

the same today: the global challenges and opportunities facing us require the broadest possible cooperation, consensus and

commitment. The G20 is the best platform for realizing opportunities of the 21st century for all.

The WTO needs a Plan B

If the WTO members do not reinvent the WTO, the world will return to less prosperous times.

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The Kiel Institute for the World Economy is an international center for research in global economic affairs, economic policy consulting, and economic education. The Institute engages especially in creating solutions to urgent problems in global economic affairs. It advises decision makers in policy, business, and society and informs the broader public about important developments in international economic policy.

The World Trade Organization (WTO) has brought enormous benefits to the international community. In small, open economies, such as the Netherlands, around a quarter of the wealth per capita depends on the WTO trading system; in Germany, the figure is around five percent or USD 66 billion. The economic gains for China or the US are even bigger in absolute terms.¹ But the multilateral trading order is in a deep, existential crisis – to which there is no easy solution. The WTO must reinvent itself if it wants to prevent the world from returning to less prosperous times.

On April 15, 1994, when the GATT members agreed on the Marrakesh Declaration that led to the creation of the WTO, there was a shared vision of the future geopolitical landscape. Following the demise of Soviet-style communism, it was generally assumed that all countries would gradually transition to a democratic, market-based system. The only remaining superpower, the United States, would create a liberal world order in its own image.

The post-war systemic rivalry between East and West would become a thing of the past. The international economic order would no longer be disrupted by geopo-

litical fault lines as the economic and humanitarian systems of the various political actors converged. Unfortunately, that hope has failed to materialize – as is now abundantly clear from the current rivalry between “Western” democratic market capitalism and the autocratic state capitalism of some emerging economies, notably China.

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This is the fundamental problem facing the WTO. Currently, the organization has 164 member states, ranging from the extremely poor to the extremely rich, from some of the world’s most appalling autocracies to model democracies, and from illiberal, closed economies, such as Venezuela, to very liberal ones, like Singapore. And even if countries have very similar institutional structures, they may pursue quite different interests within the WTO.

The WTO is an entirely member-driven body, with each member having an equal right of veto, except in the proceedings of

the now defunct Appellate Body. Given the enormous diversity of its members and systemic competition between major nations, such as the US and China, it is very difficult for the WTO to agree on a common set of rules. There are widely differing views on key economic matters, for example, including the legitimacy of state subsidies and the issue of monopoly power.

This political divergence within the WTO has been accompanied by a convergence of economic power. The GDP of the G7 countries as a percentage of global GDP has declined from almost 65 percent in the early 1990s to less than 40 percent today. The economic rise of the non-G7 countries has been driven in part by the integration of former low-wage countries into the global value chain. However, this economic convergence has not led to the hoped-for political convergence.

The motivation for liberalizing world trade has always been to promote economic convergence. That objective has been achieved. Some of the greatest beneficiaries of the WTO’s multilateral system have been countries that formerly have been relatively poor. The fact that China has been particularly successful without having copied the Western democratic, free-market model is a cause of widespread concern.

The United States, and probably also many European countries, would never have agreed to China’s accession had they known that, just a quarter of a century later, China would overtake them economically – using a radically different and opposing social model. China stopped aligning its economy with the Western model following the global economic and financial crisis of 2009, if not before, making the incompat-

ibilities between Chinese state capitalism and the Western economic model increasingly obvious. The situation has been further exacerbated in recent years as China seeks to export its own model through the Belt and Road Initiative. It is thus hardly surprising that the United States has been gradually abandoning the role it assumed back in the 1990s as the driving force behind a more liberal world trade system.

Political differences and increasing economic parity are not an issue in themselves. However, they do become a barrier when trust breaks down between key actors and each suspects the other of opportunistic behavior. Trust doesn’t appear to have been an issue when China was originally admitted to the WTO in November 2001. Since then, it has declined significantly, though.

The World Trade Organization was developed for a world with no major geostrategic rivalries. The basic premise of the WTO (and of its predecessor, the GATT) was that the sole objective of economic policy should be to increase per capita income. This universal focus leads to a simple logic: whenever liberalization of international trade results in higher per capita income, it should be welcomed. Under this model, all countries benefit from an increasing division of labor, although some trading partners benefit more than others. There has to be considerable trust for this positive-sum logic to work. Every trading partner must be sure that their dependence on foreign import and export markets will not be exploited by others. The larger the trading partner relative to one’s own economy, the greater the threat.

A high level of trust between actors makes it easier for them to view per capita

income as the main or only political objective in multilateral negotiations. The lower the level of trust, the more the actors will try to erode the relative economic power of their opponents – even if that means weakening their own economy somewhat in the process.

When policymakers no longer focus exclusively on per capita income, but also and possibly even primarily on the size of their own economy relative to their systemic competitors, the world switches from a positive-sum game to a zero-sum game. Actors are more concerned with the distribution of existing economic and political power than with creating and sharing new wealth. In such a world, the WTO’s textbook model is doomed. The principles of reciprocity and non-discrimination that have been so successful are no longer powerful enough to secure the benefits of cooperation. In the battle for economic power, the weapons deployed include tariffs, exchange rates, and international investment.

Many of the current tensions and developments in economic policy are due to the reemergence of systemic competition. Trading partners frequently adopt a mercantilist position, choosing policies that reflect their trade balance with a given rival. John Maynard Keynes, the intellectual godfather of the failed post-WWII International Trade Organization, was aware of this problem and advocated mechanisms to ensure balanced bilateral trade. The WTO (quite rightly) has no such rules for bilateral trade balances, as they do nothing to promote the shared prosperity generated by international trade relations in a positive-sum model.

Faced with systemic competition, it is also natural for policymakers to focus on

the manufacturing industry. Under the original cooperative logic behind the WTO, it should not matter which sectors a country specializes in. If a decline in industrial output is more than offset by growth in the service sector, this should be understood and accepted as a net increase in the prosperity of that country. However, if countries don't trust their trading partners to behave in a cooperative manner, it suddenly becomes important to be self-sufficient in key sectors.

Another consequence of the WTO crisis is the increase in bilateral preferential agreements. It is probably no coincidence that this increase was particularly marked at the turn of the millennium, when it became clear that the assumptions underpinning the WTO's multilateral system were no longer tenable. In the zero-sum model, where the only imperative is to strengthen one's own economy, bilateral agreements are even more attractive—especially for economies with large domestic markets, such as the United States, the EU, and China.

The current crisis of the multilateral system is therefore not only a product of the new economic nationalism espoused by leaders, such as Donald Trump, Xi Jinping, Vladimir Putin, and Narendra Modi. In fact, it was the dysfunctional nature of the WTO that enabled the new right-wing nationalist movements. It is also clear, however, that this aggressive economic nationalism is undermining confidence in multilateral agreements and further paralyzing the WTO. This in turn deprives the international community of a forum for discussion and for settling disputes.

The multilateral system has brought huge economic benefits to virtually every

country on earth. Abandoning it now would make the world poorer and raise pressing questions about the distribution of existing wealth. The challenge is therefore to adapt the WTO's rules to reflect the current, more complex political and economic realities.

In seeking to break this impasse, it is important to understand that the WTO was conceived during a brief but exceptional period in history when nationalism appeared to have been transcended. Today, we can only assume that the struggle between competing political systems for economic supremacy will continue.

Given that the economic systems of key players, such as China and the United States, are unlikely to converge in the foreseeable future, and that it will be difficult to restore lost confidence, the WTO should take the steps set out below in order to stay relevant.

One immediate threat to the credibility of the WTO is the ongoing US veto on the appointment of new judges to the WTO's Appellate Body. As a matter of the highest priority, the WTO must reform its arbitration process so it can continue to function and should simply dispense with an appeal body. This is not unusual in other dispute resolution systems and has been the case for many years in investor-state dispute settlement. Countries that want an appeals mechanism would have to find an alternative outside the WTO. The EU already has an interim appeal arbitration arrangement with Canada, and other country pairs could do the same or adopt the systems used by other nations.

In addition, the WTO should mitigate against the risk of its own collapse by preparing a "Plan B," i.e., a legal system

to replace the WTO in a worst-case scenario. Former WTO Director General and EU Trade Commissioner Pascal Lamy has suggested such a move, which would put pressure on the US to be more constructive in seeking solutions and accepting reforms rather than paralyzing the entire system. That said, it will probably not be enough to regain US support, as there is still too much concern about the rise of China. The WTO should accordingly also address the systemic differences between member states.

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This could be achieved by means of a "club system." A core of democratic market economies with mutually compatible value systems could then deepen their economic integration, surrender a certain amount of

freedom with regard to their trade policy, and transfer sovereignty to joint dispute settlement bodies. Trade with countries whose economic systems are not compatible with this type of arrangement would be subject to a special set of rules similar to the pre-1995 GATT provisions, rather than those of an updated WTO.

In some respects, the WTO is already doing this, with members forming like-minded, plurilateral groups, which exclude systemic competitors. This two-pronged approach has its shortcomings, of course. It is only the second-best solution in a world of mutual distrust between trading partners. However, the primary threat is one of complete system failure – which would have much graver cost implications. The European Union should take the lead here.

Finally, the WTO should promote bilateral trade agreements between members. Although a poor substitute for a multilateral system, bilateral agreements at least offer some certainty at a time when the global trading order is being renegotiated. These bilateral arrangements need to be compatible with the multilateral solution that becomes possible when a new global order has been established.

The WTO marked its 25th anniversary on January 1, 2020. If the international community wants to celebrate the 30th anniversary of the WTO, it must face these realities and act now. What is at stake is the prosperity of the world – and perhaps even more than that.

¹ See Felbermayr et al., 2019, The World Trade Organization at 25: Assessing the Economic Value of the Rules Based Global Trading System, Bertelsmann Stiftung (<https://www.bertelsmann-stiftung.de/en/publications/publication/did/the-world-trade-organization-at-25/>).