The Perils & Promise of Freer Trade

By Gary Clyde Hufbauer

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The "Great Recession" — triggered in 2008 by the US subprime mortgage crisis and augmented by the EU sovereign debt crisis — has claimed many victims. Among them, it hammered world trade and investment. Throughout the recession and the tepid recovery that followed, responsible officials failed to throw the lifeline of fresh liberalization; instead they tolerated protectionism in various guises. Policy indifference shows up in the numbers. Foreign direct investment (FDI) flows peaked at $2.1 trillion in 2007, but since have averaged below $1.5 trillion. World trade bounced back to its 2008 level in 2010, but with the tepid recovery and no meaningful progress in liberalization, world trade is now expanding no faster than real global GDP — only 2.5% in 2012 and possibly 4.5% in 2013.

Globalization Brings Prosperity

According to Angus Maddison, in *The World Economy: Historical Statistics* (OECD Development Centre Studies, 2003), the post-World War II era delivered the best 60 years in world history. During this period, globalization powered world prosperity, with trade and investment growing much faster than other components of the world economy. But in the wake of financial crises, failure in the Doha Round talks, and creeping protectionism, trade and investment are no longer expanding at a faster clip than world GDP. It's not that opportunities are lacking: credible econometric research shows that global trade densities are less than a third of their potential; moreover, when measured in tariff-equivalent terms, the "border effect" of tariff and non-tariff barriers approaches 100%. The problem is that responsible policy officials are not rising to the challenge by energetically dismantling barriers that continue to impede trade and investment flows.

Creeping Protectionism

Instead, policy officials around the world have tolerated the creeping accumulation of protectionist measures. Between the Cannes G20 Summit held in 2011 and the Los Cabos G20 Summit held in 2012, the Global Trade Alert documented at least 110 new protectionist measures, of which 89 were imposed by G20 members — despite the solemn free trade commitments in G20 communiques.

At the Peterson Institute we have studied one form of new protection: Local Content Requirements (LCRs) proposed or put into force since the eve of the Great Recession in 2008. While there was no avalanche to echo the Great Depression of the 1930s, an analysis of the recent LCR list reveals disconcerting trends. First, there are too many new cases — we count 107 worldwide. Second, new measures are often opaque, making them not only difficult to quantify but also difficult to challenge. They depart from the classic format of mandated purchases from domestic suppliers and instead mix price and quantity signals. For all their fuzziness, they adversely impact a significant amount of trade.

Among the 107 cases of new LCRs, some countries were more active and some industries more targeted, but the measures spread across all types of economies as well as virtually all industries. Brazil was the worst perpetrator with 15 cases, but LCRs are not limited to developing economies. Canada had five cases, including the case with perhaps the largest single impact (wind turbines). The affected industries include agriculture, health care, information technology, automotive, and many others. Our analysis suggests that, taken together, the quantifiable measures impacted over $1.7 trillion in trade flows. That accounts for approximately 13.5% of total trade in 2010 (the year when most measures were implemented). We cannot say with confidence how much the LCRs reduced trade, but a ballpark guess might be $200 billion to $400 billion.

Worrisome Investment Barriers

Anti-globalization sentiments which erupted alongside the Great Recession have, to some extent, spilled into the investment realm. Assessing liberalization and protectionist measures in 2011 affecting FDI, UNCTAD states in its *World Investment Report 2012* that 78% were liberalizing and 22% were protectionist. The balance sounds good, but back in 2000 the numbers were 94% liberalization and 6% protectionist — and the relative trends since 2011 have been in the wrong direction.

Restarting the WTO Machinery

Not only has new protectionism crept into the trading system, but more importantly the central motor of the world's liberalization machinery has stopped. The past decade was rough for the World

Trade Organization — specifically for the efforts of trade negotiators to reach a package agreement. Consequently the Doha Development Round negotiations are on the verge of catastrophic failure. The multilateral trading system will be dealt a near fatal blow if nothing results at the Bali Ministerial Conference, to be held in December 2013, from 12 years of hard negotiations. Prospects for resurrecting the WTO as the premier forum for trade negotiations will be crippled if the work of the Doha Round is cast aside. In short, the year 2013 is shaping up as the "make or break" year for the Doha Round.

Contrary to much that has been written, I am not yet ready to abandon the Doha Round as a lost cause. Instead, in a recent report for the International Chamber of Commerce Foundation, together with my colleagues, I took a fresh look and assessed the potential payoffs from seven agreements that could be concluded in 2013 and ratified in 2014. With a concerted effort, the major trading nations could use these seven agreements to construct a "WTO Recovery Package". The world economy needs strong medicine to escape the hangover from US and EU financial failures and successful trade talks can be part of the elixir.

Fortunately, much can be harvested from the Doha drafts, either as individual agreements or as packages. Years of skilled work are now captured in draft texts, and the remaining differences between WTO members are mostly political not technical. But senior officials need to focus on the global commercial payoff from a significant "WTO Recovery Package" — not their mercantilistic calculations of the "balance of concessions", arithmetic which inevitably shrinks the deal. In decades past, the GATT was a forum where countries lowered their tariffs to spark home and foreign economies in tandem, without excessive concern as to which country got the most export gains on day one. WTO negotiators should return to this healthy attitude!

Several Doha texts can be polished and ratified provided that negotiators take a flexible posture with respect to the architecture of rights and obligations. A few texts might be readily accepted by all WTO members. However, for several texts, only a subset of WTO members will be able to accept the obligations at the outset — in other words, with respect to obligations, these will be plurilateral agreements. The plurilateral agreements (and chapters within the agreements) will in turn follow two architectural models. In some cases, the agreements (or selected chapters) will extend unconditional most-favored-nation (MFN) rights either to all WTO members or to the least developed members (LDCs). This will happen when agreement members account for a high percentage of world trade in the concerned sector (close to a "critical mass", customarily defined as 85% or more of world trade). In other cases, however, the agreements will condition extension of rights on acceptance of obligations — which in practice means membership in the plurilateral agreement. To reap a decent harvest from the Doha Round, WTO members should welcome the variable architecture outlined here.

In addition, WTO members should show flexibility when it comes to packaging the harvest. It would be unfortunate if any WTO member adopts a rigid posture as to which texts must be grouped together to form an acceptable package. That kind of rigidity would replicate the "single undertaking" commitment which proved to be among the fatal flaws in the Doha negotiations. By our assessment, a draft text from the Doha Round talks which seems ripe for conversion into signed and sealed agreements covers the following agreements:

- Trade facilitation
- The International Services Agreement
- The International Digital Economy Agreement (IDEA)
- Duty-free quota-free (DFQF) market access for LDCs
- Phasing out agricultural export subsidies
- Renunciation of food export controls
- Freer trade in environmental goods and services

At the Peterson Institute, we have variously used three metrics to quantify the potential payoffs if these agreements were adopted: export gains, jobs supported, and GDP gains (or losses averted). The table below summarizes our findings. We do not suggest that the seven agreements should be viewed as a "package" — such an "all-or-nothing" approach would doom the enterprise from the start, just as the "single undertaking" proved to be a fatal flaw in the original Doha Declaration. However, to summarize our findings, if all seven agreements were ratified, the total world export gains over the medium term might reach $2.4 trillion; jobs supported around the globe (mostly in developing countries) could number 34 million; and world GDP gains combined with losses averted could amount to $2.2 trillion.

By our calculations, the greatest payoff would come from accords calling for serious trade facilitation and freer trade in international services. Over the long term, each of these agreements could expand global exports by more than $1 trillion, deliver annual GDP gains of like amounts, and support almost 30 million new jobs in the world economy. Other potential agreements cited in the table are not as potent in economic terms, but may be equally important for political balance.

TABLE 1

Long-term potential payoffs from the world trade agenda

	Export gains ($ billions)	Jobs supported (millions)	GDP gains ($ billions)
Trade facilitation	1,043	20.6	960
International services	1,129	8.6	1,038
International digital economy	178	0.4	147
DFQF market access	8	0.7	7
Agricultural subsidies	5	0.1	5
Food export controls*	n.a.	n.a.	45
Environmental goods and services	10	0.3	9
Total	2,374	30.8	2,212

Note: n.a. = not applicable
**GDP gains calculated as losses averted.*
Source: Authors' calculations

Trans-Pacific Partnership (TPP)

The WTO is not the only forum for fresh liberalization of trade and investment barriers. More than 400 bilateral and regional trade agreements have been announced, nearly all of them in the last two decades. Many bilateral FTAs place more emphasis on diplomatic ties than economic content. But the big regional agreements, such as the EU, NAFTA, and AFTA have liberalized trade and investment to a great extent. Over the next two years, the TPP negotiations will be the most important for galvanizing trade and investment growth. If Japan and South Korea join the other 11 TPP partners (Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, the US and Vietnam), the talks will become a really big deal.

But the TPP is already a big deal in both economic and political terms. The TPP 11 have a combined GDP of almost $21 trillion and $4.4 trillion in exports of goods and services. Adding Japan and South Korea would expand aggregate GDP to $28 trillion, or 40% of world GDP, and would increase exports of goods and services to $6 trillion, or about 27% of world exports. Beyond its impetus to trade and investment, the TPP serves as an instructive negotiating laboratory that could yield useful precedents for other trade initiatives. Even more important is its strategic value in reinforcing economic and political relationships among the Asia-Pacific countries.

Regional Comprehensive Economic Partnership (RCEP)

Parallel with the TPP negotiations, efforts are also underway in Asia to convert an extensive array of free trade agreements into a RCEP encompassing 16 economies. For large economies, like the US and China, the benefits of regional agreements have less to do with immediate gains than with their influence on the future trading system. The competition between the Trans-Pacific and Asian tracks appears to be such a "contest of templates". Template differences are largest for nontariff and other regulatory barriers to market access — US-style agreements, such as the TPP, have substantially higher "liberalization scores" on nearly all provisions than Asian-style agreements, such as ASEAN.

We estimate that the TPP would yield global annual benefits of almost $300 billion, while an Asian free trade agreement (similar to RCEP) would yield benefits of $500 billion. Although Asian agreements are generally less ambitious than the TPP, they yield even larger gains because they cover quickly-growing trade among countries with relatively high trade barriers. Full regional integration in an eventual Free Trade Area of Asia and the Pacific (FTAAP) would yield even greater annual benefits, in the range of $1.3 trillion to $2.4 trillion (1.5 to 2.7% of world GDP).

Conclusion

Intangible effects of renewed global economic integration could substantially amplify the potential gains traced in this short note. The consequences could include enhanced investor confidence and better macroeconomic performance; increased competition and productivity growth; and even improved political relationships. Maddison's study of historical economic performance demonstrates that global trade and investment liberalization have, in the past, accelerated world economic growth. World leaders today need to show courage, draw on the proven tonic of trade and investment liberalization, and breathe life into the lackluster global economy. JS

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