Trust in International Trade

RIETI BBL seminar, 16 July 2026

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Trust seems to be getting more important

- With trade policy uncertainty and the weaponisation of trade

- But what is the nature of trust in international trade?

- Are we moving to a world of trade following the flag?
    - Are trade flows increasingly being determined by geopolitical alignment?

- Central thesis: trust can be a consequence of trade, not its precondition. Institutions determine how cheaply it is produced; their erosion is why exchange is retreating to clubs.

Friend-shoring and trusted countries

Let's build on and deepen economic integration and the efficiencies it brings—on terms that work better for American workers. And let's do it with the ***countries we know we can count on****.* ***Favoring the "friend-shoring" of supply chains to a large number of trusted countries****, so we can continue to securely extend market access, will lower the risks to our economy, as well as to our* ***trusted trade partners****.*

(Janet Yellen, US Treasury Secretary, 13 April 2022)

Image source: IMF

Trusted partners and democratic values

- *Australia's enduring economic partnership with Japan and India — **countries that share Australia's democratic values** and commitment to the global rules-based trading system — will become increasingly important for Australia's economic security and **the resilience of our critical supply chains**.*

(Dan Tehan, Australian Trade Minister, 16 March 2022)

- *They discussed shared interests in diversifying sources of supply and strengthening resilience in critical supply chains, including through **investments in and trade between trusted partners**.*

(Readout of Ambassador Katherine Tai's Meeting with Australian Trade Minister Don Farrell, 26 May 2023)

Image source

Reliable and like-minded countries

- *The IPEF Ministerial Discussion will be the first since September last year…At this time in particular, I believe that building and* ***strengthening supply chains with reliable partners*** *will be the most important theme. I would like to exercise leadership in the discussion so that some agreement can be reached.*

  (Yasutoshi Nishimura, Minister of Economy, Trade and Industry, 23 May 2023)

- *Secondly, we will make efforts to further strengthen* ***cooperative relationships in trade and investment within the G7 and with like-minded countries*** *in order to build robust supply chains.*

  (Yasutoshi Nishimura, Minister of Economy, Trade and Industry, 4 April 2023)

Image source

Trusted and like-minded partners

- *CETA [EU–Canada Comprehensive Economic and Trade Agreement] has cemented our strong relationship with Canada, **a trusted and like-minded partner**.... This is the kind of dynamic partnership we need in today's turbulent geopolitical climate.*

  (Valdis Dombrovskis, EU Trade Commissioner, 21 Sept 2022)

- *And we're strengthening our cooperation with **reliable trading partners globally to reduce the EU's current dependencies** on just one or a few countries.*

  (Ursula Von der Leyen, European Commission President, 16 March 2023)

Image source

How pervasive is the language of “trusted partners”? Creating an index

1. Scrape

Speeches and press releases pulled from official government sites (or archived versions) by ministers responsible for trade or finance.

2. Classify & filter

Keyword search (‘export’, ‘import’, ‘supply chains’, ‘FDI’, etc., in the relevant language) flags trade-relevant documents. Items under 50 words/characters or over 5,000 words are dropped.

3. Score with GABRIEL

Relevant documents are rated against the definition using GABRIEL (Generalized Attribute Based Ratings Information Extraction Library), run on GPT-5.4 (>90% agreement with human coders).

4. Index output

Document-level scores aggregate into a measure of how much official rhetoric promotes organising trade within trusted, like-minded groupings.

Officials currently covered

Trade and Finance Minister equivalent for Australia, Canada, European Union, Japan, United Kingdom and United States

(to be extended to leaders’ speeches and statements)

Existing indexes do not capture partner-based framing

Baker–Bloom–Davis (2016) Economic Policy Uncertainty index
Caldara et al. (2020) Trade Policy Uncertainty index
Caldara–Iacoviello (2022) Geopolitical Risk index

What counts as “counterparty trust” that is a retreat from multilateralism

A document promotes trusted trade if it advocates organising trade, investment, or supply-chain relationships within a preferred group of — or in partnership with — trusted, reliable, allied or like-minded countries, or among countries with shared security or foreign-policy interests.

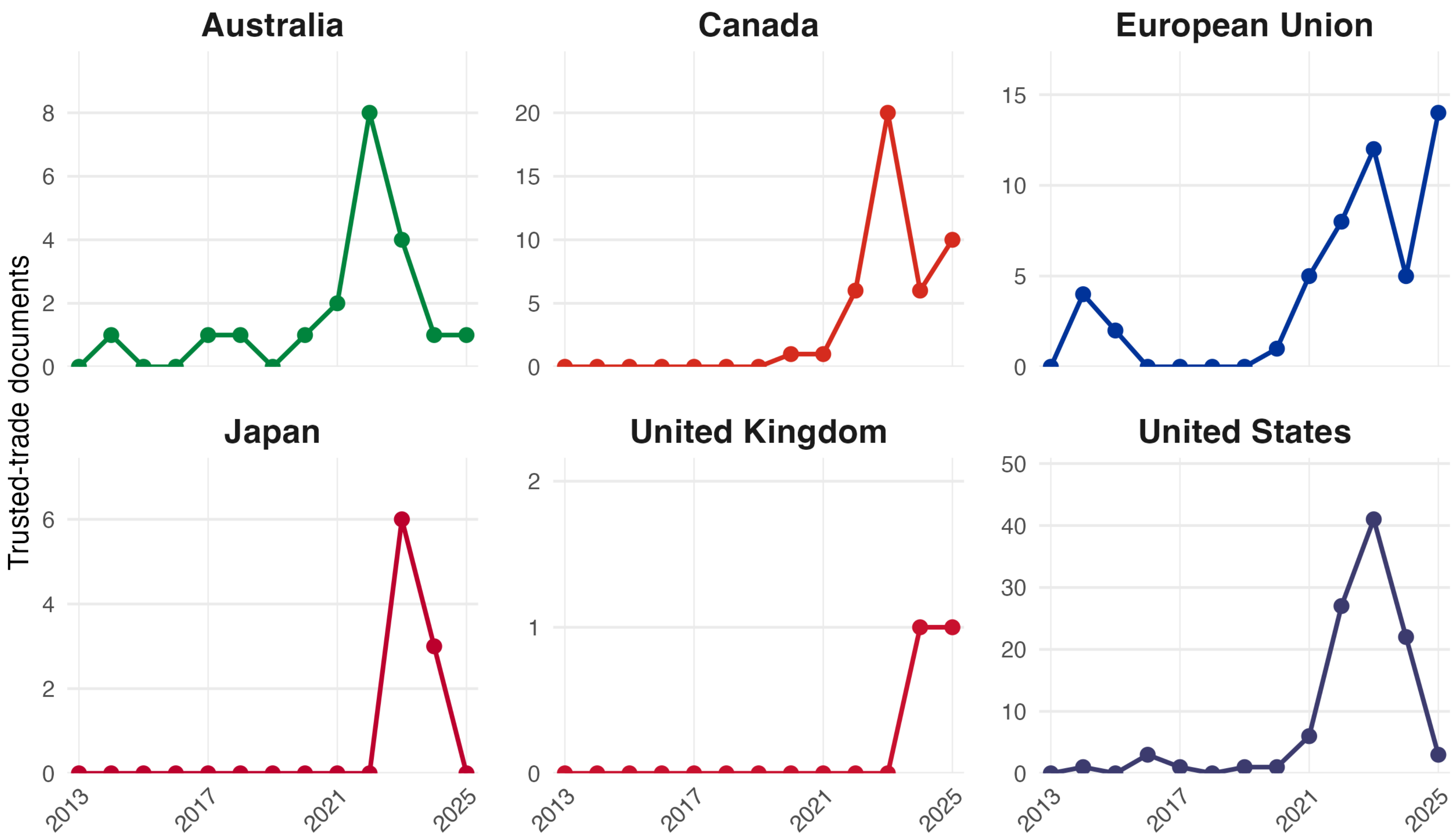
Code 1

- Clearly connects the preferred trade/investment/supply-chain relationship to trustworthiness, reliability, shared values, shared interests, or strategic alignment.
- May frame trade in terms of reducing vulnerability to its “weaponisation” as a tool of coercion by states that do not share similar values or interests.

Code 0

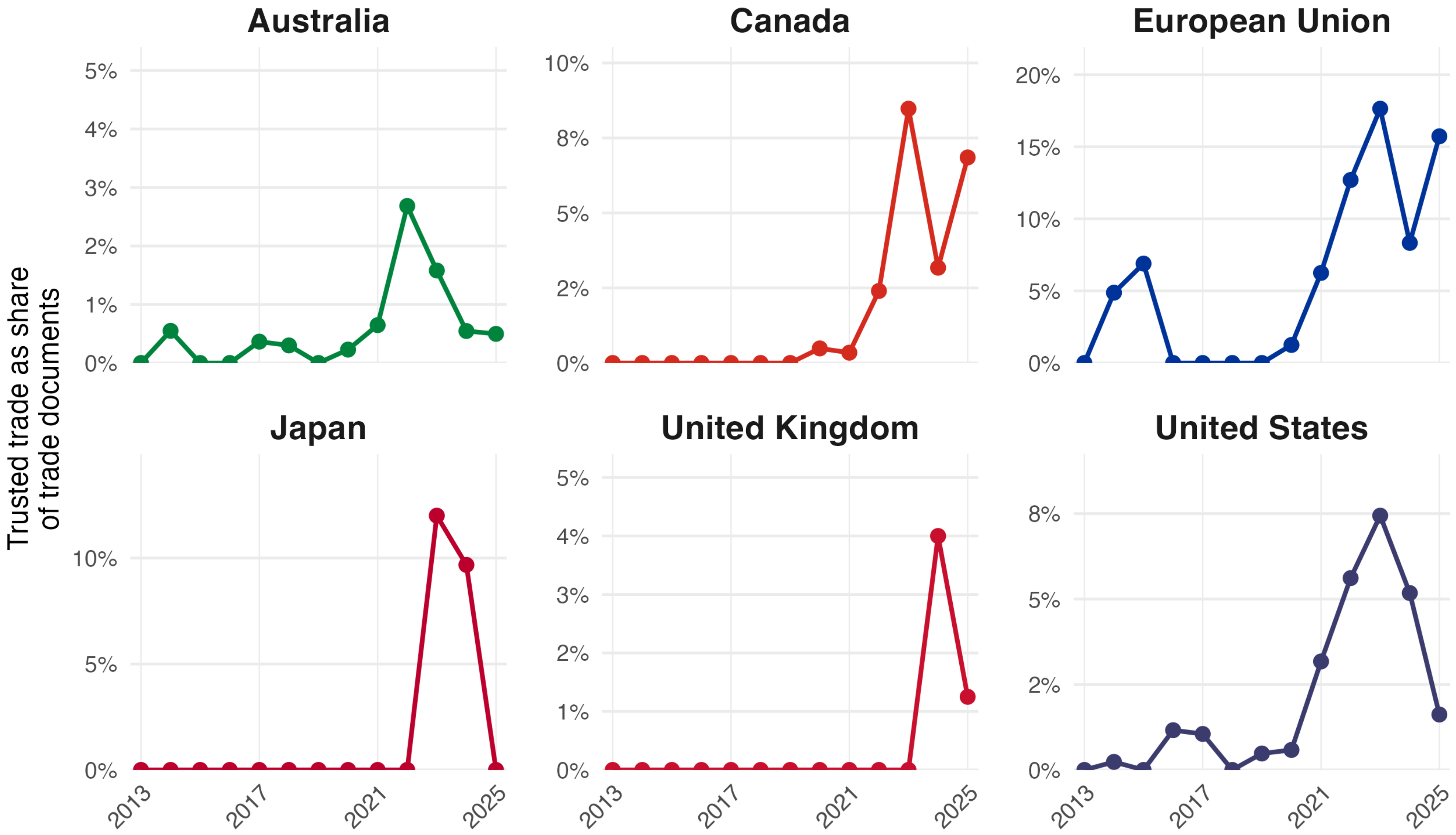
- Does not clearly promote this trusted-partner organisation of trade, investment, or supply chains.
- Mere mentions of trade agreements, free trade, regional cooperation, allies, partners, like-minded countries, diversification, resilience, supply-chain security, critical minerals, economic security, or coercion do not qualify on their own — unless used to promote the trusted-group framing above.

“Trusted trade” documents for G7 plus Australia



Source: Armstrong, Hardwick, Smith and Thapa, forthcoming

“Trusted trade” documents as a share of trade documents for G7 plus Australia



Source: Armstrong, Hardwick, Smith and Thapa, forthcoming

Trust in the rules-based system has eroded

1. **Dispute settlement paralysed**
   WTO rules no longer enforceable

2. **Security exceptions proliferate**
   Article XXI invoked for tariffs on allies;
   export controls expand;
   emergencies look like protection.

3. **Interdependence weaponised**

→

“trusted partners”

“like-minded countries”

“reliable suppliers”

“friend-shoring”

“de-risking”

Friend-shoring and “trusted supply chains” screens partners by flag before trading

A deliberate, first-best redesign of globalisation for a riskier world?

A revealed response to declining confidence in trade rules and institutions?

What can be done build trust in the system again, instead of retreating to ‘trusted trade’ blocs/clubs and trade eventually following the flag?

The costs of a retreat to blocs/clubs

- **Interwar — the canonical fragmentation episode**
  - Policy, not income, drove Britain into imperial preference (de Bromhead, Fernihough, Lampe and O'Rourke 2019); trade and currency blocs reoriented 1930s trade (Eichengreen and Irwin 1995); rising trade costs explain the trade collapse (Estevadeordal, Frantz and Taylor 2003; Jacks, Meissner and Novy 2011).

- **Cold War — alignment-run trade, priced twice**
  - East–West trade far below gravity potential (Hamilton and Winters 1992); inside CMEA, a politicisation premium — implicit Soviet subsidies of roughly US$87 billion over 1960–80 (Marrese and Vanous 1983, contested); alliances shaped trade under bipolarity (Gowa and Mansfield 1993).
  - "The Iron Curtain at its height represented a tariff equivalent of 48% in 1951, trade between East and West gradually became easier until the fall of the Berlin Wall in 1989. Despite the easing of trade restrictions, we estimate that the Iron Curtain roughly halved East-West trade flows and caused substantial welfare losses in the Eastern bloc countries that persisted until the end of the Cold War" (Campos, Heid and Jacopo Timini, 2024).

The costs of a retreat to blocs/clubs today

- **Today — model-based estimates of re-fragmentation**
  - Fragmentation losses of 0.2–7% of global GDP across scenarios (IMF: Aiyar et al. 2023); two-bloc decoupling ≈ 5% of global real income, up to 10–12% in the East bloc, largest for low-income countries (Góes and Bekkers 2022); friend-shoring up to about 4.7% of GDP in some countries (Javorcik et al. 2024).

- **Friend-shoring pays a permanent premium in every state of the world to hedge a rare one — and the poorest countries pay the most of it.**

A taxonomy of trust along 3 axes

(i) the object of trust — a specific counterparty or the institutions that constrain any counterparty.

(ii) its nature — reliability (will commitments be honoured?) or alignment (will trade be weaponised?)

(iii) its direction — trust as precondition for exchange or trust as its consequence.

Two trusts — and the object that matters most

Trust in counterparties

Beliefs about a specific partner: reliability, intentions, alignment.

Built relationship by political and other relationships.
Exclusionary, slow, fragile.

Trust in institutions

Confidence that common commitment to rules and their enforcement constrain opportunism.

Allows strangers to trade.
The substitution behind modern globalisation.

MFN is a depoliticisation device: it makes the flag less relevant to the contract.
(Greif 1993; Milgrom, North and Weingast 1990; Dixit 2003)

A trajectory towards trade following the flag

- Trade following the flag (Pollins, 1989): the limiting case — institutional trust gone almost entirely, trade tracking geopolitical alignment and power directly.

- The end of *seikei bunri*?

- When trade policy uncertainty increases, trade with "friends" increases and falls with "non-friends" (UNGA voting), 1986 to 2019 (Jakubik and Ruta, 2023)

- Political alignment affects expectations about sanctions, export controls, procurement, finance, customs risk, regulatory treatment and future market access (Clayton, Maggiori and Schreger 2023)

The importance of institutions

- Trade agreements and the GATT/WTO: rule-based, third-party-adjudicated systems (dispute settlement) made the question “which flags can we trust?” a second order issue.

- Institutions can thus be perceived as the technologies for reaching (and sustaining) bargains that make all parties better off, but that otherwise could not be achieved — through deliberation, bundling, information provision, enforcement.
- Better contract enforcement allows countries to specialise in more complex, skill-intensive products (Nunn 2007).

- Trust is a consequence of trade. Institutions determine how cheaply it is produced — and their erosion is why the world is retreating to clubs.

Institutions let trade begin without trust

1957

Australia-Japan Commerce Agreement

Twelve years after the war, at a very low prior

- An institutional initiative between recent enemies: the agreement lowered the participation threshold. The treaty did not, and could not, raise trust by itself — the signal effect that validated participation.
- Entry opened the process of building trust. Decades of honest dealings then raised counterparty trust — growing trust increases trade horizons and gains.
- The Commerce Agreement built scaffolding so trade trust could expand. By the 1970s the relationship was an anchor in both economies' trade.
- Trust was a consequence of trading, not a precondition

2020–24: Institutions allow trade to survive destruction of trust

2020

Chinese trade sanctions on Australian barley, wine, coal, lobster — never iron ore

MPIA functioned as a diplomatic and legal off-ramp

- China's trade coercion on Australia collapsed bilateral counterparty trust — and still trade survived.
- The WTO process, reinforced by the MPIA appellate review between parties, helped provide an off-ramp. China removed duties and the disputes were resolved through settlement rather than a completed appeal; iron ore (where there was interdependence or symmetric dependence) unaffected.
- Judicial process delivered what counterparty trust could not (Bagwell and Staiger 1999).
- Adjustment on exposure margins during dispute, not exit: diversification, de-risking, withheld relationship-specific investment.
- Australian appeal to the interim appellate body, won, and restored trade.

Lessons: Moving from clubs back to system of rules

- No need to rely on nostalgia for universal rules nor surrender to pure club power: a real option is to re-institutionalise trust among the willing, without waiting for a multilateral revival that is not coming.

- Clubs may seem the easiest option — with higher counterparty trust among the like-minded — but is beset by three pathologies: exclusion, discrimination, and fragmentation into rival blocs which have high economic and political costs.
  - Negative security externalities will dominate positive security externalities

- So the strategic policy design question is: what will define a club that steps back toward an enforceable system of rules rather than steps into a bloc?

Criteria for clubs to move back to multilateralism

- Open accession
  - Is membership earned by meeting standards (open) or granted by identity/geopolitics (closed)?
  - Geopolitical veto on CPTPP membership hardens CPTPP into closed club that militates against entrenchment of global rules

- Non-discrimination against non-members
  - Open regionalism

- System of rule-enforcement for members
  - MPIA reconstructs appellate enforcement among the willing

Clubs that widen, clubs that wall

- A club that builds internal trust by raising barriers to outsiders rebuilds enforcement locally but lowers it system-wide: bloc formation dominates rule-making and enforcement.
- The three criteria: open accession, non-discrimination, and independent dispute settlement for rule enforcement mark the difference between the clubs that widen and clubs that wall.
- Trust will not return in any perfect universal-rules form — it was never perfect anyway. The real choice is between clubs that widen back toward courts and clubs that wall. Only the first rebuilds what was lost.