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**Research Report**

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# SWP Comment

NO. 30 JULY 2018

## Power in the International Trading System

**Trump Administration Risks Destroying World Trade Order**

*Evita Schmieg*

**The international trading system is in flux. A spiral of protectionism threatens to expose the limits of the WTO's ability to protect against abuses and prevent trade wars. And the reason for this is astonishing: The US Administration believes that the existing rules – which the Americans themselves played a leading role in writing – disadvantage the United States. Currently the Trump Administration is working hard to dismantle the system.**

While there had already been protectionist responses to the global economic crisis of 2008/09, the real swell of fundamental criticism of global trade by populist politicians followed more recently. Today imports are discussed as a threat to domestic employment, higher tariffs as the panacea. US President Donald Trump is now putting such policies into effect, increasing tariffs on products from America's most important trading partners, including Canada, the European Union and China. The latter in turn have retaliated with countermeasures of their own. The current problems expose weaknesses in the trade order codified in the World Trade Organisation (WTO).

### Pillars of the World Trade Order

World trade is structured by three pillars anchored in the WTO. The “most-favoured nation” and “non-discrimination” principles ensure that all imports are treated alike – and at the lowest tariff – at the border regardless of where they originate from. Under “national treatment” imported goods that have passed customs must be treated no worse than domestic products. These principles are designed to ensure fairness. The second pillar is progressive liberalisation. A succession of negotiating rounds since 1948 have opened up markets to a point where the worldwide mean tariff rate has fallen below 5 percent. The last major liberalisation round – the Uruguay Round – led to the founding of the WTO in 1995, significant market opening for goods, and new rules covering numerous



other areas. The third pillar of the trade system is the WTO dispute settlement process, which has handled more than 500 cases since 1995 and issued rulings on more than 350.

## How Does Power Shape the System?

Many of the issues taken up in 1995, such as trade in services and protection of intellectual property, lie in the immediate interest of the OECD countries. Although China has become one of the most powerful players in world trade today – alongside the European Union and the United States – it only joined the WTO in 2001 and therefore played little role in creating the existing rules. Small and poor countries were also sidelined until around 2000, partly on account of their limited negotiating capacity but also because the WTO's special and differential treatment for developing countries reduced their incentive to contribute actively to shaping the system. In some cases these countries have been granted long transitional periods, in others they have been permitted to open their markets less fully or not at all.

Ultimately these decisions have led to significant negative side-effects. Global market opening benefited above all goods traded between richer countries, while the typical products exported by poorer countries remain subject to high tariffs (agricultural products, textiles, clothing). At the same time tariffs between developing countries are a great deal higher than those they impose on imports from industrialised countries. Within Africa the former exceed 13 percent, whereas average tariffs on goods originating outside the continent are just under 9 percent.

## Unfair to the United States?

Given that background it is hard to comprehend President Trump's assertion that the United States is disadvantaged under

the system as it stands. In the case of tariffs on motor vehicles, such an impression might be created by the difference in import tariffs: EU 10 percent, United States only 2.5 percent. But in fact, the United States applies a tariff of 25 percent to pick-ups, which represent a significant share of the US market. A recent study by IFO-Institut does find that, taken as a whole, the EU's tariffs are higher than those of the United States. But even that does not necessarily mean that the United States is disadvantaged. The current tariffs are the outcome of multilateral negotiations, as part of the package agreed internationally in 1995. In the last round the United States prioritised other issues, in particular services, where trade was only opened up at all in 1995. Washington's great interest in trade in services should come as no surprise, given that that is what Facebook, Google and co. primarily produce and export. And while the United States in 2017 ran a deficit of about \$150 billion in trade in goods with the EU, it had a surplus of roughly \$50 billion in trade in services. A second example is offered by the WTO's Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS), which according to the World Bank triggered an enormous transfer of resources from South to North. In 2017 the United States alone received a net \$79.5 billion from measures to protect intellectual property rights (Japan second with \$20.4 billion, Germany fourth with \$7.4 billion). In other words, the overall outcome at the time justified the United States accepting the continuation of one or other higher tariff line.

## Qui Bono?

In order to properly judge who benefits most from the world trading system, all areas must thus be included. The examples named above illustrate the findings of research since the end of the WTO Uruguay Round: developing countries came off especially poorly. Not only are the goods produced by the world's poorest subject

to the highest tariffs, but certain aspects of the rules also run counter to their interests. One prominent example of the latter is the Agreement on Trade-Related Investment Measures, (TRIMs) which prohibits a string of instruments used by developing countries, such as a minimum local content requirement for foreign direct investments. Of course such instruments are not always economically productive, but it is symptomatic that those with which industrialised countries distort investment flows – first and foremost targeted subsidies – are not regulated.

The mandate for the new WTO round that began in 2001 now placed the needs and interests of the developing countries at the centre, explicitly seeking to address the asymmetry between industrialised and developing countries. This is also reflected in the name: the “Doha Development Round”. In the meantime there has been enormous change in world trade and in the economic structures of the WTO member states. China has massively expanded its exports, as have other Asian nations. The developing countries’ share of world trade rose from 26 percent (1995) to 44 percent (2014). Only the world’s poorest countries – above all in Africa – have been unable to improve their situation: their share of world trade remains unchanged at just roughly 1 percent.

It might even be true that the EU is in a better position than the United States under today’s conditions. Even that would not be unfair, but reason for the United States to seek a new round of talks in which to assert its current interests.

## The Question of Current Account Surplus

That said, Germany’s large current account surplus does indeed distort the world economy. But the remedy cannot be for other countries to restrict German exports by imposing tariffs. Instead Germany needs to increase its imports by stimulating consumption and increasing investment, as

recently reiterated by the International Monetary Fund. This would especially help Eurozone partners that find themselves unable to improve competitiveness by means of exchange rate adjustments. But instead the United States is currently pursuing a policy that is more likely to increase its own current account deficit: The tax reform benefiting middle and high incomes will stimulate private consumption, while infrastructure spending will boost state consumption. This will naturally also stimulate imports and capital inflows. In other words, reducing the German current account surplus with the United States is not a matter for Germany alone.

## Trump and the Trade System

President Trump has made it absolutely clear that he thinks little of multilateral approaches and prefers bilateral “deals”. To that extent there is little hope of bringing the Doha Round to a successful end. Nor can one expect the WTO to address the biggest current challenges in world trade (which are not yet at all reflected in its structures) such as questions of ecological and social sustainability or the impact of information technology on trade. Failure to supply answers to these questions will cost the WTO relevance, even without the kind of additional weakening currently wrought by the United States.

The US tariff increases (where steel and aluminium were only the start) represent a challenge to the international system. The United States justifies them on the basis of the [WTO’s national security exception](#) (GATT Article XXI), whose relevance to the case at hand is doubted by many experts. Ultimately this will have to be decided through the WTO’s dispute settlement system, which the United States is undermining by blocking the appointment of judges to vacant posts. As a result the legality of Washington’s actions may in fact go unclarified. More broadly, the system as a whole will become dysfunctional: Not only will it become impossible to settle individ-

ual cases; to date dispute settlement has also played an important role as the central instrument of legal interpretation and a forum for developing the rules, for example on questions of sustainability.

## Conclusions

A strengthened World Trade Organisation would be helpful for adjudicating the present trade conflicts and perhaps even launching new initiatives. One possibility would be to grant the WTO Secretariat the right to prepare its own proposals and present them to the member states for discussion. WTO Deputy Director-General Karl Brauner recently revived the idea of such a power of initiative in an interview. Constructive as it might be, it must be expected that the United States will block all and any reform proposals – especially in the present situation. Instead the EU needs to actively seek out other (and new) cooperation partners in order to assert its interests at the international level.

The acute question for the EU is how it should shape its trade policy. The strategy of influencing the discussion in the United States by means of cleverly targeted retaliatory tariffs on products from Republican-voting regions seems not to work in the current situation where facts have become irrelevant to political debate. Economic and legal considerations are apparently not (or no longer) sufficient for a successful trade policy. Nor can economic game theory offer much guidance, relying as it does on the assumption of rational behaviour. Instead more psychological and sociological knowledge needs to be integrated into policy development and external trade strategy. There are also new challenges for diplomacy: exerting a moderating influence on the parties to economic conflicts and developing new ideas, including the question of what world trade issues can still be ad-

ressed jointly with the United States (conflicts with China spring to mind).

Possibilities for trade policy cooperation with the United States should also be sought in other areas too. One starting point is offered by the US and EU bilateral free trade agreements with Colombia. Labour standards play a significant role in both (see [SWP Comment 15/2018](#)), but the US agreement is regarded as the model. When verifying implementation the EU could seek to cooperate more closely with the United States, as a means of fostering dialogue.

Simply to concede to Trump's demands for lower tariffs (for example on cars) would appear risky, because success would confirm his strategy. Additionally a bilateral response to US demands – aiming simply to contain the damage to the EU – would weaken the international system. It would be important to keep talking about possible strategies in the scope of the “G-6” (or at least of the EU) and not to allow Trump to play his trade partners off against each other.

The EU should think seriously about a bilateral trade agreement with the United States, a “TTIP light”. Such a deal should not be restricted to tariffs on goods, where the EU has little to gain. But the current idea of including the topic of public procurement is rejected outright by the United States. The search for a solution needs to take the current situation into account: This is more about damage limitation than actively pursuing a trade policy agenda. And that is liable to require the EU to make far-reaching compromises.

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