INTERNATIONAL TRADE: FIRST PRINCIPLES FORGOTTEN

The G20 is concerned about the global financial crisis, but weaknesses in the multilateral trading system are also relevant, warns **David Robertson**

International trade has been a neglected topic during the global financial crisis (GFC). The G20 meetings summoned to deal with the collapse of financial markets have focused on the immediate effects on banks, businesses and budgets, as they should. However, their communiqués have scarcely mentioned trade or the hiatus in the World Trade Organisation (WTO) Doha Round negotiations. Yet reviving international trade is crucial for economic recovery.

The trade collapse

The effects of the GFC on international trade flows have been deep and pervasive. World merchandise exports in 2009 were 15% below the 2007 level in volume. This represented the biggest decline in global trade volumes since the General Agreement on Tariffs and Trade (GATT) was created in 1948. The only other serious trade recession was a 7% decline in trade volume in 1974–75 after the oil crisis.

The GFC caused synchronised reductions in the imports and exports of most countries. Modern supply chains, linked by efficient communications systems, quickly brought bad news to markets, consumers and producers. Paralysis in the financial sector suspended trade credit and banking services, leading to immediate reductions in output and shutdowns.

About 80% of world merchandise trade comprises manufactures that are consumed or represent investment for future production; both these activities can be deferred if economic circumstances change. However, around 80% of national expenditure in developed countries (OECD) is spent on services. Hence, postponing 1% of national expenditure on imported manufactures represents a 4% reduction in merchandise imports. On the other hand, postponing 1% of purchases of services reduces national expenditure by 1.2%. Hence, when times get difficult (such as a change in sentiment caused by the banking crisis), an expenditure multiplier ensures that trade declines faster than output. Discretionary expenditure declines first when times get difficult. Hence, merchandise trade declines faster than GDP in uncertain times.

In commodity markets, supplies respond to prices in the previous year, which means that prices fall when current demand declines. In 2008, demand for commodities (food, fuels, materials) collapsed when trade financing dried up.

In 2008, these reductions in trade flows affected most countries and all product categories. Europe and North America recorded the largest reductions in both imports and exports. In the fourth quarter of 2009, one year after the GFC, trade began to recover with small increases in shipments of chemicals, telecoms and transport equipment. This slow improvement continued in 2010.

Leading OECD economies (Germany, Japan, the Netherlands) continued to recover in the first half of 2010, based on increased exports

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and moderate reflationary expenditures. Major non-OECD economies (China, Brazil and India) continued their rapid development and healthy trade accounts throughout the GFC. Encouraged by these statistics, the WTO Secretariat released a revised, and probably optimistic, forecast that global trade would increase by 13.5% in 2010. This forecast is not consistent with recent modest economic projections from the OECD and European Community forecasters.

Many OECD countries still face adjustments to financial sector re-structuring, while fiscal and external deficits impose restraints on government policies. The United States and many EU countries are still struggling with rising unemployment and economic stagnation, even as they attempt to correct external imbalances. In these circumstances, global economic recovery will continue to depend on the new dynamic economies in Asia and Latin America. Unusually, many developing economies in Africa have also continued to grow through the financial crisis, though more slowly than in the 2006-08 period.

Support for liberalism could weaken irredeemably as WTO members continue to pursue discriminatory RTAs.

Trade relations

The WTO/GATT treaties have been the guiding influence on trade relations for more than 60 years. However, these agencies have been neglected during the past decade. The GFC is not solely a financial and banking problem. It has a structural economic aspect that presents itself as inequalities and inefficiencies. That means that WTO agreements should play a role in liberalising agriculture and protected manufacturing industries. Notably, motor vehicle production has been widely supported in OECD economies since the GFC presented. Trade protection distorts industry structures and disadvantages low-income workers. The Doha Development Round negotiations—about to enter their tenth year—offer an immediate opportunity to liberalise industrial and agricultural trade. At the recent Seoul G20 meeting, there was reference in the communiqué to 'a critical window of opportunity in 2011 to conclude the Doha Development Round negotiations'.

Regional trade discrimination using bilateral/regional trade arrangements (B/RTAs) is now the principal instrument used in trade relations. This abuse of GATT Article XXIV (Customs Unions and Free-Trade Areas) and GATS Article V (General Agreement on Trade in Services, Economic Integration) is vouchsafed by common neglect of the WTO Council, and acquiescence from the WTO Secretariat. As long as the Doha Development Round remains suspended, freedom to abrogate traditional GATT rules passes unremarked.

There are three potential accords that could move the Doha Development Round negotiations forward and enable international trade to contribute to economic recovery:

- The return to basic principles of multilateralism (most favoured nation (MFN) treatment), reciprocity and tariff binding;
- The re-adoption of GATT Article XXIV by the WTO General Council to discipline B/RTAs to reduce discrimination; and
- The re-opening of Doha Development Round negotiations with the aim of reaching an agreement, drafted to take advantage of the areas where consensus can be reached.

These steps would re-establish some order in international trade relations.

From its beginning in 1948, the driving force behind the GATT was always the United States, supported by a group of independent, high-income countries (Britain and the Commonwealth countries, supplemented by the Nordic countries). Other West European countries (and now the whole of continental Europe) were distracted by plans to establish a single European Market. After the last effort to accommodate economic globalisation in 'the single undertaking' adopted in the Uruguay Round (1987–94), even US authorities recognised that more comprehensive approaches were necessary to cater for new international forces.

The complexities in the Uruguay Round Final Act (1994) left many uncertainties and dissatisfactions, and facilitated non-compliance that immediately threatened the viability of the WTO. The Doha Accord was adopted in 2001 to resolve a catalogue of grievances, misunderstandings and disputes, as well as to address development opportunities. The Doha commitments were undertaken hurriedly in the shadow of the 9/11 attacks in New York. In retrospect, this was unwise because the tally of non-OECD demands were not carefully assessed. Good intentions were quickly tested and the negotiations became turbulent and confrontational.

Now the stakes are high and the WTO itself is threatened. Many governments are challenging the system (the European Union, Japan and the BRICs, as well as developing countries). Some officials believe that a minimalist accord should be reached in the Doha Round as soon as possible to salvage the WTO system.

Unfortunately, these challenges are occurring when the United States is dealing with its worst economic crisis in 75 years. The Democrat administration is markedly protectionist, just when the US trade deficit is a major concern. US negotiators continue to protect domestic agriculture while opposing the special measures of protection demanded for agriculture by countries such as India, Indonesia and Brazil.

Yet, there is no other country to take the lead. The European Union is following its usual mercantilist trade policy, using interventionist regulations based on the precautionary principle and harmonised laws, while pursuing bilateral trade agreements rather than multilateral liberalisation. Japan remains mercantilist and isolated. It is too early for China to relinquish its pre-occupation with economic development. India and Brazil are rising giants, but both are vulnerable to unfamiliar international storms. Thus, the quest for trade liberalisation and structural adjustment leaves the WTO vulnerable.

At the most recent meeting of senior WTO trade officials from 19 countries, in Paris in June, surprise was expressed at the 'seriousness and depth' of continuing differences among WTO governments. That meeting declared that ambitions on agriculture and manufactured products must be settled before other concessions could be discussed. Serious negotiations are unlikely in 2010.

Unless progress can be made next year (the tenth year of Doha Round negotiations), support for liberalism could weaken irredeemably as WTO members continue to pursue discriminatory RTAs.

Bilateral/Regional Trade Agreements (B/RTAs)

Ostensibly, there are two motives for the increasing popularity of B/RTAs since the closing stages of the Uruguay Round negotiations:

- The conditions attached to GATT Article XXIV have never been applied as intended. That is, free trade among members of any B/RTA should comprise 'substantially all trade' between the signatories, and be achieved within a 10-year period. (An extra condition is applied to customs unions, where tariffs against third countries should be harmonised within 10 years.)

- It is easier to achieve an agreement between two (or a few) countries than in a larger group, especially when it does not require complete free trade, and it allows sensitive sectors to be exempt.

GATT (1948) was designed to establish order in global merchandise trade after World War II. Trade in services was incorporated into the Uruguay Round agenda, and B/RTAs in services are now covered in GATS Article V. Subsequently, other policies affecting trans-border transactions have been included in B/RTAs, such as competition policy, investment rules, government procurement policies, labour and environment standards, etc. Evidence of economic gains from B/RTAs is often illusive.

Large RTAs, such as the European Union and NAFTA, increased trade between their members, so-called 'trade creation,' because tariffs on trade between members tend towards zero. However, some of this increased trade is diverted from countries outside the regional agreement, which previously provided goods at lower costs but are now subject to tariffs. This is 'trade diversion.' Thus, B/RTAs benefit members but, to some extent, at the expense of efficient non-member producers outside the agreement. These effects on third parties tend to be neglected and the costs (losses) forgotten when discussing B/RTAs.

RTAs divert political attention and resources from the multilateral trading system.

When ASEAN decided to establish a regional trade agreement in 1992, the then six members established a series of bilateral trade agreements to form the Asian Free Trade Area (AFTA), comprising 15 bilateral trade agreements.[1] This does not comprise a comprehensive program of liberalisation. Trade among the ASEAN nations has grown little faster than their total trade in the past decade. When China acceded to the WTO, the ASEAN members recognised new market opportunities and each ASEAN country now has a (nominal) bilateral FTA with China.

Political interests are often ignored when economic benefits are claimed from RTAs. Evidently, the European Union is much more than an economic entity. Any association agreement with the European Union means sacrificing independence by accepting EU laws and interference from the EU Council, European Parliament, and the European Court of Justice. The EU Commission claims that association agreements with the European Union bring market guarantees and preferred treatment in trade, but the union now has B/RTAs with much of the world (except major agricultural exporters that might endanger the CAP!).

An important consequence of B/RTAs is that they divert political attention and resources from the multilateral trading system, which exacerbates tensions in international trade relations. The United States was a latecomer to B/RTAs. Initially, the US government signed agreements with vulnerable allies, with little regard for economic interests; for example, Jordon and Israel. Its first serious B/RTA was NAFTA (1993). Many RTAs have been signed since, including with Australia in 2004. Japan is another recent convert to its own form of B/RTA. It has signed 'new-age economic partnerships' (NEPs) with Singapore and Thailand.[2]

Consequences of the GFC

The global economy is still suffering the consequences of the financial crisis. In Europe, national trade imbalances and government budget deficits are troubling many governments. Financial institutions are struggling to stabilise accounts, and bank lending is restricted and/or expensive. Many governments still face rising unemployment. Governments are reluctant to promote structural adjustment in their economies.

Because of the intensity of the GFC, world leaders decided in 2008 to enlarge their extant G7 meetings. The first meeting of G20 in November 2008 alerted participants to the intensity of the GFC, and they drafted a coordinated program to improve international cooperation. These meetings are now showing diminishing returns. Finance ministers met in Seoul on 22 October 2010, where they discussed setting limits on national trade imbalances and suggestions to calm exchange-rate tensions. However, they shied away from setting targets for current account balances. Again, there was no mention of trade policies or domestic structural adjustment. The Bank for International Settlements (BIS) proposal to triple bank capital ratios in the BASEL III agreement (announced in September) was left for the G20 Leaders to deal with at their meeting in Seoul on 11 - 12 November.

China is the principal target for demands that surplus countries should appreciate their currencies. China has foreign exchange reserves equivalent to almost 50% of its GDP, and it is criticised for continuing to run large export surpluses. On the other hand, China is an immature creditor because its domestic financial markets are unformed. The government manages interest rates and foreign exchange restrictions. China's domestic financial institutions are not permitted to take foreign exchange risks, and the government manages China's saving surplus. This comprises investments overseas, using state-owned enterprises for partnerships with foreign companies, and aid programs. But these activities are undeveloped and returns go back to the government. This institutional weakness behind the under-valued renminbi and an undeveloped domestic financial sector is the source of the problem.

But other governments are undervaluing their currencies too. Recently, Japan sold an estimated $20 billion yen to support its parity with the US dollar (i.e. counteracting an appreciation). Switzerland increased its sales of Swiss francs in the past year to prevent an appreciation. The Korean won and Brazilian real have been similarly protected. All these countries enjoy strong current account surpluses.[3]

On the other hand, the currencies of major OECD members (US dollar, euro, and pound sterling) are still over-valued.

The European Union has a similar internal disequilibrium over the euro. Germany, the Netherlands, Denmark and Austria have strong and growing economies, while the economies of Spain, Portugal, Ireland and Greece are faltering, as are most of the Central European economies (including some EU members not yet using the euro). (Britain, with a trade deficit, and Sweden, with a trade surplus, face their disparate problems outside the euro zone.) The four heavily indebted EU economies face the tough realities of participating in the euro-zone. In good times, the single currency zone allows heavy borrowing to meet public sector expenditure, but the loans have to be repaid once the reserve backing for the euro is compromised. The four weak economies are faced with external deficits that require financing from more expensive sources, and budget deficits are being severely curtailed, which brings social unrest. The commitments undertaken on joining the European Monetary System have to be met. It has a downside.

The banking crisis and financial restructuring are forcing sharp revisions to government budgets and corporate plans. As noted above, some governments are committed to fiscal rectitude and trade surpluses, and this increases the adjustment costs for others. The revival of mercantilism is spreading across Europe and North America, in much the same way it did in South East Asia after the 1997 financial crisis. The outcome of International Monetary Fund support then was to adopt, and maintain, under-valued exchange rates to increase competitiveness and add to currency reserves. This strategy has continued to sustain economic growth in ASEAN throughout the GFC and the decline in global trade.

US authorities have poured millions of dollars into world financial markets to finance the US trade deficit, but they are now resorting to antidumping duties and other 'trade enforcement tools.' The US Department of Commerce has adopted new instruments to raise antidumping and countervailing duties, and will require cash deposits on imports subject to antidumping inquiries. Even more controversial is the recent legislation passed by the US House of Representatives to allow a country to be declared 'a currency manipulator' and to treat this currency undervaluation as an export subsidy, which would subject their exports to countervailing duties. For now, this is only a threat. Senate and presidential approval is required before action is possible. The link with currency problems indicates the strong feeling in countries facing unusual economic difficulties.

An explicit policy of export promotion through under-valued exchange rates risks an inefficient, subsidised trading system, which by suggesting exports create jobs while imports destroy them will encourage protectionism. This simple mercantilist message appeals to the uninformed when economic problems appear, as has occurred in important OECD countries currently. The result will be trade disputes and slower economic recovery. The world economy has been here before—in the 1930s!

Institutional weakness in the WTO

The repeated failure of Doha Round trade negotiations in the past decade, and the spread of B/RTAs, has relegated the position of multilateral trade policy on the international agenda. So much so that trade does not rate a mention in G20 discussions of the GFC.

The rapid growth of B/RTAs in the past 20 years has been tacitly endorsed by the WTO. The Uruguay Round 'Understanding on interpretation of GATT Article XXIV (1994)' distinguished between 'full' RTAs, where tariffs and other trade barriers are eliminated on 'substantially all trade,' and 'interim' (incomplete) FTAs, where liberalisation is less exacting. Initially, this meant little because the Committee on RTAs (established in 1996 to review notified RTAs) never released its reports. With hundreds of B/RTAs being notified to the WTO by the turn of the century, in 2006 the WTO Secretariat persuaded the General Council to adopt a Transparency Mechanism for all B/RTAs to be reviewed. This removed differentiation between 'full' and 'interim' B/RTAs. Reports are submitted to WTO Council but not published. Any discrepancies over commodity coverage or liberalisation agendas, therefore, are not open to public scrutiny. The effect of the Transparency Decision has been to circumvent the scope to control RTAs in terms of GATT Article XXIV.

Conclusion

Finding a solution to the GFC requires a comprehensive program, not only to conserve the financial system but to adopt measures that strengthen the multilateral trading system by way of the Doha Round negotiations.

The WTO has a much wider remit than the GATT enjoyed. With more than 150 members, it has twice the membership. The Doha Development Round, announced in 2001, was intended to restore confidence to the trading system after the havoc and disorder at the WTO ministerial meeting in Seattle in 1999. Unfortunately, the Doha Round agenda has turned out to be comprehensive *and* complicated. This has irritated many OECD governments and encouraged them to pursue B/RTAs.

Determined leadership is required to find a multilateral solution to the GFC, and a trade accord must be part of that. Bridging the divide between US unilateralism, impatience with the EU regulatory 'model,' and meeting demands from 'the new tigers' and the rest of the developing world will not be easy. Evidently, agricultural protection is a major obstruction to development and to gains from trade. Yet this is the sector where OECD governments—and others—are intransigent. Liberalising agriculture would reduce food and material costs, facilitate growth and development, and help the world's poor. Determined leadership will also be required to get an agreement from the Doha Round negotiations.

A plurilateral coalition must be found to support such a program. The United States no longer has general acceptance, and in any case has become reluctant to lead. Power has become diffused; the European Union, Japan, China, India, Brazil and others—all want a role. It is urgent to get an agreement in the WTO now to maintain its cohesion before even deeper fissures appear (as they have in several UN agencies). Multilateralism will be difficult to sustain, which is one reason to seek a high-level trade agreement in the context of the Doha Round. It will not be easy, but there is no alternative if the GFC is to be overcome.

Endnotes

1 The four Mekong countries separately joined AFTA around 2000, meaning that AFTA now comprises 45 separate bilateral BTAs. Some conformity is proposed in the formation of an ASEAN Economic Community (AEC).

2 NEPs are not consistent with GATT Article XXIV because they exclude agriculture and fishing from any agreement, while acceptance of Japanese investment is a condition. Japan has proposed amendments to GATT Article XXIV in the Doha Round negotiations to take account of NEPs.

3 Other economies with perennial trade surpluses include Taiwan, Saudi Arabia, Libya and Venezuela.