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The Crisis in World Trade

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This policy brief (PB) provides decision-makers with a succinct review of the state of the trading system, to point to likely scenarios, and to serve as a background to or reference for the other six PBs prepared by the T20 Task Force on Trade, Investment and Globalization. The brief argues that the world trading system has been remarkably successful in many respects but that the present strain reflects causes which are deep-seated and require a strategic response. The future of the system depends critically on reinvigorating the WTO and policy change in the largest trading nations. Important measures are required to sustain the multilateral trading system, and urgent action is needed to avoid a scenario where the system fragments. The worst scenarios will disrupt global trade and see a world which splinters into large trading blocs (most likely centered around China, the European Union and the United States) and where trade relations are based to a large extent on relative power instead of rules. In such a world the smallest players – especially those whose trade is least covered by bilateral or regional agreements – will be at the greatest disadvantage. All countries will incur enormous costs only to try and reinvent a system that is already in place today under the WTO.

Proposal

The world economy has never been as closely integrated as it is today. International trade in goods and services as a share of world GDP has increased from around 35% in the mid-1980s to around 60% today, despite a hiatus during the global financial crisis. Yet, the world trading system is now confronted by an unprecedented crisis. How this crisis is resolved depends on whether the WTO can be revitalized, whether the United States reverts to its traditional role of lynchpin of the system, and whether China can adopt reforms that address the concerns of its main trading partners. While there are no sure answers to these questions, in this note we present scenarios that help bracket the uncertainty and hopefully suggest an appropriate and robust policy response.

1. The trading system is now showing signs of stress on three main fronts

First, the inability of the WTO to make progress in critical areas such as services, agricultural subsidies, investment, the facilitation of global value chains, and digital trade, is calling into question the value of the organization and the sustainability of the system of laws that it constitutes. While many poor countries feel let down by the failure to conclude the Doha Round, the industrialized economies believe that there needs to be a rebalancing of obligations between them and the most successful emerging economies, who are also now among the largest trading nations. It appears increasingly difficult to build effective coalitions to reach acceptable deals along the North–South divide[2].

Second, the impasse over the appointment of Appellate Body members threatens to bring the WTO's dispute settlement system to a halt. The concerns that has led to one country blocking new appointments relate to concerns over whether the Appellate Body has added to or diminished rights and obligations and over procedural practices.

Third, the festering of tensions is observed in a series of trade restrictive measures and countermeasures without due regard to the WTO law. Some of the trade restrictive measures are taken in response to, rightly or wrongly, perceived theft of intellectual property, forced technology transfer, and widespread and opaque subsidization, especially of state-owned enterprises (SOEs), among other reasons. Some observers believe that state-led economic systems are incompatible with membership in the WTO while others believe that changes in the WTO rules are necessary and feasible. A number of countries share many of the concerns and consider proposing WTO rule changes, even as they disagree on methods.

Unfortunately, geopolitical rivalry and technological competition may complicate any solution. The trade tensions carry the risk of a significant deterioration not only in the openness and predictability of world trade but also of international relations and the ability to cooperate on the provision of other global public goods, such as the control of carbon emissions and the achievement of the Sustainable Development Goals.

The current frictions may well have led to permanent damage, since they are not only eroding the credibility of the WTO, but they are also encouraging countries that are so inclined to weaken or reject the rules-based multilateral trade system.

2. The causes of the current attack on the trading system run deep, reflecting a growing resistance to globalization; they require a strategic response.

The increased resistance to globalization is primarily a result of the secular trend in skill-biased technological change which accounts for rising inequality, economic disruption, and the stagnation of most incomes, a trend especially evident in advanced countries, but not only there.

Globalization also contributes to increased disruption and inequality directly because it creates demand for higher skills disproportionately and gives rise to many "winner-takes-all" opportunities, especially for platform companies that can scale-up quickly and inexpensively. The disruption has been made worse by the rapid rise of newly developed economies and the coming onstream of low-skilled workers across the developing world. The shift of manufacturing from advanced countries and many developing nations to China has been especially painful. In addition, the Great Recession, surges of migrants and refugees, and terrorism exacerbated the problem. Rightly or wrongly, large current account and bilateral imbalances remain a source of tension. Although China's current account surplus has essentially vanished, and the deficit of the United States has declined from around 7% of GDP at the peak to around 3% of GDP, the bilateral imbalance remains big. Germany and several other countries continue to run very large surpluses.

Populist and nationalist leaders are presently capitalizing on the fear of globalization to erect trade and investment barriers and to severely restrict immigration. However, it is important to note that a vast majority of businesses, especially export interests, opposes protectionism. With the advance of globalization export interests have gained in power relative to import-competing interests. Moreover, with raw materials, parts and machinery accounting for 75% of world trade[3], businesses are worrying about the viability of global value chains on which they rely. Young people – the voters of tomorrow – are generally opposed to protectionism as well. As protectionism takes hold, consumers see prices rise and their choice diminished, and they, too, tend to react. Many nowadays see their ability to buy foreign goods, invest and travel abroad as a natural right. For all these reasons, most large nations remain committed to increased openness in trade and foreign investment.

Economic analysis shows that protectionism is not the right answer to the problems, which instead lies in paying more attention to the plight of the most vulnerable. Ex ante policies include investment in skills and infrastructure, or more generally in policies that improve competitiveness, and ex post policies include measures to share the gains from global integration[4]. However, the national populists have refused this course – preferring the blaming of foreigners and protectionism. Meanwhile, mainstream politicians are hampered by budget constraints in pursuing policies that enhance public investment and social welfare.

3. The world trading system rests on three main pillars, the WTO, preferential trade agreements and domestic institutions, and it has been remarkably successful.

The WTO is a global public good which supports open and predictable trade based on reciprocity. It now includes 164 members accounting for 98% of world trade, with another 22 at various stages in the process of accession. Although in recent years, trade liberalization has occurred far more rapidly outside the WTO than inside it, the WTO provides the bedrock of international trade law. The principles of non-discrimination across nations, the Most Favored Nation clause, and within the national border, the National Treatment clause, and the disciplines agreed under the WTO represent the baseline, or the reference point, for other trade agreements as well as for domestic commercial law.

Under WTO rules, preferential trade takes three main forms: unilateral, as in the granting of preferences to poor countries under the GATT 1979 Enabling Clause; bilateral, which are allowed conditionally under GATT Article 24 of the WTO (substantially all trade and tariff reductions); and regional or Mega-regional, also under Article 24[5,6]. According to the WTO, at the start of 2019, 291 regional trade agreements were in force. Trade agreements now cover over 60% of world trade, and the share is rising7. Many of the bilateral and regional agreements include rules and liberalization commitments which extend well beyond present WTO disciplines to cover behind-the-border barriers to trade and new issues such as e-commerce or the role of SOEs. The EU, NAFTA, and ASEAN free trade agreements have been especially successful in supporting regional production networks and accelerating industrialization. In the last year, notable new trade agreements included EU-Japan, EU-Canada, and the CPTPP. In March 2018, the African Continental Free Trade Agreement was signed which showed promise that global value chains may become more functional in the region. Some trade agreements are now entering a second generation, such as NAFTA/USMCA. While the possibility of Brexit looms, the European Union, the largest trade agreements is continuously being deepened and several countries have expressed interest in acceding.[8]

International commercial disputes are prevalently resolved in domestic, not international, courts. Domestic institutions – the rule of law – that affect or directly govern international trade are crucial and they are being continuously reformed. Although some of these reforms have moved in the direction of trade restrictions (Global Trade Alert points to several thousand such measures enacted by G-20 nations since the outbreak of the global financial crisis), for the most part the trend over the last several decades is in the direction of facilitating international trade. For example, in the process of joining the WTO, China changed over 2000 laws and regulations. The European Union has reformed its common agricultural policy so as to greatly reduce its reliance on trade-distorting subsidies and has discontinued the use of "zeroing" in the calculation of anti-dumping margins. Until recently, the United States had discontinued use of Section 301 as inconsistent with WTO commitments. It is worth noting that international trade has also been facilitated by the building of trade, transport and communications infrastructure. This process is especially vital in developing nations.

The combined effect of multilateral, regional, and domestic reforms on the freedom and predictability of trade has been remarkable. The MFN applied tariffs of developing countries have been cut to a fraction of what they were in the mid-1980s. And exports from the poorest countries now enter advanced countries duty-free and quota-free in the vast majority of cases. The effectively applied tariffs (which take account all preferential agreements) are now very low in most large and middle-sized trading nations. For example, in Morocco, which has negotiated several bilateral trade agreements and reduced its MFN tariffs autonomously, the effectively applied tariff rate is now near 4%. Behind-the-border barriers and non-tariff barriers at the border are difficult to measure but they clearly continue to represent a considerable impediment to trade. However, these barriers have not prevented trade in goods and services and capital flows from becoming a much more prominent feature of economic activity.

4. The future of the multilateral trading system hinges on the answer to three related questions.

There is no definite answer to the following questions, but one can identify possible answers, or scenarios, that are favorable to the continuation of the multilateral trading system (Scenarios "A"). Likewise, there are scenarios that would not be favorable to multilateralism (Scenarios "B").

Can the WTO be reformed so that its negotiating arm begins to make progress on the most crucial issues?

Scenario "A". The answer is that it can, on condition that the membership can agree to move forward on specific issues and to address them through "plurilateral" agreements (See PB2 for detailed proposals)). These would involve members who represent a critical mass of trade and who are willing to grant concessions to non-participants on an MFN basis. The critical mass requirement may be less important in the case of agreements on rules, where free riding concerns are less prevalent than agreements on market access. This would allow members who are willing to go ahead with rule-making in specific areas to do so, while helping those who consider such rules to be premature see how the rules may work in practice. It is also possible that deals can be struck where members accounting for a critical mass of trade can strike a plurilateral agreement that is not MFN as the Government Procurement agreement which was sanctioned under the Uruguay Round. It is difficult, however, to imagine that plurilateral agreements can be reached without concurrence of the major trading nations, underscoring the need for the United States, China, the European Union and Japan, among others, resolving their present differences.

Scenario "B". If the WTO negotiating arm is not revitalized, the institution will lose significance and its judicial role will also be undermined. Even if the institution retains some influence since many of its provisions have been incorporated in domestic laws, it will become increasingly irrelevant to the solution of longstanding issues such as agricultural subsidies and investment, and 21st century issues such as digital trade and the support of Global Value Chains. One of more nations, especially the major powers, may conclude that the constraints of WTO membership outweigh its benefits. Countries will rely on a combination of bilateral trade agreements, partial plurilateral trade agreements, norms from the WTO days, and power relations among the major nations where bilateral agreements are difficult to envisage at present as among China, the EU and the US. The world may move rapidly into an era of aggressive unilateralism. Smaller nations who have not struck bilateral agreements with the big three will be especially hard-hit.

Do current US trade policies constitute a new normal in the United States or do they reflect a temporary phase?

Scenario "A". Many of the current concerns behind the trade tensions are expected to persist. However, most American politicians and American businesses do not favor a lawless trading regime even if they do not exclude a power-based approach to induce negotiations or to deal with perceived infractions by state led capitalism. All major countries still seem willing to engage in WTO reform. One thing that is unclear is the question of whether the United States will challenge the WTO dispute settlement system only on procedural grounds – in which case solutions may be found – or whether it has more fundamental concerns relating to sovereignty. The assumption here is that the United States will accept procedural changes in the WTO dispute settlement system that address its concerns (See PB 3 for more detail).

Scenario "B". The U.S. leaves the WTO (de facto or de jure) following a politically unacceptable unfavorable panel decision on an important dispute, such as the U.S. use of the section 232 national security justification for its steel and aluminum tariffs, or on China's market economy status. Other countries may then need to face the reality of a WTO without the United States. If the United States reverts to a policy of isolation and protection – as it did over much of the 19th century and early 20th century, MFN treatment or better may no longer become a norm for a large part of its trade. At the same time, many countries will seek to strike a bilateral deal with the United States to ensure continued access to an important market. Over time, the United States may well become less competitive and less attractive as an investment destination. The United States' global influence will rely increasingly on its military might, and it may wane in the area of international economic relations. China and, to a lesser degree, the European Union and Japan may play an increased role in the economic sphere.

Is a state capitalist system compatible with the WTO and if so, can the reforms needed to address the concerns of main trading partners be implemented?

Scenario "A". China is not the only provider of state aid, opaque subsidies, and is not the only nation to rely on State Owned Enterprises. However, its size, growth rate, and its history of central planning make it unique. As a major beneficiary of the system, China is clearly committed to the WTO and more broadly to policies of closer integration into the global economy. However, China's size, its large state sector, and the considerable extent to which provinces can pursue economic policies in a decentralized fashion, means that the reforms needed to reduce subsidization and the scope of the state sector are complex, politically extremely sensitive, and will take time. China's trading partners must strike a balance between the exercise of continuous pressure for change and the risk of encouraging the forces within China that want it to turn inwards and adopt a defiant stance.

Scenario "B". China is reluctant or is unable to undertake the reforms to its system that are required to create a more level playing field in international trade. Tensions with the United States and its allies escalate. As in the scenario where the United States turns inwards, all aspects of international relations become more complicated.

5. In addressing the implications of these scenarios, policy makers should assume that globalization will persist even though it may slow

temporarily as the trading system runs into severe difficulties.

The present era of globalization has coincided with unprecedented rates of economic growth and poverty reduction, even though the gains it has generated have been spread unequally. Globalization, of which trade is the main vector, will continue. To see why, it is useful to keep the three forces behind it in mind.

First, globalization is a spontaneous economic process driven by producers and consumers who engage in arbitrage (buy low, sell high) in the world markets for goods, services, capital and labor. Human beings will continue to engage in this arbitrage, which they do as naturally as they breathe. The arbitrage process across the four markets is mutually-reinforcing. Developing economies, which represent a rapidly rising share of world economic activity, are especially in need of these exchanges to import technology and know-how in exchange of their abundant labor and natural resources.

The synergistic arbitrage process in the four markets is greatly facilitated by improvements in transportation and information technologies, which reduce "trade costs", including "communication costs" and "face-to-face costs"[9]. These improvements have enabled a significant transformation in the international division of labor from industry-wise to production process-wise or task-wise beginning around 1990. And now, we are experiencing a drastic reduction in matching costs for business-to-consumer and consumer-to-consumer transactions, which may trigger the development of massive service outsourcing. These changes are expected to continue and even accelerate due mainly to the advances in information technologies. Cross-border data flows have seen explosive growth and one estimate suggests that international broadband use will increase by 9 times over the next 5 years[10]. Already 12% of global trade is carried out on e-commerce platforms which did not exist a few years ago.

It is true that historically, policies, macroeconomic depression, and international conflicts have interrupted globalization in individual countries and regions in many instances, and, sometimes even across the world, as in the 1930's. In the current era, higher trade barriers, and new impediments to international investment can certainly slow globalization directly and by causing a sharp deceleration of economies. However, history teaches that a withdrawal from globalization is not technologically or economically sustainable. Politically, countries that have withdrawn from globalization have often also had to resort to repression. In shaping their long-term strategy, policy-makers should *not* assume that this time is different.

6. Accordingly, policy makers need to take several actions to avoid a widespread resurgence of protectionism that could severely dent economic growth across the world.

Policy-makers should adopt measures that aim to achieve the best scenario while also preparing contingency plans for the worst.

Policy-makers should assume that no single economy, even the largest, can isolate itself from the globalization process. Indeed, the more other countries engage in liberalization and adopt rules-based approaches to trade, the greater the advantage of becoming part of the system and the greater the disadvantage of those who stand outside it.

Accordingly, policy-makers should accelerate their efforts at striking bilateral and regional trade agreements, to engage in domestic reforms that improve their international competitiveness and facilitate integration in global value chains, and to reinvigorate the multilateral system. They should renew their pledge to avoid protectionism. When retaliating against unilateral tariffs, their response should be proportionate and time-bound and subject to periodic review. These steps will increase the pressure on all countries to remain within the system. They are also steps that guard against the worst consequences of bad scenarios, should they materialize.

As indicated in the G20 communique' of 2018 and 2017, countries should adopt measures that aid the adjustment of the most vulnerable to the spread of labor-saving technologies and of international trade involving low-wage economies. These policies may include gradualism in trade reforms in some instances, but ultimately require international cooperation and the pursuit of ex ante and ex post domestic policies that help ensure global economic engagement does not increase inequality.

The G20 should reinvigorate the WTO as a forum for negotiation. As argued in PB2, possible policy options include multilateral agreements on a specific issue with distinct lanes and speed for advanced, developing and least developed countries, as in the case of the Bali Trade Facilitation Agreement. Plurilateral agreements, especially those that allow for MFN treatment of non-participants, or those that allow for participation and eventual accession of all members appear especially promising. Possible themes for negotiation include E-commerce and participation and eventual accession of all members appear especially promising. Possible themes for negotiation include E-commerce and investment facilitation. Policy-makers need to support WTO reforms in critical areas such as the operation of global value chains (See PB6[11]) and services (See PB 5[12]). The facilitation of investment requires changes in procedures which are uncontroversial – so do not include market access, investor state dispute settlement – and represent a low-hanging fruit (See PB7[13]). Rules that govern digital trade, which is burgeoning, are urgently needed. These rules should aim for the ideal of free digital trade while addressing the legitimate concerns that relate to privacy, security, etc. (See PB4[14]). Monitoring and transparency need to improve all round [15].

Policy-makers need to make procedural changes to the WTO dispute settlement system that improves the speed and thoroughness of the system. They also need to address more fundamental questions such as the appropriate use of precedent and those relating to "judicial activism". While they need to bear in mind the concerns of the United States, the focus should be on making the system work better for all parties (See PB 3[16] for a comprehensive proposal by WTO law scholars). Policy-makers should make full use of the dispute settlement process whenever they determine that rules have been broken and their interests have been harmed.

Countries with very large current account surpluses should revisit the appropriateness of their macroeconomic and taxation policies. Policy-makers should recognize that neither global nor bilateral trade imbalances can be effectively corrected through trade policy measures, only though changes in macroeconomic and structural policies.

China, which is by some measures already the world's largest economy and appears destined to become the largest trading nation by a wide margin, must rapidly adopt reforms and a stance that correspond to its new-found status[17]. Carrying its fair share in the WTO includes lowering its MFN applied tariffs, adopting stringent rules on subsidization, on protection of intellectual property and on the rights of foreign investors. The disciplines governing SOEs – in China and elsewhere – must be such as to minimize their distorting effect on international trade. The best way to achieve these reforms is through a multilateral effort in which China is a leading participant.

The United States, which has long been the lynchpin of the international trading system, has legitimate concern to push for changes in some aspects of the current system. Continuation of the present system – albeit with certain needed reforms – is in the vital economic and security interests of the United States. It should, however, exercise its power to change the system from within.

Preparing for the worst scenarios requires envisaging a world which splinters into large trading blocks (most likely China, the European Union and the United States) and where trade relations are based to a large extent on relative power instead of rules. In such a world the smallest players – especially those whose trade is least covered by bilateral or regional agreements – will be at the greatest disadvantage. However, businesses based in the large blocks will also find that they face a far less open and predictable trading environment, while consumers face higher prices, diminished variety and, in many instances are forced to settle for lower quality goods and services. In such a world, policy-makers will be faced with a choice of retreat and protection – an unsustainable course – or of urgently negotiating new bilateral and regional agreements which include effective dispute settlement procedures. They will incur enormous costs only to reinvent a system that is already in place today under the WTO.

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[1] We thank Richard Baldwin, Eduardo Bianchi, Wallace Cheng, Manjiao Chi, Christopher Findlay and David Laborde for very helpful comments.

[2] The United States has recently tabled a paper at the WTO proposing criteria for developing country status, which is currently established by self-designation, so, for example, Singapore, one of the world's richest nations and South Korea are developing nations in the WTO. Under the criteria proposed by the United States, these countries, but also China and India would no longer qualify. China, India, South Africa and others submitted a proposal of their own to reiterate that self-declaration is appropriate in the WTO context and that per capita indicators must be given top priority when assessing development levels. This is bound to become another major area of dispute going forward.

[3] UNCTAD, 2017

[4] See Akman et al., "Mitigating the Adjustment Costs of International Trade" 2018 T20

[5] GATT Article 5, on Freedom of Transit, and its relationship to e-commerce may also be mentioned here.

[6] Several "plurilateral" agreements also exist under the WTO, such as the Government Procurement Agreement and the International Technology Agreement.

[7] For example, members of the EU – the largest trading block – conduct about 64% of their total trade within the EU and, of the 36% conducted outside the EU, about one third was covered by trade agreements with third parties. This share increased greatly with the recent conclusion of the EU-Japan and EU-Canada treaties.

[8] Several other bilateral and plurilateral agreements could be mentioned which fall outside the ambit of the WTO, such as over 2000 Bilateral Investment Treaties, Double taxation treaties, the WIPO Convention, etc. whose effect is directly or indirectly to promote trade or to enhance the benefits of trade.

[9] Baldwin "The Great Convergence"

[10] Mc Kinsey, 2019

[11] PB 6 expresses concern on the slowdown of the expansion of global value chains (GVCs) after the Global Financial Crisis and claims that GVCs must be further developed by providing proper policy environment, promoting business matching, and reducing protectionist sentiments.

[12] PB 5 warns G20's relative negligence on trade in services and appeals that strong, sustainable, and inclusive growth will not be achieved without due consideration of services responding to the recent rise of the services economy and the digital revolution.

[13] PB7 reiterates the previous T20 claim that an international framework to facilitate investment is crucial to take advantage of the globalizing momentum for sustainable development and proposes Guiding Principles on investment Facilitation for Sustainable Development.

[14] PB 4 emphasizes the importance of digital technology for G20 economies to accelerate sustainable and inclusive growth and claims that free flow of data can be placed as a logical starting point to design and verify a series of supporting policies to address people's concerns and various public policy objectives.

[15] see Lamy and Mehta https://www.thewire.in/trade/what-should-the-role-of-g-20-countries-be-in-reforming-the-wto

[16] PB3 proposes a number of important procedural changes to the WTO Dispute Settlement process, including those related to deadlines, rules for outgoing Appellate body members, and findings unnecessary to the resolution of a dispute. The brief also includes proposals for fundamental reforms, such as those relating to the use of precedent, "judicial activism", independence of the Appellate Body. The brief also discusses alternatives should the current system falter, such as arbitration under DSU Article 25 and Countermeasures under general international law.

[17] Culter, W. and K. Doyle (2019), 'China's developing country status in the WTO: time for an upgrade?', East Asia Forum, 21 January 2019. http://www.eastasiaforum.org/2019/01/21/chinas-developing-country-status-in-the-wto-time-for-an-upgrade/

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