

# A world without the WTO: what's at stake?

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## Introduction

The WTO is one of the great progenitors of planetary peace and prosperity, as was the GATT before it. It promotes multilateral cooperation that fosters trade, which, in turn, fosters peace and rising living standards worldwide. The Organisation, however, is blocked by its continued failure to get past the Doha Round.

The Doha Round was enthusiastically launched in 2001 with the goal of advancing trade opening while rebalancing the development dimension of the global trading system. Scheduled to conclude in 2005, it is a decade overdue and nowhere near agreement on core agenda items. Given the repeated efforts by members over the past 15 years, it seems clear now that the original Doha Agenda is no longer balanced in a way that makes sense to the WTO members who must lead the final drive to do the deal.

The basic problem is that the world of international commerce has changed radically since 2001 but the Doha Agenda has not. Repeated failure of the negotiations has not led to a fundamental re-evaluation. It has led to repeated extension of deadlines and a failure to recognise that we are no longer living in the world where the original Doha Agenda could provide a win-win for all players.

We argue that this 'extend and pretend' approach is a mortal threat to the WTO and perhaps the rules-based international trade system as a whole – but not in the most obvious way.

The Doha logjam has not inhibited liberalisation – far from it. As the Doha Round staggered between failures, flops and false dawns, global trade liberalisation advanced at breakneck speed. Most WTO members have massively lowered barriers to trade, investment and services bilaterally, regionally, and unilaterally – indeed, everywhere except in the WTO. The massive tariff cutting that

has taken place, shown in Table 1, was at least as great as in the previous successful Rounds.

Table 1. Tariff cutting despite the Doha deadlock

	Percentage points		Change from 2001 to 2012	
	2001	2012	Percentage point difference	Percentage cut
South Asia	22	13	-9	-41%
Middle East & North Africa (developing only)	19	12	-7	-38%
Sub-Saharan Africa (developing only)	14	11	-3	-19%
Latin America & Caribbean (developing only)	11	8	-4	-32%
East Asia & Pacific (developing only)	11	8	-3	-31%
World	10	7	-3	-30%
Europe & Central Asia (developing only)	8	4	-4	-49%
European Union	4	1	-2	-63%

Source: World Bank online database.

Note: Figures are for tariff rates (%), applied, simple mean, all products.

At the same time in and the same way, many WTO members have written new disciplines to underpin the rise of Global Value Chains (GVCs) – the force behind much of the revolutionary changes in 21st century international commerce. The Doha gridlock has also not dampened nations' interest in the WTO; 20 nations, including China and Russia, have joined since 2001.

Doha's failure is a threat for more diffuse reasons.

- First, the failure is acting like 'dry rot' in the timbers holding up the global community's common interest in multilateral cooperation on trade.

This cooperation is founded on the broadly held notion that following WTO rules is as much a good idea for each nation as it is for the world community as a whole. Yet, the notion is not held because of some philosophic predilection. Global support for multilateral cooperation on trade is broadly held because of its track record.

The support was built on the back of decades of GATT successes, with a virtuous cycle in operation. Success reinforced a common interest in multilateral cooperation which in turn facilitated further success. As the GATT could complete a new Round every five or ten years, the GATT became the 'vehicle of choice' for both trade liberalisation and rule updating. One can argue about why GATT succeeded but 'nothing succeeds like success'. The opposite must be said for the WTO.

The last big WTO 'win' came in 1997.<sup>1</sup> That is a long time ago. The leaders who celebrated it included Gerhard Schroeder, Hashimoto Ryutaro, Li Peng, Inder Kumar Gujral, Bill Clinton, and Fernando Henrique Cardoso. Every world leader since has seen their hopes raised and dashed by the Doha Round's 'fail trail'.

In a nutshell, the first danger is that the WTO's inability to provide a 'win' may reverse the virtuous cycle. It may create a situation where WTO failure directs attention to other 'vehicles of choice' – especially regional trade agreements and more recently megaregionals. There are clear signs that this has already started. Businesses around the world are giving up on the WTO as a vehicle of any kind of trade liberalisation or rule-writing. Just as dry rot can bring down a house, the WTO's 'extend and pretend' tactics may be bringing the WTO to a tipping point where everyone starts to ignore WTO rules since everyone else does.

- Second, the inability to conclude a Round means that the WTO has been unable to update its rulebook.

As a consequence, WTO judges are using 20th century rules to evaluate the merits of 21st century disputes. The last rule update came in 1994 – and that was based on an agenda agreed in 1986 when the Uruguay Round was launched. International commerce is radically more complex, but the WTO's rules are basically unchanged.

Legitimacy is the heart of the WTO's success in dispute settlement and this legitimacy exists since the rules being enforced were agreed by consensus. As consensus rule-updating is politically extremely difficult except in the context of a big package like

the Doha Round, a frozen Doha Round threatens the long-term health of the dispute settlement system.

WTO judges have muddled through with evolutionary interpretations of legal decision, but ultimately litigation without 'legislative legitimation' is unsustainable. One of two paths must be taken. Either the judges refuse to adjudicate disputes involving new issues, or they continue to extend interpretations until a major WTO member rejects a ruling – claiming that the ruling was not based on the 1994 negotiated texts. Who knows what would happen in the latter scenario but it would be a major blow to the notion that all nations have a common interest in the WTO's 'code of good conduct'. If the first path is taken, large WTO members are likely to resort to unilateralism as the US did in the 1980s.

Quite simply, it is time to either finish, or finish off the Doha Round.

### Thinking ahead on international trade

Whatever happens, it is clear that by the end of this decade, world trade governance will be quite different. The idea that the WTO is the central pillar of global trade governance will either be replaced by a multipolar system, or the WTO itself will be transformed.

On current trajectory, the multipolar system is the most likely – unless WTO members make a concerted effort to change the inertia. But the current trajectory takes us to a world where the 21st century trade rules have been written in megaregionals that were negotiated in settings that reflected large power asymmetries. This is not a solution. It would be an outcome that excluded the rising trade powers – especially China, India, and Brazil – from important developments. They would have to either formulate their own regional responses or just live with the rules written by others. Either way seriously undermines support for multilateral cooperation.

The idea of megaregionals creating a natural order of trade as a pre-established harmony is an illusion. The megaregionals lack the key elements of the GATT's success – non-discrimination and the way it fosters a common interest in supporting multilateral cooperation.

It is time to start seriously considering multi-pillar global trade governance where the WTO is just one pillar – hopefully the central pillar. This will require the WTO to finish or finish-off the Doha Round. It will also require WTO members to engage constructively in the new disciplines surrounding GVCs that have arisen in deep regional trade agreements since the 1990s.

<sup>1</sup> Specifically, Information Technology Agreement, Telecommunication and Financial Services Agreements reached in 1997. The 2013 Trade Facilitation Agreement was welcome progress but not a big win (Baldwin 2006).

The rest of the paper is organised in six additional sections. The first two sections after the introduction explain how the GATT promoted peace and prosperity, and the political economy mechanism at the heart of the WTO successes. The subsequent section covers the WTO's underperformance and explores possible reasons for the failure to close the Doha Round. After that, two sections cover the dangers ahead and possible solutions, respectively. The final section presents our concluding remarks.

## How the GATT and WTO promote peace and prosperity

The WTO, and the GATT before it, has been one of the planet's precious public goods. The multilateral cooperation supports and encourages trade, which, in turn, fosters peace and rising living standards worldwide.

The idea that trade fosters peace was famously expounded by Montesquieu in the 18th century:

*"The natural effect of commerce is to bring peace. Two nations that negotiate between themselves become reciprocally dependent, if one has an interest in buying and the other in selling. And all unions are based on mutual needs."*<sup>2</sup>

Put simply, sellers have little interest in attacking their buyers. Perhaps the most obvious example is how burgeoning trade between France and Germany flipped the switch from a war-pattern to a peace-pattern.

After fighting three increasingly horrifying wars from 1870 to 1945, the French and the Germans are now locked in one of the most intense commercial interactions in the world. At a personal level, this has brought millions of French and Germans into frequent, direct contact. French work for German companies and vice versa, and French firms are excellent customers for German firms and vice versa. The idea that going to war to, for example, would switch the nationality of Alsace-Lorraine once again is now insanity. International commerce makes Franco-German war into a 'mutually assured destruction' situation.

When it comes to why flourishing trade is synonymous with rising living standards, there is little mystery. Trade allows the market's efficiency-enhancing mechanisms to play out on a broader scale. With access to larger markets on the export side and a wider range of high-quality, reasonably-priced goods and services on the import side, trade allows nations to allocate resources to where they

can be most productive. This enables countries to achieve greater scale and agglomeration economies that are, in turn, pro-innovation, pro-productivity, and pro-growth.

Open trade also generates an imperative to innovate. As the Bhagwati-Sutherland Report put it: "Exposed to Japanese car manufacturers' competition, Detroit car makers recognised that their system of vertical integration was less efficient than a competitive supply chain model. European farmers respond to developing world agricultural imports by moving out of bulk commodities and into boutique and specialist farm goods and foods. India's car industry has been transformed by external competition to the extent that the world's smallest and cheapest car – the Tata Nano – is a world class Indian innovation".<sup>3</sup>

Trade, in other words, is a classic example of win-win cooperation. When all cooperate, all can win.

## Creating a common interest in multilateral cooperation

The GATT promoted such win-win multilateral cooperation by setting up what political scientists refer to as a 'regime' – a collection of principles, norms, rules, and procedures around which the expectations of nations and interest groups converged. The result is what could be called the GATT/WTO 'code of good conduct'. The code fostered a pattern of cooperation which fostered economic success (see Box 1 for a brief description of the code).

The resulting economic success was nothing short of spectacular. As the GATT's mutual-liberalisation process started working its magic, exports of manufactured goods boomed. This made it easy to view the GATT as good for exports, industry, and growth.

But the really useful outcome – as far as cooperation is concerned – is the fact that manufactured exports grew two and a half times faster than manufacturing output. This made it very easy to portray multilateral cooperation as win-win. One just could not say that the 'your' exports were 'stealing' demand from 'my' producers. Quite the contrary, export sales around the world were outstripping production growth by a wide margin (Figure 1). All cooperated and all won.

## Economic success shifts mind sets

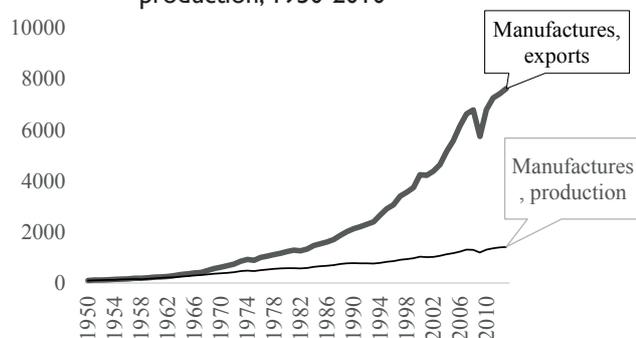
This success produced a historic shift in the mindset of global political, business, and labour leaders. Recall that in the decades before the GATT, the received wisdom was that a nation should raise

<sup>2</sup> The quote is from *The Spirit of Laws*, which Charles de Secondat, Baron de Montesquieu, published anonymously in 1748.

<sup>3</sup> HLEG (2011).

protection to protect its industry. Free trade was for starry-eyed idealists; unilateral protection was the savvy way to boost national industry and incomes. All this changed in the 1950s and 1960s. Mutual opening became the winning way; unilateral closing came to be viewed as a failed dogma of olden days.

Figure 1. Manufactured goods, world exports and production, 1950-2010



Source: WTO online database.

This manifest economic success launched a self-reinforcing cycle. Booming trade and incomes strengthened GATT members' belief that following the code of conduct was good policy from a purely nationalistic perspective. The cycle spiralled ever higher as the code continued to produce progressive, mutually advantageous trade opening decade after decade.

Perhaps even more important than this sea-change in policymakers' minds was the shift in the thinking and expectations of political pressure groups inside each member. As nations and interest groups came to expect that the rules would be respected, they adopted behaviours that conformed to the rules – thus making rule-compliance almost automatic.

Despite trade conflicts being common, the code and the win-win outcomes created a common interest among GATT members in defending multilateral cooperation. It is a precious 'public good' for world trade and, more generally, for world peace; multilateral cooperation on anything is a rare commodity these days.

More generally, the GATT/WTO has raised respect for the rule of law in the international context almost universally. It is one part of the foundation that supports respect for the concept of international law. Creation of strong dispute settlement mechanism and prohibition of unilateral measures in the WTO further reinforced it. The GATT/WTO is the leading – and probably the only – example of a multilateral and near-universal framework of rules and law.

## Diplomatic success and respect for the rule of law

The plain-to-see economic success was complemented by the GATT's diplomatic success; the GATT 'regime' helped major trade powers avoid costly conflicts.

The US, in particular, faced massive political difficulties in the GATT's early decades as firms from Germany, Japan, and other rapidly industrialising nations ate into US global market shares. In autos, electronics, capital equipment and many others, the position of the US industry was eroded. The US also had major conflicts with Japan and the EU over agricultural protection and subsidies. Likewise, as former colonies became countries and adopted their own trade policies, actual and potential conflicts were reduced as most of these new nations joined the GATT.

While the rise of German and Japanese competitors did produce some US backlash, such as the 'aggressive unilateralism' adopted in the 1980s, the mutually held belief in the GATT process helped members to work through their grievances with very little trade disruption. The agriculture conflicts were eventually settled when agriculture was finally brought into the system by the Uruguay Round.

A central element in the GATT's diplomatic success was the way the GATT code of conduct enabled members to periodically update rules to reflect new realities as they emerged. One of the most momentous changes was the wholesale adjustment of GATT obligations for developing nations that were adopted in 1965 (Part IV) and 1979 (Enabling Clause).<sup>4</sup>

This rule updating was absolutely critical. The GATT, written in the 1940s, was a product of its times. The GATT rules were heavily influenced by lessons that the North Atlantic drew from the 1930s bout of protectionism. Many specific elements, however, were included to resolve conflicts between the world's two largest traders at the time – the US and the UK.<sup>5</sup> Many of today's WTO members were colonies and thus represented by their colonising nations. The voices of other developing nations were hardly heard.

As colonies became countries in the 1960s and 1970s, and developing nations in general became more assertive, the GATT would have been torn asunder or paralysed without reform. Recognising this, GATT members updated the rules to match

4 For the reflection that led to these rule updates, see Haberler et al. (1958).

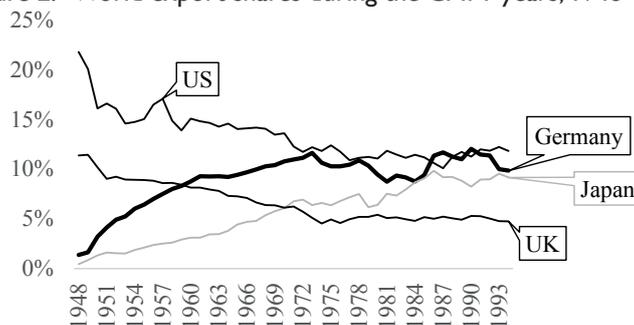
5 For example, the US was very keen on tackling Britain's Commonwealth Preferences, while Britain wanted to lower the extremely high US tariffs that have been implemented in the 1930s. See Irwin et al. (2009) for details.

the new realities with, for example, the 1965 'Part IV on Trade and Development'. The updating was done in the context of GATT Rounds.

### Box I. GATT/WTO principles: Trade's 'code of good conduct'

The GATT regime, or 'code of good conduct', hinges on a handful of basic principles. The first and perhaps most important principle – what might be called the GATT/WTO's constitutional principle – is that the world trade system should be rules-based, not results-based. The GATT/WTO should concern itself with the design, implementation, updating and enforcement of procedures, rules, guidelines, and the like – not quantitative measures of things like exports or market shares. This is not a given; some international regimes – say climate – are results based.

Figure 2. World export shares during the GATT years, 1948-1994.



Source: WTO online database.

It is easy to see why this was so critical in fostering cooperation. Suppose, by contrast, the focus had been on, say, world export shares. The massive postwar shifts shown in Figure 1 would have made it difficult for the original leaders of the GATT – the US and UK – to portray the institution as a success. Their joint share fell from 33% to 17% from 1948 to 1993. Even if the focus were on exports, which grew rapidly for almost all members, the fact that some members' exports grew faster would have been problematic for multilateral cooperation. Japan could survive the pressure from the US in the 1980s since GATT regime was rules-based.

Such issues were easier to deal with since results were not the focus of attention at the GATT. The GATT was about rules. The fact that everyone played more or less by the rules was the measure of success – that and the fact that world exports and incomes were booming.

### Non-discrimination

Among the general rules on which the GATT/WTO regime is based, the notion of non-discrimination is first on everyone's list. Indeed, it is Article I of the original document signed in 1947. The GATT and WTO have never had anything against trade barriers per se. But if a member does apply them, they should apply them equally to all members. This rule is called Most Favoured Nation (MFN) treatment since each member should be treated as well as the most favoured member, which, in plain English means non-discrimination.

The other pillar of non-discrimination in the GATT and WTO is national treatment (Article III of GATT). This says that the non-discrimination principle applies even after imports get inside the nation's borders. Things like taxes and regulations should be applied evenly between domestic and imported goods from all members according to the national treatment principle.

Non-discrimination is essential to the GATT/WTO's success in many ways. Perhaps the most important is the way that it fosters the idea that members have a common interest in subscribing to the 'code of conduct'. After all, if everyone followed the rules, but only some benefited from their application, support for the whole rule book could easily unwind. WTO members could begin to wonder whether the code really was common. Common interest could be replaced by common conflicts.

### Transparency

A closely related principle is transparency. The overarching goal of the WTO is to promote cooperation on mutually advantageous trade opening and to reduce trade-related conflicts. Both goals are much easier when everyone knows what the policies under discussion actually are. The simple requirement that national trade policies and trade barriers be published and made available to all comers avoids many conflicts before they even arrive...

... It makes it much easier to check that agreed liberalisations are implemented as promised and are not offset by new barriers. It also makes it harder for protectionist special interest groups to secretly slip in protection.

As with non-discrimination, one of the most important systemic aspects of transparency is the way that it helps support nations' buy into the rules-based approach. Quite simply, it's impossible to run a rules-based system if some nations suspect that other nations are bending the rules in secret. Transparency disarms distrust.

**Reciprocity**

Reciprocity is the third principle and arguably as important as non-discrimination. Indeed reciprocity is central to human cooperation ranging from NATO to kindergarten play groups. In the GATT liberalisation context, reciprocity means that nations that remove barriers to imports can expect other nations to reciprocate; no giving without getting.

In the world of business, or almost any other form of human interaction, this sort of give-and-get expectation would not be called a principle. It would be called common sense. In the WTO system, it is given a name and elevated to the level of a principle exactly because important exceptions have been allowed. For instance, most GATT rules and practices allow a systematic exception for developing nations. During the GATT years, they were basically allowed to get the benefit of other nation's market opening without having to reciprocally open themselves.

Reciprocity also applies in a very different setting, namely retaliation for deviation from agreements. When a nation engages in a practice or policy that undoes the gain another member had from a previous agreement, the aggrieved nation has the right to reciprocate, i.e. retaliate.

**Flexibility**

The last broad principle is flexibility. The GATT and WTO are very politically realistic, so they allow some 'safety values'. It acknowledges that members may, on occasion, come under immense domestic political pressure to reverse commitments they've made, or raise new barriers. Many such exceptions are allowed, but they are disciplined. For instance, nations can temporarily protect under certain conditions, but they are required to give 'compensation' to trade partners whose exports are affected. Likewise, exceptions for non-discrimination are permitted subject to the free trade areas, or customs union meeting certain requirements.

**The GATT's success: Rounds, rules and resolving disputes**

An international organisation is successful when it accomplishes the tasks it is assigned by the international community. The 'cahier de charge' for the GATT/WTO has three main entries: facilitating trade liberalisation, facilitating rule-updating, and facilitating dispute resolution. It has done well on all three.

**Rounds, rules, and resolving disputes**

Through nine Rounds of multilateral talks spread over five decades, GATT members managed to massively lower world tariffs from Smooth-Hawley levels in the 1940s to quite low levels today. Table 2 shows the progress since 1947.

But the GATT was much more than a tariff-cutting club.

Table 2. Tariff cuts in the GATT Rounds and membership, 1947 to 1994

	Start Year	Length (months)	Tariff cut (average cut of bound rates, %)	Number of Members
Geneva I	1947	8	26	19
Annecey	1949	8	3	20
Torquay	1950	8	4	33
Geneva II	1955	16	3	35
Dillon	1960	10	4	40
Kennedy	1963	42	37	74
Tokyo	1974	74	33	84
Uruguay	1986	91	38	125
Doha	2001	162+	-	161

Note: The Doha Round is still far from complete; number of members for Doha is as of May 2015.

Source: Authors' elaboration of data in Martin and Messerlin (2007).

## Rule-updating

GATT wrote the basic ‘rules of the road’ for international trade. The Rounds played an important function in keeping these up-to-date. GATT members often agreed to rule changes and new rules in the context of Rounds as part of the big bargains.

For example, when the GATT was signed in 1947, most of today’s WTO members were colonies. As the colonies became nations and wanted to join, it was widely recognised that rules set largely by the US and UK in 1947 would need to be refreshed to reflect new global realities. In particular, it was widely believed at the time that developing nations needed to keep industrial tariffs high to foster industrialisation. After all, all industrialised nations had industrialised that way – apart from Britain who, as the first industrialiser, didn’t face any import competition in manufactures. In reaction, the GATT adopted a series of rules that provided developing nations with ‘Special and Differential Treatment’. These were refreshed, modified, and deepened at regular intervals in the 1960s and 1970s.

Likewise, as trade became more complex – and the nature of trade barriers along with it – the GATT expanded the range of disciplines. The rule-writing advanced importantly in the Kennedy Round and the Tokyo Round. Many new rules were agreed for numerous trade-in-goods areas, and those rules have been functioning as the primary rules governing international trade. Likewise, the Uruguay Round saw extensive rule updating that extended the scope of rules to cover trade in services and intellectual property rights, culminating in the establishment of the General Agreement on Trade in Services (GATS) and the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement). The Round also produced the Agreement on Safeguards, which restricted unilateral measures.

## Dispute settlement

The GATT/WTO guarantees the enforcement of the rules of the road and the rule of law in trade. Particularly, as a result of the Uruguay Round, the WTO was granted a far more powerful dispute settlement function than that given to the GATT. Under the so-called ‘negative’ consensus rule, the filing of a complaint with the WTO will in effect lead to the establishment of a panel automatically. The same rule also applies to the adoption of panel decisions, making them automatically binding for the parties concerned. Meanwhile, the Appellate Body was installed as a permanent tribunal to provide opportunities to have panel decisions reviewed. Furthermore, procedures for retaliation and cross-retaliation were introduced to enable

complainant members to retaliate in the case of continued non-compliance with panel decisions. In short, the WTO established a mechanism for ensuring the legally binding enforcement of panel decisions.

The WTO dispute settlement procedure has been utilised actively as a mechanism for resolving disputes between WTO members. Also, as a mechanism for settling trade disputes, it has been functioning smoothly and, by now, has become established as such.

A much softer form of dispute settlement comes in the GATT/WTO function of ensuring and monitoring the implementation of rules. For this purpose, the WTO has three councils to ensure the implementation of rules for trade in goods, trade in services, and trade-related aspects of intellectual property rights, respectively. Furthermore, in order to ensure the implementation of specific WTO agreements (e.g., Antidumping Agreement, Agreement on Subsidies and Countervailing Measures) and the transparency of that process, committees dedicated to specific agreements or areas of trade have been established as subsidiary bodies to follow up on and improve the implementation of respective agreements. Those committees are also mandated to play an important role in facilitating the implementation of WTO agreements across 160 member economies. The roles played by the committees at the WTO – where, in principle, all member economies are obliged to subscribe to all of the agreements concluded – are extremely important.<sup>6</sup>

In addition to such issue-based monitoring by committees, the WTO also has a country-by-country monitoring process, which has been established as the Trade Policy Review Mechanism (TPRM), to carry out periodic surveillance of national policies. Without direct pressure, this creates peer pressure for compliance.

## Understanding the GATT’s success

The GATT was very successful in lowering the tariffs of its developed members – especially the old ‘Quad’ (Canada, EU, Japan, and the US). The basic source of these ‘wins’ was a political economy mechanism known as the ‘juggernaut effect’ – a notion that is easiest to explain in the historical context.<sup>7</sup>

When the GATT started, its members’ tariffs were leftover from the 1930s. They were, in essence, ‘politically optimal’ from a purely national perspective. Each government had chosen its tariffs

6 Footer (2010) emphasises the importance of soft law at the GATT/WTO.

7 The original treatment is in Baldwin (1994); a formal treatment is in Baldwin and Robert-Nicoud (2007).

to balance pro-tariff and anti-tariff consideration – a balancing act in which special interest groups played a large role. This political equilibrium was disturbed by the GATT reciprocal tariff-cutting talks.

Announcement of the first GATT Round shifted the political calculus inside each GATT member. Exporters – who previously had only a very indirect interest in their nation’s import tariffs – became anti-protectionists. The reason was that foreign tariffs would only come down if domestic tariff came down as well. In short, in the context of a GATT Round, lobbying for liberalisation at home was tantamount to lobbying for foreign market opening. Of course, this only held for nations who played reciprocally, namely the Quad (US, EU, Canada, and Japan) and some other developed nations.

With exporters now politically active in the tariff debate, the line-up of pro-tariff and anti-tariff pressure groups was pushed firmly in the pro-liberalisation direction – and this took place in all the participating nations. These governments found it politically optimal to remove some tariffs. The level of tariffs that made political sense when exporters were active was lower than the level that made sense when they were inactive.

In a way, the GATT’s success was not due to the international deal itself. It was due to the way the international deal altered domestic political realities in all developed-nation members (Box 2).<sup>8</sup> After all, when a nation implements a GATT Round deal, it is mostly liberalising its own barriers. Since those barriers were put in place by the nation’s domestic political process, reversing the political decision requires a change in the domestic political line up. This happens since implementing the GATT Round deal results in other nations lowering their barriers – an outcome that interests exporters who generally do not care about domestic protection. In essence, one nation’s exporters can bring down other nations’ trade barriers by forcing down trade barriers in their own nation. This all depends upon reciprocity.

It is in this sense that reciprocity was the key to GATT’s tariff cutting successes. It also explains why there was no tariff cutting for so many years by nations that played non-reciprocally (e.g. developing nations). The domestic political equilibrium in these nations was undisturbed by GATT talks and so they did not find it politically optimal to lower their tariffs.

But this is not the end of the story. The resulting tariff cuts created political economy momentum

**Box 2.** How GATT Rounds convert exporters into anti-protectionists at home

Many instances of how GATT Rounds change the array of pro- and anti-trade liberalisation forces are described by Beder (2006). For example, when the Uruguay Round faltered in 1990, the Multilateral Trade Negotiations Coalition was formed in the US as part of a lobbying effort to kick-start the suspended negotiation. It represented a wide range of US exporting companies. When it was time for Congressional approval of the Uruguay Round in 1994, the ‘Alliance for GATT Now’ was formed by US exporters and raised millions of dollars to push the US Congress into voting ‘yes’. Europe’s matching export lobby group was the ‘European Round Table of Industrialists’. Its membership includes major Europe exporting companies such as Bayer, Fiat, BP, Royal Dutch/Shell, Unilever, Hoffmann-La Roche, Total, Volvo, Renault, and Siemens. As the Round Table’s Assistant Secretary General, Caroline Walcot put it in 1993: “We have spoken to everybody. We have made press statements. We have written to Prime Ministers. We have done everything we can think of to try and press for the end of the Uruguay Round.” (Quoted in Beder 2006). A similar push by Japanese exporters was critical in allowing Japan’s Parliament to find it politically optimal to open up Japan’s market to imports overall, especially in the sensitive agricultural sector (Yoshimatsu 1998).

for a very simple reason. As tariffs came down, the pro-tariff interest groups were downsized by market forces. Import-competing firms generally got smaller, laid off workers, and became less profitable. Many went out of business. With fewer employees and profits, their political clout in the tariff debate was diminished. On the other side, foreign tariff-cutting boosted the fortune of exporters. They expanded production and sales, hired more workers, and saw profits rise. Their political clout grew. In a nutshell, the one-off tariff cuts weakened protectionist forces and strengthened liberalisation forces inside all the developed-nation GATT members.

A few years down the road, when another multilateral Round was launched, reciprocity again re-aligned the tariff-setting balance inside GATT members. Again, the Round turned exporters into anti-protectionists. But this time, the pro-tariff camp was systematically weaker in every nation and the pro-liberalisation camp was systematically stronger in every nation. Thus, the tariff levels that made good political sense in the previous GATT Round no longer made sense. They no longer balanced domestic pro-tariff and anti-tariff pressure inside each nation. The result was that all governments playing reciprocally found it politically optimal to cut tariffs again. As these fresh tariff cuts were phased in, the exit

<sup>8</sup> On the basic theoretic point of see Putnam (1988); for its application by economists to trade agreements see Ethier (1998) or an even more forceful statement in Ethier (2013).

of import-competing firms and entry of exporters again reshaped the political landscape inside each participating nation, and the cycle restarted. The juggernaut rolled forward.

### Complementary rules: Bindings and ‘don’t obey don’t object’

The GATT, which was a political masterpiece, had a series of other mechanisms to keep this gradual, mutually advantageous tariff cutting on track.

To avoid backsliding – and to ensure the juggernaut never started rolling in reverse (as it had in the 1930s) – the Rounds ‘process’ was embedded in a set of rules designed to make political reversals difficult for individual members. One particularly critical rule was the principle that a nation’s past tariff cuts were ‘bound’ in the sense that previously agreed tariff levels were not open to further negotiation (Article II of GATT). Importantly, a nation’s partners could retaliate against any violation of bindings. The effect was to ensure that each nation’s exporters would be punished for any backsliding, thus giving them an incentive to push their government to respect the bindings.

Note that this design element did not depend on the nation’s own government – it was ‘enforced’ by retaliation decisions of foreign governments. After the first Round, governments no longer had the luxury of unilaterally rebalancing the tariff without their exporters at the table. More colloquially, the binding+retaliation rule kept nations’ exporters harnessed to the anti-protection plough regardless of their own government’s stance.

Yet, another linchpin political-economy mechanism accounts for why the GATT could conclude Rounds despite the consensus principle. A variety of GATT practices on ‘Special and Differential Treatment’ adopted since 1947 created a reality where developing nations were not subject to GATT disciplines. They were exempted from an expectation of reciprocally cutting their tariffs, and they could more or less ignore any GATT rules they didn’t agree with. In the Kennedy and Tokyo Rounds, negotiations on trade rules were undertaken by the so-called ‘Codes’ approach, whereby each set of rules agreed upon was adopted in the form of a code, which would be binding only for those members that voluntarily signed them.<sup>9</sup> Moreover, the GATT dispute settlement system wasn’t strong enough to enforce compliance in any case (the ‘defendant’ had a veto over panel decisions). The Quad was happy to allow this free riding since developing nation markets were, at the time, rather insignificant.

But being excused from reciprocity did not mean the developing nations were indifferent to the GATT’s success. Despite not having to reciprocate or participate, their exports benefitted from the conclusion of Rounds. The GATT’s MFN principle meant that the tariff cuts agreed among the developed nations were automatically extended to developing nation exporters. They were free-riders, but free-riders who liked the ride.

This reality, sometimes called ‘don’t obey, don’t object’, allowed a consensus-based organisation of highly diverse nations to operate as if it were run by a small group of self-appointed, like-minded nations with big economies. Developing nations did not block progress as they were excused from tariff cutting and free riding (the GATT’s most favoured nation principle) gave them a stake in completing rounds.<sup>10</sup>

Of course, it helped that most of the GATT talks were about tariffs. Tariffs are, by nature, easy to negotiate – not just because of their malleability but also because it was easy to quantify the market access balance in any given package. It was relatively easy to quantify, for example, what US exporters were getting in the EU in exchange for what EU exporters were getting in the US. One could calculate balance of the entire tariff-cutting package at the GATT level. When talks turned to more complex, regulatory issues in the Kennedy and Tokyo Rounds, the GATT adopted the ‘Codes’ approach that essentially gave developing nation the right to opt out of any new disciplines.

### WTO underperformance

The GATT way of ‘doing business’ worked for a half century. The GATT way, however, seems to have reached the end of the road with the Doha deadlock.

#### Doha Round difficulties

The Doha Round was launched with great fanfare in 2001. The plan was to finish it by 1 January 2005. Now, in its 14th year it is nowhere near agreement on the core agenda items – the rebalancing of the trade system via improved market access in industrial goods, reduced subsidies and improved market access in agricultural goods, and liberalisation of service flows. Only one small part of the original agenda – trade facilitation – has been completed – and that just barely.

How did we get here? The original Doha agenda was based primarily on items leftover from the Uruguay Round as well as four issues (trade and competition, trade and investment, transparency in procurement, and trade facilitation) that were controversial at the time. There is also a general

<sup>9</sup> See Contracting Parties’ Decision of 28 November 1979 (L/4905)

<sup>10</sup> For details see Baldwin (2010).

promise to rebalance the dimension of development in the global trading system. As the 2001 Ministerial Declaration put it: “The majority of WTO members are developing countries. We seek to place their needs and interests at the heart of the Work Programme adopted in this Declaration. ... In this context, enhanced market access, balanced rules, and well targeted, sustainably financed technical assistance and capacity-building programmes have important roles to play.”

In launching the Doha Round, a great amount of time was devoted to discussing implementation issues. There was a widespread feeling among developing nations that they had been hoodwinked in the Uruguay Round – forced by the Single Undertaking approach to accept the old Quad’s new issues (TRIPs, TRIMs, and Services) without really getting much in return. This showed up as developing members’ demand calling for ensuring the smooth implementation of the existing WTO rules as a prerequisite to enter into a new round of negotiations. Adjustments were made to the agenda for the new round of negotiations in consideration of concerns raised by a group of developing countries led by India.

In a twist of fate, the Doha Ministerial Conference also saw China’s accession to the WTO – a change that was to have a profound impact on the political economy landscape in which Doha Round talks were held. In particular, since China made massive ‘concessions’ during its accession talks, the Doha Agenda foresaw no major new commitments from China per se and included no major items that were of particular interest to China. After all, China wasn’t at the table when the Doha Agenda was set.

The first clear failure came at the fifth Ministerial Conference held in Cancun, Mexico in 2003. The second came in the summer of 2008, the third came in 2011. Realising that there was no conceivable deal that would be win-win for all parties and complete the full agenda, WTO members agreed in 2011 to put aside most agenda items and focus on finding a ‘mini package’, giving up realising all agenda items at the same speed. Eventually it was whittled down to a relatively non-political set of developing country reforms and developed country aid promises known as Trade Facilitation. Even this mini-package failed.

Yet another attempt was made in 2013. Led by the new WTO Director-General, Roberto Azevedo, the focus on trade facilitation finally bore fruit – at least in part since developing nations like India had something new to negotiate over. The Uruguay Round strictures on food subsidies – which were viewed at the time as purely rich-nation concerns – had become emerging-nation concerns. Reality had, in essence, enlarged the Doha Round agenda

to include the possibility of granting waivers for certain Indian food programmes. But even this success almost fell through.

After what seemed to be a success at the 2013 Ministerial Conference in Bali, the mini-package was almost scuppered in 2014 by a group of countries led by India that wanted explicit ties between food security issues and the trade facilitation mini-package. Additional assurances were made in November 2014 and the mini-package survived its near-death experience. This was rapidly followed by a fresh failure to reach agreement on the post-Bali work programme by the end of 2014 as planned. The deadline for this has been pushed back to July 2015, leaving the future course of the DDA round uncertain.

### Understanding the Doha doldrums

There are many reasons for the Doha Round’s troubles but perhaps the most important is that the GATT’s ‘magic’ can no longer be used due to two key differences.

First, the juggernaut effect is working only weakly since it is low on ‘tariff fuel’. Advanced-economy tariffs were already low when the Round started on most industrial goods. Exporters to these markets had little tariff-cutting to fight for compared to previous Rounds. While the rising importance of emerging market economies – and the fact that they had not cut tariffs in earlier Round – might have provided fuel for the juggernaut. Most developing nations, however, unilaterally lowered many of their tariffs starting from the 1990s. Putting these two together means that in terms of industrial tariff-cutting, there is relatively little for the world’s big export firms to fight for – at least compared to the GATT years. Of course, there are still high tariffs in some markets on a handful of highly sensitive industries, but the value of trade covered is relatively small.

Second, the endgame of the Uruguay Round – shifting to the Single Undertaking approach – cancelled the don’t-obey-don’t-object notion that helped avoid blockages by large numbers of developing members in past Rounds.

The presumption is that every WTO member will have to abide by everything agreed in the Doha unless an explicit exception were agreed upon. As developing nations would normally have to obey, they would be expected to object to aspects that they found harmful to their interests. Given effectiveness of the WTO’s Dispute Settlement Mechanism, they could, years into the future, be held to account from provisions whose implications were unclear at the time. Thus, nations are objecting to things which implications cannot be fully enumerated. Under the WTO, the default is that everyone has

to obey, so everyone has an incentive to object (or ask for explicit special treatment).

In this way, the Single Undertaking pushed the WTO into what might be called decision-making's 'impossible trinity'. That is, under current WTO negotiating practices, agreement by consensus (so even a single member can block progress or 'take hostages' by threatening to do so), universal rules (due to the single undertaking – any exceptions have to be negotiated explicitly instead of blanket exceptions being granted automatically), and strict enforcement (as the GATT panel progress turned into the WTO Dispute Settlement Mechanism).

The WTO is thus in a situation akin to that of the European Union when it is trying to adopt treaty changes. The consensus decision making, universal rules, and hard adjudication that the WTO is facing has long been the standard situation in the EU. The EU does manage to agree treaty changes despite the 'impossible trinity', but they are very difficult, take a long time, and usually require a very broad agenda. Moreover, they are getting increasingly difficult as the diversity of EU membership rises.

Another aspect of the GATT/WTO difference that is important concerns the way that the presumption of non-reciprocity for developing nations under the GATT has been questioned. The willingness of the advanced economies to allow free riding by all developing nations is largely gone.<sup>11</sup> Vibrant growth by China, India, Brazil, Russia, and other large emerging markets means that access to these markets is no longer insignificant. The old Quad's share of global GDP has fallen from about two-thirds in 1994, to under one half in 2014.

### Dangers ahead

The GATT's five decades of economic success (market opening) and diplomatic success (reducing and resolving disputes) were the foundation of the GATT's centrality in world trade governance. This, plus the basic principles of non-discrimination, created a broadly held notion that following the GATT's code of good conduct was as much a good idea for each GATT member as it was for the world community as a whole. There was something of a chicken-and-egg cycle. Success reinforced a common interest in multilateral cooperation which in turn facilitates further success.

#### Doha Round roadblock threaten support for multilateral cooperation.

As the GATT could complete new Rounds every five or ten years, the GATT became the 'vehicle of choice' for both trade liberalisation and rule updating. One can argue about why GATT was a success, but as the old adage puts it: "Nothing

succeeds like success". The opposite can be said for the WTO.

If we were doing a performance review for the WTO based on its 'cahier de charge', the performance report would be very unbalanced. Little progress has been made on the trade liberalisation front since a handful of agreements in 1997. The Doha Round is now stalled in the middle of the road and blocking progress on rule updating as well as trade liberalisation. In fact, only one of the Organisation's functions would receive a high performance score – dispute settlement.

It has been 18 years since the WTO produced a clear win-win trade liberalisation reform – the 1997 agreements on telecom, financial services, and ITA. The Bali trade facilitation agreement was progress, but certainly nothing on the scale of the Uruguay Round, Tokyo Round, or Kennedy Round.

This is a long time without a 'win'. For instance, the world leaders who celebrated the 1997 successes included Gerhard Schroeder, Hashimoto Ryutaro, Li Peng, Inder Kumar Gujral, Nelson Mandela, Bill Clinton, and Fernando Henrique Cardoso. Boris Yeltsin was leading Russia at the time. All world leaders since then have seen their hopes raised and dashed by the WTO's promise. A large share of today's trade officials and ambassadors has never seen the WTO facilitate reciprocal liberalisation.

More importantly, interest groups around the world have to a large extent given up on the WTO as a vehicle of any kind for trade liberalisation and rule-writing, much less the vehicle of choice. Few sitting CEOs can remember the days when multilateral Rounds were an important vector for helping them do business internationally. Plainly the self-fuelling cycle of success and support for a common interest in multilateral cooperation has stopped spiralling upwards.

This is the first danger. The decade and a half of underperformance has massively eroded support for the idea that all nations have a common interest in supporting multilateral cooperation on trade.

The second danger facing the WTO is linked to the lack of progress on rule updating. The WTO still delivers on dispute resolution, but that means the WTO is hopping along on one leg. And that leg is showing some signs of problems.

#### The Litigation-legislation imbalance threatens dispute settlement

Since the WTO has been unable to conclude a Round, it has been unable to update its rulebook. As a consequence, WTO judges are using 20th century rules to evaluate the merits of 21st century disputes.

<sup>11</sup> See Schwab (2011).

The last rule update came in in 1994 – and that was based on an agenda agreed in 1986. To get a perspective on this, it's worth pointing out that the latest modernisation of the rules reflected the best and most up-to-date thinking of leaders like Helmut Kohl, Yasuhiro Nakasone, José Sarney, Margaret Thatcher, Ronald Regan, and Rajiv Gandhi. That was, for example, before the internet existed and before cell phones fit into shirt pockets. The world of international commerce has moved on a bit since then. The WTO's rules have not.

The nature of trade has become radically more complex and interlinked with the internationalisation of production networks. And state-owned enterprises have moved from obscurity to the front row. Likewise old issues such as currency manipulation are attaining major importance. WTO judges have to make their decisions based on rules that have little to say directly about these new issues.<sup>12</sup>

Looking forward, this imbalance between legislation and litigation is dangerous and could contribute to a system failure. The success of the WTO dispute settlement system rests on its legitimacy. This legitimacy rests on the fact that the rules being enforced were agreed on by consensus. As rule-updating is politically extremely difficult except in the context of a big package like the Doha Round, a frozen Doha Round threatens the long-term health of the dispute settlement system.

To date, the judges have muddled through by means of evolutionary interpretation of legal texts by panels and the Appellate Body. This is tantamount to judging today's extremely complex international disputes based on the centuries-old Magna Carta. The burden on WTO panels and panellists could become too much to bear, and, in due time, sovereign countries would find it difficult to follow their rulings. Litigation without 'legislative legitimation' is not sustainable. It is just like running a computer without having updated its operating system since 1994.

If this adjudication-based-on-old-rules continues long enough, one of two things must happen. First, the judges could refuse to adjudicate disputes on which the rules agreed in 1994 are insufficiently clear. In reaction, aggrieved WTO members are likely to introduce unilateral measures – as happened with the US's Aggressive Unilateralism of the 1980s (Bhagwati and Patrick 1990). Second, if the WTO judges continue on their current course of stretching 20th century rules to deal with 21st century disputes, the time will come when a major

WTO member rejects a ruling – claiming, quite rightly, that the ruling on the 21st century issues should not be based on negotiated texts agreed in the 20th century. It is absolutely unclear what the outcome would be, but it would be a major blow to the notion that all nations have a common interest in the WTO's 'code of good conduct' – a notion that was the very heart of how the GATT promoted peace and prosperity for 50 years.

### Megaregionals threaten WTO centrality

Curiously, the WTO underperformance on trade liberalisation and rule writing did not reflect a resistance to trade reform by WTO members. Quite the contrary. While the Doha Round staggered from failure to failure, the same WTO members have been liberalising at a furious pace bilaterally, regionally, and unilaterally. And rule-writing has proceeded apace. This non-WTO liberalisation and rule-writing has been called 21st century regionalism. This is a threat to the WTO, but the nature of the threat is subtle.

### Three elements of 21st century regionalism

21st century regionalism has three parts: Deep RTAs, BITs, and unilateralism.<sup>13</sup> Unilateralism (unilateral liberalisation and reform) is not a systemic threat to the WTO. Likewise, the BITs have co-existed with the WTO for decades without any apparent harmful spillovers. The real threat is the way that deep RTAs have displaced the WTO's central place in setting the 'rules of the road'. More specifically, deep RTAs may undermine the WTO as the forum for agreeing new rules.

There are three main reasons to worry about the WTO being sidelined on the rule writing front. First, the basic WTO trade norms are almost universally accepted and respected – a very rare thing (think of climate change, nuclear proliferation, or human rights). These norms are a global public good of enormous, if unquantifiable benefit. The universality of the norms stems in large part from the way they were promulgated – in multilateral negotiations where the GATT/WTO consensus principle held sway.

The new trade disciplines are being promulgated in settings of massive power asymmetries – the deep RTAs signed by the US, EU, and Japan with small to medium-sized developing nations. Lacking the legitimacy that comes from multilateralism and

<sup>12</sup> The 'Chinese Financial Services' and 'China – Electronic Payment Services' cases are examples of cases involving types of services that did not exist at the time of the 1994 Agreement. The US Clove Cigarettes case can also be regarded as an example of an evolutionary interpretation, this time of the TBT agreement.

<sup>13</sup> Here '21st century regionalism' is meant in the sense of Baldwin (2011). Unilateralism is included since unilateral tariff reductions, especially on parts and components, was a key element of nations' encouragement the development of regional value chains. This is especially true in East Asia since formal FTAs with Asia's main headquarter economy, Japan, were politically difficult in Asia until the 2000s (see Baldwin 2006 for a discussion).

consensus, it is not at all clear that the new norms will be universally respected.

For example, some emerging markets – China, India, and Brazil – are large enough to attract foreign investment and technology without signing deep RTAs, and they have so far shunned them.<sup>14</sup> China in particular might decide to reject some rules while embracing others – creating something like a ‘Cold War of deeper trade disciplines’. This sort of distrust could spread beyond the new rules, especially if China, India, and Brazil feel that the US is practicing what Fred Bergsten calls ‘competitive liberalisation’ (Bergsten 1996). That is to say, using RTAs to ‘encircle’ them in a way that eventually confronts them with what might be seen as an ultimatum. This outcome would be made more likely if the US reverts to its aggressive unilateralism of the 1980s (the Plaza Accord and the Structural Impediments Initiative that forced Japan to revalue and remove behind-the-border barriers) and 1970s (Nixon 10% surcharge that forced Germany to revalue).

Second, a world where there are many different rulebooks and some important players feel excluded from a large part of the system is not a world that nurtures the spirit of multilateral cooperation. It is a world where discrimination is rife and power rather than rules routinely influence outcomes. These plainly undermine the sort of self-reinforcing cycle that was important in the GATT’s success at promoting peace and prosperity. The virtuous cycle where governments and interest groups feel that all other governments and interest groups have a common interest in defending multilateral cooperation is broken. Some WTO members, including some of the new trade powers, may start to view the world trade system as rigged by the advanced technology nations.

Third, a world where WTO is of secondary importance is not a world that fosters multilateral cooperation on other issues, such as trade-related policies that help with climate mitigation and adaptation, or food shortages linked to drought or floods. US, EU, and Japanese interests will be served in the short term, and the interests of small to medium emerging markets will likewise be served (if not evenly), but where do Brazil, India, and China fit in?

If Brazil, India, and China play their assigned roles in this storyline, it may all work out peacefully. But that is not the only outcome observed when such tactics were applied historically. This is a world that starts to resemble the 19th century Great Powers situation. That episode of globalisation did not end well.

<sup>14</sup> The EU-India agreement being negotiated, for example, excludes many of the deeper disciplines in the EU’s other RTAs.

## Possible solutions

In nutshell, the problem stems from the fact that the world of trade has changed, but the WTO has not. The rise of North-South production sharing created a need for new disciplines both at the border (guarantees that international supply chains can function flawlessly) and behind the border (protection of tangible and intangible property rights, and assurances against unfair competition).

As the WTO continued to focus exclusively on the 20th century issues leftover from the Uruguay Round, WTO members turned elsewhere to set up the new disciplines. The developing nations that wanted to join GVCs sought ways of providing such assurances unilaterally and bilaterally. The advanced-technology nations setting up the GVCs were happy to negotiate the deep RTAs and BITs that would lock-in the necessary disciplines. Developing nations unilaterally lowered tariffs, especially on parts and components, to facilitate the international production sharing.

In this way, deep RTAs, BITs, and unilateral reforms became the vehicle of choice for advancing trade liberalisation and rule-writing in the 21st century. Note that given the Doha Agenda’s backward focus, 21st century regionalism was not in direct competition with the Doha Round, but ‘nothing succeeds like success’, and the Doha Round was not succeeding. Interest groups and governments were willing to pay a political price to get deep RTAs done that they were unwilling to pay to get Doha done.

This has to be the basic premise when thinking about solutions for the dangers facing the WTO. Many WTO members have realised the need for new trade disciplines and set them up in non-WTO settings (BITs, RTAs, autonomous reform, etc.). And they have realised that many forms of tariff-cutting should be thought of as a development tool, not a concession. In particular, it is too late for the most obvious solution of putting the WTO in charge of writing the multilateral 21st century disciplines. That’s already been done elsewhere by the nations that most needed them.

In this light, the megaregional initiatives are not really new. They are attempts to knit together the spaghetti bowl 21st century disciplines and autonomous reforms that already exist. The success or failure of the megaregionals is nevertheless of prime importance for the WTO’s future. The WTO’s reaction to megaregional success or failure is equally important.

Up till now, the WTO as a member-led organisation has been ignoring the demand for 21st century disciplines. It has, to put it colloquially, been engaged in a ‘pretend and extend’ strategy. Much like a bank that keeps lending to a losing business

to avoid admitting a mistake, the Organisation acts as if the Doha Round agenda should still be its most important priority and it continues to extend the deadline regardless of repeated failures.

Despite this, the success or failure of megaregionals matters hugely for the WTO's future. This is especially the case for TPP since it involves all the 21st century disciplines, includes both developed and developing nations, and helps the US get GVCs disciplines for American GVC involvement in Asia.

### Forward scenarios

What happens going forward depends upon success of mega-regionals and the WTO's reaction. The various combinations can be resumed in a simple table of outcomes (Table 3). Consider the various outcomes from left to right and top to bottom.

Table 3. Megaregional success and WTO reactions

		WTO reactions:	
		Pretend & extend	Engage with 21st century disciplines
MegaRTA outcomes:	Succeed	Continued erosion of WTO centrality; possible system failure	Multipolar world trade governance, or multilateralise 21st century disciplines
	Fail	Continued erosion of WTO centrality; bilateral solutions, or new megaregional initiatives	Window of opportunity to restore WTO centrality

### If megaregionals succeed

If the megaregionals, such as TPP, TTIP, EU-Canada, EU-Japan and Canada-Japan, are signed and implemented, the 21st century disciplines that are necessary to underpin the most dynamic aspect of international trade and investment will have been set – and only partly harmonised – outside the multilateral governance structure. In essence, the rules that have already been propagated by the US, EU and Japanese deep RTAs will become the global norm with no input from nations like China, India, Russia, and Brazil.

Nations that were excluded from the TPP and TTIP deals have two choices – as the experience of small, non-EU nations shows when European deep rules were harmonised by the EU's Single Market Programme. Non-TPP, non-TTIP nations will either follow suit and join – as Sweden, Finland, and Austria did – or they will struggle to attract supply-chain trade and investment with their idiosyncratic

domestic rules – as Norway and Switzerland did. The choice is not big as it might seem since the Swiss and Norwegians have, in essence, adopted all the EU rules unilaterally to avoid putting their businesses at a disadvantage.

In the WTO context, economically small and medium-sized nations are likely to choose the 'join' options while some of the largest nations – especially China – may go on their own with bilateral arrangements.

This would be a major change from the current situation where rules are set in the context of multilateral negotiations and agreed by all WTO members. Creating a set of rules where the new trade powers – China in particular – are excluded from the discussion would most definitely constitute a radical change in global trade governance. It would greatly undermine the notion of a common interest in supporting multilateral cooperation. While powerful nations have always dominated GATT/WTO talks, the multilateral setting and the consensus-rule allowed everyone to buy into the process in one way or the other.

There is no doubt that success of the megaregionals will create resentment among the excluded WTO members. It would be much harder for them to view world trade governance as 'code of good conduct' that everyone follows. The megaregionals – whose content was driven by the priorities of advanced-technology nations – could easily be portrayed as the rigging the world trade system in favour of the rich nations.

### WTO reaction

One possibility is that the WTO membership as a whole would react by continuing to 'pretend and extend'. The global trade governance implications of the new megaregional would be ignored to the extent possible while the Organisation pretends that the Doha Round is still doable. The 'Doha first' strategy would stay in place, so any addressing of 21st century disciplines would happen after the 20th century trade system had been rebalanced as promised in the 2001 Doha Declaration. This seems the most likely possibility as of now, in our judgement.

Recalling how GATT success created a self-fuelling spiral of support, success by the megaregionals in the face of pretend-and-extend by the WTO would surely hasten erosion of the WTO's centrality. It would become even harder to update the WTO's 1994 rulebook to reflect 21st century realities. Interest groups in both developed and developing nations would focus their political energy on the megaregionals since that is where the new rules would reside. Governments may find it convenient to pretend that the WTO might eventually restore

its centricity but in reality the WTO would be sleepwalking towards system failure where common interest in multilateral cooperation unwinds and nations start to ignore the WTO 'code of good conduct' since everyone else does.

By contrast, the WTO could adopt the opposite reaction. It could take the megaregional success as an opportunity for engaging in the 21st century disciplines that so many WTO members embraced years ago bilaterally, , and unilaterally. The engagement could take many forms.

The most robust would be to embark on an effort to multilateralise the provisions that had been knit together by the megaregionals. This would involve a negotiation that brought some or all of the new rules into the WTO mainstream. One way would be to enlarge the Doha Agenda to include the 21st century trade issues as a means of giving the major players enough material to construct a win-win package. Some analysts may think of this as a positive outcome, but others question this judgment.<sup>15</sup>

In particular, China's interests were not considered when the Doha Agenda was first formulated. The new issues might give China something to fight for. The old Quad governments would certainly find it easier to compromise on rebalancing issues if the package included gains on new issues. In this scenario, new disciplines and rules set outside the WTO will eventually come back into the WTO through the multilateralization of mega RTAs and WTO-consistent plurilateral agreements. This is the ideal scenario but to be realised only with serious efforts and collaboration.

A more modest step would be for the WTO membership to accept that megaregionals now constitute an important part of global trade governance and work out a multi-pillar architecture. This could come in the form of formal WTO approval of certain plurilaterals (ITA2, green goods,<sup>16</sup> TiSA, ACTA,<sup>17</sup> etc.).<sup>18</sup> Plurilateral agreements do not need to be focused on a single area or issue. As in the case of a proposed International Supply Chain Agreement (ISCA), it is possible to combine and negotiate multiple mutually related areas and/or issues as a package.<sup>19,20</sup>

15 Nakatomi (2013a, b, d).

16 See Hammeren (2014).

17 See Roffe and Seuba, (2014).

18 See in depth analysis of the Warwick Report (2007) and World Economic Forum (2010).

19 Refer to Nakatomi (2012, 2013c). The ISCA is a proposal to negotiate a new plurilateral agreement designed to address the needs of GVCs. More specifically, it calls for like-minded countries to negotiate, over a predefined period of time, a set of relevant issues selected by their governments and business communities.

20 See Hoekman (2014) and Nakatomi (2013c). Also, refer to Lee-Makiyama (2011) regarding issues in the area of information technology and ICTSD (2011) for those in the energy area.

Importantly, if these plurilaterals are to be part of the solution instead of adding to the problem of discrimination and exclusiveness in the world trade system, they should offer non-members MFN access, as exemplified by the ITA and the 1997 agreements on financial services and basic telecommunications services. What is important in bringing about plurilateral agreements is to seek to ensure that the resulting benefits be extended to non-participating countries on an MFN basis.<sup>21</sup> Assuring MFN treatment to non-participating countries would make plurilateral initiatives less threatening to outsiders and less undermining of the WTO spirit, thereby enabling participating countries to avoid a backlash from developing countries. Also, abiding by the MFN principle would help pave the way for incorporating the resulting plurilateral agreements into the body of WTO agreements. In this regard, the proposed TiSA is problematic in that it is envisioned to be a non-MFN-based plurilateral FTA and is being negotiated as such.<sup>22</sup>

In our view, it is also important – for the sake of global trade governance – that the plurilaterals are open to new members. This would ensure the universality and openness of the framework of an agreement negotiated so as to allow new members to participate and thus to keep the possibility open for multilateralization.

### If megaregionals fail

Given the difficulties already encountered by the key megaregionals, the TPP and TTIP, success is far from assured. Negotiations are currently underway. However, none of them have yet to pave the way for a successful conclusion. Given the number of countries involved, the size of potential economic impact, and the depth of negotiations, failure is a real possibility. Meanwhile, in the TTIP negotiations, the longstanding US-EU disagreements are coming to the fore.

### WTO reaction

If the WTO continues with its pretend-and-extend strategy even after the megaregionals failed, the status quo would continue. This does not help WTO centricity directly. After all, the failure of megaregionalism is not a failure of non-WTO avenues for rule-writing and liberalisation. The rules underpinning international production unbundling are currently based on the ad hoc collection of bilateral and regional agreements signed by the US (NAFTA, DR-CAFTA, etc.), Japan (the Japan-ASEAN bilaterals), and the EU (EU-Turkey, etc.).<sup>23</sup> New rules for 21st international

21 Low (2011) and Nakatomi (2013c).

22 Nakatomi (2014, 2015) and Bosworth (2014).

23 Note that most of the EU supply chain is inside the EU and thus covered by Single Market disciplines.

commerce would continue to be written bilaterally in deep RTAs. This is a world where WTO centrality continues to erode and the WTO continues to be unable to update its rulebook.

This would also be a world with a spaghetti bowls in rules. The principle of non-discrimination would continue to corrode. The 'common interest' in multilateral cooperation could start to become quite uncommon. Megaregional failure would, however, give the WTO more time to adjust to 21st century realities.

Alternatively, the WTO could eschew 'pretend-and-extend' and instead jump through the window of opportunity created by megaregional breakdown. Leading trade nations might realise that establishing the GVC-linked disciplines cannot be done regionally, so they might turn to the WTO.

In this scenario, the Doha Round would either be finalised by shrinking ambitions to the point where members could 'declare victory and move on'. Or the Doha agenda could be enlarged to include the new issues and this enlarged 'landing zone' makes it possible to bring the Doha Round in for a landing. In this case, the enlarged Doha Round gets done and the WTO is back in business. Of course, it is not clear why the major players would find it easier to agree to the new rules inside the WTO than they did outside in the failed megaregionals, but one possibility is that the most contentious issues, like state-owned enterprises, get left off the table.

### World without the WTO

The list of dangers facing the WTO and the analysis of solutions does not make for light bedtime reading. It does not paint an optimistic portrait of the WTO's future-scape. In most of the cases, the continued spread of regional rules and the imbalance between the WTO's rulemaking capacity and its adjudication capacity could well eventually lead to a serious undermining of the WTO – perhaps even system failure as most nations ignore the rules since they feel everyone else is ignoring them. What would the world be like without the WTO?

It seems unlikely that this system failure would resemble that of the 1930s with rising protection and defensive regional blocs. The political economy of 21st century trade has driven forward massive liberalisation of trade, investment, services, and IP policies. In short, protectionism of the 20th century sort has become destructionism as far as industrialisation, development, and growth are concerned. What is more likely is a spaghetti bowl of rules, and a re-emergence of raw power politics in trade relationships; discrimination by the

powerful against the weak, disorder in global rules, lack of effective dispute settlement, etc.<sup>24</sup>

Even if the mega RTAs succeed, they cannot ensure a harmonised global trade and investment regime. The WTO provides the basis for trade rules with an effective global enforcement mechanism. Mega RTAs cannot be its substitute. Mega RTAs do not have a global enforcement mechanism. Rules in new areas (e.g., services, investment, competition, technical barriers to trade (TBT), intellectual property, and data flows) would be developed, set, and imposed by hegemony without multilateral thinking or without due coordination. Those are the rules that are crucial to the development of GVCs or in order to accommodate the reality of international division of labour. However, there is neither a guarantee that multiple sets of rules thus developed will eventually converge into a set of global rules, nor is there a mechanism for that. We would probably end up with a world with a myriad of regional rules governing key areas such as those listed above, giving rise to a serious spaghetti bowl phenomenon in rules.<sup>25</sup>

A lack of coordination among mega RTAs could undermine the global rule of law and hinder the development of GVCs. In a world of mega RTAs, which are being pursued mainly by advanced economies, the influence of developing economies would be marginalised and those countries excluded from such RTAs would be sidelined and face discrimination. In a world where mega regionalism works, the WTO's centrality in global trade governance would have eroded and the WTO would become just one pillar of a multi-pillar global governance system.<sup>26</sup>

### Concluding vision: Multi-pillar global trade governance with the WTO as the central pillar

One thing is perfectly clear. World trade governance in 2020 will be quite different to today's system. The old idea that the GATT/WTO is the central pillar of global trade governance will either be replaced by a multipolar system, or the WTO itself will be transformed.

On current trajectory, the multipolar system is the most likely – unless WTO members make a concerted effort to change the inertia. The Doha logjam has not stopped trade liberalisation and rule writing. It will continue at a furious pace, but all of it is outside the WTO. Even if the megaregionals fail and even the WTO doesn't stumble over the

<sup>24</sup> See Nakatomi (2013a,c) for possible examples.

<sup>25</sup> Keidanren (2013) calls for establishing a "unified axis" or a common approach to negotiating rules on a sector-by-sector basis in order to avoid the risk of ending up with having different sets of rules across different RTAs.

<sup>26</sup> Baldwin (2012, 2013).

legislation-litigation imbalance, the 2020 system will be multipolar. Rules and adjudication for 20th century trade will continue inside the WTO pillar. Rule writing for and liberalisation of 21st century trade will continue – as they have done for two decades – in deep bilateral RTAs, BITs and perhaps plurilaterals such as TISA. We have already looked at the issue of adjudication for 21st century trade. After all, even without TPP and TTIP, the US, Japan, and the EU will have their regional GVC underpinned by rules set in deep bilateral RTAs, BITs, and unilateral developing nation reforms.

This would not be an optimal outcome as it would exclude the rising trade powers – especially China, India, and Brazil – from important developments. They would have to either formulate their own regional responses or just live with the rules written by others.

World trade governance seems to be sleepwalking towards system failure; hoping the WTO will continue to function even with its 20th century rulebook. However, there is no guarantee that the WTO's dispute settlement function will continue to operate. As we have analysed in this paper, litigation without legislative legitimation is not sustainable. For the WTO to continue to be effective, we need to recover the rule-writing function that the WTO hasn't had for nearly 20 years.

Given this, it is time to start seriously considering multi-pillar global trade governance where the WTO is just one pillar – hopefully the central pillar.

The idea of megaregionals creating a natural order of trade as a pre-established harmony is an illusion as they lack key elements of the GATT's success – non-discrimination and the way it fosters a common interest in supporting multilateral cooperation.

Mega RTAs have only partially been responding to the needs of the 21st century trade and GVCs by creating regional solutions led by developed countries. At the same time, they have been creating serious spaghetti bowls in rules and leaving non participants aside as well. Shutting our eyes to the dangers posed by a world without the WTO is intellectual negligence. All efforts should be made by businesses and governments to salvage the WTO and move it back to centre stage of the global governance regime – and this before it is too late.

#### **Short-term fixes: Keeping the WTO lights on**

All of these possibilities are held up by the fact that the megaregionals are still under negotiation. Until they are either dead or done, their key members will be reluctant to discuss 21st century trade disciplines in any WTO context. It would be

foolhardy to negotiate the same issues with the same partners in two venues – especially when this would mean inviting a large number of third parties to the talks.

In the meantime, there are things the WTO could do to favour outcomes that foster multilateralism. The first would be to engage in discussion, research, and reflection on what the new factories-crossing-borders disciplines really mean for the world trade system. It is essential to involve businesses in the framework so as to understand the realities of GVCs from the business perspective. To understand what should be done, however, requires avoiding the trap of using 20th century paradigms to think about 21st century regionalism.

20th century RTAs were mostly about tariff preferences. As one nation's preference is another's discrimination, 20th century thinking viewed RTAs as creating 'mercantilist allies' – who enjoyed trade creation – and 'mercantilist enemies' – who suffered trade diversion. Yet tariffs today are low worldwide on high-volume items, and goods for which tariffs are still high, are routinely omitted from RTAs. As a consequence, deep RTA provisions often resemble unilateral liberalisations that just happen to be bound via an RTA; the whole trade creation/diversion thinking is misleading or moot when it comes to many aspects of 21st century regionalism.

This lack of discrimination is intrinsic. Many deep RTA provisions impinge upon firms, services, capital, and intellectual property. Discrimination is technically difficult since it is hard to define the nationality of firms, services, capital, and IP in today's world – at least in a way that precludes low-cost circumvention. In other words, the 'rules of origin' for deep provisions are leaky. As a result, we should not think of 21st century regionalism as being mostly about discrimination (see Baldwin, Evenett and Low 2009).

Despite the lack of hard discrimination, 21st century regionalism has implications for non-members. Deep RTAs and BITs create what might be called 'soft discrimination', or an 'impulsion to conform'.

For example, when the EU signed the deepest RTA in history – the 1986 Single European Act – 20th century thinkers predicted a 'Fortress Europe'. What actually happened was quite different. There was little 'hard discrimination', but non-members dependent on the EU market were induced to embrace the EU's common rules. Firms, who wanted only one set of rules, induced their governments to mimic the EU's Single Market disciplines explicitly (European Economic Area agreement) or implicitly as in the case of Switzerland.

The systemic question then is not the old trade creation/diversion perspective of ‘who is in or out?’, but rather ‘Whose rules become the norm?’, ‘What are the costs and benefits of multilateralising the rules?’, and ‘What can be done to help developing nations for whom some of the rules may be inappropriate?’

Nations engaged in TPP and TTIP talks are aware of this soft discrimination. The plan to redress it seems to be: first talk about regionalising the deep disciplines that are currently in RTAs, then talk about multilateralising them. This ordering engenders concern among non-members as it starts in the same way as a very different, very divisive plan: permanently exclude non-members, and then achieve multilateralisation via the impulsion-to-conform. Multilateralising regionalism and regionalising multilateralism should take place simultaneously.

WTO members could diffuse tensions by changing the order. Why not start talking about how to multilateralise deep disciplines while negotiating their regionalisation in megaregionals? This would not tie progress in any megaregional to the multilateral process, but it would help clarify what is needed to bring deep disciplines into the WTO.

This walk-on-two-legs approach would have many merits. Global understanding of GVC trade and the related disciplines is disjointed and full of fallacies based on 20th century thinking. The multilateralisation discussions would help eliminate the fallacies while building understanding of the challenges.

Moreover, progress in megaregional talks would be impetus for multilateral progress, and vice versa. This sort of ‘competing forums’ approach could help avoid fragmentation of trade governance and speed harmonisation – all while reducing the tensions inherent in today’s you’re-in-or-you’re-out approach. Finally, as success of the megaregionals is far from assured, this approach would diversify the range of possible solutions to business leaders’ concerns about overlapping and intersecting bilateral disciplines.

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