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Emerging analysis

The ‘green squeeze’: an explainer

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Summary

Trade policy must incentivise and facilitate low-carbon trade. Increasingly, it also sanctions and penalises trade that is not considered environmentally friendly. Over the coming years, new green trade measures will cover an increasing share of global trade. These measures are influencing demand and supply for different inputs and capabilities as well as increasing demand for new services (e.g. for counting carbon or proving compliance). This is raising trade costs and will potentially reshape value chain and supply networks.

In view of these developments, the term ‘green squeeze’ refers to both the direct effects of new green trade measures, for example related to increased complexity and costs (in the absence of new support measures), and the indirect effects, which result from changes in prices and broader economic dynamics. Our analysis suggests greater consideration of both aspects are needed, especially for the Least Developed Countries, in view of global commitments to support trade and development.

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1. An explainer

Trade policy is increasingly being used to support climate change goals – to incentivise low-carbon trade but also to penalise and sanction trade that is not considered environmentally friendly. There are concerns that the direct and indirect effects of new green trade measures are constituting a 'green squeeze' on poorer producers. This is because – in the absence of dedicated support for adjustment – such measures are increasing the cost and complexity of exporting; there are also broader economic effects through changing relative prices.

It is now almost 10 years since the Paris Agreement was signed but we are still far away from the emissions reductions needed to avoid catastrophic climate change. Indeed, new analysis ahead of the global stocktake at the 28th Conference of the Parties (COP28) suggests global greenhouse gases need to be almost halved from current levels (43% by 2030) to limit temperatures to not more than a 1.5°C rise by the end of this century (UN Climate Change, 2023).

International trade is not only a proven route out of poverty but also vital to adapt to climate change. Trade policy has become a key instrument to contribute to addressing the urgent need to reduce emissions dramatically. Within the coming few years, new green trade measures being introduced by the major economies will cover an increasing share of global trade.

The most prominent examples of such new trade-related policies are those associated with the EU's Green New Deal. They include the Carbon Border Adjustment measure (CBAM) (implemented since 1 October 2023, with carbon credits due by 2026), the EU Deforestation Regulation (EUDR) (beginning end of 2024), the Corporate Sustainability Due Diligence Directive (CSDDD) (still in the troika process within EU institutions), the EU Textiles Strategy and more tailored moves to secure critical minerals.

Following the EU's lead on many green trade measures, other major economies are following suit: the UK recently announced its own CBAM (HM Treasury, 2023) and the US is expected to introduce similar measures to address carbon leakage and deforestation.

There is unprecedented use of industrial subsidies to promote decarbonisation by the big players. Subsidies are part of the US Inflation Reduction Act and they constitute the largest investment in reducing carbon pollution in US history. These policy developments are influencing demand and supply for different inputs and capabilities across global value chains. They are also increasing demand for new services related to counting carbon or proving compliance. This is raising trade costs and will potentially reshape existing value chain and supply networks.

As global value chains move away from ‘just in time’ to ‘just in case’ models, there are concerns of shifts away from producers at the margin. This includes as a response to the new demands for financial disclosures related to climate risks but also in anticipation of the widening of the scope of corporate due diligence requirements. There are now risks that buyers will reduce sourcing from producers ‘just in case’ of environmental harm.

For example, importers and buyers may reconsider sourcing from some producers because of perceptions regarding environmental protection frameworks. There are already examples of private sector responses to net zero resulting in reduced air freight produce to support the targets of the Paris Agreement and ‘sustainable, efficient and cost-conscious organisation’ (Wagenvoort, 2022) – even though the concept of food miles has long been debunked as a motivator for low-emissions sourcing decisions (MacGregor and Vorley, 2006).

Even when countries have their own compliance infrastructure in place, the EU is going beyond country-level assurances to ensure that the private sector provides proof there is no environmental harm from production (and, in the case of the CSDDD, that the firm is contributing to net zero targets). There are concerns that, for poorer producers, there will be increasing costs of compliance, which will unleash exclusionary forces, especially in the absence of dedicated support for trade-related adjustment.

Trade policy is a crucial part of the toolbox needed to support climate goals. However, there are concerns that the development dimensions of these policies, especially those of the EU, have not been given sufficient consideration (Lamy et al,, 2023). We focus on the effects of green trade measures on Least Developed Countries (LDCs) in view of global commitments to increase their exports[1] and related support measures like Aid for Trade.[2]

2. Types of green trade measure

The types of green trade measure being introduced include trade measures that target embedded carbon (e.g. carbon border measures), the environmental footprint of production (e.g. measures to address deforestation) and consumption (e.g. moving away from synthetic to natural fibres, in the EU Textiles Strategy) (see Riddell and Lowe, 2021). Other measures are seeking to support new green trade value chains and include securing specific inputs (e.g. critical

[1] Sustainable Development Goal (SDG) target 17.11 seeks to double LDCs' share of global exports by 2020.

[2] The Doha Programme of Action calls for ‘significantly increasing Aid for Trade support for least developed countries, which is expected to double by 2031 from 2018 levels; and (iv) increasing the participation of least developed countries in e-commerce by strengthening ICT [information and communication technology] infrastructure and building their human and institutional capacities to better support the development of and integration into digital value chains.’

minerals) and boosting productive capacity though incentivising domestic processing (using incentives).

Measures such as increasing expenditure on research and development have spillover effects that are difficult to capture. The transboundary effects of some policy measures to encourage green trade are increasingly being recognised but there is still some way to go (Mason et al., 2023). Consideration of the movement of people to address skills shortages resulting from increased demand for retrofitting remains almost totally absent from the discourse.

We use the term the 'green squeeze' to refer to both the direct and the indirect effects of new green trade measures. The direct effects arise because of the increased complexity as well as the potential costs associated with exporting in the absence of new support measures. The indirect effects are related more to changes in relative prices and broader economic effects.

3. Preliminary results

We examine the combined effects of the most prominent examples of green trade measures for LDCs: the CBAM, the EUDR and consider the implications of the CSDDD. The CBAM will incur direct transfers of resources from producers affected to the European Commission by 2026, through the submission of carbon credits.

The literature has consistently identified Mozambique as being adversely affected (African Climate Foundation and LSE, 2023). Over 90% of Mozambique's aluminium exports are destined for the EU ($2 billion, or two-thirds of a total of almost $3 billion of exports in 2022). On top of this, most of Mozambique's other exports, such as wood and fish, will be covered by the EUDR from the end of 2024, or the forthcoming CSDDD. This means the new green trade measures will cover almost all of Mozambique's total exports to the EU – 15% of all trade.

For LDCs such as Mozambique, which currently account collectively for less than 1% of global trade despite a global commitment to double shares by 2020, there are real concerns that the new green trade measures will constitute a green squeeze: adding to compliance costs, making key entry-level positions within value chains more challenging to access and raising barriers to entry.

The results arising from the broader economic effects arising from imposition of the EUDR give rise for concern. The EU is a major market for coffee exports. If we assume an increase in compliance costs[3] (without commensurate support) within a computable general equilibrium scenario, exports are reduced.[4] The fall in exports as a

[3] We assume a 10% increase.
[4] We see a reduction of just over 9%.

result of the initial shock devaluates the domestic currency, increasing in turn the relative price of tradable goods; there are exchange rate effects. More generally, the reduction in trade reduces tariff revenues. There are also implications for factor wages and household incomes.

Investments needed for compliance can fall disproportionately on smaller, poorer and less-resourced producers. This is illustrated in the case of Bangladesh, which is adapting to the Textiles Strategy and anticipating the CSDDD. According to a recent survey undertaken by the Centre for Policy Dialogue (2023), the share of firms in the textiles and clothing value chain that have integrated sustainability issues to prevent environmental damages, or that have clear policies, is lowest for small and micro (7%) compared with large (90%) firms. Under 1% have a separate manager (or officer) working on environmental compliance compared with almost 75% for larger factories. At the same time, the firms investing the most to comply, as a share of total investment, are micro factories (those with between 10 and 24 employees) (54%).

The views we have heard from business include a broad-based concern regarding the additional time and resources needed to undertake additional audits, over and above the usual requirements to access markets. There is also a need for better coordination, given the differences in policies being developed by the EU and the US regarding addressing deforestation (Jones, 2023). More generally, there is a need to address complexity and to streamline reporting requirements. The increased focus on audits has been argued to be 'increasing profits for auditors at the expense of suppliers'.[5] Within the EU, there are already multiple different focal points for the CBAM (Riddell, 2023); this situation is likely to be replicated across the EUDR and the CSDDD unless active steps are taken to streamline reporting requirements.

LDCs are concerned about the imposition of green trade measures without consideration of their development implications.[6] LDCs that are exposed, particularly to the EUDR, are vulnerable because of the sophisticated exporting requirements, coupled with weak institutional capacity to enforce existing legal frameworks. While some producers of coffee in Brazil (one of the world's largest producers, with satellite imagery systems and a strong legal framework) consider the EUDR to be in their competitive advantage (Proença, 2023), in the case of Ethiopia there are major concerns of market exclusion because of an inability to comply (Angel, 2023).

How big importers will react to the new requirements requires careful consideration and, arguably, an additional layer of corporate due diligence to change the current dynamics and foster inclusion rather than exclusion. For example, importers could be encouraged to enter

[5] Interview with major importer to the EU.
[6] See ODI (2023). Also discussed in UNCTAD (2022).

into longer-term supply relationships to enable investments to be undertaken and the use of model contracts. This could form one part of an import policy, as referred to within, for example, the UK's recent White Paper on International Development (FCDO, 2023). Coupled with improvements in digital platforms, increased traceability and transparency, could lead to greater inclusion for poorer producers.

4. Changing the dynamics

While the objectives of green trade measures in terms of addressing environmental impacts and supporting ambition in climate action must be met, there is a need to carefully consider their effects on the most vulnerable producers and countries. Most LDCs are located in Africa, and most of the vulnerable countries to climate change are LDCs. There is also a need to recast new green trade measures within the context of achieving other global goals.

The LDCs have not been able to achieve the Sustainable Development Goal (SDG) target to double shares of global exports by 2020. The Doha Programme of Action (DPoA) calls for a considerable increase in Aid for Trade resources, as well as a greater focus on digital trade; there are obvious synergies with the green trade agenda. However, there have been consistent shortfalls in Aid for Trade disbursements to the LDCs. The Aid for Trade gap for LDCs remained at $5.3 billion in 2021, leaving disbursements 28% short of commitments (UNCTAD, 2023).

Not only must shortfalls in Aid for Trade levels be addressed but clearly there is a need for additional support. Even if we assume only a 1% increase in compliance costs to the EU for LDCs, based on current trends we are talking about hundreds of millions of euros just to remain plugged into international trade. That is, for the status quo to remain. The combined effect of Aid for Trade shortfalls and new costs of compliance therefore runs into the billions.

While EU importers may assist exporters to secure compliance and avoid supply chain disruption, there is a risk that such measures will precipitate the redesign of supply lines towards suppliers located in countries where compliance and certification may be simpler. Both the direct and the indirect effects of new green trade measures are of concern.

Given the global commitments made to the LDCs, this risk must be mitigated through more concerted action. The UK's International Development White Paper includes much ambition regarding reforming global supply chains, increasing LDC trade and boosting resilience but words need to be translated into action. The consistent shortfalls we have seen in Aid for Trade to LDCs should be addressed and a strong signal sent in terms of commitments to the Paris Agreement and the SDGs and DPoA.

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