

### EU trade and climate policy linkages: potentials in times of repositioning

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# SWP Comment

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## EU Trade and Climate Policy Linkages

Potentials in Times of Repositioning

*Susanne Dröge and Felix Schenuit*

The European Union (EU) was instrumental in successfully negotiating the Paris Agreement in 2015 and is now seeking a rapid international implementation. To this end, climate policy should be brought into line with as many foreign policies as possible, including trade policy. Free trade in environmental goods or the application of national emission standards to traded goods can accelerate climate protection globally. The legal support for this agenda through the World Trade Organization (WTO) and its dispute settlement bodies will merely be a longer-term option. Therefore, the EU and its member states should engage on two fronts in particular. Firstly, the fora of the United Nations (UN) and the WTO should make the links between the two policy areas even more transparent. Secondly, the EU can operationalise its regional free trade agreements as a lever to push for the implementation of climate policies in its partner countries. In particular, the EU should review existing trade agreements for their “climate friendliness”. If the EU succeeds in redesigning its external relations at this interface, it can both enhance its climate policy performance and become more proactive in trade policy.

In the course of the last 10 years, it has become clear that more policy areas have to be part of the overall effort to achieve the global greenhouse gas (GHG) emission targets. An ambitious climate and energy policy alone is not enough to deliver on the global temperature limits agreed under the Paris Agreement and to deal with inevitable climate change impacts. Therefore, trade policy also has to be put to the test when it comes to specifying the nationally determined contributions (NDCs) announced by the parties to the Paris Agreement. Foreign trade can both support and undermine climate protection. For example, trade in

climate-friendly technologies and products can ensure their rapid deployment and more innovation. Exemptions from trade barriers therefore increase the speed of – and opportunities for – implementation of the NDCs worldwide. On the other hand, differences between national climate policy measures and related costs can contribute to outsourcing when companies change their supply chains or production sites in response to such measures (carbon leakage).



## The EU Facing Particular Challenges

The European Union and its member states are currently facing particular challenges, both in international climate policy and in trade policy. Negotiating the Paris Agreement was a diplomatic landmark. As a consequence, the EU needs to get ready for a step change and must breathe life into the agreement by increasing efforts in the member states, at the EU level, and in its external relations. This has become immensely difficult both internally – because of reluctant EU member states – and externally. If the United States (US) follows up on its 2017 announcement and withdraws from the agreement in 2020, there is reason to expect that international efforts to protect the climate will slow down. The EU cannot fill this gap on its own (SWP Comment 1/2018) and needs more capacity to mobilise its partners and intensify existing cooperation.

A renaissance of protectionism has gained speed in international trade relations. It is further aggravated by the US government's aggressive stance towards its trading partners, most recently through tariffs announced for steel and aluminium products, based on national security grounds. These tariffs, if applied, are capable of weakening the multilateral trading system considerably, because they are not covered by WTO rules on exemptions from free trade.

Moreover, the functioning of the WTO dispute settlement bodies is threatened, too. A blockade of the US administration in the appointments of new judges to the WTO Appellate Body calls into question future arbitration rulings. If Washington continues to deny their approval, the panel of seven judges would shrink from the current four to two in the course of 2018, and would thus also formally no longer be able to work from 2019 onwards.

For the interface of trade and climate policy, a weaker WTO is particularly problematic because, in recent years, an increasing awareness of the synergies has devel-

oped between the multilateral institutions of both the trade and climate regimes (SWP Research Paper 1/2018).

In international climate policy, the Chinese government wants to close the leadership gap left by the US, and it would also be open to doing so together with the EU. For this, however, Beijing lacks the experience as well as foreign policy capacities. Moreover, China is driving forward the major geo-economic project “Belt and Road Initiative” in its western neighbourhood, in which European interests play a subordinate role, if any at all (SWP Research Paper 2/2016). As China has been repeatedly compensating for a decline in its business cycle by exporting overcapacities at dumping prices, there are long-standing disputes over anti-dumping measures by the EU for Chinese steel imports. The conflict has not yet been solved, and there is also a dispute pending over Chinese solar-module exports to the EU.

Finally, in the course of Brexit, the EU's trade and climate policy cooperation with the United Kingdom (UK) will have to be redesigned. With the UK, both a climate-policy progressive member state and a strong advocate of free trade will leave the Union. It is still unclear how the negotiators from Brussels and London will regulate British access to the internal market and climate policy cooperation for the post-transition period.

## Far Reaching Competences – the EU Mandates

The EU has many responsibilities and a strong mandate in trade and climate policy. Trade policy falls within the group of “exclusive competences” of the EU (Art. 3 TFEU). It is therefore up to the European Commission to negotiate agreements with third countries. Although the EU's trade policy approach is guided by multilateralism and the leading role of the WTO, the EU also began negotiating bilateral agreements in the 1990s, for example with emerging economies and countries of the

Organisation for Economic Co-operation and Development (OECD). A Partnership Agreement has been in place with the African, Caribbean and Pacific (ACP) countries since 2008 (SWP Research Paper 6/2015). The Transatlantic Trade and Investment Partnership (TTIP) agreement with the US has been on hold since Donald Trump was elected president, and negotiations are not expected to continue any time soon. By contrast, the European-Canadian free trade agreement CETA (Comprehensive Economic and Trade Agreement) was adopted in autumn 2017, despite difficult coordination processes within the EU.

Climate policy falls under the “shared competences” of the EU (Art. 4 TFEU), that is, it is not the sole responsibility of the Commission to conduct policies and measures. Nevertheless, the EU is one of the most important actors in international climate policy. Its strong position is based on its status as a party to the United Nations Framework Convention on Climate Change (UNFCCC) and the other climate agreements. The EU negotiating team at the Conferences of the Parties consists of members of the European Commission, representatives of the respective EU presidencies and the European External Action Service, and negotiators from the EU member states (SWP Comment 1/2018).

The European Commission, together with the member states, can use the competences in both policy areas as well as their interdependence to raise the profile of the EU’s external relations. To achieve this, the EU member states will have to reactivate their support for trade and climate policy projects alike. The integration of climate policy objectives into new trade and investment agreements has the potential to increase public support for trade agreements, which has dropped sharply during the last few years. Also, the EU producers of climate-friendly technologies depend on trade policies that are supportive of climate policy measures in their home markets, as the global market for environmental goods and climate-protection technologies is growing.

## Environment and Climate in the International Trade Regime

Since the 1990s, environmental policy objectives have been taken into account in trade agreements. The North American Free Trade Agreement (NAFTA) set new standards in 1993, as, for the first time ever, environmental concerns were part of the negotiations on investment and free trade. The NAFTA preamble includes the principle of sustainable development. Among other things, the agreement stipulates that competitive advantages must not be created by lowering legal environmental standards. Also, environmental aspects have to be taken into account in dispute settlements, and environmental impacts of trade liberalisation have to be monitored. NAFTA allows that if certain conditions apply, national environmental standards may be higher than those of trading partners, even if this could disadvantage imports. NAFTA also has had an impact on the work undertaken by international organisations. The OECD, the General Agreement on Tariffs and Trade (GATT), and UN organisations started to pay attention to the links between environment and trade. As a consequence, the preamble to the 1995 WTO agreement explicitly refers to the objective of sustainable development. The WTO has also established the Committee on Trade and Environment as a permanent point of contact for WTO members on environmental and trade issues.

The Paris Agreement contains no cross-references to trade rules. However, the 1992 UNFCCC and the 1997 Kyoto Protocol both specify that climate policy must not conflict with free trade rules. The UNFCCC’s text passages on this point are, in part, citations of the relevant GATT wordings. After 2020, the Paris Agreement will leave it at the discretion of the parties whether they want to include their trade policy agendas in the design of their NDCs – which China and India are already practicing in their energy policies. Initial inventories show that many NDCs have trade-relevant aspects, be it due to emissions trading in the countries con-

cerned, the explicit demand for international technology transfer, or the ambitious plans for increasing renewable energies.

### **WTO: Free Trade for Environmental Goods**

In July 2014, 16 WTO member states and the EU launched an initiative to negotiate a new plurilateral agreement under the WTO to liberalise trade in environmental goods (Environmental Goods Agreement, EGA). Plurilateral agreements can subsequently be recognised by all WTO countries, including those that were not involved in the negotiations. The EGA is a follow-up to a decision of the APEC (Asia-Pacific Economic Cooperation) states on the reduction of customs duties for certain environmental goods, for example air-pollution-control technology, waste disposal and recycling, water treatment, or renewable-energy technologies. In the course of the EGA negotiations, APEC's list of environmental goods was extended. However, negotiations were suspended at the end of 2016, partly because the EU and China were unable to agree on the inclusion of certain products on this list. A revival of the talks and a successful conclusion would help to increase awareness of the synergies between climate and trade goals and to accelerate the international deployment of resource-efficient technologies.

### **WTO Disputes on Renewable-energy Policies**

The GATT case law and, subsequently, the dispute settlement bodies of the WTO specify how environmental- and climate-protection provisions must be taken into account in international trade law and where they violate it. In the 1990s, particular cases rose to attention because the WTO panels declared that trade measures to protect the environment were legitimate if certain conditions were met, among others that the protected object can be defined as a global resource. Disputes over national

energy-policy measures have been increasing since 2010. For example, Japan and the EU took action against Ontario's renewable-energy feed-in tariff because they believed it discriminated against foreign technology products. After an in-depth investigation, the WTO panel ruled in favour of the plaintiffs, and the Province of Ontario had to amend its programme in 2014.

The EU is also being accused. China has called for WTO consultations on various feed-in laws, which contain local content clauses, thereby favouring national solar-energy products and discriminating against Chinese suppliers. Four lawsuits have been filed against the alleged preference for biodiesel produced in EU member states. The US, on the other hand, complained that China and India were creating advantages for their national producers and investments over foreign competitors by applying local content clauses for components of renewable-energy plants. This, according to the complaint, led to the dumping of solar modules and components for wind turbines in the US market, which is why the US reacted with import duties. Not all cases have been closed. China and India reacted by filing new cases at the WTO complaining against the countervailing measures of the US.

It is very likely that the number of conflicts and the level of involvement of WTO dispute settlement bodies will increase as more and more countries implement their climate policies in accordance with the Paris Agreement. This is also because governments are not willing to jeopardise their industrial policy objectives. In order to reduce GHGs, states are resorting to subsidies for domestic companies, taxes, and levies as well as to stricter regulations and standards. Due to the deep integration of the global economy, such measures are also having an impact on traded goods and foreign investments, making disputes more likely.

## Options for Reforming Trade Agreement Rules

The WTO rules and regional trade agreements are the legal backbone when it comes to taking trade rules into account in designing national and international climate policy. The search for a reconciliation of climate and trade policy objectives should first and foremost focus on synergies, that is, how trade agreements and WTO law can be interpreted and expanded in order to advance climate policy objectives. Climate policy can be supported with trade policy instruments such as customs duties or sanctions. For example, climate policy cooperation can be made more binding if partner countries include in their trade rules some form of sanctioning in cases where a party deviates from the commonly defined objectives.

However, trade sanctions in particular are a politically sensitive instrument. If used for environmental and climate policy reasons, there is often the allegation of green protectionism. Article 6 of the Paris Agreement mentions climate policy coalitions as a way forward for cooperation, for example for countries with emissions trading schemes. In general, however, the idea of sanctioning, that is, excluding a party from such a club, should be handled with care. When implementing national climate policy measures, inclusive regional or bilateral cooperation is of high political importance. If frontrunners, to whom the historical polluter countries belong (e.g. the US, the EU, or other OECD countries), create climate clubs with trade barriers as part of their climate agenda, developing countries could be disadvantaged in their trade relations. This makes climate clubs with trade sanctions highly problematic. Instead, inclusiveness could create confidence among developing countries and contribute to securing the global consensus reached in the Paris Agreement.

The legal situation also yields some issues. WTO law provides for exemptions to the principles of free trade in order to protect global resources. These special rules

have been applied in the aforementioned disputes. However, should this system be confronted with more lawsuits in the future due to the large number of conceivable climate policy measures, this could lead to an overload. It is therefore important to specify WTO rules to clarify how climate policy and trade measures can be reconciled. Among other things, an authoritative interpretation of Article XXIV GATT could be introduced. Such an interpretation regulates exceptions to the basic principles of free trade. It could be determined that the protection of the global atmosphere constitutes a reason for limiting free trade. Still, such an exemption would need to be linked to the strict conditions in place to prevent its protectionistic use.

A one-year waiver or a peace clause could also be considered to support the implementation of the Paris Agreement. They would have to be renewed on a regular basis. Both would allow free trade restrictions for a limited period. During this period, no country would be allowed to bring up a WTO case against the related trade measures.

Reforms, which require the agreement of all WTO member states, are currently unlikely from a political point of view. However, the discussion on the trade policy implications of the Sustainable Development Goals (SDGs) and on the implementation of Agenda 2030 also shows that the WTO trade rules need to be more specific in order to exploit synergies and avoid conflicts in the longer term (SWP Comment 39/2017).

## Regional Trade Agreements Give Directions

The international trade regime has become increasingly fragmented over the last two decades. By February 2018, the WTO had been notified of a total of 669 regional free trade agreements, of which 455 were in force. In the 47 years leading up to the creation of the WTO in 1995, however, it had only been notified of 124.

The trend towards so-called mega-regional agreements has contributed to this. This cat-

egory includes CETA, the currently frozen TTIP, and the Trans-Pacific Partnership (TPP) free trade agreement negotiated between Australia, Brunei, Canada, Chile, Japan, Malaysia, Mexico, New Zealand, Peru, Singapore, the US, and Vietnam. Talks are also underway on a comprehensive Economic Partnership Agreement between the ASEAN member states and Australia, China, India, Japan, New Zealand, and South Korea.

### **Environmental Clauses in Regional Agreements**

Since NAFTA and its supplemental agreement on environmental standards, environmental provisions have been incorporated into many regional free trade agreements. These provisions can be general environmental-protection clauses, such as the goal of sustainable development, or they can safeguard national environmental standards. Tariff reductions for environmental goods and services or intentions to intensify cooperation on climate protection are also included. The EU has played its part in this development. A current example is the EU-Canadian CETA: Chapter 24 of the treaty text deals with environmental issues. The negotiations on TTIP also included a chapter on sustainable development. Moreover, the TPP agreement, to which the EU is not a party, also defines the interface between trade policy and environmental legislation in Chapter 20. Last but not least, the agreement between the EU and the Caribbean states contains agreements on poverty reduction and environmental protection that support sustainable development, and thus goes beyond pure trade liberalisation (SWP Research Paper 6/2015).

### **The Way Forward for EU Policy Action**

Both WTO reforms and negotiations on regional free trade agreements are time-consuming. Therefore, the existing trade and climate forums and processes will have to be connected in a better way. The Euro-

pean Commission can modify existing trade agreements and integrate climate targets into ongoing discussions with partner countries. For example, ACP countries need support, as spelt out in their NDCs, in particular for low-carbon energy supply or adaptation to climate change. Accordingly, the European Commission should examine whether the EU's trade agreements support these objectives and whether improvements can be made. Regarding emerging economies and OECD countries, the EU can set up climate action as an additional item in new or ongoing negotiations, as announced by Trade Commissioner Cecilia Malmström in February 2018. This is already being practised in the negotiations on the Japan-EU Free Trade Agreement. The European Parliament also recently called in a joint report by the Committee on the Environment, Public Health and Food Safety and the Committee on Foreign Affairs for closer integration of European climate diplomacy objectives with trade policy.

Transparency within and between the UNFCCC and WTO fora can also be improved. The Forum on the Impact of the Implementation of Response Measures, which deals with the economic consequences of climate policy, is part of the UNFCCC. Trade policy aspects of climate policy can also be raised there. The WTO has a comprehensive notification register for national standards and other measures relevant to trade policy. The Trade Policy Review Mechanism is an important source of information for member states and can increase transparency. Another option is to extend the WTO Committee on Trade and Environment to a Committee on Trade, Environment and Climate. Such a move, however, would need the support of WTO members.

The French government urged that the EU's trade policy should make US support for the Paris Agreement a prerequisite for new trade negotiations with Washington. However, the impact of such a measure would be limited. The implementation of the Paris Agreement depends not only on its ratification, but mainly on concrete

national policies. Therefore, this conditionality would need concrete ideas on how trade rules should be linked to compliance with climate commitments. In this context, the European Commission has recently ruled out sanctions, indirectly rejecting the French government's claims.

As trade disputes between the US and the EU are becoming more acute, a trade agreement at this time is very unlikely anyway. Rather, another proposal by the French government could attract new attention: President Emmanuel Macron used a climate policy summit in Paris in December 2017 to once again promote so-called border carbon adjustments. Accordingly, imported products would be subject to an emissions charge if they belonged to sectors that fall under the European emissions trading system or are subject to a CO<sub>2</sub> tax in EU countries.

The European Commission could also focus more on other trading partners and consider where interests are converging in light of US policies. Such talks could be initiated with China, following up on President Xi Jinping's climate policy leadership claims he has raised several times. The starting points would be the trade disputes over steel trade, which basically is an issue of global overcapacity in the sector. Also, the introduction of an emissions trading scheme in China, which will cover the country's steel producers, would be suited for deeper cooperation. A revival of mutual reflections on tariff reductions for climate-friendly products could also help to relaunch discussions on the EGA under the WTO. With a revitalised EGA initiative, the European Commission, Germany, and France could not only follow up with concrete measures to achieve their climate targets. At the same time, the agreement would also offer the opportunity to strengthen the WTO as an international organisation, and thus the multilateral orientation of European trade policy. Especially in times of increasing protectionism and the threat of a "trade war" between the US and the EU, a return to multilateral

formats can form an antipole to President Trump's ever-sharper rhetoric.

In the medium term, Brexit offers the opportunity to conclude a trade agreement with the UK that is more comprehensive than previous regional agreements and fully integrates trade- and investment-related climate targets. Although such an agreement, often referred to as "CETA +", could not reflect the full climate policy agenda built by the EU and the UK, Brussels and London could set new standards for linking trade and climate policy.

In view of the public rejection of TTIP and CETA, the European Commission has already made efforts to increase public participation in the development of such agreements ("Trade for All" strategy). If these efforts included the protection of global public goods, comprising not only the climate but also oceans and forests, and thus were to become more visible in the EU's external economic relations, this could have a positive impact on the public's acceptance of free trade agreements.

As possible synergy effects are already being discussed at the European level, member states should also take greater account and exploit them. If the EU positions itself as an advocate for merging trade and climate policy interests, it not only has the opportunity to fulfil its role as the climate policy frontrunner. It can also proactively shape its trade policy, and therefore pursue its political, economic, and geo-strategic interests.



## Additional material

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