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Global Future Council on the Future of International Trade and Investment

Strategic Brief for the Annual Meeting of Stewards of International Trade and Investment

From Bad to Worse?

The Case for Arresting the Slide in Global Trade Cooperation

Amid growing discontent over globalisation, the outlook for global trade cooperation is darkening, with very serious implications for economic growth, peace, and stability. Below we set out a diagnosis of the problems, and three brief, derivative, scenarios outlining how the future could unfold. We hold to the optimistic scenario and, in this light, the document is intended to be a "call to arms" for the World Economic Forum's Global Trade Stewards, and to governments and business at large.

Two years on, a very different picture for trade

In August 2015, the last World Economic Forum Global Agenda Council on Trade and Foreign Direct Investment published a paper on the challenges facing the world trading system. The biggest issue on the radar screen was 'mega-regional' trade agreements. Prospective deals involving leading economies, like the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership, had the potential to unleash new commercial opportunities and inject new energy into global trade diplomacy. But they also came with risks: fragmenting economic governance, and further isolating countries already stuck on the margins of international trade and investment.

Today the trading system confronts a very different set of challenges. Not the rise of possibly disruptive new pillars of trade governance, but the erosion of the international economic system that has underpinned decades of peace and prosperity. Not the spectre of exclusionary approaches to lowering non-tariff measures, but that of the deliberate introduction of discriminatory trade barriers. And this at a time when trade growth has almost ground to a halt: whereas global trade values grew twice as fast as global GDP in the three decades up to 2008, they have since underperformed GDP growth.

Two and a half years ago, failure to agree or ratify mega-regionals might have meant forgoing further liberalisation, but keeping the status quo. Today we face the risk of a permanent shift backwards: from a "rules-based system" generally respected by all, to a "deals-based system" in which powerful countries look to stretch or even break the rules to maximise national advantage, at the expense of weaker players.

Cooperating on trade is harder than it used to be. Twenty years of deep structural change in both advanced and emerging economies have complicated the politics of jobs, growth, and making compromises in international negotiating fora. The shifting balance of global economic power – itself partly a product of the open global economy's success – has produced what was dubbed a 'G-Zero world' at Davos 2011. Even if the last twenty years have seen the largest ever reduction of worldwide extreme poverty and the reduction of inequalities among countries – enormous achievements in their own right, within-country inequalities have increased in many parts of the world and one in ten people still lives in extreme poverty. The share of wealth held by the richest 1% in the world rose from one third in 2000 to one-half in 2010, while at the same time real wages grew at the slowest rate in the last 100 years.

The 2008 global financial crisis has played a major role in these developments. Pre-crisis public dissatisfaction with globalisation was not a major factor, at least in the developed world, as economies were growing rapidly and unemployment was low. Thus the need for politicians to find scapegoats for domestic ills was much lower and trade and investment liberalization could be countenanced. Post crisis the legitimacy of capitalism itself is much more in question, and particularly the financial sector, which lay at the heart of the problems. The global economy has only recovered sluggishly, and many existing structural problems have become much more apparent. In many parts of the world, trade, one of the engines of the global economy, has become a lightning rod for the deficiencies of our globalised world, fuelling public scepticism and even outright antagonism. .

There is an obvious need to keep improving the trading system and the manner in which trade works. Yet if governments start to go it alone on trade, it will become harder, not easier, to generate the jobs and rising incomes that angry electorates want. Inward-looking trade policies inevitably discriminate against trading partners, who will retaliate with inward-looking policies of their own. The singular lesson of the 1930s is that such zero-sum approaches lead to trade wars, economic stagnation, and, ultimately, conflict. The consequences today would be graver given our higher degree of interconnectedness and economic integration. And for the poorest countries, a less open global economy would close off chances to trade their way out of poverty.

A backlash foretold?

Some opposition to trade is not new, from traditional import-competing interests to more nuanced critiques about how trade opening would cause a 'race to the bottom' in environmental or labour standards and more generally in addressing non-tariff measures.

What is new is that opposition to open markets, which attracted small if non-negligible constituencies in most advanced economies, now appeals to groups sufficiently powerful to deadlock political debate and even swing election results. The social licence on which open markets rest has, in several advanced economies, become fragile if not broken. Why?

Neglect by policy and business elites of the imperative to accompany trade liberalisation with flanking domestic policies is clearly one reason. Economists' models plainly predicted that market-opening in advanced economies would diminish wages for relatively unskilled labour, and hurt some sectors while benefiting the economy as a whole. But too many leaders were not frank about the unequal distribution of benefits, and policy did too little to remedy downward pressure on incomes or equip people to upskill, adjust and join in the new opportunities being created. Anxiety over job offshoring, wage stagnation and rising inequality in many developed economies led to an overall sense of relative decline and a believe that the next generation would be worse off.

Other factors behind the anti-trade sentiment are only partially related to globalization, but lend themselves to scapegoating trade. The most important example is automation: it destroys an estimated four jobs for every one lost to trade, but imports are easier to blame than technological innovation.

For many people in the developed world, the perception of diminishing economic prospects combined with discomfort about the pace of social change, and fears - whether real or perceived - about immigration, have created a sense of threatened identity, and receptiveness to the false notion that erecting boundary walls, including walls blocking trade and investment, could turn back the clock.

Ironically, the growing backlash against trade, and globalization more generally, in the developed world is taking place at a time when faster-growing regions and countries in the developing world are increasingly embracing it. Since the developed world still constitutes the bulk of global demand, increasingly inward-looking policies there threaten development prospects of the developing world, and may encourage reversals in policy outlook – towards protectionism – that would compound the problem.

Turning back the clock is impossible, blowing it up, however, is not

It is true that global merchandise trade in value has been roughly flat for two years, a collective result of sluggish GDP growth in major economies, the fact that local-sourcing within value chains has accelerated in various regions, especially in Asia, and the accumulation of small-bore trade-restricting measures since 2009.

But policy is not the only determinant of trade, and merchandise is hardly all that is traded. Services trade continues to grow, and new services are becoming tradable thanks to advances in communications. Digital trade reaches record highs every day, contributing to innovation, growth, and jobs. While cross-border capital flows are down, knowledge-intensive and long-term direct investment has held up well. Even some of the slow merchandise trade figures are due in part to weak commodity prices. The global value chains operated by many multinational corporations will continue to underpin international trade flows, even as they reorganize in response to policy and structural changes. So globalization, in many important senses, is likely to continue in the upcoming years.

Technology, too, appears set to keep increasing productivity – both creating and destroying jobs, as it has since the dawn of the industrial age. Today, the driverless cars and intelligent machines of the Fourth Industrial Revolution threaten to replace entire classes of jobs, from truck and taxi drivers to lawyers, while also promising to create new ones in programming and innovation. This accelerating transformation will demand smart political and institutional responses.

Finally, higher growth rates in many, though not all, emerging markets means that the global rebalancing of economic and political power is set to continue.

This is no counsel of complacency. History reminds that we are capable of policy errors on a scale that can overwhelm the effects of technological progress.

Three futures for trade, 2017-2020

There is a high degree of uncertainty over how the upcoming years will unfold. Protectionist rhetoric may amount to little more than harsh words; alternatively, it could become a template for policy. The Council on the Future of International Trade and Investment has identified three potential medium-term scenarios. These are framed in terms of the famous Clint Eastwood film: The 'good', the 'bad', and the 'ugly'. As this framing suggests, and the preceding diagnosis confirms, on balance the prognosis is darkening, but it is not too late to arrest the slide. We provide some ideas towards this end in the first scenario.

1. The 'good'

Under our first, and most positive scenario, governments would follow Thucydides' dictum[1] and act to stabilize and reinforce the trading system.

Much of this agenda is domestic. One key pillar would be major investments in education, skills and vocational training, as well as active labour market policies to empower citizens to benefit from and to adjust to rapidly changing labour markets. This is critical in developing countries, too, where the disproportionate accrual of income to the relatively rich may be sowing the seeds of a future anti-market backlash. Development assistance has a role to play here, particularly for the poorest countries that cannot afford the requisite investments. The developed world has a strong interest in ensuring favourable developmental outcomes in poor countries, not least to discourage mass migration – itself a major source of the populist backlash in the developed world.

Another pillar would be across-the-board interventions to soften the blow of under- or un-employment - whether due to trade, technology or unfair domestic policies. Those interventions – range from wage top-ups and insurance to a serious look at universal basic incomes. Improvements in citizens' purchasing power would provide a clear signal of a fairer globalisation. Again, every effort should be made to support the poorest to adjust.

This agenda will not come cheap, and would require more progressive taxation. International cooperation to curb corporate tax avoidance would help raise revenue from some of globalization's biggest beneficiaries, namely multinational corporations. At the same time, competitiveness reforms and improvements in the business climate at home could help boost growth, attract investments – especially in infrastructures - and improve productivity.

On trade policy itself, while political circumstances are not conducive to ambitious new initiatives, there is scope for governments to address specific issues through "pragmatic incrementalism". In the WTO this could include bringing the Trade Facilitation Agreement into effect, taking steps to address major distortions in subsidization of agriculture and fisheries, making a start on potential rule-making to ensure e-commerce can flourish across borders, and building on current discussions to cut trade barriers on environmental goods and services. In doing so, priority should also be given to addressing trade policies that exclude the poorest countries from the global marketplace. At the same time a number of on-going bilateral and regional trade agreements could be concluded.

Lowering the costs of trade and supply-side action to support small and medium-sized firms reach customers around the world would help spread the benefits of trade more evenly. As would reforms to empower women to be equal participants in the economy and in trade. In poorer countries this goal would benefit from directing more development cooperation to building supply-side capacity and investment-friendly domestic policies. Not as a charity, but as a matter of self-interest.

Finally, there is need to ensure greater international and domestic economic policy coherence. The United Nations Sustainable Development Goals provide a useful blueprint for that. They clearly recognize trade and investment as engines for global growth, key to achieving the goal of ending extreme poverty by 2030.

Above all, 2017 should be the year when "honesty" is placed at the heart of the political and economic discourse. When nationalism and populism is replaced by honesty and pragmatism.

2. The 'bad'

This scenario would be marked by an increase in negative rhetoric and unilateral approaches to trade. At the domestic level we would see frequent use of measures from tax arrangements, to competition policy, and more traditional trade instruments such as local content regimes, import safeguards, anti-dumping and countervailing duties, and tariff increases within legal limits. Such instruments will be employed in the name of 'strategic industrial policy'. They will stop short of deliberately flouting WTO obligations, at the same time as exploiting loopholes in WTO disciplines.

As for bilateral and regional trade agreements, violations could become widespread; unilateral changes introduced, re-negotiation forced or they may even be unilaterally revoked.

Overall, politically contentious trade disputes would multiply, leading to the outbreak of mini 'trade wars' amongst key players, weakening the multilateral trading system. While some countries and regions could continue to move ahead with trade and investment integration, such as the conclusions of deals such as the Regional Comprehensive Economic Partnership, the European Union's prospective agreement with Japan, or the Continental Free Trade Agreement in Africa, new global trade agreements would diminish, potentially trickling to a halt.

In this world, clumsy attempts to tilt the playing field in favour of domestic producers would likely end up hurting their competitiveness by compromising access to know-how, components and support services. Some long-established multi-country supply chains would be interrupted, with productivity suffering as a result. Uncertainty and costs for investors and consumers would increase substantially. This would act as a drag on international economic growth, exacerbating inequality within and between countries. International institutions, which helped governments coordinate policy and keep markets broadly open through 2008-09, would become much more susceptible to breakdown in the event of a broad economic downturn and, in a multipolar global economy, system leadership would be very much in question.

1 Two thousand five hundred years ago Thucydides wrote the *History of the Peloponnesian War*. This era was characterised by the emergence of the first inter-governmental multilateral structures to manage international foreign and economic relations. These served the region well until they were fractured and eventually destroyed by the two major powers who perceived that these structures were not in their self-interests. Within a decade the collapse of these multilateral structures led to the eclipse and long term decline of both powers. The lesson from Thucydides then is clear. Maintaining prosperity, stability and security requires a cooperative environment in which countries secure their national economic interests through multilateral processes that facilitate partnerships – not rivalries. In short, misjudge the value of multilateralism and the consequences are profound.

These negative economic and political outcomes would compound populist politics and reactions, potentially promoting a downward spiral into scenario three.

3. The 'ugly'

This scenario would be marked by unconstrained tit-for-tat and major 'trade wars' among leading economies, targeting countries or companies for unilaterally determined offences, such as currency manipulation or offshoring jobs. It could go as far as institutional breakdown, with countries even choosing to leave the WTO.

It is difficult to overstate the extent to which this return to pure power politics in international economic relations would represent a break from the past 70 years of rule-based integration. Major costs would be imposed on investors and consumers alike. The cost of doing business would rise, with production forced to de-globalize. Purchasing power would decline. Poorer countries would be severely impacted with migratory pressures increasing. Political downside risks would be large and long-lasting.

As we argued in the 2015 report, this scenario – which we then called 'crumbling blocks', would be very detrimental to global security, creating powerful negative feedback loops between an increasingly contested geopolitical terrain and trade arrangements exercised through raw power. It is difficult to overstate just how insecure the world would become, and how negatively this, and potential open armed or virtual conflict between the major world powers, would affect the very ills that have given rise to populist politics. Thus the politics of populism would be likely to be at best self-defeating, at worst highly destructive.

Concluding Appeal

Since we have used Hollywood to frame the scenarios sketched out above, we wish to conclude by invoking Star Wars, and appealing to global leaders to turn away from the dark side of trade – protectionism – and return to the enlightened side of forward-looking good trade set out in the optimistic scenario. We hope the international community will choose reason over friction, collaboration over conflict, multilateral over unilateral. In short, we hope for responsive and responsible trade and investment policies.

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