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The EU's Competitiveness Crisis & the Carbon Border Adjustment Mechanism

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Summary

This Views offers context on a protectionist trade measure the EU introduced in 2023, its Carbon Border Adjustment Mechanism (CBAM) that levies a carbon content charge on imports in sectors facing competitiveness challenges. While the CBAM is branded as an effort to level the playing field in support of the EU's tenuous claim to climate leadership, it is better seen as a subsidy scheme for high emission industries that have been avoiding energy transition. These measures conflict with the EU's climate and trade treaty obligations. Malaysia's trade exposure to CBAM is low despite being overstated by local commentary. Malaysia's policy response should therefore treat CBAM as an unfair trade distortion rather than a unilateral environmental measure that requires Malaysia's compliance.

The EU's Competitiveness and Climate Crisis

The European Union (EU) is a political and economic union of 27 developed countries. Collectively, they represent the

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second largest economy in the world. Yet, size has not brought success. 2023 economic growth in the EU was stagnant at 0.4%[1]. A recent competitiveness report commissioned by the EU Presidency authored by Mario Draghi, former Italian Prime Minister and ex-President of the European Central Bank, states that the EU economy "lacks dynamism", it has fallen behind the US and China in innovating critical technologies, it faces high energy prices and struggles with competitiveness[2]. The EU has recently turned to a number of trade-related measures in the hopes that they will give it a competitive edge against more dynamic imports from China and elsewhere.

The EU is also the world's second largest polluter of planet-warming carbon dioxide. A self-identified climate leader, the EU has implemented a significant carbon price. In theory, a carbon price is supposed to be high enough to compel affected industries to decarbonise. In practice, lobbying usually ensures that carbon prices are low[3]. Regarding EU carbon pricing, the Draghi report notes that: "This cost factor is of limited importance so far as heavy industrial production has been largely covered by free allowances under the Emissions Trading Scheme (ETS).[4]" The EU's tenuous claim to climate leadership via carbon pricing rests on a strategic silence regarding its pollution subsidies.

The EU's Carbon Pricing Subsidies

CBAM originates out of the ETS, the EU's flagship climate mechanism and a pillar of its claim to international climate leadership. It combines both market mechanisms and subsidies. Subsidies in the form of free pollution allocations were introduced to exempt Europe's energy intensive polluting industries from paying a carbon price. The industries covered are: iron and steel, cement, aluminium, fertilisers, electricity and hydrogen.

The justification for doing so was to prevent "carbon leakage" a spurious concept that alleged that, absent the subsidies, beneficiary industries would relocate out of Europe to places with lower carbon standards; a form of regulatory arbitrage. There has been no serious attempt to distinguish between fundamental drivers of European direct investment abroad (DIA) and divestment due to the EU's carbon pricing policies. For example, are European companies in Malaysia and China there to dodge EU regulations or are they there to profit from local markets?

Carbon leakage serves as a means for the EU legislators and firms to justify pollution subsidies for industries that were unwilling to embrace climate transition. Not all sectors covered by the ETS were eligible for pollution subsidies. Free pollution subsidies for high-emission industries have attracted internal criticism from environmental groups and non-governmental organisations[5]. The allocation of free pollution permits has been so generous that high-emission industries have been able to turn a profit by reselling them within the ETS market[6]. If free

[1] Eurostat (2024)
[2] Draghi (2024)
[3] Green (2021)
[4] Draghi (2024)
[5] Carbon Market Watch (2019); WWF (2022)
[6] Carbon Market Watch (2019)

pollution permits were removed, then the EU's uncompetitive energy intensive industries would face higher costs.

The EU's commitment to a carbon pricing policy means that it faces pressure to impose higher costs on industry, in effect introducing carbon price inflation as a mechanism of transition. In an environment where wages or revenue are stagnant or under pressure, inflation can be punishing and politically unpopular.

Alternative policies exist to make transition cheaper as opposed to making existing carbon intensity more expensive, however the EU lacks the policy imagination and state capacity to emulate the US Inflation Reduction Act (IRA) in this regard[7]. In Malaysia for example, government has chosen to make electric vehicles cheaper via a tax incentive as opposed to making internal combustion engines more expensive.

CBAM is an Attempt at ETS Reform

The EU's attempt to reconcile its poor industrial competitiveness with reform of its free pollution subsidies has resulted in CBAM. CBAM attempts to progressively replace free pollution subsidies with import subsidies for energy intensive industries by imposing a carbon price on imports (a "border adjustment"). The carbon price is based on the weekly ETS trading price which means that it is subject to variability and will be hard for importers to predict.

Carbon pricing has until CBAM been a domestic mechanism that countries could voluntarily adopt, CBAM has made it a form of carbon tariff unilaterally imposed upon Europe's trading partners. This has upset the EU's trading partners, particularly those from the developing world.

CBAM originally proposed to phase out pollution subsidies and phase in import subsidies over a generous 9-year period. The faster phase out happens the greater the trade impact on the EU's trade partners. Reporting obligations for CBAM were implemented in October 2023. Starting in 2026, importers of CBAM goods will pay a carbon price based on the ETS price minus the free pollution subsidies. There is now an indication that this phase out may be delayed. The Draghi competitiveness report has suggested that the EU should consider postponing the phase out of free pollution subsidies if its energy intensive industries continue to struggle with competitiveness.

Analyses of CBAM often fail to set it in context with other protectionist measures employed by the EU because they take its climate claims seriously. However, the choice of CBAM sectors is quite selective and far from comprehensive in terms of climate impacts leading to the suspicion that the main objective is economic. Electric vehicles, wind turbines and solar panels all incorporate steel. However, these products are not subject to CBAM. By targeting inputs such as iron, steel and aluminium CBAM may end up encouraging exporting countries to undertake more value-added activities at home which would benefit their domestic development and raise costs

[7] Draghi (2024)

for competing industries in the EU. An exception would be construction apart from exports of pre-fabricated industrialised building system parts.

In non-CBAM sectors where the EU is struggling to be competitive, we see the use of alternative policy instruments. In the case of the import of electric vehicles, wind turbines and solar panels from China the EU is resorting to tariffs and foreign subsidy investigations[8]. It is thus tempting to view CBAM as sectoral protectionism for energy intensive industries with a climate wrapper.

Lessons for Malaysia

The EU's failures in managing CBAM and carbon pricing offer important lessons for Malaysia as it develops its response to CBAM and considers its own carbon pricing mechanisms. The EU is caught in a policy trap of its own making.

For fear of retaliatory action under the World Trade Organization (WTO), the EU has studiously avoided mention of subsidies or tariffs in relation to CBAM. Instead, it has attempted to present itself as a victim of unfairness by describing its efforts to create a "level playing field" between its firms and competition from imports or countries that may not pay an equivalent carbon price. Rather than a tariff, the CBAM levy is described as a "border adjustment". Yet, tariffs are charges applied to goods that cross borders.

Scepticism towards semantics is necessary when evaluating EU policies, unfortunately most CBAM studies adopt the language and assumptions of the EU.

For example, it is not asked why EU levels of carbon pricing should define those for the world. The EU is, after the US, the world's second-largest climate polluter. Should it not pay a higher price than developing countries under the United Nations' climate convention principle of "common but differentiated responsibilities"? Developing countries are already paying a broader price due the damage inflicted by climate change that has primarily been caused by developed countries. Trade is a means for poorer countries to generate income for national sustainable development. Imposing CBAM alongside the EU's culpability for climate change is tantamount to a form of double taxation on the developing world.

Secondly, the discussion around CBAM and free pollution allowances has ignored the other subsidies EU countries provide to offset ETS costs.

Germany is one of the leaders of subsidy initiatives despite its ideological commitment to a market economy. In August 2023, the European Commission (EC) approved a Euro 6.5 billion German subsidy to offset purported carbon leakage risk for industries that include coal mining, iron, steel, aluminium, nuclear fuel processing, and even tomato puree, milk powder and bakers' yeast[9]. What countries would tomato puree and bakers' yeast makers flee to if carbon prices were too high? In February 2024, the EC approved a Euro 4 billion decarbonisation scheme that

[8] Alkousaa, Steitz, and Chestney (2024); Manca (2024)
[9] European Commission (2023)

subsidises ETS costs for companies[10]. Thus, while the EU pledges to phase out free pollution permits under CBAM we see Germany introducing other kinds of ETS subsidies. Of course, despite the EU's talk of CBAM forming a level playing field, Europe's trade partners will not enjoy access to such subsidies, but they will be levied the ETS carbon price. This lopsided approach to subsidy removal should be challenged at the WTO.

Finally, the idea that the EU is a climate leader is losing credibility as Brussels faces a domestic backlash to its climate policies and is shifting its funding priorities towards war and arms spending[11]. The ongoing conflict with Russia has challenged the EU's complacency over unlimited US defence protection as the US confronts multiple military challenges in Middle East, Asia-Pacific as well as Europe.

Malaysian Perceptions of CBAM

In Malaysia, the CBAM has been perceived as a legitimate unilateral mechanism that should intimidate domestic stakeholders into complying by applying domestic carbon pricing or accelerating decarbonisation.

A variety of Malaysian institutions—including BNM[12] and the Ministry of Investment Trade and Industry (MITI)[13]—have accepted the EU's flawed and unsubstantiated premise for CBAM based on a cursory two-page analysis by WWF-Malaysia/BCG in their *Net Zero Pathways for Malaysia* report[14]. In an effort to scare readers into adopting a carbon price in Malaysia, WWF-Malaysia/BCG uncritically advanced the EU's logic for CBAM but failed to note:

1. The lack of evidence for carbon leakage, the core phenomenon free pollution subsidies and now CBAM were supposed to deter[15]. There is no European firm that has divested as a result of the ETS.
2. Reports filed for years by civil society groups, including WWF, on how the EU ETS enriched high emission industries via free pollution permits. From 2013-2021, industries received Euro 98.5 billion in free pollution allowances while governments received only Euro 88.5 billion in revenue[16]. From 2008-2019, the total value of free pollution allowances handed out amounted to Euro 200 billion, resulting in windfall profits of Euro 50 billion to Europe's most polluting industries[17].
3. The weakness of the EU ETS to lobbying. A study found that for Euro spent on lobbying EU governments, companies earned from Euro 1 to Euro 4.60 in free pollution permits[18].

[10] European Commission (2024b)
[11] Hancock and Tamma (2024)
[12] Bank Negara Malaysia (BNM) (2023)
[13] MIDA (2024)
[14] Boston Consulting Group and WWF-Malaysia (2021)
[15] Carbon Market Watch (2019)
[16] Carbon Market Watch (2019); WWF (2022)
[17] Carbon Market Watch (2019)
[18] Winkler (2022)

4. Mediocre annual emission reductions delivered by the EU ETS in the order of 0% to 1.5% per year[19].
5. CBAM's violations of the UNFCCC, the Paris Agreement and the WTO's GATT[20].
6. The opposition mounted by dozens of countries at the UN and WTO against CBAM[21].
7. The huge geopolitical and bureaucratic challenges for the EU to implement CBAM beyond a handful of uncompetitive sectors[22]. The CBAM FAQ produced by the EC runs to 128 questions[23].

The Malaysian institutions above have adopted the WWF-Malaysia/BCG projection that around 75% of Malaysia's exports to the EU will eventually be covered by CBAM. KRI has assessed that the initial phase of CBAM will affect only 3.4% of Malaysia's exports to the EU (see Table 1). The initial financial impact will be smaller than this suggests since the level of free pollution subsidies for EU companies will initially remain very high.

This does not account for the reflexive nature of unilateral trade discrimination by the EU. Backlash from trade partners and internal opposition can affect policy development. The EU does not enjoy unfettered agency in imposing its will on the world. If it did, it would not be a declining power. China has shown willingness to engage in countermeasures against unilateral trade measures taken by the EU.

EU agriculture is particularly vulnerable to reprisals since farmers are politically sensitive and often receive appeasement from Brussels. China threatened reprisals against brandy, dairy and pork if the EU proceeded with industrial tariffs against it[24].

The larger danger of CBAM lies beyond the EU. Several rich countries are considering some form of CBAM. These include Australia, Canada, South Korea, Taiwan, UK and US[25]. If other developed country trade partners of Malaysia adopt similar discriminatory border carbon measures, then the combined could be more significant than the relatively negligible impact of CBAM.

[19] Green (2021)
[20] CBAM contravenes UNFCCC Article 3.5 as a "disguised restriction on international trade". It goes against the Paris Agreement's Article 2 and 4, while cynically undermining Article 9 on climate finance by proposing to recycle CBAM levies taken from LDCs back to them as climate finance (EU 2023). CBAM also runs up against the GATT Articles 1 and 2.
[21] World Trade Organization (WTO) (n.d.)
[22] Kurmayer (2023)
[23] European Commission (2024a)
[24] Ford and Mackenzie (2024)
[25] GMK Center (2024)

Table 1: Potential CBAM exposure of Malaysia's exports to the EU (USD billion)

	Total exports to EU	Aluminium	% share of total exports to EU	Iron & steel	% share of total exports to EU	Fertilisers	% share of total exports to EU	Chemicals	% share of total exports to EU	Exports impacted by CBAM	% share of total exports to EU	Exports to EU impacted by CBAM (% of total exports to the world)
	USD bn	*USD bn*	*% of total*	*USD bn*	*% of total*	*USD bn*	*% of total*	*USD bn*	*% of total*	*USD bn*	*% of total*	*USD bn*
2014	19.9	0.1	0.5%	0.2	1.0%	0.0	0.0%	0.0	0.0%	0.3	1.5%	0.1%
2015	17.9	0.1	0.5%	0.2	1.1%	0.0	0.0%	0.0	0.0%	0.3	1.6%	0.1%
2016	17.2	0.1	0.4%	0.2	1.1%	0.0	0.0%	0.0	0.0%	0.3	1.5%	0.1%
2017	19.5	0.1	0.6%	0.4	1.9%	0.0	0.0%	0.0	0.0%	0.5	2.5%	0.2%
2018	22.3	0.3	1.3%	0.4	2.0%	0.0	0.0%	0.0	0.0%	0.7	3.3%	0.3%
2019	21.2	0.2	1.1%	0.4	1.8%	0.0	0.0%	0.0	0.0%	0.6	2.9%	0.3%
2020	19.8	0.1	0.7%	0.2	1.3%	0.0	0.0%	0.0	0.0%	0.4	2.0%	0.2%
2021	25.2	0.3	1.1%	0.5	1.9%	0.0	0.0%	0.0	0.0%	0.7	3.0%	0.2%
2022	29.2	1.0	3.5%	1.0	3.5%	0.0	0.1%	0.0	0.0%	2.1	7.2%	0.6%
2023	18.6	0.8	4.4%	0.7	3.7%	0.01	0.0%	0.0	0.0%	1.5	8.2%	1.0%
5-year average	**22.8**	**0.5**	**2.2%**	**0.6**	**2.4%**	**0.0**	**0.0%**	**0.0**	**0.0%**	**1.1**	**4.6%**	**0.4%**
10-year average	**21.1**	**0.3**	**1.4%**	**0.4**	**1.9%**	**0.0**	**0.0%**	**0.0**	**0.0%**	**0.7**	**3.4%**	**0.3%**

Source: UN COMTRADE/compiled by Nur Sofea Hasmira, KRI

Notes:

Data is the sum of all kinds of exports to the EU27 countries

For exports to the world in 2013, there are no exports for aluminium, iron & steel and fertilisers

For exports to the EU, there are none for chemicals

Fertiliser exports exist but amount to only millions of USD

Policy Options

1: Carbon Pricing

One response is to follow suit and adopt carbon pricing covering affected goods or all goods. This would allow Malaysia to capture carbon income locally. However, carbon pricing is inflationary and can reduce competitiveness. As the case of the EU amply demonstrates Malaysia may have to consider large counterbalancing subsidies to "level the playing field" in its favour. The more fundamental drawback to this approach is that carbon pricing is ineffective as a policy tool for climate transition. A 2021 review of ex post studies on the EU-ETS indicated limited emission reductions, ranging from 0% to 1.5% annually[26]. This is not a pace of decarbonisation in keeping with Paris Agreement goals.

Malaysia's most relevant policy response is to adopt a carbon tax on iron and steel, aluminium and the energy sector announced in Budget 2025. However, this was not explicitly referenced to CBAM and Malaysia has no electricity or hydrogen exports to the EU. Absent strong measures to support industry decarbonisation, such as full recycling of carbon tax supported by transition subsidies, the main effect of a carbon tax is likely to be mildly positive on fiscal revenue and broadly inflationary since the energy sector has widespread interlinkages with the rest of the economy.

The current policy also does not take into account the possibility that other trade partners could adopt versions of CBAM and the long-run impacts on the competitiveness of Malaysia's trade goods and domestic inflation.

It is important to note that the CBAM price an importer pays is reduced by the amount of any domestic carbon price paid. However, if Malaysia's carbon price ever rises higher than the EU's the EU is under no obligation to pay Malaysia the difference. Far from a "level playing field" the CBAM is designed with hidden asymmetries.

The introduction of CBAM basically undermines three decades of trade liberalisation conducted under the WTO and various regional free trade agreements (FTAs) that Malaysia has pursued. Any gains made in reducing tariffs on goods can be reversed by a country implementing a CBAM and echoing the EU's unsubstantiated claim that it is "WTO consistent".

Likewise, if Malaysia wishes to revisit FTA commitments then it could emulate the EU and introduce its own version of CBAM (see below). We note that Malaysia and the EU have resumed discussions on a bilateral FTA and it is possible CBAM can be used by the EU as a fiat to undermine any goods agreement.

[26] Green (2021)

2: Challenge CBAM at the WTO

Another response would require broader coordinated action among developing countries to counter. The WTO is one forum for challenges, but as developed country adherence to the WTO diminishes, affected countries can undertake their own measures to counter unfair practices. Malaysia has challenged the EU on palm oil discrimination previously, as well as jointly with Indonesia. China and India appear quite likely to mount a challenge on CBAM.

Malaysia can also take unilateral trade countermeasures against the EU such as targeting agricultural exports which are politically sensitive. This could potentially give it leverage in upcoming Malaysia-EU FTA talks as opposed to starting defensively from a low baseline.

3: Diversify Trade

The minimal impacts of CBAM on Malaysian exports of steel, aluminium and fertilisers make it relatively straightforward to diversify trade away from the EU to other less troublesome trade partners. Given stagnant growth and fiscal constraints in the EU the outlook for demand is not bright. Malaysian exporters should in any case explore more dynamic markets for their goods.

4: Out-CBAM CBAM

The accumulated carbon dioxide from Europe and North America's industrialisation is the main driving force of contemporary climate change. An historically-adjusted border carbon adjustment (HABCA) on EU goods could be used by developing countries extract the climate finance that the EU was unwilling to deliver at the 2024 COP29 climate summit in Azerbaijan. A HABCA would help to educate Europeans that greenhouse gas (GHG) concentrations in the atmosphere is primarily a problem of stocks, not flows. By focusing only on present flows carbon pricing in Europe and elsewhere has failed to grasp this elementary concept of climate science.

A single developing country implementing a HABCA could find its impact multiplied if many other developing countries join suit. The EU would surely protest, but it owes a climate debt to the developing world.

5: Industrial Policy

Is carbon pricing the only tool in town? Far from it. One of the most powerful instruments to grow the economy is industrial policy, where a state imparts support and direction to specific industries, firms or economic activities. Industrial policy has been used successfully by Northeast Asian states such as Japan, South Korea, Taiwan and China to catch up with Western industrialised states.

Industrial policy tools run the gamut from subsidies, trade protection, tax relief, credit (concessional or not), infrastructure development, to research and development support. Compared to industrial policy, the policy tools traditionally offered for climate change have been far more limited in scope and ideologically constrained.

Besides regulation, markets for trading emission credits or Pigouvian corrective taxes dominate the policy offerings. Climate advocates have been conditioned to expect the perfect carbon price to precipitate a tipping point away from fossil fuels to sustainable production and consumption. Yet, for reasons of economics, politics and vested interests carbon taxes are never high enough to meet the social cost of carbon that theory prescribes, and carbon markets get saddled with loopholes or poor valuations that render them incremental and therefore ineffectual as emissions need to be dramatically reduced in a matter of decades[27].

The industrial policy strategy employed by the US is to deploy tax credits under the IRA and subsidy reviews leading to tariff measures on clean technology imports from competing countries. No carbon pricing is used in the US policy architecture.

Conclusion

It is a mistake to respond to CBAM as a climate policy. It is fundamentally a trade and industrial policy that is not intended to deliver significant climate goals.

CBAM should be viewed as one amongst a toolbox of policies developed countries employ in order to maintain competitive advantage over economic challengers rising from the ranks of upper middle-income countries. Malaysia is one such rising country and while the impact CBAM on Malaysia's exports is small from the EU alone there is a broader strategic concern of several developed countries using CBAMs as a way to rewrite the tariff regime of the multilateral trading system.

Developed countries unhappy with the goods outcomes in the WTO or regional FTAs such as the Regional Comprehensive Economic Partnership (RCEP) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), can use CBAMs as a way to set new tariff levels that suit their current competitive challenges. Developing countries could do likewise, though the greatest income differential can be achieved via an historically-adjustment CBAM that would cause less domestic inflationary disruption than a universal carbon price. Higher prices imposed on developed country imports would be passed through to local consumers but this might create competitive import substitution opportunities. Therefore, they should be combined with positive industrial policies to support value-added domestic production where possible.

We are now in a new era where trade rules are being rewritten by unilateral action. Malaysia can either be defensive and reactive or proactive to seize competitive advantages.

[27] Green (2021)

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