

THE ECONOMIST (July 19, 2018)

Trade blockage

# The world trading system is under attack

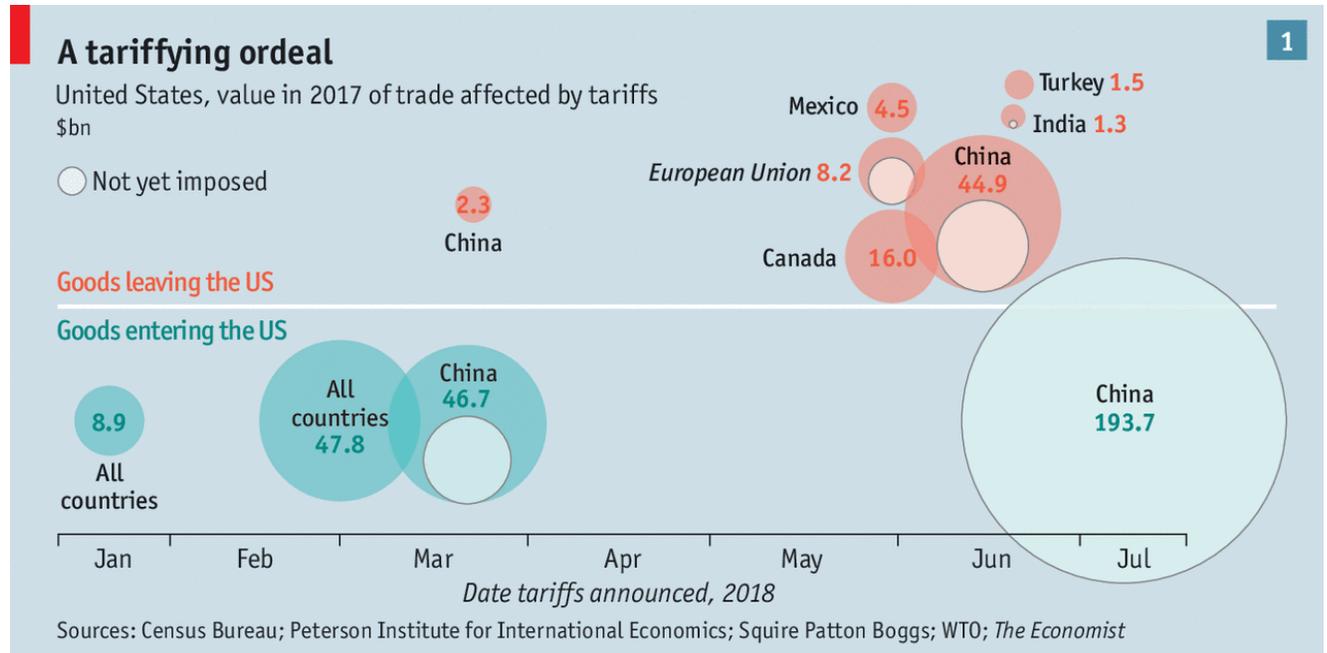
*But a peace plan may be emerging*



“MAN is an animal that makes bargains,” said Adam Smith, the father of modern economics and a champion of free trade. After reminding his American counterpart of this quote in May, the Chinese ambassador to the World Trade Organisation (WTO) added a request. “As trade negotiators, let’s bargain with each other, instead of biting each other.” Publicly, at least, the administration of **Donald Trump has only bared its fangs.**

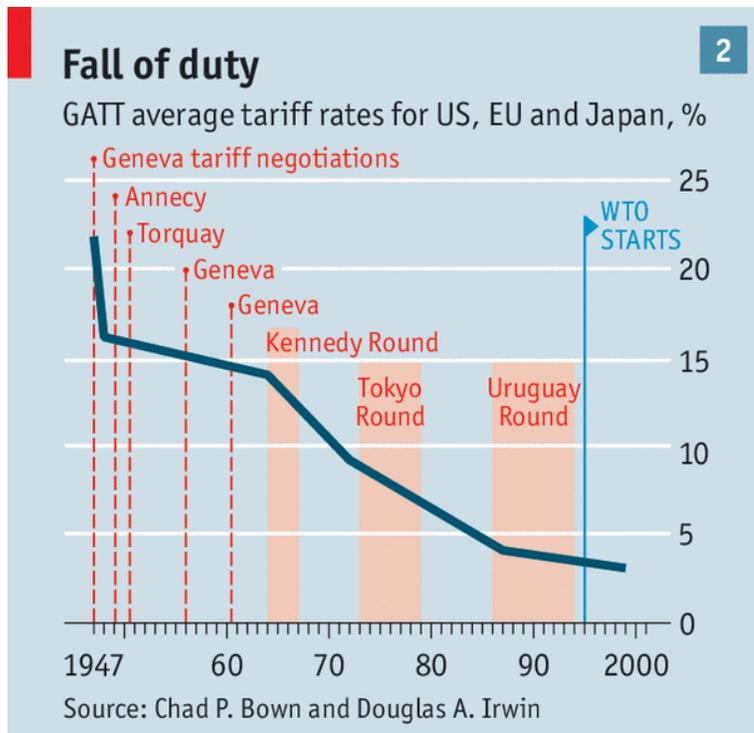
**Mr Trump is waging a trade war** that this year has already hit imports worth over \$89bn in 2017, including \$32bn of goods from China, and \$48bn of steel and aluminium (see chart 1). The fight will intensify. America plans further tariffs on \$208bn of Chinese imports and is

threatening duties on imported vehicles and car parts that will hit European and Japanese firms hard. As well as generating trade disputes with new tariffs, America is also gumming up the WTO's system for solving them, by blocking the appointment of judges to its Court of Appeals.



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Mr Trump's assault on the multilateral rules-based system threatens decades of trade liberalisation, which has nudged average tariffs between America, Europe and Japan down from 22% when the system started in 1947 to around 3% by 2000, roughly where they remain today (see chart 2). Supporters of the system, both beyond the Trump administration and throughout most of the rest of the world, fear that America's president is intent on destroying the WTO and undoing this progress. They are right to worry but may be wrong to despair. A plan is brewing to save the WTO from being torn apart in the Trump administration's jaws.



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**At the core of modern-day multilateralism is the idea that countries sign up to a set of clear commitments. The WTO's members promise not to raise tariffs above agreed levels and to apply them based on the principle of "most favoured nation" (MFN). Applied strictly, countries should not be able to discriminate between their economic friends and foes, because a lower tariff granted to one member should be granted to all. China's membership, for example, means it must apply equal tariffs on cars coming from the EU and America. And America signs up to the same treatment of cars from China and the EU.**

The system is supposed to be self-reinforcing. WTO membership involves a trade-off, between the costs of compliance and the benefits of maintaining access to a 164-strong club accounting for 98% of world trade. When deals are first struck, negotiators bargain so that the benefits of trade liberalisation outweigh the political penalties. If the penalties turn out to be greater than expected, the system has built-in safety valves. If imports are surging, subsidised or sold below cost, threatening domestic industries and jobs, members can apply defensive duties. And since 1995, if one member suspects another of rule-breaking, they have had the case heard by the WTO's panel of judges. If these arbiters decide there has been wrongdoing, they can sanction limited retaliation. The pinch of such tariffs and the shame of being labelled a rule-breaker are both supposed to ensure good behaviour.

## WTOOut

Understanding **the American assault on this system** requires identifying its various fronts. The first is driven by Mr Trump's disregard for rules. According to Axios, an American news website, he is itching to withdraw from the WTO altogether. Unshackled from the MFN principle, Mr Trump would be free to enact his own version of reciprocal trade, with tariffs that match those applied by other countries.

The prospects of an American exit are slim, as it would require the approval of Congress. But in the meantime the Trump administration is doing damage from within. Its claim that imports of steel and aluminium pose a threat to national security exploits a loophole that allows WTO members to impose tariffs in times of national emergency. Unconcerned by the erosion of trust this causes, or by damage from retaliation and higher metal prices at home, Mr Trump is undermining a set of norms that Americans have spent decades trying to build.

Such **bullying is specific to this president**. America's trading partners hit by its tariffs on steel and aluminium have so far tried to strike back within the rules, or in proportion to the damage done to them. Eight have launched formal WTO disputes. At home Mr Trump's tariffs on Canadian steel and aluminium have prompted a bipartisan chorus of disapproval.

But other fronts in the Trump administration's trade policy have greater sticking power. They are being pushed by Robert Lighthizer, the United States Trade Representative (USTR), whose influence in the White House is in stark contrast to his low profile outside it. Unlike many in the administration, he understands how the global trading system works, from experience as a trade lawyer and as a trade negotiator in the Reagan administration. He appreciates the system's value, conceding in December that the WTO does "an enormous amount of good". And crucially, his complaints about it are shared by many in Washington, DC, and across the world.

### **Judge not...**

**Two stand out. The first relates to the WTO's appellate body**—the system's supreme court. Members must unanimously approve judges to sit on a roster of seven, from which three are chosen to hear any given case. But as vacancies have arisen, the Trump administration has refused to let them be filled. From December 2019, there will be fewer judges than the minimum required to hear a case.

The Americans complain that the appellate body has become too big for its boots. Since 2011 it has not consulted WTO members when exceeding the 90-day limit to conclude a case. Often its reports are long, in part because judges make legal commentaries on arguments that were not presented by either side. To some, this is careful and principled application of the law. To others, it looks like empire-building.

More fundamentally, Mr Lighthizer fumes that this body has overstepped its remit. America's gripe is that rulings have impeded its ability to use the WTO's pressure valves. In 2003 the Bush administration was told that duties imposed to combat surging steel imports

violated WTO law. (The duties were subsequently withdrawn.) In a series of cases the body has also found that the way America applies anti-dumping duties breaks WTO rules.

One particularly painful decision relates to what exactly counts as a “public body” within WTO rules. In general, members are allowed to apply defensive duties on imports supported by government subsidies. But in China, knowing where the government ends and the private sector starts is tricky. The Americans had claimed that where the government owned a majority stake in an enterprise, it should automatically count as a “public body” liable for handing out subsidies. But the appellate body ruled against them, making it harder to apply defensive duties against state-supported production.

This leads to Mr Lighthizer’s second set of grievances, regarding China’s place in the trading system. He claims that, when WTO negotiators agreed that China should join in 2001, they expected it to evolve towards Western-style capitalism. What has emerged instead is an economy dominated by state-subsidised enterprises with a regulatory regime geared towards the theft of American intellectual property. As a result, the system does not work.

Take first the American concerns over China’s industrial policy. The WTO’s rulebook has a chapter curbing state subsidies. But it has gaps, in part because when it was written American and European negotiators were nervous of subjecting their own subsidy regimes to scrutiny and did not expect China to generate the resources to hand out vast sums of cash. Now, given China’s size and systemic importance, those holes look too big.

Next is the accusation that China defies the spirit, if not the letter, of the rules of the WTO. In many industries, China’s government required that foreign firms investing in its market did so in joint ventures with local companies. The Americans complain that too often their firms had to hand over technology as a condition of access to the Chinese market, and then watched helplessly as partners ran off with their ideas.

Mr Lighthizer’s concerns over the appellate body and China could be dealt with by negotiation, either to revisit past decisions or to fill gaps in the WTO’s rules. But getting China to the negotiating table has proved hard. When it joined the WTO its accession protocol was unusually strict. It reckoned that it had already paid enough into the system, and was not about to negotiate new definitions of public bodies that could tie its hands further.

Then there is the broader problem of getting anything new agreed on multilaterally. That requires the unanimous approval of all 164 members. For years, WTO negotiations have stalled over a disagreement between richer countries, which think everyone should share a common rulebook, and those who see carve-outs for poorer countries as necessary to protect their farmers and foster development. Members like India and South Africa have been happy to hold any deal hostage to their agenda.

An earlier American solution to this gridlock was to pursue ambitious regional trade deals. In Asia the Obama administration agreed the Trans-Pacific Partnership (TPP), to link America to 11 economies of the Pacific Rim, including Japan and Singapore. It included

tougher rules on state-owned enterprises. Meanwhile, it was also negotiating the Transatlantic Trade and Investment Partnership with the EU. Combining them could have created a free-trade area large enough to tempt the Chinese to the negotiating table, as well as a regulatory regime with enough weight to pull against the Chinese one.

After Mr Trump swiftly jettisoned that approach, Mr Lighthizer is spearheading a quicker, dirtier one. **Dusting off an old piece of trade law, he has used Section 301 of the Trade Act of 1974 to accuse the Chinese of causing harm to America's economy.** Some supposed misdemeanours fall within the WTO's rules, and so the USTR has launched an official WTO dispute. Others, which Mr Lighthizer claims relate to gaps in the rulebook, are the justification for punitive American tariffs.

**This looks like a worrying bout of unilateralism, reminiscent of the 1980s, when Section 301 was used by the Reagan administration to threaten Japan with tariffs unless it curbed its exports to America.** The resulting tangle of restrictions made free traders squirm, but advocates argued that aggression served a higher purpose. It rallied the rest of the world around stronger trade-enforcement rules, which led to the creation of the WTO's system of dispute settlement. This time Mr Lighthizer seems to be trying to weaken that system.

Further worry stems from the fact that it is unclear how the trade conflict with the Chinese will end, but easy to see how it might escalate. Mr Lighthizer's department has launched five formal disputes at the WTO in response to retaliatory duties against America's levies on steel and aluminium. In response to China's ones, the plan is for more American tariffs.

**Lighthizer at the end of the tunnel?**

Yet, amid the conflict there is still hope of salvaging a peace. As the trade cannons blast, efforts are being made to restore order. The chances of success rest on the fact that Mr Lighthizer's concerns about China are shared by others, and in particular by the EU and Japan.

**The EU sees an opportunity to act as a bridge between China and America to negotiate new rules.** It thereby hopes to address its own concerns over China's rise, while tempting America back into the multilateral system. The EU may disagree with Mr Trump's approach to China, but it recognises that it could harness America's aggression as a way to get China to agree to new constraints. The plan is to make China's choice clear, between an unstable trading system and one with new rules that meet the others' concerns.

The first hint of co-operation came last December, when Mr Lighthizer added his name, along with those of his counterparts from Japan and the EU, to a brief statement voicing shared concerns over "unfair competitive conditions caused by large market-distorting subsidies and state-owned enterprises". China, though unnamed, was clearly the target. Since then, officials from all three places have been discussing what new WTO rules might look like. And on July 16th the EU launched a working group with the Chinese to discuss reform of the multilateral system. The trilateral talks between America, the EU and Japan are meant as an incubator for rules that could be taken to China; those between the EU and

China are designed to be a sounding-board for those ideas and to prepare the ground for a proper negotiation.



**A joint statement on May 31st outlined the scope of the trilateral talks.** First on the agenda is the dull but important topic of notifications. Tariffs are obvious to observers, subsidies less so. To counter that problem, WTO members are supposed to notify others about support they hand out. But without penalties for failing to do so, many do not. The three are designing a way to strengthen the incentives to comply.

Second, the trio are trying to overturn the appellate judges' definition of "public bodies", by broadening it to make it easier to deem a state-owned enterprise to be an arm of the Chinese government. And third, the three are discussing new rules that would not only strengthen members' defences against Chinese subsidies but also limit them at the source.

Meanwhile, the **EU has drawn up plans to tweak the appellate body's rules in a way**

that it hopes will satisfy America. Poor judicial decisions are in the eye of the beholder, so no procedural change could solve that. But the EU's proposal answers a number of complaints, including clarifications to the way outgoing judges' cases are handled after their term ends.

Perhaps a grand bargain is in the works. Comfortingly, there is mounting evidence that Mr Lighthizer is not out to torpedo the WTO. This year his department has filed seven new official WTO disputes, engaged actively in discussions over new rules on e-commerce, and on July 16th even called for an end to the WTO's impasse on agriculture negotiations, suggesting that the talks should focus on market access.

**Even so, the chances of success are slim. Some American concerns are difficult to deal with under the WTO's legalistic processes.** These work best when Chinese laws can be compared with official commitments. But with technology transfer, for example, America claims that unwritten rules force firms to hand over their technology as a condition of doing business. That makes it hard to write watertight regulations and to test them in the WTO's court, particularly if the firms involved are too scared to speak for fear of losing access to the Chinese market.

Even if America, the EU and Japan do manage to draw up what they see as a perfect set of new rules, China may not play along. It wants a stable trading system and will pay attention to a **co-ordinated bombardment** from its biggest markets, but it will not sign up if it thinks it will be made poorer in the long run. The Americans would like to draw up new rules without the Chinese at the table, then ram them down their throats. That would be unacceptable to the Chinese.

The next challenge will be obtaining wider agreement to a deal concocted by only four members. To poorer countries, the idea that America can be rewarded for throwing a tantrum by winning a reform of the system will be deeply distasteful. They believe that richer countries have already tipped the rules in their favour. That is why the joint statement in May included hints about bypassing the WTO's crippling requirement for consensus, instead opting for getting a "critical mass" of countries to agree.

**Brink it on**

**Another risk to the plan is Mr Trump himself. Mr Lighthizer may be a brilliant strategist, capitalising on his boss's willingness to blow up the system in order to force the change that he wants. But he could easily fall out of favour.** The plan relies on Mr Trump playing along and stepping back from the brink at the right time. He could go too early, bought off by an offer from China's president, Xi Jinping, to buy more American goods without bringing any reform to the system. Or he could hang on too long, turning the confrontation with China into one only about power and face, and not one about trade and rules.

**Seen from one angle, the Americans are making a last-ditch effort to reshape the system they founded to serve their own interests. Unless they do it now, they reckon, China will become too powerful to contain.** Perhaps that moment has already passed. In the 1980s, when the Reagan administration acted against Japanese trade practices, Japan's GDP was around 40% of America's. But this year, according to the IMF, China's GDP will be 69% of America's, rising to 88% over the next five years.

The Chinese may call America's bluff, hoping that when Mr Trump goes in two or six years' time, the next president will be less keen to tax his citizens by raising the cost of imports. If so, expect tariffs to continue. And for the multilateral rules-based system to become still more toothless.

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