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**Research Report**

## Does the trading system have a future?

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JAN TUMLIR  
POLICY ESSAYS

# DOES THE TRADING SYSTEM HAVE A FUTURE?

MARTIN WOLF

By Martin Wolf



Number 01/2009



**About Jan Tumlir:** The late Jan Tumlir was a leading scholar of trade policy, with a distinctive constitutional, classical-liberal defence of free trade drawn from his reading of law and economics. A Czech by origin, Jan Tumlir emigrated to the West in the 1940s and in 1967 became the Director of Economic Research and Analysis at the General Agreement on Tariffs and Trade (GATT). He supervised the economic research of the GATT for almost two decades, and was known as the GATT's "resident philosopher". Tumlir emphasised the structural nature of protectionism as the outgrowth of overactive government at home. He strongly advocated a rule-based international economic order pillared on free trade and constitutional democracy.

• Read more about Jan Tumlir at [www.ecipe.org/tumlir](http://www.ecipe.org/tumlir)

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## PREFACE

Razeen Sally

FROM HIS PERCH as the *Financial Times*' chief economics commentator, Martin Wolf is one of the leading observers of the world economy. He has written perhaps the best book on modern economic globalisation. For ECIPE's first Tumlr Lecture he turns his attention to the world trading system, which he studied closely in the 1970s and '80s, first at the World Bank and then at the Trade Policy Research Centre in London.

Martin begins by evoking the memory of Jan Tumlr, the Czech *émigré* and student of law and economics who was for a long time the GATT's in-house philosopher before his untimely death in 1985. Martin knew Tumlr well, and cuts to the essence of his thinking: his *Mittleuropäisch* anxiety about ever-present dangers to the world trading system, even in seemingly prosperous times; and his rock-solid classical-liberal, "constitutional" defence of free trade.

ECIPE draws inspiration from the classical liberal tradition of political economy. Our decision to name our series of policy essays and our flagship lecture series after Jan Tumlr is deliberate. Tumlr's world-view was inspired by Adam Smith and his twentieth-century followers: Frank Knight and his idea of "government by discussion" to agree procedural rules of the game for the market economy; F.A. Hayek's theory of rules for an open, evolutionary economic order; the German Freiburg School's blend of law and economics for free economic constitutions; and James Buchanan's "constitutional economics". He fused all the above into a distinctive classical-liberal, constitutional view of international economic order. Tumlr believed that free (or free-ish) trade "abroad" depends on free markets and limited government at home. To him, overactive government at home, trespassing on private property rights and the market economy inevitably trespasses beyond the border. The result is protectionism and international conflict abroad. That is how he interpreted twentieth-century economic history; and that is why he worried about post-1945 Big Government and the "new protectionism" of the 1970s and 80s. Imagine, then, what Tumlr would have to say about governments' responses to the current global economic crisis, and what implications that might have for the world trading system.

Martin applies many of Tumlr's insights to the early twenty-first century trading system. Like Tumlr, he stresses the importance of unilateral liberalisation. He bemoans the "UNCTADisation" of the WTO, and discusses what is needed to set it on its legs again. And he worries about out-of-control discrimination resulting from a proliferation of FTAs. That, he thinks – very much in Tumlr's spirit -- has profound constitutional implications for an open trading system whose bedrock has been non-discriminatory multilateral rules.

Martin prepared this lecture in the summer of 2008 in the midst of a global credit crunch, but before it snowballed into a global economic crisis. International trade was still flourishing, while trade policy was stalling. Within weeks of the lecture "deglobalisation" set in, marked by precipitous falls in international trade and foreign direct investment. As Martin rightly signalled in 2008, a thirty-year free-market revolution has ended, and has been replaced by a new age of government intervention. The climate of ideas has shifted too. This is most visible in the rediscovery of Keynesian macroeconomics, macroeconomic policy intervention and financial-market reregulation. All this will have repercussions for swathes of microeconomic policy – and probably for trade policy and the world trading system. These are critical issues for ECIPE. I look forward to Martin's thoughts *apropos* in the seasons to come.

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## INTRODUCTION

*“In the period since World War II, national economic policies were made compatible, both internally and between countries, by the adherence of governments to international rules articulated in Bretton Woods, Havana and Geneva. On the monetary side these rules ensured relative stability of price levels, and thus also of exchange rates and on the trade side, they secured stable and non-discriminatory access of all exporters to at least the large markets of the developed countries.”*

Jan Tumlrir.

*“There is a great deal of ruin in a country.”*

Adam Smith.

I AM DELIGHTED to give a lecture on the future of the trading system that honours the memory of a brilliant man and a fine friend. I came to know Jan Tumlrir well early in the 1980s, when he ran the research department at what was still the secretariat of the General Agreement on Tariffs and Trade and I was director of studies at the Trade Policy Research Centre in London. His influence on those who thought about the political economy of the trade policy system was profound. Preparing the lecture has forced me to consider, once again, what the trading system is for, how well it is doing and where we should wish to take it. But, first, let me start with Tumlrir’s own views.

### *Tumlrir’s View of the Trading System*

TUMLRIR WAS A classical liberal in the contemporary tradition of Chicago University’s Frank Knight, the German “*ordo* liberals” and the Austrian refugee, Friedrich Hayek. He persuaded lawyers, economists and even the occasional policy-maker to ask deep questions about the purposes of the system he served. Jan never wrote a big book, leaving vast amounts of material behind him that never saw the light of day. But, in his writing for the GATT secretariat and in his conversation, he marked many people forever. I am proud to count myself among

that number. His sudden death, immediately after his retirement from the GATT in 1986, robbed the world of its finest thinker on the constitutional significance of the liberal trading system.

For Tumlrir, the principles of the post-war trading system, which themselves went back to the 19th century *système des traits*, were no merely technical matter. Nor were they just about liberalising trade, important though that was. They had constitutional significance. Their purpose was to protect the market from arbitrary government intervention and so protect states from one another. The purpose, in short, was to create a predictable economic order in the mutual interests of states, private individuals and companies.

This should not be an unfamiliar idea to Europeans, for it was one of the founding ideas of the European project, as Tumlrir himself pointed out. In an important article, he stated, “The protection of the private economy from the government was the eminent idea in forming the European enterprise.”<sup>1</sup> For Tumlrir, the international economic order performed the same function as these European rules, albeit more weakly, since the principle of non-discrimination replaced the stronger principle of national treatment and the principle of reliance on bound tariffs as an instrument of protection replaced the stronger principle of free and open internal competition. Tumlrir stated, quite famously, that “the international economic order can be seen as the second line of national constitutional entrenchment.”<sup>2</sup>

In Tumlrir’s view, therefore, there are four fundamental principles of the international trading system: the use of a transparent and market-conforming instrument of protection, the tariff; the “binding” of protection; the negotiation of lower barriers through reciprocal bargaining; and their generalisation to trade across the world through the principle of unconditional most-favoured nation treatment. The political benefit of this system is that it would take trade policy from the political armoury of states, thereby reducing the potential for mu-

1. Tumlrir, “Strong and Weak Elements in the Concept of European Integration”, in Fritz Machlup, Gerhard Fels and Hubertus Muller-Groeling, *Reflections on a Troubled World Economy: Essays in Honour of Herbert Giersch* (New York: St Martin’s Press, 1983) p. 36.
2. Tumlrir “International Economic Order and Democratic Constitutionalism”, *Ordo*, 34, 1983, p.80.

tually immiserising and pointless conflict over economic policies. The economic benefit of this system was that it would generate an integrated market economy across the globe.<sup>3</sup>

To Tumlr, the greatest of the many possible trade-policy sins was discrimination: discrimination meant arbitrary intervention by governments in economic affairs; discrimination meant unstable conditions in world market; and discrimination meant friction among nations. In the fullest statement of his views, a monograph entitled *Protectionism*, published shortly before his death, Tumlr made the growth of the so-called “voluntary export restraints” the centre of his concerns.<sup>4</sup> These he saw as classic examples of unprincipled bureaucratic intervention in economic life. They violated what he saw as the fundamental principles of the trading system and, more importantly, of a liberal international economy. They were arbitrary, often extra-legal, market-disrupting and discriminatory quantitative interventions. They were, in his view, the road to ruin.

Yet ruin did not come, or at least not to the West. It is one of my regrets that Tumlr, a refugee from what was then Czechoslovakia, did not live to see the collapse of the communism he abhorred and the expansion of economic and personal freedom that followed across the globe over the past two decades. He would have been delighted by the expansion of the European Union and the corresponding shrinkage of the Russian empire. He would have been astonished by the shift to the markets of China and India.

Yet Tumlr was also a worrier. He was a central European, after all. It is an attitude to the world I know well. He would have found many of today’s trends worrying, too. In the trading system, in particular, he would have been greatly concerned by the gadarene rush towards ever-greater and more complex discriminatory trading arrangements. I agree with him.

So where are we now? How far should Tumlr’s concerns occupy our thoughts about where the trading system is

today and where it will – and should – go tomorrow? These are the issues I wish to discuss in this lecture

### *State of Trade and the Trading System*

IF WE MOVE forward more than twenty years, how does the trading system look today? In attempting to answer this question, we need to distinguish the state of world trade from the state of the trading system. The former is in the rudest health. The latter is looking rather sicklier.

### **Dynamism of world trade**

THE DYNAMISM OF world trade is quite remarkable. Indeed, the evidence strongly suggests that as the emerging world increasingly opens up to the world economy, the underlying growth of world trade is also accelerating. Figure 1, for example, shows that the volume of world trade and of world trade in manufactures has been growing at a faster trend rate in each successive business cycle since 1981. It has also been growing at almost twice the corresponding trend rate of growth of output. World trade in commercial services is also growing rapidly: between 2000 and 2006, the value of world trade in commercial services grew at 11 per cent a year, the same rate as world merchandise exports.<sup>5</sup> This, then, is a world in which trade leads economic growth and the world economy itself is becoming ever more open.

As important as the dynamism of world trade has been the rise of significant new trading powers. If we treat the European Union as a single economy, thereby ignoring its vast internal trade, we find that in 2006 China was the third largest merchandise exporter, with \$969bn, after the EU, on \$1.482bn and the US, on \$1.038bn, but already far ahead of Japan’s \$650bn. Other important emerging exporters, apart from the oil and gas exporters, were Mexico, Taiwan, Malaysia, Singapore, Brazil and Thailand. China and India were also already the fourth and fifth largest exporters of commercial services (after the EU, the US and Japan), respectively, in 2006 (with EU internal trade once again ignored).

3. My fullest statement of these ideas is contained in “An Unholy Alliance: the European Community and the Developing Countries in the International Trading System”, in L.B.M Mennes and Jacob Kol, *European Trade Policies and the Developing World* (London: Croom Helm, 1988) pp.31-57.

4. Tumlr, *Protectionism: Trade Policy in Democratic Societies* (Washington D.C.: American Enterprise Institute, 1985).

5. World Trade Organization, *International Trade Statistics 2007*, Table I.3, p.8.



Arguably, the more important measure of the impact of emerging countries is in their role as importers. This is certainly a measure of their influence in classic reciprocal trade liberalisation within the GATT and now the WTO. Figures 2 and 3 show the situation for merchandise and services imports, respectively, in 2006. By then China was already the world's third largest importer of merchandise products (with the EU treated as a single economy), though its \$792bn was far behind the US (on \$1.919bn) and the EU (on \$1.698bn). In that year, India came ninth, with imports of \$175bn. In the case of commercial services, China again came third, with India seventh. But, given the extremely rapid growth of the trade of these countries, we can confidently expect them to become far more important in the years to come.

In all, then, we can detect two overwhelmingly important trends over the past quarter of a century. First, trade has consistently grown faster than output. This simple and powerful measure demonstrates that globalisation continues to be the most powerful economic (and, arguably, political) force in the world today. Second, the emerging countries – and, above all, China – have entered ever more powerfully into global trade. China's openness to trade is astonishing: its ratios of trade to gross domestic product are almost as high as those of South Korea, a country whose population is roughly a 30th of its size. These two developments – the continued dynamism of world trade and the opening of the emerging countries - are, of course, closely connected.

### State of the world trading system

BEHIND THE EXPLOSIVE growth in world trade and the entry of important new players on the world trading scene has been the revolutionary economic liberalisation of emerging economies. I am sure that Tumlrir would have been astonished and delighted by the bet the Chinese and, subsequently, the Indians have decided to take on the market economy and global integration. He would have been still more delighted by the collapse of Soviet communism and the Soviet empire, which liberated not just his own country, but Central and Eastern Europe. Tumlrir's personal history was, in this way, closely connected to the "great liberalisation" of this era.

If we turn to trade policies, more narrowly, the last quar-

ter century has been an era of remarkable liberalisation. Figures 4 and 5, taken from the International Monetary Fund's *World Economic Outlook* of October 2007, demonstrate the convergence of tariff rates across the world over this period. In his outstanding recent study of trade policy, Razeen Sally of the London School of Economics demonstrates the opening across the world, including the liberalisation of non-tariff barriers and of access to markets for services. He makes three other significant points: first, a big gap has opened up, particularly in developing countries, between applied and bound tariffs – in South Asia, for example, the average of the former was 17.8 per cent between 1998 and 2004, while the average for the latter was 66.5 per cent; second, protection remains far higher for agricultural commodities than for manufactures, the proportional (rather than absolute) discrepancy being particularly big in the high-income countries; and, third, use of anti-dumping measures has increased in a number of countries, notably India, as other forms of protection have been liberalised.<sup>6</sup> On balance, however, this was an era of remarkable trade liberalisation, which was part of a wider economic liberalisation and move towards the market, across the globe.

Given the wide discrepancy between bound and applied tariffs, it is evident that the world trading system, narrowly defined, namely, the GATT and then WTO, was not responsible for most of the trade liberalisation by developing countries. In fact, most of this liberalisation was undertaken unilaterally, though frequently under pressure from the International Financial Institutions. Nevertheless, the trading system has itself developed enormously, for both good and ill, over the past quarter century.

As a result of the Uruguay round and subsequent sectoral negotiations, the following big changes have occurred: first, the WTO has been created as a single undertaking, binding on all members, numbering 153 in July 2008; second, the WTO covers essentially all trade and a number of important trade related areas, notably intellectual property and trade-related investment; third, as a result, the WTO affects an increasing number of sensitive policy areas, such as food standards, previously thought of as purely domestic; fourth, there has

6. Razeen Sally, *Trade Policy, New Century: The WTO, FTAs and Asia Rising* (London: Institute of Economic Affairs, 2008) Chapter 3 "The Political Economy of Trade Policy".

been substantial liberalisation; finally, the dispute settlement system has been made much more rigorous, legalistic and binding within the WTO.

As decision-makers transformed the size, economic scope, impact and legal potency of the trading system, they also increased its political visibility.<sup>7</sup> This too has had a number of adverse consequences: first; what had previously been the play thing of a limited group of highly knowledgeable policy-makers and technocrats has become the focus of fierce pressure from a wide range of non-governmental organisations, prominent among these being ones interested in development, the environment and human rights; second, increasingly, lobbyists for such causes see advantages in using the trading system for their own rather different ends – an objective that the inclusion of intellectual property seems to justify; third, those engaged in such debates also increasingly demand a direct say in WTO decisions, making the case that the present inter-governmental arrangement is “undemocratic”; fourth, as Mr Sally notes, the demands made and positions taken in the WTO make it look and feel increasingly like UNCTAD, rather than the old GATT; and finally, as attention is increasingly turned to the concerns of a vast mass of developing countries, the economic interests that might drive further liberalisation in the high-income and big emerging economies have become increasingly distanced and disaffected.<sup>8</sup> Yet most of these developing countries have next to no influence on world trade as a whole.<sup>9</sup>

The WTO is beginning to look like a tragic example of “advance into decline”. Its birth looked like a massive breakthrough, since it turned the GATT into the international organisation it was originally supposed to become, as the International Trade Organisation. Yet,

in practice, the more institutionalised and comprehensive the trading system has become, the less effective it has also risked becoming, notably at the old business of trade liberalisation. One consequence of this has been that trade negotiators, frustrated by having to negotiate within the WTO for years, have increasingly turned to so-called free trade arrangements or, more precisely, preferential trade arrangements. As a result, they have dramatically increased the legitimacy and salience of discrimination as a fundamental feature of the trading system, a development that Tumlrir would have deplored. As I have argued in previous articles, the EU was the first important trading power to make such arrangements a central part of its trade policies, largely for political reasons.<sup>10</sup> But now it has been joined by everybody else, notably the US.

Jagdish Bhagwati of Columbia University, doyen of trade economists, has been the foremost opponent of the rise of the PTAs.<sup>11</sup> He also invented the concept of the “spaghetti bowl”, sometimes known as the “noodle bowl” in East Asia. According to Mr Sally, “by July 2005, the GATT/WTO had been notified of 330 PTAs – 206 of them since the establishment of the WTO in 1995 . . . Over 180 are currently in force, with many more expected to be operational soon. Of the PTAs in force, 84 per cent are free trade agreements (FTAs), with customs unions and partial-scope agreements making up the rest. Bilateral (country-to-country) agreements account for over 75 per cent of PTAs in force and almost 90 per cent since 1999/2000, and even more so since the launch of the Doha Round.”<sup>12</sup>

Two features of this new burst of PTAs on the world trade scene are particularly striking: first, large powers are increasingly negotiating bilateral agreements

7. I have discussed the significance of these changes in “What the World Needs from the Multilateral Trading System”, in Gary P. Sampson (ed.), *The role of the World Trade Organization in Global Governance* (Tokyo: United Nations University Press, 2001) pp.182-208 and *Why Globalization Works* (New Haven and London: Yale University Press, 2004).
8. See, on this important point, Peter Kleen, “So Alike and yet so Different: A comparison of the Uruguay Round and the Doha Round”, *Jan Tumlrir Policy Essays* Number 02/2008, March 2008, [www.ecipe.org](http://www.ecipe.org).
9. In 2006, for example, the top 20 importers (with EU internal trade ignored) took 87 per cent of world imports of merchandise products and 84 per cent of world imports of commercial services. See *International Trade Statistics 2007*, op. cit., Tables I.9 and I.11.
10. Martin Wolf, “Cooperation or conflict? The European Union in a liberal global economy”, *International Affairs*, 71(2) pp.325-337.
11. See, most recently, his *Termites and the Trading System: How Preferential Agreements Undermine Free Trade* (Oxford and New York: Oxford University Press, 2008). Razeen Sally also discusses this topic at length in his *Trade Policy, New Century*, op. cit., Chapter 5.
12. *Op. cit.*, p.122.

with small ones; and, second, countries in east Asia, the world's most dynamic and successful trading region and the one that had, hitherto, mostly kept to non-discriminatory or, as the GATT called it, "most-favoured nation", trade are now increasingly inclined towards negotiating PTAs. As Mr Sally remarks, "As of 2005, ASEAN as a regional grouping, China and India were involved in seven, nine and fifteen FTA agreements or negotiations respectively."<sup>13</sup>

Unquestionably, the move towards discriminatory trade is, an important development. So why has it been happening? Foreign policy considerations are certainly important, as they were for the EU. They are also a response to the stalled multilateral negotiations. As Mr Sally notes, to make sense, PTAs should have comprehensive sectoral coverage, be consistent with the relevant WTO provisions and go beyond WTO commitments and practice at home. "Strong, clean 'WTO-plus' PTAs should reinforce domestic economic and institutional reforms to remove market distortions and extend competition. Finally, non-preferential (MFN) tariffs should be low in order to minimise any trade diversion resulting from PTAs."<sup>14</sup> This is not what has been happening.

Professor Bhagwati distinguishes the motivations of intra-developing country PTAs from those between hegemon and others. On the former, he notes the following motives: the desire to limit the competition they face; the desire to improve their bargaining position; the desire to take centre-stage in some negotiations; the desire to do what others are doing; and insurance against failure of the Doha round. On the latter, he notes the following aims: the desire of developing countries for security; the desire of developing countries for greater credibility of their own economic reforms; and developing country fear of receiving worse terms than competitors in the hegemon's markets; desire of the hegemon to retaliate against other hegemon's PTAs and to avoid suffering discrimination in other countries' markets; and, finally, the desire of hegemon to use PTAs as a way to promote non-trade agendas, such as those on investment or labour standards.<sup>15</sup>

Does this development matter? Tumlr would have had no doubt that it matters hugely. Indeed, he would surely argue that it represents an assault on the constitutional purposes of the trading system. The willingness of governments to negotiate a host of PTAs creates a fundamental instability in the terms of competition among businesses. This instability will favour those who can manage such risks, most of which will be relatively large companies. The move towards PTAs also creates trade diversion, particularly via local content requirements, complexity and so lack of transparency. As Professor Bhagwati points out, in modern trade, where inputs may be combined from many different sources and themselves go through many stages of transformation, the very idea of identifying origin is as absurd as it is costly.<sup>16</sup>

Equally, this shift also represents an assault on the function of the trading system in calming international relations. Each country will know that its businesses may be put at a disadvantage relative to those located in other countries at almost a moment's notice. Moreover, it knows that this will happen in response to purely political, rather than, economic considerations. No less disadvantageous is the neo-imperialism of "hub-and-spoke" agreements between hegemon and peripheral countries. The former are able to force the latter to accept onerous obligations, because the peripheral countries fear that, otherwise, their competitors will gain favourable access to vital markets. These new obligations can then ultimately be forced on all weak trading partners.

Beyond the move to PTAs, we must also recognise the growing protectionism in high-income countries, particularly the US. This is driven by a host of concerns, but particularly by rising income inequality; the perceived hollowing out of the middle class and the collapse of "corporate welfare". Perhaps it was an inevitable result of a system of trade negotiation that presented liberalisation as a "concession", in return for greater market access abroad. This "disarmament treaty for mercantilists", as I have previously described it, does not look as effective or persuasive as it used to, particularly now

13. Op. cit., pp.123-4.

14. Op. cit., p.127.

15. See *Termites and the Trading System*, op. cit., pp.41-7.

16. See *Termites and the Trading System*, op.cit. Chapter 3.

that remaining barriers, both at home and abroad, are so politically sensitive. Also important is the dysfunctional nature of the global payments system, which has itself created significant protectionist pressure as current account deficits yawn wide and exchange rates shoot up and down.

### **Assessment**

HOW THEN ARE we to assess the trading system in 2008, sixty years after the GATT was agreed. We can look at the dynamism of world trade and the openness of the world economy with great pleasure. We can be delighted, too, by the great liberalisation of trade policy across the world over the past three remarkable decades. We can take pleasure, too, in much that the WTO represents and has achieved. But we must also note the failure of the Doha round after several “last ditch” efforts. We must note, too, the mushrooming growth of PTAs which violate the spirit of the non-discrimination norm in world trade and pay little or no attention to the rules on such agreements in the WTO. We must recognize, as well, the growing hostility to the WTO in many quarters. We must stress, finally, the growth of protectionist sentiment in the high-income countries, particularly the US. Ironically, the countries that promoted globalisation as an ideal are increasingly nervous of its consequences.

### ***Path Ahead for the Trading System***

SO WHERE SHOULD the trading system go now? What do we do to make sure that the trading system and, far more importantly, trade has a future? These are huge and difficult questions. I intend to focus on four areas: the role of unilateralism; disciplining PTAs; new directions for the WTO; and managing domestic adjustment.

### **Towards a reinvigorated unilateralism**

AS MR. SALLY stresses, economists have always argued in favour of unilateral trade liberalisation. While some good arguments can be advanced for reciprocal liberalisation, they depend on countries having monopoly power in trade. This is rare, at least in the long run. Furthermore, only the big countries – the US, EU and now, maybe, China – have the capacity to affect the openness of the overall trading system. For most countries, unilateral trade liberalisation continues to make sense. Moreover, the actual practice of trade policy over the last three decades has demonstrated that this is so. Encouraging further unilateral liberalisation makes excellent sense, as Mr. Sally argues. But these are choices that individual countries need to make on their own. While the international financial institutions can advise, they should do no more than that. Nor, in my view, should the EU or the US. The EU does not understand how powerless developing countries feel. Sovereignty matters for them. Let them enjoy it if they wish.

This does not mean that nothing can be done to promote wise unilateral liberalisation. What countries need is a culture of evaluation. This topic has been discussed in a number of reports. It would be hugely desirable if all member countries of the WTO, big and small, introduced a system of rigorous assessment of their trade policies into their domestic institutional framework. This would be particularly useful for the emerging countries whose barriers to trade are still, on the whole, higher than those of the high-income countries. Particularly important would be clarification of the winners and losers from trade-policy interventions.

**Towards disciplined PTAs**

IT IS ALWAYS a good approach to policy to ask whether the principles that underlie it can be generalised. So, imagine a world in which every member country of the WTO decided to negotiate a bilateral agreement with all the others. There would be over 10,000. This leaves aside all the possible plurilateral agreements. So this is a policy that has a long way to go! Now imagine what such a world would be like. Every business would face different barriers in every market. Of course, there would be some limits. It would be impossible to have different regulatory regimes governing service providers from every other country in the world. For this small mercy, may the Almighty be thanked. Nevertheless, the result would, as the fathers of the GATT (and Tumlir) understood, be bitterness and chaos.

### **Towards disciplined PTAs**

So why not do what the fathers of post-war liberalisation also did when they wanted to remove bilateral trade agreements, which often then took the form of barter trade? Why not replace all the new bilateral agreements with a multilateral agreement in which one agrees to offer to all countries the most favourable terms available in any of one’s bilateral agreements? And what might one call this new super-agreement, which pre-empts all the bilateral agreements? What about calling it the World Trade Organisation? Indeed, why not do this now before

we get to the 10,000 agreements? This is not an impractical idea. What would be needed is for the hegemonic powers to agree a free trade area amongst themselves, with the condition that any country which wished to accept the obligations of this agreement could also join. In this way, the WTO could indeed be recreated via a genuine free trade agreement. Moreover, the new open FTA could also be administered within the WTO.

This may be deemed too idealistic. If so, something more limited will have to be tried. This would be reinvigorating WTO discipline over the bilateral agreements. Ideally, the requirements should be raised to a high level, in which “substantially all” trade truly is liberalised. Also important is some agreement on what local content requirements should look like. Ideally, they would all be much the same.

### **New directions for the WTO**

THE THIRD DIRECTION of reform would be of the WTO itself. Here I would make the following suggestions.<sup>17</sup>

First, the idea of a single undertaking needs to be looked at again. Insisting that everybody signs up to everything creates two contradictory pressures – a move to the lowest common denominator and the imposition of what may turn out to be politically intolerable obligations. If the idea of a single undertaking is re-examined, it might also be possible to re-examine consensus. If countries are not bound by everything, they cannot be expected to be consulted on everything. That should make it far easier to reach agreement in trade rounds.

Second, the dispute settlement procedure needs to be reconsidered in at least one important respect: where the underlying meaning of the texts is obscure, panels should not try to invent law. They should, instead, encourage parties to return to negotiation. If necessary, they should honestly admit that the law is unclear.<sup>18</sup>

Third, the range of compensation needs to be broadened, to include financial compensation since compensation through trade often imposes unfair costs on unrelated parties. It should become quite normal for an impasse between two parties to be settled through fi-

ancial compensation. The beef hormones case between the US and the European Union seems ripe for such treatment.

Fourth, the question of legitimate infant industry protection and subsidisation needs to be re-examined. Without endorsing the wisdom of infant industry protection as a general idea, the international community should examine the question whether developing countries should have greater freedom to introduce export conditions, export subsidisation and other means to promote early stage industrialisation.

Fifth, we need to abandon huge multilateral trade rounds. It has taken more than 30 years to complete two and fail, so far, to complete a third. In an ideal world, we would complete the Doha round and then declare victory. Subsequent rounds should be narrower and should be limited to those areas where a large common interest needs to be served. I believe there are three principal areas where multilateral rules are sorely needed: civil aviation, where the plethora of bilateral agreements remains a nightmare; investment, where a multilateral code, open to voluntary signature, could be of great value; and, the most important, energy, where the potential for friction, even war, over attempts to obtain privileged access to foreign energy is very great. The agreement on energy would essentially recognize the sovereign right of exporting countries to sell to the highest bidder and so preserve a unified world market in energy resources. It would thereby undercut many of the justifications given for state-supported investment in foreign energy resources.

In all, however, the WTO should be defended. The complaints against it are hugely exaggerated, where not totally misconceived. It is not a tyranny; on the contrary, it is extremely weak. It is not undemocratic; on the contrary, it is an expression of democratic choices. It can be improved. But, without it, the big powers would do what they want to an even greater extent than they already do. It would be senseless, if not insane, to prefer that.

17. This discussion draws on Wolf, *Why Globalization Works*, *op. cit.*, pp.211-12.

18. The idea that dispute settlement should become less legalistic and more diplomatic is advanced by Claude E. Barfield in *Free Trade, Sovereignty, Democracy: the Future of the World Trade Organization* (Washington D.C.: American Enterprise Institute, 2001).



## Managing domestic adjustment

TUMLIR WOULD HAVE had no doubt that the right policy is liberalism at home and abroad. Mr. Sally takes exactly the same line in his excellent recent study. I have much sympathy with it but I no longer fully agree. It seems to me to be self-evident that the absence of a functioning social safety net leads to a focused opposition to liberal trade because it is, first, easy to blame foreigners and, second, workers cannot adequately insure themselves against the risks. At the least, it is essential for workers not to be dependent on company-sponsored insurance schemes if they are to accept the shifts in comparative advantage potentially brought about by trade in the modern world economy. This is of particular relevance in the US. Meanwhile, in the EU, the priority is not to increase the size of the social insurance programmes, which are already as generous as can be managed. It is rather to shift payments towards adjustment rather than against it. This means subsidising training and even relocation, while limiting the duration of payments of unemployment benefit.

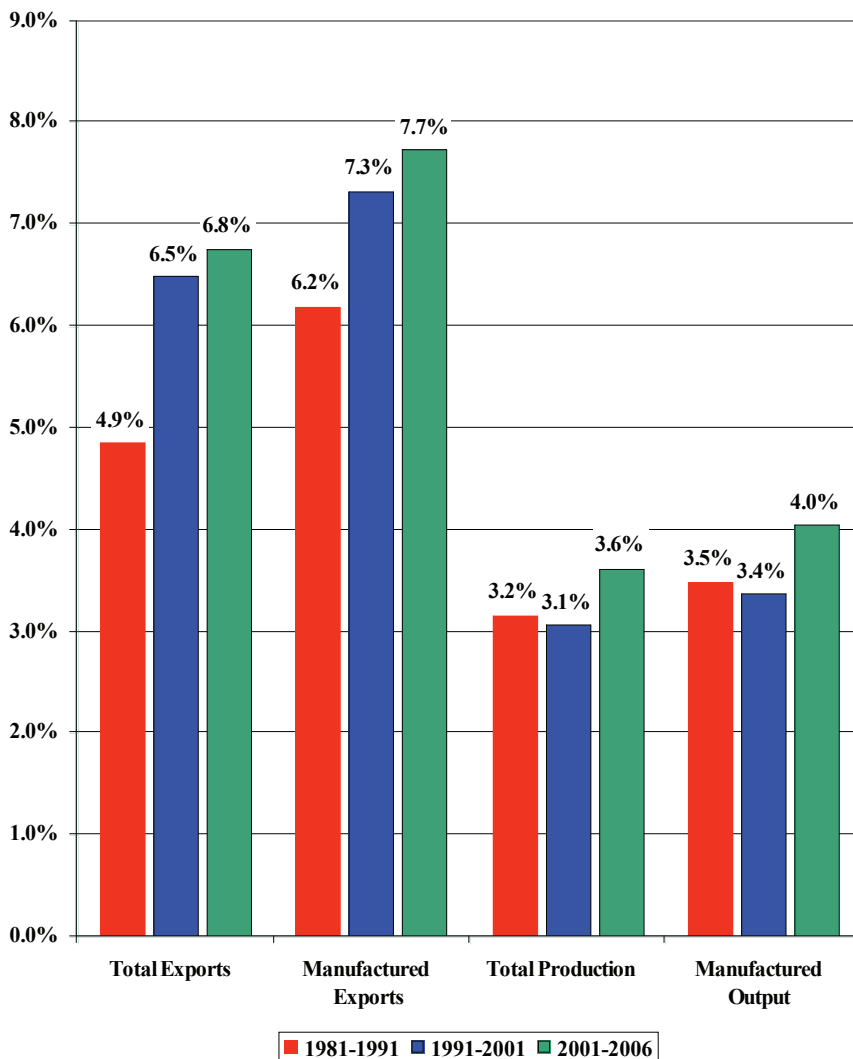
A still bigger issue arises in the context of contemporary globalisation – the structural shift in incomes away from unskilled employment and towards the most skilled. This, in my view, strains the democratic compact. It is one of the reasons for the rise in populism, particularly populism of the right. It seems to me reasonable to argue that the winners should share some of their gains with the losers, one of the best ways being via provision of high-quality public goods and services to all.

## Conclusion

THERE IS A great deal of ruin in the trading system. Yet, in many respects it has been a huge success. The opening of the world economy of the past three decades and the creation of the WTO itself are both aspects of this great success. The question, however, is where we go from here, at a time when the Doha rounds seems impossible to complete, preferential trade arrangements are exploding, the WTO is subject to constant political attack and protectionist pressures are rising, particularly in high-income countries. These difficulties are not new. Things looked even worse in the mid-1970s and, again, in the mid-1980s. Nevertheless, it is important to renew institutions and reinvigorate the move towards

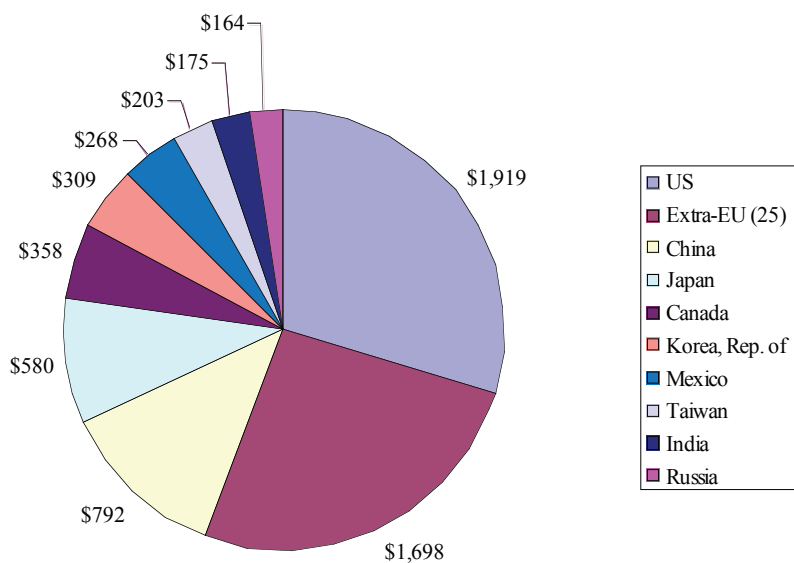
liberal trade that has brought such great opportunity to the world. The essence of my recommendations can be brought down to four points: stress the value of unilateral liberalisation; discipline PTAs, ideally by creating just one PTA available to all; refocus the WTO, by reconsidering the idea of a single undertaking and by moving away from huge rounds; and, finally, focus on the sorts of domestic reforms that will allow societies to remain open to the world. Tumlir always asked the right questions, as should we. We do not always need to agree with his answers.

**FIGURE 1: EXPORT VOLUMES AND ECONOMIC OUTPUT OVER SUCCESSIVE BUSINESS CYCLES (LOG-LINEAR TREND, PER CENT A YEAR)**



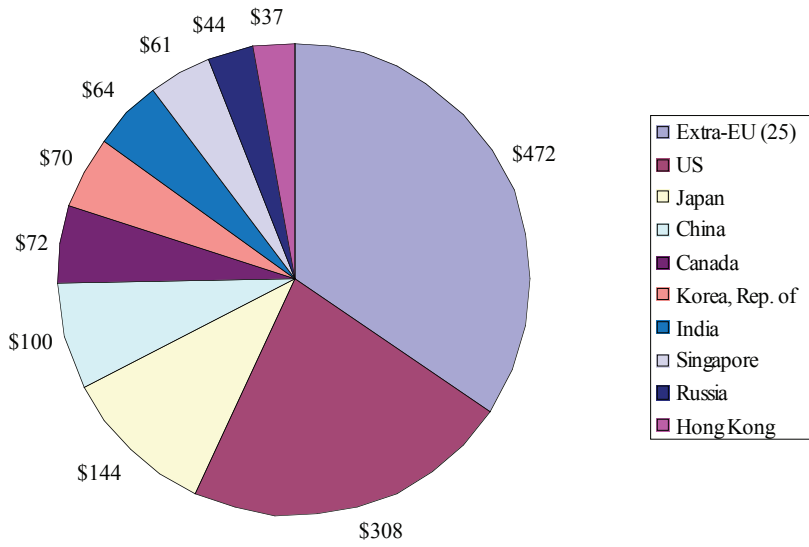
Source: WTO, International Trade Statistics 2007

**FIGURE 2: WORLD'S LEADING IMPORTERS OF MERCHANDISE PRODUCTS 2006 (\$BN)**



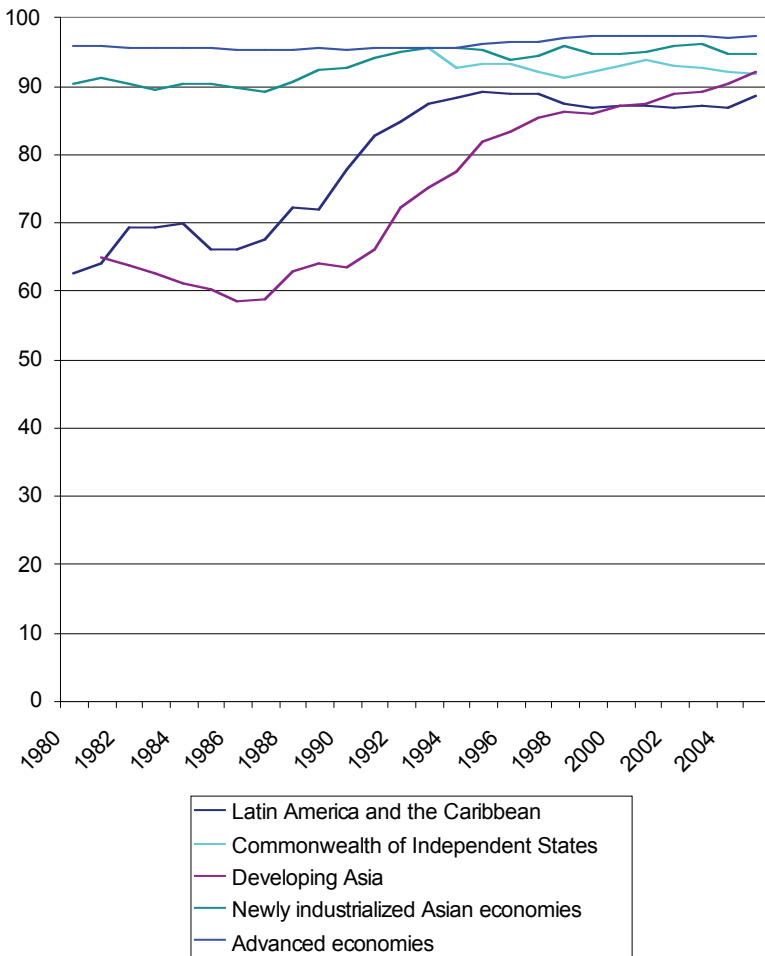
Source: World Trade Organisation, International Trade Statistics 2007

FIGURE 3: WORLD LEADING IMPORTERS OF COMMERCIAL SERVICES 2006 (\$BN)



Source: World Trade Organisation, International Trade Statistics 2007

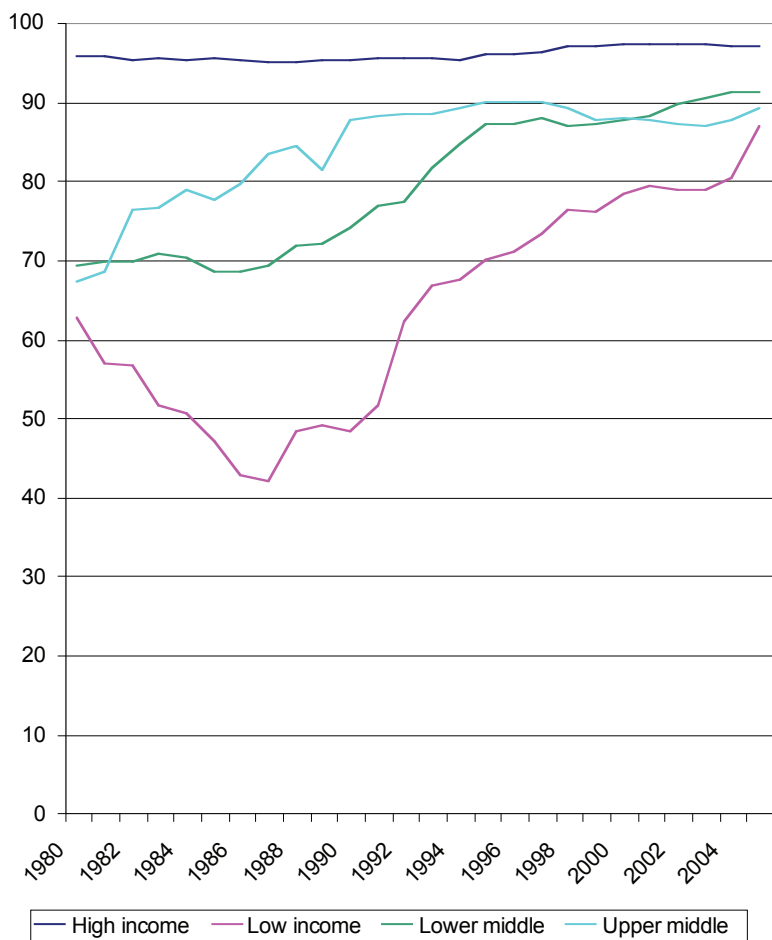
FIGURE 4: REGIONAL OPENING TO THE WORLD: 100 MINUS THE TARIFF RATE (AVERAGE OF EFFECTIVE TARIFF RATE AND OF THE AVERAGE UNWEIGHTED TARIFF RATES)



Source: International Monetary Fund, World Economic Outlook, October 2007



**FIGURE 5: OPENING TO THE WORLD BY INCOME GROUP: 100 MINUS THE TARIFF RATE  
(AVERAGE OF EFFECTIVE TARIFF RATE AND OF THE AVERAGE UNWEIGHTED TARIFF RATES)**



Source: International Monetary Fund, World Economic Outlook, October 2007



## COMMENTARY

By Patrick A. Messerlin

IT IS ALWAYS a great pleasure to discuss a paper by Martin Wolf. And there are few, if any, people better placed than Martin to talk about Jan Tumlir's work and profound influence. When leading the London-based Trade Policy Research Centre in the early 1980s, Martin made clear how much he shared Jan's views—in particular, this essential, often mistreated principle of non-discrimination as a fundamental constitutional right at the world level, as well as at the level of the European Community or any individual country. Reading Martin's piece—in particular, the sentence when Martin qualifies Jan as a “worrier” from Central Europe—I realised why such a strong statement of this principle could only come from a Central European. After all, this was the part of Europe where chaos from discrimination was at its peak during many decades of its recent history, and this chaos came with a heavy political price.

As commentator, my role is to raise differences of opinion or judgment. However, let me first list the many points on which I fully adhere to what Martin says: the consistent growth of world trade compared to domestic output since the Second World War; the amazing turn of events in China, India, etc. which is clearly a consequence and a cause of the robust health of world trade; the urgent need to improve the world trade regime (in particular the re-designing of the Single Undertaking, a trap set for reluctant developing countries in 1995 and now a trap gluing every WTO Member); the restraint that panellists involved in a WTO dispute settlement case should impose on themselves when facing very unclear provisions (with the corollary of sending back the problems to negotiators); and last but not least, the notion of a “culture of evaluation” as a key feature of advanced economies and societies—indeed, this is a common motto of ECIPE and GEM.

Let me now turn to a point where I benefit from an “unfair” advantage over Martin. Martin wrote his piece in late 2008, before trade collapsed to unprecedented lows at an unprecedented speed, with an almost instant vanishing of trade financing. Does this turn of events make inappropriate Martin's core observation on the robust state of trade (by opposition to the state of the trade regime that Martin finds much weaker)?

I do not think so. First, one should expect that, in economies based on the “just in time delivery” principle, swings in trade could be very strong if the economic crisis is deep in core economies—as is the case today. Second, it may happen that the level of trade activity could trail behind domestic output for a substantial amount of time—an evolution often qualified today as “de-globalisation”. In fact, some level of de-globalisation in the years to come would not be very surprising. It would simply translate, in the international trade dimension, the excesses of the 1990s-2000s in the largest world economies. In that period, financing was over-abundant, so was trade. As a result, trade contraction could occur for some time. But, if that is the case, it would be more accurate to talk about excessive globalisation of the 1990s and 2000s than about de-globalisation in the 2010s, and about a return to a healthier situation. Such a contraction would simply reflect the adjustment of the world economy to more appropriate spending and saving behaviour in some large economies (a change the necessity of which Martin has repeatedly underlined in his FinancialTimes column). After years of “digestion” of the previous excesses, the crucial feature of the state of trade underlined by Martin would re-emerge.

That said, let me turn to the main point on which I don't share Martin's judgment. It is to oppose the robust state of trade and the weak state of the trade regime. I would argue that the state of the trade regime is much better than he claims it to be (and that it is often said) and that the feeling of weakness flows from the fact that we are impatient because the trade regime does not deliver the desired outcomes at the speed we would like. But, if the trade regime delivers much more slowly than we would like, it remains a fact that, ultimately, it delivers.

Martin's main argument supporting the weakness of the trade regime is the proliferation of “preferential trade agreements” (PTAs). As an economist, I fully agree on the folly of PTAs (this is why I use the term PTAs, not “free trade agreements” or “regional trade agreements” which do not reflect the reality they are supposed to describe). Most justifications of PTAs provided by economists look to me like “reverse engineering”, i.e., arguments that are conceivable, but that are unable to reverse the PTAs fundamental negative impact in terms of trade distortions in the real world. In this respect, it is remarkable that very few economists remember that the founding fathers of Europe did not turn to a regional

trade agreement for its own merits, but as a second best imposed by the fact that the road to a political Europe was blocked for a very long time. The Treaty of Paris had little to do with economic integration as conceived today. It was much closer to the notion of “eternal peace” between European countries supported by cartels in steel and other “essential” products that the 1920s and 1930s were dreaming about as a way to make wars between Europeans impossible. And the Treaty of Rome (the first to create a PTA as conceived today) was unenthusiastically decided after the failure of the European Defence Community. The rapid and huge success of the European Economic Community was largely unexpected, especially after the many heated debates (now forgotten) on its negative effects in terms of what we would call today “social dumping”.

That said, as an observer (i.e. an economist remembering that we operate in a world immersed in politics), I am convinced that today PTAs are a negligible nuisance in the vast majority of cases, as I already argued (Messerlin 2007). First of all, the growth of the number of PTAs reported by the WTO Secretariat (or any other similar institution) is not representative of the reality. This number is plagued with double counting, and it relies on the dubious proposition that a bilateral PTA between two small WTO Members is the same animal as the complex plurilateral generated by the Treaty of Rome in goods and services. Indeed, the WTO Secretariat (and any other similar institution) would make great service to the world by publishing these figures with a (long) caveat on how to interpret them properly.

That said, PTAs can be divided into three categories. First, there are PTAs involving two small countries. Almost all of them are concluded by non-WTO Members or by countries having become recently independent. As Martin said, let them have their own experience. Repeated experiences in the past have shown that PTA partners come quickly to the conclusion that such PTAs are not welfare-enhancing if they are built behind high tariffs on imports from the rest of the world. If they are built behind small tariffs with respect to the rest of the world, they may have some marginal positive effects. But then, they represent no serious threat to the WTO principle of non-discrimination.

A second type of PTA is concluded between small and large economies. The experience of the last decade(s)

suggests good reasons for the following permanent apparent inconsistency: on the one hand, renewed efforts to launch new PTAs and, on the other hand, a very high rate of failure to ratify the negotiated PTAs. Such a bizarre mix flows from the asymmetrical gains from increased market access and negotiating costs for the two partners. For the small partner, a PTA with a large economy looks like a trade liberalisation with the world, with the large partner as an acceptable “proxy” of the world economy. In addition, negotiating a PTA with one country is much simpler than a WTO Round for the small partner, even if some provisions of the PTA are often (much) harder to swallow for the small country sovereignty than the corresponding WTO provisions. For the large partner, such a PTA is likely to remain largely unnoticed (too small an impact in terms of economic gains) until one or a few key vested interests in the large country feel threatened by the PTA (such interests can be tiny since the PTA trading partner is small—they simply need to be vocal and have efficient lobbying). Small losses concentrated on a few sectors combined with unnoticeable gains are enough to induce the large partner to never sign or ratify the PTA.

Last but not least, the third group of PTAs is those between two large economies. They are the ones that deserve Martin’s worries because the size of the economies in question is large enough to generate distortions in world trade. But how many PTAs of this kind exist today? Five at most: the U.S. agreements with Canada and Mexico (under NAFTA), the EC agreement with Mexico, maybe the U.S.-Australia and the EC-Turkey agreements. This is a very small number, and the U.S.-Australia agreement is the only one to have been signed during the last decade. The bitter disputes raised by the U.S.-Mexico and the EC-Turkey agreements may not have stopped politicians from suggesting new PTAs but they have cast strong doubts on such future PTAs, and slowed down their negotiation and ratification. This is best illustrated by the U.S.-Korea case or even the EC-Korea case. Interestingly, in this context, a “free trade area” (FTA) looks a less threatening formula for the world trade regime than a “customs union” (CU) since a FTA allows the smaller partner to negotiate a free trade agreement with another large country (as Mexico and now Canada with the EC) while a CU (EC-Turkey) makes such a move very difficult, despite the fact that it reduces trade distortions.

The main conclusion I draw from the above arguments is that, rather than opposing PTAs which have no effect on politicians, economists should inform politicians of the strong dynamics that would push PTA partners to expand their bilateral negotiations to a wider group. Such dynamics have recently been illustrated by Mexico unilaterally cutting its tariffs (after its free trade agreements with the U.S. and the EC) or by the “Istanbul Process” in civil aviation (which is a first step towards a multilateralisation agreement in a sector notoriously impervious to a multilateral framework). And there are good reasons to believe that such dynamics could transform future bilateral negotiations in services between the U.S. and the EC into a quasi-multilateralised trade regime (Messerlin and van der Marel 2009). In short, the world trade regime in general—and the WTO in particular—is a terribly slow and frustrating process (so is democracy). But, so far, it has delivered what it absolutely needed to deliver.

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