POLICY BRIEF – WP6

TWIN SEEDS

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How the EU can support sustainable Global Value Chains in the New Normal

The EU is facing a very uncertain and tumultuous global economic context. The 'New Normal' which is emerging represents significant shifts in alliances, policy priorities and risks. Decoupling from Russia is almost total; the Trump presidency threatens long standing trade and investment inter-dependencies; the EU-China relationship needs revision to adapt it to this new reality. In this very challenging context the EU is seeking to both develop its strategic autonomy and nurture new economic partnerships to diversify its dependencies. The final work package of the TWIN SEEDS project explored the impacts of these various shifts on Global Value Chains (GVCs). Researchers explored the impact of shifting trade and economic relations on trade, welfare and carbon emissions, at EU, national and regional levels.

This policy brief draws on this extensive research. It outlines the potential strategies for the EU to manage this evolving context which emerge from this analysis. These focus on three critical areas; managing its economic relationships in a pragmatic and informed manner; balancing environmental and competitiveness concerns and supporting the adaptation of EU regions to the new normal context.

MANAGE THE EU'S TRADING RELATIONSHIPS IN A PRAGMATIC AND INFORMED MANNER

1. Adopt a smart mix of responses to the rise in US protectionism

Our research underlines that, in case the Trump administration imposes the threatened tariffs on the EU, everyone will lose. However, the EU reaction can be targeted in a smart way by imposing variable tariffs on the US, rather than blanket retaliation. Our analysis indicates that **retaliation in certain sectors would be more efficient than in others**. For example, imposing tariffs on transport equipment imposes higher costs on the US and has lower negative effects on the EU than the same tariffs on food and agricultural goods.

At the same time, it is important to include all trade in the EU riposte, **including services**, where the US has a large trade surplus with the EU and an important comparative advantage. Finally, the EU needs to be cognizant of **the economic risks associated with the loss of US investment as a result of the government's policy shifts**, both in terms of reductions in productivity and in terms of the capacity to maintain its technological capacity. Certain regions, especially in Spain and Greece, are particularly vulnerable to such effects.

2. Negotiate with China to reduce the disruption caused by US protectionism

The deterioration of the US-China relationship has impacts far beyond the two protagonists. While trade flows are forecast to fall precipitously in both directions, a key risk for the EU is that the loss of the US market results in **trade diversion of Chinese exports to the EU**. Although the overall effect is small (our calculations suggest a 2.2% increase in trade), it is stronger in **certain sectors, with retail, IT and transport equipment increasing by around 3% and mining sectors by 4-5%.** The biggest absolute increases are forecast in retail, electronics and textiles, where the analysis suggests that exports could increase by €858m, €666m and €461m respectively. In these cases, there is a risk that the US-China trade war destabilizes the EU market and undermines the competitiveness of EU producers.

These quantitative assessments can be leveraged in negotiations with China about a reasonable reaction to the Trump ‘disruption’ of the international trading system. One possible response to these challenges could be the agreement of so-called “**voluntary export restrictions**” (VER’s). These were widely used in the past to avoid major trade disruptions including by the US vis-à-vis Japanese car producers in the 1980s as well as by the EU more recently in its bilateral negotiations with China on clothing, footwear and solar panels.

3. **Secure Open Strategic Autonomy while developing a diversified set of trade partnerships**

As the EU seeks to balance the need to increase its autonomy in key strategic goods with maintaining openness, it will need to develop new trade relationships. Although it already has the most widespread set of free trade agreements in the world, **the EU needs to do more to secure its access to markets and key raw materials in a more combative global context**. For example, countering Russian threats requires stronger engagement with the near abroad.

At the same time, the Union has much to lose from the US’s increasingly combative stance and finding alternative partners will not be easy. For example, if the US turns its back on trade integration with the EU, **even increasing integration with a large market like India (through an FTA for example) would only contribute modestly to reducing the economic damage**.

As the EU strengthens its partnerships, it needs to take account of both traditional economic interests and long-term strategic needs. **Traditional FTAs may not always be the best tools to securing the EU’s objectives**. It may be easier and more effective to negotiate novel partnerships like the Clean Trade and Investment Partnerships and sector-specific agreements with key countries.

BALANCE ENVIRONMENTAL AND COMPETITIVENESS CONCERNS

4. **Ensure both consistent regulation and strong electricity decarbonization efforts**

While policy interventions and crises like Covid-19 can result in significant reductions in carbon emissions, they tend to be short lived. Policy design must be sensitive to **this risk of boomerang effects**. In addition, policy needs to integrate the reality that significant variations in carbon emissions across the EU are deeply rooted in economic and social characteristics, such as income distribution, urban/rural form, and lifestyle preferences. Focusing on high-emission spending categories, such as mobility, housing, and diet results in the most important savings across the board. To ensure long-term effectiveness, **policies must send consistent messages to consumers and be complemented by broader systemic changes**. These include investments in public transportation and shared mobility, renovation of existing buildings, and widespread public education efforts to promote low-carbon lifestyles.

The EU has made important steps forward. Our findings underline that policies such as requiring all new cars and vans to be zero-emission by 2035 and incentives to reduce household energy consumption, are essential for meeting the 2050 net-zero objective. However, in countries where electricity generation is still heavily reliant on fossil fuels, the environmental benefits of the electrification of transport are muted. Thus, **ambitious decarbonization of the electricity sector** is vital to ensuring that EU policy efforts achieve their objectives.

In addition, our research confirms that the EU's Recovery and Resilience Facility (RRF) (part of the Next Generation EU package), has implemented several policies through the national energy and climate plans of EU member states, that have proven to be smart investments. This is because the carbon emissions generated by these funds in the short term are relatively insignificant compared to the medium-term emissions reductions achieved through efficiency improvements. Yet this progress may still not be sufficient to meet the EU's commitments under the Fit for 55 package.

5. **Address indirect carbon imports to ensure the effectiveness of the EU's carbon reduction policies**

Our research confirms that **EU efforts to reduce emissions must reach beyond its borders**, including the impact of imported goods from carbon-intensive countries. Mindful of this, the EU has developed a swathe of policies to reduce carbon leakage and ensure that EU industry remains competitive as it transitions to a low carbon economy. Our research on these policies confirms potential positive effects.

For example, we find that the **Carbon Border Adjustment Mechanism (CBAM) leads to modest positive welfare effects for the EU**. Our forecasts suggest that CBAM will result in **an overall reduction of CO_2 global emissions of 0.080%.** This is the result of shifts in demand toward the EU's comparatively cleaner producers and channelling tariff revenues towards mitigation initiatives within the EU. Emissions in non-EU countries fall by 0.14% (especially in countries whose exports are very carbon intensive such as Ukraine, Belarus and Turkey), leading to an **overall decline in carbon emissions**.

6. **Take cascading effects along GVCs into account in the design of EU regulations**

The effectiveness of the EU's policies in support of sustainable GVCs depends on [designing them with GVCs in mind](). CBAM risks penalising downstream tiers of the EU value chain, which will face higher costs for core inputs. There is a risk that exporters of high-carbon goods to the EU will reorient them towards other global producers, that will benefit from lower prices than those in the EU. This will make their final goods cheaper than EU alternatives and undermine the competitiveness of EU producers of certain goods at home and abroad. **The proposal to extend CBAM to a wider range of carbon intensive goods seems vital** to securing its objectives.

Extensive coverage of the value chain is also vital to the effectiveness of the Corporate Sustainability Due Diligence Directive (CS3D). Most risks to labour and the environment are well upstream within the GVC in indirect suppliers and their partners. Thus, **the proposal in** the Omnibus Package **to limit due diligence to direct suppliers in the first tier of the value chain risks increasing the burden on EU producers**, while failing to address the core human rights and climate risks linked to EU consumption. Additionally, although the package aims to simplify EU regulations, enhance competitiveness, and unlock additional investment capacity, it also represents a step backward in the fight against the emissions leakage linked to international trade.

SUPPORT EU REGIONS IN THE TRANSITION TO THE NEW NORMAL

7. **Secure support for regions which risk suffering from the rollback of globalization**

Some regions are particularly vulnerable to disruption of GVCs driven by pressure to reduce global linkages and reshore production. This is both because of higher reliance on trade partners which are decoupling from international linkages and because of varied positioning of different EU regions within GVCs. Certain inter-dependencies are particularly critical. For example, re-shoring strategies pursued by American companies should be monitored carefully, because of **potential adverse effects on EU regions' relatedness to the technological frontier of the value chain**.

In cases where there is a risk of losing core technological capacities, **internal policies will be needed to stimulate technological and knowledge advances of EU companies**. Another alternative is to promote foreign investments from countries with at least the same technological level of the USA. A mix of place-based innovation and educational policies, as well as incentive to capital accumulation may be considered.

8. **Ensure that trade policy choices take account of the heterogeneity of the EU and avoid exacerbating regional inequalities**

EU regions vary widely in their GVC structure, skills mix and trading relationships. As a result, **changes in trading relationships impact differently across the block**. For example, decoupling from Russia and China may have more negative effects on Eastern and Southern regions of the EU, with core regions in Southern Germany and Eastern France faring better. Potential decoupling from the US results in negative effects on GDP across the board, but these are especially high in Ireland, Greece and Portugal.

Conversely, the improvement of trading relationships also has differential effects across the Union. The biggest gains from strengthening of trading relations with India would be seen in German regions, with France and Northern Spain also benefiting. In this scenario, Greece, Portugal and Ireland see the lowest gains. As the EU seeks to expand its trading relationships to balance the deterioration of its relations with the US and other more antagonistic trade partners, it is important that it takes into account these differential regional effects. **The EU needs a balanced set of trading relationships to support EU regions** as they restructure their economic dependencies.

9. **Take account of the spatial implications of the New Normal trade policy.**

Our research indicates that the emerging 'new normal' trade policy of decoupling with antagonistic partners and recoupling with domestic and friendly nations will have **differential effects across the Union.** On the one hand, **second and third-tier city regions tend to benefit from this scenario more than capitals**. One reason why might be related to the geographical distribution of manufacturing headquarters. At least in the context of Western European countries, these are strongly concentrated in second-tier cities (for instance, Turin, Munich, Toulouse, Lyon). This result complements recent findings underlining the relevance of cities as focal points of unequal economic outcomes. It also **confirms the importance of effective regional policies** for both minimizing territorial disparities and enabling the exploitation of local untapped potential.

On the other hand, under this scenario, **regions with a large manufacturing workforce also tend to be associated with better future performance** than those specialized in tertiary activities. This phenomenon is particularly intense in Western Europe. This result is not very surprising, as manufacturing regions would gain from reshoring productive activities. Regional policy should be leveraged to support such transitions and maximize employment benefits.

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