



The European Union in Crisis

What Challenges Lie ahead and Why It Matters for Korea

Edited by
KIM Heungchong and Françoise B. NICOLAS

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**The European Union in Crisis:
What Challenges Lie ahead and Why It Matters for Korea**

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Preface

The EU is currently undergoing serious challenges from inside such as Brexit and strengthening Euroscepticism, rising populism and changing political geography, anti-immigration moods as well as retarded economic recovery. These difficulties are further compounded by global uncertainties, strengthening protectionism and rising tensions between the United States and China. Korea has been severely affected by uncertainties and risks from Europe and the EU as well as those from the global economy.

This volume of research is designed to conduct research that will hopefully illuminate what kind of difficulties the EU is now facing and what implications we can draw for Korea. This book has several features. Firstly, it is a collaborative work by both experts in Europe on each of the issues and those from the Korea Institute for International Economic Policy (KIEP). The authors have made sincere efforts to include all possible contemporary issues observed in Europe and their important meaning to Europe and the world from the experts' viewpoint. Secondly, it offers an opportunity to think over the implications that contemporary European challenges provide to Korea, which, I believe, could arouse interest in Korea and make contributions to Korean Studies in Europe. Thirdly, it focuses on the EU's external relations with the US, China and Korea on top of its challenges, which reflect the changing atmosphere of its relations with the two giants and Korea.

I would like to express my great appreciation for the tremendous efforts taken in the process of publishing the book and for the close cooperation we enjoy between Ifri and KIEP. Special thanks must be given to Dr. Françoise Nicolas, Director of Centre for Asian Studies in Ifri and Dr. Heungchong KIM, senior research fellow at KIEP, for organising the scheme of the research project and managing the whole process. I would also like to offer my sincere gratitude to the European authors for their contributions. Without their active involvement, publication of the book would not be possible. I am happy to say that this research was made possible by funding from the KIEP Europe Monitoring Project.

Korea Institute for International Economic Policy
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Executive Summary

The studies collected in this volume aim to illuminate what kind of challenges the EU and member countries have been facing now, how the challenges are developing, and what kind of implications we can draw for Korea.

Chapter One is an introductory chapter, first highlighting the importance of crises in the EU's development and then identifying the major drivers underlying the current difficulties and assessing how serious they are. Then it suggests what may be the major implications for some of the EU's economic partners, with Korea as a case in point.

Chapter Two talks about the current status of the Brexit negotiations and its impacts on countries such as Korea. The chapter covers the progress of the Brexit negotiations, chaotic status of post-negotiation politics in the UK, possible scenarios of future developments, and the impacts of Brexit on Korea as a case study. The author argues there is a growing probability for the alternative options of "no deal Brexit" or "no Brexit," rather than the existing withdrawal agreement, and points out the numerous areas left by Brexit that will need to be addressed in the EU-Korea FTA and new UK-Korea economic relations.

Chapter Three explores the rise of national populism in contemporary European politics, and the resulting changes in the political geography in Europe. It is very interesting to see how the author argues the current phenomena of rising populism are deep-rooted, much more than a mere response to the 2008 financial crisis, and closely related to the values

divide in contemporary Europe.

The next chapter concerns itself with Franco-German relations, which have been regarded as the motor of European integration. The authors appreciate the unprecedented process of reconciliation between the two countries in the course of European integration, but highlight the fundamental difference between the two countries in fiscal, monetary and defense policies arising from different political cultures. Talking about how the changing geography has placed the two countries into a leading role over the process, they suggest the two countries need to focus on exploring new areas of cooperation – agenda for future challenges in Europe such as digitalization or climate change. This chapter provides ample implications to Korea on how to make regional cooperation work under fierce rivalry and regional dynamics.

In Chapter Five, the author analyses the crisis in transatlantic relations coming into the Trump administration, and its implications for Korea. According to this chapter, the EU has responded to the protectionist approaches by the US by promoting cooperation with the US against China, staying with the US in the WTO and multilateralism, and the proposal of new trade agreements with the US and other countries. As the protectionist measures proposed by the US grow out of a prior history extending before the Trump administration, the tension is likely to last longer. The author concludes with some implications for Korea's trade policy.

Chapter Six covers China and the EU from the perspective of trade and investment. Although the two giants have achieved excellent performances in economic relations over the past several decades, tensions from China's aggressive investment strategy to Europe have been arising. The author argues that Brexit would lead to the UK's approach to the US rather than China, and that Korea would benefit from the geo-economic upheaval resulting from Brexit.

In Chapter Seven, the author explores the recent history of economic relations between the EU and Korea. The author examines the impact of the EU-ROK FTA on trade relations and elaborates on the reason why the trade structure suddenly changed after the FTA. The author argues that is not only the result of tariff and non-tariff barriers elimination, but also of sluggish demand from the EU following the economic crisis in Europe, expanding value chains with third countries by Korean giant companies, and so on. The author also argues that the EU-Japan EPA, recently signed and about to enter into force in early 2019, will have a substantial impact on the EU-Korea trade relations, as Japan and Korea are competing in many industries.

Chapter Eight examines the prospects of the EU regime and its implications to Korea. The authors talk about recent challenges in the EU such as its ageing society and enlargement process, together with other issues discussed in previous sections, which may have great impacts on discussions of the future of the EU. Then, the authors introduce

recent developments toward the future of the EU led by the EU institutions and other players in Europe. Finally, the authors present the implications the EU holds for Korea, and the third countries located in East Asia, making for rare observations to Europeans.



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Chapter 1



Introduction

**The European Union under Stress:
Why It Matters for South Korea**

*KIM Heungchong (KIEP)
Françoise B. NICOLAS (Ifri)*

- 
1. A bumpy road to economic integration
 2. Why this time is different
 3. Why all this matters for Korea
 4. The structure of the book

Undeniably, the European Union (EU) constitutes one of the main success stories of the past six decades. From the Treaties of Rome (1957) through the Single European Act (1986), the Maastricht Treaty (1992) and to the Lisbon Treaty (2007), Europe moved gradually but unambiguously towards closer economic integration. Arguably the most impressive achievement of the EU countries is the creation of the largest and most open common market in the world, backed up by a common currency (the euro).

Despite this unquestionable success, the EU is currently going through an area of serious turbulence and its difficulties are further compounded by a context of global uncertainties and rising tensions between the two other great global players, namely the United States and China. As one major partner of the EU, South Korea (hereafter Korea) is likely to be directly affected by these developments.

The objective of this introductory chapter is twofold: as a first step, it will put the current EU crisis in a longer-term perspective, highlighting the importance of crises in the EU's development. As a second step, it will seek to identify the major drivers underlying the current difficulties and assess how serious they are. As a conclusion, the paper will suggest what may be the major implications for some of the EU's economic partners, with Korea as a case in point.

1. A bumpy road to economic integration

Although European economic integration is often thought to be the result of a steady and continuous progress towards an ever closer union, with national competences being increasingly transferred to the Union, the reality is somewhat different. European integration is actually better described as an iterated process of dealing with recurring difficulties. Jean Monnet, one of the EU founding fathers, once wrote in his Memoirs: "Europe will be forged

in crises, and will be the sum of the solutions adopted from those crises.” Although this may be something of an exaggeration, there is no denying that Europe has had to weather a number of crises throughout its more than six-decade long history. Interestingly, more often than not, the European integration process seems to have regained momentum every time it was faced with difficulties.¹⁾

In addition to micro-crises (which often broke out on the occasion of a summit as a result of disagreements between the major member-states, such as the appointment of the first president of the European Central Bank in 1998 for instance), larger crises have marked turning points in Europe’s economic integration dynamics.

One first such defining moment dates back to the late 1970s. At that time, the countries forming the European Communities were faced with economic difficulties resulting, among other things, from the two oil-shocks. This period of low economic growth associated with high unemployment in Europe came to be known as “eurosclerosis”.²⁾ In addition to economic stagnation, it was also perceived as a period of stagnation of European integration. This stagnation period was brought to an end by the 1986 Single European Act (SEA),³⁾ which gave renewed momentum to the drive toward integration by framing the single market of the EEC. The objective of the SEA was to create a single continental market by 1992 as a means to secure

1) The “moving through crisis” narrative is challenged by some authors such as Parsons and Matthijs (2015). The point made in the present paper is not so much that European integration could not have gone forward in the absence of crises nor that it was exclusively the result of quick fixes to pressing problems, but that periods of difficulties provided opportunities to give new momentum to the integration process, in particular by accelerating the implementation of already agreed upon provisions or by pointing to the need for some institutional innovations.

2) This is a term coined by German economist Herbert Giersch to describe the pattern of economic stagnation (with high unemployment and low growth) in Europe in the 1970s.

3) Interestingly the revival of the process of European integration was accompanied by Franco-German rapprochement, a precondition for any new European initiative.

prosperity. The economic logic underlying the project was to exploit economies of scale provided by the EU's single internal market so as to achieve greater economic efficiency.

A second such watershed moment occurred in the wake of the European Exchange Rate Mechanism (ERM)⁴ crisis in 1992. This crisis (which took the form of speculative attacks on all European currencies – with the exception of the German Mark and Dutch Guilder) was brought about by the divergence in economic situations among European economies that resulted in a tension between the monetary stance in Germany and in the rest of the countries participating in the mechanism. This led to a widening of the fluctuation margins (which constituted a dismantlement of the ERM in everything but name) and to the exit from the mechanism of some currencies such as the pound sterling or the Italian lira.

Although the monetary union (which was to give birth to the introduction of a single currency on January 1st, 1999) was already under way at the time of the crisis, the latter acted as a wake-up call for the participating countries, pointing to the importance of economic convergence as a prerequisite for the smooth implementation of a single currency.

As a final example, the recent euro-crisis (or rather the series of crises which spread throughout Europe in the wake of the Greek crisis) provided again an opportunity to go one more step towards closer integration. By laying bare the fault lines of the EU, the crisis acted as a *de facto* catalyst for the acceleration observed ever since in the pace of reform of EU's governance. Following the euro-crisis, discussion started about the conditions for the establishment of a banking union, while progress was made in terms of fiscal coordination as well as in the way the European Central Bank operates (by being allowed in particular to buy sovereign debt).

Crises seem thus to be an inherent part of the European integration

4) The ERM was the major component of the European Monetary System that was put in place in 1979 as a way to reduce exchange rate variability and achieve monetary stability in Europe.

process. But it remains to be seen whether the crisis that the EU is going through today will again provide an opportunity for further progress and will help bring European countries one step closer to a fully-fledged economic union.

The following section provides an assessment of the various drivers behind the current crisis and suggests that it may be more serious than the previous ones for many reasons having to do with the combination of internal and external factors.

2. Why this time is different

The difficulties the EU is faced with today are multidimensional and more acute than ever. A particularly important point is that they result from the combination of internal and external factors. These two sets of factors will be examined in turn.

Internal issues include the Brexit, the rise of anti-EU populist movements in many European countries, and not only at its “borders”, as well as the deterioration of the Franco-German cooperation. All these issues necessarily impact the way the EU operates and its ability to deal with external partners, but more fundamentally they are leading to an identity crisis within the Union. Beyond the economic impact of these difficulties, there is a more fundamental questioning of the objective of the integration process and one may fear that the sense of purpose may have been lost.

The major external factors impacting the EU are pressures from two of its trading partners, namely the US and China.

2-1. Internal tensions

Brexit. The first challenge with which the EU is confronted today is the decision made by the British people through a referendum in June 2016 to leave the EU. This result came as a shock for most observers. It had been anticipated by very few analysts, but more importantly it gave an unprecedented blow to the EU; while it had experienced a series of enlargements so far (with the number of member countries rising from the initial six to twenty-eight), it is the first time that a member state had decided to leave the group, pointing to the loss of attractiveness of the European project.

The key challenge is to find a deal that would satisfy all parties. In the absence of a deal, the conditions for trade between the EU and the UK would be the non-preferential WTO terms (most-favoured nation basis), leading to substantial costs primarily for British companies, but not only.

Actually, the impact will also be substantial for external partners such as Japan or Korea. By way of illustration, Seoul and Tokyo have long seen London as their primary partner in Europe. Not only have Japanese and Korean companies invested heavily in Britain as a gateway to the EU market, but also the two governments often relied on London as the principal interlocutor when dealing with EU and Europe matters, before Brussels has emerged to be the growing key player in the EU. Put simply, Brexit means that Korean and Japan will lose Britain as its gateway to the EU both in economic and political terms.

Even after Brexit, however, the UK as a country will remain a major player on the world stage. Furthermore, it seems clear that London will need non-European partners more than ever before. The problem, however, will be to define a new framework for the bilateral relationship. Of course this will be highly dependent on the outcome of the Brexit negotiation and on the nature of the deal passed between the EU and the UK. It is thus of utmost importance for partners such as Korea to be fully aware of the

opportunities.

Quite naturally, external partners will no longer be able to use the UK as their main gateway to Europe once it leaves the EU and they will have to find alternatives, with Germany and/or France as the biggest and most obvious candidates to replace Britain.

Rise of populist movements/parties. This development is not specific to the EU but it has been a rising trend in the EU as well. The EU is increasingly seen as an agent of unfettered globalization, linked with many negative developments related to globalization. As is also the case in other parts of the world, waves of populist movements force political leaders to promote more unilateral, nationalist and protectionist policies.

Within Europe, the rise of such populist movements (be they on the right or on the left side of the political spectrum) can be observed in a number of countries, and not only in the “border areas” of the Union, namely the Central and Eastern European countries which joined the Union relatively recently (Hungary and Poland being good examples). The rise of populism can also be found in some of the founding father countries, in particular Italy, but also, albeit to a lesser extent, France and Germany.⁵⁾ Although these movements may differ widely across countries they all have in common an anti-globalization, anti-establishment and anti-élite stance. From the perspective of the EU, the challenge comes from the fact that the rise of such illiberal regimes is no longer in line with the major values on which the EU is founded, such as respect for human dignity and human rights, freedom, democracy, equality and the rule of law. In Italy for instance, where the situation is perhaps the most dramatic, the rise of populism has given rise to an unlikely coalition between the far-right (Northern) League and the post-ideological Five Star movement. The programme the two partners put forward is a bizarre mix of neoliberal policies and social protectionism with

5) The far right Alternativ für Deutschland (AfD) has successfully entered Bundestag with 94 members in 2017 federal election.

some policies defying EU rules. While the coalition is unlikely to push for Italy's exit from the EU, it is likely to challenge Brussels' economic and social policies and to normalise a dangerous form of populism and what may be called "a dystopian social contract". Recently, tensions between Italy and the rest of the European Union have ratcheted up over the Italian budget, with EC Commission President Juncker warning that "further special treatment" from the EU Commission regarding Italy's budget could precipitate the country into a Greek-style crisis and threaten the entire bloc.

Behind the rise of these populist movements, we may observe the emergence of a two-speed Europe, with those not afraid of globalization nor of their neighbours on the one hand, and on the other hand those who feel less well prepared to face globalization and thus choose to turn inward.

The Franco-German engine stalls: At the same time, the EU is also faced with difficulties in one of the two major founding fathers' countries, namely Germany, with Chancellor Merkel's political capital badly weakened in the wake of disastrous regional election results in Bavaria and Hesse for her party (the CDU). Obviously the weakening of German leadership has an impact on the Franco-German "couple", which has been seen as the major engine of European integration. Absent a well-functioning such couple, the EU has difficulties moving forward.

Given the current situation, the Franco-German dialogue has become increasingly complicated. Moreover, both countries do not see eye to eye on a number of issues and persistent disagreements between the two partners do not bode well for the future of European economic integration.

Internal disagreements have in the past affected the EU's position and the rest of the world's perception of the EU. The veto of the Belgian region of Wallonia to the EU-Canada Comprehensive Economic and Trade Agreement (CETA) for instance affected the EU's credibility as a trade actor. But this time, the internal tensions are much more substantial and challenge the very ability of the Union to act at all.

These recent political developments constitute a huge challenge for the Union as they tend to question the very nature of the Union. The gains from the EU are less and less clear; far to the contrary the EU increasingly appears to be associated with costs and unable to protect the interests of its people.

In other words, all the developments highlighted above are likely to raise some fundamental questions about the Union's credibility as an international actor and to inflict (further) reputational damage to the EU both within and outside Europe. These internal weaknesses are all the more dangerous since the Union is faced simultaneously with external challenges.

2-2. External challenges

Migrant crisis: On top of these purely internal issues, migratory movements further compound the difficulties the EU is facing today. To be sure, the source of Chancellor Merkel's recent difficulties is to be found, at least in part, in the response she gave to the recent migrant crisis (2015 onwards). This crisis poses possibly the most serious threat to the EU's existence since it was established, as nationalistic currents challenge the very roots of the European post-war dream of unity through cooperation and dialogue on shared interests. Without a doubt, the huge influx of refugees poses a more daunting problem to the EU than the fall of the Berlin Wall or the Eurozone debt crisis.

The rise of populism highlighted earlier is also apparently associated with the perceived threat coming from a large influx of migrants. Radical right parties are opposed to immigration and the policies of the EU on this issue which they deem unwise.

As if the EU did not have enough to do with problems in its immediate neighbourhood, the behaviour of its two largest partners (China and the US) has also become increasingly challenging.

The rise of China's assertiveness, in particular through the Belt and Road

Initiative (BRI) calls for a well-coordinated response on the part of the EU, but this is no easy task given the wide divergence of views within the EU with regards to the Chinese initiative. The initiative, launched in 2013 by President Xi Jinping, aims at connecting China to the rest of the world (Europe, Southeast Asia, the Middle East, Africa and even Latin America) through the development of hard infrastructure (roads, railway lines, etc.) but also of soft infrastructure (such as norms and standards). In other words, the objectives of the initiative are more ambitious than is often claimed and are geostrategic in nature.

The diverging views prevailing in Europe are made even more problematic as China has engaged sixteen Central and Eastern European countries (eleven EU member states and five Western Balkan countries⁶) under the so-called 16+1 cooperation format. The 16+1 format is an initiative by China aimed at intensifying and expanding cooperation with these 16 countries in many fields spanning investments, transport, finance, science, education and culture. Although the format is officially a multilateral approach, in reality it has remained largely bilateral in nature, with China keeping the upper hand. The 16 countries are seen by China as a bridgehead for the implementation of its BRI in Europe.

More importantly, while China refuses to admit that it is adopting a divide and rule strategy, there is no denying that for the EU as a group, the 16+1 format constitutes a threat to its political unity and to its normative influence on the Central and Eastern European countries. To be more specific, given the rising importance of the immaterial dimension of the BRI, China is in a much better position to impose its own norms and standards in countries over which it has managed to exert an influence.

President Trump's unpredictability. Since he took office in January 2017,

6) These are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Montenegro, Poland, Romania, Serbia, Slovakia, and Slovenia.

President Trump has made many moves that he had announced during his campaign – including the renegotiation of NAFTA and the Korea-US FTA, and withdrawal from the Trans-Pacific Partnership (TPP), a trade alliance negotiated with eleven other economies located along the Atlantic or Pacific Oceans, including Japan – but he went even further in a number of cases where nobody could have anticipated his approach, slapping prohibitive tariffs on many imported goods in an official attempt to maintain employment at home. President Trump’s withdrawal of the US from the Paris accord on climate change and from the TPP reflects an inward looking strategy supposed to help achieve the President’s objective to “make America great again”. For traditional allies such as the EU, this change in policy orientation is not easy to accommodate. Moreover, as much as his disruptive trade policies, President Trump’s unpredictability is a challenge for his long-time partners. On the latter point, for instance, President Trump is not exclusively focusing on China in his aggressive protectionist policy; his allies are not treated differently. Also his usual turnabouts blaming all of America’s problems on China and its president on one day, and calling the latter “a fantastic guy who is truly my friend” the following day are not easy to anticipate nor to decipher. In these conditions the definition of a proper US policy is particularly difficult for the EU.

3. Why all this matters for Korea

Under the circumstances described above, it is increasingly clear that the challenges the EU is now facing will be difficult to solve in a short-term. The 2019 European Parliament election will surely show increased political fragmentation with much growing power shift toward Eurosceptics. Although Germany’s stance toward the EU will remain unchanged, Angela Merkel’s fading power will make it harder to keep Franco-German relations effective

under very demanding circumstances. Brexit, still an on-going process, will cast a fundamental doubt on the future of the European integration, whether or not the process is proceeding smoothly and favorably. All in all, it will be imperative for the EU to tackle the rising problems from a long-term perspective, recognizing that the challenges are developing and evolving rather than likely to fade out anytime soon.

Worse than that, the adversities surrounding the EU make it difficult to maintain a consistent external policy direction. The EU used to be seen as a traditionally reliable partner for its partners, but the current trouble it is going through is creating anxiety among its partners. Consequently, it is getting more difficult for the partners to establish consistent, stable and future-oriented relations with the EU. Korea is no exception in this regard. Observing how uncertainties from internal and external challenges prevail throughout Europe, Korea, one of the strategic partner countries of the EU, has no choice but to remain in an ambiguous situation where it waits to see what will be done in Europe and the EU tomorrow. This is a bad situation for both the EU and Korea, because they are now closely interrelated not only in the bilateral economic sphere but also in terms of various multilateral relations in political, security, socio-economic areas and even in normative ones.

Since 1963 when Korea and the EU established diplomatic ties, the relations between the two have experienced unprecedented changes. First of all, the trade volume between Korea and the EU increased by 324 times over the period 1971–2017. Korea's exports to the EU and its imports from the EU increased by 621 times and by 223 times respectively over the same period. Korea ranks number 8 in terms of exports and imports of EU's trading partners, which makes Korea the third largest trading partner of the EU in Asia. The EU is the largest investor in Korea, and in turn, Korea has been one of the major investors in the Central and Eastern member countries of the EU since 2004.

The economic relations between the two have been better shaped in qual-

itative terms as well as in quantitative terms. The initial period of Korea-EU relations, marked by the EU's non-reciprocal preferentiality, has changed into one of reciprocity. Clear convergence, not only in income levels⁷⁾ but also in fields like regulation and standards, has been observed as well.⁸⁾ In the course of the qualitative process of convergence, the Korea-EU FTA has played a pivotal role. In 2006, Korea became aware that the EU's stance was shifting in favor of a new generation FTA initiative with Korea, a change which Korea welcomed as well. After two years of negotiations beginning from 2007, and another two years to complete the process of finalizing a legally-binding text and gaining parliament approval, Korea and the EU finally implemented the FTA in 2011. This success marks the apex of the economic relations between Korea and the EU, and relations between the two have never been closer.

Due to the strengthened economic ties between the two on top of world-wide globalization and rapidly expanding value chains, turmoils in any part of the EU easily and almost simultaneously transfer to Korea. Think about what happened in Korea when the outcome of the Brexit referendum was released on 24 June 2016. The Korean stock exchange was suspended in the early afternoon of the same day due to a free-fall of stock prices, and KRW-USD exchange rates suddenly skyrocketed. Since the outbreak of the Greek crisis in 2010, the Korean stock exchange and F/X markets had been severely fluctuating at the mercy of any bad news from Greece. Similarly, if the "no deal" scenario prevails for Brexit in March of 2019, it is obvious that the Korean economy will be hit hard again. Any risks and uncertainties in Europe have become not only *their* problem but also *Korea's* problem.

This is not the whole story, however; there are other reasons why the EU

7) Twelve member countries of the EU surpassed Korea in terms of GDP per capita in current prices in 2017, while Korea outdoes the remaining sixteen members. – IMF World Economic Outlook 2018.

8) For more detailed history of the development in the Korea-EU relations, see Kim H. (2013).

matters for Korea. For the last sixty years, European integration has been regarded as the best example of regional integration. People in the world including Koreans have been watching the process of European integration with admiration, as Europe has conducted gradual power transfer from nation states to supra-national entities in a peaceful manner. The EU institutions have been successful in securing exclusive competence through establishing common policies such as commercial, agricultural, fishery, and competition policies, and in expanding the areas of shared and supporting competences. Sometimes multi-speed approaches, interpreted to be a more flexible and practical way, were applied in achieving monetary union and signing the Schengen Agreement. It is a success story for all who support regional integration, not just the EU.

In this sense, it is very surprising and even painful to observe that populist parties who represent anti-EU, anti-immigration, and chauvinistic nationalism, are gaining ground, and even grasping political power in Europe. In Italy, a so-called “anti-establishment” party and a “far right” party embarked on a coalition government, and member countries including France, Germany, the Netherlands, Austria, Sweden, and Denmark witness rapidly rising supporting rates in favor of anti-EU parties. In the UK, the British people directly expressed their willingness against the EU through referendum.

These are all disappointing stories for Korea. The Republic of Korea, located in the southern part of the Korean Peninsula in Northeast Asia, has long advocated initiatives of regional cooperation and integration to secure peace and prosperity in the region. In particular, Korea, one of the two countries on the divided Korean Peninsula, has expressed its keen interest in the role of European integration in the unification process of Germany. It is inspiring for a country who takes the grand project of unification as an ultimate goal, to study how Germany created a favorable environment for unification by firm committing itself to European integration. This is another

reason why the EU matters for Korea.

As a matter of fact, Germany has been successful in erasing the German problem,⁹⁾ and thus in re-unifying the country in 1990, by persevering toward European integration. Germany has made tremendous efforts to persuade neighboring countries that it would do its best to support and contribute to the project of European integration. Germany has been one of the key engines of European integration. It has shown its firm commitment to an ever-closer Union in the form of financial and non-financial support. But now we observe fading optimism on European integration in Europe, which casts a fundamental doubt on regional integration in East Asia. The dream to achieve close regional cooperation and integration in East Asia is losing momentum recently, which is filling many Koreans with unease because it indicates that Germany's path toward unification through regional integration may not be applicable for the case of Korea any longer.

In addition to regional integration, Korea has sought to find many useful lessons from the EU and Europe on emerging challenges in the course of development, as European countries have already experienced many challenges ahead of Korea, being successful sometimes and in others not so successful in solving them. One of the most important agenda on these lines is the welfare state. Many Western European countries established welfare states throughout the golden era of the 1950s and 1960s, and since then have maintained the basic framework despite the gradual failure of past models under the economic difficulties of the 1970s and 1980s. Coming into the 1990s, rapidly emerging challenges such as widening income disparity, globalization, and economic crisis hit the complex fabric of the societies and

9) Should a state be created in Europe which covers a substantial part of the areas where the German language is spoken, the country may become too big, too powerful, and thus too dangerous to exist in Europe. It would violate the balance of power in Europe, and thus pose a big threat and problem to other European countries. This has been a chronic concern raised by neighbor European states since the early 19th century.

emerged as top priorities in the national agenda of many European countries. A wide range of social discourse between the stakeholders in society was followed by reforms in the welfare systems of many countries. The issues of ageing societies, pension crisis, sluggish productivity growth and frozen wage levels especially for the unskilled were added to the existing list of challenges, most of which Korea is now facing.

Korea has sought to identify the success and failure of these agenda from the case of European countries. The current crisis born out of economic and welfare conundrums observed in many Western societies has cast rather pessimistic views on the state of the welfare system. Growing reservation and opposition to the free movement of people, one of the basic principles of European integration, has been one of the driving forces toward anti-immigration sentiment, Brexit, and the rise of populist parties. Korea is very keen to watch how these problems will develop and how the EU and member countries will solve them, as, again, this is not their problem, but Korea's problem or problem-to-be.

4. The structure of the book

Against this backdrop, this volume aims to illuminate what kind of challenges the EU and member countries are currently facing, how these challenges are developing, and what kind of implications we can draw for Korea.

In Chapter Two following this introduction, Elvire Fabry talks about the current status of the Brexit negotiations and its impact on other countries, most notably Korea. The chapter covers the progress of the Brexit negotiations, chaotic status of post-negotiation politics in the UK, possible scenarios of future developments, and the impacts of Brexit on Korea as a case study. The author argues that there is a growing probability for the alternative options of a “no deal Brexit” or “no Brexit” rather than the existing

withdrawal agreement, and that Brexit leaves many issues to address in the EU-Korea FTA and the new UK-Korea economic relations in the near future.

Chapter Three explores the rise of national populism in contemporary European politics, and the resulting changes in the political geography in Europe. It is very interesting to see how Matthew Goodwin argues the current phenomena of rising populism are deep-rooted rather than a sheer response to the 2008 financial crisis, with these closely related to the values divide in contemporary Europe.

The next chapter addresses Franco-German relations, regarded as the motor of European integration. The authors appreciate the unprecedented process of reconciliation between the two countries in the course of European integration, but highlight the fundamental difference between the two countries in their fiscal, monetary and defense policies arising from different political cultures. Talking about the changing geography that has led to the two countries taking the lead over the process, they suggest the two countries need to focus on exploring new areas of cooperation – agenda for future challenges in Europe such as digitalization or climate change. This chapter provides ample implications to Korea how to make regional cooperation work under fierce rivalry and regional dynamics.

In Chapter Five, Iana Dreyer analyses a crisis in transatlantic relations in the Trump administration and its implications to Korea. According to this chapter, the EU has responded to protectionist approaches by the US in many ways, such as cooperating with the US against China, staying with the US in the WTO and multilateralism, and proposing new trade agreements with the US and other countries. As the protectionist measures proposed by the US are grounded in a history extending before the Trump administration, the tension will last longer. The author concludes with some implications for Korea's trade policy.

Chapter Six covers China and the EU in trade and investment. Although

the two giants have achieved excellent performance in economic relations over the several decades, tensions from China's aggressive investment strategy to Europe have been arising. The author argues that Brexit would lead to the UK's approach to the US rather than China, and Korea would benefit from the geo-economic upheaval from Brexit.

In Chapter Seven, Françoise Nicolas explores the recent history of economic relations between the EU and Korea. The author examines the impact of the EU-ROK FTA on trade relations and elaborates on the reason why the trade structure suddenly changed after the FTA. She argues this is not only the result of tariff and non-tariff barriers elimination, but also of sluggish demand from the EU following the economic crisis in Europe, expanding value chains with third countries by Korean giant companies, and so on. The author also argues that the EU-Japan EPA, recently signed and about to enter into force in early 2019, will have a substantial impact on the EU-Korea trade relations, as Japan and Korea are competing in many industries.

Chapter Eight examines the prospects of the EU regime and its implications for Korea. First of all, Heungchong Kim and H. Jean Lee talk about recent challenges in the EU such as its ageing society and enlargement process, together with other issues mentioned before, which may have great impacts on discussions concerning the future of the EU. Then, the authors introduce recent developments toward the future of the EU at the EU institutions and other players in Europe. Finally, the authors argue the implications the EU offers to Korea, the third countries located in East Asia, making for rare observations to Europeans.



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Chapter 2



Brexit: the Knowns Amongst the Unknowns

For the UK, the EU and Third Countries,
notably South Korea

Elvire FABRY (Jacques Delors Institute)

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1. Introduction
 2. State of play of Brexit negotiations
 3. Potential scenarios for EU FTAs' transition
 4. A case study:
 - Prospect for South Korea trade relations with the EU and the UK
 5. Conclusion

After months of struggle between the EU 27 and the UK over the terms of a withdrawal agreement, proceeding to an orderly Brexit remains very challenging. By ruling out any cherry-pick between rights and obligations of EU membership, the EU has restrained available options for the future relationship. Yet, British political parties remain very divided on the priorities of Brexit. With no clear majority for any scenario, the process is held hostage to the British political spasms and the probability for a “no deal” or a “remain option” increases.

To assess the impact of Brexit on the UK, the EU and trade relations with third countries, this paper starts thus by analysing the state of play of negotiations at the end of 2018 and remaining post-Brexit scenarios. It then scrutinises the stumbling blocks on the road to an autonomous UK trade strategy, notably the possibility for the UK to negotiate a transition for EU FTAs. And finally, it focuses on the impact of Brexit on South Korea’s trade relations with the EU and the UK: a case study which provides with a useful reference for the prospect of a “Global Britain”, as South Korea is the kind of export led economy cherished by Brexiters and can be considered as a peer trading partner.

1. Introduction

The first-ever withdrawal of a member state since the European Union’s inception raises a multitude of technical and legal issues, as much for the United Kingdom (UK) and the European Union (EU), as for third countries with which the UK has to renegotiate at least 759 agreements.¹⁰⁾ It is, in ad-

10) These 759 agreements include 295 bilateral trade agreements, 202 regulatory cooperation agreements (ranging from competition policy to data sharing), 69 agreements concerning fisheries, 65 on transport (mainly aviation), 49 on customs controls, 45 on nuclear power, and 34 on agriculture (McClellan 2017).

dition, complex to agree on the future relationship between the UK and the EU considering the conflicting motives of the referendum vote in June 2016. Beyond popular scepticism towards the European integration, the immigration of Eastern European citizens, the financial contribution to the EU budget, there is the EU's infringement upon the British sovereignty. But the willingness to recover sovereignty is twofold. By withdrawing from the EU, some Brexiters want to pull away from ever more interdependence, as much from the EU as from globalisation. While for others, Brexit will allow to engage more actively in globalisation, without what they identify as EU constraints. They look forward to shaping a "Global Britain" with an autonomous trade strategy, which will be "more ambitious" than the EU trade strategy.

To deal with this complex negotiation and facilitate an orderly Brexit, the EU has imposed a sequencing of the process – first the Exit is to be discussed and then the post-Brexit. On November 25, 2018, after months of struggle and delay, an agreement has been signed on a withdrawal deal including the terms of a transition period which will leave time to negotiate the future new relation.

However, at this stage, we remain in very turbulent Brexit waters, with the withdrawal deal and the negotiation on the future UK-EU relationship held hostage to the British political spasms. The UK should exit the EU on March 29, 2019 – two years after the UK triggered article 50 of the TEU – but British political parties remain divided on the priorities of Brexit and crashing out with no deal is still possible, if the deal does not pass the decisive test of a vote in the House of Commons. It would be the most chaotic scenario.

The most contentious issue in the withdrawal negotiation was to agree on a backstop solution preventing the return of a border and potential conflicts between Northern Ireland and the Republic of Ireland, if in the end the post-Brexit deal does not provide an efficient alternative solution. Like all the previous proposals of backstop, the option put forward in the with-

drawal deal would have strong implications for the whole UK and has provoked immediate negative reactions from all sides of the British political spectrum and increased tensions within the political parties.

At the time of writing this paper, there are still a lot of moving pieces and uncertainty as to how things might play out. Whether the withdrawal deal is voted or not, and whatever interpretation is given to the political declaration setting out the framework for the future relationship between the UK and the EU, there is still room for diverse scenarios. We can thus usefully explore the many potential outcomes of this Brexit conundrum and in particular its impact for third countries.

For trade partners, the attractiveness of the post-Brexit UK depends, first of all, upon the new EU-UK relationship agreed to, in other words on the loss of access to the European market that Westminster is ready to accept in exchange for a restored British sovereignty. The closer it remains to the Single market, the more attractive it remains.

For many years the UK has been considered by third countries as a gateway to Europe offering competitive advantages to international firms and it has been appealing for inward foreign direct investment (FDI). The weight of the UK's economy on "the day after" will thus be directly downgraded from the world trade "premier league" – the US, the EU and China – to the second division trade powers.

After exiting the EU in 2019, the UK will only represent 2.19% of global GDP, and it will hardly remain the sixth largest economy in the world (after India),¹¹⁾ representing 1.9% of global trade in goods and 4.9% in global trade in services. Meanwhile, the EU, with or without the UK, should remain the world's second largest economic power after China in terms of GDP (on a PPP basis). Together, China, the EU (minus the UK) and the USA, com-

11) The UK and the France remain shoulder to shoulder in the global economic ranking (IMF 2018). https://www.imf.org/external/datamapper/PPPSH@WEO/OEMDC/ADVEC/WEO_WORLD/GBR.

mand 48% of the global GDP (PPP),¹²⁾ 42% of global trade in goods (not counting internal EU trade), and 43% of global trade in services.

Whatever successful economic policies conducted, the UK will have lost bargaining power in its trade negotiation with third countries, notably with the three big powers: the EU, the US and China. Exploring the feasibility of an ambitious “Global Britain” after Brexit is even more complex at a moment of strong turbulences in global trade with Donald Trump’s offensive protectionism and the rising risk of a global trade war.

As the future EU-UK relationship will have a strong impact on UK trade relations with third countries, the paper starts by assessing the state of play of EU-UK negotiations. It then analyses the stumbling blocks on the road to an autonomous UK trade strategy and finally provides an assessment of the potential impact of Brexit on a specific case study, the EU-South Korea FTA. A closer analysis of this FTA is indeed particularly interesting, not so much because South Korea (ROK) is the first Asian country with which the EU implemented a trade agreement in 2011, but because South Korea’s economic development is based on the kind of export-led, hi-tech, skills-based economy cherished by Brexiters. Its booming economy which managed to maintain a 3% GDP growth in 2017 has allowed an improvement of standards of living at a very high speed although – a key point for Brexiters – South Korea is not part of a major trading bloc¹³⁾ and has no access to natural resources of its own. Beyond the very important and sustained investment in education and skills, this achievement could be attributed to the implementation of a series of ambitious bilateral agreements,¹⁴⁾ allowing South Korea to trade actively with the most important economies in the world. South Korea is notably the only OECD country which has trade deals with

12) Idem.

13) South Korea is considering joining the TPP (Trans-Pacific Partnership) and it is part of the RCEP (Regional Comprehensive Economic Partnership) negotiations.

14) With the EU in 2011, with the USA in 2012, China in 2015, Canada in 2012, Australia in 2015.

the three major trade powers (EU, USA and China). Brexiters could thus consider South Korea as a role model for the post-Brexit period.

In addition, after Brexit, the UK will be a second-tier economy like South Korea. Its expected 2.19% of global GDP (PPP) in 2019 would get closer to the current 1.58% of global GDP (PPP) of South Korea. The UK's combined trade volume (exports plus imports) in goods and services in 2016 reached €1.700bn and is as well close to the South Korea's €1.400bn.¹⁵⁾ South Korea looks thus at the UK as a peer trade actor rather than a giant akin to the big three. Their bilateral negotiations will be between two peers rather than a negotiation with a bigger, more powerful partner. The new trade relations that the UK will succeed to negotiate with South Korea could thus be taken as a key reference for the prospect of a "Global Britain".

2. State of play of Brexit negotiations

The ratification of the withdrawal deal would mitigate the immediate economic consequences of Brexit. It would prevent the UK from jumping from the edge of a cliff into chaos and uncertainty - the so-called "no deal" scenario. The long-term economic impact of Brexit would itself depend on the future relation of the UK and the EU negotiated during the transition period. Article 50 of the Treaty of the European Union requested to complement the withdrawal deal with a common understanding of such relationship, without specifying how detailed this framework has to be.¹⁶⁾ It thus remains to be seen how much room for interpretation has been left in the final political declaration agreed on the 25 November 2018.

15) World Bank, 2016, constant US 2010 dollars.

16) From General Affairs Council on Article 50 (Background Document), held in May 2018, (<http://www.consilium.europa.eu/media/34594/background-gac-art-50-en.pdf>).

2-1. The deal on the withdrawal and the transition period agreement

2-1-1. A withdrawal conditioned by the Irish issue

At the turn of the summer 2018, Michel Barnier, the EU's Brexit negotiator considered that 80% of the withdrawal deal was done. The financial settlement (the UK should pay an average €40bn to the EU for its previous commitments as a member state) and most aspects of citizens' rights were agreed upon. However, to strike a deal, negotiators had to solve a number of pending important issues, including the protection of personal data sent to the UK while it was a member state, an arbitration system to resolve any dispute between the parties, as well as the protection of European geographical indications and above all the sensitive Irish border issue.

The UK and the EU share the same imperative to avoid restoring physical borders between the Republic of Ireland and Northern Ireland. In 1998, the Good Friday agreement supported by the EU put an end to three decades of violence and killings between Catholics and Protestants. It notably secured the Common Travel Area (CTA) shaped in the wake of the creation of the Irish Free State, in 1922, as a border-free space comprising Ireland, the UK and the "Crown Dependencies" of the Isle of Man and the Channel Islands. This area provides social, economic and political rights which tend to a mutual recognition of the Irish and British citizenships (Gouez 2017).

While the return of borders splitting villages is seen as a direct threat to the peace process, the way to avoid that remained the backbone of the withdrawal negotiation.

As a withdrawal deal could not be ratified by the EU-27 without a clear guarantee that no Irish border would be restored in a case of no deal at the end of the transition period, the backstop solution plans to keep Northern Ireland closely aligned with the EU.

It will build a single customs territory between the EU and the UK, with

the latter maintaining the EU's common external tariff on third countries. There would be no tariffs or quotas for goods traded between the UK and EU, and no need for proof of origin. Northern Ireland will be part of the same customs territory as the UK, but unlike the UK would have to apply EU customs law as set out in the Union's Customs Code.

Northern Ireland will become an EU rules taker. To avoid regulatory checks in Northern Ireland, Ireland will stay in line with EU Single market rules in particular in areas such as technical regulation of goods, agriculture and environmental production. This will require some products being brought to Northern Ireland from the rest of the UK to be subject to checks and controls. As the EU insisted on protecting itself from unfair competition, the whole UK will also have to align with EU future changes in taxation, environmental protection, labour and social standards, state aid and competition policy.

While the rest of Britain could diverge on EU regulation, there will need to be some checks on goods moving from Great Britain to Northern Ireland, but both sides agree to look at ways of easing the compliance burden.¹⁷⁾ In addition, leaving the backstop cannot be decided unilaterally by the UK but by a decision from the Joint committee stating that the alternative agreed does not lead to restore an Irish border.

However, this backstop would only enter into force at the end of the transition period if the UK and the EU do not reach a deal that prevents from restoring an Irish border.

17) The British government initially agreed on December 2017 on Brussels' "backstop" solution that would keep Northern Ireland in "full alignment" with the EU's Single Market and Customs union rules. But an amendment of the House of Common on the Custom Bill opposed in July 2018 the idea of a sea border between Northern Ireland and the rest of the UK. The new border checks should thus be managed in such a way it does not re-establish a sea border.

2-1-2. A most needed transition

A transition period became also mandatory to mitigate the blow of an abrupt Brexit and to leave time to negotiate the future relationship between the UK and the EU. Downing Street had therefore little choice but to conform with the EU27 terms. The transition will thus allow the status quo to prevail until December 2020, with the UK participating and financially contributing to EU policies, but having no say in EU-level decisions. Any extension of the transition period for one or two more years, until the ultimate deadline of December 2022, would compel the UK to contribute to the EU budget (most probably with no rebate).

The future relationship is even less subject to a negotiation between the UK and the EU. It is rather a domestic British negotiation. The EU is above all a legal construction and the 27 Member States are not ready to compromise on the indivisibility of the four freedoms in the Single Market (the free movement of goods, services, capital and people) or on any other EU redline. The UK will remain a special partner for the EU but as a third country, it will not be allowed to cherry-pick between EU legal constraints and benefits. The trade-off is between domestic UK priorities: a restored British sovereignty and the loss of access to the Single Market.

2-2. Post-Brexit scenarios

Will the UK deviate from European standards, to the benefit of its legal autonomy, sacrificing its preferential access to the Single Market? With less access to the Single Market, the deterioration of the UK status as a financial hub and the drop in FDI inflows will probably go along with a decrease in trade.

Or will it give priority to the Single Market and align its standards and regulations with the EU, thus sacrificing its legal autonomy (while maintaining some form of border controls), as practiced by countries in the European

Economic Area? The more the British gain in terms of sovereignty, the higher the economic cost will be. Conversely, the more they attempt to limit the economic cost, the more they will have to align themselves with EU rules, without being able to influence them.

Building domestically a compromise that is politically acceptable and economically viable remains a very slow and painful process. In the light of the political declaration on the future EU-UK relationship attached to the withdrawal agreement and agreed with the EU27 on November 25, 2018, what can we expect?

Are the custom territory and the dynamic regulatory alignment drafted in the backstop solution, the closest economic ties the Prime Minister can sell to the Conservative Party? Is the political declaration giving way to a long gradual journey to “Brino”, closer to the UK remaining completely in the Single Market? Or will the increasing risk of a political crisis leading to a “no deal” scenario at the end of the transition period, give way to a hard Brexit scenario that would only be mitigated by an FTA+ agreement?

2-2-1. A political declaration vs the cherry picking temptation

On July 2018, the pressure of already decreasing foreign direct investments and calls from the business community to maintain close economic ties with the EU pushed the Prime Minister, Theresa May, to put forward a White paper, the so-called “Chequers plans”, preserving free access to the Single Market at least for goods. The EU made it very clear from the start that this plan was not compatible with EU redlines.¹⁸⁾ The idea to keep the

18) In July 2018 White paper priority was given to:

- Free trade for all goods, including agri-food products based on no tariffs and an alignment on the EU rulebook, to protect the existing integrated supply chains and ‘just-in-time’ processes.
- Facilitated customs arrangement (FCA) – based on technologies not yet available on shelves – intended to allow the UK to keep an autonomous trade policy with other third countries: if tariffs differ, the UK would collect tariffs on EU-bound goods on its

UK in the Single Market for goods alone and in “a” Customs Union, without the external dimension of “the” EU Customs Union, which in particular provides the European Commission with the competence of trade policy with third countries, could not be accepted by the EU.

The political declaration attached to the withdrawal agreement remains thus vague on the future concrete plans and at the same time clear on opposing any form of cherry picking: e.g. for financial services the UK will only rely on equivalences. The willingness on both sides to keep the future relationship as close and co-operative as possible is limited by the fact that the two parties will remain “separate markets and distinct legal orders”. Anything that is negotiated must be consistent with the Single market’s integrity (i.e. the EU’s four freedoms), and should not threaten the sovereignty of the UK. Yet, on many issues, such as services opening, security, and others, cooperation remains very open. In addition, the political declaration is not binding and it does not prevent significant changes in position from either side. Rather than resolving the fundamental choices of the future relationship, the political declaration preserves the principle of a close cooperation, notably the development of “an ambitious, wide-ranging and balanced economic partnership” (article 17).

With the many grey zones of this declaration, there could hardly be any meaningful assessment of its impact on business, except that it is going in the right direction, limiting bilateral trade frictions. Despite having an autonomous legal order, the UK’s unilateral alignment on the EU rulebook would lead to fewer physical inspections on goods than no alignment.

The political declaration opens the way to a close cooperation, somewhere

behalf.

- End of the freedom of movement but no visa would be requested for short business stays, tourists and students, in addition to mutual recognition of qualifications.
- End of European Court of Justice (ECJ) jurisdiction over the UK and a new joint committee established instead.

between the frictionless option of EEA membership – estimated as having the lower negative impact on post-Brexit UK economy and a Free Trade Agreement, thus corresponding to an average loss of 3% in GDP over 15 years.¹⁹⁾

By preserving a flexible interpretation of the final text, the negotiators intended to win support from the largest number of MPs at the time of the vote. Would this help to win the withdrawal vote, it could as well turn to be a trap for the next stage of the post-Brexit negotiation, as beyond the call for a close cooperation it does not yet clearly point to a specific scenario.

While the Swiss model based on multiple bilateral agreements is considered to be too complex to be replicated²⁰⁾ there would be essentially two alternative options: a new-generation FTA (FTA+) like the CETA agreed with Canada, or the “Norwegian model” based on the European Economic Area (EEA) membership. The EU and the UK will then adapt to the thickness of border chosen by the British government. The only clear fact six months ahead of the Exit, is that a “no deal” scenario” remains the worst case scenario.

19) The National Institute of Economic and Social Research has however released on 26 November 2018 an estimate of a loss of 3.9% of GDP by 2030 (compared to remaining in the EU) for the scenario of a positive vote on the November deal plus an FTA; while the loss would be reduced to 2.8% of GDP by 2030 for a scenario of a positive vote on the November deal plus the Backstop entering into force at the end of the transition period (Hantzsche *et al.* 2018).

20) The complex nature of the more than 120 bilateral agreements governing EU-Swiss relations invalidates this model from the outset. It should be noted, however, that while the access of Swiss goods to the single market is still the most similar to that of EEA companies (including for the rule of origin which would also be applicable), there is no bilateral EU-Swiss agreement for services. This means, therefore, that Swiss financial services do not enjoy access to the single market. Moreover, this model as well as the Norwegian model detailed below provide substantial access to the Single Market which is conditioned by the adoption of European regulations, not only by economic sectors but also across the board (environmental regulation, or regulations on data protection and public subsidies, etc.).

2-2-2. Everything but the “no deal” scenario

A “no deal” scenario can happen at different stages. If the withdrawal and transition agreement fails to pass the vote in the House of Commons²¹⁾ before March 29, 2019, if there is no agreement on the future EU-UK relationship during the transition period, or if the British parliament, the European parliament or any EU member state, does not ratify the Post-Brexit agreement.

By rejecting the withdrawal deal, the British MPs would impose on the UK the worst economic cost and many unknown consequences. In the absence of an agreement, the UK would have to comply with the conditions negotiated at the WTO to access the Single Market for goods (tariff quotas) and services; conditions which are, by definition, much less favourable than the Single Market ones.

Customs controls would have to be restored between the UK and the EU-27 to ensure the tariffs collection and compliance control. The mobilisation of the technological and human resources required to restore these controls is a major challenge in itself. Congestion and bottlenecks at borders would result in a scenario of trade chaos. This accumulation of logistical problems, the additional supply delays, the increase in customs tariffs and new non-tariff barriers resulting from the end of regulatory alignment with the EU would seriously undermine bilateral trade, the proper functioning of value chains and the flows of FDI.

A significant impact on the British economy

As this “no deal” scenario is not a strategy, but would result from an ultimate political crisis, contingency planning on the part of the business community remains mandatory to face its highly disruptive consequences: food supply shortage, the hardening of the Irish border could provoke civil unrest,

21) A vote on December 13, 2017 in the House of Commons imposed this new vote on the final agreement that would be ratified by the EU-27.

the status of legal contracts and commercial arrangements with EU companies would be unclear, supply chains would suffer important delays and additional costs.

As early as the end of 2017, the European Commission already issued over 60 sector-specific preparedness notices²²⁾ setting out the legal and practical implications of the withdrawal in the absence of any withdrawal agreement, and therefore briefing people on contingency planning; well in advance of first similar efforts by the British government in August 2018.

The negative impact of this scenario would naturally vary according to the economic sector and to the side of the border. The Society of Motor Manufacturers and Traders (SMMT) has warned that the comeback of WTO tariffs on finished car and vans heading across the Channel would cost the automotive industry and consumers at least €5.7 billion; at worst raising the cover price of a U.K.-built car sold in the EU by €3,000 on average, and vans by €2,000 (Posaner 2018). The shock would even be more brutal for the British economy because the UK is more dependent on trade with the EU than the EU-27 is with the UK.

In 19 member states (MS), the level of trade-related exposure to Brexit is less than 2% of national GDP, and in 12 MS it is less than 1%.²³⁾ The estimate of the Rand Corporation is thus that the UK's GDP would be reduced by 4.9% (\$140bn) over 10 years, while for the EU the loss would only be 0.7% of GDP (Ries *et al.* 2017). The estimates of the House of Commons' Exiting the European Union Committee even forecasts a loss of GDP growth of 8% over 15 years for the UK (House of Commons' EEUC 2018). For Swati Dhingra, professor of economics at the LSE, a "no-deal" would result in a 30-40% drop in EU-UK trade over ten years (Dhingra and de Lyon 2018).

22) https://ec.europa.eu/info/brexit/brexit-preparedness/preparedness-notices_en

23) The UK in a Changing Europe (2018), "Cost of a No Deal Revisited," September 3, p. 18. Available at: <https://www.statista.com/statistics/270452/united-kingdoms-share-of-global-domestic-product-gdp/>

WTO schedules of concessions: a leverage for third countries

While being a full WTO member, the UK still needs to agree with the EU and all other WTO members on its own schedules of concessions (trade regime with regard to WTO members) once it has left the EU. The UK and the EU already agreed in early October 2017 on a splitting of tariff quotas for agricultural products set on the basis of average trade flows over the last three years. However, the other WTO members, who would be easily satisfied with the alternative option of the UK continuing with the EU's schedules of concessions, may prove to be wavier of the splitting option. Twenty countries²⁴⁾ have already objected that they were not consulted and that it may disrupt the delicate balance of the current quotas. Other WTO members may also use this leverage.

If in December 2018, it is a pragmatic “everything but the no deal” approach that prevails when the British MPs vote on the withdrawal agreement, it will still leave Theresa May with the difficult task to assess if for the post-Brexit deal she can keep the UK closer to the EU than with an FTA +.

2-2-3. An FTA +: pragmatism by default

An FTA based on the model of the EU-Canada agreement, which provisionally entered into force in September 2017, would reintroduce a harder border between the EU and the UK than the Norwegian model. CETA is presented as a new-generation free trade agreement, as, in addition to tariffs removal, it also deals with other issues such as procurement contracts, intellectual property protection and to some extent services.

A CETA + version going beyond concessions granted to Canada could ensure the removal of customs tariffs for most goods and keep access to procurement contracts on all levels open. On the other hand, the lack of full regulatory alignment with the EU would prevent the application of mutual

24) Argentina, Brazil, Canada, China, India, Japan, New Zealand, Russia, Thailand, Uruguay, USA, etc.

recognition of conformity assessments to all sectors. Non-tariff barriers and certification checks would be restored to trade, with a significant additional cost for value chains.

It would thus have to be seen how far the UK would engage in unilateral regulatory alignment with the EU, as suggested in the November 25, 2018 political declaration, to assess the limitation of those additional costs.

Moreover, CETA covers only partially services (mutual recognition of qualifications, maritime transport, portfolio management, among others). Commitments vary according to the four modes of provision²⁵⁾ While CETA is less restrictive in terms of services than the Swiss model, it does not grant a financial passport and maintains the local licence requirement, which remains the main barrier to cross-border financial services. A CETA+ version providing the UK with greater openings for services would hardly be digestible by the EU as it would force to grant the same concessions to Canada (James and Bryant, 2016) and other countries with which the EU has FTAs including MFN clauses.²⁶⁾

The UK government estimates that this scenario would generate a 5% drop in UK GDP growth over 15 years (House of Commons' EEUC 2018).

The November 2018 political declaration gives also room for a gradual journey towards a “Brino”, in other words towards the Norwegian model.

2-2-4. A gradual journey towards a “Brino”

The so-called Norwegian model would be the least harmful for companies. Full alignment with the Single Market legislation would allow companies to trade goods (with the exception of agricultural and fisheries products) and services without customs tariffs. Freedom of movement would also reassure UK companies with regard to a lack of manpower in certain sectors.

25) Cross-border supply (mode 1), consumption abroad (mode 2), commercial presence through a subsidiary or office (mode 3) and presence of natural persons (mode 4).

26) South Korea, Singapore, the Caribbean islands and Japan.

Maintaining the UK’s participation in the Horizon 2020 programme - the European research networks - would protect UK and EU-27 companies’ innovation potential. This model also includes agreements regulating competition policy, consumer protection and education.

However, in this model, UK companies would have to ensure compliance with EU rules of origin. As the European Free Trade Association (EFTA) members - including Norway - do not form a customs union with the EU and each has its own trade policy, border controls are maintained: exporters from these countries must prove the origin of their products and comply with preferential criteria, thereby not conducting trade diversion. IT systems, joint control zones and authorised economic operators (AEOs) simplify these controls. Yet if the customs control system implemented between Sweden and Norway is considered the most advanced worldwide, the circulation of most goods takes an average amount of time ranging from 3 to 9 minutes, with additional delays during busy periods. Conversely, lorries currently take a few seconds to clear the UK port of Dover and it is estimated that an additional time of 2 minutes due to customs controls would result in 17-mile queues. It should also be noted that EFTA members do not take part in the Common Agricultural Policy or the Common Fisheries Policy. According to the British government’s estimate, this scenario would result in

Table 1. Impact assessment of three post-Brexit scenarios

SCENARIOS	LOSS IN GDP GROWTH (over the next 15 years)
No deal scenario (WTO regime)	-8%
Comprehensive EU-UK FTA	-5%
EEA membership	-2%

The analysis assumes in all scenarios that the UK will conclude a trade deal with the US that would benefit GDP by about 0.2% in the long term.

Source: “EU Exit Analysis - Cross Whitehall Briefing”, House of Commons Exiting the EU Committee, January 29, 2018, p. 16.

UK GDP losses of 2% over 15 years (House of Commons' EEUC 2018).

2-2-5. The cost of “British spasms”

As finding an alternative solution to the Irish backstop remains challenging, the fear to be trapped in a common custom territory with the EU at the end of the transition period, continues to spark internal spasms in the Conservative party, as well as it had led the Labour party, the Northern Ireland's Democratic Unionist Party to declare that they would vote against it. While there is no clear majority in Parliament for any scenario, a rejection of the Withdrawal agreement by the House of Commons cannot be excluded.

A “no deal” scenario could then be stoically confronted by the British people. Or to avoid this fall from the edge of the cliff, the UK could unilaterally revoke Article 50 with the intention of triggering it again after a period of time leaving further time for renegotiation of a new agreement (the legal feasibility of this action under EU laws is highly debated). Members of Parliament could ask the PM to renegotiate a new deal. The UK could thus request from the EU an extension of Article 50 that would have to be approved unanimously by all EU Member States. Finally, this extension could also leave time for a second referendum allowing the British people to choose between the “no deal”, the withdrawal deal or to remain in the EU. This diversity of scenarios and the large interpretation of the political declaration increase the Brexit uncertainty and is already impacting UK's trade.

The cost of uncertainty

It is well known that trade agreements play a major role in reducing trade policy uncertainty and trade flows adjust in anticipation of trade agreements (Limao and Maggi 2015; Carballo *et al.* 2018). Reciprocally, the Brexit limbo is already impacting UK's trade. There are signs of diversion of UK exports and imports in goods, as well as shift from third country. According to the

estimates by Douch *et al.* (2018), there is already an aggregate drop in exports to the EU of around 16 % across the post-referendum period, and around 13 % to non-EU countries. The authors consider it a prolonged negative demand shock, rather than an adjustment issue. While substantial parts of the British electorate may have chosen ‘the wide open sea’, there is little evidence of the world outside Europe switching to British exports – in fact, it is rather the reverse. Trade exports with third countries (sample of 14 countries including South Korea) lowered by 13.3% in comparison with synthetic Britain (without the Brexit vote effect). However, with South Korea, UK trade performed well – as with China and New Zealand.

The additional uncertainty that third business has to consider is the one concerning the UK’s status in the 759 international agreements which have been signed by the EU and which apply to the UK, starting with all the trade agreements that the EU has signed with third countries. As Michel Barnier reminded on December 20, 2017 “legally speaking, mechanically, the day after the U.K. has left the EU institutions, the U.K. will no longer be covered by our international agreements”. What are then the available alternatives?

3. Potential scenarios for EU FTAs’ transition

On January 2017 faced with the need to build an autonomous trade strategy for the UK outside the EU, British PM Theresa May endorsed the vision of a “Global Britain” “always acting as the strongest and most passionate advocate for free trade right across the globe”. Declarations from high-level officials have made clear that the UK stands ready to offer the same market access conditions they have now to trading partners and that the international response has already proven to be positive. New FTAs with third countries could be agreed quickly, allowing the UK to reap new economic benefits. The British government had thus prepare a customs bill (taxation bill), and a

trade bill laying the post-Brexit regulatory framework for replication of current trade agreements the UK is party to as an EU member.

Yet, the UK cannot conclude any new FTA before the end of the Transition period, as the integrity of the customs union (CU) would be compromised: any British concession of preferential tariffs to third countries which are more favourable than EU tariffs would undermine the CU.

If at the end of the Transition period, the UK faces a “no deal” – applies the backstop solution and remains thus in a custom union with the EU – it would limit its scope of trade negotiations with third countries: they could only cover services, intellectual property, public procurement, data and regulatory barriers to trade in goods, without the leverage of tariffs concessions.

Alternatively, if the UK favours the Norwegian model or an FTA +, while avoiding to restore an Irish border, it will be able to negotiate FTAs with third countries.²⁷⁾ The priority would therefore be to deal with the existing FTAs. Legally speaking, the day after the UK leaves the EU on the March 29, 2019, it will no longer be covered by the EU’s international agreements. On top of that, the integrity of the CU during the Transition implies that current FTAs continue to apply to the UK without reciprocity.

3-1. Avoiding the asymmetry of the Turkish regime

If the transition period does not come with an equivalent transition period for the withdrawal from FTAs, the UK would find itself in an asymmetrical regime with third countries, similar to that of Turkey with the EU. As a member of the CU, the UK would have to maintain the same EU common external tariff with regard to third countries, while third countries would not have to bear the same obligation. UK exporters would be subject to less favourable WTO tariffs and it would increase the negative impact of leaving

27) The FTAs signed by Norway are nevertheless constrained by its alignment on the EU’s regulatory model.

the Single Market.

If the EU-Japan FTA enters into force before March 2019, UK's market would be hit twice: in addition to not being able to enjoy the FTA preferential access to Japan's market, it would lose attractiveness in Japan's view for no longer being part of the Single Market.

Yet, British companies are not the only ones concerned. European companies, which are part of the same value chains as British companies, would be affected by the UK's exit from the current rules of origin of these FTAs. If, when leaving the EU, the British content of European exports is no longer considered as "EU" content, some products may no longer enjoy preferential access to the third country in question, thus being subject to higher tariffs.²⁸⁾

It is thus in the UK's and the EU's mutual interest to maintain the status quo during the transition period, allowing the UK to continue to benefit from these FTAs, and not merely being constrained by them.

The UK would merely have two options to avoid the risk of this worst-case scenario: grandfathering and replication.

3-2. Grandfathering of the EU trade agreements

The first option would be to apply the principle of acquired rights, known as grandfathering (Holmes and Gasiorek 2017), which would imply that the clauses of these agreements would remain applicable to the UK, even after its exit from the EU. Grandfathering would allow these agreements to continue to apply to the UK and the third countries concerned, the latter accepting to consider the UK to be a signatory of these agreements via the EU during the transition period. In this framework, the UK and the EU would still be considered as a single entity.

It would not be a mere formal procedure: beyond the EU's "green light",

28) While the Turkish case limits the impact of the rule of origin issue through the country's membership in the pan-Euro-Med cumulation of origin area.

consent must also be obtained from the third countries who have signed these FTAs via an exchange of letters or a protocol to be incorporated into the treaty in question. Yet the UK government seems to favour the grandfathering option, leaving time to prepare a replication or a renegotiation during the Transition period.

3-3. Replication of the EU trade agreements

The idea of copying and pasting the texts of existing treaties between the EU and third countries into new international agreements and signing them one minute after the UK's exit from the EU is not as easy as it may seem.

3-3-1. The rules of origin challenge.

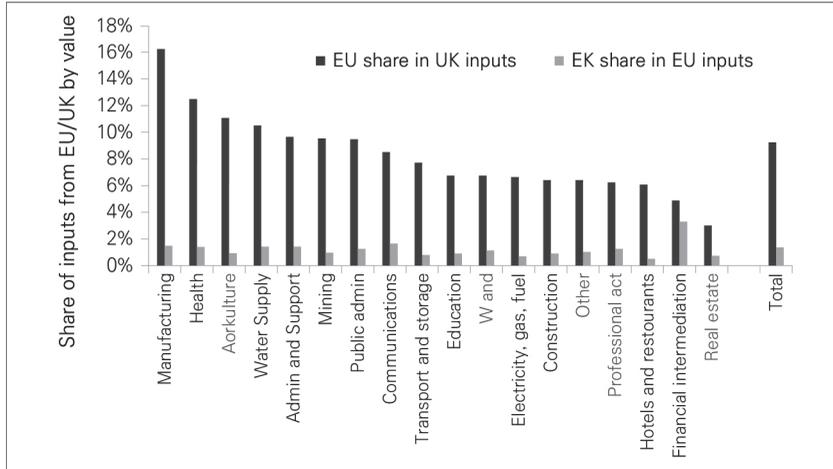
A Customs Union operates without rules of origin (RoO) because the parties apply a common external tariff and a common trade defence regime, while an FTA requires those rules to avoid trade diversion via a lower tariff regime. All European preferential agreements include a bilateral cumulation of origin (materials originating in country A which are processed in country B are considered to originate from country B when the end product is intended for export to country A); whereas, an FTA does not generally include a diagonal cumulation clause of the RoO between three or more countries.

The EU-ROK FTA does not provide for this cumulation. This is particularly worrying for car makers as the current FTA currently requires them to show that 55% of any vehicle is made of “local” EU content, in order to qualify for preferential access to ROK.

A UK-ROK deal which would contain similar 55% “local content requirement”, would penalise UK car makers whose cars, manufactured via pan-European supply chains, are only 41% UK-made. This would mean, that cars manufactured in the UK would be subject to an 8% tariff (i.e. the current WTO MFN level) when exported to South Korea, even if the UK

and South Korea agreed to continue to apply the current EU-ROK FTA.

Figure 1. Share of inputs from EU (for UK) of from UK (for EU) by value



Source: Peter Level, Firms' supply chains form an important part of UK-EU trade: what does this mean for future trade policy?, Institute for Fiscal Studies, 8 January 2018.

If the UK wished to maintain the same access to the Single Market for goods using ROK components, it would have to shift manufacturing to the EU or to negotiate a diagonal cumulation of origin with the EU and ROK in order to allow businesses to comply with ROs. And it would still have to prove that these British goods actually originate from the UK to the extent required by the RoOs. This cumulation would have to be negotiated also with other EU's FTA partners, if the UK wants to avoid the negative impact on its market of the loss of preferential market around the world.

It could be in the interest of the EU to agree on a diagonal cumulation clause with FTA partners.²⁹⁾ Yet its consent, most needed by the UK, would

²⁹⁾ At the moment the EU only accepts such a diagonal cumulation on the basis of an alignment of third countries on its RoOs and only in two cases: as part of the pan-Euro-Med area and with the Western Balkan countries.

increase the EU's leverage in the overall Brexit negotiation.³⁰⁾

3-3-2. Tariff quotas renegotiation

FTAs impose a quota limiting the number of units for some products which may enter the market tariff-free or with a preferential tariff. Should the EU quota be continued in the new bilateral agreements between the UK and third countries, or should it be renegotiated with the third country in accordance with the volume of UK-third country trade on a given date – which would also have to be agreed upon? Such renegotiations would result in the EU and third countries reassessing their current quotas.

These two issues, RoO and quotas, already demonstrate that copying and pasting current FTAs into bilateral agreements between the UK and third countries would require trilateral negotiations (between the EU, the UK and third countries) which could extend beyond the deadline of March 2019.

Furthermore, the replication option further increases pressure on the UK to make concessions to third countries as the new FTAs may well apply even beyond the transition period. In leaving the EU, the UK will become a market far less attractive for third countries than the vast EU Single Market.

As they will be accessing a more limited market, they may not want to make the same concessions to the UK as those granted to the EU, or demand a greater price for maintaining the same concessions, depending on their leverage.

Three countries — South Korea, Chile and South Africa — have already raised objections to a mere replication and may be followed by others. A Chilean official said that Santiago was “in principle in favour of preserving the commercial flows” during transition but demanded concessions in the agricultural sector, which would apply to a future deal with the country. The

30) It should be noted that in May's Chequers plan, which keeps the UK out of a common external tariff with the EU, the Facilitated Customs Arrangements proposed does not eliminate the rule of origin control.

EU-Chile FTA includes, indeed, safeguards that Europe enforced to protect sensitive agriculture sectors.

In the case of a trade partner which has a trade deficit with the UK, could it be tempted to let the current FTA expire during the transition? Trade threats during the transition period might provide extra leverage to third countries on future deals, potentially forcing in return longer-term concessions from the UK.

London has however received encouraging signals from Japan and Canada, willing to keep the status quo, since any renegotiation of British market access terms would be too time intensive, and they prefer to preserve a stable and predictable trading relationship.

The status quo, based on grandfathering, could thus prevail during the transition period. Yet, the simultaneous renegotiation of the 40 EU FTAs before the end of 2020 remains difficult not only for the UK. Third countries will want to assess the new EU-UK partnership before committing into bilateral negotiations. Despite the optimism of Liam Fox, the International trade secretary, the obvious lack of time to negotiate them and ratify them by March 2019, raises concerns. If grandfathering is not applied, it could lead the UK to refocus on securing four of five major EU deals, including with South Korea, Canada, South Africa and Switzerland.

The UK may also simply not be powerful enough to make the replication demands on its own and would then need the EU to be its broker to get trade partners on board for a transitional plan.

The EU has not publicly indicated if it is willing to help: Michel Barnier, the EU chief negotiator, has only warned that it will be ultimately up to third countries to let the UK benefit from the FTAs after March 2019. But if Brussels was going to use all its weight to convince its FTA partners, it would provide Brussels with more leverage in the bilateral negotiation on the future EU-UK relations.

The UK could then use the transition period to replicate FTAs into new

bilateral agreements. If this involves preserving the current terms of the agreements, the UK and third countries would have the option of revising these agreements in accordance with their respective interests at a later stage.

3-4. Prospect for a “Global Britain”

The “no deal” scenario would also have a negative impact on UK trade with EU third countries: the UK would leave the EU with no grandfathering or replication of EU FTAs, leaving the “Global Britain” with MFN WTO terms only. With less access to the Single Market, the attractiveness of the UK’s economy for third countries would rely first of all on deregulation: something hardly acceptable for UK citizens and which would pull away the UK from its main export destination, namely the EU Single Market. In addition, the amount of trade depends positively on the size of the two countries’ economies but negatively on the distance between them (Krugman 2018).

The “Global Britain” challenge is not only about building an autonomous trade policy. It is first about increasing trade with trade partners in order to compensate for the expected decrease in trade with the EU-27 due to Brexit.

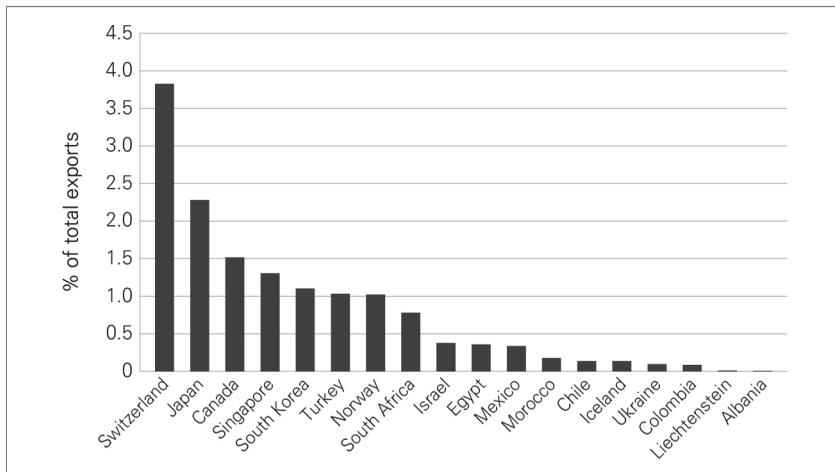
The UK government has made it clear that it could be faster and more flexible than the EU as a whole, because it would no longer be constrained by what it considers protectionist interests in other EU countries. This “Global Britain” vision has been ironically building up at a time of strong EU trade negotiation activism. The EU has already more than 36 preferential trade agreements covering 60 third countries.³¹⁾ By the time of Brexit, this number could even rise to 64 countries, as new agreements with countries including Singapore, Japan, and Vietnam might be ratified, others have been

31) Free trade agreement includes Economic Partnership Agreements (EPA), Association agreements (AA), partnership and cooperation agreements (PCA) and other EU agreements that include a trade dimension.

recently signed (Mexico) and more agreements are under negotiations (Mercosur, Australia, New Zealand, ...).

Third countries with which the EU has an FTA accounted for only 17.2% of UK exports in goods on average during the period 2013-2015 (European Union Committee 2017). The UK remains very dependent on the Single Market³²), with 44% of UK goods and services exports going to the EU-27, and 53% of goods and services imports coming from there, despite a slight decrease of the share of UK-EU bilateral trade in UK's external trade in the past years (- 7% of UK exports to the EU from 2006 to 2017).

Figure 2. Percentage of total UK exports to EU FTA partners



Notes: As of publication the agreement with Singapore is yet to be ratified, and the agreement with Japan yet to be signed. Both are expected to be finalised prior to the completion of the proposed Brexit transition period.

Source: Geographical breakdown of the current account. The Pink Book: 2017, ONS.

In addition, as Joseph Stiglitz underlines, the service sector which makes up 79% of UK's GDP and 80% of its employment, and the exports of which

³²) Even, if the UK is the least member state dependant from the Single Market.

double the imports, “tends to grow with regional economic and legal integration” (Woods 2018). The UK has an obvious interest in opening services market. But it remains a challenging task in FTA negotiations. Despite the steady decline in transport costs (down 11% between 1986 and 2006) facilitating access to markets further afield, geographic proximity remains important in the service sector and strengthens the Single Market’s appeal for UK exports and imports. Distance reduces the volume of trade by as much: +10% distance reduces the trading of services by 7% (Head, Mayer and Ries 2009).

Above all, intra-EU service provision has increased by approximately 60% since the creation of the Single Market, a magnitude not comparable with the profits derived from FTAs (Ebell 2016, p.37). The opening of the services market remains notoriously limited in these agreements, although the Doha’s multilateral agenda on this issue has led to some timid progress in services liberalisation in the 118 preferential agreements notified to the WTO in 2014. The Trade in Services Agreement (TISA), currently being negotiated between 23 members of the WTO representing 70% of global services trade, is the most ambitious in this field. The EU brings its full weight to bear here, with the opportunities from the regulatory alignment implemented as part of its Single Market. It remains to be seen which form of additional leverage the UK will use with third countries to negotiate a greater opening of their services market.

3-5. The interdependence of goods and services

The increasing interdependence of goods and services sectors should also be kept in mind as connectivity between production systems is growing and with it the share of services in the value-added of manufactured goods. This is estimated at 20% to 47% across all sectors (Antimiani and Cernat 2017, p.4). Goods and services are increasingly interlinked and indivisible in trade.

It has become difficult to split a production chain over two separate categories corresponding to different trade regimes. Yet, as reminded by Springford and Lowe (2018), the UK services sector is highly dependent on EU value chains for manufactured goods: the UK Trade Policy Observatory estimates that the added value of domestic services incorporated in British manufacturing exports exceeds £50 billion per year, equivalent to the amount of UK financial services exports. The prospect that ambitious FTAs with third countries covering trade in services could offset the losses resulting from Brexit, is therefore tenuous. Brexit highlights the European regulatory leadership, known as the “Brussels effect” (Beattie 2017). If the UK wished to diverge from EU regulations in some sectors, adopting those of another large key market, such as the USA, would still be more meaningful than to adopt a British only regulation.

While, as seen above, a duplication of the EU FTAs may be more complex than expected, any negotiation with the US, China, Hong Kong, Japan and India which are high on the UK’s priority list, will request to start from scratch. And the UK – representing today less than one-eighth of the EU economic power – will not have outside the EU the same economic weight and attractiveness as when being part of the Single Market. Increasing the benefits of those deals to its own advantage remains a challenge.

The UK’s ability to negotiate preferential agreements that would be more ambitious than EU’s current FTAs, remains hypothetical. This would probably come at the cost of deregulation, creating level playing field imbalances with the EU – an issue anticipated by the political declaration with provisions ensuring the level playing between the two parties, going along with any economic partnership. Moreover, UK’s leeway in future trade negotiations with third countries would be significantly limited by its inability to grant additional concessions on customs tariffs for goods, which is the traditional leverage employed by developed countries to obtain preferential access to the services markets of emerging countries.

4. A case study: Prospect for South Korea trade relations with the EU and the UK

4-1. EU-ROK: a key FTA for the EU

4-1-1. A second generation trade model

The EU-ROK FTA was concluded relatively quickly after only two years of negotiations. By 2011, the deal was provisionally implemented and entered into force in December 2015. Until the provisional implementation of the EU-Canada FTA, CETA, on September 21, 2017, the EU-ROK was considered the most comprehensive EU FTAs. Import duties were gradually eliminated on almost all products. The agreement also goes far beyond the liberalisation of services market that both parties have already implemented under their GATS (General Agreement on trade in Services) commitments. For example, the treaty includes stronger intellectual property rights (including geographical indications), regulatory cooperation, sustainable development provisions, aims to open up public procurement, as well as specific commitments to reduce non-tariff barriers in many sectors, including cars, pharmaceuticals, and electronics. As a result, the EU-South Korea agreement is often seen as a model “second generation” trade agreement.

Table 2. Regulatory cooperation in the EU-South Korea FTA

The FTA addresses non-tariff barriers in four sectors specifically: motor vehicles and parts, pharmaceutical products and medical devices, chemicals, and electronics. It also aims to increase market access in services and investments.

Motor vehicles and parts

The EU and South Korea have agreed to align their regulations with the World Forum for Harmonisation of Vehicle Regulations (WP.29). The WP.29 is in the framework of the United Nations Economic Commission for Europe (UN ECE). Both sides have also committed to providing full market access by eliminating tariff and non-tariff barriers.

Table 2. Continued

Compliance with these commitments is being monitored by a working group established under the FTA. Korea has agreed to accept 'EURO VI' certificates for heavy duty commercial vehicles, as well as simplified electronic documentary procedures for imports of E-marked tyres in 2016.

Pharmaceutical products and chemicals

The EU and South Korea have agreed to make immediately available to the other party any laws, regulations, procedures, administrative rulings and implementing guidelines related to pharmaceutical products. Such laws and regulations will take into account, as appropriate, international provisions, practices, and guidelines.

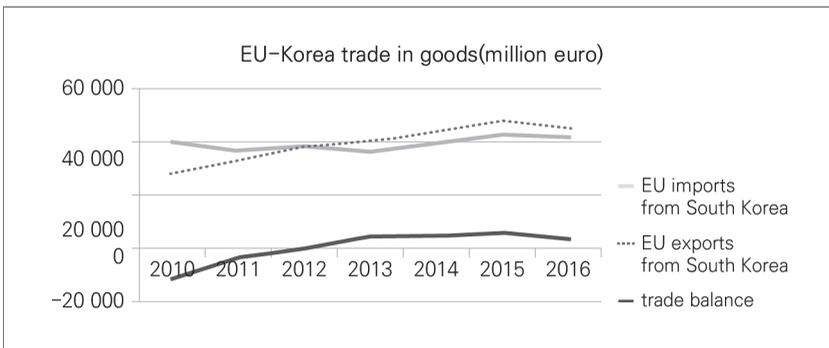
For chemicals, there are a number of initiatives including protection of public health and the environment, implementing appropriate regulatory mechanisms, and developing best practices on chemicals assessment and management. For both pharmaceutical products and chemicals, working groups have been established to monitor areas of the agreement and to exchange updates on regulations.

Electronics (part of capital goods and machinery in this report)

For electronics, the EU and South Korea agree to recognize three international standard-setting bodies, which are to be used as the basis for any standards, technical regulation or conformity assessment procedures: the International Standards Organisation (ISO), the International Electro-technical Commission (IEC) and the International Telecommunication Union (ITU). To facilitate conformity assessments, a list of approved testing laboratories must be notified to the other party under the FTA. Unlike the sectors above, no working group has been established on electronics.

Source: House of Lords - Brexit: trade in goods - European Union Committee, 2017. <https://publications.parliament.uk/pa/ld201617/ldselect/ldecom/129/12910.htm#footnote-176>

Figure 3. EU Exports to and Imports from Korea, 2010-2016 (billion EUR)



Source: Evolution of trade under EU-ROK FTA (COM (2017) 614 final)

4-1-2. EU's positive trade balance with ROK

The EU's €11.6 billion trade deficit with Korea in 2010 has turned into a trade surplus of €3.1 bn in 2016. In 2010, EU exports to ROK were €28.0 bn, and imports from ROK were €39.5 bn ; while in 2016, EU exports were €44.5 bn, and imports were €41.4 bn. The current level of EU exports to ROK would have generated duty payments of approximately €2 bn had the FTA not been in place.³³⁾

Between 2015 and 2016 total EU trade with ROK declined: exports to ROK declined by 6.9%, while imports declined by 2.2%. The EU trade surplus thus decreased from 5.4 to €3.1 bn. EU exports decreased in particular on machinery and appliances (by 8.2%) and transport equipment (by 6.4%). These two sectors represent more than 50% of EU exports to Korea.

The decline is in line with the overall pattern of trade for the EU in 2016. Between 2015 and 2016 total EU exports to the world declined by 2.4%. EU imports from the world declined by 1.2%.

South Korea was the EU's 8th largest import originator (with imports from Korea remaining relatively stable: 2.6% of total imports in 2010 an still 2.7% in 2017) and the 8th largest export market in 2017 (EU exports to ROK represented 2% of total EU exports in 2010, and 2.7% in 2017).³⁴⁾

On the Korean side, the EU's share in total Korean imports increased from 9.1% before the start of the FTA implementation to 12.8% in 2016, making the EU the 2nd largest Korea's import originator (after China). Over the same period of time, the EU's share in total Korean exports declined from 11.5% to 10.9%,³⁵⁾ making the EU the 3rd largest Korean export market. The EU is Korea's 3rd largest partner in terms of total trade (after

33) This calculation is based on Korean imports from the EU at HS6 level, in the fifth year of the FTA implementation (ITC data).

34) From http://trade.ec.europa.eu/doclib/docs/2006/september/tradoc_113448.pdf

35) The EU's share in total Korean imports refers to Korea's imports from the EU as a share of Korea's imports from the world. The EU's share in total Korean exports describes Korea's exports to the EU as a share of Korea's exports to the world.

China and US).

To summarise, the EU business sector has taken advantage of this FTA as demonstrated by the high preference utilisation rate, reflecting to what extent EU exporters are using the FTA preferences.³⁶⁾ In 2016, the overall EU Preference Utilisation Rate on the Korean market was as high as 71% (while only 61.1% in 2012).

In addition, in late November 2018, this FTA remains the only EU FTA in force in East Asia. The EU-Vietnam is not yet signed and the very promising EU-Japan is not yet ratified.

4-1-3. Brexit's potential impact on the EU-ROK FTA

The EU-ROK FTA resulted from a delicate compromise between a very large and powerful economy, the EU, and an economy and trading power less than one-tenth of the size of the EU. As a result, the EU had a stronger negotiation position than South Korea, and the latter had even to make more concessions to secure an agreement in the European Parliament, including a new “safeguard” clause to protect European industry and a guarantee that new Korean car emissions limits would not be detrimental to European car manufacturers.

South Korea could thus seize the opportunity of Brexit to ask the EU for a review of this FTA which turned its positive trade balance with the EU into a deficit. The review could concern the automobile sector, as well as the services market, and in particular the legal services. As underlined by Simon Hix and Hae-Won Jun (2017), the terms of the EU-ROK FTA for the legal services were first of all for UK interests, since, along with the US, the UK continues to dominate the ranking of the top 50 law firms in the world.

However, if the UK pressures South Korea into giving a better access to

36) It is equal to the following ratio:

$$\frac{\text{Korea's preferential imports (the value of EU exports to Korea that enter Korea under the preferential rates)}}{\text{Korea's preference eligible imports (the value of EU exports to Korea that are eligible for preferential rates)}}$$

its services market than what it gave to the EU, Seoul would have to offer the same to the EU in application of the WTO MFN clause on services, and reciprocally. The EU cannot give a better access to its services market without giving the same access to other countries with which it also has an FTA. In addition, if South Korea extends market access to the UK, the US may demand a similar level of access under its agreement with Korea. Ever since Korea negotiated FTAs with the EU and the US in parallel, the US has tried to make sure that it gets a similar level of market access to Korea than the one granted to the EU. As a result, it is unlikely that South Korea would be willing to offer better service market access to the UK than that currently granted under the EU-South Korea FTA.

It should also be underlined that, despite the fact that the EU is a major investor in South Korea (in 2015 its FDI stocks amounted to €49.8bn), the current EU-ROK FTA does not include an investment chapter. Its negotiation started before the FDI became an exclusive competence of the EU. The EU is thus willing to amend the FTA to include provisions on investment protection standards and the Investment Court System agreed with Canada in CETA.

4-2. UK-ROK new FTA: trade amongst “equal” partners

In 2017, South Korea is only the UK’s 14th largest trading partner. While the UK is the second EU Member State exporting to South Korea (after Germany), there is only a small portion of UK exports going to the ROK. But the British exports to ROK more than doubled in the first three years of the EU-ROK deal, and the UK has a positive trade balance with South Korea, which would make the duplication of the current FTA very attractive for the UK.

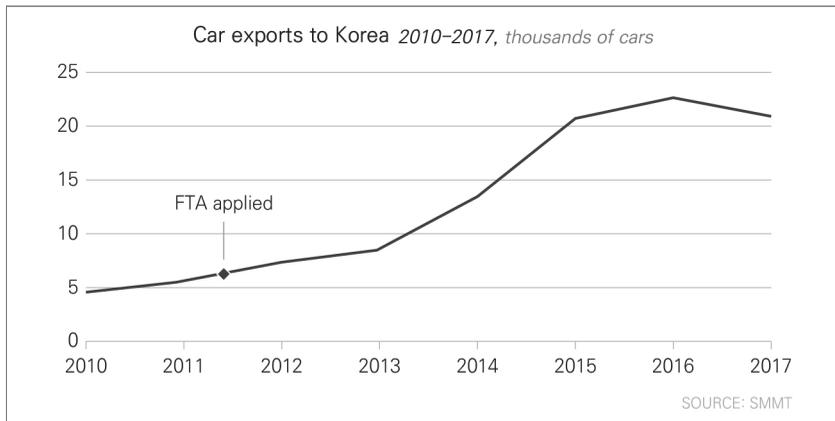
In particular, in 2017, the ROK was the UK’s third-biggest importer of British North Sea crude oil, which is a significant source of revenue for the

UK. Britain's Department for International Trade said its oil exports to South Korea in 2017 earned Britain two billion pounds (\$2.81 billion) and made up 14% of its total oil exports, the biggest share after the Netherlands and China.

The removal of the oil tariff has led to an annual increase of UK oil exports of 47% between 2011 and 2015. In 2015 oil accounted for one third of total goods exports and tended to increase its share while sanctions were imposed on Iran.

UK car sales to South Korea went also from below 2,000 in 2010 (a year before the deal), to almost 21,000 units in 2017. There was a major boost as well for UK pottery industry (ceramics).

Figure 4. Car exports to Korea



Source: Fears grow that South Korea may demand concessions from Britain to replicate EU trade agreement, Peter Foster, The Telegraph, 4 February 2018.

If the UK was losing the benefit of the EU-ROK FTA, UK exports of £5bn could face an average tariff approaching 9% (Institute for Government 2017). However, having an economy about the size of the UK economy, Seoul may be reluctant to simply replicate the terms of the EU-South Korea

FTA in a new UK-South Korea FTA. Seoul might expect a more equal ‘partnership’ with an independent UK. It could ask for more access in areas as automobiles and high-tech exports and offer less in others, including legal and

Table 3. UK trade with South Korea

Product	Value in 2015 (\$, 000's)	Annual growth in value, 2011-15 (% p.a.)	Share of UK imports (%)	Product	Value in 2015 (\$, 000's)	Annual growth in value, 2011-15 (% p.a.)	Share of UK exports (%)
UK imports from South Korea				UK exports to South Korea			
1 Vehicles and parts and accessories thereof	1,672,322	12	2.1	1 Mineral fuels, mineral oils and products of their distillation	2,095,006	25	6.4
2 Electrical machinery and equipment and parts thereof	844,824	-8	1.4	2 Machinery, mechanical appliances and parts thereof	1,336,682	17	2.1
3 Ships, boats and floating structures	780,494	361	45.1	3 Vehicles and parts and accessories thereof	842,101	33	1.7
4 Machinery, mechanical appliances and parts thereof	763,966	7	1.0	4 Optical, photographic, cinematographic, medical or surgical products	473,998	23	2.6
5 Mineral fuels, mineral oils and products of their distillation	675,451	26	1.3	5 Electrical machinery and equipment and parts thereof	366,730	4	1.3
All products	6,306,250	9	1.0	All products	7,213,517	12	1.5
South Korean imports from UK				South Korean exports to UK			
1 Ships, boats and floating structures	2,991,231	14	7.8	1 Mineral fuels, mineral oils and products of their distillation	1,419,686	33	1.4
2 Vehicles and parts and accessories thereof	1,697,056	24	2.5	2 Machinery, mechanical appliances and parts thereof	977,731	12	2.1
3 Machinery, mechanical appliances and parts thereof	1,121,272	11	1.8	3 Vehicles and parts and accessories thereof	828,818	39	5.5
4 Electrical machinery and equipment and parts thereof	513,484	-5	0.4	4 Electrical machinery and equipment and parts thereof	427,333	9	0.5
5 Aircraft, spacecraft, and parts thereof	226,090	44	12.1	5 Optical, photographic, cinematographic, medical or surgical products	416,043	13	2.3
All products	7,854,429	10	1.5	All products	6,129,520	12	1.4

Note: the data are not symmetric because they are reported by UK and South Korean sources separately.

Source: ITC calculations based on UN COMTRADE statistics. UK imports/exports reported by UK.

South Korean imports/exports reported South Korea.

financial services. Concessions, particularly in the area of services, which were actually to a great extent the result of UK demands in the EU FTA.

In many specific areas the EU-ROK FTA goes well beyond Korea's GATS commitments. In terms of services trade, it will not be easy for the UK to get better terms in a future UK-South Korea FTA than the current level of liberalisation, particularly in the financial and telecommunication sectors.

Seoul might also look at its other FTAs, like its FTA with Canada or the EFTA, as the starting point for negotiation with the UK. But they are much more restrictive in services than its FTAs with the EU and the USA. The UK would lose out on these significant concessions that Korea made to clinch its agreements with two of its main trading partners. It might thus give a harder work to get a bilateral deal relatively quickly and it may not be as beneficial to the UK as the EU one is.

However, as mentioned previously, there is no investment chapter in EU-ROK FTA and South Korea should welcome a bilateral investment agreement with the UK.

Brexit remains high on South Korea's agenda. The Park Geun-hye administration called to anticipate a potential economic slowdown and requested an allocation of 10 trillion won (\$8.4 billion) in extra budget to create jobs and assist corporate restructuring due to Brexit. But the so-called South Korea-UK trade working group met thus only twice in 2017. A trade deal with the UK might be less a priority for ROK, than it is for post-Brexit UK which will try to sign as many agreements with the current EU FTA partners as possible. While Donald Trump's protectionist trade policy restrains access to the US market, East-Asia countries would tend even more to prioritise trade deals with the EU.

5. Conclusion

Despite PM Theresa May's initial wish to transform the post-Brexit UK into "the champion of free trade", there are many stumbling blocks on the road to "Global Britain". Even if the House of Commons were to vote the withdrawal deal in December 2018, the political declaration on the future relationship between the EU and the UK can be interpreted in a flexible way which opens the way as much for an FTA + as for a Norwegian scenario. Both scenarios would allow the UK to have an autonomous trade policy. Yet, at this stage, for the Irish border, there is no obvious alternative to the backstop solution (single customs territory with the EU) which would prevent the UK from signing trade agreements with third countries. The Norwegian model would limit the negative economic impact of Brexit and preserve the attractiveness of the British market for third countries by keeping the UK aligned on the Single Market regulation. But it would go against a core motive of the referendum vote: the end of the freedom of movement of people. This "Brino" solution would request a profound evolution of the domestic political debate during the transition period. Alternatively, an FTA+ would restore more frictions in the bilateral UK-EU trade, compared to the current situation with the UK as a member-state. It would also reduce the leverage of the UK in its bilateral negotiation with third countries.

The EU 27 has little leverage on the decisive vote of the withdrawal agreement in the British Parliament. The danger of a spill-over effect from economic to other political domains, including security matters, could contribute to mobilise the British public opinion towards "everything but the 'no deal'". Yet, the probability of a "no deal" scenario remains high – be it in March 2019 or at the end of the transition period. A strong confidence in the British resilience capacity could open the way to this cathartic "no deal" exit, unless the British people were to decide to remain in the EU.

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Chapter 3



The Rise of Populism in the EU and Changes in Political Geography

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- A large, faint background image of a network map of Europe. The map shows the outline of the continent with various nodes (circles) connected by lines, representing a network or data flow. The map is overlaid on a blurred cityscape background.
1. Introduction
 2. The evolution of national populism
 3. Explaining the rise:
Challenging conventional wisdoms
 4. Conclusions

The rise of national populism has been one of the most striking developments to have taken place in contemporary European politics. This chapter explores this phenomenon and the resulting changes in Europe's political geography. It begins by charting the evolution of national populism in the post-war period and then challenges several conventional wisdoms that have emerged with regard to these movements, such as the popular claim that this political phenomenon is rooted in the post-2008 financial crisis. Drawing on three decades of research in the social sciences, the chapter challenges such claims and instead points to the much greater importance of a values divide in contemporary Europe and one that looks to remain on the landscape for many years to come.

1. Introduction

The rise of national populism has been one of the most striking developments to have taken place in contemporary European politics. National populism can be defined as a political movement that seeks to prioritise the interests and culture of the nation state, and which seeks to give voice to a people who feel neglected, even held in contempt, by distant and often self-serving elites.³⁷⁾ This political phenomenon is reflected in the 2016 vote for Brexit in the United Kingdom, the election of Donald Trump as the forty-fifth president of the United States, and strong results at elections for an assortment of national populist parties in Europe such as National Rally (previously the National Front) in France, the 'Freedom Parties' in Austria and the Netherlands, the UK Independence Party, Fidesz in Hungary, the League in Italy, the Alternative for Germany and the Sweden Democrats.

These parties are not identical. While they share much in common on the

37) Roger Eatwell and Matthew Goodwin (2018), *National Populism: The Revolt Against Liberal Democracy*, Penguin Pelican

socio-cultural dimension – typically opposing immigration, Islam, social liberalism and adopting sceptical if not hostile positions toward the European Union (EU) – on the economic dimension they often pursue interventionist or openly protectionist approaches, which has relevance to international powers such as Korea. Marine Le Pen has adopted a more economically protectionist line, criticizing what she calls ‘savage globalization’, while other parties such as the Sweden Democrats have advocated labour market stress testing and more interventionist government policies on the economy. Were such parties to attract even more success at the European level then it appears likely that they would advocate not only reformed policies in the cultural sphere (i.e. restrictive immigration) but also in the economic sphere (i.e. more protectionist positions and ‘national preference’ positions that seek to prioritize ‘native’ workers). In Europe, there are also important differences between East and West. While some national populists like Geert Wilders in the Netherlands aim to cultivate public opposition to Islam by claiming to defend LGBT communities, others like Viktor Orbán in Hungary are hostile to Islam but advocate traditional social conservatism when it comes to issues like the family and rights for same-sex couples. In this chapter, I will draw on existing research to explore the rise of national populism within the political geography of the EU and challenge popular conventional wisdoms about its support.

2. The evolution of national populism

2-1. The first three waves of national populism

It has been three decades since Klaus von Beyme (1988)³⁸ edited a collec-

38) Beyme, Klaus von ed. (1988), *Right-Wing Extremism in Western Europe*, Routledge.

tion of essays on what he called the ‘third wave’ of right-wing extremism in Europe. This was one of the first academic books to explore the emergence of a new generation of parties and is seen by scholars as an important watershed text in the literature. According to von Beyme, the first wave began in the immediate aftermath of the Second World War and included an assortment of neo-fascist and neo-Nazi groups that remained on the fringe, or were banned outright by a more ‘militant defensive democracy’, like that in post-war Germany. This was also a period of European history when social norms against ethnic nationalism and anti-democratic messages were strong. Some of the more notable early parties included the Socialist Reich Party in Germany, formed in 1949, but banned three years later by the Federal Constitutional Court, or Oswald Mosley’s short-lived Union Movement in the United Kingdom.

The second wave was more openly populist in nature and though slightly more successful it also failed to build a sustained challenge to the established parties. The most significant was ‘Poujadism’ in 1950s France, an anti-establishment populist revolt that attracted support from the self-employed and small businesses who opposed their nation’s societal and economic modernization. Other examples include the Farmers Party in the Netherlands and the National Democratic Party of Germany that was founded in 1964 and had limited success in Bavaria, Saxony and Hesse (only narrowly failing to reach the 5 per cent threshold to win representation in the Bundestag in 1969). Other parties included in the second wave were the ‘Progress parties’ in Denmark and Norway, which emerged in the 1970s, while calling for tax-cuts and opposing welfare before later shifting their attention to the issue of immigration. Another was the National Front (NF) in Britain, which was rooted in an assortment of right-wing and neo-Nazi groups that had merged in the late 1960s, some of who could trace their lineage direct to Mosley.³⁹⁾ The Front peaked in 1979 when it stood more than 300 candi-

39) Matthew J. Goodwin (2011), *New British Fascism: Rise of the British National Party*, Routledge.

dates though never secured a single seat in the House of Commons.

A third and more significant wave of national populism emerged during the 1980s and 1990s, long before the terrorist attacks of 9/11, post-2008 Great Recession and 2014-2015 refugee crisis. Indeed, it is worth underlining the critical point that the third wave of national populism commenced *before* the collapse of Lehman Brothers and the onset of the financial crisis, which can be explained by the fact that their appeal is rooted as much if not more so in cultural grievances than economic worries. The more successful third wave was reflected in the emergence of Jean-Marie Le Pen and the Front National (FN) in France in the mid-1980s, as well as the Freedom Party of Austria that was taken over by Jörg Haider in 1986. Both of these parties would evolve into major movements. In 1988, Jean-Marie Le Pen garnered over 14 percent of the vote at presidential elections in France and then in 1990 Haider and the Freedom Party attracted nearly 17 percent of the vote at national elections. They would also soon be joined by others, such as Flemish Bloc in Belgium, Northern League in Italy, and the Swiss People's Party in Switzerland.

Crucially, as von Beyme (1988) noted, the third wave also differed from its predecessors in two respects. First, unlike its predecessors the third wave was anchored in philosophical 'New Right' debates, led by self-described 'metapolitical' writers and thinkers who adopted Gramsci's claim that intellectual hegemony was a precondition for serious power. New Right thinkers sought to provide the ideological narratives that might help to lead national populists from the margins to the mainstream.⁴⁰⁾ Most important was a change of strategy for how to mobilize public opposition to immigration. 'Classical' biological and hierarchical forms of racism, which had been discredited in the shadow of the Second World War, made way for a new doctrine of 'ethno-pluralism', the idea that culturally distinct groups must be kept separate in order to preserve their unique national characters. Described

40) Paul Hainsworth ed. (2008), *The Extreme Right in Western Europe*, Routledge.

by some as ‘differentialism’ or ‘cultural racism’, these arguments about the ‘cultural incompatibility’ of immigrants, refugees or settled minorities like Muslims would now replace past claims about white racial supremacy. As Rydgren (2005) later observed, the ethno-pluralist doctrine allowed national populists to more effectively rally anxiety over immigration and ethnic change without being stigmatized as blatant racists.⁴¹⁾ Such parties also downplayed their hostility to the liberal democratic system, instead advocating more ‘direct’ conceptions of democracy that sought to give greater voice and influence to ‘the people’.

A second development was the internationalization of national populism and strengthening links between these parties. Increasingly, scholars pointed to the ‘cross-national diffusion’ of ideas strategies from one country to the other, whereby national populists would emulate one another. Such international cooperation often took place in the European Parliament where such parties sought to foster formal alliances.

2-2. The emergence of a distinct fourth wave

During the first two decades of the twenty-first century national populists continued to attract rising support. The parties above were joined by the likes of the UK Independence Party, Sweden Democrats, True Finns, Pim Fortuyn List and the Party for Freedom in the Netherlands and Law and Justice in Poland, among others. Once again, it is also worth pointing out that some of these parties in states like the United Kingdom, Sweden, Austria and the Netherlands emerged amid stable or strong economies with comparatively low unemployment. Though many scholars have viewed these as part of the continuing third wave, thereby viewing them in the same light as movements that were active in the 1980s, I would argue that since the

41) Jens Rydgren (2005), “Is Extreme Right-Wing Populism Contagious? Explaining the Emergence of a New Party Family,” *European Journal of Political Research*, 44.3: 413-437.

2000s we have witnessed the emergence of a distinct ‘fourth wave’ – a cycle of mobilization that can be differentiated from its predecessors on four counts.

First, aside from putting even greater emphasis on the ethno-pluralist doctrine there have been other programmatic changes that are glossed by lumping these parties in with their predecessors. Movements in the fourth wave put stronger emphasis on the issue of Islam and the perceived ‘threat’ from settled and growing Muslim communities, refugees from mainly Muslim states, and the so-called ‘Islamification’ of the EU. These arguments often linked to the ‘Eurabia thesis’).⁴²⁾ This shift, in turn, reflects a changing issue agenda in the EU area, which has seen a general rise in the perceived salience among voters of the issues of immigration, refugees and security. For example, between 2015 and 2018 there was a sharp rise in the percentage of voters that identified immigration and terrorism as the most important issues facing the EU.

This shift has also led some parties within the fourth wave to forge much stronger alliances with pro-Israel groups and funders, and also to voice strong support for LGBT communities while simultaneously warning of the ‘threat’ posed by Islam – a change that also appears to be helping them to mobilize support among some voters who are pro-LGBT but simultaneously hostile toward Islam.⁴³⁾ Meanwhile, whereas in earlier decades some national populists saw the EU as a useful bulwark against communism, in the early years of the twenty-first century these parties generally became more skeptical or opposed outright to the EU and/or further European integration. Studies have now demonstrated that anti-EU sentiment has become more strongly related to support for national populism than in previous years,

42) José Pedro Zúquete (2008), “The European Extreme-Right and Islam: New Directions?” *Journal of Political Ideologies*, 13.3: 321-344.

43) Spierings, Niels, Lubbers, Marcel and Zaslove, Andrej (2017), “‘Sexually Modern Nativist Voters’: Do they Exist and do they Vote for the Populist Radical Right?” *Gender and Education*, 29.2: 216-237.

alongside key drivers like perceptions of ‘ethnic threat’ and distrust of established parties.⁴⁴⁾

There have also been other changes, notably with regard to economic policy, although here there is less consistency. While some parties have shifted to a more protectionist stance, like National Rally in France, which at the 2017 French presidential election demanded more state intervention to protect native workers, others appear more at ease with free markets while expressing ‘welfare chauvinism’, the idea that welfare benefits and rights should be restricted to the national in-group and kept from threatening outsiders. For example, the national populist Sweden Democrats have asked voters to ‘choose immigration or welfare’. Nonetheless, given the general upward curve in support for both national populists and radical left-wing or Green parties, it appears likely that international powers such as Korea will, over the longer-term, be faced with a European sphere that is instinctively more protectionist than in earlier years, as the economic positions of these populist forces generally converge on an opposition to the perceived detrimental effects of free markets and ‘neoliberalism’.

Aside from changing programmes, the fourth wave of national populist parties is also characterized by more articulate campaigns that downplay any opposition to the democratic system and overt links to political extremism. Few parties permit the links to more extreme (and extra-parliamentary) groups that characterized their predecessors. In the United Kingdom, for example, UKIP banned members of more extreme parties from joining as members. Meanwhile, some of the most successful fourth wave leaders like Marine Le Pen ruled out official cooperation with more extreme parties like Golden Dawn, Jobbik in Hungary or Ataka in Bulgaria. Studies have shown

44) Werts, Han, Scheepers, Peers and Lubbers, Marcel (2013), “Euro-scepticism and Radical Right-Wing Voting in Europe, 2002–2008: Social Cleavages, Socio-Political Attitudes and Contextual Characteristics Determining Voting for the Radical Right,” *European Union Politics*, 14.2: 183-205.

that one important reason why fourth wave parties have enjoyed more success than their predecessors is precisely because they have distanced themselves from neo-Nazism, blatant racism and conspiratorial anti-Semitism.⁴⁵⁾

Another feature has been much closer cooperation at the international level. Rising levels of success have enabled such parties to work together in order to access financial resources. In 2007, the short-lived 'Identity, Tradition, Sovereignty' group in the European Parliament brought together the French National Front, Freedom Party of Austria, Greater Romania Party, Flemish Interest, Ataka in Bulgaria, and Italy's Alessandra Mussolini and one member from a small neo-fascist group. In 2015, the more durable 'Europe of Nations and Freedom' was created which brought together the French National Front, Austrian Freedom Party, Geert Wilders' Party for Freedom in the Netherlands, Italian Northern League, Flemish Interest, Polish Congress of the New Right and a former UKIP Member of the European Parliament. They would later be joined by a member of the Alternative for Germany (AfD).⁴⁶⁾ The group also has links with Tomio Okamura, the Czech-Japanese leader of the Czech Freedom and Direct Democracy movement. Others like the True Finns in Finland and UKIP's Nigel Farage have steered clear of this group though Farage has close links to the Alternative for Germany, Sweden Democrats and President Trump (as well as Five Star in Italy although this is not a national populist movement).

Lastly, the fourth wave is characterized by even more striking and durable levels of support. Furthermore, the dynamics of this support differ from the past in significant ways. Parties that arose in the third wave, like the French National Front and Austrian Freedom Party, have reached new heights and

45) Art, David (2011), *Inside the Radical Right: The Development of Anti-Immigrant Parties in Western Europe*, Cambridge University Press.

46) Although that member would later defect to the breakaway party from the AfD, the 'Blue Party', which had been set up by his wife and former AfD leader Frauke Petry.

gained more experience of executive power, whether nationally or locally. In 2016, against the backdrop of the votes for Brexit and Trump, the Austrian Freedom Party's candidate attracted 46 per cent of the vote at presidential elections while the next year the party finished second at national elections with support from one in four voters. It joined a coalition government with the centre-right People's Party.

In the same year, 2017, in France Marine Le Pen reached the last round of her country's presidential election in which she lost to Emmanuel Macron but attracted nearly 36 per cent of the vote, almost double what her father had polled in 2002. While national populists have failed to breakthrough in other states – like Ireland, Portugal and Spain – over the past decade national populists have enjoyed record or strong returns in Denmark, Norway, Greece, Hungary, Poland, Slovakia and Switzerland.

During the early years of the twenty-first century, there has also emerged strong support for national populists in states that used to be thought 'immune' to this trend. During the 1990s, academics routinely included chapters on 'negative cases' like Britain, Germany, the Netherlands and Sweden, where the question to answer was not why national populism had succeeded but rather why it had failed. Yet each of these democracies have witnessed major breakthroughs, whether by Nigel Farage and UKIP, the Alternative for Germany (AfD), Geert Wilders and the Party for Freedom or Sweden Democrats, which in 2018 attracted a record 17 percent of the vote.

In the United Kingdom, UKIP first used local and European Parliament elections to navigate a majoritarian electoral system, winning the 2014 European Parliament elections outright (as did the National Front in France and the Danish People's Party). At the 2015 general election, UKIP's nearly 13 per cent of the vote translated into only one seat in parliament.⁴⁷⁾ Nonetheless, the British case serves as a reminder for why national populists

47) Goodwin, Matthew and Milazzo, Caitlin (2015), *UKIP: Inside the Campaign to Redraw the Map of British Politics*, Oxford University Press.

do not need elected power to wield considerable influence. UKIP failed to establish a strong parliamentary presence but played a central role in forcing a referendum on EU membership and the Brexit vote. Around seven in ten 'Leave' voters had voted for UKIP or considered doing so. Slightly later, in 2017 in Germany, the AfD captured nearly 13 per cent of the national vote and its first (94) seats in the Bundestag. In Eastern Germany the AfD, which already held seats in 14 of Germany's 16 state parliaments, emerged as the most popular party among men (and the most popular of all in Saxony). The result undermined the claim that national populists could not find success in the country that had produced National Socialism. In the Netherlands, the Pim Fortuyn List and then Party for Freedom have attracted significant parliamentary representation, with the PVV finishing second in 2017 with 13 per cent of the vote. In Sweden, the Sweden Democrats emerged to win their first (20) seats in the Riksdag before reaching new record shares of the vote in 2014 and then again in 2018.

There have also been important changes to the dynamics of support for national populism. Some parties, like Le Pen's in France, have polled stronger than in the past among women, proving able to close the so-called 'gender gap' that has historically characterized their electorates.⁴⁸ In broad terms, since von Beyme's writing in the 1980s these parties have become far more adept at mobilising support from manual workers, often becoming the most popular choice for this group (as was evident in states like France in the mid-1990s, or in the United Kingdom between 2013-2015).⁴⁹ While most parties draw their core support from the working-class, they have also reached into low skill service sector workers, clerks and also (as is the case for the most successful parties) parts of the middle-class. That said, the core

48) Abdelkarim Amengay, Anja Durovic, Nonna Mayer (2018), "L'impact du genre sur le vote Marine Le Pen," Working draft paper sent to author.

49) Ford, Robert and Goodwin, Matthew (2014), *Revolt on the Right: Explaining Support for the Radical Right in Britain*, Routledge.

supporters of national populism tend to be in work, occupying a precarious position, and often lack university degrees.

3. Explaining the rise: Challenging conventional wisdoms

How can we explain the rise of national populism? In recent years, many observers of European politics have sought to answer this question by drawing a straight line from the fourth wave of national populism to the post-2008 financial crisis, Great Recession, sovereign debt crisis and subsequent austerity policies. This ‘crisis narrative’ has been especially popular among left-wing thinkers where complex questions about national identity, belonging, immigration and borders are reduced to transactional debates about economic resources, inequality and redistribution.

3-1. The crisis narrative

Indeed, the argument is not new. The tendency to trace political extremism or radicalism to economic crises has been shaped strongly by interwar fascism and Nazism that arose against the backdrop of the Wall Street Crash in 1929, Great Depression and rampant unemployment. Yet this is also a misreading of history. In Italy, though strikes sparked anxiety over the threat from Communism and an uncertain economic future, when Mussolini and the fascists took power the country was not engulfed by a crisis. In Germany, while a severe depression was present recent research suggests that it was not people who were hit hardest by the crisis who swung behind Hitler and the Nazis. While the unemployed and those on the bottom of the economic ladder tended to vote for the Communists and Social Democrats, it was actually

the ‘working poor’ who were the most likely to switch over to the Nazis; self-employed shopkeepers, small farmers, lawyers and other professionals and domestic employees.⁵⁰⁾

Nonetheless, the idea that the fourth wave has been fuelled by economic crisis has gained momentum. It was encouraged by events in Greece where in 2012, against the backdrop of the Eurozone crisis and harsh austerity, public support for the neo-Nazi Golden Dawn movement increased from 0.3 percent in 2009 to 7 percent in 2012, enough to hand the neo-Nazi party its first (21) seats in parliament. These were not the first fascists to win election in post-war Europe. In 1992, Mussolini’s grand-daughter had won election in Naples and would later serve in the Senate and European Parliament. But the sudden rise of Golden Dawn fuelled a broader belief that Europe’s financial crisis was leading to a revival of fascism.

The crisis narrative encouraged three other claims about national populism: first, that these revolts are rooted in events that unfolded after 2008; second, that national populists are mainly fuelled by white voters who live on low incomes, welfare or who are unemployed; and, third, that these voters are ‘old white men’ who are struggling to adapt to the modern global economy where university degrees and high skills are the new currency. The implication, we are often told, is that the angry white man will soon be replaced by tolerant and more highly educated millennials.

Each of these claims are linked closely to the ‘Left Behind thesis’, the idea that populist revolts appeal mainly to low income whites who are economically marginalized. This is, however, a misinterpretation of the original thesis which focused as much on the role of values and how these are shaped by things like educational attainment.

Yet the narrower income-focused interpretation flourished after Brexit

50) King, Gary., Ori Rosen, Martin Tanner and Alexander F. Wagner (2008), “Ordinary economic voting behavior in the extraordinary election of Adolf Hitler,” *The Journal of Economic History*, 68(4), 951-996.

and the election of Trump in 2016, which many observers traced to economically impoverished whites. Some pointed to the fact that the average Leave vote among voters on the highest incomes (i.e. earning more than £3,700 each month) was 38 per cent whereas among those on the lowest incomes (i.e. less than £1,200 each month) it was 66 per cent. Similarly, when two economists sat down to examine what they called the ‘Brexit-Trump Syndrome’ they focused almost exclusively on incomes and the crisis, arguing how ‘there can be little doubt that in Michigan and Merthyr Tydfil, South Carolina and Sunderland, the dissatisfaction of people on below-average incomes drove the outcome’.⁵¹)

This focus on left behind whites was entrenched by a parallel discussion about the ‘politics of despair’, which linked populism to economically disadvantaged communities where marginalized whites were effectively killing themselves. One year before Trump’s victory, one study found that mortality rates among middle-aged white Americans who did not have college degrees had increased significantly, most likely due to alcoholism, drug addiction and/or suicide. Some drew parallels with the only other documented case of an increase in the mortality rate for a large demographic group in the Western world, which was Russian men who had spiralled into alcoholism and/or suicide following the collapse of the Soviet Union. During the primaries in 2016, the *Washington Post* pointed to an ‘eerie correlation’ in voting data, suggesting that the insurgent Trump was performing strongest in counties where middle-aged whites were dying the fastest. The renegade outsider had tapped into a profound sense of despair among poorly educated whites who had been left behind by economic change.

Linked to this are arguments about generational change, namely that national populism is fuelled by old (white) men. Consequently, its future poten-

51) Jacobs, Michael and Mazzucato, Mariana (2016), “The Brexit-Trump Syndrome: It’s the economics stupid,” *LSE British Politics and Policy*, blog: <http://blogs.lse.ac.uk/politicsandpolicy/the-brexit-trump-syndrome/>

tial will diminish as each year passes. The rise of highly educated millennials whose social networks are more ethnically, religiously or culturally diverse, and who are often more tolerant, alongside newly ascendant groups like ethnic minorities, will combine to reduce the amount of space for national populists. Those who make these arguments, for instance, point to the fact that the average Brexit vote among pensioners was over 60 per cent but among 18-34-year olds it was only 30 per cent. Such facts even led one commentator to calculate that if you assume that birth and death rates in Britain remain constant and a cohort effect stays in place (whereby the young will retain their pro-EU views) then on current projections Remain will hold a clear and overwhelming majority in 2021 (!)

These arguments are linked closely to the theory of value change put forward by the political scientist Ronald Inglehart in the 1970s. Due to the arrival of improved economic conditions and the expansion of higher education, old white men who hold traditional socially conservative values and who formed the dominant majority in the West in earlier decades are gradually being replaced by their children and grandchildren who subscribe to more progressive or socially liberal values. The argument is seductive and often cited by outlets like the *Economist* when claiming that the populist threat will inevitably diminish as each generation replaces the last. Consistently, older cohorts who are the most likely to object to their relatives marrying a Muslim, to favour reductions in immigration, to think that being born in Britain or having British ancestors are very important markers of national identity while attempts to give equal opportunities to same-sex couples have gone too far.

The implication is two-fold. First, to counter national populism governments should focus on restoring economic stability, growth and employment, as well as boosting conditions for white workers on low incomes, on welfare and in poverty. The second is that countering these revolts becomes a waiting game – that effectively liberal democracies need only wait for gen-

eration to replace the last. But when you come to look at the evidence these broader claims are actually deeply misleading. Interrogating them reveals how our popular debates are too simplistic.

3-2. Challenging the crisis narrative

Consider the general life cycle of national populism. The phenomenon that found its expression in Brexit and Trump emerged long before the collapse of Lehman Brothers. It was in the 1980s and 1990s when the third wave attracted significant support while in the late 1990s and 2000s parties like the National Front in France and Austrian Freedom Party reached new peaks. While national populism was a long time coming it has also endured amid very different economic cycles. According to a recent paper that examines its electoral evolution between 1990 and 2008, national populism enjoyed its most significant advance between 1990 and 2008 – before the eruption of the Great Recession. During the most severe period of the crisis, between 2009 and 2013, national populists gained an average of only 1.2 points, which is hardly a major boost.

Furthermore, they often recorded their strongest results in parts of Europe that had been relatively spared from the worst effects of the crisis. Regions with high unemployment during the crisis saw declining support for the radical right, whereas regions with still relatively low unemployment rates during the crisis saw its vote shares increase while those regions that maintained high growth rates saw the strongest support of all.⁵²⁾ The fourth wave was well established long before the financial meltdown and often did not need the crisis to gather support.

In fact, if you compare support for the fourth wave of national populism

52) Stockemer, Daniel (2017), “The Economic Crisis (2009–2013) and Electoral Support for the Radical Right in Western Europe—Some New and Unexpected Findings,” *Social Science Quarterly*.

during the three years before the outbreak of the Great Recession and the three years after the crisis you do not find much of an effect. If you looked across the EU the first thing you might note is that around ten EU member states do not have successful national populists despite the fact that many of the same states were hit hard by the crisis and the events that unfolded, like Cyprus, Ireland, Portugal and Spain. Many of these same states also recorded some of the sharpest declines in political trust. Even in Greece, the hardest hit country, Golden Dawn has ‘only’ recruited support from one in ten voters. Conversely, of the seven states that have seen the most rapid gains for national populists since 2004 many like Austria and Denmark, remain well below the average rates of unemployment, debt and reductions in GDP. Or consider Sweden, which despite having a growing and strong economy with low unemployment and a strong welfare state still witnessed the rise of the Sweden Democrats.

Indeed, two of the most successful national populist revolts have taken place in Austria and the Netherlands, two states that have had some of the lowest unemployment rates within the EU. In affluent and stable Switzerland, it was in 2007 – on the eve of the crisis – when the Swiss People’s Party attracted nearly 29 per cent of voters, its highest share on record. In Britain, UKIP achieved its first breakthrough in 2004, capturing 16 per cent of the vote at European Parliament elections after forty-eight quarters of growth. This is not to say that the crisis or worry about economic loss are not important. In Europe, one recent study suggests that the financial crisis exacerbated the divide between the haves and the have nots, encouraging an erosion of support for the main parties and higher levels of volatility.⁵³) But while it may have enlarged space for national populism it was clearly not the major cause.

Subjective worries also appear to be just as important as objective eco-

53) Hernández, Enrique and Kriesi, Hanspeter (2016), “The Electoral Consequences of the Financial and Economic Crisis in Europe,” *European Journal of Political Research*, 55.2: 203-224.

conomic distress. Support for Brexit was much stronger among those who subjectively felt they had been left behind. The average Leave vote among those who felt they were living comfortably was 41 percent but among those who felt they were just getting by it was 60 percent and among those who said they were finding it quite or very difficult to get by it was 70 per cent. Trump also polled well among average and some voters on above average incomes but he did especially well among voters who felt that their economic and social position was deteriorating relative to other groups in society.

Nor do these parties merely recruit the unemployed, low income voters and/or people on the very bottom step of the economic ladder. Rather, over the past thirty years social scientists have often found that skilled and semi-skilled manual workers – i.e. people who are in employment – are the most likely to support these parties. One influential study estimated that just prior to the eruption of the global financial crisis parties like the Freedom Party of Austria and the National Front in France drew the bulk of their support from a fairly broad alliance of manual workers, low skilled service sector workers, clerks and the self-employed, while socio-cultural middle-class professionals in sectors such as media and the arts were noticeably under-represented.⁵⁴⁾

3-3. The rise of a values divide

How can we explain this support? While the crisis narrative is undermined by the life cycle of national populism and evidence on the dynamics of its support, it also says little about the role of value conflicts in this political mobilization. Today, there is an emerging consensus in the academic literature that national populism owes as much if not more to perceived conflicts

54) Oesch, Daniel (2008), “Explaining workers’ support for right-wing populist parties in Western Europe: Evidence from Austria, Belgium, France, Norway, and Switzerland,” *International Political Science Review*, 29.3: 349-373.

over values than to conflict over economic resources, and how these are underpinning by educational divides. Politics today is no longer underpinned by a neat dividing line between 'left and right', between socialists on one side and traditional conservatives or classical liberals on the other. These older divisions over economic redistribution have been joined, and are now possibly being eclipsed by, new divisions over competing values, between those who share a more universalistic, individualistic and socially liberal outlook, and those who hold a more traditionalist outlook, who put a premium on order, stability, conformity and group identities.

One useful starting point is in 1971, when Inglehart examined how people's value priorities were changing in the West. Inglehart argued that because of economic growth, the welfare state, an expansion of university education and greater access to information, people were becoming more likely to exhibit post-material values and less likely to adhere to materialist values. This was what he called the "silent revolution" theory of value change. Writing at a time when there were few successful national populists in the West, and in the shadow of the New Left revolts during the 1960s, Inglehart argued that "a transformation may be taking place in the political culture of advanced industrial societies. This transformation seems to be altering the basic value priorities of given generations as a result of changing conditions influencing their basic socialization".⁵⁵) In the years that followed, analyses threw further light on this intergenerational shift from materialist to post-materialist values. Among older groups, materialist values that focused on economic and physical security were predominant while among younger ones post materialist values that stressed things like autonomy, human rights, quality of life and self-expression became increasingly widespread. As economic growth swept across the West citizens felt more secure and became more concerned about new issues. Unlike older and less well-educated mate-

55) Inglehart, Ronald (1971), "The Silent Revolution in Europe: Intergenerational Change in Post-Industrial Societies," *American Political Science Review*, 65.4: 991-1017.

realists who worried about how to secure scarce resources, fend off competition and protect their nation state from threatening outsiders, more economically secure and degree-holding post-materialists turned to issues like environmentalism, multiculturalism and how to defend and expand rights for women, same-sex couples, refugees, immigrants and ethnic minorities. This had clear political repercussions. In several democracies, the evolving value priorities facilitated the emergence of new challengers on the left, like Green and left-wing populist parties. But not everybody participated in the silent revolution.

Beginning in the 1970s and 1980s the start of a backlash to this cultural change became clearly visible and was reflected in growing levels of support for the third wave of national populism, where a loose alliance of left behind voters began to rally around calls for a reassertion of more traditionalist values. These voters typically lacked degrees and tended to share more socially conservative or authoritarian values. These groups often had quite different life experiences but they shared a rejection of the shift toward a more individualistic society where the dominant liberal consensus supported if not celebrated things like mass immigration, transnational and global identities and European integration. The opposition to immigration or Islam that dominates the outlook of national populists is only one part of a much broader values-led backlash.

One of the first people to spot this backlash was the Italian political scientist, Piero Ignazi. He asked a simple but important question – why, in an era of mounting post-materialism and economic growth, was Europe witnessing a growing number of voters shifting over to parties like the National Front in France, the Austrian Freedom Party, or the Progress Parties in Scandinavia? He argued that alongside post-materialism a different mood had started to take root in Europe – this mood included the emergence of new priorities and issues not treated by the main parties, a disillusionment towards parties in general, a growing lack of confidence in the political system and its in-

stitutions and a general pessimism about the future. It was anchored mainly in a reassertion of a different set of values – concerns about authority, patriotism, the role of the family and traditional moral values, much of which had been legitimized by the rise of neo-conservatism in the United States and Britain. The West, concluded Ignazi (1992), was beginning to witness the emergence of a “silent counter-revolution”.⁵⁶⁾

The values divide had probably always existed but it was brought to the fore and increasingly politicized by the experiences of the 1970s and 1980s, in particular the arrival of immigration as a major issue in European politics and the perceived inability of established parties to respond in a way that satisfied increasingly anxious electorates. In the words of Ignazi. ‘A mounting sense of doom, in contrast to post materialist optimism, has been transformed into new demands, mainly unforeseen by the established parties. These demands include law and order enforcement and, above all, immigration control, which seems to be the leading issue for all new right-wing parties. This value change, stimulated by the reaction to postmaterialism and by a new combination of authoritarian issues, might be identified as a silent counter-revolution’.

Those who flocked to national populists are thus significantly more likely to view immigrants as a burden on the welfare state, bad for the economy and as undermining national culture. Consider Brexit, as well. Among those who oppose gender equality, equality for same-sex couples, who want to see stiffer sentences for criminals and favour the death penalty support for Brexit was higher than it was among liberals who hold the opposite views on these issues. The average leave vote among people who want to see the death penalty reintroduced was 71 per cent but among those who oppose the death penalty it was only 20 per cent.⁵⁷⁾ Similarly, in Europe many studies of

56) Ignazi, Piero (1992), “The Silent Counter-Revolution,” *European Journal of Political Research*, 22.1: 3-34.

57) Goodwin, Matthew, and Oliver Heath (2016), *Brexit vote explained: poverty, low skills and lack*

populist right voters have now shown that the most important predictor of this support is their negative attitudes toward immigrants, ethnic minorities and their deep concern about how these are seen to threaten the nation state.

In a recent paper, Inglehart returned with his colleague Pippa Norris to explore the rise of the populist right and similarly came to the conclusion that it is a cultural backlash rather than economic insecurity that can account for the surge in votes for parties that present themselves as the main opponents to the rapid cultural changes that commenced in the 1960s. Even after applying social and demographic controls all of the cultural value scales were the strongest predictors of support. In their words: “populist support was strengthened by anti-immigrant attitudes, mistrust of global and national governance and support for authoritarian values...Their greatest support is concentrated among the older generation, men, the religious, majority populations, and the less educated – sectors generally left behind by progressive tides of cultural value change. The electoral success of these parties at the ballot box can be attributed mainly to their ideological and issue appeals to traditional values”.⁵⁸⁾

Nor is this divide simply pitting young millennials against old white men. Rather, it is structured strongly by a sharp educational divide. In 2017, Marine Le Pen polled strongly among voters aged under 40 years-old but who often had no university degree while in countries like Austria national populists have polled strongest among younger men who have also lacked university education, which has been shown to encourage a more liberal outlook. Trump, too, made his strongest advances in areas of the United States where average education levels are low. Given that these deeper currents that run through educational experience and values are integral to the

of opportunities, Joseph Rowntree Foundation.

58) Inglehart, Ronald, and Pippa Norris (2016), “Trump, Brexit, and the rise of populism: Economic have-nots and cultural backlash,” Paper for the roundtable on “Rage against the Machine: Populist Politics in the U.S., Europe and Latin America,” September 2016, annual meeting of the American Political Science Association, Philadelphia.

national populist revolt, it seems unlikely that the fourth wave will disappear anytime soon.

4. Conclusions

For these reasons, the cultural divide between populist nationalists and cosmopolitan liberals will likely continue to push questions about national identity, immigration, and integration to the forefront. This development has been troubling for the mainstream but especially social democrats who have struggled to respond in a language that resonates among their traditional working-class voters. Many of these voters are economically protectionist, hostile toward things like free trade and big banks, but they are also socially conservative, favouring restrictive immigration policies, adhering to more exclusive conceptions of nationhood and instinctively sceptical toward the shift toward transnational organizations (like the European Union). Crucially, and what many on the centre-left failed to recognize, is that their traditional voters often prioritize cultural protectionism over economic protectionism. Since 2015, in particular, the centre-left across Europe has suffered a loss of support. In 2017, social democrats in Austria, France, the Netherlands and Germany experienced some of their worst performances on record while national populists enjoyed some of their strongest.

A closely related trend concerns the steep decline in class voting that has also been taking place across most Western democracies in the post-war period. Though not restricted to the centre-left, the working classes are much less likely to be swayed by the old class-based loyalties that used to guide their parents and grandparents. By the time you get to the 1990s, for example, it has been estimated that social class voting was less than half as strong as it had been a generation earlier – thus things like income and class became much weaker predictors of how somebody would vote at an election

when compared to their attitudes toward issues like immigration and national identity. Many centre-left parties gambled that they could win over the new middle-classes while retaining the traditional working-classes but are now realizing that they lost the gamble.

When seen in the whole, while national populism was a long time coming it is now difficult to avoid the conclusion that it will remain on the landscape for many years, perhaps decades, to come. While individual elections will come and go – Donald Trump may not be re-elected, Brexit may well be overturned (although this seems unlikely) – the deeper currents that have underpinned these rebellions will remain firmly in place, swirling beneath our politics and no doubt waiting to find their expression in a new revolt against liberal democracy.

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Chapter 4



Whither the Franco-German Motor?

Overcoming Disputes and Reaching Compromises

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1. Introduction: From wonder to strategy
 2. Education and culture
 3. Eurozone reform
 4. Defence
 5. The way ahead
 6. Conclusions: Lessons learned

France and Germany are widely seen as the “motor” of European integration. The very close bilateral relation they have built upon their unprecedented process of reconciliation is clearly a great success. Yet, fundamental differences persist between the two countries, in particular when it comes to fiscal and monetary policies (pertaining to the Eurozone) and to defense. These differences are not related to parties in power, but to very different political cultures. They consequently constitute structural challenges France and Germany must overcome. Moreover, a changing European environment – no longer characterized by binary North-South dividing lines but by a multitude of “camps” and constellations depending on the subject – make it difficult for Paris and Berlin to continue to play their role as a “motor” for European integration. Against that backdrop, this chapter analyses what France and Germany need to do to further strengthen their relationship and move it beyond European crisis management, which dominated ever since the 2008 economic and financial crisis broke out. It argues that Paris and Berlin must not underestimate the intercultural dimension in their bilateral relationship and start addressing future challenges such as digitalization or climate change together.

1. Introduction: From wonder to strategy

France and Germany are widely seen as the “motor” of European integration. Not only is the bilateral relationship between the two countries the closest in the world, Paris and Berlin (previously Bonn) also played decisive roles in many of the European Union’s key turning points and moves toward closer integration. From being a project of reconciliation, friendship between the two countries has moved on to largely being about managing crises and shaping the future of European integration. But in light of changing circumstances, both within the EU and globally, they now have one more

step to take and must integrate a stronger strategic dimension into their cooperation.

Given centuries of rivalry and wars, reconciliation between France and Germany was no matter of course. It is thus rightly qualified as a geopolitical miracle. The signing of the Elysée Treaty on 22 January 1963 by French president Charles de Gaulle and West German chancellor Konrad Adenauer is generally seen as the landmark event in this process. In reality, the starting point came in May 1950 with the Schuman Declaration, in which French foreign minister Robert Schuman called for the German and French coal and steel industries (as a core element of the armaments industry) to be placed under a common European authority. But even in the immediate post-war period, first attempts at rapprochement took place at the level of civil society. Organized on a very small scale, they were at the origin of a movement that grew and allowed the two societies to get closer.

In Cold War times, friendship between the two “hereditary enemies” obviously only concerned the Federal Republic of Germany, while the Eastern German Democratic Republic was firmly anchored in the Communist bloc. The Cold War context is important to bear in mind, and notably the indirect role played by the United States: by ensuring Western Europe’s security, NATO members no longer needed to fear each other and could consequently focus on cooperation leading to mutual benefits. For France and West Germany, the Elysée Treaty laid the ground for close political cooperation, and thereby also paved the way for deepened European integration. Paris and Bonn, later on Berlin, took on the role as the “engine” for European cooperation that resulted in the creation of the European Economic Community (EEC) in 1958, followed by the European Union in 1993.

After a period of relative inertia in recent years, Emmanuel Macron’s election as French president in May 2017 led to high hopes on a reinvigorated Franco-German relationship.⁵⁹⁾ However, Angela Merkel’s difficulty to form

a coalition after the September 2017 Bundestag election and the less than lukewarm reactions to the proposals Macron made in his Sorbonne speech just days after the German election quickly led most observers to temperate their optimism. Behind the official discourse of Franco-German friendship, cooperation is not always run as smoothly as it may seem from an outside perspective. All too often, concepts, interests and therefore priorities differ quite widely. While reconciliation thus may be considered France and Germany's tremendous 20th century achievement, the process has not led to aligned positions and views on a multitude of core issues. As we shall discuss below, Paris and Berlin indeed continue to pursue different approaches to key matters such as economic and budgetary policies or defence.

These differences are of a structural nature, linked to national features rather than contingent on political forces in power. But therein also lies the strength of Franco-German compromise: if Berlin and Paris manage to find a common approach, chances are high this compromise will be viable across Europe. This, in any case, has been one of the reasons for the tandem's success in pushing European integration forward.⁶⁰⁾ Franco-German disagreements indeed often reflect divisions within the European Union at large. In light of current transatlantic tension, Brexit and far-reaching disagreement on a wide variety of matters within the European Union – including fundamental issues and values – a functioning Franco-German tandem is crucial. But the question is whether Paris and Berlin still can play their traditional role under such circumstances. Against that backdrop, this paper intends to take stock of Franco-German relations in three highly relevant fields of bi-

59) Benner, Thorsten and Thomas Gomart (2017), "Meeting Macron in the Middle. How France and Germany can Revive the EU," *Foreign Affairs* (May 8), Available at www.foreignaffairs.com/articles/europe/2017-05-08/meeting-macron-middle (accessed December 14, 2018).

60) Krotz, Ulrich and Joachim Schild (2013), *Shaping Europe: France, Germany, and Embedded Bilateralism from the Elysée Treaty to Twenty-First Century Politics*, Oxford: Oxford University Press.

lateral cooperation: education and culture, Eurozone reform and defence. It will assess how well Paris and Berlin work together, identify the main stumbling blocks and eventually discuss what this means for both countries' role as a motor of European integration.

2. Education and culture

The 1963 Franco-German Elysée Treaty not only laid the groundwork for political cooperation, it also emphasized the need for deeper understanding between people and societies. As early as in the 1950s, French and German leaders relied on exchanges at the level of civil society. The very first bilateral agreement aimed to promote the teaching of foreign languages, as well as cooperation within and outside of universities (based on a Cultural Agreement of October 23, 1954). Today, the main objective has been reached: Within society, the mistrust of earlier times has been replaced by reciprocal trust.⁶¹⁾ The neighbouring country is no longer seen as a stranger, but as a friend – or at least as a partner with whom one shares numerous values.

2-1. Youth exchange

The Franco-German Youth Office (FGYO) plays a key role. Since its creation in 1963, millions of young Frenchmen and Germans participated in exchange programs and got to know the other country through first-hand experience: every year, over 200,000 young people participate in one of the 8,000 exchange programmes the FGYO supports or organizes.⁶²⁾ The

61) Demesmay, Claire (2019), “Des images et des mots : la perception de l'autre dans le couple franco-allemand,” Kunststiftung NRW, ed., *Auf dem Weg in die Zukunft: Die deutsch-französischen Beziehungen 100 Jahre nach dem Ersten Weltkrieg*, Berlin: Hatje Cantz.

62) Defrance, Corine and Ulrich Pfeil (2013), *Les jeunes dans les relations transnationales: L'Office*

Youth Office proved so successful that, after the end of the Cold War, the model was replicated by creating a German-Polish Youth Office to pursue reconciliation and deeper understanding between reunified Germany and Poland.

Since its creation, the FGYO has emphasized curricular and extra-curricular exchanges between young people from both countries. Be it through tour groups, individual stays in host families, or internships, it seeks to encourage youths to learn the language and discover the neighbouring country's culture. Acquiring intercultural competence was soon identified as a crucial element in these exchanges, pushing the organizers to employ adapted pedagogic materials and surround themselves with specialized trainers. Moreover, the FGYO continuously adapted its offers. To infuse the exchanges with a new dynamic, some programmes have been opened to third-party countries, e.g. in the Balkans or on the Mediterranean's southern rim.

Offering since 1999 numerous dual-degree programs across all academic disciplines, the Franco-German University is another successful example of youth exchange between France and Germany. It is in fact a network of more than 100 French and German universities. The co-funded institution coordinates and finances integrated curricula recognized by a double – or sometimes triple – diploma, in which 6,500 students participate each year. This is not to mention the doctoral colleges it supports, which allow 300 PhD students each year to conduct their research within the framework of a “co-supervision”, leading to a doctorate awarded by both a French and a German university.

2-2. Towards a common narrative

Alongside the systematization of exchanges, France and Germany

franco-allemand pour la jeunesse 1963-2008, Paris: Presses de la Sorbonne Nouvelle.

launched several initiatives aimed at fostering the emergence of a common historical vision, indispensable to the elaboration of a European project. The Manual of Franco-German History is one of its strongest symbols. The wish to create “a manual of Franco-German history with identical content for both countries in order to deepen mutual comprehension” was formulated by a Youth Parliament during the ceremonies for the Elysée Treaty’s 40th anniversary in January 2003. Political authorities in both countries soon got interested and a committee of about 20 historians and representatives of educational institutions was established. The result: three manuals on European and world history from Antiquity to the present aimed at high school students, released between 2006 and 2011.

The richly documented work problematizes the differences in approach in France and Germany, hence fully embracing the divergences in interpreting historical events.⁶³⁾ Its success is yet fairly limited, as it is mainly used in Franco-German schools and schools with European sections. Nevertheless, despite modest sales, the political impact of this manual should not be underestimated. A comparable initiative was launched between Poland and Germany, as well as between Germany and the Czech Republic. Similarly, a book on contemporary Southeast Asian history written by Korean, Chinese, and Japanese historians was published in 2012.⁶⁴⁾ Furthermore, the Manual of Franco-German History may be a first step towards teaching a common history for all Europeans. Though this may take time, the Franco-German relationship can be considered a laboratory for even more European ambitions.

The Manual of Franco-German History was preceded by an initiative seeking to create Franco-German journalism. On the eve of German re-

63) Monnet, Pierre (2006), “Un manuel d’histoire franco-allemand,” *Revue historique*, No 638, pp. 409-422.

64) Kim, Seungryeol (2009), “International History Textbook Work from a Global Perspective: The Joint Franco-German History Textbook and Its Implications for Northeast Asia,” *Journal of Northeast Asian History*, 6/2, pp. 75-101 (December).

unification, in October 1990, Paris and Berlin signed a State Treaty creating the bi-national and bi-lingual TV channel Arte. It stipulated that programmes should encourage understanding between European people. Yet, while this achievement carries a strong symbolic dimension, it is often reproached for its cultural elitism. For several years, Arte has sought to break with this image and combat low viewership by showing more popular programmes. Nonetheless, the channel only boasts limited success, especially in Germany. Moreover, it reaches mainly an educated audience of frequent travellers and consumers of cultural goods, already committed to the European cause.

2-3. Elitism and trivialization of relations

Cultural collaboration such as Arte, the Franco-German University's integrated curricula, or even the FGYO's exchange programs (despite efforts, in the last years, to target young people from disadvantaged backgrounds) suffers from an elitist bias. In addition, there is a certain trivialisation of the Franco-German relationship. In times of globalisation, the partner country is simply no longer exotic for young people used to travelling easily. This trivialization has resulted in a continuous decline in the learning of the other's language since the 1990s – more brutal in France than in Germany. Though leaders of the two countries regularly refer to the importance of learning the partner's language – inscribed in the Elysée Treaty and in the recently signed treaty of Aachen – this commitment is not applied in practice.

The trivialization of Franco-German relations is such that some regret the fascination that once existed between France and Germany. Observing that the teaching of the partner language has been plummeting constantly for several years, and regretting French and German intellectuals' ignorance of the partner country's cultural production, historian Pierre Nora deduced that European cultures are quickly heading towards renationalization.⁶⁵ For

Nora, the Franco-German cultural relationship is characterized today by a “desire to stand out” rather than an effort to come together.

However, this normalization/trivialisation of the bilateral relationship may also be seen as a sign of its solidity. Fascination with the other does not necessarily imply knowledge, and can be accompanied by animosity, as was the case in the past. How Frenchmen and Germans see each other remains coloured by numerous clichés, often reinforced by the media, especially in periods of crisis. Moreover, as the memory of the wars of the 20th century fade, the links uniting the two countries seem to be governed by reason rather than emotion. But thanks to the numerous exchanges that have allowed for the construction of close links between the two societies, Franco-German cooperation has reached such a level of normalcy that political crises are not felt in the realm of civil society. The end of mutual fascination comes today with a peaceful relationship with the partner country.

3. Eurozone reform

Among the many issues relevant to the Franco-German relationship, economic and monetary policy is certainly the most important. In this field, France and Germany have specific traditions, which result in different preferences, quite irrespective of the political orientation of governments. Yet it is also the issue on which the two countries have cooperated most in recent years, contributing to a level of integration, and therefore intra-European interdependence, never achieved in other policy areas. France and Germany have very close trade relations.⁶⁵ But even more importantly, both states

65) Nora, Pierre (2012), “Deutsch-französisches Verhältnis: Man hat sich auseinandergelebt,” *Frankfurter Allgemeine Zeitung* (February 16). Available at www.faz.net/aktuell/feuilleton/deutsch-franzoesisches-verhaeltnis-man-hat-sich-auseinandergelebt-11651980.html (accessed December 14, 2018).

pushed for the creation and gradual deepening of the common market, as well as the establishment of the Monetary Union in 1999, in which 19 EU Member States now participate.

3-1. Fundamental differences

In the French economic tradition, the State plays a strategic role. Political authorities should be able to mobilize all means of economic policy to reach the objectives that the government set for itself. Rules are understood to be interpreted with some flexibility. According to the traditional German approach, in line with the ordoliberal logic, the State sets the basic rules of economic life then to be respected by independent economic stakeholders. It is up to companies and their employees to create prosperity, not administrative and political institutions. This conception has heavily impacted the Common market, as well as the Economic and monetary union (EMU). These Franco-German dissonances can also be identified in growth models: France concentrates on internal demand, while Germany focuses on exports, and thus on the competitiveness of its companies. In France, German economic policy is often considered uncooperative, as it entails pressure on wages that affects neighbouring countries. Conversely, there is recurrent critique in Germany that France's attempts to improve its competitiveness are inadequate.

Another issue of profound disagreement, which precedes the creation of the single currency and is inseparable from its history, is the economic and

66) In 2017, Germany was France's top commercial partner: Franco-German exchanges (exports + imports) represented 15.4% of its total exchanges. Until 2014, France was also Germany's top commercial partner; it is now only fourth, after China, the Netherlands and the United States. See French Ministry of the Economy and Finances. 2018. *Les échanges commerciaux entre la France et l'Allemagne en 2017* (April 17). Available at <https://www.tresor.economie.gouv.fr/Articles/2018/04/17/les-echanges-commerciaux-entre-la-france-et-l-allemande-en-2017> (accessed December 14, 2018).

monetary governance of the Eurozone. For Germany, this was supposed to be accompanied by strict management rules, especially with regards to budgetary orthodoxy. On the contrary, France traditionally emphasizes the importance of not stifling economic growth and, like other member-states, often allowed itself to take liberties with the budgetary criteria laid down in the European treaties. From Paris' perspective, the priority has always been to establish a European "economic government", which Berlin considered unnecessary for a long time. It is only with the aggravation of the situation in Greece and tensions within the Eurozone that the two countries began to move closer together. Berlin accepted to reform European governance, while France agreed to follow a policy of more tightly controlled public deficits.

Finally, the European Central Bank (ECB)'s role is an eternal source of contention between the two countries. From the German point of view, it must be legally and politically independent. As a guarantor of both the stability of the single currency and the Economic and Monetary Union's credibility, it is not allowed to grant loans to states, nor to bail out public deficits. It is on this principle, which is non-negotiable for Germany, that the ECB was built. While France officially accepts the Central Bank's independence, the concept of an independent administrative authority is foreign to most French leaders. Since the ECB's creation, they often criticised it for its – allegedly excessive – concern for inflation and for a lack of interest in exchange rate policy, which, according to the Bank's detractors, leads to an overvaluation of the euro compared to the US dollar and thus undermines European companies' competitiveness.

3-2. Implications for European integration

When the Greek public debt crisis broke out in 2009, these divergences reappeared. While Paris was calling for quick aid, Berlin refused to question

the no-bailing out principle enshrined in European treaties. After long and difficult negotiations, France and Germany finally reached an agreement in spring 2010. It consisted in activating a rescue plan, as Paris judged necessary, on the conditions of budgetary adjustments and ambitious structural reforms in Greece, as well as the participation of the International Monetary Fund, as Berlin demanded. In the meantime, the ECB has followed unorthodox policies, notably by buying back on the secondary market sovereign bonds of Eurozone states that faced investor distrust, in order to lower interest rates. Though the German government is now proving more conciliatory towards this approach, many Germans oppose it, especially at the Bundesbank. The highly critical judgment of the Federal Constitutional Court in July 2017 on the purchase of State bonds reflects this hostility.

At the same time, France and Germany have been working since 2010 to strengthen monetary union stability – always through compromise.⁶⁷⁾ While French conceptions predominated between summer 2008 and summer 2010, Germany soon made its voice heard. Paris may have failed to impose Eurobonds, but it succeeded in persuading Germany of the necessity to create and maintain an anti-crisis firewall, the European Financial Stability Facility (EFSF), transformed in autumn 2012 into the European Stability Mechanism (ESM). In addition to the conditions it placed on the adoption of these measures, Berlin succeeded in reinforcing budgetary discipline, now treated as a priority on the European level. With the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union, implemented in 2013, the budgetary and economic policy of member-states be-

67) Jamet, Jean-François, Franck Lirzin, Joachim Schild, and Daniela Schwarzer (2013), “Krisenmanagement und Governance-Reformen in der Eurozone – Enge Abstimmung bei divergierenden Lösungsansätzen,” Claire Demesmay, Martin Koopmann, and Julien Thorel eds., *Die Konsenswerkstatt. Deutsch-französische Kommunikations- und Entscheidungsprozesse in der Europapolitik*. Baden-Baden: Nomos. See also Schild, Joachim (2013), “Leadership in hard times. Germany, France, and the Management of the Eurozone Crisis,” *German Politics & Society*, n° 31, vol. 1, pp. 24-47.

came the subject of increased surveillance by the European Commission. Finally, in order to stabilize the financial system of the Eurozone, France and Germany have been involved in the creation of a European Banking Union, not without difficulties due to their major disagreements, in particular on deposit guarantees.

The accession of Emmanuel Macron to the French presidency in May 2017 relaunched discussions on the reform of the Eurozone. His ambitious project to create a Eurozone budget managed by a Minister of Finance, himself monitored by a Eurozone Parliament, is far from being unanimously approved in Germany. In part of the political class, it has awakened fears of financial transfers, which Germany has always opposed, especially because of the sharing of risk they imply. It was not until the Franco-German meeting at Meseberg castle (the German government's guest house) in June 2018 that the two states made a difficult rapprochement. Among their proposals, Merkel and Macron announced their agreement to form a Eurozone budget dedicated to investments. This could be interpreted as a concession from Germany to its French partner, but since neither the amount nor the functioning of this budget has been specified, the compromise remains very vague. The controversies within Germany over a European unemployment reinsurance scheme, following a proposal by the Federal Ministry of Finance in autumn 2018, shows how sensitive the issue of risk sharing is in Germany.⁶⁸⁾ Moreover, Paris and Berlin set the framework, but wish to define the content with their European partners. This makes an ambitious compromise even more complicated, since several EU member-states radically oppose the idea (a group sometimes dubbed "Hanseatic League" as its members are to be found in Northern and North-Eastern Europe led by the Netherlands).

68) Schwarzer, Daniela (2018), "Europäische Arbeitslosenrückversicherung. Eurozonen-Reform sollte ein zyklisches Stabilisierungsinstrument enthalten," *DGAPkompakt* Nr. 26 (October 25). Available at <https://dgap.org/de/think-tank/publikationen/dgapkompakt/europaeische-arbeitslosenrueckversicherung> (accessed December 14, 2018).

4. Defence

Like in the field of monetary and budgetary policies, Franco-German differences in the field of defence are long-standing and profound.⁶⁹⁾ Both countries' strategic cultures are essentially different, and the past has left its marks on French and German reasoning on security and defence. There are, of course, symbols of close friendship even in the defence field. For example, the Franco-German Brigade was created in the late 1980s. True integration, however, has not happened so far: although the Brigade is currently deployed in Mali, the separate French and German units contribute to separate operations.

4-1. Fundamental differences

The French discourse on defence matters is still that of a great power, as e.g. illustrated by President Macron's 2018 speech to the Diplomatic Corps.⁷⁰⁾ Security and defence is a policy field characterized by a significant degree of consensus across a political spectrum otherwise more focused on divides. France's permanent seat at the United Nations Security Council (UNSC) and its own national nuclear deterrent are considered important factors in a policy intended to lead to "strategic autonomy." To that end, France must retain full-spectrum armed forces in order to act on its own or with allies, as well as it must maintain its nuclear deterrent.

69) Kunz, Barbara (2018), "The Three Dimensions of Europe's Defence Debate," *German Marshall Fund of the United States Policy Brief* No. 24. Available at www.gmfus.org/publications/three-dimensions-europes-defence-debate (accessed December 14, 2018).

70) Macron, Emmanuel (2018), "Transcription du discours du président de la République – vœux au corps diplomatique" (January 5). Available at : www.elysee.fr/declarations/article/transcription-du-discours-du-president-de-la-republique-v-ux-au-corp-s-diplomatique/ (accessed December 14, 2018).

Germany, on the other hand, officially only regained full national sovereignty in March 1991, following its reunification. For decades, strategic thinking was outsourced to Washington and Brussels, with Germany's approach characterised by restraint. As of 2018, Berlin is still struggling to find its role on the European and international scene when it comes to security. That post-Cold War business as usual no longer was an option became clear at the latest in 2011, when Germany's UNSC abstention on Libya caused severe diplomatic rifts between Berlin and its closest allies, accusing Germany of a lack of solidarity and of hiding behind its past in order to avoid taking on responsibility. This led to a new German approach, in particular in discourse, to German foreign policy. This new discourse, sometimes labelled "Munich consensus" is centred on the notion of responsibility, which has since then almost become a mantra. The real-life repercussions of this new discourse have yet not really materialized so far, in any case not in a decisive evolution of German strategic culture or concrete defence policy measures.

These fundamental differences in strategic culture of course have consequences at all other levels of security and defence policy. First, although France and Germany officially share threat perceptions, Paris and Berlin's priorities are not necessarily on par. This applies first of all to defence matters as such: they are a much higher priority in Paris than in Berlin. Moreover, the key issue from a French perspective is terrorism. France consequently mainly looks south, to Africa and the Middle East. Germany, in turn, tends to look east. From these geographical priorities, second, also derive preferences for defence policy: while defence in the South is about crisis management, a potential Russian threat requires measures intended to strengthen deterrence and collective territorial defence. This, thirdly, leads to different priorities when it comes to institutional settings: while "*l'Europe de la défense*", i.e. defence in an EU framework, has always been close to French hearts, Germany remains Atlanticist and primarily bets on NATO. It is of course wrong to assume that these French and German preferences are

completely black or white. The reality is naturally more nuanced – yet these fundamental patterns continue to shape Paris and Berlin’s approaches to European integration in the field of defence.

4-2. Implications for European integration

The defence dimension of European integration is the so-called European Union’s Common Security and Defence Policy (CSDP). According to the Lisbon Treaty, CSDP is not about collective territorial defence, but exclusively about crisis management outside the EU. Territorial defence in Europe is the North Atlantic Treaty Organization’s (NATO) task. CSDP may also cover cooperation in the fields of capabilities and industries. Notably these latter aspects gained new momentum when provisions on the so-called Permanent Structured Cooperation (PESCO)⁷¹⁾ were activated in the wake of Brexit: in so far 17 projects, those member states that are “willing and able” take their cooperation a step further. France and Germany played a decisive role in activating PESCO.⁷²⁾ However, although Paris and Berlin had the same objective, it was not for the same reasons: ambitions and priorities were again different in this process. Paris sought to use PESCO in order to make the EU a more effective and efficient security actor, with a clear focus on operations. Paris consequently preferred a PESCO with only those countries as participants that are indeed “able and willing”. Berlin, in turn, put strong emphasis on the European integration dimension, insisting

71) See European External Action Service, “Permanent Structured Cooperation (PESCO) – Fact Sheet.” Available at https://eeas.europa.eu/headquarters/headquarters-homepage/34226/permanent-structured-cooperation-pesco-factsheet_en (accessed December 14, 2018).

72) Billon-Galland, Alice and Martin Quencez (2017), “Can France and Germany Make PESCO Work as a Process Toward EU Defence?” *German Marshall Fund of the United States Policy Brief* No. 33. Available at www.gmfus.org/publications/can-france-and-germany-make-pesco-work-process-toward-eu-defense (accessed December 14, 2018).

on the necessity of an inclusive PESCO with as many EU members participating as possible. Moreover, operations are not a German priority, which is why Berlin's priority were capabilities. The final version of PESCO clearly resembles German preferences, with now 25 member states out of 27 taking part.

In light of the above-described differences and the way in which they translate into examples such as French and German approaches to PESCO, it is hardly surprising that Paris and Berlin do not pursue ambitious operational cooperation. Rather, the bulk of common projects is currently in the industrial realm. Most importantly, this includes the joint development and production of a replacement for the Rafale and Eurofighter jets, called FCAS, with an initial agreement signed between Airbus and Dassault in April 2018.⁷³) Paris and Berlin also pledged to continue and deepen their cooperation on land systems and drones. If these projects – and in particular the FCAS – work out, they have the potential to shape the European defence industry for decades. At the same time, it is also clear that industrial projects cannot solve issues at the levels of strategy and priorities – in particular given that they are not free from frictions either, notably regarding the export of jointly built armaments. As a result, European defence is lacking firm and ambitious Franco-German leadership.

5. The way ahead

In a European Union torn apart by internal tensions and faced with complex geopolitical challenges, the traditional Franco-German method of con-

73) Bryan, Victoria (2018), "Airbus, Dassault to team up for new fighter jet project," *Reuters* (April 25). Available at www.reuters.com/article/us-germany-airshow-airbus-dassault-avi/airbus-dassault-to-team-up-for-new-fighter-jet-project-idUSKBN1HW14U (accessed December 14, 2018).

sensus-building clearly has its limitations. In this new context, the relationship needs to evolve towards a new purpose, and therefore a new basis – without, however, forgetting its origins. It must leave the crisis management mode behind that characterized it since the beginning of the Euro crisis, and develop a long-term strategic vision for the European Union. In so doing, it needs to pay ever greater attention to the environment in which it evolves, be it at the European or global level. Equally importantly, it must widen its scope and embrace the future challenges: climate change, the digital revolution and artificial intelligence, asylum and migration – as well as, more broadly and on a global scale, the future of multilateralism.

5-1. Broadening the scope

In recent years, France and Germany have deepened their cooperation on migration issues. Germany's decision to suspend the Dublin Regulation in August 2015, followed by the arrival of a large number of refugees in the country, put Franco-German cooperation to a serious test. With radically different interests, the two governments could hardly reach an agreement. Since controlling migration movements has become their common goal again after autumn 2015, both governments have insisted on protecting the EU's external borders and committed themselves to strengthening the operational capacities of Frontex (European Border and Coast Guard Agency) – with a certain success. In the medium and long term, as announced at their Meseberg 2018 meeting, they want to establish a European asylum system with a common asylum authority.⁷⁴⁾ But when it comes to distributing refu-

74) French Government, German Government (2018), "Erklärung von Meseberg," Declaration after the June 19, 2018 Ministerial Meeting in Meseberg (June 19). Available at www.diplomatie.gouv.fr/de/frankreichs-beziehungen-zu-deutschland-osterreich-und-der-schweiz/bilaterale-beziehungen-mit-deutschland/neuigkeiten/article/europa-gemeinsame-erklarung-deutschlands-und-frankreichs-19-06-2018 (accessed December 14, 2018).

gees in Europe, Franco-German cooperation has only had limited impact. Although the idea was taken up by the European Commission, the Visegrád Group (Czech Republic, Hungary, Poland and Slovakia) radically opposes it and obstructs any agreement. Franco-German cooperation does not allow for overcoming this deep divide in the EU.

Regarding other major challenges, the fight against global warming should be a priority for Franco-German cooperation. In their common position paper of spring 2018, the two parliaments called on both governments to intensify their cooperation on implementing the 2015 Paris Climate Agreement and the 2017 One Planet Summit commitments. They aim for “ambitious decarbonation by 2050.”⁷⁵⁾ According to the June 2018 Meseberg Declaration, a working group at ministerial level is to be set up to develop common positions on energy transition and to discuss the question of a European minimum price for CO₂. The decision is certainly a step in the right direction, but the road to an ambitious agreement, as parliaments want, is full of obstacles – also due to domestic political controversies on the subject. In terms of energy policies and energy security, France and Germany are quite far apart due to rather different energy mixes. France relies heavily on nuclear energy – even if it plans to reduce its part in the energy mix in the future – while Germany decided to phase out its nuclear reactors after the 2011 Fukushima accident – a decision that still causes mixed feelings in Paris as it is seen as a unilateral act without prior consultations. Similar reproaches are made in Central and Eastern Europe when it comes to Berlin’s backing of Nord Stream 2. In particular Nordic countries, the Baltics and Poland oppose this pipeline strongly because of its geopolitical implications at a time

75) Franco-German Working Group of the Bundestag and the National Assembly (2018), “Common Position on the Renewal of the Elysée Treaty,” May 20, p. 5. Available at [www2.assemblee-nationale.fr/content/download/68974/703161/version/1/file/2018_06_20+Position+commune_N3+FR+ALL+\(version+finale\).pdf](http://www2.assemblee-nationale.fr/content/download/68974/703161/version/1/file/2018_06_20+Position+commune_N3+FR+ALL+(version+finale).pdf) (accessed December 14, 2018).

when relations with Russia are extremely difficult. Germany's aspirations to become a gas hub in Europe are said to undermine European energy security as well as the European Energy Union. French company Engie is also part of Nord Stream 2.

Digitalization brings along such profound changes that the Franco-German tandem cannot ignore it. Also in Meseberg, the creation of a Franco-German centre for artificial intelligence was announced. The idea is promising but given the challenge's importance and the competition from other projects of the same nature, in Europe and elsewhere, the answer to digital issues must also be ambitious. Overall, be it climate protection or digitalization, moving quickly and mobilizing appropriate resources is mandatory. Yet, responsiveness is not the strength of Franco-German cooperation, characterized by slow ways of compromise building. For all these global issues, moreover, it is essential to cooperate with other partners already well positioned on these areas, in Europe but of course also outside.

5-2. Taking responsibility in global governance

At the global level, a multipolar international system is about to emerge. Yet, multipolarity is far from automatically bringing about effective multilateralism – to the contrary. Both Paris (although perhaps more reluctantly) and Berlin (with a greater sense of adherence) were hitherto used to Washington upholding the international order, based on multilateral institutions. The United States' president actively undermining the existing multilateral order poses considerable challenges to the states traditionally part of the West. Both Germany's and France's weight on the international scene is limited, occasional beliefs to the contrary held in either capital notwithstanding. They have obligated themselves in the Treaty of Aachen to intensify their cooperation in the United Nations, but their direct global impact is insufficient. The answer lies with increased European cooperation,

making use of the combined impact of the soon 27 EU members. One step into that direction may be the introduction of a higher rate of EU foreign policy decisions taken with qualified majority voting (QMV) in the European Council. Jean-Claude Juncker, the President of the European Commission, took up this proposal in his 2018 speech on the State of the Union, just as it is part of the aforementioned bilateral Franco-German Meseberg Declaration. In practice, however, especially France is sceptical to the idea, out of fear of finding itself in a minority position on issues it deems crucial to its national interest. The debate on a European seat in the United Nations Security Council, or greater coordination among European members of the UNSC, runs along similar lines. Finally, increasing pressure on existing multi-lateral structures will also push Europeans, and France and Germany in particular, to seek to build new partnerships with like-minded partners. To this end, it is key to foster partnership with like-minded partners on, for example, trade. One of these partners should obviously be the Republic of Korea.

All of this will require to introduce a truly strategic dimension into the bilateral Franco-German relationship – a dimension that, as surprising as it may sound, is currently missing.⁷⁶⁾ Europeans – and thus also Paris and Berlin – will have to deal with grand strategy and the role they aspire for in the world. This not only includes finding common approaches to the new transatlantic relationship. It also means that Paris and Berlin should reach a common understanding of China’s role in a multipolar world and how they position themselves vis à vis China’s Belt and Road Initiative. So far, France’s stance is a way more critical than Germany’s, although Berlin is growing increasingly wary.⁷⁷⁾ But they do not seem to have a common strategy in

76) Kempin, Ronja, and Barbara Kunz (2017), “France, Germany, and the Quest for European Strategic Autonomy,” *Notes du Cerfa* 141 (December). Available at www.ifri.org/en/publications/notes-de-lifri/notes-cerfa/france-germany-and-quest-european-strategic-autonomy-franco (accessed December 14, 2018).

77) Ekman, Alice (2018), “La France face aux nouvelles routes de la soie chinoises,” *Etudes de l’Ifri* (October). Available at www.ifri.org/fr/publications/etudes-de-lifri/france-face-

response to initiatives such as the 16+1 format, launched by China to intensify its cooperation with Central European and Balkan states, which is likely to strengthen intra-European divisions. Similarly, France and Germany should develop a common strategy on energy matters in the relationship with Russia. Given Europeans' dependence on Russian gas, particularly in Central Europe, and the competition between EU Member States to become a distribution hub, they should develop a shared view on Europe's Energy Security – while ensuring EU' cohesion.

5-3. New European dynamics, new challenges for the Franco-German cooperation

At the European level, the challenges are equally obvious. For decades, France and Germany worked towards compromise between the North and the South, both spearheading their respective “camp”. As of 2019, EU affairs are no longer binary but much more multifaceted. The increased complexity of EU affairs also means that there are no fixed constellations or intra-EU alliances. Dividing lines on one issue will differ from dividing lines on other issues.

As a consequence, Paris and Berlin's relative weight has diminished. While some had hoped that the United Kingdom's leaving the Union would remove obstacles for deepened integration, new dividing lines have come to the fore. Many smaller member states will no longer be able to “hide” behind the United Kingdom and will have to become more vociferous in their (potential) disagreement with Franco-German positions. Various member states have now anti-European or at least EU-sceptical governments. The

aux-nouvelles-routes-de-soie-chinoises-0 (accessed December 14, 2018). See also Schäfer, Michael (2016), “Co-driving the new Silk Road,” *Berlin Policy Journal* (January 12). Available at <https://berlinpolicyjournal.com/co-driving-the-new-silk-road/> (accessed December 14, 2018).

basic “pro-European” consensus among all EU-members is no longer a matter of course. Reasons for this are intricate and manifold. First, the Eurocrisis has widened the gap between the more affected South, calling for its Northern partners’ solidarity, and the North, more committed than ever to budgetary orthodoxy. Secondly, migratory pressure, a source of intra-European tensions for years, has led to a very harsh (and still unresolved) conflict between southern and western states facing migratory movements on the one hand and eastern states refusing to accept refugees on their territory on the other. In both cases, national egoisms were revived and contributed to the emergence of Eurosceptic or even outright anti-European parties.

Moreover, the various rounds of EU enlargement have arguably never been properly “digested” and led to a challenged core narrative. This in particular applies to the enlargement rounds to the east in 2004 and after, bringing countries into the European Union that were formerly part of the Eastern Bloc. The EU’s founding narrative “never again war” failed to be updated to incorporate those new members’ experiences of Soviet domination – often considered the “fresher” trauma, for which people want acknowledgement and the recognition of sufferings. The step to deep mistrust vis-à-vis the Franco-German tandem and fears of yet another experience of domination is logically not far away – and led *inter alia* to the creation of the so-called “Three Seas Initiative” (with 12 Central and Eastern European states on the Baltic, Black and Adriatic Sea), more or less explicitly labelled a counterweight to the so-called Paris-Berlin axis.

All these developments affect the Franco-German tandem’s capacity to generate consensus and even more so its ability to be a motor for European integration. Most of all, they are obliging France and Germany to rethink the way they include their European partners in order to fulfil their primary function: to overcome obstacles and reach compromises.

6. Conclusions: Lessons learned

For decades, the Franco-German relationship focused on reconciliation. This was obviously the main task at hand after a long history of devastating wars opposing the two countries. It would be erroneous to believe that reconciliation is achieved once and for all. Anti-German statements made during the 2017 French presidential campaign, for instance, clearly illustrate the need for ongoing efforts to promote understanding. While Marine Le Pen, the leader of the far-right party, presented herself as “the Anti-Merkel” and called the French president “vice-chancellor,”⁷⁸⁾ and the far-left politician Jean-Luc Mélenchon argues in an entire book dedicated to Germany that the country is a danger for Europe.⁷⁹⁾ And also among those who clearly defend close Franco-German cooperation, it is all too often clear that the knowledge on the other side’s thinking and the ways political systems work is in fact insufficient. The intercultural dimension consequently remains as crucial as ever. The work on deepened understanding must therefore be continued, if not expanded – for instance by more systematically including parliamentarians.

The Franco-German relationship is a work in progress. It requires constant dialog and permanent effort to overcome intercultural barriers that persist between the two countries – and will continue to persist. Getting the intercultural dimension right is nevertheless just a prerequisite for successful bilateral cooperation, not the end. These differences must, however, not be seen as a weakness, but rather as a potential strength of the tandem, as it allows it to forge consensus and compromise on the European level. For this to happen, Paris and Berlin must be creative. The Treaty of Aachen, which the two governments signed in January 2019, could help them do so – provided that it is not limited to symbolic declarations of friendship and rituals

78) Le Pen, Marine (2017), “I am the anti-Merkel,” *BBC Newsnight* (28 March). Available at www.youtube.com/watch?v=SeEHQhARESU (accessed December 14, 2018).

79) Mélenchon, Jean-Luc (2015), *Le Hareng de Bismarck. Le poison allemand*, Paris: Plon.

of reconciliation. The experimentation clause called for by the Franco-German Working Group of the Bundestag and the National Assembly for the new treaty can be an opportunity to deepen cross-border cooperation, and therefore help to advance European integration despite the important dividing lines that exist.

Bilateral cooperation needs to take place at a variety of levels. Firstly, it needs to be broadly anchored in society: among youths, through exchange programs and education, or at the local level through partnerships between cities and villages. It is key to make people meet, to raise awareness for intercultural differences as much as for shared values. This is the growing ground for future success in bilateral cooperation. Simultaneously, bilateral cooperation requires in-depth expertise on cutting-edge technologies and complex issues. In many political fields, particularly on economic issues, this cooperation is very advanced. As new challenges emerge, it must also expand and involve new actors involved in specific issues. As the recent deep divisions in the EU (only North-South, but also East-West) have made clear, nothing is certain for the success of the Franco-German relationship. It is only on the condition of permanent renewal and openness to others that it will be able to play the role of a driving force that Europe absolutely needs in a critical period of tension.

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Chapter 5

A stylized, bold, black letter 'K' is positioned within a white square frame. The 'K' is composed of thick, slightly irregular strokes, giving it a hand-drawn or graphic feel. The square frame is partially visible, with the top and right sides being more prominent.

The EU and the Rise of US Protectionism

Iana DREYER (Borderlex)

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- The background of the lower half of the page features a network map. It consists of numerous grey circular nodes of varying sizes connected by thin, light grey lines. The nodes are distributed across the frame, with a higher density in the lower-left and lower-right areas. The overall effect is that of a global or digital network. In the bottom right corner, there is a faint, out-of-focus image of a city skyline with several tall buildings.
1. Introduction
 2. The deterioration of EU-US trade relations since the end of the Obama administration
 3. EU's response to the Trump administration's trade policies
 4. Conclusions and implications for Korea

This paper analyses the gradual descent into the current transatlantic crisis since the end of the Obama administration. The EU's response to the challenge posed by its estrangement from the US has been fourfold. First, to avoid being hit by US protectionist measures the EU has tried to deflect the US' attention to China and emphasised its shared outlook with the US on the country's state-capitalist trading practices. Second, the EU has sought to keep the US engaged in the World Trade Organization. The third set of actions has involved keeping bilateral trade tensions down by agreeing to launch a trade negotiation process, without renouncing the use of trade retaliation. The fourth set of actions has involved signing new free trade agreements with other countries. The paper argues that the transatlantic rift is likely to be durable. The US' retreat from Europe, and from multilateral institutions precedes the Trump administration. This has systemic implications for the international trading system. The author concludes with some considerations on what this could mean for South Korea's trade policy.

1. Introduction

To outside observers, the transatlantic rift over trade policy witnessed since the Republican nominee Donald Trump took over the White House in early 2017 might have come as a surprise. The United States (US)' sudden turn to protectionism towards its closest allies has caught many of them off guards. The US' muscular approach to trade with Europe mixes security considerations and trade policy, with criticisms centring on Europe's insufficient contributions to the North Atlantic Treaty Organization (NATO) and its export surplus with the US.

The Trump administration's policies have deepened an already simmering existential crisis in the European Union (EU). Trump's challenge to the World Trade Organization (WTO) is perceived as a direct threat to what the

EU stands for and to how it functions: rules-based international cooperation. The EU's economy is highly trade and export dependent. Its industry is deeply enmeshed in global supply chains spanning both the Atlantic and Asia. The rules-based multilateral trading system centred on the WTO is vital to the EU's economic and geopolitical interests, especially at a time of rising new powers in the world economy, most prominently China.

The crisis has jolted the EU into proactive diplomacy aimed at salvaging the WTO and averting a descent into mutually damaging tariff retaliation with the US. But the US-EU crisis is in fact part of deeper trends in US politics and the transatlantic alliance.

This paper describes and analyses the gradual descent into the current transatlantic crisis over trade policy since the end of the Obama administration and the EU's response to it. If one were to sum up the EU's response to Trump's protectionism, it is that the EU's main efforts have focused on trying to deflect the US' attention to China. Yet specific transatlantic grievances remain unresolved. The risk of descent into tit-for-tat protectionist measures remains.

It is challenging to come to firm conclusions on a situation that remains in flux. However, clear trends in the international trading order are perceptible. These are: more power games in trade, less policy stability, and likely re-orderings in global supply chains over time. The paper concludes with some considerations on what this can mean for South Korea as an economy and in its trade diplomacy.

2. The deterioration of EU-US trade relations since the end of the Obama administration

The US' turn to an extreme form of mercantilism and bilateralism under

President Donald Trump has plunged transatlantic relations into a deep crisis. Yet tensions did not arise in a vacuum, as signs of increasing estrangement have been perceptible for years.

2-1. The TTIP impasse

In January 2017, the outgoing Obama administration and the EU stowed away negotiations towards a Transatlantic Trade and Investment Partnership Agreement (TTIP).

Concluding more than three years of negotiations, a joint statement issued by the European Commission and the US Trade Representative reads: “The progress we have achieved so far gives us confidence that, with continued engagement by both sides, and with the political will to prioritize long-term gains for our economies and our broader relationship, the United States and the EU could achieve what we set out to do in 2013: conclude an ambitious, balanced, comprehensive, and high-standard agreement that strengthens the transatlantic partnership and builds upon our economic relationship in ways that raise living standards and increase competitiveness on both sides of the Atlantic.” The aim of this joint statement was to settle on a common ground on which the negotiations would be based if they were to be restarted one day.

2-1-1. The rationale for TTIP

TTIP was partly conceived as a response to the perception in Europe that the US were ‘retreating’ from their strategic engagement on the Old Continent.

Obama had announced a political and economic ‘pivot to Asia’, and the Transpacific Partnership (TPP), the initially twelve-country free trade agreement, was one of the cornerstones of Washington’s new focus on Asia. The US was seeking to deepen alliances and hedge against China’s increasing eco-

conomic and political clout in the region, so TPP aimed not only to liberalise and boost trade, but also to develop a common rule-book that would counter China's state-capitalist growth model.

TPP brought new competition to European firms operating in the Asia-Pacific. Japan's decision to join TPP appears to have been the trigger for the EU's decision – driven by trade commissioner Karel De Gucht – to launch TTIP negotiations. The transpacific pact as conceived at that time would have covered 40% of world output, without the EU having a say on the rules it would create.⁸⁰⁾

Seen from Brussels, TTIP would have kept the US engaged in Europe, and set the rules for an economic market place that would have covered close to half the world's output.

The main aims of TTIP were to entirely eliminate 97% import tariffs on goods, open up services markets, free up flows of liquid natural gas trade (the EU was hoping to induce the US to eliminate its gas export licences as Central and Eastern European countries sought to tap the country's shale gas resources⁸¹⁾ and unlock the digital economy.

TTIP's most notable goal was to set a framework for 'regulatory cooperation' across the Atlantic that would go further than earlier attempts to forge closer regulatory ties. The EU and US had concluded industrial standard mutual recognition agreements in the 1990s, and launched TEC (Transatlantic Economic Cooperation) in 2007 to boost regulatory dialogue. During the TTIP talks, negotiators sought to make regulators on both sides of the Atlantic agree on means to reduce trade costs without undermining each other's regulatory prerogatives. Nine sectors were envisaged for specific agreements: chemicals, cosmetics, engineering, ICT, medical devices, motor

80) Lee-Makiyama, Hosuk (2014), "Why Europe needs to take TPP seriously," ECIFE website, November 2014. Available on <http://ecife.org> (Accessed on 17 December 2018)

81) Dreyer Iana (2014), "Energising TTIP: diversification through trade?" *EUISS Policy Brief*, No 18.

vehicles, textiles, pharmaceuticals and pesticides. Negotiators also sought to reaffirm labour and environmental standards they would like to see applied globally.

2-1-2. Why TTIP stalled

On a technical level, when the talks were halted, they had not achieved sufficient maturity. The depth, complexity and wide range of topics covered in the negotiation, some of them for the first time ever in international trade negotiations, means that at least two or three more years would have been needed to achieve a workable text.

The US had not given the same priority to TTIP as the EU had. As a result, it had not invested sufficient negotiating resources. In Europe, TTIP had created an uproar in public opinion in many member states, chiefly among them Germany. There was no appetite in Europe to make difficult political decisions required to conclude a trade pact with the US.

Long-standing market access differences could not be overcome. The EU was not ready to liberalise imports of certain US agriculture products nor accept US demands on digital issues ('new services' and data flows), the US was not ready to give way on EU demands to loosen its strict 'Buy American' provisions in its public tenders and to open up maritime services trade. The only tangible outcome of the TTIP process was an agreement on mutual recognition of standards for so-called 'good manufacturing practices' for pharmaceuticals. That agreement was finally signed as a stand-alone text, independently of TTIP.

When Donald Trump won the US presidential elections in November 2016 after a campaign marked by brash protectionist rhetoric and vehement criticisms of the WTO, TPP and the North American Free Trade Agreement (NAFTA), it became clear that TTIP would need to be shelved.

2-2. US trade policy under Trump

Within days of entering the White House Trump broke with decades of bipartisan US policies in the geostrategic field and international trade. Trump's trade policy can be characterised as follows: an extreme form of mercantilism bent on reducing bilateral trade deficits with individual countries, and a focus on delivering special export deals for sectors of particular importance to strategic electoral constituencies (e.g. farmers in the central states of the US, shale gas in North Dakota). This is combined with a confrontational trade stance towards China.

As background to the trade policy issues, the US is also displaying what one could term 'leadership fatigue' in international security. The White House is highly sceptical of multilateralism more broadly as a means to organise international relations. It sees asymmetric bilateral relations among nation states as a more effective way to advance US interests.

2-2-1. China containment

The Trump administration's main trade policy focus is China. In 2017 it stepped up trade defence measures against imports from China. In 2018, Washington unleashed an outright trade war. At the time of writing of this article the US had put in place punitive tariffs of up to 25% against US\$ 310 billion worth of trade from China.

The US has severely restricted Chinese company investments in the country as CFIUS (Committee on Foreign Investment in the US), the body in charge of scrutinising the national security implications of foreign direct investments, blocked several M&A deals in 2017. The US also initiated legislation to control exports of sensitive technology (such as artificial intelligence technologies), with primarily China in mind. Washington appears to aim for some form of strategic containment of China. This could result in potentially breaking complex industrial supply chains across the Pacific.

2-2-2. National security tariffs and WTO crisis

In the autumn of 2017, the president ordered a report on the national security implications of imports of steel and aluminium. In early 2018, the Department of Commerce released a report that found that imports of steel and aluminium did pose a threat to national security and recommended the introduction of import tariffs. In the spring of 2018, the US president went on to ask for a new report on the national security implications of automobile imports.

The national security exception invoked to introduce steel and aluminium tariff means the US exempted itself from all basic WTO rules. WTO rules allow members to introduce discriminatory trade restrictive measures against third countries to preserve their essential security interests. But they also set limits to that prerogative⁸²). Historically, WTO members have refrained from using this exception for fear it would lead to the unravelling of the trading system.

The US went on to ask US political and military allies to agree to curb their exports to the US if they wished not to see those tariffs imposed on them. Korea, Argentina and Brazil accepted to cap their exports to the US in return for an exemption. This practice is reminiscent of the ‘voluntary export restraints’ (VERs) that the US had imposed on Japanese exports in the 1980s and that were outlawed by the WTO in the 1990s.

The EU tried to obtain an exemption from these tariffs from the US – without accepting to be drawn into discussing export restraints, which it

82) Article XXI of GATT stipulates: “Nothing in this Agreement shall be construed (a) to require any contracting party to furnish any information the disclosure of which it considers contrary to its essential security interests; or (b) to prevent any contracting party from taking any action which it considers necessary for the protection of its essential security interests (i) relating to fissionable materials or the materials from which they are derived; (ii) relating to the traffic in arms, ammunition and implements of war and to such traffic in other goods and materials as is carried on directly or indirectly for the purpose of supplying a military establishment; (iii) taken in time of war or other emergency in international relations”.

considers WTO-incompatible. The EU's main argument was that the EU is an ally of the US and does not represent a national security threat. The EU failed: tariffs came into force on 1 June 2018.

The value of US tariffs on EU metals is estimated at about €6 billion per year. The EU retaliated with tariffs worth €3.8 billion. It brought a complaint against US actions in the WTO's Dispute Settlement Mechanism (DSM). Eight other WTO members also filed disputes at the WTO: Canada, China, India, Mexico, Norway, Russia, Switzerland and Turkey. The US for its part filed a complaint against the retaliatory measures introduced by China, Canada and the EU. Panels to adjudicate these cases are expected to be set up in the coming months.

The outcome of judgements are uncertain. The DSB could exempt the US in the Section 232 cases, or to the contrary take a view, which could alienate the US even further. But it is also not clear if there would be any appellate mechanism at all to deal with any appeals and conclude the cases.

Indeed, the Trump administration has plunged the WTO into an existential crisis by blocking the nomination of new Appellate Body (AB) members to replace those whose terms have expired. The seven-judge body, already suffering from an overload of dispute cases, cannot function if there are not at least three judges sitting. By September 2018, the number of AB members was already down to three.

President Trump has repeatedly made negative statements about the WTO. It qualified the organisation as "a disaster" for the US. During his election campaign he threatened to leave the organisation altogether⁸³). To date the trade policy community sees it as still possible that the US withdraw. Cynics may argue that even if it does not withdraw, neutralising the Appellate Body is the most effective way of making the WTO irrelevant.

83) Dyer, George (2016), "Trump threatens to pull US out of WTO," *Financial Times*, 24. (July)

2-2-3. NAFTA and KORUS renegotiation

In January 2017, Donald Trump pulled the US out of TPP. Within several months of his tenure, the US president re-opened NAFTA. Negotiations were concluded in October 2018. The agreement was renamed to the United States Mexico Canada agreement – USMCA. Changes to the original NAFTA were limited in number, but significant in their sector-specific and political impact.

Changes include: greater market openings for US dairy, egg and poultry exporters; greater US market access for dairy, peanuts and sugar; Canada removing its NAFTA market access provisions in public procurement; more stringent intellectual property provisions; scaled-down investor-state arbitration provisions (which remain only for some sectors in Mexico); new currency manipulation rules; new digital trade and e-commerce rules; and a tightening up of rules of origin for autos. The agreement also has a 16-year sunset clause.

The rules of origin in the automobile sector require 75 percent content (up from 62.5%) to be North American-made and produced by 40-45 percent of workers earning at least US\$ 16 an hour. These new rules are seen as an attempt to disincentivise production in Mexico.

The US and Korea also renegotiated their KORUS bilateral free trade agreement. Korea accepted the renegotiation in return for avoiding Section 232 tariffs on metals. Korea doubled a quota for US manufacturers and the US extended by another twenty years a 25% US import duty on Korean light trucks that should have expired by 2021. Seoul also agreed to recognise US standards for car parts used in servicing and to accept US environmental standards for autos.

Lastly, the US succeeded in strong-arming Japan into launching bilateral trade negotiations. After the US pulled out of TPP, Tokyo prioritised salvaging the agreement and to push for its coming into force among the remaining eleven parties. It succeeded: CPTPP will come into force in early 2019.

Tokyo's initial position was to tell the US it would be welcome to re-join TPP. Japan did not engage with the US on steel and aluminium tariffs – and as a result its producers saw the Section 232 tariffs applied to them. In the autumn of 2018 Tokyo relented and accepted to start bilateral negotiations.

2-2-4. Bilateral quotas and China and EU “poison” pills

The Trump administration's strong arm tactics resulted in FTA partners accepting curbs in their exports, and even their freedom to deal as they see fit with China and the EU. Here are some prominent examples.

- Korea capped steel exports to the US at 70% of the average volume from the previous three years on a product-by-product basis in KORUS.
- In a side-letter to USMCA, the parties agreed on quotas if the US were to impose Section 232 national security tariffs on autos. The quotas are 2.6 million passenger cars from each Mexico and Canada, and US\$ 32.4 billion for auto parts from Canada and US\$ 108 from Mexico.
- Under the USMCA the parties committed to a China ‘poison pill’. The parties are to notify the others of the launch of trade negotiations with ‘non market economy countries’.⁸⁴⁾ “Entry by any Party into a free trade agreement with a non-market country, shall allow the other Parties to terminate this Agreement on six-month notice and replace this Agreement with an agreement as between them (bilateral agreement)”, the text of the USMCA reads.⁸⁵⁾
- The USMCA aims to preclude Mexico and Canada to register on any new geographical indications (GIs), protected names for specialty foods from specific geographical locations (e.g. Parma ham) - at least without US

84) Non market economy countries refers to jurisdictions treated with a different price comparison methodologies in trade remedy investigations to account for state intervention in their production processes.

85) United States Trade Representative, *USMCA, Chapter 32, Exceptions and General Provisions*. USTR Website, <https://ustr.gov> (Accessed on 23 November 2018).

scrutiny. The agreement sets up “procedures that allow interested persons to object to the protection or recognition of a geographical indication, and that allow for any such protection or recognition to be refused.”⁸⁶⁾ This is a direct contestation of the EU’s policy of enlisting FTA partners to protection of its GIs: the EU did so in CETA, its trade agreement with Canada, and with Mexico.⁸⁷⁾

The US has sounded out the EU to find out if it were ready to accept a quota on autos in return for bilateral tariff agreement negotiations towards which both parties are currently preparing (more below). So far, the EU has refused.⁸⁸⁾ The US appears to have asked the United Kingdom for such a quota as part of current scoping talks ahead of a planned launch of bilateral trade agreements in April 2019 after Britain leaves the EU.⁸⁹⁾

2-3. Continuity and disruption in US trade policy

Before analysing the EU’s response to the course taken by the Trump administration on trade, it is worth pondering the extent of the disruption it introduced in US trade policies.

86) Horseman, Chris (2018), “USMCA challenges EU’s advance on GI protection – but too late for Mexico?” *Borderlex website* (11 October). <http://borderlex.eu> (Accessed on 23 November 2018).

87) In 2016, the EU and Mexico started a process of renegotiation of their 2001 FTA.

88) Intervention of Ignacio Garcia-Bercero, Director and Chief Negotiator at the European Commission’s Directorate General for trade during an international trade committee meeting of the European Parliament, 20 November 2018. Viewable online here: <http://www.europarl.europa.eu/ep-live/en/committees/video?event=20181120-1430-COMMITTEE-INTA> (Accessed on 23 November 2018).

89) Confidential UK business source involved in consultations with the UK government on the future US-UK trade agreement.

2-3-1. A lot of continuity and some changes

The elements of continuity are many. First, it is the Obama administration that had started blocking Appellate Body member appointments in Geneva. Secondly, hedging against China's rise was already a central plank in the Obama administration's foreign policy.

Thirdly, labour unions play a strong role in shaping US trade policies in the steel sector. While unions are seen as key supporters of the Democratic Party, it is not the first time a Republican administration works – as is the case of Donald Trump – with them to impose sweeping import tariffs. In 2002, the George W Bush administration introduced safeguards on steel – but rolled them back after a pushback from US allies.

Fourthly, and more fundamentally, criticism of globalisation, of international trade agreements and of China's economic policy has played a major role in US politics for years. Since the financial and economic crisis, the realisation that the US is a superpower facing relative economic and political decline has increased. The US has a strong constituency of voters who reject the trade policies championed in the US since the 1990s, namely the creation of the WTO and its strong dispute settlement mechanism, and the signing of NAFTA and of other reciprocally negotiated free trade agreements. During his election campaign in 2008, Barack Obama had promised to renegotiate NAFTA – only to renege on his pledge.

Donald Trump was able to pull out so easily of TPP because his predecessor had failed to get the agreement ratified in the autumn 2016. The Obama administration refrained from tabling an agreement that had proven highly controversial in US public opinion and in Congress. TPP then got entangled in the US election campaign. The Democrats' presidential candidate, Hillary Clinton – a strong advocate of TPP during her earlier tenure as Secretary of State – announced she would not back the agreement. When TPP landed on Donald Trump's desk in January 2017, the agreement was in fact still-born.

To Richard Katz (Katz 2016),⁹⁰ in TPP, “the United States has gained more on its priorities, such as investment, finance, and intellectual property, than it has given to its negotiating partners on theirs”. Nonetheless, it was not able to garner sufficient consensus for the agreement. “The US government simply no longer has much power to corral competing interest groups to agree to a trade pact that would promote growth through market liberalization while at the same time addressing the concerns of those who are hurt by liberalization”. This, according to Katz, creates a political “vacuum that gives narrow interest groups their veto power. To its allies abroad, the result is that the US appears both less benign and less hegemonic.”

However, the Trump administration went even further than the Obama administration. Not only did it impose more market openings for selected products (e.g. autos, dairy) in its FTA re-negotiations with Canada, Mexico and Korea, but it *reversed* earlier liberalisation commitments notably in the auto sector. It introduced a permanent power game in its relationships with its two neighbours through the USMCA’s sunset clause. And yet, it is not at all clear whether USMCA will pass Congress.

2-3-2. Trump’s perception of the EU as commercial and regulatory rival for the US

China might be the Trump administration’s main target. But the EU is not far behind. Trump appears to resent the EU’s global export prowess and its individual member states’ trade surplus with the US. In December 2017, euro area countries posted a €23 billion goods trade surplus with the rest of the world, of which Germany alone accounted for €11 bn (the EU28 as a whole posted a small goods trade deficit).⁹¹ In an interview with Bloomberg,

90) Katz, Richard (2016), “Trading Down. Is the TPP making the US a less benign hegemon?” *Foreign Affairs* (21 September). <http://www.foreignaf> (Accessed on 23 November 2018).

91) Eurostat, *Euro area international trade in goods surplus €3.3 bn*, January 2018, (Accessed on 19 March 2018).

Donald Trump said the EU is “as bad as China, just smaller”.⁹²⁾

This new hostility however adds to a long-established sense of rivalry over global markets and regulatory influence with the EU, be it in Asia or in the Americas. The US is wary of the EU’s expansion of its geographical indications, via its free trade agreements. The Obama administration was already a vocal critic of Germany’s current account surplus (currently at ca 8% of the country’s gross domestic product⁹³⁾).

The novelty of Donald Trump’s administration is its break with a long tradition of bipartisan US support for the process of EU political integration initiated in the years following World War II. Trump and members of his team – not least national security adviser John Bolton – are avowedly Eurosceptic. The current US administration supports Britain’s impending departure from the EU – something the Obama administration did not.

The White House took many months in 2017 to accept it needed to deal with Brussels and not member state capitals for any matters related to the EU’s Common Commercial Policy – which is an exclusive EU competence.

In this context, TTIP negotiations under the Obama administration appear like a missed opportunity to overcome deep-rooted transatlantic strategic and commercial divergences, which now are now growing even further.

3. EU’s response to the Trump administration’s trade policies

The White House’s trade policies challenged the EU into attempting to

92) Donnan, Shaun (2018), “Trump Makes Clear EU Won’t Escape His Ire Over Trade for Long.” *Bloomberg website* (31 August). <http://www.bloomberg.com> (Accessed on 21 November 2018).

93) Jones, Claire (2018), “Germany on course for world’s largest current account surplus,” *Financial Times*. (20 August)

lead a coalition in favour of salvaging the WTO-centred trading system, whilst engaging in damage limitation with Washington.

3-1. TTIP phoenix revived?

In the weeks following the coming into force of tariffs on steel and aluminium, and with the looming threats of auto tariffs, the EU stepped up efforts to contain the political crisis and avert mutual tariff escalation.

The damage to the EU economy resulting from auto tariffs is likely to be much larger than the steel and aluminium tariffs. The EU estimates that more than € 50 billion worth of annual trade flows is at stake – and this does not include the damage to the sophisticated supply chains spanning the Atlantic.

Steel and aluminium tariffs in fact harmed US allies more than they harmed China, supposedly the main culprit of steel ‘dumping’ on global markets and presumably a greater security threat than NATO allies, Canada or most EU members. The Peterson Institute for Economics estimated that proposed tariffs would eliminate US \$14.2 billion of US imports in a year, yet only \$689 million from China, less than 5 percent of the total. More than half percent of the trade losses – estimated at US \$7.5 billion – would hurt US military allies, the EU, Canada, Japan, and South Korea alone (Bown 2018)⁹⁴.

The EC managed to engage the US president personally in a negotiating process that maintains a ‘truce’ on the imposition of new auto tariffs. Indeed, Section 232 tariffs are an executive prerogative, and any final decision on these rests with the US president.

The joint statement (European Commission 2018a)⁹⁵ released after the

94) Bown, Chad (2018), “Trump’s Steel and Aluminium Tariffs Are Counterproductive. Here Are 5 More Things You Need to Know,” *Trade and Investment Policy Watch blog*, Peterson Institute for International Economics (7 March). <http://piie.com> (Accessed on 23 November 2018).

meeting announces that a joint transatlantic group – an ‘Executive Working Group’ - will seek to open the path to agreements on trade and energy. The two sides “agreed to work together toward zero tariffs, zero non-tariff barriers and zero subsidies on non-auto industrial goods”. The statement also says: “We will also work to reduce barriers and increase trade in services, chemicals, pharmaceuticals, medical products, as well as soybeans.”

“Secondly, we agreed today to strengthen our strategic cooperation with respect to energy. The European Union wants to import more liquefied natural gas (LNG) from the United States to diversify its energy supply,” says the statement.

The third topic on which the two parties found common ground was “[joining] forces to protect American and European companies better from unfair global trade practices”. In practice this means reining in the trade policy practices of – mainly – China. They also pledged to work on WTO issues.

Finally, the two sides pledged not to adopt import tariffs on each other while the two parties continued negotiating on a possible trade agreement.

‘Negotiations’ are ongoing at the time of writing. The two sides are seeking to launch formal negotiations on bilateral tariff reductions. The Trump-Juncker statement says the deal would cover industrial tariffs excluding autos. Subsequently the US said it wanted agriculture tariffs in the scope of the agreement. The EU refuses to include these (because it knows it will not obtain better market access in public procurement markets – an important quid pro quo for the EU). But the EU is suggesting to include tariff eliminations on auto – something the US appears to be reluctant to do.

In November 2018, EU and US regulators appeared close to finding an agreement on mutual recognition of certain standards and conformity assessment procedures in the area of pharmaceuticals and medical devices – basically picking up work that had started and advanced well during the

95) European Commission (2018a), Joint U.S.-EU Statement following President Juncker’s visit to the White House. (25 July)

TTP process. Washington and the EU are also working on regulatory cooperation in the area of cybersecurity.

All in all, the EU and US have revived important aspects of the TTP project, leaving out services, procurement and many regulatory areas.

3-1-1. Section 232 auto tariff threat persists

The Trump-Juncker agreement was made at a time when it was becoming clear that the release of the Department of Commerce report on national security implications of auto imports, initially expected in late August, would be postponed until the early months of 2019. This was the result of push-back from industry and Congress against the tariffs.

The politics of the auto tariff threat remains volatile. The White House continues to wield the threat of such tariffs. The EU's position is that it is ready to retaliate with its own tariffs should the US introduce such measures. At a meeting with Members of the European Parliament, Ignacio Garcia Bercero, the European Commission's chief negotiator for the United States said: "There will be a firm response to any report which threatens or applies tariffs or quotas on EU exports of cars or of car parts."⁹⁶⁾ The Commission says it has prepared a list of products, which includes autos and agricultural products, to which it would apply what it terms 'rebalancing measures' – i.e. retaliatory tariffs.

The EU would use the same legal argument as with the measures taken against the US' steel and aluminium tariffs. It would argue that in fact these measures are safeguard measures, but that these measures are illegal. On this basis it would have recourse to article 8 of the WTO's Agreement on Safeguards. The text allows members to introduce compensatory tariffs if no agreed solution is found with the country introducing the protectionist measures. The tariffs need to be commensurate to the scale of the safeguard

⁹⁶⁾ See Ignacio Garcia Bercero. Footnote 88.

measures. In practice the EU is expected to apply duties only on trade worth half or less of the estimated value of trade affected by US measures. And it would most likely apply them in stages – as it did in its response to the US’s steel and aluminium tariffs.

The transatlantic crisis has involved a significant effort by the Commission and European capitals, including Berlin and Paris, to come to a common, single, EU political position vis-à-vis Washington on the trade file. The main intra-European balancing act was to see ‘hardliners’ such as France and the Netherlands advocating refusal to negotiate any agreements under political pressure and tariff retaliation, and ‘soft’ countries such as Germany, Italy, or various Central and Eastern European countries ready to engage and negotiate with the US and seen as sceptical of tariff retaliation. The overall EU result is in fact a blend of all approaches: limited negotiation, and limited retaliation.

The German policy establishment for its part is gradually taking more seriously long-standing criticisms of the country’s excessive current account surplus by the US, and by institutions such as the International Monetary Fund and the European Commission.⁹⁷⁾

In 2018, the two leading German foreign policy think tanks Deutsche Gesellschaft für Aussenpolitik⁹⁸⁾ and Stiftung Wirtschaft und Politik⁹⁹⁾ published papers recommending that Germany actively seek to reduce its current account surplus to help ease trade tensions globally as well as macro-economic imbalances in the Eurozone. The recommendations were made as part of papers discussing the transatlantic trade row and the current domestic challenges to the EU’s own future. The two topics are seen by the authors

97) Der Spiegel (2018), “Leistungsbilanz - Deutschland erzielt weltweit größten Überschuss,” *Spiegel Online* (20 August). <http://www.spiegel.de> (Accessed 17 December 2018).

98) Liesenhoff, Philipp (2018), “Die Risiken des amerikanischen Protektionismus für Europa,” *DGAPKompact* No 8, 28 March 2018.

99) Dieter, Heribert (2018), “Stubbornly ‘Germany First. Options for Reducing the World’s Largest Current Account Surplus,” *SWP Comment 2018/C 48*. (November)

as going hand in hand. So far, there is no shift in German economic policy to help reduce that surplus.

Great Britain, which is in the process of leaving the EU, has quietly supported the EU's position and approach to the transatlantic trade crisis, whilst engaging in preparatory diplomacy with Washington aiming for the launch of bilateral free trade negotiations after March 2019.

3-2. Building a “circle of friends”

With the advent of the Trump administration and the failure of TTIP, the EU accelerated its already very active bilateral free trade agreement negotiation agenda.

An agreement with Canada, the Comprehensive Economic and Trade Agreement known as CETA, was ratified by the European Parliament in early 2017 and came into force in September the same year. Negotiations that had started in 2013 with Japan were concluded successfully in late 2017. In the spring 2018, the EU swiftly finalised negotiations with Mexico. The EU made significant efforts to make progress on free trade negotiations with the South American bloc Mercosur; negotiations dating back to the 1990s which were relaunched in 2016.

Japan and Mexico deliberately turned to the EU once their trade relationships with the US deteriorated significantly. Japan, which had negotiated a trade agreement with the EU was postponing difficult political decisions over the agreement in the autumn 2016 while it awaited US ratification of the TPP. Once it became clear that the US was retreating, Prime Minister Shinzo Abe ordered his administration to finalise negotiations with Brussels.

The Commission also accelerated slumbering ratification procedures of recently concluded FTAs with Singapore and Vietnam. In 2018, it revived efforts to launch a region-to-region free trade agreement with the Association of South East Asian Nations (ASEAN) by setting up a joint working group

to scope out an agreement.¹⁰⁰ Lastly, in the summer 2018, the EU launched new free trade negotiations with Australia and New Zealand.

The EU is trying to assert its commercial and regulatory presence where the US is retreating – in particular in the Asia-Pacific. It is trying to conclude free trade agreements with all members of the CPTPP. Trade commissioner Cecilia Malmström describes her policy as creating “a circle of friends” with “like-minded” countries on trade, who believed in the principles of what she terms “open and fair trade”, as well as “rules-based trade”.¹⁰¹

3-3. Between the US and China

The transatlantic crisis has jolted the EU into action aimed at preserving the WTO-centred multilateral trading system – this involves a political balancing act with China.

3-3-1. Working with Tokyo and other allies on keeping the US engaged and in the WTO

The EU’s official view of the Trump administration’s trade policy is that although it targets its allies, the fundamental driver of US trade policy is discontent over China’s trade policies.

The Trump administration itself gave the EU reason to believe so. The first informal contacts between the Trump administration and EU officials in the spring and summer 2017 involved the US asking the EU to join its fight against Chinese trade policies. The author’s understanding was that the US wanted to work with the EU on Chinese intellectual property right issues

100) European Commission (2018b), *The Sixteenth AEM-EU Trade Commissioner Consultations*, (2 March), *Singapore JOINT MEDIA STATEMENT*.

101) European Commission (2018c), *Transatlantic Trade in Turbulent Times - Speech by Cecilia Malmström, European Commissioner for Trade*. (19 July)

and company take-overs in the West, with the US pressing the EU to take a tougher stance towards Chinese investments.

The EU was initially unclear what specific actions the US would ask for. However, Brussels was keen to engage on a ‘positive agenda’ (Dreyer 2017)¹⁰² with Washington. After Robert Lighthizer was confirmed in his post as USTR in November 2017, concrete work could begin.

The EU shares US administration views on Chinese trade and investment policies. Shared woes (real or perceived) include: excessive subsidisation of domestic industry, intellectual property violations including forced technology transfers, state-owned enterprises distorting local and global markets, digital protectionism, and investments by state-backed Chinese companies into Western high-tech and infrastructure sectors aimed at acquiring specific know-how and gaining political influence.

Both Brussels and Washington have been reluctant to treat imports from China as produced under ‘market economy’ conditions in their trade defence policies. EU legislative changes enacted in 2017 to put Brussels in compliance with WTO requirements vis-à-vis China did not alter the fact: the EU just extended the possibility to use methodologies previously reserved to a specific list of formerly communist countries to all WTO members, albeit with somewhat less discretion than previously.

The EU had further taken note of the fact that China’s rise in the WTO was one of the factors in the organisation’s failure to deliver on the Doha Round of multilateral trade negotiations. The China factor explains the reluctance of many WTO members in the developing world to sign on to new liberalisations.

China itself is perceived as not wanting to conclude trade agreements. For example, ongoing negotiations over the phase-out of fisheries subsidies defined as illegal, unreported and unregulated by the UN body UNCLOS, are seen as stumbling primarily over Chinese resistance to the idea as its fishing

102) Dreyer, Iana (2017), “EU in quest for “positive agenda” with United States,” Borderlex website (17 July). <http://borderlex.eu> (Accessed on 23 November 2018).

fleets expand their global activities.

Japan has been sharing similar views to those of the EU, although its own priorities are forced technology transfers rather than the subsidy issue. China's economic and political emergence is Japan's foremost strategic challenge. It reinforces Japan's dependence on the US' security umbrella.

When it became clear that the 11th WTO Ministerial Conference in Buenos Aires would close with no new trade agreement, the US, EU and Japan released a joint statement¹⁰³) on the need for the world trading system to "level the playing field". The statement reads: "We shared the view that severe excess capacity in key sectors exacerbated by government-financed and supported capacity expansion, unfair competitive conditions caused by large market-distorting subsidies and state owned enterprises, forced technology transfer, and local content, requirements and preferences are serious concerns for the proper functioning of international trade, the creation of innovative technologies and the sustainable growth of the global economy. We, to address this critical concern, agreed to enhance trilateral cooperation in the WTO and in other forums, as appropriate, to eliminate these and other unfair market distorting and protectionist practices by third countries." Three more trilateral meetings took place in 2018 to cement the informal working relationship between the three powers.

For the EU, the trilateral format is mainly a tool of engagement with the US aimed at keeping Washington at the discussion table - and in the WTO. The EU makes a point of stressing its differences with the US. In June 2018, the EU filed a WTO case against Chinese intellectual property practices. The move came after the US had done the same. The US introduced unilateral trade barriers following an investigation of intellectual property violations under its 'Section 301' legislation. The EU did not follow the path of unilateral retaliation and has openly criticised the US for doing so.

103) METI (undated), Joint Statement, METI Website. <http://www.meti.go.jp/press/2017/12/20171213001/20171213001-1.pdf> (Accessed on 23 November 2018).

3-3-2. A proactive WTO reform agenda

The initial focus on working with Tokyo was enlarged in 2018 to building channels of communication and informal cooperation with other WTO members.

Cooperation was stepped up with WTO members which call themselves ‘friends of the system’. It includes Australia, Canada, Chile, Mexico, Norway, Switzerland, South Korea, Singapore, Turkey, Hong Kong, Colombia, Costa Rica and Pakistan. The EU and members of this group who are also members of the G20 worked towards a joint statement of trade ministers at Mar del Plata, Argentina, in September 2018, which calls for urgent WTO reform. As members of the G20, China and India, among others, agreed to come on board an agenda of WTO reform that is fundamentally driven by what used to be the Quad: US, EU, Japan and Canada. China announced in November it would table its own proposals.

In the summer of 2018, the EU released a series of WTO reform proposals¹⁰⁴). These aim at responding to US criticisms of the WTO and of the Appellate Body. The second set of proposals aim at introducing more flexible formats for trade negotiations that break with the need for consensus among all WTO members to launch and conclude new deals.

The third set of proposals focuses on improving the surveillance and compliance functions of the WTO secretariat and to induce China and other emerging markets to take on more obligations. One major proposal tabled jointly with Japan and the US aims to improve compliance with obligations for WTO members to notify their subsidies to the organisation’s secretariat in Geneva. The three aim to introduce penalties for countries not complying with their reporting and substantive obligations under the Subsidies and Countervailing Measures agreement.

Other proposals include new rules to contain the role of state-owned en-

104) European Commission (2018d), “European Commission presents comprehensive approach for the modernisation of the World Trade Organisation.” (18 September)

terprises in the global economy (including agreeing on a definition of what is a ‘public body’), and the end to a currently binary classification of WTO members between developing country and developed country status. The WTO’s Special and Differential Treatment principle allows developing country WTO members to benefit from exemptions or longer adaptation times to rules and to take on less trade liberalisation commitments. Several G20 members – prominently among them China – are seen by the EU, the US and other advanced economies from unjustifiably benefiting from this developing country status ‘loophole’.

3-3-3. A balancing act with China

The final and most striking EU response to the transatlantic rift is increased direct strategic engagement with China. The EU’s policy combines both cooperation and dialogue, and a pushback against certain Chinese policies.

The EU is watching with concern China’s Belt and Road Initiative (BRI). It is indeed at the receiving end of a strategy launched by Beijing in 2013 that aims at connecting China’s hinterland with lucrative markets on the western end of the Eurasian landmass via Chinese-funded transport infrastructure. The EU has long criticised the initiative for favouring Chinese firms and not respecting international norms, for example on public tendering (namely the Government Procurement Agreement in the WTO – of which China is not a member).

EU policy makers are concerned about the political effects of China’s investments in infrastructure projects in Central and Eastern Europe. Since 2012, China is cultivating ties to sixteen non Western European member states, some of which are EU members, under the heading ‘16+1’. China’s engagement with these countries is perceived as dividing the EU. Individual member states have been seen as defending in European Council meetings pro-Chinese views in areas ranging from trade defence to human rights. In

2018, the arrival of a populist-party led government coalition in Italy is raising concerns about its policy independence vis-à-vis China, especially in matters related to strategic investments.¹⁰⁵⁾

Chinese companies' recent acquisitions of EU firms possessing valuable intellectual property is raising eyebrows. Chinese firms significantly stepped up their foreign direct investments in Europe in recent years. There are concerns that many of the most recent investments are in sectors aimed at fulfilling the Chinese government's economic development goals – 'Made in China 2025'.

The EU is preparing legislation aimed at screening foreign investments at EU-level to avert risks to national security in the EU. Though nominally non-discriminatory, the initiative was triggered by China's investment surge in Europe.

The EU is also pressing China to conclude long-standing negotiations towards a Comprehensive Investment Agreement. The deal aims to liberalise investments, to set rules and standards for investments, and to protect investors. After four years of negotiations in July 2018, the two made a first exchange of offers.

The exchange of offers was the crowning of a successful bilateral EU-China summit in mid-July 2018. The two previous annual summits ended with no satisfactory outcome, as the two sides could not agree on a joint statement. In 2017 China had refused to sign off on a joint statement as it disagreed with the EU's continued treatment of China as non-market economy in its trade defence cases.

In 2018, the two sides released a long joint statement making cooperation pledges in a wide range of policy areas. The most symbolically charged statement in the joint declaration is the announcement of a joint working group

105) Casarini, Nicola (2018), "Commentary: Italy's new government risks undermining EU unity on trade and investment," Borderlex website (25 July). <http://borderlex.eu> (Accessed on 23 November 2018).

on WTO reform. “The two sides are strongly committed to fostering an open world economy, improving trade and investment liberalisation and facilitation, resisting protectionism and unilateralism, and making globalisation more open, balanced, inclusive, and beneficial to all”, we read. The two sides “are also committed to cooperating on the reform of the WTO to help it meet new challenges and establish a joint working group on WTO reform”.

China is not entirely satisfied with its new relationship with the EU. China perceives the EU’s new investment screening legislation as a protectionist move.

Discussions on reforms of the WTO with China are bound to be difficult. The two sides met in October 2018. So far they have managed to find common ground on Appellate Body reform issues. But China largely rebuffs Western criticisms of its economic model as articulated in most other proposals on technology transfers, state-owned enterprises and subsidies. China is balking at the idea that it should no longer be allowed to declare itself a developing country in the WTO. China resents the fact that the EU continues to treat Chinese imports as not being produced under market economy conditions in its recently overhauled trade defence legislation.

Should WTO reform discussions proceed, China is likely to find allies. Various economies in Asia – including South Korea – have or are likely to have misgivings about the sharp focus on subsidies and state-owned enterprises of the EU and the US. The notion that penalties should apply to non-notifying WTO members is also likely to face significant resistance, and so is the idea of a graduation mechanism for developing economies.

4. Conclusions and implications for Korea

The situation described in this paper remains in flux. It is challenging to make any predictions, nor to come to very firm conclusions on how far the US will go in its turn towards protectionism, and how new dynamics initiated

by the EU and other WTO and G20 players in response will play out. However, there are clear trends that are here to stay.

The way governments manage the situation will most likely determine the extent to which damage can be limited in the short to medium term, before long-term arrangements can be made by the world's major powers if they invest the political capital to do so.

Here are this author's main take-aways.

4-1. A new world?

4-1-1. Transatlantic trade relations

The EU's geostrategic rift with US is likely to widen over time. Political relationships with Europe will become more transactional and less driven by a sense of common purpose inherited from the post-World War II era.

The EU and the US are most likely to fail in their endeavour to conclude a limited free trade agreement focusing on industrial tariffs. This is because there would be no support in US Congress for an agreement that excludes agricultural goods. There could be limited regulatory agreements in pharmaceuticals and medical devices, and perhaps other regulatory areas in 2019.

There is a widespread expectation that the US will proceed with auto tariffs under its Section 232 legislation. One can expect the EU to remain consistent in its response and to retaliate in return, as well as file a new complaint in the WTO's DSM. Transatlantic relationships will be deeply damaged as a result. The EU's response will put a strain on its efforts to remain united in its efforts to respond to President Trump.

4-1-2. China

Tensions between the US and China are here to stay. The scale of continued confrontation and of the likely further escalation of the US-China

‘trade war’ remains to be seen.

The EU and China will not become allies on trade issues. Indeed, if no satisfactory outcome is found to the current stalemate in the WTO, EU-China tensions could grow even further. However, the recent attempt at coming together on issues of common interest – saving the WTO’s Appellate Body – is to be taken very seriously and could lead to certain limited outcomes.

Supply chains, primarily in the auto industry but also in the high tech and ICT sectors, are most likely to enter a phase of reordering. Global companies will seek to reduce their exposure to China.

4-1-3. World trading system

The likelihood that the current US administration will accept to lift its blockage of nominations of new Appellate Body members is very low. 2019 will be a turning point. The world trading system will be driven more than ever since the creation of the WTO in the mid-1990s on decisions made by the great powers and shaped by asymmetric relationships between large powers and small or medium-sized economies depending on the security umbrella of, and market access to, their bigger and more powerful allies or neighbours.

The ongoing WTO disputes over the US national security measures will likely damage the organisation.

It cannot be excluded however that diplomatic efforts by the EU, China and other mid-sized powers around for example the WTO bear some fruit in the medium term. It could be that they end up finding a way of maintaining an appellate body function in the system (it is possible to do so) even if the US does not participate in it.

4-1-4. EU unity, Brexit and US trade policy

“Similarly to his Russian counterpart [Vladimir Putin], [Donal Trump] prefers to deal with twenty-seven European countries that are relatively

small rather than with a united bloc. 'This unprecedented situation forces Europeans to act with greater determination', writes Dutch political philosopher Luuk van Middelaar on the ongoing transatlantic crisis. "In such a situation, where humiliation is never far away... the idea of 'sovereignty' starts making sense."¹⁰⁶

Provided the EU manages to deal with the current surge in populist and Eurosceptic movements within its own member states, the ongoing transatlantic crisis is likely to lead to gradual, incremental changes in the bloc's external policies. The EU is already largely a united actor in traditional trade policy, but over time wider geostrategic and security issues – so far largely left to member states – and trade are most likely to become more intermingled in the EU's external action.

Any shift to a more unitary EU on the global scene will largely depend on a change in policy direction in Germany, be it in embracing a more unified European defence policy, in matters related to Euro area reform, or when it comes to tackling its own current account surplus. Though Germany is bound to move slowly, there are clear signs that the transatlantic crisis is focusing minds in Berlin. This could ultimately lead to gradual policy change over time.

All this will make life more difficult for Britain outside the EU. The shape and content of the bilateral free trade agreement between Britain and the US will largely depend on what future relationship Britain and the EU27 will work out amongst themselves over the next years – i.e. over the extent of divergence in regulatory and customs policy with the EU and Britain will settle on. This will take several years, regardless of Britain's exit scenario. In the meantime, London and Washington will not be able to negotiate a comprehensive bilateral free trade agreement, and London will not play a meaningful role in shaping international trade policy for the foreseeable future.

106) Van Middelaar, Luuk (2018), *Quand l'Europe improvise. Dix ans de crises politiques*, Gallimard, p. 407.

4-2. Implications for South Korea

Korea is faced with stark dilemmas in the trade policy and geopolitical configuration described in this paper. It has significant overlapping interests with all parties involved, and more overlapping interests with China, than perhaps other economically advanced G20 members. In terms of its security interests it shares with Japan an extreme reliance on the US security umbrella (cf. China, North Korea) Korea and Japan entertain their own bilateral relationship with Washington and continue to harbour political dissensions (for a variety of historical reasons that won't be discussed here).

In terms of its trade policy, interests with Japan are also very similar as both rely on supply chains in China, but also in the wider Asia-Pacific region. Yet South Korea and Japan have not been able to establish strong cooperative patterns in trade policy. Instead what has dominated is rivalry in access to global markets (each signed its own FTAs with the EU and individual countries in South East Asia, Oceania and Latin America). South Korea was not a signatory to the TPP. Japan took a leadership role in the Asia Pacific to preserve most of the deal and turn it into an 11-country CPTPP where Japan sets the tone. Exclusion from the CPTPP could have consequences for Korea's influence and supply chains in Asia.

Korea is participating in Regional Comprehensive Economic Partnership negotiations. RCEP aims to include an Asia-wide free trade area that mainly eliminated tariffs and includes the regional grouping ASEAN as well as China. RCEP is not expected to run as deep as CPTPP in setting rules for economies with high levels of technical sophistication.

South Korea has become a highly developed and technologically advanced society. Yet it continues to pursue international policies that point to its relatively recent past as an emerging market. For example, South Korea continues to declare itself a developing country in the WTO. South Korea has shared interests with China and other emerging markets vis-à-vis United

States trade remedy measures. In fact, it is largely the US rejection of WTO rulings against its trade remedies, partly on the basis of disputes filed by South Korea in Geneva that triggered the Appellate Body crisis. South Korea is also suspicious of Western moves to put restrictions on subsidies to companies and further discipline the activities of state-owned companies.

Korea participated in the now-defunct Obama-era ‘plurilateral’ agreements on Trade in Services and Environmental Goods Agreement with a subset of like-minded WTO members, the majority of which are advanced economies.

South Korea and the EU have been discussing an upgrade to their bilateral free trade agreement, which has been in force since 2011. But they have not yet been able to do so – partly due to the Korean view that it did not gain much from the agreement, partly because of a row over labour rights. Among the approaches South Korea could take to make the best of its highly constrained trade policy choices, the author suggests the following.

- *Join the CPTPP.* Korea has expressed interest in joining the grouping. For political and economic (supply chain) reasons this appears as a good way to strengthen resilience in the face of political pressure from larger powers and offers greater opportunities for supply chain diversification.
- *Agree to modernise the FTA with the EU.* This will offer more opportunities for supply chain integration and diversification, and help boost innovative, services-based activities. An added bonus will be deeper political partnerships with Europe.
- *Act as a bridge-builder in the WTO’s reform discussions.* As a medium-sized G20 member sharing interests with both ‘Quad’ countries and China, Korea can be seen as ideally positioned to help craft compromises on sensitive issues such as subsidies and state-owned enterprises.

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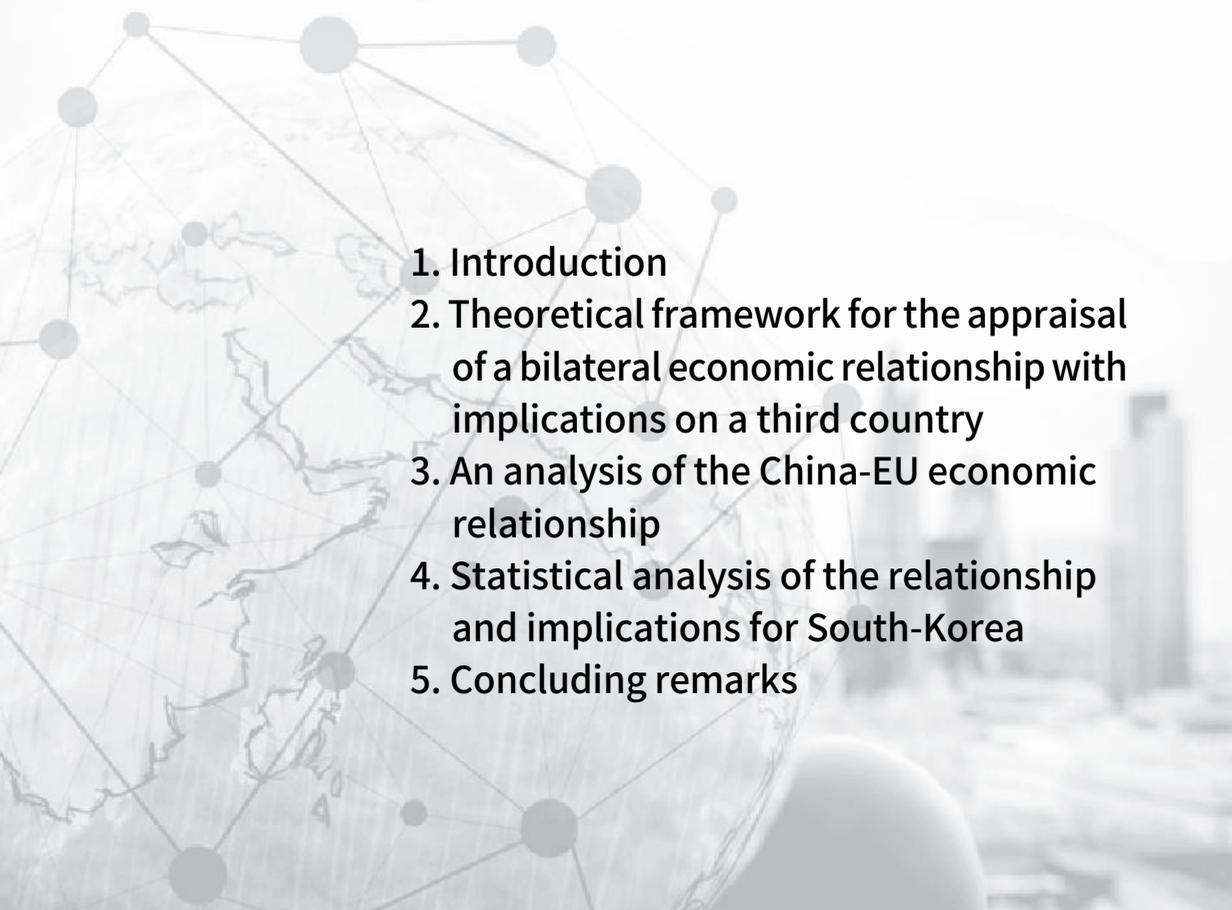
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Chapter 6



China and the EU: Main Economic Issues in Trade and Investment

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- A background graphic featuring a network of grey nodes connected by thin lines, overlaid on a faint map of the world. The nodes are of varying sizes, and the lines form a complex web structure.
1. Introduction
 2. Theoretical framework for the appraisal of a bilateral economic relationship with implications on a third country
 3. An analysis of the China-EU economic relationship
 4. Statistical analysis of the relationship and implications for South-Korea
 5. Concluding remarks

The chapter analyses the China-EU economic relationship in the background of an uncertain macro-economic environment epitomised by Brexit and rising protectionist trends, and the way this relationship might ultimately affect the South Korea-EU economic connection. A descriptive statistical analysis shows that trade and investment flows between the three economies have been increasing, as if to challenge economic retrenchment at the global level. However, China's encroachment on some "key" EU industries through its aggressive direct investment strategy brings the question as to the long-term benefits arising from Chinese direct investment in the EU. In that vein, the development of an EU direct investment policy aimed at harmonising the different direct investment regimes prevailing in the EU would facilitate market access and investment protection in China. Brexit could represent an opportunity for China who needs to counter the new protectionist trends. But, the new British trade and investment strategy is likely to imply a much stronger economic relationship with the USA to the detriment of China. That would leave countries such as South Korea (and Japan) as the Asian winners of rising US protectionism.

1. Introduction

Despite a number of macro-economic indicators pointing towards a global economic recovery, the world economy remains fragile with for example the People's Republic of China (thereafter referred to as China) eventually comforting itself in a "new normal" growth trajectory (Morales and Andreosso-O'Callaghan, 2018). According to the latest trade growth forecasts (WTO, 2018), merchandise trade in volume terms will only increase by 3.9 per cent in 2018 (down from 4.4 per cent according to some earlier forecasts by the same institution) and it will slow down to 3.7 per cent in 2019. The Trump tariffs are deemed to have a major impact on the Chinese econo-

my (Lovely and Liang 2018), whereas Brexit will create asymmetric shocks within the EU-27 as a whole with the Republic of Ireland being the most affected country. In this uncertain macro-economic environment, the China-EU and South Korea-EU economic relationships try to evolve unabated with the aim of overcoming the trade tensions at the world level and of solidifying global free trade. As a result, the current China-EU economic relationship can only be appraised in the background of rising trade tensions at the global and regional levels due to rising protectionist trends and retrenchment.¹⁰⁷⁾ The objective of this paper is therefore to analyse the China-EU evolving economic relationship and the way this relationship might affect the South Korea-EU economic connection. In order to do so, the paper starts with a theoretical framework highlighting economic integration in the case of three countries. This is followed by a literature review and by an assessment of the double bilateral economic relationship (i.e. China-EU and South Korea-EU). A third section uses some descriptive statistics in order to shed some light on these economic relationships whereas a last section concludes.

2. Theoretical framework for the appraisal of a bilateral economic relationship with implications on a third country

From a theoretical viewpoint, economic integration between two countries A and B – through trade and investment – has given rise to a plethora of studies following the seminal writings of Jacob Viner (Viner 1950). These

¹⁰⁷⁾ The Trump Tariffs have only been a catalytic point in a rising protectionist trend that was already visible shortly after the global financial crisis erupted (see Andreosso-O'Callaghan and Uprasen 2009).

studies show on the main the positive welfare gains arising from the lifting of trade barriers between the two countries. In particular, the limited form of economic integration represented by the Customs Union entails internal free trade and (external) protection. The elimination of tariffs on imports from the member countries, and the adoption of a common external tariff on imports from the rest of the world lead to substantial trade creation effects for the participating countries through a better allocation of resources.¹⁰⁸⁾ The issues of trade deflection and also of direct investment deflection – using inputs from the new trade theories – or of how a traditional foreign direct investment (FDI) recipient can be negatively affected by rising competitive advantages in countries of the same region, is less well-known and has nurtured fewer studies. In our specific case, an important question is whether a closer economic partnership between the EU and China through trade and direct investment might eventually side-line South Korea. The double issue of trade and investment deflection has started receiving some (late) attention with the 5th enlargement of the EU. For example, Lejour *et al.* (2001) use a CGE model to analyse the economic implications of the EU fifth enlargement on both the incumbent and new EU member states. They find substantial overall gains for the candidate member states, in spite of some sectors shrinking therein, and small welfare increases in most EU countries. These results tend to suggest that economic integration does, on the main, lead to positive effects with trade creation effects being predominant. However, when including foreign direct investment, studies such as those by Altomonte and Guagliano (2002) and Bevan, *et al.* (2001) look at the potential redistribution of intra-EU FDI flows after the fifth enlargement in the EU, showing in some cases the zero-sum game nature of the adjustment.

108) For a very critical survey of old and new trade theories and policies, see Deraniyagala and Fine(2001).

3. An analysis of the China-EU economic relationship

Of the two economic bilateral relationships – China-EU and South Korea-EU – the latter is the deepest given that it takes the form of a new generation free trade area (FTA) between the two entities. The South Korea-EU FTA is provisionally in force since July 2011, and a brief assessment of its impact seems to point towards greater benefits accruing to the EU than to South Korea in the area of trade (European Commission 2014 and 2018).

Of a very different nature is the China-EU evolving economic relationship as will be shown here. A first sub-section deals with the economic relationship in general and a second sub-section will highlight the position of certain EU countries herein (namely Germany and the UK); then, the sensitive issue of FDI will be appraised.

3-1. The evolving China-EU economic relationship

After the US embargo in 1950 and the re-orientation of sino-foreign trade towards the Soviet block, diplomatic relations between the then EEC¹⁰⁹⁾ and China ceased until 1975, although some sino-West European trade had resumed in 1953. In 1978, the EEC-China Trade Agreement was signed, the first agreement of the kind between the two parties; it was followed by the Textile Agreement in 1979, and by a Trade and Economic Co-operation Agreement in 1985. Based on this 1985 trade and cooperation agreement, the EU-China Strategic Partnership was launched in 2003. Of notable importance after the famous EU Commission publication of its “new Asia strategy” in 1994 (European Commission 1994), was the setting-up of regu-

109) European Economic Community.

lar EU-China Summits (since April 1998), fora for discussions at which a number of sensitive issues such as market access and human rights have been and still are discussed and/or mentioned. With the ensuing *EU-China Comprehensive Strategic Partnership* launched in 2003 and the *EU-China 2020 Strategic Agenda for Cooperation* launched in November 2013, the implementation of which was reiterated at the 20th China-EU Summit in July 2018, it is clear that – in the eyes of EU policy makers at least – the bilateral relationship has deepened, that it has been upgraded over the years, and that the EU has been most keen to “constructively engage” with what is still nevertheless a non-market economy controlled by an authoritarian regime.

As mooted by Andreosso-O’Callaghan and Nicolas (2007), the relationship has been one of opposing forces spreading between rivalry and complementarity. On the China side, the deepening of EU-China relations culminates with the Belt and Road Initiative (BRI). This very ambitious infrastructural project aims at facilitating trade (Solmecke 2016) and at completing the Chinese FDI policy based on the Chinese “go west” policy of the early 2000s by encouraging Chinese production sites outside China’s Eastern belt (Andreosso and Dathe 2016: 140). Ultimately, the “initiative” aims at creating an efficient and integrated transit transport system between Europe, the Caucasus and Central Asia as well as a trade and investment corridor stretching, for example, from Lisbon and Vladivostok. It should be noted that the EU TRACECA (Transport Corridor Europe-Caucasus-Asia) programme launched in 1993 was also motivated by reaching out to the Far East and that land-bridge rail connections were established before the BRI was officially announced in 2013 (as OBOR or “One-Belt-One-Road” initiative at the time), given that connections exist since 2011 from Urumqi, Astana and Minsk to Europe; a connection between Xinjiang and Kazakhstan opened in 1990 and this can be seen as the first modern direct route between China and Central Asia. The core idea of these initiatives is to revive the connectivity between “East and West” by land (train) rather than by sea, and this

connectivity would be more environmental-friendly than, for example, air freight. Of particular importance in the Belt and Road Initiative is the role played by different multinational enterprises (MNEs), in particular by MNEs in the transport, logistics and construction sectors from Asia as well as from Europe. For example, the cement industry would be one of the primary beneficiaries of the BRI, bearing in mind the fact that Chinese cement firms suffer from a sizeable over-capacity problem (estimated at 35 per cent) in this industry. Other motivations for the BRI on the Chinese side are the losses registered by Chinese firms for example in the aviation industry (Solmecke 2016). On the EU side, where demand since the global financial crisis has not fully recovered, the BRI coincides with the EU plan to deepen the Single Market with a substantial investment plan. Between the announcement of the Chinese “go west” policy in 2000 and that of the BRI policy in 2013 lies the global financial crisis; consequently, a pertinent question that follows is whether the crisis has been an opportunity for the deepening of the EU-China economic relationship, particularly for foreign investors. As we have argued elsewhere (Andreosso-O’Callaghan and Dathe 2016) and in spite of the difficulties encountered when trying to measure with accuracy Chinese FDI flows in the EU and elsewhere, the data show that Chinese outward direct investment has increased substantially in EU countries since the crisis, with for example a quadrupling of Chinese direct investment stocks in the EU between 2010 and 2012. The UK has been an important recipient, but peripheral countries such as Greece, Italy and Portugal have also been systematically targeted by Chinese state-owned enterprises, bearing in mind the requests imposed on these peripheral countries by the EU Commission, European Central Bank and International Monetary Fund to privatize and sell off large minority stakes in their utility and infrastructural sectors. As a result, Chinese direct investors have been “opportunistic” and the year 2015 seems to represent a turning point in China-EU economic relations; before that date, China was a passive recipient of outward direct investment, where-

as since that date, it has turned into a more aggressive sender of direct investment, in the EU in the particular.

Beyond the sphere of economics and business, it should also be noted that in the eyes of some scholars, the BRI would allow Europe “to return to the centre of the world” (Wang 2015: 103), and it is seen also as a way to “balance the development of the trans-Atlantic relationship” (Wang 2015: 106). However, since the BRI was launched in 2013, some developments have unfolded which might alter significantly the China-EU economic relationship. This is an issue to which we now turn.

3-2. The German and UK positions

From an economic viewpoint, Germany and the UK occupy central positions in the EU given their respective GDP and trade weights in relative terms. In 2017, Germany represented 21.3 per cent of the total EU-28 GDP whereas the share of the UK was second, with 15.2 per cent of the EU total (EUROSTAT 2018). With Brexit, the global size and weight of the EU would decline, an issue that will be explored in more details in the quantitative part of this chapter. In Germany, the largest economy of the EU – which is also China’s top economic priority in the EU – the vision by German officials *vis-à-vis* the BRI and Chinese increasing inroads into EU business in general changed in 2015 from being rather positive before that date, to becoming more problematic after; it has been swinging between conflict and cooperation (Harnisch 2017). The conflict can be perceived increasingly among the general public, policy makers and some industrialists. The reasons for this change are, among others, the sale of Kuka robotics in January 2016 to China by a German firm. Seen as being a sale in a “critical” technology-based firm, this sale added to the solar panel saga that had led progressively to the decimation of the German solar-panel industry by heavily-subsidised Chinese firms.¹¹⁰⁾ Perhaps the non-recognition of China as a

market economy by leading economic and trade players such as the USA in 2017 has also contributed to raising some questions about the fairness of the Chinese policy regime and to shaping a less welcoming attitude *vis-à-vis* Chinese businesses in Germany. In the second phase (or after 2015) the official position in Berlin is still positive *vis-à-vis* the BRI and this might need to be connected with the fact that the share of Germany as a founding participant of the Asian Infrastructure Investment Bank (AIIB) is the highest of all non-Asian countries. Despite this, one can sense a degree of scepticism permeating some German business circles (Harnisch 2017).

Towards the other end of the EU spectrum, in terms of the China-EU economic relationship, lies the UK. Even before the 2016 Brexit referendum, and despite the open-arms attitude of some EU countries such as Portugal and Greece (the “distressed periphery”) to attract Chinese direct investment during the euro-crisis, the UK had the highest share of Chinese direct investment stock of all EU countries (Andreosso-O’Callaghan and Dathe 2016). This mirrors the ambition of a “golden era” that had characterized the UK-China relationship at least until the British decision to delay the Hinkley Point nuclear power project in 2016 based on security grounds (see below under II.3). Among all 28 EU members, the UK has been the most dedicated supporter of the market economy status in favour of China. With the Brexit preparations, the British Government has been embarking upon a “go global” strategy aimed in particular at Chinese investment and trade, at least as much as possible. For example, on a visit to China in early 2018, Prime Minister Theresa May agreed a number of measures to improve access to the Chinese market, particularly in the area of financial services (The Times, 31/07/18). From a Chinese perspective, a continued strong relationship with the UK would allow the Chinese economy to benefit from British expertise in the area of financial services and financial corporate

110) For more on the Chinese pricing and other strategies in the solar-panel industry, the interested reader can refer to Gang (2015).

governance. The City (in London) is Europe's leading financial RMB offshore clearing centre, ranking second after Hong Kong, and the next strategy of the Chinese Government is to move to a convertible RMB in the City. Also, in other areas such as trade in goods and direct investment, a post-Brexit UK would be seen as a springboard to the EU-27, in the same way as the UK in the EU-28 was used by Chinese investors as a main gateway to the EU. The UK plan is to start formal trade negotiations for a possible "free trade plus" deal with China after Brexit, a deal that would cover investment. From Beijing's viewpoint, this deal would only be possible after the UK has completed its new economic relationship with the EU-27.

However, the UK's new trade and investment policy would also encompass stronger economic links with the USA, links that would also take the shape of a "free trade plus" deal; this deal would be negotiated and signed before any such deal would come to terms with China. In light of the antagonistic approach taken by the Trump Administration *vis-à-vis* China, it therefore looks as if the UK were faced with a dilemma, in terms of its post-Brexit trade and investment policy: if it signs a deal with the USA, it would need to side-line with the USA *vis-à-vis* China in policies areas such as market economy status, navigation in the South China Sea as well as North Korean and Hong-Kong issues. This strategy would imply less engagement with China and it could therefore be that the sought-after "golden era" that was supposed to characterise China-UK relations has definitely come to an end. Brexit might actually render more difficult the China EU-27 economic relationship and this leaves the question as to what type of new (post-Brexit) relationship the EU-27 is going to foster with China. As we have seen supra, China's encroachment on some "key industries" – such as solar-panels in Germany or energy in Portugal – has gradually nurtured the EU questioning about the welfare benefits of Chinese inward direct investment in the EU. FDI can therefore become an important stumbling block in further negotiations, and the approach of the EU is clarified in the ensuing sub-section.

3-3. The increasingly important issue of FDI policy

EU competence in the area of FDI policy has all along been subsumed in the EU (common) commercial policy. With the 2009 Treaty of Lisbon, the EU has been empowered to negotiate and conclude FDI agreements, and we thus have a common direct investment policy in the making, which after the current transition period would allow, eventually, the transfer of authority over FDI policy to the EU. Bilateral Investment Treaties (BITs) remain in place during the transition period and the long-term goal is to replace these bilateral BITs by pan-EU BITs, such as the EU-China BIT and the EU-South Korea BIT in particular. The EU and China are currently negotiating for an EU-China Bilateral Investment Treaty, negotiations that were launched in November 2013. It should be noted that most of the work is on outward FDI (Meunier 2014); this follows the logic of the EU business strategy which is to secure and boost competitiveness and productivity of EU firms. The new policy would “protect EU outbound FDI [...] and regulate inbound FDI” (Meunier 2014: 999). This common direct investment policy is aimed ultimately at reorganising the many different investment rules existing across the EU-28 (minus one), where many different investment regimes exist. For example, Greece and Bulgaria tended to have had very open regimes, although in June 2017 a coalition of EU countries (including Portugal, Malta, Greece, Czech Republic and Sweden) started lobbying for stricter controls on inward direct investment. In some cases, there are stringent controls in the “sensitive sectors”, such as defence in the cases of France and Germany, but this is not the case in all “sensitive sectors” in the EU as a whole. An example in point is the attempt by the Chinese government to become involved in the European nuclear power industry through the British door. The temporary UK Government freeze in 2016 of the approval for the £18bn Hinkley Point C project because of security concerns in relation to China’s stake did not however deter the Chinese ambition to penetrate the

EU nuclear energy market. In July 2018, China Nuclear Power Group, one of the prominent Chinese SOEs (State-Owned Enterprise) showed its interest in buying a major stake in several British nuclear power stations operated by EDF Energy, a subsidiary of the French EDF, which is most eager to raise finance in order to see its €33bn debt diminish (The Guardian 2018).

Whereas the primary objective sought by the EU in drafting and implementing the new investment policy is market access and investment protection in China, for Chinese firms the streamlining of all BITs with EU countries into one would be of indisputable benefit. From China's viewpoint, direct investment flows into EU countries particularly since the 2008 crisis have highlighted the lack of a common approach *vis-à-vis* FDI in the EU, and all what Chinese firms need are simplified rules and an entry point into the EU, after which all the Single Market is theirs. Interestingly, an over-riding priority for the EU is the Chinese market, and the BIT it is currently negotiating with China would be the first test of this new policy. Important stumbling blocks for China in the negotiations are sustainable development and human rights clauses (in line with article 205 of the Lisbon Treaty). China is rather remotely interested in these issues whereas it is quite different for the EU as a whole, given its projecting itself as a "principled actor". From an EU viewpoint, other contentious issues encompass technology leaking and stealing as well as the SOEs' political control in business affairs, prompting one to infer that China is not a security ally of the EU and of Europe. Much progress needs to be made in this area, since there is not even a definition of the concept of "national" security in the context of EU policy, as there is for example in the case of the USA.¹¹¹⁾

Some small progress has nevertheless been made with the European Parliament initiative on investment screening going back to 2012. Investment screening for inward investment exists in about 11 member states only. However, a much more pro-active approach needs to be taken in this area.

111) "National" meaning "EU" in this case.

Different, diverging, and sometimes incompatible and incoherent FDI strategies at the level of the different EU countries are still seen as an opportunity for China which is capitalising on these divisions, given its “divide and conquer” strategy (Meunier 2014: 1010). This is clear for inward FDI, and the global financial crisis has tended to exacerbate these intra-EU divisions.

4. Statistical analysis of the relationship and implications for South Korea

This final section aims at shedding some light on the strength of the double bilateral economic relationship (China-EU and South Korea – EU). Table 4 depicts the trade position in goods over the 2001-17 period. It shows the increasingly negative trade balance of the EU-28 (and also of the EU-27) *vis-à-vis* China, which corresponds to a five-fold increase during the period under review. This trend went unabated except during the first years of the global financial crisis.

Table 4. Trade balance in total goods (HS classification, selected years)

(Unit: thousand USD)

	2001	2002	2007	2012	2017
EU28-China	-52504297	-59479717	-250302573	-229504662	-285627098
EU27-China (excl. UK)	-38195107	-42411627	-204655719	-188925453	-247298125
EU28-Korea	-8484369	-8198365	-26677925	-7598602	-6783421
EU27-Korea (excl. UK)	-5665022	-5666452	-23778957	-10048300	-8973485
Korea-EU28	6011273	6445831	19399239	-717197	-2661080
Korea-EU27 (excl. UK)	4874814	4627669	16109959	721281	-4972634

Source: ITC trade map (2017) (ITC, Geneva).

Table 5. Trade balance in services (selected years)

(Unit: thousand USD)

	2002	2007	2012	2016
EU28-China	-	3561000	7229000	9707000
EU27-China (excl. UK)	-	2464000	4933000	7517000
EU28-Korea	-	4313000	5145000	6622000
EU27-Korea (excl. UK)		3077000	4580000	5345000

Source: ITC trade map (2017) (ITC, Geneva).

The South Korea – EU-28 position also shows a trade deficit for both the EU-28 and EU-27 for all years recorded, although the situation is less clear for the latter period (2012 and 2017); according to EUROSTAT figures, the EU trade deficit in goods has tended to decline and then to disappear altogether at the end of the period under study thanks to the success – from the EU viewpoint – of the EU-Korea FTA. However, ITC figures shown in Table 4 suggest that the EU deficit with South Korea has indeed declined but that both the EU-28 and EU-27 still have a small deficit in 2017 (of US\$6.78bn and US\$8.97bn respectively). Given its comparative advantage in services, and in particular in business services with the group of emerging countries, the EU trade balance in services is – not surprisingly – positive with both China and South Korea over the 2002-16 period (Table 5). As before in the case of goods, the exit of the UK from the EU leads to substantial changes in these trade positions. In the case of services (Table 5), the EU-27 trade surplus with China shrinks by 22 per cent in 2016 (against only -13 per cent in the case of goods in 2017). These few descriptive statistics show the relative important involvement of the British economy in the services sector.

Table 6. Bilateral FDI flows between South Korea, the EU, and China (selected years)

(Unit: Million USD)

	1997	2002	2007	2012
Korea				
Korea-EU28				
Inwards	1679	1251	-1611.6	1556.5
Outwards	188	593	3189	4417.1
Korea-EU27 (excl. UK)				
Inwards	1585	1136	-1812.1	772.5
Outwards	132	583	3060.1	4185.6
Korea-China				
Inwards	2	81	46.7	245.5
Outwards	618	914	4913.2	5406
European Union				
EU28-China				
Inwards	-	-148	436	9408
Outwards	-	6696	13694	27640
EU27-China (excl. UK)				
Inwards	-	-148	404	9103
Outwards	-	1519	8247	16438
EU28-Korea				
Inwards	-	-254	226	2549
Outwards	-	2329	9938	3859
EU27-Korea (excl. UK)				
Inwards	-	-215	216	2224
Outwards	-	835	1009	-1705
China				
China-EU28				
Inwards	-	3710	3945	2595
Outwards	-	-	1045	6120
China-EU27 (excl. UK)				
Inwards	-	2814	3114	-
Outwards	-	-	478	3345
China-Korea				
Inwards	-	2721	3678	3038
Outwards	-	-	57	942

Source: UNCTAD (2013) Bilateral FDI Statistics (Geneva).

Finally, Table 6 shows the bilateral direct investment position. It shows for example that in 2012, South Korean direct investment flows to the EU-28 reached US\$4.4bn against a US\$1.5bn inflows of EU direct investment in South Korea leading to a positive balance for South Korea in that year. South-Korea's positive direct investment balance does not change when the UK is excluded from the analysis. From the viewpoint of the EU, bilateral direct investment with China (second part of Table 6), the figures show a formidable increase of Chinese FDI in both the EU-27 and EU-28, in line with China's "go global" strategy. Finally, when looking at the China South-Korea direct investment relationship (bottom part of Table 6), one can also notice the comfortable position of South-Korean direct investment in China all along, although Chinese outward direct investment to South Korea is also increasing remarkably in the latter part of the period.

5. Concluding remarks

A simple statistical analysis spanning from the Asian Financial Crisis until recent years shows that the trilateral China-Korea-EU economic relationship seems to have been strengthening as if to challenge the rise of protectionism and retrenchment at the global level. Trade and direct investment flows between the three economies have been on the increase and have been recovering after the more recent euro-area crisis. The EU relationship with South-Korea is more advanced than that with China in that it takes the form of a FTA implemented since 2011. The figures also substantiate the fact that China is fully committed to its "going global" and BRI strategies and this is shown in particular by exponential increases in Chinese direct investment flows in the two economies, although the balance is still in favour of South Korea and the EU-27 or EU-28 at the time of writing. The EU's "engagement" with China has taken the form of multiple accords since 1978 and

fora since 1998, and the current work is in terms of negotiating a pan-EU Bilateral Investment Treaty (BIT) with all countries in general, but in particular with China. This is a tardy response to the Chinese “go global” strategy and, in some ways, this is to appease the mounting scepticism in relation to Chinese direct investment inroads in “key” EU industries. Indeed, China’s encroachment on some “key industries” – such as machine-tools or solar-panels in Germany and energy in Portugal – puts to question the long-term welfare benefits accruing from Chinese inward direct investment in the EU as a whole. Further EU “engagement” with China would for example imply that the building of the Euro-Asia trade and transport platform and corridor (through BRI) would entail the development and implementation of Rules of Origin, labour standards, transparent and competitive tender processes in public procurement markets, etc. Whether this EU style of doing business would be accepted by the Chinese authorities is another issue.

A priori, the UK’s exit from the European Union could represent a sizeable opportunity for China, a country that is seeking an easy entry point into what could be consolidated as a large European Free Trade Area (or Customs Union) in the future, precisely at a time when the Chinese Government is looking for stronger economic partnerships with advanced countries so as to counter the protectionist trends from the USA. From the viewpoint of China indeed, it is important to consolidate the economic relationship with both the UK and the EU-27 given the antagonistic stances taken in terms of trade policy in Washington. In the current climate of rising protectionism, perhaps China is more reliant on the EU today than ever since the re-institution of diplomatic relations with western countries in the 1970s. But on the other hand, the British post-Brexit strategy of reaching out to new trade and investment partners is likely to imply a much stronger economic (and political) relationship with the USA (than when it was an EU member) to the detriment of China, and ultimately of the China EU-27 eco-

conomic relationship. As a result, the Asian winners of rising US protectionism directed towards the Chinese economy could be the market economies that have fruitfully and lawfully connected with the EU, namely South Korea (and Japan).

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Chapter 7



Changing Landscape of Korea's Economic Relations with Europe

Françoise B. NICOLAS (Ifri)

- 
- A background image featuring a network map of Asia and Europe. The map is overlaid with a complex network of grey lines and circular nodes of varying sizes, representing economic or trade connections. The map is semi-transparent, allowing a blurred cityscape to be seen through it.
1. Introduction
 2. EU-Korea economic relationship:
A quantitative analysis
 3. Qualitative analysis: what drives
the relationship
 4. Conclusions and prospects

A major feature of the economic relationship between the EU and Korea over the past decade lies in the asymmetrical rise in trade flows, with a sharp rise in EU's exports to Korea and a much more modest rise in EU's imports from Korea. In addition, the automobile industry has been the EU's fastest and most consistently growing export sector.

The implementation of the Korea-EU FTA undoubtedly played a role in these developments, with EU's exports to Korea being boosted by the elimination of non-tariff barriers, but also by the reduction in trade policy uncertainty. However, other factors were also at play. First, the persistently slower economic growth recorded by the EU may explain its import performances. Moreover, divergence in business strategies between Korean and European firms also explains the asymmetry between EU's exports and imports, as in the case of the automotive industry. Lastly, the expansion of regional production networks (RPNs) provides a convincing explanation to the drop in imports from Korea in the electronics sector.

Overall the two partners have managed so far to tighten their trade and investment relations in a mutually beneficial manner, but external factors such as the recent ratification of the Japan-EU FTA may easily reverse the trend.

1. Introduction

In 2006, in the context of the redefinition of a new competitiveness-based trade strategy¹¹²⁾ Korea was identified by the European Commission (EC) as an ideal partner with which to negotiate a new generation FTA.¹¹³⁾ Capitalizing on the momentum gained from the Korea-US FTA, Korea and

112) This new policy was defined in the European Commission's communication *Global Europe: Competing in the World*, issued in October 2006.

113) These agreements have a comprehensive and ambitious coverage and aim at the highest possible degree of trade liberalization.

the EU started negotiating in 2007 and the agreement could be finalized in a surprisingly speedy manner (after only eight rounds of negotiations). It has now been seven years since the FTA was provisionally applied on July 1, 2011, and almost three years since it came formally into force on December 13, 2015. The bilateral relationship has no doubt been impacted by the FTA and assessments of such impact have been produced by the European Commission as well as by various private researchers and institutions over the past years¹¹⁴). However, the implementation of the FTA can certainly not account for all changes and various additional factors may have been at play in influencing the economic interactions between the two parties, including the rise of China's economy, the reorganization of regional production networks/global value chains, the rise of protectionist trends in many parts of the world, among other things.

The objective of the paper is not to replicate one more time an assessment of the implementation and impact of the FTA, but to put it in a broader perspective and suggest possible explanations for the recent evolution of the bilateral relationship going beyond the exclusive prism of the Korea-EU FTA.

The first part of the paper provides a detailed statistically based overview (from the EU perspective) of the changes in the bilateral economic relationship over the past decade, taking trade and investment into account. Beyond the aggregate picture, the paper provides a more granular perspective and examines the behaviour of some specific sectors as well as the position of some individual member states with a view to underlining the specificities of their connections with Korea.

As a second step, the paper seeks to identify which forces may have been at play behind the observed changes, highlighting the role of factors other than the FTA. In the conclusion, the paper takes a prospective approach,

114) European Commission (2014, 2015, 2017), Amighini (2017), Civic Consulting and Ifo Institute (2017), IBF International Consulting and Ecorys (2017), and Majchrowska (2017) among others.

suggesting how the bilateral relation may evolve in the future, and what could be done to improve the quality/depth of the partnership.

2. EU-Korea economic relationship: A quantitative analysis

2-1. Trade in goods¹¹⁵):

Dynamic and increasingly concentrated

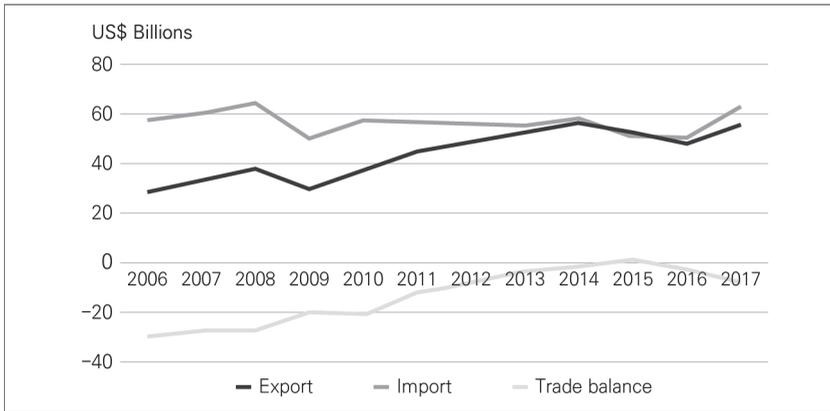
2-1-1. General overview

In 2017, Korea was the EU's eighth largest trading partner for both exports and imports of goods. Bilateral trade is dominated by manufactured goods, which account for 84 per cent of EU exports to, and 95 per cent of imports from, Korea.

Total bilateral trade has risen by 25 per cent from 2010 to 2017 (and by 35 per cent from 2006 to 2017). But this rise has been extremely asymmetrical with a sharp rise in EU's exports to Korea (49 per cent) and a much more modest rise in EU's imports from Korea (9 per cent). The trade between the two partners reached a low in 2009 as a result of the global financial crisis (GFC), but EU's exports were quick to recover, and at a quicker pace than imports. This asymmetry can certainly be explained by the persistently slower growth in the EU than in Korea post-crisis. The upward trend has been almost consistent ever since, with some minor slowdown in 2015 and 2016, again as a result of persistently sluggish growth in the EU.

115) Throughout the paper the statistical analysis uses the UN Comtrade database.

Figure 5. EU28 trade with Korea



Source: Author's own compilation using UN Comtrade database.

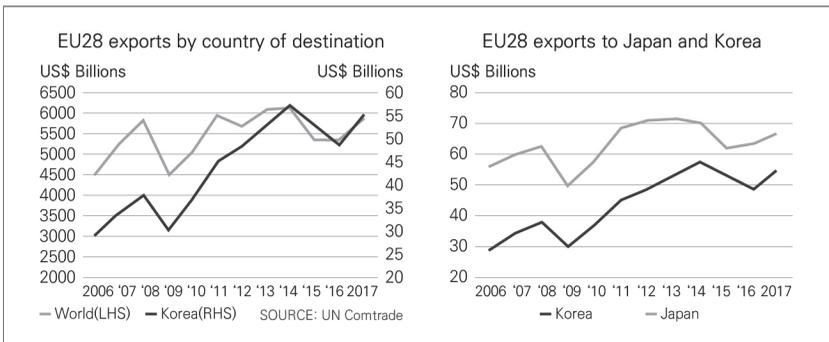
These developments have turned the EU's trade in goods deficit of US\$ 29 billion in 2006 (US\$ 21 billion in 2010) into a small surplus of US\$ 1.4 billion in 2015. The following years, the EU trade balance fell back into deficit but at a much more manageable level (US\$ 2.4 billion), although it has been widening again in 2017 to US\$ 7.7 billion. It remains to be seen whether this is just a blip or a new turnaround and the return to the traditional situation of a deep chronic deficit.

Interestingly, *EU exports to Korea* have exhibited a specific pattern; they rose more sharply than EU exports to the rest of the world, and in particular to other Asian countries such as Japan. Although it remains overall modest, the share of Korea as a destination for EU exports has thus slightly risen over time (from 0.6 in 2006 to 0.7 per cent in 2010 and to close to 1 per cent in 2017). Moreover, the computation of EU's trade bias vis-à-vis Korea suggests that exports to Korea tend to be slightly higher than what would be observed under a neutral assignment of trade across all partners. The overall bias ratio has risen from 24.6 to 34.8 from 2006 to 2017.¹¹⁶ This suggests

116) The measure is borrowed from Petri (2005). It is calculated as $x_{ij}x_{**} / x_{i*}x_{*j}$, with

that factors specific to the bilateral relation may have been at play, with the implementation of the Korea-EU FTA as a possible explanation as will be seen below in more details.

Figure 6. EU28 exports by country of destination and EU28 exports to Japan and Korea

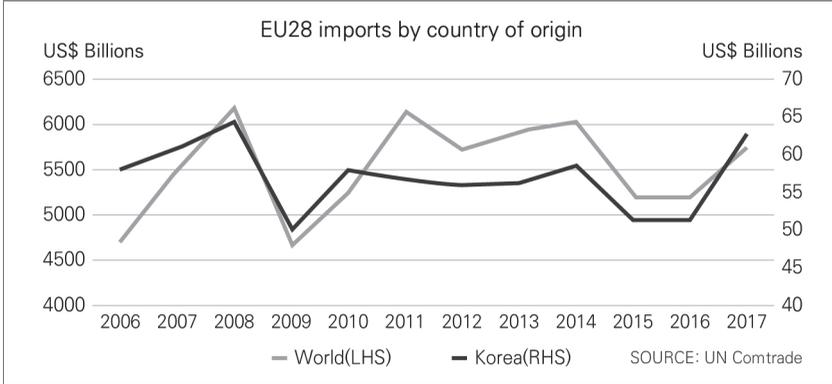


Source: Author's own compilation using UN Comtrade database.

On the *import side*, in contrast, Korea behaves very much like the other partners of the EU, and the share of Korea as a source of imports for the EU has been stable over time (at about 1 percent). Compared to 2006 (when it reached 1.2 per cent), however, Korea's share has even declined in 2017, suggesting perhaps that Korea has suffered more than others partners from the current sluggish demand in the EU. Whether the sharp recovery in EU's imports from Korea in 2017 constitutes an inflection point remains to be seen.

x_{ij} as the exports of country i to country j , x_{**} as the total world exports, x_{i*} as the total exports of country i and x_{*j} as the total imports of country j . This double-relative measure of trade intensity (sometimes called the gravity measure) deflates the absolute measure *both* with the worldwide export share of the exporting country and the worldwide import share of the importing country.

Figure 7. EU28 imports by country of origin



Source: Author's own compilation using UN Comtrade database.

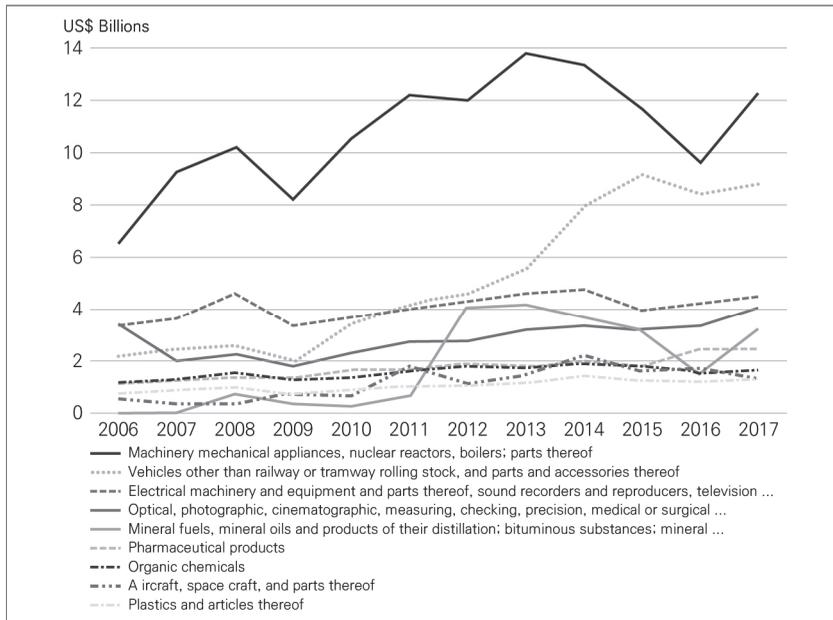
2-1-2. Sectoral breakdown

When breaking down exports by Harmonized Commodity Classification (HS) groups, the rise in EU exports to Korea seems to have been primarily driven by two groups, namely “machinery, mechanical appliances, nuclear reactors, boilers, and parts thereof” (84) and “vehicles other than railway or tramway rolling stock, and parts and accessories thereof” (87). For the former category, however, the trend is not regular and after a sharp rise, exports have slowed down substantially, leading to no major change in its share of total exports from 2006 to 2017. The latter category (87) has been the fastest and most consistently growing export sector: the rise has been very sharp since 2009, resulting in a substantial increase in its share in total EU exports to Korea (from 7.7 to 16 percent from 2006 to 2017). Also, when compared again to what would be observed under a neutral assignment of trade flows, EU’s exports of category 87 appear clearly biased in Korea’s favour.

A relatively strong rise can be observed, to a lesser extent, in the share of pharmaceutical products (from 3.9 to 4.4 - but 5.1 percent in 2016), but also of chemical products, dairy products, beverages and plastic and articles thereof. For all these categories the bias indicator has also been rising

consistently. The hypothesis of a factor specific to the bilateral relation (such as the Korea-EU FTA) highlighted above is confirmed.

Figure 8. EU28 exports to Korea



Source: Author's own compilation using UN Comtrade database.

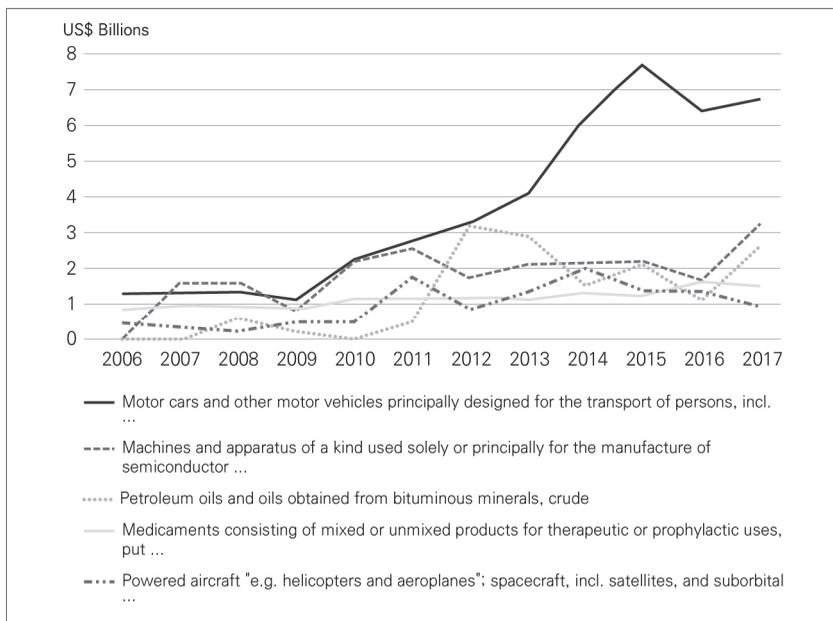
Another salient feature is the rising degree of concentration of EU's exports to Korea, with the total share of the top five (ten) export sectors rising from 53.5 (68.3) to 59.8 (73.8) over the period 2006 – 2017. In spite of this rising concentration, overall the number of exported products has also been on an upward trend.

At a more disaggregated level (4-digit), the main driver is the category “Motor cars and other motor vehicles principally designed for the transport of persons” (8703). The change in trend is particularly clear starting in 2010. EU exports of motor cars and other motor vehicles have increased by more than 200 per cent since 2010 and by 427 per cent since 2006. As a result, the

share of this sector in total EU exports to Korea has dramatically risen (from 4.4 per cent in 2006) to account for 14.5 per cent of the total in 2015, before dropping to slightly more than 12 per cent in 2017. It is worth noting, however, that EU exports of car parts to Korea falls short of EU imports.

At the same time, the weight of Korea in EU's exports has been on the rise for motor cars (rising from 0.4 to 1.7 per cent from 2006 to 2017, after reaching 2.1 per cent in 2015), but also for categories 8486 (machines used for the manufacturing of semi-conductors), 2709 (petroleum oils), or 9013 (LCD devices).

Figure 9. EU28 exports to Korea (4-digit)

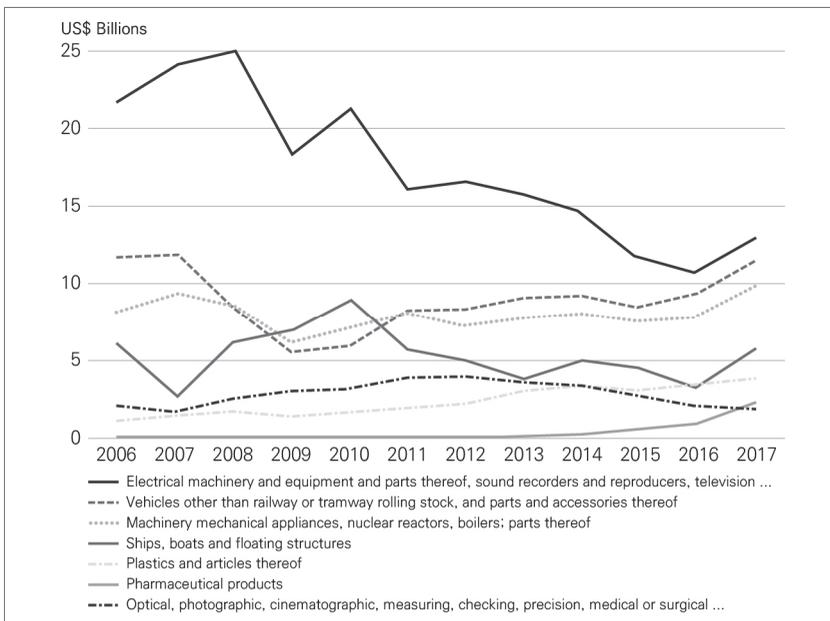


Source: Author's own compilation using UN Comtrade database.

Behind the overall stability highlighted earlier with regards to EU's imports from Korea, major shifts can be observed, with very contrasted evolutions across sectors, leading to some (albeit limited) changes in the pattern of

EU imports of Korean goods. In particular, a sharp drop can be observed in the share of imports of electrical machinery (voice recorders, etc., category 85) from 37 to 21 per cent. The share of motor vehicles (category 87) has also dropped in EU's imports from Korea over the period under consideration (from 20 per cent in 2006 to 18 per cent in 2017, after hitting a low of 10 per cent in 2010), and the same holds true for ships and boats (with a drop from 15 per cent in 2010 to 9 per cent in 2017). In contrast, the share of machinery and mechanical appliances (87) has remained stable at about 16 per cent, while the share of pharmaceutical products or other organic chemicals has been slightly on the rise (from less than one to more than 3 per cent of total imports). Overall, however, there has not been any major change in the number of total products imported from Korea.

Figure 10. EU28 imports from Korea

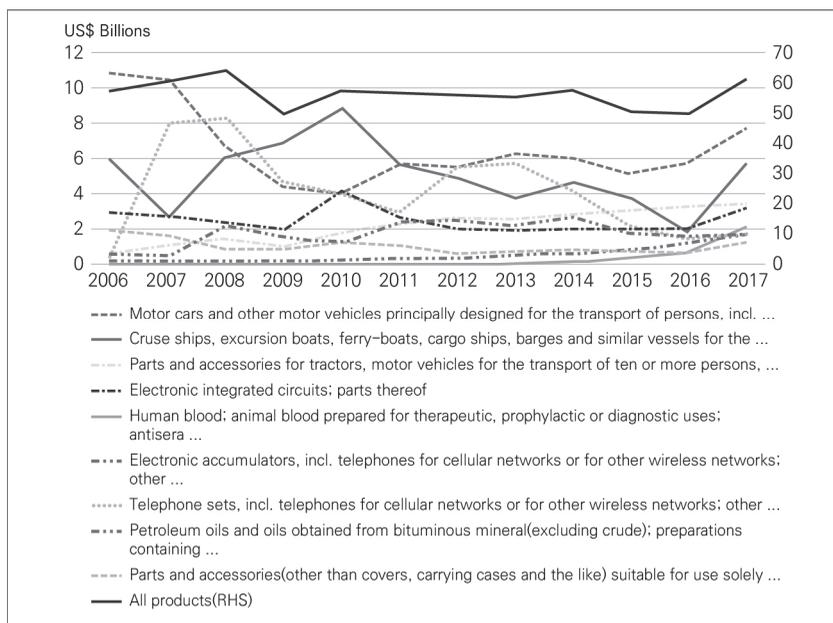


Source: Author's own compilation using UN Comtrade database.

As a result of these various changes, the degree of concentration of EU's imports has substantially declined, with the share of the top five products dropping from 84 to 69 per cent from 2006 to 2017.

At a more disaggregated 4-digit level, the evolutions also differ widely across sectors. A sharp drop can be observed in imports of cruise ships and excursion boats (category 8901) starting in 2010, and in imports of telephone sets (category 8517) as early as 2008. This drop appears to have been compensated to some extent by the rise in imports of motor cars and other motor vehicles (category 8703) starting in 2010, hence the overall relative stability of total imports.

Figure 11. EU28 imports from Korea (4-digit)



Source: Author's own compilation using UN Comtrade database.

2-1-3. Intra-industry trade

Interestingly, EU exports to, and imports from, Korea tend to be on the whole in the same categories of goods (at the two-digit level, these are categories 84, 85 and 87¹¹⁷). These three categories account for 46.5 per cent of EU's exports to Korea in 2017 (41.6 per cent in 2006) and for 54 per cent of EU's imports from Korea (72 per cent in 2006).

The leading role played by these sectors in exports and imports suggests that the expansion of bilateral trade is characterized by expanding “intra-industry trade”. For categories 87 and 85 in particular, even when considered at the 4-digit level EU's exports to and imports from Korea tend to be in the same types of goods, namely motor cars and other motor vehicles (8703), parts and accessories of motor cars (8708), and electronic integrated circuits (8542). Specialized products in the same industry are likely to be exchanged to exploit economies of scale and specialization, and a more diverse range of products are made available to producers and consumers as tariffs and other trade barriers are reduced. The expansion of such intra-industry trade indicates that supply chains have become more integrated and that there have been gains from economies of scale and increased technological specialization (more on this below).

However, the similarity in exports to, and imports from, Korea is not always as clear. For category 84 in particular, exports and imports are substantially different with the EU exporting machines used for the manufacture of semiconductors (8486) and importing parts and accessories for calculating machines, automatic data processing machines and office machines (8473) for instance.

Moreover, beyond the three leading products highlighted earlier, inter-in-

117) 84: Machinery, mechanical appliances, nuclear reactors, boilers; parts thereof; 85: Electrical machinery and equipment and parts thereof; sound recorders and reproducers, television; 87: Vehicles other than railway or tramway rolling stock, and parts and accessories thereof.

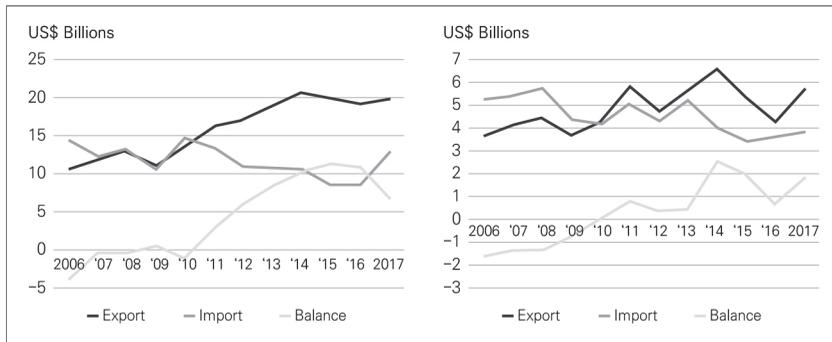
dustry trade is still vibrant, with the EU importing ships (89), plastics and articles thereof (39) from Korea¹¹⁸, while it exports optical, medical precision instruments (90) and pharmaceutical products (30) to Korea.

2-1-4. Individual countries' perspectives

All EU member states are not as actively involved in trade with Korea. There are three member states whose imports of goods from Korea exceeded the US\$ 5 billion mark in 2017: with US\$ 13 billion, Germany tops the list, the United Kingdom comes next (US\$ 5.3 billion), followed by the Netherlands (US\$ 5.2 billion).¹¹⁹

The same three countries are also the largest exporters to Korea. Germany is by far the number one, with US\$ 19.8 billion, far ahead of the UK (US\$ 7.5 billion), the Netherlands (US\$ 6.5 billion), and France (US\$ 5.7 billion).

Figure 12. Germany-Korea trade and France-Korea Trade



Source: Author's own compilation using UN Comtrade database.

Interestingly, after five years of consistent rise (2009 – 2014), Germany's exports to Korea have tended to plateau over the most recent period, while its imports have been declining consistently over the past decade, with a

118) A substantial share (about half) of these exports is directed to the UK.

119) Italy ranks number 4.

sharp recovery in 2017. Still, Germany has the largest trade in goods surplus with Korea.¹²⁰⁾ With close to US\$ 7 billion, Germany's trade surplus is much larger than France's total exports to Korea (US\$ 5.7 billion).

Overall, 13 member states had a trade in goods surplus with Korea in 2017, ranging from less than US\$ 10 million for Malta to US\$ 8.4 billion for Germany. France, the United Kingdom and the Netherlands were the only other countries whose trade surplus was larger than US\$ 1.5 billion.¹²¹⁾ The remaining 15 member-states had a trade in goods deficit, starting at US\$ 100 million for Bulgaria to US\$ 4.6 billion for Slovakia at the other end of the spectrum. Greece, the Czech Republic, Poland and Spain were the only other countries whose trade deficit with South Korea was larger than US\$ 1 billion.

While both France and Germany tend to import the same categories of products from Korea¹²²⁾, their export specialization patterns differ to some extent, with Germany being more clearly specialized in motor vehicles, and France in aircrafts. The UK differs from the two other countries on both imports and exports. UK imports from Korea are dominated by motor vehicles, which started to pick up as early as 2010. On the export side, the number one category for the UK is mineral fuels.

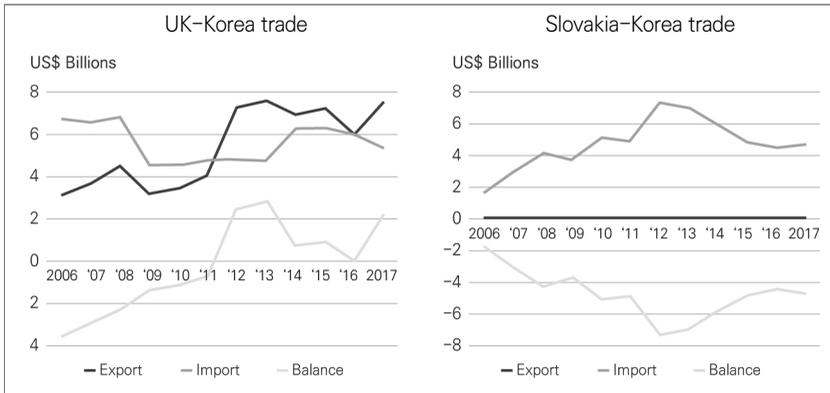
More interestingly perhaps, South Korea is also an important partner for smaller member-states such as Slovakia (which ranked as the number five EU importer from Korea in 2017) or Greece (number seven), and for other Central and Eastern European economies such as the Czech Republic, and, to a lesser extent, Poland.

120) While Slovakia has the largest deficit.

121) Korea is the 8th largest source of trade surplus for France.

122) As exemplified by a similarity index of 0.79. The dominant sectors are electrical machinery, motor vehicles and machinery and mechanical appliances (85, 87 and 84).

Figure 13. UK-Korea trade and Slovakia's trade with Korea



Source: Author's own compilation using UN Comtrade database.

For Slovakia, imports from Korea account for more than 22 per cent of its total extra-EU imports (and only 6 per cent of its total imports).¹²³ Although Korea's share in Slovakia's total imports is more modest (6 per cent), it exceeds 10 per cent for many widely imported goods such as parts and accessories for tractors and motor vehicles (8709), or parts suitable for use with transmission and reception apparatus (8529), 20 per cent for automatic data-processing machines and accessories thereof, and it may reach more than 40 per cent for some products such as parts suitable for use with internal combustion piston engine (8409). The major driver of Slovakia's trade deficit with Korea is category 8708 (parts and accessories for tractors and motor vehicles).

For most of these new trade partners, the change in their trade with Korea is driven by the rise in the extensive margin.¹²⁴ In other words, a substantial

123) Imports from Korea account for 13 per cent for Greece, for 8 per cent for the Czech Republic, and only 4 per cent for Poland.

124) While the intensive margin depicts the change in the value of traded quantities in already existing product categories, the extensive margin shows the amount of traded goods and services of new product categories; in other words, it refers to the "probability" to trade

share of their trade with Korea is in newly traded products.¹²⁵⁾

2-2. Beyond trade in goods

2-2-1. Trade in services: the EU's persistent surplus

As was the case for trade in goods, trade in services between the two partners has been extremely dynamic over the past few years, and in particular since the implementation of the FTA. EU exports of services to Korea increased by 49 percent,¹²⁶⁾ compared to 35 percent for EU imports from Korea from 2010 to 2015. With EU exports of services systematically twice as large as EU imports, the EU has maintained a systematic trade surplus of about US\$ 8billion.

Again, as for trade in goods, all EU member states do not fare in the same way. The United Kingdom and Germany are ahead of the rest as exporters of services, accounting respectively for about 23 per cent and 15 per cent of total exports to Korea.

Interestingly, although Korea is still in deficit vis-à-vis the EU, service imports from Korea increased drastically over the past few years, and at a much higher pace than imports from other reference trade partners such as Japan for instance.

In terms of sectors, financial and business services, and construction account for about a third of EU service exports to Korea, while financial and business services, and wholesale and retail account for more than 80 per cent of EU service imports from Korea. Moreover, in contrast to what was observed for trade in goods, the sectoral breakdown has not substantially changed over time.

products.

125) The rise in the extensive margin can also be observed for other Korea' trade partners.

126) Outperforming exports to other partners in the region such as Japan or Taiwan (Civic Consulting and Ifo 2017).

2-2-2. Direct investment flows

In parallel to trade flows, direct investment flows have also intensified between the two partners over the period 2006 to 2017, with EU inward FDI stocks increasing by 59 percent and EU outward direct investment stock in Korea increasing by 33 percent. However, quite naturally, given the difference in size between the two partners,¹²⁷⁾ EU direct investment flows to Korea vastly exceed Korea direct investment outflows to the EU in absolute value, with the former almost systematically twice as large as the latter. Similarly, the EU direct investment stocks in Korea are about 2.5 times bigger than Korean direct investment stocks in the EU.

In 2016, the EU was the number one foreign direct investor in Korea,¹²⁸⁾ accounting for about one third of direct investment flows into Korea (US\$ 7.4 billion out of a total of US\$ 21.3 billion); this was around three times the amount of the previous year. European investors are primarily active in the service sector (finance, business services, and construction) and, to a lesser extent, in the manufacturing sector (in particular in chemical engineering, biomedicine, industrial machinery and equipment).

Among European investors, the Netherlands traditionally rank first, ahead of the UK, Germany, and France.¹²⁹⁾ Financial centres such as Malta and Luxembourg also loom large. German investors, however, tend to be increasingly involved in industrial cooperation endeavours in sectors, such as the electronics, automotive and aviation industries.

At the same time, Korean investors have also stepped up their investments in the EU. In the wake of the GFC Korean companies regained their appetite for European acquisitions, encouraged by the drop in asset prices

127) Considered as a single market, the EU is 14 times larger than the Korean domestic market.

128) In terms of cumulated investments, the EU is almost the double of the second largest investor, Japan.

129) France was the fourth largest EU investor in Korea in 2016, focusing in particular on financial services.

caused by the continent's debt crisis and the strength of the won. Their interest has been maintained ever since and Korean investors now rank among the most active Asian investors in the EU.

As is the case for trade, Germany ranks high on Korean investors' priority list¹³⁰⁾ and it tends to be used as a springboard to the rest of the EU. The place of the UK as a destination for Korean investors also deserves a special mention. The UK has traditionally been a major investment destination for Korean companies, and recent surveys suggest that they intend to maintain their investment activities in spite of the forthcoming Brexit, with a persistent strong emphasis on real estate. In the first half of 2018 for instance, Korean investment totalled about US\$ 1.5 billion, which is already more than double the US\$ 680 million invested in the whole of 2017 and is expected by various analysts to continue to increase significantly in the remainder of the year. The acquisition by Mirae Asset Global Investments of Blackstone's London office for US\$ 460 million was the largest transaction so far.

In addition to the UK and Germany, France, the Netherlands, Italy and Belgium have emerged as popular destinations for Korean investors in the past few years. Probably in an effort of diversification ahead of Brexit. In this respect, Korean investors behave no differently than other foreign and Asian investors for that matter (Japanese or Singaporeans for instance), although they tend to be even more active.

As was the case with trade, Korea is also an increasingly important investment partner in several Central and Eastern European countries, but this time primarily in the manufacturing sector. Although Korean ODI has had a dominant role in the Czech Republic, Poland and Slovakia for a long time (as early as the late 1990s),¹³¹⁾ it has accelerated over the past decade or so.

130) At the end of 2016, Korean aggregate direct investment in Germany stood at US\$ 4.5 billion, compared to less than US\$ 1 billion in France.

131) Daewoo for instance established a basis in Poland in the automobile industry and elec-

Taking advantage of a cheap, committed, skilled and affordable labour force, of otherwise good production conditions and of the attractiveness of the EU market, Korean car manufacturers such as Kia and Hyundai have established production bases and moved their development centres to the 4 Visegrad countries. Hyundai has three investment projects in the Czech Republic, while Kia started producing in Slovakia in 2004. Also, although it is increasingly challenged by China, Korean ODI is still ahead in Poland in 2017.

In a nutshell, the EU-Korea economic partnership has become increasingly tight and diversified, with a broader range of countries trading with Korea and being invested by Korean firms. But the evolution of the relationship also appears to be somehow asymmetrical, with apparently larger gains for the EU than for Korea. The next section seeks to provide possible explanations to this development.

3. Qualitative analysis: what drives the relationship

There may not be one single explanation to the changes highlighted in the previous section and different factors may account for the developments observed in different sectors. The cases of the automotive and electrical machinery sectors, which account for the largest share of bilateral trade flows, will be examined separately.

Over the past decade, the major change has been the entry into force of the EU-Korea FTA,¹³²⁾ and one can legitimately expect this agreement to have an impact on the bilateral relationship, although this cannot account for all changes, and even less so since some of those appear to be in contradiction with expectations. As highlighted above, the parallel evolution of

tronics in the late 1990s, taking advantage of the Polish privatization process.
132) 1 July 2018 marked the 7th anniversary of the EU-South Korea FTA.

EU's imports from Korea and EU's imports from the rest of the world suggests that non-specific drivers have been at play. In particular, the sharp decline in EU's imports observed in 2015 and 2016 irrespective of their origin has certainly more to do with factors that are EU specific.

3-1. The Korea-EU FTA and its impact

Although it is not always easy to disentangle the impact of various factors, there is a strong suspicion that the entry into force of the bilateral FTA has impacted the intensity as well as the nature of the bilateral relation.

While a preferential trade agreement sometimes remains a dead letter, such is not the case for the Korea-EU FTA. A number of factors point to an effective implementation of the FTA.

A first factor is the high preference utilization rate. At about 70 per cent on average for EU exporters to Korea, it is much higher than for other FTAs; moreover, the rate is even higher (95 per cent) for highly traded goods such as automobiles. For Korean exports to the EU, the overall preference utilisation rate is even higher than the EU rate, at 87 per cent in 2016 (compared 84 per cent in 2014).

A second sign relates to the rise in the number of tariff lines which have been gradually liberalized. As is standard practice with FTAs tariff elimination has been taking place gradually in the EU-Korea FTA but the majority of import duties had been removed in 2011, and the remaining ones – with exception of a limited number of agricultural products – were removed after 5 years on 1 July 2016. At the end of the transition period, tariffs are now removed on 99 per cent of tariff lines.

As explained in the previous section the specific pattern of EU-Korea trade flows (compared to other bilateral flows) points to a positive impact of the FTA. First, Korean exports to the EU may not have grown much but they have grown noticeably faster than those of a reference group including

Japan, Taiwan, and Malaysia, since July 2011 when the FTA was launched. Exports to the EU from Korea increased by about 20 percent, while exports to the EU from the three reference countries largely stagnated until 2016, suggesting that the FTA must have played a role.

At the same time, the sharp increase in EU's exports to Korea compared to total EU's exports (in particular EU's exports to Japan) is also a testament to the potential role played by the FTA. Without providing a formal proof, these observations highlight the possibility that the divergence is due to the FTA.

Interestingly, although more tariff elimination was front-loaded in the EU case than in the Korean case, Korean exports to the EU rose at a much slower pace than European exports to Korea. Several explanations may be found for this somewhat paradoxical development; they are related to initial differences in the trade policy environment of the two countries. The first one has to do with the initial low level of protection which prevailed in the EU before the FTA came into force. With lower tariffs applied to Korean exports to the EU (2.5 per cent on average)¹³³) than to EU exports to Korea (6.2 per cent), a larger impact could be expected from tariff liberalization on EU exports than on Korean exports.

Moreover, the reduction in trade policy uncertainty resulting from the entry into force of the FTA was probably more important for EU exporters than for Korean exporters. This is because the gap between bound and applied tariffs (the so-called tariff overhang or "water") tended to be rather large in the case of Korea, creating substantial uncertainty for trading partners, as tariffs could be easily (and legally) raised at any moment.¹³⁴) Actually, the fact that the rise in EU's exports started as early as 2009 (when the FTA was initialled but not yet in force) suggests that there may have been some

133) Also a larger share of Korean exports to the EU entered duty-free compared to EU exports to Korea.

134) See Lakatos and Nilsson (2017, p. 188) for more details on this point.

positive anticipatory trade effects resulting from a reduction in trade policy uncertainty. In contrast there was no tariff overhang in the case of the EU, and as a result no gain in uncertainty reduction in the absence of any major trade policy uncertainty.

Lastly, and more importantly perhaps, since non-tariff barriers (NTBs) and other “behind the border measures” were notoriously more important in Korea than in the EU, it should not come as a surprise that the elimination of such barriers, specifically in the automotive, pharmaceutical, medical devices and electronics sectors, had a more substantial impact on European exports to Korea than the other way around. The automotive industry is a case in point which is examined below.

3-2. The automotive sector as a case study

In the automotive industry, EU-Korea trade is characterized by two distinct developments that deserve some explanations: namely a dramatic rise in EU’s exports of cars to Korea¹³⁵⁾ and a much slower rise in Korean exports of cars to the EU. The asymmetrical behaviour of these two types of flows may be thought to result from the difference in the timing of tariff reduction adopted by the EU and Korea, but this argument is not fully convincing, be it only because empirical evidence suggests that some effects are sometimes felt ahead of the entry into force of an agreement as a result of anticipations.¹³⁶⁾

A more convincing explanation to the sharp rise in European car exports to Korea pertains to the dismantlement of a number of NTBs (in particular specific Korean safety and environmental protection standards) which had blocked, or at least complicated, the entrance of EU car producers to the

135) As highlighted earlier, while the share of cars (87) used to be around 7 per cent of total EU exports to Korea in 2006, it has been rising consistently since the FTA came into effect to reach 16 percent in 2017 (after reaching 17.4 per cent in 2016).

136) See Lakatos and Nilsson (2017, p. 194).

Korean market in the past.¹³⁷⁾ The NTB provisions included in the Korea-EU FTA, which focused not only on automobiles, but also on electronics, pharmaceuticals and medical equipment, clearly reflected the export interest of the EU. Surveys of EU players once the FTA had come into force strongly suggest that the agreement was perceived as having made things easier by eliminating a number of NTBs and facilitating access to the Korean market.¹³⁸⁾

The dramatic rise observed is perfectly in line with the results of some prospective analyses such as Decreux *et al.* (2010), which anticipated the rise in EU's exports of cars to Korea to exceed 400 per cent. The conclusions of this study were at odds with those of most others, precisely because it was the only one that tried to account for the impact of a dismantlement of NTBs. In contrast the mere elimination of tariffs was not expected to have much of an impact on EU's car exports to Korea.¹³⁹⁾

During the negotiation period, serious concerns were expressed on the European side (in particular by the European Auto Manufacturers Association - ACEA) about the threat of an "invasion" of Korean cars.¹⁴⁰⁾ And yet, these concerns proved ill-founded: EU's imports of Korean cars dropped quite sharply until 2010 and never returned to their earlier level. The late removal of tariffs on exports of Korean cars to the EU is sometimes offered as an explanation, but it cannot easily account for the subdued expansion of these exports until recently, since the level of tariffs prevailing before the FTA entry into force was probably too low to act as a strong deterrent.

An additional explanation of the relatively small rise in imported cars from Korea compared to exported cars to Korea has to do with the divergence in

137) As explained in Juust *et al.* (2017, p. 6).

138) Cherry (2018), p. 33.

139) According to Erixon and Lee-Makiyama (2010, p. 6), NTBs in the car industry were estimated to be around 90 per cent, compared to tariffs at a mere 8 per cent.

140) The EAMA thought that the EU car industry was set to lose from the deal and lobbied forcefully to block the deal.

business strategies between Korean and European car manufacturers. While EU car manufacturers primarily rely on exports to serve foreign markets,¹⁴¹⁾ such is not the case for Korean carmakers who tend to rely more on direct investment abroad.¹⁴²⁾ The reasons for the latter choice of strategy are many. Circumventing tariff barriers may be one explanation. But other considerations related to differences in business conditions probably play a larger role.

A first factor has certainly to do with the high concentration of Korean car production to a limited number of producers (Kia and Hyundai). As suggested by Erixon and Lee-Makiyama (2010, p. 9), under these circumstances it has proven much more efficient for Korean car manufacturers to locate production in Europe rather than to export from Korea to Europe at high transport costs.¹⁴³⁾

Moreover, the segmentation of export markets in terms of regulations provides a further incentive to Korean car producers to use direct investment rather than export to penetrate the EU market. As explained by Basedow (2018), the Korean car industry is in an intermediary position between the two dominant global (and incompatible) regulatory regimes for cars – the US American and the European UNECE régime. The pragmatic (yet costly) solution Korean car manufacturers have found to the problem posed by the incompatibility between the two regimes is to operate different factories and production lines for cars going to different markets.¹⁴⁴⁾ For all

141) According to Felbermayr *et al.* (2017, p. 14), this is the result of the historical development of the EU customs union and single market which has fostered an export-led growth model.

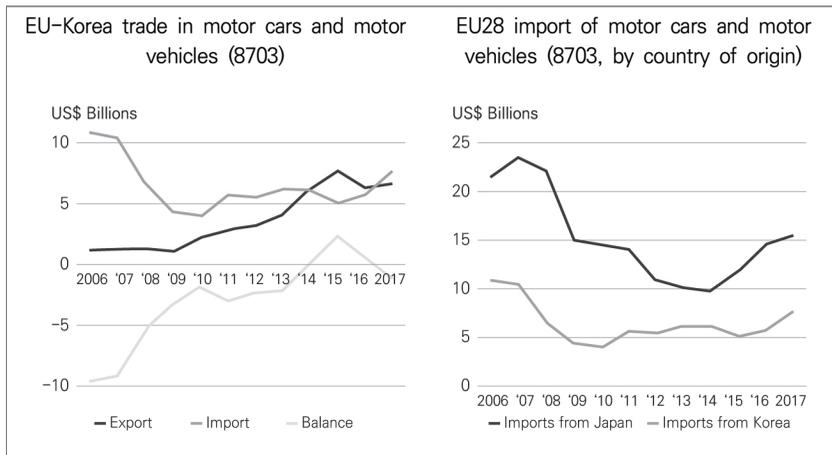
142) A similar observation is made by Binder (2018, p. 3) about Japanese car producers.

143) By way of illustration in volume terms, 55 per cent of Hyundai cars sold in Europe are EU-made. And overall, half of Korean cars sold in European markets are produced in Slovakia and the Czech Republic (Kang 2017, p. 19).

144) As explained in the previous section, Kia and Hyundai have invested heavily in Eastern Europe which they use as a gateway to the rest of the European market. Of course the disintegration of production chains to match different regulatory regimes imposes sig-

these reasons, focusing exclusively on trade flows may be somewhat misleading as the change in Korean car exports to the EU is only one part of the story.

Figure 14. EU-Korea trade in motor cars and motor vehicles and EU28 imports of motor cars and motor vehicles from Japan and Korea



Source: Author's own compilation based on UN Comtrade database.

Once the FTA entered into force, however, EU's imports from Korea picked up again while imports of Japanese cars dropped further to reach a low point in 2014. The differentiated dynamics of these two flows suggests that the FTA must have had a dampening effect; more specifically the decline due to low growth and gloomy local economic conditions in the EU turned out to be limited for imports from Korea compared to imports from other source countries. More recently, in contrast, the parallel recovery in EU's imports of Japanese and Korean cars may probably be attributed to the improvement in local conditions and to a return to more sustained growth.

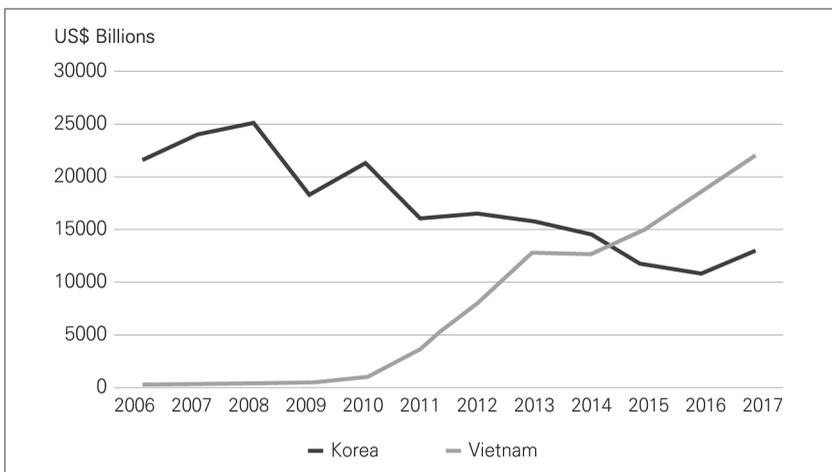
nificant opportunity costs on Korean manufacturers who are forced to forego economies of scale, and this is probably why they are engaging in efficiency-seeking direct investment in Central and Eastern European countries in particular.

3-3. The role of global value chains in the electrical and electronics sector

The drop in EU's imports of electrical machinery and equipment (HS category 85) from Korea should also be put in perspective and not necessarily be interpreted as a negative development for the Korean industry. This is likely to be the result of the reorganization of production by Korean companies rather than a loss of competitiveness.

The increasing importance of regional trade integration in East Asia and the expansion of global value chains (GVCs) and more specifically of regional production networks (RPNs) has to be taken into account and may provide a convincing explanation to the aforementioned development. In the electronics sector in particular, Korean manufacturers, and more specifically Samsung, have chosen to relocate part of their production in Southeast Asia (namely Vietnam) in order to reduce their costs of production. As a result, exports of some Korean electronic goods to the EU no longer originate

Figure 15. EU28 imports of electrical machinery and equipment



Source: Author's own compilation using UN Comtrade database.

from Korea but from Vietnam.

The validity of this hypothesis is confirmed by the opposite evolution of EU's imports of electronic goods from Vietnam and from Korea. For category 85, the sharp rise in EU's imports from Vietnam in parallel to the decline in imports from Korea strongly suggests that the former has taken over the latter. Samsung's exports to the EU from Vietnam are nowadays six times larger than those originating from Korea.

3-4. Other explanatory factors

Beyond the FTA, local conditions prevailing in host-countries also matter and may play the role of pull or push factors. Sluggish economic growth in the EU in the wake of the global financial crisis no doubt accounts for the disappointing performances of some Korean companies in the EU market. The sharp fall in domestic demand in the EU affected Korean exports, as well as other countries' exports. In particular, the sharp decline observed in 2015 and 2016 can be accounted for by the slowdown in economic activity in the EU. However, as explained earlier the FTA has to some extent mitigated these shocks.

In very much the same vein, the drop in Korean exports of some products such as ships to the EU is due to the specific conditions prevailing in this sector rather than to the FTA.

Similarly, Korean direct investment in Europe was pushed at some point by the strength of the won and the drop in European asset prices rather than by the imposition of some specific regulations aimed exclusively at Korean investors.

Changing circumstances within the EU also have an impact on the way the two partners interact. To be more specific, in the past year or so, the diversification of Korean investment away from the UK has most likely to do with the prospect of Brexit.

4. Conclusions and prospects

While Korea and the EU used to be thought to be undertraded, over the past decade there has been a sharp rise in their economic exchanges suggesting that the potential of bilateral trade is being gradually tapped and that the expected correction is under way. However, the asymmetry in the evolution of bilateral trade flows, with the EU emerging in a more favourable position than Korea, is *prima facie* rather surprising. The above analysis suggests that the implementation of the Korea-EU FTA may to some extent account for this development, in particular thanks to the powerful impact of NTBs elimination. However, too hasty conclusions should be avoided since putting the exclusive focus on trade flows is insufficient to accurately gauge the real value of productive activities by Korean companies. The substitution of trade by FDI is a major feature of Korean companies' business strategies. Overall the two partners have managed so far to tighten their trade and investment relations in a mutually beneficial manner.

The further evolution of bilateral EU-ROK trade and investment relationship, however, also depends on external factors. Three potentially important developments are worth mentioning. First, the recent ratification of the Japan-EU FTA can be expected to impact the EU-Korea relationship negatively since Korean exports to the EU tend to be rather similar to Japan's exports to the EU. For Korea, the primary impact that can be expected from the entry into force of the EU-Japan FTA is a sharp rise in competition. In particular, once the Japan-EU FTA is implemented, this will be the end of Korean car manufacturers' cost advantage in the automotive sector in the EU market.

Secondly, the recent deterioration of the trade relations between the US and the rest of the world is also likely to affect the Korea-EU relation, but positively this time, as it may lead to more trade diversion in favour of like-minded partners such as Korea and the EU.

A final major unknown relates to the future of the Brexit negotiation. Should the Brexit materialize in the coming months, a number of adjustments will be required not only on the part of the Korean government but also of Korean companies. It remains to be seen whether and how the two sides will find a way to maintain their “excellent bilateral relationship” that may also be consistent with the preservation of the Korea-EU FTA.

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Chapter 8



The Future of the EU and Its Implications to Korea

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- A background image showing a network map of Asia with nodes and connecting lines, overlaid on a blurred cityscape.
1. Introduction
 2. Latent problems and revealed challenges
 3. Criticisms on the EU regime
 4. Projection on the future of the EU
 5. Implications for Korea

The EU is in the midst of crisis. The root of the turbulence dates back to the 1980s–90s when the welfare states started to break down, but emerging challenges and their escalation into crisis have been conspicuous around since 2010, seen in such developments as the European economic crisis, refugee crisis, rising populism and subsequent upheaval in the political geography, and Brexit. Combating the challenges, the EU institutions have proposed several scenarios for the future of the EU. The path for the future is mainly dependent upon responses from the member states such as people's willingness to preserve the union, as well as the political, security and economic environments surrounding the EU.

The future of the EU provides ample meaning and insights to Korea. First of all, Korea's relations with the EU and member countries will change depending on the future model of the EU, in accordance with the areas of EU action. Second, as a model of regional integration, the future shape of the EU will have a tremendous influence on the path of regional integration in East Asia. Korea will try to avoid all negative aspects of regional integration while striving to make the best use of positive aspects identified from the case of European integration. Third, rising populism and far-right parties in Europe indicate that widening income disparity and ill-designed immigration policy can be easily transferred to a very sensitive political agenda, so Korea needs to prepare for such situations in advance. Fourth, Korea needs to be very careful in dealing with the unification process and consider in advance what kind of difficulties a unified Korea will face, considering the case of the EU's enlargement.

1. Introduction

The EU is currently under severe stress. The United Kingdom, one of the biggest member countries, is leaving the union in 2019, after the chaotic de-

velopments of the two-year process of exit negotiations between the UK and the EU. Anti-EU populist parties continue to gain ground in France, Germany, the UK, Austria, Denmark, the Netherland, the Czech Republic, etc. *Leγα*, the far-right party in Italy proclaiming the slogans of anti-EU and anti-immigration, finally grasped political power in June of 2018 by joining the coalition government. Moreover, political party groups who are in support of an anti-EU platform took more than ten percent of seats in the last European Parliament election, and are expected to gain firmer ground in the upcoming 2019 election. The European Union seems to be a punching bag or, at least, fair game for the public and politics in Europe. Europe is in a crisis.¹⁴⁵⁾

This is a big reversal when recalling how many people in Europe addressed that the European integration movement, unfolding over the last 60 years or so, had been a great success in line with ever-closer union. It would still be fair to argue that European integration *is* a success, as there are quite good grounds to believe this: the ECSC, started by only six countries in 1951, has been developed into the EU with twenty-eight member states now. The degree of integration has greatly advanced. The earliest form of economic integration aimed at just a customs union has since become an economic union with the Single Market and Euro-zone. The European Union has been transformed into a more advanced unity with exclusive competences in many areas. Through the Lisbon Treaty, which entered into force in 2009, the European Union acquired the legal status of representing the whole community, and the European Parliament (representing the European citizens) substantially strengthened its power in comparison to the Council of the European Union (representing the member states), implying the reinforcement of representativeness in the structure of political power in the EU. It is indeed hardly an overstatement to claim that the European Union is one of the greatest achievements that mankind has ever created.

145) Beck and Underhill (2017), p. 1.

All of a sudden, however, the foundation for the union seems to be collapsing. What has happened in the union? It is interesting to note that the crisis of the EU was not that widely popularized and accepted until a few years after the global financial crisis. In about 2010, a series of economic crises occurred in some member countries of the euro-zone including Greece, but few people would coin the situation for the EU in crisis. Then the Greek sovereign crisis developed into a storm, threatening the existence of the euro-zone in 2012. Recurring every year or every other year since 2010, the Greek crisis has widened the rift of opinion among European citizens on how to save the euro-zone and Greece. The crisis of the EU, however, does not necessarily imply the economic one in the EU. Rather it extends much beyond economic affairs, so that it shows more complicated and wide angles, deeply related to the identity problem of the EU and Europe.

A series of terror attacks by extremist groups have dried up people's tolerance for immigrants, and the 2015 refugee crisis hit the whole Europe and enflamed anti-immigration sentiments. There have been a growing number of people who believe that the EU is impotent in securing its citizens' security against the refugee crisis. The Brexit referendum in 2016 demonstrated how anti-EU mood is widely spread among the ordinary people of the union. The future of the EU is now severely challenged.

The EU is now at a crossroads to decide which directions the union should go. There are many signboards ahead: stop here, go back and stay, go further together, go further only with whom to do, or anything else. It is difficult to anticipate which way the EU will adopt, or which way will lead to desirable results for the union. In this chapter, we will discuss these issues. Starting with a brief recap of the main challenges the EU is currently facing, we will see how the EU has been shaping the future regarding the issues, followed by the scenarios of the EU's future suggested by the European Commission. We will wrap up the chapter by adding some factors to consider, together with implications for the future development of the EU to a

third country in Asia, like Korea.

2. Latent problems and revealed challenges

It would be fair to say that the current crisis of the EU must have a long-rooted origin. First of all, the socio-economic environments surrounding Europe have fallen into deterioration. The globalization process taking place since the 1980s has had asymmetrically negative impacts on the wage levels of unskilled workers, leading to a widening income disparity in Western Europe. The ageing society caused by demographic change has encountered difficulties in productivity and innovation in the economies, not to mention fiscal burden on pension and healthcare related.¹⁴⁶⁾ The resulting challenge has pointed out the need for political parties in power to reform the pension system and welfare regime, leading to nation-wide discontent among the ordinary people. Climate change and environmental problems also added extra burden on the economies by accompanying stricter environmental standards in industries.

It is a matter of course that these challenges are not problems that apply just to the EU, but for almost all developed countries in general. Solving the challenges within the community, however, has caused more disturbances than other countries out of the EU, because it should be solved collectively in the EU level, and EU-wide solutions require a very high level of collaboration, which is difficult to achieve especially in hard times.

If we turn our eyes to internal affairs, long-pending troubles embedded in the community have been present in the EU. While deepening integration in the region, the coordination of regulatory regimes among members has often aroused the anger of the citizens, because coordination is understood as im-

146) European Commission (2018), p. 6.

proper interference by unelected powers from Brussels. Fundamental economic inconsistency in the euro-zone among highly industrialized economies and less industrialized ones, once believed to be solved with free movement of people and fiscal activation at the EU level, has contributed to growing intrinsic instability in the system, as well. The approach to the ever-closer union has been often understood clearly to be an elite process, which has aroused widespread antipathy among ordinary Europeans.

All of these problems constitute a nourishing basis for strengthening anti-EU sentiments. It was only after the global financial crisis and the subsequent European economic crisis, however, that the EU had to meet unprecedented challenges which had emerged to the surface. The revealed challenges exposed a strong risk of political, economic, and social matter escalating into a mixed-up explosion, not to mention the complexity behind determining whether these were purely internal or external issues.

Rising populism after 2010 is one of the major challenges that can be addressed. By accepting rapidly rising Euroscepticism as a major propaganda, populist parties have gained substantial ground in the political geography. They have blamed the EU for the main culprit bringing not only many economic problems such as rising unemployment and shrinking welfare benefits, but also other issues such as dissolution of traditional local communities. They argue that the countries would have handled these complex problems in a more refined manner, had it not been for the EU. Brexit is an outcome of populism, distinctively Euroscepticism, and is more than just about economics.¹⁴⁷⁾

A great number of migration and refugees from the areas surrounding the EU as well as backwards regions in the community pose another big threat to the future of the EU. Due to the Single Market, free movement of people from the central European members to the western ones are fully guaranteed,¹⁴⁸⁾ which provided a good excuse for voters at the Brexit referendum

147) Cox (2017), p. 16.

to cast in favour of “leave.” Free movement of people does not necessarily confine the issue to the coverage of simple moving, but also does include more complicated issues such as long-term residence without permit, job-seeking without work permits, free opening of own business, and eligibility of pension, all of which can be easily blamed as negatively impacting the welfare of the existing inhabitants.

When it comes to immigration from outside of the community, this has become a serious social problem in Europe as too many immigrants came to the community in a short period of time, particularly in 2015. More than a million migrants and refugees arrived in Europe in 2015 due to the civil war in Syria, amounting to three to four times more than in the previous year. Europe was fazed. Confronting this influx of irregular migration, coined a “refugee crisis,” the EU tried to improve the situation, but revealed its incompetence in dealing with it to meet the expectations of existing inhabitants. Before cutting a deal with Turkey, the EU has already accepted a huge number of refugees. While the number of refugees peaked, the European Commission proposed the “European agenda on migration” in May 2015 to manage migration and asylum, to control Schengen border from illegal crossing, and to maintain solidarity within the EU. Nonetheless, the response was slow and in some ways not so effective and efficient, as the EU shares competences with member states in this field and member states have split positions on the issues. It is undeniable that the refugee crisis had triggered the speed-up in rising power of the populist parties.

Against rapidly emerging challenges and problems in the EU, the EU institutions tried to confront the challenges, but in many cases only aroused harsh criticism by the public in member states. For instance, the plan of introducing a refugee quota for member states, proposed by the EU, was se-

148) After a seven years’ grace period since 2007, the free movement principle entered into force in 2014 for the people from Romania and Bulgaria, leading to enormous immigration to the UK and other western European member states.

verely criticized and some member countries refused to accept it. As the EU exposes its limitations in responding to the crisis, so vivid discourse about the reform of the EU has occurred around Europe: How should the EU better respond to the impending challenges? How could the EU handle the depth and scope of integration with current member states in a satisfactory manner? Should the EU concentrate on the existing member states or take a bold step toward further enlargement? European institutions have been trying to answer these questions.

3. Criticisms on the EU regime

The challenges surrounding the EU as mentioned above are critical to the EU, as they must be solved or, at least, managed within the EU regime to maintain its sustainability. Therefore, with respect to the future of the EU, the issue of how to meet and manage these challenges gains tremendous importance, as they could create an initial chasm that leads to the whole dismantling of the EU in the future. When considering the nature of the problems, however, not all this criticism on the EU may be justified, as the EU system cannot be a master key to solve the problems hounding the contemporary European states. It may be plausible to argue that the EU is simply a scapegoat, requiring to solve all problems the nation states have ever had.¹⁴⁹⁾ The EU may be struggling with problems insolvable by herself.

Nevertheless, it is noteworthy to pay full attention to the criticisms raised by the public and member states: one of the fundamental criticisms on the EU is not over the existence of these challenges and problems in the EU, but

149) Gamble (2017) also agreed to this point that national governments can easily dump their responsibility to the supranational institutions of the EU, because they are too remote from the people and a symbol of globalization, liberalization, and cosmopolitanism. – Gamble (2017) pp.81-84 in Beck and Underhill eds (2017).

that the EU institutions have shown but minimum capability in tackling the problems. Such “impotence” on the part of the EU in combating the challenges makes it harder to justify the competences of the EU action. Criticism that the EU is impotent, and in some cases, even the cause of all problems can be easily developed to the matter of distrust: the greatest threat to European integration comes from declining *trust* in EU institutions. Reversing this trend is essential for integration to prosper.¹⁵⁰⁾ All in all, it is crucial to restore trust in institutions, as is the case that Jean Monnet emphasized the importance of the institution building for the grand project to be lasting.¹⁵¹⁾

To make matters worse, the bureaucracy at EU institutions is criticized for failing to recognize the seriousness of the situation. Pointing out the failure of the grand project, George Soros argued that, in some ways, the Brussels bureaucracy fails to understand that it is losing the battle, much like the case of the waning days of the Soviet Union.¹⁵²⁾ He issued a scathing criticism on the EU’s lost momentum, namely that “Now the EU is in the hands of constitutional lawyers who find loopholes to get thing done so things that ought to be simple become very convoluted.”¹⁵³⁾ The rift between the European elites and the ordinary people in recognizing the EU has dramatically widened in the course of economic and refugee crises. The technocratic crisis management of ‘econocracy’ and austerity politics has eroded what little sense of solidarity there might have been.¹⁵⁴⁾ The principle of political equal-

150) Yesilada, B.A. *et al.* (2018), p. 100.

151) “Nothing is possible without men, but nothing is lasting without institutions.” “Rien n’est possible sans les hommes, rien n’est durable sans les institutions” – J. Monnet(1976) *Mémoires*, p. 360.

152) *Financial Times*, “FT Person of the Year : George Soros,” 19 Dec. 2018.

153) *Ibid.* He appreciates the Europe federalists’ driving force in the early stage, by adding that “The EU was built by visionaries who knew the weaknesses of what they were doing but had reason to believe that when the moment comes the political will can be summoned to take the next step forward.”

154) Ferrera (2017), pp. 23-25 in Beck and Underhill eds (2017).

ity among nations in the EU has entirely broken down,¹⁵⁵⁾ and the European Social Model has gone astray.

Criticism is directed at the EU architecture, too. The current system has taken a kind of muddling through strategy, and it is neither a federal state nor a collection of member states, which causes problems in dealing with problems. The criticism does not imply that the EU should go in the direction of either a federal state or an intergovernmental entity, but that the EU must rearrange its competence areas to make full use of the fiscal federalism principles.¹⁵⁶⁾ The principles tell that the areas of externalities across sub-central units and of returns to scale should apply centralisation, while decentralization needs to be applied in the areas of information asymmetries across all units and of heterogeneity of preferences.¹⁵⁷⁾

Against all these adversities, European institutions have tried to plot where the EU should go in the future. Here are some ideas and initiatives on the future of the EU proposed by the EU institutions.

4. Projection on the future of the EU

4-1. A new start for Europe

As the atmosphere changed after the global financial crisis and the sovereign debt crisis, the European Commission had to make necessary adjustments on its plans accordingly. In July 2014, President Jean-Claude Juncker, candidate of the position at that time, presented the political guidelines of the European Commission in his speech. He set out a vision of ten priority areas, which eventually became the core policy agenda of the European

155) Beck and Underhill (2017), p. 3.

156) Wyplosz (2017), p. 113 in Beck and Underhill eds (2017).

157) Wyplosz (2017), p. 114.

Commission for 2015 to 2019. These are: 1) stimulating investment and creating jobs, 2) a digital single market, 3) secure, affordable and sustainable energy, 4) a deeper and fairer internal market, 5) a deeper and fairer economic and monetary union, 6) balanced and open trade, 7) shared values of justice and fundamental rights, 8) European agenda on migration, 9) global role of the EU, and 10) more transparent and democratic EU.¹⁵⁸⁾

It can be said that previously mentioned challenges of the EU were somewhat considered in this agenda. However, its focus is on the short-term future of the EU, as the agenda was originally intended, such as boosting investment and employment. It was taken for granted that all EU member states, including the UK, have the obligation to contribute for the perpetuity of the EU. For instance, the idea of imposing Germany's debt brake rule (Schuldenbremse) at the EU level was seriously considered, and there were anticipations that a fiscal union would be formed in the near future. At that point, there was no doubt that the EU would be taking the path of in-depth integration and none were to fall out from the EU.

4-2. Bratislava declaration and roadmap

In September 2016, the European Council in Bratislava agreed on a roadmap to strengthen the solidarity of the EU. Remember that the Bratislava Summit was held after the Brexit referendum in the UK. The summit signified an enormous change in the EU plans in that the implications of the UK leaving it had to be considered. At the Bratislava Summit, member states agreed on the following issues: 1) common tackling of the challenges in the EU and member states' level, 2) controlling of the irregular migrants and the Schengen border, 3) internal security and fighting terrorism, 4) external security and defence, 5) economic and social development, especially consider-

¹⁵⁸⁾ European Commission (2014).

ing the youth population.¹⁵⁹⁾

The EU started to become genuinely concerned about the future, accepting the fact that not all member states share the same thoughts, and acknowledging the possibilities of being pulled apart. The Bratislava declaration is significant in terms of the EU member states assuring themselves to stick together to prevent another fall out.

4-3. White paper on the future of Europe

In March 2017, the European Commission suggested five interesting scenarios of the EU to come by 2025, depending on how strongly the member states will work with each other. In line with the Bratislava Declaration, these scenarios are for EU27, all considering the UK ruled out of the EU membership.

Five scenarios were proposed as following:¹⁶⁰⁾

- 1) Scenario 1. Carry on: this scenario is to maintain the current stance in the future, strengthening the member states' cooperation in the field of finance, foreign policy, and security.
- 2) Scenario 2. Nothing but the Single Market: this scenario focuses more on the single market, and other areas are concerned more with the individuality of the member states.
- 3) Scenario 3. Those who want more do more: cooperation levels are determined depending on the policy area and the willingness of the member states' participation level. Some areas, such as the Single Market, would gain further cooperation, while areas such as fiscal or defence union may not be achieved, as each member state will enjoy their sovereignty on different matters.
- 4) Scenario 4. Doing less more efficiently: areas in focus are narrowed

159) European Council (2016).

160) European Commission (2017), pp. 16-25.

down and all member states work closely only on the selected areas.

5) Scenario 5. Doing much more together: without exception, all member states working closely on all matters.

Significance lays in reflecting the reality and considering the challenges that the EU is currently facing. Moreover, considering the EU motto of “united in diversity,” the suggested scenarios seem to accept the diverse positions of the member states. These scenarios would also be one of the few EU documents mentioning decentralisation of EU leadership.

When viewing the impact of the five scenarios in six policy sectors as in Table 7, we can easily see that the EU’s position on European single market and trade area remains solid, regardless of how diverse the EU may grow in the future and how unpredictable it may be. It is because the area is the basis of EU’s foundation and lower limit of European integration. Although the digital market would be another issue, the European single market is generally expected to strengthen in the future. On the other hand, economic & monetary union (EMU), Schengen, migration & security, foreign policy and defence, EU budget, and capacity to deliver columns would vary by scenarios. It is evident that Scenario 2 pays the least attention to integration, and solely shows interest in the Single Market. In contrast, Scenario 5 is the most ambitious, showing the highest level of integration. The future of the European Union is difficult to predict, as the scenarios will be determined based on the choices of all 27 EU member states. Considering the uncertainties surrounding the EU and member states, nobody knows which direction or scenario the EU regime will take.

Table 7. Impact on policies of the five EU scenarios by the European Commission

	Single market & trade	Economic & Monetary Union	Schengen, migration & security	Foreign policy & defence	EU budget	Capacity to deliver
Scenario 1. Carry on	Single market is strengthened, including the energy and digital sectors; the EU27 pursues progressive trade agreements	Incremental progress on improving the functioning of the euro area	Cooperation in the management of external borders stepped up gradually; progress towards a common asylum system; improved coordination on security matters	Progress is made on speaking with one voice on foreign affairs; closer defence cooperation	Partly modernised to reflect the reform agenda agreed at 27	Positive agenda for action yields concrete results; decision-making remains complex to grasp; capacity to deliver does not always match expectations
Scenario 2. Nothing but the Single Market	Single market for goods and capital strengthened; standards continue to differ; free movement of people and services not fully guaranteed	Cooperation in the euro area is limited	No single migration or asylum policy; further coordination on security dealt with bilaterally; internal border controls are more systematic	Some foreign policy issues are increasingly dealt with bilaterally; defence cooperation remains as it is today	Refocused to finance essential functions needed for the single market	Decision-making may be easier to understand but capacity to act collectively is limited; issues of common concern often need to be solved bilaterally
Scenario 3. Those who want more do more	As in "Carrying on", single market is strengthened and the EU27 pursues progressive trade agreements	As in "Carrying on" except for a group of countries who deepen cooperation in areas such as taxation and social standards	As in "Carrying on" except for a group of countries who deepen cooperation on security and justice matters	As in "Carrying on" except for a group of countries who deepen cooperation on defence, focusing on military coordination and joint equipment	As in "Carrying on"; additional budgets are made available by some Member States for the areas where they decide to do more	As in "Carrying on"; a positive agenda for action at 27 yields results; some groups achieve more together in certain domains; decision-making becomes more complex

Table 7. Continued

	Single market & trade	Economic & Monetary Union	Schengen, migration & security	Foreign policy & defence	EU budget	Capacity to deliver
Scenario 4. Doing less more efficiently	Common standards set to a minimum but enforcement is strengthened in areas regulated at EU level; trade exclusively dealt with at EU level	Several steps are taken to consolidate the euro area and ensure its stability; the EU27 does less in some parts of employment and social policy	Cooperation on border management, asylum policies and counterterrorism matters are systematic	The EU speaks with one voice on all foreign policy issues; a European Defence Union is created	Significantly redesigned to fit the new priorities agreed at the level of the EU27	Initial agreement on tasks to priorities or give up challenging once in place, decision-making may be easier to understand; the EU acts quicker and more decisively where it has a greater role
Scenario 5. Doing much more together	Single market strengthened through harmonisation of standards and stronger enforcement; trade exclusively dealt with at EU level	Economic, financial and fiscal Union is achieved as envisioned in the report of the Five Presidents of June 2015	As in "Doing less more efficiently", cooperation on border management, asylum policies and counterterrorism matters are systematic	As in "Doing less more efficiently", the EU speaks with one voice on all foreign policy issues; a European Defence Union is created	Significantly modernised and increased, backed up by own resources; a euro area fiscal stabilisation function is operational	Decision-making is faster and enforcement is stronger across the board; question of accountability arise for some who feel that the EU has taken too much power away from the Member States

Source: European Commission (2017), pp. 17, 19, 21, 23, 25.

5. Implications for Korea

A discussion on the future of the EU may look rather irrelevant to Korea, as it is a story of a region geographically far from Korea, and is one of regional integration which Korea has not been involved in. Breaking down the issues, however, some important implications to Korea can be drawn. First, the changing landscape of the EU in the future will make huge influences on Korea's external policy towards the EU and Europe, as the EU is the second largest economic entity in the world. Second, as a model of regional integration, the future shape of the EU will wield tremendous influence on the path of regional integration in East Asia. Third, the rise of populism and far-right parties in Europe implies that widening income disparity and ill-designed and/or inconsiderate immigration policy can be easily transferred to a very sensitive political agenda, so Korea needs to prepare for similar situations in advance. Fourth, Korea needs to be careful in dealing with the unification process, and consider in advance what kind of difficulties a unified Korea will face, considering the case of the EU's enlargement.

Before we talk about the issues directly, it would be worthy of note to grasp the whole picture of the relations between the EU and Korea. The official diplomatic relations between Korea and the current EU member states started after the 2nd World War,¹⁶¹⁾ and diplomatic ties between the EU and Korea began as late as in 1963. Despite the short history of relations, Korea and the then European Community (EC) started building amiable relations with each other and the relationship deepened throughout the new century, forming a “mature partnership.”¹⁶²⁾

161) Korea established diplomatic relations with most of western European countries in the 19th century, but after 1948, when the Republic of Korea (ROK) was founded, ROK once again started to establish diplomatic ties with UK (1949), France (1949), (West) Germany (1955) and Italy (1956).

162) Ministry of Foreign Affairs (accessed on October 20, 2018).

Since 1963 the relations between the two have experienced revolutionary changes. When it comes to trade and investment, the trade volume between Korea and the EU increased by more than 300 times over the period 1971–2017, and Korea now ranks number eight in both exports and imports on the EU’s trading partners list. The EU has been the largest investor to Korea after the 2000s, and Korea has been one of the major investors to the new EU member states as well.

It is true that the initial period of Korea-EU relations was overwhelmingly marked by EU’s non-reciprocal preferentiality, as Korea was one of the least developed countries in the world in the 1960s. This non-reciprocal relationship slowly changed to one of reciprocity around the late 1980s after Korea hosted the 1988 Olympic Games. In 1989 and 1990, the two parties agreed to open their representative offices in Seoul and Brussels, and the EU produced its strategic paper on the Korean Peninsula, which was the first among its papers toward the Asian countries. In the mid-1990s the relations between the two were greatly upgraded through the establishment of the Framework Agreement for Trade and Cooperation in 1996.

The Korea-EU FTA has played a pivotal role in strengthening the economic relations between the two. Since entering into force in 2011, the FTA has led to not only huge increases in the trade volume between the two despite the European economic crisis and rapidly expanding regional value chains, but also regulatory convergence in standards and regulations between the two. The Framework Agreement was revised in 2010 after the Korea-EU FTA negotiations ended and the Lisbon Treaty entered into force from the EU side. Now, the two have forged very close relations with each other, confirming in 2013¹⁶³) that Korea should be aware of the path that the EU is heading towards, because both parties’ relations are closely interlinked.

Based upon the above observation, we argue that the future of the EU will have a tremendous impact on Korea’s international economic policy towards

163) Council of the European Union (2013).

the EU. Depending upon the future model of the EU, Korea's relations with the EU and member countries will vary, as the areas of EU action will evolve accordingly.

Table 8 shows current areas of EU action, implying which areas the EU has exclusive, shared and supporting competences. As shown in the Table, customs union, competition, euro-zone, trade and investment agreement, and common fisheries policy are areas that only the EU can legislate. The areas of shared competences imply that both EU and member countries are able to pass laws, but member countries can do so only if the EU has not already proposed laws or has decided that it will not.¹⁶⁴ Remember that the areas of single market, cohesion, agriculture and fisheries, transport, energy, research and space, and ODA are those of shared competence after the

Table 8. Areas of EU action

Exclusive competences	Shared competences	Supporting competences
<ul style="list-style-type: none"> • customs union • competition rules for the single market • monetary policy for the Eurozone countries • trade and international agreements (under certain circumstances) • marine plants and animals regulated by the common fisheries policy 	<ul style="list-style-type: none"> • single market • employment and social affairs • economic, social and territorial cohesion • agriculture • fisheries • environment • consumer protection • transport • trans-European networks • energy • security and justice • public health • research and space • development cooperation and humanitarian aid 	<ul style="list-style-type: none"> • public health • industry • culture • tourism • education and training, youth and sport • civil protection • administrative cooperation

Source: European Commission. https://ec.europa.eu/info/about-european-commission/what-european-commission-does/law/areas-eu-action_en (accessed on December 10, 2018).

164) European Commission. https://ec.europa.eu/info/about-european-commission/what-european-commission-does/law/areas-eu-action_en (accessed on December 10, 2018).

Lisbon Treaty. In some areas, the EU has no power to pass laws and may not interfere with member countries' ability to do so, which is called supporting competences. Industry, culture & tourism, education and training are those of the EU's supporting competences.

If the EU opts for Scenario 1 or Scenario 5, then many parts of shared competences will be moved to the exclusive competence areas such as energy, digital economy, border control, defence, and budget, but in the case of Scenario 5, the level of integration is much higher than in Scenario 1, so that a Fiscal Union, European Defence Union, and single migration and asylum policy will be created. The difference between Scenarios 4 and 5 is if this strengthened degree of integration in Schengen and foreign/defence areas will be applied only to specific members or the whole member states. The difference between Scenarios 1 and 3 is, again, the coverage of member states. Scenario 2 will result in the least integrated entity, where only a part of single market areas such as goods and capital are achieved but not services or people.

If the principles of fiscal federalism proposed by Wyplosz (2017), then SGP (Stability and Growth Pact), mostly fiscal discipline, and Structural Funds and Cohesion Fund (now both in the area of exclusive competences) need to be decentralized, while the areas of Banking Union (developing into the exclusive competences) and R&D (now in the areas of shared or supporting competences) should be centralized. These are related to the cases under Scenario 2 or 4, but differ a little bit in details.

Depending upon the scenarios, the EU-Korea relations will develop in a different direction. As the contemporary Korea-EU FTA is a comprehensive pact in nature, some possible changes in energy, agriculture & fisheries and ODA could be included in the existing FTA framework, but in the areas of migration and refugee, security, and some cultural and judicial cooperation which is currently included in the Korea-EU FTA, separate agreements between the EU and Korea need to be developed and constitute independent

pillars other than the FTA under the Framework Agreement.

Second, as a model of regional integration, the future shape of the EU will have a tremendous influence on the initiatives of regional cooperation and integration in East Asia. Korea strives to avoid any negative aspect of regional integration, trying to make the best use of positive aspects proved in the case of European integration. Before any implications or lessons are delivered, let us overview the current state of regional initiatives of cooperation in East Asia.

Sixteen Asian countries are continuing trade talks with each other in what is being called the Regional Comprehensive Economic Partnership (RCEP). The origin of the RCEP dates back to 2012 when ASEAN proposed a comprehensive and combined package of six ASEAN+1 FTAs (ASEAN FTA with PRC, ROK, Japan, India, Australia and New Zealand), in order to “strengthen economic linkages, to enhance trade and investment related activities, and to minimize the development gap among the parties,”¹⁶⁵ Several multilateral trade negotiations, such as the Trans-Pacific Partnership (TPP) or Transatlantic Trade and Investment Partnership (TTIP) negotiations emerged during the time period. The RCEP is different from other multilateral trade negotiations, as significant players and emerging economies of the same region – Asia – are collaborating. Moreover, it is the only multilateral trade negotiation that China is taking part in. Therefore, the RCEP could be the first move toward the Asian integration.

Since the first round of RCEP negotiations in Brunei 2013, 24 rounds of negotiations have taken place up to the end of 2018. So far, the negotiations have been progressing relatively smoothly but very slowly. Current progress of the RCEP may have been triggered while corresponding to the recent protectionist measures of the US.¹⁶⁶ All participating parties of the RCEP

165) RCEP. ASEAN website. https://asean.org/?static_post=rcep-regional-comprehensive-economic-partnership. (Accessed on December 1, 2018).

166) Tani, Mayuko (2018). “RCEP talks relegate US-China tariff battle to subplot status,”

have the motives to come about together. The leaders of the participating countries officially stated that all are determined to conclude the negotiations by 2019.^{167),168)} Although each party has different areas of sensitivity, the RCEP is going toward a “meaningful outcome” in goods, services, and investment sectors as well as in other chapters.¹⁶⁹⁾ The problem with the RCEP lies in how it cannot place the level of liberalization high due to the wide disparity in levels of development between the participating Asian countries. Therefore, the RCEP is not as ambitious as the CPTPP (Comprehensive and Progressive TPP), and much inferior to the EU in terms of market integration.

As for monetary and banking cooperation, ASEAN+3 has expanded the Chiang Mai Initiative (CMI) into the Chiang Mai Initiative Multilateralization (CMIM) to strengthen the role of the currency swap agreement. The creation of the CMI dated back to 1998 after the Asian currency crisis occurred. Recognizing the necessity of safety nets among Asian countries, Asian countries proposed various ideas of regional safety nets such as the Asian Monetary Fund (AMF) proposed by Japan. The idea of the Chiang Mai

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- Nikkei (November 10). <https://asia.nikkei.com/Politics/International-Relations/RCEP-talks-relegate-US-China-tariff-battle-to-subplot-status> (Accessed on December 1, 2018).
- 167) Arshad, Arlina (2018), “RCEP talks making substantial progress, says Indonesia,” *The Straits Times* (November 15). <https://www.straitstimes.com/singapore/rcep-talks-making-substantial-progress-says-indonesia> (Accessed on December 1, 2018).
- 168) ‘Joint Leader’s Statement on the RCEP Negotiations – 14 November 2018, Singapore.’ Department of Foreign Affairs and Trade, Australian government. <https://dfat.gov.au/trade/agreements/negotiations/rcep/news/Pages/joint-leaders-statement-on-the-rcep-negotiations-14-november-2018-singapore.aspx> (Accessed on December 1, 2018).
- 169) RCEP. ASEAN website. https://asean.org/?static_post=rcep-regional-comprehensive-economic-partnership. (Accessed on December 1, 2018). According to ASEAN, other chapters are ‘Customs Procedures and Trade Facilitation (CPTF), Government Procurement, Institutional Provisions, Sanitary and Phytosanitary (SPS) Measures, and Standards, Technical Regulations, and Conformity Assessment Procedures (STRACAP), which, added to the earlier concluded Chapters on Economic and Technical Cooperation (ECOTECH) and on Small and Medium Enterprises.’

Initiative was developed to conduct the role of a regional safety net. It was developed as a bilateral swap arrangement between the ASEAN+3 created in 2000, acting as a financial safety net.¹⁷⁰⁾ The CMI was not sufficient in itself to rescue a country in trouble because of the scope of its safety net and bilateral nature. After the global financial crisis, however, a consensus was reached to expand the multilateralization of the CMI. The total size of the CMIM facility was expanded to USD 120 billion.¹⁷¹⁾ In 2014, the size was further enlarged to USD 240 billion and the IMF de-linked portion was increased from 20% to 30%.¹⁷²⁾ As shown in Table 9, China, Japan, and Korea are responsible for 80% of the contributions and carry stronger influence within the facility. The CMIM has two functions: the “CMIM Stability Facility (CMIM-SF)” for crisis resolution, and the “CMIM Precautionary Line (CMIM-PL)” for crisis prevention. With the CMIM-SF arrangement, in the IMF-linked portion, maturity date of the drawings is set at one year after the date of drawing with two renewals, totalling up to 3 years in the supporting period, while the IMF de-linked portion allows drawing of up to 30% of each party’s swap quota or maximum arrangement amount as well as maturity of 6 months with 3 renewals, totalling up to 2 years in the supporting period.¹⁷³⁾

170) ASEAN+3 member countries are Brunei Darussalam, Cambodia, China, including Hong Kong, Indonesia, Japan, Korea, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam. Chiang Mai Initiative – ASEAN. <https://www.asean.org/uploads/2012/10/17902.pdf> (Accessed on December 1, 2018).

171) Overview of the CMIM. AMRO. <https://amro-asia.org/about-amro/amro-and-the-cmim/> (Accessed on December 1, 2018).

172) *Ibid.*

173) *Ibid.* CMIM-PL, introduced in 2014, has the 5 qualification criteria of ① external position, ② fiscal policy, ③ monetary policy, ④ financial sector soundness and supervision, and ⑤ data adequacy that is applied rather flexibly, with an access duration of 6 months with 3 renewals, totalling up to 2 years.

Table 9. Contribution and voting power of CMIM members

	Financial contribution		Purchasing Multiple	Maximum Arrangement Amount	Basic votes	Votes based on contribution	Total voting power			
	USD (billion)	(%)					(no. of vote)	(no. of vote)	(no. of vote)	(%)
China	76.80	China (excl. HK) 68.40	32.0	28.50	0.5	34.20	3.20	68.40	71.60	25.43
		Hong Kong, China 8.40		3.50	2.5	6.30	0.00	8.40	8.40	2.98
Japan	76.80	32.00	0.5	38.40	3.20	76.80	80.00	28.41		
Korea	38.40	16.00	1	38.40	3.20	38.40	41.60	14.77		
Plus 3	192.00	80.00		117.30	9.60	192.00	201.60	71.59		
Indonesia	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369		
Thailand	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369		
Malaysia	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369		
Singapore	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369		
Philippines	9.104	3.793	2.5	22.76	3.20	9.104	12.304	4.369		
Vietnam	2.00	0.833	5	10.00	3.20	2.00	5.20	1.847		
Cambodia	0.24	0.100	5	1.20	3.20	0.24	3.44	1.222		
Myanmar	0.12	0.050	5	0.60	3.20	0.12	3.32	1.179		
Brunei	0.06	0.025	5	0.30	3.20	0.06	3.26	1.158		
Lao PDR	0.06	0.025	5	0.30	3.20	0.06	3.26	1.158		
ASEAN	48.00	20.00		126.20	32.00	48.000	80.00	28.41		
Total	240.00	100.00		243.50	41.60	240.00	281.60	100.00		

Source: Overview of the CMIM. AMRO. (Accessed on December 1, 2018).

Meanwhile, ASEAN+3 has strengthened its surveillance system through the ASEAN+3 Macroeconomic Research Office (AMRO), aiming to contribute to securing macroeconomic and financial stability in the ASEAN+3 region. AMRO has 3 important functions: conducting macroeconomic surveillance, supporting the implementation of the CMIM, and providing technical assistance to members.¹⁷⁴⁾ Initially, AMRO was established in April

174) Overview. AMRO. <https://amro-asia.org/about-amro/who-we-are/#members> (Accessed on December 1, 2018.)

2011 in Singapore as a company limited by guarantee in Singapore. After ASEAN+3 members' signing of the AMRO agreement in October 2014, it was re-established as an international organisation in 2016, surveilling the economy of the ASEAN+3 region.¹⁷⁵⁾ The activities of AMRO were strengthened afterwards by signing MoUs with the ADB, IMF, and ESM. After the ASEAN+3 Finance Ministers' and Central Bank Governors' Meeting in May 2018, a joint statement confirmed AMRO's critical role of supporting CMIM issues, as well as executing its Strategic Direction and Medium-term Implementation Plan.¹⁷⁶⁾

Launched in December 2002, the Asia Bond Markets Initiative (ABMI) serves to promote regional financial cooperation and integration in the ASEAN+3 region. Before the global financial crisis, there were huge capital inflows from advanced economies towards emerging economies. After the global financial crisis in 2008, the ABMI's main focus on developing an alternative source of funding by promoting local currency-denominated bonds has been reinforced while extending its role through the operation of 4 task forces: ① promoting the issuance of local-currency-denominated bonds, ② facilitating demand for local-currency-denominated bonds, ③ strengthening the regulatory framework, ④ improving related infrastructure for bond markets, along with technical assistance projects (TAs) to develop local currency bond markets.^{177),178)} Recently, ASEAN+3 agreed on accepting non-ASEAN+3 countries as observers in the ASEAN+3 Bond Market Forum (ABMF), and Common Understanding on Cross-Border Business Continuity

175) *Ibid.*

176) Joint Statement of the 21st ASEAN+3 Finance Ministers' and Central Bank Governors' Meeting. ASEAN. May 4, 2018. <https://asean.org/storage/2018/05/Final-Draft-Joint-Statement-of-the-21st-AFMGM-3-00000002.pdf> (Accessed on December 1, 2018).

177) ADB (2017), "The Asian Bond Markets Initiative: Policy Maker Achievements and Challenges," pp. 5-10.

178) All information of ASEAN+3 members' bond market can be found in Asian Bonds Online (ABO) in the website <https://asianbondsonline.adb.org/>.

Planning (BCP) and Cybersecurity in Cross-Border Settlement Infrastructure Forum (CSIF) to create safe linkages among Central Securities Depository–Real Time Gross Settlement (CSD-RTGS) systems that ensures the resilience of increasingly interconnected financial systems.¹⁷⁹⁾

Observing the crisis in Europe and the EU, East Asia including Korea may think that too high a level of economic integration could prove harmful for less-developed economies in hard times, and thus great caution should be taken when it comes to regional integration, especially in the area of people’s movement and common monetary policy without a common financial policy, that is, a banking union.

In the scenarios of the future of the EU in Table 7, Scenario 2 seems to be most relevant to the case of East Asia, as it is the least integrated vision of the EU in the future. In Scenario 2, free movement of goods and capital are guaranteed, but not in services or people. This vision of a single market provides important implications to East Asia, so that any FTA initiatives together with capital movement would be desirable for East Asia. In this scenario, many issues should be solved through bilateral negotiations, which shows a clear limitation on regional integration.

Third, the rise of populism and far-right parties in Europe implies that widening income disparity and ill-designed immigration policy can be easily transferred to a very sensitive political agenda, so Korea needs to prepare for the cases in advance. A widening income disparity is a source of low productivity, low growth rate and enhanced social tension. The best solution to alleviate income disparity would probably be to focus on job creation; but at the same time efforts must be made to strengthen the welfare system. One of the important lessons from the case of the EU is that we need to check out the efficiency of the welfare system, so that the budget is spent effec-

179) Joint Statement of the 21st ASEAN+3 Finance Ministers’ and Central Bank Governors’ Meeting. ASEAN. May 4, 2018. <https://asean.org/storage/2018/05/Final-Draft-Joint-Statement-of-the-21st-AFMGM-3-00000002.pdf> (Accessed on December 1, 2018).

tively, and that the delivery system needs to be much improved to enhance the effectiveness of the welfare system.

As for immigration policy, it will be inevitable to expand immigration to Korea when considering its birth rate has fallen to the lowest level in the world. The birth rate in 2018 has evidently fallen below 1.00 in Korea, which is a record low number unprecedented in other advanced countries. One of the important lessons from the European experience is that it is essential to design very careful and considerate programmes for immigrants to assist their adaptation to the Korean society. An open attitude toward foreign immigrants, financial assistance to them in the initial stage and active inclusion in the social welfare system are essentially indispensable, but never enough in themselves to complete an effective immigration policy. A collective approach including active policies in education, housing and job market through the whole life cycle needs to be applied to mitigate any possible problems from the drop-out and isolation of these immigrants.

Fourth, Korea needs to be very careful in dealing with the unification process and consider in advance what kind of difficulties a unified Korea will face, considering the case of the EU's enlargement. Considering the case of unification in the Korean Peninsula, Scenario 1 or 5 as well as 2 would be relevant. After the unification, Scenario 1 as well as Scenario 5 indicate a speedy unification which is similar to the case of transition of Eastern Europe. In some areas like energy and digital areas, cooperation would be expedited under Scenario 1.

Observing the rise of populism and anti-EU sentiment, we need to consider why this trend is gaining strength despite huge subsidies from the EU to areas in support for its new member states since 2004. The far-right party in Germany has gained firmer ground in the old Eastern territory, as well. Not only job creation but also engagement is important. People from the new areas should lead their own local communities by developing and using the instruments to manage their own society.

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