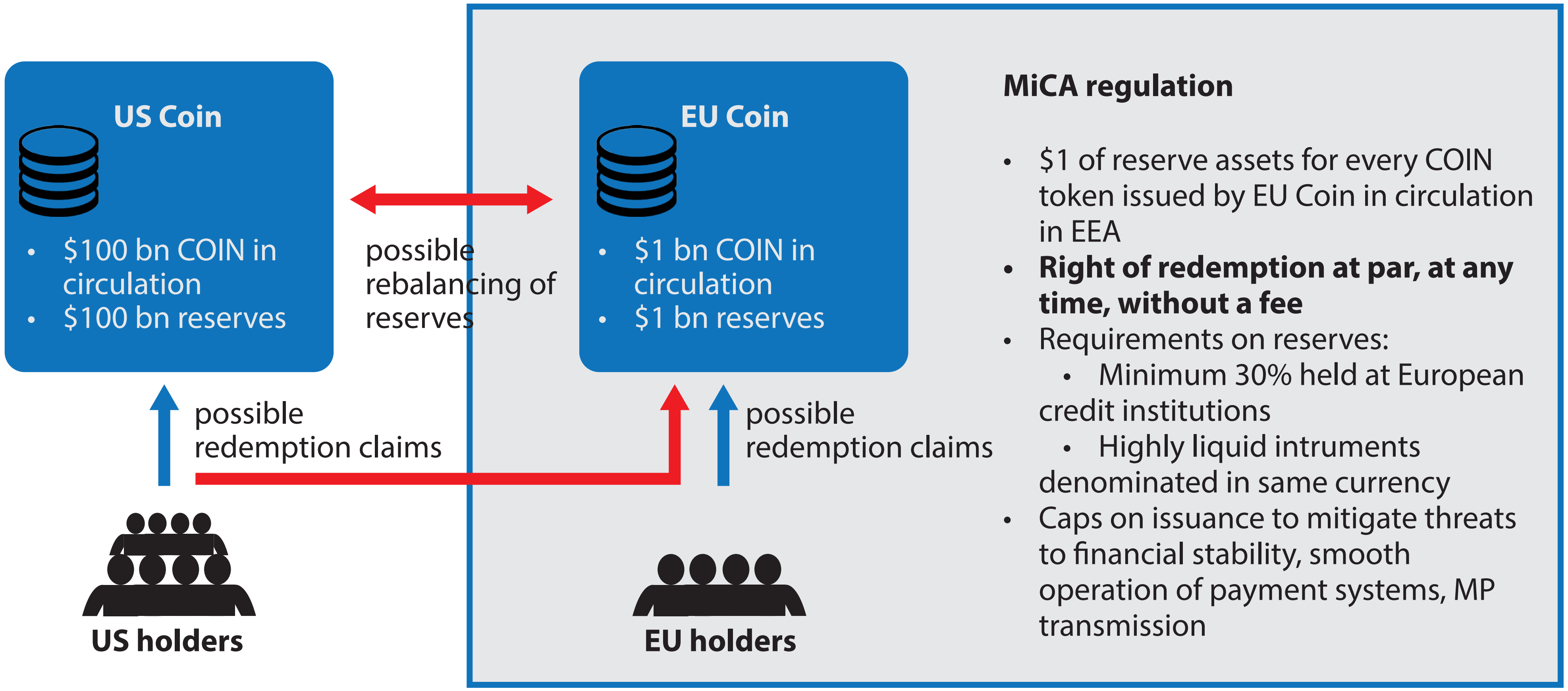
Figure 1. Illustrative example of an EU and third-country stablecoin multi-issuer model applied to the EU and US



Notes: The diagram conceptualises the flow of reserves and redemption claims between an EU and a US stablecoin issuer. It highlights how tokens can move and be redeemed in either jurisdiction, while underlying reserves remain subject to two regulatory and supervisory silos, increasing the risk of misalignment in crises.
Source: ESRB, Report on stablecoins, crypto-investment products and multi-function groups, October 2025.

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Second, there might be contagion to and across banks. If a run on an EU stablecoin issuer occurs, and the issuer is a credit institution, direct contagion may affect the bank. For e-money institutions (EMIs), large, required reserves (eg. 30% or 60% deposited with EU banks for (non-significant issuers) mean that redemptions could strain the liquidity positions of associated banks, especially those with concentrated exposure to cryptoasset players.

The risk is heightened by the likely development of 'crypto-friendly' banks: with no overall cap on the aggregate stablecoin-related liability any one bank can have, the rise of banks heavily reliant on crypto sector funding is likely, amplifying systemic risk. The fragility of this funding and the consequent systemic risk were observed in the US mini-crisis of March 2023 (Silicon Valley Bank, Signature Bank, Silvergate Bank), which required major intervention by the federal authorities (Admati *et al* 2023).

There is a significant likelihood of circumvention of EU safeguards and regulatory arbitrage. Foreign-issued tokens under a multi-issuer arrangement may exploit favourable EU rules (eg. par redemption, absence of fees, market prominence), while not being subject to EU-level reserves, risk management, or supervisory scrutiny.

The risk is exacerbated by the difficulty of tracking the effective volumes of tokens in circulation within the EU and abroad, especially for those held in off-chain wallets. Thus, requirements designed to mitigate financial stability and policy risks (eg. issuance caps for foreign currency electronic money tokens, enhanced oversight at critical thresholds) become difficult to uphold.

Note that there is an incentive to hold stablecoins in the US: although the GENIUS Act prohibits paying interest on stablecoins, there is a way around this via cryptoasset service providers which can hold the stablecoins and pay interest to the owner.

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The multi-issuer stablecoin scheme does not provide the necessary investor protection, one of the main objectives of MiCAR. Investors may be led to believe an 'EU-branded' stablecoin carries full EU protections when part of the token stock is issued outside the EU and not subject to MiCAR.

Moreover, supervisory reach is limited, especially because EU supervisors lack control over third-country assets or operations yet may have to take actions with respect to redemptions from holders who have acquired tokens from third-country issuers. This is a sharp deviation from standards in classical banking regulation.

EU regulators have no control over the marketing practices of third-country issuers, which might misrepresent redemption arrangements and links to the EU-based issuer. That then poses reputational risks for the EU authorities. The model sets a precedent for non-EU issuers to access the EU single market while evading regulatory obligations, making the EU vulnerable to international regulatory arbitrage.

While EU supervisors cannot oversee non-EU risk management, they would de facto be tasked with maintaining the solvency and liquidity of all tokens, a legal and prudential stretch never tolerated in the traditional crossborder banking world.

There are several issues regarding reserve allocation and the operational hurdles to running a multi-issuer stablecoin scheme. First, the rebalancing mechanism. For the system to work, reserve assets must be transferable in both directions between the EU and non-EU issuers to fulfil redemptions as they arise. This is only as effective as the underlying legal and operational frameworks and the ability to move funds promptly — often unreliable, especially under stress.

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Where reserves are invested in third-country money market funds, as permitted under the GENIUS Act, redemption can be frozen by local authorities, further weakening the reliability of crossborder pools. The most acute risk, therefore, is having a liquidity shortfall locally due to operational, legal, or market blockages in moving assets crossborder.

Second, we lack reliable data on where tokens are held, due to the prevalence of self-hosted wallets (44% for Circle USDC as of February 2025) and limited reporting from non-EU crypto providers. This leads to large judgment calls in stress testing and risk modelling for EU supervisors.

The actual exposure of the EU issuer is unknown; estimates of 'EU-circulating' supply are only lower bounds, reducing confidence in reserve adequacy and crisis planning. Limited knowledge of self or omnibus wallet holders means redemption behaviour is unpredictable, raising the risk of unanticipated runs.

Arbitrage opportunities would arise if the coin were trading below par in one jurisdiction and could be redeemed at par and for free in the EU, inviting profit-seeking redemptions during even minor price declines — a classic 'run' scenario. The MiCAR ban on redemption fees amplifies this incentive.

Legal and supervisory considerations

Crossborder multi-issuer schemes entirely within the EU are governed by MiCAR, which grants national competent authorities latitude under Article 35 (own funds requirements), Article 45(4) (liquidity enhancements post-stress testing), and Article 94(1)v (broad preventive powers), enabling strengthened buffers for at-risk institutions. Increases to own funds requirements would have legal precedent: for example, a 20% uplift for non-significant issuers and a 20–40% increase for significant ones, based on stress test findings, risk outlook, and redemption guarantees.

The European Banking Authority (EBA) can take into account considerations relating to multi-issuance. If the token is 'significant', it is subject to EU-level oversight, which facilitates crossborder coordination and a level playing field. But classification is hindered by incomplete or contested data about token distribution and reporting inadequacies by Crypto Asset Service Providers (CASPs).

Still, supervisors may revoke authorisations, impose redemption fees, or limit redemptions in an emergency, provided they meet the MiCAR flexibility requirements.

Policy options and recommendations

There is a wide range of policy options available to the EU authorities for dealing with the specific risks posed by multi-issuer stablecoins. The first would simply be to ban them, as the European Systemic Risk Board has recommended. Against this, there has been considerable lobbying pressure in Brussels from well-funded issuers.

But some key members of the European Parliament have resisted and have written to Commissioner Albuquerque setting out their concerns. And President Lagarde of the European Central Bank has forcefully expressed her opposition to multi-issuer stablecoins (Lagarde 2025). At the time of writing, the European Commission had not set out its final position.

If the Commission deems that under existing legislation, multi-issuer stablecoins are permissible, then they could propose amendments to MiCAR to cover multi-issuer schemes explicitly and lay out a framework for cross-jurisdiction equivalence, reciprocity, and asset ringfencing protections.

Meanwhile, macroprudential authorities should intensify scrutiny and systemic risk analysis of multi-issuer schemes. The authorities could require EU stablecoin issuers engaged in multi-issuer arrangements to set high minimum

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denomination amounts, or limit issuance if the ECB identifies payment systems or monetary policy risks. They could impose higher own-funds or stricter liquidity requirements based on stress-testing outcomes whenever reserve sufficiency is in doubt.

Enhanced disclosure obligations for issuers would be desirable, with the European Securities Markets Authority (ESMA) providing whitepaper disclosure templates detailing the structure, risks, and reserve-management specifics of any multi-issuer token. These should be strengthened, with harmonised reporting standards for cryptoasset service providers and issuers, both inside and outside the EU, to map accurate token distribution and calibrate policy.

Ideally, the authorities should develop enforceable global regulatory standards in coordination with Financial Stability Board (FSB) guidance and robust cooperation agreements to ensure liquidity flows and consistent application of prudential rules, even during crises. And within the EU, national competent authorities (NCAs) should coordinate, but not in a decentralised way — an EU-level approach is judicially and practically more robust.

Decentralised equivalence assessments (by each NCA) create the risk of fragmentation, a practice the European Commission would not tolerate in other areas of financial regulation. The European Banking Authority or European Securities Markets Authority should lead here.

The multi-issuer model introduces critical vulnerabilities into the EU financial system, undermines MiCAR's single-market protections, and exposes EU issuers to liabilities and operational risks beyond their control.

Systemic risks include investor runs, bank contagion, loss of monetary policy sovereignty, and undermined regulatory credibility. Immediate regulatory action at both EU and global levels is necessary, with legal clarification

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of multi-issuance, harmonised prudential tools, robust cooperation arrangements, and enhanced crisis management protocols. ■

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Author's Note: Co-Chair of European Systemic Risk Board Crypto Asset Task Force. Views expressed here are personal and not those of the Task Force, whose report was published on 20 October 2025. I am grateful for exchanges with Yvan Dubravica, Adam Glogowski, Steffen Kern, and Elisabeth Noble on these issues. This column extends the analysis in Portes (2025). It is an amended version of a chapter to appear in a CEPR eBook edited by Dirk Niepelt. This article was originally published on VoxEU.org.

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An EU reparations loan is the right way to help Ukraine

There will be a post-war reconstruction of Ukraine. Charles Lichfield and Nicolas Véron examine how European Union countries should agree to back a clever financing workaround that would leave Russia's assets untouched but leverage them to support Ukraine

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Can the full amount of immobilised Russian sovereign assets be offered to Ukraine, without confiscating the money outright? EU finance ministers discussed the issue on 10 October, with Stephanie Lose, economic affairs minister of Denmark, which currently chairs EU ministerial meetings, saying *"not finding new financing for Ukraine is definitely not an option,"* and that EU countries would continue work on a European Commission plan for a loan to Ukraine based on the Russian assets.

That plan has not been made public but was previewed by European Commission President Ursula von der Leyen a month ago: *"With the cash balances associated to these Russian assets, we can provide Ukraine with a reparations loan. The assets themselves will not be touched. And the risk will have to be carried collectively. Ukraine will only pay back the loan once Russia pays for the reparations."*

Our interpretation of how the plan might work is based on media reporting and conversations with participants. When Russia invaded Ukraine in February 2022, its central bank held securities at Euroclear Bank, the leading international central securities depository, based in Brussels. These were quickly immobilised by sanctions and have mostly come to maturity since then.

Consequently, the Bank of Russia has accumulated deposits at Euroclear Bank, denominated in over ten currencies and estimated at around €180 billion. It cannot move this cash and is not entitled to interest on it, given Euroclear Bank's contractual terms.

For two years after the invasion, Euroclear earned interest income on the trapped Russian cash, with one quarter going to the Belgian state as corporate income tax. Since early 2024, the EU has confiscated nearly all Euroclear's associated after-tax income.

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In December 2024, this stream became the basis of the Extraordinary Revenue Acceleration (ERA) loans to Ukraine, totalling $50 billion, raised by the EU with the United States, United Kingdom, Japan and Canada. If the Commission's reparations loan mechanism is implemented, the EU is expected to repay all ERA lenders, including itself.

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When Russia invaded Ukraine in February 2022, its central bank held securities at Euroclear Bank, the leading international central securities depository, based in Brussels. These were quickly immobilised by sanctions and have mostly come to maturity since then

The reparations loan – also supported by German Chancellor Friedrich Merz – would involve Euroclear lending an equivalent amount to the immobilised assets, say €180 billion (in the same currencies), to a European entity. This may be the EU itself or an ad-hoc special-purpose vehicle – we refer to it as 'Europe'.

The zero-interest loan would not cost to Euroclear since it no longer gains interest income on the cash. Europe would reimburse the ERA loans and lend the rest – about €135 billion – to Ukraine.

If Russia eventually pays reparations, Europe will use these to reimburse Euroclear. Because this is uncertain, Euroclear's loan would be backed by guarantees from participating member states, ideally all EU countries.

That would represent a significant, albeit contingent, new commitment but is worth the effort. If Ukraine loses the war, the subsequent financial costs – and other tragic consequences – are likely to be far greater for Europe.

State guarantees for the loan would probably require approval from national parliaments. Euroclear would also need assurance that the block on Russia's cash will remain for the duration of its loan to Europe, because otherwise it would be at risk of having to borrow the difference at a loss.

EU leaders have already said Russian assets should stay immobilised until reparations are paid, but putting this reassurance into law would allow the EU to escape the need to renew the immobilisation every six months – a process that requires unanimity.

How the EU will get there is not yet entirely clear, but we assume the willing capitals will find a solution. EU leaders will further discuss the reparations loan at a summit on 23-24 October.

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In our understanding, Euroclear will be reimbursed even if future diplomacy results in a settlement in which Russia does not pay reparations. But the loan mechanism would be a powerful incentive to European countries to insist that Russia must pay reparations, and to use their leverage accordingly. This may be why the reparations loan idea has been met with furious pushback from Russian propagandists.

Meanwhile, by guaranteeing the integrity of international reserves held in Europe and of Euroclear as a securities depository, the scheme would avoid undermining the international monetary order. It achieves the best possible balance between the many parameters that have shaped the debate on Russia's immobilised reserves.

If this ingenious scheme fails, there will be alternatives for EU provision of support to Ukraine, but they will be less good. All Europeans should thus support a well-designed reparations loan. ■

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This article is based on a Bruegel First Glance.

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From resilience to strength

The EU must speed up its integration and overhaul a model of export-led growth that has faltered amid mounting geopolitical turmoil. Christine Lagarde warns that the EU is increasingly vulnerable to shocks and is lagging behind in areas that will drive growth such as AI

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I would like to start with a quote:

> *"The world around us does not stand still.*
>
> *In recent years, the global environment has been transformed in ways that none of us could have imagined. We have seen the post-war global order fracturing, the rise of new – and some old – powers, rapid changes in technology, and an uncertain outlook for global trade and finance.*
>
> *Uncertainty abounds and conventional wisdom is being challenged, in politics, in diplomacy and in economics. And, unavoidably, this calls on Europe to consider its place in the world and reset its ambitions."*

This may sound like the kind of passage you have heard in many speeches this year. But, in fact, it is from the first speech I gave as ECB President –in November 2019[1].

In that speech, I urged Europe to recognise that its old growth model – built on export-led growth – was coming under strain. And I called for a shift: to focus instead on developing our domestic economy as a source of resilience in an uncertain world. My point was not to argue for protectionism or inward-looking policies.

It was about realism: recognising the world as it is. And it was about acknowledging that the solution was already in front of us: the untapped potential of our own internal market. Six years on, that diagnosis has only become clearer and stronger.

Europe has become more vulnerable, also due to our dependency on third countries for our security and the supply of critical raw materials. Global shocks have intensified, with rising US tariffs, Russia's invasion of Ukraine and stiffening competition from China.

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At the same time, our internal market has stood still, especially in the areas that will shape future growth, like digital technology and artificial intelligence, as well as the areas that will finance it, such as capital markets. And yet – as Galileo famously said – *"it moves."* Europe continues to show resilience, revealing sources of strength that could grow if only we allow them to.

So the question I would like to address today is: how do we move from being resilient but vulnerable to being genuinely strong? And what will it take to do so?

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Europe's vulnerabilities stem from having a growth model geared towards a world that is gradually disappearing

Vulnerabilities in Europe's growth model

Europe's vulnerabilities stem from having a growth model geared towards a world that is gradually disappearing. We embraced globalisation more than any other advanced economy. In the two decades before the pandemic, external trade as a share of GDP almost doubled in the EU, while in the United States it barely moved[2].

This deep integration brought significant benefits: the number of jobs supported by EU exports[3] rose by 75%, reaching almost 40 million[4] – and for many years, this was a source of resilience. But today, that same openness has become a vulnerability. Exports have become a far less reliable engine of growth, reflecting the changing global landscape.

In mid-2023, for instance, ECB staff expected exports to grow by around 8% by mid-2025. In reality, they have not grown at all. And looking ahead, exports are projected to subtract from growth over the next two years[5]. This has been felt most acutely in countries with large manufacturing sectors, which have faced a prolonged slump in industrial production.

As a result, growth across the euro area has become more uneven. At the same time, this export-led growth model has resulted in a persistent current account surplus, increasing our reliance on other countries to generate our wealth – especially the United States.

Euro area residents now hold nearly 10% of their total equity investments in US stocks, totalling €6.5 trillion – about two times the amount they held at the end of 2015[6]. This has been a rational response: US markets have delivered returns roughly five times higher than Europe's since 2000. But it has created a vicious circle.

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As US markets channel European savings into high-productivity sectors, the performance gap between our economies widens – prompting yet more European savings to flow across the Atlantic. The result is stagnating productivity at home and growing dependence on others.

Finally, we now face a new form of vulnerability shared by all major economies: the weaponisation of dependencies on key raw materials and technologies. ECB analysis shows that more than 80% of large euro area firms are no more than three intermediaries away from a Chinese rare earth supplier[7].

Recent supply shocks – for example, the shortage of automotive chips – have shown how a single chokepoint can stall entire sectors. These vulnerabilities do not trigger dramatic crises. Instead, they erode growth quietly, as each new shock nudges us onto a slightly lower trajectory. Over time, the cumulative effect of this 'lost growth' and lost productivity becomes material.

In mid-2023, ECB staff projected that the economy would expand by 3.6% cumulatively by mid-2025. In reality, it has grown by only 2.3% – a shortfall equivalent to an entire year of growth in normal times, and productivity has turned out worse.

Sources of resilience in the domestic economy

Yet even as this changing world has exposed our vulnerabilities, 2025 has revealed Europe's latent strengths. Our experience this year has shown that a resilient domestic economy can shield Europe against global turbulence.

Three sources of domestic strength have helped cushion the impact of global shocks – our *people*, our *potential* and our *policy*.

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First, our people. We have benefited from an unusually strong labour market – one that has remained remarkably resilient even as growth has slowed. Typically, employment tends to grow at roughly half the pace of real GDP. Yet since the end of the pandemic, that relationship has been almost one-to-one in Europe[8].

This strength has created a virtuous circle: rising employment has supported consumption, which in turn has sustained services output and created still more jobs – particularly in labour-intensive sectors[9].

Second, our potential. Despite the notion that Europe is lagging behind in AI, European firms are moving quickly through the digital transition – and that is making investment more resilient to global uncertainty.

While tangible investment has fallen in the past two years as manufacturing has weakened, intangible investment has risen sharply[10], keeping overall business investment broadly stable. Firms continue to invest in AI and digital infrastructure because, for any company that wants to stay competitive, these are no longer optional.

Third, our policy. Fiscal policy, in particular, has acted countercyclically, buffering the economy rather than amplifying downturns, as we saw after the financial crisis.

The fiscal packages now being implemented for defence and infrastructure – especially here in Germany – are coming at the right time for Europe and will have a measurable effect on growth.

ECB staff estimate that higher government investment between now and 2027 will offset around one-third of the trade shock[11].The ECB is also playing its part by delivering price stability. We have cut interest rates by 200 basis points from their peak, and this is increasingly feeding through into easier financing conditions, which is helpful to support demand. We will continue to adjust our policy as needed to ensure that inflation remains at our target.

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Together, these three sources of resilience will help anchor growth at home. Domestic demand is set to become the main engine of expansion in the years ahead[12]. And this shift should also help narrow Europe's current account surplus, which has already halved since its peak in 2018[13].

The potential of the domestic market

This experience underlines the power of a resilient domestic economy, strengthened by open strategic autonomy. But it also exposes how much potential Europe continues to leave untapped.

Today, despite more than 30 years of the Single Market, trade barriers within the EU remain too high in key areas. ECB analysis finds that internal barriers in services and goods markets are equivalent to tariffs of around 100% and 65%, respectively[14].

Of course, we should not expect these barriers to disappear altogether: not all products are equally tradeable, and national preferences will always play a role. Policy can reduce certain frictions, but it cannot eliminate them entirely[15].

But we should expect two things. First, that barriers are low enough for the sectors that will shape future growth to operate in a truly European market. This is clearly not the case for digital services, which will drive future innovation, and capital markets, which must finance it.

Second, we should expect that being inside the Single Market offers a clear advantage over being outside it – in other words, that internal barriers are lower than external ones.

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But this is also not currently the case for services: over the past 20 years, barriers to crossborder trade within Europe have been declining no faster than those faced by international firms seeking to operate here.

This helps explain why, even though services now account for three-quarters of Europe's economy, trade in services within the EU makes up only about one-sixth of GDP – roughly the same as our trade in services with the rest of the world.

This is a vast waste of potential – especially at a time when we must rely more on ourselves than on others. And the key point is that *achieving these gains would not require radical change*.

Our analysis shows that if all EU countries were merely to lower their barriers to the same level as that of the Netherlands, internal barriers could fall by about 8 percentage points for goods and 9 percentage points for services[16]. If we only did a quarter of that, it would be sufficient to boost internal trade enough to fully offset the impact of US tariffs on growth[17]. So the question we must now ask is: why are we not taking these steps?

Towards a new governance

The answer comes down to governance. Fully harmonising all national laws and regulations is not realistic, nor is it always even necessary. But we lack effective tools to overcome barriers in the areas where progress matters most.

I believe that three steps can help us move forward. The first is to revive the principle of mutual recognition – the very engine of liberalisation that powered the Single Market in the 1980s.

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Mutual recognition means that if a good or service is lawfully provided in one member state, it should be allowed to circulate freely across the EU without the need to comply with every other country's rules. For example, in the EU there is a system of automatic recognition of professional qualifications for a number of sectoral professions.

Such mutual recognition is also visible in financial services. Today, banks benefit from a passporting system: a single licence granted by the ECB enables them to provide services across Europe. But they still face different rules in foundational elements of the framework they operate in. Completing the banking union and deepening our capital markets would therefore be transformative, accelerating our path towards a truly integrated home market.

The same logic applies to the digital economy. Just as passporting embodies mutual recognition in banking, the mutual recognition of digital identities, trust services and other credentials would dramatically improve interoperability and eliminate hidden costs that are slowing the growth of Europe's digital markets.

The second step is to streamline decision-making – by extending qualified majority voting to the areas on which Europe's future growth depends. While qualified majority voting has been instrumental in driving integration, it has now largely reached its limits. In several critical fields, the continued requirement for unanimity in the European Council still prevents meaningful progress towards completing the Single Market.

Taxation is the clearest example. Reforms such as harmonising VAT rules or establishing a common consolidated corporate tax base remain stuck because of national vetoes, leaving firms to navigate a maze of fragmented tax regimes.

This fragmentation is especially damaging in a world of digital business models and intangible assets, where tax policy cannot be managed within national borders alone. For example, a digital platform providing cloud or

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software services across Europe must currently comply with 27 different VAT systems, each with its own definition of where value is created for tax purposes.

This complexity tilts the playing field towards large US firms that can absorb the associated costs – exactly the opposite of what Europe needs if it wants to nurture its own digital champions.

Moving to qualified majority voting, using the passerelle clause where necessary – which allows the European Council to shift specific areas from unanimity to majority voting without changing the Treaties – could help break this deadlock.

The third step is to take a more radical approach to simplification – and I do not mean simply trimming regulations through the Omnibus packages. The fastest way to achieve genuine simplification is not by repealing existing rules, but by creating new '28th regimes' – optional EU legal frameworks that sit alongside national law rather than replacing it.

These frameworks would allow firms to opt into a single European rulebook in specific areas, without requiring full harmonisation across all member states. A prime candidate is company law[18], as proposed in the Letta and Draghi reports.

A European company law regime would provide firms – in particular start-ups and scale-ups – with a simpler path to operate across borders, cutting through the complexity of 27 different national systems.

This approach has worked before. The EU Trademark (1993) and Community Design (2001) were both 28th regimes, offering optional EU-wide intellectual property titles alongside national rights. And both have been widely adopted, especially by firms active across multiple markets.

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Their success shows how an optional EU framework can reduce fragmentation and even generate healthy 'systems competition': when firms choose the EU rules, national systems are put under pressure to adapt.

The European Commission is planning to present a 28th regime proposal as part of its renewed and welcome ambition to set clear deadlines for removing barriers identified in the 'Single Market Roadmap to 2028'. But progress will depend on political will.

The first step may be modest – such as creating a digital business identity, giving firms a single trusted profile to register and operate online across the EU – but it could set a powerful precedent for broader reforms to follow.

If we get this right, firms that could grow based on genuinely European regimes would also be best placed to access pan-European financing, helping to channel our vast savings into productive investment.

Completing the Single Market – in the real economy and in finance – is therefore a mutually reinforcing project, strengthening Europe's competitiveness and its capacity to invest in the future.

Conclusion

The world will not slow down for Europe – but we can decide how we move forward. If we make our Single Market truly single, Europe's growth will no longer depend on the decisions of others, but on our own choices. This was my message six years ago. Today, that message has only grown more urgent.

Another six years of inaction – and lost growth – would not just be disappointing. It would be irresponsible. But the experience of this year should also give us confidence. It has shown that our economy has real sources of strength – and that, if we act, those strengths can be multiplied.

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The steps we need to take are not beyond our reach. They require no new treaties, no radical rewiring of our Union – only the political will to use the tools we already have. If we can summon that will, Europe can move from being merely resilient to being genuinely strong. ■

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Endnotes

1. Lagarde, C (2019), "The future of the euro area economy", speech at the Frankfurt European Banking Congress, Frankfurt am Main, 22 November.

2. External trade as a share of GDP rose from 26% to 43% in the EU, whereas it increased from 23% to just 26% in the United States.

3. To non-EU countries.

4. Rueda-Cantuche, JM, Piñero, P and Kutlina-Dimitrova, Z (2021), EU Exports to the World: Effects on Employment, Publications Office of the European Union, Luxembourg.

5. See footnote 12 for details.

6. ECB (2025), "Euro area quarterly balance of payments and international investment position:fourth quarter of 2024", statistical release, 4 April.

7. Banin, M, D'Agostino, M, Gunnella, V and Lebastard, L (2025), "How vulnerable is the euro area to restrictions on Chinese rare earth exports?", Economic Bulletin, Issue 6, ECB.

8. Between the end of 2021 and mid-2025, cumulative employment rose by 4.1% – an increase of 6.3 million of people in employment – while real GDP increased by 4.3%. See Lagarde, C (2025), "Beyond hysteresis: resilience in Europe's labour market", opening panel remarks at the annual Economic Policy Symposium "The policy implications of labour market transition" organised by the Federal Reserve Bank of Kansas City in Jackson Hole, 23 August.

9. Anderton, R, Aranki, T, Bonthuis, B and Jarvis, V (2014), "Disaggregating Okun's law: decomposing the impact of the expenditure components of GDP on euro area unemployment", Working Paper Series, No 1747, ECB, December.

10. Excluding volatile Irish assets.

11. Lagarde, C (2025), "Trade wars and central banks: lessons from 2025", keynote speech at the Bank of Finland's 4th International Monetary Policy Conference, Helsinki, 30 September.

12. Cumulatively, ECB staff expect domestic demand to add 3.1 percentage points to growth between the second quarter of 2025 and the fourth quarter of 2027, while exports are projected to subtract 0.6 percentage points. See ECB (2025), ECB staff macroeconomic projections for the euro area, September.

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13. Lagarde, C (2025), "Opening remarks", remarks at the panel on the "Global Economic Outlook" at the 40th Annual G30 International Banking Seminar, Washington DC, 18 October.
14. Bernasconi, R, Cordemans, N, Gunnella, V, Pongetti, G and Quaglietti, L (2025), "What is the untapped potential of the EU Single Market?", Economic Bulletin, Issue 8, ECB (forthcoming). These "tariff equivalents" should be understood as measures of estimated trade frictions rather than actual policy-imposed tariffs. They reflect a combination of policy-related barriers and structural or cultural factors – such as consumer preferences and taste differences – that cannot be directly addressed through policy alone.
15. Head, K and Mayer, T (2025), "No, the EU does not impose a 45% tariff on itself", VoxEU column, Centre for Economic Policy Research, 13 November.
16. Bernasconi, R et al (2025), op. cit.
17. According to ECB simulations, this reduction in barriers would raise trade within the EU by around 3%, offsetting the 0.7 percentage point reduction in GDP growth between 2025 and 2027 caused by US tariffs and the related uncertainty.
18. So far, most legal reforms aimed at improving the business environment have relied on soft coordination, voluntary standards or limited harmonisation directives. This approach reflects national sensitivities in certain areas (eg. company law, tax law and labour law) that remain primarily a member state competence. However, previous attempts at soft convergence have only led to modest results.

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This article is based on a speech delivered at the 35th Frankfurt European Banking Congress, Frankfurt am Main, 21 November 2025.

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The next steps for European economic security

The world has changed fundamentally. Ignacio García Bercero and Niclas Poitiers argue that the EU needs a balanced strategy to cut reliance on the US and China while improving its capacity to counter coercive economic threats

Executive summary

The European Union's economic security strategy was initially developed at a time of close transatlantic cooperation and focused largely on risks linked to Chinese dominance of certain parts of global manufacturing. However, given the diminished commitment of the United States to its traditional alliances and to multilateral rules, EU economic security planning now also needs to take into account the risk of US coercive action.

The EU must combine a medium-term strategy to reduce dependencies on both China and the US in critical areas with the capacity to react in the short term to threats of coercion. This requires supply chain chokepoints to be identified. There should also be a political discussion with EU countries on the circumstances in which the EU Anti-Coercion Instrument should be deployed, and the appropriate measures to respond to coercion.

The EU's various tools for responding to urgent threats to its economic security need to be adapted to the new geopolitical context. The EU should prioritise support for research and development in relation to critical technologies and should ensure a more targeted and effective approach to state aid. It should avoid 'buy Europe' policies that contradict its international commitments and limit the scope for partnering with third countries.

On traditional economic statecraft tools, screening of foreign investment needs to be transformed to responding more effectively to economic security threats, while export controls need to be better coordinated. Given the need to de-risk relationships with both the US and China, strengthening economic partnerships has become ever more important.

Moreover, more robust governance structures to manage the use of economic security tools and partnerships with like-minded countries internationally need to be developed.

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1 Introduction

In 2023, the European Commission published a European economic security strategy (European Commission, 2023a)[1]. It was conceived at a time when the European Union could rely on close cooperation with the United States and was part of a coordinated transatlantic response to the risk of the weaponisation of economic dependence by China. China's dominant position in several manufacturing sectors, particularly in the processing of critical raw materials, was a particular focus.

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The move to a new EU economic security doctrine deserves a broader discussion on how to mitigate risks in the new geopolitical environment

EU-US alignment on economic security justified using the G7 as institutional platform to coordinate responses to economic coercion and, potentially, to develop economic security standards. On the EU side, the 2023 strategy is now being developed into an economic security 'doctrine' that focuses on how different policy tools can contribute towards mitigating economic security risks.

The move to a new economic security doctrine, in addition to EU initiatives on critical raw materials and on industrial policies, deserve a broader discussion on how to mitigate economic security risks in the new geopolitical environment.

The world has changed fundamentally (Sapir *et al* 2025). The administration of US President Donald Trump has shown little interest in coordinating action with allies when it comes to 'de-risking' relations with China. The US has even threatened the EU and its members with coercive action. This threat remains despite the EU-US trade deal inked in July 2025 envisaging cooperation on economic security[2].

All of this is happening in the context of war on the European continent and the major threat from Russia. US weaponisation of economic interdependence, which was thus far mostly wielded in favour of common transatlantic objectives (Farrell and Newman, 2019), might now become detrimental to European interests. Meanwhile, China has shown its readiness to weaponise economic dependencies through its dominance of the processing of the critical raw materials relied on by EU manufacturing.

The 2023 EU economic security strategy triggered risk assessments in four areas[3]:

1. Supply chain vulnerabilities;

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2. Critical infrastructure;

3. Technology security;

4. Economic coercion.

The strategy did not clearly define economic security but rather used economic security as an umbrella term for a collection of instruments (Chimits *et al* 2024). Such a lack of conceptual clarity could lead to confirmation bias or confusion about the instruments needed to respond to different types of economic security threat (Pisani-Ferry *et al* 2024).

Some ambiguity can be helpful in providing leeway when deciding on defensive action, but vague risk assessments can be problematic when trying to devise strategies to minimise risks. This implies that while it can make strategic sense to not be too tied down to reactive policies, proactive policies should be based on thorough risk assessments and definitions.

This is particularly the case for measures aimed at reducing supply-chain vulnerability, for which a balance is needed between industrial policies and foreign economic policies. Given the changing external threat environment, the EU economic security doctrine needs to be continuously reviewed and adapted. Since the economic security strategy was published, various steps have been taken as part of its implementation (Table 1).

The challenge now is for economic security is to move beyond a process of risk assessments to risk-mitigation strategies based on the coherent deployment of economic security tools. The foundation for economic security

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Table 1. EU policy developments on economic security since 2023

Date	Document	Purpose
June 2023	Communication on an Economic Security Strategy (European Commission, 2023a).	Sets out the Commission's views on the economic security threats to be guarded against and the relevant EU policies for this purpose.
Oct 2023	Recommendation on further risk assessments on critical technologies (European Commission, 2023b).	10 critical technology areas identified for joint risk assessments by member states and the Commission; four to be done urgently.
Dec 2023	Adoption of the Anti-Coercion Instrument (ACI, Regulation (EU) 2023/2675).	Regulation allowing for a calibrated EU response in the event of economic coercion by a third country.
Jan 2024	Commission publishes five initiatives on technology security and research.	Proposal for a revision of the FDI screening regulation (European Commission 2024a); white paper on export controls (European Commission 2024b); white paper on outbound investment; white paper on R&D for dual use technologies (European Commission 2024c); and a proposal for a Council Recommendation on research security (European Commission 2024d).
Apr 2024	Letta report on the single market (Letta, 2024).	Suggests various improvements for economic security, including establishing an Economic Security Council, broadening the scope of de-risking and defining a framework for cooperation with 'rival partners'.
May 2024	Adoption of the Critical Raw Materials Act (CRMA, Regulation (EU) 2024/1252).	Seeks to reduce dependency on single sources (in particular China) for critical raw materials. It includes streamlined permitting and measures to improve recycling and circularity.
July 2024	Political Guidelines for 2024-2029 European Commission (von der Leyen 2024).	Calls for economic security to form one of the three pillars of a new 'foreign economic policy'.

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Sep 2024	Draghi report (Draghi 2024).	Section 4 focusses on reducing vulnerabilities to external pressure and dependencies.
	Mission Letter to Commissioner-designate for Trade and Economic Security Maroš Šefčovič[4].	Places economic security under the renamed Directorate General for Trade and Economic Security; calls for the development of a "new economic security doctrine, which outlines the strategic use of our economic security tools within the EU"; calls for the development of economic security standards with international partners for key supply chains.
Oct 2024	Adoption of the Internal Market Emergency and Resilience Act (IMERA; Regulation (EU) 2024/2747).	Aims to reduce impact of crises on the functioning of the single market and to ensure the availability of critical supplies.
Jan 2025	Recommendation on outbound investment screening (Recommendation (EU) 2025/63).	Calls on EU governments to review their companies' outbound investments in non-EU companies in three crucial technology areas, which will inform whether further action at EU level is needed.

Source: Bruegel.

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policies has to be a clearly articulated view about the geopolitical positioning of the EU and the relationship between economic security and the EU's overall economic strategy.

In this *Policy Brief* we assess the main threats to EU economic security (section 2) and then analyse and make recommendations on the roles of industrial policies, foreign economic policies and economic statecraft tools in mitigating the economic security risks facing the EU, and for the governance of economic security (section 3).

This is not to suggest that these instruments are the only tools for the mitigation of economic security risks. Horizontal policies that reinforce growth in the European economy, and notably underpin the single market and an open trade policy, are also critical enablers to promote economic security.

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2 The main threats to EU economic security

2.1 Import dependency

Overreliance on crucial imports is a clear risk to the EU economy. The ability of countries to restrict access to these imports strengthens their coercive power. Moves by both the US and China to restrict certain exports of chips[5] and raw materials[6] show this risk must be taken seriously.

A particular challenge is that a de-risking strategy for sectors such as the processing of critical raw materials requires close coordination among like-minded countries and substantial investment before dependency can be reduced significantly. An effective strategy to develop alternative sources of supply for critical raw materials, for example, would have to be structural in scope and implemented over the medium to long term[7].

The 2023 European economic security strategy listed various ways to identify dependencies, such as stress tests, and the Commission has developed some metrics already. The Commission's Joint Research Centre has published a set of economic indicators to capture the EU's trade dependencies on third countries, broken down by exporting and importing countries and sector (Piñero Mira *et al* 2024).

However, both data and analytical challenges make identifying genuine import dependencies very hard (Mejean and Rousseaux 2024). It is difficult to measure substitutability, both intertemporally and cross-product. In other words, it is hard to know which products are genuinely critical to EU production or consumption.

Because of re-exporting and complex supply chains, it is also difficult to capture the EU's ability to produce the products in question in the event of a shock, and to identify ultimate import and export dependencies[8].

Broader import diversification is welcome, especially given the documented churn in the products for which the EU has dependencies (Vicard and Wibaux 2023). Detailed risk assessments and attempts to reduce dependencies should be limited to areas for which weaponisation would lead to greatest macroeconomic or social impacts.

There is broad agreement that de-risking is necessary for a narrow category of goods. These include semiconductors, batteries, critical raw materials and some pharmaceuticals (Pisani-Ferry *et al* 2024). These dependencies relate primarily to China (Figure 1).

The attitude of the Trump Administration means that areas previously overlooked must now also be considered. For instance, a thorough examination of critical defence dependencies should be prioritised (Burilkov and Wolff 2025; Mejino-López and Wolff 2025). Similarly, while energy dependence has generally been associated with Russia, EU dependence on imported liquified natural gas (LNG) from the US since the Russia's 2022 invasion of Ukraine should be considered a potential pressure point (Keliauskaitė *et al* 2025).

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Beyond these categories, it is difficult to know exactly where to de-risk. Thus, engagement with the private sector in critical sectors is crucial, especially to identify upstream inputs for which there may be significant bottlenecks. Another important factor is that not all dependencies require the same policy response. For some, the EU might want to diversify imports (eg. LNG), whereas in defence, it could prioritise boosting European production or procurement from close allies such as the United Kingdom and Canada.

More importantly, the fact that many import dependencies can only be reduced in the medium term implies the need to develop strategies to deter coercive action in the short term. More attention should be paid, in close cooperation with member states and the private sector, to the identification of chokepoints based on reverse dependencies (ie. chokepoints under EU control), which could be targeted in attempted economic coercion.

Identifying such chokepoints may be critical if the EU Anti-Coercion Instrument (ACI, Table 1) is to be used in a targeted way – the ACI empowers the EU to react with a broad range of retaliatory measures should it threatened with economic coercion. In such cases, other measures may be more effective than import tariffs because affected countries may be able to diversify or simply absorb the tariff.

2.2 Export vulnerabilities

China has sought to apply economic coercion to the EU through restrictions on imports to its market (McCaffrey and Poitiers 2024). For example, Chinese attempts to sway member state decisions on the imposition of countervailing duties on Chinese electric vehicles included threats to limit access to the Chinese market for Spanish pork[9] and French cognac[10].

While such limitations are not macroeconomically significant, they have the potential to shape political outcomes. In the end, however, Chinese threats did not prevent the adoption by the EU of countervailing duties on electric vehicles[11]. But these types of threats might be more successful in areas in which the EU can only act on the basis of a positive qualified majority.

Understanding these risks is crucial. It is not always direct exposure that matters, as export restrictions may be applied further down the supply chain (China threatened to restrict imports of EU cars that contained parts from Lithuania in response to the opening of a Taiwanese representative office in Vilnius; McCaffrey and Poitiers 2024).

Such instances have helped firms understand that they may become casualties in this new geopolitical landscape, and firms seem to be diversifying supply chains and, in some cases, building secondary supply chains[12].

The conclusion of new free trade agreements would make a significant contribution to diversifying export markets and could go together with tools to facilitate trade and the integration of value chains, such as negotiation with FTA partners of a common protocol on rules of origin or a supply chain resilience agreement.

2.3 Foundational technologies

The area of foundational and emergent technologies presents the strongest case for active industrial policies in the name of economic security. These are technologies with the potential to significantly disrupt and reshape the global economy.

A strong presence in the development of such technologies will help ensure the EU's future strategic indispensability. In other words, the EU would be better equipped to hit back at the coercive measures of others and by doing so would change the decision-making calculus of would-be adversaries.

The semiconductor sector is a prime example. The EU does not control the fabrication of semiconductors, but, in ASML in the Netherlands, has a monopoly on the machines used for their production (Poitiers and Weil 2022b).

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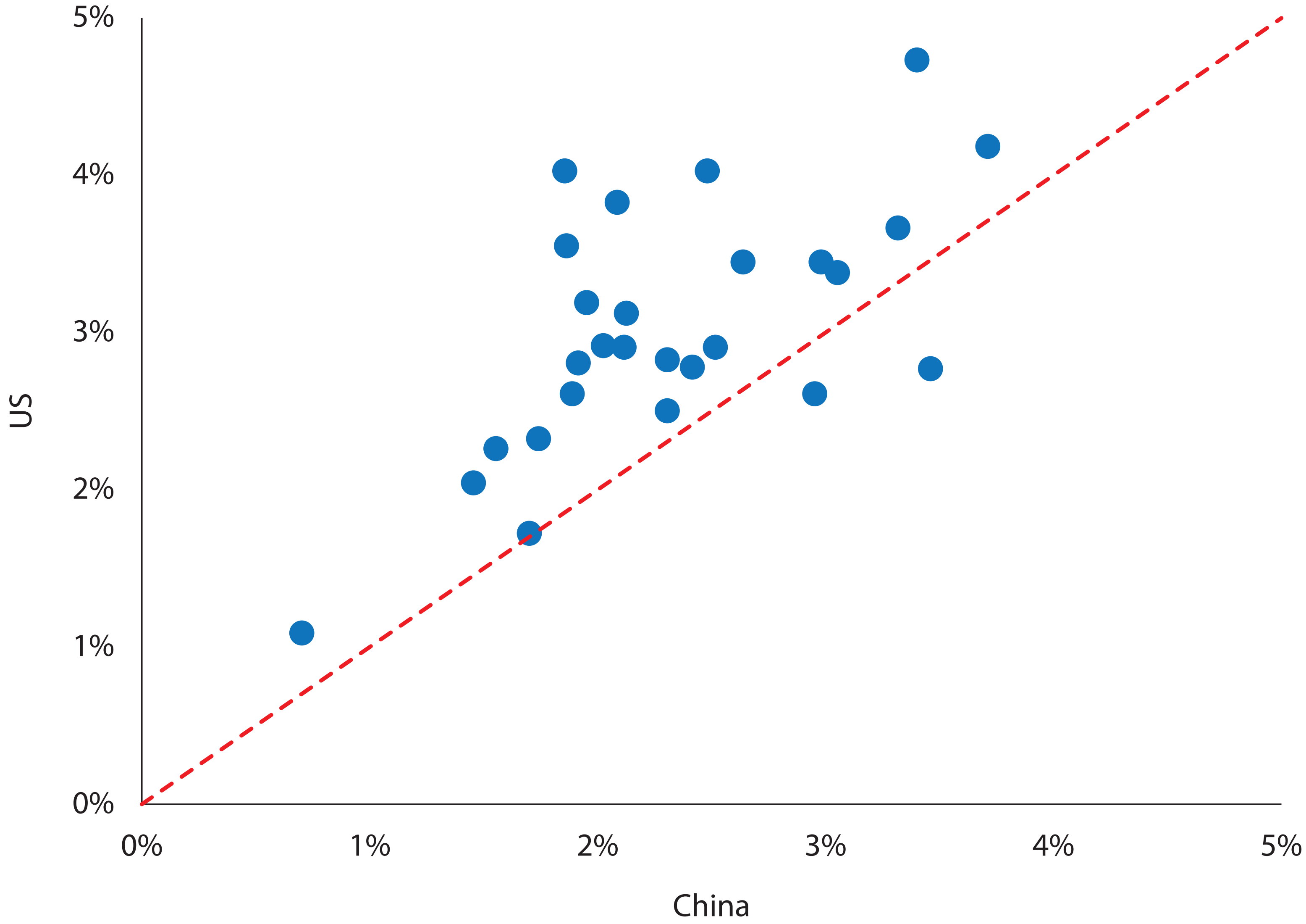
Figure 1. Dependencies of EU countries on US vs China (% of GDP, 2022)



Note: each dot represents a country and its position on an index that captures the "domestic gross value added generated by the exports of an economy to a trade partner directly and indirectly through third countries. This indicator is built up on domestic value added in exports and domestic value added in foreign final use" (Eurostat).
Source: Bruegel based on Eurostat trading partner exposure index.

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This means the EU cannot be easily excluded from semiconductor value chains. On the other hand, allowing other economies to develop monopoly power in critical technologies would tie the EU's hands.

The EU needs to protect its lead in the areas in which it maintains a significant edge, such as the ultraviolet lithography machines produced by ASML. However, given the scale and speed of developments in these sectors, it is equally important to play a pioneering role in the next generation of foundational technologies.

The EU previously held a dominant position in research and development in clean tech, before falling behind China (García-Herrero *et al* 2024). Eulaerts *et al* (2025) have identified emerging critical technologies using a range of techniques and these could be a solid basis for guiding future R&D support.

2.4 Financial and digital dependencies

Given US dominance in finance, there may be a risk of US financial coercion, not only trade coercion[13]. This was a feature of the first Trump administration when, for instance, pressure was put on HSBC over its interactions with Huawei, and on Swift to disconnect Iranian banks. Given the US desire to maintain the dominant role of the dollar and trust in its financial system, it is unclear exactly how far coercion in this sector could go.

However, the record of the first Trump administration and the actions of the second to date imply that this risk should be taken seriously. This is especially important given that finance did not feature in the European economic security strategy and, therefore, preparations in this area may justify a specific new risk assessment[14].

The EU also relies on US digital services in many areas. The US tech giants often enjoy monopolistic power, and there are often few alternatives, apart from Chinese providers. This dependency is a potential EU weakness, especially when it comes to critical digital infrastructure such as cloud services and satellites[15].

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European attempts to break these US monopolies and compete in digital services continue to be significant sources of friction in transatlantic relations, resulting in US threats of trade restrictions as a response to the enforcement of EU digital regulations[16].

The EU should, therefore, prioritise reducing its reliance on US digital infrastructure and finding the most effective responses to US threats. As with critical raw materials dependencies, reducing dependencies linked to US digital or financial dominance requires a medium- to long-term strategy and a combination of different EU tools.

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3 The development of risk mitigation strategies

3.1 Industrial policies

Economic security is often presented as a justification for more proactive industrial policies, boosting domestic industry, particularly through state aid. Important Projects of Common European Interest (IPCEI) are the main EU-level tool for this. These are large-scale industrial projects using novel technologies and serving a strategic European interest, supported by public subsidies.

The European Chips Act (Regulation (EU) 2023/1781) follows this mould, as a more lenient sector-specific version of an IPCEI. It's state-aid pillar uses the same R&D justification for state aid as ICPEIs and has the same conditionality, with the exception that it not only allows the promotion of completely new technologies, but also supports the introduction of technologies to the EU in the case of chip foundries (Poitiers and Weil 2022b).

For this type of industrial policy, there is a lack of clarity on the criteria for identification of industrial sectors for which an expansion of domestic production is both economically viable and necessary from an economic security perspective.

Whereas much of the focus has been on sectors for which there is an import dependency, not all import dependencies represent an economic security threat; in several sectors, diversification of import suppliers may be a better economic strategy. A better approach may be to subsidise R&D and its deployment in sectors that are at the technological frontier.

Moreover, IPCEIs have not been an unqualified success. Selection of individual large projects for significant subsidies has seen a number of notable failures. The Chips Act's flagship project was to be a semiconductor factory in Magdeburg Germany, slated to receive €10 billion in subsidies.

Meant to promote European high-end manufacturing, the project was halted in 2024[17]. Northvolt, a Swedish battery company that received significant ICPEI subsidies to build a battery supply chain independent of China went bankrupt in early 2025 (Tagliapetra and Trasi 2024).

ICPEIs are not the only policy tool intended to promote economic security by promoting investment in European strategic industries. The Critical Raw Materials Act (see Table 1) and the Net Zero Industry Act (NZIA, Regulation (EU) 2024/1735) introduce standards and procurement rules that seek to promote the diversification of European supply in sectors in which China has a market-dominating position (Le Mouel and Poitiers 2023; Tagliapietra *et al* 2023).

The main economic security tool under the NZIA has been the introduction of resilience criteria, sometimes combined with criteria related to sustainability or protection against cybersecurity risks. Resilience criteria require public buyers to diversify supply sources when procuring strategic technologies (ie. when the EU is dependent on a single supplier for more than 50 percent of its imports).

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This approach needs to develop further. While the need to support certain industries through industrial policies (including subsidies) is clear, IPCEIs are not up to the task. The process of agreeing an ICPEI requires significant haggling between national government funders and large companies.

This favours established national industries over areas of import dependency, in which there is a lack of well-connected European industries. Furthermore, its use of an R&D state-aid exemption to support strategic industries makes the process onerous, while political pressure to approve projects under this narrow rule undermines the stringency of state-aid control (Poitiers and Weil 2022a).

Similarly, a better understanding of the problems that these policies try to solve is needed in order to design more targeted policies. The Chips Act's emphasis is on foundries producing high-end chips but this does not address the causes of shortages during the pandemic and the EU's strategic vulnerabilities relative to China.

The European Commission has also published work mapping the EU's import vulnerabilities to its comparative production advantages, a valuable exercise that should help to inform when and how to implement industrial policies (Arjona *et al* 2023; Poitiers *et al* 2024).

Trade and Economic Security Commissioner Šefčovič has been asked *"to develop economic security standards for key supply chains with our G7 and other likeminded partners"* (see footnote 2). As discussed in section 3.4, it is not clear that the G7 is the relevant forum for developing such standards. There is also a need for greater conceptual clarity about the reasons for such standards. For instance, should such standards be met to benefit from certain incentives, or as a condition of market access? So far, the only standard with a clear economic security rationale is the NZIA resilience criteria.

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In relation to consumption subsidies for green products or preferences for green procurement, the promotion of lead markets would argue for standards based on well-defined carbon-footprint and circularity requirements, which in cases of high dependency may be combined with resilience standards.

However, the risk of the emergence of an amalgamation of unrelated requirements to establish an ill-defined 'economic security standard' could lead to discrimination and protectionism.

One particular concern is the introduction in the EU's February 2025 Clean Industrial Deal (European Commission 2025) of the concept of 'Buy Europe' or 'minimum European content', under which only products with a certain level of European content will benefit from access to government procurement or other benefits, such as consumption subsidies. Such policies would be incompatible with the EU's international obligations and could also become a major obstacle to developing partnerships as part of the economic security strategy.

Moreover, the introduction of such criteria is not necessary to de-risk from China since China is not a member of the World Trade Organization Government Procurement Agreement and 'resilience' criteria will often be sufficient for de-risking purposes outside of government procurement. A 'Buy Europe' policy could be a major obstacle to partnerships with likeminded countries and for the diversification of supply chains.

A more coherent approach to the deployment of industrial and foreign economic policies for economic security purposes requires a multi-step analysis:

1. Identify the most economically significant economic security risks in terms of supply chain dependencies and risks in relation to critical technologies;

2. Conduct an economic assessment of the extent to which the EU has the capacity to increase production in the EU, or to maintain its lead or develop foundational technologies;

3. Identify the most effective tools to achieve the industrial policy objectives; and

4. Develop partnership strategies for the diversification of external supplies as the most cost-effective approach to reducing vulnerabilities.

The economic security doctrine should contribute towards better governance on the use of industrial policy and its interface with trade and other external policies.

3.2 Economic statecraft instruments

In certain instances, the promotion of economic security justifies the introduction of export or investment restrictions. These are the two most traditional economic statecraft instruments, use of which has intensified in recent years. In the EU, they are managed at member state level, though there have been ongoing attempts to reinforce EU coordination.

The EU has also adopted a specific instrument to respond to economic coercion: the Anti-Coercion Instrument (ACI; Table 1), which empowers the European Commission to retaliate against economic coercion with a variety of coordinated measures. To be triggered, the Council of the EU decides whether an instance of economic coercion has taken place. Once this decision has been taken, the European Commission has broad powers to retaliate against the offending country in a proportionate manner.

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At the time of writing, the EU has not yet deployed the ACI, though Chinese responses to the EU countervailing duties on EVs or President Trump's so-called reciprocal tariffs could have fallen within its scope. The unwillingness to deploy the ACI in circumstances of clear coercive threats raises serious questions about its credibility. The EU must be ready to deploy the ACI in case US threats of digital regulation materialise, or if China seeks to weaponise critical raw materials dependencies to influence EU decision making.

The identification of chokepoints and reverse dependencies is crucial in identifying possible response measures. The EU also needs to build the capacity to respond to possible escalation by the coercer. A discussion with EU countries should take place ahead of any invocation of the ACI to identify the appropriate tools to deter or respond to threats linked to digital regulation or the dependency on critical raw materials.

More broadly, the ACI should not be treated only a measure of last resort. The instrument allows targeted responses against measures or threats that seek to influence sovereign choices by the EU or its member states. Not responding to coercion would fundamentally weaken the EU as a geopolitical actor.

Another measure to protect European economic interests against foreign interference is screening of foreign direct investment. This is intended to protect strategic technologies from acquisition by potential geopolitical adversaries.

However, the European Commission plays only an advisory and coordinating role on FDI screening. EU governments decide themselves whether or not to block FDI, based on national-security concerns. The Commission has proposed reinforcing FDI screening (see Table 1) so that all EU countries have the capacity to screen investments in sectors that are critical for economic security; this would improve the coherence of investment screening.

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The adoption of the Commission proposal (European Commission 2024a) is the minimum required to ensure adequate protection against risks of technology leakage, or relating to the protection of critical infrastructure.

The US has increased the use of export controls on dual-use technologies, particularly those related to semiconductors. China has introduced controls on critical raw materials exports, potentially causing major economic disruption. For the EU, greater coordination of export controls among member states is critical, in case escalating geopolitical tensions result in tit-for-tat export controls by the US and China.

The economic security framework should propose reinforced coordination of export controls at EU level, including an early warning mechanism under which the Commission and EU governments would be notified when a member state is considering the introduction of new controls.

3.3 Foreign economic policies

The two main foreign economic policies that can be deployed to reinforce economic security are trade policy and development cooperation policy. The EU's vast network of free trade agreements (FTAs) is an essential tool to reduce export dependencies at time when the EU is vulnerable to the combination of US protectionism, and the Chinese focus on exports as the main source of growth.

Of particular importance are trade agreements with emerging economies that are both highly protected and have a substantial growth potential, such as the Mercosur bloc, India and Indonesia. It is also essential that the EU seeks to maintain maximum stability and predictability by leading a broad coalition that prepares the ground for World Trade Organization reform (García Bercero 2025).

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Since WTO reform will take time, the EU should also seek ways to reinforce linkages between its bilateral trade agreements. This could be done, for example, through a common protocol on rules of origin, or closer cooperation with likeminded partners on supply chain resilience.

The EU could work with the members of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership as the starting point for such reinforced cooperation. To develop partnerships with third countries, inward-looking economic security policies should be avoided and support for rule-based trade must be maintained.

However, FTAs alone are unlikely to make a decisive contribution to the diversification of imports because WTO-mandated most-favoured nation tariffs for the areas in which the EU is highly dependent on China are often zero or very low[18].

Moreover, FTAs and the WTO often have limited disciplines on export restrictions, or on issues relating to the business environment. Clean Trade and Investment Partnerships (CITPs) such as that signed with South Africa in November 2025[19] could fill this gap. To be successful, such partnerships should bring together all the relevant tools available to the EU to prepare balanced packages that are attractive to developing partners, including:

1. Identification of projects for which EU companies are ready to invest in the green value chain, including financial de-risking tools;

2. Rules relating to the business environment that address the main obstacles to investment in the country concerned;

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3. An offer to provide technical cooperation and regulatory dialogue to facilitate compliance with European Green Deal regulations. This could include cooperation on carbon pricing or on the development of national deforestation plans, for instance.

CTIPs could be negotiated as self-standing agreements or in the context of broader FTA or investment facilitation agreement negotiations. For CTIPs to be effective, it is critical to have sufficient EU-level funding to support both financial de-risking and technical-assistance activities. This could be done through an 'external partnerships' window in the new Competitiveness Fund.

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3.4 Governance of economic security

The implementation of economic security strategies raises a governance challenge. At EU level, there is a need to coordinate deployment of the various economic security tools, for which different parts of the Commission are responsible, and to ensure a robust framework for sharing information and for the coordination of EU and member state instruments. At international level, the relationship between WTO rules and economic security measures, and whether a new institutional framework is needed to coordinate economic security policies, must be clarified.

The creation of the role of European commissioner responsible for economic security was an important step towards better coordination of the work being done in the Commission, both on risk assessment and on ensuring synergy and coherence in the deployment of the different economic security tools. This would imply a reinforcement of cooperation between the relevant Commission services, with a coordinating role for the trade directorate-general.

At the political level, the Commissioners' Project Group on Economic Security[20] could steer work on risk-mitigation strategies and arbitrate in case of potential conflicts between services.

The Commissioners' Project Group could perform two critical functions. It should agree on the prioritisation of economic security threats and should ask a lead service to coordinate the preparation of risk-mitigation strategies, based on contributions from all relevant services.

Prioritisation of threats should be based on a rigorous analysis of the risk of weaponisation of dependencies, and on the economically efficient means to mitigate such risks. In this context, the Commissioners' group could seek an economic analysis from the Commission's economic and financial affairs directorate-general.

Such risk-mitigation strategies should assess how all available tools that can contribute towards risk mitigation can be deployed coherently. These strategies should then be dis-cussed with member states to encourage consistency between EU and member state actions, and to provide a basis for a 'Team Europe'[21] approach to engage with third countries to develop de-risking partnerships.

At the working level, the Commissioners' group should regularly update risk assessments and review cooperation activities with third countries. There should also be opportunities to consult the private sector when developing sectoral de-risking strategies.

In this context there may also be a need to develop instruments to gather the information needed to underpin economic security. This may require working more closely with those member states and economic operators present in priority value chains, to identify vulnerabilities that need to be de-risked. This work would be particularly relevant to identify reverse dependencies.

It is critical to fully involve member states in the assessment of risks, the development of risk-mitigation strategies and in seeking coordinated responses in areas of national competence, particularly when there is external pressure

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to align with the US. The Commission has already established an Economic Security Network to promote integrated advice from member states.

This should be reinforced (Steinberg and Wolff 2023; Letta 2024) through the establishment of a Council Working Group on Economic Security. The group should also evaluate policies relating to investments and export controls, on which most decisions are made at member state level. At the ministerial level, a Council meeting of ministers responsible for trade and industrial policies should be held once a year.

The WTO framework provides a basis for the development of economic security policies, even if there are gaps that should be clarified as part of a plan for WTO reform (Pinchis-Paulsen 2025; Pinchis-Paulsen *et al* 2024). The current rule book provides enough policy space for countries to adopt sanctions in the event of war or other emergencies, or to adopt measures to restrict investments or exports of dual-use technologies. WTO rules are, therefore, no obstacle for the use of traditional economic statecraft tools or sanctions in response to hard security threats.

The WTO rules on subsidies are also sufficiently flexible to accommodate policies that may need to be adopted for economic security purposes, though there may be a need to reinforce these rules to prevent their use to generate dependencies and to clarify when resilience criteria can be applied. In other words, economic security should not become a justification for adoption of WTO-incompatible measures.

The WTO does not at this stage provide a forum in which economic security policies can be discussed. There are also questions about whether the WTO dispute-settlement mechanism is the most appropriate tool to address conflicts arising from the implementation of economic security measures. The WTO framework could, however, be critical role in preventing tit-for-tat escalation by ensuring that any response to measures based on essential security concerns remains proportionate.

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For instance, instead of reviewing the legal justification for export controls on dual-use technologies, an arbitration panel could establish the economic impact of the measures and review the proportionality of possible responses. All of these issues could be part of the discussion on WTO reform.

Beyond WTO, the G7 has been important for discussions on economic security. However, it is unlikely that the Trump administration would be ready to enter into a genuine process of consultation on economic security policies and measures. When the US might try to coerce other G7 members, it is difficult to see how meaningful any discussions in a G7 anti-coercion forum would be.

Nevertheless, there may be scope to cooperate on policies aiming at de-risking import dependencies in certain priority areas, such as critical raw materials.

In the absence of effective G7 cooperation, the EU could seek to reinforce bilateral dialogues on economic security issues with likeminded partners, notably the UK, Japan, Canada, Australia and South Korea. This could provide the basis for an informal group to coordinate policies on the de-risking of critical value chains and on responses to coercion.

4 Recommendations and conclusions

Our main policy recommendations arising from the analysis in section 3 are:

- New economic security risk assessments should be started to evaluate risks associated with EU dependencies on digital and financial infrastructure;
- The Commission should accelerate work on the identification of supply-chain choke-points, based on reverse dependencies;

- Medium-term risk-mitigation strategies need to be developed for priority economic security risks, particularly related to dependencies on critical raw materials and digital and financial infrastructures;

- The Anti-Coercion Instrument should be made ready for deployment in case threats related to digital regulation or export controls on critical raw materials are used as a coercive instrument;

- The Commission should propose reinforced coordination on export controls, and the investment screening regulation should be reinforced based on the Commission proposal;

- Any proposal to use industrial policy for economic security reasons should be preceded by a robust assessment of the economic security risks and an economic analysis that establishes the proper balance between industrial policies and foreign economic policies;

- Measures inconsistent with the EU's international commitments should be avoided;

- The EU should include cooperation on economic security in its international trade and investment agreements, and should develop clean trade and investment partnerships as an instrument to support diversification of green value chains;

- A new Council Working Group should be established to discuss priority risk-mitigation strategies and to attend, at least once a year, a ministerial-level discussion on the implementation of the economic security strategy;

- At the international level, the EU should include discussions on economic security in its strategy on WTO reform, while coordinating policies with an informal group of like-mind-ed countries and negotiating a

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supply-chain resilience agreement with the Comprehensive and Progressive Agreement for Trans-Pacific Partnership.

The current geopolitical context implies that the EU needs to de-risk its relationships with China and the US, while facing a major hard security threat from Russia. This challenging environment makes it essential for the EU to develop broad alliances with countries that wish to maintain rules-based cooperation. The EU will need to stay decoupled from Russia economy for as long as it represents a threat.

The objective with China and the US should be to reduce dependencies while maintaining a maximum of mutually beneficial economic engagement. The extensive nature of dependencies implies the need for medium-term de-risking strategies, combined cooperation. However, the EU must also be ready to respond to threats of coercion.

Most economic security measures are preventive: an insurance policy to limit the risk of geopolitical tensions harming economic interests. In most instances economic security is not about responding to hard security threats, so it is essential to have institutional mechanisms that allow for the evaluation of trade-offs.

In particular, trade-restrictive economic security measures need to be balanced against the economic benefits of openness, or of achieving other essential EU objectives, such as the net zero transition. Whenever possible, win-win policies, including reinforcement of the single market, support for R&D, free trade agreements and support for green investment in developing countries, should be preferred over measures that restrict trade. ■

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Endnotes

1. See European Commission press release of 20 June 2023, 'An EU approach to enhance economic security'.

2. European Commission, 'The EU-US trade deal: Restoring stability and predictability', undated. Despite the EU-US trade deal, there have been US threats of tariffs as a response to EU digital regulation (see section 2.4).

3. Other economies have also introduced policies and strategies aimed at bolstering their version of economic security. See Chimits et al (2024) for an overview of different countries' measures.

4. Mission Letter from Ursula von der Leyen to Commissioner-designate for Trade and Economic Security Maroš Šefčovič, 17 September 2024.

5. The US policy is evolving; see Michael Acton, Dimitri Sevastopulo and James Politi, 'US scraps Biden-era rule that aimed to limit exports of AI chips', Financial Times, 21 May 2025. See also Kana Inagaki, Sarah White, Ian Johnston and Ryan McMorrow, 'Carmakers gear up for chip battle after China curbs Nexperia exports', Financial Times, 17 October 2025.

6. See Ryan McMorrow and Dimitri Sevastopulo 'China unveils sweeping rare-earth export controls to protect 'national security'', Financial Times, 10 October 2025.

7. A European Commission intention to produce a 'RESourceEU plan' is a recognition of this. See speech of 25 October 2025 by Commission President Ursula von der Leyen at the Berlin Global Dialogue.

8. For a more detailed discussion, see Mejean and Rousseaux (2024) and Pisani-Ferry et al (2024).

9. Thomas Hale, Joe Leahy and Barney Jopson, 'Spain's Pedro Sánchez calls on EU to "reconsider" Chinese EV tariffs'.

10. Edward White, Adrienne Klasa and Andy Bounds, 'China targets EU brandy imports with anti-dumping penalties', Financial Times, 4 October 2024.

11. Matt Geraci, 'China's lobbying did not block the EU's new EV tariffs. But it may yet weaken them', New Atlanticist, 4 October 2024, Atlantic Council.

12. See Economist Impact, 'Trade in Transition 2025: Balancing optimism with caution', undated.

13. Gillian Tett, 'Dollar dominance means tariffs are not the only game in town', Financial Times, 10 January 2025; Katie Martin, 'Trump's freewheeling disruption could extend to the dollar' Financial Times, 20 February 2025.

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14. Miran (2024) discussed using access to swap lines, which are a crucial tool for international financial stability, as an incentive to sign an accord that would force countries to accept a write-off on US government bond holdings. See also Elisa Martinuzzi, Jesús Aguado, Balazs Koranyi, Stefania Spezzati and John O'Donnell, 'Exclusive: Some European officials weigh if they can rely on Fed for dollars under Trump', Reuters, 24 March 2025.
15. For a discussion on satellites, see Alan Beattie, 'Europe tries to fix its plumbing — and leave Starlink behind', Financial Times, 20 March 2025. More broadly on digital services, see Fabry (2025).
16. Barbara Moens and Aime Williams, 'Donald Trump threatens retaliatory tariffs after EU hits Google with €2.95bn fine', Financial Times, 5 September 2025.
17. Michael Acton and Guy Chazan, 'Intel outlines plans to cut costs and boost chip business in turnaround push', Financial Times, 16 September 2024.
18. In the case of critical raw materials, see Le Mouel and Poitiers (2023).
19. See European Commission news of 20 November 2025, 'EU and South Africa sign first-ever Clean Trade and Investment Partnership (CTIP)'.
20. See Decision of the President of the European Commission on the establishment of a Commissioners' Project Group on Economic Security, 7 January 2025.
21. See Team Europe Initiatives website, European Commission.

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The authors would like to thank Guntram Wolff for detailed comments and Connor McCaffrey for his excellent research assistance. This article is based on Bruegel Policy Brief N°32/2025.

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Securing strategic autonomy

Europe's lack of defence capabilities leaves it vulnerable to economic and foreign policy pressure. Philipp Hildebrand, Hélène Rey and Moritz Schularick outline key principles for establishing a European Future of Defence Architecture and a framework for its financing

Europe must urgently strengthen its defence capabilities to secure strategic autonomy. The absence of such capacity leaves the continent vulnerable to economic and foreign policy pressure, threatening the survival of the EU and its core values. Europe must also address the overwhelming dominance of US capital markets.

This column outlines key principles for establishing a European Future of Defence Architecture and the common framework for its financing. Such a framework would support the development of a safe and liquid European securities market at a propitious moment, as global investors are actively seeking alternatives to the dollar. It would address a critical and urgent collective security need. It would establish the governance and foundations necessary for the emergence of a European safe asset, which is a critical step forward for the integration of European financial markets.

By Europe, we refer to a coalition of willing EU countries – the 'European Team' – prepared to move quickly, as time is short.

European Future of Defence Architecture

This column does not address traditional expenditures such as personnel, munitions, and tanks. Instead, it focuses on the development of European strategic autonomy in next-generation military technologies such as a European sky shield, hypersonic weapons, strategic enablers such as the cloud, AI infrastructure, advanced software, quantum computing, cyber capabilities, satellite constellations, drones, robotics, and critical-mineral processing technologies.

Security needs and these technologies have a distinctly European dimension. These technologies cannot be deployed efficiently at the national level. Today, fragmented defence spending has produced duplication, inefficiency, and lack of scale. Europe lags in essential fields[1]. To reverse this, the European Team must:

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- Pool resources and engage in joint, predictable procurement over extended periods.
- Ensure some competition among the European Team firms for long-term contracts.
- Rely on long-term commitments to build industrial capacity and foster innovation.

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The urgency cannot be overstated. Russian aggression, shifting US commitments, and global competition over trade, technology, critical minerals, talent, and intellectual property create a narrow window of political alignment. Europe must seize this opportunity to safeguard its autonomy and to finally develop and integrate its financial markets

Many of these technologies will be dual-use, contributing to both security and long-term productivity growth. Their relative novelty limits the entrenched influence of national champions and lobbies, giving policymakers an opportunity to pursue joint procurement without legacy obstacles. Digital technologies and satellites are prime examples of dual-use technologies, of transcending national borders, and of being crucial for our defence.

Governance of the European Future of Defence Architecture

Article 346 TFEU exempts the defence industry from standard EU Single Market provisions, including non-discrimination in procurement. Hence an intergovernmental treaty among European Team countries is necessary. The intergovernmental treaty should allow the coalition of countries to deliver on their future of defence goals quickly. For this a special attention to the robustness of the decision-making process and its rules will be called for.

Steering Committee of Defence and Technology Experts

This body, transcending national borders, should define forward-looking priorities, allocate resources within a multi-year budget, plan investments, and ensure quality control, scale, and interoperability.

- For its innovation mandate, the committee could draw on the DARPA[2] model of governance.
- The overall multi-year budget should be determined by European Team representatives, taking NATO commitments and other national defence needs into account.
- A Team Europe Military Purchase mechanism should be put in place (similar to US Foreign Military Sales) in order to simplify defence purchases by all European countries and allies (scope to be defined by the steering committee).

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Financing

The European Defence Architecture is a joint investment and requires joint financing. Because of past underinvestment in European defence, defence spending needs to be front-loaded to catch up and therefore debt financing in the short run is needed. Individual countries cannot shoulder, nor perform efficiently, the necessary catch up in future of defence technologies, which have a European dimension.
Alongside the Defence and Technology Committee, a Steering Committee for Financing Future Defence should be created. The two steering committees should work in close cooperation.

Mandate of the Financing Committee

- Issue joint European Future of Defence Bonds to minimise financing costs (joint and several liabilities).
- Achieve sovereign status for these bonds[3].
- Ensure eligibility for ECB refinancing operations.

Such a mandate would help accelerate the development of deeper, more liquid capital markets to compete with the growing dominance of the US capital market since the Global Financial Crisis.

Achieving sovereign status likely requires:

1. A predictable issuance calendar enabled by the recurring nature of defence financing.

2. Revenue streams attached to the bonds

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3. Minimum issuance scale or predictable growth over time.

4. Transparency and credibility of the European Team's commitments.

Repayment shares using national revenues or the use of common tax resources should be decided by European Team representatives.

Sketch of a possible future of defence spending profile for a catch up

- Spending of 1% of GDP per year for the next ten years, going down to a steady 0.5% thereafter.

- Future of Defence issues 1% of GDP with ten-year maturity, each year for ten years and rolls over the new debt so there are no payments (on principal or interest) for the first ten years.

- The outstanding debt in 2035 would represent about 10% of GDP (at 3% annual interest rate). From 2035 on, the debt would be stabilised with member country fiscal resources. About 1% of GDP would be rolled over every year with member countries fiscal resources covering the interest costs (net of growth) and the flow of 0.5% of current future of defence expenditures.

- After 2035, the contribution of member country fiscal resources would be about 0.6% of GDP for a steady permanent defence spending of 0.5% of GDP and payment of interest to stabilise the debt-to-GDP ratio.

- With a GDP of €15.9 trillion in 2024 (team made of France, Germany, Italy, Spain, the Netherlands, Belgium, Luxemburg, Poland, Ireland, Sweden, Denmark, Finland, Greece, Estonia, Lithuania, Latvia), nominal growth of about 2%, cumulative spending would be about €1.8 trillion for ten years (2026-2035) for the catch-up phase[4].

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- If the team consisted of the entire EU, with a GDP of about €17.9 trillion in 2024, nominal growth of about 2%, this gives a cumulative spending of about €2 trillion for ten years (2026-2035) for the catch-up phase.

- Fiscal resources after ten years – for example, VAT receipts of each country could be allocated.

This defence spending profile can be scaled up or down depending on the identified military needs put forward by the Steering Committee of Defence and Technology Experts.

For example, for the team made of France, Germany, Italy, Spain, the Netherlands, Belgium, Luxemburg, Poland, Ireland, Sweden, Denmark, Finland, Greece, and the Baltic countries, a catching up phase spending of 0.5% of GDP per year for the next ten years would lead to cumulated spending of about €900 billion and a debt-to-GDP ratio of about 5% in 2035.

Governance of Future of Defence Bonds

We focus on one possible implementation, but there are several. For concreteness, we take an example where the Financing Committee could be housed within the European Stability Mechanism (ESM). Other possibilities include the European Investment Bank (EIB) or a new agency. If the ESM were used, one would need to create two distinct pillars:

- Pillar I: Current 'European Monetary Fund' functions (crisis management function)

- Pillar II: Financing functions for the European Defence Architecture (common investment function)

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Advantages of using the ESM:

- Established via intergovernmental treaty.

- Experienced in bond issuance and well capitalised.

- Crucially, ESM debt is off member-state balance sheets – a key advantage given fiscal constraints and NATO commitments.

The ESM treaty (not yet ratified) should be amended to:

- Authorise lending not only to member states but also to agencies (eg. the Future of European Defence Agency).

- Reflect the creation of the second financing pillar of a very different nature from the first pillar. The second pillar is there to fund a common investment of Team Europe.

- Authorise some non-euro area and some non-EU members to be part of pillar II of the ESM.

One potential disadvantage of using the ESM for this initiative is the fact that the ESM was explicitly designed as a crisis mechanism for the euro area and not a general financing vehicle. For that reason, the creation of a new financing agency could instead be considered.

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Composition of the European Team

- The European Team should begin with a subset of EU countries willing to move quickly, prioritising governance quality over size. It would be highly desirable to quickly associate non-EU countries such as Norway, the UK, Switzerland, and Ukraine.

- Once established, the framework should remain open to other volunteer countries.

This inclusiveness should be considered when revising the ESM treaty and building the legal framework or when setting up a new dedicated financing and issuing agency.

Why this approach would work

- Urgency: the geopolitical situation is recognised as critical across European capitals.

- European dimension: defence needs and technologies naturally transcend borders.

- Financing credibility: purpose-driven, efficient joint issuance contrasts with earlier Eurobond proposals.

- Market timing: global investors seek safe alternatives to dollar assets.

- Fiscal flexibility: enables member states to meet NATO commitments despite fiscal constraints.

- Economy: dual-use contributes to both security and long-term productivity growth. Proper governance of a common investment and joint financing helps build up the savings investment union and a European safe asset.

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- Institutional blueprints: building on a NATO European branch/DARPA/ESM can help speed up the implementation.

- Historical context: allows Germany to channel large defence commitments into joint European projects, which is a plus given Europe's history.

Time horizon

- Treaty amendments and ratifications: approximately one year.

- Establishment of steering committees: similar timeframe.

- Strategy: begin rapidly with a small group and limited projects, ensuring sound governance, then scale up.

The urgency cannot be overstated. Russian aggression, shifting US commitments, and global competition over trade, technology, critical minerals, talent, and intellectual property create a narrow window of political alignment. Europe must seize this opportunity to safeguard its autonomy and to finally develop and integrate its financial markets. ■

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Endnotes
1. The current initiatives such as the 2023 EDIRPA (€300 million) to subsidise common procurement or the €150 bn loans to EU member states by SAFE (Security Action for Europe) are important and are complementary to this European defence architecture. They are key to address some of the current issues linked to the Ukraine war. But they are too small and insufficiently forward looking to provide incentives for innovation and industrial capacity building for the Future of Defence described in this column.
2. On the innovation side, DARPA is characterised by an agile governance structure – with experts in the relevant technological fields – to allocate funds to multiple research teams pursuing specific objectives, with clearly defined milestones evaluated before further disbursements are made. What characterizes DARPA is precisely this ability to set clear goals, provide incentives and resources, and ensure that those goals are achieved as quickly as possible.
3. The failure to obtain full sovereign status in the past meant that jointly issued debt by European countries or the European Commission has not been included in indices, therefore has more limited demand and less attractive financing terms. The goal of the Steering committee should be to issue Future of Defence bonds at close to zero spread compared to the best euro area bond market performers. Because of the sound institutional set up, Future of Defence bonds should benefit from a convenience yield within a short time horizon, which would decrease the spread of the Future of Defence bonds. Pure defence bonds might exclude some investors due to their investment policies, but that we do not believe this is a significant constraint.
4. If catch up spending of 2% of EU GDP was made during a five-year period (2026-2030) with stabilisation and steady spending afterwards, debt would be stable at 10% of GDP after 2030. Cumulative spending would be €1.9 trillion (2026-2030) for the EU.

This article was originally published on VoxEU.org.

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Can the World Trade Organization survive?

The foundations of the multilateral trading system have been shaken. Petros Mavroidis argues that reviving the WTO will require a determined effort from the key stakeholders to address issues that the membership has previously avoided

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The second administration of United States President Donald Trump has shaken the foundations of the multilateral trading system by implementing unilateral tariffs on imports from most of its partners, and by signing 'deals' with a few of them. It is impossible to legally reconcile these actions with the letter and spirit of the World Trade Organization (WTO).

The fundamental purpose of the WTO is to promote non-discriminatory trade liberalisation, primarily through the most-favoured nation (MFN) principle, while subjecting disputes to compulsory third-party adjudication (CTPA).

The high, new US tariffs and so-called deals run afoul of MFN, CTPA and several other WTO legal institutions. The US view under Trump seems to be that legality should not stand in the way of political expediency when it comes to promoting US interests as understood by the current US administration.

This is happening when the policy relevance of the WTO had already been undermined. Geopolitical concerns have turned its traditional consensus-based voting mechanism into a formidable impediment to block its legislative functions. Its adjudicative function has been moribund since 2019, when the first Trump administration took steps to make the WTO Appellate Body largely redundant. While the WTO still has offices in Geneva, the emerging disequilibrium is hardly sustainable. The WTO has been practically reduced to redundancy, at least with respect to influencing relations between the US and each of its partners.

Assuming that current US policy does not change, the relevance of the WTO could wane further. Reviving the multilateral organisation will require a valiant effort from the key stakeholders, and the determination to address issues that the membership has previously avoided. This paper highlights some of them.

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1 The lay of the land

'Unprecedented' best captures what has happened in United States trade policy since President Donald Trump returned to the White House for a second term. The kick off was 'Liberation Day' on 2 April 2025, when President Trump signed Executive Order 14257 'Regulating Imports with a Reciprocal Tariff to Rectify Trade Practices That Contribute to Large and Persistent Annual United States Goods Trade Deficits'[1].

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He hoisted a sizeable chart, prepared by Secretary of Commerce Howard Lutnick, and showed the world the new tariffs that the US would apply on imports originating in over 60 countries. In this, the second Trump administration was promising to be different from the first.

Within a couple of days, President Trump, most likely startled by the subsequent losses in the stock-market, announced that he would suspend the application of tariffs for 90 days[2]. At the same time, he announced that he would pursue 90 trade deals in 90 days.

Instead of forming a worldwide coalition against President Trump's initiative – which violated the letter and the spirit of the World Trade Organization and shook the foundations of the multilateral system – nations rushed to the White House to negotiate and conclude these deals. In quick succession the United Kingdom, Vietnam, Indonesia, the Philippines, Japan, Korea and the European Union signed separate deals with the US[3], while China agreed to a truce in retaliatory tariffs, which, at the time of writing, has since been extended twice.

Those that did not sign deals, either because they did not request one or because President Trump did not seek to negotiate one, had to await their fate. Free-trading nations seemingly forgot the famous quip attributed to Benjamin Franklin: *"We must all hang together, or assuredly we shall all hang separately."*

Tariffs are President Trump's favourite policy instrument. On assuming office in his first term, President Trump resuscitated Section 232, an almost forgotten legal instrument. He invoked it to restrict imports of steel products in the name of national security. Section 232 was enacted in 1955 and forms an integral part of the US Trade Agreements Extensions Act, but had since fallen into disuse[4].

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The first Trump administration used it to impose tariffs against a host of nations. Canada, China, the EU, India, Korea, Mexico, Norway, Russia, Switzerland and Turkey responded by filing complaints at the WTO. The choice of instrument that Trump used was calculated: Section 232 provides the US President with substantial discretion, as Section 232 does not address the effect of imports on the marketplace, but rather their potential unavailability in case of emergency.

A flurry of litigation followed at the WTO[5] and all WTO panels concluded the same thing: US measures were inconsistent with WTO rules. The US circumvented enforcement of these rulings by 'appealing into the void'[6]. Undeterred by this experience, Trump introduced a new wave of Section 232 investigations on returning to the White House for his second term.

It is unclear what the link is between the Section 232 investigations/tariffs and the Liberation Day tariffs. In principle, these are distinct instruments: the former aims to address critical shortages, whereas the latter is meant to address entirely different policy objectives. The link between the Section 232 investigations and the Liberation Day tariffs became clear when the US administration announced, on 2 August 2025, the actual implementation of the Liberation Day tariffs.

Deborah Elms compiled an informative table showing that, with a few exceptions (including Brazil, Brunei and Philippines), the tariffs implemented on 2 August were lower than or equal to the tariffs announced on Liberation Day[7]. Shortly after 2 August, President Trump announced that imports from India would face a 50 percent tariff, instead of the announced 25 percent, because India was buying too much Russian oil[8].

What is too much was never specified. The EU continues to purchase relatively small quantities of Russian oil (purchases should be phased out by 2028) but was spared additional tariffs. China, meanwhile, continues to

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purchase substantial quantities of Russian oil, but President Trump decided to spare China from any additional tariffs.

The US administration seems determined to enforce the new tariffs and deals that it has signed. While it is very doubtful that it can achieve the stated goals (reduce the deficit, increase tariff income and encourage 'greenfield' investment in the US), the data so far points to some encouraging results for the US administration – enough to present the policy as a success to the American public.

President Trump can also count on the absence of domestic political opposition and the acquiescence of the world trading community. Even if the US Supreme Court[9] rules against the Trump administration's actions, the likeliest scenario is that President Trump will use a different avenue to re-impose tariffs.

The world is now entering a new era in which the US continues to be a member of the WTO while disrespecting its two core features: avoiding trade discrimination and unilaterally increasing protectionism, in this case, its capped level of customs duties (tariffs). What does this mean for the WTO? Can it continue with 'business as usual', or is its effective end drawing near? This is the core question we ask in this paper.

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2 The legality of US tariffs

At the time of writing, US tariffs – whether unilateral or the result of deals – share the following features in relation to WTO agreements:

- The WTO has not, so far, been notified of any trade deal or new tariff by the Trump administration. Judging from the information disseminated through the United States Trade Representative (USTR) webpage, all deals and new higher tariffs violate the obligation to notify the WTO (Article X of the GATT) as they fall under measures of 'general application'[10];

- By imposing different levels of tariffs on the same product depending on its origin – either through unilateral increases or following the conclusion of a trade deal – the US also violates its obligation to treat all like goods originating from WTO members on a Most Favoured Nation (MFN) basis (Article I of the GATT);

- By increasing its duties above the level agreed following reciprocal negotiations during the 1986-1993 Uruguay round, the US is violating Article II of the GATT[11].

The signed trade deals might vary in content, but all of them share some elements:

- There is practically no quid pro quo when the US administration offers a trade deal – other than the US abandoning its unilateral Liberation Day tariffs and occasional, generic announcements about future relations – as it is always the party transacting with the US that commits to a certain behaviour. These deals are termed 'reciprocal' only because they reflect President Trump's belief that the US has not received reciprocity in the past. It is, in other words, pay-back for the perceived, previously unfair treatment[12];

- They are not formal international agreements. They are not written documents signed by both parties. It is usually the US that informs the public about their content by uploading a summary of the deals concluded on the USTR webpage. At the time of writing, some of the deals have not been published at all[13];

The US is not prepared to submit itself to WTO adjudication for disputes arising from the implementation of these deals. It purports to resolve them bilaterally, thus violating Article 23.2 of the Dispute Settlement Understanding (DSU), which states that the WTO is the sole and exclusive forum for the resolution of all trade disputes[14].

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2.1 US tariffs and WTO law

At the time of writing, China (Dispute Settlements DS633 and DS638), Canada (Dispute Settlements DS634, DS635 and DS637) and more recently Brazil (Dispute Settlement DS640) have challenged the legality of US tariffs under WTO rules. A 25 percent duty is paid on all Canadian goods not complying with the United States-Mexico-Canada Trade Agreement, whereas Brazilian goods are subjected to a 50 percent tariff as a result of President Trump's displeasure with the legal proceedings against former Brazilian President Jair Bolsonaro[15]. Chinese goods are subject to a 30 percent tariff until a permanent agreement with the US has been negotiated and concluded[16].

Canada's complaints concern specific product markets (autos, steel, non-energy goods). China's complaints will de facto be on hold until the trade truce ends and might be resurrected afterwards, depending on the outcome of US negotiations. Brazil's is the only complaint that specifically targets the Liberation Day tariffs[17].

There is a question mark as to whether those who made a deal might be pre-empted from challenging the US measures. After all, they negotiated with the US and acquiesced to the measures. Because of this acquiescence, the legal argument goes, a complainant should be 'estopped' from challenging the validity of the deals at the WTO.

However, the WTO Appellate Body did not see a case for applying acquiescence or estoppel and has, in fact, ruled against its application in DS265: EC-Export Subsidies on Sugar (Mavroidis, 2022a, pp. 44-48). If this precedent is adhered to in future cases, the EU could turn against the US and challenge the adherence of its recent deal with the US to the relevant WTO rules.

In light of its stated aims[18], could the US justify its measures by invoking the Security Exception (Article XXI) of GATT? No, is the short answer. Article XXI allows WTO members to take *"any action which it considers necessary for the protection of its essential security interests… in time of war or other emergency in international relations."*

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The law under this provision[19] makes it clear that what matters for a successful invocation of Article XXI is when the action is taken. 'Emergency' has been consistently interpreted quite narrowly by WTO panels, shown in the exhaustive survey of case law in Mavroidis (2025), and is confined to war-like situations, or extreme situations such as the disruption of diplomatic relations.

In DS597: US-Origin Marking (Hong Kong, China), the panel held that the fact that trade between US and China had shown no signs of breakdown indicated the absence of an emergency (§7.354)[20]. Here, we are dealing with the exact opposite scenario: trading nations share the negotiating table with the US and peacefully conclude trade deals for the medium to long run.

Nvidia's situation provided additional confirmation that there is no emergency being addressed by these restrictions. Mavroidis (2025a) discussed how former US President Biden kept and strengthened the first Trump administration's restrictions on exports to China, making it practically impossible to export even legacy microchips to China. One might agree or disagree whether the prohibition of such exports serves US national security, but this is precisely what President Trump and President Biden aimed to safeguard through their measures.

The second Trump administration, following heavy lobbying by Nvidia's CEO, allowed the company to export H20s (an elaborate microchip) to China, conditional upon the payment of an export tax of 15 percent, baffling some US security experts along the way[21]. Evidently, President Trump seems to see little threat from China, even when trading in high-tech goods.

In doing so, President Trump was prepared to test the US Constitution. Article 1, Section 9, Clause 5 of the US Constitution (the 'Export Clause') prohibits Congress from laying taxes and duties on articles exported from any state[22]. The US Supreme Court has interpreted the Export Clause as requiring not simply an omission of a tax upon

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exported articles, but also a freedom from any tax which directly burdens the process of exporting[23]. Nvidia's 15 percent tax would, arguably, contravene this.

Note that President Trump's understanding of the term 'national emergency' is quite liberal, as the number of invocations of Section 232 show. His interpretation notwithstanding, he still allowed the export of an elaborate chip to China, even though he himself had previously labelled China a threat to US national security[24]. Under the circumstances, it would be very hard indeed to defend the claim that the US measures are necessary to protect national security before a WTO panel.

The only appropriate, available option to justify these US measures is a 'waiver'. A waiver, if granted, would be akin to the WTO membership providing the US with a green light to provisionally waive its obligations under Articles I and II of the GATT. But, as per Article IX of the Agreement establishing the WTO, a waiver is granted only in exceptional circumstances, which must be explicitly stated.

What are the exceptional circumstances here? It would be a travesty indeed to equate trade deficits with exceptional circumstances. All members could then sooner or later ask for a similar exception, undoing the entire system of trade liberalisation through waivers. Additionally, a three-quarters majority of the WTO's membership must vote in favour of granting a waiver.

In fact, the threshold is even higher in these circumstances: unanimity is required for deviations from MFN. And it is precisely a deviation from MFN that the US would be requesting. How would Brazil or India or any other country that feels unfairly targeted by the US tariffs vote when the occasion arises? Waivers are granted for up to a year, and if a longer period has been agreed, an annual review follows the original waiver. But the US does not want multilateral review of its tariffs and trade deals to begin with.

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US Trade Representative Greer made it clear that on trade, the US wants to be judge, jury and executioner, all in one (see footnote 14). At the time of writing, this discussion is hypothetical, as no request for a waiver has been tabled. But Greer's observation holds in more general manner: there is no mention of the WTO in any of the deals that the current US administration has signed.

It is worth noting that, outside of the Trump administration, there are few commentators who believe that the Liberation Day tariffs can be reconciled with the current WTO rules or could even 'save the WTO'[25]. Such claims misconstrue, in our view, the letter and spirit of key WTO institutions overseeing activities such as the re-negotiation of tariff commitments.

Even assuming that the US was interested in renegotiating its tariffs – a generous assumption, given that the US has shown no interest in WTO procedures – it would have to request the initiation of a process whereby it would need to consider compensation, usually in the form of lower tariffs. But the US does not seem to be willing to lower the tariff level in any product market.

The Liberation Day tariffs apply to all imports across the board originating in the targeted countries. Article XXVIII of GATT is not constructed to address the circumstances that the world trading community is now facing.

Additionally, a renegotiation of tariffs under Article XXVIII leads to new MFN (most-favoured nation) non-discriminatory tariffs, which is precisely what the Trump administration has sought to avoid. Opting for MFN (eg. non-discriminatory) tariffs would run afoul of the aims of the Liberation Day tariffs, which is to force bilateral deals and diminish the multilateral regime.

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Pauwelyn (2025) argued that the Liberation Day tariffs could be accommodated within the WTO and, in fact, that they could prove to be its saviour by inciting negotiations under Article XXVIII of GATT. We disagree. The Trump administration has thus far demonstrated no willingness to negotiate within the structure of the WTO.

Past experience, as noted, also does not support a similar endeavour, as Article XXVIII negotiations are not wholesale negotiations; they are for renegotiating specific tariff lines. Most importantly, this instrument is meant to reestablish reciprocity by realigning tariffs. Reciprocity would be measured using the preexisting tariff levels as benchmark.

For instance, if the US wanted to increase protectionist tariffs on textiles from five to 10 percent, it would be called on to reduce its protections in another area for the sake of reciprocity. Of course, the US does not want to realign its tariffs – it wants to increase them without compensating anyone affected.

Nevertheless, the best response to the claim raised by Hervé Jouanjean, Jennifer Hillman and Joost Pauwelyn (see footnote 25) was given by the USTR Jamieson Greer (see footnote 14) after the US-EU Turnberry deal. Paying no heed at all to WTO legal disciplines, he simply asserted that the 'ancient régime' is obsolete and pronounced the advent of the new 'fair and balanced' scheme that the Trump administration is unilaterally attempting to impose.

Even if it was to lose before a WTO panel, the US could always circumvent the ruling by appealing into the void. The policy choices of the Trump administration are thus, in recourse and in intent, unconstrained by WTO law.

2.2 US tariffs and US law

While some critical voices against the prolific use of Section 232 tariffs have been raised, the Trump administration has not suffered any major domestic pushback against its policies[26]. Destler (2005) and Mutz (2021) have shown

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that both major US political parties have been generally aligned on trade policy over the last two to three decades[27].

Private citizens, nonetheless, have contested the legality of tariffs under US law. Is it then likely that Liberation Day tariffs will soon be a thing of the past after intervention by the US judiciary? We believe not, and here is why.

While WTO law sets the benchmark to judge the legality of President Trump's actions as the international commitments that the US has adopted, under US law it is the doctrine of the separation of powers, embedded in the US Constitution and related documents, that serves as a benchmark.

Responding to a complaint lodged against the Liberation Day tariffs, the Court of International Trade (CIT) – a US Federal Court – cast doubt on their legality. In its decision[28], the CIT found that President Trump had exceeded his authority when imposing the tariffs to address a national emergency, predicated on the constitutional doctrine of separation of powers.

The CIT found that Section 122 of the Trade Act of 1974 limits the President's authority to impose tariffs for the purpose of addressing trade deficits through the International Emergency Economic Powers Act (IEEPA)[29]. The President thus cannot impose tariffs when invoking the IEEPA. The same court issued an injunction.

The CIT decision was appealed before the CAFC (Court of Appeals for the Federal Circuit). The CAFC confirmed the CIT decision in substance. It found that the President could not have legitimately invoked the IEEPA to impose the Liberation Day tariffs, given that the text of the statute does not grant any power to impose them.

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It was slightly more nuanced, though: it held that the IEEPA confers powers on the President to regulate trade in times of emergency. Invoking the Yoshida precedent[30], the CAFC distinguished the 'Reciprocal' and 'Trafficking and Immigration Tariffs'[31] from tariffs that were upheld in Yoshida arising under IEEPA's predecessor statute, the Trading with the Enemies Act (TWEA). It found that the more limited tariffs in Yoshida did not exceed the authority granted to President Richard Nixon by TWEA.

Conversely, the Reciprocal and Trafficking and Immigration Tariffs were unbounded in scope, amount, and duration. In other words, IEEPA may or may not authorise some tariffs, but it definitely does not authorise the Liberation Day tariffs.

While both decisions agreed that there must be some limits on any tariffing authority under IEEPA, and that the Liberation Day tariffs did not fall within those limits, the CIT imposed a hard limit by way of the Trade Act, whereas the CAFC identified no principled limit at all. CAFC went on to remand the case back to CIT to decide on whether there was room to call for permanent injunction[32].

Neither of the two US courts interpreted the term 'emergency'. They still both alluded to the possibility that without a review of the President's understanding of the term, abuses cannot be excluded. So, the two courts on the one underscored the need to interpret the term 'emergency' (in order to avoid abuses), but on the other refused to do so themselves.

At the moment of writing, the US Supreme Court has agreed to hear the case in November 2025. A decision will realistically not be issued before 2026, and may be delayed until summer 2026. Several questions make it hard to predict its decision: will it base its decision on an interpretation of the term 'emergency' (US courts have rarely done this in the past), or will it instead aim to understand whether the IEEPA includes powers to impose tariffs?

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Or will it do both, providing a comprehensive resolution of the dispute? Will it follow the argument of the CAFC and try to distil whether, in emergency situations, the President can impose some tariffs – but of what magnitude?

Even if the Supreme Court curtails his powers, President Trump could still impose tariffs through different methods, though he might not end up as close to his desired outcome. Section 122 of the Trade Act[33] is the most promising avenue: it allows the President to impose duties of up to 15 percent or quotas for up to 150 days on imports from all countries, or selectively against countries that maintain unjustifiable or unreasonable restrictions on US commerce. If triggered, Trump could then supplement it after the 150-day cutoff with actions under Section 301[34]. Still, neither of these two acts would guarantee the same horizontal impact of the Liberation Day tariffs if they were upheld under the IEEPA.

2.3 Unconstrained (de facto) by law…

It is not the aim of this paper to delve into why deals were signed[35]. They are there, and the higher tariffs agreed in these deals are likely to stay for some time, even if the US Supreme Court judges the Trump administration's actions under the IEEPA to be unconstitutional. Our analysis shows that it is unlikely that they will be rolled back for legal reasons.

On the other hand, if the higher tariffs and deals do meet the stated objectives – a highly unlikely proposition[36] – the Trump administration will still claim victory over the critics and keep them in place: even marginally achieving their stated targets would provide the Trump administration with enough ammunition to present its policies as successful.

The second Trump administration has not, like the first, openly threatened departure from the WTO[37], and thus we should be prepared for a world with the WTO and US tariffs simultaneously in place. And more tariffs are on their

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way. While litigation regarding the legality of Liberation Day tariffs is pending before the Supreme Court, at the time of writing the Trump administration has launched two new Section 232 investigations covering a wide range of products[38]. Unsurprisingly, most analysts agree that the tariffs are here to stay[39].

If any confirmation was needed, USTR Greer (2025) stated it in so many words: *"It took over 50 years from that first meeting at Bretton Woods until the creation of the WTO. It has been 30 years since. Fewer than 130 days from the beginning of the Trump Round, the Turnberry system is by no means complete, but its construction is well underway …"*

3 The way forwards (or backwards): preferences and policy options

Nations sign trade agreements to create certainty about the cost of transacting, as Handley and Limão (2017), among others, have argued – not for the opposite purpose. As the Trump administration keeps inventing new reasons to impose additional tariffs, either sector-specific or across the board, uncertainty looms.

European Commission President Ursula von der Leyen hailed the EU's deal with the US, going so far as to state that *"today's deal creates certainty in uncertain times"*[40]. But the EU and the US did not sign a formal, binding, international agreement enumerating the responsibilities of the transacting parties in case of breach. All von der Leyen can count on is the word of President Trump.

Experience suggests that new tariffs might be imposed for new reasons (extensive margin), and that the level of tariffs agreed might be increased again if the current measures do not produce the expected effects (intensive margin).

Neither of these risks are small. Deficits, for one, might reappear unless the consumption to savings ratio has been addressed. What if the current deals do not, for example, reduce the deficit to the satisfaction of the US? How can anyone, under the circumstances, speak of certainty?

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Consider: initially the US imposed higher tariffs to reduce its deficit, to incite investment in the US and to replace tax income. Later tariffs were imposed to address the perceived unfair treatment of the former president of Brazil Jair Bolsonaro, to punish those buying too much oil from Russia, or to threaten punishment for those recognising the Palestinian state.

The reasons for imposing tariffs risk being extended further. There are inconsistencies, too: India is being punished for buying Russian oil, but the EU is not; neither the UK nor France were threatened with additional tariffs for recognising a Palestinian state either.

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A look into the Trade Policy Uncertainty (TPU) Index is quite telling in this respect[41]. More uncertainty should, all things being equal, lead to more trade contraction. Can the WTO still play a role? Adherence to its rules-based system provides certainty in international transactions. Can Trump's 'Turnberry system' do that? Can it prove to be the WTO-ersatz?

3.1 Tariffs and deals under the WTO's roof: an uneasy relationship (with no end in sight)

As things stand, some WTO members – especially those that have signed trade deals with the US – think that these deals and the WTO can coexist. The same may be true for those that are now facing higher tariffs when exporting to the US, as they have so far not taken action against it. In this scenario, members are likely to tolerate higher tariffs and US-dictated deals for as long as they last, while continuing to go about their other WTO business as usual.

After all, the WTO does not know of ex-officio complaints. It operates a decentralised system of enforcement that was put into place with the advent of the DSU. This perspective seems realistic, since the US does not for now question its ongoing participation in the WTO.

For some time, it seemed that the Trump administration was wavering on leaving the WTO, though it never formally announced its withdrawal. The appointment in July 2025 of Jennifer DJ Nordquist[42] at the WTO to cover the post of Deputy-Director General is evidence that the US administration entertains no thoughts of quitting. But the current US Administration is not consistent.

On 29 August 2025 (just a month after Nordquist's appointment), the US announced that it will stop paying its contributions to the WTO. The WTO annual budget is largely financed from contributions by its members[43], calculated based on each member's share of international trade[44]. It is easy to understand why the US' contribution matters, as the US is one of the world's largest exporters.

The White House adopted a 'rescission package', stating that it would stop funding some international organisations, including the WTO, *"that do not support major US policies or priorities or have been operating contrary to American interests for many years. This account funded: … $29 million to the toothless World Trade Organization (WTO), which has for decades aided and abetted global trade cheating by the Chinese Communist party"*[45].

'Aided and abetted global cheating' are harsh words, indeed. The Trump administration was following in the footsteps of the Biden administration, which had also not paid the annual contribution to the WTO during its final year – though without using similar language[46]. Note that non-payment of dues does not lead to exclusion[47].

Regardless, a few days after being first issued, the rescission package was revised without much fanfare, this time not listing the WTO among the organisations to which the US would stop paying its agreed contributions[48]. For now, the US is a member of the WTO with no stated intention to withdraw from the organisation.

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No one can predict for sure whether the US has definitively decided to turn the page. In fact, while has not threatened withdrawal in the weeks prior to the publication of this paper, it does not behave in WTO-consistent manner either. The continued implementation of its Liberation Day tariffs is the best proof of this.

Is it sustainable, though, to continue participating in an organisation in which 165 members respect MFN rules when transacting with each other, but not when transacting with the 166th member (which happens to be the largest one)? For how long can this continue? If WTO members take the view that the present is a mayfly, a temporary aberration, then such an attitude could be justified. But can anyone vouch that the Turnberry system will soon be no more?

We mentioned above the disputes that Brazil, Canada and China have initiated against the US at the WTO. The US, however, does not seem to care much about its WTO obligations at this stage, and one can assume that it will appeal to the void should there be a panel report against it. But this is not the only recourse these countries have.

Brazil (or Canada, or China, or anyone who has not made a trade deal with the US) could also initiate a complaint against the EU, UK or anyone who has undertaken WTO-inconsistent commitments[49]. What is the guarantee that Brazil will sit back and accept not only the higher US tariffs, but also the alienation of its MFN rights in the EU market as a result of the EU deal with the US? Recall that those who made deals with the US condoned WTO-noncompliant actions, including by opening their market on non-MFN basis to the US.

In case of a complaint against it, the EU would have the choice to appeal into the void or face countermeasures – assuming that they would prefer not to jeopardise their trade deal with the US. But this choice is not altogether safe, either. Brazil, Canada and China are Multi-Party Interim Appeal Arbitration Arrangement (MPIA) members[50]: their appeals can be hosted outside of the main appeals process.

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This means that the EU, the UK and other members will have to accept the imposition of countermeasures against them if they continue to honour their deal with the US. The attitude of those affected by the non-MFN deals is a risk factor for the stability of the current, precarious equilibrium.

Another risk factor is an obstructive attitude on the part of the US. Why would the US allow the value of its current strategy to be eroded by further liberalisation? What would be the interest for the US in standing by and allowing deeper integration across the rest of the world, risking the evisceration of its deals[51]?

In this vein, one should not discard the fact that it is the US that is judge, jury and executioner of these trade deals. Borrowing from Olson (1993), we could go so far as to state that we are observing the emergence of a 'roving bandit', uninterested in investing in the current regime and quite willing to extract as much value as possible from its partners for as long as it has the power to do so.

Being the self-proclaimed judge, jury and executioner of these trade deals, what would stop the US from turning the tables once again in the future if the deals do not yield the expected outcome?

Thus, to guarantee the longevity of the current status quo, the WTO membership would need to enforce the deals and simultaneously agree to non-enforcement of their WTO rights, while accepting the exorbitant privilege of the US administration to decide whether the terms of the bargain have been honoured. This would mean that members will not only avoid challenging the US, but also each other, for violating MFN.

If challenges do occur, those who will suffer most will be the 'small fish'; that is, the members of MPIA with little bargaining power that will be called to face countermeasures. These members might be eventually called on to

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accept the imposition of countermeasures against them if they want to continue honouring their 'deal' with the US[52].

The lack of stability inherent in the current situation was perfectly illustrated in the case of DS641[53]. China submitted a dispute against Canada because the latter introduced a tariff quota and imposed a surtax on steel products. Arguably, Canada did that to address steel over-capacity.

It is quite clear though, that President Trump's aggressive policy on steel (which led to high tariffs on various steel products) exacerbated the problem. Canada, in its attempt to cut its losses, engaged in beggar-thy-neighbour tactics and imposed part of the cost on innocent bystanders, ie. its trading partners. China reacted by lodging a dispute. Others might follow.

Finally, even if we assume that somehow everyone will show maximum tolerance, those who still have faith in the WTO's function risk losing interest in the organisation if the current status quo is prolonged. For how much can the WTO achieve under the circumstances, with the US unwilling to support multilateral solutions? How will the WTO legislate non-discriminatory trade liberalisation when one of its key members opposes it? And why would 165 trading nations continue to commit to an under-performing institution? Why would they invest in it[54]? WTO DG Okonjo-Iweala put it succinctly in the following terms: *"the status quo is not an option"*[55].

It is clear that the WTO needs reform. Its foundational documents need rewriting to address issues including the role of the state in the market, the collective effort to address global challenges such as climate change and the continuing quest for development. It needs to address the crisis of the Appellate Body being in abeyance for six years and counting. But it can only do that if its members agree that it is a forum worth investing in.

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The last thing the WTO needs at this stage is further undermining of its authority. The WTO is one of the last global organisations in which global solutions to global problems should and could be sought. Alas, the very founder of the regime, the US, is turning its back on multilateralism, and there is no obvious substitute for the leadership gap that it is leaving behind.

A genuine 'Kindleberger trap' is arising: theorists predict that, in the absence of an engaged hegemon, as Kindleberger (1973) understood the term, none of the three global powers (China, the EU and the US) has the incentive to assume the requisite cost and lead negotiations on the establishment of a new and much-needed international order. Carvalho *et al* (2025), in an excellent study, explained that, at best, each of them would be incentivised to be a free-rider on the others' efforts.

This is roughly the current situation, with China, the US and the EU being almost equally pre-eminent in the trade sphere. Each of them acting separately risks a hostile reaction by the other two, especially given differences in their worldview on international trade. They face a competitive fringe, in other words.

As per Kindleberger, a hegemon only has the incentive to create a rules-based system; maintaining it in a multipolar world, after the hegemon ceases to enjoy its privileged position, could happen through the concerted efforts of other nations who see it in their interest to continue their cooperation[56]. This much, in the absence of empirical proof so far, could be true in the realm of a real, multipolar world.

In the context of the current bipolar (or tripolar) world, though, in which the leading countries all have market power, keeping a rules-based regime afloat can be harder, as each of the leading nations has the power to influence the regime, to some extent, to its advantage.

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The analysis by Carvalho *et al* (2025) goes against the idea that, even in the absence of a hegemon, a collective hegemony (that is, the idea that two or three states can cooperate to sustain the order that the progressively weakened hegemon has established) is possible. At the very least, Carvalho *et al* (2025) qualify this idea by pointing to the lack of incentives for any of the two or three leading players to invest in keeping (and updating) the existing the regime.

Carvalho *et al* (2025) do not hypothesise about what replaces multilateralism. The re-regionalisation of trade emerges as possibility. So, what are the options if Okonjo-Iweala's statement (see footnote 55) about the non-sustainability of the status quo is proved right? We see two: a return to the spirit of multilateralism as reflected in the WTO of 1995 (or even the GATT as it evolved through the years), or a farewell to multilateralism and the espousal of regionalised trade. These are outlined next.

3.2 Return to multilateralism

A return to the WTO as it was originally planned is possible only if the US decides to forego its new approach to trade deals. Otherwise, it is the US that should walk out – there is no other way. To save the WTO and preserve the spirit of multilateralism, the US and the WTO would have to part ways if the US does not change its attitude[57]. However, this does not seem to be the US's wish.

The WTO membership could provoke a 'USexit' by invoking Article 60 of the Vienna Convention on the Law of Treaties and asking the US to leave the organisation for failing to observe the most fundamental obligations of the organisation[58]. A unanimous decision by the membership on this seems unlikely, as Howse (2025) correctly observed; as a result, this option is a long shot.

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Members could attempt a last-ditch negotiation to bring the US back to the multilateral house, and they should be prepared to amend the WTO's rules in order to lure the US back to the spirit of multilateralism. The red line should be the MFN principle. In this context, it would be advisable to distinguish between a short-term agenda that would make it palatable for the US to reverse course and a medium-term agenda that would benefit the institution at large.

The initial agenda should take care of the US's legitimate (or half-legitimate) concerns. The introduction, for example, of flexibility in the current Safeguards Agreement is long overdue, as Sykes (2006) argued[59]. In similar vein, bringing in an antitrust framework for crisis cartels[60] to address the over-supply of steel products could also go some way in persuading trading nations that the world trading system can still deliver.

To sweeten the multilateral lure further, the members could mull over the wisdom of Compulsory Third-Party Adjudication (CTPA). The US was behind the idea of amending the GATT and introducing CTPA in the world trading system in the form of Article 23.2 of the DSU, during the Uruguay Round negotiations (1986-1994). Things have changed, and it is unlikely that they will change back, as the US seems to be generally averse to international adjudication.

Why not emulate the International Court of Justice regime and provide the members with discretion with respect to accepting CTPA (on reciprocity grounds). This is, of course, a second-best solution, but probably a price worth paying if it proves enough to persuade the US to abandon unilateralism and return to the WTO house[61].

In line with Tucker's (2022) apt suggestion, adherence to the WTO should be accompanied by a pledge to never aggress other members. 'Doux commerce' should find its institutional home by contract, since it could not do so by custom.

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The medium-run agenda should aim to update and modernise the WTO. The renegotiation of the WTO Subsidies Agreement should be a priority: as it stands now, this is largely an outdated agreement. It contains no safe havens for subsidies that provide public goods. It is further quite inappropriate for dealing with global value chains. The same could be said about 'economic security', a concept that has emerged as a key concern for many trading nations.

The discussion on the link between trade on the one hand, and development and environment on the other, should start in earnest this time. It would be wise in this context to introduce changes in the current regime that would facilitate recourse to variable geometry.

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3.3 Farewell to the WTO – in search of new pastures

Commission President Von der Leyen recently called for a rapprochement between the EU and the signatories of Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), with the goal of establishing an international trade framework[62]. While clearly not seen as alternative to the WTO, a rapprochement seems necessary to reinforce the multilateral spirit that the overwhelming majority of trading nations still abide by. Similar thinking has been developing in various circles for some time now, and the Trump administration's tactics have accelerated it.

The WTO has long been in dire straits. The CTPA has been paralysed, but most importantly, its legislative function is moribund. At the current juncture, when the key impediments are internal barriers, like-mindedness is crucial to successful trade integration. Like-mindedness, in turn, is a function of preferences, priorities and the capacity to act. The sub-Saharan Africans might be as concerned as Sweden or Norway about climate change. Their priority, however, is to address malnutrition at home.

The WTO is no club for like-minded players anymore, and the trading community has painfully realised that heterogeneity and deep integration of their club is a zero-sum game.

The second Trump administration has added a new dimension to this discussion. The country that commentators considered to be a key player in moving trade integration further and faster has, for some time now, decided to disengage from WTO affairs. Those who still believe that they can and should go further and faster in advancing multilateralism could decide to form a new club.

The EU-CPTPP rapprochement is an example of this discussion[63] and can operate in the background of the WTO. If the WTO falls into complete paralysis because of the attitude of the current US administration, it will be for the EU-CPTPP leaders to decide whether they will attempt to weather the crisis or simply move to new pastures. For now, the thinking in Brussels is that the EU-CPTPP is a complement and not a substitute to the WTO[64].

Judging by the GATT experience[65], it is probably wiser to start with the EU-CPTPP structure before opening up to, at the very least, some key G20 members that would like to come aboard. A move along these lines would likely anger the US. The EU-CPTPP forum together represents over 30 percent of global GDP and close to 50 percent of international trade[66]. This fact alone might persuade them to build the alliance that they did not build on 2 April 2025, when the Liberation Day tariffs were announced.

The consensus rule was the key legitimising force in the GATT era. In the current geopolitical situation, it has become hostage to the exercise of veto power. Uninhibited by the shackles of consensus-based rule that apply in the WTO, the leaders of countries that still believe in reciprocity, ex ante and not ex post, could charge ahead with a new institution. Of course, this could be achieved even while keeping the WTO open for business in Geneva. However, the policy-relevant decisions will have de facto migrated elsewhere.

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4. All is not yet lost (or is it?)

Reinert (2023) warned forcefully about the risks associated with economic nationalism and the ensuing decline of global cooperation. A lack of international cooperation risks negative spillovers beyond international trade. This is certainly a graver risk[67].

Since the establishment of the multilateral trade order, the big players have largely led by example. Indeed, the success of the regime is largely due to their unwavering support and commitment. The US not only led the effort to found the initial regime but was instrumental in updating and strengthening it. Some eyebrows were raised in 1971 when President Nixon imposed a tariff surcharge, but any parallels with the current situation are misguided. At the time, the US was facing a true emergency as the Bretton Woods system of fixed parities was becoming increasingly untenable.

A more suitable comparison would be the extensive recourse by the US to Section 301 during the last years of the Reagan administration, a policy that his successor George HW Bush did not halt. Legitimately annoyed with the EU's refusal to adopt a series of GATT panels condemning the Common Agricultural Policy, the US retaliated unilaterally[68]. Nonetheless, legitimate annoyance does not amount ipso facto to legality.

The US subsequently used sticks and no carrots asking Brazil, India, Japan and a few other countries to open up their services markets and guarantee a certain level of protection for intellectual property rights. Bhagwati (1990) provided an excellent analysis of the perils of unilateralism, but the US remained tone-deaf. During the Uruguay Round (1986-1994), it equally pursued its agenda to establish a multilateral compulsory third-party adjudication regime.

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The quid pro quo for abandoning unilateralism for the US was the advent of three new WTO Agreements: the General Agreement on Trade in Services, the Agreement on Trade-Related Aspects of Intellectual Property Rights and the Dispute Settlement Understanding. The US, in other words, used its bargaining power to deepen and expand the multilateral trading order.

That was then – it surely is not now. The second Trump administration is using its bargaining power to undo the multilateral trading order as we knew it and to erect new barriers to trade. The MFN is certainly a constraint for players with substantial bargaining power. They cannot profit enough from bargaining power asymmetries, and free-riding can and does occur[69].

But the US leaders in the period immediately following the Second World War had learned the lessons of isolationism, having experienced the consequences of the disastrous Smoot-Hawley Tariff Act. The Roosevelt and Truman administrations were prepared to assume the requisite cost and establish a rules-based system that would provide stability and keep trading nations together.

This is not the case anymore. The second Trump administration is exploiting its power asymmetry to achieve an outcome in the short term that risks upending the order built. There should be no illusion that the collateral damage of the current policies is not limited to fewer trade opportunities for those who face higher tariffs, as well as those who rushed to make a deal with the US. This is a blow to the rules-based system.

Will genuine reform that preserves the spirit of the Bretton Woods institutions ever take place with the US inside the multilateral house? It seems increasingly likely that we are headed towards decoupling and segmented markets. The only unknown is whether the WTO will still be around when and if the spirit for a global accord returns in the

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key capitals of the world. Our preferred solution would be for a return to the WTO along the lines discussed in section 3.2.

Alas, this looks increasingly unrealistic. It seems that the realpolitik choice is between a farewell to the WTO and finding room for the US's new trade deals under its roof. The difference between the two is that the former leads to the WTO's demise in one decisive strike. The latter option is best described as 'Chinese torture or death by a thousand cuts (or deals)'.

Just before this paper was written, President Trump announced a new flurry of duties on pharma products, big trucks, kitchen cabinets and bathroom vanities, all in the name of national security[70]. Nowadays the rest of the world is left to react. The EU first announced that it planned tariffs on Chinese steel imports[71], followed by Taiwan's announcement that it would curb exports of semiconductors to South Africa[72]. Russia announced its decision to block exports of petrol[73] and China of electric vehicles[74].

It seems that the world, in the name of geopolitics, has opened the Pandora's Box of trade uncertainty. There is nothing the WTO can do about any of these initiatives, unless its members decide to complain about it. But, so far, none have. The trade order established in 1948 and strengthened in 1995 is being replaced by disorder – a situation in which order has no place at all. Will the 'adults in the room' stand aside alike Nero and watch Rome surrender to the flames, or will they do something about it? It remains to be seen.

In his acceptance speech for the presidential nomination at the Democratic National Convention in 1952 in Chicago, Adlai Stevenson said[75]:

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“When the tumult and the shouting die, when the bands are gone and the lights are dimmed, there is the stark reality of responsibility.”

May this spirit guide the leaders called to decide the future of multilateralism. ■

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Endnotes

1. This phrase is admirably precise and refreshingly truthful. The US, as we explain later on, is not addressing the trade deficit per se through this instrument, but only the trade deficit in the context of goods-trade. The US is, in fact, running a persistent trade surplus in the realm of services trade. Services represent 80 percent of US gross domestic product (GDP). See World Bank, 'Services, value added (% of GDP) - United States'.

2. The S&P 500 index of US companies had fallen by 12.1 percent by the time markets closed on 8 April 2025 as investors panicked about tariffs potentially causing a recession in the US. However, it was not just US shares that lost value. In the UK, markets fell by 10.8 percent by 9 April. Simon Evenett and Johannes Fritz astutely observed that the Liberation Day tariffs constituted a shift: the US is not targeting China anymore; is targeting the entire world. See Simon Evenett and Johannes Fritz, 'US Reciprocal Tariffs: Upending the Global Trade Policy Landscape', VoxEU, 3 April 2025.

3. At the time of writing, only three of the deals appear on an official US government webpage, namely: White House, 8 May 2025 'General Terms for the United States of America and the United Kingdom of Great Britain and Northern Ireland Economic Prosperity Deal'; White House, 21 August 2025, 'Joint Statement on a United States-European Union framework on an agreement on reciprocal, fair and balanced trade'; and White House, 22 July 2025, 'Joint Statement on Framework for United States-Indonesia Agreement on Reciprocal Trade'.

4. Tucker (2022) mentioned that this instrument had been used six times in the past, as US presidents before Donald Trump had acquiesced to only six of 49 petitions. For a full discussion, see Mavroidis (2025).

5. See World Trade Organization, 'DS556 United States — Certain Measures on Steel and Aluminium Products', 26 January 2023.

6. 'Appeal into the void' is the consequence of the first Trump administration's decision to stop renewing the mandate of the WTO Appellate Body members (the second instance court). The Dispute Settlement Understanding (DSU), the agreement organising adjudication within the WTO regime, was not amended, and as a result the Appellate Body continued to exist as a sort of legal fiction. So, a losing party can always appeal a hostile panel report to an Appellate Body that lacks the capacity to adjudicate. During the appeal process, the report does not enjoy any legal status and

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consequently cannot be enforced. The US appeal into the void did not stop the EU and others from rebalancing their tariffs on steel vis-à-vis the US. President Biden sought a deal with the EU exempting its exports from tariffs for two years in a row. See Reuters, 'Biden extends EU steel, aluminium tariff exemption for 2 years', 28 December 2022.

7. Deborah Elms, 'Napkin deals and trade edicts: The only certainty in global trade is uncertainty', Hinrich Foundation, 5 August 2025.

8. Chris Kay, Krishn Kaushik and Andres Shipani, 'Narendra Modi Tells Indian He Will Never Compromise in Face of 50% Tariffs', The Financial Times, 7 August 2025.

9. The legality of tariffs has been challenged on constitutional grounds, as we explain later.

10. Some details about these deals have emerged – even though the WTO continues to be officially unaware of them. It was reported that Japan had 45 days, counting from 2 September 2025 when President Trump formally enacted the terms of the deal, to invest $550 billion in areas earmarked by the President himself, and revealed details about the splitting of profits between the US and the investor (Japan). See Aime Williams and Leo Lewis, 'Trump to Direct Japan's $550 billion Investment in US After Deal with Tokyo', The Financial Times, 6 September 2025. Their story makes claims by developing countries, dating from the 1980s and regarding the direction of investors and distribution of benefits, pale in comparison to the US-Japan deal.

11. It has been hinted that the EU and the US have signed a WTO-consistent FTA. If this were the case, then of course, at least the violation of the MFN would have been 'healed'. But this is hardly the case from a legal point of view. Article XXIV of GATT allows for deviations from the MFN if two or more parties reduce or eliminate their tariff protection. Here we observe the opposite trend. Furthermore, there is nothing like a plan that has been worked out to reduce/eliminate the current tariff protection in the foreseeable future. Hence, this argument should be discarded. See Joost Pauwelyn, 'Wait a minute, did the EU and the US just conclude a free trade agreement in line with WTO rules?' LinkedIn, undated.

12. Feaver (2024) formulated in prescient terms his claim that the second Trump administration would keep "transactionalism" as the cornerstone of its foreign policy, despite having little to show from its experience during the first administration. See Peter D Feaver, 'How Trump Will Change the World', Foreign Affairs, 6 November 2024.

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13. Except for the three deals published on the USTR webpage (footnote 3), President Trump has further published some features of the deal with Korea via his Truth Social account. See here.
14. The WTO endorses Compulsory Third-Party Adjudication (CTPA), and it is WTO panels that will be called on to adjudicate all disputes on the subject-matter which comes under the jurisdiction of the WTO. The current USTR, Jamieson Greer, left no doubt that this is not an option for the Trump administration, when stating: "… Importantly, these commitments are actionable, and the United States will enforce them. Rather than the drawn-out dispute settlement process favoured by the old guard of trade bureaucrats, the new US approach is to closely monitor implementation of the deals and swiftly reimpose a higher tariff rate for noncompliance if needed. President Trump uniquely recognizes that the privilege of selling into the world's most lucrative consumer market is a mighty carrot. And a tariff is a formidable stick." See Jamieson Greer, 'Why We Remade the Global Order', New York Times, 7 August 2025.
15. On 11 September 2025, the highest Brazilian Court sentenced Bolsonaro to 27 years in prison for inciting an insurrection against the legitimately elected government of Brazil. At the time of writing, it remains to be seen how the US government will react to the news. See Ana Ionova and Jack Nicas, 'Bolsonaro Sentenced to 27 Years in Prison for Plotting Coup in Brazil', New York Times, 11 September 2025.
16. Reportedly, the truce between the US and China was extended for 90 more days, until November 2025. See James Politi and Ryan McMorrow, 'Donald Trump Extends Trade War Truce with China', The Financial Times, 12 August 2025.
17. We would like to underscore here that Brazil is not contesting the legality of a deal under the WTO rules, but simply the legality of higher tariffs.
18. White House, 'Statement on President Trump's Declaration of a National Emergency' 2 April 2025.
19. Discussed in detail in Mavroidis (2025).
20. See WTO, 'DS597: United States — Origin Marking Requirement'.
21. Michael Acton, Tim Bradshaw, Aimee William, James Politi and Demetri Sevastopulo, 'Donald Trump Threatens 100% Tariffs on Chips but with a Carve-Out for Apple', The Financial Times, 7 August 2025.
22. This provision has been consistently interpreted widely; see, for example, United States v. U.S. Shoe Corp. 523 U.S. 360 (1998).

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23. Fairbank v. United States (1901), 181 U.S. 283, 293; A.G. Spaulding & Bros. v. Edwards (1923) 262 U.S. 66, 69, 70.
24. White House, 'Fact Sheet: President Donald J. Trump Takes Action to Address the Threat to National Security from Imports of Copper', 30 July 2025.
25. Hervé Jouanjean, Jennifer Hillman and Joost Pauwelyn, 'How the US Reciprocal Plan Could Save the WTO', International Economic Law and Policy Blog, 24 February 2025.
26. Most vocal among them, US Senator Jacky Rosen issued a letter arguing that the Section 232 tariffs were running against the interests of US small and medium enterprises; however, no US Senator has defended the global trade order. See Office of Jacky Rosen, 'Rosen Statement on Trump's Cost-Raising Tariffs Going Into Effect', 1 August 2025.
27. Many of those who do oppose Trump's policies, like Michael Froman, still take issues with the relevance of MFN. See Michael Froman, 'After the Trade War', Foreign Affairs, *11 August 2025.*
28. The CIT found that both the Liberation Day, as well as the 'trafficking' tariffs (eg. the tariffs against Canada, China and Mexico for not effectively addressing the trafficking of opioids), violated US law as the President could not have invoked emergency powers under the International Emergency Economic Powers Act to impose them. See V.O.S. Selections Inc., v. Donald J. Trump, 25-1812.
29. IEEPA refers to the International Emergency Economic Powers Act, a 1977 US federal law that authorises the president to regulate economic transactions after declaring a national emergency related to a foreign threat.
30. Yoshida Int'l v. United States, 378 F. Supp. 1155, 1175–76 (Cust. Ct. 1974).
31. These are the two sets of tariffs imposed by President Trump. The reciprocal tariffs refer to the Liberation Day tariffs, and the court here was using the name that the Trump Administration had officially applied. The 'trafficking' tariffs were a more specific set targeting imports from China, Mexico and Canada because of their alleged roles in facilitating illegal immigration and fentanyl trafficking.
32. The CIT could still decide on an injunction, but it is quite doubtful that this will be the case. Between the CIT and CAFC decisions, the US Supreme Court in CASA v. Trump (606 U.S. 2025) made it almost impossible for Federal Courts to issue nation-wide injunction relief. Instead of universal relief, Federal Courts are to provide 'complete relief' only to the specific

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plaintiffs who have standing in the case before them. Thus, they can only address the specific harm suffered by the actual parties to the litigation. Litigants seeking to affect a larger group of people must pursue their claims as a class action under Federal Rule of Civil Procedure 23. Of course, all this might be a pure academic discussion, as the Supreme Court could step in to stay an injunction until it has decided itself in definitive manner. See CASA v. Trump (606 US 2025). Pahis (2025) provided an excellent and succinct account of this litigation.

33. Section 122 of the Trade Act of 1974 gives the President the authority to impose a temporary tariff of up to 15 percent for up to 150 days to address "large and serious United States balance-of-payments deficits."

34. Section 301 of the Trade Act of 1974 (1974) (Public Law 93-618).

35. EU trade officials went on record stating that the 'deal' they signed with the US had nothing to do with economics. See Janan Ganesh, 'Europe's Necessary Appeasement of Donald Trump', The Financial Times, 24 September 2025.

36. See Joseph Gagnon, 'Why Higher Tariffs Won't Shrink the Trade Deficit', Realtime Economics, 24 February 2025, Peterson Institute for International Economics.

37. Woodward (2020) included in his account of the Trump Presidency the following dialogue between President Trump and WTO Director-General Roberto Azevêdo (p. 225): "Roberto, you treat us very badly. The United States is considered this very wealthy place, and China is considered a developing nation, and India's a developing nation. If you're a developing nation, you get things that nobody else will get. We're going to be a developing nation. When Azevedo protested, Trump said 'Here's what I'm doing. I'm pulling out of the World Trade Organization'".

38. US Department of Commerce 'Notice of Request for Public Comments on Section 232 National Security Investigation…', Docket No. 250924-0160, 26 September 2025; US Department of Commerce 'Notice of Request for Public Comments on Section 232 National Security Investigation', Docket No. 250924-0161, 26 September 2025.

39. For example, Harry Murphy Cruise, 'The Future of Trade: Tariffs, Taxes, and Economic Trends', Oxford Economics Blog, 5 August 2025, and Alan Wolff, 'Are Trump's Tariffs a Path to a New World Trade Order?', Realtime Economics, 11 August 2025, Peterson Institute for International Economics. They add that President Trump has not established a new trade order but has simply set requirements for dealing with the US.

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40. European Commission, 'Statement by President von der Leyen on the deal on tariffs and trade with the United States', 27 July 2025.
41. This Index measures the level of uncertainty surrounding trade policy by tracking the frequency of news articles that mention both 'trade policy' and 'uncertainty' keywords. It was developed by Federal Reserve economists and helps to gauge the potential impact of trade policy uncertainty on the economy. See Policy Uncertainty website.
42. World Trade Organization news of 28 July 2025, 'DG Okonjo-Iweala appoints new Deputy Director-General'.
43. The US has also been strengthening its critique of the WTO Secretariat for overstepping its mandate without, however, offering persuasive arguments to substantiate its claims. See James Bacchus, 'Another Misguided US Attack on the WTO', Cato at Liberty, 28 March 2025, Cato Institute. See also WTO Doc. G/C/M/150 of 27 January 2025 at pp. 81.
44. See the WTO Secretariat Budget for 2025 website.
45. White House, 'Historic Pocket Rescission Package Eliminates Woke, Weaponized, and Wasteful Spending', 29 August 2025.
46. There are no provisions in the WTO Financial Regulations (WTO doc. WT/L/156/Rev. 4 of 2 February 2023) to expel members that are in arrears with their payments. Only the Administrative Measures mentioned in Annex B of the quoted document can be applied. The severity of sanctions escalates as they fall further behind with their payments. After the third year that they have been in arrears, members will be designated 'Inactive'. But this does not mean that they cannot vote (and thus block consensus). The most severe penalty is that a defaulting member cannot have its delegates chair WTO committees – hardly a threat for those defaulting. The list of members in arrears is read out at the end of every General Council meeting. It is also reflected in the minutes of the meetings. This is some form of 'name and shame', but it has hardly been effective. The personal engagement by former Directors-General of the WTO, who raised the issue in bilateral meetings with ministers of defaulting members, is probably the most effective way to persuade a defaulting member to pay up. It is doubtful that this would work in the present circumstances.
47. The European Commission has lost no time in proposing the tariff reductions necessary to honour the deal struck with the US. See European Commission press release of 28 August 2025, 'EU proposes tariff reductions to implement EU-US deal'.

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48. See White House from 29 August 2025 (footnote 45). See also Olivia Le Poidevin, Andrea Shalal and Emma Farge, 'White House drops World Trade Organization from list of funding cuts', Reuters, 4 September 2025.

49. We read, for example, in §1 of the Joint Statement between the US and the EU "(….) that the European Union intends to eliminate all tariffs on U.S. industrial goods". §4 of the same document refers to rules of origin that the two partners will negotiate to ensure that benefits under their deal will accrue predominantly [sic] to the US and the EU. See European Commission, 'Joint Statement on a United States-European Union framework on an agreement on reciprocal, fair and balanced trade', 21 August 2025.

50. The Multi-Party Interim Appeal Arbitration Arrangement (MPIA) is an agreement among several WTO members to provide an interim appellate mechanism for disputes, as the WTO's Appellate Body is currently unable to function. The MPIA is based on Article 25 of the DSU.

51. Mexico has been weighing the pros and cons of imposing tariffs on non-FTA partners. See David Alire Garcia and Amy Stillman, 'Mexico Weighs Tariffs on China, Others Without Trade Deal (1)', Daily Tax Report, 5 September 2025. If this happened, then we might be witnessing a domino effect on tariff re-alignment. This sort of behaviour is yet another risk factor casting doubt on the longevity of the current status quo.

52. The Philippines, for example, applies an MFN rate of 20 percent on motor cars coming under HS 877021010. It imposes a five percent duty on its imports originating in FTAs it has signed with WTO members (WTO Tariff & Trade Data, Integrated Database and Consolidated Tariff Schedules). And it agreed to apply zero percent duty on imports of US motor cars.

53. WTO, 'DS641: Canada — Surtax and Tariff Rate Quotas on Imports of Certain Steel and Aluminium Goods, Including Goods Containing Chinese-Origin Inputs'.

54. Interestingly, Helpman (2025) noted that trade within the 'China bloc' and within the 'US bloc' (assuming we can speak of two blocs) is increasing faster than international trade in general.

55. Ngozi Okonjo-Iweala, 'A Stress Test for the WTO', The Financial Times, 4 September 2025.

56. Referring here to the work of Keohane (1984) and Snidal (1985).

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57. As argued by Anne O Krueger, 'Trump's Tariffs Chaos Could Reverse 80 Years of Economic Progress', The Project Syndicate, 23 April 2025; and Kristen Hopewell, 'To Save the Global Economy Kick the US Out of the WTO', Politico, 7 July 2025. See also Horn and Mavroidis (2025).
58. See the discussion of this provision in Horn and Mavroidis (2025) and Howse (2025).
59. The WTO Safeguards Agreement allows signatories to temporarily close their markets when facing unanticipated volumes of imports. Alas, case law has interpreted it in very strict manner, making recourse to this instrument almost impossible. A 'flexibilisation' of the current regime would help address the concern of the US that it should be able to close its market whenever warranted, without being subjected to onerous countermeasures.
60. Crisis cartel refers to the collaboration between government and private sector, or even between organisations, during unprecedented conditions (eg. an economic crisis) to counter the effect of disruption.
61. Mavroidis (2022a) provided a succinct account of the negotiating history of the DSU, paying particular attention to the role of the US, a catalyst by any reasonable benchmark in this context.
62. CPTPP is a free trade agreement between 12 countries: Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the United Kingdom and Vietnam. See European Commission press release of 23 June 2025, 'Joint read-out from the meeting between President von der Leyen and Prime Minister Luxon'.
63. But recall that the analysis by Carvalho et al (2025) cast doubt on whether an EU-CPTPP coalition would be incentivised to invest in a new global regime. It seems likelier that this will become a 'club' agreement, which willing players might join.
64. See Ursula von der Leyen, '2025 State of the Union Address', 10 September 2025.
65. Irwin et al (2008) argued persuasively that the like-mindedness of participants was key to the successful negotiation of a trade-cum-security agreement that probably seemed unattainable a few months before the negotiation had started.
66. Calculated using WTO membership fees as a proxy. Using the same calculation methodology, the US represents approximately 11.5 percent of world trade.

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67. The unravelling of cooperation does not necessarily entail the elimination of blocs; see Gideon Rachman, 'The relationship between Xi and Putin is built to last', The Financial Times, 20 May 2024. Goddard (2025) argued that in President Trump's conception of things, three blocs should emerge out of the destruction of the multilateral order, one led by the US, one by Russia and one by China. It is of course, hard to predict what happens next, but the signals that the current US administration sends to denote its dissatisfaction with the current international order are both loud and clear.
68. Mavroidis (2022b) provided the full list of disputes in which the US prevailed, and when faced with intransigence (since the European Economic Community as it was then known refused to adopt the reports), the US had recourse to unilateral retaliation by increasing its duties in a series of products of interest to key European lobbies.
69. Bagwell and Staiger (2004) astutely observed that there are mechanisms built into the GATT/WTO legal system which aim to reduce the potential for free-riding, but they also conceded that these mechanisms reduce but do not eliminate free-riding.
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I am indebted once again to Henrik Horn for numerous discussions and helpful comments on previous drafts. Ignacio Garcia-Bercero, our disagreements notwithstanding, provided excellent detailed comments. Charles M Cantore, Simon Evenett, Clarisa BFF Long, Patrick A Low, Stratos Pahis and Bob Staiger discussed different aspects of the paper with me. I profited a lot from a discussion we had at Bruegel on 11 September 2025, when Niclas Poitiers, André Sapir, Nicolas Veron and Jeromin Zettelmeyer generously shared their expertise with me and helped me re-balance the key point of this paper.

This article is based on Bruegel Working Paper 25/2025.

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Reforming the global trading system

The global trading system needs to reform. Ignacio García Bercero considers a first step in coalition building where two of the world's major trading blocs have signalled their willingness to work to repair a system undermined by the US and China

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An initiative to reform the global trading system, on the basis of cooperation between the European Union and the twelve nations of the Comprehensive and Progressive Agreement for Transpacific Partnership (CPTPP), took a first significant step on 20 November. Trade ministers from the two blocs met and issued a statement expressing concerns about economic coercion and market distorting practices leading to excess capacity.

This can be read as criticism of both the United States and China, though neither were named. Other shared understandings reflected in the statement include a commitment to ensure that measures impacting on trade are *"implemented in a transparent manner consistent with existing rules governing trade and investment."* At a time when there is a risk of the EU adopting measures contrary to its World Trade Organization and free-trade agreement (FTA) commitments, this is an important message.

CPTPP members represent 13% of world GDP and about 15% of global trade. The EU, for which the figures are about 15% and 16%, respectively, already has FTAs with all CPTPP members except Australia, Malaysia and Brunei, and it is negotiating such agreements with the first two. The CPTPP was initially negotiated with the US and many of its rules are based on the model the US follows in its FTAs.

There are therefore major differences between the CPTPP provisions and those in EU FTAs. For the EU to join the agreement would have little added value. It is therefore fitting that the two blocs plan instead to reinforce cooperation with the common objective of strengthening rules-based trade at a particularly challenging time.

There has been some speculation that EU-CPTPP cooperation could be the basis for an alternative trading system in light of the crisis around the WTO. To counter such perceptions, much of the 20 November joint statement

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is dedicated to signalling support for work to reform the WTO. This is framed as reinforcing the relevance and effectiveness of the WTO in addressing challenges *"including practices which distort trade and investment flows."*

There is also support in the statement for the incorporation into the WTO of open plurilateral agreements, in particular the Agreement on Electronic Commerce, agreed in 2024, and the 2023 deal on Investment Facilitation for Development. Because of the difficulty of reaching a multilateral agreement on reform of the WTO's main

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The trade ministers' 20 November statement could prove to be a first step in building a coalition to reform the global trading system. But this also requires all participants to avoid measures that contradict their WTO commitments, or those entered into in FTAs dispute settlement mechanism – which is presently non-functioning – there are calls to avoid measures that block the resolution of ongoing disputes and to expand participation in the Multi-Party Interim Appeal Arbitration Agreement, an alternative set up in 2020 to the currently stuck WTO procedures. EU/CPTPP cooperation should be intensified in the lead up to the next WTO Ministerial in March 2026, the statement said.

The statement also identifies work streams for EU-CPTPP bilateral cooperation, beyond WTO reform efforts. These include expanding bilateral trade in goods and services, improving customs procedures, addressing non-tariff barriers and streamlining border and regulatory processes. On digital trade and supply-chain resilience, there is a suggestion that the EU and CPTPP may be open to negotiate common rules, although the language remains very cautious. Such cooperation could be discussed by trade ministers at next year's WTO Ministerial.

In the meantime, officials working to prepare the next round of talks should focus on three initiatives:

- Preparing joint proposals on WTO reform: these could include a proposal to start preparatory work on updating subsidy rules;

- Evaluate the options on digital trade and supply-chain resilience: this could start with a comparative analysis of agreements that have been concluded on those issues by the EU or CPTPP members; from this, a recommendation to start negotiations could be prepared for ministers.

- Commissioning a study on possible further steps to facilitate trade between the EU and the CPTPP: this could include a common protocol of rules of origin, simplification of customs procedures and/or mutual recognition of conformity assessments.

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The trade ministers' 20 November statement could prove to be a first step in building a coalition to reform the global trading system. But this also requires all participants to avoid measures that contradict their WTO commitments, or those entered into in FTAs. ■

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This article is based on a Bruegel First Glance.

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Rewiring trade for a warming world

The challenge for policymakers is to build rules that function amid disagreement in a divided world. Dennis Snower discusses how COP30 can turn climate goals into trade rules

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COP30 in Belém has made one thing unmistakably clear: environmental sustainability can no longer be siloed from global trade. The next frontier in climate policy lies in reshaping the rules of international commerce so they reflect the real ecological costs – and benefits – of economic exchange. Yet we live in a divided world, fractured not only by wealth and power but by fundamentally different value systems across generations, regions, and discount rates.

In this column, I outline how trade rules can be made responsive to environmental costs in such a context – by distributing policy authority across institutions, leveraging 'coalitions of the willing', and aligning finance with principles of precaution and proportionality.

The proposals build on insights from climate economics (Stern 2007, Weitzman 2014), global governance (Hovi *et al* 2016), policy analysis under deep uncertainty (Lempert *et al* 2024), as well as policy contributions on climate clubs, carbon pricing, and sustainable trade (eg. Campolmi 2024, Lashkaripour 2022, Snower 2022, Pisani-Ferry *et al* 2023, Weder di Mauro and Zettelmeyer 2025).

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Mapping the political economy of environmental trade rules

Environmental trade measures inevitably generate winners and losers – not only across countries, but also across time. Four major divides define the problem:

1. Current versus future generations, where short-term economic interests dominate long-term ecological sustainability.
2. Rich versus poor countries, where carbon-intensive exporters fear 'green protectionism'.
3. Politically powerful versus weaker states, where the latter struggle to shape standards.
4. High versus low discount-rate constituencies, which value environmental risks differently.

A robust trade framework must remain operational even when actors disagree about environmental costs. That requires procedural fairness, redistributive mechanisms, and adaptive governance – principles familiar to economists but still absent from trade law.

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Trade must now serve as a channel for managing uncertainty, not amplifying it. That means institutionalising precaution, embedding redistribution, and rewarding participation in coalitions of the willing

From principles to practice: institutional roles

National governments

Governments remain the central actors in implementing climate-responsive trade rules. They can:

- Conduct trade and environment impact assessments (TEIAs) that include long-term, low-discount evaluations of environmental externalities in export sectors.
- Enact border carbon adjustments compatible with WTO rules under Article XX (General Exceptions) – provided they use transparent, internationally verified emissions data.
- Earmark carbon revenues for intergenerational investment funds, similar to sovereign wealth funds but targeted at ecosystem restoration.

These measures align with the precautionary principle, ensuring trade does not cause irreversible harm before evidence is complete (Cooney 2004).

International organisations

The WTO, UNEP, and OECD can establish shared methodologies for measuring the carbon and biodiversity footprints of traded goods. The WTO's Committee on Trade and Environment can help clarify how Article XX applies to climate-linked trade measures, reducing litigation risk.

The World Bank and regional development banks can co-finance adjustment costs for developing countries – aligning with the 'common but differentiated responsibilities' (CBDR) principle.

Businesses and consumer organisations

Firms can internalise environmental costs via green certification schemes and supply chain disclosures (such as

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the EU's Corporate Sustainability Reporting Directive). Consumer associations can amplify these mechanisms by verifying that labels and digital product passports reflect real environmental data.

Insurers and financial institutions

Insurers and institutional investors can price environmental risk into trade finance. By linking premiums or credit spreads to carbon and biodiversity metrics, they create a financial gradient that rewards low-impact trade.

This market-driven risk adjustment aligns with Weitzman's (2014) argument that fat-tailed climate risks justify higher precautionary costs today to avoid catastrophic losses later.

The role of coalitions of the willing

Because universal agreement is improbable, coalitions of the willing – clusters of like-minded states – can pioneer climate-trade integration. Climate clubs (Hovi *et al* 2016) or sectoral alliances (eg. the Clean Energy Materials Club or the Zero Deforestation Supply Chain Coalition) can set common standards for carbon accounting, circular production, or deforestation-free trade.

These clubs can offer:

- Reciprocal trade preferences (eg. lower tariffs or procurement access for members).
- Technology-sharing agreements and joint certification systems for green exports.
- Revenue-sharing schemes, where proceeds from BCAs finance green transitions in low-income partners.

Club-like structures can overcome global coordination failures by creating credible incentives for cooperation while avoiding free-riding.

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Financing the transition

Implementing climate-aligned trade policy requires new fiscal architecture:

- Carbon border revenues can be recycled into green transition funds under international supervision, with disbursement linked to measurable outcomes (emission cuts, reforestation).
- Green bonds and blended finance mechanisms can leverage private capital for exporters facing adjustment costs.
- Insurance and reinsurance pools, backed by development banks, can cover climate-related export disruptions.

This financing logic reflects Stern's (2007) insight that upfront investment in mitigation and adaptation yields long-term welfare gains – effectively treating ecological stability as capital formation.

Balancing precaution and proportionality

A recurring tension in trade governance is whether to apply the precautionary principle (restrict potentially harmful trade until safety is proven) or to maintain the onus of proof on regulators (allow trade unless harm is demonstrated).

For climate-linked trade, the answer must be context-dependent:

- When environmental harm is irreversible (eg. deforestation, biodiversity collapse), the precautionary principle should dominate.
- When evidence is ambiguous but reversible, proportionality and due process should guide policy, ensuring restrictions are temporary, targeted, and reviewable.

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This pragmatic balance is consistent with WTO jurisprudence and EU environmental law, allowing environmental ambition without violating the principle of open trade.

Towards a resilient global trade system

COP30 has reframed trade as an instrument of planetary stewardship. The challenge for policymakers is not to reach universal agreement on the exact 'price' of carbon, but to build rules that function amid disagreement – rules that redistribute fairly, evolve adaptively, and reflect long-term ecological value.

Trade must now serve as a channel for managing uncertainty, not amplifying it. That means institutionalising precaution, embedding redistribution, and rewarding participation in coalitions of the willing.

The 2026 US G20 presidency will test whether an 'America First' mindset can evolve into 'Earth First Trade' – one that recognises that in an interconnected economy, the health of global trade depends on the health of the planet. ■

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This article was originally published on VoxEU.org.

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Balancing profit shifting and investment

The GMT represents the most ambitious international effort to curb profit shifting to tax havens. Katarzyna Bilicka, Michael Devereux and Irem Güçeri argue that profit shifting doesn't just affect tax revenues, it alters investment incentives, creating fundamental trade-offs that cannot be ignored

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President Trump's second-term tax agenda has already reshaped the global fiscal landscape – most notably through the passage of the 'One Big Beautiful Bill Act' (OBBBA) and a sharp, if legally contested, escalation in tariff use. But arguably the most consequential change for the structure of the international tax system has been his decision to withdraw the US from the multilateral agreement, negotiated by more than 140 countries under the OECD's Inclusive Framework, to introduce a 15% global minimum tax (GMT) on multinational enterprises (MNEs).

The GMT represents the most ambitious international effort in decades to curb profit shifting to tax havens. At the time of writing, 57 countries have already implemented measures to introduce the tax, and ten more have implementation in progress[1].

But what, exactly, is at stake – for countries which have introduced the GMT, and for those that have not? How much profit shifting actually occurs? How is real activity affected by taxation, and how does that change when multinationals move paper profits across borders? And how costly are the elaborate tax-avoidance structures that make such shifting possible?

Economists have long debated the magnitude of profit shifting. Empirical estimates date back to Hines and Rice's (1994) work that assumed that the more an MNE grows its profit shifting activities, the more and more costly it becomes to shift the next dollar of profit to tax havens.

Meta-analyses of firm-level studies (Beer *et al* 2019, Heckemeyer and Overesch 2017) suggest that reported taxable profits fall by a little over 1% when the tax rate rises by one percentage point – a modest semi-elasticity. Yet macroeconomic analyses using country-level data (Clausing 2016, Tørsløv *et al* 2022) find far larger responses. Why do the two literatures disagree?

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Our recent research (Bilicka *et al* 2025) helps resolve this puzzle by identifying what has been missing from firm-level studies, namely, a more realistic treatment of global MNEs' tax avoidance practices and acknowledging the large number of multinationals that shift all their profits out of high-tax countries.

These 'full shifters' behave fundamentally differently from firms that shift only part of their profits and ignoring them systematically understates the true scale of profit shifting by roughly half.

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Recognising the importance of extensive margin helps reconcile conflicting evidence, explains why multinationals respond so strongly to tax changes in aggregate, and clarifies the true trade-offs facing policymakers as they reshape international taxation for the 21st century

Treating tax avoidance as an investment

To explore this behaviour, we build a structural model in which each multinational decides not only how much capital to invest in each country, but also how much to invest in a tax-avoidance asset: the firm's internal capability to move profits to low-tax locations. This 'tax avoidance asset' acts as a public good within the multinational: once established, it reduces the variable cost of shifting profit for all subsidiaries worldwide.

The idea reflects companies' real-life policy choices. A company that owns valuable intellectual property might establish a cost-sharing agreement that allocates patent ownership to its Caribbean affiliate. Setting up such an arrangement might be expensive, but once in place, the marginal cost of routing income through that structure is small.

Firms without such capacity face much higher marginal costs and may remain taxable in high-rate countries. Recognising the initial investment into avoidance and its impact on the variable profit-shifting cost changes the predicted responses to tax reforms.

Quantifying fixed and variable costs of profit shifting

Our study distinguishes between fixed and variable costs of profit shifting. Using corporate tax return data from the UK, we estimate that the fixed costs (of setting up the structure) are 1.5% of the true tax base. The variable costs (maintaining it and shifting each additional pound) add another 3%.

These costs vary across firms depending on their business models and opportunities for shifting. For firms with low costs, full shifting is optimal. For others, partial shifting makes sense. And for some, the costs outweigh the benefits entirely. These estimates highlight the significant resources MNEs allocate to tax avoidance – lawyers, transfer-pricing specialists, and complex intra-group arrangements.

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Why focusing only on the 'intensive margin' misses half the story

The standard economic model of profit shifting treats avoidance as a smooth, continuous response: a firm shifts a little more profit when tax differentials widen. Empirical studies using microdata typically estimate this relationship by regressing reported profits on tax rates, implicitly assuming that every firm adjusts at the margin.

In practice, however, many firms report zero taxable profits year after year. There are, of course, business-as-usual reasons for such patterns alongside profit shifting, including true company losses that can be carried over to multiple tax periods.

But even when we account for these 'true' losses, there remains a substantial share of MNEs reporting zero taxable profits persistently. This is because, once a multinational has established the structure that allows them to move profits to low-tax jurisdictions, the marginal cost of shifting an additional dollar may be small.

This pattern – some firms shifting intensively, others completely – creates a wedge between micro-level and macro-level estimates of the semi-elasticity of profit shifting. The latter capture both the intensive response among partial shifters and the extensive decision to exit the tax base entirely. Our goal was to model both margins jointly and quantify the underlying costs that generate such heterogeneity.

Reconciling divergent elasticities: micro versus macro perspectives

The model reconciles the conflicting evidence from previous studies. Using UK tax data, we estimate that a one percentage point increase in the tax rate reduces reported profits by 2.4%. This matches the range of 'macro' estimates, which typically find elasticities of between 2.5 and 5.2 (Clausing 2016, Hines and Rice 1994).

But if we replicate the approach of typical firm-level studies – focusing only on firms with positive taxable income – we get an elasticity of just 1.3, closely matching the consensus from micro studies of around 1.1 to 1.4 (Beer *et al* 2019, Heckemeyer and Overesch 2017). The gap therefore stems from ignoring firms that have exited the tax base altogether.

The investment trade-off

Profit shifting doesn't just affect tax revenues – it fundamentally alters investment incentives. Our model recognises that profit shifting reduces the effective tax rate on capital, and so in turn reduces the cost of capital for investment in real productive assets.

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As a result, multinationals that engage in aggressive profit shifting respond much less to statutory tax rate changes when making investment decisions. A one percentage point tax increase reduces their capital investment by just 0.8%. Firms that don't shift profits respond more than twice as strongly, cutting investment by 1.8%. This happens because profit shifting dampens the tax impact, keeping the effective tax rate low even when statutory rates rise.

Policies that successfully curb profit shifting will raise the effective tax rate multinationals face, potentially reducing investment. We gain revenue and reduce wasteful avoidance costs, but at the price of higher costs of capital and potentially lower investment.

Lessons from the Italian CFC reform

We test our model through a quasi-natural experiment: the 2002 Italian Controlled Foreign Company (CFC) reform, which tightened rules on profit shifting to tax havens. CFC rules operate, for the purpose of our model, in a very similar way to the way in which current minimum tax rules work.

Using a difference-in-differences approach, we find that the reform significantly reduced profit shifting by Italian MNEs operating in the UK. This led to higher reported UK taxable income but had limited short-term effects on investment. These results align with our model's prediction that curbing profit shifting increases the cost of capital for productive assets, potentially dampening investment in the long run.

Policy experiments highlight trade-offs in tax reform

Our framework also allows us to conduct counterfactual analyses of tax policy scenarios, offering insights into the trade-offs faced by governments:

- **Reducing high-rax country rates.** Lowering corporate tax rates in high-tax jurisdictions reduces the incentive for firms to shift profits abroad, leading to increased domestic investment. This comes at the expense of tax revenue collected domestically.

- **Increasing tax haven rates or introducing a global minimum tax.** Raising tax rates in havens curbs profit shifting but may also deter investment in high-tax countries due to higher capital costs. For example, a 15% GMT significantly reduces profit shifting and the wasteful investments associated with tax avoidance networks. This raises global welfare for relatively low rates of GMT such as the currently agreed 15%. But global welfare declines with higher GMT rates due to distortive effects of the tax on investment.

Our findings highlight that the optimal tax policy depends on balancing these trade-offs. For instance, while a GMT creates revenue gains by discouraging profit shifting, its broader impact on productive investment varies across countries.

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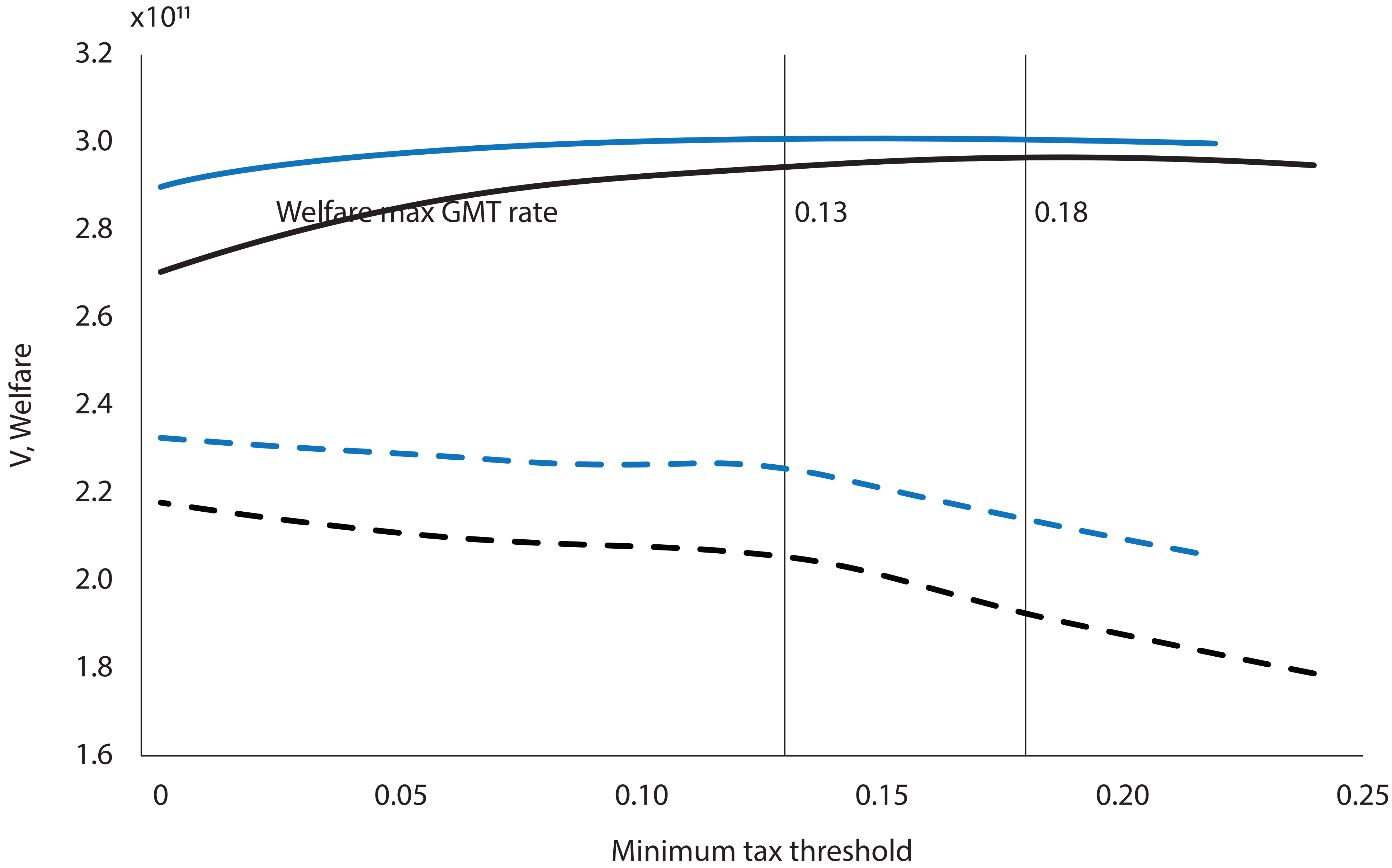
Figure 1. Impact of global minimum tax at varying threshold rates on welfare



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In Figure 1, we demonstrate that there are efficiency gains from introducing a GMT at moderate levels, and that the optimal rate varies depending on the implementing high-tax country's own tax rate. The initial gains for low levels of GMT thresholds arise from the elimination of costly tax avoidance investments. The dashed lines in the figure show the net present value of MNE cash flows (denoted V) and the smooth lines indicate global welfare.

Based on our simple measure of welfare as a tax revenue-investment trade-off, for a country with a 30% home corporate tax rate (the black lines), the optimal GMT rate is 18%, while this rate is 13% for a country with a 20% home corporate tax rate (the blue lines).

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What this means for policy

As countries implement the global minimum tax and debate further reforms, two lessons emerge. First, the scale of profit shifting may be larger than many firm-level studies suggest – perhaps twice as large – and revenue projections based solely on intensive-margin responses will be too conservative.

Second, the connection between profit shifting and investment creates fundamental trade-offs that cannot be ignored. In implementing policies aimed at eliminating profit shifting, policymakers need to balance revenue needs, efficiency gains from reduced avoidance costs, and the effects on real economic activity. Recognising the importance of extensive margin helps reconcile conflicting evidence, explains why multinationals respond so strongly to tax changes in aggregate, and clarifies the true trade-offs facing policymakers as they reshape international taxation for the 21st century. ■

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Endnote
1. See the PwC Pillar 2 Tracker.

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This article was originally published on VoxEU.org.

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