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Reforming the International Trading System for Recovery, Resilience and Inclusive Development

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Abstract

For many observers, the best strategy to build back better after the Covid-19 crisis is to double down on pre-pandemic policies: at the domestic level through market disciplines to contain production costs, especially of labour and taxes; internationally, by reforming the WTO to further trade liberalization, secure intellectual property and contain state subsidies. This paper argues that this prescription is flawed by weak economic analysis and selective choice of data, and that a different reform agenda is urgently needed if developing countries (but also many in the developed world) are to recover better from the Covid-19 crisis, build resilience to future shocks and achieve transformative development that can deliver the SDGs. The agenda we outline is centred on a recovery strategy to boost domestic demand, jobs and household incomes and a diversification strategy into higher productivity sectors. The discussion focuses on developing countries.

Key words: WTO reform, hyperglobalization, structural transformation, policy space, intellectual property rights, Covid-19, recovery, resilience, Agenda 2030.

Contents

Acknowledgements

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1. Introduction

The world economy is still reeling from the Covid-19 shock and the subsequent restrictions to social and economic activity. While in the developed world governments have been able to mobilize a massive arsenal of monetary and fiscal measures to prop up their economies, estimated at between 20 and 25 per cent of their GDP, the poorest developing countries have mobilized just one per cent of their output to mitigate the damage from a vicious cycle of capital flight, plunging trade and investment flows, collapsing output and tax revenues and, in some cases, soaring debt service (TDR, 2020; UNCTAD, 2021). While the global economy is now recovering, there are growing concerns that developing countries might face a lost decade and the aborted delivery of the sustainable development goals (SDGs).

For some observers, the sharp declines in trade and foreign investment flows caused by the Covid-19 crisis, along with a resort to export restrictions, are only the latest in a series of setbacks for the international trading system. In particular, a surge of "murky" protectionism following the global financial crisis has, it is argued, been compounded over the last decade by "populist" politics, typified by Brexit and the tariff wars launched by the Trump administration, and reinforced by deepening political rifts at the WTO. These hidden and more overt forms of protectionism have, it is claimed, not only distorted and slowed down global trade but also triggered a dangerous retreat from the post-war liberal international economic order (Baldwin and Evenett, 2020).

From this perspective, the best (indeed, only) hope of building back better from the current crisis comes from adopting policies at the domestic level to increase competitiveness and at the international level to deepen integration through reforms at the WTO, including further reductions in industrial tariffs, liberalization of services (particularly those linked to the emerging digital economy), stronger intellectual property rules, ending "unfair" state support and the alignment of trade rules with climate goals.

Such measures are tightly tuned to the demands of a hyperglobalized world and attached to the promise that supporting entrepreneurship, extending supply chains and strengthening competition will boost trade and investment and revive growth, particularly in developing countries. In reality, the revival of hyperglobalization after the global financial crisis, coincided with sluggish investment demand, a marked increase in market concentration and rising corporate rents, exacerbating income inequalities and squeezing domestic markets, all of which contributed to a slowdown of trade over the past decade.

These intertwining trends follow, in part, from many of the measures adopted to boost competitiveness (particularly through wage repression) which tend to weaken domestic demand (TDR, 2012, 2013), based on the illusion that all countries can be net exporters (a "fallacy of composition"). The more likely result has been a "race to the bottom" (TDR, 2014). But these trends were also associated with a prolonged period of trade (and financial) liberalization which had constrained the role of the public sector and narrowed the policy space needed both to respond to economic shocks (TDR, 2014, 2015) and to advance a transformative agenda for sustained and inclusive development (TDR, 2016). As a result, many developing countries have become even more dependent on attracting footloose capital inflows, on commodity exports or assembling low-skill manufactures (TDR, 2018) and on remittances, as sources of foreign exchange.

Despite this record, policymakers in many countries continue to see these same measures as the only route to the recovery of trade, and, by implication, economic growth, and the basis on which reform of the multilateral system should advance after the pandemic. This paper argues that this diagnosis of the ills of the international trading system is flawed by weak economic analysis and selective choice of data, and that a different reform agenda is urgently needed if developing countries (but also many in the developed world) are to recover better from this crisis, build resilience to future shocks and pursue transformative development strategies that can deliver the SDGs. The agenda we outline is centred on recovery of domestic demand, jobs and household incomes in both developed and developing countries (TDR, 2019: 3), although the discussion focuses on the latter.

The paper traces the emergence and spread of free trade advocacy in support of hyperglobalization, resulting in rules and practices that privilege a small number of "winners", perpetuating economic asymmetries and imbalances that hamper the prospects for inclusive and sustainable development, particularly in developing countries. It identifies key stylized trends in the modern trading system, neglected in much of the current debate on its reform, and outlines some alternative principles for rebalancing it. It sets out a recovery agenda for developing countries, focusing on reforms to the existing rules and structures of the trading system, which could help them recover faster and better in line with the Agenda 2030.

2. Free trade: destiny or dogma?

A system of unrestricted international flows of goods, services and factors of production has always been one of the principal aims of economic liberalism and, since the late 1970s, has been regarded by many as the essence of globalization. Arguments in its favour have often harked back to the "classical" liberal theme linking commercial activity to personal liberty through constraints on the potential abuse of state power and a view of unhindered commerce and trade as a "natural order", oftentimes framed in theological terms.[1]

The contemporary case for free trade has replaced Divine Providence with the rational representative agent beloved of neo-classical economic theory, taking key ideas of classical political economy out of historical context and promoting them again as natural laws. In particular, specializing according to their comparative advantage should allow countries to reap efficiency gains from moving to a production and trading profile that uses their relatively abundant resources to the full, importing goods that embody otherwise relatively scarce resources. Thus, countries with plenty of unskilled labour and land should produce and export primary commodities or basic manufactures, while importing machinery and sophisticated industrial products from countries where these happen to be plentiful. As such, a country`s factor endowments are taken as a state of nature rather than the result of social relations and action. Even countries which are lagging behind in all sectors would benefit by pursuing this logic through rapid opening up. This "win-win" logic is seen by advocates as "the deepest and most beautiful result in all of economics" (Findlay, 1991: 99), but also as an example of what Joseph Schumpeter called Ricardo's vice, whereby radically simplified assumptions distort our understanding of economic reality (Keen, 2017; Rodrik, 2018).

Starting in the early 1980s, armed with abstract models of an ideal economy and fully exploiting the economic shocks that hit much of the developing world at that time, an

[1] According to one of the leading 19th century campaigners for "free trade", Richard Cobden, "A Law which prevents free trade is a law which interferes with the wisdom of the Divine Providence and substitutes the law of wicked men for the law of nature".

intrepid band of international economists set about correcting what they saw as decades of economic distortion (through high levels of protection, state subsidies and overvalued exchange rates) resulting from an (unnatural) government desire to accelerate industrialization through import substitution strategies. Rapid opening up to international business would, instead, expose local firms and farms to international prices and induce them to take up activities that would benefit from global competition. In essence, what was being offered was the realization of a self-regulating market order with the Bretton Woods institutions in the vanguard of "getting prices right" through dedicated adjustment programmes that subsequently became known as the "Washington Consensus" (Williamson, 1990).

The case for unleashing global market forces was bolstered by the apparent precision with which conventional economists claimed to be able to pinpoint the gains from trade liberalization (Cline, 2005). Computable general equilibrium modelling introduced a veneer of technical authority into the debates on the costs and benefits of openness while an endless stream of cross-country regressions provided empirical support for the "win-win" logic of a globalizing world. These exercises follow a standard format of measuring the size and statistical significance of coefficients relating a dependent variable (such as per capita income growth or the level of income) to a set of country-specific variables, including a proxy for openness. A positive coefficient on the latter is taken as sufficient evidence for rapid trade liberalization.

A tendency to exaggerate the gains from trade liberalization dates back to the early 1980s with debates about Northern trade agreements, such as the Canada-US free trade agreement and the single European market. It became commonplace during the Uruguay Round and reached new heights in the run-up to the 4th WTO Ministerial meeting in Doha when free-traders fell over themselves to promote the new Round as a panacea, post-9/11, for a whole range of conditions from global stagnation to terrorism.[2] The World Bank (2002) predicted between $1.5 and $7.5 trillion of additional cumulative income to developing countries from the liberalization of goods and services. Significantly, and with a good deal less fanfare, in the run-up to the Hong Kong Ministerial meeting in December 2005, the World Bank markedly scaled back its predictions of the likely benefits of significant tariff cuts and other liberalizing measures to below $100bn and accepted that most of the gains would accrue to the richer countries.

These exaggerated claims reflect the fact that while the underlying model is much admired for its mathematical elegance, it rests on a set of severely restrictive assumptions whose distance from reality has troubled generations of leading economists beginning with Adam Smith, no less, who insisted that a universal system of free international trade was more a utopian ideal than a coherent blueprint for policy and that the costs of adjusting to it required that it be done "only by slow gradations, and with a good deal of reserve and circumspection" (cited in Panic, 1988:124). For others, the implausibility of a world populated by small firms, with perfect information about consumer tastes and available production technologies, untroubled by learning or scale economies, and where immobile factors of production are always fully employed, has

[2] The World Bank was quick out of the blocks with this type of analysis in its World Development Report in 1987, which classified 41 developing countries according to their openness to trade since the 1960s, reporting the highest growth in income per capita in the strongly outward-looking economies and the lowest in the strongly inward-looking ones. A subsequent slew of more academic studies followed, all reporting similar findings. The IMF (1997) and the WTO (1998) were soon promoting these as evidence that "policies toward foreign trade are among the more important factors promoting economic growth and convergence in developing countries". Drawing from a growing body of academic literature that followed the same approach, the World Bank (2002:1) concluded that "Globalization generally reduces poverty because more integrated economies tend to grow faster and this growth is usually widely diffused."

long cast a cautionary shadow over recommendations for rapid trade liberalization (Panic,1988:121-39). Indeed, both Smith and David Ricardo were fully aware of how freer trade might very well lead to widening income gaps among trading partners (Darity and Davis, 2005). Although the case for free trade still courses through the veins of most economics student and many trade bureaucrats, leading members of the profession have kept at least one sceptical eye on its “win-win” logic, as testified by “new trade theorists”, who modelled the growth of trade between similarly endowed countries with heterogenous firms (Krugman, 1979; Melitz, 2003; Bernard et al., 2011), with an acknowledgement by some that “genuine harm” can result for some countries from “the roulette wheel of evolving comparative advantage” (Samuelson, 2004: 142).

In response, proponents of rapid liberalization have doubled down on their policy advice by setting aside the “static” gains from liberalization and emphasizing instead its potential “dynamic” gains. These include scale economies from enlarging the potential market through exports and from increasing the diversity of intermediate inputs, spillovers and learning effects that come with importing goods and hosting FDI, and a much faster pace of capital formation from easing an otherwise binding financial constraint (Srinivasan and Bhagwati, 2001: 31–32). From this perspective, trade liberalization mixed with measures to attract the right kind of capital is expected to act as a catalyst for productivity growth (Edwards, 1998), including through institutional improvements and better governance (Winters, 2004).

In practice, however, the task of measuring the impact of liberalization through these various channels still involves many implausible assumptions and most statistical exercises resort to an ad hoc mixture of partial and general equilibrium modelling, combining traditional assumptions with more modern insights. Winters (2004) acknowledges as much in his frequently cited review of the links between trade liberalization and economic performance, bringing in investment as a likely catalyst for why openness works in successful cases. More generally, as core principles have been abandoned, a good deal of the case for rapid liberalization appears to rest more and more on specific episodes of growth and integration, particularly in East Asia where countries have established a strong nexus between investment and exports. However, closer study of these experiences has shown that policy makers pursued trade liberalization as part of a strategy for industrialization rather than as an end to itself (and in a historical and geopolitical context very different from today’s) with very different policy conclusions for how to make openness work for development (Wade, 1990; Rodrik, 1999; TDR, 1996; 2003; 2016).

3. Trade liberalization in the era of hyperglobalization

Beginning in the 1980s, the move to rapid trade liberalization in developing countries was pursued largely under the tutelage of the Bretton Woods institutions and pushed through the policy conditionalities attached to their lending programmes; three-quarters of the World Bank`s Structural Adjustment Loans in the 1980s included demands for trade policy reform (Stewart, 1995) and remained a central component in subsequent iterations of the Washington Consensus (Birdsall et al, 2010; Babb and Kentikelnis 2020).

The Uruguay Round, launched in 1986 and completed eight years later, amplified this move and became the mothership for a new generation of trade agreements that introduced significant changes in the content of liberalization programmes (Davis, 2019).

These new agreements went beyond GATT`s focus on tariff reductions to include a whole range of “trade-related” measures that had previously been regarded as the preserve of national policy, such as industrial development, government procurement and intellectual property laws.

This expanded agenda was taken much further in mega trade agreements pushed bilaterally or regionally by developed countries and which now underpin some of the envisaged pathways to WTO reform. As Dani Rodrik has shown, the underlying premise running through this new generation of agreements was "harmonization" in a broad swathe of public policies to ensure that they do not "distort trade" to the advantage of any party (Rodrik 2018). In practice, when applied in envisaged agreements between developed and developing countries, these types of provisions become severe impediments to developmental policies and programmes aimed at structural transformation and (e.g. in the case of TRIPS plus provisions) further entrenched the dominant (and increasingly monopolistic) position of developed-country corporations (Ostry, 2002).

While these changes in content reflected shifting ideological currents, they were also a product of systemic (and ongoing) shifts in the structure of global markets. International trade has always been dominated by big firms. However, in the decades following the end of the Second World War, markets remained contested, as new entrants emerged and as bargaining in the workplace, along with effective State regulations, constrained the power and reach of large corporations. Many of those constraints on corporate power have since been eroded in the era of hyperglobalization as capital became more mobile (and more footloose), technological changes reduced transaction costs and more countries opened up to international business. The resulting expansion of trade has been closely tied to the spread of global value chains (GVCs) governed by lead firms, principally headquartered in advanced economies (Milberg and Winkler, 2013; Kozul-Wright and Fortunato, 2020). These have allowed more developing countries to participate in the international division of labour by providing specific links in the chains, including in manufacturing sectors, drawing on their abundance of cheap unskilled labour. The promise was that such fledgling manufacturing activities, through a mixture of upgrading and spillover effects, would quickly establish robust and inclusive growth paths aligned to their comparative advantage.

Propelled by these changes, the number of trade agreements and other kinds of international economic treaties (such as bilateral agreements on investment protection, avoidance of double taxation, etc.) rose exponentially after 1990. Between 1990 and 2015, the number of trade agreements increased from 50 to 279, with many of them plurilateral. Bilateral investment treaties (BITs) grew almost tenfold from 238 to 2,239 over the same period. These legal changes certainly facilitated trade and cross-border investment (although trade and investment are driven more by global demand, than regulatory changes), but also expanded profit-making opportunities for large corporations through tangible asset acquisition, intangible asset shifting and financial speculation.

As a result, the main actors and beneficiaries of this metamorphosis of “trade” were not workers or States, but rather the largest corporate players that were involved in lobbying for and shaping the rules of international trade and finance. In this process, large international firms headquartered mostly in developed countries found themselves in a privileged position to influence rule making and to reorganize large swathes of world production, thereby creating possibilities of expanding their cost-minimizing strategies on a global scale.

Against this backdrop, talk of a rules-based order “as the only credible assurance against protectionism and the economics of destruction” (Sutherland, 1994), “levelling the playing field” (Lamy, 2006) and advancing “the great convergence” (*Financial Times*, 2007), does not reflect the actual workings of the international trading system and its impact on developing countries (Braunstein et al., 2019) . In a world where large international firms dominate the organization of trade and production, advantages are created rather than given, and scale economies and learning are defining features of productive activities, first-mover advantages persist, market entry is likely to be slow and expensive, historical accidents can have long-run economic consequences, and “market forces do not select a single, predetermined outcome, instead they tend to preserve the established pattern, whatever that pattern may be” (Gomory and Baumol, 2001). In other words, free trade perpetuates technological and industrial imbalances favouring specialization in low productivity activities in developing countries and high-productivity activities in developed ones.

This environment is a very long way from the imaginary world of small firms in competition with each other and permanently providing full employment, where a lower tariff option is assumed to make everyone better off. And as Gomory and Baumol insist, given that the modern trading system is so different from the 18th-century, largely agricultural world in which the free-trade model was conceived, the analysis of how trade works needs to start from a very different set of stylized trends.

4. Stylized trends in the modern trading system

A number of features of the global economic landscape are key to understanding the workings of the contemporary trading system and set the scene for a reform agenda that can make that system work for more inclusive, resilient and stable outcomes, particularly for developing countries.

4.1 Trading more earning less

While developing countries have been trading more, including in manufacturing goods, the increase has been heavily concentrated in a small number of countries, principally from East Asia. Moreover, the developing country share of global value added has not risen in tandem with its share of exports and productivity growth has been weak even in countries that have raised their share of exports in GDP. The continued reproduction of the division of labour established under colonialism has meant that almost all developing countries are firmly integrated into some GVCs, but in subordinate roles - as providers of primary commodities and outsourced, low-wage assembly activities. Thus, the central