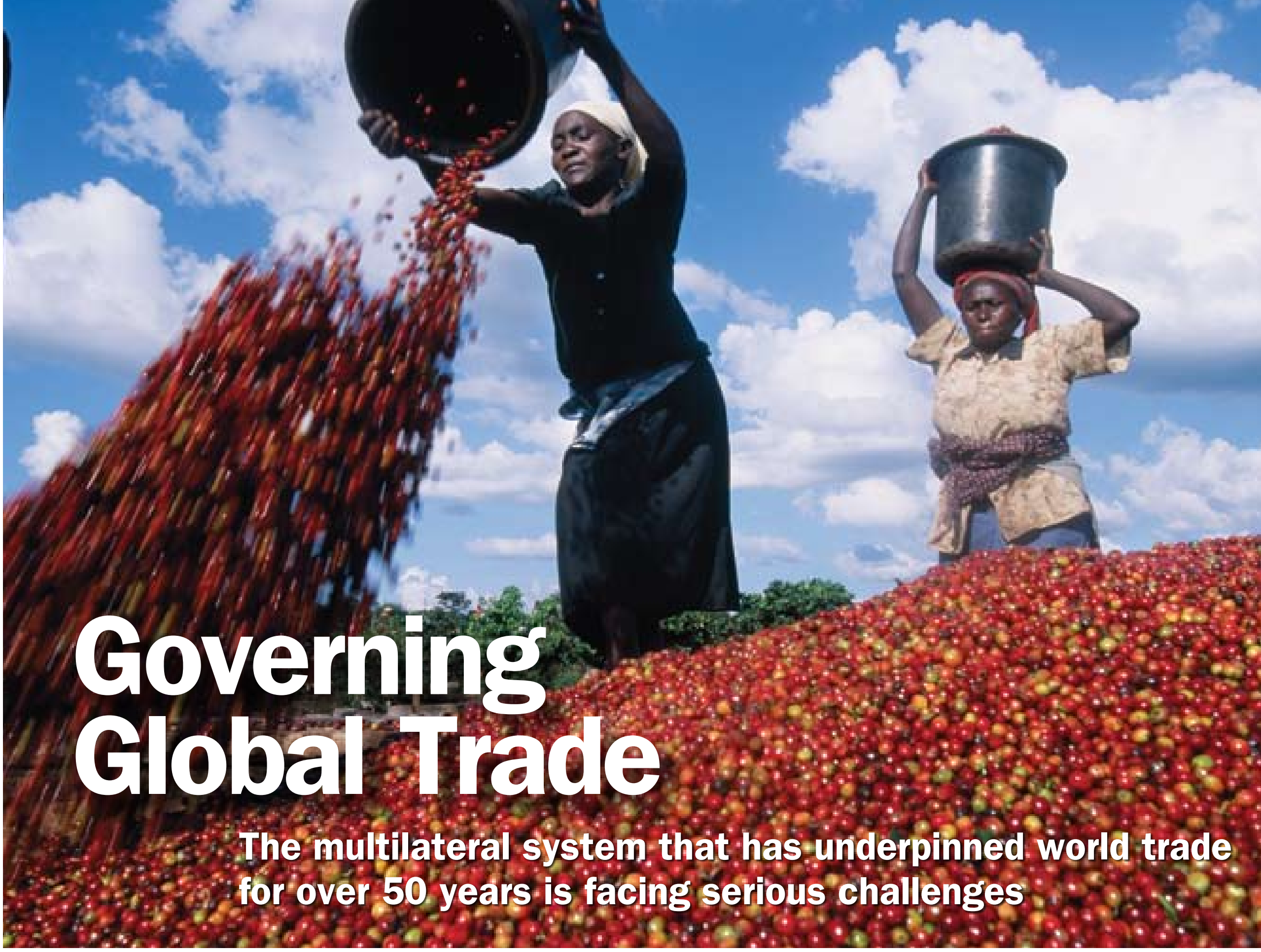


Governing Global Trade

The multilateral system that has underpinned world trade for over 50 years is facing serious challenges

Kenyan coffee pickers empty buckets of arabica beans.

Uri Dadush and Julia Nielson

WITH the Doha Round negotiations of the World Trade Organization (WTO) proving to be drawn out and difficult, WTO ministerial conferences plagued by discord inside negotiating rooms and violent protests outside, and preferential trade agreements growing at an unprecedented rate, has the multilateral system of rules that has governed international trade in the postwar era outlived its usefulness?

Our answer is no. But, as for much of the postwar international architecture, the strength of the multilateral trading system cannot be taken for granted. The system is facing significant challenges, and two issues lie at their core: the increased role of developing countries and the sensitivity of the unfinished liberalization agenda. The picture is further complicated by the proliferation of preferential trade agreements. How these challenges are met will determine whether international trade will continue to be governed by multilateral disciplines or characterized by competing trade blocs and escalating disputes.

Underpinnings of trade growth

Measured by actual trade flows, the multilateral trading system would appear to have been very successful. Today, WTO members account for more than 90 percent of world trade in goods (including oil). Trade grew, on average, almost twice as fast as GDP between 1990 and 2005 (World Bank, World Development Indicators). Global trade is expected to hit about $16 trillion in 2007, equal to 31 percent of world GDP. At the same time, stocks of foreign direct investment grew almost five times as fast as world GDP. The domestic sales of foreign affiliates are larger than world exports and rely critically on trade in intermediate goods, further underscoring the importance of trade integration in modern economic activity.

Falling transportation costs and other technological innovations have been key drivers of trade growth, but declining barriers to trade have also contributed. Between 1983 and 2003, average applied tariffs on manufacturing in developing countries dropped from slightly less than 30 percent to about 9 percent (World Bank, 2007). Some two-thirds of this liberalization was undertaken unilaterally, and about one-fourth through multilateral agreements.

The trading system embodied in the General Agreement on Tariffs and Trade (the GATT, the WTO's predecessor) and now in the WTO has underpinned this liberalization in five important ways.

First, it has ensured that progress is locked in, guarding against backsliding, even as circumstances change. China's growing clout in the global economy has prompted calls for tariff increases in importing countries, but WTO rules have held increases in check. Lock-in matters: if Japan had bound its rice tariff in 1955 (bound tariffs, duty rates that countries commit to under the WTO, are difficult to raise), that tariff would still be 46 percent rather than more than 500 percent.

Second, the principle of nondiscrimination (most favored nation, MFN), which lies at the heart of the system, has helped ensure that new trade opportunities arising from tariff reductions under the GATT/WTO have been available to *all* countries participating in the system and not just to a favored few.

Third, the system's predictability and transparency have encouraged reform because countries know the parameters within which their trading partners operate and because of demonstration effects. Multilateral negotiations center on bound and not applied tariffs (the duty actually levied on an imported good, generally lower than the bound tariff), allowing countries to liberalize at their own pace, knowing that they would not waste negotiating chips as they reduced their applied tariffs.

Fourth, WTO accession has permitted countries to negotiate MFN treatment in exchange for liberalization commitments. China's accession in 2001 underpinned far-reaching domestic reforms and helped China become the world's third largest exporter. Accession of such countries as Vietnam, Saudi Arabia, and, prospectively, Russia may imply less far-reaching commitments but has brought, or is expected to bring, almost 250 million people into the mainstream of world trade.

Fifth, the WTO's dispute-settlement mechanism has enabled smaller, poorer countries to achieve changes to trade policies in much larger and more powerful countries. More than 300 disputes have been resolved, about one-third of them brought by developing countries (Messerlin, Zedillo, and Nielson, 2005). Moreover, a number of disputes never make it to court because of the mechanisms the WTO provides for countries to negotiate solutions.

Developing countries are key players

A key question now is how to take account of the increasing role of developing countries. These countries have become major participants in world trade: their share of global exports rose from 22 percent in 1980 to 32 percent in 2005 and is expected to reach 45 percent by 2030 (see Chart 1) (World Bank, 2006). About two-thirds of the WTO's members are developing countries.

Reaching agreements. The strength of the WTO is that it is based on a contract among its members, and its core function is to provide a forum for governments to negotiate with each other. But consensus decision making in the WTO, with 151 members, can be long and arduous. The frank, back-room exchanges that led to deals in the past have become increasingly unwieldy as the membership and expectations of inclusiveness have grown. If the United States and the European Union can no longer present deals to other members as a fait accompli, reaching agreement essentially remains a process of concentric circles: tentative agreements among a small circle of major players and/or small countries for which the issue is critical (in what is known as the "Green Room" process) are gradually extended to others, with additional concessions or adjustments along the way.

A debate has arisen about the inclusiveness of this process, in part because some of the poorest members are not represented at the WTO in Geneva, and other developing countries attempt to cover the broad agenda with small delegations. The solution has been an informal system of like-minded countries—whose leaders are represented in the Green Room process—coming together on particular issues.

Reaping the benefits. Although representative groups of countries are essential, one of the strengths of the negotiating process in the WTO is the fluidity of the alliances that comprise them. Countries can be allies on one issue and opponents on another. This fluidity is a healthy sign of the seriousness with which obligations are taken.

Central to the WTO's success has been the fact that countries have multiple interests that they are constantly balancing against each other. A suboptimal outcome in one area can be accepted in the context of gains in other areas. These trade-offs make consensus possible.

But many of the poorest WTO members may not see a balance of gains across the system. Their immediate gains may be limited to a handful of products, reflecting the lack of diversification in their exports. For them, it may be worth blocking consensus on a broader deal over the outcome on a single issue.

Even developing countries with broader trade interests may feel they cannot benefit from the system. The WTO can reinforce domestic reforms, but reforms are not without adjustment costs, and some developing countries may struggle to provide safety nets. Others may be unable to invest in the machinery necessary to reap the benefits from some WTO agreements (for example, related to standards). Critically, they may be unable to take advantage of new market access.

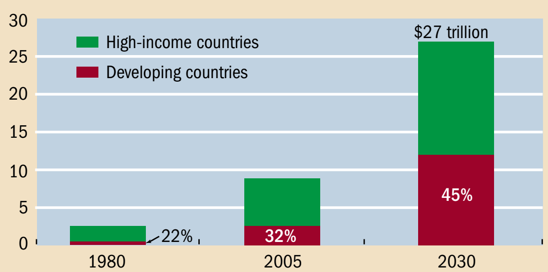
High costs and delays from inefficient customs, ports, and transportation constrain exports from developing countries. The location of labor-intensive apparel production, traditionally an important export for poor countries, is increasingly determined by lead time and reliability requirements. Costs per operator hour in Kenya may be more than 10 percent lower than in coastal China, but lower productivity and less efficient supply chains eliminate that advantage (Werner International; World Bank, 2007). Shifts into higher-value-added products are also constrained by weak infrastructure.

Chart 1

Major traders

Developing countries are playing an active role in world trade.

(total exports, trillion 2001 dollars)



Source: World Bank simulations with Linkage model.

Some of the poorest countries fear that the system may even harm their interests. Those that have received unilateral preferences for particular products fear that liberalization by trading partners will erode the value of these preferences. They oppose not only their own liberalization, but also liberalization *by others* because of the adjustment costs.

More aid for trade. Additional aid to address these constraints—aid for trade—will be an essential complement to any multilateral trade deal. Paradoxically, part of the solution to helping poor countries feel that they have a stake in the trading system lies in the broader development community, with donors supporting countries that highlight trade as a priority in their development strategies. But donors will need to honor their commitments to increase overall aid if trade needs are to be better addressed without competing for resources with existing development priorities.

Differentiation. Developing countries have formed influential coalitions and are playing a more active role in the Doha Round negotiations. For example, the Group of 20, led by Brazil and India, argues for agricultural reform in developed countries.

This greater activism has occurred in parallel with the decision to make development the focus of the current negotiations. But negotiations under the Doha Development Agenda have struggled, in part because of differences over what a "development round" means. There is general agreement that rich countries should reduce trade barriers, but some think the development round means a focus on developing countries' own reforms, and others feel that development is best served by additional flexibility *not* to reform. Considerable debate has focused on how much flexibility should be extended and to whom.

WTO rules grant "special and differential treatment" to developing countries, with additional flexibility for the least developed countries. But there is no further generalized differentiation by income level among developing countries. The 18 low-income countries that are not classified as least developed receive no additional special treatment beyond that extended to all developing countries. Developing countries also self-designate in the WTO and include some high-income (Singapore) countries. This has complicated negotiations because developed countries are reluctant to extend to China the special treatment they may grant to Cameroon.

There is pressure for greater differentiation among developing countries, both from some developing countries—such as small economies—that want their special problems recognized and from developed countries that want to limit flexibility for more advanced developing countries. However, most developing countries resist greater differentiation, in part because, despite their diverse interests, it undermines their power as a group. For the system to remain relevant beyond the Doha Round, it is likely that reforms will need to be considered to increase the speed and flexibility of the negotiating apparatus.

The unfinished agenda

Challenges also remain on the substance of the regotiating agenda.

Agricultural protection. Fifty years of the multilateral trading system has seen limited progress in reining in agricultural protection. In all regions, tariffs remain significantly higher in agriculture than in manufactures (see Chart 2), and trade-distorting subsidies, banned in manufacturing, continue to be a feature of the agricultural sector. According to the Organization for Economic Cooperation and Development, rich-country taxpayers (in the form of subsidies) and consumers (in the form of higher prices because of trade barriers) pay about $268 billion a year to support agriculture, with the European Union ($134 billion), Japan ($47 billion), and the United States ($43 billion) leading the pack.

Meanwhile, in developing countries, 73 percent of the poor live in rural areas, and agriculture and agroprocessing account for 30–60 percent of GDP and an even larger share of employment. But agricultural protection is also high in developing countries, to the detriment of their own poor consumers, exporters, and other poor countries, which are increasingly their trading partners.

Bringing agriculture into line with trade rules for other sectors is an important test of the WTO's ability to deliver for development—all the more because the multilateral system is the only forum in which agricultural subsidies (which cannot be reduced on a preferential basis) can be tackled.

Protection on manufactures. Although the remaining high tariffs in developed countries tend to be concentrated in areas of developing country export interest (labor-intensive manufactures, such as clothing), protection in developing countries is some four times higher than in high-income countries. The price of high tariffs in developing countries is, again, paid by their own consumers, exporters (whose competitiveness in world markets and participation in global production chains are harmed by more expensive inputs), and their developing country trading partners (which account for one-fourth of developing country exports).

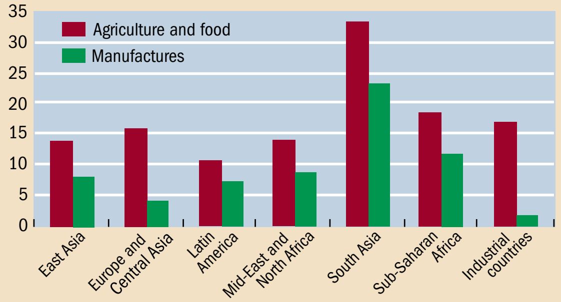
As the counterpart to agricultural reform in rich countries, developing countries should be prepared to lower and bind their tariffs on manufactures in the current negotiations. There is considerable scope to do so: bound tariffs are, on

Chart 2

Protection for agriculture

Barriers are much higher in agriculture than in manufacturing.

(average tariffs, percent)



Source: World Bank calculations based on Purdue University, Global Trade Analysis Project, version 6.03.

average, some two and a half times higher than applied tariffs in developing countries.

Protection on services. But the gains from further liberalization in manufactures are dwarfed by the potential gains from liberalization in services*:* the increase in real income from halving protection on services would be five times larger than that from comparable liberalization in goods trade. Global trade in services accounts for $2.8 trillion, or not quite one-fifth of world trade (World Bank, World Development Indicators). Access to quality and cost-effective services, such as finance, transport, and telecommunications, plays a key role in determining competitiveness.

But market opening in services is complex because new regulations or institutions may be needed to ensure that liberalization strengthens competition and that important public policy goals—such as universal service—are met. Aid for trade may be needed for the design of regulations and financing of new institutions in developing countries. Regulatory and political challenges are also entailed in an area of key offensive interest for developing countries in the Doha Round: the temporary movement of people to supply services. Greater coordination between trade and migration authorities will be required to realize the potential for win-win outcomes for both developed countries with aging populations and developing countries with large numbers of young job seekers.

Current WTO commitments on services are significantly less liberal than the regimes being applied, and narrowing this gap will be an important objective of the current negotiations. Progress in binding services liberalization is a further quid pro quo for the industrial countries in return for their politically difficult reforms in agriculture.

Pressure to include new issues. Notwithstanding this unfinished agenda, some of the most advanced WTO members are seeking rules in new areas, reflecting the sophistication of their economies. Many of these areas (such as competition policy) require investments in domestic institutions, investments that may not represent development priorities for resource-strapped countries.

The system is also under increasing pressure to address such issues as human rights, migration, labor, and environmental concerns. Part of the reason is the effectiveness of the WTO's dispute-settlement system, but the absence of similar mechanisms in the other organizations that exist to address such issues suggests that the problem is one not of forum but of political will.

This pressure also reflects the fact that globalization has seen large trends in the global economy (often understood as trade) affecting people's lives more directly than ever before. While the system may find it difficult to resist the pressure to address new issues, WTO members' energies would be better spent addressing those outstanding trade issues, such as egregiously high protection on agriculture, that lie at the core of what the system can deliver for development.

Managing these challenges is further complicated by the proliferation in recent years of reciprocal preferential trade agreements (PTAs): more than 200 PTAs are in force, a sixfold increase over the past two decades (see box). By 2010, close to 400 PTAs are due to be implemented.

The challenges facing the multilateral trading system are difficult, and we offer no blueprint for their resolution beyond general observations. The system is a global public good of enormous importance, and its importance grows along with the share of trade in world economic activity. We must continue to build on the existing foundations that have served the global economy well to date. A successful conclusion to the Doha Round will be critical, and a Doha deal along the lines currently being negotiated is possible and would bring significant benefits. Not least, it would demonstrate that the WTO remains capable of making inroads into the large unfinished agenda we have outlined. ■

The PTA debate

Whether PTAs enhance welfare depends on their design. Although deep integration agreements and open regionalism may benefit the parties and assist MFN liberalization, not all PTAs are high quality, some are net trade diverting, and still others are paper agreements. Such PTAs are creating a web of different requirements, posing problems for small traders in poor countries. Simplified and nonrestrictive rules of origin are critical if PTAs are to promote participation in global production chains, as are parallel reductions in MFN tariffs to limit the scope for trade diversion.

But PTAs, which have been around for centuries, often reflect geopolitical objectives or the desire for more and faster liberalization than can be achieved multilaterally. Few would challenge the notion that PTAs are here to stay. But the WTO can help minimize possible harm. It can promote greater transparency and opportunities for learning and help reduce their trade-diverting effects. And the WTO remains the only place where agricultural subsidies can realistically be tackled and is the key channel for the major trading powers to manage their trade relationships with each other.

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