

TRADE COOPERATION IN AN AGE OF GEOPOLITICS

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Geopolitical rivalry does not end the need for trade cooperation, but the multilateral system must adapt

For decades, the global economy rested on the premise that international trade was beneficial despite geopolitical differences. The rules of the multilateral trading system, established with the General Agreement on Tariffs and Trade (GATT) in 1947 and embedded in the World Trade Organization (WTO) in 1995, were crafted for a world where governments rarely used trade to achieve geopolitical goals. That world is now under threat.

The United States and China, whose growing trade integration has shaped the past three decades of globalization, now often refer to each other as geopolitical rivals. They increasingly use trade policy to advance strategic objectives—limiting technology transfers, restricting exports of critical products, pursuing national security goals. Many observers fear that the return of geopolitics will fragment the global economy, unraveling decades of integration.

Yet this pessimistic outcome is not inevitable. Our research shows that even strategic rivals can benefit from trade cooperation. The problem is that the return of geopolitics is at odds with the existing institutional framework, which was designed for a different era. If the trading system is to survive, it must adapt to a world where countries use trade policy to advance geopolitical objectives.

The power problem

Standard economic models assume governments strive to improve the welfare of their citizens. In this setting, a country raises tariffs to increase its real income at the expense of trading partners by improving its terms of trade—the price of its exports relative to imports. Since all countries face the same incentives, uncoordinated tariff policy traps them in a situation of inefficiently high protection and low welfare. Trade agreements exist to escape this trap through coordinated tariff reductions.

Geopolitical rivalry changes the calculation, raising questions about the sustainability of trade cooperation. Drawing on the realist tradition in international relations, we suppose that rival governments care not only about their absolute welfare but also about their relative power—how they stack up against adversaries. Policy decisions are shaped by both economic gain and strategic advantage.

Consider a government seeking dominance in the semiconductor industry. It will design trade policies not only to expand its domestic chip sector but also to shrink its rival's. A tariff becomes attractive because it damages foreign competitors, transforming trade policy from a tool of economic management into an instrument of strategic competition. Manipulation of the terms of trade is no

longer the only reason to use trade policy in a world where countries have geopolitical objectives.

The international relations scholar John Mearsheimer captured this logic in his classic book *The Tragedy of Great Power Politics*. States motivated by relative power concerns, he writes, are likely to forgo large gains in their own power if such gains give rival states even greater power. This logic has significant implications for trade policy: A country might reject a highly beneficial trade deal if it would make its adversary stronger, or it might implement a damaging trade measure because it would be even more damaging to its adversary.

Cooperation amid rivalry

Does this mean trade cooperation is doomed? Not necessarily. Even in a model where governments care about their relative geopolitical power, the results for trade cooperation are more hopeful than many “realists” would expect.

It is true that the emergence of geopolitical rivalry drives up tariffs in a noncooperative setting. If hurting your rival is part of your objective, protectionist measures become more attractive, even if it lowers income. This results in a noncooperative equilibrium (or Nash equilibrium, in game theory), which features higher tariffs and less trade than in a world without rivalry, because both governments use trade policy to harm the other country.

Nevertheless, geopolitical rivalry doesn't change the fact that economic efficiency still matters. As long as they care at least somewhat about their citizens' welfare, governments that start from a position of noncooperation could adopt policies that make both countries better off. Unless rivalry becomes so extreme that governments care only about dominating their adversary, they would still negotiate with each other to increase economic efficiency and thus their citizens' welfare. Enlightened self-interest—the same force that drove postwar trade liberalization—remains a viable foundation for cooperation, even between strategic adversaries.

The adjustment problem

Yet even if cooperation remains possible, the transition from one equilibrium to another poses serious difficulties. It took decades of negotiations under GATT/WTO rules to move from the high-tariff world that emerged during World War II to a new, low-tariff era. Its two key pillars, reciprocity and nondiscrimination, served the trading system well by helping governments move from a noncooperative to a cooperative equilibrium.

What are the consequences for the trading sys-

tem of the eruption of geopolitical rivalry today? Governments that care about relative power threaten to impose higher tariffs to hurt their rivals. The old agreement no longer reflects the new reality. A new cooperative equilibrium is needed. The question is how government can get there.

Two paths are possible. The first is what we call “war and redemption.” Countries allow the old agreement to collapse, triggering a trade war that pushes tariffs higher. Eventually, governments negotiate a new agreement through traditional reciprocal tariff reductions. This path is economically costly and would likely require lengthy negotiations but fits within the existing framework of multilateral trade rules.

The second path is more efficient but requires institutional innovation. Countries negotiate an immediate transition, avoiding economic disruption. But this adjustment involves moving along the frontier of possible efficient outcomes (see box). To sustain cooperation, the country for which the geopolitical shock is less severe must make concessions that reduce its welfare relative to the status quo. This is neither reciprocal nor mutually advantageous in the traditional sense, and the WTO's foundational principle of reciprocity cannot accommodate it.

The challenge deepens in the multilateral world. Along with reciprocity, the principle of nondiscrimination might not facilitate adjustment, as it requires that any trade benefit extended to one member be extended to all. But when two rivals need to transfer economic benefits between each other, third countries are excluded and face consequences.

The 2020 Phase One agreement between the United States and China illustrates the problem. The deal, intended to ease trade tensions, included Chinese commitments to buy specific quantities of US goods. World Bank research at the time of the agreement predicted that although both countries would have gained relative to continued escalation, exporters in Europe, Latin America, and elsewhere would have been hurt if China had redirected imports from those regions to the US. The fact that the agreement was struck outside multilateral trade rules points to a deeper problem: The current system cannot accommodate the adjustments that geopolitical rivalry demands.

A geopolitical exemption

If the multilateral trading system is to remain relevant, it must create space for geopolitical adjustment while protecting third countries. In our research, we propose a geopolitical exemption to the fundamental principles of reciprocity and nondiscrimination that would allow strategic

rivals to make discriminatory tariff adjustments under strict conditions.

There is a precedent for such an exemption. The trading system already accommodates certain forms of discrimination—for instance, allowing members to form preferential trade agreements, such as through free trade areas. These agreements advance the goal of liberalizing trade as long as they meet strict conditions: They cover “substantially all trade” among members and do not raise barriers against nonmembers. A geopolitical exemption would serve a different purpose: accommodating rivalry between strategic competitors while minimizing damage to the broader multilateral system.

The exemption would require that any discriminatory adjustments between rivals leave world prices between the rivals and third countries unchanged, thus limiting trade diversion. Implementing such a rule would be technically complex. But the alternative is worse: Geopolitical adjustment happens either outside the multilateral framework, undermining existing trade rules and imposing costs on neutral countries, or doesn’t happen at all, leaving the world trapped in destructive trade conflicts.

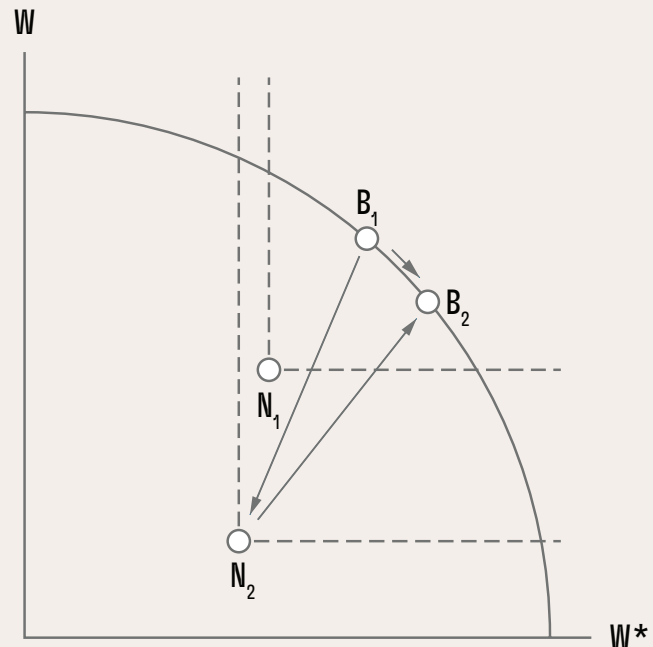
Preserving cooperation

We argue that the return of geopolitics does not eliminate the economic case for cooperation. Even countries engaged in strategic rivalry can benefit from negotiated agreements. The fundamental logic that sustained decades of trade opening remains intact. But new mechanisms are needed if geopolitical rivals are to adjust their trade relationships without engaging in disruptive trade wars or imposing undue costs on third countries.

The trading system has adapted before when circumstances changed—adding new agreements as the global economy evolved during multiple rounds of negotiations. The challenge today is to undertake a similar adaptation for geopolitical realities, preserving the core functions of the system while updating its rules for a changed world. The geopolitical exemption we propose would provide such a mechanism, establishing safeguards that maintain the integrity of the multilateral system while acknowledging the reality of strategic competition. **F&D**

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Two Paths of Adjustment to Geopolitics



The axes represent the welfare levels of two rival countries (home, without *, and foreign, with *); the curved line traces the efficiency frontier. N_1 represents the noncooperative equilibrium that emerged during World War II; B_1 is the lower-tariff equilibrium reached under General Agreement on Tariffs and Trade/World Trade Organization rules. When geopolitical rivalry erupts, the noncooperative equilibrium shifts to N_2 .

Two paths to the new equilibrium at B_2 are possible. The first, from B_1 to N_2 to B_2 , is what we call “war and redemption.” The collapse of the old agreement pushes tariffs up to the new noncooperative level N_2 . This path is long and economically costly but fits within the existing multilateral framework. The second path, directly from B_1 to B_2 , is more efficient but requires institutional innovation as it implies a nonreciprocal exchange. Countries negotiate an immediate transition, avoiding economic disruption.