Chapter 3
The Future of the World Trading System

Uri Dadush

International trade is prevalent in our daily lives. The operation of cross-border value chains is crucial for firms across the world. Yet, the trading system has never, in the post-war era, been under as severe a strain as is the case seen today. In this chapter, I will try to make sense of this apparent paradox, and I will outline some possible steps to ensure that trade remains open and predictable.

The post-war era saw an unprecedented advance in global economic integration, and since the fall of the Berlin Wall, the process accelerated further. Thus, the share of trade of goods and services in world GDP increased from less than 40% in 1990 to 60% today, while the share of global Foreign Direct Investment (FDI) in GDP has trebled. World trade slowed sharply in the wake of the financial crisis of 2008-9 leading some to believe that this marks the end of globalization – the "peak trade" theory. I disagreed. What is true is that the growth of world trade prior to the crisis was temporarily boosted by a hundred-year positive shock, namely the entry of China and other developing countries into the world economic mainstream, and that this was not going to repeat. However, the biggest reason for the slowdown in trade was cyclical, not structural. The financial crisis had a disproportionate depressing effect on investment and on the demand for consumer durables, which rely heavily on trade for both markets and for parts and components. With the economic recovery, trade has accelerated again, even though it is unlikely to match pre-crisis growth rates on a sustained basis.

Mc Kinsey recently issued a report on digital globalization that should help put the idea of "peak trade" to rest. They show that the amount of cross-border bandwidth used has grown 45 times since 2005, and project that it will increase 9 times over the next 5 years. We may now only be at the threshold of the next wave of globalization, which will consist of information flows and be powered by artificial intelligence. This coming wave will entail an explosion of e-commerce that will create opportunities for small firms (e.g. in arts and crafts), greatly increase the tradability of many services (e.g. taxi rides, short-term apartment rentals, medical diagnosis), increase the share of services in the provision of manufactures (e.g. remote monitoring and operation of devices through the internet of things), and enable entirely automated customized manufacturing (3D printing). Mc Kinsey estimates that already, today, about 12% of global goods trade is carried out on e-commerce platforms, which until recently, did not exist.

Drivers

What accounts for the secular, seemingly unstoppable, advance of world trade? The present era of globalization can be dated back to the great navigational advances and exploits of the 15th century. Ferdinand Magellan, who died in 1521 on his way to the first circumnavigation of the earth, can be justifiably called the first globalist. The centuries since show that trade is powered by three forces: (1) markets (i.e. consumers and producers), (2) technology and (3) policy. Consumers who continually search for better products at lower prices and producers who look for cheaper input and for customers willing and able to pay are not inclined to stop at the border. Technology, especially innovation in transport and communication, is key to reducing the costs of trading and to making trading opportunities known. Policies allow trade by lowering tariff and non-tariff barriers but they can also stop trade by raising barriers or by prohibiting trade altogether.

In the post-war period, the advance of markets abetted by policy is best symbolized by the creation of the World Trade Organization (WTO) in 1995, the rule-making body whose 164 members account for 98% of world trade, and the establishment within that institution of the Dispute Settlement System, which has ruled upon hundreds of cases. Moreover, the benefits of the advance of markets and of technology is best conveyed by noting that, according to World Bank data, the world's average per capita income has about trebled since 1960, and the share of the absolute poor in the world's population has declined from 36% in 1990 to 10% in 2015.

Why, in the light of this remarkable progress, is the trading system under direct challenge today? The challenge to the trading system is today most evident in President Trump's questioning of the United States' major trade agreements, namely his withdrawal from the Trans-Pacific Trade Agreement, his renegotiation of the North-America and Korea-United States Free Trade Agreements, both of which have moved in the direction of less free trade, his imposition of steel tariffs and tariffs on some $250 billion of imports from China, and his threat to impose tariffs on automobile imports. Perhaps, most important is President Trump's direct challenge to the legitimacy of the WTO's dispute settlement system on account of its ostensible "overreaching," or legislating on issues outside its mandate, and ruling too often against the United States.

However, it would be unfair and overly simple to attribute current tensions to the United States alone. The decision of the United Kingdom to exit the European Union (EU) and the EU's refusal to entertain the notion that the UK could remain part of the single market, while outside the EU, has called into question one of the world's most important trade relationships. According to Global Trade alert, over the last ten years, G20 members have adopted far more individual trade restrictive measures than trade-opening ones.

Countercurrents

The present trade tensions reflect five sets of problems, none of which are new, and none of which are amenable to a quick fix. In order of importance these problems are: the uneven sharing of the benefits from the current era of globalization and technological advancements, especially, but not only, in the United States; crises and the wave of populism; Chinese exceptionalism; macroeconomic imbalances; and the dysfunction of the World Trade Organization (WTO). Each of these issues have been the object of extensive study, including dozens if not hundreds of academic papers, and they have also been the object of many reform attempts. Yet, while progress has been made in some areas, each issue remains, and the trends, unfortunately, are not promising.

Inequality: Much of the rise in inequality and the increased economic disruption, which stirs the discontent with globalization, is due to unskilled-labor-saving technology, not trade. However, the disruptive effects of trade and technology interact and reinforce each other in many ways. For example, cheaper transport and communication facilitate outsourcing and all forms of trade; and, firms, which are confronted with new sources of low-cost competitors, respond by automating and innovating. Technology facilitates trade, and trade prompts technology adoption. Separating the effect of these two powerful forces is hard. And workers who are employed in sectors exposed to international competition and who lose their jobs naturally find it easier to blame foreigners than to blame robots.

Trade and technology appear to have hit unskilled workers in the United States the hardest, where social safety nets are the weakest. In the US, the life expectancy of white men who are high-school dropouts was 67 in 2008, down from 70 in 1990. According to a recent Brookings study, the mortality rate for Whites with a high school degree or less, aged 50-54 has shot up from over 700 per 100,000 to over 900 per 100,000 since 2000, and is now much higher than that of Blacks and Hispanics. Angus Deaton, the Nobel Prize winner who coauthored this study calls them "Deaths of Despair." Based on the GINI coefficient and on shares of different income percentiles, the United States has become the most unequal advanced country after Israel, reaching levels of inequality not very different from those in developing countries such as Mexico.

The largest disruptive effects of trade liberalization may be behind us, as trade is already largely free, and there does not appear to be another China about to rise (India is a candidate for the next great trade disruption but this remains a distant and uncertain prospect). Therefore, ironically, the next wave of job losses is just more likely to come from increased protectionism than from the trade liberalization.

However, there is no sign that technology and the other forces driving increased inequality are slowing, on the contrary. Labor-saving technology (artificial intelligence, autonomous vehicles, etc.) is, according to a recent Mc Kinsey report and to others, already capable of displacing hundreds of millions of workers. Furthermore, in our globalized IT-driven economy, the returns to innovation tend to accrue to small groups of people. And the return to capital – whose ownership is highly concentrated - continues to outstrip the rate of growth of GDP by a wide margin, as argued by Tomas Piketty and confirmed by recent empirical studies. Though governments should be fighting these trends, the recent tax, spending and health-care reforms in the United States, which is the advanced country with the most unequal income distribution, do the opposite. The reforms benefit wealthy individuals and companies far more than they help the average American. Even though social spending in the United States is very low by the standards of other advanced countries, in coming years, rising budget deficits will put even greater pressure towards reducing it.

Crises and Populism: Rising individual and regional inequality caused by technology and by globalization provides only part of the answer to what caused the rise in protectionism. For example, an interesting analysis of election outcomes by the Barclays Investment Bank highlights another important cause, namely a growing concern about the loss of sovereignty to super-national institutions such as the European Union, the WTO, and to far-reaching and deep trade agreements such as the now discarded Trans-Pacific-Partnership.

Of course, these concerns are far from new – inequality and the worry about eroding sovereignty were with us 20 years ago, and longer, back when the resurgence of right-wing nationalism and protectionism was still only nascent in most countries. Yet, grievances tend to cumulate if they are not addressed. In addition, what is new is the grave effect of the global financial crisis and the glacial pace of recovery from it. The crisis established the perception that policy-makers ("the elites") were not only incapable, but that the choices they made, such as bailing out the banks, were self-serving and inequitable. EU enlargement to the East is also quite new, and it led to a surge of European migrants into the

UK – widely believed to be the most important grievance of those who voted for Brexit. The recent instability in the Middle East and the spur given to large refugee flows and to terrorism also contributed to the legitimation of a brand of nationalism that is racist and religiously intolerant.

Populist policies spread and trade is often a target. Thus, the President of the United States, the world's richest country and the architect of the Post-War trading system, said in his inauguration speech:

> "For many decades, we've enriched foreign industry at the expense of American industry; [...] and spent trillions of dollars overseas while America's infrastructure has fallen into disrepair and decay. We've made other countries rich while the wealth, strength, and confidence of our country has disappeared over the horizon. One by one, the factories shuttered and left our shores, with not even a thought about the millions upon millions of American workers left behind. The wealth of our middle class has been ripped from their homes and then redistributed across the entire world."

There are many other examples. Brexit has already been mentioned. Marine Le Pen, the anti-Euro head of the National Front, once an outcast party, obtained one third of votes in the last French Presidential election. Matteo Salvini, a right-wing nationalist and anti-European Union populist has become the most popular politician in Italy. Right-wing nationalist politicians have prevailed in Hungary, Poland, and pose a serious challenge in Austria and the Netherlands.

China: A great paradox and unprecedented feature of the current era is that the world's largest exporter and manufacturer (the Chinese manufacturing sector is as large as that of the United States and Japan combined) remains a state-driven developing country. Even as its firms conquer world markets, China's average tariffs are two to three times higher than those of the European Union, Japan, and the United States. Although many Chinese firms already operate at the cutting edge of technology, and China is increasingly enforcing intellectual property rights at home, it continues to be accused by scores of firms and observers across Europe and the United States of forcing technology transfer from foreign investors and to engage in widespread intellectual property theft. Although the share of State-Owned Enterprises in China's employment has declined sharply in past decades, it remains far higher than that of any large economy, and these enterprises are widely believed to benefit from preferential non-transparent credit awarded by the formal banking system, which also remains state owned. As Chinese firms penetrate global markets with exports and, increasingly, with acquisitions and greenfield investment, the differences between the Chinese system and that of its advanced country competitors have become an increasing source of friction.

On one crucial issue, China has changed. China's current account surplus has declined massively, from around 10% of GDP a few years ago to below 1% of GDP projected by the IMF for 2018. Thus, China is making rapid progress towards a more balanced growth model, one that is less reliant on exports and more reliant on domestic demand. In fact, for countries around the globe, China is well on its way to becoming their largest export market by a wide margin. However, given the economy's large presence on world markets, its high investment rate and rapid growth as both importer and exporter, the tensions associated with Chinese exceptionalism are more likely to increase than abate. As the saying goes, it is difficult to sleep next to an elephant, whichever way it turns.

Imbalances: In designing the International Monetary Fund at the end of World War 2, the great British economist John Maynard Keynes and his American counterpart Harry Dexter White had imbalances, and the risk they posed for international macroeconomic stability and the trading system, was at the center of their preoccupations. Tensions over large current account deficits and surpluses are always present. However, in recent years, the dramatic narrowing of China's current account surplus and of the United States' deficit had taken some steam out of the issue. Nevertheless, China's large bilateral trade surplus with the United States remained a source of tension, and President's Trump obsession with bilateral imbalances – whose importance economists dismiss – has added a lot of fuel to the fire. Yet, it is not at all clear what China could do to significantly and quickly reduce its bilateral trade surplus with the United States, an outcome that Trump's negotiators are demanding.

Germany's very large current account surplus, which is nearly as big as that of China's and Japan's combined, is a more recent phenomenon, but it has become an equally important source of tension, not only with the United States but with other members of the Euro zone, especially the struggling countries of the South. To a significant degree, Germany's surplus is the artificial result of the creation of the Euro – since had Germany retained the Deutsche Mark, it would almost certainly have seen a very large appreciation. It is true that Germany's monetary, exchange rate and trade policies are in the hands of European institutions, so outside of Germany's direct control. However, there is no sign that Germany is prepared to undertake the increased government spending, higher wage policies, or tax reforms that would be needed to significantly dent its current account surplus and provide some relief to its Euro zone partners and help defuse trade tensions. Unfortunately, with the new tax and spending policies in the United States, the nation's current account deficit is projected to widen again in coming years, spelling even more trouble in the future.

WTO. The institution, which is the bedrock of the orderly, open and predictable trading system that emerged after World War 2, has – contrary to the popular narrative – registered significant successes since its establishment in 1995 as a follow-on to the GATT. Most notable, as already mentioned, are the expansion of its membership which now covers 98% of world trade (versus some 85% at inception), the Bali Trade Facilitation Agreement, the Government Procurement Agreement, the Information Technology Agreement and its extension, the prohibition of agricultural export subsidies, and of voluntary export restraints. However, the WTO's incapacity to move forward on wide-ranging multilateral negotiations in the Doha agenda and to deal with many long-standing trade impediments, such as agricultural subsidies and barriers to services trade, and even less to take on new issues such as electronic commerce, has meant that its negotiating arm has fallen behind the times.

Its other major function, the dispute settlement system, has continued to be extensively used, but has come under increasing challenge, mainly from the United States, for "overreaching" and "gap-filling", i.e. adjudicating on issues or in a way that goes beyond that which negotiators had agreed. All this preceded the arrival of Mr. Trump. Continuing a policy of the Obama administration, the United States is now refusing to replace the members of the Appellate body as their terms come due. This means that the Dispute Settlement system could effectively cease to function before the end of 2019. Moreover, three recent measures undertaken by the United States are almost certainly in violation of the WTO, namely the spurious appeal to national security in raising tariffs on steel and aluminum imports, the negotiation of voluntary export restraints on the same with Korea, and the section 301 actions against China, which now sees almost half its exports to the United States the subject of increased tariffs. The effective demise of the Doha agenda, the flouting of WTO rules by its emblematic member and the United States' increased reluctance to support its adjudication is bound to weaken it further. A de facto exit of the United States from the WTO leading to the organization's demise or to a truncated WTO is no longer unthinkable.

This panoramic of the causes of the current trade tensions underscores the importance of a coordinated and broad-based approach in resolving them, such as could be undertaken by the G-20 context but looks distinctly unlikely at present. All this strongly suggests that things will get worse before they get better. Far from going away, the present challenges to the trading system are likely to become even more pressing in the future.

Drawing the Threads: Implications for policy action

Standing up to Mr. Trump is not easy. It risks escalation. However, the greater risk is condoning polices which are likely only to result in more and more protectionism and which undermine the legal foundations of the present system. The Trump administration will end, perhaps sooner than later, and the next administration, whether Democrat of Republican is unlikely to be as disruptive or reckless as the current one. Even so, many of the trade concerns that are prevalent today will continue.

There is no easy solution to the issue of inequality and disruption caused by globalization and technology. Policy-makers must step up their efforts to explain the benefits of trade, while at the same time strengthening the mechanisms that protect the most vulnerable. However, there are limits to social assistance and the most promising long-term solutions are those that promote mobility of workers, which above-all means building skills and flexibility. In a note published in the Global Solutions Journal, prepared under the aegis of the Trade working group of the G20, several co-authors and I have elaborated a set of proposals intended to mitigate the cost of adjustment to international trade shocks.

China must accelerate its market reforms, engage in more far-reaching trade liberalization and privatization, and take more aggressive measures to boost consumption. If it is, one day, to lead the reforms of the trading system, as its size and dynamism suggest it should, it must first resolve its internal contradictions. Germany must, for its own sake address those of its Southern European partners, and for trade peace, increase public spending, raise its public sector and minimum wages, and encourage more domestic investment to bring down its current account surplus. The United States will sooner or later have to reverse its tax cuts on the wealthy to contain inequality and reverse its policy of fiscal stimulus to reduce its budget deficits. These measures will help contain the United States' national overspending which lies at the root of its current account deficits.

The members of the WTO need to find ways to revitalize its negotiating arm – for example by undertaking multiple sectoral or plurilateral agreements. They should aim to reform and strengthen the dispute settlement system (as recent white papers issued by the European Union and Canada have proposed) to respond to the concerns of the United States and others. But they should also prepare for a contingency where the United States effectively abandons the Dispute Settlement Understanding. At the same time, nations should accelerate their efforts to conclude bilateral and regional trade agreements that are complementary to the WTO. These agreements are very important in consolidating and deepening trade liberalization and can provide an insurance policy against a resurgence of protectionism. For example, members of the

European Union, such as Belgium now conduct about 80% of their trade under regional and bilateral trade agreements.

As already said, trade tensions are likely to get worse before they get better. The current impasse may persist over many years, but my expectation (or perhaps more accurately, my hope) is that ultimately the international community will avoid a return to the trade wars of the 1930s and to the import substitution practiced in many parts of the world just a few decades ago.

I do not base my cautious optimism on confidence in the capacity of policy-makers to deal comprehensively and rapidly with the issues – I expect that they will do what they can under severe political constraints and, at best, muddle through. I base my hope on the forces that are pushing for a more integrated global economy, and which are becoming stronger with every passing day. The same information, communication and transportation technologies that are disrupting our societies are also bringing firms and consumers closer together irrespective of national borders. In addition, firms and consumers are more aware than ever of the opportunities of arbitrage across the world market in goods, services and capital. In such a world, it is increasingly difficult to separate free trade from individual freedom. History has shown again and again that those that choose to withdraw behind national borders in the face of the twin forces of markets and technology, sooner or later succumb to them