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Four Scenarios for the Future of Trade and Investment

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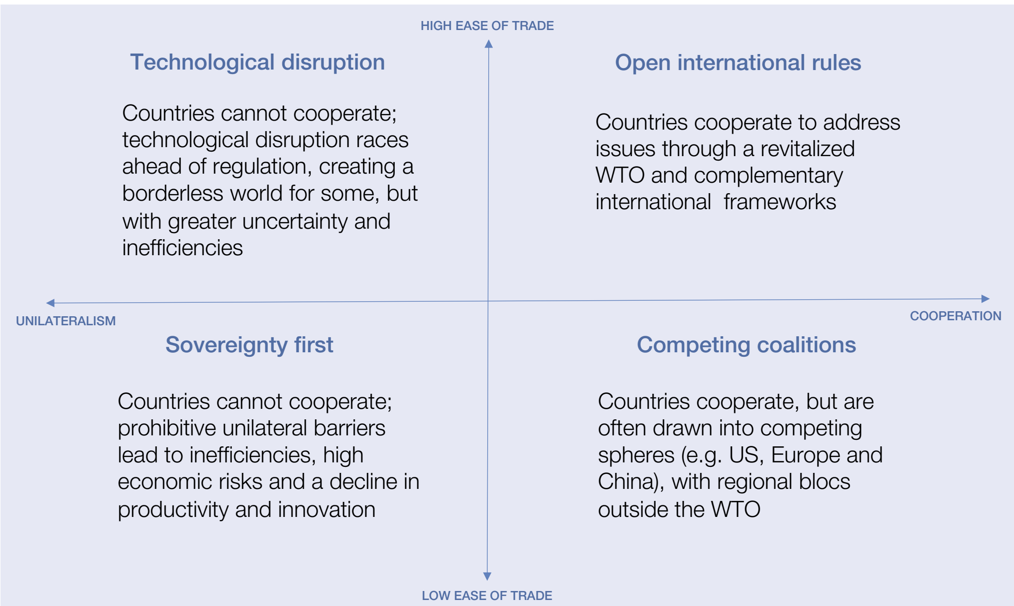
The views expressed in this paper are those of the Global Future Council on International Trade and Investment and not necessarily the World Economic Forum.

The global policy outlook for trade and investment has darkened over the past year. Trade conflict has proliferated, structural challenges remain and business sentiment has dampened. There is an urgent need for leadership to stop a potential slide into economic conflict that might undermine global growth and stability. This briefing highlights four stylized scenarios that the world might move into in the near-to-medium term and flags the risks and opportunities associated with each.

Geopolitical tensions have coupled with rising domestic discontent over globalization in some countries, calling into question the functioning of global economic institutions. The tariff has returned as a policy tool for managing trade relations, triggering tit-for-tat retaliation that risks spiraling into unconstrained protectionism and putting the World Trade Organization (WTO) at risk. Some underlying drivers of these developments have to do with the global technological race,



uncertainties associated with China's economic rise as well as mounting nationalism and populism in many parts of the world.

While the United States and China have made efforts to negotiate a truce to the ongoing trade confrontation, the reliance on unilateral and bilateral mechanisms raises the risk that the world might be moving towards a power rather than rules-based approach. Uncertainties associated with these geo-economic tensions have already had a negative impact on business and investor confidence, with potentially large and protracted disruptions to the operation of global value chains.

Some moves have helped the world avoid what the Council called the "ugly" trade set-up in its 2017 briefing. The Comprehensive and Progressive Agreement for Trans-Pacific Partnership came into force in the final days of 2018, signaling continued resolve among major economies to deepen integration and address 21st-century governance issues such as digital trade, state-owned enterprises and environmental protection. The European Union-Japan Economic Partnership Agreement, covering one-third of global gross domestic product, will follow suit in early 2019, as will the Africa Continental Free Trade Agreement, while the US-Mexico-Canada Agreement – the revised version of the North American Free Trade Agreement – was recently signed. Additionally, in the midst of WTO turmoil, the US, the EU and Japan are engaged in a trilateral conversation to address key trade governance concerns. Various other groups of economies are also spearheading initiatives to modernize global trade rules.

At the same time, technological innovation continues apace. New technologies such as 3D printing have the potential to re-organize the entire manufacturing process, while the applications of artificial intelligence continue to expand, with the possibility of radically transforming entire sectors – including in ways not yet envisioned.

Where might these various forces lead us? Are we headed for a normalization of trade wars, or will state leaders find a way to maintain cooperative arrangements? Will these cooperative arrangements be in the form of open frameworks or exclusive clubs? How might technological change interact with broader geopolitical dynamics to shape the future of global trade and investment?

Our four scenarios are designed to prompt reflection on key geopolitical and economic variables. Geopolitically, this includes whether major countries choose to cooperate on trade and investment or opt for a "unilateral" path; and economically, whether businesses experience low or high ease of trade. The latter should be taken broadly to mean how easily goods, services, capital and people move across borders. Each scenario has been deliberately drawn in stark terms to sharpen the risks and trade-offs involved – reality may end up somewhere in between or a combination of parts.

Table 1: Value of bilateral trade targeted by additional tariffs

United States	**China**
$253 billion	$113 billion
United States	**EU**
$3 billion	$7 billion
United States	**Canada**
$12 billion	$13 billion
United States	**Mexico**
$3 billion	$3 billion

Source: Based on data from Palmer and McClure, September 2018.

HIGH EASE OF TRADE

Technological disruption

- Low barriers but unilateral competition creates inefficient, unstable global environment
- Fragmented data governance raises cybersecurity risks; first mover advantages create IP, economic espionage incentives
- Power-based resolution of trade/investment conflicts create uncertainty, raising costs, lowering investment flows and productivity
- High costs for SME entry in some technologies
- Pockets of high innovation; winner often takes all

Open international rules

- Reformed, revitalized WTO, including flexible multilateralism and plurilateral arrangements
- Deeper cooperation addressed through complementary preferential trade agreements
- Low barriers and predictable rules facilitate efficient allocation of investment across value chains
  Rules-based transparent, speedy conflict resolution
- Global cooperation on data flows and cybersecurity
- Continued innovation and global growth, with productivity gains

UNILATERALISM

COOPERATION

Sovereignty first

- "Normalization" of trade wars with trade and investment used as geostrategic weapons
- Unwinding of cooperative arrangements lead to disrupted GVCs and fragmented markets
- Rising barriers to innovation and cross-border knowledge transfer, drop in investment flows and business confidence, productivity decline
- High consumer costs, unemployment and social unrest
- Heightened risk of international conflict with no means for orderly dispute resolution

Competing coalitions

- Deep structural rifts in global economy create closed, "fortress-like" regional trading blocs around larger economies
- Fragmented value chains due to political management of trade/investment flows
- Bifurcated investment flows (China vs US, Japan, EU)
  Three worlds of data governance (US, EU, China)
- High costs of "switching" across regional blocs
- Negative impact on innovation and long-term productivity

LOW EASE OF TRADE

1. Open international rules

In this, the most optimistic scenario, countries come together to cooperate, and trade flows move easily across borders. Major economies jointly commit to address points of conflict and new regulatory challenges that spill across borders through multilateral frameworks. Countries engage in serious collaboration to revitalize the WTO, with significant contributions from advanced and larger emerging economies. Action is taken on major issues: optimizing the negotiating function to modernize trade rules; minimizing distortions created by unfair subsidies; emergent areas such as digital trade; unresolved issues in liberalization, for example, in agriculture and services; the WTO's monitoring role; and the dispute settlement mechanism.

One way for the WTO to effectively address such a daunting policy agenda is through a more flexible multilateralism. This means building in policy space for a subset of WTO members to pursue deeper cooperation in select issues through open plurilateral arrangements – as was done with the expansion of the Information Technology Agreement – complemented by WTO-consistent preferential trade agreements. Major cooperative efforts would be placed on strengthening mechanisms for conflict resolution, ensuring that processes are not only expeditious, but also rules-based and transparent. Importantly, international cooperation is also accompanied by domestic measures to make trade more inclusive and sustainable.

Alongside these WTO reforms, public and private stakeholders cooperate across different international platforms to strengthen existing mechanisms for investment flow governance. Stronger cooperation lowers market uncertainty and reduces production barriers, facilitating the efficient allocation of capital across global value chains. Likewise, trade policy-makers build cooperative mechanisms with other policy communities on relevant issues, including data flows, cybersecurity and the environment, laying coherent global governance foundations for innovation, growth and productivity.

2. Competing coalitions

This scenario contains some features that closely match the situation the world has been drifting towards. Here, countries engage in cooperation, but much of it is shaped by emerging deep structural rifts over the appropriate role of the state in governing inter-related issues: data flows, investment, and, in particular, advanced industrial technology that holds national security applications. Amidst these differences, trade and investment flows are shaped by political intervention rather than price signals, and pressure comes to bear on multinationals to restructure and localize value chains.

Considering the impossibility of making progress in the WTO context, multilateral networks are supplanted by closed regional trade and investment blocs. The fortress-like nature of these arrangements stands in contrast to the plurilateral arrangements highlighted in the previous scenario, which were open and inclusive, and to preferential trade agreements aimed at deepening trade cooperation in ways complementary to the WTO.

These structural rifts could have a profound impact on investment due to heightened concerns over the geopolitical and security implications of investment from countries such as China. As a result, investment flows become bifurcated between those from China and those from other economies such as the US, the EU and Japan. The movement of information across borders is also subject to three divergent governance regimes: the US approach grounded in principles of unimpeded data movement; the European perspective that more heavily emphasizes issues of privacy and consumer protection; and the Chinese view anchored around cyber sovereignty.

In this scenario there is high risk that some regions – such as sub-Saharan Africa, South-East Asia and Latin America – and global businesses become caught in between different spheres of influence. In a zero-sum dynamic, individual countries might come under pressure to lean towards one bloc over another, with negative repercussions for geopolitical stability, economic development and global governance. Long-term economic uncertainty deepens, and with weak mechanisms for speedy or rules-based dispute resolution, commercial disputes become more frequent. While trade and investment barriers *within* blocs might be low, there are high frictions associated with moving *between* one bloc and another, leading to high "switching costs" for firms with an international footprint. Such closed economic networks are likely to generate substantial barriers to innovation and knowledge transfer, with a negative impact on productivity and technological progress.

3. Technological disruption

In this scenario, unilateral action dominates over country cooperation, but technological innovation races ahead of regulation, potentially creating a borderless world for some but also wide-spread uncertainty and problems for others. In this world of firm-led disruption, there are pockets of radical innovation with the potential for winner-take-all profits. There is a danger, though, of a distorted playing field for small- and medium-sized enterprises, with high barriers to entry in some technologies – notably those with high fixed costs or that are capital intensive – and greater fragmentation in the global economy.

While the potential benefits from being a first-mover in any given industry would be outsized, these advantages combined with the lack of strong mechanisms for intellectual property (IP) protection generates incentives for IP theft and other forms of economic espionage. Fragmentation of regulatory frameworks for data flow governance also raises cybersecurity risks and costs.

Given such uncertainties, investment flows that are dependent on long-term predictability are likely to be dampened. Small businesses and consumers in weaker economies will probably not have access to the latest technologies and services. Conflict between governments based on power considerations in trade and investment may also increase. Without multilateral options for rules-based dispute resolution, differences will be settled on power considerations, generating yet more uncertainty and higher business costs.

4. Sovereignty first

In this scenario, unilateral action again dominates over cooperation, with a high frequency of economic conflict leading to a "normalization" of trade wars between major economies. Trade and investment issues become political weapons in broader geopolitical competition, unleashing tit-for-tat retaliation that cannot easily be de-escalated or contained. The uncertainty and instability associated with entrenched economic conflict has harmful effects on investment flows and business confidence. Under such circumstances, firms are likely to find themselves facing high barriers to engaging in innovation and knowledge exchange. Existing global value chains face deep disruptions, potentially even leading to reshoring or de-globalization.

The global economy slides into protracted decline, creating major domestic challenges for most countries. These challenges include higher costs for consumers and elevated levels of unemployment, as well as domestic unrest. As many societies, including major powers, turn inwards to deal with domestic crises, populist and protectionist sentiments may lead to heightened risks of international conflict. The retreat into unilateralism would reinforce the lack of options for orderly dispute resolution at the international level, generating dangerous feedback loops that further deepen the risks of long-lasting economic decline.

Questions to consider

- What actions are required to de-escalate trade confrontations, engage in renewed rule-making and strengthen WTO dispute settlement?
- What indicators would signal a movement into one scenario versus another, and what warning systems could be put in place?
- In an increasingly power-driven trade landscape, how do we ensure that priorities of all countries, including those of the least developed, are addressed?
- What actions can we take to ensure that small and medium enterprises remain globally competitive?
- What roles can the private sector play in working with governments to avoid highly disruptive trade and investment scenarios?
- What domestic measures are required to defuse protectionist pressures and support greater international trade cooperation?

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