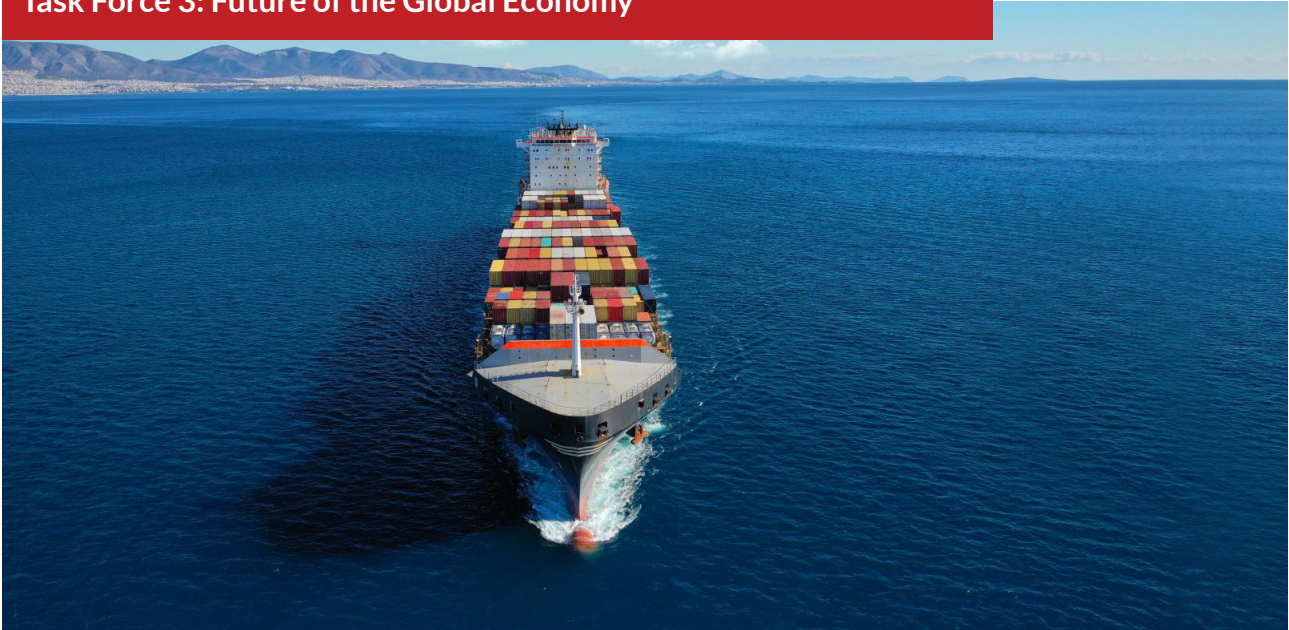


Task Force 3: Future of the Global Economy



G7 Trade Relations in Unchartered Waters: Future-Proofing Trade Relations for a Changing Geopolitical and Goeconomic Environment

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Abstract

Interdependencies in global trade are increasingly no longer seen as a win-win and welfare enhancing situation. Instead, they are perceived as a possible vulnerability, which can be weaponized for geopolitical purposes. In this challenging environment, G7 countries are attempting to strengthen supply chains for critical and strategic goods and technologies among themselves and with trusted partners. The current geoeconomic environment presents both a challenge and an opportunity for G7 countries to resolve older trade conflicts and address new trade disputes in more cooperative and strategic ways. The recent disruptions of the global value chain have centred the focus on security. Countries are now working to increase the resilience of their supply chains and diversify their trade relations, also to counter China's pervasive influence in the economy through state-owned enterprises (SOEs) and subsidies.

The challenge

The present geoeconomic environment is characterized by an increasing rivalry between several large economies. At the centre stands the trade conflict between the United States – plus the largely aligned EU – and China, but this is far from the only conflict which burdens international relations. As a consequence, interdependencies in global trade are increasingly no longer seen as a win-win and welfare enhancing situation. Instead, they are perceived as a possible vulnerability, which can be weaponized for geopolitical purposes. In this challenging environment, G7 countries are attempting to strengthen supply chains for critical and strategic goods and technologies among themselves and with trusted partners.

In addition, long-standing as well as new *trade tensions* among the G7 countries risk impeding deep and comprehensive cooperation. The G7 members, who share common values and stand for democracy, human rights, and market economies, are natural partners in shaping global trade and making supply chains more resilient and sustainable. As such, G7 countries have pursued many cooperative bilateral trade partnerships: The EU (including the G7 countries France, Germany, and Italy) has a trade and cooperation agreement (TCA) with the UK, a comprehensive free trade agreement with Canada (CETA), and an economic partnership agreement (EPA) with Japan; in contrast, the Transatlantic Trade and Investment Partnership (TTIP) with the USA failed. The United States and Canada are part of the USMCA (a free-trade area including also Mexico), while the United States and Japan have a relatively limited bilateral trade agreement (just to name a few). In addition, the G7 countries are engaged in negotiating trade and technology arrangements such as the EU-US Trade and Technology Council and the Indo-Pacific Economic Framework for Prosperity (IPEF). Lastly, the G7 countries are also part of three plurilateral joint statement initiatives on services, e-commerce, and micro, small and medium enterprises (MSMEs) of the World Trade Organisation (WTO). However, despite frequent references to the like-mindedness

of the G7, there are a number of long-standing trade tensions among G7 countries and several attempts to establish a free trade agreement between the US and the EU have failed over the decades.

The current geoeconomic environment presents both a challenge and an opportunity for the G7 countries to *resolve older trade conflicts and address new trade disputes* in a more cooperative and strategic ways. The G7 need to address the following challenges:

1) *Renaissance of industrial policy*: Since the rise of China and the Covid-19 pandemic, all G7 members (and many countries around the world) are pursuing industrial policy strategies to foster the green transition, to advance the digital revolution, and to react to the changing geopolitical environment. Examples for this are the US Inflation Reduction Act (IRA) and the EU Green Deal Industrial Plan. These policies pose the risk – if not modified and implemented carefully in compliance with WTO rules – of a global subsidies race.

2) *Use of unilateral trade measures*: Several G7 members are implementing unilateral trade measures. For example, in 2018, US President Donald Trump imposed steel and aluminium tariffs on the basis of national security (Section 232) against all trading partners, including the like-minded G7 allies. These tariffs have not been removed until today (although they have been paused against EU and others (and replaced with tariff-rate quotas) until March 2025 by the Democratic administration under Joe Biden). Another example is the Carbon Border Adjustment Mechanism (CBAM), which the EU has introduced for all trading partners, and which is seen as discriminatory by other G7 member countries as well as non G7 countries.

3) *Diverging sanctions, export controls, and anti-coercion instruments*: After Russia's invasion of Ukraine, the G7 coordinated the implementation of economic and financial sanctions against Russia. However, G7 countries are much less well coordinated when it comes to enforcement. This holds also true regarding sanctions against other countries, such as Iran and China, where differences prevail. The same is the case concerning export controls on which G7 countries have coordinated much less than on sanctions. And for sanctions to be more effective, the G7 need to converge on the methods and their effectiveness among themselves first and add more allies in their implementation as increased global integration creates opportunities to sidestep sanctions, reducing their effectiveness.

4) *Lack of international cooperation at the WTO*: Despite all G7 countries being members in the WTO, there is still a lack of common goals and of concerted action at the multilateral level. For example, despite valid grievances relating to the multilateral dispute settlement system, the United States still holds the system hostage, blocking the Appellate Body, while the EU advocates a multi-party interim appeal arrangement to circumvent the US opposition. It is unlikely that 2024 will bring a final solution to the binding two-tiered dispute settlement system.

5) *Uncoordinated race for new partnerships*: Emerging economies in Asia, Latin America, Africa and other parts of the world are becoming increasingly drivers of the global economic growth and setting their own agenda and perspectives in the international political economy. Many of them are attractive partners for the G7 countries, who are trying to negotiate new partnerships agreements such as resource partnerships. Often these attempts are unilateral with limited coordination or cooperation among the G7 members. G7 countries need to be more serious about not only coordinating among themselves but also listening to the priorities of these emerging countries in the Global South and collaborating with them in formulating global governance.

Therefore, despite being generally like-minded countries and allies in security and democracy related issues, conflicts among the G7 members are increasing, including in the trade area. The question is: What can the G7 do to prevent geoeconomic trade conflicts among its members (which can also spill-over to non-G7 countries) and to solve present ones?

The role of the G7

The geoeconomic shifts have brought G7 back to the fore. The ongoing economic rivalry between major economic powers but also the experiences during the Covid-19 pandemic, or recent terrorist attacks on vessels in the Gulf of Aden, which caused disruptions in global value chains, has given rise to a new focus on economic security. Apart from a decoupling from Russia, the focus is largely on China and the pervasive influence of the Chinese government in the economy, especially through SOEs and generous subsidies or forced tech transfer. G7 countries want to enhance the resilience of their supply chains and diversify their trade relations, particularly with trusted partners, in order to de-risk or even de-couple from China (with differences among major players such as the United States and the EU). This relates to strategic inputs such as chips, batteries, and critical raw materials, which are vital for the digital and green transition.

Many of the above-mentioned issues have been on the agenda of the G7 for the last years. Within the G7 Hiroshima Leaders' Communiqué in May 2023, the G7 members stated that “ensuring economic resilience and economic security globally remains our best protection against the weaponization of economic vulnerabilities”. Accordingly, the G7 committed to “enhance collaboration by launching the Coordination Platform on Economic Coercion to increase our collective assessment, preparedness, deterrence and response to economic coercion” (G7 2023). G7 leaders tasked their trade ministers to deepen discussions on export controls and measures against economic coercion. The language of the Communiqué was much weaker regarding the multilateral trading system, however. The G7 agreed to promote a rules-based trading system, also mentioning WTO reform albeit without going into any detail. While they committed to supporting the plurilateral joint statement initiatives (JSIs) on e-commerce at the WTO, this did not prevent the United States to rescind its support for e-commerce proposals given concerns over data flows later that year. Lastly, little was said about industrial subsidies or unilateral trade

measures such as steel tariffs or CBAM.

Recommendations to the G7

The G7 needs to prevent trade conflicts among its members as quickly as possible to remain effective and create the basis for progress on the multilateral level. The conflictual issues relate to the increasing role of the state in the economy (industrial policy), unilateral trade measures, national security concerns, and WTO cooperation. How can this be achieved?

Industrial policy

G7 countries are increasingly intervening in their economies to promote the digital and green transition. In August 2022, US President Joe Biden signed the Inflation Reduction Act (IRA), through which the government is investing 369 billion US dollars over the course of ten years. The legislation, which is directed at speeding up the energy transition and transforming the US economy by facilitating the adoption of “clean” technologies, has several nationalist provisions (particularly through domestic content requirements), which pose a challenge to the competitiveness of industry of the other G7 countries. The EU has its own investment program, the Green Deal, which plans for an investment of 1 trillion Euro over a period of ten years. The EU also answered with a Green Deal Industrial Plan to the IRA, which includes proposals to simplify state aid policies and to establish a European Sovereignty Fund to support investment in strategic sectors (European Commission 2023).

These national approaches enhance the risks of a global subsidies race and more frictions among the G7 allies and also with their trading partners with less deep pockets to compete in it.

Recommendation 1: The G7 countries need to commit to enhanced transparency on the design of policy instruments and the amounts of subsidies given. For example, the G7 could establish an early warning mechanism. One example is the Clean Energy Incentives Dialogue, which the EU and the US launched in March 2023 as a part of the Trade and Technology Council (TTC). The aim is to “avoid any disruptions in transatlantic trade and investment flows that could arise from our respective incentives” (EU and US 2023). Both sides commit to enhanced cooperation and transparency to avoid possible measures “at each other’s expense”. The dialogue also wants to address systemic issues and best practices on how to move forward to avoid negative spillover effects. This approach needs to be broadened to the like-minded countries of the G7 and additional partners (maybe also using the G20 as an appropriate platform to expand economic ties), who are willing to commit to these best practices. This dialogue format could – for example – be included in a formalized G7 working group, which spans over individual G7 presidencies. Because of the urgency, first steps could be agreed upon during the final T7 summit in Puglia (Italy), and then picked up by the Canadian Presidency in 2025. Besides enhanced transparency

and an early warning mechanism, the working group could also establish a joint code of conduct to avoid a green subsidy race and the use discriminatory policies such as local content provisions. In addition, the G7 should support global efforts to collect data on industrial subsidies such as the Joint IMF/World Bank/WTO effort and the Global Trade Alert.¹ This data is crucial for the analysis of the implications of existing green subsidies and could form the basis for the discussions in the new G7 working group.

Recommendation 2: The G7 should also revitalize the Trilateral Initiative and extend it to all G7 members. In 2020, the EU, the United States, and Japan had tabled proposals for dealing with state subsidies (particularly in the industrial goods sector), including a reform of the WTO Agreement on Subsidies and Countervailing Measures. For example, they proposed a broader definition of subsidies, the inclusion of additional types of subsidies, particularly those that flow through state-owned enterprises, as well as stricter reporting obligations and sanction mechanisms. The Trilateral Initiative also pushed for reforming the rules for state-owned enterprises, overcapacities, and market distortions. Since then, however, the enthusiasm to work on these proposals has weakened as the United States, the EU, and Japan themselves have passed extensive subsidies packages. Thus, the three negotiation partners are fearful that their measures could become actionable under a new subsidies agreement, curtailing their space to advance the green and digital transformation. Given the gravity of the issue, the G7 should re-initiate these talks, adding a new component: the definition of green subsidies. The WTO's Agreement on Agriculture could serve as example for this as it differentiates between different types of subsidies according to their goal and effect on trade. As such, domestic support programs for the purpose of environmental protection fall under the so called "green box" subsidies (if they are not trade-distorting and not targeted at specific products).

Unilateral measures

The G7 countries share the common goal of enhancing their economic security (but often becomes a manifestation of mercantilist practices) and of promoting the digital and green transition. Many of the unilateral measures, which lead to frictions with other G7 countries as well as third countries are connected to these two aspects. This relates to the US 232 tariffs (economic security), CBAM (green transition), internet governance and the application of digital services taxes.

Recommendation 3: In order to avoid trade conflicts in these fields, the G7 (in cooperation with non G7-countries) need to develop scenarios on how to establish secure and sustainable production and supply chains together, instead of individually. Japan was one of the first G7 countries to adopt an Economic Security Adoption Act (February 2022), which includes the goal

¹ Subsidy Platform: <https://www.subsidydata.org/en/subsidydata/home>; Global Trade Alert: <https://www.globaltradealert.org>.

of strengthening supply chain resilience (Jochheim 2023). The United States is also working on this issue bilaterally through the TTC (with the EU) and the Indo-Pacific Economic Framework for Prosperity (IPEF) (with Japan). These approaches need to be streamlined into G7 processes and harmonized as much as possible into a single framework. As such, it can also be expanded more easily to third countries. Moreover, when referring to Article XXI exception of GATT G7 members must take utmost care to prevent proliferation of costly ‘national security’ trade restrictions.

Particularly pressing is how to deal with different regulations and taxes on carbon emissions as unilateral measures threaten to be highly trade distorting. For this purpose, the G7 formally launched the G7 Climate Club in December 2022, now consisting of the full G7 as well as Australia, Argentina, Chile, Colombia, Indonesia, Luxembourg, and the Netherlands. The Climate Club aims not only to improve coordination, transparency, and support for emissions reduction policies. It is also meant to overcome the “free rider problem” (countries that benefit from public goods without paying for their provision) of international agreements by setting emissions-reduction standards within the club and then penalizing non-compliant countries outside of the club. However, many questions remain unanswered such as on concrete commitments, monitoring mechanisms, as well as sanctioning instruments in terms of non-compliance.

Recommendation 4: The G7 climate club needs to consider how to help developing countries in their transition away from fossil fuels and as how to become more inclusive. There need to be discussions on how to get developing countries on board, including through climate finance commitments, possible technology transfers and technical assistance to operationalise climate justice. There have been many pledges with regard to climate financing, but G7 members need to make sure to implement their promises as soon as possible to remain credible. In addition, the Club must consider its impact on the exports of many LDCs and developing countries whose carbon pricing mechanisms are rudimentary. The climate club also needs to try to attract high-emitting emerging market economies to have an impact. Overall, data-based monitoring mechanisms are crucial to avoid a politicization of the club.

Another area where concrete action is required are international resource partnerships. G7 countries are aiming at increasing the resilience of their raw materials supply and value chains through bilateral resource partnerships with resource rich countries but also between each other. For example, the EU and the United States are currently, negotiating a critical minerals agreement, seeking to foster supply chains in raw materials. The United States and Japan have signed a critical minerals agreement in 2023. The G7 countries, together with Australia, the EU, Finland, the Republic of Korea, Norway, Sweden, the UK are part of the Minerals Security Partnership (MSP), which aims at working with governments and industry to facilitate targeted support for strategic projects along the value chain. Further initiatives are the Sustainable Critical Minerals Alliance led by Canada and the Voluntary Critical Mineral Security Program of the International Energy Agency. The G7 referenced many of these programs under Japan’s chairmanship, tabling a Five-Point Plan for Critical Minerals Security.

Recommendation 5: With respect to critical minerals and other key inputs to the green transition, the G7 should intensify its work on establishing a mechanism to secure G7-wide supply chains (including also trusted non-G7 firms) in order to ensure a level-playing field and strike a balance between legitimate national interests and an excess of competition among G7 members. One idea would be to cooperate in a plurilateral critical minerals “buyers club”, an agreement that secures access to critical minerals for all members, avoiding (harmful) national competition among members. As the G7 cannot secure these materials without cooperation with critical-raw material-abundant partners, the G7 should also aim at negotiating plurilateral resource partnerships with resource-rich countries. For these partnerships to be attractive, they need to be much more on eye-level than in the past and more strongly encompass components such as technology transfer and investment.

Sanctions, export controls, and anti-coercion instruments

Over the past few years, many G7 countries have tightened their export controls for critical technologies as well as created new trade instruments to counter economic coercion. Particularly after Russia’s invasion of Ukraine, the G7 countries implemented several sanction packages. New sanctions were also imposed vis-à-vis China regarding human rights violations. Closer coordination among G7 countries is advisable because of the following two reasons: 1) Uncoordinated actions regarding design, implementation, and enforcement reduces the effectiveness of these measures. 2) Because of the global and regional nature of value chains as well as the high trade interdependence of G7 countries, such unilateral measures also affect each other’s trade. In particular, in the case of the United States, these measures have a direct impact on other G7 countries due to their extraterritorial character.

Recommendation 6: As such, the G7 members should collaborate more during the policymaking process, for example through the creation of more formalized working groups at the cabinet or sub-cabinet level of ministries which issue regulations, grants, and other measures aimed at increasing economic security. The G7 Non-proliferation Directors and Finance Ministers’ Groups could serve as a model for new working groups on sanctions, export controls, and anti-coercion measures. Such an additional working group structure could reduce lag-time between G7 decision-making and members’ implementation. It could also help to facilitate the coordination and harmonization of the G7 as well as the establishment of frameworks that can be implemented by all members. These frameworks could be coupled with analyses of the overall goal of sanctions, export controls, and anti-coercion measures, as well as guidance regarding their implementation. At the same time, G7 members should conduct a review of the effectiveness of economic security measures with the aim of adjusting them if necessary.

WTO cooperation

In a geoeconomic environment, which is characterized by increasing trade frictions and fragmentation, transparent global rules and their implementation are key.

The G7 must prioritise a rules-based multilateral trade system to prevent conflicts among its members and with the trading partners. The relevance of the WTO system depends increasingly on its success to meet new challenges. It urgently requires reform regarding its legislative (rule-making), judicial (dispute settlement) and monitoring functions. G7 cooperation is essential to address the reform needs, without which they can table a coherent approach in G20 or multilateral fora.

Recommendation 7: G7 members should acknowledge that their economic and trade relations play an important role in enhancing the group's overall resiliency and economic security. The G7 should look to improve their coordination and coordination with the G20, while also looking to expand the size and diversity of cooperating countries which will enhance risk mitigation. A reformed and updated WTO provides a natural venue for such an effort. All G7 countries are WTO members and committed to a reform of the global trading system. However, the concerns and reform ideas differ – also within the (supposedly) like-minded club. Therefore, G7 countries should commit to a common set of reform proposals and actively engage with other WTO members – starting with G20 members – to achieve support in revitalizing the multilateral trading system. This relates to:

- The G7 should jointly work towards revising the WTO's decision-making for new rules. As such, G7 members could coordinate on enhancing and improving the regular work of WTO committees with an emphasis on transparency, monitoring and regulatory cooperation while also committing to maintain WTO tariff commitments. Building trust and experience with reform in these areas could help set the stage for more challenging reform discussions on dispute resolution and longer-term future market access commitments.
- Plurilateral negotiations, previously often described as a “second best” approach, are becoming an instrument actively pursued by developing countries and/or by actors aiming at adapting the WTO's agenda by including issues at the interface between trade and sustainability. While these negotiations are pursued by subgroups of WTO members, their outcomes are often multilateral since the benefits of these agreements are also relevant for non-participants. The G7 should actively promote the plurilateral approach by participating in the broad range of initiatives (so far not all G7 members are engaged in all initiatives) and engage in a policy dialogue with developing countries on how to make plurilaterals agreement open, inclusive and development-friendly. This should also include commitments for capacity-building to enable them to actively participate in plurilaterals negotiations (Berger et al. 2023).
- G7 should review challenging issues like unintended broadening of national-security exceptions, industrial subsidies, and trade sanctions to provide a like-minded approach among themselves in order to prevent geoeconomic trade conflicts. This could provide a concrete

model for further deliberations at multilateral level.

- G7 countries need to be more serious about not only coordinating among themselves but also listening to the priorities of these emerging countries in the Global South and collaborating with them in formulating global governance.

New partnerships

In the changing geoeconomics and geopolitical environment, there is the danger of fragmentation between various groupings and members.

Recommendation 8: Given the high economic and political costs of this development, the G7 should collectively promote partnerships with like-minded emerging economies in Asia, Latin America, Africa, and other parts of the world.

- Within its so-called outreach, the G7 invites leaders from African, Asian, and South American countries to the G7 summit. These vary from summit to summit. The G7 could consider inviting selected countries on a permanent, others on a rotating basis. Furthermore, the G7 could deliberate whether to invite leaders of the most important regional arrangements as permanent guests to the G7. In addition, the G7 could consider introducing a more formalized guest country structure to some working groups. Such a new structure needs to be done at eye-level, also taking the interests and concerns of the partner countries into account.
- All G7 countries are striving for new partnerships with like-minded emerging economies on a wide range of issues (trade and technology, resources and energy, infrastructure etc.). The best-case would be plurilateral agreements or at least more strongly coordinated approaches. At least, the G7 countries should inform each other more regularly to avoid contradictory approaches.

Conclusion

The G7 should focus on strengthening trade ties among its members as a key priority in a global environment characterized by increasing geoeconomic competition. As substantial progress risks to be undermined in the short-term by a degree of political uncertainty in view of forthcoming elections in the EU and the United States, the G7 under the Italian Presidency should focus its efforts to enhance cooperation in areas with a higher degree of likemindedness, such as measures aimed at pursuing economic coercion. At the same time, common ground with like-minded G20 countries should be pursued with greater energy to reduce economic and trade frictions between the G7 and other emerging markets.

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